

# LEVEL 3 COMMUNICATIONS INC

## FORM 10-K (Annual Report)

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549  
  
**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2008

OR

☐ **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: 0-15658

**Level 3 Communications, Inc.**  
(Exact name of Registrant as specified in its charter)

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

**47-0210602**  
(I.R.S. Employer  
Identification No.)

**1025 Eldorado Boulevard, Broomfield, Colorado**  
(Address of principal executive offices)

**80021-8869**  
(Zip code)

**(720) 888-1000**  
(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:

**Common Stock, par value \$.01 per share**

**The NASDAQ Stock Market LLC**

Securities registered pursuant to section 12(g) of the Act:  
**None**

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

☒ Large accelerated filer      ☐ Accelerated filer      ☐ Non-accelerated filer      ☐ Smaller Reporting company  
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

As of June 30, 2008 the aggregate market value of common stock held by non-affiliates of the registrant approximated \$3.1 billion based upon the closing price of the common stock as reported on the NASDAQ Global Select Market as of the close of business on that date. Shares of common stock held by each executive officer and director and by each entity that owns 10% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

<u>Title</u>	<u>Outstanding</u>
Common Stock, par value \$.01 per share	1,621,291,204 as of February 25, 2009

#### DOCUMENTS INCORPORATED BY REFERENCE

List hereunder the following documents if incorporated by reference and the Part of the Form 10-K (e.g., Part I, Part II, etc.) into which the document is incorporated: (1) Any annual report to security holders; (2) Any proxy or information statement; and (3) Any prospectus filed pursuant to Rule 424(b) or (c) under the Securities Act of 1933. The listed documents should be clearly described for identification purposes (e.g., annual report to security holders for fiscal year ended December 24, 1980).

Portions of the Company's Definitive Proxy Statement for the 2009 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K

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*Unless the context otherwise requires, when we use the words "Level 3," "we," "us" or "our company" in this Form 10-K, we are referring to Level 3 Communications, Inc., a Delaware corporation, and its subsidiaries, unless it is clear from the context or expressly stated that these references are only to Level 3 Communications, Inc. In this Form 10-K, we may refer to our former subsidiary Software Spectrum, Inc. and its subsidiaries as "Software Spectrum."*

*The Level 3 logo and Level 3 are registered service marks of our wholly owned subsidiary, Level 3 Communications, LLC, in the United States and other countries. All rights are reserved. This Form 10-K refers to trade names and trademarks of other companies. The mention of these trade names and trademarks in this Form 10-K is made with due recognition of the rights of these companies and without any intent to misappropriate those names or marks. All other trade names and trademarks appearing in this Form 10-K are the property of their respective owners.*

### **Cautionary Factors That May Affect Future Results (Cautionary Statements Under the Private Securities Litigation Reform Act of 1995)**

This Form 10-K contains forward-looking statements and information that are based on the beliefs of our management as well as assumptions made by and information currently available to us. When we use the words "anticipate", "believe", "plan", "estimate" and "expect" and similar expressions in this Form 10-K, as they relate to us or our management, we are intending to identify forward-looking statements. These statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions.

Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, our actual results may vary materially from those described in this document. These forward-looking statements include, among others, statements concerning:

- our communications business, its advantages and our strategy for continuing to pursue our business;
- anticipated development and launch of new services in our business;
- anticipated dates on which we will begin providing certain services or reach specific milestones in the development and implementation of our business strategy;
- growth of the communications industry;
- expectations as to our future revenue, margins, expenses, cash flows and capital requirements; and
- other statements of expectations, beliefs, future plans and strategies, anticipated developments and other matters that are not historical facts.

These forward-looking statements are subject to risks and uncertainties, including financial, regulatory, environmental, industry growth and trend projections, that could cause actual events or results to differ materially from those expressed or implied by the statements. The most important factors that could prevent us from achieving our stated goals include, but are not limited to, the effects on our business and our customers of the current economic turmoil and the disruptions in the financial markets as well as our failure to:

- integrate acquisitions;
- increase the volume of traffic on our network;
- provide services that do not infringe the intellectual property and proprietary rights of others;
- successfully use new technology and information systems to support new and existing services;

- develop new services that meet customer demands and generate acceptable margins;
- attract and retain qualified management and other personnel; and
- meet all of the terms and conditions of our debt obligations.

Except as required by applicable law and regulations, we undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. Further disclosures that we make on related subjects in our additional filings with the SEC or Securities and Exchange Commission should be consulted. For further information regarding the risks and uncertainties that may affect our future results, please review the information set forth below under "ITEM 1A. RISK FACTORS."

## Part I

### ITEM 1. BUSINESS

*Unless the context otherwise requires, when we use the words "Level 3," "we," "us" or "our company" in this Form 10-K, we are referring to Level 3 Communications, Inc., a Delaware corporation, and its subsidiaries, unless it is clear from the context or expressly stated that these references are only to Level 3 Communications, Inc. Throughout this Form 10-K we use various industry terms and abbreviations, which we have defined in the Glossary of Terms at the end of this description of our business.*

Through our operating subsidiaries, we engage primarily in the communications business.

We are a facilities based provider (that is, a provider that owns or leases a substantial portion of the plant, property and equipment necessary to provide its services) of a broad range of integrated communications services. We have created our communications network generally by constructing our own assets, but also through a combination of purchasing and leasing other companies and facilities. Our network is an advanced, international, facilities based communications network. We designed our network to provide communications services, which employ and take advantage of rapidly improving underlying optical, Internet Protocol, computing and storage technologies.

*Market and Technology Opportunity.* We believe that ongoing technology advances in both optical and Internet Protocol technologies have been revolutionizing the communications industry. We also believe that these advances have, and will continue to, facilitate decreases in unit costs for communications service providers that are able to most effectively take advantage of these technology advances. Service providers that can effectively take advantage of technology improvements and reduce unit costs will be able to offer lower prices, which, we believe, will stimulate substantial increases in the demand for communications services. We believe there are two primary factors that are continuing to drive this market dynamic:

- *Rapidly Improving Technologies.* Over the past few years, both Internet Protocol or IP and optical based networking technologies have undergone extremely rapid innovation, due, in large part, to market based development of underlying technologies. This rapid technology innovation has resulted in both an improvement in price-performance for optical and Internet Protocol systems, as well as rapid improvement in the functionality and applications supported by these technologies. For example, these improvements are enabling voice over IP services or VoIP that are challenging traditional telephone network or PSTN services. We believe that this rapid innovation will continue well into the future across a number of different aspects of the communications marketplace.
- *High Demand Elasticity.* We believe decreases in communications services costs and prices cause the development of new bandwidth-intensive applications, which, over time, result in even more significant increases in bandwidth demand. In addition, we believe that communications services are direct substitutes for other, existing modes of information distribution from sources such as

traditional broadcast entertainment as well as distribution of software, audio and video content using physical media delivered using motor transportation systems. An example of this dynamic is the use of the Internet for the distribution of video entertainment.

We believe that as communications services improve more rapidly than these alternative content distribution systems, significant demand will be generated from these sources of information. We also believe that high elasticity of demand from both these new applications and the substitution for existing distribution systems will continue for the foreseeable future. We believe that while high demand elasticity will be manifested over time, government regulation and communications supply chain inefficiencies may cause realization of demand to be delayed.

We also believe that there are significant implications that result from this market dynamic. These implications include the following:

- *Incorporating Technology Changes.* Given the rapid rate of improvement in optical and Internet Protocol technologies, communications service providers that are most effective at rapidly deploying new services that take advantage of these technologies will have an inherent cost and service advantage over companies that are less effective at deploying new services that use these technologies.
- *Controlling Local Facilities.* Given the consolidation in the number of local access providers—that is, the providers of connections from long distance and backbone networks to traffic aggregation points or end user locations—communications service providers that have ownership of local and/or metropolitan network facilities as opposed to communications service providers that obtain these facilities from others will have an inherent cost and service advantage over companies that do not have ownership over these types of assets.
- *Capital Intensity.* The rapid improvements in these technologies and the need to move to new technologies more quickly results in shortened economic lives of underlying assets. To achieve improvements in service capabilities and unit cost reductions, service providers will need to deploy new generations of technology sooner, resulting in a more capital-intensive business model. Those providers with the technical, operational and financial ability to take advantage of the rapid advancements in these technologies are expected to have higher absolute capital requirements, shortened asset lives, rapidly decreasing unit costs and prices, rapidly increasing unit demand and higher cash flows and profits.

## **Our Communications Business Strategy**

We are seeking to capitalize on the opportunities presented by the expanded coverage of our communications network as well as the significant and rapid advancements in optical and Internet Protocol technologies. Key elements of our strategy include:

- *Offer a Comprehensive Range of Communications Services Over Our End-to-End Network.* We provide a comprehensive range of communications services designed to meet the needs of our customers over our network. Beginning in 2006, we expanded our targeted customer base to include enterprise or business customers through the acquisitions we completed during 2006 and early 2007.

Our communications service offerings include:

- Internet Protocol and data services—including (1) Internet access and IP and Ethernet Virtual Private Networks and (2) broadband transport services such as wavelengths, dark fiber and private line services (transoceanic, backhaul, intercity, metro and unprotected private line services);

- content distribution services including caching and downloading, streaming as well as video broadcast services;
- colocation services; and
- Softswitch and voice services—including wholesale VoIP component services, enterprise or business voice services, wholesale voice origination and termination services and managed modem for the dial-up access business.

The availability of these services varies by location.

For several years we have been developing services that take advantage of the investment that we have made in our network and that generally target large, existing markets for communications services. We have also expanded our existing markets for communications services through the acquisitions we completed in 2006 and early 2007 that enabled us to offer services directly to enterprise or business customers. Through these efforts we have increased significantly our addressable market by targeting new customers as well as new voice and data services that take advantage of the geographic coverage and cost advantages of our network.

With respect to our wholesale customers, we provide these customers with several options for accessing our intercity network—including our metropolitan networks and colocation facilities. Our metropolitan networks enable us to connect directly to points of high traffic aggregation. These traffic aggregation facilities are typically locations where our customers wish to interconnect with our intercity network. Our metropolitan networks allow us to extend our network services to these aggregation points at low costs. With respect to our enterprise customers, we provide these customers with access to our network either by directly connecting to their location or by serving that location with a connection from another communications services provider. As of December 31, 2008, we have:

- approximately 77,000 intercity route miles in North America and Europe, which we expect to reduce to approximately 52,000 intercity route miles after we complete the integration of acquired companies, connecting 22 countries;
- approximately 125 markets having metropolitan fiber networks containing approximately 27,000 route miles in the United States and Europe; and
- approximately 7,900 traffic aggregation points and buildings in the aggregate.

We believe that providing colocation services in facilities directly connected to our network attracts communications intensive customers by allowing us to offer those customers reduced bandwidth costs, rapid provisioning of additional bandwidth, interconnection with other third party networks and improved network performance.

Additionally, our metropolitan networks allow us to compete for certain local communications traffic, which constitutes a significant percentage of the communications market. As of December 31, 2008, we had secured approximately 6.9 million square feet of space for our Gateway and transmission facilities and other technical space and had completed the build-out of approximately 4.6 million square feet of this space.

- *Provide Low Cost Backbone Services Through An Upgradeable Backbone Network.* Many portions of our originally constructed intercity and metropolitan networks were designed to provide high quality communications services at a lower cost. As we continue to integrate our acquired operations, our network and business processes will seek to enable us to cost effectively deploy future generations of optical and IP networking components (both fiber and transmission electronics and optronics) and thereby expand capacity and reduce unit costs. In addition, our strategy is to maximize the use of open, non-proprietary interfaces in the design of our network



software and hardware. This approach is intended to provide us with the ability to purchase the most cost effective network equipment from multiple vendors and allow us to deploy new technology more rapidly and effectively.

- *Target Top Global Bandwidth Customers.* With respect to our wholesale service offerings, our primary distribution strategy is to use a national, direct sales force focused on high bandwidth usage businesses. These businesses include incumbent local exchange carriers, international carriers also known as PTTs, major internet service providers or ISPs, broadband cable television operators, wireless providers, major interexchange carriers, the U.S. government, voice service providers, system integrators and other businesses that purchase communications services in a manner that is consistent with these other customers. Providing communications services to many of these businesses is at the core of our market enabling strategy. We identify as wholesale customers those customers that purchase significant amounts of capacity to serve the needs of their customers or their internal needs.
- *Further Develop Existing Enterprise Customer Business.* With respect to our business markets customers, our primary distribution strategy is to use a locally based direct sales force to target business customers, state governments, higher education institutions and academic consortia with high demands for mission critical communications services. We also complement our direct sales force with an indirect sales channel of agent partners.
- *Develop Market Leading Content Distribution Service Offerings.* At December 31, 2008, we operated one of the largest Internet Protocol backbones in the world. In other words, we operate one of the largest networks over which Internet content is transported from content sources to third party owned access networks connected directly to end users. We continue to believe that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video online. To meet the needs of customers driving this growth, we are focused on refining our service offerings to provide a full portfolio of services to support content distribution, including high speed IP services, colocation, Content Delivery Network services and video acquisition. We believe that we are the only service provider that offers, owns and operates this portfolio of services on a broad scale, which provides a unique opportunity to offer customers flexible access, end to end solutions and/or building block services to meet their evolving needs.
- *Expand Metropolitan Network Coverage.* We expect to selectively extend the current reach of our existing metropolitan networks by opportunistically adding additional connections to buildings and other traffic aggregation points from these networks. These connections will enable us to reach additional potential customers and reduce our costs for the termination of our customers' communications traffic on other carriers' networks.
- *Pursue Acquisition Opportunities.* For a number of years, we have engaged in significant acquisition activities. In evaluating potential acquisition opportunities, among other criteria, we evaluate the potential acquisition according to the transaction's ability to generate positive cash flow from high credit quality customers. For these opportunities, we generally look for companies with recurring revenue that comes predominantly from services we already provide, in geographic areas that are already served, with customers that are consistent with our existing customer base. It is this group of acquisitions that generally also provide significant synergy opportunities as a result of overlapping network and service offerings.

As we seek to expand the addressable market for our services, we also evaluate opportunities that would expand our service capabilities. Transactions that would be included in this category would expand the geographic scope of our network or would provide capabilities for additional services or distribution channels. For these opportunities, we generally consider whether the targeted company's distribution strategy is consistent with our strategy and whether management

believes that the target's current and/or future revenues can be significantly increased and/or expenses can be significantly reduced as a result of a combination with our operations. Generally these acquisition opportunities will not provide the same level of synergy opportunity that the category of acquisitions described in the paragraph above provide to us.

- *Develop Advanced Operational Processes and Business Support Systems.* We have developed and continue to develop substantial and scalable operational processes and business support systems specifically designed to enable us to offer services efficiently to our targeted customers. We believe that over time these systems will reduce our operating costs, give our customers direct control over some of the services they buy from us and allow us to grow rapidly while minimizing redesign of our business support systems.
- *Attract and Motivate High Quality Employees.* We have developed programs designed to attract and retain employees with the technical and business skills necessary for our business. These programs include our long term incentive programs.

## Our Strengths

We believe that the following strengths will assist us in implementing our strategy:

- *Experienced Management Team.* We have assembled a management team that we believe is well suited for our business objectives and strategy. Our senior management has substantial experience in leading the development, marketing and sale of communications services and in managing, designing and constructing metropolitan, intercity and international networks.
- *A Comprehensive Range of Communications Services.* We provide a comprehensive range of communications services designed to meet the needs of our customers over our network. Our communications service offerings include:
  - Internet Protocol and data services—including (1) Internet access and IP and Ethernet Virtual Private Networks and (2) broadband transport services such as wavelengths, dark fiber and private line services (transoceanic, backhaul, intercity, metro and unprotected private line services);
  - content distribution services including caching and downloading, streaming as well as video broadcast services;
  - colocation services; and
  - Softswitch and voice services—including wholesale VoIP component services, enterprise or business voice services, wholesale voice origination and termination services and managed modem for the dial-up access business.

The availability of these services varies by location.

For several years we have been developing services that take advantage of the investment that we have made in our network and that generally target large, existing markets for communications services. We have also expanded our existing markets for communications services through our acquisitions that enabled us to offer services directly to enterprise or business customers. Through these efforts we have increased significantly our addressable market by adding new targeted customers as well as new voice and data services that take advantage of the geographic coverage and cost advantages of our network.

- *Significant metropolitan network platform.* As of December 31, 2008, we have metropolitan fiber networks in approximately 125 markets in North America and Europe, which contain approximately 27,000 route miles and connect in the aggregate approximately 7,900 traffic aggregation points and buildings. Our metropolitan networks enable us to connect directly to

points of high traffic aggregation and customer locations and reduce our costs for the termination of our customers' communications traffic on other carriers' networks.

- *End-to-End Network Platform.* Our strategy has been and continues to be to deploy network infrastructure in major metropolitan areas and to link these networks with significant intercity and trans-oceanic networks in North America and Europe. We believe that the integration of our metropolitan and intercity networks with our colocation facilities will expand the scope and reach of our on-net customer coverage, facilitate the uniform deployment of technological innovations as we manage our future upgrade paths and allow us to grow or scale our service offerings rapidly. We believe that we are the only international communications service provider with the unique combination of:
  - a substantial intercity network;
  - large fiber count metropolitan networks;
  - substantial colocation facilities; and
  - innovative content distribution technology and services.
- *Advanced IP Backbone.* We operate one of the largest international IP networks or backbones. Our IP services deliver a broad range of IP transit and network interconnection solutions tailored to meet the varied needs of high bandwidth users.
- *Extensive Patent Portfolio.* Through acquisitions and through our own research and development, we have created an extensive patent portfolio, consisting of approximately 900 patents and patent applications filed in the United States and around the world. Our patent portfolio includes patents filed in each of the last three decades covering technologies ranging from data and voice services to content distribution to transmission and networking equipment. Most of our issued patents are not scheduled to expire for more than ten years. We have used our patent portfolio in a number of ways. First, developing or acquiring technologies and receiving the legal right to preclude others from using them may give us a competitive advantage. Second, the breadth and depth of our patent portfolio may deter others, particularly telecommunications operators, from bringing patent infringement claims against us for fear of counter-claim by us. We will continue to file new patent applications as we enhance and develop products and services, we will continue to seek opportunities to expand our patent portfolio through strategic acquisitions and licensing, and we will continue to appropriately enforce our patents against infringement by others.
- *Softswitch based Co-Carrier Network.* Our experience in operating our Softswitch based co-carrier network is combined with a set of infrastructure and other management experiences, which include extensive local interconnection with local exchange carriers, experience in scaling a Softswitch based platform, and an ability to provide seamless interconnection to the traditional telephone network or PSTN. We believe that our extensive co-carrier network and Softswitch infrastructure provides us with a competitive advantage in providing various voice over IP or VoIP services.
- *A More Readily Upgradeable Network Infrastructure.* With respect to a substantial portion of our network, the network was designed to take advantage of technological innovations, incorporating many of the features that are not present in older communication networks, and provide us flexibility to take advantage of future developments and innovations. We designed the transmission network to optimize aspects of fiber and optronics simultaneously as a system to deliver low unit cost to our customers. As fiber and optical transmission technology changes, we expect to realize new unit cost improvements by deploying more cost efficient technologies in our network. We believe that our network design will enable us to lower costs and prices while enjoying higher margins than our competitors.

## **Our Communications Services**

### *Customer Focused Organization*

We operate the customer interacting or customer facing aspects of our communications business in four groups. We believe that this structure enables us to focus more effectively on the needs of our customers. These four groups are:

- Wholesale Markets Group
- Business Markets Group
- Content Markets Group; and
- European Markets Group.

We believe this structure enables those employees in these customer facing roles to develop and deliver high quality communications services that are based on the needs of the customers that the group is seeking to serve. Each of these groups is supported by dedicated employees in sales and segment marketing. Each of the groups is also supported by centralized service or product management and development, general marketing, network services, engineering, information technology, and corporate functions including legal, finance, strategy and human resources. It is through the Wholesale Markets, Business Markets, Content Markets and European Markets groups that we offer our comprehensive range of communications services.

*Wholesale Markets Group.* The Wholesale Markets Group is focused on delivering communications services to meet the high bandwidth needs of many of the largest global communications services providers on a wholesale basis. The Wholesale Markets Group's customers typically integrate or package our services into their own products and services to offer voice, video and data services to their end-user customers and in some instances to satisfy their own internal needs.

The market segments that the Wholesale Markets Group addresses include:

- domestic and international carriers;
- voice service providers, which include calling card companies, conferencing providers, and contact centers that use VoIP technology to better manage costs and enable advanced applications;
- wireless providers;
- broadband cable television operators;
- system integrators; and
- the U.S. federal government.

*Business Markets Group.* The Business Markets Group is focused on delivering communications services to meet the telecommunications needs of: enterprises; higher education institutions and academic consortia; and state and local governments. We also focus on local and regional carriers, ISPs, enhanced service providers, application service providers, wireless providers, mobile virtual network operators, VoIP providers as well as datacenters and hosting facilities. The Business Markets Group focuses on providing its targeted customers with the full suite of Internet Protocol and data services, colocation and voice services.

*Content Markets Group.* As we believe that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet, the Content Markets Group focuses on offering solutions ranging from end-to-end communications services to individual building block services to meet

the content distribution needs of its customers. Customers that the Content Markets Group serves include:

- video distribution companies;
- providers of online gaming;
- software distributors;
- portal and search providers;
- social networking providers; and
- traditional media distribution companies including broadcasters, television networks and sports leagues.

*European Markets Group.* The European Markets Group focuses on the communications needs of European customers and services in Europe for customers located outside of Europe. The European Markets Group's target customers are similar to the target customers of the Wholesale Markets Group and the Content Markets Group.

### *Service Offerings*

We offer a comprehensive range of communications services, which currently include the following services. All of these services are available to customers of each of the customer facing groups, however their availability varies by location. The following is an overview description of some of the services that we offer.

- *Network and Internet Services.* We offer both wholesale-oriented communications services to enable large scale networks and high speed access to the Internet as well as similar services designed for the enterprise marketplace. We offer a portfolio of data communications services ranging from basic network infrastructure components such as dark fiber, wavelength, and private line services to higher level routed data services such as Ethernet, Internet Transit and IP VPN. Our Network and Internet Services include the following.
- *Transport Services.* Transport services include wavelengths (Level 3 Intercity Wavelength Services and Level 3 Metro Wavelength Services) and private lines (Level 3 Intercity Private Line Services and Level 3 Metro Services). These services are available across our metropolitan and intercity fiber network. Wavelength services provide unprotected point-to-point connections of a fixed amount of bandwidth with Ethernet or SONET interfaces. Wavelength services are available at 2.5 Gbps and 10 Gbps speeds, which represent the largest capacity of dedicated transport services. This service offering targets customers that require significant amounts of bandwidth, desire more direct control and provide their own network management. Private line services are also point-to-point connections of dedicated bandwidth but usually include SONET or SDH protection to provide resiliency to fiber or equipment outages. Private line services are available in a range of speeds. Level 3 also offers Metro and Intercity Ethernet Private Line Services with Fast-E and Gig-E interfaces. Customers generally use our transport services to create their own SONET/SDH, ATM and IP networks. We typically offer transport services in annual or multi-year contracts with monthly payments, or in long-term pre-paid agreements.

Level 3 also provides transport services within our transatlantic cable system connecting North America and Europe as well as via leased bulk capacity on other transoceanic systems. "International Backhaul" transport services, interconnecting cable landing stations and the terrestrial North American and European networks, are also available.

- *High Speed Internet Protocol (IP) Service.* Level 3 operates one of the largest international Internet backbones providing connectivity among customer IP, content and application networks. Built largely on our own intercity and metropolitan networks in North America and Europe, we provide customers with high performance, reliability and scalability. Access to the Internet is enabled through interconnection among our customers across our network as well as interconnections with other Internet service provider "peers."
- *Dedicated Internet Access.* Dedicated Internet Access, or DIA, is Level 3's Enterprise focused Internet access product leveraging the same core Internet backbone as our other Internet Services. Level 3 operates one of the largest international Internet backbones in the world and is regularly considered one of the most connected Internet networks. Level 3's Dedicated Internet Access service provides Internet connectivity over a Tier One Internet backbone through a wide variety of access methods and speeds. The service also includes Domain Name services, primary, secondary and caching and is available as either a stand-alone service or as a complement to our other communications services.
- *VPN Services.* Built on our optical transport and MPLS networks, we offer customers the ability to create private point-to-point, point-to-multipoint, and full-mesh networks based on IP VPN, Virtual Private LAN Service, or VPLS, ATM and Frame Relay technologies. These services allow service providers, corporations, government entities, and distribution businesses to replace multiple networks with a single, cost-effective solution that simplifies the transmission of voice, video, and data over a single or converged network. The service allows the customer to achieve this convergence without sacrificing the quality of service or security levels of traditional dedicated transport offerings. These solutions are used for service provider and corporate data and voice networks, data center networking, disaster recovery and out-of-region or redundant customer connectivity for other service providers.
- *Dark Fiber Service.* Level 3 Intercity Dark Fiber and Level 3 Metro Dark Fiber provide carriers, service providers, government entities and large enterprises a complete infrastructure when a fiber solution is required based on unique applications, control or scale requirements. The services include fiber, colocation space in our Gateway and in our network facilities, power and physical operations and maintenance of the fiber and associated infrastructure.
- *Colocation Service.* We offer high quality, data center space where customers can locate servers, content storage devices and communications network equipment in a safe and secure technical operating environment. At our colocation sites, we offer high-speed, reliable connectivity to our network and to other networks, including metro and intercity networks, the traditional telephone network and the Internet.
- *Content Distribution.* Our primary Content Distribution products and services include the following.
  - *Content Delivery Network.* Our content delivery network services combine our IP network, gateway facilities and patented technology that directs a requestor or end user to the best location or server cluster in our network to retrieve the requested content based on location and network conditions. Our CDN services provide customers with improved performance, economics, scalability, reliability and reach for their web applications. Our Caching and Download Services provide efficient http delivery of large files such as video, software, security patches, audio and graphics to mass audiences. Our Streaming Services can be used to deliver high performance streams, either live or on-demand, to end users using leading proprietary protocols. Each service set provides a set of flexible features to enable customers to control their content delivery to ensure quality end-user experience, security, freshness and targeting. We also offer storage solutions enabling customers to upload and

store content to our network as part of an optimized delivery platform. In addition to our delivery services, our patented Intelligent Traffic Management service enables customers to set rules to dynamically route traffic to meet failover or dual vendor objectives.

- *Media Delivery Services.* We also offer media delivery services to customers seeking to manage, protect and monetize content delivered over the internet. Media Delivery Services extend support for online distribution models and operation by providing customers with means to ingest and digitize live video content and to manage the organization and presentation of both live and on demand video to end users via a content management system. Additionally, support for content monetization via paid and advertising supported models is provided. Media Delivery Services leverage our Content Delivery Network for the delivery of managed content to end users.
- *Fiber Optic and Satellite Video Transport Services.* We offer various services to provide audio and video feeds over fiber or satellite for broadcast and production customers. These services vary in capacity provided, frequency of use (that is, may be provided on an occasional or dedicated basis) and price. In 2009, Super Bowl XLIII® marked the 20<sup>th</sup> consecutive year that the NFL used these services, and the five year anniversary of the first live broadcast event ever carried using our new high definition (HD) transport service offering. We also offer encoding services to translate the broadcast video feeds we carry for our customers into formats for Internet distribution.
- *Switched Services.* We pioneered and developed the Softswitch—a distributed computer system that emulates the functions performed by traditional circuit switches—which enables us to control and process voice and data calls over an Internet Protocol network. We also offer several traditional circuit switch-based voice services. Our Switched Services include the following.
  - *Level 3 VoIP Enhanced Local.* Level 3 VoIP Enhanced Local is a VoIP solution that enables broadband cable operators, IXC's, voice over IP providers, and other companies operating their own switching infrastructure to launch IP-based local and long-distance voice to residential and business customers via any broadband connection. With the purchase of Level 3 VoIP Enhanced Local service, a customer obtains the essential building blocks required to offer residential or business voice over IP phone service such as local phone numbers, local number portability, local and long distance calling, E-911, operator assistance, directory listings, and directory assistance.
  - *Level 3 Local Inbound.* Level 3 Local Inbound service terminates traditional telephone network originated calls to Internet Protocol termination points. Customers, such as call centers, conferencing providers, and voice over IP service providers, can obtain telephone numbers from us or port-in local telephone numbers that the customer already controls. These local calls are then converted to IP and transported over our backbone to a customer's IP voice application at a customer-selected IP voice end point.
  - *Level 3 E-911 Direct.* Level 3 E-911 Direct is a portfolio of Enhanced 911 solutions, including a fixed-location solution with network connections to public safety answering points or PSAPs that serve approximately 80 percent of all U.S. households, and a solution for nomadic voice over IP providers that takes advantage of the same network connections as the fixed-location solution. A nomadic voice over IP provider is a company that permits its end user customer to use VoIP services from more than one location. When used with the services provided by a third party VoIP Positioning Center, or VPC, to collect, update and report subscriber location information, our Level 3 E-911 Direct service enables VoIP service providers to supply 911 services to their subscribers.



- *Level 3 One Plus.* Level 3 One Plus service provides non-facilities-based resellers, or carriers with regional networks, the ability to originate long distance calls from anywhere in the continental US. Level 3 then terminates the domestic, international and Operator Services calls over our network or customers may choose to have calls handed back to them over a dedicated facility. This service suite features Automatic Number Identification (ANI)-based and Carrier Identification Code (CIC)-based services.
- *Level 3 Enterprise Local and Long Distance Voice Services.* Level 3 Enterprise Local Voice Services provide PSTN connectivity for customer telephone equipment; telephone numbers, which include associated directory listings; standard services, which include operator services, directory assistance, and 911 services; and long-distance access, which provides equal access to all long-distance carriers, including Level 3. Level 3 Enterprise Long Distance services offer intrastate and interstate voice service at simple, cost-effective rates as well as access to over 290 international locations.
- *Level 3 Enterprise Toll-Free Services.* Level 3 Enterprise Toll-Free Services offer customers the ability to receive and pay for inbound calls, rather than those calls being paid for by the call originator. Additionally, a number of routing and call information features are available.
- *Level 3 Voice Termination.* Level 3 Voice Termination consists of local and long distance transport and termination services, offered over circuit switch or Softswitch technologies. These services are offered primarily to inter-exchange carriers, or IXC's, wireless providers, local phone companies, cable companies and voice over IP providers. We also offer the termination of international voice traffic over circuit switch or Softswitch technologies. Customers for these services include local phone companies, wireless providers, cable companies and voice over IP providers.
- *Level 3 Toll Free.* Level 3 Toll Free consists of wholesale services that terminate toll free calls that are originated on the traditional telephone network. These toll free calls are carried over either a circuit switch or Softswitch network and delivered to customers in Internet Protocol or traditional TDM format. Customers for these services include call centers, conferencing providers, and voice over IP providers.
- *Level 3 Managed Modem.* Level 3 Managed Modem is an outsourced, turn-key infrastructure solution for the management of dial up access to the public Internet. ISPs comprise a majority of the customer base for Level 3 Managed Modem and are provided a fully managed dial up network infrastructure. As part of this service, Level 3 arranges for the provision of local network coverage, dedicated local telephone numbers, racks and modems as well as dedicated connectivity from the customer's location to the Level 3 Gateway facility.

For a discussion of certain geographic information regarding our revenue from external customers and long-lived assets, please see the notes to our Consolidated Financial Statements appearing elsewhere in this Form 10-K. For a discussion of our communications revenue, please also see Management's Discussion and Analysis of Financial Condition and Results of Operations appearing later in this Form 10-K. Our management continues to review our existing lines of business and service offerings to determine how those lines of business and service offerings assist with our focus on the delivery of communications services and meeting our financial objectives. This exercise takes place both with respect to integration activities and in the ordinary course of our business. To the extent that certain lines of business or service offerings are not considered to be compatible with the delivery of communications services or with obtaining our financial objectives, we may exit those lines of business or stop offering those services in part or in whole.



## **Our communications network**

Our network is an advanced, international, facilities based communications network. Today, we primarily provide services over our own facilities. At December 31, 2008, our network encompasses:

- approximately 67,000 intercity route miles in North America, which we expect to reduce to approximately 42,000 intercity route miles after we complete the integration of acquired companies;
- an intercity network covering approximately 10,000 miles across Europe;
- approximately 125 markets having metropolitan fiber networks containing approximately 27,000 route miles in the United States and Europe, connecting approximately 7,900 traffic aggregation points and buildings in the aggregate;
- approximately 145 markets in service in North American and approximately 45 markets in service in Europe;
- approximately 6.9 million square feet of Gateway and transmission facilities in North America and Europe; and
- substantial transoceanic cable system capacity, primarily across the Atlantic ocean.

*Intercity Networks.* Our approximately 67,000 mile fiber optic intercity network in North America, which we expect will be approximately 42,000 miles after we complete our integration of acquired companies, consists of the following:

- Multiple conduits. In approximately 30,000 miles of our intercity network, we have installed groups of multiple conduits. We believe that the availability of spare conduit will allow us to deploy future technological innovations in optical networking components as well as providing us with the flexibility to offer conduit to other entities.

Initial installation of optical fiber strands designed to accommodate dense wave division multiplexing transmission technology. In addition, we believe that the installation of newer optical fibers will allow a combination of greater wavelengths of light per strand, higher transmission speeds and longer physical spacing between network electronics. We also believe that each new generation of optical fiber will allow increases in the performance of these network design aspects and will therefore enable lower unit costs.

- High speed Intercity Dense Wave Division Multiplexing, or DWDM, equipment providing high quality, reliable and cost effective transmission across our fiber backbone. We are continually evaluating advancements in technology that will enable us to scale, lower our cost and provide higher speed services over our intercity network. We believe that the market will continue to move toward Ethernet based services and higher speed interfaces. Through our technology evaluations we believe that we have positioned ourselves to be able to deliver these capabilities for both our own IP network needs as well as those of our customers.
- A design that maximizes the use of open, non-proprietary hardware and software interfaces to allow less costly upgrades as hardware and software technology improves.

During the first quarter of 2001, we completed our initial construction activities relating to our North American intercity network. Also during 2001, we completed the migration of customer traffic from our original leased capacity network to our completed North America intercity network. Deployment of the North American intercity network was accomplished through simultaneous construction efforts in multiple locations, with different portions being completed at different times. In 2003, we added approximately 2,985 miles to our North America intercity network as part of the Genuity transaction, and in 2005, we added approximately 30,000 miles (including IRUs) to our

intercity network as part of the WiTel Communications transaction. In 2006 and January 2007, we added approximately 26,000 miles (including IRUs) to our North America intercity network as part of the various acquisitions during that period.

In Europe, we have completed construction of our fiber optic intercity network with characteristics similar to those of the North American intercity network in a multiple ring architecture. During 2000, we completed the construction of Ring 1 of our European network. Ring 1, which is approximately 1,900 miles, connects the major European cities of Paris, Frankfurt, Amsterdam, Brussels and London and was operational at December 31, 2000. Also in 2000, we acquired multiple conduits from another operator, configured in a ring in Germany which we call Ring 2. Ring 2, which is approximately 1,650 miles, connects the major German cities of Berlin, Dusseldorf, Frankfurt, Hamburg, and Munich. Ring 2 became operational during the first quarter of 2001. Subsequently, we created four additional fiber based rings generally through IRU acquisitions from other operators to connect our expanded operations in Europe that are described below and to add additional markets to the network. The first additional ring, added in 2006, is approximately 2,150 miles and connects Copenhagen, Stockholm and Oslo and the second additional ring is approximately 1,700 miles and connects Milan, Zurich and Geneva. The third additional ring, added in 2007, covers Central and Eastern Europe, and is approximately 1,500 miles connecting markets such as Prague, Vienna and Budapest. The fourth additional ring is approximately 1,900 miles and connects Barcelona, Madrid and Paris.

During 2002, we completed an expansion of our European operations to six additional cities. Our expansion to these additional locations was facilitated through the acquisition of available capacity from other carriers in the region. During 2003, we completed an expansion of our European operations to five additional cities. In addition, during 2004, we completed an expansion of our European operations to two cities. During 2005, we completed an expansion of our European operations to one city. During 2006, we obtained dark fiber primarily in those cities currently served by leased wavelength capacity and additionally in 2006 we completed an expansion of our European operations to 9 additional cities. During 2007, we obtained dark fiber in three cities that had been served by leased wavelength capacity and additionally in 2007 we completed an expansion of our European operations to 10 additional cities. The dark fiber combined with appropriate transmission equipment enables us to sell a full suite of transport and IP services in these markets. In 2008, we continued our European expansion to two additional cities using leased wavelength capacity. We expect to continue our expansion in 2009 to one or two additional cities.

Our European network is linked to our North American intercity network by leased capacity and by the Level 3 transatlantic cable system, which was completed and placed into service during 2000 and originally had a design capacity of 1.28 Tbps. The deployment of the system—which we refer to as the Yellow system—was completed pursuant to a co-build agreement announced in February 2000, whereby Global Crossing Ltd. participated in the construction of, and obtained a 50% ownership interest in the Yellow system. Under the co-build agreement, Level 3 and Global Crossing Ltd. each now separately own two of the four fiber pairs on the Yellow system. The Yellow system was recently upgraded and our two fiber pairs have a current capacity of 550 Gbps and we believe has a theoretical upgrade capacity to 1.8 Tbps assuming both fiber pairs are fully upgraded.

We also acquired additional capacity on Global Crossing Ltd.'s transatlantic cable, Atlantic Crossing 1, during 2000 to serve as redundant capacity for our fiber pairs on the Yellow system. We also own capacity in the TAT14 cable system. In connection with the WiTel acquisition, we have secured additional capacity on Atlantic Crossing 1 and on TAT-14. In 2006, we purchased 300 Gigabits of transatlantic capacity with the right to purchase 300 Gigabits of additional optional capacity from Apollo Submarine Cable System Ltd. In January 2007 we purchased 150 Gigabits of the additional optional capacity available from Apollo Submarine Cable System Ltd, 150 Gigabits in May 2007 and an additional 100 Gigabits in November 2007. We are also an owner on the Japan-US, and China-US cable systems, an IRU holder on Southern Cross cable system as well as an owner on the Americas II

cable and an IRU holder on the Arcos system. We also own capacity on the Reliance-Globacom transatlantic system Flag Atlantic-1 and capacity on the Hibernia transatlantic cable system.

*Local Market Infrastructure.* Our local facilities include fiber optic metropolitan networks connecting our intercity network and Gateways to buildings housing communications-intensive end users and traffic aggregation points—including ILEC and CLEC central offices, long distance carrier points-of-presence or POPs, cable head-ends, wireless providers' facilities and Internet peering and transit facilities. As of December 31, 2008, we had in the aggregate approximately 7,900 traffic aggregation points and buildings connected to our metropolitan networks. Our high fiber count metropolitan networks allow us to extend our services directly to our customers' locations at low costs, because the availability of this network infrastructure does not require extensive multiplexing equipment to reach a customer location, which is required in ordinary fiber constrained metropolitan networks.

We had secured approximately 6.9 million square feet of space for our Gateway and transmission facilities as of December 31, 2008, and had completed the buildout of approximately 4.6 million square feet of this space. Our initial Gateway facilities were designed to house local sales staff, operational staff, our transmission and Internet Protocol routing and Softswitch facilities and technical space to accommodate colocation services—that is, the colocation of equipment by high-volume Level 3 customers, in an environmentally controlled, secure site with direct access to Level 3's network generally through dual, fault tolerant connections. As a result of our acquisitions, some of our facilities are larger than our initial facilities and were designed to include a smaller percentage of total square feet for our transmission and Internet Protocol routing/Softswitch facilities and a larger percentage of total square feet to support the sale of colocation services. Availability of these services varies by location.

As of December 31, 2008, we had operational, facilities-based, local metropolitan networks in 116 U.S. markets and 9 European markets.

As of December 31, 2008, we also had approximately 145 markets in service in North America and approximately 45 markets in service in Europe.

## **Our Patent Portfolio**

Through acquisitions and through our own research and development, we have created an extensive patent portfolio, consisting of approximately 900 patents and patent applications filed in the United States and around the world. Our patent portfolio includes patents filed in each of the last three decades covering technologies ranging from data and voice services to content distribution to transmission and networking equipment. Most of our issued patents are not scheduled to expire for more than ten years.

In addition to the patents and patent applications we own, we have received licenses to patents held by others, including through a cross-license with IBM, giving us access to technology covered by IBM's approximately 40,000 patents covering many technologies relevant to our business. While patents give us the right to prevent others, particularly competitors, from using our proprietary technologies, patent licenses give us the freedom to operate our business without the risk of interruption from the holder of the patent that has been licensed to us.

We have used our patent portfolio in a number of ways. First, developing or acquiring technologies and receiving the legal right to preclude others from using them may give us a competitive advantage. Second, the breadth and depth of our patent portfolio may deter others, particularly telecommunications operators, from bringing patent infringement claims against us for fear of counter-claim by us. There have been relatively few patent infringements suits brought against us to date. Most of those have been initiated by patent-holding companies who do not operate telecommunications

businesses and who are less likely to be subject to a counter-claim of infringement by us. Finally, the extensiveness of our patent portfolio gives us the option to cross-license with others having similarly broad portfolios on terms acceptable to us, mitigating the risk that others will wish to assert patent infringement claims against us.

We will continue to file new patent applications as we enhance and develop products and services, we will continue to seek opportunities to expand our patent portfolio through strategic acquisitions and licensing, and we will continue to appropriately enforce our patents against infringement by others.

## **Our Content Delivery Network**

Content Delivery Network, or CDN, describes a system of computers networked together across the Internet to provide content to users in the most efficient manner to enable an optimal user experience. In a CDN, nodes or groups of computers are deployed in multiple locations closer to the end user, also known as the "edge of the network" and cooperate with each other to satisfy requests for content by end users, transparently moving content behind the scenes to optimize the delivery process. Requests for content are directed intelligently through sophisticated software applications to nodes that provide optimal performance for end users.

Our content delivery network is a unique configuration of our hosting and network assets located in approximately 17 countries, which is designed to improve the performance, reliability, and reach of web applications.

We believe that as a result of the combination of our CDN assets and our other network infrastructure, we are strongly positioned to grow our market share in the CDN business. This belief is based on several factors.

- *Network Scale.* Because we own our own network, our ability to increase capacity to meet the needs of content providers is greater than other CDN providers who do not have the flexibility to quickly increase their available network capacity.
- *Network Reach.* Our customers' content reaches global Internet destinations using an average number of "hops" that are fewer than with most other providers, enabling our customers to easily reach their audiences and provide better performance. The fewer number of hops required to reach Internet destinations serves to reduce latency and jitter.
- *Low Cost Position.* Because we own much of the underlying network infrastructure, we believe that we are positioned to offer cost advantages to our customers. By moving content at scale, our customers can take advantage of lower unit costs for bandwidth, colocation, servers and disk space.

## *CDN Applications*

There are an increasing number of applications for CDN, across many types of customers, particularly Internet-centric businesses and businesses that desire to accommodate increasingly larger file sizes for transmission over the Internet. The media and entertainment industries use CDN services to provide on-demand streaming and live streaming. Social Networking businesses require CDN to provide their customers with fast reliable music and video downloads. Likewise, through the use of CDN, software companies are able to provide software downloads for their customers. Online retailers and advertisers use CDN services to provide images and to download advertisements. Online gaming companies provide for game downloads, applications updates and delivery of demos and trailers through CDN.

## *Content Distribution Services Architecture*

The CDN platform uses our existing physical network and infrastructure, and is composed of the Edge server or computer, which provides caching and streaming functions and the Global server, which provides load balancing—that is, a computer that directs the traffic to the most efficient server to meet the end user's request. The Edge server enables the storage of popular content in a location that is closer to the end user and thereby reduces bandwidth requirements and improves response times for content stored in the cache. The Global server or computer load balancing components of the CDN directs end user requests to the content source that is best able to serve the request of the particular end user, such as routing to the service node that is closest to the end user or to the one with enough capacity to service the request of the end user.

We also transmit audio and video programming for our customers over our fiber-optic network and via satellite. We use our network to carry many live traditional broadcast and cable television events from the site of the event to the network control centers of the broadcasters of the event. These events include live sporting events of the major professional sports leagues. For live events where the location is not known in advance, such as breaking news stories in remote locations, we provide an integrated satellite and fiber-optic network based service to transmit the content to our customers. Most of our customers for these services contract for the service on an event-by-event basis; however, we have some customers who have purchased a dedicated point-to-point service, which enables these customers to transmit programming at any time.

## **Distribution Strategy**

Our communications services sales strategy with respect to our Wholesale Markets Group and Europe is to utilize a direct sales force focused on companies with high bandwidth and/or voice requirements. These businesses include incumbent local exchange carriers, established next generation carriers, international carriers also known as PTTs, major ISPs, broadband cable television operators, major interexchange carriers, wireless carriers, systems integrators, governments, emerging VoIP service providers, calling card providers, conferencing providers and call centers.

With respect to our Business Markets Group, medium to large enterprises will be serviced by a field based direct sales force. Smaller business opportunities are serviced by an inside sales force generally selling pre-defined bundles of services. We also complement our direct sales force with an indirect sales channel of agent partners.

Our communications services sales strategy with respect to the Content Markets Group is also to utilize a direct sales force. Targeted customers include video distribution companies; providers of online gaming and mega-portals; software service providers; social networking providers; and traditional media distribution companies including broadcasters, television networks and sports leagues.

We have in place policies and procedures to review the financial condition of potential and existing customers. We apply these procedures to determine whether collectability of services billed is probable prior to the time that we begin delivering services to a customer. If the financial condition of an existing customer deteriorates to a point where payment for services is in doubt, we will not recognize revenue attributable to that customer until we receive cash. Based on these policies and procedures, we believe our exposure to collection risk within the communications business and the possible effect on our financial statements is limited. We may also experience the effects of the downturns in the economy and specifically the telecommunications industry; however, we believe the concentration of credit risk with respect to receivables is mitigated due to the dispersion of our customer base among geographic areas and remedies provided by terms of contracts and by law.

For the year ended December 31, 2008, our top ten customers represented approximately 31% of our consolidated total revenue. Revenue from our largest customer, AT&T Inc. and its subsidiaries,

represented approximately 12% of our consolidated total revenue for 2008. The next largest customer accounted for approximately 5% of our consolidated total revenue and most of the remaining top ten customers each account for 3% or less of our consolidated total revenue.

In connection with the acquisition of WilTel in December 2005, we acquired a large customer contract between WilTel and SBC Communications, a subsidiary of AT&T. We expect that the revenue generated under this contract will continue to decline over time as SBC Communications migrates its traffic from our network to the merged SBC and AT&T Communications network that SBC Communications acquired from the former AT&T.

## **Business Support Systems**

In order to pursue our sales and distribution strategies, we have developed and are continuing to develop and implement a set of integrated software applications designed to automate our operational processes. These development activities also relate to the integration of the systems that were used by the companies that we have acquired. Through the development of a robust, scalable business support system, we believe that we have the opportunity to develop a competitive advantage relative to traditional telecommunications companies. In addition, we recognize that for the success of certain of our services that some of our business support systems will need to be easily accessible and usable directly by our customers.

We are currently deploying a unified set of simplified processes and systems that are streamlining and synchronizing our service, sales, and operational functions through our "Unity" platform. Unity has been designed to provide improved capability in service catalog management, sales opportunity management, customer management, quoting, order entry, order workflow, physical and logical network inventory management, service management, and financial management. We completed the foundation of our Unity platform processes and systems development objectives at the end of 2008 and we are now focused on operational efficiency improvements and data integrity and migration.

Key design aspects of the business support system development program are:

- integrated modular applications to allow us to upgrade specific applications as new services are available;
- a scalable architecture that allows our customers and distributors direct access to certain functions that would otherwise have to be performed by our employees;
- phased completion of software releases designed to allow us to test functionality on an incremental basis;
- "web-enabled" applications so that on-line access to order entry, network operations, billing, and customer care functions is available to all authorized users, including our customers;
- use of a tiered, client/server architecture that is designed to separate data and applications, and is expected to enable continued improvement of software functionality at minimum cost; and
- use of pre-developed or commercial "off-the-shelf" applications, where applicable, which will interface to our internally developed applications.

## **Our Employees**

As of December 31, 2008, we had approximately 5,300 employees. We believe that our success depends in large part on our ability to attract and retain substantial numbers of qualified employees.

## Competition

The communications industry is highly competitive. A number of factors in recent years have increased the number of competitors in the market. First, the Telecommunications Act of 1996 created opportunities for non-incumbent providers to enter the marketplace. Second, the capital markets responded by making funding more available to new and existing competitors. Third, enthusiasm over the opportunities created by the rapid developments of the Internet led investors and market participants in general to overestimate the rate at which demand for communications services would grow. Finally, the emergence of new IP-based services has created prospects for new entrants with non-traditional business models to compete with legacy providers.

We believe that a confluence of these factors created an unsustainable level of competition in the market. We believe that this was evidenced by both the number of competitors vying for similar business and by the amount of inventory or capacity each brought to the market for many services. The result of these actions was an oversupply of capacity and an intensely competitive environment.

While we believe the current industry structure has improved significantly, we believe that further restructuring is likely. With the growth of communications demand, excess capacity is increasingly being absorbed. Similarly, some form of industry consolidation will continue to occur based on underlying economics. Given the large ongoing fixed costs associated with operating a backbone network, we believe that the natural industry structure will continue to evolve to a more limited number of competitors with each having high traffic scale across their networks.

While we believe that the long-run industry structure will evolve toward that described above, uncertainty surrounds how the existing competitive landscape will evolve toward this new structure. For example, while a number of next-generation and incumbent providers have been consolidated, we believe there are still a number of competitors operating fundamentally poor business models, are resource constrained, and are unlikely to be long-term survivors in their current forms. In addition, while the completed acquisition transactions by AT&T and Verizon have given those companies greater scale and product breadth, the ultimate effect of these transactions on the industry structure is yet to be known.

We believe that each competitor's long-run success in the market will be driven by its available resources (for example, financial, personnel, marketing, customers) and the effectiveness of its business model (for example, service focus and mix, cost effectiveness, ability to adapt to new technologies, channel effectiveness). We recognize that many of our existing and potential competitors in the communications industry have resources significantly greater than ours.

In the short term, the current economic environment may put increased pressure on competitors that lack a strong financial position, and as a result competition may become more intense as these competitors seek to win business in a slower market.

Our primary competitors are long distance carriers, incumbent local exchange carriers, competitive local exchange carriers, PTTs, Content Delivery Network companies, and other companies that provide communications services. The following information identifies some key competitors for each of our product offerings.

Our key competitors for our voice service offerings are other providers of wholesale communications services including AT&T, Verizon, Qwest, Global Crossing and competitive local exchange carriers. Our key competitors for managed modem services are other providers of dial up Internet access including AT&T, Verizon and PAETEC Communications.

For our IP and Data services, we compete with companies that include Verizon, AT&T, Global Crossing and Cogent in North America, and TeliaSonera, Global Crossing and Cogent in Europe.



For transport services, our key competitors in the United States are other facilities based communications companies including AT&T, Verizon, Qwest, tw telecom and XO. In Europe, our key competitors are other carriers such as PTTs, Telia International, Colt, KPN, Belgacom and Global Crossing.

Our key competitors for our colocation services are other facilities based communications companies, and other colocation providers such as web hosting companies and third party colocation companies. In the United States, these companies include Equinix, Savvis, Switch & Data and Internap. In Europe, competitors include Equinix, Global Switch, InterXion, Telecity and Telehouse Europe.

In the enterprise market, our key competitors include incumbent local exchange carriers (such as AT&T, Verizon and Qwest and competitive local exchange carriers.

For content distribution network or CDN services, our key competitors include Akamai Technologies and Limelight Networks.

The communications industry is subject to rapid and significant changes in technology. For instance, recent technological advances permit substantial increases in transmission capacity of both new and existing fiber, and the introduction of new products or emergence of new technologies may reduce the cost or increase the supply of certain services similar to those which we plan on providing. Accordingly, in the future our most significant competitors may be new entrants to the communications industry, which—unlike the traditional incumbent carriers we also compete with—are not burdened by an installed base of outmoded or legacy equipment.

## **Regulation**

### *Federal Regulation*

The Federal Communications Commission or the FCC has jurisdiction over interstate and international communications services, among other things. The FCC's regulation of common carriers without market power, such as us, is less stringent than its regulation of dominant incumbent local exchange carriers. We have obtained FCC approval to land our transatlantic cable in the United States. We have obtained FCC authorization to provide international services on a facilities and resale basis as well as various wireless licenses. Under the Telecommunications Act of 1996 (the "1996 Act"), any entity, including cable television companies, electric and gas utilities, may enter any telecommunications market, subject to reasonable state regulation of safety, quality and consumer protection.

The FCC has pending a Notice of Proposed Rulemaking ("NPRM") to initiate a comprehensive review of rules governing the pricing of special access service offered by ILECs subject to price cap regulation. Special access pricing by these carriers currently is subject to price cap rules, as well as pricing flexibility rules which permit these carriers to offer volume and term discounts and contract tariffs (Phase I pricing flexibility) and/or remove from price caps regulation special access service in a defined geographic area (Phase II pricing flexibility) based on showings of competition. In the NPRM the FCC tentatively concludes to continue to permit pricing flexibility where competitive market forces are sufficient to constrain special access prices, but undertakes an examination of whether the current triggers for pricing flexibility accurately assess competition and have worked as intended. The NPRM also asks for comment on whether certain aspects of ILEC special access tariff offerings (e.g., basing discounts on previous volumes of service; tying nonrecurring charges and termination penalties to term commitments; and imposing use restrictions in connection with discounts), are unreasonable. At this time, we cannot predict the impact, if any, that a ruling on the NPRM will have on our network cost structure.

Both AT&T and Verizon, in connection with large acquisitions, have agreed to abide by certain conditions that are enforceable by the FCC in connection with special access prices, terms and conditions. In December 2007, we filed a complaint against AT&T alleging, among other things, that



AT&T had violated those commitments. At this stage, the proceeding is continuing and we intend to vigorously pursue our claims. We cannot at this time predict the outcome of that proceeding.

As of August 1, 2001, our tariffs for interstate end user services were eliminated and our tariffs for international interexchange services were eliminated on January 28, 2002. Our rates must still be just and reasonable and nondiscriminatory. Our state tariffs remain in place. We have historically relied primarily on our sales force and marketing activities to provide information to our customers regarding these matters and expect to continue to do so. Further, in accordance with the FCC's orders we maintain a schedule of our rates, terms and conditions for our domestic and international private line services on our web site.

*Intercarrier compensation.* Telecommunications carriers compensate one another for traffic carried on each other's networks. Interexchange carriers pay access charges to local telephone companies for long distance calls that originate and terminate on local networks. Local telephone companies typically charge one another for local and Internet-bound traffic terminating on each other's networks. The entire methodology by which carriers compensate one another for exchanged traffic, whether it be for local, intrastate or interstate traffic, is under review at the FCC.

Apart from this comprehensive review of intercarrier compensation, individual compensation issues have been the subject of FCC and state commission rulings. Since 1997 the issue of compensation to be paid for calls dialed to Internet service providers or ISPs has been heavily litigated. Since 2004, the issue of compensation to be paid in connection with the exchange of Voice over Internet Protocol or VoIP calls has also been the subject of much debate.

In its decision on Nov. 5, 2008, the FCC responded to a mandamus order from the United States Circuit Court of Appeals for the District of Columbia concerning its 2001 ISP Remand Order. In that Mandamus Order, the FCC clarified that it had jurisdiction over ISP bound traffic pursuant to the reciprocal compensation provisions of the Telecommunications Act of 1996 regardless of whether the traffic was local or long distance. The FCC then decided to maintain the existing compensation regime it had established for ISP-bound traffic with a rate of \$0.0007 per minute of use. The Mandamus Order has been appealed to the Court of Appeals. In addition, a number of states have been asked to implement the Mandamus Order. The Company cannot predict the outcome of those proceedings.

Level 3 maintains approximately 233 interconnection agreements with other telecommunications carriers. These agreements set out the terms and conditions under which the parties will exchange traffic. The largest agreements are with AT&T and Verizon. Level 3's agreement with AT&T expires on January 11, 2011. Level 3's agreement with Verizon expires on March 31, 2009. Upon expiration of the agreement, Level 3 and Verizon will continue to provide services until a successor agreement has been reached.

As interconnection agreements expire, we will continue to negotiate new agreements but at this time cannot predict what the final terms will be, including compensation for ISP-bound traffic or VoIP traffic. In the event we initiate arbitration before a state commission to establish the terms of the interconnection agreement, we cannot predict what the final terms will be, including compensation for ISP-bound traffic or VoIP traffic.

Given the general uncertainty surrounding the effect of the FCC and state decisions and appeals, we may have to change (1) how we treat the compensation we receive for terminating calls bound for ISPs if the agreements under which compensation is paid provided for the incorporation of changes in FCC rules and regulations; (2) the manner in which we account for the compensation and costs of intercarrier compensation for VOIP.

There is also uncertainty in respect to intercarrier compensation for VoIP traffic. As in the ISP intercarrier compensation situation, the FCC has issued a number of rulings asserting its jurisdiction over such traffic, but to date it has not issued any rulings on the scope and rate of intercarrier

compensation to be paid by carriers exchanging VoIP traffic. While carriers that serve VoIP providers such as Level 3 have typically asserted that VoIP traffic is local in nature and thereby subject to local compensation rates, the RBOCS and other incumbents have taken the position that some or all of this traffic should be subject to higher intrastate or interstate rates. A number of carriers have filed petitions with the FCC seeking a declaratory ruling on the treatment of VoIP traffic. These petitions have either been withdrawn or rejected based on procedural grounds. In those cases, the FCC did not resolve the question of the appropriate intercarrier compensation. The last petition, filed by Embarq, was withdrawn on February 11, 2009.

Until such time as the FCC acts in such a way as to either clarify its rulings on ISP compensation, VoIP compensation or rules on intercarrier compensation in its entirety, and such rules are final and non-appealable, the scope of intercarrier compensation obligations between carriers exchanging ISP or VoIP traffic is uncertain.

*Universal Service.* Level 3 is subject to federal and state regulations that implement universal service support for access to communications services in rural, high-cost and low-income markets at reasonable rates; and access to advanced communications services by schools, libraries and rural health care providers. Currently, the FCC assesses Level 3 a percentage of interstate and international revenue it receives from retail customers as its contribution to the Federal Universal Service Fund. The FCC is currently considering changing the method by which our contributions are assessed to a flat-fee charge, such as a per-line or per-number charge. Any change in the assessment methodology may affect Level 3's revenues but at this time, it is not possible to predict the extent we would be affected, if at all.

### *State Regulation*

The 1996 Act is intended to increase competition in the telecommunications industry, especially in the local exchange market. With respect to local services, ILECs are required to allow interconnection to their networks and to provide unbundled access to network facilities, as well as a number of other pro-competitive measures. Because the implementation of the 1996 Act is subject to numerous state rulemaking proceedings on these issues, it is currently difficult to predict how quickly full competition for local services will be realized.

State regulatory agencies have jurisdiction when our facilities and services are used to provide intrastate telecommunications services. A portion of our traffic may be classified as intrastate telecommunications and therefore subject to state regulation. We expect that we will offer more intrastate telecommunications services (including intrastate switched services) as our business and product lines expand. To provide intrastate services, we generally must obtain a certificate of public convenience and necessity from the state regulatory agency and comply with state requirements for telecommunications utilities, including state tariffing requirements. We currently are authorized to provide telecommunications services in all fifty states and the District of Columbia. In addition, we will be required to obtain and maintain interconnection agreements with ILECs where we wish to provide service. We expect that we should be able to negotiate or otherwise obtain renewals or successor agreements through adoption of others' contracts or arbitration proceedings, although the rates, terms, and conditions applicable to interconnection and the exchange of traffic with certain ILECs could change significantly in certain cases. The degree to which the rates, terms, and conditions may change will depend not only upon the negotiation and arbitration process and availability of other interconnection agreements, but will also depend in significant part upon state commission proceedings that either uphold or modify the current regimes governing interconnection and the exchange of certain kinds of traffic between carriers.

States also often require prior approvals or notifications for certain transfers of assets, customers or ownership of certificated carriers and for issuances by certified carriers of equity or debt.

### *Local Regulation*

Our networks are subject to numerous local regulations such as building codes and licensing. Such regulations vary on a city-by-city, county-by-county and state-by-state basis. To install our own fiber optic transmission facilities, we need to obtain rights-of-way over privately and publicly owned land. Rights-of-way that are not already secured, or which may expire and not be renewed, may not be available to us on economically reasonable or advantageous terms.

### *Regulation of Voice over Internet Protocol (VoIP)*

#### *Federal and State*

Due to the growing acceptance and deployment of VoIP services, the FCC and state public utility commissions are conducting regulatory proceedings that could affect the regulatory duties and rights of entities such as us or our affiliates that provide IP-based voice applications. There is regulatory uncertainty as to the imposition of access charges and other taxes, fees and surcharges on VoIP services that use the public switched telephone network. There is regulatory uncertainty as to the imposition of traditional retail, common carrier regulation on VoIP products and services.

The rules respecting the payments made by carriers for the exchange of VoIP traffic have been subject to much debate. The FCC has not clarified whether VoIP traffic is to be subjected to the access charges regime that is applicable to traditional telecom service, or whether VoIP traffic is to be treated as an "information service" or "enhanced" and not subject to access charges. There are a number of petitions and proceedings pending before the FCC where this issue could be resolved. At this time, it is difficult to predict the outcome of any of these proceedings or the timing for their eventual resolution. As a result, we cannot predict the effect that any such rulings could have on our provision of VoIP services.

The FCC has classified VoIP services as "interstate" services subject to FCC regulations, and has stated that states have limited authority to regulate the offering of VoIP services. On September 22, 2003, Vonage Holdings Corporation ("Vonage") filed a petition with the FCC requesting a declaration that its offerings, which originate on a broadband network in IP format and terminate on the PSTN, are interstate information services not subject to state regulation under the 1996 Act and existing FCC rules. On November 10, 2004, the FCC adopted an order (which was subsequently upheld on appeal) ruling that Vonage's service was an interstate service not subject to state regulation.

On June 3, 2005, the FCC issued an order (which was subsequently upheld on appeal) requiring all interconnected VoIP providers to deliver enhanced 911 capabilities to their subscribers by no later than November 28, 2005. We have modified our service offerings to VoIP providers in order to assist them in complying with the FCC mandate.

In 2007, the FCC imposed some regulatory requirements on VoIP providers that had previously been applicable only to traditional telecommunications providers. Specifically, the FCC (a) imposed obligations on VoIP providers to contribute to the federal universal service fund, and (b) required VoIP carriers to comply with regulations relating to local number portability (including contributing to the costs of managing number portability requirements). In addition, a number of state public utility commissions are conducting regulatory proceedings that could impact our rights and obligations with respect to IP-based voice applications. Specifically, some states have taken the position that the "local" component of VoIP service is subject to traditional regulations applicable to local telecommunications services, such as the obligation to pay intrastate universal service fees.

We cannot predict the outcome of any of these petitions and regulatory proceedings or any similar petitions and regulatory proceedings pending before the FCC or state public utility commissions. Moreover, we cannot predict how their outcomes may affect our operations or whether the FCC or

state public utility commissions will impose additional requirements, regulations or charges upon our provision of services related to IP communications.

### *European Regulation*

Unlike the United States which has a fractured regulatory scheme with respect to VoIP services, the European Union has adopted a more systematic approach to the convergence of networks and VoIP regulation specifically. The European Commission will oversee the implementation by its member-states of six new directives developed to regulate electronic communications in a technology and platform neutral manner. Implementation of the directives has not been uniform across the Member States of the European Union and it is difficult to predict when they will be implemented at the national level. Even with harmonization, the national regulatory agencies will continue to be responsible for issuing general authorizations and specific licenses.

The European Union's approach to the regulation of VoIP turns on whether VoIP is voice telephony. The European Commission has defined voice telephony to have four elements: (1) commercial offering as voice telephony; (2) provision to the public; (3) provision to and from the public switched telephone network termination points; and (4) direct speech transport and switching of speech in real time, particularly at the same level of reliability and speech quality as provided by the PSTN. In its "Communication from the Commission, Consultation on Voice on the Internet" in June 2000, the European Commission directed that "Member States should continue to allow Internet access providers to offer voice over Internet protocol under data transmission general authorizations, and that specific licensing conditions are not justified."

The European Commission has subsequently redefined its definitions to suggest that some VoIP offerings are voice telephony. In its December 2000 communication, the European Commission noted that increasing quality and reliability as well as marketing of voice capabilities with bundled services, made certain kinds of "voice over Internet" much more like voice services. While the current European Commission directives do not mandate the treatment of VoIP as voice telephony, the commission will continue to reevaluate the regulation of VoIP as service quality becomes the equivalent of traditional voice telephony.

In February 2003, the European Union adopted a new regulatory framework for electronic communications that is designed to address in a technologically neutral manner the convergence of communications across telecommunications, computer and broadcasting networks. The directives address: (1) framework (2) interconnection and access, (3) authorization and licensing, (4) universal service and (5) privacy. These directives and an additional decision on radio spectrum replace the existing 20 directives on electronic communications. Under the framework, voice telephony providers will face additional obligations, including specific licensing and universal service obligations. Others will likely face new regulation. One example could be VoIP. If it is classified as an electronic communications service, rather than voice telephony, it would still be subject to additional regulations to achieve regulatory parity with other electronic communications.

The United Kingdom was one of the first countries to fully implement the European Union's new framework for electronic communications, which it did by July 25, 2003. At that time, certain provisions of the United Kingdom's Telecommunications Act of 1984 were repealed. Pursuant to that framework, the licensing regime was replaced with a general authorization. Our existing licenses were canceled and replaced with a general authorization.

Under the regime, the United Kingdom regulates VoIP as an electronic communication service. The degree of regulation imposed on the service depends upon whether the service is considered to be a Publicly Available Telephone Service (PATS). A service is considered to be a PATS if the following conditions are met: it is marketed as a substitute for the traditional telephone service; the service appears to the customer to be a substitute for the traditional public telephone service over which they expect access to emergency services; or the service provides the customers sole means of access to the traditional circuit switched public telephone network.

### *Canadian Regulation*

Pursuant to the *Telecommunications Act* ("Act"), the Canadian Radio-television and Telecommunications Commission ("CRTC"), has jurisdiction to regulate telecommunications communications and their service offerings in Canada (telecommunications is a Federal jurisdiction). Regulatory developments over the past several years have terminated the historic monopolies of the ILECs bringing significant competition to this industry for both domestic and international long distance services. On December 14, 2006, the Governor in Council (Federal Cabinet) for the first time exercised its statutory power to issue a binding Policy Direction requiring the CRTC, in regulating the telecommunications industry, to rely on market forces to the maximum extent possible, regulating only to the extent necessary and then in an efficient and a proportionate way. The provision of Canadian domestic and international transmission facilities based services remains restricted to "Canadian carriers". These carriers must have majority ownership and control in fact by Canadians. There are no such Canadian ownership and control requirements for companies that resell the services and facilities of a Canadian carrier. Level 3 operates as a reseller in Canada. If the ownership restrictions are repealed, we anticipate that we will be able to expand our operations and service offerings in Canada. The liberalization of Canadian carrier ownership and control is controversial and there are no immediate prospects for such a change.

While competition is permitted in virtually all other Canadian telecommunications market segments, we believe that the ILECs continue to retain a substantial majority of the local and calling card markets. Beginning in May 1997 and furthered by a Federal Government policy direction, the CRTC has released a number of decisions opening to competition the Canadian local telecommunications services market. As a result, networks operated by CLECs may now be interconnected with the networks of the ILECs. Transmission facilities-based CLECs are subject to the same majority Canadian ownership "Canadian carrier" requirements as transmission facilities-based long distance carriers. CLECs have the same status as ILECs, but without universal service or customer tariff filing obligations. All bundled and unbundled local services (including residential lines and other bulk services) may now be resold, but ILECs need not provide these services to resellers at wholesale prices. The CRTC has ruled that resellers cannot be classified as CLECs, and thus are not entitled to CLEC interconnection terms and conditions.

With respect to VoIP services, the CRTC ruled in Decision 2005-28 that it should forbear from regulating circuit-switched VoIP services. As a result, ILECs are not required to file tariffs for the provision of long distance VoIP services. With respect to local VoIP services, the Governor in Council varied the CRTC decision to treat VoIP services as other local exchange services by making an exception for access-independent VoIP services that do not include an ILEC-provided loop. Furthermore, the ILEC, Bell Canada, has received approval of its application to be relieved of the requirement to obtain pre-approval for price changes for its local VoIP services. Bell has been permitted to notify the CRTC two business days in advance of changes as long as the price is within an authorized range.

In a March 3, 2008 decision, the CRTC established the regulatory framework for wholesale telecommunications services with rules for the regulation and pricing provided by ILECs to competitive service providers such as alternative local and long distance carriers, resellers and ISPs. The CRTC

decision revised its definition of an "essential service", established a six-category framework for the CRTC's regulation of wholesale telecommunications services, categorized various available wholesale services within these identified categories, and established the regulatory conditions associated with each service category, notably mandated access and pricing principles, as well as the process for the phase-out of regulation for certain services found to be non-essential. In its 1997 local competition decision, the CRTC had tied essential facilities to those provided on a monopoly basis. In the 2008 decision, non-monopoly facilities will have to be provided to competitors if the CRTC makes a determination that withdrawal of mandatory access would likely result in a substantial lessening or prevention of competition. The CRTC classified wholesale services that are currently regulated into six categories: essential, conditional essential, conditional mandated non-essential, public good, interconnection, and non-essential subject to phase-out of regulation. Very few services were classified as essential. In the category of "conditional essential" wholesale services, the CRTC included wholesale services used for local telephony (primarily unbundled local loops), low-speed competitor digital network access services, DS-0 and DS-1 access facilities and ADSL access services used to provide high-speed Internet access services to residences and businesses. This essential conditional category classification will continue until it is demonstrated that wholesale alternatives functionally equivalent are sufficiently present such that withdrawing mandated access would not likely result in a substantial lessening or prevention of competition in the local exchange services market. Regarding network interconnection services, customer access facilities, and support structure services, the CRTC considers that these arrangements are technologically and competitively neutral to the greatest extent possible, enable competition from new technologies, and do not artificially favour Canadian carriers or resellers.

The CRTC has conditionally forbore from regulating the retail Internet services, but not the wholesale Internet services, of Canadian carriers preserving its regulatory powers relating to unjust discrimination and undue preference or advantage. The CRTC has ruled (Telecom Decision 2008-108) that Bell Canada's application of its traffic-shaping measures to its wholesale ADSL access service known as Gateway Access Service (GAS) were not in violation of the Act. In Public Notice 2008-19, the CRTC noted that Decision 2008-108 dealt only with Bell Canada's practice of throttling P2P traffic at certain times of the day in relation to its GAS being provided to wholesale customers. In the Public Notice, the CRTC announced it would explore the current and potential Internet traffic management practices of all ISPs operating in Canada, examining both retail and wholesale services. Following the filing of written submissions, the CRTC will hold an oral public hearing commencing July 6, 2009 to consider the issues relating to Internet traffic management practices.

## **Our Other Business**

Our company was incorporated as Peter Kiewit Sons', Inc. in Delaware in 1941 to continue a construction business founded in Omaha, Nebraska in 1884. In subsequent years, we invested a portion of the cash flow generated by our construction activities in a variety of other businesses. We entered the coal mining business in 1943, the telecommunications business in 1988, the information services business in 1990 and the alternative energy business in 1991. We have also made investments in several development-stage ventures.

In December 1997, our stockholders ratified the decision of the Board to effect the split-off separating our historical construction business from the remainder of our operations. As a result of the split-off, which was completed on March 31, 1998, we no longer own any interest in the prior construction business. In conjunction with the split-off, we changed our name to "Level 3 Communications, Inc.," and the entity that held the prior construction business changed its name to "Peter Kiewit Sons', Inc."

On November 30, 2005, we completed the sale of our ( i )Structure, LLC subsidiary to Infocrossing, Inc. Prior to the sale, ( i )Structure provided computer operations outsourcing to customers located primarily in the United States. On September 7, 2006, we completed the sale of 100% of the

capital stock of our indirect, wholly owned subsidiary, Software Spectrum, Inc., to Insight Enterprises, Inc. Prior to the sale, Software Spectrum was a leading direct marketer of software and provider of software licensing services to corporations. With the completion of the sale of Software Spectrum, we exited the information services business.

### *Coal Mining*

We are engaged in coal mining through our subsidiary, KCP, Inc. or KCP. KCP has a 50% interest in two mines, which are operated by a subsidiary of Peter Kiewit Sons', Inc. or PKS. Decker Coal Company or Decker is a joint venture with Western Minerals, Inc., which is a subsidiary of Rio Tinto Energy America Inc. Black Butte Coal Company or Black Butte is a joint venture with Bitter Creek Coal Company, a subsidiary of Anadarko Petroleum Corporation. The Decker mine is located in southeastern Montana and the Black Butte mine is in southwestern Wyoming. The coal mines use the surface mining method.

The coal produced from the KCP mines is sold primarily to electric utilities, which burn coal to produce steam to generate electricity. Essentially all of the sales were made under long-term contracts. Approximately 63%, 67% and 68% of KCP's revenue in 2008, 2007 and 2006, respectively, were derived from long-term contracts with PacifiCorp (Black Butte), Idaho Power (Black Butte), The Detroit Edison Company (with Decker), and Commonwealth Edison Company (with Decker). The mines have commitments to deliver approximately 20.7 million tons of coal through 2014 under contracts with PacifiCorp, Idaho Power and Virginia Power. The mines also have other sales commitments, including those with The Detroit Edison Company, Sierra Pacific and Minnesota Power that provide for the delivery of approximately 7.7 million tons through 2012. Under a mine management agreement, KCP pays a subsidiary of PKS an annual fee equal to 30% of KCP's adjusted operating income. The fee for 2008 was approximately \$1 million.

The coal industry is highly competitive. KCP competes not only with other domestic and foreign coal suppliers, some of whom are larger and have greater capital resources than KCP, but also with alternative methods of generating electricity and alternative energy sources. In 2007, the most recent year for which information is available, KCP's production represented less than 1% of total U.S. coal production. Demand for KCP's coal is affected by economic, political and regulatory factors. For example, recent "clean air" laws may stimulate demand for low sulfur coal. KCP's western coal reserves generally have a low sulfur content (less than one percent) and are currently useful principally as fuel for coal-fired, steam-electric generating units.

KCP's sales of its coal, like sales by other western coal producers, typically provide for delivery to customers at the mine. A significant portion of the customer's delivered cost of coal is attributable to transportation costs. Most of the coal sold from KCP's western mines is currently shipped by rail to utilities outside Montana and Wyoming. The Decker and Black Butte mines are each served by a single railroad. Many of their western coal competitors are served by two railroads and such competitors' customers often benefit from lower transportation costs because of competition between railroads for coal hauling business. Other western coal producers, particularly those in the Powder River Basin of Wyoming, have lower stripping ratios (that is, the amount of overburden that must be removed in proportion to the amount of minable coal) than the Black Butte and Decker mines, often resulting in lower comparative costs of production. As a result, KCP's production costs per ton of coal at the Black Butte and Decker mines can be as much as four and five times greater than production costs of certain competitors. Because of these cost disadvantages, there is no assurance that KCP will be able to enter into additional long-term coal purchase contracts for Black Butte and Decker production. In addition, these cost disadvantages may adversely affect KCP's ability to compete for sales in the future.



We are required to comply with various federal, state and local laws and regulations concerning protection of the environment. KCP's share of land reclamation expenses for the year ended December 31, 2008 was approximately \$3 million. KCP's share of accrued estimated reclamation costs was \$96 million at December 31, 2008. We were not required to make significant capital expenditures for environmental compliance with respect to the coal business in 2008. We believe our compliance with environmental protection and land restoration laws will not affect our competitive position since our competitors in the mining industry are similarly affected by such laws. However, failure to comply with environmental protection and land restoration laws, or actual reclamation costs in excess of our accruals, could have an adverse effect on our business, results of operations, and financial condition.

## **Glossary of Terms**

access	Telecommunications services that permit long distance carriers to use local exchange facilities to originate and/or terminate long distance service.
access charges	The fees paid by long distance carriers to LECs for originating and terminating long distance calls on the LECs' local networks.
backbone	A high-speed network that interconnects smaller, independent networks. It is the through- portion of a transmission network, as opposed to spurs which branch off the through- portions.
ATM (asynchronous transfer mode)	An information transfer standard that is one of a general class of packet technologies that relay traffic by way of an address contained within the first five bytes of a standard fifty-three byte long packet or cell. The ATM format can be used by many different information systems, including LANs, to deliver traffic at varying rates, permitting a mix of data, voice and video.
CAP	Competitive Access Provider. A company that provides its customers with an alternative to the local exchange company for local transport of private line and special access telecommunications services.
caching	A process by which a Web storage device or cache is located between Web servers (or origin servers) and a user, and watches requests for HTML pages and objects such as images, audio, and video, then saves a copy for itself. If there is another request for the same object, the cache will use its copy, instead of asking the origin server for it again.
capacity	The information carrying ability of a telecommunications facility.
carrier	A provider of communications transmission services by fiber, wire or radio.



CDN	Content Distribution Network or CDN describes a system of computers networked together across the Internet that cooperate transparently to deliver various types of content to end users. The delivery process is optimized generally for either performance or cost. When optimizing for performance, locations that can serve content quickly to the user are chosen. When optimizing for cost, locations that are less expensive to serve from may be chosen instead.
central office	Telephone company facility where subscribers' lines are joined to switching equipment for connecting other subscribers to each other, locally and long distance.
CLEC	Competitive Local Exchange Carrier. A company that competes with LECs in the local services market.
co-carrier	A relationship between a CLEC and an ILEC that affords each company the same access to and right on the other's network and provides access and services on an equal basis.
common carrier	A government-defined group of private companies offering telecommunications services or facilities to the general public on a non-discriminatory basis.
conduit	A pipe, usually made of metal, ceramic or plastic, that protects buried cables.
DS-3	A data communications circuit capable of transmitting data at 45 Mbps.
dark fiber	Fiber optic strands that are not connected to transmission equipment.
dedicated lines	Telecommunications lines reserved for use by particular customers.
dialing parity	The ability of a competing local or toll service provider to provide telecommunications services in such a manner that customers have the ability to route automatically, without the use of any access code, their telecommunications to the service provider of the customers' designation.
equal access	The basis upon which customers of interexchange carriers are able to obtain access to their Primary Interexchange Carriers' (PIC) long distance telephone network by dialing "1", thus eliminating the need to dial additional digits and an authorization code to obtain such access.
facilities based carriers	Carriers that own and operate their own network and equipment.

fiber optics	A technology in which light is used to transport information from one point to another. Fiber optic cables are thin filaments of glass through which light beams are transmitted over long distances carrying enormous amounts of data. Modulating light on thin strands of glass produces major benefits including high bandwidth, relatively low cost, low power consumption, small space needs and total insensitivity to electromagnetic interference.
Gbps	Gigabits per second. A transmission rate. One gigabit equals 1.024 billion bits of information.
ILEC	Incumbent Local Exchange Carrier. A company historically providing local telephone service. Often refers to one of the Regional Bell Operating Companies (RBOCs). Often referred to as "LEC" (Local Exchange Carrier).
Interconnection	Interconnection of facilities between or among the networks of carriers, including potential physical colocation of one carrier's equipment in the other carrier's premises to facilitate such interconnection.
InterLATA	Telecommunications services originating in a LATA and terminating outside of that LATA.
Internet	A global collection of interconnected computer networks which use a specific communications protocol.
IntraLATA	Telecommunications services originating and terminating in the same LATA.
ISDN	Integrated Services Digital Network. An information transfer standard for transmitting digital voice and data over telephone lines at speeds up to 128 Kbps.
ISPs	Internet Service Providers. Companies formed to provide access to the Internet to consumers and business customers via local networks.
IXC	Interexchange Carrier. A telecommunications company that provides telecommunications services between local exchanges on an interstate or intrastate basis.
Kbps	Kilobits per second. A transmission rate. One kilobit equals 1,024 bits of information.
LATA	Local Access and Transport Area. A geographic area composed of contiguous local exchanges, usually but not always within a single state. There are approximately 200 LATAs in the United States.
leased line	An amount of telecommunications capacity dedicated to a particular customer along predetermined routes.
LEC	Local Exchange Carrier. A telecommunications company that provides telecommunications services in a geographic area. LECs include both ILECs and CLECs.

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local exchange	A geographic area determined by the appropriate state regulatory authority in which calls generally are transmitted without toll charges to the calling or called party.
local loop	A circuit that connects an end user to the LEC central office within a LATA.
long distance carriers	Long distance carriers provide services between local exchanges on an interstate or intrastate basis. A long distance carrier may offer services over its own or another carrier's facilities.
Mbps	Megabits per second. A transmission rate. One megabit equals 1.024 million bits of information.
MPLS	MultiProtocol Label Switching. A standards-approved technology for speeding up network traffic flow and making it easier to manage. MPLS involves setting up a specific path for a given sequence of packets, identified by a label put in each packet, thus saving the time needed for a router or switch to look up the address to the next node to forward the packet to.
multiplexing	An electronic or optical process that combines a large number of lower speed transmission lines into one high speed line by splitting the total available bandwidth into narrower bands (frequency division), or by allotting a common channel to several different transmitting devices, one at a time in sequence (time division).
NAP	Network Access Point. A location at which ISPs exchange traffic with each other.
OC-3	A data communications circuit capable of transmitting data at 155 Mbps.
OC-12	A data communications circuit capable of transmitting data at 622 Mbps.
OC-48	A data communications circuit capable of transmitting data at approximately 2.45 Gbps.
PBX	Private Branch eXchange. A PBX, sometimes known as a phone switch or phone switching device, is a device that connects office telephones in a business with the PSTN. The functions of a PBX include routing incoming calls to the appropriate extension in an office, sharing phone lines between extensions, automated greetings for callers using recorded messages, dialing menus, connections to voicemail, automatic call distribution and teleconferencing.

peering	The commercial practice under which ISPs exchange traffic with each other. Although ISPs are free to make a private commercial arrangement, there are generally two types of peering. With a settlement free peering arrangement the ISPs do not need to pay each other for the exchange of traffic. With paid peering, the larger ISP receives payment from the smaller ISP to carry the traffic of that smaller ISP. Peering occurs at both public and private exchange points.
POP	Point of Presence. Telecommunications facility where a communications provider locates network equipment used to connect customers to its network backbone.
private line	A dedicated telecommunications connection between end user locations.
PSTN	Public Switched Telephone Network. That portion of a local exchange company's network available to all users generally on a shared basis (i.e., not dedicated to a particular user). Traffic along the public switched network is generally switched at the local exchange company's central offices.
Public Safety Answering Point	An answering location for 911 calls originating in a given area. PSAPs are typically a common bureau used to answer emergency calls and dispatch safety agencies such as police, fire, emergency medical, etc.
RBOCs	Regional Bell Operating Companies. Originally, the seven local telephone companies established as a result of the AT&T Divestiture.
reciprocal compensation	The compensation of a CLEC for termination of a local call by the ILEC on the CLEC's network, which is the same as the compensation that the CLEC pays the ILEC for termination of local calls on the ILEC's network.
resale	Resale by a provider of telecommunications services (such as a LEC) of such services to other providers or carriers on a wholesale or a retail basis.
router	Equipment placed between networks that relays data to those networks based upon a destination address contained in the data packets being routed.
selective router	Telephone switch or functional equivalent, controlled by the relevant local exchange carrier (LEC), which determines the PSAP to which a 911 call should be delivered based on the location of the 911 caller.
SONET	Synchronous Optical Network. An electronics and network architecture for variable bandwidth products which enables transmission of voice, data and video (multimedia) at very high speeds. SONET ring architecture provides for virtually instantaneous restoration of service in the event of a fiber cut or equipment failure by automatically rerouting traffic in the opposite direction around the ring.

special access services	The lease of private, dedicated telecommunications lines or "circuits" along the network of a local exchange company or a CAP, which lines or circuits run to or from the long distance carrier POPs. Examples of special access services are telecommunications lines running between POPs of a single long distance carrier, from one long distance carrier POP to the POP of another long distance carrier or from an end user to a long distance carrier POP.
streaming	Streaming is the delivery of media, such as movies and live presentations, over a network in real time. A computer (a streaming server) sends the media to another computer (a client computer), which plays the media as it is delivered.
switch	A device that selects the paths or circuits to be used for transmission of information and establishes a connection. Switching is the process of interconnecting circuits to form a transmission path between users and it also captures information for billing purposes.
Tbps	Terabits per second. A transmission rate. One terabit equals 1.024 trillion bits of information.
T-1	A data communications circuit capable of transmitting data at 1.544 Mbps.
unbundled	Services, programs, software and training sold separately from the hardware.
unbundled access	Access to unbundled elements of a telecommunications services provider's network including network facilities, equipment, features, functions and capabilities, at any technically feasible point within such network.
VoIP	Voice over Internet Protocol
VPC	VoIP Positioning Center. An entity that maintains an end user location database and manages the technology including query keys and routing number pools used to deliver 911 calls to the correct PSAP for emergency handling.
web site	A server connected to the Internet from which Internet users can obtain information.
wireless	A communications system that operates without wires. Cellular service is an example.
world wide web or web	A collection of computer systems supporting a communications protocol that permits multimedia presentation of information over the Internet.
xDSL	A term referring to a variety of newer Digital Subscriber Line technologies. Some of these newer varieties are asymmetric with different data rates in the downstream and upstream directions. Others are symmetric. Downstream speeds range from 384 Kbps (or "SDSL") to 1.5 to 8 Mbps ("ADSL").

## Directors and Executive Officers

Set forth below is information as of February 27, 2009, about our directors and our executive officers. Our executive officers have been determined in accordance with the rules of the SEC.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Walter Scott, Jr.	77	Chairman of the Board
James Q. Crowe	59	Chief Executive Officer and Director
Jeffrey K. Storey	48	President and Chief Operating Officer
Charles C. Miller, III	56	Vice Chairman, Executive Vice President and Director
Sunit S. Patel	47	Executive Vice President and Chief Financial Officer
Thomas C. Stortz	57	Executive Vice President, Chief Legal Officer and Secretary
Eric J. Mortensen	50	Senior Vice President and Controller
R. Douglas Bradbury	58	Director
Douglas C. Eby(1)	49	Director
Admiral James O. Ellis, Jr.(3)	61	Director
Richard R. Jaros(2)	57	Director
Robert E. Julian(1)	69	Director
Michael J. Mahoney(2)	58	Director
Arun Netravali(2)	62	Director
John T. Reed(1)(3)	65	Director
Michael B. Yanney(3)	75	Director
Dr. Albert C. Yates(2)	67	Director

- (1) Member of Audit Committee  
(2) Member of Compensation Committee  
(3) Member of Nominating and Governance Committee

## Other Management

Set forth below is information as of February 27, 2009, about the following members of senior management of Level 3 Communications, LLC.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Sureel A. Choksi	36	Chief Marketing Officer
Andrew Crouch	38	President Wholesale Markets Group
James Heard	46	President European Markets Group
Jeffrey Tench	36	President Business Markets Group
Grant van Rooyen	35	President Content Markets Group
John F. Waters, Jr.	43	President Operations, Chief Technology Officer
Kevin T. Hart	42	Chief Information Officer

Walter Scott, Jr. has been the Chairman of the Board of the Company since September 1979, and a director of the Company since April 1964. Mr. Scott has been Chairman Emeritus of Peter Kiewit Sons', Inc. ("PKS") since the split-off in 1998. Mr. Scott is also a director of PKS, Berkshire Hathaway Inc., MidAmerican Energy Holdings Company, and Valmont Industries, Inc.

James Q. Crowe has been the Chief Executive Officer of the Company since August 1997, and a director of the Company since June 1993. Mr. Crowe was also President of the Company until July 2000. Mr. Crowe was President and Chief Executive Officer of MFS Communications Company, Inc. ("MFS") from June 1993 to June 1997. Mr. Crowe also served as Chairman of the Board of WorldCom from January 1997 until July 1997, and as Chairman of the Board of MFS from 1992 through 1996.

Jeffrey K. Storey has been the President and Chief Operating Officer of the Company since December 2008. From December 2005 until May 2008, Mr. Storey, was President—Leucadia Telecommunications Group of Leucadia National Corporation, where he directed and managed Leucadia's investments in telecommunications companies. Prior to that, beginning in October 2002 Mr. Storey was President and Chief Executive Officer of WilTel Communications Group, LLC until its sale to the Company in December 2005. Prior to this position, Mr. Storey was Senior Vice President—Chief Operations Officer, Network for Williams Communications, Inc., where he had responsibility for all areas of operations for the company's communications network, including planning, engineering, field operations, service delivery and network management.

Charles C. Miller, III has been Vice Chairman and Executive Vice President of the Company since February 15, 2001. Mr. Miller has also been a director of the Company since February 19, 2009. Mr. Miller was previously a director from February 2001 until May 2004. Prior to joining the Company, Mr. Miller was President of Bellsouth International, a subsidiary of Bellsouth Corporation from 1995 until December 2000. Prior to that, Mr. Miller held various senior level officer and management position at BellSouth from 1987 until 1995.

Sunit S. Patel has been Chief Financial Officer and an Executive Vice President of the Company since March 2008. Prior to that, Mr. Patel was Chief Financial Officer from May 2003 and a Group Vice President of the Company from March 13, 2003 to March 2008. Prior to that, Mr. Patel was Chief Financial Officer of Looking Glass Networks, Inc., a provider of metropolitan fiber optic networks, from April 2000 until March 2003. Mr. Patel was Treasurer of WorldCom Inc. and MCIWorldcom Inc., each long distance telephone services providers from 1997 to March 2000. From 1994 to 1997, Mr. Patel was Treasurer of MFS Communications Company Inc., a competitive local exchange carrier.

Thomas C. Stortz has been Executive Vice President, Chief Legal Officer and Secretary since February 2004. Prior to that, Mr. Stortz was Group Vice President, General Counsel and Secretary of the Company from February 2000 to February 2004. Prior to that, Mr. Stortz served as Senior Vice President, General Counsel and Secretary of the Company from September 1998 to February 1, 2000. Prior to that, he served as Vice President and General Counsel of Peter Kiewit Sons', Inc. and Kiewit Construction Group, Inc. from April 1991 to September 1998. He has served as a director of Peter Kiewit Sons', Inc.

Eric J. Mortensen has been Senior Vice President and Controller of the Company since 2003. Prior to that, Mr. Mortensen was Vice President and Controller of the Company from 1999 to 2003 and was the Controller of the Company from 1997 to 1999. Prior to that, Mr. Mortensen was Controller and Assistant Controller of Kiewit Diversified Group for more than five years.

R. Douglas Bradbury has been a director of the Company since February 19, 2009. Mr. Bradbury is a private investor. Mr. Bradbury served as Vice Chairman of the Company from 2000 to 2003 and as Executive Vice President and Chief Financial Officer of the Company from 1997 to 2000. Mr. Bradbury was previously a member of the Company's Board from 1997 to 2003. Prior to joining Level 3, Mr. Bradbury was Executive Vice President and Chief Financial Officer of MFS Communications Company, Inc. until its purchase by WorldCom, Inc. in 1996. He currently serves on the board of directors of LodgeNet Interactive Corporation, a leading provider of media and connectivity solutions designed to meet the needs of hospitality, healthcare and other guest-based businesses.

Douglas C. Eby has been a director of the Company since August 2007. Mr. Eby is chairman and CEO of TimePartners LLC, an investment advisory firm since 2004. Prior to that from April 1997 until September 2007, Mr. Eby was President of Torray LLC, a registered investment advisory firm, having joined Torray LLC in 1992. Mr. Eby is also a member of the Board of Directors of Markel Corporation, a specialty insurance company, Realty Finance Corporation, a commercial real estate specialty finance company, and Suburban Healthcare System. Since July 2007, Mr. Eby is also a

member of the Board and past Chairman of the Boys and Girls Clubs of Greater Washington, D.C. Mr. Eby is a member of the Audit Committee.

Admiral James O. Ellis, Jr. U.S. Navy (ret.) has been a director of the Company since March 2005. Effective May 18, 2005, Admiral Ellis became the president and chief executive officer of the Institute of Nuclear Power Operations or INPO, a nonprofit corporation established by the nuclear utility industry in 1979 to promote the highest levels of safety and reliability in the operation of nuclear electric generating plants. Admiral Ellis most recently served as Commander, U.S. Strategic Command in Omaha, Nebraska, before retiring in July 2004 after 35 years of service in the U.S. Navy, as Commander of the Strategic Command. In his Naval career, he held numerous commands. A graduate of the U.S. Naval Academy, he also holds M.S. degrees in Aerospace Engineering from the Georgia Institute of Technology and in Aeronautical Systems from the University of West Florida. He served as a Naval aviator and was a graduate of the U.S. Naval Test Pilot School. Admiral Ellis is also a member of the Board of Directors of Lockheed Martin Corporation, a global security company and Inmarsat PLC, an owner and operator of geostationary satellites from which a wide range of voice and high-speed data services are provided. Admiral Ellis is the Chairman of the Nominating and Governance committee.

Richard R. Jaros has been a director of the Company since June 1993 and served as President of the Company from 1996 to 1997. Mr. Jaros has been a private investor for more than the past five years. Mr. Jaros served as Executive Vice President of the Company from 1993 to 1996 and Chief Financial Officer of the Company from 1995 to 1996. He also served as President and Chief Operating Officer of CalEnergy from 1992 to 1993. Mr. Jaros is the Chairman of the Compensation Committee.

Robert E. Julian has been a director of the Company since March 1998. Mr. Julian has been a private investor for more than the past five years. From 1992 to 1995 Mr. Julian served as Executive Vice President and Chief Financial Officer of the Company. Mr. Julian is a member of the Audit Committee.

Michael J. Mahoney has been a director of the Company since August 2007. Mr. Mahoney is a private investor since March 2007. From 2000 until March 2007, Mr. Mahoney was the president and chief executive officer of Commonwealth Telephone Enterprises. Prior to that, from 1997 until 2000, Mr. Mahoney was president and chief operating officer of RCN Corporation. Mr. Mahoney also served as president and chief operating officer of C-TEC Corporation from 1993 until 1997. Mr. Mahoney is a member of the Board of Trustees of Wilkes University. Mr. Mahoney is a member of the Compensation Committee.

Arun Netravali has been a director of the Company since April 2003. Mr. Netravali is currently the managing partner of OmniCapital Group LLC, a venture capital firm since November 2004. Mr. Netravali was a private investor from April 2003 until November 2004. Prior to that, Mr. Netravali was Chief Scientist for Lucent Technologies, working with academic and investment communities to identify and implement important new networking technologies from January 2002 to April 2003. Prior to that position, Mr. Netravali was President of Bell Labs as well as Lucent's Chief Technology Officer and Chief Network Architect from June 1999 to January 2002. Bell Labs serves as the research and development organization for Lucent Technologies. Mr. Netravali is a director of LSI Corporation, a leading provider of innovative silicon, systems and software technologies. Mr. Netravali is a member of the Compensation Committee.

John T. Reed has been a director of the Company since March 2003. Mr. Reed has been a private investor since February 2005. Mr. Reed is also a Director of and Chairman of the Audit Committee of First National Nebraska, Inc. and a Director of, and a member of the Audit, Nominating, Investment and Compensation committees of Investors Real Estate Trust, a real estate investment trust. Mr. Reed is also Chairman-Elect of Boys Town, located in Boys Town, Nebraska. Mr. Reed was Chairman of HMG Properties, the real estate investment banking joint venture of McCarthy Group, Inc. from 2000



until February 2005. Prior to that, he was Chairman of McCarthy & Co., the investment banking affiliate of McCarthy Group. Prior to joining McCarthy Group in 1997, Mr. Reed spent 32 years with Arthur Andersen LLP. Mr. Reed is the Chairman of the Audit Committee and a member of the Nominating and Governance Committee.

Michael B. Yanney has been a director of the Company since March 1998. He has served as Chairman of the Board of The Burlington Capital Group, LLC (formerly known as America First Companies L.L.C.) for more than the last five years. Mr. Yanney also served as President and Chief Executive Officer of The Burlington Capital Group, LLC. Mr. Yanney is a member of the Nominating and Governance Committee.

Dr. Albert C. Yates has been a director of the Company since March 2005. Dr. Yates retired after 13 years as president of Colorado State University in Fort Collins, Colorado in June 2003. He was also chancellor of the Colorado State University System until October 2003, and is a former member of the board of the Federal Reserve Board of Kansas City-Denver Branch and the board of directors of First Interstate Bank and Molson Coors Brewing Company. He currently serves as a director of Guaranty Bancorp, a bank holding company that operates 34 branches in Colorado through a single bank, Guaranty Bank and Trust Company, and StarTek, Inc., a leading provider of high value business process outsourcing services to the communications industry. Dr. Yates is a member of the Compensation Committee.

Sureel A. Choksi has been Chief Marketing Officer since January 2008, responsible for product management and marketing. Prior to that, Mr. Choksi was President Wholesale Markets Group from August 2006 to January 2008. Prior to that, Mr. Choksi was Executive Vice President of Switched Services from January 2006 to August 2006. Prior to this role, Mr. Choksi was Executive Vice President of Services from November 2004 to January 2006, responsible for developing and managing Level 3's communications services. Prior to that, Mr. Choksi was Executive Vice President Softswitch Services from January 2004 and Group Vice President Transport and Infrastructure from May 2003 until January 2004. Mr. Choksi was a Group Vice President and Chief Financial Officer of the Company from July 2000 to May 2003. Prior to that, Mr. Choksi was Group Vice President Corporate Development and Treasurer of the Company from February 2000 until August 2000. Prior to that, Mr. Choksi served as Vice President and Treasurer of the Company from January 1999 to February 2000. Prior to that, Mr. Choksi was a Director of Finance at the Company from 1997 to 1998, an Associate at TeleSoft Management, LLC in 1997 and an Analyst at Gleacher & Company from 1995 to 1997.

Andrew Crouch has been the President of the Wholesale Markets Group since January 2008, after serving as Group Vice President of Sales for the Wholesale Markets Group beginning in April 2006. Prior to that, Mr. Crouch served as the Senior Vice President of the Carrier Channel from January 2005 to April 2006, and Senior Vice President of the Enterprise Voice Services from January 2004 to January 2005. Mr. Crouch began his career at Level 3 in November 2001 as the Senior Vice President of Sales for the Cable and ISP Channel and held this position until December 2003. Before joining Level 3, Mr. Crouch served as the Deputy General Manager within the Corporate Clients Division at British Telecom. He also served as the Vice President of Commercial Operations for Concert Communications, a joint venture between British Telecom and AT&T from January 2000 to October 2001.

Jeffrey Tench has been the President of the Business Markets Group since November 2008, after serving as Group Vice President for Product Management beginning earlier in 2008. Prior to that, Mr. Tench served as the Senior Vice President of Product Management for Enterprise Products from March 2007 to January 2008. Mr. Tench began his career at Level 3 in 1999, and has held a range of product management positions across the entire Level 3 portfolio, including two years as Senior Vice President of Product for Level 3's European Markets Group. Before joining the Company, Mr. Tench served in a range of sales and product management positions at U S WEST Communications.

James Heard has been the President of the European Markets Group since April 2008. Prior to that, Mr. Heard was Managing Director for the European Markets Group from March 2007 to April 2008. From 1996 until 2007, Mr. Heard worked for British Telecommunications, in a number of senior management roles, including serving as the General Manager, Financial Services Group within BT Global services. He also served as the Vice President of Commercial Operations, Global accounts for Concert Communications, a joint venture between British Telecom and AT&T from January 2000 to June 2002. Prior to British Telecommunications, Mr. Heard served as Regional Sales Manager for Olivetti UK from March 1990 until June 1996.

Grant van Rooyen has been President of the Content Markets Group since April 2008. From March 2008 until April 2008, Mr. van Rooyen was the Group Vice President of the Content Markets Group with responsibility for sales, offer management, operations, research and development and a number of services including the Vyvx and CDN businesses. Mr. van Rooyen was the Senior Vice President of Marketing for the Company from February 2006 until January 2008, responsible for all Marketing activity in the Company. He has also served as the Senior Vice President of Product Management and Delivery for various services, including colocation, Internet services, Vyvx and CDN. Mr. van Rooyen was based in Europe and worked in our European business from 2004 through 2006 where he was the Vice President for Product Management, Delivery and Marketing. Mr. van Rooyen joined Level 3 in 1999 in London and held positions in International Business Development and Global Submarine Services. He joined Level 3 from the Global Satellite Services Division at British Telecom where he managed finance and commercial operations.

John F. Waters, Jr. has been President Operations, Chief Technology Officer since January 2008. Prior to that, Mr. Waters was Executive Vice President, Chief Technology Officer from January 2004 to January 2008. Prior to that, Mr. Waters was Group Vice President and Chief Technology Officer of the Company from February 2000 to January 2004. Prior to that, Mr. Waters was Vice President, Engineering of the Company from November 1997 until February 2000. Prior to that, Mr. Waters was an executive staff member of MCI Communications from 1994 to November 1997.

Kevin T. Hart has been Chief Information officer since January 2008. Prior to that, Mr. Hart was Group Vice President Global Systems Development and Chief Information Officer from January 2005 to 2008. Prior to that, Mr. Hart was Vice President of Telecommunications, Media & Entertainment at Capgemini (formerly Ernst & Young), a management consulting firm in Dallas, Texas, for over nine years. In that role, he was responsible for the overall growth and direction of the organization's Communications Operations Support Systems, Billing/Business Support Systems and the Network Management Systems service offerings and delivery. Prior to joining Capgemini's management consulting practice, he held the positions of Director of Strategic Planning at International Paper and Manager of Operations at SBC Communications.

At our 2009 Annual Meeting of Stockholders, the term of office of all of our directors will expire. At each annual meeting of stockholders, successors to the directors whose term expires at that annual meeting will be elected for a one-year term. Our officers are elected annually to serve until each successor is elected and qualified or until his or her death, resignation or removal.

We believe that the members of the Audit Committee are independent within the meaning of the listing standards of The NASDAQ Stock Market, LLC. The Board has determined that Mr. John T. Reed, Chairman of the Audit Committee, qualifies as a "financial expert" as defined by the Securities and Exchange Commission. The Board considered Mr. Reed's credentials and financial background and found that he was qualified to serve as the "financial expert."

## **Our website**

Our website is [www.level3.com](http://www.level3.com) . We caution you that any information that is included in our website is not part of this Form 10-K.

## **Code of Ethics**

We have adopted a code of ethics that complies with the standards mandated by the Sarbanes-Oxley Act of 2002. The complete code of ethics is available on our website at [www.level3.com](http://www.level3.com). At any time that the code of ethics is not available on our website, we will provide a copy upon written request made to Investor Relations, Level 3 Communications, Inc., 1025 Eldorado Blvd., Broomfield, Colorado 80021. We caution you that any information that is included in our website is not part of this Form 10-K. If we amend the code of ethics, or grant any waiver from a provision of the code of ethics that applies to our executive officers or directors, we will publicly disclose such amendment or waiver as required by applicable law, including by posting such amendment or waiver on our website at [www.level3.com](http://www.level3.com) or by filing a Form 8-K with the Securities and Exchange Commission or SEC.

## **SEC Filings**

Our Form 10-K, along with all other reports and amendments filed with or furnished to the SEC are publicly available free of charge on the investor relations section of our website as soon as reasonably practicable after we file such materials with, or furnish them to, the SEC. We caution you that the information on our website is not part of this or any other report we file with, or furnish to, the SEC.

## **Section 16(a)—Beneficial Ownership Reporting Compliance**

Except as described below, to our knowledge, no person that was a director, executive officer or beneficial owner of more than 10% of the outstanding shares of our common stock failed to timely file all reports required under Section 16(a) of the Securities Exchange Act of 1934. With respect to ten open market purchases of our 6% Convertible Subordinated Notes due 2010, our director, Robert E. Julian, did not timely file a Form 4.

## **Employees**

As of December 31, 2008, we had approximately 5,300 total employees. We believe that our success depends in large part on our ability to attract and retain substantial numbers of qualified employees.

## **ITEM 1A. RISK FACTORS**

### **Forward Looking Statements**

We, or our representatives, from time to time may make or may have made certain forward-looking statements, either orally or in writing, including without limitation statements made or to be made in this Form 10-K, our Quarterly Reports on Form 10-Q, information contained in other filings with the SEC, press releases and other public documents or statements. In addition, our representatives, from time to time, participate in speeches and calls with market analysts, conferences with investors or potential investors in our securities and other meetings and conferences. Some of the information presented at these speeches, calls, meetings and conferences may include forward-looking statements. We use words like "plans," "estimates," "expects," "anticipates" or "believes" to identify forward-looking statements.

We wish to ensure that all forward-looking statements are accompanied by meaningful cautionary statements, so as to ensure to the fullest extent possible the protections of the safe harbor established in the Private Securities Litigation Reform Act of 1995. Accordingly, all forward-looking statements are qualified in their entirety by reference to, and are accompanied by, the following discussion of certain important factors that could cause actual results to differ materially from those projected in these forward-looking statements. We caution the reader that this list of important factors may not be exhaustive. We operate in a rapidly changing business, and new risk factors emerge from time to time.

We cannot predict every risk factor, nor can we assess the effect, if any, of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those projected in any forward-looking statements. Accordingly, forward-looking statements should not be relied upon as a prediction of actual results. Further, we undertake no obligation to update forward-looking statements after the date they are made to conform the statements to actual results or changes in our expectations.

## **Risks Related to our Business**

### ***Current uncertainty in the global financial markets and the global economy may negatively affect our financial results.***

Current uncertainty in the global financial markets and economy may negatively affect our financial results. A prolonged period of economic decline could have a material adverse effect on our results of operations and financial condition and exacerbate some of the other risk factors we have described below. Our customers may defer purchases of our services in response to tighter credit and negative financial news or reduce their demand for our services. Our customers may also not be able to obtain adequate access to credit, which could affect their ability to make timely payments to us or ultimately cause the customer to file for protection from creditors under applicable insolvency or bankruptcy laws. If our customers are not able to make timely payments to us, our accounts receivable could increase.

In addition, our operating results and financial condition could be negatively affected if as a result of economic conditions:

- customers defer or forgo purchases of our services;
- customers are unable to make timely payments to us;
- the demand for, and prices of, our services are reduced as a result of actions by our competitors or otherwise;
- key suppliers upon which we rely are unable to provide us with the materials we need for our network on a timely basis; or
- our financial counterparties, insurance providers or other contractual counterparties are unable to, or do not meet, their contractual commitments to us.

For more information, please see the risk factor below under the caption, "Termination of relationships with key suppliers could cause delay and additional costs."

### ***Recent disruptions in the financial markets could affect our ability to obtain debt or equity financing or to refinance our existing indebtedness on reasonable terms (or at all), and have other adverse effects on us.***

Widely documented commercial credit market disruptions have resulted in a tightening of credit markets worldwide. Liquidity in the global credit markets have been severely contracted by these market disruptions, making it costly to obtain new lines of credit or to refinance existing debt, when debt financing is available at all. The effects of these disruptions are widespread and difficult to quantify, and it is impossible to predict when the global credit markets will improve or when the credit contraction will stop. As a result of the ongoing credit market turmoil, we may not be able to obtain debt or equity financing or to refinance our existing indebtedness on favorable terms (or at all), which could affect our strategic operations and our financial performance and force modifications to our operations.

If we were unable to refinance our debt or to raise additional capital on acceptable terms, our ability to operate our business would be impaired. As of December 31, 2008, we had an aggregate of approximately \$6.580 billion of long-term debt on a consolidated basis, including current maturities,

premiums and discounts, capital leases and our commercial mortgage, and approximately \$876 million of stockholders' equity. Of this long-term debt, approximately \$186 million is due to mature in 2009, approximately \$583 million is due to mature in 2010 and approximately \$569 million is due to mature in 2011, in each case excluding issue discounts, premiums and fair value adjustments. For more information, please see the risk factor below under the caption "We may not be able to repay our existing debt; failure to do so or refinance the debt could prevent us from implementing our strategy and realizing anticipated profits."

### ***Communications Group***

***Our financial condition and growth depends upon the successful integration of our acquired businesses. We may not be able to efficiently and effectively integrate acquired operations, and thus may not fully realize the anticipated benefits from such acquisitions.***

Achieving the anticipated benefits of the acquisitions that we have completed starting in December 2005 will depend in part upon whether we can integrate our businesses in an efficient and effective manner.

Since December 2005, we have acquired, in chronological order, WilTel Communications Group, LLC, Progress Telecom, LLC, ICG Communications, Inc., TelCove, Inc., Looking Glass Networks Holding Co., Inc., Broadwing Corporation, the CDN services business of SAVVIS, and Servecast Limited. In the future we may acquire additional businesses in accordance with our business strategy. The integration of our acquired businesses and any future businesses that we may acquire involves a number of risks, including, but not limited to:

- demands on management related to the significant increase in size after the acquisition;
- the disruption of ongoing business and the diversion of management's attention from the management of daily operations to the integration of operations;
- failure to fully achieve expected synergies and costs savings;
- unanticipated impediments in the integration of departments, systems, including accounting systems, technologies, books and records and procedures, as well as in maintaining uniform standards, controls, including internal control over financial reporting required by the Sarbanes-Oxley Act of 2002, procedures and policies;
- loss of customers or the failure of customers to order incremental services that we expect them to order;
- failure to provision services that are ordered by customers during the integration period;
- higher integration costs than anticipated; and
- difficulties in the assimilation and retention of highly qualified, experienced employees, many of whom are geographically dispersed.

Successful integration of these acquired businesses or operations will depend on our ability to manage these operations, realize opportunities for revenue growth presented by strengthened service offerings and expanded geographic market coverage, obtain better terms from our vendors due to increased buying power, and eliminate redundant and excess costs to fully realize the expected synergies. Because of difficulties in combining geographically distant operations and systems which may not be fully compatible, we may not be able to achieve the financial strength and growth we anticipate from the acquisitions.

We cannot be certain that we will realize our anticipated benefits from our acquisitions, or that we will be able to efficiently and effectively integrate the acquired operations as planned. If we fail to integrate the acquired businesses and operations efficiently and effectively or fail to realize the benefits we anticipate, we would be likely to experience material adverse effects on our business, financial condition, results of operations and future prospects.

***We need to continue to increase the volume of traffic on our network to become and/or remain profitable.***

We must continue to increase the volume of data, voice and content transmissions on our communications network at acceptable prices in order to realize our targets for anticipated revenue growth, cash flow, operating efficiencies and the cost benefits of our network. If we do not maintain or improve our current relationships with existing customers and develop new large volume and enterprise customers, we may not be able to substantially increase traffic on our network, which would adversely affect our ability to become and/or remain profitable.

***Intellectual property and proprietary rights of others could prevent us from using necessary technology to provide our services or subject us to expensive intellectual property litigation.***

If technology that is necessary for us to provide our services was determined by a court to infringe a patent held by another entity that is unwilling to grant us a license on terms acceptable to us, we could be precluded by a court order from using that technology and we would likely be required to pay a significant monetary damages award to the patent-holder. The successful enforcement of these patents, or our inability to negotiate a license for these patents on acceptable terms, could force us to cease using the relevant technology and offering services incorporating the technology. In the event that a claim of infringement was brought against us based on the use of our technology or against our customers based on their use of our services for which we are obligated to indemnify, we could be subject to litigation to determine whether such use or sale is, in fact, infringing. This litigation could be expensive and distracting, regardless of the outcome of the suit.

While our own patent portfolio may deter other operating companies from bringing such actions, patent infringement claims are increasingly being asserted by patent holding companies, which do not use technology and whose sole business is to enforce patents against operators, such as us, for monetary gain. Because such patent holding companies, commonly referred to as patent "trolls," do not provide services or use technology, the assertion of our own patents by way of counter-claim would be largely ineffective. We have already been the subject of time-consuming and expensive patent litigation brought by certain patent holding companies and we can reasonably expect that we will face further claims in the future, particularly if legislation now discussed in Congress is not enacted in a way that will decrease the number and frequency of claims by patent trolls.

***Our business requires the continued development of effective business support systems to implement customer orders and to provide and bill for services.***

Our business depends on our ability to continue to develop effective business support systems. In certain cases, the development of these business support systems is required to realize our anticipated benefits from our acquisitions. This is a complicated undertaking requiring significant resources and expertise and support from third-party vendors. Following the development of the business support systems, the data migration regarding network and circuit inventory must be completed for the full benefit of the systems to be realized. Business support systems are needed for:

- accepting and inputting customer orders for services;
- provisioning, installing and delivering these services; and
- billing for these services.

Because our business provides for continued rapid growth in the number of customers that we serve and the volume of services offered as well as requires the integration of acquired companies' business support systems, there is a need to continue to develop our business support systems on a schedule sufficient to meet proposed milestone dates. The failure to continue to develop effective unified business support systems could materially adversely affect our ability to implement our business plans, realize anticipated benefits from our acquisitions and meet our financial goals and objectives.

***Our revenue is concentrated in a limited number of customers.***

A significant portion of our communications revenue is concentrated among a limited number of customers. For the year ended December 31, 2008, our top ten customers represented approximately 31% of our consolidated total revenue. Revenue from our largest customer, AT&T Inc. and its subsidiaries, represented approximately 12% of our consolidated total revenue for 2008. The next largest customer accounted for approximately 5% of our consolidated total revenue and most of the remaining top ten customers each account for 3% or less of our consolidated total revenue. If we lost one or more of our top five customers, or, subject to the following, if one or more of these major customers significantly decreased orders for our services, our business would be materially and adversely affected.

In connection with the acquisition of WilTel in December 2005, we acquired a large customer contract between WilTel and SBC Communications, a subsidiary of AT&T, which we refer to as the SBC Master Services Agreement. We recognized \$201 million and \$303 million of revenue under the SBC Master Services Agreement during 2008 and 2007, respectively. The agreement provided a gross margin purchase commitment of \$335 million, which was fully satisfied in 2008. However, AT&T, Inc., continues to purchase services from us under the SBC Master Services Agreement as it continues to migrate the services provided under the agreement to its own network facilities. As a result of the satisfaction of the gross margin purchase commitment, we expect that the revenue generated under the SBC Master Services Agreement will continue to decline. For more information regarding the SBC Master Services Agreement, please see the discussion in "Management's Discussion and Analysis of Financial Condition and Results of Operations."

***We may lose customers if we experience system failures that significantly disrupt the availability and quality of the services that we provide. System failures may also cause interruptions to service delivery and the completion of other corporate functions.***

Our operations depend on our ability to avoid and mitigate any interruptions or degradation in service for customers. Interruptions in service or performance problems, for whatever reason, could undermine confidence in our services and cause us to lose customers or make it more difficult to attract new ones. In addition, because many of our services are critical to the businesses of many of our customers, any significant interruption or degradation in service could result in lost profits or other losses to customers. Although we generally limit our liability for service failures in our service agreements to limited service credits, generally in the form of free service for a short period of time and we generally exclude any liability for "consequential" damages such as lost profits, a court might not enforce these limitations on liability, which could expose us to financial loss. In addition, we often provide our customers with committed service levels. If we are unable to meet these service level commitments, we may be obligated to provide service credits or other compensation to our customers, which could negatively affect our operating results.

The failure of any equipment or facility on our network, including our network operations control centers and network data storage locations, could result in the interruption of customer service and other corporate functions until necessary repairs are effected or replacement equipment is installed. In addition, our business continuity plans may not be adequate to address a particular failure that we experience. Delays, errors, network equipment or network facility failures, including with respect to our



network operations control centers and network data storage locations, could also result from natural disasters, disease, accidents, terrorist acts, power losses, security breaches, vandalism or other illegal acts, computer viruses, or other causes. Our business could be significantly hurt from these delays, errors, failures or faults including as a result of:

- service interruptions;
- exposure to customer liability;
- the inability to install new service;
- the unavailability of employees necessary to provide services;
- the delay in the completion of other corporate functions such as issuing bills and the preparation of financial statements; or
- the need for expensive modifications to our systems and infrastructure.

For more information, please see the risk factor below under the caption, "Termination of relationships with key suppliers could cause delay and additional costs."

***There is no guarantee that we will be successful in increasing sales of our content distribution service offering.***

As we believe that one of the largest sources of future incremental demand for our communications services will be derived from customers that are seeking to distribute their video, feature rich content or applications over the Internet, we purchased the content distribution network or CDN assets of SAVVIS, Inc. in January 2007 and we purchased Servecast Limited in July 2007. Although we have sold high speed Internet access, transport and colocation services since the late 1990's, we have only been selling our CDN services since January 2007. As a result, there are many difficulties that we may encounter, including customer acceptance, customer support system development issues, intellectual property matters, technological issues, developmental constraints and other problems that we may not anticipate. There is no guarantee that we will be successful in generating significant revenues from our CDN service offering.

***Failure to develop and introduce new services could affect our ability to compete in the industry.***

We continuously develop, test and introduce new communications services that are delivered over our communications network. These new services are intended to allow us to address new segments of the communications marketplace and to compete for additional customers. In certain instances, the introduction of new services requires the successful development of new technology. To the extent that upgrades of existing technology are required for the introduction of new services, the success of these upgrades may be dependent on reaching mutually-acceptable terms with vendors and on vendors meeting their obligations in a timely manner. In addition, new service offerings may not be widely accepted by our customers. If our new service offerings are not widely accepted by our customers, we may terminate those service offerings and we may be required to impair any assets or technology used to develop or offer those services. If we are not able to successfully complete the development and introduction of new services in a timely manner, our business could be materially adversely affected.

***Rapid technological changes can lead to further competition.***

The communications industry is subject to rapid and significant changes in technology. In addition, the introduction of new services or technologies, as well as the further development of existing services and technologies may reduce the cost or increase the supply of certain services similar to those that we provide. As a result, our most significant competitors in the future may be new entrants to the communications industry. These new entrants may not be burdened by an installed base of outdated



equipment or obsolete technology. Our future success depends, in part, on our ability to anticipate and adapt in a timely manner to technological changes. Failure to do so could have a material adverse effect on our business.

***During our communications business operating history we have generated substantial net operating losses, and we expect to continue to generate net operating losses.***

Our expenditures combined with non-cash compensation expense as well as depreciation and amortization expense could result in substantial net losses for the near future. For the fiscal years ended December 31, 2008 and December 31, 2007, we incurred net losses of approximately \$290 million and \$1.114 billion, respectively. We expect to continue to experience net losses, and we may not be able to achieve or sustain profitability in the future. Continued net losses could limit our ability to obtain the cash needed to expand our network, make interest and principal payments on our debt, or fund other business needs.

We will need to continue to expand and adapt our network in order to remain competitive, which may require significant additional funding. Additional expansion and adaptations of our communications network's electronic and software components will be necessary in order to respond to:

- growing number of customers;
- the development and launching of new services;
- increased demands by customers to transmit larger amounts of data;
- changes in customers' service requirements;
- technological advances by competitors; and
- governmental regulations.

Future expansion or adaptation of our network will require substantial additional financial, operational and managerial resources, which may not be available at the time. If we are unable to expand or adapt our network to respond to these developments on a timely basis and at a commercially reasonable cost, our business will be materially adversely affected.

***The market prices for certain of our communications services have decreased in the past and may decrease in the future, resulting in lower revenue than we anticipate.***

Over the past few years, the market prices for certain of our communications services have decreased. These decreases resulted from downward market pressure and other factors including:

- technological changes and network expansions which have resulted in increased transmission capacity available for sale by us and by our competitors;
- some of our customer agreements contain volume-based pricing or other contractually agreed-upon decreases in prices during the term of the respective agreements; and
- some of our competitors have been willing to accept smaller operating margins in the short term in an attempt to increase long-term revenues.

In order to retain customers and revenue, we often must reduce prices in response to market conditions and trends. As our prices for some of our communications services decrease, our operating results may suffer unless we are unable to either reduce our operating expenses or increase traffic volume from which we can derive additional revenue.

We also expect revenue from our managed modem services to continue to decline primarily as a result of end users migrating to broadband services.

***We may be liable for the information that content owners or distributors distribute over our network.***

The law relating to the liability of private network operators for information carried on or disseminated through their networks is still unsettled. We may become subject to legal claims relating to the content disseminated on our network, even though such content is owned or distributed by our customers or a customer of our customers. For example, lawsuits may be brought against us claiming that material distributed using our network was inaccurate, offensive, or violated the law or the rights of others. Claims could also involve matters such as defamation, invasion of privacy and copyright infringement. In addition, the law remains unclear over whether content may be distributed from one jurisdiction, where the content is legal, into another jurisdiction, where it is not. Companies operating private networks have been sued in the past, sometimes successfully, based on the nature of material distributed, even if the content is not owned by the network operator and the network operator has no knowledge of the content or its legality. It is not practical for us to monitor all of the content which is distributed using our network. If we need to take costly measures to reduce our exposure to these risks, or are required to defend ourselves against such claims, our financial results could be negatively affected.

***The need to obtain additional capacity for our network from other providers increases our costs.***

We use network resources owned by other companies for portions of our network in North America, in Europe and elsewhere. We obtain the right to use such network portions, including both telecommunications capacity and rights to use dark fiber, through operating leases and IRU agreements. In several of those agreements, the counter party is responsible for network maintenance and repair. If a counter party to a lease or IRU suffers financial distress or bankruptcy, we may not be able to enforce our rights to use these network assets or, even if we could continue to use these network assets, we could incur material expenses related to maintenance and repair. We could also incur material expenses if we were required to locate alternative network assets. We may not be successful in obtaining reasonable alternative network assets if needed. Failure to obtain usage of alternative network assets, if necessary, could have a material adverse effect on our ability to carry on business operations. In addition, some of our agreements with other providers require the payment of amounts for services whether or not those services are used.

In the normal course of business, we need to enter into interconnection agreements with many domestic and foreign local telephone companies, but we are not always able to do so on favorable terms. Costs of obtaining local service from other carriers comprise a significant proportion of the operating expenses of long distance carriers. Similarly, a large proportion of the costs of providing international service consists of payments to other carriers. Changes in regulation, particularly the regulation of local and international telecommunication carriers, could indirectly, but significantly, affect our competitive position. These changes could increase or decrease the costs of providing our services.

***We may be unable to hire and retain sufficient qualified personnel; the loss of any of our key executive officers could adversely affect our business.***

We believe that our future success will depend in large part on our ability to attract and retain highly skilled, knowledgeable, sophisticated and qualified managerial, professional and technical personnel. We have experienced significant competition in attracting and retaining personnel who possess the skills that we are seeking. As a result of this significant competition, we may experience a shortage of qualified personnel.

Our businesses are managed by a small number of key executive officers, including James Q. Crowe, Chief Executive Officer. The loss of any of these key executive officers could have a material adverse effect on our business.

***We must obtain and maintain permits and rights-of-way to operate our network.***

If we are unable, on acceptable terms and on a timely basis, to obtain and maintain the franchises, permits and rights-of-way needed to expand and operate our network, our business could be materially adversely affected. In addition, the cancellation or non-renewal of the franchises, permits or rights-of-way that are obtained could materially adversely affect our business. Our communications operating subsidiaries are defendants in several lawsuits that, among other things, challenge the subsidiaries' use of rights-of-way. The plaintiffs have sought to have these lawsuits certified as class actions. It is possible that additional suits challenging use of our rights-of-way will be filed and that those plaintiffs also may seek class certification. The outcome of such litigation may increase our costs and adversely affect our operating results.

***Termination of relationships with key suppliers could cause delay and additional costs.***

Our business is dependent on third-party suppliers for fiber, computers, software, optronics, transmission electronics and related components that are integrated into our network, some of which are critical to the operation of our business. If any of these critical relationships is terminated, a supplier either exits or curtails its business as a result of the current economic conditions, a supplier fails to provide critical services or equipment, or the supplier is forced to stop providing services due to legal constraints, such as patent infringement, and we are unable to reach suitable alternative arrangements quickly, we may experience significant additional costs or we may not be able to provide certain services to customers. If that happens, our business could be materially adversely affected.

***AT&T and Verizon may not provide us local access services at prices which allow us to effectively compete.***

We acquire a significant portion of our local access services, the connection between our owned network and the customer premises, from incumbent local exchange carriers or ILECs. With the recent acquisitions by AT&T and Verizon, the ILECs now compete directly with our business and may have a tendency to favor themselves and their affiliates to our detriment. Network access represents a very large portion of our total costs and if we face less favorable pricing and provisioning, we may be at a competitive disadvantage to the ILECs.

***We are subject to significant regulation that could change in an adverse manner.***

Communications services are subject to significant regulation at the federal, state, local and international levels. These regulations affect our business and our existing and potential competitors. Delays in receiving required regulatory approvals (including approvals relating to acquisitions or financing activities), completing interconnection agreements with other carriers, or the enactment of new and adverse regulations or regulatory requirements may have a material adverse effect on our business. In addition, future legislative, judicial and regulatory agency actions could have a material adverse effect on our business.

Federal legislation provides for a significant deregulation of the U.S. telecommunications industry, including the local exchange, long distance and cable television industries. This legislation remains subject to judicial review and additional Federal Communications Commission, or FCC, rulemaking. As a result, we cannot predict the legislation's effect on our future operations. Many regulatory actions are under way or are being contemplated by federal and state authorities regarding important issues. These actions could have a material adverse effect on our business.

***The laws in certain countries currently do not permit us to offer services directly in those countries.***

Ownership of telecommunications facilities that originate or terminate traffic in certain countries, such as Canada and China, is currently limited to nationals of those countries. This restriction hinders our entry into those markets.

***Potential regulation of Internet service providers in the United States could adversely affect our operations.***

The FCC has, to date, treated Internet service providers as enhanced service providers. In addition, Congress has, to date, not sought to heavily regulate the provision of IP-based services. Both Congress and the FCC are considering proposals that involve greater regulation of IP-based service providers. Depending on the content and scope of any regulations, the imposition of such regulations could have a material adverse effect on our business and the profitability of our services.

***The communications industry is highly competitive with participants that have greater resources and a greater number of existing customers.***

The communications industry is highly competitive. Many of our existing and potential competitors have financial, personnel, marketing and other resources significantly greater than ours. Many of these competitors have the added competitive advantage of a larger existing customer base. In addition, significant new competition could arise as a result of:

- the consolidation in the industry;
- allowing foreign carriers to more extensively compete in the U.S. market;
- further technological advances; and
- further deregulation and other regulatory initiatives.

If we are unable to compete successfully, our business could be significantly affected.

***We may be unable to successfully identify, manage and assimilate future acquisitions, investments and strategic alliances, which could adversely affect our results of operations.***

We continually evaluate potential investments and strategic opportunities to expand our network, enhance connectivity and add traffic to our network. In the future, we may seek additional investments, strategic alliances or similar arrangements, which may expose us to risks such as:

- the difficulty of identifying appropriate investments, strategic allies or opportunities on terms acceptable to us;
- the possibility that senior management may be required to spend considerable time negotiating agreements and monitoring these arrangements;
- potential regulatory issues applicable to the telecommunications business;
- the loss or reduction in value of the capital investment;
- our inability to capitalize on the opportunities presented by these arrangements; and
- the possibility of insolvency of a strategic ally.

There can be no assurance that we would successfully overcome these risks or any other problems encountered with these investments, strategic alliances or similar arrangements.

## **Other Operations**

### ***Environmental liabilities from our historical operations could be material.***

There could be environmental liabilities arising from historical operations of our predecessors, for which we may be liable. Our operations and properties are subject to a wide variety of laws and regulations relating to environmental protection, human health and safety. These laws and regulations include those concerning the use and management of hazardous and non-hazardous substances and wastes. We have made and will continue to make significant expenditures relating to our environmental compliance obligations. Despite our best efforts, we may not at all times be in compliance with all of these requirements.

In connection with certain historical operations, we have responded to or been notified of potential environmental liability at approximately 150 properties as of February 15, 2009. We are engaged in addressing or have liquidated environmental liabilities at 72 of those properties. Of these: (a) we have formal commitments or other potential future costs at 15 sites; (b) there are 10 sites with minimal future costs; (c) there are 12 sites with unknown future costs and (d) there are 35 sites with no likely future costs. The remaining 78 properties have been dormant for several years. We could be held liable, jointly or severally, and without regard to fault, for such investigation and remediation. The discovery of additional environmental liabilities related to historical operations or changes in existing environmental requirements could have a material adverse effect on our business.

### ***Potential liabilities and claims arising from coal operations could be significant.***

Our coal operations are subject to extensive laws and regulations that impose stringent operational, maintenance, financial assurance, environmental compliance, reclamation, restoration and closure requirements. These requirements include those governing air and water emissions, waste disposal, worker health and safety, benefits for current and retired coal miners, and other general permitting and licensing requirements. Despite our best efforts, we may not at all times be in compliance with all of these requirements. Liabilities or claims associated with this non-compliance could require us to incur material costs or suspend production. Mine reclamation costs that exceed reserves for these matters also could require us to incur material costs.

## **General**

***If we are unable to comply with the restrictions and covenants in our debt agreements, there would be a default under the terms of these agreements, and this could result in an acceleration of payment of funds that have been borrowed.***

If we were unable to comply with the restrictions and covenants in any of our debt agreements, there would be a default under the terms of those agreements. As a result, borrowings under other debt instruments that contain cross-acceleration or cross-default provisions may also be accelerated and become due and payable. If any of these events occur, there can be no assurance that we would be able to make necessary payments to the lenders or that we would be able to find alternative financing. Even if we were able to obtain alternative financing, there can be no assurance that it would be on terms that are acceptable.

### ***We have substantial debt, which may hinder our growth and put us at a competitive disadvantage.***

Our substantial debt may have important consequences, including the following:

- the ability to obtain additional financing for acquisitions, working capital, investments and capital or other expenditures could be impaired or financing may not be available on acceptable terms;

- a substantial portion of our cash flows will be used to make principal and interest payments on outstanding debt, reducing the funds that would otherwise be available for operations and future business opportunities;
- a substantial decrease in cash flows from operating activities or an increase in expenses could make it difficult to meet debt service requirements and force modifications to operations;
- we have more debt than certain of our competitors, which may place us at a competitive disadvantage; and
- substantial debt may make us more vulnerable to a downturn in business or the economy generally.

We had deficiencies of earnings to cover fixed charges of \$236 million for the fiscal year ended December 31, 2008, \$1.068 billion for the fiscal year ended December 31, 2007, \$720 million for the fiscal year ended December 31, 2006, \$634 million for the fiscal year ended December 31, 2005, and \$409 million for the fiscal year ended December 31, 2004.

***We may not be able to repay our existing debt; failure to do so or refinance the debt could prevent us from implementing our strategy and realizing anticipated profits.***

If we were unable to refinance our debt or to raise additional capital on acceptable terms, our ability to operate our business would be impaired. As of December 31, 2008, we had an aggregate of approximately \$6.580 billion of long-term debt on a consolidated basis, including current maturities, premiums and discounts, capital leases and our commercial mortgage, and approximately \$876 million of stockholders' equity. Of this long-term debt, approximately \$186 million is due to mature in 2009, approximately \$583 million is due to mature in 2010 and approximately \$569 million is due to mature in 2011, in each case excluding issue discounts, premiums and fair value adjustments.

Our ability to make interest and principal payments on our debt and borrow additional funds on favorable terms depends on the future performance of the business. If we do not have enough cash flow in the future to make interest or principal payments on our debt, we may be required to refinance all or a part of our debt or to raise additional capital. We cannot be sure that we will be able to refinance our debt or raise additional capital on acceptable terms.

***Restrictions and covenants in our debt agreements limit our ability to conduct our business and could prevent us from obtaining needed funds in the future.***

Our debt and financing arrangements contain a number of significant limitations that restrict our ability to, among other things:

- borrow additional money or issue guarantees;
- pay dividends or other distributions to stockholders;
- make investments;
- create liens on assets;
- sell assets;
- enter into sale-leaseback transactions;
- enter into transactions with affiliates; and
- engage in mergers or consolidations.

***The unpredictability of our quarterly results may adversely affect the trading price of our common stock.***

Our revenue and operating results will vary significantly from quarter to quarter due to a number of factors, many of which are outside of our control and any of which may cause the price of our common stock to fluctuate. The primary factors, among other things, that may affect our quarterly results include the following:

- the timing of costs associated with the operation of our business and our integration activities with respect to our recently completed acquisitions;
- demand for communications services;
- loss of customers or the ability to attract new customers;
- changes in pricing policies or the pricing policies of our competitors;
- costs related to acquisitions of technology or businesses;
- changes in regulatory rulings; and
- general economic conditions as well as those specific to the communications and related industries.

A delay in generating revenue or the timing of recognizing revenue and expenses could cause significant variations in our operating results from quarter to quarter. It is possible that in some future quarters our results may be below analysts and investors expectations. In these circumstances, the price of our common stock will likely decrease.

***If certain transactions occur with respect to our capital stock, we may be unable to fully utilize our net operating loss carryforwards to reduce our income taxes.***

As of December 31, 2008, we had net operating loss carry forwards of approximately \$4.7 billion for federal income tax purposes. If certain transactions occur with respect to our capital stock that result in a cumulative ownership change of more than 50 percentage points by 5-percent stockholders over a three-year period as determined under rules prescribed by the U.S. Internal Revenue Code of 1986, as amended (the "Code") and applicable regulations, annual limitations would be imposed with respect to our ability to utilize our net operating loss carry forwards and certain current deductions against any taxable income we achieve in future periods.

We have entered into transactions over the applicable three year period that, when combined with other changes in ownership that are outside of our control, have resulted in cumulative changes in the ownership of our capital stock. Additional transactions that we enter into, as well as transactions by existing 5% stockholders and transactions by holders that become new 5% stockholders that we do not participate in, could cause us to incur a 50 percentage point ownership change by 5% stockholders and, if we trigger the above-noted Code imposed limitations, such transactions would prevent us from fully utilizing net operating loss carry forwards and certain current deductions to reduce income taxes.

***Increased scrutiny of financial disclosure, particularly in the telecommunications industry in which we operate, could adversely affect investor confidence, and any restatement of earnings could increase litigation risks and limit our ability to access the capital markets.***

Congress, the SEC, other regulatory authorities and the media are intensely scrutinizing a number of financial reporting issues and practices. If we were required to restate our financial statements as a result of a determination that we had incorrectly applied generally accepted accounting principles or as a result of other factors or errors, that restatement could adversely affect our ability to access the capital markets or the trading price of our securities. The recent scrutiny regarding financial reporting has also resulted in an increase in litigation in the telecommunications industry. There can be no

assurance that any such litigation against us would not materially adversely affect our business or the trading price of our securities.

***Terrorist attacks and other acts of violence or war may adversely affect the financial markets and our business.***

Since the September 11, 2001 terrorist attacks and subsequent events, there has been considerable uncertainty in world financial markets. The full effect on the financial markets of these events, as well as concerns about future terrorist attacks, is not yet known. They could, however, adversely affect our ability to obtain financing on terms acceptable to us, or at all.

There can be no assurance that there will not be further terrorist attacks against the United States or U.S. businesses. These attacks or armed conflicts may directly affect our physical facilities or those of our customers. These events could cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and world financial markets and economy. Any of these occurrences could materially adversely affect our business.

***Our international operations and investments expose us to risks that could materially adversely affect the business.***

We have operations and investments outside of the United States, as well as rights to undersea cable capacity extending to other countries, that expose us to risks inherent in international operations. These include:

- general economic, social and political conditions;
- the difficulty of enforcing agreements and collecting receivables through certain foreign legal systems;
- tax rates in some foreign countries may exceed those in the U.S.;
- foreign currency exchange rates may fluctuate, which could adversely affect our results of operations and the value of our international assets and investments;
- foreign earnings may be subject to withholding requirements or the imposition of tariffs, exchange controls or other restrictions;
- difficulties and costs of compliance with foreign laws and regulations that impose restrictions on our investments and operations, with penalties for noncompliance, including loss of licenses and monetary fines;
- difficulties in obtaining licenses or interconnection arrangements on acceptable terms, if at all; and
- changes in U.S. laws and regulations relating to foreign trade and investment.

***Additional issuances of equity securities by us would dilute the ownership of our existing stockholders.***

We may issue equity in the future in connection with acquisitions or strategic transactions, to adjust our ratio of debt to equity, including through repayment of outstanding debt, to fund expansion of our operations or for other purposes. To the extent we issue additional equity securities, the percentage ownership of our existing stockholders would be reduced.



***Anti-takeover provisions in our charter and by-laws could limit the share price and delay a change of management.***

Our restated certificate of incorporation and by-laws contain provisions that could make it more difficult or even prevent a third party from acquiring us without the approval of our incumbent board of directors. These provisions, among other things:

- prohibit stockholder action by written consent in place of a meeting;
- limit the right of stockholders to call special meetings of stockholders;
- limit the right of stockholders to present proposals or nominate directors for election at annual meetings of stockholders; and
- authorize our board of directors to issue preferred stock in one or more series without any action on the part of stockholders.

In addition, the terms of most of our long term debt require that upon a "change of control," as defined in the agreements that contain the terms and conditions of the long term debt, we make an offer to purchase the outstanding long term debt at either 100% or 101% of the aggregate principal amount of that long term debt.

These provisions could limit the price that investors might be willing to pay in the future for shares of our common stock and significantly impede the ability of the holders of our common stock to change management. Provisions and agreements that inhibit or discourage takeover attempts could reduce the market value of our common stock.

***If a large number of shares of our common stock is sold in the public market, the sales could reduce the trading price of our common stock and impede our ability to raise future capital.***

We cannot predict what effect, if any, future issuances by us of our common stock will have on the market price of our common stock. In addition, shares of our common stock that we issue in connection with an acquisition may not be subject to resale restrictions. The market price of our common stock could drop significantly if certain large holders of our common stock, or recipients of our common stock in connection with an acquisition, sell all or a significant portion of their shares of common stock or are perceived by the market as intending to sell these shares other than in an orderly manner. In addition, these sales could impair our ability in the future to raise capital through the sale of additional common stock in the capital markets.

***The market price of our common stock has been volatile and, in the future, the market price of our common stock may fluctuate substantially due to a variety of factors.***

The market price of our common stock has been subject to volatility and, in the future, the market price of our common stock may fluctuate substantially due to a variety of factors, including:

- the depth and liquidity of the trading market for our common stock;
- quarterly variations in actual or anticipated operating results;
- changes in estimated earnings by securities analysts;
- market conditions in the communications and information services industries;
- announcement and performance by competitors;
- regulatory actions; and
- general economic conditions.

In addition, in recent months the stock market generally has experienced significant price and volume fluctuations. Those market fluctuations could have a material adverse effect on the market price or liquidity of our common stock.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

Our headquarters are located on 46 acres in the Interlocken Advanced Technology Environment within the City and County of Broomfield, Colorado. The campus facility, which is owned by our wholly owned subsidiary HQ Realty, Inc., encompasses approximately 850,000 square feet of office space.

Additionally, we lease approximately 120,000 square feet of office and technical space in a building located at 180 Peachtree Street, NW in Atlanta, Georgia. We also lease approximately 143,000 square feet of office and technical space in the building known as One Technology Center located at 100 South Cincinnati Avenue in Tulsa, Oklahoma and approximately 42,000 square feet of office space in the Southpointe office park in Canonsburg, Pennsylvania. We also use approximately 8,900 square feet of office space that we own in the building located at 200 Technology Drive, Pittsburgh, Pennsylvania. We also lease approximately 128,000 square feet of office space in a building located at 1122 South Capital of Texas Highway in Austin, Texas. In Europe, we have approximately 211,000 square feet of office space in the United Kingdom and approximately 3,000 square feet of office space in France.

Properties relating to our network operations in the communications business are described under "ITEM 1. BUSINESS—Our Communications Network" above.

Our Gateway facilities are designed to house local sales staff, operational staff, our transmission and IP routing/switching facilities and technical space to accommodate colocation of equipment by high-volume Level 3 customers. We ended 2008 with approximately 6.9 million square feet of space for our Gateway and transmission facilities and have completed construction on approximately 4.6 million square feet of this space. Our Gateway space is either owned by us or is held pursuant to long-term lease agreements.

We have entered into various agreements regarding our unused office and technical space in order to reduce our ongoing operating expenses regarding such space.

Properties relating to our coal mining segment are described under "ITEM 1. BUSINESS—Our Other Businesses" above. In connection with certain existing and historical operations, we are subject to environmental risks.

## **ITEM 3. LEGAL PROCEEDINGS**

In April 2002, Level 3 Communications, Inc., and two of its subsidiaries were named as defendants in *Bauer, et. al. v. Level 3 Communications, LLC, et al.*, a purported class action covering 22 states, filed in state court in Madison County, Illinois. In July 2001, Level 3 was named as a defendant in *Koyle, et. al. v. Level 3 Communications, Inc., et. al.*, a purported two state class action filed in the U.S. District Court for the District of Idaho. In November of 2005, the court granted class certification only for the state of Idaho. In September 2002, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *Smith et. al. v. Sprint Communications Company, L.P., et al.*, a purported nationwide class action filed in the United States District Court for the Northern District of Illinois. In April 2005, the Smith plaintiffs filed a Fourth Amended Complaint which did not include Level 3 or Williams Communications, Inc. as a party, thus ending both companies' involvement in the Smith case. On February 17, 2005, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *McDaniel, et. al., v. Qwest Communications Corporation, et al.*, a purported class action

covering 10 states filed in the United States District Court for the Northern District of Illinois. All of these actions involve the companies' right to install its fiber optic cable network in easements and right-of-ways crossing the plaintiffs' land. In general, the companies obtained the rights to construct their networks from railroads, utilities, and others, and have installed their networks along the rights-of-way so granted. Plaintiffs in the purported class actions assert that they are the owners of lands over which the companies' fiber optic cable networks pass, and that the railroads, utilities, and others who granted the companies the right to construct and maintain their networks did not have the legal authority to do so. The complaints seek damages on theories of trespass, unjust enrichment and slander of title and property, as well as punitive damages. The companies have also received, and may in the future receive, claims and demands related to rights-of-way issues similar to the issues in these cases that may be based on similar or different legal theories.

The Company and its subsidiaries have negotiated a proposed nationwide class settlement affecting persons who own or owned land next to or near railroad rights of way. The United States District Court for the District of Massachusetts in *Kingsborough v. Sprint Communications Co. L.P.* has granted preliminary approval of the proposed settlement which, if finally approved, will resolve all of the pending actions. The proposed settlement will provide cash payments to class members based on various factors that include:

- the length of the right of way where the cable is installed;
- the state where the property is located; and
- how the railroad obtained its property rights.

The proposed settlement will also provide the Company and its subsidiaries with a permanent telecommunications easement, which gives them certain rights over the railroad right of way.

It is still too early for the Company to reach a conclusion as to the ultimate outcome of the proposed settlement of these actions. However, management believes that the Company and its subsidiaries have substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend them vigorously if a satisfactory form of settlement is not ultimately approved. Additionally, management believes that any resulting liabilities for these actions, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could affect future cash flows.

In February 2009, Level 3 Communications, Inc., certain of its current officers and a former officer were named as defendants in purported class action lawsuits filed in the United States District Court for the District of Colorado, which have been consolidated as *In re Level 3 Communications, Inc. Securities Litigation (Civil Case No. 09-cv-00200-PAB-CBS)*. The Plaintiffs in each complaint allege, in general, that throughout the purported class period of February 8, 2007 to October 23, 2007, the defendants failed to disclose material adverse facts about the Company's business and operations. Specifically, defendants failed to disclose or indicate the following: (1) that the Company's efforts to integrate the numerous acquired companies were not going well; (2) that, specifically, the Company was experiencing an increase in service activation times, which was negatively impacting the Company's service installation intervals and the rate of its revenue growth; (3) that the Company was also experiencing challenges in its service management processes that were resulting in longer response times to resolve customer's network service issues; (4) that steps taken by the Company to remedy the problems were not working and actually, further complicating the issues and making them worse; (5) that, as a result of the above, the Company did not have adequate provisioning capability to convert its increasing sales, or signed orders, into revenue generating service; (6) that the Company lacked adequate internal controls; and (7) that, as a result of the above, the statements made by the defendants during the purported class period lacked a reasonable basis. The complaints seek damages based on purported violations of Section 10(b) of the Securities Exchange Act of 1934, Securities and

Exchange Commission Rule 10b-5 promulgated thereunder and Section 20(a) of the Securities Exchange Act of 1934.

It is too early for the Company to reach a conclusion as to the ultimate outcome of these actions. However, management believes that the Company has substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend these actions vigorously.

The Company and its subsidiaries are parties to many other legal proceedings. Management believes that any resulting liabilities for these legal proceedings, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could affect future cash flows.

#### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders, through the solicitation of proxies or otherwise.

## Part II

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

*Market Information.* Our common stock is traded on the NASDAQ Global Select Market of The NASDAQ Stock Market LLC under the symbol "LVL.T." As of February 25, 2009, there were approximately 7,900 holders of record of our common stock, par value \$.01 per share. The table below sets forth, for the calendar quarters indicated, the high and low per share sale prices of our common stock as reported by the NASDAQ Global Select Market of The NASDAQ Stock Market LLC.

<u>Year Ended December 31, 2008</u>	<u>High</u>	<u>Low</u>
First Quarter	\$3.53	\$1.68
Second Quarter	4.48	1.96
Third Quarter	3.90	2.44
Fourth Quarter	2.75	0.57
<u>Year Ended December 31, 2007</u>	<u>High</u>	<u>Low</u>
First Quarter	\$6.80	\$5.54
Second Quarter	6.30	5.20
Third Quarter	6.42	4.28
Fourth Quarter	5.10	2.66

*Equity Compensation Plan Information.*

We have only one equity compensation plan—The 1995 Stock Plan, as amended—under which we may issue shares of our common stock to employees, officers, directors and consultants. This plan has been approved by our stockholders. The following table provides information about the shares of our common stock that may be issued upon exercise of awards under the 1995 Stock Plan as of December 31, 2008.

<u>Plan Category</u>	<u>Number of securities to</u>		<u>Weighted-average</u>	<u>Number of securities</u>
	<u>be issued upon exercise</u>	<u>of outstanding options,</u>	<u>exercise price of</u>	<u>remaining available for</u>
	<u>warrants and rights</u>	<u>warrants and rights</u>	<u>outstanding options,</u>	<u>future issuance under</u>
				<u>equity compensation plans</u>
Equity compensation plans approved by stockholders	40,858,846†	\$	3.90†‡	78,375,455
Equity compensation plans not approved by stockholders	0	\$	0.00	0

† Includes awards of outperform stock options or outperform stock appreciate units ("OSOs"). For purposes of this table, these securities are considered to use a single share of our common stock from the total number of shares reserved for issuance under the 1995 Stock Plan.

‡ Includes weighted-average exercise price of outstanding OSOs at the date of grant. The exercise price of an OSO is subject to change based upon the performance of our common stock relative to the performance of the S&P 500® Index from the time of the grant of the award until the award has been exercised.

OSOs are currently designed to provide recipients of the awards with the incentive to maximize stockholder value and to reward recipient employees only when the price of our common stock outperforms the S&P 500® Index between the date of grant and the date that the OSO is exercised or settled. For the OSOs granted beginning in April 2007, OSOs have a three-year life and vest 100% on

the third anniversary of the date of the award and will fully settle on that date. In other words, recipients of these OSOs will not be able to voluntarily exercise the OSOs as they will settle automatically with value on the third anniversary of the date of the award or expire without value on that date. This type of instrument is sometimes referred to as a "European style option." For OSOs granted prior to April 2007, the OSOs generally have a four-year life and vest 50% at the end of the first year after grant, with the remaining 50% vesting in four equal quarterly installments so that the OSOs are fully vested by the end of the second year after grant.

OSOs have an initial strike price that is equal to the closing market price of our common stock on the trading day immediately prior to the date of grant. This initial strike price is referred to as the "Initial Price." On the settlement date or the date that an employee elects to exercise an OSO, the Initial Price is adjusted—as of that date—by a percentage that is equal to the aggregate percentage increase or decrease in the S&P 500® Index over the period beginning on the date of grant and ending on the trading day immediately preceding the settlement or exercise date. The Initial Price, however, can not be adjusted below the closing price of our common stock on the day that the OSO was granted.

The value of all OSOs will increase as the price of our common stock increases relative to the performance of the S&P® 500 Index over time. This increase in value is attributable in part to the use of a "success multiplier."

The mechanism for determining the value of an individual OSO award is described below: The Initial Price is adjusted over time (the "Adjusted Strike Price") until the settlement or exercise date. The adjustment is an amount equal to the percentage appreciation or depreciation in the value of the S&P 500® Index from the date of grant to the settlement date. The value of the OSO increases for increasing levels of outperformance. OSOs have a multiplier range from zero to four depending upon the performance of our common stock relative to the S&P 500® Index as shown in the following table.

Then the Pre-multiplier Gain Is Multiplied by	
If Level 3 Stock Outperforms the S&P 500® Index by:	a Success Multiplier of:
0% or Less	0.00
More than 0% but Less than 11%	Outperformance percentage multiplied by <sup>4</sup> / 11
11% or More	4.00

The pre-multiplier gain is our common stock price minus the Adjusted Strike Price on the settlement or exercise date.

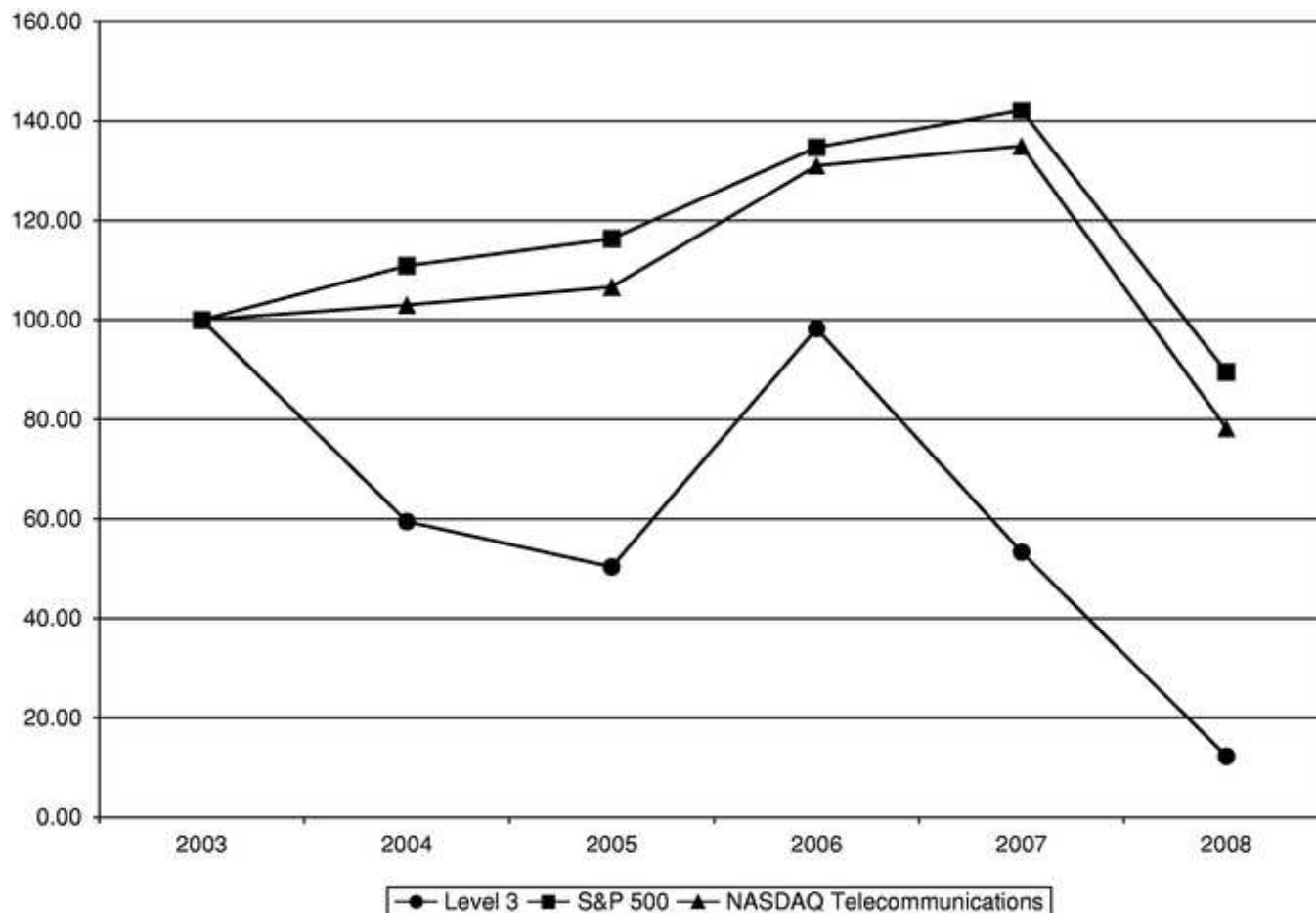
*Dividend Policy.* Our current dividend policy, in effect since April 1, 1998, is to retain future earnings for use in our business. As a result, our directors and management do not anticipate paying any cash dividends on shares of our common stock in the foreseeable future. In addition, under certain of our debt covenants we may be restricted from paying cash dividends on shares of our common stock.

*Performance Graph.*

The following performance graph shall not be deemed to be incorporated by reference by means of any general statement incorporating by reference this Form 10-K into any filing under the Securities Act of 1933, as amended or the Securities Exchange Act of 1934, except to the extent that the company specifically incorporates such information by reference, and shall not otherwise be deemed filed under such acts.

The graph compares the cumulative total return of our common stock for the five year period from 2004 through 2008 with the S&P® 500 Index and the Nasdaq Telecommunications Index. The graph assumes that the value of the investment was \$100 on December 31, 2003, and that all dividends and other distributions were reinvested.

**Comparison of Five Year Cumulative Total Return  
Among Our Common Stock, the S&P® 500 Index  
and the Nasdaq Telecommunications Index**



	12/03	12/04	12/05	12/06	12/07	12/08
Level 3 Common Stock	100.00	59.47	50.35	98.25	53.33	12.28
S&P 500® Index	100.00	110.88	116.33	134.70	142.10	89.53
NASDAQ Telecommunications	100.00	103.00	106.64	131.01	134.97	78.22

## ITEM 6. SELECTED FINANCIAL DATA

The Selected Financial Data of Level 3 Communications, Inc. and its subsidiaries appear below.

	Fiscal Year Ended(1)				
	2008	2007	2006	2005	2004
(dollars in millions, except per share amounts)					
<b>Results of Operations:</b>					
Revenue	\$4,301	\$ 4,269	\$3,378	\$1,719	\$1,776
Loss from continuing operations(2)	(290)	(1,114)	(790)	(707)	(478)
Income (loss) from discontinued operations(3)	—	—	46	69	20
Net loss	(290)	(1,114)	(744)	(638)	(458)
<b>Per Common Share:</b>					
Loss from continuing operations(2)	(0.19)	(0.73)	(0.79)	(1.01)	(0.70)
Income (loss) from discontinued operations(3)	—	—	0.05	0.10	0.03
Net loss	(0.19)	(0.73)	(0.74)	(0.91)	(0.67)
Dividends(4)	—	—	—	—	—
<b>Financial Position:</b>					
Total assets	9,638	10,254	9,994	8,277	7,544
Current portion of long-term debt(5)	186	32	5	—	143
Long-term debt, less current portion(5)	6,394	6,832	7,357	6,023	5,067
Stockholders' equity (deficit)(6)	876	1,070	374	(476)	(157)

- (1) The operating results of Software Spectrum, Inc. ("Software Spectrum"), which was sold in 2006, and ( i ) Structure, LLC (" i ) Structure"), which was sold in 2005, are included in discontinued operations for all periods presented for which Level 3 owned each business.

The Company acquired the managed modem businesses of ICG Communications, Inc. and Sprint Communications Company, L.P. on April 1, 2004 and October 1, 2004, respectively.

The Company purchased WilTel Communications Group, LLC ("WilTel") on December 23, 2005, and recorded approximately \$38 million of revenue attributable to this business in 2005.

The Company purchased Progress Telecom, LLC ("Progress Telecom") on March 20, 2006; ICG Communications, Inc. ("ICG Communications") on May 31, 2006; TelCove, Inc. ("TelCove") on July 24, 2006 and Looking Glass Networks Holding Co., Inc. ("Looking Glass") on August 2, 2006. The WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass results of operations and financial position are included in the consolidated financial statements from the respective dates of their acquisition. During 2006, the Company recorded revenue attributable to Progress Telecom of \$49 million, ICG Communications of \$46 million, TelCove of \$166 million and Looking Glass of \$33 million.

The Company purchased Broadwing Corporation ("Broadwing") on January 3, 2007; the Content Delivery Network services business of SAVVIS, Inc. (the "CDN Business") on January 23, 2007 and Servecast Limited on July 11, 2007. During 2007, the Company recorded revenue attributable to Broadwing of \$946 million, the CDN Business of \$17 million and Servecast of \$3 million.

On June 5, 2008, Level 3 completed the sale of its Vyvx advertising distribution business to DG FastChannel, Inc. and received gross proceeds at closing of approximately \$129 million in cash. Net proceeds from the sale approximated \$121 million after deducting transaction-related costs. Revenue attributable to the Vyvx advertising distribution business totaled \$15 million in 2008 through the date of sale, \$36 million in 2007 and \$35 million in 2006. The Vyvx businesses were acquired by the Company at the end of 2005 in the WilTel acquisition.



- (2) In 2004, the Company recognized a gain of \$197 million as a result of the early extinguishments of certain long-term debt and \$113 million of termination revenue.

In 2005, the Company recognized \$133 million of termination revenue and approximately \$23 million of impairment and restructuring charges.

In 2006, the Company recognized approximately \$13 million of impairment and restructuring charges, and a loss on early extinguishment of debt of \$83 million as a result of the amendment and restatement of its senior secured credit facility and certain debt exchanges and redemptions.

In 2007, the Company recognized approximately \$12 million of impairment and restructuring charges, and a loss on the early extinguishment of debt of \$427 million as a result of the refinancing of its senior secured credit agreement and certain debt exchanges, redemptions and repurchases. The Company also recognized a gain of \$37 million on the sale of marketable equity securities and a tax benefit of \$23 million related to certain state tax matters.

In 2008, the Company recognized approximately \$25 million of impairment and restructuring charges, \$44 million of induced debt conversion expenses attributable to the exchange of certain of the Company's convertible debt securities, a gain on the early extinguishment of debt of \$125 million as a result of certain debt repurchases, and a \$99 million gain on the sale of the Company's Vyvx advertising distribution business and the sale of certain of its smaller long distance voice customers. The Company also revised its estimates of the amounts and timing of its original estimate of undiscounted cash flows related to certain future asset retirement obligations in the fourth quarter of 2008. As a result, the Company reduced its asset retirement obligations liability by \$103 million with an offsetting reduction to property, plant and equipment of \$21 million, selling, general and administrative expenses of \$86 million, depreciation and amortization of \$11 million and an increase to goodwill of \$15 million.

- (3) In 2005, the Company sold ( i )Structure and recognized a gain on the sale of \$49 million. For fiscal years 2005 and 2004, ( i )Structure revenue approximated costs.

In 2006, the Company sold Software Spectrum and recognized a gain on the sale of \$33 million. The income from the operations of Software Spectrum was \$13 million, \$20 million and \$20 million for the fiscal years 2006, 2005 and 2004, respectively.

- (4) The Company's current dividend policy, in effect since April 1998, is to retain future earnings for use in the Company's business. As a result, management does not anticipate paying cash dividends on shares of common stock in the foreseeable future. In addition, the Company is restricted under certain covenants from paying cash dividends on shares of its common stock.

- (5) In 2004, the Company received net proceeds of \$987 million from the issuance of a \$730 million Senior Secured Term Loan due 2011 and the issuance of \$345 million of 5.25% Convertible Senior Notes due 2011. The Company used the net proceeds to repay portions of its 9.125% Senior Notes due 2008, 11% Senior Notes due 2008, 10.5% Senior Discount Notes due 2008 and 10.75% Senior Euro Notes due 2008. The Company repurchased portions of the outstanding notes at prices ranging from 83 percent to 89 percent of the repurchased principal balances. The net gain on the early extinguishment of the debt, including transaction costs, realized foreign currency losses and unamortized debt issuance costs, was \$50 million for these transactions. Also in 2004, the Company paid approximately \$54 million and assumed certain obligations to extinguish a Genuity capital lease obligation and recognized a gain of \$147 million on the transaction.

In 2005, the Company received net proceeds of \$877 million from the issuance of \$880 million of 10% Convertible Senior Notes due 2011. Also in 2005, a wholly owned subsidiary of the Company received net proceeds of \$66 million from the completion of a refinancing of the mortgage of its

corporate headquarters. The subsidiary entered into a new mortgage loan of \$70 million at an initial fixed rate of 6.86% through 2010.

In 2006, the Company received net proceeds of \$142 million from the issuance by its wholly owned subsidiary of \$150 million of Floating Rate Senior Notes due 2011, net proceeds of \$538 million from the issuance of \$550 million of 12.25% Senior Notes due 2013, net proceeds of \$326 million from its issuance of \$335 million of 3.5% Convertible Senior Notes due 2012 and net proceeds of \$1.239 billion (excluding prepaid interest) from the issuance by its wholly owned subsidiary of \$1.250 billion of 9.25% Senior Notes due 2014. Also in 2006, the Company exchanged a portion of its outstanding 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 for \$46 million of cash and \$692 million aggregate principal of new 11.5% Senior Notes due 2010. In addition, the Company redeemed the remaining outstanding 9.125% Senior Notes due 2008 totaling \$398 million, 10.5% Senior Discount Notes due 2008 totaling \$62 million and repurchased 99.3% of its wholly owned subsidiary's 10.75% Senior Notes due 2011 totaling \$497 million.

In 2007, the Company received net proceeds of \$982 million from the issuance by its wholly owned subsidiary of 8.75% Senior Notes due 2017 and Floating Rate Senior Notes due 2015 and net proceeds of \$1.382 billion for the refinancing of its senior secured credit agreement. In connection with the refinancing of the senior secured credit agreement the borrower repaid its \$730 million Senior Secured Term Loan due 2011. In 2007, the Company redeemed \$488 million of its outstanding 12.875% Senior Notes due 2010, \$96 million of outstanding 11.25% Senior Notes due 2010 and \$138 million (€104 million) of outstanding 11.25% SeniorEuro Notes due 2010. Also in 2007, the Company's wholly owned subsidiary repurchased \$144 million of its outstanding Floating Rate Senior Notes due 2011, the Company repurchased \$59 million of its outstanding 11% Senior Notes due 2008, \$677 million of its outstanding 11.5% Senior Notes due 2010 and \$61 million (€46 million) of its outstanding 10.75% Senior Euro Notes due 2008. The Company also completed the exchange of \$605 million of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of common stock during 2007. The Company also converted or repurchased \$180 million of Broadwing's outstanding 3.125% Convertible Senior Debentures due 2026 through the issuance of 17 million shares of common stock and the payment of \$106 million in cash in 2007.

In 2008, the Company received proceeds of \$400 million from the issuance of its 15% Convertible Senior Notes due 2013. In connection with the issuance of the 15% Convertible Senior Notes due 2013, the Company completed tender offers and repurchased \$163 million of its 2.875% Convertible Senior Notes due 2010, \$173 million of its 6% Convertible Subordinated Notes due 2010 and \$124 million of its 6% Convertible Subordinated Notes due 2009. In 2008, the Company completed exchanges with holders of various issues of its convertible debt in which the Company issued approximately 48 million shares of the Company's common stock in exchange for \$18 million of its 6% Convertible Subordinated Notes due 2009, \$47 million of its 10% Convertible Senior Notes due 2011, \$19 million of its 2.875% Convertible Senior Notes due 2010, \$15 million of its 5.25% Convertible Senior Notes due 2011 and \$9 million of its 3.5% Convertible Senior Notes due 2012. Also in 2008, the Company repurchased \$39 million aggregate principal amount of its 6% Convertible Subordinated Notes due 2009 and \$32 million aggregate principal amount of its 6% Convertible Subordinated Notes due 2010. The Company also repaid at maturity the remaining \$20 million of its outstanding 11% Senior Notes due 2008 and approximately \$6 million (€4 million) of its outstanding 10.75% Senior Euro Notes due 2008.

- (6) In 2004, the Company realized \$95 million of foreign currency losses on the repurchase of its Euro denominated debt.

In 2005, the Company issued 115 million shares of common stock, valued at approximately \$313 million, as the stock portion of the purchase price paid to acquire WilTel.

In 2006, the Company issued approximately 125 million shares of common stock in a public offering, valued at approximately \$543 million.

In 2006, the Company issued 20 million shares of common stock, valued at approximately \$66 million, as the stock portion of the purchase price paid to acquire Progress Telecom; 26 million shares of common stock, valued at approximately \$131 million, as the stock portion of the purchase price paid to acquire ICG Communications; 150 million shares of common stock, valued at approximately \$623 million, as the stock portion of the purchase price paid to acquire TelCove; and 21 million shares of common stock, valued at approximately \$84 million, as the stock portion of the purchase price paid to acquire Looking Glass.

In 2007, the Company issued 197 million shares of common stock in exchange for \$605 million of its 10% Convertible Senior Notes due 2011. The Company also issued 123 million shares of common stock, valued at approximately \$688 million, as the stock portion of the purchase price to acquire Broadwing Corporation. Also in 2007, the Company issued 17 million shares of common stock in connection with the conversion of \$179 million of Broadwing's outstanding 3.125% Convertible Senior Debentures due 2026.

In 2008, the Company issued approximately 48 million shares of common stock in exchange for \$108 million aggregate principal amount of various issues of its convertible debt.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This document contains forward looking statements and information that are based on the beliefs of management as well as assumptions made by and information currently available to Level 3 Communications, Inc. and its subsidiaries ("Level 3" or the "Company"). When used in this document, the words "anticipate", "believe", "plan", "estimate" and "expect" and similar expressions, as they relate to the Company or its management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this document.

The following discussion should be read in conjunction with the Company's consolidated financial statements (including the notes thereto), included elsewhere herein.

Level 3 Communications, Inc., through its operating subsidiaries, is primarily engaged in the communications business, with additional operations in coal mining.

### ***Communications Business***

The Company is a facilities based provider of a broad range of communications services. Revenue for communications services is recognized on a monthly basis as these services are provided. For contracts involving private line, wavelengths and dark fiber services, Level 3 may receive up-front payments for services to be delivered for a period of generally up to 20 years. In these situations, Level 3 defers the revenue and amortizes it on a straight-line basis to earnings over the term of the contract. At December 31, 2008, for contracts where up-front payments were received for services to be delivered in the future, the Company's weighted average remaining contract period was approximately 12 years.

Communications revenue consists of:

- Core Communications Services
- Other Communications Services

The two categories of Communications revenue are in different phases of the service life cycle, requiring different levels of investment and focus, and providing different contributions to the Company's Communications Adjusted EBITDA. Management of Level 3 believes that growth in revenue from its Core Communications Services is critical to the long-term success of its communications business. At the same time, the Company believes it must continue to effectively manage the positive cash flows from its Other Communications Services. Core Communications Services includes revenue from Core Network Services and Wholesale Voice Services. Core Network Services revenue represents higher margin services and Wholesale Voice Services represents lower margin services. The Company believes that trends in the communications business are best gauged by looking at revenue trends in Core Network Services. The Company manages Wholesale Voice performance based on gross margin contribution. Core Network Services includes revenue from transport and infrastructure, IP and data services, including content delivery network services, local and enterprise voice services and Level 3 Vyvx broadcast services. Wholesale Voice Services includes revenue from long distance voice services, including domestic voice termination, international voice termination and toll free services. Other Communications Services includes revenue from managed modem and its related reciprocal compensation services and SBC Contract Services, which includes revenue from the "SBC Master Services Agreement", which was obtained in the December 2005 acquisition of WilTel Communications Group, LLC ("WilTel").

*Core Communications Services*

The Company's transport and infrastructure services include metropolitan and intercity wavelengths, private line, ethernet private line, dark fiber, colocation services, professional services and transoceanic services. Growth in transport and infrastructure revenue is largely dependent on increased demand for bandwidth services and available capital of companies requiring communications capacity for their own use or in providing capacity as a service provider to their customers. These expenditures may be in the form of monthly payments or up-front payments for private line, wavelength or dark fiber services. The Company is focused on providing end-to-end transport services to its customers to directly connect customer locations with a private network. Pricing for end-to-end services has been stable. For metropolitan transport services, prices have been stable and in some instances are increasing. For intercity transport services, the Company continues to experience pricing pressure for point-to-point locations, particularly in locations where a large number of carriers co-locate their facilities. An increase in demand may be partially offset by declines in unit pricing.

IP and data services primarily include the Company's high speed Internet access service, dedicated Internet access ("DIA") service, ATM and frame relay services, IP and ethernet virtual private network ("VPN") services, and content delivery network ("CDN") services, which includes streaming services. Level 3's Internet access service is a high quality and high-speed Internet access service offered in a variety of capacities. The Company's VPN services permit businesses of any size to replace multiple networks with a single, cost-effective solution that greatly simplifies the converged transmission of voice, video, and data. This convergence to a single platform can be obtained without sacrificing the quality of service or security levels of traditional ATM and frame relay offerings. VPN services also permit customers to prioritize network application traffic so that high priority applications, such as voice and video, are not compromised in performance by the flow of low priority applications such as email.

The Company believes that one of the largest sources of future incremental demand for the Company's Core Communications Services will be from customers that are seeking to distribute their feature rich content or video over the Internet. Revenue growth in this area is dependent on the continued increase in usage by both enterprises and consumers and the pricing environment. An increase in the reliability and security of information transmitted over the Internet and declines in the cost to transmit data have resulted in increased utilization of e-commerce or web based services by businesses. Although the pricing for data services is currently stable, the IP market is generally characterized by price compression and high unit growth rates depending upon the type of service, resulting in growth in absolute revenue. The Company experienced price compression in the high-speed IP market in 2008 and expects that pricing for its high-speed IP services will continue to decline in 2009.

The Company's Core Network Services includes local and enterprise voice services. Local voice services are primarily components that enable other service providers to deliver business or consumer-ready voice products to their end customers. Enterprise voice services are business-grade voice services that the Company sells directly to its business customers.

The Company, through its Level 3 Vyvx business, provides transport services for the audio and video programming of its customers over the Company's fiber-optic network and via satellite. It uses the Company's fiber-optic network to carry live traditional broadcast and cable television events from the site of the event to the network control centers of the broadcasters of the event.

For live events where the location is not known in advance, such as breaking news stories in remote locations, the Company provides an integrated satellite and fiber-optic network-based service to transmit the content to its customers. Most of Level 3 Vyvx's customers for these services contract for the service on an event-by-event basis; however, there are some customers who have purchased a dedicated point-to-point service which enables these customers to transmit programming at any time.

Prior to the sale of the Vyvx advertising distribution business, Level 3 Vyvx distributed advertising spots to radio and television stations throughout the U.S., both electronically and in physical form. Customers for these services utilized a network-based method for aggregating, managing, storing and distributing content for content owners and rights holders.

On June 5, 2008, Level 3 completed the sale of its Vyvx advertising distribution business to DG FastChannel, Inc. and received gross proceeds at closing of approximately \$129 million in cash. Level 3 has retained ownership of Vyvx's core broadcast business, including the Vyvx Services Broadcast Business' content distribution capabilities.

The financial results of the Vyvx advertising distribution business are included in the Company's consolidated results of operations through the date of sale on June 5, 2008.

Level 3 recognized a gain on the sale of the Vyvx advertising distribution business of \$96 million in 2008. The gain is presented in the consolidated statements of operations as "Gain on sale of business groups, net."

The Company has developed content distribution services through the acquisition of the Content Delivery Network services business ("CDN Business") of SAVVIS, which it purchased in January 2007 from SAVVIS, and the acquisition of Dublin, Ireland based Servecast Ltd., which it purchased in July 2007. The Company believes that the addition of the CDN Business with its strong, broad portfolio of patents will help the Company secure its commercial efforts in the heavily patented CDN market, in which a number of competitors have significant, patented intellectual property. Level 3 believes that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet.

The Company offers Wholesale Voice Services that target large and existing markets. The revenue potential for Wholesale Voice Services is large; however, the pricing and margins are expected to continue to decline over time as a result of the new low-cost IP and optical-based technologies. In addition, the market for Wholesale Voice Services is being targeted by many competitors, several of which are larger and have more financial resources than the Company.

#### *Core Communications Services Market Groups*

In order to serve the changing needs of customers in growing markets and to drive growth across the Communications organization, Core Communications Services revenue by customer is also disaggregated into four customer-facing market groups as follows:

- The Wholesale Markets Group services the communications needs of the largest national and global service providers, including carriers, cable companies, wireless companies, voice service providers, systems integrators and the federal government. These customers typically integrate Level 3 services into their own products and services to offer to their end user customers.
- The Business Markets Group targets enterprise customers and regional carriers who value a local, professional sales force. Specific customer markets include medium and large businesses, local and regional carriers, state and local government entities, and higher education institutions and consortia.
- The Content Markets Group focuses on serving media and content companies with large and growing bandwidth needs. Customers in this market include video distribution companies, providers of gaming, mega-portals, software service providers, social networking providers, as well as more traditional media distribution companies such as broadcasters, satellite companies, television networks and sports leagues.
- The European Markets Group serves large European consumers of bandwidth, including the largest European and international carriers, large system integrators, voice service providers,

cable operators, Internet service providers, content providers, and government and education sectors.

The Company believes that the alignment of Core Communications Services around customer markets should allow it to drive growth while enabling it to better focus on the needs of its customers. Each of these groups is supported by dedicated employees in sales and marketing. Each of these groups is also supported by non-dedicated, centralized service or product management and development, corporate marketing, global network services, engineering, information technology, and corporate functions including legal, finance, strategy and human resources.

Core Communications Services revenue by customer-facing market group was as follows:

(dollars in millions)	Year Ended December 31,		
	2008	2007	2006
Wholesale Markets Group	\$2,177	\$2,045	\$1,205
Business Markets Group	959	941	327
Content Markets Group	398	380	254
European Markets Group	326	256	187
Total Core Communications Services	<u>\$3,860</u>	<u>\$3,622</u>	<u>\$1,973</u>

The classification of customers within each customer-facing market group can change based upon sales team assignments, merger and acquisition activity by customers and other factors.

#### *Other Communications Services*

The Company's Other Communications Services are mature services that are not critical areas of emphasis for the Company. Other Communications Services includes revenue from managed modem and its related reciprocal compensation services and SBC Contract Services, which includes revenue derived under the SBC Master Services Agreement that was obtained in the WilTel acquisition. The Company and its customers continue to see consumers migrate from narrow band dial-up services to higher speed broadband services as the narrow band market matures. Additionally, America Online, a primary consumer of the Company's dial-up services, has been implementing a strategic change in its approach to its dial-up internet access business over the past few years that has accelerated the loss of its dial-up subscribers. During 2007, America Online's strategy accelerated the decline in managed modem revenue and contributed to further declines in managed modem revenue in 2008. The Company recognized approximately \$103 million of managed modem revenue in 2008, a 35% decline from the \$158 million of managed modem revenue recognized in 2007. The declines in managed modem revenue from America Online have been offset to some extent by an increase in market share as a result of certain competitors exiting segments of this business. The Company believes that the low-cost structure of its network will enable it to compete aggressively for new business in the declining managed modem market.

The Company receives compensation from other carriers when it terminates traffic originating on those carriers' networks. This reciprocal compensation is based on interconnection agreements with the respective carriers or rates mandated by the FCC. The Company has interconnection agreements in place for the majority of traffic subject to reciprocal compensation. In addition, a majority of the Company's existing reciprocal compensation revenue is associated with agreements that are in effect through 2009 or beyond. The Company continues to negotiate new interconnection agreements or amendments to its existing interconnection agreements with local carriers as needed. The Company earns the majority of its reciprocal compensation revenue from providing managed modem services. The Company also receives reciprocal compensation from its voice services.



*Communications Business Strategy and Objectives*

The Company's management continues to review all existing lines of business and service offerings to determine how those lines of business and service offerings enhance the Company's focus on delivery of communications services and meeting its financial objectives. To the extent that certain lines of business, business groups or service offerings are not considered to be compatible with the delivery of the Company's services or with meeting its financial objectives, Level 3 may exit those lines of business or stop offering those services.

The Company is focusing its attention on the following operational and financial objectives:

- increasing sales;
- improving the customer experience to increase customer retention and reducing customer churn;
- achieving sustainable generation of positive cash flows from operations in excess of capital expenditures;
- reducing network costs and operating expenses;
- growing Core Communications Services revenue, particularly Core Network Services revenue;
- continuing to show improvements in Adjusted EBITDA as a percentage of revenue;
- completing the integration of acquired businesses;
- growing its content delivery network services;
- continuing to implement its metro network strategy;
- managing cash flows provided by its Other Communications Services; and
- refinancing its future debt maturities.

The Company's management believes the introduction of new services or technologies, as well as the further development of existing technologies, may reduce the cost or increase the supply of certain services similar to those provided by Level 3. The ability of the Company to anticipate, adapt and invest in these technology changes in a timely manner may affect the Company's future success.

In 2006, the Company strategically expanded its presence in metropolitan markets and began offering services to enterprise customers through its Business Markets Group. This strategy allowed the Company to terminate traffic over its owned facilities rather than paying third parties to terminate the traffic. The expansion into new metro markets also provided additional opportunities to sell services to bandwidth intensive businesses on the Company's national and international networks. In order to expedite the expansion of its metro business, Level 3 acquired Progress Telecom, ICG Communications, TelCove and Looking Glass in 2006 and Broadwing in the first quarter of 2007. Level 3 also strategically expanded its content delivery network services with the acquisitions of the CDN Business in the first quarter of 2007 and Servecast in the third quarter of 2007. The results of operations attributable to each acquisition are included in the consolidated financial statements from the date of acquisition. Below is a summary of the Company's 2007 and 2006 acquisitions.

*Servecast Acquisition:* On July 11, 2007, Level 3 completed the acquisition of Servecast Limited, a Dublin, Ireland based provider of live and on-demand video management and streaming services for broadband and mobile platforms. Level 3 paid approximately €34 million, or \$46 million, in cash, including transaction costs, to complete the acquisition of Servecast.

*CDN Business Acquisition:* On January 23, 2007, Level 3 completed the acquisition of the Content Delivery Network services business of SAVVIS, Inc. Level 3 paid approximately \$133 million in cash,



including transaction costs, to acquire the assets of the CDN Business, including network elements, customer contracts and intellectual property used in the CDN Business.

***Broadwing Acquisition:*** On January 3, 2007, Level 3 acquired Broadwing, a publicly held provider of optical network communications services. Under the terms of the merger agreement, Level 3 paid \$8.18 of cash plus 1.3411 shares of Level 3 common stock for each share of Broadwing common stock outstanding at closing. In total, Level 3 paid approximately \$755 million of cash, including transaction costs, and issued approximately 123 million shares of the Company's common stock, valued at \$688 million. As part of the Broadwing acquisition, approximately 3.8 million previously issued Broadwing warrants (valued at approximately \$4 million) became exercisable for approximately 5.1 million shares of Level 3 common stock.

In connection with the acquisition of Broadwing, the Company guaranteed \$180 million in aggregate principal amount of Broadwing Corporation's 3.125% Convertible Senior Debentures due 2026 (the "Broadwing Debentures") and the transaction included \$24 million in capital lease obligations related primarily to a metro fiber IRU agreement. As of February 16, 2007, the holders of \$179 million in aggregate principal amount of the Broadwing Debentures converted their Broadwing Debentures into a total of 17 million shares of Level 3 common stock and approximately \$105 million in cash pursuant to the terms of the indenture governing the Broadwing Debentures and the agreement whereby Level 3 acquired Broadwing. The remaining \$1 million in aggregate principal amount of the Broadwing Debentures was repurchased by Broadwing at 100% of par as required by the indenture governing the Broadwing Debentures.

***Looking Glass Acquisition:*** On August 2, 2006, Level 3 completed the acquisition of Looking Glass, a privately held Illinois-based telecommunications company. The consideration paid by Level 3 consisted of approximately \$13 million in cash, including transaction costs, and approximately 21 million shares of Level 3 common stock valued at \$84 million. In addition, at the closing, Level 3 repaid approximately \$67 million of Looking Glass liabilities.

***TelCove Acquisition:*** On July 24, 2006, Level 3 completed the acquisition of TelCove, a privately held Pennsylvania-based telecommunications company. The consideration paid by Level 3 consisted of approximately \$461 million in cash, including transaction costs, and approximately 150 million shares of Level 3 common stock valued at \$623 million. In addition, Level 3 repaid approximately \$132 million of TelCove liabilities.

***ICG Communications:*** On May 31, 2006, Level 3 acquired all of the stock of ICG Communications, a privately held Colorado-based telecommunications company, from MCCC ICG Holdings, LLC excluding certain assets and liabilities. Under the terms of the purchase agreement, Level 3 purchased ICG Communications for aggregate consideration consisting of approximately 26 million shares of Level 3 common stock, valued at \$131 million, and approximately \$47 million in cash, including transaction costs and working capital adjustments.

***Progress Telecom:*** On March 20, 2006, Level 3 completed its acquisition of all of the membership interests of Progress Telecom from PT Holding Company LLC ("PT Holding") excluding certain specified assets and liabilities of Progress Telecom. Progress Telecom was owned by PT Holding which is jointly owned by Progress Energy, Inc. and Odyssey Telecorp, Inc. Under the terms of the purchase agreement, Level 3 purchased Progress Telecom for an aggregate purchase price consisting of approximately \$68 million in cash, including transaction costs and working capital adjustments, and approximately 20 million shares of Level 3 common stock, valued at \$66 million.

Level 3 will continue to evaluate acquisition opportunities and could make additional acquisitions in the future.

The successful integration of acquired businesses into Level 3 is important to the success of Level 3. The Company must continue to identify synergies and integrate acquired networks and support organizations, while maintaining the service quality levels expected by customers to realize the anticipated benefits of these acquisitions. Successful integration of these acquired businesses continues to depend on the Company's ability to manage these operations, realize opportunities for revenue growth presented by strengthened service offerings and expanded geographic market coverage, and to eliminate redundant and excess costs to fully realize the expected synergies. If the Company is not able to efficiently and effectively continue to integrate the acquired businesses or operations, the Company may experience material negative consequences to its business, financial condition or results of operations.

In 2007, during the second quarter and portions of the third quarter, the Company's service activation times increased as a result of the following issues:

- Continuing to use the multiple order entry and provisioning systems and processes that were operated by the acquired companies to provision end-to-end services.
- Insufficient training on the multiple systems for employees performing service activation functions.
- Lack of sufficient staffing levels in some service activation areas.
- Identifying and fixing service activation throughput issues was challenging as a result of decentralizing service activation functions across the customer facing groups.

This increase in service activation cycle time had a negative effect on the Company's service installation intervals and the rate of Core Communications Services revenue growth during 2007. During this same period, the Company also experienced challenges in its service management processes that resulted in longer response times to resolve customer's network service issues. As a result of consolidating key operational functions and organizations as part of the integration effort, the Company's operating environment became more complex in the first half of 2007.

During the second and third quarters of 2007, the Company implemented certain process and organizational changes that were expected to improve service activation times and allow it to achieve its previously forecasted revenue and Adjusted EBITDA growth. However, these changes were not adequate to address the breadth of the problems encountered during the second and third quarters of 2007. As a result of these service activation and service management issues, the growth in Communications Services revenue and Adjusted EBITDA was lower than originally expected for the full year 2007.

The Company has taken steps to improve its existing processes and systems to address the increase in service activation times and improve its service management. With respect to the latter, the Company saw improvements in its service management during the fourth quarter of 2007 and in 2008. Additionally, the Company believes it has implemented sufficient improvements in service activation capabilities to match installation capacity to customer demand for services.

The Company has ongoing process and system development work that is being implemented as part of the integration efforts which have and are expected to further address the service activation and service management issues of systems and processes utilized by acquired companies as well as provide significant overall improvements to operations. The Company completed the foundation of its processes and systems development objectives at the end of 2008 and is now focused on operational efficiency improvements.

Recent changes in the composition of the Company's revenue have required the Company to manage operating expenses carefully and to concentrate its capital expenditures on those technologies and assets that enable the Company to develop its Core Communications Services further and replace the decline in revenue and earnings from Other Communications Services. Recent uncertainty in the

global financial markets and economy has also required the Company to continue to manage its cost structure more efficiently. In addition, our operating results and financial condition could be negatively affected if as a result of economic conditions:

- customers defer or forgo purchases of our services;
- customers are unable to make timely payments to us;
- the demand for, and prices of, our services are reduced as a result of actions by our competitors or otherwise;
- key suppliers upon which we rely are unable to provide us with the materials we need for our network on a timely basis; or
- our financial counterparties, insurance providers or other contractual counterparties are unable to, or do not meet, their contractual commitments to us.

In addition to the operational objectives mentioned above, the Company has also been focused on improving its liquidity, financial condition, and extending the maturity dates of certain debt.

In December 2008, the Company completed tender offers for and repurchased \$163 million in the aggregate of its 2.875% Convertible Senior Notes due 2010, \$173 million of its 6% Convertible Subordinated Notes due 2010 and \$124 million of its 6% Convertible Subordinated Notes due 2009. In connection with the completion of the tender offers, the Company issued \$400 million aggregate principal amount of its 15% Convertible Senior Notes due 2013.

In October 2008, the Company completed exchanges with holders of various issues of its convertible debt in which the Company issued approximately 48 million shares of the Company's common stock in exchange for \$18 million of its 6% Convertible Subordinated Notes due 2009, \$47 million of its 10% Convertible Senior Notes due 2011, \$19 million of its 2.875% Convertible Senior Notes due 2010, \$15 million of its 5.25% Convertible Senior Notes due 2011 and \$9 million of its 3.5% Convertible Senior Notes due 2012.

The Company will continue to look for opportunities to improve its financial position and focus its resources on growing revenue and managing costs for the communications business.

### ***Coal Mining***

Level 3, through its two 50% owned joint-venture surface mines, one each in Montana and Wyoming, sells coal primarily through long-term contracts with public utilities. The long-term contracts for the delivery of coal establish the price, volume, and quality requirements of the coal to be delivered. Revenue under these and other contracts is generally recognized when coal is shipped to the customer.

### ***Information Services***

On November 30, 2005, the Company sold its wholly owned subsidiary, ( i )Structure, LLC, which provided computer outsourcing services primarily to small and medium-sized businesses. The Company also completed the disposition of its remaining subsidiary in the information services business, Software Spectrum, Inc. on September 7, 2006. The results of operations and financial position for ( i )Structure and Software Spectrum are reflected as discontinued operations for all applicable periods presented in this report.

### ***Critical Accounting Policies and Estimates***

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of

assets, liabilities, revenue, expenses and related disclosures. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. The Company evaluates these estimates on an ongoing basis. Actual results may differ from these estimates under different assumptions or conditions.

While the Company has other accounting policies that involve estimates such as the allowance for doubtful accounts, revenue reserves, useful lives of long-lived assets, accruals for estimated tax and legal liabilities, cost of revenue disputes for communications services, valuation allowance for deferred tax assets, and unfavorable contracts recognized in purchase accounting, management has identified the policies below, which require the most significant judgments and estimates to be made in the preparation of the consolidated financial statements, as critical to its business operations and the understanding of its results of operations.

#### *Revenue*

Revenue for communications services, including transport, infrastructure, data, colocation, IP, Vvix broadcast, voice, and managed modem, is recognized monthly as the services are provided. Communications services are provided either on a usage basis, which can vary period to period, or at a contractually committed amount.

Reciprocal compensation revenue is recognized when an interconnection agreement is in place with another carrier, or if an agreement has expired, when the parties have agreed to continue operating under the previous agreement until a new agreement is negotiated and executed; or at rates mandated by the FCC. Periodically, the Company will receive payment for reciprocal compensation services in excess of FCC rates and before an agreement is in place. These amounts are included in other current liabilities on the consolidated balance sheets until a final agreement has been reached and the necessary regulatory approvals have been received at which time the reciprocal compensation revenue is recognized. These amounts were insignificant to the Company in 2008, 2007 and 2006.

Revenue attributable to leases of dark fiber pursuant to indefeasible rights-of-use agreements ("IRUs") that qualified for sales-type lease accounting and were entered into prior to June 30, 1999, were recognized at the time of delivery and acceptance of the fiber by the customer. Certain sale and long-term IRU agreements of dark fiber and capacity entered into after June 30, 1999, are required to be accounted for in the same manner as sales of real estate with property improvements or integral equipment. This accounting treatment results in the deferral of revenue for the cash that has been received and the recognition of revenue ratably over the term of the agreement (generally up to 20 years).

Termination revenue is recognized when a customer disconnects service prior to the end of the contract period and for which Level 3 had previously received consideration and for which revenue recognition was deferred. Termination revenue is also recognized when customers make termination penalty payments to Level 3 to settle contractually committed purchase amounts that the customer no longer expects to meet or when a customer and Level 3 renegotiate a contract under which Level 3 is no longer obligated to provide product or services for consideration previously received and for which revenue recognition has been deferred. Termination revenue is reported in the same manner as the original product or service provided.

Accounting practice and guidance with respect to the accounting treatment of revenue continues to evolve. Any changes in the accounting treatment could affect the manner in which the Company accounts for revenue within its communications and coal businesses.

### *Non-Cash Compensation*

The Company recognizes stock-based compensation expense for all share-based payment awards in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123R, "Share-Based Payment" ("SFAS No. 123R"). Under the fair value recognition provisions of SFAS 123R, the Company recognizes stock-based compensation expense net of an estimated forfeiture rate, recognizing compensation cost for only those awards expected to vest over the requisite service period of the awards. Determining the appropriate fair value model and calculating the fair value of share-based payment awards require subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. The Company issues outperform stock options in which the value received is based on a formula involving a multiplier related to the level by which the Company's common stock outperforms the S&P 500® Index. The Company utilizes a modified Black-Scholes model due to the additional variables required to calculate the effect of the success multiplier for its outperform stock options, including estimating the expected volatility of the S&P 500® Index. As a result of the deterioration of the Company's stock price at the end of 2008, the aggregate intrinsic value of outstanding outperform stock options was zero as of December 31, 2008.

The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and the Company uses different assumptions, stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and recognize expense only for those shares expected to vest. If actual forfeiture rates are materially different from the Company's estimate, stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

### *Valuation of Long-Lived Assets*

The Company performs an assessment of its long-lived assets, including finite-lived acquisition-related intangible assets, for impairment when events or changes in circumstances indicate that the carrying value of assets or asset groupings may not be recoverable. This review requires the identification of the lowest level of identifiable cash flows for purposes of grouping assets subject to review. The estimate of undiscounted cash flows includes long-term forecasts of revenue growth, gross margins and operating expenses. All of these items require significant judgment and assumptions. The impairment analysis of long-lived assets also requires the Company to make certain subjective assumptions and estimates regarding the expected future use of certain additional conduits and the expected future use of certain empty conduit. An impairment loss may exist when the estimated undiscounted cash flows attributable to the assets are less than their carrying amount. If an asset is deemed to be impaired, the amount of the impairment loss recognized represents the excess of the long-lived asset's carrying value as compared to its estimated fair value, based on management's assumptions and projections.

The Company conducted a long-lived asset impairment analysis in the fourth quarter of 2008 and concluded that its long-lived assets, including finite-lived acquisition-related intangible assets, were not impaired. To the extent that future changes in assumptions and estimates cause a change in estimates of future cash flows that indicate the carrying amount of the Company's long-lived assets, including finite-lived acquisition-related intangible assets, may not be recoverable, the Company may incur impairment charges in the future to write-down the carrying amount of the Company's long-lived assets, including finite-lived acquisition-related intangible assets, to their estimated fair value.

### *Valuation of Goodwill and Acquired Indefinite-Lived Intangible Assets*

The Company performs an assessment of its goodwill for impairment annually at the end of the fourth quarter, or more frequently if the Company determines that indicators of impairment exist. The Company's impairment review process compares the fair value of each reporting unit to its carrying

value. The Company's reporting units are consistent with the reportable segments identified in Note 14 to the Consolidated Financial Statements. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired and no further testing is performed. If the carrying value of the reporting unit exceeds its fair value, then a second step must be performed, and the implied fair value of the reporting unit's goodwill must be determined and compared to the carrying value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then an impairment loss equal to the difference will be recorded.

The Company's fair value methodology consists of a quoted market price approach whereby the Company calculates the market capitalization of Level 3 using quoted market prices, adds an estimated control premium, and then assigns that fair value to the reporting units. The Company also performs a discounted cash flow analysis that includes estimates of revenue, costs, growth rates and an appropriate discount rate. These estimates are based on historical data, various internal estimates and management's expectations of future trends.

The Company conducted its goodwill impairment analysis at the end of the fourth quarter of 2008 and concluded that its goodwill was not impaired.

The Company also performs an assessment of its indefinite-lived acquisition-related intangible assets annually at the end of the fourth quarter, or more frequently if the Company determines that indicators of impairment exist. The Company's impairment review process compares the fair value of the indefinite-lived acquisition-related intangible assets to their respective carrying values. If the fair value of the indefinite-lived acquisition-related intangible assets exceeds their carrying values, then the indefinite-lived acquisition-related intangible assets are not impaired.

The Company's fair value methodology primarily consists of a discounted cash flow analysis that includes estimates of revenue, costs, growth rates and an appropriate discount rate and market comparable estimates. These estimates are based on historical data, various internal estimates and management's expectations of future trends.

The Company conducted its indefinite-lived acquisition-related intangible asset impairment analyses at the end of the fourth quarter of 2008 and concluded that there was no impairment. As a result of the sale of the Vyvx advertising distribution business in the second quarter of 2008, the Company also performed an impairment analysis of its indefinite-lived, Vyvx trade name and concluded that there was no impairment as of June 30, 2008.

To the extent that future changes in the Company's assumptions and estimates cause a change in the related fair value estimates that indicate the carrying amount of the Company's goodwill and indefinite-lived acquisition-related intangible assets may not be recoverable, the Company may incur impairment charges in the future to write-down the carrying amount of the Company's goodwill and indefinite-lived acquisition-related intangible assets to their estimated fair value.

#### *Asset Retirement Obligations*

The Company's asset retirement obligations consist of legal requirements to remove certain of its network infrastructure at the expiration of the underlying right-of-way ("ROW") term, restoration requirements for leased facilities and reclamation requirements in the coal mining business to remediate previously mined properties. The initial and subsequent measurement of the Company's asset retirement obligations require the Company to make significant estimates regarding the eventual costs and probability or likelihood that the Company will be required to remove certain of its network infrastructure, restore certain of its leased properties and remediate certain of its previously mined properties. In addition, the Company must estimate the periods over which these costs will be incurred and present value the total of such costs using the Company's estimate of its credit-adjusted risk-free interest rate.

The Company regularly evaluates its asset retirement obligations to determine if the amount and timing of its cash flow estimates continue to be appropriate based on current facts and circumstances.

As a result of indicators suggesting that the estimated cash flows underlying the Company's ROW asset retirement obligations were too high, the Company revised its assessment on December 31, 2008. Network infrastructure relocations indicated that the Company is not being required to physically remove its underground network infrastructure at rates consistent with the Company's previous estimates. Other internal and external information corroborated these lower rates. As a result, on December 31, 2008, the Company revised its probability assessment related to its requirement to physically remove its underground network infrastructure at the end of the underlying ROW terms, which caused a significant reduction to the related cash flows that the Company believes will be required to settle its ROW asset retirement obligations. The Company reduced its asset retirement obligation liability accordingly as of December 31, 2008.

As part of the ROW asset retirement obligation change in estimate, the Company determined that certain of its asset retirement obligations for acquired entities should have been higher at the acquisition date. As a result, the Company increased goodwill by approximately \$15 million as of December 31, 2008.

The Company also determined that its estimates of restoration costs for its leased facility asset retirement obligations were too high based on current costs to restore. As a result, on December 31, 2008, the Company reduced its estimates of the cash flows that it believes will be required to settle its leased facility asset retirement obligations at the end of the respective lease terms, which resulted in a reduction to the Company's asset retirement obligation liability.

In the fourth quarter of 2008, the Company was awarded a long-term coal contract, which will extend the life of one of the Company's coal mining operations. As a result of the increase in the estimated life of one of the Company's coal mining operations, the Company revised the timing of its cash flows to remediate the mining site causing a reduction in its asset retirement obligation liability in the fourth quarter of 2008.

As a result of the aforementioned revisions in the estimated amount and timing of cash flows for asset retirement obligations, the Company reduced its asset retirement obligation liability by \$103 million with an offsetting reduction to property, plant and equipment of \$21 million, general and administrative expenses of \$86 million, depreciation and amortization of \$11 million and an increase to goodwill of \$15 million. The Company reduced property, plant and equipment to the extent of the carrying amount of the related long-lived asset initially recorded when the asset retirement obligation liability was established. The remaining amount of the reduction to the asset retirement obligation was recorded as a reduction to depreciation expense, to the extent of historical depreciation of the related long-lived asset, and selling, general and administrative expense.

### ***Recently Issued Accounting Pronouncements***

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement was effective for financial assets and liabilities, as well as for non-financial assets and liabilities that are recognized or disclosed at fair value on a recurring basis for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. FASB Staff Position ("FSP") FAS 157-2, "Effective Date of FASB Statement No. 157" ("FSP 157-2") defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for non-financial assets and liabilities that are not recognized or disclosed at fair value on a recurring basis. SFAS No. 157 did not have a material effect on the Company's



consolidated results of operations or financial condition in 2008. The Company does not expect the adoption of the remaining portions of SFAS No. 157 to have a material effect on the Company's consolidated results of operations and financial position.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" ("SFAS No. 141R"), which replaces SFAS No. 141, "Business Combinations" ("SFAS No. 141"). SFAS No. 141R retains the underlying concepts of SFAS No. 141 in that an entity is required to recognize the assets acquired and liabilities assumed at their fair value on the acquisition date. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items to require: (1) expensing acquisition related costs as incurred; (2) expensing changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date; (3) valuing noncontrolling interests at fair value at the acquisition date; (4) generally expensing restructuring costs associated with an acquired business; (5) capitalizing in-process research and development assets acquired; and (6) measuring acquirer shares issued in consideration for a business combination at fair value on the acquisition date opposed to the announcement date. SFAS No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R is to be applied prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The effect of adopting SFAS No. 141R on the Company's consolidated results of operations and financial condition will be largely dependent on the size and nature of business combinations completed after December 31, 2008.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS No. 160"). SFAS No. 160 requires noncontrolling interests, previously referred to as minority interests, to be treated as a separate component of equity, not as a liability or other item outside of permanent equity and applies to the accounting for noncontrolling interests and transactions with noncontrolling interest holders in consolidated financial statements. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective for the Company beginning January 1, 2009. The Company does not currently expect the adoption of SFAS No. 160 to have a material effect on its consolidated results of operations and financial condition.

In March 2008, the FASB issued Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133" ("SFAS No. 161"). SFAS 161 applies to all derivative instruments and related hedged items accounted for under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). SFAS No. 161 requires entities to provide greater transparency about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. This statement is effective for the Company beginning January 1, 2009. The Company does not expect the adoption of SFAS No. 161 to have a material effect on its consolidated results of operations and financial condition.

On May 9, 2008, the FASB issued FSP APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)" ("FSP APB 14-1"). FSP APB 14-1 requires issuers of a certain type of convertible debt to separately account for the debt and equity components of the convertible debt in a way that reflects the issuer's borrowing rate at the date of issuance for similar debt instruments without the conversion feature. FSP APB 14-1 applies to certain of the Company's convertible debt. FSP APB 14-1 is effective for the Company beginning on January 1, 2009 and will be applied retrospectively to all quarterly and annual periods that will be presented in the Company's consolidated financial statements. Early adoption of FSP APB 14-1 is not permitted. The adoption of FSP APB 14-1 is expected to significantly increase the Company's non-cash interest expense and reduce basic and diluted earnings (loss) per share.

In November 2008, the FASB ratified EITF Issue No. 08-7, "Accounting for Defensive Intangible Assets," ("EITF 08-7"). EITF 08-7 applies to defensive intangible assets, which are acquired intangible



assets that the acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. As these assets are separately identifiable, EITF 08-7 requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting. Defensive intangible assets must be recognized at fair value in accordance with SFAS No. 141R and SFAS No. 157. EITF 08-7 is effective for defensive intangible assets acquired in fiscal years beginning on or after December 15, 2008 and will be adopted by the Company beginning on January 1, 2009. The effect of adopting EITF 08-7 on the Company's consolidated results of operations and financial condition will be largely dependent on the size and nature of business combinations completed after December 31, 2008.

**Results of Operations 2008 vs. 2007**

(dollars in millions)	Year Ended		
	December 31,	December 31,	Change
	2008	2007	%
<b>Revenue:</b>			
Communications	\$ 4,226	\$ 4,199	1%
Coal mining	75	70	7%
Total revenue	4,301	4,269	1%
<b>Costs and Expenses: (exclusive of depreciation and amortization shown separately below)</b>			
Cost of revenue:			
Communications	1,740	1,769	(2)%
Coal mining	69	64	8%
Cost of revenue	1,809	1,833	(1)%
Depreciation and amortization	931	942	(1)%
Selling, general and administrative	1,505	1,723	(13)%
Restructuring and non-cash impairment charges	25	12	108%
Total costs and expenses	4,270	4,510	(5)%
Operating Income (Loss)	31	(241)	113%
<b>Other Income (Expense):</b>			
Interest income	15	54	(7)%
Interest expense	(534)	(577)	7%
Gain (Loss) on extinguishment of debt, net	81	(427)	—
Gain on sale of business groups	99	—	—
Other, net	24	55	(56)%
Total other income (expense)	(315)	(895)	65%
Loss Before Income Taxes	(284)	(1,136)	75%
Income Tax (Expense) Benefit	(6)	22	—
Net Loss	\$ (290)	\$ (1,114)	74%

Communications revenue consists of:

- 1) Core Communications Services, which includes Core Network Services and Wholesale Voice Services;
  - Core Network Services includes revenue from transport and infrastructure, IP and data services, local and enterprise voice services and Level 3 Vyvx broadcast services.
  - Wholesale Voice Services includes revenue from long distance voice services, including domestic voice termination, international voice termination and toll free services.

- 2) Other Communications Services includes revenue from managed modem and its related reciprocal compensation services and SBC Contract Services, which includes revenue from the SBC Master Services Agreement, which was obtained in the December 2005 acquisition of WilTel.

Communications revenue attributable to each of these services is as follows:

(dollars in millions)	Year Ended December 31,	
	2008	2007
<b>Communications Services:</b>		
Core Network Services	\$ 3,147	\$ 2,994
Wholesale Voice Services	713	628
Total Core Communications Services	3,860	3,622
Other Communications Services	366	577
Total Communications Services Revenue	\$ 4,226	\$ 4,199

**Communications Revenue** increased 1% in 2008 compared to 2007. Contributing to this increase in Communications revenue was an increase in Core Communications Services revenue in 2008 compared to 2007. This increase in Core Communications Services revenue is the result of a combination of growth in the Company's Core Network Services and Wholesale Voice Services.

The Company experienced growth across several services within Core Network Services in 2008 compared to 2007, including infrastructure, transport, colocation, data, IP, including CDN services, and Vyvx broadcast services. The Company continues to experience strong demand for infrastructure and transport services for complex nationwide solutions and colocation capacity in large markets. Vyvx broadcast revenue increased primarily as a result of the proliferation of high definition sports, news and entertainment programming. Partially offsetting the increase in Core Network Services revenue was lower Vyvx advertising distribution revenue. On June 5, 2008, the Company completed the sale of the Vyvx advertising distribution business and therefore only recorded Vyvx advertising distribution revenue in 2008 from January 1, 2008 through June 5, 2008. Revenue attributable to the Vyvx advertising distribution business was \$15 million in 2008 compared to \$36 million in 2007.

The increase in Wholesale Voice Services revenue is attributable to an increase in voice termination and toll free voice services. The growth in voice termination revenue is primarily attributable to an increase in demand from wireless carrier customers. Toll free revenue increased primarily due to higher traffic attributable to conferencing provider customers. The Company continues to concentrate its sales efforts on maintaining incremental gross margins in the 30% range for these services. The Company expects to experience some volatility in revenue as a result of this strategy.

Other Communications Revenue declined to \$366 million in 2008 from \$577 million in 2007. The decrease is primarily the result of a decline in managed modem revenue as a result of the continued migration from narrow band dial-up services to higher speed broadband services by end user customers, especially in large metropolitan areas. The Company expects managed modem revenue to continue to decline in the future due to an increase in the number of subscribers migrating to broadband services and potential pricing concessions in 2009 as contracts are renewed.

Reciprocal compensation revenue from managed modem services also declined in 2008 compared to 2007 as a result of the continuing decline in demand for managed modem services. The Company has historically earned the majority of its reciprocal compensation revenue from managed modem services, although the Company continues to generate a portion of its reciprocal compensation revenue from voice services, which is reported within Core Network Services revenue. To the extent the Company is unable to sign new interconnection agreements or signs new agreements containing lower rates, or there is a significant decline in the Company's managed modem dial-up business, or FCC or state regulations change such that carriers are not required to compensate other carriers for terminating ISP-bound traffic, reciprocal compensation revenue may decline significantly over time.

Also contributing to the decrease in Other Communications revenue was lower SBC Contract Services revenue as a result of the migration of the SBC traffic to the AT&T network and the satisfaction by SBC of its gross margin commitment under the SBC Master Services Agreement in 2008. During the second quarter of 2008, the gross margin commitment on the SBC Master Services Agreement was satisfied; however AT&T, Inc. ("AT&T"), which merged with SBC in 2005, continues to purchase services from Level 3 under the SBC Master Services Agreement as it continues to migrate the services provided under the agreement to its own network facilities. The SBC Master Services Agreement was an agreement between SBC Services Inc. and WilTel and was obtained in the WilTel acquisition. WilTel and SBC amended their agreement in June 2005 to run through 2009. The Company recognized \$201 million and \$303 million of revenue under the SBC Contract Services Agreement during 2008 and 2007, respectively. The agreement provided a gross margin purchase commitment of \$335 million from December 2005 through the end of 2007 and \$75 million from January 2008 through the end of 2009 and stipulated that originating and terminating access charges paid to local phone companies get passed through to SBC in accordance with a formula that approximates costs and do not count against the gross margin purchase commitment. SBC fully satisfied the \$335 million gross margin purchase commitment during the third quarter of 2007. As a result of satisfying the initial gross margin purchase commitment, SBC's purchases of services that exceeded the original \$335 million gross margin purchase commitment counted toward the \$75 million gross margin purchase commitment for the period from January 2008 through the end of 2009. SBC satisfied \$39 million of the \$75 million gross margin purchase commitment in 2007 with the remaining \$36 million satisfied in 2008.

Additionally, the SBC Contract Services Agreement provided for the payment of \$50 million by SBC if certain performance criteria were met by Level 3. The performance-based incentive provisions of the agreement ended on December 31, 2007. The Company met the required performance criteria and recorded annual revenue of \$25 million in both 2006 and 2007 under the agreement.

**Coal mining** revenue increased to \$75 million in 2008 from \$70 million in 2007, primarily as a result of a long-term supply contract that enabled a customer to buyout future coal purchase commitments with the Company. The Company does not have any further obligations with respect to future coal commitments under the contract, and therefore recognized the transaction as revenue in 2008. Partially offsetting this increase were lower volumes of coal sold in 2008 compared to 2007.

**Cost of Revenue** for the communications business includes leased capacity, right-of-way costs, access charges, satellite transponder lease costs, and other third party costs directly attributable to the network, but excludes depreciation and amortization and related impairment expenses. Prior to the sale of the Vyvx advertising distribution business, the Company included in communications cost of revenue package delivery costs and the blank tape media costs associated with this business.

Cost of revenue for the communications business, as a percentage of communications revenue, was 41% in 2008 compared to 42% in 2007. This decrease is primarily attributable to the synergies derived from acquisitions. During 2007 and the first part of 2008, the Company was able to eliminate some of the costs associated with duplicate circuits serving the same markets. Also contributing to the decrease was the continued reduction in Other Communications Services revenue, in particular, SBC Contract Services revenue. The gross margins for SBC Contract Services revenue are lower than the gross margins for Core Communications Services revenue and managed modem and reciprocal compensation from managed modem revenue. Partially offsetting this decrease were increases in Wholesale Voice Services revenue as a percentage of total communications revenue and lower managed modem revenue. The incremental gross margins for Wholesale Voice Services revenue are in the 30% range versus 80% for Core Network Services revenue and the gross margin for managed modem revenue is generally higher than for Core Network Services revenue.

**Coal mining** cost of revenue approximated 92% of coal mining revenue in 2008 and 91% in 2007. The increase in coal mining cost of revenue as a percentage of coal mining revenue in 2008 is the

result of an increase in energy costs to mine the coal partially offset by the buyout by a coal customer of future coal purchase commitments resulting in the recognition of revenue with no associated costs in 2008.

**Depreciation and Amortization** expense decreased 1% to \$931 million in 2008 from \$942 million in 2007. The decrease is primarily attributable to the \$11 million reduction to depreciation and amortization expense resulting from the Company revising its estimates of its asset retirement obligations liability in the fourth quarter of 2008. Also contributing to the decrease was reduced amortization expense on intangible assets due to the disposal of \$22 million of carrying value of amortizable intangible assets in the Vyvx advertising distribution sale and certain of the Company's amortizable intangible assets becoming fully amortized in early 2008. These decreases in depreciation and amortization were partially offset by higher accelerated depreciation in 2008 on network infrastructure assets that were abandoned as a result of the Company relocating small scale portions of its network and reductions in the useful lives of certain of the Company's amortizable intangible assets in the second quarter of 2007.

The Company expects depreciation and amortization expense of between \$900 million to \$940 million in 2009 based on the Company's current expectations of the timing and amounts of capital expenditures in 2009.

**Selling, General and Administrative** expenses include salaries, wages and related benefits (including non-cash, stock based compensation expenses), property taxes, travel, insurance, rent, contract maintenance, advertising, accretion expense on asset retirement obligations and other administrative expenses. Selling, general and administrative expenses also include certain network related expenses such as network facility rent, utilities and maintenance costs.

Selling, general and administrative expenses decreased 13% to \$1.5 billion in 2008 compared to \$1.7 billion in 2007. The decrease is primarily attributable to the \$86 million reduction to selling, general and administrative expenses resulting from the Company revising its estimates of its asset retirement obligations liability in the fourth quarter of 2008. Also contributing to the decrease were synergies that have been achieved as a result of acquisition integration efforts and the Company's focus on reducing operating expenses. Specifically, decreases in employee compensation and related costs, professional fees and vendor services, and facilities-based expenses all contributed to the decrease in selling, general and administrative expenses in 2008 compared to 2007.

Included in selling, general and administrative expenses in 2008 and 2007 were \$78 million and \$122 million, respectively, of non-cash, stock-based compensation expenses related to grants of outperform stock options and restricted stock units and restricted stock shares. The decrease in non-cash, stock-based compensation expense in 2008 compared to 2007, is primarily due to the Company not making its annual discretionary grant to its 401(k) plan. The Company made a discretionary contribution to the 401(k) plan in Level 3 common stock for the year ended December 31, 2007 of \$16 million. Non-cash, stock-based compensation also decreased in 2008 compared to 2007 for those employees eligible for accelerated vesting of stock awards at retirement and as a result of a lower weighted-average fair value of restricted stock awards granted in 2008 compared to 2007. See Note 12 of the Notes to Consolidated Financial Statements for more details.

The Company expects to continue its focus on reducing selling, general and administrative expenses in 2009.

**Restructuring and Impairment Charges** increased to \$25 million in 2008 from \$12 million in 2007 as a result of an increase in costs associated with employee terminations. See Note 8 of the Notes to Consolidated Financial Statements for more details.

The Company may experience further restructuring charges in 2009 in connection with the continued integration of acquired businesses as a result of the deployment of improved business

processes and systems and the possible need to adjust its cost structure if revenue performance is not satisfactory due to negative effects of the current economy or other reasons, which could result in additional headcount reductions.

**Adjusted EBITDA**, as defined by the Company, is net income (loss) from the consolidated statements of operations before (1) income taxes, (2) total other income (expense), (3) non-cash impairment charges included within restructuring and impairment charges, (4) depreciation and amortization and (5) non-cash stock compensation expense included within selling, general and administrative expenses in the consolidated statements of operations.

Adjusted EBITDA is not a measurement under GAAP and may not be used in the same way by other companies. Management believes that Adjusted EBITDA is an important part of the Company's internal reporting and is a key measure used by management to evaluate profitability and operating performance of the Company and to make resource allocation decisions. Management believes such measurement is especially important in a capital-intensive industry such as telecommunications. Management also uses Adjusted EBITDA to compare the Company's performance to that of its competitors and to eliminate certain non-cash and non-operating items in order to consistently measure from period to period its ability to fund capital expenditures, fund growth, service debt and determine bonuses.

Adjusted EBITDA excludes non-cash impairment charges and non-cash stock compensation expense because of the non-cash nature of these items. Adjusted EBITDA also excludes interest income, interest expense, income taxes and gain (loss) on extinguishment of debt because these items are associated with the Company's capitalization and tax structures. Adjusted EBITDA also excludes depreciation and amortization expense because these non-cash expenses reflect the effect of capital investments which management believes should be evaluated through cash flow measures. Adjusted EBITDA excludes the gain on sale of business groups and net other income (expense) because these items are not related to the primary operations of the Company.

There are limitations to using non-GAAP financial measures, including the difficulty associated with comparing companies that use similar performance measures whose calculations may differ from the Company's calculations. Additionally, this financial measure does not include certain significant items such as interest income, interest expense, income taxes, depreciation and amortization, non-cash impairment charges, non-cash stock compensation expense, gain (loss) on early extinguishment of debt, the gain on sale of business groups and net other income (expense). Adjusted EBITDA should not be considered a substitute for other measures of financial performance reported in accordance with GAAP.

Note 14 of the Notes to Consolidated Financial Statements provides a reconciliation of Adjusted EBITDA for each of the Company's reportable operating segments.

Adjusted EBITDA for the communications business was \$1.0 billion in 2008 compared to \$823 million in 2007. The increase in Adjusted EBITDA for the communications business is primarily attributable to the growth in the Company's Core Communications Services revenue and the benefits of continued operating expense reductions from integration activities, partially offset by declines in Other Communications Services revenue. Also contributing to the increase in Adjusted EBITDA for the communications business in 2008 was the \$86 million reduction to selling, general and administrative expenses resulting from the Company revising its estimates of the amounts of its asset retirement obligations liability in the fourth quarter of 2008.

**Interest Income** decreased to \$15 million in 2008 from \$54 million in 2007. The decrease in interest income was primarily due to a decrease in the Company's average invested cash balances and a decrease in the average returns on the portfolio. The Company's average return on its portfolio decreased to 2.0% in 2008 compared to 4.8% in 2007. The average portfolio balance decreased to \$735 million in 2008 compared to \$1.0 billion in 2007.

The Company invests its funds primarily in government and government agency securities, money market funds and commercial paper depending on liquidity requirements. The Company's investment strategy generally provides lower yields on the funds than would be obtained on alternative investments, but reduces the risk to principal in the short term prior to these funds being used in the Company's business.

**Interest Expense** decreased 7% to \$534 million in 2008 from \$577 million in 2007. Interest expense decreased primarily as a result of a decrease in interest rates on the Company's unhedged variable rate debt. Interest rates on the Company's unhedged variable rate debt approximated 6% in 2008 and 8% in 2007. Interest expense also decreased as a result of the debt for equity exchanges, debt redemptions, debt repurchases and debt repayment transactions that were completed by the Company in 2007 and 2008. See Note 11 of the Notes to Consolidated Financial Statements for more details.

**Gain on Sale of Business Groups** totaled \$99 million in 2008 compared to zero 2007. On June 5, 2008, Level 3 completed the sale of its Vyvx advertising distribution business to DG FastChannel, Inc. and recognized a gain on the sale of \$96 million in the second quarter of 2008. In addition, in the fourth quarter of 2008 Level 3 completed the sale of certain of its smaller long distance voice customers and recognized a gain on the sale of approximately \$3 million. See Note 2 of the Notes to Consolidated Financial Statements for more details.

**Gain (Loss) on Extinguishment of Debt** was a gain of \$81 million in 2008 compared a loss of \$427 million in 2007. The 2008 gain on extinguishment of debt consisted of a gain of \$125 million as a result of certain debt repurchases prior to maturity, partially offset by a \$44 million loss attributable to induced debt conversion expenses related to the exchange of certain of the Company's convertible debt securities. The 2007 loss on extinguishment of debt consisted of a loss of \$427 million as a result of the refinancing of the Company's senior secured credit agreement and certain debt exchanges, redemptions and repurchases prior to maturity. See Note 11 of the Notes to Consolidated Financial Statements for more details.

The Company may enter into additional transactions in the future to repurchase or exchange existing debt that may result in gains or losses on the extinguishment of debt.

**Other, net** was \$24 million in 2008 and \$55 million in 2007. Other, net is primarily comprised of gains and losses on the sale of non-operating assets, marketable securities, realized foreign currency gains and losses and other income.

**Income Tax Benefit (Expense)** was a \$6 million expense in 2008 and was a \$22 million benefit in 2007. The income tax expense for 2008 was primarily the result of state income taxes.

The Company incurs income tax expense attributable to income in various Level 3 subsidiaries, including the coal business, that are required to file state or foreign income tax returns on a separate legal entity basis. The Company also recognizes accrued interest and penalties in income tax expense related to uncertain tax benefits that have not been recognized in the Company's tax returns.

As of December 31, 2008, the Company had net operating loss carry forwards of approximately \$4.7 billion for federal income tax purposes. Under the rules prescribed by U.S. Internal Revenue Code ("IRC") Section 382 and applicable regulations, if certain transactions occur with respect to an entity's capital stock that result in a cumulative ownership shift of more than 50 percentage points by 5-percent stockholders over a testing period, annual limitations are imposed with respect to the entity's ability to utilize its net operating loss carry forwards and certain current deductions against any taxable income the entity achieves in future periods. The Company had entered into transactions over the testing period resulting in significant cumulative shifts in the ownership of its capital stock which alone would not have resulted in an ownership change under IRC Section 382. However, when the Company's actions are coupled with the trading activity in the Company's common stock throughout 2008 by third-party market participants, the Company believes that in 2008 the Company experienced a cumulative

ownership change of more than 50 percentage points by 5-percent stockholders during the applicable testing period. Prior to the ownership change, the Company had net operating loss carry forwards of \$9.7 billion. The Company believes that the limitation of its net operating loss carry forwards will not have a near term effect on its consolidated results of operations and financial position. The Company also believes that the limitation of its net operating loss carry forwards has an immaterial effect on the current intrinsic value of the Company's business taken as a whole. Additional transactions could cause the Company to incur a subsequent 50 percentage point ownership change by 5-percent stockholders and, if the Company triggers the above-noted IRC imposed limitations, could further limit it from fully utilizing the remaining net operating loss carry forwards and certain current deductions to reduce income taxes.

### ***Results of Operations 2007 vs. 2006***

(dollars in millions)	Year Ended		
	December 31,	December 31,	Change
	2007	2006	%
<b>Revenue:</b>			
Communications	\$ 4,199	\$ 3,311	27%
Coal mining	70	67	4%
Total revenue	4,269	3,378	26%
<b>Costs and Expenses: (exclusive of depreciation and amortization shown separately below)</b>			
Cost of revenue:			
Communications	1,769	1,460	21%
Coal mining	64	57	12%
Cost of revenue	1,833	1,517	21%
Depreciation and amortization	942	730	29%
Selling, general and administrative	1,723	1,258	37%
Restructuring and non-cash impairment charges	12	13	(8)%
Total costs and expenses	4,510	3,518	28%
Operating Loss	(241)	(140)	(72)%
<b>Other Income (Expense):</b>			
Interest income	54	64	(16)%
Interest expense	(577)	(648)	11%
Loss on extinguishment of debt, net	(427)	(83)	(414)%
Other, net	55	19	189%
Total other income (expense)	(895)	(648)	(38)%
Loss from Continuing Operations Before Income Taxes	(1,136)	(788)	(44)%
Income Tax Benefit (Expense)	22	(2)	—
Loss from Continuing Operations	(1,114)	(790)	(41)%
Income from Discontinued Operations	—	46	(100)%
Net Loss	\$ (1,114)	\$ (744)	(50)%



Communications revenue consists of the following:

(dollars in millions)	Year Ended December 31,	
	2007	2006
<b>Communications Services:</b>		
Core Network Services	\$ 2,994	\$ 1,518
Wholesale Voice Services	628	455
Total Core Communications Services	3,622	1,973
Other Communications Services	577	1,338
Total Communications Services Revenue	<u>\$ 4,199</u>	<u>\$ 3,311</u>

The 84% increase in Core Communications Services revenue for 2007 compared to 2006 is due to growth in the Company's revenue from existing services, as well as revenue from the Progress Telecom, ICG Communications, TelCove, Looking Glass, Broadwing, CDN Business and Servecast acquisitions. The Company purchased Progress Telecom in March 2006, ICG Communications in May 2006, TelCove in July 2006 and Looking Glass in August 2006. The Company purchased Broadwing and the CDN Business in January 2007 and Servecast in July 2007. From a financial reporting perspective, the Company integrated into the Level 3 business the operations of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass in 2006, and Broadwing and the CDN Business in the first half of 2007. As a result, separate revenue information by revenue category for these acquired companies is no longer reported other than for the SBC Contract Services revenue acquired from WilTel.

As described earlier, the growth in Core Communications Services revenue was lower than expected during the second, third and fourth quarters of 2007 as a result of an increase in service activation times and challenges in service management processes. Service activation times increased during the second and third quarters of 2007 as a result of the following issues.

- Continuing to use the multiple order entry and provisioning systems and processes that were operated by the acquired companies to provision end-to-end services.
- Insufficient training on the multiple systems for employees performing service activation functions.
- Lack of sufficient staffing levels in some service activation areas.
- Identifying and fixing service activation throughput issues was challenging as a result of decentralizing service activation functions across the customer facing groups in the third quarter of 2006.

Transport and infrastructure revenue increased 69% for 2007 compared to 2006. The increase was the result of growth in existing services and the recognition of a full year of revenue in 2007 for Progress Telecom, ICG Communications, TelCove and Looking Glass acquisitions completed in 2006, as well as the revenue from the Broadwing acquisition completed in January 2007. Increased demand in the cable and wireless market segments for complex nationwide solutions and colocation capacity in large markets contributed to the revenue growth in existing services in 2007 as compared to 2006.

IP and data revenue increased 94% for 2007 compared to 2006. The increase was the result of growth in existing services and the recognition of a full year of revenue in 2007 for Progress Telecom, ICG Communications, TelCove and Looking Glass acquisitions completed in 2006, as well as a full year of revenue from the Broadwing acquisition completed in early January 2007. IP and data revenue also increased in 2007 as a result of the CDN Business acquisition completed in January 2007 and the Servecast acquisition completed in July 2007. IP and data revenue also increased due to traffic growth



in North America from new and existing customers that exceeded the rate of price compression experienced in 2007. During the second quarter of 2007, the Company also implemented new, reduced pricing under the terms of a contract renewal for its largest IP and data customer which partially offset the overall growth of IP and data revenue in the last half of 2007. Continued revenue growth in the Company's VPN service also contributed to the increase in IP and data revenue during 2007.

Level 3's voice revenue increased 121% for 2007 compared to 2006. The increase is primarily attributable to the operations acquired in the TelCove and Broadwing acquisitions, particularly domestic and international voice termination services, and growth in Level 3's existing wholesale and VoIP-related services including voice termination, local inbound, enhanced local and toll free services.

Level 3 Vvyx revenue increased 15% for 2007 compared to 2006. The increase was a result of an increase in advertising distribution revenue and the continued demand for high-definition broadcast services in sports, news and entertainment.

Managed modem revenue declined 45% to \$158 million for 2007 compared to 2006 as a result of the continued migration from narrow band dial-up services to higher speed broadband services by end user customers, especially in large metropolitan areas. This change has resulted in a decline in the demand for managed modem ports.

Reciprocal compensation revenue from managed modem services declined 8% to \$94 million for 2007 compared to 2006 as a result of the continuing decline in demand for managed modem services. As a result of the Company's acquisitions of WilTel, TelCove and Broadwing, the Company has started to generate a portion of its reciprocal compensation revenue from voice services. For the full year ending December 31, 2007, the Company recognized \$26 million of reciprocal compensation revenue earned from voice services, which are included in Core Communications Services revenue.

Managed IP services revenue declined 61% to \$22 million for 2007 compared to 2006. As discussed earlier, to date the Company has not invested in this service and the decline in revenue is attributable to the disconnection of service by existing customers. The Company's legacy managed IP services business consists primarily of a business that was acquired in 2003.

SBC Contract Services revenue decreased 66% to \$303 million for 2007 compared to 2006 as expected due to the migration of the SBC traffic to the AT&T network. The SBC Contract Services agreement was obtained in December 2005 as part of the WilTel acquisition. Under the terms of the agreement, SBC has gross margin purchase commitments through 2009. SBC fully satisfied the \$335 million gross margin purchase commitment for the period from December 2005 through December 2007 during the third quarter of 2007. As a result of satisfying the initial gross margin purchase commitment, SBC's purchases of services that exceed the original \$335 million gross margin purchase commitment counted toward the \$75 million gross margin purchase commitment for the period from January 2008 through the end of 2009. As of December 31, 2007, SBC had satisfied \$39 million of the \$75 million gross margin purchase commitment.

**Coal mining** revenue increased 4% to \$70 million in 2007 compared to 2006. The increase was attributable to an increase in the tons of coal sold from the Black Butte mine, partially offset by a decrease in the tons of coal sold from the Decker mine. Overall, the price per ton for coal from both mines was up slightly in 2007 compared to 2006.

**Cost of Revenue** for the communications business, as a percentage of revenue, for 2007 and 2006 was 42% and 44%, respectively. The decrease in the 2007 cost of revenue, as a percentage of revenue, was primarily attributable to the continued decrease in SBC Contract Services revenue from 2006 to 2007. The margins for SBC Contract Services revenue are lower than the margins earned on other components included in Core and Other Communications Services revenue. Also contributing to the decrease in 2007 cost of revenue, as a percentage of revenue, were cost of revenue synergy savings that have been achieved as a result of acquisition integration efforts. The Company believes that cost of revenue synergy savings of \$80 million on an annualized basis have been achieved through integration efforts in 2007.

Coal mining cost of revenue, as a percentage of revenue, increased to 91% for 2007 compared to 85% in 2006. The increase in cost of revenue, as a percentage of revenue, in 2007 as compared to 2006 was due to planned equipment maintenance costs at one mine and higher costs related to overburden removal at another mine.

**Depreciation and Amortization** expense increased 29% to \$942 million for 2007 compared to 2006. The increase is primarily attributable to the increased depreciation and amortization expense recognized on communications tangible and intangible assets that were acquired through acquisitions completed in 2006 and 2007, as well as depreciation expense on the approximately \$241 million increase in capital expenditures for 2007 compared to 2006.

In addition, during the second quarter of 2007, the Company reviewed and adjusted the estimated useful lives used for amortization of customer-related intangible assets for the ICG Communications, TelCove and Looking Glass acquisitions effective June 1, 2007. This resulted in increased amortization expense of \$9 million during the year ended December 31, 2007.

During the fourth quarter of 2007, the Company finalized the purchase price allocation for the Broadwing acquisition which resulted in reduced amortization expense related to intangible assets for the Broadwing acquisition from the date of acquisition totaling approximately \$18 million, as compared to the total amortization expense that would have been recognized for 2007 prior to the change in the valuation of the intangible assets.

The increase in depreciation expense for 2007 was partially offset by a \$44 million decrease in depreciation expense compared to the same period in 2006 attributable to the increase in estimated useful lives for network fiber and IP and transmission equipment implemented in the second and third quarters of 2006.

**Selling, General and Administrative** expenses increased 37% to \$1.7 billion in 2007 compared to 2006. This increase is primarily attributable to the expenses associated with the operations acquired in the Progress Telecom, ICG Communications, TelCove and Looking Glass transactions during 2006; the Broadwing and CDN Business transactions in January 2007; and the Servecast transaction in July 2007. Specifically, increases in compensation, bonus and employee related costs, network related costs and facility-based expenses all contributed to the increase in selling, general and administrative expenses in 2007. Offsetting the increases discussed above were selling, general and administrative expense synergy savings that have been achieved as a result of acquisition integration efforts. As of the end of 2007, the Company believes that it has achieved annualized run rate synergies in selling, general and administrative expenses totaling approximately \$105 million. Also offsetting the increase in selling, general and administrative expenses in 2007 compared to 2006 was a reduction in incentive-based compensation expense of \$32 million as a result of lower than expected financial performance in 2007.

Included in selling, general and administrative expenses for 2007 and 2006 were \$122 million and \$84 million, respectively, of non-cash stock-based compensation expense related to grants of outperform stock options and restricted stock units and restricted stock shares. The increase in non-cash compensation expense in 2007 compared to 2006, is due to an increase in the number of restricted stock units and restricted stock shares issued to employees as a result of an increase in the number of employees eligible in 2007 compared to 2006, an increase in the 401(k) employee match and annual discretionary grant made to the 401(k) plan and an increase in non-cash compensation expense for those employees eligible for accelerated vesting of stock awards at retirement; with the overall increase partially offset by a reduction in the number of outperform stock options and units issued in 2007 compared to 2006. The number of employees eligible to participate in the Company's stock-based long-term incentive plan increased significantly from 2006 to 2007 as a result of the employees of acquired companies becoming eligible to participate in the long-term incentive plan at the beginning of 2007.

In 2007, the Company recognized additional non-cash stock-based compensation expense totaling approximately \$11 million for those employees eligible for accelerated vesting of stock awards at retirement. The Company provides accelerated vesting of stock awards at the date an employee retires if the employee meets certain age and years of service requirements and certain other requirements. Under SFAS No. 123R, the fair value of stock-based employee awards are expensed over the minimum service period, which is from the grant date to the earliest vesting date. Therefore, the Company is required to fully expense at the grant date the value of stock awards made to those employees that already meet both the age and years of service requirements for accelerated vesting at retirement at the date of grant. If the employee will meet the age and years of service requirements for accelerated vesting at retirement sooner than the normal vesting period for the stock awards, then the Company is required to use that shorter period for recognition of the non-cash compensation expense associated with the grant.

Included in the 2006 non-cash compensation expense of \$84 million was \$6 million related to the revaluation of the October 2005 and January 2006 grants using May 15, 2006 as the revised grant date, as there had not been stockholder approval of those awards prior to that date, which was deemed necessary for determination of the grant date for those awards under SFAS No. 123R.

**Restructuring and Non-Cash Impairment Charges** declined 8% to \$12 million in 2007 compared to 2006. The Company recognized severance charges of \$11 million in 2007 and \$5 million in 2006 related to workforce reductions in the communications business in North America. The workforce reductions completed in 2007 were primarily related to the integration of companies acquired by Level 3 in 2006 and January 2007. The Company recognized non-cash impairment charges of \$1 million and \$8 million in 2007 and 2006, respectively. The non-cash impairment charge of \$1 million in 2007 and \$4 million of the 2006 charge were primarily related to previously capitalized costs of certain information technology development projects no longer used by the Company. The costs incurred for these projects, including capitalized labor, were impaired as the Company did not expect to utilize the assets in the future. The remaining \$4 million non-cash impairment charge in 2006 was related to excess land of the communications business deemed available for sale in Germany. This charge resulted from the difference between the recorded carrying value and the estimated market value of the land. During the third quarter of 2007, the Company reclassified the excess land in Germany to property, plant and equipment due to the fact the land had not been sold and was no longer being actively marketed for sale.

**Adjusted EBITDA** for the communications business was \$823 million and \$677 million in 2007 and 2006, respectively. The increase was primarily attributable to the Adjusted EBITDA contribution from the operations acquired in the Progress Telecom, ICG Communications, TelCove, Looking Glass, Broadwing, CDN Business and Servecast acquisitions, growth in the Company's Core Communications Services revenue and the benefits of cost of revenue and operating expense synergies realized in 2007 from integration activities, partially offset by declines in other communications services revenue, SBC Contract Services revenue and costs of integration incurred during 2007 as compared to 2006.

Adjusted EBITDA for the coal mining business decreased to \$5 million in 2007 from \$8 million in 2006. The decrease is primarily attributable to an increase in the amount of coal sold from the Black Butte mine which has higher stripping ratios that result in higher overall costs and a planned increase in maintenance costs for mining equipment in 2007.

**Interest Income** decreased 16% to \$54 million in 2007 compared to 2006. The decrease in interest income was primarily due to a decrease in the average invested balance partially offset by an increase in the average return on the portfolio. The Company's average return on its portfolio increased to 4.8% in 2007 compared to 4.3% in 2006. The average portfolio balance decreased to \$1.0 billion in 2007 compared to \$1.5 billion in 2006.

**Interest Expense** decreased 11% to \$577 million in 2007 compared to 2006. Interest expense decreased primarily as a result of the debt for equity exchanges, debt redemptions and debt repurchases that were completed by the Company in the first quarter of 2007 and the debt repurchased in 2006. The decrease in interest expense was partially offset by the 2006 and 2007 debt issuances. See Note 11 of the Notes to Consolidated Financial Statements for more details.

**Loss on Extinguishment of Debt** was \$427 million in 2007 compared to \$83 million in 2006. The 2007 loss on extinguishment of debt consisted of a loss of \$427 million as a result of the refinancing of its senior secured credit agreement and certain debt exchanges, redemptions and repurchases prior to maturity. The 2006 loss on extinguishment of debt consisted of a \$54 million loss from the repurchase of certain debt and a \$55 million loss on the amendment and restatement of Level 3 Financing's Senior Secured Term Loan due 2011, partially offset by a \$27 million gain realized on a debt exchange.

**Other, net** increased 189% to \$55 million in 2007 compared to \$19 million in 2006. Other, net is primarily comprised of gains and losses on the sale of marketable securities and non-operating assets, realized foreign currency gains and losses and other income. The increase in 2007 compared to 2006 is primarily due to a gain of \$37 million recognized in the fourth quarter of 2007 on the sale of 80% of the Company's holdings of Infinera common stock.

**Income Tax Benefit (Expense)** was a \$22 million benefit in 2007 and was a \$2 million expense in 2006. The income tax benefit for 2007 was primarily the result of reversing \$23 million of the valuation allowance against the Company's deferred tax asset for certain state NOLs. These state tax NOLs were converted to a state tax credit carry forward associated with a change in the state tax law that replaced the tax on net income with a tax on gross margin. The Company now expects it will be able to use this state tax credit carry forward against current and future state taxable gross margin.

**Income from Discontinued Operations** in 2006 of \$46 million was related to the discontinued operations of the Company's Information Services segment. The Company sold Software Spectrum, Inc. ("Software Spectrum") to Insight Enterprises, Inc. ("Insight") in September 2006. There were no gains or losses from discontinued operations recognized in 2007. Software Spectrum, Inc.'s results of operations resulted in income from discontinued operations of \$13 million in 2006. In addition, Level 3 recognized a gain on the sale of Software Spectrum to Insight in 2006 of \$33 million.

## Financial Condition—December 31, 2008

Cash flows provided by (used in) operating activities, investing activities and financing activities for the years ended December 31, 2008 and 2007, respectively are summarized as follows:

(dollars in millions)	Year Ended		
	December 31,	December 31,	
	2008	2007	Change
Net Cash Provided by Operating Activities	\$ 413	\$ 231	\$ 182
Net Cash Used in Investing Activities	(321)	(961)	640
Net Cash Used In Financing Activities	(34)	(243)	209
Effect of Exchange Rates on Cash and Cash Equivalents	(4)	6	(10)
Net Change in Cash and Cash Equivalents	<u>\$ 54</u>	<u>\$ (967)</u>	<u>\$1,021</u>

### Operating Activities

Cash provided by operating activities increased by \$182 million in 2008 compared to 2007. The increase in cash provided by operating activities was primarily due to an increase in Adjusted EBITDA, favorable changes in working capital items and lower interest payments. The favorable change in

working capital items is primarily due to the changes in accounts payable and other current liabilities, partially offset by changes in accounts receivable, other current assets and deferred revenue.

### ***Investing Activities***

Cash used in investing activities decreased by \$640 million in 2008 compared to 2007. Cash used for acquisitions totaled \$670 million, net of cash acquired, in 2007 as a result of the acquisitions of Broadwing, Servecast and the CDN business. The Company did not complete any acquisitions in 2008. In addition, the Company received net proceeds from the sale of its Vyvx advertising distribution business and the sale of certain of its smaller long distance voice customers of \$124 million in 2008. The Company also reduced its capital expenditures by \$184 million in 2008 compared to 2007, primarily as a result of a reduction in integration-related capital expenditures and more efficiently managing capital expenditure requirements. Partially offsetting these favorable changes in 2008 was cash received in 2007 of \$333 million from the sale and maturity of marketable securities compared to \$4 million in 2008, and an increase in restricted cash.

### ***Financing Activities***

Cash used in financing activities decreased \$209 million in 2008 compared to 2007. In 2008, cash flows from financing activities include \$400 million of proceeds from the issuance of the 15% Convertible Senior Notes. The Company used the proceeds from this offering to repurchase portions of its 6% Convertible Subordinated Notes due 2009 and 2010 and 2.875% Convertible Senior Notes due 2010 for approximately \$336 million. In addition, the Company repaid the final amounts due under the 11% Senior Notes due 2008 and 10.75% Senior Euro Notes due 2008 of approximately \$26 million, repurchased a portion of its 6% Convertible Subordinated Notes due 2009 and 2010 for \$68 million, and made capital lease and commercial mortgage payments of approximately \$6 million using cash on hand.

In 2007, cash flows from financing activities include approximately \$2.4 billion of net proceeds from the issuance of the Floating Rate Senior Notes due 2015, the 8.75% Senior Notes due 2017 and the Senior Secured Credit Facility due 2014. The Company used the net proceeds from these offerings along with cash on hand to retire or refinance approximately \$2.6 billion of its debt. Financing activities for 2007 also include proceeds of \$26 million from the exercise of warrants for the Company's common stock associated with the Broadwing transaction and other equity-based instruments.

### ***Liquidity and Capital Resources***

The Company incurred a net loss of \$290 million in 2008 and \$1.1 billion in 2007. The Company used \$449 million for capital expenditures and generated \$413 million in cash flows from operating activities in 2008. This compares to \$633 million of cash used for capital expenditures and \$231 million of cash flows provided by operating activities in 2007.

Cash interest payments are expected to be lower than the \$531 million made in 2008 based on current debt outstanding, current interest rates on the Company's variable rate debt and the financing and other capital markets transactions completed in 2007 and 2008. Capital expenditures for 2009 are expected to be lower than the \$449 million in 2008 as the Company expects to continue to efficiently manage its capital expenditure requirements. The Company expects to invest in base capital expenditures (estimated capital required to keep the network operating efficiently and new service development) with the remaining capital expenditures expected to be success-based, or tied to incremental revenue. As of December 31, 2008, the Company had long-term debt contractual obligations, including capital lease and commercial mortgage obligations and excluding premium and discounts on debt issuance and fair value adjustments of approximately \$186 million that mature in

2009 and \$583 million that mature in 2010. The Company's commercial mortgage obligation matures in 2010, but may be extended to 2015 at the election of the Company.

Level 3 had \$768 million of cash and cash equivalents on hand at December 31, 2008. In addition, \$130 million of current and non-current restricted cash and securities are used to collateralize outstanding letters of credit, long-term debt, certain operating obligations of the Company and certain reclamation liabilities associated with the coal mining business. Based on information available at this time, the Company believes that its current liquidity and anticipated future cash flows from operations will be sufficient to fund its business for at least the next twelve months.

The Company may elect to secure additional capital in the future, at acceptable terms, to improve its liquidity or fund acquisitions. In addition, in an effort to reduce future cash interest payments, as well as future amounts due at maturity or to extend debt maturities, Level 3 or its affiliates may, from time to time, issue new debt, enter into debt for debt, debt for equity or cash transactions to purchase its outstanding debt securities in the open market or through privately negotiated transactions. Level 3 will evaluate any such transactions in light of then existing market conditions and the possible dilutive effect to stockholders. The amounts involved in any such transaction, individually or in the aggregate, may be material. See Note 11 of the Notes to Consolidated Financial Statements for more details regarding the Company's 2008 and 2007 financing transactions.

In addition to raising capital through the debt and equity markets, the Company may sell or dispose of existing businesses, investments or other non-core assets. For example, in 2008, Level 3 completed the sale of its Vyvx advertising distribution business and the sale of certain of its smaller long distance voice customers and received aggregate net cash proceeds of \$124 million.

Consolidation of the communications industry may continue. In 2006 and 2007, Level 3 participated in the consolidation of the communications industry with the acquisitions of several companies. Level 3 will continue to evaluate consolidation opportunities and could make additional acquisitions in the future.

### Off-Balance Sheet Arrangements

Level 3 has not entered into off-balance sheet arrangements that have had, or are likely to have, a current or future material effect to its results of operations or its financial position.

### Contractual Obligations

The following table summarizes the contractual obligations and commercial commitments of the Company at December 31, 2008, as further described in the Notes to Consolidated Financial Statements.

#### *Payments Due by Period*

		Less than	1 - 3	4 - 5	After
	Total	1 Year	Years	Years	5 Years
<b>Contractual Obligations</b>					
Long-Term Debt, including current portion	\$6,586	\$ 186	\$1,152	\$1,575	\$3,673
Interest Obligations	2,801	521	1,020	850	410
Asset Retirement Obligations	151	8	14	18	111
Operating Leases	882	153	259	209	261
Right of Way Agreements	1,175	110	174	158	733
Purchase Obligations	365	365	—	—	—
<b>Other Commercial Commitments</b>					
Letters of Credit	30	2	2	—	26

The Company's debt instruments contain certain covenants which, among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates. If the Company should fail to comply with these covenants, amounts due under the instruments may be accelerated at the note holder's discretion after the declaration of an event of default.

Long-term debt obligations exclude issue discounts and premiums and fair value adjustments.

Interest obligations assume interest rates on variable rate debt do not change from December 31, 2008. In addition, interest is calculated based on debt outstanding as of December 31, 2008, and on existing maturity dates.

Certain right of way agreements include provisions for increases in payments in future periods based on the rate of inflation as measured by various price indexes. The Company has not included estimates for unknown increases in future periods in the amounts included above.

Certain non-cancelable right of way agreements provide for automatic renewal on a periodic basis. Payments due under these agreements with automatic renewal options have been included in the table above for a period of 17 years from January 1, 2009, which approximates the economic remaining useful life of the Company's conduit. In addition, certain other right of way agreements are cancellable or can be terminated under certain conditions by the Company. The Company includes the payments under such cancelable right of way agreements in the table above for a period of 1 year from January 1, 2009, if the Company does not consider it likely that it will cancel the right of way agreement within the next year.

Purchase obligations represent all outstanding purchase order amounts of the Company as of December 31, 2008.

The table above does not include other long-term liabilities, such as liabilities recorded for legal matters and income taxes that are not contractual obligations by nature. The Company cannot determine with any degree of certainty the years in which these liabilities might ultimately be paid.



## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### *Interest Rate Risk*

Level 3 is subject to market risks arising from changes in interest rates and foreign exchange rates. As of December 31, 2008, the Company had borrowed a total of \$1.7 billion primarily under a Senior Secured Term Loan due 2014 and Floating Rate Senior Notes due 2015 that bear interest at LIBOR rates plus an applicable margin. As the LIBOR rates fluctuate, so too will the interest expense on amounts borrowed under the debt instruments. The weighted average interest rate on the variable rate instruments at December 31, 2008, was approximately 7.0%.

In March 2007, Level 3 Financing, Inc., the Company's wholly owned subsidiary, entered into two interest rate swap agreements to hedge the interest payments on \$1 billion notional amount of floating rate debt. The two interest rate swap agreements are with different counterparties and are for \$500 million each. The interest rate swap agreements were effective beginning in 2007 and mature in January 2014. Under the terms of the interest rate swap agreements, Level 3 receives interest payments based on rolling three month LIBOR terms and pays interest at the fixed rate of 4.93% under one arrangement and 4.92% under the other. Level 3 has designated the interest rate swap agreements as a cash flow hedge on the interest payments for \$1 billion of floating rate debt.

The remaining, or unhedged, variable rate debt has a weighted average interest rate of 7.0% at December 31, 2008. A hypothetical increase in the weighted average rate by 1% point (i.e. a weighted average rate of 8.0%) would increase the Company's annual interest expense by approximately \$7.0 million. At December 31, 2008, the Company had \$4.9 billion (excluding fair value adjustments, discounts and premiums) of fixed rate debt bearing a weighted average interest rate of 8.7%. A decline in interest rates in the future will not benefit the Company with respect to the fixed rate debt due to the terms and conditions of the indentures relating to that debt that would require the Company to repurchase the debt at specified premiums if redeemed early.

Indicated changes in interest rates are based on hypothetical movements and are not necessarily indicative of the actual results that may occur. Future earnings and losses will be affected by actual fluctuations in interest rates and foreign currency rates.

### *Foreign Currency Exchange Rate Risk*

The Company conducts a portion of its business in currencies other than the U.S. dollar, the currency in which the Company's consolidated financial statements are reported. Correspondingly, the Company's operating results could be adversely affected by foreign currency exchange rate volatility relative to the U.S. dollar. The Company's European subsidiaries use the local currency as their functional currency, as the majority of their revenue and purchases are transacted in their local currencies. Although the Company continues to evaluate strategies to mitigate risks related to the effect of fluctuations in currency exchange rates, the Company will likely recognize gains or losses from international transactions. Changes in foreign currency rates could adversely effect the Company's operating results.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Financial statements and supplementary financial information for Level 3 Communications, Inc. and Subsidiaries begin on page F-1.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.



## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of December 31, 2008. Based upon such review, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective and are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in reports it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

### **Changes in Internal Control Over Financial Reporting**

There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the fourth quarter of 2008 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

### **Management's Report on Internal Control Over Financial Reporting**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, management assessed the effectiveness of internal controls over financial reporting as of December 31, 2008 based on the guidelines established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our assessment, management has concluded that our internal control over financial reporting was effective as of December 31, 2008.

The Company's independent registered public accounting firm, KPMG LLP, has issued an audit report on its assessment of the Company's internal control over financial reporting as of December 31, 2008. This report appears on page F-3.

## **ITEM 9B. OTHER INFORMATION**

None.

### **Part III**

#### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this Item 10 is incorporated by reference to our definitive proxy statement for the 2009 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission, however certain information is included in ITEM 1. BUSINESS above under the caption "Directors and Executive Officers."

#### **ITEM 11. EXECUTIVE COMPENSATION**

The information required by this Item 11 is incorporated by reference to our definitive proxy statement for the 2009 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

For information as of December 31, 2008, with respect to compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance, please see "Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER REPURCHASES OF EQUITY SECURITIES" above.

The information required by this Item 12 is incorporated by reference to our definitive proxy statement for the 2009 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this Item 13 is incorporated by reference to our definitive proxy statement for the 2009 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information required by this Item 14 is incorporated by reference to our definitive proxy statement for the 2009 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

### **Part IV**

#### **ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES**

- (a) Financial statements and financial statement schedules required to be filed for the registrant under Items 8 or 15 are set forth following the index page at page F-l. Exhibits filed as a part of this report are listed below. Exhibits incorporated by reference are indicated in parentheses.
- 3.1 Restated Certificate of Incorporation of Level 3 Communications, Inc. (Exhibit 3(i) to the Registrant's Current Reports on Form 8-K filed on May 23, 2008).
  - 3.2 Specimen Stock Certificate of Common Stock, par value \$.01 per share (Exhibit 3 to the Registrant's Form 8-A filed on March 31, 1998).
  - 3.3 Amended and Restated By-laws of Level 3 Communications, Inc. (Exhibit 3(ii) to the Registrant's Current Report on Form 8-K filed on May 23, 2008).

- 4.1.1 Form of Subordinated Debt Securities Indenture (incorporated by reference to Exhibit 4.2 to Amendment 1 to the Registrant's Registration Statement on Form S-3 (File No. 333-68887) filed with the Securities and Exchange Commission on February 3, 1999).
- 4.1.2 First Supplemental Indenture, dated as of September 20, 1999, between the Registrant and IBJ Whitehall Bank & Trust Company as Trustee relating to the Registrant's 6% Convertible Subordinated Notes due 2009 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated September 20, 1999).
- 4.1.3 Second Supplemental Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 6% Convertible Subordinated Notes due 2010 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated February 29, 2000).
- 4.2 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 11 <sup>1</sup> / 4 % Senior Notes due 2010 (Exhibit 4.2 to the Registrant's Registration Statement on Form S-4 File No. 333-37362).
- 4.3 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 11 <sup>1</sup> / 4 % Senior Euro Notes due 2010 (Exhibit 4.2 to the Registrant's Registration Statement on Form S-4 File No. 333-37364).
- 4.4 Amended and Restated Indenture dated as of July 8, 2003, by and between the Company and The Bank of New York, as successor to IBJ Whitehall Bank & Trust Company, as trustee (amends and restates the Senior Debt Indenture, a Form of which was filed as an Exhibit to the Company's Registration Statement on Form S-3-File No. 333-68887) (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed July 8, 2003).
- 4.5 First Supplemental Indenture, dated as of July 8, 2003, by and between the Company and The Bank of New York, as successor to IBJ Whitehall Bank & Trust Company, as Trustee (Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed July 8, 2003).
- 4.6 Indenture, dated as of October 1, 2003, by and between Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc. as Issuer and The Bank of New York as Trustee relating to the Level 3 Financing, Inc. 10.75% Senior Notes due 2011 (Exhibit 4.11 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2003).
- 4.7.1 Indenture, dated as of October 24, 2003, by and between the Registrant and The Bank of New York as Trustee relating to the Registrant's 9% Convertible Senior Discount Notes due 2013 (Exhibit 4.12 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2003).
- 4.7.2 First Supplemental Indenture, dated as of February 7, 2005, by and between the Company and The Bank of New York, as Trustee relating to the Registrant's 9% Convertible Senior Discount Notes due 2013. (Exhibit 4.12.2 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2005).
- 4.8 Supplemental Indenture, dated as of October 20, 2004, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2014. (Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed October 22, 2004).

- 4.9 Supplemental Indenture, dated as of October 20, 2004 among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1 2003, among Level 3 Financing, Inc. as Issuer, Level 3 Communications, Inc. as Guarantor and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2011. (Exhibit 99.1 to the Registrant's Current Report on Form 8-K/A-1 filed October 22, 2004).
- 4.10 Indenture, dated December 2, 2004, among Level 3 Communications, Inc. and The Bank of New York. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 4.11 Supplemental Indenture, dated December 1, 2004, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York, as Trustee, relating to the Level 3 Financing 10.75% Senior Notes due 2011. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 4.12 Second Supplemental Indenture dated as of April 4, 2005, by and between Level 3 Communications, Inc. and the Bank of New York, as trustee (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed April 8, 2005).
- 4.13 Indenture, dated as of January 13, 2006, among Level 3 Communications, Inc. as Issuer and The Bank of New York, as Trustee relating to the 11.50% Senior Notes Due 2010 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated January 17, 2006).
- 4.14 Indenture, dated as of March 14, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the Floating Rate Senior Notes due 2011 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated March 16, 2006).
- 4.15 Indenture, dated as of March 14, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the 12.25% Senior Notes due 2013 of Level 3 Financing, Inc. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 16, 2006).
- 4.16 Third Supplemental Indenture between Level 3 Communications, Inc. and The Bank of New York, as Trustee, relating to up to \$345,000,000 aggregate principal amount of 3.5% Convertible Senior Notes due 2012, dated as of June 13, 2006 supplement to the Amended and Restated Indenture dated as of July 8, 2003 (Senior Debt Securities) (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 13, 2006).
- 4.17 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2011 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.18 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, Supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2011 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated October 17, 2006).

- 4.19 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.20 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.21 Indenture, dated as of October 30, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer, and The Bank of New York, as Trustee, relating to the 9.25% Senior Notes due 2014 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated October 30, 2006).
- 4.22 Supplemental Indenture, dated as of December 27, 2006, among Level 3 Communications, Inc., Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., as Issuer, Level 3 Communications, Inc., as Guarantor, and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2011 2014 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated December 28, 2006).
- 4.23 Indenture, dated as of February 14, 2007, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the Floating Rate Senior Notes due 2015 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 4.24 Indenture, dated as of February 14, 2007, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the 8.75% Senior Notes due 2017 of Level 3 Financing, Inc. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 4.25 Supplemental Indenture, dated as of February 23, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York, as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., as Issuer, Level 3 Communications, Inc., as Guarantor, and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed February 26, 2007).

- 4.26 Supplemental Indenture, dated as of March 1, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc., together with Level 3 Communications, Inc. and Level 3 Communications, LLC, as Guarantors and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, by and among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York as Trustee relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2011 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 2, 2007).
- 4.27 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2011 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.28 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Broadwing Financial Services, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2011 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.29 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes Due 2013 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated March 16, 2007).

- 4.30 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Broadwing Financial Services, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes Due 2013 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.31 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 20, 2004 among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated December 1, 2004, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes Due 2011 (Exhibit 4.5 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.32 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Broadwing Financial Services, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of October 30, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.6 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.33 Supplemental Indenture, dated as of March 13, 2007, among Level 3 Communications, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of January 13, 2006, among Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Communications, Inc.'s 11.5% Senior Notes Due 2010 (Exhibit 4.7 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.34 Supplemental Indenture, dated as of April 9, 2007, among Level 3 Communications, LLC, Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated October 30, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated April 11, 2007).
- 4.35 Supplemental Indenture, dated as of April 9, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated October 30, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated April 11, 2007).



- 4.36 Supplemental Indenture, dated as of January 4, 2007, among Broadwing Financial Services, Inc., Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated October 30, 2006 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.2 to the Registrant's Current Report on Form S-4/A dated May 14, 2007).
- 4.37 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Communications, LLC, Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 8.75% Senior Notes Due 2017 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated May 31, 2007).
- 4.38 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 8.75% Senior Notes Due 2017 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated May 31, 2007).
- 4.39 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Communications, LLC, Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2015 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated May 31, 2007).
- 4.40 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2015 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated May 31, 2007).
- 4.41 Indenture, dated as of December 24, 2008, among Level 3 Communications, Inc. and The Bank of New York Mellon as Trustee, relating to Senior Debt Securities (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated December 24, 2008).
- 4.42 First Supplemental Indenture, dated as of December 24, 2008, among Level 3 Communications, Inc. and The Bank of New York Mellon as Trustee, relating to Level 3 Communications, Inc.'s 15% Convertible Senior Notes due 2013 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated December 24, 2008).
- 10.1 Separation Agreement, dated December 8, 1997, by and among Peter Kiewit Sons', Inc., Kiewit Diversified Group Inc., PKS Holdings, Inc. and Kiewit Construction Group Inc. (Exhibit 10.1 to the Registrant's Form 10-K for 1997).
- 10.2 Amendment No. 1 to Separation Agreement, dated March 18, 1997, by and among Peter Kiewit Sons', Inc., Kiewit Diversified Group Inc., PKS Holdings, Inc. and Kiewit Construction Group Inc. (Exhibit 10.1 to the Registrant's Form 10-K for 1997).
- 10.3 Form of Aircraft Time-Share Agreement (Exhibit 10.7 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001).



- 10.4 Securities Purchase Agreement, dated as of February 18, 2005, among Level 3 Communications, Inc. and the Investors named therein (Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed February 22, 2005).
- 10.5 1995 Stock Plan of Level 3 Communications, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated December 20, 2007).
- 10.6.1 Outperform Stock Option Amended and Restated Master Award Agreement of Level 3 Communications, Inc. (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated December 20, 2007).
- 10.6.2 Form of OSO Master Award Agreement of Level 3 Communications, Inc. (Exhibit 10.3 to the Registrant's Current Report on Form 8-K dated December 20, 2007).
- 10.7 Form of Amended Master Deferred Issuance Stock Agreement of Level 3 Communications, Inc. (Exhibit 10.4 to the Registrant's Current Report on Form 8-K dated December 20, 2007).
- 10.8 Form of Amended and Restated Deferred Issuance Stock Agreement (Exhibit 10 to the Registrant's Quarterly Report on Form 10-Q for the three months ended March 31, 2008 dated May 12, 2008).
- 10.9 Purchase Agreement by and among Level 3 Communications, LLC, PT Holding Company LLC, Progress Telecommunications Corporation, EPIK Communications Incorporated, Florida Progress Corporation, Odyssey Telecorp, Inc. and Level 3 Communications, Inc. dated as of January 25, 2006 (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated January 30, 2006).
- 10.10 Form of Registration Rights and Transfer Restriction Agreement by and among Level 3 Communications, Inc., PT Holding Company LLC, Progress Telecommunications Corporation, Caronet, Inc., and EPIK Communications Incorporated to be entered into on the closing of the transaction contemplated by the Purchase Agreement 2006 (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated January 30, 2006).
- 10.11 Agreement and Plan of Merger by and among Level 3 Communications, Inc., Eldorado Acquisition Three, LLC and TelCove, Inc. dated as of April 30, 2006. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated April 19, 2006).
- 10.12 Registration Rights and Transfer Restriction Agreement, dated May 31, 2006, by and among Level 3 Communications, Inc., MCCC ICG Holdings LLC, Columbia Capital Equity Partners III(QP), L.P., Columbia Capital Partners III (Cayman), L.P., Columbia Capital Equity Partners III (AI), L.P., Columbia Capital Investors III, L.L.C., Columbia Capital Employees Investors III, L.L.C., M/C Venture Partners V, L.P., M/C Venture Investors, L.L.C., Chestnut Venture Partners, L.P., and Bear Investments, LLLP. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 1, 2006).
- 10.13 Stock Purchase Agreement, dated July 20, 2006, among Level 3 Communications, Inc., Technology Spectrum, Inc. and Insight Enterprises, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated July 26, 2006).
- 10.14 Registration Rights Agreement, dated as of August 2, 2006, between Level 3 Communications, Inc. and Cheshire Holding Corp., as agent for the security holders of Looking Glass Networks Holding Co., Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated August 3, 2006).

- 10.15 Agreement and Plan of Merger among Level 3 Communications, Inc., Level 3 Services, LLC, Level 3 Colorado, Inc. and Broadwing Corporation, dated as of October 16, 2006 (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 10.16 Agreement and Plan of Merger, dated as of October 16, 2006, as Amended by the First Amendment to Agreement and Plan of Merger Dated as of November 21, 2006, among Level 3 Communications, Inc., Level 3 Services, LLC, Level 3 Colorado, LLC (n/k/a Level 3 Colorado, Inc.) and Broadwing Corporation (attached as Annex A to the proxy statement/prospectus included in the registrant's Registration Statement on Form S-4 (333-138462) (Incorporated by reference to Exhibit 2.1 to the Registrant's Registration Statement on Form S-4 (333-138462)). (Exhibit 10.1 to the Registrant's Current Report on Form 8-K/A dated November 27, 2006).
- 10.17 Exchange Agreement, dated as of January 11, 2007, among Level 3 Communications, Inc., Southeastern Asset Management, Inc., on behalf of its investment advisory clients, and Legg Mason Opportunity Trust, a series of Legg Mason Investment Trust, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated January 17, 2007).
- 10.18 Credit Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.19 Guarantee Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., the Subsidiaries of Level 3 Communications, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.20 Collateral Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc., the Subsidiaries of Level 3 Communications, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.3 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.21 Indemnity, Subrogation and Contribution Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc., the Subsidiaries of Level 3 Communications, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.4 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.22 Omnibus Offering Proceeds Note Subordination Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc., Level 3 Communications, LLC, the Subsidiaries (Exhibit 10.5 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.23 Supplement No. 1 to Omnibus Offering Proceeds Note Subordination Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Communications, LLC, Level 3 Financing, Inc., the Subsidiaries (Exhibit 10.6 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.24 Amended and Restated Loan Proceeds Note, dated March 13, 2007, issued by Level 3 Communications, LLC to Level 3 Financing, Inc. (Exhibit 10.7 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.25 Amended and Restated Loan Proceeds Note Collateral Agreement, dated March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, LLC and Merrill Lynch Capital Corporation (Exhibit 10.8 to the Registrant's Current Report on Form 8-K dated March 16, 2007).

- 10.26 Amended and Restated Loan Proceeds Note Guarantee Agreement, dated March 13, 2007, among Broadwing Financial Services, Inc., and Level 3 Financing, Inc. (Exhibit 10.9 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.27 Standstill Agreement, dated November 19, 2007, by and between Level 3 Communications, Inc. and Southeastern Asset Management, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated November 19, 2007).
- 10.28 Separation Agreement and General Release, dated March 20, 2008, among Kevin J. O'Hara and Level 3 Communications, LLC (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated March 20, 2008).
- 10.29 Consulting Agreement, dated March 20, 2008, among Level 3 Communications, LLC and Kevin J. O'Hara (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated March 20, 2008).
- 10.30 Securities Purchase Agreement, dated November 17, 2008, among Level 3 Communications, Inc. and the Investors named therein (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated November 18, 2008).
- 10.31 Amendment No. 1 to Securities Purchase Agreement, dated December 16, 2008, among Level 3 Communications, Inc. and the Investors named therein (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated December 16, 2008).
- 10.32 Amendment No. 2 to Securities Purchase Agreement, dated December 24, 2008, among Level 3 Communications, Inc. and the Investors named therein (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated December 24, 2008).
- 10.33 Separation Agreement and General Release, dated December 31, 2008, among John Neil Hobbs and Level 3 Communications, LLC.
- 10.34 Consulting Agreement, dated December 31, 2008, among Level 3 Communications, LLC and Hobbs Management, LLC.
- 12 Statements re computation of ratios.
- 21 List of subsidiaries of the Company.
- 23 Consent of KPMG LLP.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, this 27<sup>th</sup> day of February, 2009.

LEVEL 3 COMMUNICATIONS, INC.

By: /s/ JAMES Q. CROWE

Name: James Q. Crowe  
Title: *Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>/s/ WALTER SCOTT, JR.</u> Walter Scott, Jr.	Chairman of the Board	February 27, 2009
<u>/s/ JAMES Q. CROWE</u> James Q. Crowe	Chief Executive Officer and Director	February 27, 2009
<u>/s/ SUNIT S. PATEL</u> Sunit S. Patel	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	February 27, 2009
<u>/s/ ERIC J. MORTENSEN</u> Eric J. Mortensen	Senior Vice President and Controller (Principal Accounting Officer)	February 27, 2009
<u>/s/ R. DOUGLAS BRADBURY</u> R. Douglas Bradbury	Director	February 27, 2009
<u>/s/ DOUGLAS C. EBY</u> Douglas C. Eby	Director	February 27, 2009
<u>/s/ JAMES O. ELLIS, JR.</u> James O. Ellis, Jr.	Director	February 27, 2009
<u>/s/ RICHARD R. JAROS</u> Richard R. Jaros	Director	February 27, 2009

<u>/s/ ROBERT E. JULIAN</u> Robert E. Julian	Director	February 27, 2009
<u>/s/ CHARLES C. MILLER, III</u> Charles C. Miller, III	Executive Vice President, Vice Chairman and Director	February 27, 2009
<u>/s/ MICHAEL J. MAHONEY</u> Michael J. Mahoney	Director	February 27, 2009
<u>/s/ ARUN NETRAVALI</u> Arun Netravali	Director	February 27, 2009
<u>/s/ JOHN T. REED</u> John T. Reed	Director	February 27, 2009
<u>/s/ MICHAEL B. YANNEY</u> Michael B. Yanney	Director	February 27, 2009
<u>/s/ ALBERT C. YATES</u> Albert C. Yates	Director	February 27, 2009

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

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Schedules not indicated above have been omitted because of the absence of the conditions under which they are required or because the information called for is shown in the consolidated financial statements or in the notes thereto.

## **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders  
Level 3 Communications, Inc.:

We have audited the accompanying consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit) and comprehensive loss for each of the years in the three-year period ended December 31, 2008. These consolidated financial statements are the responsibility of Level 3 Communications, Inc.'s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Level 3 Communications, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Level 3 Communications, Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 27, 2009 expressed an unqualified opinion on the effectiveness of Level 3 Communications, Inc.'s internal control over financial reporting.

/s/ KPMG LLP

Denver, Colorado  
February 27, 2009

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Level 3 Communications, Inc.:

We have audited Level 3 Communications, Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Level 3 Communications, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Management's Report on Internal Control Over Financial Reporting". Our responsibility is to express an opinion on Level 3 Communications Inc.'s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Level 3 Communications, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit) and comprehensive loss for each of the years in the three-year period ended December 31, 2008, and our report dated February 27, 2009 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Denver, Colorado  
February 27, 2009



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

For each of the three years ended December 31, 2008

	2008	2007	2006
	(dollars in millions, except per share data)		
Revenue:			
Communications	\$ 4,226	\$ 4,199	\$ 3,311
Coal mining	75	70	67
Total revenue	4,301	4,269	3,378
Costs and Expenses (exclusive of depreciation and amortization shown separately below):			
Cost of revenue:			
Communications	1,740	1,769	1,460
Coal mining	69	64	57
Total cost of revenue	1,809	1,833	1,517
Depreciation and amortization	931	942	730
Selling, general and administrative	1,505	1,723	1,258
Restructuring and impairment charges	25	12	13
Total costs and expenses	4,270	4,510	3,518
Operating Income (Loss)	31	(241)	(140)
Other Income (Expense):			
Interest income	15	54	64
Interest expense	(534)	(577)	(648)
Gain on sale of business groups, net	99	—	—
Gain (loss) on early extinguishment of debt, net	81	(427)	(83)
Other, net	24	55	19
Total other income (expense)	(315)	(895)	(648)
Loss from Continuing Operations Before Income Taxes	(284)	(1,136)	(788)
Income Tax (Expense) Benefit	(6)	22	(2)
Loss from Continuing Operations	(290)	(1,114)	(790)
Discontinued Operations:			
Income from discontinued operations	—	—	13
Gain on sale of discontinued operations	—	—	33
Income from Discontinued Operations	—	—	46
Net Loss	\$ (290)	\$ (1,114)	\$ (744)
Shares Used to Compute Basic and Diluted Loss Per Share (in thousands)	1,564,996	1,517,616	1,003,255
Earnings (Loss) Per Share (Basic and Diluted):			
Loss from Continuing Operations	\$ (0.19)	\$ (0.73)	\$ (0.79)
Income from Discontinued Operations	—	—	.05
Net Loss	\$ (0.19)	\$ (0.73)	\$ (0.74)

See accompanying notes to consolidated financial statements.

# **LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

## **CONSOLIDATED BALANCE SHEETS**

**DECEMBER 31, 2008 AND 2007**

	2008	2007
	(dollars in millions, except per share data)	
<i>Assets</i>		
Current Assets:		
Cash and cash equivalents	\$ 768	\$ 714
Marketable securities	—	9
Restricted cash and securities	3	10
Receivables, less allowances for doubtful accounts of \$16 and \$20, respectively	390	404
Other	83	88
Total Current Assets	1,244	1,225
Property, Plant and Equipment, net	6,159	6,669
Restricted Cash and Securities	127	117
Goodwill	1,432	1,421
Other Intangibles, net	559	680
Other Assets, net	117	142
Total Assets	\$ 9,638	\$ 10,254
<i>Liabilities and Stockholders' Equity</i>		
Current Liabilities:		
Accounts payable	\$ 365	\$ 396
Current portion of long-term debt	186	32
Accrued payroll and employee benefits	105	97
Accrued interest	117	128
Current portion of deferred revenue	168	175
Other	111	144
Total Current Liabilities	1,052	972
Long-Term Debt, less current portion	6,394	6,832
Deferred Revenue, less current portion	719	763
Other Liabilities	597	617
Total Liabilities	8,762	9,184
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock, \$.01 par value, authorized 10,000,000 shares: no shares outstanding	—	—
Common stock, \$.01 par value, authorized 2,250,000,000 shares: 1,617,615,258 issued and outstanding in 2008 and 1,537,862,685 issued and outstanding in 2007	16	15
Additional paid-in capital	11,254	11,004
Accumulated other comprehensive income (loss)	(51)	104
Accumulated deficit	(10,343)	(10,053)
Total Stockholders' Equity	876	1,070
Total Liabilities and Stockholders' Equity	\$ 9,638	\$ 10,254

See accompanying notes to consolidated financial statements.

# **LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

## **CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For each of the three years ended December 31, 2008**

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(dollars in millions)		
<b>Cash Flows from Operating Activities:</b>			
Net Loss	\$(290)	\$(1,114)	\$(744)
Income from discontinued operations	—	—	(46)
Loss from continuing operations	(290)	(1,114)	(790)
Adjustments to reconcile loss from continuing operations to net cash provided by operating activities of continuing operations:			
Depreciation and amortization	931	942	730
(Gain) loss on debt extinguishments, net	(81)	427	83
Asset retirement obligation adjustment	(86)	—	—
Loss on impairments	8	1	8
Gain on sale of property, plant and equipment and other assets	(3)	(40)	(7)
Gain on sale of business groups, net	(99)	—	—
Non-cash compensation expense attributable to stock awards	78	122	84
Deferred income taxes	—	(23)	—
Amortization of debt issuance costs	16	15	19
Accreted interest on long-term debt discount	—	22	38
Accrued interest on long-term debt	(13)	(5)	32
Change in working capital items net of amounts acquired:			
Receivables	5	21	131
Other current assets	2	18	8
Payables	(26)	(73)	(23)
Deferred revenue	(34)	17	(53)
Other current liabilities	6	(105)	(32)
Other, net	(1)	6	(7)
<b>Net Cash Provided by Operating Activities of Continuing Operations</b>	<b>413</b>	<b>231</b>	<b>221</b>
<b>Cash Flows from Investing Activities:</b>			
Capital expenditures	(449)	(633)	(392)
Proceeds from sale of business groups, net	124	—	—
Proceeds from sales and maturities of marketable securities	4	333	280
Purchases of marketable securities	—	—	(98)
(Increase) decrease in restricted cash and securities, net	(5)	12	(21)
Advances from discontinued operations, net	—	—	18
Acquisitions, net of cash acquired	—	(670)	(749)
Proceeds from sale of discontinued operations, net of cash sold	—	(2)	307
Proceeds from sale of property, plant and equipment	3	5	7
Other	2	(6)	—
<b>Net Cash Used in Investing Activities</b>	<b>\$(321)</b>	<b>\$ (961)</b>	<b>\$(648)</b>

(continued)

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
**For each of the three years ended December 31, 2008**

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(dollars in millions)		
<b>Cash Flows from Financing Activities:</b>			
Long-term debt borrowings, net of issuance costs	\$ 400	\$ 2,349	\$ 2,256
Payments on and repurchases of long-term debt, including current portion and refinancing costs	(436)	(2,618)	(1,110)
Proceeds from warrants and stock-based equity plans	—	26	—
Equity offering	—	—	543
Other	2	—	—
<b>Net Cash Provided by (Used in) Financing Activities</b>	<b>(34)</b>	<b>(243)</b>	<b>1,689</b>
<b>Discontinued Operations:</b>			
Net cash used in discontinued operating activities	—	—	(20)
Net cash used in investing activities	—	—	(23)
<b>Net Cash Used in Discontinued Operations</b>	<b>—</b>	<b>—</b>	<b>(43)</b>
Effect of Exchange Rates on Cash and Cash Equivalents	(4)	6	10
<b>Net Change in Cash and Cash Equivalents</b>	<b>54</b>	<b>(967)</b>	<b>1,229</b>
<b>Cash and Cash Equivalents at Beginning of Year:</b>			
Cash and cash equivalents of continuing operations	714	1,681	379
Cash and cash equivalents of discontinued operations	—	—	73
<b>Cash and Cash Equivalents at End of Year:</b>			
Cash and cash equivalents of continuing operations	<u>\$ 768</u>	<u>\$ 714</u>	<u>\$ 1,681</u>
<b>Supplemental Disclosure of Cash Flow Information:</b>			
Cash interest paid	\$ 531	\$ 545	\$ 559
Income taxes paid	4	1	—
<b>Noncash Investing and Financing Activities:</b>			
Common stock issued for acquisitions	\$ —	\$ 692	\$ 904
Long-term debt converted to equity	151	879	—
Decrease in deferred revenue related to acquisitions	—	—	10

See accompanying notes to consolidated financial statements.

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

For each of the three years ended December 31, 2008

	Common Stock		Additional	Accumulated Other Comprehensive	Accumulated	
	Shares	\$	Paid-in Capital	Income (Loss)	Deficit	Total
	(dollars in millions)					
Balances at December 31, 2005	817,767,818	\$ 8	\$ 7,759	\$ (51)	\$ (8,192)	\$ (476)
Adjustment for EITF No. 04-6	—	—	—	—	(3)	(3)
Adjusted balances at December 31, 2005	817,767,818	8	7,759	(51)	(8,195)	(479)
Common Stock:						
Acquisitions	216,917,837	2	902	—	—	904
Equity offering, net of offering costs	125,000,000	2	541	—	—	543
Common stock issued under employee stock and benefit plans and other	18,737,450	—	15	—	—	15
Stock-based compensation expense	—	—	88	—	—	88
Net Loss	—	—	—	—	(744)	(744)
Other Comprehensive Income	—	—	—	47	—	47
Balances at December 31, 2006	1,178,423,105	12	9,305	(4)	(8,939)	374
Common Stock:						
Acquisitions	122,942,018	1	691	—	—	692
Common stock issued under employee stock and benefit plans and other	22,558,511	—	8	—	—	8
Debt conversion to equity	213,939,051	2	877	—	—	879
Stock-based compensation expense	—	—	123	—	—	123
Net Loss	—	—	—	—	(1,114)	(1,114)
Other Comprehensive Income	—	—	—	108	—	108
Balances at December 31, 2007	1,537,862,685	15	11,004	104	(10,053)	1,070
Common Stock:						
Common stock issued under employee stock and benefit plans and other	32,131,248	—	21	—	—	21
Debt conversion to equity	47,621,325	1	150	—	—	151
Stock-based compensation expense	—	—	79	—	—	79
Net Loss	—	—	—	—	(290)	(290)
Other Comprehensive Loss	—	—	—	(155)	—	(155)
Balances at December 31, 2008	1,617,615,258	\$16	\$ 11,254	\$ (51)	\$ (10,343)	\$ 876

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**  
**For each of the three years ended December 31, 2008**

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(dollars in millions)		
Net Loss	\$(290)	\$(1,114)	\$(744)
Other Comprehensive Income (Loss) Before Income Taxes:			
Foreign currency translation	(63)	131	48
Unrealized holding gain (loss) on available-for-sale investment	(7)	7	1
Unrealized holding loss on interest rate swaps	(60)	(37)	—
Other, net	(25)	7	(2)
Other Comprehensive Income (Loss), Before Income Taxes	(155)	108	47
Income Tax Related to Items of Other Comprehensive Income (Loss)	—	—	—
Other Comprehensive Income (Loss), Net of Income Taxes	(155)	108	47
Comprehensive Loss	<u>\$(445)</u>	<u>\$(1,006)</u>	<u>\$(697)</u>

**SUPPLEMENTARY STOCKHOLDERS' EQUITY (DEFICIT) INFORMATION**

	Net Foreign Currency Translation  <u>Adjustment</u>	Unrealized Holding Gain (Loss) on Investment  <u>and Interest Rate Swaps</u>	<u>Other</u>	<u>Total</u>
	(dollars in millions)			
Accumulated Other Comprehensive Income (Loss):				
Balance at December 31, 2005	\$ (19)	\$ (1)	\$(31)	\$ (51)
Change	48	1	(2)	47
Balance at December 31, 2006	29	—	(33)	(4)
Change	131	(30)	7	108
Balance at December 31, 2007	160	(30)	(26)	104
Change	(63)	(67)	(25)	(155)
Balance at December 31, 2008	<u>\$ 97</u>	<u>\$ (97)</u>	<u>\$(51)</u>	<u>\$ (51)</u>

See accompanying notes to consolidated financial statements.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### (1) Organization and Summary of Significant Accounting Policies

##### *Description of Business*

The Company is a facilities based provider (that is, a provider that owns or leases a substantial portion of the plant, property and equipment necessary to provide its services) of a broad range of integrated communications services. The Company has created its communications network generally by constructing its own assets, but also through a combination of purchasing and leasing other companies and facilities. The Company's network is an advanced, international, facilities based communications network. The Company designed its network to provide communications services, which employ and take advantage of rapidly improving underlying optical, Internet Protocol, computing and storage technologies.

The Company is also engaged in coal mining through its two 50% owned joint-venture surface mines, one each in Montana and Wyoming.

##### *Principles of Consolidation and Basis of Presentation*

The consolidated financial statements include the accounts of Level 3 Communications, Inc. and subsidiaries (the "Company" or "Level 3") in which it has control, which are enterprises engaged in the communications and coal mining businesses. Fifty-percent-owned mining joint ventures are consolidated on a pro rata basis. All significant intercompany accounts and transactions have been eliminated. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States.

Level 3 acquired WiTel Communications Group, LLC ("WiTel") on December 23, 2005; Progress Telecom, LLC ("Progress Telecom") on March 20, 2006; ICG Communications, Inc. ("ICG Communications") on May 31, 2006; TelCove, Inc. ("TelCove") on July 24, 2006; Looking Glass Networks Holding Co., Inc. ("Looking Glass") on August 2, 2006; Broadwing Corporation ("Broadwing") on January 3, 2007; the Content Delivery Network services business ("CDN Business") of SAVVIS, Inc. on January 23, 2007; and Servecast Limited ("Servecast") on July 11, 2007. As applicable, the Company also acquired these companies' operating subsidiaries. The results of operations, cash flows and financial position attributable to these acquisitions are included in the consolidated financial statements from the respective dates of their acquisition.

On September 7, 2006, Level 3 sold Software Spectrum, Inc. ("Software Spectrum"), the Company's software reseller business, to Insight Enterprises, Inc. ("Insight Enterprises"). The results of operations, financial condition and cash flows for the Software Spectrum business have been classified as discontinued operations in the consolidated financial statements and related notes through its date of sale.

On June 5, 2008, Level 3 completed the sale of its Vyvx advertising distribution business to DG FastChannel, Inc. Level 3 has retained ownership of Vyvx's core broadcast business, including the Vyvx Services Broadcast Business' content distribution capabilities. The financial results of the Vyvx advertising distribution business are included in the Company's consolidated results of operations through the date of sale. See Note 2 for more details regarding the disposition of the Vyvx advertising distribution business. The disposal of the Vyvx advertising distribution business did not meet the criteria under Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") for presentation as discontinued operations since the business was not considered an asset group.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (1) Organization and Summary of Significant Accounting Policies (Continued)

##### *Foreign Currency Translation*

Generally, local currencies of foreign subsidiaries are the functional currencies for financial reporting purposes. Assets and liabilities are translated into U.S. dollars at year-end exchange rates. Revenue, expenses and cash flows are translated using average exchange rates prevailing during the year. Gains or losses resulting from currency translation are recorded as a component of accumulated other comprehensive income (loss) in stockholders' equity (deficit) and in the statements of comprehensive loss. A significant portion of the Company's foreign subsidiaries have either the British Pound or the Euro as the functional currency, both of which experienced significant fluctuations against the U.S. dollar during 2008, 2007 and 2006. As a result, the Company has experienced significant foreign currency translation adjustments that are recognized as a component of accumulated other comprehensive income (loss) in stockholders' equity (deficit) and in the statement of comprehensive loss in accordance with SFAS No. 52 "Foreign Currency Translation". The Company considers its investments in its foreign subsidiaries to be long-term in nature.

##### *Reclassifications*

Certain immaterial reclassifications have been made to prior years to conform to the current period's presentation.

##### *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 and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The accounting estimates that require management's most significant and subjective judgments include revenue recognition, the valuation and recognition of stock-based compensation expense, the valuation of long-lived assets, goodwill and acquired indefinite-lived intangible assets and the valuation of asset retirement obligations. In addition, the Company has other accounting policies that involve estimates such as the allowance for doubtful accounts, revenue reserves, the determination of the useful lives of long-lived assets, the recognition of the fair value of assets acquired and liabilities assumed in business combinations, accruals for estimated tax and legal liabilities, valuation allowance for deferred tax assets and cost of revenue disputes for communications services. Actual results may differ from these estimates under different assumptions or conditions and such differences could be material.

##### *Communications*

Revenue for communications services is recognized on a monthly basis as these services are provided based on contractual amounts expected to be collected. Management establishes appropriate revenue reserves at the time services are rendered based on an analysis of historical credit activity to address, where significant, situations in which collection is not reasonably assured as a result of credit risk, potential billing disputes or other reasons.

Reciprocal compensation revenue is recognized when an interconnection agreement is in place with another carrier, or if an agreement has expired, when the parties have agreed to continue operating under the previous agreement until a new agreement is negotiated and executed; or at rates mandated by the FCC. Periodically, the Company will receive payment for reciprocal compensation



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (1) Organization and Summary of Significant Accounting Policies (Continued)

services in excess of FCC rates and before an agreement is in place. These amounts are included in other current liabilities on the consolidated balance sheet until a final agreement has been reached and the necessary regulatory approvals have been received at which time the reciprocal compensation revenue is recognized. These amounts were insignificant to the Company in 2008, 2007 and 2006.

For certain sale and long-term infeasible right of use or IRU contracts involving private line, wavelengths and dark fiber services, the Company may receive up-front payments for services to be delivered for a period of up to 20 years. In these situations, the Company defers the revenue and amortizes it on a straight-line basis to earnings over the term of the contract.

Termination revenue is recognized when a customer discontinues service prior to the end of the contract period, for which Level 3 had previously received consideration and for which revenue recognition was deferred. Termination revenue is also recognized when customers are required to make termination penalty payments to Level 3 to settle contractually committed purchase amounts that the customer no longer expects to meet or when a customer and Level 3 renegotiate a contract under which Level 3 is no longer obligated to provide services for consideration previously received and for which revenue recognition has been deferred.

The Company is obligated under dark fiber IRUs and other capacity agreements to maintain its network in efficient working order and in accordance with industry standards. Customers are obligated for the term of the agreement to pay for their allocable share of the costs for operating and maintaining the network. The Company recognizes this revenue monthly as services are provided.

Level 3's customer contracts require the Company to meet certain service level commitments. If Level 3 does not meet the required service levels, it may be obligated to provide credits, usually in the form of free service, for a short period of time. The original services that resulted in the credits are not included in revenue and, to date, have not been material.

Cost of revenue for the communications business includes leased capacity, right-of-way costs, access charges, satellite transponder lease costs and other third party costs directly attributable to the network, but excludes depreciation and amortization and related impairment expenses. Prior to the sale of the Vyvx advertising distribution business, the Company included in communications cost of revenue package delivery costs and blank tape media costs associated with this business.

The Company recognizes the cost of network services as they are incurred in accordance with contractual requirements. The Company disputes incorrect billings from its suppliers of network services. The most prevalent types of disputes include disputes for circuits that are not disconnected by its supplier on a timely basis and usage bills with incorrect or inadequate information. Depending on the type and complexity of the issues involved, it may and often does take several quarters to resolve the disputes.

In determining the amount of the cost of network service expenses and related accrued liabilities to reflect in its financial statements, the Company considers the adequacy of documentation of disconnect notices, compliance with prevailing contractual requirements for submitting these disconnect notices and disputes to the provider of the network services, and compliance with its interconnection agreements with these carriers. Judgment is required in estimating the ultimate outcome of the dispute resolution process, as well as any other amounts that may be incurred to conclude the negotiations or settle any litigation. Actual results may differ from these estimates under different assumptions or conditions and such differences could be material.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Organization and Summary of Significant Accounting Policies (Continued)**

*Coal Mining*

The Company sells coal primarily through long-term contracts with public utilities. The long-term contracts for the delivery of coal establish the price, volume, and quality requirements of the coal to be delivered. Revenue under these and other contracts is generally recognized when coal is shipped to the customer.

*USF and Gross Receipts Taxes*

Emerging Issues Task Force Issue ("EITF") 06-03 "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)" ("EITF 06-03") provides guidance regarding the accounting and financial statement presentation for certain taxes assessed by a governmental authority. The Company adopted EITF Issue No. 06-03 on January 1, 2007. The scope of EITF No. 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, Universal Service Fund ("USF") contributions and some excise taxes. The Task Force concluded that entities should present these taxes in the income statement on either a gross or a net basis. The Company records USF contributions on a gross basis in its consolidated statements of operations, but records sales, use, value added and excise taxes billed to its customers on a net basis in its consolidated statements of operations. Communications revenue and cost of revenue on the consolidated statements of operations includes USF contributions totaling \$65 million, \$63 million and \$19 million for the years ended December 31, 2008, 2007 and 2006, respectively.

*Advertising Costs*

The Company expenses the cost of advertising as incurred. Advertising expense is included as a component of selling, general and administrative expenses in the accompanying consolidated statements of operations. Advertising expense was \$8 million, \$16 million and \$8 million for the years ended December 31, 2008, 2007 and 2006, respectively.

*Stock-Based Compensation*

Beginning January 1, 2006, the Company adopted the provisions of SFAS No. 123R, "Share-Based Payment" ("SFAS No. 123R"). The Company recognizes the estimated fair value of these compensation costs, net of an estimated forfeiture rate, over the requisite service period of the award, which is generally the option vesting term. The Company estimates forfeiture rates based on its historical experience.

*Income Taxes*

The Company recognizes deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts using enacted tax rates in effect for the year the differences are expected to reverse. The Company records a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized. The Company recognizes interest and penalty expense associated with uncertain tax positions as a component of income tax expense in the consolidated statements of operations.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Organization and Summary of Significant Accounting Policies (Continued)**

*Cash and Cash Equivalents*

The Company classifies investments as cash equivalents if they are readily convertible to cash and have original maturities of three months or less at the time of acquisition. Cash and cash equivalents consist primarily of highly liquid investments in government and government agency securities and money market funds issued or managed by financial institutions in the United States and Europe and commercial paper depending on liquidity requirements. As of December 31, 2008 and 2007, the carrying value of cash and cash equivalents approximates fair value due to the short period of time to maturity.

*Derivative Financial Instruments*

The Company uses derivative financial instruments, primarily interest rate swaps, to hedge certain interest rate exposures. The Company has designated its interest rate swap agreements as a cash flow hedge. The change in the fair value of the interest rate swap agreements is reflected in other comprehensive income (loss) due to the fact that the interest rate swap agreements are designated as an effective cash flow hedge. The Company evaluates the effectiveness of the hedge on a quarterly basis. The Company recognizes any ineffective portion of the hedge in the consolidated statements of operations. The Company does not use derivative financial instruments for speculative purposes.

The Company also has equity conversion rights associated with debt instruments, which are not designated as hedging instruments, and were considered derivative instruments as of December 31, 2008. The Company recognizes the gains or losses from changes in fair values of these derivative instruments in other income (expense) in the statements of operations. Gains and losses from these derivative instruments were not material for any period presented.

*Allowance for Doubtful Accounts*

Trade accounts receivable are recorded at the invoiced amount and can bear interest. The Company establishes an allowance for doubtful accounts for accounts receivable amounts that may not be collectible. The Company determines the allowance for doubtful accounts based on the aging of its accounts receivable balances and an analysis of its historical experience of bad debt write-offs. The Company reviews its allowance for doubtful accounts quarterly. Past due balances over 60 days and over a specified amount are reviewed individually for collectability. Accounts receivable balances are written-off against the allowance for doubtful accounts after all means of collection have been exhausted and the potential for recovery is considered remote. All of the Company's allowance for doubtful accounts relates to its communications business. The Company recognized bad debt expense, net of recoveries, of approximately \$9 million in 2008, \$11 million in 2007 and \$1 million in 2006.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(1) Organization and Summary of Significant Accounting Policies (Continued)***Property, Plant and Equipment*

Property, plant and equipment are recorded at cost. Depreciation and amortization for the Company's property, plant and equipment are computed on straight-line and accelerated (for certain coal assets) methods based on the following useful lives:

Facility and Leasehold Improvements	10 - 40 years
Network Infrastructure (including fiber and conduit)	12 - 25 years
Operating Equipment	4 - 7 years
Furniture, Fixtures, Office Equipment and Other	2 - 7 years

The Company capitalizes costs directly associated with expansions and improvements of the Company's communications network, customer installations, including employee related costs, and generally capitalizes costs associated with network construction and provisioning of services. The Company amortizes such costs over an estimated useful life of three to seven years.

In addition, the Company continues to develop business support systems required for its business. The external direct costs of software, materials and services, and payroll and payroll related expenses for employees directly associated with business support systems projects are also capitalized. Upon the completion of a project, the total cost of the business support system is amortized over an estimated useful life of three years.

Capitalized labor and related costs associated with employees and contract labor working on capital projects were approximately \$83 million, \$102 million and \$72 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Leasehold improvements are depreciated over the shorter of their estimated useful lives or lease terms that are reasonably assured.

The Company performs periodic internal reviews to determine depreciable lives of its property, plant and equipment based on input from global network services personnel, actual usage and the physical condition of the Company's property, plant and equipment.

*Asset Retirement Obligations*

The Company recognizes a liability for legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of a long-lived asset in the period incurred in accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations" ("SFAS No. 143"). The fair value of the obligation is also capitalized as property, plant and equipment and then amortized over the estimated remaining useful life of the associated asset. Increases to the asset retirement obligation liability due to the passage of time are recognized as accretion expense and included within selling, general and administrative expenses for the Communications business and within cost of revenue for the Coal Mining business on the Company's consolidated statements of operations. Changes in the liability due to revisions to future cash flows are recognized by increasing or decreasing the liability with the offset adjusting the carrying amount of the related long-lived asset. To the extent that the downward revisions exceed the carrying amount of the related long-lived asset initially recorded when the asset retirement obligation liability was established, the Company records the remaining adjustment as a reduction to depreciation expense, to the extent of historical depreciation of the related long-lived asset, and selling, general and administrative expense.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(1) Organization and Summary of Significant Accounting Policies (Continued)**

The Company revised its estimates of the amounts and timing of its original estimate of undiscounted cash flows related to certain future asset retirement obligations in the fourth quarter of 2008. As a result, the Company reduced its asset retirement obligations liability by \$103 million with an offsetting reduction to property, plant and equipment of \$21 million, selling, general and administrative expenses of \$86 million, depreciation and amortization of \$11 million and an increase to goodwill of \$15 million. See Note 5 for more details regarding the Company's asset retirement obligation activities.

*Business Combinations*

All of the Company's business combinations have been accounted for using the purchase method of accounting and, accordingly, are included in Level 3's results of operations as of the date of each acquisition. The Company allocates the purchase price of its acquisitions to the tangible assets acquired, liabilities assumed and intangible assets acquired, including in-process research & development ("IPR&D"), based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. The excess of those fair values over the purchase price is recorded as a reduction to long-lived assets.

*Goodwill and Acquired Indefinite-Lived Intangible Assets*

SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), prohibits the amortization of goodwill and purchased intangible assets with indefinite useful lives. The Company reviews goodwill and purchased intangible assets with indefinite lives for impairment annually at the end of the fourth quarter and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with SFAS No. 142. For goodwill, the Company performs a two-step impairment test. In the first step, the Company compares the fair value of each reporting unit to its carrying value. The Company's reporting units are consistent with the reportable segments identified in Note 14. The Company estimates the fair value of its reporting units based on a combination of quoted market price and income approaches. Under the quoted market price approach, the Company estimates the fair value based upon the market capitalization of Level 3 using quoted market prices, adds an estimated control premium, and then assigns that fair market value to the reporting units. Under the income approach, the Company calculates the fair value of a reporting unit based on the present value of estimated future cash flows. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is not impaired and no further testing is performed. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then a second step is performed and the implied fair value of the reporting unit's goodwill is determined and compared to the carrying value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then an impairment loss equal to the difference is recorded.

SFAS 142 also requires that the fair value of acquired indefinite-lived intangible assets be estimated and compared to their carrying value each year. The Company estimates the fair value of these intangible assets primarily utilizing an income approach. The Company recognizes an impairment loss when the estimated fair value of the indefinite-lived purchased intangible assets is less than the carrying value.

The Company conducted its goodwill and acquired indefinite-lived intangible assets impairment analyses at the end of the fourth quarters of 2008, 2007 and 2006 and concluded that its goodwill and acquired indefinite-lived intangible assets were not impaired in any of those periods. As a result of the

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Organization and Summary of Significant Accounting Policies (Continued)**

sale of the Vyvx advertising distribution business in the second quarter of 2008, the Company also performed an impairment analysis of its indefinite-lived Vyvx trade name and concluded that there was no impairment as of June 30, 2008.

*Long-Lived Assets Including Finite-Lived Purchased Intangible Assets*

The Company amortizes acquired intangible assets with finite lives using the straight-line method over the estimated economic lives of the assets, ranging from four to twelve years.

The Company evaluates long-lived assets, such as property, plant and equipment and acquired intangible assets with finite lives, for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with SFAS No. 144. The Company assesses the recoverability of the assets based on the undiscounted future cash flows the assets are expected to generate and recognizes an impairment loss when estimated undiscounted future cash flows expected to result from the use of the assets plus net proceeds expected from disposition of the assets, if any, are less than the carrying value of the assets. If an asset is deemed to be impaired, the amount of the impairment loss represents the excess of the asset's carrying value compared to its estimated fair value.

The Company conducted a long-lived asset impairment analysis at the end of the fourth quarter of 2008 and concluded that its long-lived assets, including finite-lived acquired intangible assets, were not impaired.

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash equivalents, accounts receivable, restricted cash and securities and derivatives. The Company maintains its cash equivalents, restricted cash and securities and derivatives with various financial institutions. These financial institutions are primarily located in the United States and Europe and the Company's policy is to limit exposure with any one institution. As part of its cash and risk management processes, the Company performs periodic evaluations of the relative credit standing of the financial institutions. The Company also has established guidelines relative to financial instrument credit ratings, diversification and maturities that seek to maintain safety and liquidity. The Company's investment strategy generally results in lower yields on investments but reduces the risk to principal in the short term prior to these funds being used in the Company's business. The Company has not experienced any material losses on financial instruments held at financial institutions. The Company utilizes interest rate swap contracts to protect against the effects of interest rate fluctuations. Such contracts involve the risk of non-performance by the counterparty, which could result in a material loss.

The Company provides communications services to a wide range of wholesale and enterprise customers, ranging from well capitalized national carriers to small early stage companies in the United States and Europe. Credit risk with respect to accounts receivable is generally diversified due to the large number of entities comprising Level 3's customer base and their dispersion across many different industries and geographical regions. The Company performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral from its customers, although letters of credit and deposits are required in certain limited circumstances. The Company has from time to time entered into agreements with value-added resellers and other channel partners to reach consumer and enterprise markets for voice services. The Company has policies and procedures in place to

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(1) Organization and Summary of Significant Accounting Policies (Continued)**

evaluate the financial condition of these resellers prior to initiating service to the final customer. The Company maintains an allowance for doubtful accounts based upon the expected collectability of accounts receivable. Due to the Company's credit evaluation and collection process, bad debt expenses have not been significant; however, the Company is not able to predict changes in the financial stability of its customers. Any material change in the financial status of any one or a particular group of customers may cause the Company to adjust its estimate of the recoverability of receivables and could have a material adverse effect on the Company's results of operations. At December 31, 2008, one customer with operations in North America and Europe accounted for approximately 12% of gross accounts receivable. Fair values of accounts receivable approximate cost due to the short period of time to collection.

A relatively small number of customers account for a significant percentage of the Company's revenue. The Company's top ten customers accounted for approximately 32%, 34% and 55% of Level 3's communications revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Revenue attributable to AT&T, Inc. and its subsidiaries, including SBC Communications, Bell South Communications and AT&T Mobility (formerly Cingular Wireless) accounted for approximately 12%, 15% and 32% of consolidated revenue for the years ended December 31, 2008, 2007 and 2006, respectively. Revenue attributable to AT&T is included in the communications business.

*Recently Issued Accounting Pronouncements*

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement was effective for financial assets and liabilities, as well as for non-financial assets and liabilities that are recognized or disclosed at fair value on a recurring basis for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. FASB Staff Position ("FSP") FAS 157-2, "Effective Date of FASB Statement No. 157" ("FSP 157-2") defers the effective date of SFAS No. 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for non-financial assets and liabilities that are not recognized or disclosed at fair value on a recurring basis. SFAS No. 157 did not have a material effect on the Company's consolidated results of operations or financial condition in 2008. The Company does not expect that the adoption of the remaining portions of SFAS No. 157 to have a material effect on the Company's consolidated results of operations and financial position.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" ("SFAS No. 141R"), which replaces SFAS No. 141, "Business Combinations" ("SFAS No. 141"). SFAS No. 141R retains the underlying concepts of SFAS No. 141 in that an entity is required to recognize the assets acquired and liabilities assumed at their fair value on the acquisition date. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items to require: (1) expensing acquisition related costs as incurred; (2) expensing changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date; (3) valuing noncontrolling interests at fair value at the acquisition date; (4) generally expensing restructuring costs associated with an acquired business; (5) capitalizing in-process research; and development assets acquired and (6) measuring acquirer shares issued in consideration for a business combination at fair value on the acquisition date opposed to the



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Organization and Summary of Significant Accounting Policies (Continued)**

announcement date. SFAS No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R is to be applied prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The effect of adopting SFAS No. 141R on the Company's consolidated results of operations and financial condition will be largely dependent on the size and nature of business combinations completed after December 31, 2008.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS No. 160"). SFAS No. 160 requires noncontrolling interests, previously referred to as minority interests, to be treated as a separate component of equity, not as a liability or other item outside of permanent equity and applies to the accounting for noncontrolling interests and transactions with noncontrolling interest holders in consolidated financial statements. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. This statement is effective for the Company beginning January 1, 2009. The Company does not currently expect the adoption of SFAS No. 160 to have a material effect on its consolidated results of operations and financial condition.

In March 2008, the FASB issued Statement No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133" ("SFAS No. 161"). SFAS 161 applies to all derivative instruments and related hedged items accounted for under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). SFAS No. 161 requires entities to provide greater transparency about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. This statement is effective for the Company beginning January 1, 2009. The Company does not expect the adoption of SFAS No. 161 to have a material effect on its consolidated results of operations and financial condition.

On May 9, 2008, the FASB issued FSP APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)" ("FSP APB 14-1"). FSP APB 14-1 requires issuers of a certain type of convertible debt to separately account for the debt and equity components of the convertible debt in a way that reflects the issuer's borrowing rate at the date of issuance for similar debt instruments without the conversion feature. FSP APB 14-1 applies to certain of the Company's convertible debt. FSP APB 14-1 is effective for the Company beginning on January 1, 2009 and will be applied retrospectively to all quarterly and annual periods that will be presented in the Company's consolidated financial statements. Early adoption of FSP APB 14-1 is not permitted. The adoption of FSP APB 14-1 is expected to significantly increase the Company's non-cash interest expense and reduce basic and diluted earnings (loss) per share.

In November 2008, the FASB ratified EITF Issue No. 08-7, "Accounting for Defensive Intangible Assets," ("EITF 08-7"). EITF 08-7 applies to defensive intangible assets, which are acquired intangible assets that the acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. As these assets are separately identifiable, EITF 08-7 requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting. Defensive intangible assets must be recognized at fair value in accordance with SFAS No. 141R and SFAS No. 157. EITF 08-7 is effective for defensive intangible assets acquired in fiscal years beginning on or after December 15, 2008, and will be adopted by the Company in the first quarter of 2009. The effect of adopting EITF 08-7 on the Company's consolidated results of operations and financial



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (1) Organization and Summary of Significant Accounting Policies (Continued)

condition will be largely dependent on the size and nature of business combinations completed after December 31, 2008.

#### (2) Vyvx Advertising Distribution Business Disposition

On June 5, 2008, Level 3 completed the sale of its Vyvx advertising distribution business to DG FastChannel, Inc. and received gross proceeds at closing of approximately \$129 million in cash. Net proceeds from the sale approximated \$121 million after deducting transaction-related costs.

Operating results and cash flows from the Vyvx advertising distribution business are presented in continuing operations for all periods presented through the date of sale. The disposal of the Vyvx advertising distribution business did not meet the criteria under SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") for presentation as discontinued operations since the business was not considered an asset group.

Level 3 recognized a gain on the sale of the Vyvx advertising distribution business of \$96 million in 2008. The gain is presented in the consolidated statements of operations as "Gain on Sale of Business Groups."

The carrying amounts of the major classes of assets and liabilities included in the sale of the Vyvx advertising distribution business were as follows (in millions):

Other Current Assets	\$ 1
Property, Plant and Equipment, net	3
Other Intangibles, net	22
Accounts Payable	(1)
	<u>\$25</u>

Revenue attributable to the Vyvx advertising distribution business totaled \$15 million in 2008, \$36 million in 2007 and \$35 million in 2006. The financial results, assets and liabilities of the Vyvx advertising distribution business are included in the Communications operating segment through the date of sale.

#### (3) Loss Per Share

The Company computes basic net loss per share by dividing net loss for the period by the weighted average number of shares of common stock outstanding during the period. Diluted net loss per share is computed by dividing net loss for the period by the weighted average number of shares of common stock outstanding during the period and including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding convertible notes, stock options, stock based compensation awards and other dilutive securities. No such items were included in the computation of diluted loss per share in 2008, 2007 or 2006 because the Company incurred a loss from continuing operations in each of these periods and the effect of inclusion would have been anti-dilutive.

The effect of approximately 489 million, 315 million and 481 million shares issuable pursuant to the various series of convertible notes outstanding at December 31, 2008, 2007 and 2006, respectively, have not been included in the computation of diluted loss per share because their inclusion would have been anti-dilutive to the computation. In addition, the effect of the approximately 57 million, 55 million and 54 million stock options, outperform stock options, restricted stock units and warrants outstanding at December 31, 2008, 2007 and 2006, respectively, have not been included in the computation of diluted loss per share because their inclusion would have been anti-dilutive to the computation.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (4) Property, Plant and Equipment

The components of the Company's property, plant and equipment as of December 31, 2008 and 2007 are as follows (in millions):

	Cost	Accumulated Depreciation	Book Value
<b>December 31, 2008</b>			
Land	\$ 169	\$ —	\$ 169
Land Improvements	68	(35)	33
Facility and Leasehold Improvements:			
Communications	1,856	(682)	1,174
Coal Mining	151	(150)	1
Network Infrastructure	5,568	(1,967)	3,601
Operating Equipment:			
Communications	3,738	(2,615)	1,123
Coal Mining	72	(65)	7
Furniture, Fixtures and Office Equipment	139	(121)	18
Other	24	(22)	2
Construction-in-Progress	31	—	31
	<u>\$11,816</u>	<u>\$ (5,657)</u>	<u>\$6,159</u>
<b>December 31, 2007</b>			
Land	\$ 174	\$ —	\$ 174
Land Improvements	60	(32)	28
Facility and Leasehold Improvements:			
Communications	1,856	(589)	1,267
Coal Mining	153	(151)	2
Network Infrastructure	5,591	(1,705)	3,886
Operating Equipment:			
Communications	3,455	(2,267)	1,188
Coal Mining	72	(64)	8
Furniture, Fixtures and Office Equipment	141	(117)	24
Other	27	(24)	3
Construction-in-Progress	89	—	89
	<u>\$11,618</u>	<u>\$ (4,949)</u>	<u>\$6,669</u>

Land primarily represents owned assets of the communications business, including land improvements. Capitalized business support systems and network construction costs that have not been placed in service have been classified as construction-in-progress.

Depreciation expense was \$832 million in 2008, \$838 million in 2007 and \$652 million in 2006.

In 2006, Level 3 determined that the period it expected to use its existing fiber and certain equipment was longer than the remaining useful lives as originally estimated. As a result, the Company extended the depreciable lives of its existing fiber from 7 years to 12 years, its existing transmission

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(4) Property, Plant and Equipment (Continued)**

equipment from 5 years to 7 years and its existing IP equipment from 3 years to 4 years. These changes in estimate were accounted for prospectively, in accordance with SFAS No. 154, and reduced depreciation expense, loss from continuing operations and net loss by approximately \$80 million, or \$0.08 per share, for the year ended December 31, 2006.

**(5) Asset Retirement Obligations**

The Company's asset retirement obligations consist of legal requirements to remove certain of its network infrastructure at the expiration of the underlying right-of-way ("ROW") term, restoration requirements for leased facilities and reclamation requirements in the coal mining business to remediate previously mined properties. The Company recognizes its estimate of the fair value of its asset retirement obligations in the period incurred in other long-term liabilities. The fair value of the asset retirement obligation is also capitalized as property, plant and equipment and then amortized over the estimated remaining useful life of the associated asset.

As a result of indicators suggesting that the estimated cash flows underlying the Company's ROW asset retirement obligations were too high, the Company revised its assessment on December 31, 2008. Network infrastructure relocations indicated that the Company is not being required to physically remove its underground network infrastructure at rates consistent with the Company's previous estimates. Other internal and external information corroborated these lower rates. As a result, on December 31, 2008, the Company revised its probability assessment related to its requirement to physically remove its underground network infrastructure at the end of the underlying ROW terms, which caused a significant reduction to the related cash flows that the Company believes will be required to settle its ROW asset retirement obligations. The Company reduced its asset retirement obligation liability accordingly as of December 31, 2008.

As part of the ROW asset retirement obligation change in estimate, the Company determined that certain of its asset retirement obligations for acquired entities should have been higher at the acquisition date. As a result, the Company increased goodwill by approximately \$15 million as of December 31, 2008.

The Company also determined that its estimates of restoration costs for its leased facility asset retirement obligations were too high based on current costs to restore. As a result, on December 31, 2008, the Company reduced its estimates of the cash flows that it believes will be required to settle its leased facility asset retirement obligations at the end of the respective lease terms, which resulted in a reduction to the Company's asset retirement obligation liability.

In the fourth quarter of 2008, the Company was awarded a long-term coal contract, which will extend the life of one of the Company's coal mining operations. As a result of the increase in the estimated life of one of the Company's coal mining operations, the Company revised the timing of its cash flows to remediate the mining site causing a reduction in its asset retirement obligation liability in the fourth quarter of 2008.

As a result of the aforementioned revisions in the estimated amount and timing of cash flows for asset retirement obligations, the Company reduced its asset retirement obligation liability by \$103 million with an offsetting reduction to property, plant and equipment of \$21 million, selling, general and administrative expenses of \$86 million, depreciation and amortization of \$11 million and an increase to goodwill of \$15 million. The Company reduced property, plant and equipment to the extent

# **LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

### **(5) Asset Retirement Obligations (Continued)**

of the carrying amount of the related long-lived asset initially recorded when the asset retirement obligation liability was established. The remaining amount of the reduction to the asset retirement obligation was recorded as a reduction to depreciation expense, to the extent of historical depreciation of the related long-lived asset, and selling, general and administrative expense.

Approximately \$71 million and \$61 million of restricted cash and securities were legally restricted to settle the Company's coal mining reclamation liabilities at December 31, 2008 and 2007, respectively, and are recorded in non-current, restricted cash and securities on the consolidated balance sheets.

The following table provides asset retirement obligation activity for the years ended December 31, 2008 and 2007 (in millions):

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Asset retirement obligation at January 1	\$ 231	\$202
Liabilities incurred	2	12
Accretion expense	25	21
Liabilities settled	(4)	(4)
Revision in estimated cash flows	(103)	—
Asset retirement obligation at December 31	<u>\$ 151</u>	<u>\$231</u>

### **(6) Goodwill**

The changes in the carrying amount of goodwill during the year ended December 31, 2008 are as follows (in millions):

	<u>Communications</u>	<u>Coal</u>	
	<u>Segment</u>	<u>Mining</u>	<u>Total</u>
Balance as of December 31, 2007	\$ 1,421	\$ —	\$1,421
Goodwill adjustments	12	—	12
Effect of foreign currency rate change	(1)	—	(1)
Balance as of December 31, 2008	<u>\$ 1,432</u>	<u>\$ —</u>	<u>\$1,432</u>

The goodwill adjustments primarily relate to asset retirement obligation revisions. The Company revised its estimate of the amount of its original estimate of undiscounted cash flows related to certain ROW asset retirement obligations at December 31, 2008. As part of the ROW asset retirement obligation change in estimate, the Company determined that certain of its asset retirement obligations for acquired entities should have been higher at the acquisition date. As a result, the Company increased goodwill by approximately \$15 million as of December 31, 2008.

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (7) Acquired Intangible Assets

Identifiable acquisition-related intangible assets as of December 31, 2008 and December 31, 2007 were as follows (in millions):

	Gross Carrying Amount	Accumulated Amortization	Net
<b>December 31, 2008</b>			
Finite-Lived Intangible Assets:			
Customer Contracts and Relationships	\$ 743	\$ (325)	\$418
Patents and Developed Technology	141	(52)	89
	<u>884</u>	<u>(377)</u>	<u>507</u>
Indefinite-Lived Intangible Assets:			
Vyvx Trade Name	32	—	32
Wireless Licenses	20	—	20
	<u>\$ 936</u>	<u>\$ (377)</u>	<u>\$559</u>
<b>December 31, 2007</b>			
Finite-Lived Intangible Assets:			
Customer Contracts and Relationships	\$ 772	\$ (248)	\$524
Patents and Developed Technology	141	(37)	104
	<u>913</u>	<u>(285)</u>	<u>628</u>
Indefinite-Lived Intangible Assets:			
Vyvx Trade Name	32	—	32
Wireless Licenses	20	—	20
	<u>\$ 965</u>	<u>\$ (285)</u>	<u>\$680</u>

Acquired finite-lived intangible asset amortization expense was \$99 million in 2008, \$104 million in 2007 and \$78 million 2006.

During 2007, the Company changed the estimated useful lives of certain of its customer-related intangible assets that were established in periods prior to 2007, which resulted in a net increase in amortization expense of approximately \$9 million for the year ended December 31, 2007, or less than a \$0.01 per basic and diluted share.

The weighted average useful lives of the Company's acquired finite-lived intangible assets was 7.6 years for customer contracts and relationships and 9.0 years for patents and developed technology.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(7) Acquired Intangible Assets (Continued)**

As of December 31, 2008, estimated amortization expense for the Company's finite-lived acquisition-related intangible assets over the next five years and thereafter is as follows (in millions):

2009	\$ 93
2010	92
2011	91
2012	69
2013	51
Thereafter	111
	<u>\$507</u>

**(8) Restructuring and Impairment Charges**

Changing economic and business conditions as well as organizational structure optimization efforts have caused the Company to initiate various workforce reductions resulting in involuntary employee terminations. The Company has also initiated multiple workforce reductions resulting from the integration of acquired companies. Restructuring charges totaled \$25 million in 2008, \$11 million in 2007 and \$5 million in 2006.

During the fourth quarter of 2008, the Company initiated a workforce reduction of approximately 400 employees, or 7% of the Company's total employee base, and incurred a restructuring charge of \$12 million, all of which related to the communications business. The workforce reductions relate to multiple levels within the organization and across multiple locations within North America. The terms of the workforce reduction, including the involuntary termination benefits to be received by affected employees, were communicated by the Company in the fourth quarter of 2008. The Company expects to conclude this workforce reduction in the first quarter of 2009. As of December 31, 2008, none of the \$12 million of involuntary termination benefits was paid and are recorded in accrued payroll and employee benefits on the consolidated balance sheets.

All of the activities related to the Company's prior restructurings were completed as of December 31, 2008.

Impairment charges classified within restructuring and impairment charges on the consolidated statements of operations totaled zero in 2008, \$1 million in 2007 and \$8 million in 2006. In 2006, the Company recognized \$4 million of non-cash impairment charges as a result of the decision to terminate projects for certain voice services and certain information technology projects in the Communications business which had been previously capitalized. These projects had identifiable costs which the Company was able to separate for impairment. The costs incurred for these projects, including capitalized labor, were impaired as the carrying value of these projects were no longer expected to provide future benefit to the Company. In addition, the Company recognized \$4 million of non-cash impairment charges primarily related to excess land of the communications business held for sale in Germany in 2006. This charge resulted from the difference between the recorded carrying value and the estimated market value of the land. During the third quarter of 2007, the Company reclassified the excess land in Germany as property, plant and equipment due to the fact the land had not been sold and was no longer being actively marketed for sale.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(8) Restructuring and Impairment Charges (Continued)**

The Company also has accrued contract termination costs of \$49 million as of December 31, 2008, for facility lease costs, primarily in North America, that the Company continues to incur without economic benefit. Accrued contract termination costs are recorded in other liabilities (current and non-current) in the consolidated balance sheets. The Company expects to pay the majority of these costs through 2018. The Company incurred charges of approximately \$11 million in 2008 as the Company ceased using additional facilities and as a result of revisions to the estimated cash flows for certain facility subleases. The Company did not incur any such charges in 2007 or 2006. The Company records charges for contract termination costs within selling, general and administrative expenses in the consolidated statements of operations.

**(9) Fair Value**

SFAS No. 157 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and considers assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions, and risk of nonperformance.

*Fair Value Hierarchy*

SFAS No. 157 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. SFAS No. 157 establishes three levels of inputs that may be used to measure fair value:

*Level 1* —Quoted prices in active markets for identical assets or liabilities. As of December 31, 2008, the Company did not have any Level 1 assets or liabilities that are measured at fair value on a recurring basis.

*Level 2* —Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 liabilities that are measured at fair value on a recurring basis include the Company's interest rate swap agreements and other derivative contracts.

The interest rate swaps are priced using discounted cash flow techniques that use observable market inputs, such as LIBOR-based yield curves, forward rates, and credit ratings. The embedded derivative contracts are priced using inputs that are observable in the market, such as the Company's current and historical stock prices, risk-free interest rates, credit ratings and other contractual terms of certain of the Company's convertible debt.

*Level 3* —Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities. The Company does not have any SFAS No. 157 Level 3 assets or liabilities that are measured at fair value on a recurring basis.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(9) Fair Value (Continued)***Assets and Liabilities Measured at Fair Value on a Recurring Basis*

Assets and liabilities measured at fair value on a recurring basis consisted of the following types of instruments as of December 31, 2008 (in millions):

	Significant Other
	Observable
	Inputs (Level 2)
Interest Rate Swap Liabilities (included in other non-current liabilities)	\$ 97
Embedded Derivative Contracts (included in other non-current liabilities)	13
Total Liabilities Measured at Fair Value	<u>\$ 110</u>

**(10) Financial Instruments***Available for Sale Investments*

The Company did not have any material available-for-sale investments as of December 31, 2008.

At December 31, 2007, marketable securities totaling \$9 million consisted of an investment in the common stock of Infinera Corporation ("Infinera"). The fair value of the Infinera investment as of December 31, 2007 was \$9 million. For the year ended December 31, 2007, an unrealized gain of \$7 million was recorded on the investment in Infinera and is included in other comprehensive income (loss).

In 2007, the Company sold approximately 80% of its investment in Infinera, received proceeds of \$45 million and recognized a gain on the sale of \$37 million. In 2008, the Company sold the remainder of its investment in Infinera, received proceeds of approximately \$4 million and recognized a gain on the sale of \$2 million.

The cost of the equity securities used in computing the unrealized and realized gains is determined by specific identification. Fair values are estimated based on quoted market prices for the securities.

The Company recognized gains of \$2 million from the sale of marketable equity securities in 2006.

*Restricted Cash and Securities*

Restricted cash and securities consists primarily of cash and investments that serve to collateralize outstanding letters of credit, long-term debt and certain performance and operating obligations of the Company, as well as cash and investments restricted to fund certain reclamation liabilities of the Company. Restricted cash and securities are recorded in other assets (current or non-current) in the consolidated balance sheets depending on the duration of the restriction and the purpose for which the restriction exists.

The cost and fair value of restricted cash and securities totaled \$130 million at December 31, 2008 and \$127 million at December 31, 2007.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(10) Financial Instruments (Continued)***Cash Flow Hedges*

The Company has floating rate long-term debt (see Note 11). These obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense also decreases. On March 13, 2007, Level 3 Financing Inc., the Company's wholly owned subsidiary, entered into two interest rate swap agreements to hedge the interest payments on \$1 billion notional amount of floating rate debt. The two interest rate swap agreements are with different counterparties and are for \$500 million each. The transactions were effective beginning April 13, 2007 and mature on January 13, 2014. Under the terms of the interest rate swap transactions, the Company receives interest payments based on rolling three month LIBOR terms and pays interest at the fixed rate of 4.93% under one arrangement and 4.92% under the other. The Company has designated the interest rate swap agreements as a cash flow hedge on the interest payments for \$1 billion of floating rate debt. The Company evaluates the effectiveness of the hedge on a quarterly basis. The Company measures effectiveness by offsetting the change in the variable portion of the interest rate swaps with the changes in interest expense paid due to fluctuations in the LIBOR-based interest rate. The Company recognizes any ineffective portion of the hedge in the consolidated statements of operations. Hedge ineffectiveness for the Company's cash flow hedges was not material in any period presented.

The fair value of the interest rate swap agreements was a liability of \$97 million as of December 31, 2008 and a liability of \$37 million as of December 31, 2007. Unrealized losses of \$60 million in 2008 and \$37 million in 2007 were recorded on the interest rate swap agreements and are included in other comprehensive income (loss). The change in the fair value of the interest rate swap agreements is reflected in other comprehensive income (loss) due to the fact that the interest rate swap agreements are designated as an effective cash flow hedge of \$1 billion notional amount of the Company's floating rate debt.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (11) Long-Term Debt

As of December 31, 2008 and 2007, long-term debt was as follows (in millions):

<u>(dollars in millions)</u>	<u>2008</u>	<u>2007</u>
Senior Secured Term Loan due 2014	\$1,400	\$1,400
Senior Notes due 2008 (11.0%)	—	20
Senior Euro Notes due 2008 (10.75%)	—	5
Senior Notes due 2010 (11.5%)	13	13
Fair value adjustment on Senior Notes due 2010	—	(1)
Senior Notes due 2011 (10.75%)	3	3
Floating Rate Senior Notes due 2011 (9.459% as of December 31, 2008)	6	6
Issue discount on Senior Notes due 2011	—	—
Senior Notes due 2013 (12.25%)	550	550
Issue discount on Senior Notes due 2013	(2)	(2)
Senior Notes due 2014 (9.25%)	1,250	1,250
Issue premium on Senior Notes due 2014	9	10
Floating Rate Senior Notes due 2015 (6.845% as of December 31, 2008)	300	300
Senior Notes due 2017 (8.75%)	700	700
Convertible Senior Notes due 2010 (2.875%)	192	374
Convertible Senior Notes due 2011 (5.25%)	330	345
Convertible Senior Notes due 2011 (10.0%)	228	275
Convertible Senior Notes due 2012 (3.5%)	326	335
Convertible Senior Notes due 2013 (15.0%)	400	—
Convertible Senior Discount Notes due 2013 (9.0%)	295	295
Convertible Subordinated Notes due 2009 (6.0%)	181	362
Convertible Subordinated Notes due 2010 (6.0%)	308	514
Debt discount due to embedded derivative contracts	(13)	—
Commercial Mortgage due 2010 (6.86%)	69	69
Capital leases	35	41
	<u>6,580</u>	<u>6,864</u>
Less current portion	(186)	(32)
	<u>\$6,394</u>	<u>\$6,832</u>

The estimated fair value of the Company's long-term debt approximated \$4.0 billion at December 31, 2008 and \$6.3 billion at December 31, 2007. The fair values of the Company's long-term debt were estimated using the December 31, 2008 and December 31, 2007 average of the bid and ask trading quotes. The Commercial Mortgage does not trade. The fair value of this instrument is assumed to approximate its carrying value as of December 31, 2008 and December 31, 2007. The 9% Convertible Senior Discount Notes due 2013, the 10% Convertible Senior Notes due 2011, and the 15% Convertible Senior Notes due 2013 are not traded in an active market. The fair value of these notes were calculated using a Black-Scholes valuation model to value the equity portion of the security and market yields on other Level 3 traded debt of similar characteristics and discounted cash flows to value the debt portion of the security. The 11.5% Senior Notes due 2010, Floating Rate Notes due 2011 and the 10.75% Senior Notes due 2011 are not actively traded debt instruments. The estimated fair value of these debt instruments was derived using market yields on other Level 3 traded debt of similar characteristics and discounted cash flows.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(11) Long-Term Debt (Continued)***2008 Debt Issuances*

In December 2008, the Company issued \$400 million aggregate principal amount of its 15% Convertible Senior Notes due 2013 and received gross proceeds of \$400 million. Accrued but unpaid debt issuance costs are expected to be approximately \$3 million. The proceeds from this issuance were primarily used to repurchase, through tender offers, a portion of the Company's 6% Convertible Subordinated Notes due 2009, 6% Convertible Subordinated Notes due 2010 and 2.875% Convertible Senior Notes due 2010. See a detailed description of the notes below.

*2008 Debt Repurchases*

In September 2008, in various transactions, the Company repurchased \$39 million aggregate principal amount of its 6% Convertible Subordinated Notes due 2009 at discounts to the principal amount and recognized a net gain on extinguishment of debt of \$1 million. Unamortized debt issuance costs totaled less than \$1 million and accrued interest paid at the time of repurchase totaled less than \$1 million.

In September 2008, the Company repurchased \$32 million aggregate principal amount of its 6% Convertible Subordinated Notes due 2010 at a discount to the principal amount and recognized a net gain on extinguishment of debt of \$2 million. Unamortized debt issuance costs totaled less than \$1 million and accrued interest paid at the time of repurchase totaled \$1 million.

In December 2008, in connection with the issuance of the 15% Convertible Senior Notes due 2013, the Company repurchased using \$336 million in cash, through tender offers \$460 million aggregate principal amount of various issues of its convertible debt securities at discounts to par and recognized a gain on the extinguishment of debt of approximately \$122 million. The gain consisted of a \$124 million cash gain, which was partially offset by \$2 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$7 million.

The December 2008 debt repurchases consisted of the following:

- \$163 million of 2.875% Convertible Senior Notes due 2010;
- \$173 million of 6% Convertible Subordinated Notes due 2010; and
- \$124 million of 6% Convertible Subordinated Notes due 2009.

*2008 Debt for Equity Exchanges*

On multiple dates in October 2008, the Company entered into exchange agreements with holders of various issues of its convertible debt and issued approximately 48 million shares of Level 3 common stock in exchange for approximately \$108 million aggregate principal amount of its convertible debt securities. The shares of the Company's common stock are exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. These transactions were considered to be induced conversions in accordance with SFAS No. 84 "Induced Conversions of Convertible Debt—An Amendment of APB Opinion No. 26" ("SFAS No. 84") and as a result, the Company recorded a non-cash loss in the fourth quarter of 2008 on the exchange of the \$108 million aggregate principal amount of convertible debt securities of approximately \$44 million, consisting of \$43 million of debt conversion expense and \$1 million of previously capitalized debt issuance costs. The loss was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Long-Term Debt (Continued)**

The fourth quarter 2008 exchange transactions consisted of the following:

- \$18 million of 6% Convertible Subordinated Notes due 2009;
- \$47 million of 10% Convertible Senior Notes due 2011;
- \$19 million of 2.875% Convertible Senior Notes due 2010;
- \$15 million of 5.25% Convertible Senior Notes due 2011; and
- \$9 million of 3.5% Convertible Senior Notes due 2012.

*2008 Debt Repayments*

During March 2008, Level 3 Communications, Inc. repaid the remaining \$20 million of outstanding 11% Senior Notes due 2008 and \$6 million (€4 million) of outstanding 10.75% Senior Euro Notes due 2008. The Company also made capital lease and commercial mortgage payments of approximately \$6 million in 2008.

*2007 Debt for Equity Exchanges*

In January 2007, in two separate transactions, Level 3 completed the exchange of \$605 million in aggregate principal amount of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of Level 3's common stock. The shares of the Company's common stock are exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. The Company recognized a \$177 million loss on extinguishment of debt for the exchanges. Included in the loss was approximately \$1 million of unamortized debt issuance costs.

*2007 Redemptions and Repurchases*

In March 2007, the Company redeemed using cash the entire \$722 million of outstanding principal amount of the following debt issuances and recognized a loss on extinguishment of debt totaling \$54 million on the redemption transactions.

- Redeemed \$488 million of outstanding 12.875% Senior Notes due 2010 at a price equal to 102.146% of the principal amount and recognized a \$12 million loss on extinguishment of debt consisting of a \$10 million cash loss and \$2 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million.
- Redeemed \$96 million of outstanding 11.25% Senior Notes due 2010 at a price equal to 101.875% of the principal amount and recognized a \$3 million loss on extinguishment of debt consisting of a \$2 million cash loss and \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million.
- Redeemed \$138 million (€104 million) of outstanding 11.25% Senior Euro Notes due 2010 at a price equal to €101.875 per €1,000 of principal amount and recognized a \$39 million loss on extinguishment of debt consisting of a \$38 million cash loss and \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million (less than €1 million).

LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(11) Long-Term Debt (Continued)

In March 2007, the respective issuers repurchased using cash, through tender offers, \$941 million of the outstanding principal amounts of the following debt issuances and recognized a loss on extinguishment of debt totaling \$186 million on the repurchase transactions.

- Repurchased \$144 million of its outstanding Floating Rate Senior Notes due 2011 at a price equal to \$1,080 per \$1,000 principal amount of the notes, which included \$1,050 as the tender offer consideration and \$30 as a consent payment, and recognized an \$18 million loss on extinguishment of debt consisting of a \$12 million cash loss and \$6 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$8 million.
- Repurchased \$59 million of its outstanding 11% Senior Notes due 2008 at a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which included \$1,024.28 as the tender offer consideration and \$30 as a consent payment, and recognized a \$3 million loss on extinguishment of debt consisting of a \$3 million cash loss and less than \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$3 million.
- Repurchased \$677 million of its outstanding 11.5% Senior Notes due 2010 at a price equal to \$1,115.26 per \$1,000 principal amount of the notes, which included \$1,085.26 as the tender offer consideration and \$30 as a consent payment, and recognized a \$141 million loss on extinguishment of debt consisting of a \$78 million cash loss and \$63 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$3 million.
- Repurchased \$61 million (€46 million) of its outstanding 10.75% Senior Euro Notes due 2008 at a price equal to €1,061.45 per €1,000 of principal amount of the notes, which included €1,031.45 as the tender offer consideration and €30 as a consent payment, and recognized a \$24 million loss on extinguishment of debt consisting of a \$24 million cash loss and less than \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$3 million (€2 million).

In connection with the tender offers completed in the first quarter of 2007, Level 3 and Level 3 Financing, Inc. ("Level 3 Financing"), a wholly owned subsidiary of the Company, obtained consents to certain proposed amendments to the respective indentures governing the notes that are subject to the tender offer transactions described above to eliminate substantially all of the covenants, amend certain repurchase rights, certain discharge rights and certain events of default and related provisions contained in those indentures.

On February 23, 2007, Level 3 Financing completed a consent solicitation with respect to certain amendments to the indenture governing Level 3 Financing's outstanding 12.25% Senior Notes due 2013 that allowed for the incurrence of debt based upon a multiple of cash flow available for fixed charges on a "pro forma" basis giving effect to any acquisition, merger or consolidation completed prior to February 1, 2007. Additional debt as permitted under the amended indenture was incurred in March 2007. In connection with the consent solicitation, the Company paid consent fees totaling approximately \$2 million which were capitalized as additional debt issuance costs and will be amortized over the remaining life of the related debt issuances using the effective interest method.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(11) Long-Term Debt (Continued)***2007 Debt Refinancings*

In March 2007, Level 3 Financing refinanced its senior secured credit agreement and received net proceeds of \$1.382 billion. The proceeds from this transaction were used to repay the existing \$730 million Senior Secured Term Loan due 2011 and other debt. The effect of this transaction was to increase the amount of senior secured debt from \$730 million to \$1.4 billion, reduce the interest rate on that debt from the London Interbank Offering Rate ("LIBOR") plus 3.00% to LIBOR plus 2.25% and extend the final maturity from 2011 to 2014. The Company recognized a \$10 million loss on this transaction related to unamortized debt issuance costs. See a detailed description of the Senior Secured Term Loan due 2014 below.

*Senior Secured Term Loan due 2014*

On March 13, 2007, Level 3, as guarantor, Level 3 Financing, as borrower, Merrill Lynch Capital Corporation, as administrative agent and collateral agent, and certain other agents and certain lenders entered into a Credit Agreement, pursuant to which the lenders extended a \$1.4 billion senior secured term loan ("Senior Secured Term Loan due 2014") to Level 3 Financing. The term loan matures on March 13, 2014 and has an interest rate of LIBOR plus an applicable margin of 2.25% per annum and is payable in cash at the end of each LIBOR period elected in arrears, beginning July 13, 2007, provided that in the case of a six month interest period, interim interest payments are required at the end of the first three months. The borrower has the option of electing one, two, three or six month LIBOR at the end of each interest rate period and may elect different options with respect to different portions of the affected borrowing. The interest rate on \$1.0 billion of the Senior Secured Term Loan due 2014 resets quarterly and was 7.0% as of December 31, 2008. The interest rate on the remaining \$400 million of the Senior Secured Term Loan due 2014 currently is reset monthly and was 7.0% as of December 31, 2008. As of December 31, 2007, the interest rate on the entire \$1.4 billion of the Senior Secured Term Loan due 2014 was 7.49%

Level 3 Financing's obligations under this term loan are, subject to certain exceptions, secured by certain assets of the Company and certain of the Company's material domestic subsidiaries that are engaged in the telecommunications business. The Company and these subsidiaries have also guaranteed the obligations of Level 3 Financing under the Senior Secured Term Loan due 2014. During the second quarter of 2007, Level 3 Communications, LLC and its material domestic subsidiaries obtained all material governmental authorizations and consents required in order for them to pledge certain of their assets and guarantee the Senior Secured Term Loan due 2014. The guarantee was entered into by Level 3 Communications, LLC and its material domestic subsidiaries on June 28, 2007.

The Senior Secured Term Loan due 2014 includes certain negative covenants which restrict the ability of the Company, Level 3 Financing and any restricted subsidiary to engage in certain activities. The Senior Secured Term Loan due 2014 also contains certain events of default. It does not require the Company or Level 3 Financing to maintain specific financial ratios or other financial metrics.

Level 3 used a portion of the original net proceeds after transaction costs to repay Level 3 Financing's \$730 million Senior Secured Term Loan due 2011 under that certain credit agreement dated June 27, 2006. In addition, Level 3 used a portion of the net proceeds to fund the purchase of certain of its existing debt securities.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Long-Term Debt (Continued)**

Debt issuance costs of \$18 million were capitalized and are being amortized to interest expense over the term of the Senior Secured Term Loan due 2014 using the effective interest method. As a result of amortization, the capitalized debt issuance costs have been reduced to \$14 million at December 31, 2008.

*11.5% Senior Notes Due 2010*

In January 2006, Level 3 Communications, Inc. issued \$692 million aggregate principal amount of its 11.5% Senior Notes due 2010. The fair value of the 11.5% Senior Notes due 2010 was approximately \$73 million less than the face amount of the debt. The accretion of the \$73 million discount is being reflected as interest expense in using the effective interest method. The 11.5% Senior Notes due 2010 were recorded at their fair value on the transaction date and accrete to their face value at maturity.

The 11.5% Senior Notes are senior unsecured obligations of the Company, ranking equal in right of payment to all other senior unsecured obligations of the Company. The 11.5% Senior Notes due 2010 mature on March 1, 2010, and bear interest at a rate per annum equal to 11.5%. Interest on the notes is payable on March 1 and September 1 of each year, beginning on September 1, 2006. The Company may redeem some or all of the 11.5% Senior Notes due 2010 at any time on or after March 1, 2009, at 100% of their principal amount plus accrued interest.

In March 2007, the Company repurchased \$677 million of its outstanding 11.5% Senior Notes due 2010 at a price equal to \$1,115.26 per \$1,000 principal amount of the notes, which included \$1,085.26 as the tender offer consideration and \$30 as a consent payment, and recognized a \$141 million loss on extinguishment of debt consisting of a \$78 million cash loss and \$63 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$3 million. As of December 31, 2008, a total of \$13 million aggregate principal amount remains outstanding.

Debt issuance costs of \$11 million were originally capitalized and were being amortized to interest expense over the term of the 11.5% Senior Notes due 2010. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2008.

*10.75% Senior Notes due 2011*

In October 2003, Level 3 Financing received \$486 million of net proceeds from a private placement offering of \$500 million aggregate principal amount of its 10.75% Senior Notes due 2011 ("10.75% Senior Notes"). As of December 31, 2008, a total of \$497 million aggregate principal amount of the 10.75% Senior Notes had been redeemed. Interest on the notes accrues at 10.75% per year and is payable in arrears on April 15 and October 15 each year in cash. These notes are guaranteed by Level 3 Communications, LLC and Level 3 Communications, Inc. (See Note 16).

The 10.75% Senior Notes are subject to redemption at the option of Level 3 Financing, in whole or in part, at any time or from time to time, plus accrued and unpaid interest thereon to the

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (11) Long-Term Debt (Continued)

redemption date, if redeemed during the twelve months beginning October 15, of the years indicated below:

	Redemption
Year	Price
2008	102.688%
2009 and thereafter	100.000%

On December 27, 2006, Level 3 Financing entered into a Supplemental Indenture, which modified the original indenture dated as of October 1, 2003 ("10.75% Note Indenture"), among Level 3, as Guarantor, Level 3 Financing, as issuer, and The Bank of New York, as Trustee, relating to the 10.75% Notes. Pursuant to the Supplemental Indenture, the 10.75% Note Indenture was amended to eliminate substantially all of the covenants, certain repurchase rights and certain events of default and related provisions contained in the 10.75% Note Indenture.

The 10.75% Senior Notes are senior, unsecured obligations of Level 3 Financing, ranking *pari passu* with all existing and future senior unsecured indebtedness of Level 3 Financing.

Debt issuance costs of \$14 million were originally capitalized and are being amortized to interest expense over the term of the 10.75% Senior Notes. As a result of amortization and repurchases, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2008.

#### *Floating Rate Senior Notes due 2011*

On March 14, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, as borrower, entered into an indenture with the Bank of New York, as trustee, and issued \$150 million aggregate principal amount of floating rate senior notes due 2011 ("Floating Rate Senior Notes due 2011") in a private offering. After transaction costs, the Company received net proceeds associated with this offering of \$142 million.

In March 2007, the Company repurchased \$144 million of its outstanding Floating Rate Senior Notes due 2011 at a price equal to \$1,080 per \$1,000 principal amount of the notes, which included \$1,050 as the tender offer consideration and \$30 as a consent payment, and recognized an \$18 million loss on extinguishment of debt consisting of a \$12 million cash loss and \$6 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$8 million.

The Floating Rate Senior Notes due 2011 rank equal in right of payment with all other senior unsecured obligations of Level 3 Financing and have an initial interest rate equal to the six month London Interbank Offered Rate ("LIBOR"), plus 6.375%, which will be reset semi-annually. Interest on the notes is payable on March 15 and September 15 of each year, beginning on September 15, 2006. The interest rate was 9.46% at December 31, 2008. The Floating Rate Senior Notes due 2011 were priced at 96.782% of par and will mature on March 15, 2011. The discount, after the debt repurchase is less than \$1 million and is reflected as a reduction in long-term debt and is being amortized as interest expense over the term of the Floating Rate Senior Notes due 2011 using the effective interest method. These notes are guaranteed by Level 3 Communications, Inc. and Level 3 Communications, LLC (See Note 16).



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (11) Long-Term Debt (Continued)

The Floating Rate Senior Notes due 2011 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after March 15, 2008 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning March 15, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2008	102.0%
2009	101.0%
2010	100.0%

Debt issuance costs of \$3 million were capitalized and are being amortized over the term of the Floating Rate Senior Notes due 2011 using the effective interest method. As a result of amortization and the debt repurchase, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2008.

#### *12.25% Senior Notes due 2013*

On March 14, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, as borrower, entered into an indenture with the Bank of New York, as trustee, and issued \$250 million aggregate principal amount of 12.25% senior notes due 2013 ("12.25% Senior Notes due 2013") in a private offering.

On April 6, 2006, the Company issued \$300 million aggregate principal amount of 12.25% Senior Notes due 2013 in a private offering. These notes, together with the \$250 million aggregate principal amount of 12.25% Senior Notes due 2013 issued on March 14, 2006, are treated under the same indenture as a single series of notes. The Company received net proceeds of \$538 million associated with the 12.25% Senior Notes due 2013.

The 12.25% Senior Notes due 2013 are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. These notes are guaranteed by Level 3 Communications, Inc. and Level 3 Communications, LLC (See Note 16). The notes will mature on March 15, 2013. Interest on the notes accrues at 12.25% per year and is payable on March 15 and September 15 of each year, beginning on September 15, 2006. The \$250 million of 12.25% Senior Notes due 2013 issued on March 14, 2006 were priced at 96.618% of par. The \$300 million of 12.25% Senior Notes due 2013 issued on April 6, 2006 were priced at 102% of par. The resulting net discount for the two issuances of approximately \$2 million is reflected as a reduction in long-term debt and is being amortized as interest expense over the remaining term of the 12.25% Senior Notes due 2013 using the effective interest method.

The 12.25% Senior Notes due 2013 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after March 15, 2010 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (11) Long-Term Debt (Continued)

interest thereon to the redemption date, if redeemed during the twelve months beginning March 15, of the years indicated below:

Year	Redemption Price
2010	106.125%
2011	103.063%
2012	100.000%

The 12.25% Senior Notes due 2013 contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of approximately \$11 million were capitalized and are being amortized over the term of the 12.25% Senior Notes due 2013. As a result of amortization, the capitalized debt issuance costs have been reduced to \$10 million at December 31, 2008.

#### *9.25% Senior Notes Due 2014*

On October 30, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, Inc. as borrower, received \$588 million of net proceeds after transaction costs, from a private offering of \$600 million aggregate principal amount of its 9.25% Senior Notes due 2014 ("9.25% Senior Notes Due 2014"). On December 13, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, Inc. as borrower, received \$661 million of net proceeds after transaction costs and accrued interest, for a second offering of \$650 million aggregate principal amount of 9.25% Senior Notes due 2014. These notes together with the \$600 million aggregate principal amount of 9.25% Senior Notes due 2014 issued on October 30, 2006 were issued under the same indenture and will be treated as a single series of notes. The Company received total net proceeds of \$1.239 billion (excluding prepaid interest).

The 9.25% Senior Notes due 2014 are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. These notes are guaranteed by Level 3 Communications, Inc. (See Note 16). The notes will mature on November 1, 2014. Interest on the 9.25% Senior Notes Due 2014 accrues at 9.25% interest per year and is payable semi-annually in cash on May 1 and November 1 beginning May 1, 2007. The \$600 million of 9.25% Senior Notes due 2014 issued on October 30, 2006 were priced at par. The \$650 million of 9.25% Senior Notes due 2014 issued on December 13, 2006 were priced at 101.75% of par plus accrued interest from October 30, 2006, representing an effective yield of 8.86% to the purchasers of these senior notes. The resulting premium of the two issuances of approximately \$11 million is reflected as an increase to long-term debt and is being amortized as a reduction to interest expense over the remaining term of the 9.25% Senior Notes due 2014 using the effective interest method. As of December 31, 2008, the premium remaining was approximately \$9 million.

The 9.25% Senior Notes Due 2014 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after November 1, 2010 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (11) Long-Term Debt (Continued)

interest thereon to the redemption date, if redeemed during the twelve months beginning November 1, of the years indicated below:

Year	Redemption Price
2010	104.625%
2011	102.313%
2012	100.000%

At any time or from time to time on or prior to November 1, 2009, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the 9.25% Senior Notes Due 2014 at a redemption price equal to 109.25% of the principal amount of those notes so redeemed, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the 9.25% Senior Notes Due 2014 would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

The 9.25% Senior Notes due 2014 contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of approximately \$23 million were capitalized and are being amortized over the term of the 9.25% senior Notes Due 2014. As a result of amortization, the capitalized debt issuance costs have been reduced to \$18 million at December 31, 2008.

#### *Floating Rate Senior Notes Due 2015 and 8.75% Senior Notes Due 2017*

On February 14, 2007, Level 3 Financing received \$982 million of net proceeds after transaction costs, from a private offering of \$700 million aggregate principal amount of its 8.75% Senior Notes due 2017 (the "8.75% Senior Notes") and \$300 million aggregate principal amount of its Floating Rate Senior Notes due 2015 (the "2015 Floating Rate Senior Notes"). The 8.75% Senior Notes and the 2015 Floating Rate Senior Notes are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. Level 3 Communications, Inc. and Level 3 Communications, LLC have guaranteed the 8.75% Senior Notes and the 2015 Floating Rate Senior Notes (See Note 16). Interest on the 8.75% Senior Notes accrues at 8.75% interest per year and is payable semi-annually in cash on February 15th and August 15th beginning August 15, 2007. The principal amount of the 8.75% Senior Notes will be due on February 15, 2017. Interest on the 2015 Floating Rate Senior Notes accrues at LIBOR plus 3.75% per annum, reset semi-annually. The interest rate was 6.85% at December 31, 2008. Interest on the 2015 Floating Rate Senior notes is payable semi-annually in cash on February 15th and August 15th beginning August 15, 2007. The principal amount of the 2015 Floating Rate Senior Notes will be due on February 15, 2015.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (11) Long-Term Debt (Continued)

At any time prior to February 15, 2012, Level 3 Financing may redeem all or a part of the 8.75% Senior Notes upon not less than 30 nor more than 60 days' prior notice, at a redemption price equal to 100% of the principal amount of the 8.75% Senior Notes so redeemed plus the 8.75% Applicable Premium as of, and accrued and unpaid interest thereon (if any) to, the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date).

With respect to the 8.75% Senior Notes, "8.75% Applicable Premium" means on any redemption date, the greater of (1) 1.0% of the principal amount of such 8.75% Senior Notes and (2) the excess, if any, of (a) the present value at such redemption date of (i) 104.375% of the principal amount of such 8.75% Senior Notes plus (ii) all required interest payments due on such 8.75% Senior Notes through February 15, 2012 (excluding accrued but unpaid interest to the redemption date), computed using a discount rate equal to the Treasury Rate (as defined in the indenture governing the 8.75% Senior Notes) as of such redemption date plus 50 basis points, over (b) the principal amount of such 8.75% Senior Notes.

The 8.75% Senior Notes are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after February 15, 2012 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning February 15, of the years indicated below:

Year	Redemption Price
2012	104.375%
2013	102.917%
2014	101.458%
2015	100.000%

At any time or from time to time on or prior to February 15, 2010, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the 8.75% Senior Notes at a redemption price equal to 108.75% of the principal amount of the 8.75% Senior Notes so redeemed, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the 8.75% Senior Notes would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

At any time prior to February 15, 2009, Level 3 Financing may redeem all or a part of the Floating Rate Senior Notes, upon not less than 30 nor more than 60 days' prior notice, at a redemption price equal to 100% of the principal amount of the Floating Rate Senior Notes so redeemed plus the Applicable Premium as of, and accrued and unpaid interest thereon (if any) to, the redemption date

LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(11) Long-Term Debt (Continued)

(subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date).

With respect to the Floating Rate Senior Notes, "Applicable Premium" means, on any redemption date, the greater of (1) 1.0% of the principal amount of such Floating Rate Senior Notes and (2) the excess, if any, of (a) the present value at such redemption date of (i) the redemption price of 102% of the principal amount of such Floating Rate Senior Notes, plus (ii) all required interest payments due on such Floating Rate Senior Notes through February 15, 2009 (excluding accrued but unpaid interest to the redemption date), such interest payments to be determined in accordance with the indenture governing the Floating Rate Senior Notes assuming that LIBOR in effect on the date of the applicable redemption notice would be the applicable LIBOR in effect through February 15, 2009, computed using a discount rate equal to the Treasury Rate (as defined in the indenture governing the Floating Rate Senior Notes) as of such redemption date plus 50 basis points, over (b) the principal amount of such Floating Rate Senior Notes.

The Floating Rate Senior Notes are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after February 15, 2009 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning February 15, of the years indicated below:

Year	Redemption Price
2009	102.0%
2010	101.0%
2011	100.0%

At any time or from time to time on or prior to February 15, 2009, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the Floating Rate Senior Notes at a redemption price equal to 100.0% of the principal amount of the Floating Rate Senior Notes so redeemed, plus a premium equal to the interest rate on the Floating Rate Senior Notes applicable on the date that notice of the redemption is given, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the Floating Rate Senior Notes would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

The 8.75% Senior Notes and the 2015 Floating Rate Senior Notes contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Long-Term Debt (Continued)**

Debt issuance costs of approximately \$16 million were capitalized and are being amortized over the term of the 8.75% Senior Notes due 2017. As a result of amortization, the capitalized debt issuance costs have been reduced to approximately \$15 million at December 31, 2008.

Debt issuance costs of approximately \$6 million were capitalized and are being amortized over the term of the Floating Rate Senior Notes due 2015. As a result of amortization, the capitalized debt issuance costs have been reduced to approximately \$5 million at December 31, 2008.

*2.875% Convertible Senior Notes due 2010*

In July 2003, Level 3 Communications, Inc. completed the offering of \$374 million aggregate principal amount of its 2.875% Convertible Senior Notes due 2010 ("2.875% Convertible Senior Notes") in an underwritten public offering pursuant to the Company's shelf registration statement. Interest on the notes accrues at 2.875% per year and is payable semi-annually in arrears in cash on January 15 and July 15, beginning January 15, 2004. The 2.875% Convertible Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured debt. The 2.875% Convertible Senior Notes contain limited covenants, which restrict additional liens on assets of the Company.

On multiple dates in October 2008, the Company completed the exchange of \$19 million in aggregate principal amount of its 2.875% Convertible Senior Notes for a total of 7 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to these exchanges were exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. These transactions were considered to be induced conversions in accordance with SFAS No. 84 and as a result, the Company recorded a non-cash loss in the fourth quarter of 2008 on the exchange of the 2.875% Convertible Senior Notes of \$8 million, consisting of approximately \$8 million of debt conversion expense and less than \$1 million of previously capitalized debt issuance costs. The loss was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

In December 2008, the Company repurchased using \$101 million in cash, through tender offers, \$163 million aggregate principal amount of its 2.875% Convertible Senior Notes at a price equal to \$620 per \$1,000 principal amount of the notes and recognized a gain on the extinguishment of debt of approximately \$61 million. The gain consisted of a \$62 million cash gain, which was partially offset by \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$2 million. The gain was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

The remaining 2.875% Convertible Senior Notes are convertible into shares of the Company's common stock at a conversion rate of \$7.18 per share, subject to certain adjustments. At any time and from time to time, the Company, at its option, may redeem for cash all or a portion of the notes. The Company may exercise this option only if the current market price for Level 3's common stock for at least 20 trading days within any 30 consecutive trading day period exceeds prices ranging from 160% of the conversion price on July 15, 2008 decreasing to 150% of the conversion price on or after July 15, 2009. The Company would also be obligated to pay the holders of the redeemed notes a cash amount equal to the present value of all remaining scheduled interest payments.

Debt issuance costs of \$13 million were originally capitalized and are being amortized to interest expense over the term of the 2.875% Convertible Senior Notes. As a result of amortization, exchanges

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (11) Long-Term Debt (Continued)

and repurchases the capitalized debt issuance costs have been reduced to approximately \$2 million at December 31, 2008.

##### *5.25% Convertible Senior Notes due 2011*

On December 2, 2004, Level 3 Communications, Inc. completed the offering of \$345 million aggregate principal amount of its 5.25% Convertible Senior Notes due 2011 ("5.25% Convertible Senior Notes") in a private offering. Interest on the notes accrues at 5.25% per year and is payable semi-annually in arrears in cash on June 15 and December 15, beginning June 15, 2005. The 5.25% Convertible Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured debt of Level 3 Communications, Inc. The 5.25% Convertible Senior Notes contain limited covenants which restrict additional liens on assets of the Company.

In October 2008, the Company completed the exchange of \$15 million in aggregate principal amount of its 5.25% Convertible Senior Notes for a total of 5 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to this exchange were exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. This transaction was considered to be an induced conversion in accordance with SFAS No. 84 and as a result, the Company recorded a non-cash loss in the fourth quarter of 2008 on the exchange of the 5.25% Convertible Senior Notes of \$3 million, consisting of approximately \$3 million of debt conversion expense and less than \$1 million of previously capitalized debt issuance costs. The loss was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

The remaining 5.25% Convertible Senior Notes are convertible, at the option of the holders, into shares of the Company's common stock at a conversion rate of \$3.98 per share, subject to certain adjustments. Upon conversion, the Company will have the right to deliver cash in lieu of shares of its common stock, or a combination of cash and shares of common stock. In addition, holders of the 5.25% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount plus accrued interest and a make whole premium. As of December 31, 2008, the make whole premium privileges on the 5.25% Convertible Senior Notes had lapsed.

On or after December 15, 2008, Level 3, at its option, may redeem for cash all or a portion of the notes. The 5.25% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than 60 nor less than 30 days' notice, on or after December 15, 2008, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning December 15, of the years indicated below:

	Redemption
Year	Price
2008	102.250%
2009	101.500%
2010 and thereafter	100.750%

Debt issuance costs of \$11 million were originally capitalized and are being amortized to interest expense over the term of the 5.25% Convertible Senior Notes. As a result of amortization and exchanges, the remaining unamortized debt issuance costs were \$4 million at December 31, 2008.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (11) Long-Term Debt (Continued)

*10% Convertible Senior Notes due 2011*

In April 2005, Level 3 Communications, Inc. received \$877 million of net proceeds, after giving effect to offering expenses, from an offering of \$880 million aggregate principal amount of its 10% Convertible Senior Notes due 2011 ("10% Convertible Senior Notes") to institutional investors. Interest on the notes accrues at 10% per year and will be payable semi-annually on May 1 and November 1 beginning on November 1, 2005. The 10% Convertible Senior Notes are unsecured unsubordinated obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future unsecured unsubordinated debt of Level 3 Communications, Inc. The 10% Convertible Senior Notes contain limited covenants which restrict additional liens on assets of the Company.

In January 2007, in two separate transactions, Level 3 completed the exchange of \$605 million in aggregate principal amount of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to these announced exchanges are exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. The Company recognized a \$177 million loss on extinguishment of debt for the exchanges. Included in the loss was approximately \$1 million of unamortized debt issuance costs.

In October 2008, the Company completed the exchange of \$47 million in aggregate principal amount of its 10% Convertible Senior Notes for a total of 22 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to this exchange was exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. This transaction was considered to be an induced conversion in accordance with SFAS No. 84 and as a result, the Company recorded a non-cash loss in the fourth quarter of 2008 on the exchange of the 10% Convertible Senior Notes of \$15 million, consisting of approximately \$15 million of debt conversion expense and less than \$1 million of previously capitalized debt issuance costs. The loss was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

The remaining 10% Convertible Senior Notes are convertible by holders at any time and from time to time into shares of Level 3 common stock at a conversion price of \$3.60 per share (subject to adjustment in certain events). This is equivalent to a conversion rate of approximately 277.77 shares per \$1,000 principal amount of notes. In addition, holders of the 10% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount of the notes plus accrued interest and a make whole premium.

On or after May 1, 2009, Level 3, at its option, may redeem for cash all or a portion of the notes. The 10% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than sixty nor less than thirty days' notice, on or after May 1, 2009, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning May 1, of the years indicated below:

Redemption	
Year	Price
2009	103.330%
2010 and thereafter	101.670%



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (11) Long-Term Debt (Continued)

Debt issuance costs of \$3 million were originally capitalized and are being amortized to interest expense over the term of the 10% Convertible Senior Notes. As a result of amortization and exchanges, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2008.

*3.5% Convertible Senior Notes due 2012*

On June 13, 2006 Level 3 Communications, Inc. received \$326 million of net proceeds, after giving effect to offering expenses, from a public offering of \$335 million aggregate principal amount of its 3.5% Convertible Senior Notes due 2012 ("3.5% Convertible Senior Notes"). The 3.5% Convertible Senior Notes were priced at 100% of the principal amount. The notes are senior unsecured obligations of the Company, ranking equal in right of payment with all the Company's existing and future unsubordinated indebtedness. The 3.5% Convertible Senior Notes will mature on June 15, 2012. Interest on the notes is payable semi-annually in arrears on June 15 and December 15 of each year, beginning on December 15, 2006. The 3.5% Convertible Senior Notes contain limited covenants which restrict additional liens on assets of the Company.

In October 2008, the Company completed the exchange of \$9 million in aggregate principal amount of its 3.5% Convertible Senior Notes for a total of 3 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to this exchange was exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. This transaction was considered to be an induced conversion in accordance with SFAS No. 84 and as a result, the Company recorded a non-cash loss in the fourth quarter of 2008 on the exchange of the 3.5% Convertible Senior Notes of \$2 million, consisting of approximately \$2 million of debt conversion expense and less than \$1 million of previously capitalized debt issuance costs. The loss was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

The remaining 3.5% Convertible Senior Notes will be convertible by holders at any time before the close of business on June 15, 2012 into shares of Level 3's common stock at a conversion price of \$5.46 per share (subject to adjustment in certain events). This is equivalent to a conversion rate of approximately 183.1502 shares of common stock per \$1,000 principal amount of these notes. Upon conversion, the Company will have the right to deliver cash in lieu of shares of its common stock, or a combination of cash and shares of common stock. In addition, holders of the 3.5% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount of the notes plus accrued interest. In addition, if a holder elects to convert its notes in connection with certain changes in control, Level 3 could be required to pay a make whole premium by increasing the number of shares deliverable upon conversion of the notes.

The 3.5% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than 60 nor less than 30 days' notice, on or after June 15, 2010, plus accrued and unpaid interest thereon (if any) to the redemption date, if redeemed during the twelve months beginning June 15, of the years indicated below:

Redemption	
Year	Price
2010	101.17%
2011	100.58%

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(11) Long-Term Debt (Continued)**

Debt issuance costs of \$9 million were originally capitalized and are being amortized to interest expense over the term of the 3.5% Convertible Senior Notes. As a result of amortization and the exchange, the capitalized debt issuance costs have been reduced to approximately \$6 million at December 31, 2008.

*15% Convertible Senior Notes Due 2013*

On December 24, 2008 the Company received gross proceeds of \$373.8 million and on December 31, 2008 the Company received gross proceeds of \$26.2 million from the issuance of its \$400 million 15% Convertible Senior Notes due 2013 ("15% Convertible Senior Notes"). Accrued but unpaid debt issuance costs are expected to be approximately \$3 million and are being amortized to interest expense over the term of the 15% Convertible Senior Notes. The proceeds from this issuance were primarily used to repurchase, through tender offers, a portion of the Company's 6% Convertible Subordinated Notes due 2009, 6% Convertible Subordinated Notes due 2010 and 2.875% Convertible Senior Notes due 2010. The 15% Convertible Senior Notes were priced at 100% of the principal amount. The 15% Convertible Senior Notes are unsecured and unsubordinated obligations and will rank equally with all the Company's existing and future unsecured and unsubordinated indebtedness. The 15% Convertible Senior Notes will mature on January 15, 2013. Interest on the notes will accrue from the date of original issuance at a rate of 15% per year and will be payable on January 15 and July 15 of each year, beginning on January 15, 2009. The 15% Convertible Senior Notes contain limited covenants which restrict additional liens on assets of the Company.

The 15% Convertible Senior Notes are convertible by holders into shares of the Company's common stock at an initial conversion price of \$1.80 per share (which is equivalent to a conversion rate of 555.5556 shares of common stock per \$1,000 principal amount of the 15% Convertible Senior Notes), subject to adjustment upon certain events, at any time before the close of business on January 15, 2013. If at any time following the date of original issuance of the 15% Convertible Senior Notes and prior to the close of business on January 15, 2013 the closing per share sale price of the Company's common stock exceeds 222.2% of the conversion price then in effect for at least 20 trading days within any 30 consecutive trading day period, the 15% Convertible Senior Notes will automatically convert into shares of Level 3 common stock, plus accrued and unpaid interest (if any) to, but excluding the automatic conversion date, which date will be designated by the Company following such automatic conversion event.

Holders of the 15% Convertible Senior Notes may require the Company to repurchase all or any part of their notes upon the occurrence of a designated event at a price equal to 100% of the principal amount of the notes, plus accrued and unpaid interest to, but excluding, the repurchase date, if any.

In addition, if a holder elects to convert its 15% Convertible Senior Notes in connection with certain changes in control, the Company could be required to pay a make-whole premium by increasing the number of shares deliverable upon conversion of such notes. Any make whole premium will have the effect of increasing the number of shares due to holders of the 15% Convertible Senior Notes upon conversion.

*9% Convertible Senior Discount Notes due 2013*

In October 2003, Level 3 Communications, Inc. issued \$295 million aggregate principal amount at maturity of 9% Convertible Senior Discount Notes due 2013. Interest on the 9% Convertible Senior

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Long-Term Debt (Continued)**

Discount Notes accretes at a rate of 9% per annum, compounded semiannually, to an aggregate principal amount of \$295 million by October 15, 2007. Cash interest did not accrue on the 9% Convertible Senior Discount Notes prior to October 15, 2007. Commencing October 15, 2007, interest on the 9% Convertible Senior Discount Notes accrues at the rate of 9% per annum and is payable in cash semiannually in arrears. Accreted interest expense of \$20 million for the year ended December 31, 2007 on the 9% Convertible Senior Discount Notes due 2013 was added to long-term debt.

The 9% Convertible Senior Discount Notes are convertible into shares of the Company's common stock at a conversion rate of \$9.99 per share, subject to certain adjustments. On or after October 15, 2008, the Company, at its option, may redeem for cash all or a portion of the notes. The Company may exercise this option only if the current market price for at least 20 trading days within any 30 consecutive trading day period exceeds 140% of the conversion price on October 15, 2008. This amount will be decreased to 130% and 120% on October 15, 2008 and 2010, respectively, if the initial holders sell greater than 33.33% of the notes. The Company is also obligated to pay the holders of the redeemed notes a cash amount equal to the present value of all remaining scheduled interest payments.

The 9% Convertible Senior Discount Notes are subject to conversion into common stock at the option of the holder, in whole or in part, at any time or from time to time at a conversion rate of 100.09 shares per \$1,000 of face value of the debt plus accrued and unpaid interest thereon to the conversion date.

These notes are senior unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured indebtedness of Level 3 Communications, Inc.

*6% Convertible Subordinated Notes due 2009*

In September 1999, the Company received \$798 million of proceeds, after transaction costs, from an offering of \$823 million aggregate principal amount of its 6% Convertible Subordinated Notes Due 2009 ("Subordinated Notes 2009"). The Subordinated Notes 2009 are unsecured and subordinated to all existing and future senior indebtedness of the Company. Interest on the Subordinated Notes 2009 accrues at 6% per year and is payable each year in cash on March 15 and September 15. The principal amount of the Subordinated Notes 2009 will be due on September 15, 2009.

In September 2008, in various transactions, the Company repurchased \$39 million aggregate principal amount of its Subordinated Notes 2009 at discounts to the principal amount and recognized a net gain on extinguishment of debt of \$1 million. Unamortized debt issuance costs totaled less than \$1 million and accrued interest paid at the time of repurchase totaled less than \$1 million.

In October 2008, the Company completed the exchange of \$18 million in aggregate principal amount of its Subordinated Notes 2009 for a total of 10 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to these exchanges were exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. These transactions were considered to be induced conversions in accordance with SFAS No. 84 and as a result, the Company recorded a non-cash loss in the fourth quarter of 2008 on the exchange of the Subordinated Notes 2009 of \$14 million, consisting of approximately \$14 million of debt conversion expense and less than \$1 million of previously capitalized debt issuance costs. The loss was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Long-Term Debt (Continued)**

In December 2008, the Company repurchased using \$114 million in cash, through tender offers, \$124 million aggregate principal amount of Subordinated Notes 2009 at a price equal to \$920 per \$1,000 principal amount of the notes and recognized a gain on the extinguishment of debt of approximately \$9 million. The gain consisted of a \$10 million cash gain, which was partially offset by \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$2 million. The gain was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

The remaining Subordinated Notes 2009 may be converted into shares of common stock of the Company at any time prior to maturity, unless previously redeemed, repurchased or the Company has caused the conversion rights to expire. The conversion rate is 15.3401 shares per each \$1,000 principal amount of Subordinated Notes 2009, subject to adjustment in certain circumstances. On or after September 15, 2002, the Company, at its option, may cause the conversion rights to expire. The Company may exercise this option only if the current market price exceeds approximately \$91.27 (which represents 140% of the conversion price) for 20 trading days within any period of 30 consecutive trading days including the last day of that period.

Debt issuance costs of \$25 million were originally capitalized and are being amortized to interest expense over the term of the Subordinated Notes 2009. As a result of amortization, exchanges and repurchases the capitalized debt issuance costs have been reduced to \$1 million at December 31, 2008.

*6% Convertible Subordinated Notes due 2010*

In February 2000, Level 3 Communications, Inc. received \$836 million of net proceeds, after transaction costs, from a public offering of \$863 million aggregate principal amount of its 6% Convertible Subordinated Notes due 2010 ("Subordinated Notes 2010"). The Subordinated Notes 2010 are unsecured and subordinated to all existing and future senior indebtedness of the Company. Interest on the Subordinated Notes 2010 accrues at 6% per year and is payable semi-annually in cash on March 15 and September 15 beginning September 15, 2000. The principal amount of the Subordinated Notes 2010 will be due on March 15, 2010.

In December 2008, in connection with the issuance of the \$400 million of 15% Convertible Senior Notes due 2013, the Company repurchased using \$121 million in cash, through tender offers, \$173 million aggregate principal amount of Subordinated Notes 2010 at a price equal to \$700 per \$1,000 principal amount of the notes and recognized a gain on the extinguishment of debt of approximately \$51 million. The gain consisted of a \$52 million cash gain, which was partially offset by \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$3 million. The gain was recorded in gain (loss) on extinguishment of debt in the consolidated statements of operations.

In September 2008, the Company repurchased \$32 million aggregate principal amount of Subordinated Notes 2010 at a discount to the principal amount and recognized a net gain on extinguishment of debt of \$2 million. Unamortized debt issuance costs totaled less than \$1 million and accrued interest paid at the time of repurchase totaled \$1 million.

The remaining Subordinated Notes 2010 may be converted into shares of common stock of Level 3 Communications, Inc. at any time prior to the close of business on the business day immediately preceding maturity, unless previously redeemed, repurchased or Level 3 Communications, Inc. has

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Long-Term Debt (Continued)**

caused the conversion rights to expire. The conversion rate is 7.416 shares per each \$1,000 principal amount of Subordinated Notes 2010, subject to adjustment in certain events.

On or after March 18, 2003, the Company, at its option, may cause the conversion rights to expire. The Company may exercise this option only if the current market price exceeds approximately \$188.78 (which represents 140% of the conversion price) for at least 20 trading days within any period of 30 consecutive trading days, including the last trading day of that period.

Debt issuance costs of \$27 million were originally capitalized and are being amortized to interest expense over the term of the Subordinated Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to \$1 million at December 31, 2008.

*Commercial Mortgage*

In the third quarter of 2005, the HQ Realty, Inc., a wholly owned subsidiary of the Company, completed a refinancing of the mortgage on the Company's corporate headquarters. On September 27, 2005, HQ Realty, Inc. entered into a \$70 million loan at an initial fixed rate of 6.86% through 2010, the anticipated repayment date as defined in the loan agreement ("Commercial Mortgage"). The term of the Commercial Mortgage may be extended to a final maturity date of October 1, 2015 at the election of HQ Realty, Inc. If the term is extended, after 2010 through maturity in 2015, the interest rate will adjust to the greater of 9.86% or the five year U.S. Treasury rate plus 300 basis points. HQ Realty, Inc. received \$66 million of net proceeds after transaction costs and has deposited \$1 million into restricted cash accounts as of December 31, 2008, for future facility improvements and property taxes. HQ Realty, Inc. was required to make interest only payments in the first year and began making monthly principal payments in the second year based on a 30-year amortization schedule.

Debt issuance costs of \$1 million were capitalized and are being amortized as interest expense over the term of the Commercial Mortgage. As a result of amortization, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2008.

The assets of HQ Realty, Inc. are not available to satisfy any third party obligations other than those of HQ Realty, Inc. In addition, the assets of the Company and its subsidiaries other than HQ Realty, Inc. are not available to satisfy the obligations of HQ Realty, Inc.

*Capital Leases*

The Company leases certain dark fiber facilities and metro fiber under noncancelable IRU agreements that are accounted for as capital leases. All of these capital leases were assumed by the Company through its previous acquisitions. Interest rates on capital leases approximate 8% on average as of December 31, 2008. Depreciation expense related to assets under capital leases is included in depreciation and amortization expense.

*Covenant Compliance*

At December 31, 2008 and 2007, the Company was in compliance with the covenants on all outstanding debt issuances.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (11) Long-Term Debt (Continued)

##### *Long-Term Debt Maturities:*

Aggregate future maturities of long-term debt and capital leases (excluding issue discounts, premiums and fair value adjustments) were as follows as of December 31, 2008 (in millions):

2009	\$ 186
2010	583
2011	569
2012	328
2013	1,247
Thereafter	3,673
	<u>\$6,586</u>

#### (12) Employee Benefit Plans

The Company records non-cash compensation expense for its outperform stock appreciation rights that it refers to as Outperform Stock Options ("OSO"), restricted stock units and shares, 401(k) matching contributions and discretionary 401(k) contributions. Total non-cash compensation expense related to these equity awards was \$78 million in 2008, \$122 million in 2007 and \$84 million in 2006. Included in discontinued operations for 2006 is non-cash compensation of \$2 million.

The following table summarizes non-cash compensation expense and capitalized non-cash compensation for each of the three years ended December 31, 2008 (in millions):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
OSO	\$13	\$ 35	\$38
Restricted Stock	36	42	20
401(k) Match Expense	30	30	18
401(k) Discretionary Grant Plan	—	16	12
	<u>79</u>	<u>123</u>	<u>88</u>
Capitalized Noncash Compensation	(1)	(1)	(2)
	<u>78</u>	<u>122</u>	<u>86</u>
Discontinued Operations	—	—	(2)
	<u>\$78</u>	<u>\$122</u>	<u>\$84</u>

OSO units and restricted stock units and shares are granted under the Company's 1995 Stock Plan, as amended, which term extends through September 25, 2010. The Company's 1995 Stock Plan, as amended, provides for accelerated vesting of stock awards upon retirement if an employee meets certain age and years of service requirements and certain other requirements. Under SFAS No. 123R, if an employee meets the age and years of service requirements under the accelerated vesting provision, the award would be expensed at grant or expensed over the period from the grant date to the date the employee meets the requirements, even if the employee has not actually retired. The Company recognized non-cash compensation expense for employees that met the age and years of service requirements for accelerated vesting at retirement of \$7 million in 2008, \$11 million in 2007 and zero in 2006.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (12) Employee Benefit Plans (Continued)

##### *Outperform Stock Options*

During the second quarter of 2006, the October 2005 and January 2006 grants of Outperform Stock Option ("OSO") units were revalued using May 15, 2006 as the grant date, as there had not been stockholder approval of those awards prior to that date, which was deemed necessary for determination of the grant date for those awards under SFAS No. 123R, and resulted in an additional \$6 million in non-cash compensation expense.

The Company's OSO program was designed so that the Company's stockholders would receive a market return on their investment before OSO holders receive any return on their options. The Company believes that the OSO program directly aligns management's and stockholders' interests by basing stock option value on the Company's ability to outperform the market in general, as measured by the Standard & Poor's ("S&P") 500 Index. Participants in the OSO program do not realize any value from awards unless the Company's common stock price outperforms the S&P 500® Index during the life of the grant. When the stock price gain is greater than the corresponding gain on the S&P 500® Index (or less than the corresponding loss on the S&P 500® Index for grants awarded before September 30, 2005), the value received for awards under the OSO plan is based on a formula involving a multiplier related to the level by which the Company's common stock outperforms the S&P 500® Index. To the extent that Level 3's common stock outperforms the S&P 500 Index, the value of OSO units to a holder may exceed the value of nonqualified stock options.

The initial strike price, as determined on the day prior to the OSO grant date, is adjusted over time (the "Adjusted Strike Price"), until the exercise date. The adjustment is an amount equal to the percentage appreciation or depreciation in the value of the S&P 500® Index from the date of grant to the date of exercise. The value of the OSO increases for increasing levels of outperformance. OSO units have a multiplier range from zero to four depending upon the performance of Level 3 common stock relative to the S&P 500® Index as shown in the following table.

<u>If Level 3 Stock Outperforms the S&amp;P 500® Index by:</u>	<u>Then the Pre-multiplier Gain Is Multiplied by a Success Multiplier of:</u>
0% or Less	0.00
More than 0% but Less than 11%	Outperformance percentage multiplied by <sup>4</sup> / 11
11% or More	4.00

The Pre-multiplier gain is the Level 3 common stock price minus the Adjusted Strike Price on the date of exercise.

Upon exercise of an OSO, the Company shall deliver or pay to the grantee the difference between the Fair Market Value of a share of Level 3 common stock as of the day prior to the exercise date, less the Adjusted Strike Price (the "Exercise Consideration"). The Exercise Consideration may be paid in cash, Level 3 common stock or any combination of cash or Level 3 common stock at the Company's discretion. The number of shares of Level 3 common stock to be delivered by the Company to the grantee is determined by dividing the Exercise Consideration to be paid in Level 3 common stock by the Fair Market Value of a share of Level 3 common stock as of the date prior to the exercise date. Fair Market Value is defined in the OSO agreement, but is currently the closing price per share of Level 3 common stock on the NASDAQ exchange. Exercise of the OSO units does not require any cash outlay by the employee.



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (12) Employee Benefit Plans (Continued)

Prior to March 31, 2007, OSO awards vested over 2 years and had a 4-year life. Fifty percent of the awards vested at the end of the first year after grant, with the remaining 50% vested over the second year (12.5% per quarter). As part of a comprehensive review of its long-term compensation program completed in the first quarter of 2007, beginning with awards made on or after April 1, 2007, OSO units are awarded monthly to employees in mid-management level and higher positions, have a three year life, vest 100% and fully settle on the third anniversary of the date of the award and are valued as of the first day of each month. Recipients have no discretion on the timing to exercise OSO units granted on or after April 1, 2007, thus the expected life of all such OSO units is three years.

As of December 31, 2008, there was \$20 million of unamortized compensation expense related to granted OSO units. The weighted average period over which this cost will be recognized is 1.94 years.

The fair value of the OSO units granted is calculated by applying a modified Black-Scholes model with the assumptions identified below. The Company utilized a modified Black-Scholes model due to the additional variables required to calculate the effect of the success multiplier of the OSO program. The Company believes that given the relative short life of the options and the other variables used in the model, the modified Black-Scholes model provides a reasonable estimate of the fair value of the OSO units at the time of grant.

	Year Ended December 31,		
	2008	2007	2006
S&P 500 Expected Dividend Yield Rate	2.00%	1.78%	1.78%
Expected Life	3 years	3 years	3.4 years
S&P 500 Expected Volatility Rate	13%	12%	12%
Level 3 Common Stock Expected Volatility Rate	56%	55%	55%
Expected S&P 500 Correlation Factor	.32	.28	.28
Calculated Theoretical Value	147%	146%	153%
Estimated Forfeiture Rate	11.87%	11.88%	10.19%

The fair value of each OSO grant equals the calculated theoretical value multiplied by the Level 3 common stock price on the grant date.

The expected life data was stratified based on levels of responsibility within the Company. The theoretical value used in 2006 was determined using the weighted average exercise behavior for these groups of employees. As described above, recipients have no discretion on the timing to exercise OSO units granted on or after April 1, 2007, thus the expected life of all such OSO units is three years. Volatility assumptions were derived using historical data as well as current market data.

The fair value for OSO units awarded to participants during the years ended December 31, 2008, 2007 and 2006 was approximately \$18 million, \$32 million and \$50 million, respectively.



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (12) Employee Benefit Plans (Continued)

Transactions involving OSO units awarded are summarized in the table below. The Option Price Per Unit identified in the table below represents the initial strike price, as determined on the day prior to the OSO grant date for those grants.

	Units	Initial Strike Price Per Unit	Weighted Average Initial Strike Price	Aggregate Intrinsic Value (in millions)	Weighted Average Remaining Contractual Term
Balance December 31, 2005	14,245,976	\$2.03 - \$6.66	\$ 3.34	\$ 9.3	2.34 years
Options granted	8,092,915	2.87 - 5.39	4.49		
Options cancelled	(1,101,849)	2.03 - 6.66	3.71		
Options expired	(3,010,367)	2.03 - 6.66	3.62		
Options exercised	(2,941,180)	2.03 - 4.44	2.97		
Balance December 31, 2006	15,285,495	\$2.03 - \$6.66	3.93	82.7	2.54 years
Options granted	4,818,069	3.03 - 6.10	5.25		
Options cancelled	(631,603)	2.03 - 6.66	5.08		
Options expired	(1,767,687)	2.03 - 6.66	5.37		
Options exercised	(1,999,717)	2.03 - 5.39	2.87		
Balance December 31, 2007	15,704,557	\$2.03 - \$6.10	4.27	2.4	2.04 years
Options granted	4,592,809	0.94 - 3.44	2.70		
Options cancelled	(1,552,070)	1.05 - 6.10	4.65		
Options expired	(2,228,545)	2.03 - 6.10	3.97		
Options exercised	(709,483)	2.03 - 3.39	2.42		
Balance December 31, 2008	15,807,268	\$0.94 - \$6.10	\$ 3.90	\$ —	1.56 years
Options exercisable ("vested"):					
December 31, 2006	7,903,200	\$2.03 - \$6.66	\$ 3.48		
December 31, 2007	9,821,827	\$2.03 - \$5.70	\$ 3.72		
December 31, 2008	7,962,066	\$2.03 - \$5.39	\$ 3.95	\$ —	1.11 years

Range of Exercise Prices	OSO units Outstanding at December 31, 2008			OSO units Exercisable at December 31, 2008		
	Number Outstanding	Weighted Average Remaining Life (years)	Weighted Average Initial Strike Price	Number Exercisable	Weighted Average Initial Strike Price	
\$0.94 - \$1.05	741,335	2.87	\$ 1.00	—	\$ —	
2.03 - 3.04	5,203,042	1.46	2.58	2,836,847	2.47	
3.36 - 4.65	4,216,088	1.59	3.85	2,200,792	4.08	
5.18 - 6.10	5,646,803	1.45	5.53	2,924,427	5.29	
	15,807,268	1.56	\$ 3.90	7,962,066	\$ 3.95	

In the table above, the weighted average initial strike price represents the values used to calculate the theoretical value of OSO units on the grant date and the intrinsic value represents the value of OSO units that have outperformed the S&P 500® Index as of December 31, 2008.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (12) Employee Benefit Plans (Continued)

The total realized value of OSO units exercised was \$2 million, \$19 million and \$20 million for the years ended December 31, 2008, 2007 and 2006, respectively. The Company issued approximately 466,000, 3.2 million and 3.8 million shares of Level 3 common stock upon the exercise of OSO units for the years ended December 31, 2008, 2007 and 2006, respectively. The number of shares of Level 3 stock issued upon exercise of an OSO unit varies based upon the relative performance of Level 3's stock price and the S&P 500® Index between the initial grant date and exercise date of the OSO unit.

As of December 31, 2008, based on the Level 3 common stock price and post-multiplier values, the Company was not obligated to issue any shares for vested and exercisable OSO units as the Company's common stock price did not outperform the S&P 500® Index.

#### *Restricted Stock and Units*

Restricted stock units and shares are granted to the recipients at no cost. Restrictions on transfer lapse over one to four year periods. The fair value of restricted stock units and shares awarded totaled \$43 million, \$68 million and \$27 million, for the years ended December 31, 2008, 2007 and 2006, respectively. The fair value of these awards was calculated using the value of the Level 3 common stock on the grant date and are being amortized over the periods in which the restrictions lapse. As of December 31, 2008, unamortized compensation cost related to nonvested restricted stock and restricted stock units was \$34 million and the weighted average period over which this cost will be recognized is 2.66 years.

The changes in restricted stock and restricted stock units are shown in the following table:

	Number	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2005	23,376,843	\$ 2.06
Stock and units granted	5,874,765	4.65
Lapse of restrictions	(7,225,744)	2.13
Stock and units forfeited	(2,575,137)	2.45
Nonvested at December 31, 2006	19,450,727	2.76
Stock and units granted	11,992,520	5.67
Lapse of restrictions	(6,997,946)	2.71
Stock and units forfeited	(2,173,989)	4.20
Nonvested at December 31, 2007	22,271,312	4.20
Stock and units granted	17,627,904	2.43
Lapse of restrictions	(9,701,473)	3.57
Stock and units forfeited	(4,063,944)	4.08
Nonvested at December 31, 2008	<u>26,133,799</u>	<u>\$ 3.26</u>

The total fair value of restricted stock and restricted stock units whose restrictions lapsed in the years ended December 31, 2008, 2007 and 2006 was \$35 million, \$19 million and \$15 million, respectively.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(12) Employee Benefit Plans (Continued)**

*Warrants*

As of December 31, 2008, there were approximately 15.3 million warrants outstanding ranging in exercise price from \$4.00 to \$29.00, all of which were fully vested and for which compensation expense had been fully recognized in the consolidated statements of operations. The weighted average exercise price of these warrants was \$7.22 as of December 31, 2008.

In connection with the acquisition of Broadwing, approximately 4 million previously issued Broadwing warrants were converted into warrants to purchase approximately 5 million shares of Level 3 common stock at a weighted average exercise price of \$5.76 per share of Level 3 common stock. In 2007, approximately 3 million of the Broadwing warrants were exercised to purchase approximately 4 million shares of Level 3 common stock and resulted in proceeds to the Company totaling approximately \$23 million. As of December 31, 2007 and 2008, warrants to purchase approximately 1 million shares of Level 3 common stock remained outstanding. The weighted average exercise price of these warrants was \$5.38 as of December 31, 2008.

*401(k) Plan*

The Company and its subsidiaries offer their qualified employees the opportunity to participate in a defined contribution retirement plan qualifying under the provisions of Section 401(k) of the Internal Revenue Code ("401(k) Plan"). Each employee is eligible to contribute, on a tax deferred basis, a portion of annual earnings generally not to exceed \$15,500 in 2008. The Company matches 100% of employee contributions up to 7% of eligible earnings or applicable regulatory limits. Effective March 6, 2009, the Company is reducing its match to 100% of employee contributions up to 3% of eligible earnings or applicable regulatory limits.

The Company's matching contributions are made with Level 3 common stock based on the closing stock price on each pay date. The Company's matching contributions are made through units in the Level 3 Stock Fund, which represent shares of Level 3 common stock. The Level 3 Stock Fund is the mechanism that is used for Level 3 to make employer matching and other contributions to employees through the Level 3 401(k) plan. Employees are not able to purchase units in the Level 3 Stock Fund. Employees are able to diversify the Company's matching contribution as soon as it is made, even if they are not fully vested. The Company's matching contributions will vest ratably over the first three years of service or over such shorter period until the employee has completed three years of service at such time the employee is then 100% vested in all Company matching contributions, including future contributions. The Company made 401(k) Plan matching contributions of \$30 million, \$30 million and \$18 million for the years ended December 31, 2008, 2007 and 2006, respectively. The Company's matching contributions are recorded as non-cash compensation and included in selling, general and administrative expenses.

The Company made a discretionary contribution to the 401(k) plan in Level 3 common stock for the years ended December 31, 2007 and 2006 equal to three percent of eligible employees' earnings each year. The 2007 and 2006 deposits were made into the employees' 401(k) accounts during the first quarter of the subsequent year. Level 3 recorded an expense of \$16 million in 2007 and \$11 million in 2006 for the discretionary contribution. The Company did not make a discretionary contribution to the 401(k) plan for the year ended December 31, 2008.

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (13) Income Taxes

An analysis of the income tax benefit (provision) attributable to loss from continuing operations before income taxes for each of the years in the three year period ended December 31, 2008 follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(dollars in millions)		
Current:			
United States federal	\$ 1	\$—	\$—
State	(7)	(3)	—
Foreign	—	2	(2)
	<u>(6)</u>	<u>(1)</u>	<u>(2)</u>
Deferred, net of changes in valuation allowances:			
United States federal	—	—	—
State	—	23	—
Foreign	—	—	—
Income tax benefit (provision)	<u>\$ (6)</u>	<u>\$22</u>	<u>\$ (2)</u>

The United States and foreign components of income (loss) from continuing operations before income taxes follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(dollars in millions)		
United States	\$(188)	\$(1,016)	\$(710)
Foreign	(96)	(120)	(78)
	<u>\$(284)</u>	<u>\$(1,136)</u>	<u>\$(788)</u>

A reconciliation of the actual income tax benefit (provision) and the tax computed by applying the U.S. federal rate (35%) to the loss from continuing operations before income taxes for each of the three years ended December 31, 2008 follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(dollars in millions)		
Computed tax benefit at statutory rate	\$100	\$ 397	\$ 276
State income tax benefit	9	39	26
Stock option plan exercises	(4)	8	3
Disallowance of losses on extinguishments of debt	(15)	(62)	(3)
Other, net	(3)	(9)	—
Change in valuation allowance	(93)	(351)	(304)
Income tax benefit (provision)	<u>\$ (6)</u>	<u>\$ 22</u>	<u>\$ (2)</u>

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (13) Income Taxes (Continued)

The components of the net deferred tax assets (liabilities) as of December 31, 2008 and 2007 were as follows:

	2008	2007
	(dollars in millions)	
Deferred Tax Assets:		
Fixed assets and intangible assets	\$ 171	\$ 59
Accrued payroll and related benefits	80	41
State tax credit carry forwards	23	23
Investment in securities	—	25
Investment in joint ventures	82	94
Unutilized tax net operating loss carry forwards	1,790	3,690
Accrued liabilities and deferred revenue	—	11
Other assets or liabilities	—	6
Total Deferred Tax Assets	2,146	3,949
Deferred Tax Liabilities:		
Accrued liabilities and deferred revenue	(69)	—
Total Deferred Tax Liabilities	(69)	—
Net Deferred Tax Assets before valuation allowance	2,077	3,949
Valuation Allowance	(2,054)	(3,926)
Net Non-Current Deferred Tax Asset after Valuation Allowance	\$ 23	\$ 23

As of December 31, 2008, the Company had net operating loss carry forwards of approximately \$4.7 billion for federal income tax purposes. Under the rules prescribed by U.S. Internal Revenue Code ("IRC") Section 382 and applicable regulations, if certain transactions occur with respect to an entity's capital stock that result in a cumulative ownership shift of more than 50 percentage points by 5-percent stockholders over a testing period, annual limitations are imposed with respect to the entity's ability to utilize its net operating loss carry forwards and certain current deductions against any taxable income the entity achieves in future periods. The Company had entered into transactions over the testing period resulting in significant cumulative shifts in the ownership of its capital stock which alone would not have resulted in an ownership change under IRC Section 382. However, when the Company's actions are coupled with the trading activity in the Company's common stock throughout 2008 by third-party market participants, the Company believes that in 2008 the Company experienced a cumulative ownership change of more than 50 percentage points by 5-percent stockholders during the applicable testing period. Prior to the ownership change, the Company had net operating loss carry forwards of \$9.7 billion. The Company believes that the limitation of its net operating loss carry forwards will not have a near term effect on its consolidated results of operations and financial position. Additional transactions could cause the Company to incur a subsequent 50 percentage point ownership change by 5-percent stockholders and, if the Company triggers the above-noted IRC imposed limitations, could further limit it from fully utilizing the remaining net operating loss carry forwards and certain current deductions to reduce income taxes.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (13) Income Taxes (Continued)

planning strategies in making this assessment. A valuation allowance has been recorded against deferred tax assets, as the Company has concluded that under relevant accounting standards it is not more likely than not that the deferred tax assets are realizable.

The valuation allowance for deferred tax assets was approximately \$2.0 billion as of December 31, 2008 and approximately \$3.9 billion as of December 31, 2007. The net change in the valuation allowance for the year ended December 31, 2008 was approximately \$1.9 billion. A significant portion of the change in valuation allowance is attributable to the IRC Section 382 limitation. This limitation reduced the deferred tax asset for unutilized net operating loss carry forwards and associated valuation allowance, by approximately \$2.1 billion during 2008. This reduction in valuation allowance was partially offset by the valuation allowance recorded for additional deferred tax assets, for the portion of the 2008 net operating losses not subject to the IRC Section 382 limitation, and other changes in deferred tax assets.

The U.S. federal tax loss carry forwards expire through 2028 and are subject to examination by the tax authorities until three years after the carry forwards are utilized. The U.S. federal tax loss carry forwards expire as follows (dollars in millions):

<u>Expiring December 31</u>	<u>Amount</u>
2024	\$ 536
2025	1,175
2026	987
2027	1,539
2028	438
	<u>\$4,675</u>

The Company has approximately \$95 million of tax loss carry forwards for controlled foreign corporations at December 31, 2008, the majority of which have no expiration period. In addition, the Company has approximately \$128 million of state tax loss carry forwards with various expiration periods through 2028.

The majority of the Company's foreign assets and operations are owned by entities that have elected to be treated for U.S. tax purposes as unincorporated branches of a U.S. holding company and, as a result, the taxable income or loss and other tax attributes of such entities are included in the Company's U.S. federal consolidated income tax return. However, the Company has some foreign subsidiaries that have not so elected and therefore are treated for U.S. tax purposes as controlled foreign corporations. With respect to such controlled foreign corporations, as of December 31, 2008, the Company has no plans to repatriate undistributed earnings of such controlled foreign corporations as any earnings are deemed necessary to fund ongoing European operations and planned expansion. Undistributed earnings of such controlled foreign corporations that are permanently invested and for which no deferred taxes have been provided are immaterial as of December 31, 2008 and 2007.

The Company adopted the provisions of FIN No. 48 on January 1, 2007. The adoption of FIN No. 48 did not affect the Company's liability for uncertain tax positions. The Company's liability for uncertain tax positions totaled \$16 million at December 31, 2008 and \$18 million at December 31, 2007. These amounts also include the related accrued interest and penalties associated with the uncertain tax positions if applicable. The Company does not expect the liability for uncertain tax

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (13) Income Taxes (Continued)

positions will change significantly during the twelve months ended December 31, 2009; however, actual changes in the liability for uncertain tax positions could be different than currently expected. A rollforward of the liability for uncertain tax positions follows:

<u>(dollars in millions)</u>	<u>Amount</u>
Balance as of December 31, 2007	\$ 18
Gross increases—tax positions prior to 2008	3
Gross increases—during 2008	1
Gross decreases—tax positions prior to 2008	(6)
Balance as of December 31, 2008	<u>\$ 16</u>

The Company, or at least one of its subsidiaries, files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2003. The Internal Revenue Service and state and local taxing authorities reserve the right to audit any period where net operating loss carry forwards are available. During the third quarter of 2008, the Company and the Internal Revenue Service settled an income tax audit for years 1999 through 2001 in addition to 1996 interest issues resulting in a refund of \$1 million to the Company. In addition, the Internal Revenue Service completed an examination of certain adjustments to the Company's U.S. income tax returns for 2002 resulting from final resolution of the 1999 through 2001 audit. The Company is currently under audit by taxing authorities in the United Kingdom for tax years 2002 through 2004 and in France for tax years 2005 through 2006.

The Company recognizes accrued interest and penalties related to uncertain tax positions in income tax expense in its consolidated statements of operations. The Company's liability for uncertain tax positions includes approximately \$10 million of accrued interest and penalties at December 31, 2008.

## (14) Segment Information

SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information" defines operating segments as components of an enterprise for which separate financial information is available and which is evaluated regularly by the Company's chief operating decision maker, or decision making group, in deciding how to allocate resources and assess performance. Operating segments are managed separately and represent separate strategic business units that offer different products and serve different markets. The Company's current reportable segments include: communications and coal mining (see Note 1). Other primarily includes corporate assets and overhead not attributable to a specific segment. In the third quarter of 2006, the Company exited the information services business as a result of the sale of Software Spectrum.

Adjusted EBITDA, as defined by the Company, is net income (loss) from the consolidated statements of operations before (1) gain (loss) from discontinued operations, (2) income taxes, (3) total other income (expense), (4) non-cash impairment charges included within restructuring and impairment charges, (5) depreciation and amortization and (6) non-cash stock compensation expense included within selling, general and administrative expenses on the consolidated statements of operations.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Segment Information (Continued)**

Adjusted EBITDA is not a measurement under GAAP and may not be used in the same way by other companies. Management believes that Adjusted EBITDA is an important part of the Company's internal reporting and is a key measure used by management to evaluate profitability and operating performance of the Company and to make resource allocation decisions. Management believes such measurement is especially important in a capital-intensive industry such as telecommunications. Management also uses Adjusted EBITDA to compare the Company's performance to that of its competitors and to eliminate certain non-cash and non-operating items in order to consistently measure from period to period its ability to fund capital expenditures, fund growth, service debt and determine bonuses.

Adjusted EBITDA excludes non-cash impairment charges and non-cash stock compensation expense because of the non-cash nature of these items. Adjusted EBITDA also excludes interest income, interest expense, income taxes and gain (loss) on extinguishment of debt because these items are associated with the Company's capitalization and tax structures. Adjusted EBITDA also excludes depreciation and amortization expense because these non-cash expenses reflect the effect of capital investments which management believes should be evaluated through cash flow measures. Adjusted EBITDA excludes the gain on sale of business groups and net other income (expense) because these items are not related to the primary operations of the Company.

There are limitations to using non-GAAP financial measures, including the difficulty associated with comparing companies that use similar performance measures whose calculations may differ from the Company's calculations. Additionally, this financial measure does not include certain significant items such as interest income, interest expense, income taxes, depreciation and amortization, non-cash impairment charges, non-cash stock compensation expense, gain (loss) on early extinguishment of debt, the gain on sale of business groups and net other income (expense). Adjusted EBITDA should not be considered a substitute for other measures of financial performance reported in accordance with GAAP.

The data presented in the following tables includes information for the years ended December 31, 2008, 2007 and 2006 for all statement of operations and cash flow information presented, and as of December 31, 2008 and 2007 for all balance sheet information presented. Information related to the acquired businesses is included from their respective acquisition dates. Revenue and the related expenses are attributed to countries based on where services are provided.



# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (14) Segment Information (Continued)

Segment information for the Company's Communications and Coal Mining businesses is summarized as follows (in millions):

	Year Ended December 31,		
	2008	2007	2006
<i>Revenue from external customers:</i>			
Communications	\$4,226	\$ 4,199	\$3,311
Coal Mining	75	70	67
	<u>\$4,301</u>	<u>\$ 4,269</u>	<u>\$3,378</u>
<i>Adjusted EBITDA:</i>			
Communications	\$1,039	\$ 823	\$ 677
Coal Mining	\$ 5	\$ 5	\$ 8
Other	\$ (4)	\$ (4)	\$ (3)
<i>Capital expenditures:</i>			
Communications	\$ 446	\$ 631	\$ 391
Coal Mining	3	2	1
	<u>\$ 449</u>	<u>\$ 633</u>	<u>\$ 392</u>
<i>Depreciation and amortization:</i>			
Communications	\$ 929	\$ 935	\$ 729
Coal Mining	2	7	1
	<u>\$ 931</u>	<u>\$ 942</u>	<u>\$ 730</u>
<i>Total assets:</i>			
Communications	\$9,509	\$10,128	\$9,849
Coal Mining	121	115	127
Other	8	11	18
	<u>\$9,638</u>	<u>\$10,254</u>	<u>\$9,994</u>

The following is a summary of geographical information (in millions):

	Year Ended December 31,		
	2008	2007	2006
<i>Revenue from external customers:</i>			
North America	\$3,975	\$4,011	\$3,188
Europe	326	258	190
	<u>\$4,301</u>	<u>\$4,269</u>	<u>\$3,378</u>
<i>Long-lived assets:</i>			
North America	\$6,244	\$6,790	\$6,450
Europe	718	818	747
	<u>\$6,962</u>	<u>\$7,608</u>	<u>\$7,197</u>

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (14) Segment Information (Continued)

The majority of North American revenue consists of services delivered within the United States. The majority of European revenue consists of services delivered within the United Kingdom, France and Germany. Revenue from transoceanic services is allocated to Europe.

The Company includes all non-current assets, except for goodwill, in its long-lived assets.

Communications revenue consists of:

- 1) Core Communications Services, which includes Core Network Services and Wholesale Voice Services;
  - Core Network Services includes revenue from transport and infrastructure, IP and data services, local and enterprise voice services and Level 3 Vyvx broadcast services.
  - Wholesale Voice Services includes revenue from long distance voice services, including domestic voice termination, international voice termination and toll free services.
- 2) Other Communications Services includes revenue from managed modem and its related reciprocal compensation services and SBC Contract Services, which includes revenue from the SBC Master Services Agreement, which was obtained in the acquisition of WilTel.

	Core Communications	Other Communications	
	Services	Services	Total
	(in millions)		
Communications Revenue			
2008			
North America	\$ 3,534	\$ 366	\$3,900
Europe	326	—	326
	<u>\$ 3,860</u>	<u>\$ 366</u>	<u>\$4,226</u>
2007			
North America	\$ 3,366	\$ 575	\$3,941
Europe	256	2	258
	<u>\$ 3,622</u>	<u>\$ 577</u>	<u>\$4,199</u>
2006			
North America	\$ 1,787	\$ 1,334	\$3,121
Europe	186	4	190
	<u>\$ 1,973</u>	<u>\$ 1,338</u>	<u>\$3,311</u>

# **LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

### **(14) Segment Information (Continued)**

The following information provides a reconciliation of Net Income (Loss) to Adjusted EBITDA by reportable segment, as defined by the Company, for the years ended December 31, 2008, 2007 and 2006 (in millions):

#### **2008**

	<u>Communications</u>	<u>Coal Mining</u>	<u>Other</u>
Net Income (Loss)	\$ (294)	\$ 3	\$ 1
Income Tax Provision (Benefit)	4	—	2
Total Other (Income) Expense	322	—	(7)
Depreciation and Amortization Expense	929	2	—
Non-Cash Compensation Expense	78	—	—
Adjusted EBITDA	<u>\$ 1,039</u>	<u>\$ 5</u>	<u>\$ (4)</u>

#### **2007**

	<u>Communications</u>	<u>Coal Mining</u>	<u>Other</u>
Net Income (Loss)	\$ (1,113)	\$ (3)	\$ 2
Income Tax Provision (Benefit)	(17)	1	(6)
Total Other (Income) Expense	895	—	—
Non-Cash Impairment Charge	1	—	—
Depreciation and Amortization Expense	935	7	—
Non-Cash Compensation Expense	122	—	—
Adjusted EBITDA	<u>\$ 823</u>	<u>\$ 5</u>	<u>\$ (4)</u>

#### **2006**

	<u>Communications</u>	<u>Coal Mining</u>	<u>Other</u>	<u>Discontinued Information Services</u>
Net Income (Loss)	\$ (800)	\$ 7	\$ 3	\$ 46
Income from Discontinued Operations	—	—	—	(46)
Income Tax Provision (Benefit)	4	—	(2)	—
Total Other (Income) Expense	652	—	(4)	—
Non-Cash Impairment Charge	8	—	—	—
Depreciation and Amortization Expense	729	1	—	—
Non-Cash Compensation Expense	84	—	—	—
Adjusted EBITDA	<u>\$ 677</u>	<u>\$ 8</u>	<u>\$ (3)</u>	<u>\$ —</u>

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (15) Commitments, Contingencies and Other Items

In April 2002, Level 3 Communications, Inc., and two of its subsidiaries were named as defendants in *Bauer, et. al. v. Level 3 Communications, LLC, et al.*, a purported class action covering 22 states, filed in state court in Madison County, Illinois. In July 2001, Level 3 was named as a defendant in *Koyle, et. al. v. Level 3 Communications, Inc., et. al.*, a purported two state class action filed in the U.S. District Court for the District of Idaho. In November of 2005, the court granted class certification only for the state of Idaho. In September 2002, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *Smith et. al. v. Sprint Communications Company, L.P., et al.*, a purported nationwide class action filed in the United States District Court for the Northern District of Illinois. In April 2005, the Smith plaintiffs filed a Fourth Amended Complaint which did not include Level 3 or Williams Communications, Inc. as a party, thus ending both companies' involvement in the Smith case. On February 17, 2005, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *McDaniel, et. al., v. Qwest Communications Corporation, et al.*, a purported class action covering 10 states filed in the United States District Court for the Northern District of Illinois. All of these actions involve the companies' right to install its fiber optic cable network in easements and right-of-ways crossing the plaintiffs' land. In general, the companies obtained the rights to construct their networks from railroads, utilities, and others, and have installed their networks along the rights-of-way so granted. Plaintiffs in the purported class actions assert that they are the owners of lands over which the companies' fiber optic cable networks pass, and that the railroads, utilities, and others who granted the companies the right to construct and maintain their networks did not have the legal authority to do so. The complaints seek damages on theories of trespass, unjust enrichment and slander of title and property, as well as punitive damages. The companies have also received, and may in the future receive, claims and demands related to rights-of-way issues similar to the issues in these cases that may be based on similar or different legal theories.

The Company and its subsidiaries have negotiated a proposed nationwide class settlement affecting persons who own or owned land next to or near railroad rights of way. The United States District Court for the District of Massachusetts in *Kingsborough v. Sprint Communications Co. L.P.* has granted preliminary approval of the proposed settlement which, if finally approved, will resolve all of the pending actions. The proposed settlement will provide cash payments to class members based on various factors that include:

- the length of the right of way where the cable is installed;
- the state where the property is located; and
- how the railroad obtained its property rights.

The proposed settlement will also provide the Company and its subsidiaries with a permanent telecommunications easement, which gives them certain rights over the railroad right of way.

It is still too early for the Company to reach a conclusion as to the ultimate outcome of the proposed settlement of these actions. However, management believes that the Company and its subsidiaries have substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend them vigorously if a satisfactory form of settlement is not ultimately approved. Additionally, management believes that any resulting liabilities for these actions, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could affect future cash flows.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(15) Commitments, Contingencies and Other Items (Continued)**

In February 2009, Level 3 Communications, Inc., certain of its current officers and a former officer were named as defendants in purported class action lawsuits filed in the United States District Court for the District of Colorado, which have been consolidated as *In re Level 3 Communications, Inc. Securities Litigation (Civil Case No. 09-cv-00200-PAB-CBS)*. The Plaintiffs in each complaint allege, in general, that throughout the purported class period of February 8, 2007 to October 23, 2007, the defendants failed to disclose material adverse facts about the Company's business and operations. Specifically, defendants failed to disclose or indicate the following: (1) that the Company's efforts to integrate the numerous acquired companies were not going well; (2) that, specifically, the Company was experiencing an increase in service activation times, which was negatively impacting the Company's service installation intervals and the rate of its revenue growth; (3) that the Company was also experiencing challenges in its service management processes that were resulting in longer response times to resolve customer's network service issues; (4) that steps taken by the Company to remedy the problems were not working and actually, further complicating the issues and making them worse; (5) that, as a result of the above, the Company did not have adequate provisioning capability to convert its increasing sales, or signed orders, into revenue generating service; (6) that the Company lacked adequate internal controls; and (7) that, as a result of the above, the statements made by the defendants during the purported class period lacked a reasonable basis. The complaints seek damages based on purported violations of Section 10(b) of the Securities Exchange Act of 1934, Securities and Exchange Commission Rule 10b-5 promulgated thereunder and Section 20(a) of the Securities Exchange Act of 1934.

It is too early for the Company to reach a conclusion as to the ultimate outcome of these actions. However, management believes that the Company has substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend these actions vigorously.

The Company and its subsidiaries are parties to many other legal proceedings. Management believes that any resulting liabilities for these legal proceedings, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could affect future cash flows.

*Letters of Credit*

It is customary in Level 3's industries to use various financial instruments in the normal course of business. These instruments include letters of credit. Letters of credit are conditional commitments issued on behalf of Level 3 in accordance with specified terms and conditions. As of December 31, 2008 and 2007, Level 3 had outstanding letters of credit of approximately \$30 million and \$36 million, respectively, which are collateralized by cash, which is reflected on the consolidated balance sheet as restricted cash. The Company does not believe it is practicable to estimate the fair value of the letters of credit and does not believe exposure to loss is likely nor material.

*Operating Leases*

The Company is leasing rights-of-way, facilities and other assets under various operating leases which, in addition to rental payments, may require payments for insurance, maintenance, property taxes and other executory costs related to the lease. Certain leases provide for adjustments in lease cost based upon adjustments in various price indexes and increases in the landlord's management costs.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (15) Commitments, Contingencies and Other Items (Continued)

The right-of-way agreements have various expiration dates through 2060. Payments under these right-of-way agreements were \$112 million in 2008, \$106 million in 2007 and \$75 million in 2006.

The Company has obligations under non-cancelable operating leases for certain colocation and office facilities, including lease obligations for which facility related restructuring charges have been recorded. The lease agreements have various expiration dates through 2099. Rent expense, including common area maintenance, under non-cancelable lease agreements was \$193 million in 2008, \$190 million in 2007 and \$132 million in 2006.

For those leases involving communications colocation and right-of-way agreements, the Company anticipates that it will renew these leases under option provisions contained in the lease agreements given the significant cost to relocate the Company's network and other facilities.

Future minimum payments for the next five years under network and related right-of-way agreements and non-cancelable operating leases for facilities consist of the following as of December 31, 2008 (in millions):

	Right-of-Way		
	Agreements	Facilities	Total
2009	\$ 110	\$ 153	\$ 263
2010	91	138	229
2011	83	121	204
2012	80	112	192
2013	78	97	175
Thereafter	733	261	994
Total	<u>\$ 1,175</u>	<u>\$ 882</u>	<u>\$2,057</u>

Certain right of way agreements include provisions for increases in payments in future periods based on the rate of inflation as measured by various price indexes. The Company has not included estimates for these increases in future periods in the amounts included above.

Certain non-cancelable right of way agreements provide for automatic renewal on a periodic basis. Payments due under these agreements with automatic renewal options have been included in the table above for a period of 17 years from January 1, 2009, which approximates the economic remaining useful life of the Company's conduit. In addition, certain other right of way agreements are cancellable or can be terminated under certain conditions by the Company. The Company includes the payments under such cancelable right of way agreements in the table above for a period of 1 year from January 1, 2009, if the Company does not consider it likely that it will cancel the right of way agreement within the next year.

#### (16) Condensed Consolidating Financial Information

As discussed in Note 11, Level 3 Financing has issued senior notes as described below:

- In October 2003, Level 3 Financing issued \$500 million of 10.75% Senior Notes due 2011. The 10.75% Senior Notes were registered with the Securities and Exchange Commission in 2005. The Company repurchased \$497 million of the 10.75% notes in 2006.

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (16) Condensed Consolidating Financial Information (Continued)

- In March 2006, Level 3 Financing issued \$150 million of Floating Rate Senior Notes due 2011 and \$250 million of 12.25% Senior Notes due 2013. The Company repurchased \$144 million of the Floating Rate Senior Notes due 2011 in 2007.
- In April 2006, Level 3 Financing issued an additional \$300 million of 12.25% Senior Notes due 2013.
- In October 2006, Level 3 Financing issued \$600 million of 9.25% Senior Notes due 2014 and in December 2006 issued an additional \$650 million of 9.25% Senior Notes due 2014.
- In February 2007, Level 3 Financing issued \$700 million of 8.75% Senior Notes due 2017 and \$300 million of Floating Rate Senior Notes due 2015.

The notes discussed above are unsecured obligations of Level 3 Financing; however, they are also jointly and severally and fully and unconditionally guaranteed on an unsecured senior basis by Level 3 Communications, Inc. and Level 3 Communications, LLC.

In addition, Level 3 Financing's 12.25% Senior Notes due 2013, Floating Rate Senior Notes due 2011 and 9.25% Senior Notes due 2014 are jointly and severally and fully and unconditionally guaranteed by Broadwing Financial Services, Inc., a wholly owned subsidiary of Level 3 Communications, Inc. As a result of this guarantee, the Company has included Broadwing Financial Services, Inc. in the condensed consolidating financial information below for the periods subsequent to the acquisition of Broadwing on January 3, 2007.

In conjunction with the registration of the 10.75% Senior Notes, Floating Rate Senior Notes due 2011, 12.25% Senior Notes due 2013, 9.25% Senior Notes due 2014, 8.75% Senior Notes due 2017 and Floating Rate Senior Notes due 2015 the accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10 "Financial statements of guarantors and affiliates whose securities collateralize an issue registered or being registered." The operating activities of the separate legal entities included in the Company's consolidated financial statements are interdependent. The accompanying condensed consolidating financial information presents the results of operations, financial position and cash flows of each legal entity and, on an aggregate basis, the other non-guarantor subsidiaries based on amounts incurred by such entities, and are not intended to present the operating results of those legal entities on a stand-alone basis.

Level 3 Communications, LLC leases equipment and certain facilities from other wholly owned subsidiaries of Level 3 Communications, Inc. These transactions are eliminated in the consolidated results of the Company.

The Condensed Consolidating Balance Sheet as of December 31, 2007 has been reclassified within the Level 3 Financing Inc. entity and Other Subsidiaries, to reflect the transfer between entities of the \$37 million interest rate swap liability and to reclassify the liability from Other Assets, net to Other Liabilities. These changes did not have any effect on the Level 3 Consolidated Balance Sheet as of December 31, 2007 or affect the financial results for the year ended December 31, 2007.

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (16) Condensed Consolidating Financial Information (Continued)

#### Condensed Consolidating Statements of Operations For the year ended December 31, 2008

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
	(dollars in millions)						
Revenue	\$ —	\$ —	\$ 1,720	\$ —	\$ 2,795	\$ (214)	\$4,301
Costs and Expenses:							
Cost of Revenue	—	—	684	—	1,328	(203)	1,809
Depreciation and Amortization	—	—	362	—	569	—	931
Selling, General and Administrative	1	—	1,243	—	272	(11)	1,505
Restructuring and Impairment Charges	—	—	25	—	—	—	25
Total Costs and Expenses	1	—	2,314	—	2,169	(214)	4,270
Operating Income (Loss)	(1)	—	(594)	—	626	—	31
Other Income (Expense):							
Interest Income	—	1	10	—	4	—	15
Interest Expense	(155)	(369)	—	(2)	(8)	—	(534)
Interest Income (Expense) Affiliates, net	787	1,103	(1,951)	—	61	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(998)	(1,733)	527	—	—	2,204	—
Other Income (Expense), net	77	—	7	—	(120)	—	204
Other Income (Expense)	(289)	(998)	(1,407)	(2)	(177)	2,204	(315)
Income (Loss) from Operations	(290)	(998)	(2,001)	(2)	803	2,204	(284)
Income Tax Benefit (Expense)	—	—	(5)	—	(1)	—	(6)
Net Income (Loss)	\$ (290)	\$ (998)	\$ (2,006)	\$ (2)	\$ 802	\$ 2,204	\$ (290)



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (16) Condensed Consolidating Financial Information (Continued)

Condensed Consolidating Statements of Operations  
For the year ended December 31, 2007

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC (dollars in millions)	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
Revenue	\$ —	\$ —	\$ 1,439	\$ 27	\$ 2,994	\$ (191)	\$ 4,269
Costs and Expenses:							
Cost of Revenue	—	—	553	—	1,434	(154)	1,833
Depreciation and Amortization	—	—	345	—	597	—	942
Selling, General and Administrative	3	—	1,251	27	479	(37)	1,723
Restructuring and Impairment Charges	—	—	12	—	—	—	12
Total Costs and Expenses	3	—	2,161	27	2,510	(191)	4,510
Operating Income (Loss)	(3)	—	(722)	—	484	—	(241)
Other Income (Expense):							
Interest Income	2	1	43	—	8	—	54
Interest Expense	(202)	(365)	(1)	(1)	(8)	—	(577)
Interest Income (Expense) Affiliates, net	781	976	(1,818)	—	61	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(1,329)	(1,934)	444	—	—	2,819	—
Other Income (Expense)	(363)	(29)	7	—	13	—	(372)
Other Income (Expense)	(1,111)	(1,351)	(1,325)	(1)	74	2,819	(895)
Income (Loss) from Operations	(1,114)	(1,351)	(2,047)	(1)	558	2,819	(1,136)
Income Tax Benefit	—	22	—	—	—	—	22
Net Income (Loss)	\$ (1,114)	\$ (1,329)	\$ (2,047)	\$ (1)	\$ 558	\$ 2,819	\$ (1,114)

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (16) Condensed Consolidating Financial Information (Continued)

#### Condensed Consolidating Statements of Operations For the year ended December 31, 2006

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC (dollars in millions)	Other Subsidiaries	Eliminations	Total
Revenue	\$ —	\$ —	\$ 1,304	\$ 2,270	\$ (196)	\$3,378
Costs and Expenses:						
Cost of Revenue	—	—	525	1,179	(187)	1,517
Depreciation and Amortization	—	—	358	372	—	730
Selling, General and Administrative	6	—	816	445	(9)	1,258
Restructuring and Impairment Charges	—	—	9	4	—	13
Total Costs and Expenses	6	—	1,708	2,000	(196)	3,518
Operating Income (Loss)	(6)	—	(404)	270	—	(140)
Other Income (Expense):						
Interest Income	16	1	40	7	—	64
Interest Expense	(432)	(207)	—	(9)	—	(648)
Interest Income (Expense) Affiliates, net	860	666	(1,572)	46	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(1,209)	(1,561)	141	—	2,629	—
Other Income (Expense)	27	(108)	7	10	—	(64)
Other Income (Expense)	(738)	(1,209)	(1,384)	54	2,629	(648)
Income (Loss) from Continuing Operations Before Income Taxes	(744)	(1,209)	(1,788)	324	2,629	(788)
Income Tax (Expense) Benefit	—	—	—	(2)	—	(2)
Income (Loss) from Continuing Operations	(744)	(1,209)	(1,788)	322	2,629	(790)
Income from Discontinued Operations	—	—	—	46	—	46
Net Income (Loss)	\$ (744)	\$ (1,209)	\$ (1,788)	\$ 368	\$ 2,629	\$ (744)

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (16) Condensed Consolidating Financial Information (Continued)

Condensed Consolidating Balance Sheets  
December 31, 2008

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC (dollars in millions)	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
<b>Assets</b>							
Current Assets:							
Cash and cash equivalents	\$ 67	\$ 10	\$ 555	\$ —	\$ 136	\$ —	\$ 768
Restricted cash and securities	—	—	1	—	2	—	3
Accounts Receivable, net	—	—	73	—	317	—	390
Due from (to) affiliates	11,148	9,306	(22,122)	17	1,651	—	—
Other	6	9	36	—	32	—	83
Total Current Assets	11,221	9,325	(21,457)	17	2,138	—	1,244
Property, Plant and Equipment, net	—	—	3,150	—	3,009	—	6,159
Restricted Cash and Securities	18	—	25	—	84	—	127
Goodwill and Other Intangibles, net	—	—	540	—	1,451	—	1,991
Investment in Subsidiaries	(8,043)	(13,041)	3,484	—	—	17,600	—
Other Assets, net	11	76	15	—	15	—	117
Total Assets	\$ 3,207	\$ (3,640)	\$ (14,243)	\$ 17	\$ 6,697	\$ 17,600	\$9,638
<b>Liabilities and Stockholders' Equity (Deficit)</b>							
Current Liabilities:							
Accounts payable	\$ 3	\$ —	\$ 147	\$ —	\$ 215	\$ —	\$ 365
Current portion of long-term debt	181	—	1	1	3	—	186
Accrued payroll and employee benefits	—	—	97	—	8	—	105
Accrued interest	24	93	—	—	—	—	117
Current portion of deferred revenue	—	—	96	—	72	—	168
Other	—	1	59	—	51	—	111
Total Current Liabilities	208	94	400	1	349	—	1,052
Long-Term Debt, less current portion	2,079	4,216	7	19	73	—	6,394
Deferred Revenue, less current portion	—	—	630	—	89	—	719
Other Liabilities	44	97	284	—	172	—	597
Stockholders' Equity (Deficit)	876	(8,047)	(15,564)	(3)	6,014	17,600	876
Total Liabilities and Stockholders' Equity (Deficit)	\$ 3,207	\$ (3,640)	\$ (14,243)	\$ 17	\$ 6,697	\$ 17,600	\$9,638

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (16) Condensed Consolidating Financial Information (Continued)

Condensed Consolidating Balance Sheets  
December 31, 2007

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC (dollars in millions)	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
<b>Assets</b>							
Current Assets:							
Cash and cash equivalents	\$ —	\$ 27	\$ 588	\$ —	\$ 99	\$ —	\$ 714
Marketable securities	8	—	—	—	1	—	9
Restricted cash and securities	—	—	7	—	3	—	10
Accounts receivable, net	—	—	80	—	324	—	404
Due from (to) affiliates	10,575	8,549	(20,897)	20	1,753	—	—
Other	7	8	32	—	41	—	88
Total Current Assets	10,590	8,584	(20,190)	20	2,221	—	1,225
Property, Plant and Equipment, net	—	—	3,256	—	3,413	—	6,669
Restricted Cash and Securities	18	—	24	—	75	—	117
Goodwill and Other Intangibles, net	—	—	151	—	1,950	—	2,101
Investment in Subsidiaries	(6,951)	(11,270)	4,481	—	—	13,740	—
Other Assets, net	16	84	17	—	25	—	142
Total Assets	\$ 3,673	\$ (2,602)	\$ (12,261)	\$ 20	\$ 7,684	\$ 13,740	\$10,254
<b>Liabilities and Stockholders' Equity (Deficit)</b>							
Current Liabilities:							
Accounts payable	\$ —	\$ —	\$ 170	\$ —	\$ 226	\$ —	\$ 396
Current portion of long-term debt	25	—	—	1	6	—	32
Accrued payroll and employee benefits	—	—	88	—	9	—	97
Accrued interest	33	95	—	—	—	—	128
Deferred revenue	—	—	91	—	84	—	175
Other	—	—	47	—	97	—	144
Total Current Liabilities	58	95	396	1	422	—	972
Long-Term Debt, less current portion	2,511	4,217	—	20	84	—	6,832
Deferred Revenue	—	—	644	—	119	—	763
Other Liabilities	34	37	208	—	338	—	617
Stockholders' Equity (Deficit)	1,070	(6,951)	(13,509)	(1)	6,721	13,740	1,070
Total Liabilities and Stockholders' Equity (Deficit)	\$ 3,673	\$ (2,602)	\$ (12,261)	\$ 20	\$ 7,684	\$ 13,740	\$10,254

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (16) Condensed Consolidating Financial Information (Continued)

#### Condensed Consolidating Statements of Cash Flows For the year ended December 31, 2008

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC (dollars in millions)	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
Net Cash Provided by (Used in) Operating Activities	\$ (149)	\$ (377)	\$ (159)	\$ (1)	\$ 1,099	\$ —	\$ 413
Cash Flows from Investing Activities:							
Capital expenditures	—	—	(160)	—	(289)	—	(449)
Proceeds from sale of business group, net	—	—	—	—	124	—	124
(Increase) decrease in restricted cash and securities, net	—	—	3	—	(8)	—	(5)
Proceeds from sale of property, plant and equipment and other assets	—	—	1	—	2	—	3
Other	—	—	2	—	4	—	6
Net Cash Used in Investing Activities	—	—	(154)	—	(167)	—	(321)
Cash Flows from Financing Activities:							
Long-term debt borrowings	400	—	—	—	—	—	400
Payments on and repurchases of long-term debt	(431)	—	—	(1)	(4)	—	(436)
Increase (decrease) due from affiliates, net	245	360	282	2	(889)	—	—
Other	2	—	—	—	—	—	2
Net Cash Provided by (Used in) Financing Activities	216	360	282	1	(893)	—	(34)
Effect of Exchange Rates on Cash and Cash Equivalents	—	—	(2)	—	(2)	—	(4)
Net Change in Cash and Cash Equivalents	67	(17)	(33)	—	37	—	54
Cash and Cash Equivalents at Beginning of Period	—	27	588	—	99	—	714
Cash and Cash Equivalents at End of Period	\$ 67	\$ 10	\$ 555	\$ —	\$ 136	\$ —	\$ 768

# LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### (16) Condensed Consolidating Financial Information (Continued)

#### Condensed Consolidating Statements of Cash Flows For the year ended December 31, 2007

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
			(dollars in millions)				
Net Cash Provided by (Used in) Operating Activities	\$ (229)	\$ (306)	\$ (146)	\$ (15)	\$ 927	\$ —	\$ 231
Cash Flows from Investing Activities:							
Proceeds from sale and maturity of marketable securities	280	—	—	—	53	—	333
Decrease in restricted cash and securities, net	—	—	1	—	11	—	12
Capital expenditures	—	—	(271)	—	(362)	—	(633)
Acquisitions, net of cash acquired and investments	—	—	(893)	—	217	—	(676)
Proceeds from sale of discontinued operations	—	(2)	—	—	—	—	(2)
Proceeds from sale of property, plant and equipment and other assets	—	—	2	—	3	—	5
Net Cash Provided by (Used in) Investing Activities	280	(2)	(1,161)	—	(78)	—	(961)
Cash Flows from Financing Activities:							
Long-term debt borrowings, net of issuance costs	—	2,349	—	—	—	—	2,349
Payments on and repurchases of long-term debt, including current portion and refinancing costs	(1,619)	(887)	—	(1)	(111)	—	(2,618)
Proceeds from warrants and stock-based equity plans	26	—	—	—	—	—	26
Increase (decrease) due from affiliates, net	1,527	(1,139)	300	16	(704)	—	—
Net Cash Provided by (Used in) Financing Activities	(66)	323	300	15	(815)	—	(243)
Effect of Exchange Rates on Cash and Cash Equivalents	—	—	3	—	3	—	6
Net Change in Cash and Cash Equivalents	(15)	15	(1,004)	—	37	—	(967)
Cash and Cash Equivalents at Beginning of the Year	15	12	1,592	—	62	—	1,681
Cash and Cash Equivalents at End of the Year	\$ —	\$ 27	\$ 588	\$ —	\$ 99	\$ —	\$ 714

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## (16) Condensed Consolidating Financial Information (Continued)

Condensed Consolidating Statements of Cash Flows  
For the year ended December 31, 2006

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Other Subsidiaries	Eliminations	Total
	(dollars in millions)					
Net Cash Provided by (Used in) Operating Activities of Continuing Operations	\$ (380)	\$ (183)	\$ 62	\$ 722	\$ —	\$ 221
Cash Flows from Investing Activities:						
Proceeds from sale and maturity of marketable securities	175	5	100	—	—	280
Purchases of marketable securities	—	—	(98)	—	—	(98)
Decrease (increase) in restricted cash and securities	1	2	(10)	(14)	—	(21)
Capital expenditures	—	—	(166)	(226)	—	(392)
Investments and acquisitions	—	—	(761)	12	—	(749)
Proceeds from sale of discontinued operations, net of cash sold	—	—	—	307	—	307
Advances from discontinued operations, net	—	—	—	18	—	18
Proceeds from sale of property, plant and equipment and other assets	—	—	6	1	—	7
Net Cash Provided by (Used in) Investing Activities	176	7	(929)	98	—	(648)
Cash Flows from Financing Activities:						
Long-term debt borrowings, net of issuance costs	326	1,930	—	—	—	2,256
Payments on long-term debt, including current portion (net of restricted cash)	(513)	(596)	—	(1)	—	(1,110)
Equity offering	543	—	—	—	—	543
Increase (decrease) due from affiliates, net	(174)	(1,154)	2,170	(842)	—	—
Net Cash Provided by (Used in) Financing Activities	182	180	2,170	(843)	—	1,689
Net Cash Used in Discontinued Operations	—	—	—	(43)	—	(43)
Effect of Exchange Rates on Cash and Cash Equivalents	—	—	14	(4)	—	10
Net Change in Cash and Cash Equivalents	(22)	4	1,317	(70)	—	1,229
Cash and Cash Equivalents at Beginning of Year (includes cash of discontinued operations)	37	8	275	132	—	452
Cash and Cash Equivalents at End of Year	\$ 15	\$ 12	\$ 1,592	\$ 62	\$ —	\$ 1,681

## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### (22) Unaudited Quarterly Financial Data

	Three Months Ended							
	March 31,		June 30,		September 30,		December 31,	
	2008	2007	2008	2007	2008	2007	2008	2007
	(dollars in millions except per share data)							
Revenue	\$1,092	\$1,056	\$1,090	\$1,052	\$1,070	\$1,061	\$1,049	\$1,100
Operating Income (Loss)	(52)	(75)	(3)	(79)	4	(58)	82	(29)
Net Income (Loss)	(181)	(647)	(33)	(202)	(120)	(174)	44	(91)
Earnings (Loss) per Share:								
Basic	\$ (0.12)	\$ (0.44)	\$ (0.02)	\$ (0.13)	\$ (0.08)	\$ (0.11)	\$ 0.03	\$ (0.06)
Diluted	\$ (0.12)	\$ (0.44)	\$ (0.02)	\$ (0.13)	\$ (0.08)	\$ (0.11)	\$ (0.03)	\$ (0.06)

Earnings (loss) per share for each quarter is computed using the weighted-average number of shares outstanding during that quarter, while earnings (loss) per share for the year is computed using the weighted-average number of shares outstanding during the year. Thus, the sum of the earnings (loss) per share for each of the four quarters may not equal the earnings (loss) per share for the year.

In the second quarter of 2008, the Company completed the sale of its Vyvx advertising distribution business to DG FastChannel, Inc. and a recognized a gain of \$96 million.

In the fourth quarter of 2008, the Company recognized a \$12 million restructuring charge, \$44 million of induced debt conversion expenses attributable to the exchange of certain of the Company's convertible debt securities, and a gain on the early extinguishment of debt of \$125 million as a result of certain debt repurchases. The Company also revised its estimates of the amounts and timing of its original estimate of undiscounted cash flows related to certain future asset retirement obligations and reduced selling, general and administrative expenses by \$86 million and depreciation and amortization by \$11 million.

In the first quarter of 2007, the Company purchased Broadwing and the CDN Business. The Company also recognized a \$427 million net loss on the extinguishment of various debt instruments in several transactions.

In the third quarter of 2007, the Company purchased Servecast Limited.

In the fourth quarter of 2007, the Company recognized a \$37 million gain related to the partial sale of its investment in Infinera stock and recognized a tax benefit of \$23 million related to certain changes in state income tax law that primarily occurred in the second quarter of 2007.





***SEPARATION AGREEMENT AND GENERAL RELEASE***

This Separation Agreement and General Release ("Agreement") is entered into by and between John N. Hobbs ("EMPLOYEE") and LEVEL 3 COMMUNICATIONS, LLC, its parent and affiliated companies ("COMPANY"). In the event that the EMPLOYEE signs and does not revoke this Agreement, the Agreement shall become effective and enforceable on the expiration date of the seven day revocation period referenced in paragraph 14 (the "Effective Date").

In connection with certain organizational changes, COMPANY and EMPLOYEE have determined that it is in their mutual best interests to end their employment relationship. Because COMPANY wants to recognize the service of EMPLOYEE and because EMPLOYEE and COMPANY wish to end the relationship without any disputes or differences following execution of this Agreement, and in consideration for the mutual promises contained herein, EMPLOYEE and COMPANY agree as follows:

1. EMPLOYEE'S employment with and position as an officer of the COMPANY will be terminated effective December 31, 2008. EMPLOYEE shall execute the Resignation attached hereto as Exhibit "A".
2. If EMPLOYEE signs and does not revoke this Agreement, subject to the terms of this Agreement, on the Effective Date, COMPANY will pay to EMPLOYEE, in all cases less withholding for federal and state taxes and less appropriate payroll deductions: the amount of Five Hundred Thousand Dollars (\$500,000.00). Such payment shall be made in a lump sum distribution as soon as administratively feasible after the effective date of this Agreement (as set forth in Paragraph 14(d)) but in no event later than April 1, 2009. In addition, if EMPLOYEE elects such coverage, COMPANY will provide to EMPLOYEE COBRA benefit continuation coverage for one month. The costs associated with these additional benefits shall be deemed separation pay that COMPANY has offered to EMPLOYEE freely and without obligation and in consideration for this Agreement.
3. As additional consideration for this Agreement, subject to the terms of this Agreement, if EMPLOYEE signs and does not revoke this Agreement, upon the Effective Date, EMPLOYEE will be entitled to the following:
  - 3.1 Outperform Stock Options ("OSOs"). EMPLOYEE and COMPANY are parties to an Outperform Stock Option Master Award Agreement ("OSO Master Award Agreement"), which incorporates and is governed by the Level 3 Communications, Inc. 1995 Stock Plan, as amended and restated (the "Stock Plan"). Notwithstanding the terms of the OSO Master Award Agreement, EMPLOYEE'S fully vested OSO's shall, consistent with the terms of the OSO Master Award Agreement, be exercisable for a period of one year following EMPLOYEE'S termination date. No OSOs shall be exercisable beyond the date upon which they expire under the terms of the applicable OSO Master Award Agreement. In addition, EMPLOYEE expressly recognizes and agrees, notwithstanding the terms of the OSO Master Award Agreement, that with respect to any OSO award where the period in which to exercise has been modified herein, the Adjusted Initial Price may never be below the Initial Price as set forth in the Outperform Stock Option Award Letter of the corresponding OSO(s). Any OSO awards that are not vested prior to the termination date shall be forfeited.
  - 3.2 Restricted Stock Units ("RSUs"). EMPLOYEE and COMPANY are parties to an Amended Master Deferred Issuance Stock Agreement, which incorporates and is governed by the Stock Plan. Consistent with the above-referenced Amended Master Deferred Issuance Stock Agreement, EMPLOYEE has been awarded RSUs, and as of December 31, 2008, 602,898 RSUs have restrictions that have not lapsed. Notwithstanding the terms of the Amended

- 3.3 EMPLOYEE shall receive the full amount of any discretionary bonus awarded to EMPLOYEE for calendar year 2008, as such bonus amount is determined in the sole discretion of the Level 3 Communications, Inc.'s Compensation Committee, taking into account the COMPANY'S performance, the EMPLOYEE's performance, and other such factors as the Compensation Committee deems appropriate. EMPLOYEE agrees that any discretionary bonus amount determined by the Compensation Committee for calendar year 2008 shall only be paid to EMPLOYEE as a severance benefit. Such bonus payment, if any, shall be made in a lump sum distribution as soon as administratively feasible, but in no event later than May 1, 2009.
- 3.4 COMPANY reserves the right to make, and the EMPLOYEE hereby consents to, any amendments to the Plan, the EMPLOYEE'S Amended Master Issuance Deferred Stock Agreement, RSU Award Letters, OSO Master Award Agreements, and Outperform Stock Option Award letters, as COMPANY deems necessary to comply with the provisions of Section 409A of the Internal Revenue Code of 1986, and the applicable rules and regulations thereunder.
- 3.5 Except as provided here in, EMPLOYEE will not be entitled to any additional awards or vesting in any of the COMPANY'S stock plans, stock option plans, or other benefit plans. *In addition, nothing in the Agreement is intended to nor shall modify the actual expiration date of any award of OSOs.*
4. Notwithstanding any provision in this Agreement to the contrary, any payment or delivery of securities otherwise required to be made hereunder to EMPLOYEE, at any date as a result of the termination of EMPLOYEE'S employment (other than any payment made in reliance upon Treas. Reg. Section 1.409A-1(b)(9) (Separation Pay Plans) or Treas. Reg. Section 409A-1(b)(4) (Short-Term Deferrals)) shall be delayed for such period of time as may be necessary to meet the requirements of Section 409A(a)(2)(B)(i) of the Internal Revenue Code of 1986, as amended (the "Code"). On the earliest date on which such payments or deliveries can be made without violating the requirements of Section 409A(a) (2)(B)(i) of the Code, there shall be paid or delivered to EMPLOYEE, in a single cash lump sum or delivery, as the case may be, an amount equal to the aggregate amount of all payments or deliveries delayed pursuant to the preceding sentence.
5. Except as provided herein, this Agreement shall expressly and unconditionally supersede and render void any and all claims, rights, title or interest in or with respect to any employee compensation, commission payments, or benefit to which EMPLOYEE may have been entitled by virtue of his employment with COMPANY, excluding claims relating to social security, workers' compensation or unemployment insurance benefits.
6. Release and Covenant Not To Sue. In exchange for the benefits offered herein, EMPLOYEE hereby releases and discharges COMPANY, its directors, officers, employees, agents or successors and assigns, of and from any demands or claims, of whatever kind or nature, whether known or unknown, arising out of his employment or separation from employment with COMPANY, except for the unwaivable claims referred to above and any indemnification rights available in the Certificate of Incorporation or by-laws at the time of an indemnification claim, if any. EMPLOYEE waives these claims on behalf of himself and on behalf of his heirs, assigns, and anyone who may or does make a claim in his behalf. The claims waived and discharged include, but are not limited to: claims of breach of express or implied contract, promissory estoppel, detrimental reliance, wrongful discharge, infliction of emotional distress, claims under the Employee Retirement Income Security Act of 1974 or the Family and Medical Leave Act of 1993, the WARN Act, or claims of discrimination under the Title VII of the Civil Rights Act of 1964, as

amended, the Age Discrimination in Employment Act of 1967, as amended, the Americans with Disabilities Act of 1990, the Sarbanes Oxley Act of 2002, the Internal Revenue Code, or any other local, state or federal law or regulation, as of the date of this Agreement. EMPLOYEE specifically agrees and covenants not to sue COMPANY, its predecessors, successors and assigns, as well as past and present officers, directors, and employees for any of the above mentioned claims, or any other claim related to his employment and EMPLOYEE represents and warrants that he has not filed any such claim to date.

7. Non Disparagement; Cooperation. EMPLOYEE will engage in no conduct and make no statements that are derogatory about or detrimental to COMPANY or any of its officers or employees. COMPANY, through any of its leadership at the level of Group Vice President and above, will engage in no conduct and make no statements that are derogatory about or detrimental to EMPLOYEE. EMPLOYEE further agrees to continue to cooperate with the COMPANY and its representatives in all pending and future claims and litigation against the COMPANY for which he may have information and knowledge, and further agrees to cooperate with COMPANY with respect to wrapping up matters where he was involved, including necessary debriefings.

8. Company Information, Property and Intellectual Property.

EMPLOYEE affirms that

- (a) s/he has turned over to his/her manager any information in his/her custody that is (i) considered a COMPANY record; (ii) subject to a legal hold; or (iii) otherwise critical to the conduct of Level 3 business; and that he/she has not deleted, removed or altered and will not delete or otherwise remove or alter any data or configuration from any COMPANY equipment or system without prior written approval from his/her direct supervisor; and
- (b) with the exception of the COMPANY issued personal computer ("COMPANY Computer") s/he has returned or will promptly return to COMPANY all COMPANY equipment, Confidential Information, and other materials and that s/he will not at any time, except as authorized by the Chief Executive Officer of COMPANY, for his/her own benefit or the benefit of any other person or entity, disclose or cause to be disclosed any information, materials, systems, procedures, processes, manuals, forms, customer or employee lists, business plans or other trade secrets or confidential information regarding COMPANY. Prior to his Termination Date, EMPLOYEE will make the COMPANY Computer available to allow COMPANY to remove all COMPANY information it deems necessary. EMPLOYEE shall not be allowed to take ownership of the COMPANY Computer unless and until he has allowed COMPANY access as set forth herein. EMPLOYEE further acknowledges and agrees that s/he continues to be bound by the COMPANY'S Intellectual Property and Confidential Information policies, previously acknowledged by EMPLOYEE, copies of which are attached hereto as Exhibit "B".

9. No Solicitation/No Competition. EMPLOYEE agrees, for a period of 12 months beyond EMPLOYEE'S termination date set forth in paragraph 1 above, that he will not: (a) directly or indirectly solicit the services of, induce away from employment with, or hire any employee of COMPANY or its affiliates during their employment with COMPANY; (b) solicit from any corporation, firm, or organization that is a customer of COMPANY any business, service, or product that the COMPANY is providing said customer; (c) induce or attempt to induce any customer, supplier, licensee or other business relation of the COMPANY to cease doing business with the COMPANY or interfere with the relationship between any such customer, supplier, licensee or business relation and COMPANY; or (d) directly or indirectly engage in, own, manage, be employed by, assist, loan money to, or promote business for any person or entity who or which is engaged in the same business as COMPANY, offers for sale the same products or services as the COMPANY, or otherwise is a competitor of COMPANY, without the express written consent of

the Chief Executive Officer of the COMPANY. Section 9(d) shall be limited to: (i) companies that include within their corporate structure competitive local exchange carrier(s) and/or incumbent local exchange carrier(s), which with affiliates have, for their most recent fiscal year, annual consolidated total communications revenue equal to or greater than \$1 Billion; or (ii) providers of content delivery network services which with affiliates have, for their most recent fiscal year, consolidated total content delivery network revenues greater than \$50 million; or (iii) international communication services providers which with affiliates have a presence in the United States and, with affiliates, have, for their most recent fiscal year, annual consolidated total revenue equal to or greater than \$1Billion; or (iv) XO Holdings, Inc., Global Crossing Ltd., Qwest Communications International Inc., AT&T Inc., Sprint Nextel Corporation, Time Warner Telecom Inc., Verizon Communications Inc., Limelight Networks, Inc., Akamai Technologies Inc., PAETEC Holding Corp., Reliance Communications Venture Limited, including in each case their affiliates, successors and assigns.

10. Remedies. EMPLOYEE agrees further that if he breaches or otherwise acts inconsistent with the provisions of Paragraphs 6, 7, 8 or 9, COMPANY'S obligations under the provisions of Paragraphs 2 and 3 are terminated, and COMPANY may bring an action in a court of competent jurisdiction and recover as liquidated damages pursuant to the terms of Paragraph 2 and 3 of this Agreement, its costs and attorney's fees and any other available remedy. EMPLOYEE also expressly acknowledges that any breach or threatened breach of Paragraphs 8 or 9 might cause irreparable injury to the COMPANY and that money damages may not provide an adequate remedy at law for such injury. To the extent there is litigation involving this Agreement, the party who substantially prevails shall be entitled to their fees and expenses.
11. Non-Admission. This Agreement will not in any way be construed as an admission by COMPANY of a violation of any federal, state or local law or ordinance, or any enforceable right of EMPLOYEE, and COMPANY specifically denies any wrongdoing on its part, or on the part of its directors, employees or agents.
12. Headings. The headings of the sections herein are included solely for convenience of reference and, whether included or not, shall not control the meaning or interpretation of any of the provisions of this Agreement.
13. Review and Acknowledgment. This Separation Agreement and General Release sets forth the entire agreement between EMPLOYEE and COMPANY and may not be modified or canceled in any manner except in writing and signed by both parties. EMPLOYEE hereby acknowledges that COMPANY has made no representations or promises to me other than those contained in this Agreement. If any provision of this Agreement is found to be unenforceable, that provision will be enforced to the greatest extent permitted by law and all other provisions will remain fully enforceable.

This Agreement will be governed by Colorado law. Any action to enforce the terms of this Separation Agreement and General Release will be brought exclusively in state or federal court located in the City and County of Denver, Colorado and EMPLOYEE and COMPANY consent to personal jurisdiction and venue in those courts.

14. ***EMPLOYEE acknowledges that he has read and understands the following notifications:***
  - (a) ***EMPLOYEE is advised to and understands his opportunity to consult with an attorney regarding the Agreement before executing it;***
  - (b) ***EMPLOYEE acknowledges that he executes this Agreement having been advised and understands that it releases any and all claims under the Age Discrimination in Employment Act of 1967;***

- (c) *EMPLOYEE acknowledges that he was provided this Agreement on December 31, 2008 and that he has up to forty-five (45) days in which to consider and accept this Agreement;*
- (d) *EMPLOYEE may revoke this Agreement at any time within seven (7) days following execution of this Agreement by delivering written notice of such revocation to Thomas C. Stortz, Executive Vice President, 1025 Eldorado Boulevard, Broomfield, Colorado 80021, and that this Agreement will not become effective or enforceable until the expiration of this seven (7) day revocation period;*
- (e) *by entering into this Agreement, EMPLOYEE has read and understands the terms of this Agreement, that his signature below is truly voluntary, and that he has entered into this Agreement knowingly and willfully.*

DATED this 31st day of December, 2008

EMPLOYEE

/s/ John N. Hobbs

\_\_\_\_\_  
John N. Hobbs

COMPANY

/s/ Thomas C. Stortz

\_\_\_\_\_  
By: Thomas C. Stortz  
Title: EVP

SEPARATION AGREEMENT AND GENERAL RELEASE

### CONSULTING AGREEMENT

This CONSULTING AGREEMENT (" *Agreement* ") is made as of the 31st day of December, 2008 (the " *Effective Date* ") by and between **LEVEL 3 COMMUNICATIONS, LLC** , a Delaware limited liability company (" *Company* "), whose address is 1025 Eldorado Boulevard, Broomfield, CO 80021 and **HOBBS MANAGEMENT, LLC** , a limited liability company (" *Consultant* "), whose address is 1845 Sugarloaf Club Drive, Duluth, GA, 30097. Company and Consultant hereby agree as follows:

1. **Services** . During the term of this Agreement, Consultant agrees to perform the following work and services: operations analysis and support, capital raising support, regulatory and government affairs support, market positioning and strategy, customer targeting, sales, mergers and acquisitions support, and any other activities related to his prior responsibilities with Company, requested by a President, Chief Operating Officer, or Chief Executive Officer, to be performed at such locations as are designated by Company ("Services"). The Services to be provided by Consultant to Company shall be performed by John N. Hobbs. Consultant shall be available to provide Company the Services under this Agreement for such time as reasonably requested by Company. As used in this Agreement, references to Consultant shall include all of Consultant's managers, officers, members and employees.
2. **Representations** . Consultant represents and warrants that the execution of this Agreement and the performance of Consultant's obligations hereunder shall not violate the terms of any other agreement or any rule, law, order or consent decree by which Consultant or John N. Hobbs is bound.
3. **Term** . Unless earlier terminated, the term of this Agreement shall be from the Effective Date to June 30, 2009, unless earlier terminated as provided herein.
4. **Consideration** . In consideration for Consultant's full and timely performance of the Services, Company shall pay Consultant the sum of Fifty Thousand Dollars (\$50,000.00) per month, payable in arrears on the 1<sup>st</sup> day following each month of this Agreement.
5. **Expenses and Administrative Support** . Subject to the Company's travel and expense reimbursement policies, the Company shall reimburse Consultant for Consultant's reasonable expenses incurred in performing the Services. Company will provide Consultant with administrative support, to the extent it is necessary for the performance of Services. In addition, Consultant shall be allowed to continue the use of Company's computer during the term of this Agreement, but will not have access to Company's computer network. All expenses to be reimbursed shall be submitted directly to Thomas C. Stortz for payment.
6. **Independent Contractor** . Consultant and Company, expressly intending that no employment, partnership, or joint venture relationship is created by this Agreement, hereby agree as follows:
  - A. Consultant shall act at all times as an independent contractor hereunder and is not an employee, partner, or co-venturer of, or in any other relationship with Company. The manner in which Consultant's services are rendered shall be within Consultant's sole control and discretion.
  - B. Neither Consultant nor anyone employed by or acting for or on behalf of Consultant shall ever be construed as an employee of Company and Company shall not be liable for employment or withholding taxes or any benefits respecting Consultant or any employee of Consultant.
  - C. Consultant shall determine when, where and how Consultant shall perform the Services.



- D. Consultant shall take all steps to ensure that Consultant and Consultant's employees (if any) are treated as independent contractors of Company.
- E. Consultant expressly acknowledges and agrees that except to the extent expressly provided in Sections 5 and 6 above, neither Consultant nor anyone employed by or acting for or on behalf of Consultant shall receive or be entitled to any consideration, compensation or benefits of any kind from Company, including without limitation, pension, stock options, profit sharing or similar plans or benefits, or accident, health, medical, life or disability insurance benefits or coverages.
- F. To the extent permitted by law, Consultant, for Consultant and for anyone claiming through Consultant, waives any and all rights to any consideration, compensation or benefits, except as expressly provided for herein.
7. **Indemnity .** Consultant shall indemnify and hold harmless Company and its officers, directors, agents and employees, from and against any and all claims, demands, causes of action, losses, damages, costs and expenses (including reasonable attorneys' fees) arising out of or relating to Consultant's execution of this Agreement, Consultant's performance of the Services, a breach of the Consultant's representations contained in this Agreement or any claim for withholding or other taxes that might arise or be imposed due to this Agreement or the performance of the Services, except to the extent such claim, demand, cause of action, loss, damage, cost and expense is caused solely by the negligent acts or failures to act of Company, its officers, directors, agents and employees, in which case Company shall indemnify and hold Consultant harmless from any and all claims, demands, causes of action, losses, damages, costs and expenses (including reasonable attorney fees) to the extent and in the same proportion as said loss or damage was caused by Company's (or its officers, directors, agents and employees') negligent acts or failures to act.
8. **Confidential Information.** All information and materials disclosed during the performance of this Agreement shall be subject to the Non-Disclosure Agreement dated December 15, 2008, executed by John N. Hobbs and the Company, which is incorporated herein and is considered a material part of this Agreement.
9. **Confidentiality of Agreement.** The terms of this Agreement, and the proposal of and discussions relating to this Agreement, are and shall remain confidential as between the parties, unless, and to the extent, disclosure is required by law or to secure advice from a legal or tax advisor.
10. **Standard of Conduct.** In rendering Services under this Agreement, Consultant shall conform to high professional standards of work and business ethics.
11. **Public Relations.** This Agreement shall not be construed as granting to Consultant any right to use any of Company or its affiliates' trademarks, service marks or trade names, or otherwise refer to Company in any marketing, promotional or advertising materials or activities. Without limiting the generality of the forgoing, Consultant shall not disclose (i) the terms and conditions of this Agreement, or (ii) the existence of the project or any contractual relationship between Company and Consultant, except as is reasonably necessary to perform the Services, or (iii) issue any publication or press release relating directly or indirectly to (i) or (ii) above; without Company's prior written consent.
12. **No-Solicitation / No Competition.** Consultant agrees, that for a period of 12 months from the Effective Date, it, or any of its employees, including John N. Hobbs as well as the Consultant's officers, directors, and managers, will not: (a) directly or indirectly, solicit the services of, induce away from employment with, or hire any employee of Company or its affiliates during their employment with Company and for a period of six months after they are no longer employed by Company, without Company's prior written consent; (b) solicit, directly or indirectly, for himself or on behalf of a third party any corporation, firm, or organization that is a customer of Company

any business, service or product that the Company is providing said customer; (c) without the express written consent of the Chief Executive Officer of the Company, which consent will not be unreasonably withheld, directly or indirectly engage in, own, manage, be employed by, assist, loan money to, or promote any business, for any person or entity; or (d) directly or indirectly engage in, own, manage, be employed by, assist, loan money to, or promote any business, for any person or entity who or which is engaged in the same business of Company, offers for sale the same products or services of the Company, or otherwise is a Competitor of Company. Section 12(d) shall be limited to: (i) companies that include within their corporate structure competitive local exchange carrier(s) and/or incumbent local exchange carrier(s), which with affiliates have, for their most recent fiscal year, annual consolidated total communications revenue equal to or greater than \$1 Billion; or (ii) providers of content delivery network services which with affiliates have, for their most recent fiscal year, consolidated total content delivery network revenues greater than \$50 million; or (iii) international communication services providers which with affiliates have a presence in the United States and, with affiliates, have, for their most recent fiscal year, annual consolidated total revenue equal to or greater than \$1Billion; or (iv) XO Holdings, Inc., Global Crossing Ltd., Qwest Communications International Inc., AT&T Inc., Sprint Nextel Corporation, Time Warner Telecom Inc., Verizon Communications Inc., Limelight Networks, Inc., Akamai Technologies Inc., PAETEC Holding Corp., Reliance Communications Venture Limited, including in each case their affiliates, successors and assigns.

- 13. *Conceptions.*** Consultant acknowledges that Company is engaged in a continuous program of research, development and marketing in connection with its business and that, in the performance of the Services, Consultant may participate in and support such activities. To the extent that Consultant participates in or supports such activities on behalf of Company, Consultant hereby agrees to promptly disclose exclusively to Company all improvements, original works of authorship, process, computer programs, ideas, discoveries, techniques, data bases and trade secrets (" *Conceptions* "), whether or not patentable or copyrightable, that are made, conceived, first reduced to practice or created by Consultant, either alone or jointly with others. Consultant further agrees that all Conceptions that (a) are developed using equipment, supplies, facilities or trade secrets of Company, or (b) result from or are any way connected with the Services performed by Consultant, or (c) relate to the business or the actual or anticipated research or development of Company, including any "moral" rights under any copyright or other similar law, shall be the sole and exclusive property of, and are hereby automatically assigned to, Company. Consultant agrees to assist Company in obtaining and enforcing all rights and other legal protections for the Proprietary Information and the Conceptions and to execute any and all documents that Company may reasonably request in connection therewith. Consultant's agreement set forth in the preceding sentence shall continue throughout the period of five (5) years following the termination or expiration of this Agreement; however, Company agrees to pay Consultant reasonable consideration for time actually spent and sufficiently documented by Consultant for such assistance during such five (5) year period.
- 14. *Termination.*** To the extent the Company, through its Compensation Committee Chairman, provides a consent pursuant to Section 12 (c), the Company's payment obligations under this Agreement shall cease as of the date of such consent.

Company may terminate this Agreement for "cause". For purposes of this Agreement "cause" shall mean the Company's good faith determination that the Consultant or Consultant's employees has committed any of the following in breach of this Agreement: (1) failure to provide Services; (2) conduct that is materially injurious to Company or any of its affiliates; (3) fraud, theft or embezzlement or any other material act of dishonesty with respect to Company or its affiliates; (4) willful use or imparting of any confidential or proprietary information of Company or an affiliate; (5) a felony or crime involving moral turpitude; or (6) Consultant's employment with or

performance of any work or services on behalf of any other company, person, or other entity, including any self-employment.. In the event that Company reasonably believes, in good faith, that Consultant has breached the Agreement, Company shall provide Consultant prior written notice of such alleged breach (the "Alleged Breach Notice"), which notice shall identify with reasonable particularity the basis for such belief, along with the provision of the Agreement that Company alleges has been breached. If Consultant disagrees with Company's belief as set forth in the Alleged Breach Notice, Consultant and the Chairman of the Compensation Committee, on Company's behalf, shall attempt in good faith to resolve the dispute within fourteen (14) business days of Consultant's receipt of the Alleged Breach Notice. If Consultant and Company are unable to definitively resolve the dispute and Company, in good faith, maintains its position that Consultant has breached the Agreement, Company shall promptly send a second notice to Consultant (the "Notice of Breach"). If Consultant does not cure such alleged breach within five (5) business days of receipt of the Notice of Breach, Company may take any action at law or in equity that it may otherwise have against Consultant, including terminating the Agreement, and paying to Consultant the pro-rata amount due for Services performed as of the date of termination. Except for such payment, Company's payment obligations under this Agreement shall cease.

If this Agreement is terminated, the provisions of Sections 2, 6, 7, 8, 9, 11, 12 (but not Section 12(c)), 13, 17, 18, 19, 20, and 21 shall survive and be enforceable by either party to this Agreement.

- 15. *Assignment.*** Neither this Agreement nor any rights or obligations created hereby may be assigned by either party and any attempt to do so shall be void, provided, however, Company may freely assign this Agreement to Company affiliates and subsidiaries and in connection with a change in control of Company.

**16. *Notice.***

- A.** Whenever under the provisions of this Agreement it shall be necessary or desirable for one party to serve any notice, request, demand, report or other communication on another party, the same shall be in writing and shall be served (i) personally; (ii) by independent, reputable, overnight commercial carrier; or (iii) by electronic transmission where the sender is able to obtain verification of receipt and review, and where the electronic transmission is immediately followed by service of the original of the subject item in the manner provided in clause (i), or (ii) hereof; addressed as follows:

If to Company:                      Level 3 Communications, LLC  
Attn: Chief Legal Officer  
1025 Eldorado Blvd.  
Broomfield, CO 80021  
Facsimile (720) 888-5127

If to Consultant:                      Hobbs Management, LLC  
Attn: John N. Hobbs  
1845 Sugarloaf Club Drive  
Duluth, GA 30097

- B.** Any party may, from time to time, by notice in writing served upon the other party as aforesaid, designate an additional and/or a different mailing address or an additional and/or a different person to whom all such notices, requests, demands, reports and communications are thereafter to be addressed. Any notice, request, demand, report or other communication served personally shall be deemed delivered upon receipt, if received by independent courier shall be deemed delivered on the date of receipt as shown by the addressee's registry or

certification receipt or on the date receipt at the appropriate address, as shown on the records or manifest of the independent courier, and if served by facsimile transmission shall be deemed delivered on the date of receipt as shown on the received facsimile (provided the original is thereafter delivered as aforesaid).

17. ***Affiliates .*** All representations, covenants and agreements of Consultant and/or John N. Hobbs set forth in this Agreement made to or for the benefit or protection of Company shall also benefit and protect, with equal force and effect, all affiliates of Company.
18. ***Authority.*** Consultant shall have no authority to legally bind Company or its affiliates to any liability or obligation whatsoever. Consultant shall advise all persons and entities with whom he communicates on behalf of Company that Consultant is only a consultant and has no authority to bind Company or its affiliates.
19. ***Entire Agreement.*** The foregoing constitutes the entire agreement between the parties relating to the subject matter hereof, and supersedes all prior understandings, agreements and documentation relating to the subject matter hereof. This Agreement may be amended only by an instrument executed by Company and Consultant.
20. ***Severability.*** If any provision of this Agreement is held to be unenforceable for any reason, it shall be modified rather than voided, if possible, in order to achieve the intent of the parties to the extent possible. In any event, all other provisions of this Agreement shall be deemed valid and enforceable to the fullest extent possible.
21. ***Governing Law.*** This Agreement and the rights and obligations of the parties hereto shall be governed by, and construed and enforced in accordance with, the laws of the State of Colorado.

#### **LEVEL 3 COMMUNICATIONS, LLC**

By: /s/ Thomas C. Stortz

Name: Thomas C. Stortz

Title: Executive Vice President

#### **HOBBS MANAGEMENT, LLC**

By: /s/ John N. Hobbs

Name: John N. Hobbs

Title: Partner

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Exhibit 10.34

CONSULTING AGREEMENT

**LEVEL 3 COMMUNICATIONS, INC.**  
**STATEMENT REGARDING COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES AND**  
**PREFERRED STOCK DIVIDENDS**

	Fiscal Year Ended				
	2008	2007	2006	2005	2004
Loss from Continuing Operations Before Income Taxes	\$(284)	\$(1,136)	\$(788)	\$(702)	\$(477)
Interest on Debt, Net of Capitalized Interest	534	577	648	530	485
Amortization of Capitalized Interest	48	68	68	68	68
Interest Expense Portion of Rental Expense	68	63	44	25	29
Earnings (Losses) Available for Fixed Charges	<u>\$ 366</u>	<u>\$ (428)</u>	<u>\$ (28)</u>	<u>\$ (79)</u>	<u>\$ 105</u>
Interest on Debt	<u>\$ 534</u>	<u>\$ 577</u>	<u>\$ 648</u>	<u>\$ 530</u>	<u>\$ 485</u>
Preferred Dividends	—	—	—	—	—
Interest Expense Portion of Rental Expense	68	63	44	25	29
Total Fixed Charges	<u>\$ 602</u>	<u>\$ 640</u>	<u>\$ 692</u>	<u>\$ 555</u>	<u>\$ 514</u>
Ratio of Earnings to Fixed Charges	—	—	—	—	—
Deficiency	<u>\$(236)</u>	<u>\$(1,068)</u>	<u>\$(720)</u>	<u>\$(634)</u>	<u>\$(409)</u>

LEVEL 3 COMMUNICATIONS, INC. STATEMENT REGARDING COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES  
AND PREFERRED STOCK DIVIDENDS

**Significant Subsidiaries As of and for the Fiscal Year ending December 31, 2008**

- Level 3 Communications, Inc.
- Level 3 Financing, Inc.
- Level 3 Communications, LLC
  - Broadwing, LLC
    - Broadwing Communications Holdings, LLC
    - Broadwing Communications, LLC
  - TelCove Operations, LLC
  - WilTel Communications Group, LLC
    - WilTel Communications, LLC
    - Vyvx, LLC
- BTE Equipment, LLC
- Level 3 International, Inc.
  - Level 3 Holdings, B.V.
    - Level 3 Communications Limited (UK)
    - Level 3 Communications GmbH (Germany)
- Level 3 Holdings, Inc.
- KCP, Inc.

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[Significant Subsidiaries As of and for the Fiscal Year ending December 31, 2008](#)

**Consent of Independent Registered Public Accounting Firm**

The Board of Directors  
Level 3 Communications, Inc.:

We consent to the incorporation by reference in the registration statements (Nos. 333-53914, 333-91899, 333-68887, 333-71713, 333-115062, 333-125262, 333-130710, 333-132695, 333-134668, 333-136413, 333-139836, 333-139838, 333-153644, 333-154976, and 333-156709) on Form S-3 and the registration statements (Nos. 333-79533, 333-42465, 333-68447, 333-58691, 333-52697, 333-115472, and 333-115751) on Form S-8 of Level 3 Communications, Inc. of our reports dated February 27, 2009, with respect to the consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit) and comprehensive loss for each of the years in the three-year period ended December 31, 2008, and the effectiveness of internal control over financial reporting as of December 31, 2008, which reports appear in the December 31, 2008 annual report on Form 10-K of Level 3 Communications, Inc.

/s/ KPMG LLP

Denver, Colorado  
February 27, 2009

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[Consent of Independent Registered Public Accounting Firm](#)

**CERTIFICATIONS\***

I, James Q. Crowe, certify that:

1. I have reviewed this annual report on Form 10-K of Level 3 Communications, Inc.;
2. Based on my knowledge, this annual 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 27, 2009

/s/ JAMES Q. CROWE

James Q. Crowe  
Chief Executive Officer

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\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

QuickLinks

[CERTIFICATIONS](#)

**CERTIFICATIONS\***

I, Sunit S. Patel, certify that:

1. I have reviewed this annual report on Form 10-K of Level 3 Communications, Inc.;
2. Based on my knowledge, this annual 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 27, 2009

/s/ SUNIT S. PATEL

Sunit S. Patel  
Chief Financial Officer

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\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

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[CERTIFICATIONS](#)

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Form 10-K of Level 3 Communications, Inc. (the "Company") for the year ended December 31, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James Q. Crowe, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ JAMES Q. CROWE

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James Q. Crowe  
*Chief Executive Officer*  
February 27, 2009

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CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-  
OXLEY ACT OF 2002

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Form 10-K of Level 3 Communications, Inc. (the "Company") for the year ended December 31, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Sunit S. Patel, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ SUNIT S. PATEL

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Sunit S. Patel  
*Chief Financial Officer*  
February 27, 2009

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CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-  
OXLEY ACT OF 2002

# LEVEL 3 COMMUNICATIONS INC

## FORM 10-K (Annual Report)

Filed 02/29/08 for the Period Ending 12/31/07

Address	1025 ELDORADO BOULEVARD BLDG 2000 BROOMFIELD, CO 80021
Telephone	7208881000
CIK	0000794323
Symbol	LVLT
SIC Code	4813 - Telephone Communications, Except Radiotelephone
Industry	Communications Services
Sector	Technology
Fiscal Year	12/31

Use these links to rapidly review the document

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**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**FORM 10-K**

(Mark One)

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

**For the fiscal year ended December 31, 2007**

**OR**

☐ **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: 0-15658**

**Level 3 Communications, Inc.**

(Exact name of Registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**47-0210602**

(I.R.S. Employer  
Identification No.)

**1025 Eldorado Boulevard, Broomfield, Colorado**

(Address of principal executive offices)

**80021-8869**

(Zip code)

**(720) 888-1000**

(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:

**Common Stock, par value \$.01 per share**

**The NASDAQ Stock Market LLC**

Securities registered pursuant to section 12(g) of the Act:

**None**

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒  
No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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 ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐  
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

As of June 30, 2007 the aggregate market value of common stock held by non-affiliates of the registrant approximated \$6.5 billion based upon the closing price of the common stock as reported on the NASDAQ Global Select Market as of the close of business on that date. Shares of common stock held by each executive officer and director and by each entity that owns 10% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Title	Outstanding
Common Stock, par value \$.01 per share	1,545,421,165 as of February 26, 2008

DOCUMENTS INCORPORATED BY REFERENCE

List hereunder the following documents if incorporated by reference and the Part of the Form 10-K (e.g., Part I, Part II, etc.) into which the document is incorporated: (1) Any annual report to security holders; (2) Any proxy or information statement; and (3) Any prospectus filed pursuant to Rule 424(b) or (c) under the Securities Act of 1933. The listed documents should be clearly described for identification purposes (e.g., annual report to security holders for fiscal year ended December 24, 1980).

Portions of the Company's Definitive Proxy Statement for the 2008 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K

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*Unless the context otherwise requires, when we use the words "Level 3," "we," "us" or "our company" in this Form 10-K, we are referring to Level 3 Communications, Inc., a Delaware corporation, and its subsidiaries, unless it is clear from the context or expressly stated that these references are only to Level 3 Communications, Inc. In this Form 10-K, we may refer to our former subsidiary Software Spectrum, Inc. and its subsidiaries as "Software Spectrum."*

*The Level 3 logo and Level 3 are registered service marks of our wholly owned subsidiary, Level 3 Communications, LLC, in the United States and other countries. All rights are reserved. This Form 10-K refers to trade names and trademarks of other companies. The mention of these trade names and trademarks in this Form 10-K is made with due recognition of the rights of these companies and without any intent to misappropriate those names or marks. All other trade names and trademarks appearing in this Form 10-K are the property of their respective owners.*

### **Cautionary Factors That May Affect Future Results (Cautionary Statements Under the Private Securities Litigation Reform Act of 1995)**

This Form 10-K contains forward-looking statements and information that are based on the beliefs of our management as well as assumptions made by and information currently available to us. When we use the words "anticipate", "believe", "plan", "estimate" and "expect" and similar expressions in this Form 10-K, as they relate to us or our management, we are intending to identify forward-looking statements. These statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions.

Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, our actual results may vary materially from those described in this document. These forward-looking statements include, among others, statements concerning:

- our communications business, its advantages and our strategy for continuing to pursue our business;
- anticipated development and launch of new services in our business;
- anticipated dates on which we will begin providing certain services or reach specific milestones in the development and implementation of our business strategy;
- growth of the communications industry;
- expectations as to our future revenue, margins, expenses, cash flows and capital requirements; and
- other statements of expectations, beliefs, future plans and strategies, anticipated developments and other matters that are not historical facts.

These forward-looking statements are subject to risks and uncertainties, including financial, regulatory, environmental, industry growth and trend projections, that could cause actual events or results to differ materially from those expressed or implied by the statements. The most important factors that could prevent us from achieving our stated goals include, but are not limited to, our failure to:

- integrate strategic acquisitions;
  - increase the volume of traffic on our network;
  - defend our intellectual property and proprietary rights;
  - successfully complete commercial testing of new technology and information systems to support new services;
  - develop new services that meet customer demands and generate acceptable margins;
  - attract and retain qualified management and other personnel; and
-



- meet all of the terms and conditions of our debt obligations.

Except as required by applicable law and regulations, we undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. Further disclosures that we make on related subjects in our additional filings with the SEC or Securities and Exchange Commission should be consulted. For further information regarding the risks and uncertainties that may affect our future results, please review the information set forth below under "ITEM 1A. RISK FACTORS."

## Part I

### ITEM 1. BUSINESS

*Unless the context otherwise requires, when we use the words "Level 3," "we," "us" or "our company" in this Form 10-K, we are referring to Level 3 Communications, Inc., a Delaware corporation, and its subsidiaries, unless it is clear from the context or expressly stated that these references are only to Level 3 Communications, Inc. Throughout this Form 10-K we use various industry terms and abbreviations, which we have defined in the Glossary of Terms at the end of this description of our business.*

Through our operating subsidiaries, we engage primarily in the communications business.

We are a facilities based provider (that is, a provider that owns or leases a substantial portion of the plant, property and equipment necessary to provide its services) of a broad range of integrated communications services. We have created our communications network generally by constructing our own assets, but also through a combination of purchasing and leasing other companies and facilities. Our network is an advanced, international, facilities based communications network. We designed our network to provide communications services, which employ and take advantage of rapidly improving underlying optical, Internet Protocol, computing and storage technologies.

*Market and Technology Opportunity.* We believe that ongoing technology advances in both optical and Internet Protocol technologies have been revolutionizing the communications industry. We also believe that these advances have, and will continue to, facilitate decreases in unit costs for communications service providers that are able to most effectively take advantage of these technology advances. Service providers that can effectively take advantage of technology improvements and reduce unit costs will be able to offer lower prices, which, we believe, will stimulate substantial increases in the demand for communications services. We believe there are two primary factors that are continuing to drive this market dynamic:

- *Rapidly Improving Technologies.* Over the past few years, both Internet Protocol or IP and optical based networking technologies have undergone extremely rapid innovation, due, in large part, to market based development of underlying technologies. This rapid technology innovation has resulted in both an improvement in price-performance for optical and Internet Protocol systems, as well as rapid improvement in the functionality and applications supported by these technologies. For example, these improvements are enabling voice over IP services or VoIP that are challenging traditional telephone network or PSTN services. We believe that this rapid innovation will continue well into the future across a number of different aspects of the communications marketplace.
- *High Demand Elasticity.* We believe decreases in communications services costs and prices cause the development of new bandwidth-intensive applications, which, over time, result in even more significant increases in bandwidth demand. In addition, we believe that communications services are direct substitutes for other, existing modes of information distribution from sources such as traditional broadcast entertainment as well as distribution of software, audio and video content using physical media delivered using motor transportation systems. An example of this dynamic is the use of the Internet for the distribution of video entertainment.

We believe that as communications services improve more rapidly than these alternative content distribution systems, significant demand will be generated from these sources of information. We also believe that high elasticity of demand from both these new applications and the substitution for existing distribution systems will continue for the foreseeable future. We believe that while high demand elasticity will be manifested over time, government regulation and communications supply chain inefficiencies may cause realization of demand to be delayed.

We also believe that there are significant implications that result from this market dynamic. These implications include the following:

- *Incorporating Technology Changes.* Given the rapid rate of improvement in optical and Internet Protocol technologies, communications service providers that are most effective at rapidly deploying new services that take advantage of these technologies will have an inherent cost and service advantage over companies that are less effective at deploying new services that use these technologies.
- *Capital Intensity.* The rapid improvements in these technologies and the need to move to new technologies more quickly results in shortened economic lives of underlying assets. To achieve improvements in service capabilities and unit cost reductions, service providers will need to deploy new generations of technology sooner, resulting in a more capital-intensive business model. Those providers with the technical, operational and financial ability to take advantage of the rapid advancements in these technologies are expected to have higher absolute capital requirements, shortened asset lives, rapidly decreasing unit costs and prices, rapidly increasing unit demand and higher cash flows and profits.

## **Our Communications Business Strategy**

We are seeking to capitalize on the opportunities presented by the expanded coverage of our communications network as well as the significant and rapid advancements in optical and Internet Protocol technologies. Key elements of our strategy include:

- *Offer a Comprehensive Range of Communications Services Over Our End-to-End Network.* We provide a comprehensive range of communications services designed to meet the needs of our customers over our network. Beginning in 2006, we expanded our targeted customer base to include enterprise or business customers through the acquisitions we completed during 2006 and early 2007.

Our communications service offerings include:

- Internet Protocol and data services—including (1) Internet access and IP and Ethernet Virtual Private Networks and (2) broadband transport services such as wavelengths, dark fiber and private line services (transoceanic, backhaul, intercity, metro and unprotected private line services);
- content distribution services including caching and video broadcast services;
- colocation services; and
- Softswitch and voice services—including wholesale VoIP component services, enterprise or business voice services, wholesale voice origination and termination services and managed modem for the dial-up access business.

The availability of these services varies by location.

For several years we have been developing services that take advantage of the investment that we have made in our network and that generally target large, existing markets for communications services. We have also expanded our existing markets for communications

services through the acquisitions we completed in 2006 and early 2007 that enabled us to offer services directly to enterprise or business customers. Through these efforts we have increased significantly our addressable market by adding new targeted customers as well as new voice and data services that take advantage of the geographic coverage and cost advantages of our network.

With respect to our wholesale customers, we provide these customers with several options for accessing our intercity network—including our metropolitan networks and colocation facilities. Our metropolitan networks enable us to connect directly to points of high traffic aggregation. These traffic aggregation facilities are typically locations where our customers wish to interconnect with our intercity network. Our metropolitan networks allow us to extend our network services to these aggregation points at low costs. With respect to our enterprise customers, we provide these customers with access to our network either by directly connecting to their location or by serving that location with a connection from another communications services provider. As of December 31, 2007, we have:

- approximately 77,000 intercity route miles in North America and Europe, which we expect to reduce to approximately 48,000 intercity route miles after we complete the integration of acquired companies, connecting 20 countries;
- approximately 125 markets having metropolitan fiber networks containing approximately 27,000 route miles in the United States and Europe; and
- approximately 7,300 traffic aggregation points and buildings in the aggregate.

We believe that providing colocation services in facilities directly connected to our network attracts communications intensive customers by allowing us to offer those customers reduced bandwidth costs, rapid provisioning of additional bandwidth, interconnection with other third party networks and improved network performance.

Additionally, our metropolitan networks allow us to compete for certain local communications traffic, which constitutes a significant percentage of the communications market. As of December 31, 2007, we had secured approximately 6.9 million square feet of space for our Gateway and transmission facilities and other technical space and had completed the build-out of approximately 4.6 million square feet of this space.

- *Provide Low Cost Backbone Services Through An Upgradeable Backbone Network.* Many portions of our originally constructed intercity and metropolitan networks were designed to provide high quality communications services at a lower cost. As we continue to integrate our acquired operations, our network and business processes will seek to enable us to cost effectively deploy future generations of optical and IP networking components (both fiber and transmission electronics and optronics) and thereby expand capacity and reduce unit costs. In addition, our strategy is to maximize the use of open, non-proprietary interfaces in the design of our network software and hardware. This approach is intended to provide us with the ability to purchase the most cost effective network equipment from multiple vendors and allow us to deploy new technology more rapidly and effectively.
- *Target Top Global Bandwidth Customers.* With respect to our wholesale service offerings, our primary distribution strategy is to use a national, direct sales force focused on high bandwidth usage businesses. These businesses include incumbent local exchange carriers, international carriers also known as PTTs, major internet service providers or ISPs, broadband cable television operators, wireless providers, major interexchange carriers, the U.S. government and enhanced service providers. Providing communications services to many of these businesses is at the core of our market enabling strategy. We identify as wholesale customers those customers that purchase significant amounts of capacity to serve the needs of their customers.

- *Further Develop Existing Enterprise Customer Business.* With respect to our business markets customers, our primary distribution strategy is to use a locally based direct sales force to target business customers, state governments, higher education institutions and academic consortia with high demands for mission critical communications services. In this category we also target regional carriers that make communications services buying decisions locally.
- *Develop Market Leading Content Distribution Service Offerings.* At December 31, 2007, we operated one of the largest Internet Protocol backbones in the world. In other words, we operate one of the largest networks over which Internet content is transported from content sources to third party owned access networks connected directly to end users. As a result of this network scale, in early 2007 we embarked on a strategy to refine our capabilities to address the communications needs of those organizations that produce the content that individuals want to view over the Internet. This service offering includes high speed IP services, colocation services and services that cost effectively distribute the content that is produced for consumption over the Internet. We believe that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet. Furthermore, we believe that we are the only services provider with a single source, full portfolio of end-to-end content distribution solutions, and that we are in a unique position to offer a range of building blocks to meet these customers' needs.
- *Expand Metropolitan Network Coverage.* We expect to selectively extend the current reach of our existing metropolitan networks by opportunistically adding additional connections to buildings and other traffic aggregation points from these networks. These connections will enable us to reach additional potential customers and reduce our costs for the termination of our customers' communications traffic on other carriers' networks.
- *Pursue Acquisition Opportunities.* For a number of years, we have engaged in significant acquisition activities. In evaluating potential acquisition opportunities, among other criteria, we evaluate the potential acquisition according to the transaction's ability to generate positive cash flow from high credit quality customers. For these opportunities, we generally look for companies with recurring revenue that comes predominantly from services we already provide, in geographic areas that are already served, with customers that are consistent with our existing customer base. It is this group of acquisitions that generally also provide significant synergy opportunities as a result of overlapping network and service offerings.

As we seek to expand the addressable market for our services, we also evaluate opportunities that would expand our service capabilities. Transactions that would be included in this category would expand the geographic scope of our network or would provide capabilities for additional services or distribution channels. For these opportunities, we generally consider whether the targeted company's distribution strategy is consistent with our strategy and whether management believes that the target's current and/or future revenues can be significantly increased and/or expenses can be significantly reduced as a result of a combination with our operations. Generally these acquisition opportunities will not provide the same level of synergy opportunity that the category of acquisitions describe above provide to us.

- *Develop Advanced Operational Processes and Business Support Systems.* We have developed and continue to develop substantial and scalable operational processes and business support systems specifically designed to enable us to offer services efficiently to our targeted customers. We believe that over time these systems will reduce our operating costs, give our customers direct control over some of the services they buy from us and allow us to grow rapidly while minimizing redesign of our business support systems.

- *Attract and Motivate High Quality Employees.* We have developed programs designed to attract and retain employees with the technical and business skills necessary for our business. The programs include our long term incentive programs.

## Our Strengths

We believe that the following strengths will assist us in implementing our strategy:

- *Experienced Management Team.* We have assembled a management team that we believe is well suited for our business objectives and strategy. Our senior management has substantial experience in leading the development, marketing and sale of communications services and in managing, designing and constructing metropolitan, intercity and international networks.
- *A Comprehensive Range of Communications Services.* We provide a comprehensive range of communications services designed to meet the needs of our customers over our network. Beginning in 2006, we expanded our targeted customer base to include enterprise or business customers.

Our communications service offerings include:

- Internet Protocol and data services—including (1) Internet access and IP and Ethernet Virtual Private Networks and (2) broadband transport services such as wavelengths, dark fiber and private line services (transoceanic, backhaul, intercity, metro and unprotected private line services);
- content distribution services including caching and video broadcast services;
- colocation services; and
- Softswitch and voice services—including wholesale VoIP component services, enterprise or business voice services, wholesale voice origination and termination services and managed modem for the dial-up access business.

The availability of these services varies by location.

For several years we have been developing services that take advantage of the investment that we have made in our network and that generally target large, existing markets for communications services. We have also expanded our existing markets for communications services through our acquisitions that enabled us to offer services directly to enterprise or business customers. Through these efforts we have increased significantly our addressable market by adding new targeted customers as well as new voice and data services that take advantage of the geographic coverage and cost advantages of our network.

- *Significant metropolitan network platform.* As of December 31, 2007, we have metropolitan fiber networks in approximately 125 markets in North America and Europe, which contain approximately 26,000 route miles and connect in the aggregate approximately 7,300 traffic aggregation points and buildings. Our metropolitan networks enable us to connect directly to points of high traffic aggregation and customer locations and reduce our costs for the termination of our customers' communications traffic on other carriers' networks.
- *End-to-End Network Platform.* Our strategy has been and continues to be to deploy network infrastructure in major metropolitan areas and to link these networks with significant intercity and trans-oceanic networks in North America and Europe. We believe that the integration of our metropolitan and intercity networks with our colocation facilities will expand the scope and reach of our on-net customer coverage, facilitate the uniform deployment of technological innovations as we manage our future upgrade paths and allow us to grow or scale our service

offerings rapidly. We believe that we are the only international communications service provider with the unique combination of:

- a substantial intercity network;
- large fiber count metropolitan networks;
- substantial colocation facilities; and
- significant content distribution technology and services.
- *Advanced IP Backbone.* We operate one of the largest international IP networks or backbones. Our IP services deliver a broad range of IP transit and network interconnection solutions tailored to meet the varied needs of high bandwidth companies.
- *Extensive Patent Portfolio.* Through acquisitions and through our own research and development, we have created an extensive patent portfolio, consisting of approximately 880 patents and patent applications filed in the United States and around the world. Our patent portfolio includes patents filed in each of the last three decades covering technologies ranging from data and voice services to content distribution to transmission and networking equipment. Most of our issued patents are not scheduled to expire for more than ten years. We have used our patent portfolio in a number of ways. First, developing or acquiring technologies and receiving the legal right to preclude others from using them may give us a competitive advantage. Second, the breadth and depth of our patent portfolio may deter others, particularly telecommunications operators, from bringing patent infringement claims against us for fear of counter-claim by us. We will continue to file new patent applications as we enhance and develop products and services, we will continue to seek opportunities to expand our patent portfolio through strategic acquisitions and licensing, and we will continue to enforce our patents against infringement by others.
- *Softswitch based Co-Carrier Network.* Our experience in operating our Softswitch based co-carrier network is combined with a set of infrastructure and other management experiences, which include extensive local interconnection with local exchange carriers, experience in scaling a Softswitch based platform, and an ability to provide seamless interconnection to the traditional telephone network or PSTN. We believe that our extensive co-carrier network and Softswitch infrastructure provides us with a competitive advantage in the emerging voice over IP or VoIP marketplace.
- *A More Readily Upgradeable Network Infrastructure.* With respect to a substantial portion of our network, the network was designed to take advantage of technological innovations, incorporating many of the features that are not present in older communication networks, and provide us flexibility to take advantage of future developments and innovations. We designed the transmission network to optimize all aspects of fiber and optronics simultaneously as a system to deliver the lowest unit cost to our customers. As fiber and optical transmission technology changes, we expect to realize new unit cost improvements by deploying the most cost efficient technologies in our network. We believe that our network design will enable us to lower costs and prices while enjoying higher margins than our competitors.

## Our Communications Services

### *Customer Focused Organization*

Beginning in August 2006, we realigned the customer interacting or customer facing aspects of our communications business into four groups to focus more effectively on the needs of our customers. These four groups are:

- Wholesale Markets Group
- Business Markets Group
- Content Markets Group; and
- Europe

This realignment was implemented to enable those employees in these customer facing roles to develop and deliver high quality communications services that are based on the needs of the customers that the group is seeking to serve. Each of these groups is supported by dedicated employees in sales and segment marketing. Each of the groups is also supported by centralized service or product management and development, general marketing, global network services, engineering, information technology, and corporate functions including legal, finance, strategy and human resources. It is through the Wholesale Markets, Business Markets, Content Markets and Europe groups that we offer a comprehensive range of communications services.

*Wholesale Markets Group.* The Wholesale Markets Group is focused on delivering communications services to meet the high bandwidth needs of many of the largest global communications services providers on a wholesale basis. The Wholesale Markets Group's customers integrate or package our services into their own products and services to offer voice, video and data services to their end-user customers.

The market segments that the Wholesale Markets Group addresses include:

- domestic and international carriers;
- voice service providers, which include calling card companies, conferencing providers, and contact centers that use VoIP technology to better manage costs and enable advanced applications;
- wireless providers;
- broadband cable television operators;
- system integrators; and
- the U.S. government.

*Business Markets Group.* The Business Markets Group is focused on delivering communications services to meet the telecommunications needs of: small, medium and large enterprises; regional carriers; higher education institutions and academic consortia; and state and local governments. Local and regional carriers include ISPs, enhanced service providers, application service providers, wireless providers, mobile virtual network operators, VoIP providers as well as datacenters and hosting facilities. The Business Markets Group focuses on providing its targeted customers with the full suite of data, Internet, transport and voice services.

*Content Markets Group.* As we believe that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet, the Content Markets Group focuses on offering a range

of end-to-end communications services building blocks to meet the content distribution needs of its customers. Customers that the Content Markets Group serves include:

- video distribution companies;
- providers of online gaming and mega-portals;
- software service providers;
- social networking providers; and
- traditional media distribution companies including broadcasters, television networks and sports leagues.

*Europe.* The Europe group focuses on the communications needs of European customers and the European aspects of customers located outside of Europe. The Europe group target customers are similar to the target customers of the Wholesale Markets Group and the Content Markets Group.

#### *Service Offerings*

We offer a comprehensive range of communications services, which currently include the following services. All of these services are available to customers of each of the customer facing groups, however their availability varies by location. The following is an overview description of some of the services that we offer.

- *Network and Internet Services.* We offer both wholesale-oriented communications services to enable large scale networks and high speed access to the Internet as well as similar services designed for the enterprise marketplace. We offer a portfolio of data communications services ranging from basic network infrastructure components such as dark fiber, wavelength, and private line services to higher level routed data services such as Ethernet, Internet Transit and IP VPN. Our Network and Internet Services include the following.
- *Transport Services.* Transport services include wavelengths (Level 3 Intercity Wavelength Services and Level 3 Metro Wavelength Services) and private lines (Level 3 Intercity Private Line Services and Level 3 Metro Services). These services are available across our metropolitan and intercity fiber network. Wavelength services provide unprotected point-to-point connections of a fixed amount of bandwidth with Ethernet or SONET interfaces. Wavelength services are available at 2.5 Gbps and 10 Gbps speeds, which represent the largest capacity of dedicated transport services. This service offering targets customers that require significant amounts of bandwidth, desire more direct control and provide their own network management. Private line services are also point-to-point connections of dedicated bandwidth but usually include SONET or SDH protection to provide resiliency to fiber or equipment outages. Private line services are available in a range of speeds. Level 3 also offers Metro and Intercity Ethernet Private Line Services with Fast-E and Gig-E interfaces. Customers generally use our transport services to create their own SONET/SDH, ATM and IP networks. We typically offer transport services in annual contracts with monthly payments or long-term pre-paid agreements.

Level 3 also provides transport services within our transatlantic cable system connecting North America and Europe as well as via leased bulk capacity on other transoceanic systems. "International Backhaul" transport services, interconnecting cable landing stations and the terrestrial North American and European networks, are also available.

- *High Speed Internet Protocol (IP) Service.* Level 3 operates one of the largest international Internet backbones providing connectivity among customer IP, content and application networks. Built on our own intercity and metropolitan networks in North America and



Europe, we provide customers with high performance, reliability and scalability. Access to the Internet is enabled through interconnection among our customers across our network as well as interconnections with other Internet Service provider "peers."

- *Dedicated Internet Access.* Dedicated Internet Access, or DIA, is Level 3's Enterprise focused Internet access product leveraging the same core Internet backbone as our other Internet Services. Level 3 operates one of the largest international Internet backbones in the world and is regularly considered one of the most connected Internet networks. Level 3's Dedicated Internet Access service provides Internet connectivity over a Tier One Internet backbone through a wide variety of access methods and speeds. The service also includes Domain Name services, primary, secondary and caching and is available as either a stand-alone service or as a complement to our other communications services.
- *VPN Services.* Built on our optical transport and MPLS networks, we offer customers the ability to create private point-to-point, point-to-multipoint, and full-mesh networks based on IP VPN, Virtual Private LAN Service, or VPLS, ATM and Frame Relay technologies. These services allow service providers, corporations, government entities, and distribution businesses to replace multiple networks with a single, cost-effective solution that simplifies the transmission of voice, video, and data over a single or converged network. The service allows the customer to achieve this convergence without sacrificing the quality of service or security levels of traditional dedicated transport offerings. These solutions are used for service provider and corporate data and voice networks, data center networking, disaster recovery and out-of-region or redundant customer connectivity for other service providers.
- *Colocation Service.* We offer high quality, data center space where customers can locate servers, content storage devices and communications network equipment in a safe and secure technical operating environment. At our colocation sites, we offer high-speed, reliable connectivity to our network and to other networks, including metro and intercity networks, the traditional telephone network and the Internet.
- *Dark Fiber Service.* Level 3 Intercity Dark Fiber and Level 3 Metro Dark Fiber provide carriers, service providers, government entities and large enterprises a complete infrastructure when a fiber solution is required based on unique applications, control or scale requirements. The services include fiber, colocation space in our Gateway and in our network facilities, power and physical operations and maintenance of the fiber and associated infrastructure.
- *Content Distribution.* Our primary Content Distribution products and services include the following.
- *Content Delivery Network.* Our content delivery network services combine our IP network, gateway facilities and patented technology that directs a requestor or end user to the best location or server cluster in our network to retrieve the requested content based on location and network conditions. Our CDN services provide customers with improved cost performance, scalability, reliability and reach for their web applications. Our Caching and Download Services provide efficient delivery of large files such as video, software, security patches, audio and graphics to mass audiences. Our Streaming Services can be used to deliver high performance streams, either live or on-demand, to end users using leading proprietary protocols. We also offer storage solutions enabling customers to upload and store content to our network as part of an optimized delivery platform. In addition to our delivery services, our Intelligent Traffic Management software continuously monitors systems and Internet conditions and enables customers to set rules to dynamically route traffic to meet failover or dual vendor objectives.

- *Media Delivery Services.* Since the acquisition of Servecast in July 2007, we offer media delivery services to customers seeking to manage, protect and monetize content delivered over the internet. Media Delivery Services provide customers with means to ingest and digitize live video content and to manage the organization and presentation of both live and on demand video to end users via a content management system. Content may be secured to prevent unauthorized access, redistribution or syndication. Additionally, support for content monetization via paid and advertising supported models is provided. Media Delivery Services leverage our Content Delivery Network for the delivery of managed content to end users.
- *Fiber Optic and Satellite Video Transport Services.* We offer various products to provide audio and video feeds over fiber or satellite for broadcast and production customers. These products vary in capacity provided, frequency of use (that is, may be provided on an occasional or dedicated basis) and price. In 2004, Super Bowl® XXXVIII was the first live broadcast event ever carried using our new high definition (HD) transport product.
- *Advertising Distribution Services.* These services include Audio Distribution and Video Distribution. Our Audio Distribution services distribute radio spots to stations via electronic and physical distribution. Spots are distributed to over 10,500 stations in North America via the Internet using no proprietary hardware. Our Video Distribution services offer customers the capability to deliver video content electronically and physically to television stations, broadcast networks and cable networks across the United States.

On December 19, 2007, we announced that our wholly owned subsidiaries, WiTel Communications, LLC, Level 3 Communications, LLC and Vyvx, LLC, as the sellers, had entered into an Asset Purchase Agreement with DG FastChannel, Inc. Pursuant to the terms of the Purchase Agreement, the sellers will sell to DG FastChannel for cash certain assets relating to the Advertising Distribution Services business. Under the terms of the Purchase Agreement, we will receive \$129 million in cash upon the closing of the transaction. The purchase price is subject to certain post closing working capital adjustments. Consummation of the transaction is subject to customary closing conditions, including receipt of applicable federal regulatory approvals.

- *Switched Services.* We pioneered and developed the Softswitch—a distributed computer system that emulates the functions performed by traditional circuit switches—which enables us to control and process voice and data calls over an Internet Protocol network. We also offer several traditional circuit switch-based voice services. Our Switched Services include the following.
- *Level 3 VoIP Enhanced Local.* Level 3 VoIP Enhanced Local is a VoIP solution that enables broadband cable operators, IXCs, voice over IP providers, and other companies operating their own switching infrastructure to launch IP-based local and long-distance voice to residential and business customers via any broadband connection. With the purchase of Level 3 VoIP Enhanced Local service, a customer obtains the essential building blocks required to offer residential or business voice over IP phone service such as local phone numbers, local number portability, local and long distance calling, E-911, operator assistance, directory listings, and directory assistance.
- *Level 3 Local Inbound.* Level 3 Local Inbound service terminates traditional telephone network originated calls to Internet Protocol termination points. Customers, such as call centers, conferencing providers, and voice over IP service providers, can obtain telephone numbers from us or port-in local telephone numbers that the customer already controls. These local calls are then converted to IP and transported over our backbone to a customer's IP voice application at a customer-selected IP voice end point.

- *Level 3 E-911 Direct.* Level 3 E-911 Direct is a portfolio of E-911, or Enhanced 911, solutions, including a fixed-location solution with network connections to public safety answering points or PSAPs that serve approximately 70 percent of all U.S. households, and a solution for nomadic voice over IP providers that takes advantage of the same network connections as the fixed-location solution. Enhanced 911 service allows an emergency services operator to automatically receive information related to a 911 caller's registered address and callback phone number. A nomadic voice over IP provider is a company that permits its end user customer to use VoIP services from more than one location. Level 3 E-911 Direct provides the network capabilities that route and complete 911 calls to appropriate selective routers and PSAPs on the traditional telephone 911 network. When used with the services provided by a third party VoIP Positioning Center, or VPC, to collect, update and report subscriber location information, our Level 3 E-911 Direct service enables VoIP service providers to supply 911 services to their subscribers.
- *Level 3 One Plus.* Level 3 One Plus service provides non-facilities-based resellers, or carriers with regional networks, the ability to originate PSTN calls from anywhere in the continental US. Level 3 then terminates the domestic, international and Operator Services calls over our nationwide network, or customers may choose to have calls handed back to them over a dedicated facility. This service suite features Automatic Number Identification (ANI)-based and Carrier Identification Code (CIC)-based services as well as a dedicated end-user service.
- *Level 3 Enterprise Local and Long Distance Voice Services.* Level 3 Enterprise Local Voice Services provide PSTN connectivity for customer telephone equipment; telephone numbers, which include associated directory listings; standard services, which include operator services, directory assistance, and 911 services; and long-distance access, which provides equal access to all long-distance carriers, including Level 3. Level 3 Enterprise Long Distance services offer intrastate and interstate voice service at simple, cost-effective rates as well as access to over 290 international locations.
- *Level 3 Enterprise Toll-Free Services.* Level 3 Enterprise Toll-Free Services offer customers the ability to receive and pay for inbound calls, rather than those calls being paid for by the call originator. Additionally, a number of routing and call information features are available.
- *Level 3 Voice Termination.* Level 3 Voice Termination consists of long distance transport and termination services, offered over circuit switch or Softswitch technologies. These services are offered primarily to inter-exchange carriers, or IXC's, wireless providers, local phone companies, cable companies and voice over IP providers. We also offer the termination of international voice traffic over circuit switch or Softswitch technologies. Customers for these services include local phone companies, wireless providers, cable companies and voice over IP providers.
- *Level 3 Toll Free.* Level 3 Toll Free consists of services that terminate toll free calls that are originated or placed on the traditional telephone network. These toll free calls are carried over either a circuit switch or Softswitch network and delivered to customers in Internet Protocol or traditional TDM format. Customers for these services include call centers, conferencing providers, and voice over IP providers.
- *Level 3 Managed Modem.* Level 3 Managed Modem is an outsourced, turn-key infrastructure solution for the management of dial up access to the public Internet. ISPs comprise a majority of the customer base for Level 3 Managed Modem and are provided a fully managed dial up network infrastructure. As part of this service, Level 3 arranges for the provision of local network coverage, dedicated local telephone numbers, racks and modems as well as dedicated connectivity from the customer's location to the Level 3 Gateway facility.

For a discussion of certain geographic information regarding our revenue from external customers and long-lived assets, please see the notes to our Consolidated Financial Statements appearing elsewhere in this Form 10-K. For a discussion of our communications revenue, please also see Management's Discussion and Analysis of Financial Condition and Results of Operations appearing later in this Form 10-K. Our management continues to review our existing lines of business and service offerings to determine how those lines of business and service offerings assist with our focus on the delivery of communications services and meeting our financial objectives. This exercise takes place both with respect to integration activities and in the ordinary course of our business. To the extent that certain lines of business or service offerings are not considered to be compatible with the delivery of communications or with obtaining our financial objectives, we may exit those lines of business or stop offering those services.

### **Our communications network**

Our network is an advanced, international, facilities based communications network. Today, we primarily provide services over our own facilities. At December 31, 2007, our network encompasses:

- approximately 67,000 intercity route miles in North America, which we expect to reduce to approximately 38,000 intercity route miles after we complete the integration of acquired companies;
- approximately 125 markets having metropolitan fiber networks containing approximately 27,000 route miles in the United States and Europe, connecting approximately 7,300 traffic aggregation points and buildings in the aggregate;
- local networks in approximately 116 North American markets;
- an intercity network covering approximately 10,000 miles across Europe;
- local networks in approximately 9 European markets;
- approximately 6.9 million square feet of Gateway and transmission facilities in North America and Europe; and
- a 1.28 Tbps capable transatlantic cable system currently equipped at 640 Gbps.

*Intercity Networks.* Our approximately 67,000 mile fiber optic intercity network in North America, which we expect will be approximately 38,000 miles after we complete our integration of acquired companies, consists of the following:

- Multiple conduits. In approximately 30,000 miles of our intercity network, we have installed groups of multiple conduits. We believe that the availability of spare conduit will allow us to deploy future technological innovations in optical networking components as well as providing us with the flexibility to offer conduit to other entities.
- Initial installation of optical fiber strands designed to accommodate dense wave division multiplexing transmission technology. In addition, we believe that the installation of newer optical fibers will allow a combination of greater wavelengths of light per strand, higher transmission speeds and longer physical spacing between network electronics. We also believe that each new generation of optical fiber will allow increases in the performance of these network design aspects and will therefore enable lower unit costs.
- High speed Intercity Dense Wave Division Multiplexing, or DWDM, equipment providing high quality, reliable and cost effective transmission across our fiber backbone. We are continually evaluating advancements in technology that will enable us to scale, lower our cost and provide higher speed services over our intercity network. We believe that the market will continue to move toward Ethernet based services and higher speed interfaces. Through our technology

evaluations we believe that we have positioned ourselves to be able to deliver these capabilities for both our own IP network needs as well as those of our customers.

- A design that maximizes the use of open, non-proprietary hardware and software interfaces to allow less costly upgrades as hardware and software technology improves.

During the first quarter of 2001, we completed our construction activities relating to our North American intercity network. Also during 2001, we completed the migration of customer traffic from our original leased capacity network to our completed North America intercity network. Deployment of the North American intercity network was accomplished through simultaneous construction efforts in multiple locations, with different portions being completed at different times. In 2003, we added approximately 2,985 miles to our North America intercity network as part of the Genuity transaction, and in 2005, we added approximately 30,000 miles (including IRUs) to our intercity network as part of the WilTel Communications transaction. In 2006 and January 2007, we added approximately 26,000 miles (including IRUs) to our North America intercity network as part of the various acquisitions during that period.

In Europe, we have completed construction of our fiber optic intercity network with characteristics similar to those of the North American intercity network in a multiple ring architecture. During 2000, we completed the construction of Ring 1 and Ring 2 of our European network. Ring 1, which is approximately 1,900 miles, connects the major European cities of Paris, Frankfurt, Amsterdam, Brussels and London and was operational at December 31, 2000. Ring 2, which is approximately 1,650 miles, connects the major German cities of Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg, and Munich. Ring 2 became operational during the first quarter of 2001. Subsequently, we created two additional rings generally through IRU acquisitions to connect to our expanded operations in Europe that are described below. The first ring is approximately 2,150 miles and connects Copenhagen, Stockholm and Oslo and the second ring is approximately 1,700 miles and connects Milan, Zurich and Geneva.

During 2002, we completed an expansion of our European operations to seven additional cities. Our expansion to these additional locations was facilitated through the acquisition of available capacity from other carriers in the region. During 2003, we completed an expansion of our European operations to four additional cities. In addition, during 2004, we completed an expansion of our European operations to two cities. During 2005, we completed an expansion of our European operations to one city. During 2006, we obtained dark fiber primarily in those cities currently served by leased wavelength capacity and additionally in 2006 we completed an expansion of our European operations to 9 additional cities. During 2007, we obtained dark fiber in three cities that had been served by leased wavelength capacity and additionally in 2007 we completed an expansion of our European operations to 9 additional cities. In 2008, we expect to continue our European expansion to one additional city using leased wavelength capacity. We expect to use the dark fiber with appropriate transmission equipment to sell a full suite of transport and IP services.

Our European network is linked to our North American intercity network by the Level 3 transatlantic 1.28 Tbps capable cable system, which was also completed and placed into service during 2000. The transatlantic cable system—which we refer to as the Yellow system—has a current capacity of 640 Gbps and was upgradeable to 1.28 Tbps when brought into service. The deployment of the Yellow system was completed pursuant to a co-build agreement announced in February 2000, whereby Global Crossing Ltd. participated in the construction of, and obtained a 50% ownership interest in, the Yellow system. Under the co-build agreement, Level 3 and Global Crossing Ltd. each now separately own and operate two of the four fiber pairs on the Yellow system. We also acquired additional capacity on Global Crossing Ltd.'s transatlantic cable, Atlantic Crossing 1, during 2000 to serve as redundant capacity for our fiber pairs on the Yellow system. We also own capacity in the TAT14 cable system. In connection with the WilTel acquisition, we have secured additional capacity on Global Crossing's transatlantic cable, Atlantic Crossing 1, and TAT-14. In 2006, we purchased 300 Gigabits of transatlantic

capacity with the right to purchase 300 Gigabits of additional capacity from Apollo Submarine Cable System Ltd. In January 2007 we purchased 150 Gigabits of the additional capacity available from Apollo Submarine Cable System Ltd, 300 Gigabits in May 2007 and an additional 100 Gigabits in November 2007. We are also an owner on the Japan-US, and China-US cable systems, an IRU holder on Southern Cross cable system as well as an owner on the Americas II cable and an IRU holder on the Arcos system.

*Local Market Infrastructure.* Our local facilities include fiber optic metropolitan networks connecting our intercity network and Gateways to buildings housing communications-intensive end users and traffic aggregation points—including ILEC and CLEC central offices, long distance carrier points-of-presence or POPs, cable head-ends, wireless providers' facilities and Internet peering and transit facilities. As of December 31, 2007, we had in the aggregate approximately 7,300 traffic aggregation points and buildings connected to our metropolitan networks. Our high fiber count metropolitan networks allow us to extend our services directly to our customers' locations at low costs, because the availability of this network infrastructure does not require extensive multiplexing equipment to reach a customer location, which is required in ordinary fiber constrained metropolitan networks.

We had secured approximately 6.9 million square feet of space for our Gateway and transmission facilities as of December 31, 2007, and had completed the buildout of approximately 4.6 million square feet of this space. Our initial Gateway facilities were designed to house local sales staff, operational staff, our transmission and Internet Protocol routing and Softswitch facilities and technical space to accommodate colocation services—that is, the colocation of equipment by high-volume Level 3 customers, in an environmentally controlled, secure site with direct access to Level 3's network generally through dual, fault tolerant connections. Some of our facilities are larger than our initial facilities and were designed to include a smaller percentage of total square feet for our transmission and Internet Protocol routing/Softswitch facilities and a larger percentage of total square feet to support the sale of colocation services. Availability of these services varies by location.

As of December 31, 2007, we had operational, facilities-based, local metropolitan networks in 116 U.S. markets and 9 European markets.

As of December 31, 2007, we had approximately 145 markets in service in North America and approximately 42 markets in service in Europe.

## **Our Patent Portfolio**

Through acquisitions and through our own research and development, we have created an extensive patent portfolio, consisting of approximately 880 patents and patent applications filed in the United States and around the world. Our patent portfolio includes patents filed in each of the last three decades covering technologies ranging from data and voice services to content distribution to transmission and networking equipment. Most of our issued patents are not scheduled to expire for more than ten years.

In addition to the patents and patent applications we own, we have received licenses to patents held by others, including through a recently-announced cross-license with IBM, giving us access to that company's more than 40,000 patents covering many technologies relevant to our business. While patents give us the right to prevent others, particularly competitors, from using our proprietary technologies, patent licenses give us the freedom to operate our business without the risk of interruption from the holder of the patent that has been licensed to us.

We have used our patent portfolio in a number of ways. First, developing or acquiring technologies and receiving the legal right to preclude others from using them may give us a competitive advantage. By way of example, at the end of 2007, we initiated a lawsuit against competitor Limelight Networks, Inc., alleging that that company infringes three of our patents relating to the distribution of content. That lawsuit is expected to go to trial before the end of 2008 and, if successful, could result in a court order prohibiting Limelight from using our patented technology in relevant service offerings. Second, the breadth and depth of our patent portfolio may deter others, particularly telecommunications operators, from bringing patent infringement claims against us for fear of counter-claim by us. There have been relatively few patent infringements brought against us to date. Most of those have been initiated by patent-holding companies who do not operate telecommunications businesses and who are less likely to be subject to a counter-claim of infringement by us. Finally, the extensiveness of our patent portfolio allows us to cross-license with others having similarly broad portfolios on terms acceptable to us, mitigating the risk that others will be able to assert patent infringement claims against us.

We will continue to file new patent applications as we enhance and develop products and services, we will continue to seek opportunities to expand our patent portfolio through strategic acquisitions and licensing, and we will continue to enforce our patents against infringement by others.

## **Our Content Delivery Network**

Content Delivery Network, or CDN, describes a system of computers networked together across the Internet to provide content to users in the most efficient manner to enable an optimal user experience. In a CDN, nodes or groups of computers are deployed in multiple locations closer to the end user, also known as the "edge of the network" and cooperate with each other to satisfy requests for content by end users, transparently moving content behind the scenes to optimize the delivery process. Requests for content are directed intelligently through sophisticated software applications to nodes that provide optimal performance for end users.

Our content delivery network is a unique configuration of our hosting and network assets located in approximately 17 countries, which is designed to improve the performance, reliability, and reach of web applications.

We believe that as a result of the combination of our CDN assets and our other network infrastructure, we are strongly positioned to grow our market share in the CDN business. This belief is based on several factors.

- *Network Scale.* Because we own our own network, our ability to increase capacity to meet the needs of content providers is greater than other CDN providers who do not have the flexibility to quickly increase their available network capacity.
- *Network Reach.* Our customers reach global Internet destinations using an average number of "hops" that are fewer than with most any other provider, enabling our customers to easily reach their audiences and provide better performance. The fewer number of hops required by our customers to reach their Internet destinations serves to reduce latency and jitter.
- *Low Cost Position.* Because we own the underlying network infrastructure, we believe that we are positioned to offer cost advantages to our customers. By moving content at scale, our customers can take advantage of lower unit costs for bandwidth, colocation, servers and disk space.

## *CDN Applications*

There are an increasing number of applications for CDN, across many types of customers, particularly Internet-centric businesses and businesses that desire to accommodate increasingly larger

file sizes for transmission over the Internet. The media and entertainment industries use CDN services to provide on-demand streaming and live streaming. Social Networking businesses require CDN to provide their customers with fast reliable music and video downloads. Likewise, through the use of CDN, software companies are able to provide software downloads for their customers. Online retailers and advertisers use CDN services to provide images and flash files and to download advertisements. Online gaming companies provide for game downloads, applications updates and delivery of demos and trailers through CDN.

### *Content Distribution Services Architecture*

The CDN platform uses our existing physical network and infrastructure, and is composed of the Edge server or computer, which provides caching and streaming functions and the Global server, which provides load balancing—that is, a computer that directs the traffic to the most efficient server to meet the end users request. The Edge server enables the storage of popular content in a location that is closer to the end user and thereby reduces bandwidth requirements and improves client response times for content stored in the cache. The Global server or computer load balancing components of the CDN directs end user requests to the content source that is best able to serve the request of the particular end user, such as routing to the service noted that is closest to the end user or to the one with enough capacity to service the request of the end user.

We also transmit audio and video programming for our customers over our fiber-optic network and via satellite. We use our network to carry many live traditional broadcast and cable television events from the site of the event to the network control centers of the broadcasters of the event. These events include live sporting events of the major professional sports leagues. For live events where the location is not known in advance, such as breaking news stories in remote locations, we provide an integrated satellite and fiber-optic network based service to transmit the content to our customers. Most of our customers for these services contract for the service on an event-by-event basis; however, we have some customers who have purchased a dedicated point-to-point service, which enables these customers to transmit programming at any time.

We also distribute advertising spots to radio and television stations throughout the United States, both electronically and in physical form. Customers for these services can utilize a network-based method for aggregating, managing, storing and distributing content for content owners and rights holders. On December 19, 2007, we announced that our wholly owned subsidiaries, WilTel Communications, LLC, Level 3 Communications, LLC and Vyvx, LLC, as the sellers, had entered into an Asset Purchase Agreement with DG FastChannel, Inc. Pursuant to the terms of the Purchase Agreement, the sellers will sell to DG FastChannel for cash certain assets relating to the Advertising Distribution Services business. Under the terms of the Purchase Agreement, we will receive \$129 million in cash upon the closing of the transaction. The purchase price is subject to certain post closing working capital adjustments. Consummation of the transaction is subject to customary closing conditions, including receipt of applicable federal regulatory approvals.

### **Distribution Strategy**

Our communications services sales strategy with respect to our Wholesale Markets Group and Europe is to utilize a direct sales force focused on companies with high bandwidth and/or voice requirements. These businesses include incumbent local exchange carriers, established next generation carriers, international carriers also known as PTTs, major ISPs, broadband cable television operators, major interexchange carriers, wireless carriers, systems integrators, governments, emerging VoIP service providers, calling card providers, conferencing providers and call centers.

With respect to our Business Markets Group, medium to large enterprises will be serviced by a field based direct sales force. Smaller business opportunities are serviced by an inside sales force



generally selling pre-defined bundles of services. We also compliment our direct sales force with an indirect sales channel of agent partners.

Our communications services sales strategy with respect to the Content Markets Group is also to utilize a direct sales force. Targeted customers include video distribution companies; providers of online gaming and mega-portals; software service providers; social networking providers; and traditional media distribution companies including broadcasters, television networks and sports leagues.

We have in place policies and procedures to review the financial condition of potential and existing customers. We apply these procedures to determine whether collectability of services billed is probable prior to the time that we begin delivering services to a customer. If the financial condition of an existing customer deteriorates to a point where payment for services is in doubt, we will not recognize revenue attributable to that customer until we receive cash. Based on these policies and procedures, we believe our exposure to collection risk within the communications business and the possible effect on our financial statements is limited. We may also experience the effects of possible downturns in the economy and specifically the telecommunications industry; however, we believe the concentration of credit risk with respect to receivables is mitigated due to the dispersion of our customer base among geographic areas and remedies provided by terms of contracts and statutes.

For the year ended December 31, 2007, our top ten customers represented approximately 34% of our consolidated total revenue. Revenue from our largest customer, AT&T Inc. and its subsidiaries, including SBC Communications, BellSouth and Cingular, (assuming those subsidiaries were wholly owned by AT&T for all of 2007), represented approximately 15% of our consolidated total revenue for 2007. The next largest customer accounted for approximately 5% of our consolidated total revenue and the remaining top ten customers each account for 3% or less of our consolidated total revenue.

In connection with the acquisition of WilTel in December 2005, we acquired a large customer contract between WilTel and SBC Communications, a subsidiary of AT&T. We expect that the revenue generated under this contract will continue to decline over time as SBC Communications migrates its traffic from our network to the merged SBC and AT&T Communications network that SBC Communications acquired from the former AT&T.

## **Business Support Systems**

In order to pursue our sales and distribution strategies, we have developed and are continuing to develop and implement a set of integrated software applications designed to automate our operational processes. These development activities also relate to the integration of the systems that were used by the companies that we have acquired. Through the development of a robust, scalable business support system, we believe that we have the opportunity to develop a competitive advantage relative to traditional telecommunications companies. In addition, we recognize that for the success of certain of our services that some of our business support systems will need to be easily accessible and usable directly by our customers.

We are currently deploying a unified set of simplified processes and systems that are streamlining and synchronizing our service, sales, and operational functions through our "Unity" platform. Unity has been designed to provide improved capability in service catalog management, sales opportunity management, customer management, quoting, order entry, order workflow, physical and logical network inventory management, service management, and financial management.

Key design aspects of the business support system development program are:

- integrated modular applications to allow us to upgrade specific applications as new services are available;

- a scalable architecture that allows our customers and distributors direct access to certain functions that would otherwise have to be performed by our employees;
- phased completion of software releases designed to allow us to test functionality on an incremental basis;
- "web-enabled" applications so that on-line access to order entry, network operations, billing, and customer care functions is available to all authorized users, including our customers;
- use of a tiered, client/server architecture that is designed to separate data and applications, and is expected to enable continued improvement of software functionality at minimum cost; and
- use of pre-developed or commercial "off-the-shelf" applications, where applicable, which will interface to our internally developed applications.

## **Our Employees**

As of December 31, 2007, we had approximately 6,680 employees. We believe that our success depends in large part on our ability to attract and retain substantial numbers of qualified employees.

## **Competition**

The communications industry is highly competitive. A number of factors in recent years have increased the number of competitors in the market. First, the Telecommunications Act of 1996 created opportunities for non-incumbent providers to enter the marketplace. Second, the capital markets responded by making funding more available to new and existing competitors. Third, enthusiasm over the opportunities created by the rapid developments of the Internet led investors and market participants in general to overestimate the rate at which demand for communications services would grow. Finally, the emergence of new IP-based services has created prospects for new entrants with non-traditional business models to compete with legacy providers.

We believe that a confluence of these factors created an unsustainable level of competition in the market. We believe that this was evidenced by both the number of competitors vying for similar business and by the amount of inventory or capacity each brought to the market for many services. The result of these actions was an oversupply of capacity and an intensely competitive environment.

While we believe the current industry structure has improved significantly, we believe that further restructuring is likely. With the growth of communications demand, excess capacity is increasingly being absorbed. Similarly, some form of industry consolidation will continue to occur based on underlying economics. Given the large ongoing fixed costs associated with operating a backbone network, we believe that the natural industry structure will continue to evolve to a more limited number of competitors with each having high traffic scale across their networks.

While we believe that the long-run industry structure will evolve toward that described above, uncertainty surrounds how the existing competitive landscape will evolve toward this new structure. For example, while a number of next-generation and incumbent providers have been consolidated, we believe there are still a number of competitors operating fundamentally poor business models, are resource constrained, and are unlikely to be long-term survivors in their current forms. In addition, the ultimate effect of the completed acquisition transactions by AT&T and Verizon is yet to be known.

We believe that each competitor's long-run success in the market will be driven by its available resources (for example, financial, personnel, marketing, customers) and the effectiveness of its business model (for example, service focus and mix, cost effectiveness, ability to adapt to new technologies, channel effectiveness). We recognize that many of our existing and potential competitors in the communications industry have resources significantly greater than ours.

Our primary competitors are long distance carriers, incumbent local exchange carriers, competitive local exchange carriers, PTTs, Content Delivery Network companies, and other companies that provide communications services. The following information identifies key competitors for each of our product offerings.

Our key competitors for our voice service offerings are other providers of wholesale communications services including AT&T, Verizon, Sprint and competitive local exchange carriers. Our key competitors for managed modem services are other providers of dial up Internet access including Verizon and Qwest Communications.

For our IP and Data services, we compete with companies that include Verizon, Sprint, AT&T, Qwest Communications, Global Crossing, Cogent and XO in North America, and Sprint, Verizon, France Telecom, Deutsche Telecom, Global Crossing and Cogent in Europe.

For transport services, our key competitors in the United States are other facilities based communications companies including AT&T, Verizon, Sprint, Qwest Communications and XO. In Europe, our key competitors are other carriers such as PTTs, Telia International, Colt Telecom Group plc, Verizon, and Global Crossing.

Our key competitors for our colocation services are other facilities based communications companies, and other colocation providers such as web hosting companies and third party colocation companies. In the United States, these companies include AT&T, Savvis, Equinix, Switch & Data and Qwest Communications. In Europe, competitors include Global Switch, InterXion, Redbus, Telecity and Telehouse Europe.

For enterprise services, our key competitors include incumbent local exchange carriers (such as AT&T, Verizon and Qwest), long distance services providers (such as Sprint), and competitive local exchange carriers (such as Time Warner Telecom and XO).

For content distribution network or CDN services, our key competitors include Akamai Technologies and Limelight Networks.

The communications industry is subject to rapid and significant changes in technology. For instance, recent technological advances permit substantial increases in transmission capacity of both new and existing fiber, and the introduction of new products or emergence of new technologies may reduce the cost or increase the supply of certain services similar to those which we plan on providing. Accordingly, in the future our most significant competitors may be new entrants to the communications industry, which—unlike the traditional incumbent carriers we also compete with—are not burdened by an installed base of outmoded or legacy equipment.

## **Regulation**

### *Federal Regulation*

The Federal Communications Commission or the FCC has jurisdiction over interstate and international communications services, among other things. The FCC's regulation of common carriers without market power, such as us, is less stringent than its regulation of dominant incumbent local exchange carriers. We have obtained FCC approval to land our transatlantic cable in the United States. We have obtained FCC authorization to provide international services on a facilities and resale basis. Under the Telecommunications Act of 1996 (the "1996 Act"), any entity, including cable television companies, electric and gas utilities, may enter any telecommunications market, subject to reasonable state regulation of safety, quality and consumer protection.

The FCC has pending a Notice of Proposed Rulemaking ("NPRM") to initiate a comprehensive review of rules governing the pricing of special access service offered by ILECs subject to price cap regulation. Special access pricing by these carriers currently is subject to price cap rules, as well as

pricing flexibility rules which permit these carriers to offer volume and term discounts and contract tariffs (Phase I pricing flexibility) and/or remove from price caps regulation special access service in a defined geographic area (Phase II pricing flexibility) based on showings of competition. In the NPRM the FCC tentatively concludes to continue to permit pricing flexibility where competitive market forces are sufficient to constrain special access prices, but undertakes an examination of whether the current triggers for pricing flexibility accurately assess competition and have worked as intended. The NPRM also asks for comment on whether certain aspects of ILEC special access tariff offerings (e.g., basing discounts on previous volumes of service; tying nonrecurring charges and termination penalties to term commitments; and imposing use restrictions in connection with discounts), are unreasonable. At this time, we cannot predict the impact, if any, that a ruling on the NPRM will have on our network cost structure.

Both AT&T and Verizon, in connection with large acquisitions, have agreed to abide by certain conditions that are enforceable by the FCC in connection with special access prices, terms and conditions. In December 2007, we filed a complaint against AT&T alleging, among other things, that AT&T had violated those commitments. At this stage, the proceeding is continuing and we intend to vigorously pursue our claims. We cannot at this time predict the outcome of that proceeding.

As of August 1, 2001, our tariffs for interstate end user services were eliminated and our tariffs for international interexchange services were eliminated on January 28, 2002. Our rates must still be just and reasonable and nondiscriminatory. Our state tariffs remain in place. We have historically relied primarily on our sales force and marketing activities to provide information to our customers regarding these matters and expect to continue to do so. Further, in accordance with the FCC's orders we maintain a schedule of our rates, terms and conditions for our domestic and international private line services on our web site.

*Intercarrier compensation.* Telecommunications carriers compensate one another for traffic carried on each other's networks. Interexchange carriers pay access charges to local telephone companies for long distance calls that originate and terminate on local networks. Local telephone companies typically charge one another for local and Internet-bound traffic terminating on each other's networks. The entire methodology by which carriers compensate one another for exchanged traffic, whether it be for local, intrastate or interstate traffic, is under review at the FCC.

Apart from this comprehensive review of intercarrier compensation, individual compensation issues have been the subject of FCC and state commission rulings. Since 1997 the issue of compensation to be paid for calls dialed to Internet service providers or ISPs has been heavily litigated. Since 2004, the issue of compensation to be paid in connection with the exchange of Voice over Internet Protocol or VoIP calls has been also been the subject of much debate.

While the FCC has released a number of orders asserting its jurisdiction over intercarrier compensation for ISP traffic, states such as California and Massachusetts have increasingly assumed the role of determining the compensation obligations as between the carrier serving the customer dialing the ISP and the carrier serving the ISP. RBOCs and other incumbent local exchange carriers typically assert that either they owe no compensation to the carrier serving the ISP or alternatively that they are owed compensation by such carrier.

There is also uncertainty in respect to intercarrier compensation for VoIP traffic. As in the ISP intercarrier compensation situation, the FCC has issued a number of rulings asserting its jurisdiction over such traffic, but to date it has not issued any rulings on the scope and rate of intercarrier compensation to be paid by carriers exchanging VoIP traffic. While carriers that serve VoIP providers such as Level 3 have typically asserted that VoIP traffic is local in nature and thereby subject to local compensation rates, the RBOCs and other incumbents have taken the position that some or all of this traffic should be subject to higher intrastate or interstate rates. Currently the FCC has two forbearance petitions before it requesting that the FCC either forbear from subjecting VoIP to the higher interstate

or intrastate rates, or alternatively to forbear from imposing rules that might be construed to require the payment of access charges on VoIP traffic terminated to the PSTN.

Until such time as the FCC acts in such a way as to either clarify its rulings on ISP compensation, VoIP compensation or rules on intercarrier compensation in its entirety, and such rules are final and non-appealable, the scope of intercarrier compensation obligations between carriers exchanging ISP or VoIP traffic is uncertain.

Prior to 2004, we entered into agreements providing for payment of compensation for terminating ISP-bound traffic with Verizon, in its former Bell Atlantic operating territory, with SBC Corporation for the 13-state operating territory that includes its affiliates Pacific Bell, Southwestern Bell, Ameritech and Southern New England Telephone, and with BellSouth in its nine-state operating territory. We also entered into interconnection agreements with Qwest, Cincinnati Bell Telephone, and Sprint that reflect the intercarrier compensation rates adopted by the FCC in its ISP Remand Order.

In late 2003, we reached an agreement with SBC, now AT&T, continuing payment for the exchange of ISP-bound traffic. In February 2005, we and SBC agreed to successor interconnection agreements which cover the payment for the exchange of ISP traffic and treating VoIP traffic as subject to dispute. The SBC agreement expired on December 31, 2006. Level 3 and SBC continue to provide services and exchange payments under that agreement until a successor agreement is reached.

In May 2004, we reached a new interconnection agreement with Bell South, now AT&T, that incorporated terms contained in FCC orders relating to ISP-bound traffic. Level 3 and BellSouth agreed that compensation for VoIP traffic was disputed. BellSouth requested renegotiation of this agreement in early October 2006; the parties continue to provide services and exchange payments under the agreement until a successor agreement is reached.

As a result of representations regarding the extension of interconnection agreements made by AT&T to the FCC in connection with its merger with BellSouth, we have requested that AT&T extend the BellSouth and SBC (now AT&T) interconnection agreements for a three-year period with an effective termination date of January 10, 2011. We are awaiting a response from AT&T.

In September 2004, Level 3 and Verizon amended our existing interconnection agreements to establish intercarrier compensation terms. The compensation section of amendments to those agreements expired in August 2007. Level 3 and Verizon will continue to provide services under these agreements until successor agreements are executed.

We are negotiating new agreements with each of these carriers but at this time cannot predict what the final terms will be, including compensation for ISP-bound traffic or VoIP traffic. Given the general uncertainty surrounding the effect of the FCC and state decisions and appeals, we may have to change (1) how we treat the compensation we receive for terminating calls bound for ISPs if the agreements under which compensation is paid provided for the incorporation of changes in FCC rules and regulations; (2) the manner in which we account for the compensation and costs of intercarrier compensation for VOIP.

*Universal Service.* Level 3 is subject to federal and state regulations that implement universal service support for access to communications services in rural, high-cost and low-income markets at reasonable rates; and access to advanced communications services by schools, libraries and rural health care providers. Currently, the FCC assesses Level 3 a percentage of interstate revenue it receives from retail customers as its contribution to the federal Universal Service Fund. The FCC is currently considering changing the method by which our contributions are assessed to a flat-fee charge, such as a per-line or per-number charge. Any change in the assessment methodology may affect Level 3's revenues but at this time, it is not possible to predict the extent we would be affected if at all.

## *State Regulation*

The 1996 Act is intended to increase competition in the telecommunications industry, especially in the local exchange market. With respect to local services, ILECs are required to allow interconnection to their networks and to provide unbundled access to network facilities, as well as a number of other pro-competitive measures. Because the implementation of the 1996 Act is subject to numerous state rulemaking proceedings on these issues, it is currently difficult to predict how quickly full competition for local services will be realized.

State regulatory agencies have jurisdiction when our facilities and services are used to provide intrastate telecommunications services. A portion of our traffic may be classified as intrastate telecommunications and therefore subject to state regulation. We expect that we will offer more intrastate telecommunications services (including intrastate switched services) as our business and product lines expand. To provide intrastate services, we generally must obtain a certificate of public convenience and necessity from the state regulatory agency and comply with state requirements for telecommunications utilities, including state tariffing requirements. We currently are authorized to provide telecommunications services in all fifty states and the District of Columbia. In addition, we will be required to obtain and maintain interconnection agreements with ILECs where we wish to provide service. We expect that we should be able to negotiate or otherwise obtain renewals or successor agreements through adoption of others' contracts or arbitration proceedings, although the rates, terms, and conditions applicable to interconnection and the exchange of traffic with certain ILECs could change significantly in certain cases. The degree to which the rates, terms, and conditions may change will depend not only upon the negotiation and arbitration process and availability of other interconnection agreements, but will also depend in significant part upon state commission proceedings that either uphold or modify the current regimes governing interconnection and the exchange of certain kinds of traffic between carriers. In May 2004, we reached agreement on new interconnection agreements with BellSouth in all nine of the BellSouth states. In September 2004, we reached new interconnection agreements with Verizon, and with SBC in February 2005.

States also often require prior approvals or notifications for certain transfers of assets, customers or ownership of certificated carriers and for issuances by certified carriers of equity or debt.

## *Local Regulation*

Our networks are subject to numerous local regulations such as building codes and licensing. Such regulations vary on a city-by-city, county-by-county and state-by-state basis. To install our own fiber optic transmission facilities, we need to obtain rights-of-way over privately and publicly owned land. Rights-of-way that are not already secured may not be available to us on economically reasonable or advantageous terms.

## *Regulation of Voice over Internet Protocol (VoIP)*

### *Federal and State*

Due to the growing acceptance and deployment of VoIP services, the FCC and state public utility commissions are conducting regulatory proceedings that could affect the regulatory duties and rights of entities such as us or our affiliates that provide IP-based voice applications. There is regulatory uncertainty as to the imposition of access charges and other taxes, fees and surcharges on VoIP services that use the public switched telephone network. There is regulatory uncertainty as to the imposition of traditional retail, common carrier regulation on VoIP products and services.

The rules respecting the payments made by carriers for the exchange of VoIP traffic have been subject to much debate. The FCC has not clarified whether VoIP traffic is to be subjected to the access charges regime that is applicable to traditional telecom service, or whether VoIP traffic is to be treated as an "information service" or "enhanced" and not subject to access charges. There are a number of

petitions and proceedings pending before the FCC where this issue could be resolved. At this time, it is difficult to predict the outcome of any of these proceedings or the timing for their eventual resolution. As a result, we cannot predict the effect that any such rulings could have on our provision of VoIP services.

The FCC has classified VoIP services as "interstate" services subject to FCC regulations, and has stated that states have limited authority to regulate the offering of VoIP services. On September 22, 2003, Vonage Holdings Corporation ("Vonage") filed a petition with the FCC requesting a declaration that its offerings, which originate on a broadband network in IP format and terminate on the PSTN, are interstate information services not subject to state regulation under the 1996 Act and existing FCC rules. On November 10, 2004, the FCC adopted an order (which was subsequently upheld on appeal) ruling that Vonage's service was an interstate service not subject to state regulation.

On June 3, 2005, the FCC issued an order (which was subsequently upheld on appeal) requiring all interconnected VoIP providers to deliver enhanced 911 capabilities to their subscribers by no later than November 28, 2005. We have modified our service offerings to VoIP providers in order to assist them in complying with the FCC mandate.

In 2007, the FCC imposed some regulatory requirements on VoIP providers that had previously been applicable only to traditional telecommunications providers. Specifically, the FCC (a) imposed obligations on VoIP providers to contribute to the federal universal service fund, and (b) required VoIP carriers to comply with regulations relating to local number portability (including contributing to the costs of managing number portability requirements). In addition, a number of state public utility commissions are conducting regulatory proceedings that could impact our rights and obligations with respect to IP-based voice applications. Specifically, some states have taken the position that the "local" component of VoIP service is subject to traditional regulations applicable to local telecommunications services, such as the obligation to pay intrastate universal service fees.

We cannot predict the outcome of any of these petitions and regulatory proceedings or any similar petitions and regulatory proceedings pending before the FCC or state public utility commissions. Moreover, we cannot predict how their outcomes may affect our operations or whether the FCC or state public utility commissions will impose additional requirements, regulations or charges upon our provision of services related to IP communications.

#### *European Regulation*

Unlike the United States which has a fractured regulatory scheme with respect to VoIP services, the European Union has adopted a more systematic approach to the convergence of networks and VoIP regulation specifically. The European Commission will oversee the implementation by its member-states of six new directives developed to regulate electronic communications in a technology and platform neutral manner. Implementation of the directives has not been uniform across the Member States of the European Union and it is difficult to predict when they will be implemented at the national level. Even with harmonization, the national regulatory agencies will continue to be responsible for issuing general authorizations and specific licenses.

The European Union's approach to the regulation of VoIP turns on whether VoIP is voice telephony. The European Commission has defined voice telephony to have four elements: (1) commercial offering as voice telephony; (2) provision to the public; (3) provision to and from the public switched telephone network termination points; and (4) direct speech transport and switching of speech in real time, particularly at the same level of reliability and speech quality as provided by the PSTN. In its "Communication from the Commission, Consultation on Voice on the Internet" in June 2000, the European Commission directed that "Member States should continue to allow Internet access providers to offer voice over Internet protocol under data transmission general authorizations, and that specific licensing conditions are not justified."

The European Commission has subsequently redefined its definitions to suggest that some VoIP offerings are voice telephony. In its December 2000 communication, the European Commission noted that increasing quality and reliability as well as marketing of voice capabilities with bundled services, made certain kinds of "voice over Internet" much more like voice services. While the current European Commission directives do not mandate the treatment of VoIP as voice telephony, the commission will continue to reevaluate the regulation of VoIP as service quality becomes the equivalent of traditional voice telephony.

In February 2003, the European Union adopted a new regulatory framework for electronic communications that is designed to address in a technologically neutral manner the convergence of communications across telecommunications, computer and broadcasting networks. The directives address: (1) framework (2) interconnection and access, (3) authorization and licensing, (4) universal service and (5) privacy. These directives and an additional decision on radio spectrum replace the existing 20 directives on electronic communications. Under the framework, voice telephony providers will face additional obligations, including specific licensing and universal service obligations. Others will likely face new regulation. One example could be VoIP. If it is classified as an electronic communications service, rather than voice telephony, it would still be subject to additional regulations to achieve regulatory parity with other electronic communications.

The United Kingdom was one of the first countries to fully implement the European Union's new framework for electronic communications, which it did by July 25, 2003. At that time, certain provisions of the United Kingdom's Telecommunications Act of 1984 were repealed. Pursuant to that framework, the licensing regime was replaced with a general authorization. Our existing licenses were canceled and replaced with a general authorization.

Under the regime, the United Kingdom regulates VoIP as an electronic communication service. The degree of regulation imposed on the service depends upon whether the service is considered to be a Publicly Available Telephone Service (PATS). A service is considered to be a PATS if the following conditions are met: it is marketed as a substitute for the traditional telephone service; the service appears to the customer to be a substitute for the traditional public telephone service over which they expect access to emergency services; or the service provides the customers sole means of access to the traditional circuit switched public telephone network.

While the Ofcom, the United Kingdom regulator, has established technical standards and interconnection rights for VoIP service providers, it has recently opened a consultation to assess the appropriate allocation of phone numbers to VoIP providers. We cannot predict the result of this proceeding and how it will affect our ability to provide services.

As we expand the deployment of our VoIP applications in Europe, we will have to consider the appropriate regulatory requirements for each nation before deploying services.

#### *Canadian Regulation*

The Canadian Radio-television and Telecommunications Commission, or the CRTC, has jurisdiction to regulate long distance telecommunications services in Canada. Regulatory developments over the past several years have terminated the historic monopolies of the regional telephone companies, bringing significant competition to this industry for both domestic and international long distance services, but also lessening regulation of domestic long distance companies. Resellers, which, as well as facilities based carriers, now have interconnection rights, but which are not obligated to file tariffs, may not only provide transborder services to the U.S. by reselling the services provided by the regional companies and other entities but also may resell the services of the former monopoly international carrier, Teleglobe Canada or Teleglobe, including offering international switched services provisioned over leased lines. Although the CRTC formerly restricted the practice of "switched hubbing" over leased lines through intermediate countries to or from a third country, the CRTC lifted this restriction. The Teleglobe monopoly on international services and undersea cable landing rights



terminated as of October 1, 1998, although the provision of Canadian international transmission facilities based services remains restricted to "Canadian carriers" with majority ownership by Canadians. Ownership of non-international transmission facilities are limited to Canadian carriers but we can own international undersea cables landing in Canada. We cannot, under current law, enter the Canadian market as a provider of transmission facilities based domestic services. In 2003, two committees of the Canadian House of Commons issued conflicting recommendations on whether to lift the foreign ownership restrictions that prohibit carriers like us from owning intra-Canadian transmission facilities. If the ownership restrictions are repealed, we anticipate that we will be able to expand our operations and service offerings in Canada. Recent CRTC rulings address issues such as the framework for international contribution charges payable to the local exchange carriers to offset some of the capital and operating costs of the provision of switched local access services of the incumbent regional telephone companies, in their capacity as ILECs, and the new entrant CLECs.

While competition is permitted in virtually all other Canadian telecommunications market segments, we believe that the regional companies continue to retain a substantial majority of the local and calling card markets. Beginning in May 1997, the CRTC released a number of decisions opening to competition the Canadian local telecommunications services market, which decisions were made applicable in the territories of all of the regional telephone companies. As a result, networks operated by CLECs may now be interconnected with the networks of the ILECs. Transmission facilities based CLECs are subject to the same majority Canadian ownership "Canadian carrier" requirements as transmission facilities based long distance carriers. CLECs have the same status as ILECs, but they do not have universal service or customer tariff-filing obligations. CLECs are subject to certain consumer protection safeguards and other CRTC regulatory oversight requirements. CLECs must file interconnection tariffs for services to interexchange service providers and wireless service providers. Certain ILEC services must be provided to CLECs on an unbundled basis and subject to mandatory pricing, including central office codes, subscriber listings, and local loops in small urban and rural areas. For a five-year period, certain other important CLEC services must be provided on an unbundled basis at mandated prices, notably unbundled local loops in large, urban areas. ILECs, which, unlike CLECs, remained fully regulated, are subject to price cap regulation in respect of their utility services and these services must not be priced below cost. Interexchange contribution payments are now pooled and distributed among ILECs and CLECs according to a formula based on their respective proportions of residential lines, with no explicit contribution payable from local business exchange or directory revenue. CLECs must pay an annual telecommunications fee based on their proportion of total CLEC operating revenue. All bundled and unbundled local services (including residential lines and other bulk services) may now be resold, but ILECs need not provide these services to resellers at wholesale prices. Transmission facilities based local and long distance carriers (but not resellers) are entitled to colocate equipment in ILEC central offices pursuant to terms and conditions of tariffs and intercarrier agreements. Certain local competition issues are still to be resolved. The CRTC has ruled that resellers cannot be classified as CLECs, and thus are not entitled to CLEC interconnection terms and conditions. The CRTC conducted a proceeding in 2004 to review issues relating to the introduction of VoIP technology. The CRTC has expressed a number of preliminary views about how it proposes to regulate VoIP services including the view that VoIP services (and service providers) should be regulated according to the CRTC's existing rules. If the preliminary views are confirmed, then the rules for VoIP-based services will depend on the category of service provider (ie., ILEC, CLEC or reseller), the nature of the service and the geographic area in which the service is provided.

## **Our Other Business**

Our company was incorporated as Peter Kiewit Sons', Inc. in Delaware in 1941 to continue a construction business founded in Omaha, Nebraska in 1884. In subsequent years, we invested a portion of the cash flow generated by our construction activities in a variety of other businesses. We entered the coal mining business in 1943, the telecommunications business in 1988, the information services

business in 1990 and the alternative energy business in 1991. We have also made investments in several development-stage ventures.

In December 1997, our stockholders ratified the decision of the Board to effect the split-off separating our historical construction business from the remainder of our operations. As a result of the split-off, which was completed on March 31, 1998, we no longer own any interest in the prior construction business. In conjunction with the split-off, we changed our name to "Level 3 Communications, Inc.," and the entity that held the prior construction business changed its name to "Peter Kiewit Sons', Inc."

On November 30, 2005, we completed the sale of our ( i )Structure, LLC subsidiary to Infocrossing, Inc. Prior to the sale, ( i )Structure provided computer operations outsourcing to customers located primarily in the United States.

On September 7, 2006, we completed the sale of 100% of the capital stock of our indirect, wholly owned subsidiary, Software Spectrum, Inc., to Insight Enterprises, Inc. In connection with the transaction, we received total proceeds of approximately \$351 million in cash. Prior to the sale, Software Spectrum was a leading direct marketer of software and provider of software licensing services to corporations. With the completion of the sale of Software Spectrum, we exited the information services business.

### *Coal Mining*

We are engaged in coal mining through our subsidiary, KCP, Inc. or KCP. KCP has a 50% interest in two mines, which are operated by a subsidiary of Peter Kiewit Sons', Inc. or PKS. Decker Coal Company or Decker is a joint venture with Western Minerals, Inc., which is a subsidiary of Rio Tinto Energy America Inc. Black Butte Coal Company or Black Butte is a joint venture with Bitter Creek Coal Company, a subsidiary of Anadarko Petroleum Corporation. The Decker mine is located in southeastern Montana and the Black Butte mine is in southwestern Wyoming. The coal mines use the surface mining method.

The coal produced from the KCP mines is sold primarily to electric utilities, which burn coal to produce steam to generate electricity. Essentially all of the sales were made under long-term contracts. Approximately 36%, 37% and 44% of KCP's revenue in 2007, 2006 and 2005, respectively, were derived from long-term contracts with Commonwealth Edison Company (with Decker) and The Detroit Edison Company (with Decker). KCP has commitments to deliver approximately 9.0 million tons of coal through 2012 under contracts with Commonwealth Edison and Detroit Edison. KCP also has other sales commitments, including those with Sierra Pacific, Idaho Power, PacifiCorp, and Minnesota Power that provide for the delivery of approximately 6.8 million tons through 2011. Under a mine management agreement, KCP pays a subsidiary of PKS an annual fee equal to 30% of KCP's adjusted operating income. The fee for 2007 was approximately \$1 million.

The coal industry is highly competitive. KCP competes not only with other domestic and foreign coal suppliers, some of whom are larger and have greater capital resources than KCP, but also with alternative methods of generating electricity and alternative energy sources. In 2006, the most recent year for which information is available, KCP's production represented less than 1% of total U.S. coal production. Demand for KCP's coal is affected by economic, political and regulatory factors. For example, recent "clean air" laws may stimulate demand for low sulfur coal. KCP's western coal reserves generally have a low sulfur content (less than one percent) and are currently useful principally as fuel for coal-fired, steam-electric generating units.

KCP's sales of its coal, like sales by other western coal producers, typically provide for delivery to customers at the mine. A significant portion of the customer's delivered cost of coal is attributable to transportation costs. Most of the coal sold from KCP's western mines is currently shipped by rail to utilities outside Montana and Wyoming. The Decker and Black Butte mines are each served by a single

railroad. Many of their western coal competitors are served by two railroads and such competitors' customers often benefit from lower transportation costs because of competition between railroads for coal hauling business. Other western coal producers, particularly those in the Powder River Basin of Wyoming, have lower stripping ratios (that is, the amount of overburden that must be removed in proportion to the amount of minable coal) than the Black Butte and Decker mines, often resulting in lower comparative costs of production. As a result, KCP's production costs per ton of coal at the Black Butte and Decker mines can be as much as four and five times greater than production costs of certain competitors. Because of these cost disadvantages, there is no assurance that KCP will be able to enter into additional long-term coal purchase contracts for Black Butte and Decker production. In addition, these cost disadvantages may adversely affect KCP's ability to compete for sales in the future.

We are required to comply with various federal, state and local laws and regulations concerning protection of the environment. KCP's share of land reclamation expenses for the year ended December 31, 2007 was approximately \$7 million. KCP's share of accrued estimated reclamation costs was \$98 million at December 31, 2007. We did not make significant capital expenditures for environmental compliance with respect to the coal business in 2007. We believe our compliance with environmental protection and land restoration laws will not affect our competitive position since our competitors in the mining industry are similarly affected by such laws. However, failure to comply with environmental protection and land restoration laws, or actual reclamation costs in excess of our accruals, could have an adverse effect on our business, results of operations, and financial condition.

## Glossary of Terms

access	Telecommunications services that permit long distance carriers to use local exchange facilities to originate and/or terminate long distance service.
access charges	The fees paid by long distance carriers to LECs for originating and terminating long distance calls on the LECs' local networks.
backbone	A high-speed network that interconnects smaller, independent networks. It is the through- portion of a transmission network, as opposed to spurs which branch off the through- portions.
ATM (asynchronous transfer mode)	An information transfer standard that is one of a general class of packet technologies that relay traffic by way of an address contained within the first five bytes of a standard fifty-three byte long packet or cell. The ATM format can be used by many different information systems, including LANs, to deliver traffic at varying rates, permitting a mix of data, voice and video.
CAP	Competitive Access Provider. A company that provides its customers with an alternative to the local exchange company for local transport of private line and special access telecommunications services.
caching	A process by which a Web storage device or cache is located between Web servers (or origin servers) and a user, and watches requests for HTML pages and objects such as images, audio, and video, then saves a copy for itself. If there is another request for the same object, the cache will use its copy, instead of asking the origin server for it again.

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capacity	The information carrying ability of a telecommunications facility.
carrier	A provider of communications transmission services by fiber, wire or radio.
CDN	Content Distribution Network or CDN describes a system of computers networked together across the Internet that cooperate transparently to deliver various types of content to end users. The delivery process is optimized generally for either performance or cost. When optimizing for performance, locations that can serve content quickly to the user are chosen. When optimizing for cost, locations that are less expensive to serve from may be chosen instead.
central office	Telephone company facility where subscribers' lines are joined to switching equipment for connecting other subscribers to each other, locally and long distance.
CLEC	Competitive Local Exchange Carrier. A company that competes with LECs in the local services market.
co-carrier	A relationship between a CLEC and an ILEC that affords each

	company the same access to and right on the other's network and provides access and services on an equal basis.
common carrier	A government-defined group of private companies offering telecommunications services or facilities to the general public on a non-discriminatory basis.
conduit	A pipe, usually made of metal, ceramic or plastic, that protects buried cables.
DS-3	A data communications circuit capable of transmitting data at 45 Mbps.
dark fiber	Fiber optic strands that are not connected to transmission equipment.
dedicated lines	Telecommunications lines reserved for use by particular customers.
dialing parity	The ability of a competing local or toll service provider to provide telecommunications services in such a manner that customers have the ability to route automatically, without the use of any access code, their telecommunications to the service provider of the customers' designation.
equal access	The basis upon which customers of interexchange carriers are able to obtain access to their Primary Interexchange Carriers' (PIC) long distance telephone network by dialing "1", thus eliminating the need to dial additional digits and an authorization code to obtain such access.
facilities based carriers	Carriers that own and operate their own network and equipment.

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fiber optics	A technology in which light is used to transport information from one point to another. Fiber optic cables are thin filaments of glass through which light beams are transmitted over long distances carrying enormous amounts of data. Modulating light on thin strands of glass produces major benefits including high bandwidth, relatively low cost, low power consumption, small space needs and total insensitivity to electromagnetic interference.
Gbps	Gigabits per second. A transmission rate. One gigabit equals 1,024 billion bits of information.
ILEC	Incumbent Local Exchange Carrier. A company historically providing local telephone service. Often refers to one of the Regional Bell Operating Companies (RBOCs). Often referred to as "LEC" (Local Exchange Carrier).
Interconnection	Interconnection of facilities between or among the networks of carriers, including potential physical colocation of one carrier's equipment in the other carrier's premises to facilitate such interconnection.
InterLATA	Telecommunications services originating in a LATA and terminating outside of that LATA.
Internet	A global collection of interconnected computer networks which use a specific communications protocol.
IntraLATA	Telecommunications services originating and terminating in the same LATA.
ISDN	Integrated Services Digital Network. An information transfer standard for transmitting digital voice and data over telephone lines at speeds up to 128 Kbps.
ISPs	Internet Service Providers. Companies formed to provide access to the Internet to consumers and business customers via local networks.
IXC	Interexchange Carrier. A telecommunications company that provides telecommunications services between local exchanges on an interstate or intrastate basis.
Kbps	Kilobits per second. A transmission rate. One kilobit equals 1,024 bits of information.
LATA	Local Access and Transport Area. A geographic area composed of contiguous local exchanges, usually but not always within a single state. There are approximately 200 LATAs in the United

	States.
leased line	An amount of telecommunications capacity dedicated to a particular customer along predetermined routes.
LEC	Local Exchange Carrier. A telecommunications company that provides telecommunications services in a geographic area. LECs include both ILECs and CLECs.

local exchange	A geographic area determined by the appropriate state regulatory authority in which calls generally are transmitted without toll charges to the calling or called party.
local loop	A circuit that connects an end user to the LEC central office within a LATA.
long distance carriers	Long distance carriers provide services between local exchanges on an interstate or intrastate basis. A long distance carrier may offer services over its own or another carrier's facilities.
Mbps	Megabits per second. A transmission rate. One megabit equals 1.024 million bits of information.
MPLS	MultiProtocol Label Switching. A standards-approved technology for speeding up network traffic flow and making it easier to manage. MPLS involves setting up a specific path for a given sequence of packets, identified by a label put in each packet, thus saving the time needed for a router or switch to look up the address to the next node to forward the packet to.
multiplexing	An electronic or optical process that combines a large number of lower speed transmission lines into one high speed line by splitting the total available bandwidth into narrower bands (frequency division), or by allotting a common channel to several different transmitting devices, one at a time in sequence (time division).
NAP	Network Access Point. A location at which ISPs exchange traffic with each other.
OC-3	A data communications circuit capable of transmitting data at 155 bps.
OC-12	A data communications circuit capable of transmitting data at 622 Mbps.
OC-48	A data communications circuit capable of transmitting data at approximately 2.45 Gbps.
PBX	Private Branch eXchange. A PBX, sometimes known as a phone switch or phone switching device, is a device that connects office telephones in a business with the PSTN. The functions of a PBX include routing incoming calls to the appropriate extension in an office, sharing phone lines between extensions, automated greetings for callers using recorded messages, dialing menus, connections to voicemail, automatic call distribution and teleconferencing.

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peering	The commercial practice under which ISPs exchange traffic with each other. Although ISPs are free to make a private commercial arrangement, there are generally two types of peering. With a settlement free peering arrangement the ISPs do not need to pay each other for the exchange of traffic. With paid peering, the larger ISP receives payment from the smaller ISP to carry the traffic of that smaller ISP. Peering occurs at both public and private exchange points.
POP	Point of Presence. Telecommunications facility where a communications provider locates network equipment used to connect customers to its network backbone.
private line	A dedicated telecommunications connection between end user locations.
PSTN	Public Switched Telephone Network. That portion of a local exchange company's network available to all users generally on a shared basis (i.e., not dedicated to a particular user). Traffic along the public switched network is generally switched at the local exchange company's central offices.
Public Safety Answering Point	An answering location for 911 calls originating in a given area. PSAPs are typically a common bureau used to answer emergency calls and dispatch safety agencies such as police, fire, emergency medical, etc.
RBOCs	Regional Bell Operating Companies. Originally, the seven local telephone companies established as a result of the AT&T

	Divestiture.
reciprocal compensation	The compensation of a CLEC for termination of a local call by the ILEC on the CLEC's network, which is the same as the compensation that the CLEC pays the ILEC for termination of local calls on the ILEC's network.
resale	Resale by a provider of telecommunications services (such as a LEC) of such services to other providers or carriers on a wholesale or a retail basis.
router	Equipment placed between networks that relays data to those networks based upon a destination address contained in the data packets being routed.
selective router	Telephone switch or functional equivalent, controlled by the relevant local exchange carrier (LEC), which determines the PSAP to which a 911 call should be delivered based on the location of the 911 caller.
SONET	Synchronous Optical Network. An electronics and network architecture for variable bandwidth products which enables transmission of voice, data and video (multimedia) at very high speeds. SONET ring architecture provides for virtually instantaneous restoration of service in the event of a fiber cut or equipment failure by automatically rerouting traffic in the opposite direction around the ring.

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special access services	The lease of private, dedicated telecommunications lines or "circuits" along the network of a local exchange company or a CAP, which lines or circuits run to or from the long distance carrier POPs. Examples of special access services are telecommunications lines running between POPs of a single long distance carrier, from one long distance carrier POP to the POP of another long distance carrier or from an end user to a long distance carrier POP.
streaming	Streaming is the delivery of media, such as movies and live presentations, over a network in real time. A computer (a streaming server) sends the media to another computer (a client computer), which plays the media as it is delivered.
switch	A device that selects the paths or circuits to be used for transmission of information and establishes a connection. Switching is the process of interconnecting circuits to form a transmission path between users and it also captures information for billing purposes.
Tbps	Terabits per second. A transmission rate. One terabit equals 1.024 trillion bits of information.
T-1	A data communications circuit capable of transmitting data at 1.544 Mbps.
unbundled	Services, programs, software and training sold separately from the hardware.
unbundled access	Access to unbundled elements of a telecommunications services provider's network including network facilities, equipment, features, functions and capabilities, at any technically feasible point within such network.
VoIP	Voice over Internet Protocol
VPC	VoIP Positioning Center. An entity that maintains an end user location database and manages the technology including query keys and routing number pools used to deliver 911 calls to the correct PSAP for emergency handling.
web site	A server connected to the Internet from which Internet users can obtain information.
wireless	A communications system that operates without wires. Cellular service is an example.
world wide web or web	A collection of computer systems supporting a communications protocol that permits multimedia presentation of information over the Internet.
xDSL	A term referring to a variety of new Digital Subscriber Line

technologies. Some of these new varieties are asymmetric with different data rates in the downstream and upstream directions. Others are symmetric. Downstream speeds range from 384 Kbps (or "SDSL") to 1.5 to 8 Mbps ("ADSL").



## Directors and Executive Officers

Set forth below is information as of February 28, 2008, about our directors and our executive officers. Our executive officers have been determined in accordance with the rules of the SEC.

Name	Age	Position
Walter Scott, Jr.	76	Chairman of the Board
James Q. Crowe	58	Chief Executive Officer and Director
Kevin J. O'Hara	47	President and Chief Operating Officer
Charles C. Miller, III	55	Vice Chairman and Executive Vice President
Thomas C. Stortz	56	Executive Vice President, Chief Legal Officer and Secretary
Sunit S. Patel	46	Group Vice President and Chief Financial Officer
John Neil Hobbs	48	Executive Vice President Sales and Operations of Level 3 Communications, LLC
Brady Rafuse	44	President Content Markets Group of Level 3 Communications, LLC and President and CEO of Europe Operations
Eric J. Mortensen	49	Senior Vice President and Controller
Douglas C. Eby	48	Director
Admiral James O. Ellis, Jr.(3)	60	Director
Richard R. Jaros(2)	56	Director
Robert E. Julian(1)(2)	68	Director
Michael J. Mahoney	57	Director
Arun Netravali(2)	61	Director
John T. Reed(1)(3)	64	Director
Michael B. Yanne(3)	74	Director
Dr. Albert C. Yates(1)	66	Director

- (1) Member of Audit Committee
- (2) Member of Compensation Committee
- (3) Member of Nominating and Governance Committee

## Other Management

Set forth below is information as of February 28, 2008, about the following members of senior management of Level 3 Communications, LLC, except as otherwise noted.

Name	Age	Position
Raouf F. Abdel	40	President Business Markets Group
Sureel A. Choksi	35	Chief Marketing Officer
Andrew Crouch	37	President Wholesale Markets Group
John F. Waters, Jr.	43	President Operations, Chief Technology Officer
Kevin T. Hart	41	Chief Information Officer
Margaret E. Porfido	50	Chief Human Resources Officer
Donald H. Gips	48	Group Vice President

Walter Scott, Jr. has been the Chairman of the Board of the Company since September 1979, and a director of the Company since April 1964. Mr. Scott has been Chairman Emeritus of Peter Kiewit Sons', Inc. ("PKS") since the split-off in 1998. Mr. Scott is also a director of PKS, Berkshire Hathaway Inc., MidAmerican Energy Holdings Company, and Valmont Industries, Inc. Mr. Scott is the Chairman of the Board of Directors.

James Q. Crowe has been the Chief Executive Officer of the Company since August 1997, and a director of the Company since June 1993. Mr. Crowe was also President of the Company until July 2000. Mr. Crowe was President and Chief Executive Officer of MFS Communications Company, Inc. ("MFS") from June 1993 to June 1997. Mr. Crowe also served as Chairman of the Board of WorldCom from January 1997 until July 1997, and as Chairman of the Board of MFS from 1992 through 1996.

Kevin J. O'Hara has been President of the Company since July 2000 and Chief Operating Officer of the Company since March 1998. Mr. O'Hara was also Executive Vice President of the Company from August 1997 until July 2000. Prior to that, Mr. O'Hara served as President and Chief Executive Officer of MFS Global Network Services, Inc. from 1995 to 1997, and as Senior Vice President of MFS and President of MFS Development, Inc. from October 1992 to August 1995. From 1990 to 1992, he was a Vice President of MFS Telecom, Inc. ("MFS Telecom").

Charles C. Miller, III has been Vice Chairman and Executive Vice President of the Company since February 15, 2001. Mr. Miller was also a director from February 15, 2001 until May 18, 2004. Prior to that, Mr. Miller was President of Bellsouth International, a subsidiary of Bellsouth Corporation from 1995 until December 2000. Prior to that, Mr. Miller held various senior level officer and management position at BellSouth from 1987 until 1995.

Thomas C. Stortz has been Executive Vice President, Chief Legal Officer and Secretary since February 2004. Prior to that, Mr. Stortz was Group Vice President, General Counsel and Secretary of the Company from February 2000 to February 2004. Prior to that, Mr. Stortz served as Senior Vice President, General Counsel and Secretary of the Company from September 1998 to February 1, 2000. Prior to that, he served as Vice President and General Counsel of Peter Kiewit Sons', Inc. and Kiewit Construction Group, Inc. from April 1991 to September 1998. He has served as a director of Peter Kiewit Sons', Inc.

Sunit S. Patel has been Chief Financial Officer since May 2003 and a Group Vice President of the Company since March 13, 2003. Prior to that, Mr. Patel was Chief Financial Officer of Looking Glass Networks, Inc., a provider of metropolitan fiber optic networks, from April 2000 until March 2003. Mr. Patel was Treasurer of WorldCom Inc. and MCIWorldcom Inc., each long distance telephone services providers from 1997 to March 2000. From 1994 to 1997, Mr. Patel was Treasurer of MFS Communications Company Inc., a competitive local exchange carrier. On October 15, 2007, the Company announced that it has begun a search for a new Chief Financial Officer, and that Mr. Patel is expected to remain with the Company during the transition.

John Neil Hobbs has been Executive Vice President Sales and Operations since January 2008. Mr. Hobbs has responsibility for our Wholesale Markets Group, Business Markets Group and Global Network Services. Prior to that, Mr. Hobbs was President Global Network Services from August 2006 to January 2008. Prior to that, Mr. Hobbs was Executive Vice President Sales and Marketing from January 2006 to August 2006. Prior to that, Mr. Hobbs was Group Vice President Global Sales from September 2000 to January 2006. Prior to that, Mr. Hobbs was President, Global Accounts for Concert, a joint venture between AT&T and British Telecom from July 1999 until September 2000. Prior to that, Mr. Hobbs was Director Transition and Implementation for the formation of Concert representing British Telecom from June 1998 until July 1999. From April 1997 until June 1998, Mr. Hobbs was British Telecom's General Manager for Global Sales & Service and from April 1994 until April 1997, Mr. Hobbs was British Telecom's General Manager for Corporate Clients.

Brady Rafuse has been President Content Markets Group since August 2006 and President and CEO of our European operations since January 2006. Prior to this role, Mr. Rafuse was Group Vice President and President of our European operations from August 2001 to January 2006 and Senior Vice President of European Sales and Marketing from December 2000 to August 2001. Prior to that, Mr. Rafuse served as Head of Commercial Operations for Concert, a joint venture between AT&T and British Telecom, from September 1999 to December 2000, and in a variety of positions with British Telecom from 1987 until December 2000. His last position was as General Manager, Global Energy Sector which he held from August 1998 to September 1999 and prior to that he was Deputy General Manager, Banking Sector from April 1997 to August 1998.

Eric J. Mortensen has been Senior Vice President and Controller of the Company since 2003. Prior to that, Mr. Mortensen was Vice President and Controller of the Company from 1999 to 2003 and was the Controller of the Company from 1997 to 1999. Prior to that, Mr. Mortensen was Controller and Assistant Controller of Kiewit Diversified Group for more than five years.

Douglas C. Eby has been a director of the Company since August 2007. Mr. Eby is chairman and CEO of TimePartners LLC, an investment advisory firm since 2004. Prior to that from April 1997 until September 2007, Mr. Eby was President of Torray LLC, an registered investment advisory firm, having joined Torray LLC in 1992. Mr. Eby is also a member of the Board of Directors of Markel Corporation, CBRE Realty Finance, Inc. and Suburban Healthcare System. Since July 2007, Mr. Eby is also the Chairman of the Board of the Boys and Girls Clubs of Greater Washington, D.C.

Admiral James O. Ellis, Jr. U.S. Navy (ret.) has been a director of the Company since March 2005. Effective May 18, 2005, Admiral Ellis became the president and chief executive officer of the Institute of Nuclear Power Operations or INPO, a nonprofit corporation established by the nuclear utility industry in 1979 to promote the highest levels of safety and reliability in the operation of nuclear electric generating plants. Admiral Ellis most recently served as Commander, U.S. Strategic Command in Omaha, Nebraska, before retiring in July 2004 after 35 years of service in the U.S. Navy, as Commander of the Strategic Command. In his Naval career, he held numerous commands. A graduate of the U.S. Naval Academy, he also holds M.S. degrees in Aerospace Engineering from the Georgia Institute of Technology and in Aeronautical Systems from the University of West Florida. He served as a Naval aviator and was a graduate of the U.S. Naval Test Pilot School. Admiral Ellis is also a member of the Board of Directors of Lockheed Martin Corporation and Inmarsat PLC. Admiral Ellis is the Chairman of the Nominating and Governance committee.

Richard R. Jaros has been a director of the Company since June 1993 and served as President of the Company from 1996 to 1997. Mr. Jaros has been a private investor for more than the past five years. Mr. Jaros served as Executive Vice President of the Company from 1993 to 1996 and Chief Financial Officer of the Company from 1995 to 1996. He also served as President and Chief Operating Officer of CalEnergy from 1992 to 1993. Mr. Jaros is the Chairman of the Compensation Committee.

Robert E. Julian has been a director of the Company since March 1998. Mr. Julian has been a private investor for more than the past five years. From 1992 to 1995 Mr. Julian served as Executive Vice President and Chief Financial Officer of the Company. Mr. Julian is a member of the Audit Committee and the Compensation Committee.

Michael J. Mahoney has been a director of the Company since August 2007. Mr. Mahoney is a private investor since March 2007. From 2000 until March 2007, Mr. Mahoney was the president and chief executive officer of Commonwealth Telephone Enterprises. Prior to that, from 1997 until 2000, Mr. Mahoney was president and chief operating officer of RCN Corporation. Mr. Mahoney also served as president and chief operating officer of C-TEC Corporation from 1993 until 1997. Mr. Mahoney is a member of the Board of Trustees of Wilkes University.

Arun Netravali has been a director of the Company since April 2003. Mr. Netravali is currently the managing partner of OmniCapital Group LLC, a venture capital firm since November 2004. Mr. Netravali was a private investor from April 2003 until November 2004. Prior to that, Mr. Netravali was Chief Scientist for Lucent Technologies, working with academic and investment communities to identify and implement important new networking technologies from January 2002 to April 2003. Prior to that position, Mr. Netravali was President of Bell Labs as well as Lucent's Chief Technology Officer and Chief Network Architect from June 1999 to January 2002. Bell Labs serves as the research and development organization for Lucent Technologies. Mr. Netravali is a director of LSI Corporation. Mr. Netravali is a member of the Compensation Committee.

John T. Reed has been a director of the Company since March 2003. Mr. Reed has been a private investor since February 2005. Mr. Reed is also a Director of and Chairman of the Audit Committee of First National Bank of Omaha. Mr. Reed is also Chairman of the Board of Alegent Health, a health care system headquartered in Omaha, Nebraska and a member of the Board and Chairman of the Audit Committee of Father Flanagan's Boys' Home located in Boys Town, Nebraska. Mr. Reed was Chairman of HMG Properties, the real estate investment banking joint venture of McCarthy Group, Inc. from 2000 until February 2005. Prior to that, he was Chairman of McCarthy & Co., the investment banking affiliate of McCarthy Group. Prior to joining McCarthy Group in 1997, Mr. Reed spent 32 years with Arthur Andersen LLP. Mr. Reed is the Chairman of the Audit Committee and a member of the Nominating and Governance Committee.

Michael B. Yanney has been a director of the Company since March 1998. He has served as Chairman of the Board of The Burlington Capital Group, LLC (formerly known as America First Companies L.L.C.) for more than the last five years. Mr. Yanney also served as President and Chief Executive Officer of The Burlington Capital Group, LLC. Mr. Yanney is a member of the Nominating and Governance Committee.

Dr. Albert C. Yates has been a director of the Company since March 2005. Dr. Yates retired after 13 years as president of Colorado State University in Fort Collins, Colorado in June 2003. He was also chancellor of the Colorado State University System until October 2003, and is a former member of the board of the Federal Reserve Board of Kansas City-Denver Branch and the board of directors of First Interstate Bank and Molson Coors Brewing Company. He currently serves as a director of Centennial Bank Holdings, Inc. and StarTek, Inc. Dr. Yates is a member of the Audit Committee.

Raouf F. Abdel has been President Business Markets Group since February 2007. Prior to that, Mr. Abdel was Group Vice President of Integration and Development Services from March 2006 to February 2007. Prior to those roles, Mr. Abdel was Senior Vice President of Integration and Development Services from November 2005 to March 2006, responsible for managing Level 3's integration and systems and process development. Prior to that, Mr. Abdel was Senior Vice President of Product Development from September 2003 to November 2005, responsible for developing and managing Level 3 product development activities. Prior to that, Mr. Abdel was Senior Vice President of M&A Integration from March 2002 to September 2003, responsible for managing the execution of Level 3's integration activities. From July 2000 until March 2002, Mr. Abdel was Senior Vice President of Network Deployment, and from September 1999 until July 2000, Mr. Abdel was Vice President of Colocation Services. Mr. Abdel joined Level 3 in February 1998 as Senior Director of Construction.

Sureel A. Choksi has been Chief Marketing Officer since January 2008, responsible for product management and marketing. Prior to that, Mr. Choksi was President Wholesale Markets Group from August 2006 to January 2008. Prior to that, Mr. Choksi was Executive Vice President of Switched Services from January 2006 to August 2006. Prior to this role, Mr. Choksi was Executive Vice President of Services from November 2004 to January 2006, responsible for developing and managing Level 3's communications services. Prior to that, Mr. Choksi was Executive Vice President Softswitch Services from January 2004 and Group Vice President Transport and Infrastructure from May 2003 until

January 2004. Mr. Choksi was a Group Vice President and Chief Financial Officer of the Company from July 2000 to May 2003. Prior to that, Mr. Choksi was Group Vice President Corporate Development and Treasurer of the Company from February 2000 until August 2000. Prior to that, Mr. Choksi served as Vice President and Treasurer of the Company from January 1999 to February 1, 2000. Prior to that, Mr. Choksi was a Director of Finance at the Company from 1997 to 1998, an Associate at TeleSoft Management, LLC in 1997 and an Analyst at Gleacher & Company from 1995 to 1997.

Andrew Crouch has been the President of the Wholesale Markets Group since January 2008, after serving as Group Vice President of Sales for the Wholesale Markets Group beginning in April 2006. Prior to that, Mr. Crouch served as the Senior Vice President of the Carrier Channel from January 2005 to April 2006, and Senior Vice President of the Enterprise Voice Services from January 2004 to January 2005. Mr. Crouch began his career at Level 3 in November 2001 as the Senior Vice President of Sales for the Cable and ISP Channel and held this position until December 2003. Before joining Level 3, Mr. Crouch served as the Deputy General Manager within the Corporate Clients Division at British Telecom. He also served as the Vice President of Commercial Operations for Concert Communications, a joint venture between British Telecom and AT&T from January 2000 to October 2001.

John F. Waters, Jr. has been President Operations, Chief Technology Officer since January 2008. Prior to that, Mr. Waters was Executive Vice President, Chief Technology Officer from January 2004 to January 2008. Prior to that, Mr. Waters was Group Vice President and Chief Technology Officer of the Company from February 2000 to January 2004. Prior to that, Mr. Waters was Vice President, Engineering of the Company from November 1997 until February 1, 2000. Prior to that, Mr. Waters was an executive staff member of MCI Communications from 1994 to November 1997.

Kevin T. Hart has been Chief Information officer since January 2008. Prior to that, Mr. Hart was Group Vice President Global Systems Development and Chief Information Officer from January 2005 to 2008. Prior to that, Mr. Hart was Vice President of Telecommunications, Media & Entertainment at Capgemini (formerly Ernst & Young), a management consulting firms in Dallas, Texas, for over nine years. In that role, he was responsible for the overall growth and direction of the organization's Communications Operations Support Systems, Billing/Business Support Systems and the Network Management Systems service offerings and delivery. Prior to joining Capgemini's management consulting practice, he held the positions of Director of Strategic Planning at International Paper and Manager of Operations at SBC Communications.

Margaret E. Porfido has been Chief Human Resources Officer since May 2007. Prior to that, Ms. Porfido was Senior Vice President Executive Operations from February 2000, acting as the chief of staff to Kevin J. O'Hara, Level 3's president and chief operating officer. Ms. Porfido joined Level 3 in September 1998 as Vice President Business Development. Prior to joining Level 3, Ms. Porfido served as Chief of Staff and chief legal adviser to Colorado Governor Roy Romer. Prior to her government service, Ms. Porfido was an attorney in private practice.

Donald H. Gips has been Group Vice President Corporate Strategy since January 2001. Prior to that, Mr. Gips was Group Vice President, Sales and Marketing of the Company from February 2000. Prior to that, Mr. Gips served as Senior Vice President, Corporate Development from November 1998 to February 2000. Prior to that, Mr. Gips served in the White House as Chief Domestic Policy Advisor to Vice President Gore from April 1997 to April 1998. Before working at the White House, Mr. Gips was at the Federal Communications Commission as the International Bureau Chief and Director of Strategic Policy from January 1994 to April 1997. Prior to his government service, Mr. Gips was a management consultant at McKinsey and Company.

At our 2008 Annual Meeting of Stockholders, the term of office of all of our directors will expire. At each annual meeting of stockholders, successors to the directors will be elected for a one-year term.

Our officers are elected annually to serve until each successor is elected and qualified or until his or her death, resignation or removal.

We believe that the members of the Audit Committee are independent within the meaning of the listing standards of The NASDAQ Stock Market, LLC. The Board has determined that Mr. John T. Reed, Chairman of the Audit Committee, qualifies as a "financial expert" as defined by the Securities and Exchange Commission. The Board considered Mr. Reed's credentials and financial background and found that he was qualified to serve as the "financial expert."

### **Our website**

Our website is [www.level3.com](http://www.level3.com). We caution you that any information that is included in our website is not part of this Form 10-K.

### **Code of Ethics**

We have adopted a code of ethics that complies with the standards mandated by the Sarbanes-Oxley Act of 2002. The complete code of ethics is available on our website at [www.level3.com](http://www.level3.com). At any time that the code of ethics is not available on our website, we will provide a copy upon written request made to Investor Relations, Level 3 Communications, Inc., 1025 Eldorado Blvd., Broomfield, Colorado 80021. We caution you that any information that is included in our website is not part of this Form 10-K. If we amend the code of ethics, or grant any waiver from a provision of the code of ethics that applies to our executive officers or directors, we will publicly disclose such amendment or waiver as required by applicable law, including by posting such amendment or waiver on our website at [www.level3.com](http://www.level3.com) or by filing a Form 8-K with the Securities and Exchange Commission or SEC.

### **SEC Filings**

Our Form 10-K, along with all other reports and amendments filed with or furnished to the SEC are publicly available free of charge on the investor relations section of our website as soon as reasonably practicable after we file such materials with, or furnish them to, the SEC. We caution you that the information on our website is not part of this or any other report we file with, or furnish to, the SEC.

### **Section 16(a)—Beneficial Ownership Reporting Compliance**

Except as described below, to our knowledge, no person that was a director, executive officer or beneficial owner of more than 10% of the outstanding shares of our common stock failed to timely file all reports required under Section 16(a) of the Securities Exchange Act of 1934. On one occasion, Dr. Albert C. Yates filed a late Form 4 to report an open market purchase of our common stock.

### **Employees**

As of December 31, 2007, we had approximately 6,680 total employees. We believe that our success depends in large part on our ability to attract and retain substantial numbers of qualified employees.

## **Item 1A. RISK FACTORS**

### **Forward Looking Statements**

We, or our representatives, from time to time may make or may have made certain forward-looking statements, either orally or in writing, including without limitation statements made or to be made in this Form 10-K, our Quarterly Reports on Form 10-Q, information contained in other filings with the SEC, press releases and other public documents or statements. In addition, our

representatives, from time to time, participate in speeches and calls with market analysts, conferences with investors or potential investors in our securities and other meetings and conferences. Some of the information presented at these speeches, calls, meetings and conferences may include forward-looking statements. We use words like "expects," "anticipates" or "believes" to identify forward-looking statements.

We wish to ensure that all forward-looking statements are accompanied by meaningful cautionary statements, so as to ensure to the fullest extent possible the protections of the safe harbor established in the Private Securities Litigation Reform Act of 1995. Accordingly, all forward-looking statements are qualified in their entirety by reference to, and are accompanied by, the following discussion of certain important factors that could cause actual results to differ materially from those projected in these forward-looking statements. We caution the reader that this list of important factors may not be exhaustive. We operate in a rapidly changing business, and new risk factors emerge from time to time. We cannot predict every risk factor, nor can we assess the effect, if any, of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those projected in any forward-looking statements. Accordingly, forward-looking statements should not be relied upon as a prediction of actual results. Further, we undertake no obligation to update forward-looking statements after the date they are made to conform the statements to actual results or changes in our expectations.

## **Risks Related to Our Businesses**

### ***Communications Group***

**Our financial condition and growth depends upon the successful integration of our acquired businesses. We may not be able to efficiently and effectively integrate acquired operations, and thus may not fully realize the anticipated benefits from such acquisitions.**

Achieving the anticipated benefits of the acquisitions that we have completed starting in December 2005 will depend in part upon whether we can integrate our businesses in an efficient and effective manner.

Since December 2005, we have acquired, in chronological order, WilTel Communications Group, LLC, Progress Telecom, LLC, ICG Communications, Inc., TelCove, Inc., Looking Glass Networks Holding Co., Inc., Broadwing Corporation, the CDN services business of SAVVIS, and Servecast Limited. In the future we may acquire additional businesses in accordance with our business strategy. The integration of our acquired businesses and any future businesses that we may acquire involves a number of risks, including, but not limited to:

- demands on management related to the significant increase in size after the acquisition;
- the disruption of ongoing business and the diversion of management's attention from the management of daily operations to the integration of operations;
- failure to fully achieve expected synergies and costs savings;
- unanticipated impediments in the integration of departments, systems, including accounting systems, technologies, books and records and procedures, as well as in maintaining uniform standards, controls, including internal control over financial reporting required by the Sarbanes-Oxley Act of 2002, procedures and policies;
- loss of customers or the failure of customers to order incremental services that we expect them to order;
- failure to provision services that are ordered by customers during the integration period;
- higher integration costs than anticipated; and

- difficulties in the assimilation and retention of highly qualified, experienced employees, many of whom are geographically dispersed.

Successful integration of these acquired businesses or operations will depend on our ability to manage these operations, realize opportunities for revenue growth presented by strengthened service offerings and expanded geographic market coverage, obtain better terms from our vendors due to increased buying power, and eliminate redundant and excess costs to fully realize the expected synergies. Because of difficulties in combining geographically distant operations and systems which may not be fully compatible, we may not be able to achieve the financial strength and growth we anticipate from the acquisitions.

We cannot be certain that we will realize our anticipated benefits from our acquisitions, or that we will be able to efficiently and effectively integrate the acquired operations as planned. If we fail to integrate the acquired businesses and operations efficiently and effectively or fail to realize the benefits we anticipate, we would be likely to experience material adverse effects on our business, financial condition, results of operations and future prospects.

**We need to continue to increase the volume of traffic on our network to become profitable.**

We must continue to increase the volume of data, voice and content transmissions on our communications network at acceptable prices in order to realize our targets for anticipated revenue growth, cash flow, operating efficiencies and the cost benefits of our network. If we do not maintain or improve our current relationships with existing customers and develop new large volume and enterprise customers, we may not be able to substantially increase traffic on our network, which would adversely affect our ability to become profitable.

**Intellectual property and proprietary rights of others could prevent us from using necessary technology to provide our services or subject us to expensive intellectual property litigation.**

If technology that is necessary for us to provide our services was determined by a court to infringe a patent held by another entity that is unwilling to grant us a license on terms acceptable to us, we could be precluded by a court order from using that technology and would likely be required to pay a significant monetary damages award to the patent-holder. The successful enforcement of these patents, or our inability to negotiate a license for these patents on acceptable terms, could force us to cease using the relevant technology and offering services incorporating the technology. In the event that a claim of infringement was brought against us based on the use of our technology or against our customers based on their use of our services for which we are obligated to indemnify, we could be subject to litigation to determine whether such use or sale is, in fact, infringing. This litigation could be expensive and distracting, regardless of the outcome of the suit.

While our own extensive patent portfolio may deter other operating companies from bringing such actions, patent infringement claims are increasingly being asserted by patent holding companies, which do not use technology and whose sole business is to enforce patents against operators, such as us, for monetary gain. Because such patent holding companies, commonly referred to as patent "trolls," do not provide services or use technology, the assertion of our own patents by way of counter-claim would be largely ineffective. We have already been the subject of time-consuming and expensive patent litigation brought by certain patent holding companies and we can reasonably expect that we will face further claims in the future, particularly if legislation now pending in Congress is not enacted in a way that will decrease the number and frequency of claims by patent trolls.



**Our business requires the continued development of effective business support systems to implement customer orders and to provide and bill for services.**

Our business depends on our ability to continue to develop effective business support systems. In certain cases, the development of these business support systems is required to realize our anticipated benefits from our acquisitions. This is a complicated undertaking requiring significant resources and expertise and support from third-party vendors. Business support systems are needed for:

- accepting and inputting customer orders for services;
- provisioning, installing and delivering these services; and
- billing for these services.

Because our business provides for continued rapid growth in the number of customers that we serve and the volume of services offered and requires the integration of acquired companies' business support systems, there is a need to continue to develop our business support systems on a schedule sufficient to meet proposed milestone dates. The failure to continue to develop effective unified business support systems could materially adversely affect our ability to implement our business plans, realize anticipated benefits from our acquisitions and meet our financial goals and objectives.

**Our revenue is concentrated in a limited number of customers.**

A significant portion of our communications revenue is concentrated among a limited number of customers. For the year ended December 31, 2007, our top ten customers represented approximately 34% of our consolidated total revenue. Revenue from our largest customer, AT&T Inc. and its subsidiaries, including SBC Communications, BellSouth and AT&T Mobility (assuming those subsidiaries were wholly owned by AT&T for all of 2007), represented approximately 15% of our consolidated total revenue for 2007. The next largest customer accounted for approximately 5% of our consolidated total revenue and most of the remaining top ten customers each account for 3% or less of our consolidated total revenue. If we lost one or more of our top five customers, or if one or more of these major customers significantly decreased orders for our services, our business would be materially and adversely affected.

In connection with the acquisition of WilTel in December 2005, we acquired a large customer contract between WilTel and SBC Communications, now known as AT&T. We expect that the revenue generated under this contract will continue to decline over time as SBC Communications migrates its traffic from our network to the merged SBC and AT&T Communications network that SBC Communications acquired when it purchased the former AT&T.

**We may lose customers if we experience system failures that significantly disrupt the availability and quality of the services that we provide.**

Our operations depend on our ability to avoid and mitigate any interruptions in service or reduced capacity for customers. Interruptions in service or performance problems, for whatever reason, could undermine confidence in our services and cause us to lose customers or make it more difficult to attract new ones. In addition, because many of our services are critical to the businesses of many of our customers, any significant interruption in service could result in lost profits or other losses to customers. Although we limit our liability for service failures in our service agreements to limited service credits, generally in the form of free service for a short period of time, a court might not enforce these limitations on liability, which could expose us to financial loss. In addition, we often provide our customers with committed service levels. If we are unable to meet these service level commitments as a result of service interruptions, we may be obligated to provide service credits to our customers, which could negatively affect our operating results.

The failure of any equipment or facility on our network, including our network operations control centers and network data storage locations, could result in the interruption of customer service until necessary repairs are effected or replacement equipment is installed. Network failures, delays and errors could also result from natural disasters, terrorist acts, power losses, security breaches, computer viruses, or other causes. These failures, faults or errors could cause delays, service interruptions, expose us to customer liability, or require expensive modifications that could significantly hurt our business.

**There is no guarantee that we will be successful in increasing sales of our content distribution service offering.**

As we believe that one of the largest sources of future incremental demand for our communications services will be derived from customers that are seeking to distribute their feature rich content, applications or video over the Internet, we purchased the content distribution network or CDN assets of SAVVIS, Inc. in January 2007 and we purchased Servecast Limited in July 2007. Although we have sold high speed Internet access, transport and colocation services since the late 1990's, we have only been selling our CDN services since January 2007. As a result, there are many difficulties that we may encounter, including customer acceptance, intellectual property matters, technological issues, developmental constraints and other problems that we may not anticipate. There is no guarantee that we will be successful in generating significant revenues from our CDN service offering.

**Failure to develop and introduce new services could affect our ability to compete in the industry.**

We continuously develop, test and introduce new communications services that are delivered over our communications network. These new services are intended to allow us to address new segments of the communications marketplace and to compete for additional customers. In certain instances, the introduction of new services requires the successful development of new technology. To the extent that upgrades of existing technology are required for the introduction of new services, the success of these upgrades may be dependent on reaching mutually-acceptable terms with vendors and on vendors meeting their obligations in a timely manner. In addition, new service offerings may not be widely accepted by our customers. If our new service offerings are not widely accepted by our customers, we may terminate those service offerings and we may be required to impair any assets or technology used to develop or offer those services. If we are not able to successfully complete the development and introduction of new services in a timely manner, our business could be materially adversely affected.

**Rapid technological changes can lead to further competition.**

The communications industry is subject to rapid and significant changes in technology. In addition, the introduction of new services or technologies, as well as the further development of existing services and technologies may reduce the cost or increase the supply of certain services similar to those that we provide. As a result, our most significant competitors in the future may be new entrants to the communications industry. These new entrants may not be burdened by an installed base of outdated equipment or obsolete technology. Our future success depends, in part, on our ability to anticipate and adapt in a timely manner to technological changes. Failure to do so could have a material adverse effect on our business.

**During our communications business operating history we have generated substantial losses, and we expect to continue to generate losses.**

The development of our communications business required, and may continue to require, significant expenditures. These expenditures could result in substantial negative cash flow from operating activities and substantial net losses for the near future. For the fiscal years ended December 31, 2007 and December 31, 2006, we incurred losses from continuing operations of approximately \$1.114 billion and \$790 million, respectively. We expect to continue to experience losses,

and we may not be able to achieve or sustain operating profitability in the future. Continued operating losses could limit our ability to obtain the cash needed to expand our network, make interest and principal payments on our debt, or fund other business needs.

We will need to continue to expand and adapt our network in order to remain competitive, which may require significant additional funding. Additional expansion and adaptations of our communications network's electronic and software components will be necessary in order to respond to:

- growing number of customers;
- the development and launching of new services;
- increased demands by customers to transmit larger amounts of data;
- changes in customers' service requirements;
- technological advances by competitors; and
- governmental regulations.

Future expansion or adaptation of our network will require substantial additional financial, operational and managerial resources, which may not be available at the time. If we are unable to expand or adapt our network to respond to these developments on a timely basis and at a commercially reasonable cost, our business will be materially adversely affected.

**The market prices for certain of our communications services have decreased in the past and may decrease in the future, resulting in lower revenue than we anticipate.**

Over the past few years, the market prices for certain of our communications services have decreased. These decreases resulted from downward market pressure and other factors including:

- technological changes and network expansions which have resulted in increased transmission capacity available for sale by us and by our competitors;
- some of our customer agreements contain volume-based pricing or other contractually agreed-upon decreases in prices during the term of the respective agreements; and
- some of our competitors have been willing to accept smaller operating margins in the short term in an attempt to increase long-term revenues.

In order to retain customers and revenue, we often must reduce prices in response to market conditions and trends. As our prices for some of our communications services decrease, our operating results may suffer unless we are unable to either reduce our operating expenses or increase traffic volume from which we can derive additional revenue.

We expect revenue from our managed modem services to continue to decline, primarily due to:

- an increase in the number of subscribers migrating to broadband services;
- continued pricing pressures; and
- declining customer obligations under existing contractual arrangements.

**We may be liable for the information that content owners or distributors distribute over our network.**

The law relating to the liability of private network operators for information carried on or disseminated through their networks is still unsettled. We may become subject to legal claims relating to the content disseminated on our network, even though such content is owned or distributed by our customers or a customer of our customers. For example, lawsuits may be brought against us claiming that material distributed using our network was inaccurate, offensive, or violated the law or the rights

of others. Claims could also involve matters such as defamation, invasion of privacy and copyright infringement. In addition, the law remains unclear over whether content may be distributed from one jurisdiction, where the content is legal, into another jurisdiction, where it is not. Companies operating private networks have been sued in the past, sometimes successfully, based on the nature of material distributed, even if the content is not owned by the network operator and the network operator has no knowledge of the content or its legality. It is not practical for us to monitor all of the content which is distributed using our network. If we need to take costly measures to reduce our exposure to these risks, or are required to defend ourselves against such claims, our financial results could be negatively affected.

**The need to obtain additional capacity for our network from other providers increases our costs.**

We use network resources owned by other companies for portions of our network both in North America and in Europe. We obtain the right to use such network portions, including both telecommunications capacity and rights to use dark fiber, through operating leases and IRU agreements. In several of those agreements, the counter party is responsible for network maintenance and repair. If a counter party to a lease or IRU suffers financial distress or bankruptcy, we may not be able to enforce our rights to use these network assets or, even if we could continue to use these network assets, we could incur material expenses related to maintenance and repair. We could also incur material expenses if we were required to locate alternative network assets. We may not be successful in obtaining reasonable alternative network assets if needed. Failure to obtain usage of alternative network assets, if necessary, could have a material adverse effect on our ability to carry on business operations. In addition, some of our agreements with other providers require the payment of amounts for services whether or not those services are used.

In the normal course of business, we need to enter into interconnection agreements with many domestic and foreign local telephone companies, but we are not always able to do so on favorable terms. Costs of obtaining local service from other carriers comprise a significant proportion of the operating expenses of long distance carriers. Similarly, a large proportion of the costs of providing international service consists of payments to other carriers. Changes in regulation, particularly the regulation of local and international telecommunication carriers, could indirectly, but significantly, affect our competitive position. These changes could increase or decrease the costs of providing our services.

**We may be unable to hire and retain sufficient qualified personnel; the loss of any of our key executive officers could adversely affect on our business.**

We believe that our future success will depend in large part on our ability to attract and retain highly skilled, knowledgeable, sophisticated and qualified managerial, professional and technical personnel. We have experienced significant competition in attracting and retaining personnel who possess the skills that we are seeking. As a result of this significant competition, we may experience a shortage of qualified personnel.

Our businesses are managed by a small number of key executive officers, including James Q. Crowe, Chief Executive Officer, Kevin J. O'Hara, President and Chief Operating Officer and Charles C. Miller, III, Vice Chairman and Executive Vice President. The loss of any of these key executive officers could have a material adverse effect on our business.

**We must obtain and maintain permits and rights-of-way to operate our network.**

If we are unable, on acceptable terms and on a timely basis, to obtain and maintain the franchises, permits and rights-of-way needed to expand and operate our network, our business could be materially adversely affected. In addition, the cancellation or non-renewal of the franchises, permits or

rights-of-way that are obtained could materially adversely affect our business. Our communications operating subsidiaries are defendants in several lawsuits that, among other things, challenge the subsidiaries' use of rights-of-way. The plaintiffs have sought to have these lawsuits certified as class actions. It is possible that additional suits challenging use of our rights-of-way will be filed and that those plaintiffs also may seek class certification. The outcome of such litigation may increase our costs and adversely affect our operating results.

**Termination of relationships with key suppliers could cause delay and additional costs.**

Our business is dependent on third-party suppliers for fiber, computers, software, optronics, transmission electronics and related components that are integrated into our network, some of which are critical to the operation of our business. If any of these critical relationships is terminated or a supplier fails to provide critical services or equipment and we are unable to reach suitable alternative arrangements quickly, we may experience significant additional costs or we may not be able to provide certain services to customers. If that happens, our business could be materially adversely affected.

**AT&T and Verizon may not provide us local access services at prices which allow us to effectively compete.**

We acquire a significant portion of our local access services, the connection between our owned network and the customer premises, from incumbent local exchange carriers or ILECs. With the recent acquisitions by AT&T and Verizon, the ILECs now compete directly with our business and may have a tendency to favor themselves and their affiliates to our detriment. Network access represents a very large portion of our total costs and if we face less favorable pricing and provisioning, we may be at a competitive disadvantage to the ILECs.

**The success of our subscriber based VoIP services is dependent on the growth and public acceptance of VoIP telephony in general.**

The success of our subscriber based VoIP services is dependent upon future demand for VoIP telephony services in general in the marketplace. In order for the IP telephony market to continue to grow, several things may need to occur, including the following:

- Telephone and cable service providers must continue to invest in the deployment of high speed broadband networks to residential and commercial customers.
- VoIP networks must continue to improve quality of service for real-time communications, managing effects such as packet jitter, packet loss and unreliable bandwidth, so that toll-quality service can be provided.
- VoIP telephony equipment and services must achieve a similar level of reliability that users of the public switched telephone network have come to expect from their telephone service, including emergency calling features and capabilities.
- VoIP telephony service providers must offer cost and feature benefits to their customers that are sufficient to cause the customers to switch away from traditional telephony service providers.

If any or all of these factors fail to occur, our VoIP services business may not continue or grow as expected.

**We are subject to significant regulation that could change in an adverse manner.**

Communications services are subject to significant regulation at the federal, state, local and international levels. These regulations affect our business and our existing and potential competitors. Delays in receiving required regulatory approvals (including approvals relating to acquisitions or

financing activities), completing interconnection agreements with incumbent local exchange carriers, or the enactment of new and adverse regulations or regulatory requirements may have a material adverse effect on our business. In addition, future legislative, judicial and regulatory agency actions could have a material adverse effect on our business.

Federal legislation provides for a significant deregulation of the U.S. telecommunications industry, including the local exchange, long distance and cable television industries. This legislation remains subject to judicial review and additional Federal Communications Commission, or FCC, rulemaking. As a result, we cannot predict the legislation's effect on our future operations. Many regulatory actions are under way or are being contemplated by federal and state authorities regarding important issues. These actions could have a material adverse effect on our business.

**The law in certain countries currently does not permit us to offer services directly in those countries.**

Ownership of telecommunications facilities that originate or terminate traffic in certain countries, such as Canada and China, is currently limited to nationals of those countries. This restriction hinders our entry into those markets.

**Potential regulation of Internet service providers in the United States could adversely affect our operations.**

The FCC has, to date, treated Internet service providers as enhanced service providers. In addition, Congress has, to date, not sought to heavily regulate the provision of IP-based services. Both Congress and the FCC are considering proposals that involve greater regulation of IP-based service providers. Depending on the content and scope of any regulations, the imposition of such regulations could have a material adverse effect on our business and the profitability of our services.

**The communications industry is highly competitive with participants that have greater resources and a greater number of existing customers.**

The communications industry is highly competitive. Many of our existing and potential competitors have financial, personnel, marketing and other resources significantly greater than ours. Many of these competitors have the added competitive advantage of a larger existing customer base. In addition, significant new competition could arise as a result of:

- the consolidation in the industry, led by AT&T and Verizon;
- allowing foreign carriers to more extensively compete in the U.S. market;
- further technological advances; and
- further deregulation and other regulatory initiatives.

If we are unable to compete successfully, our business could be significantly affected.

**We may be unable to successfully identify, manage and assimilate future acquisitions, investments and strategic alliances, which could adversely affect our results of operations.**

We continually evaluate potential investments and strategic opportunities to expand our network, enhance connectivity and add traffic to our network. In the future, we may seek additional investments, strategic alliances or similar arrangements, which may expose us to risks such as:

- the difficulty of identifying appropriate investments, strategic allies or opportunities on terms acceptable to us;
- the possibility that senior management may be required to spend considerable time negotiating agreements and monitoring these arrangements;

- potential regulatory issues applicable to the telecommunications business;
- the loss or reduction in value of the capital investment;
- our inability to capitalize on the opportunities presented by these arrangements; and
- the possibility of insolvency of a strategic ally.

There can be no assurance that we would successfully overcome these risks or any other problems encountered with these investments, strategic alliances or similar arrangements.

### ***Other Operations***

#### **Environmental liabilities from our historical operations could be material.**

There could be environmental liabilities arising from historical operations of our predecessors, for which we may be liable. Our operations and properties are subject to a wide variety of laws and regulations relating to environmental protection, human health and safety. These laws and regulations include those concerning the use and management of hazardous and non-hazardous substances and wastes. We have made and will continue to make significant expenditures relating to our environmental compliance obligations. Despite our best efforts, we may not at all times be in compliance with all of these requirements.

In connection with certain historical operations, we have responded to or been notified of potential environmental liability at approximately 148 properties as of February 15, 2008. We are engaged in addressing or have liquidated environmental liabilities at 70 of those properties. Of these: (a) we have formal commitments or other potential future costs at 14 sites; (b) there are 10 sites with minimal future costs; (c) there are 11 sites with unknown future costs and (d) there are 35 sites with no likely future costs. The remaining 78 properties have been dormant for several years. We could be held liable, jointly or severally, and without regard to fault, for such investigation and remediation. The discovery of additional environmental liabilities related to historical operations or changes in existing environmental requirements could have a material adverse effect on our business.

#### **Potential liabilities and claims arising from coal operations could be significant.**

Our coal operations are subject to extensive laws and regulations that impose stringent operational, maintenance, financial assurance, environmental compliance, reclamation, restoration and closure requirements. These requirements include those governing air and water emissions, waste disposal, worker health and safety, benefits for current and retired coal miners, and other general permitting and licensing requirements. Despite our best efforts, we may not at all times be in compliance with all of these requirements. Liabilities or claims associated with this non-compliance could require us to incur material costs or suspend production. Mine reclamation costs that exceed reserves for these matters also could require us to incur material costs.

### ***General***

#### **If we are unable to comply with the restrictions and covenants in our debt agreements, there would be a default under the terms of these agreements, and this could result in an acceleration of payment of funds that have been borrowed.**

If we were unable to comply with the restrictions and covenants in any of our debt agreements, there would be a default under the terms of those agreements. As a result, borrowings under other debt instruments that contain cross-acceleration or cross-default provisions may also be accelerated and become due and payable. If any of these events occur, there can be no assurance that we would be able to make necessary payments to the lenders and noteholders or that we would be able to find

alternative financing. Even if we were able to obtain alternative financing, there can be no assurance that it would be on terms that are acceptable.

**We have substantial debt, which may hinder our growth and put us at a competitive disadvantage.**

Our substantial debt may have important consequences, including the following:

- the ability to obtain additional financing for acquisitions, working capital, investments and capital or other expenditures could be impaired or financing may not be available on acceptable terms;
- a substantial portion of our cash flow will be used to make principal and interest payments on outstanding debt, reducing the funds that would otherwise be available for operations and future business opportunities;
- a substantial decrease in cash flows from operating activities or an increase in expenses could make it difficult to meet debt service requirements and force modifications to operations;
- We have more debt than certain of our competitors, which may place us at a competitive disadvantage; and
- substantial debt may make us more vulnerable to a downturn in business or the economy generally.

We had substantial deficiencies of earnings to cover fixed charges of approximately \$1.068 billion for the fiscal year ended December 31, 2007. We had deficiencies of earnings to cover fixed charges of \$720 million for the fiscal year ended December 31, 2006, \$634 million for the fiscal year ended December 31, 2005, \$409 million for the fiscal year ended December 31, 2004 and \$681 million for the fiscal year 2003.

**We may not be able to repay our existing debt; failure to do so or refinance the debt could prevent us from implementing our strategy and realizing anticipated profits.**

If we were unable to refinance our debt or to raise additional capital on acceptable terms, our ability to operate our business would be impaired. As of December 31, 2007, we had an aggregate of approximately \$6.864 billion of long-term debt on a consolidated basis and including current maturities, and approximately \$1.07 billion of stockholders' equity.

Our ability to make interest and principal payments on our debt and borrow additional funds on favorable terms depends on the future performance of the business. If we do not have enough cash flow in the future to make interest or principal payments on our debt, we may be required to refinance all or a part of our debt or to raise additional capital. We cannot be sure that we will be able to refinance our debt or raise additional capital on acceptable terms.

**Restrictions and covenants in our debt agreements limit our ability to conduct our business and could prevent us from obtaining needed funds in the future.**

Our debt and financing arrangements contain a number of significant limitations that restrict our ability to, among other things:

- borrow additional money or issue guarantees;
- pay dividends or other distributions to stockholders;
- make investments;
- create liens on assets;
- sell assets;



- enter into sale-leaseback transactions;
- enter into transactions with affiliates; and
- engage in mergers or consolidations.

**If certain transactions occur with respect to our capital stock, we may be unable to fully utilize our net operating loss carryforwards to reduce our income taxes.**

As of December 31, 2007, we had net operating loss carry forwards of approximately \$9.5 billion for federal income tax purposes, including \$953 million of net operating loss carry forwards from acquired companies after limitations that existed at the date of acquisition or that resulted from the acquisitions or both. If certain transactions occur with respect to our capital stock that result in a cumulative ownership change of more than 50 percentage points by 5-percent stockholders over a three-year period as determined under rules prescribed by the U.S. Internal Revenue Code and applicable regulations, annual limitations would be imposed with respect to our ability to utilize our net operating loss carry forwards and certain current deductions against any taxable income it achieves in future periods.

We have entered into transactions over the last three years resulting in significant cumulative changes in the ownership of our capital stock. Additional transactions that we enter into, as well as transactions by existing 5% stockholders and transactions by holders that become new 5% stockholders that we do not participate in, could cause us to incur a 50 percentage point ownership change by 5% stockholders and, if we trigger the above-noted Internal Revenue Code imposed limitations, such transactions would prevent us from fully utilizing net operating loss carry forwards and certain current deductions to reduce income taxes.

**The unpredictability of our quarterly results may adversely affect the trading price of our common stock.**

Our revenue and operating results will vary significantly from quarter to quarter due to a number of factors, many of which are outside of our control and any of which may cause the price of our common stock to fluctuate. The primary factors, among other things, that may affect our quarterly results include the following:

- The timing of costs associated with our integration activities with respect to our recently completed acquisitions;
- demand for communications services;
- loss of customers or the ability to attract new customers;
- changes in pricing policies or the pricing policies of our competitors;
- costs related to acquisitions of technology or businesses;
- changes in regulatory rulings; and
- general economic conditions as well as those specific to the communications and related industries.

A delay in generating revenue or the timing of recognizing revenue and expenses could cause significant variations in our operating results from quarter to quarter. It is possible that in some future quarters our results may be below analysts and investors expectations. In these circumstances, the price of our common stock will likely decrease.

**Increased scrutiny of financial disclosure, particularly in the telecommunications industry in which we operate, could adversely affect investor confidence, and any restatement of earnings could increase litigation risks and limit our ability to access the capital markets.**

Congress, the SEC, other regulatory authorities and the media are intensely scrutinizing a number of financial reporting issues and practices. Although all businesses face uncertainty with respect to how the U.S. financial disclosure regime may be affected by this process, particular attention has been focused recently on the telecommunications industry and companies' interpretations of generally accepted accounting principles.

If we were required to restate our financial statements as a result of a determination that we had incorrectly applied generally accepted accounting principles, that restatement could adversely affect our ability to access the capital markets or the trading price of our securities. The recent scrutiny regarding financial reporting has also resulted in an increase in litigation in the telecommunications industry. There can be no assurance that any such litigation against us would not materially adversely affect our business or the trading price of our securities.

**Terrorist attacks and other acts of violence or war may adversely affect the financial markets and our business.**

Since the September 11, 2001 terrorist attacks and subsequent events, there has been considerable uncertainty in world financial markets. The full effect on the financial markets of these events, as well as concerns about future terrorist attacks, is not yet known. They could, however, adversely affect our ability to obtain financing on terms acceptable to us, or at all.

There can be no assurance that there will not be further terrorist attacks against the United States or U.S. businesses. These attacks or armed conflicts may directly affect our physical facilities or those of our customers. These events could cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and world financial markets and economy. Any of these occurrences could materially adversely affect our business.

**Our international operations and investments expose us to risks that could materially adversely affect the business.**

We have operations and investments outside of the United States, as well as rights to undersea cable capacity extending to other countries, that expose us to risks inherent in international operations. These include:

- general economic, social and political conditions;
- the difficulty of enforcing agreements and collecting receivables through certain foreign legal systems;
- tax rates in some foreign countries may exceed those in the U.S.;
- foreign currency exchange rates may fluctuate, which could adversely affect our results of operations and the value of our international assets and investments;
- foreign earnings may be subject to withholding requirements or the imposition of tariffs, exchange controls or other restrictions;
- difficulties and costs of compliance with foreign laws and regulations that impose restrictions on our investments and operations, with penalties for noncompliance, including loss of licenses and monetary fines;

- difficulties in obtaining licenses or interconnection arrangements on acceptable terms, if at all; and
- changes in U.S. laws and regulations relating to foreign trade and investment.

**Additional issuances of equity securities by us would dilute the ownership of our existing stockholders.**

We may issue equity in the future in connection with acquisitions or strategic transactions, to adjust our ratio of debt to equity, including through repayment of outstanding debt, to fund expansion of our operations or for other purposes. To the extent we issue additional equity securities, the percentage ownership of our existing stockholders would be reduced.

**If a large number of shares of our common stock is sold in the public market, the sales could reduce the trading price of our common stock and impede our ability to raise future capital.**

We cannot predict what effect, if any, future issuances by us of our common stock will have on the market price of our common stock. In addition, shares of our common stock that we issue in connection with an acquisition may not be subject to resale restrictions. The market price of our common stock could drop significantly if certain large holders of our common stock, or recipients of our common stock in connection with an acquisition, sell all or a significant portion of their shares of common stock or are perceived by the market as intending to sell these shares other than in an orderly manner. In addition, these sales could impair our ability to raise capital through the sale of additional common stock in the capital markets.

**Anti-takeover provisions in our charter and by-laws could limit the share price and delay a change of management.**

Our restated certificate of incorporation and by-laws contain provisions that could make it more difficult or even prevent a third party from acquiring us without the approval of our incumbent board of directors. These provisions, among other things:

- prohibit stockholder action by written consent in place of a meeting;
- limit the right of stockholders to call special meetings of stockholders;
- limit the right of stockholders to present proposals or nominate directors for election at annual meetings of stockholders; and
- authorize our board of directors to issue preferred stock in one or more series without any action on the part of stockholders.

In addition, the terms of most of our long term debt require that upon a "change of control," as defined in the agreements that contain the terms and conditions of the long term debt, we make an offer to purchase the outstanding long term debt at either 100% or 101% of the aggregate principal amount of that long term debt.

These provisions could limit the price that investors might be willing to pay in the future for shares of our common stock and significantly impede the ability of the holders of our common stock to change management. Provisions and agreements that inhibit or discourage takeover attempts could reduce the market value of our common stock.

**The market price of our common stock has been volatile and, in the future, the market price of our common stock may fluctuate substantially due to a variety of factors.**

The market price of our common stock has been subject to volatility and, in the future, the market price of our common stock may fluctuate substantially due to a variety of factors, including:

- the depth and liquidity of the trading market for our common stock;
- quarterly variations in actual or anticipated operating results;
- changes in estimated earnings by securities analysts;
- market conditions in the communications services industry;
- announcement and performance by competitors;
- regulatory actions; and
- general economic conditions.

In addition, in recent months the stock market generally has experienced significant price and volume fluctuations. Those market fluctuations could have a material adverse effect on the market price or liquidity of our common stock.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

#### **ITEM 2. PROPERTIES**

Our headquarters are located on 46 acres in the Interlocken Advanced Technology Environment within the City and County of Broomfield, Colorado. The campus facility, which is owned by our wholly owned subsidiary HQ Realty, Inc., encompasses approximately 850,000 square feet of office space.

Additionally, we lease approximately 121,180 square feet of office and technical space in a building located at 180 Peachtree Street, NW in Atlanta, Georgia. We also lease approximately 213,594 square feet of office and technical space in the building known as One Technology Center located at 100 South Cincinnati Avenue in Tulsa, Oklahoma and approximately 54,000 square feet of office space in the Southpointe office park in Canonsburg, Pennsylvania, comprised of approximately 42,500 square feet in the building located at 121 Champion Way and approximately an additional 11,300 square feet in the building located at 601 Technology Drive. We also lease approximately 130,000 square feet of office space in a building located at 1122 South Capital of Texas Highway in Austin, Texas. In Europe, we have approximately 211,000 square feet of office space in the United Kingdom and approximately 3,000 square feet of office space in France.

Properties relating to our network operations in the communications business are described under "ITEM 1. BUSINESS—Our Communications Network" above.

Our Gateway facilities are designed to house local sales staff, operational staff, our transmission and IP routing/switching facilities and technical space to accommodate colocation of equipment by high-volume Level 3 customers. We ended 2007 with approximately 6.9 million square feet of space for our Gateway and transmission facilities and have completed construction on approximately 4.6 million square feet of this space. Our Gateway space is either owned by us or is held pursuant to long-term lease agreements.

We have entered into various agreements regarding our unused office and technical space in order to reduce our ongoing operating expenses regarding such space.

Properties relating to our coal mining segment are described under "ITEM 1. BUSINESS—Our Other Businesses" above. In connection with certain existing and historical operations, we are subject to environmental risks.

### ITEM 3. LEGAL PROCEEDINGS

In April 2002, Level 3 Communications, Inc., and two of its subsidiaries were named as defendants in *Bauer, et. al. v. Level 3 Communications, LLC, et al.*, a purported class action covering 22 states, filed in state court in Madison County, Illinois. In July 2001, Level 3 was named as a defendant in *Koyle, et. al. v. Level 3 Communications, Inc., et. al.*, a purported two state class action filed in the U.S. District Court for the District of Idaho. In November of 2005, the court granted class certification only for the state of Idaho. In September 2002, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *Smith et. al. v. Sprint Communications Company, L.P., et al.*, a purported nationwide class action filed in the United States District Court for the Northern District of Illinois. In April 2005, the Smith plaintiffs filed a Fourth Amended Complaint which did not include Level 3 or Williams Communications, Inc. as a party, thus ending both companies' involvement in the Smith case. On February 17, 2005, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *McDaniel, et. al., v. Qwest Communications Corporation, et al.*, a purported class action covering 10 states filed in the United States District Court for the Northern District of Illinois. These actions involve the companies' right to install its fiber optic cable network in easements and right-of-ways crossing the plaintiffs' land. In general, the companies obtained the rights to construct their networks from railroads, utilities, and others, and have installed their networks along the rights-of-way so granted. Plaintiffs in the purported class actions assert that they are the owners of lands over which the companies' fiber optic cable networks pass, and that the railroads, utilities, and others who granted the companies the right to construct and maintain their networks did not have the legal authority to do so. The complaints seek damages on theories of trespass, unjust enrichment and slander of title and property, as well as punitive damages. The companies have also received, and may in the future receive, claims and demands related to rights-of-way issues similar to the issues in these cases that may be based on similar or different legal theories. To date, other than as noted above, all adjudicated attempts to have class action status granted on complaints filed against the companies or any of their subsidiaries involving claims and demands related to rights-of-way issues have been denied.

It is still too early for the Company to reach a conclusion as to the ultimate outcome of these actions. However, management believes that the Company and its subsidiaries have substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend them vigorously if a satisfactory form of settlement is not approved.

The Company and its subsidiaries are parties to many other legal proceedings. Management believes that any resulting liabilities for these legal proceedings, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could affect future cash flows.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders, through the solicitation of proxies or otherwise.

## Part II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

**Market Information.** Our common stock is traded on the NASDAQ Global Select Market of The NASDAQ Stock Market LLC under the symbol "LVL.T." As of February 26, 2008, there were 7,890 holders of record of our common stock, par value \$.01 per share. The table below sets forth, for the calendar quarters indicated, the high and low per share closing sale prices of our common stock as reported by the NASDAQ Global Select Market of The NASDAQ Stock Market LLC.

Year Ended December 31, 2007	High	Low
First Quarter	\$ 6.76	\$ 5.57
Second Quarter	6.26	5.26
Third Quarter	6.41	4.46
Fourth Quarter	5.04	2.82
Year Ended December 31, 2006	High	Low
First Quarter	\$ 5.60	\$ 2.73
Second Quarter	5.72	3.78
Third Quarter	5.46	3.44
Fourth Quarter	6.02	4.93

#### Equity Compensation Plan Information.

We have only one equity compensation plan—The 1995 Stock Plan, as amended—under which we may issue shares of our common stock to employees, officers, directors and consultants. This plan has been approved by our stockholders. The following table provides information about the shares of our common stock that may be issued upon exercise of awards under the 1995 Stock Plan as of December 31, 2007.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by stockholders	38,503,698†	\$ 4.45†‡	91,780,820
Equity compensation plans not approved by stockholders	0	\$ 0.00	0

† Includes awards of nonqualified stock options, restricted stock, restricted stock units and outperform stock options or outperform stock appreciation units ("OSOs"). For purposes of this table, OSOs are considered to use a single share of our common stock from the total number of shares reserved for issuance under the 1995 Stock Plan.

‡ Includes weighted-average exercise price of outstanding nonqualified stock options and OSOs at the date of grant. The exercise price of an OSO is subject to change based upon the performance of our common stock relative to the performance of the S&P 500 ® Index from the time of the grant of the award until the award has been exercised.

Recipients of OSOs do not realize any value from these awards unless our common stock price outperforms the S&P 500® Index during the life of the grant. When the stock price gain is greater than the corresponding gain on the S&P 500® Index (or less than the corresponding loss on the S&P 500® Index for grants awarded before September 30, 2005), the value received for awards under the OSO program is based on a formula involving a multiplier related to the level by which our common stock outperforms the S&P 500® Index. To the extent that our common stock outperforms the S&P 500® Index, the value of OSO units to a holder may exceed the value of nonqualified stock options.

The initial strike price, as determined on the day prior to the OSO grant date, is adjusted over time, which we refer to as the Adjusted Strike Price, until the exercise date or the vesting date, as the case may be. The adjustment is an amount equal to the percentage appreciation or depreciation in the value of the S&P 500® Index from the date of grant to the date of exercise or vesting, as the case may be. Beginning on April 1, 2007, OSO units are awarded monthly to employees in mid-management level and higher positions, have a three year life, will vest 100 percent on the third anniversary of the date of the award and will fully settle on that date. Recipients have no discretion on the timing to exercise OSO units granted on or after April 1, 2007.

The value of the OSO increases for increasing levels of outperformance. OSO units have a multiplier range from zero to four depending upon the performance of our common stock relative to the S&P 500® Index as shown in the following table.

If Level 3 Stock Outperforms the S&P 500® Index by:	Then the Pre-multiplier Gain Is Multiplied by a Success Multiplier of:
0% or Less	0.00
More than 0% but Less than 11%	Outperformance percentage multiplied by <sup>4</sup> / 11
11% or More	4.00

The Pre-multiplier gain is our common stock price minus the Adjusted Strike Price on the date of exercise or the vesting date, as the case may be. Unlike the exercise of a non-qualified stock option, in the situation where the outperformance is 11 percent or greater, the number of shares of our common stock issued upon exercise or vesting of an OSO may be up to four times the number of OSOs awarded.

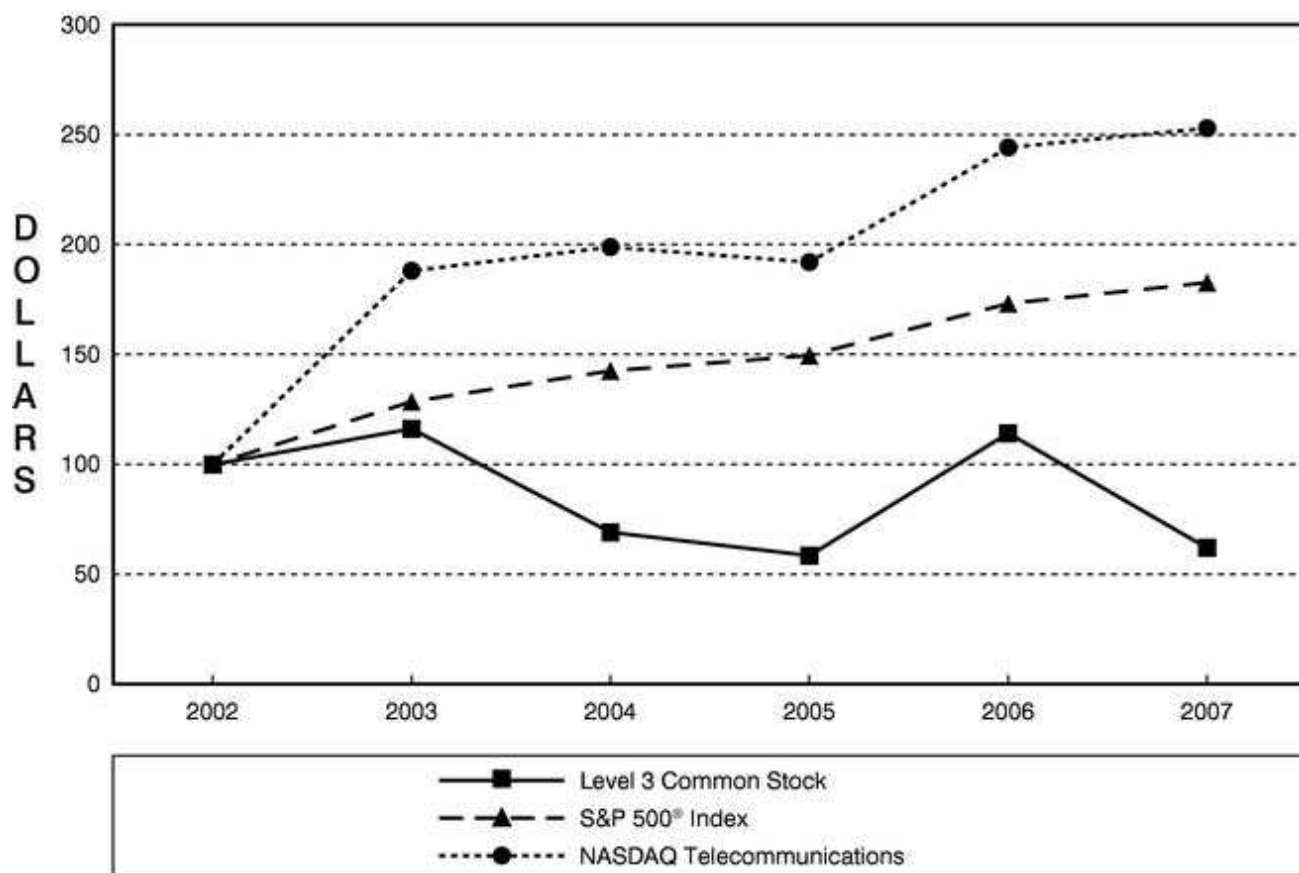
*Dividend Policy.* Our current dividend policy, in effect since April 1, 1998, is to retain future earnings for use in our business. As a result, our directors and management do not anticipate paying any cash dividends on shares of our common stock in the foreseeable future. In addition, under certain of our debt covenants we may be restricted from paying cash dividends on shares of our common stock.

## Performance Graph.

The following performance graph shall not be deemed to be incorporated by reference by means of any general statement incorporating by reference this Form 10-K into any filing under the Securities Act of 1933, as amended or the Securities Exchange Act of 1934, except to the extent that the company specifically incorporates such information by reference, and shall not otherwise be deemed filed under such acts.

The graph compares the cumulative total return of our common stock for the five year period from 2003 through 2007 with the S&P® 500 Index and the Nasdaq Telecommunications Index. The graph assumes that the value of the investment was \$100 on December 31, 2002, and that all dividends and other distributions were reinvested.

**Comparison of Five Year Cumulative Total Return  
Among Our Common Stock, the S&P® 500 Index  
and the Nasdaq Telecommunications Index**



	12/02	12/03	12/04	12/05	12/06	12/07
<b>Level 3 Common Stock</b>	<b>100.00</b>	<b>116.33</b>	<b>69.18</b>	<b>58.57</b>	<b>114.29</b>	<b>62.04</b>
<b>S&amp;P 500® Index</b>	<b>100.00</b>	<b>128.68</b>	<b>142.69</b>	<b>149.70</b>	<b>173.34</b>	<b>182.87</b>
<b>NASDAQ Telecommunications</b>	<b>100.00</b>	<b>188.26</b>	<b>199.05</b>	<b>192.21</b>	<b>244.42</b>	<b>253.15</b>



## ITEM 6. SELECTED FINANCIAL DATA

The Selected Financial Data of Level 3 Communications, Inc. and its subsidiaries appear below.

	Fiscal Year Ended(1)				
	2007	2006	2005	2004	2003
	(dollars in millions, except per share amounts)				
Results of Operations:					
Revenue	\$ 4,269	\$ 3,378	\$ 1,719	\$ 1,776	\$ 2,027
Loss from continuing operations(2)	(1,114)	(790)	(707)	(478)	(695)
Income (loss) from discontinued operations(3)	—	46	69	20	(21)
Net loss	(1,114)	(744)	(638)	(458)	(711)
Per Common Share:					
Loss from continuing operations(2)	(0.73)	(0.79)	(1.01)	(0.70)	(1.23)
Income (loss) from discontinued operations(3)	—	0.05	0.10	0.03	(0.04)
Net loss	(0.73)	(0.74)	(0.91)	(0.67)	(1.26)
Dividends(4)	—	—	—	—	—
Financial Position:					
Total assets	10,245	9,994	8,277	7,544	8,302
Current portion of long-term debt(5)	32	5	—	143	124
Long-term debt, less current portion(5)	6,832	7,357	6,023	5,067	5,249
Stockholders' equity (deficit)(6)	1,070	374	(476)	(157)	181

- (1) The operating results of Software Spectrum, Inc. ("Software Spectrum"), which was sold in 2006, ( i )Structure, LLC ("( i )Structure"), which was sold in 2005, the Midwest Fiber Optic Network business acquired from Genuity, Inc. in 2003 and sold in 2003 are included in discontinued operations for all periods presented for which Level 3 owned each business.

The Company purchased substantially all of the assets and operations of Genuity, Inc. in February 2003. The Company also purchased Teltel Communications, Inc. in July 2003.

The Company acquired the managed modem businesses of ICG Communications, Inc. and Sprint Communications Company, L.P. on April 1, 2004 and October 1, 2004, respectively.

The Company purchased WilTel Communications Group, LLC ("WilTel") on December 23, 2005, and recorded approximately \$38 million of revenue attributable to this business in 2005.

The Company purchased Progress Telecom, LLC ("Progress Telecom") on March 20, 2006; ICG Communications, Inc. ("ICG Communications") on May 31, 2006; TelCove, Inc. ("TelCove") on July 24, 2006 and Looking Glass Networks Holding Co., Inc. ("Looking Glass") on August 2, 2006. The WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass results of operations and financial position are included in the consolidated financial statements from the respective dates of their acquisition. During 2006, the Company recorded revenue attributable to Progress Telecom of \$49 million, ICG Communications of \$46 million, TelCove of \$166 million and Looking Glass of \$33 million.

The Company purchased Broadwing Corporation ("Broadwing") on January 3, 2007; the Content Delivery Network services business of SAVVIS, Inc. (the "CDN Business") on January 23, 2007 and Servecast Limited on July 11, 2007. During 2007, the Company recorded revenue attributable to Broadwing of \$946 million, the CDN Business of \$17 million and Servecast of \$3 million.

- (2) In 2003, the Company recognized approximately \$346 million of termination and settlement revenue, \$45 million of impairment and restructuring charges, a gain of approximately \$70 million from the sale of "91 Express Lanes" toll road assets, \$200 million of induced conversion expenses

attributable to the exchange of the Company's convertible debt securities, and a gain of \$41 million as a result of the early extinguishment of long-term debt.

In 2004, the Company recognized a gain of \$197 million as a result of the early extinguishments of certain long-term debt and \$113 million of termination revenue.

In 2005, the Company recognized \$133 million of termination revenue and approximately \$23 million of impairment and restructuring charges.

In 2006, the Company recognized \$11 million of termination revenue, approximately \$13 million of impairment and restructuring charges, and a loss on early extinguishment of debt of \$83 million as a result of the amendment and restatement of its senior secured credit facility and certain debt exchanges and redemptions.

In 2007, the Company recognized \$10 million of termination revenue, approximately \$12 million of impairment and restructuring charges, and a loss on early extinguishment of debt of \$427 million as a result of the refinancing of its senior secured credit agreement and certain debt exchanges, redemptions and repurchases. The Company also recognized a gain of \$37 million on the sale of marketable equity securities and a tax benefit of \$23 million related to certain state tax matters.

- (3) In 2005, the Company sold ( i )Structure and recognized a gain on the sale of \$49 million. For fiscal years 2005 and 2004, ( i )Structure revenue approximated costs. The loss from operations was \$17 million in 2003 for ( i )Structure.

In 2006, the Company sold Software Spectrum and recognized a gain on the sale of \$33 million. The income (loss) from the operations of Software Spectrum including the contact services business sold in 2003 were \$13 million, \$20 million, \$20 million and \$(16) million for the fiscal years 2006, 2005, 2004 and 2003, respectively.

- (4) The Company's current dividend policy, in effect since April 1998, is to retain future earnings for use in the Company's business. As a result, management does not anticipate paying cash dividends on shares of common stock in the foreseeable future. In addition, the Company is restricted under certain covenants from paying cash dividends on shares of its common stock.
- (5) In 2003, the Company received net proceeds of \$848 million from the issuance of \$374 million of 2.875% Convertible Senior Notes due 2010 and the issuance by its wholly owned subsidiary of \$500 million of 10.75% Senior Notes due 2011. The Company completed a debt exchange whereby the Company issued \$295 million (face amount) of 9% Convertible Senior Discount Notes due 2013 and common stock in exchange for \$352 million (book value) of long-term debt. In addition, Level 3 using cash on hand, restricted cash and the proceeds from the issuance of the 10.75% Senior Notes due 2011, repaid in full, the \$1.125 billion purchase money indebtedness outstanding under the Senior Secured Credit Facility. Also in 2003, the Company repurchased, using common stock, approximately \$1.007 billion face amount of its long-term debt and recognized a gain of approximately \$41 million as a result of the early extinguishment of debt.
- In 2004, the Company received net proceeds of \$987 million from the issuance of a \$730 million Senior Secured Term Loan due 2011 and the issuance of \$345 million of 5.25% Convertible Senior Notes due 2011. The Company used the net proceeds to repay portions of its 9.125% Senior Notes due 2008, 11% Senior Notes due 2008, 10.5% Senior Discount Notes due 2008 and 10.75% Senior Euro Notes due 2008. The Company repurchased portions of the outstanding notes at prices ranging from 83 percent to 89 percent of the repurchased principal balances. The net gain on the early extinguishment of the debt, including transaction costs, realized foreign currency losses and unamortized debt issuance costs, was \$50 million for these transactions. Also in 2004, the Company paid approximately \$54 million and assumed certain obligations to extinguish a Genuity capital lease obligation and recognized a gain of \$147 million on the transaction.

In 2005, the Company received net proceeds of \$877 million from the issuance of \$880 million of 10% Convertible Senior Notes due 2011. Also in 2005, a wholly owned subsidiary of the Company received net proceeds of \$66 million from the completion of a refinancing of the mortgage of its corporate headquarters. The subsidiary entered into a new mortgage loan of \$70 million at an initial fixed rate of 6.86% through 2010.

In 2006, the Company received net proceeds of \$142 million from the issuance by its wholly owned subsidiary of \$150 million of Floating Rate Senior Notes due 2011, net proceeds of \$538 million from the issuance of \$550 million of 12.25% Senior Notes due 2013, net proceeds of \$326 million from its issuance of \$335 million of 3.5% Convertible Senior Notes due 2012 and net proceeds of \$1.239 billion (excluding prepaid interest) from the issuance by its wholly owned subsidiary of \$1.250 billion of 9.25% Senior Notes due 2014. Also in 2006, the Company exchanged a portion of its outstanding 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 for \$46 million of cash and \$692 million aggregate principal of new 11.5% Senior Notes due 2010. In addition, the Company redeemed the remaining outstanding 9.125% Senior Notes due 2008 totaling \$398 million, 10.5% Senior Discount Notes due 2008 totaling \$62 million and repurchased 99.3% of its wholly owned subsidiary's 10.75% Senior Notes due 2011 totaling \$497 million.

In 2007, the Company received net proceeds of \$982 million from the issuance by its wholly owned subsidiary of 8.75% Senior Notes due 2017 and Floating Rate Senior Notes due 2015 and net proceeds of \$1.382 billion for the refinancing of its senior secured credit agreement. In connection with the refinancing of the senior secured credit agreement the borrower repaid its \$730 million Senior Secured Term Loan due 2011. In 2007, the Company redeemed \$488 million of its outstanding 12.875% Senior Notes due 2010, \$96 million of outstanding 11.25% Senior Notes due 2010 and \$138 million (€104 million) of outstanding 11.25% SeniorEuro Notes due 2010. Also in 2007, the Company's wholly owned subsidiary repurchased \$144 million of its outstanding Floating Rate Senior Notes due 2011, the Company repurchased \$59 million of its outstanding 11% Senior Notes due 2008, \$677 million of its outstanding 11.5% Senior Notes due 2010 and \$61 million (€46 million) of its outstanding 10.75% Senior Euro Notes due 2008. The Company also completed the exchange of \$605 million of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of common stock during 2007. The Company also converted or repurchased \$180 million of Broadwing's outstanding 3.125% Convertible Senior Debentures due 2026 through the issuance of 17 million shares of common stock and the payment of \$106 million in cash in 2007.

- (6) In 2003, the Company issued approximately 216 million shares of common stock, valued at approximately \$953 million, in exchange for long-term debt. Included in the value of common stock issued, are induced conversion premiums of \$200 million for convertible debt securities.

In 2004, the Company realized \$95 million of foreign currency losses on the repurchase of its Euro denominated debt.

In 2005, the Company issued 115 million shares of common stock, valued at approximately \$313 million, as the stock portion of the purchase price paid to acquire WilTel.

In 2006, the Company issued approximately 125 million shares of common stock in a public offering, valued at approximately \$543 million.

In 2006, the Company issued 20 million shares of common stock, valued at approximately \$66 million, as the stock portion of the purchase price paid to acquire Progress Telecom; 26 million shares of common stock, valued at approximately \$131 million, as the stock portion of the purchase price paid to acquire ICG Communications; 150 million shares of common stock, valued at approximately \$623 million, as the stock portion of the purchase price paid to acquire TelCove;

and 21 million shares of common stock, valued at approximately \$84 million, as the stock portion of the purchase price paid to acquire Looking Glass.

In 2007, the Company issued 197 million shares of common stock in exchange for \$605 million of its 10% Convertible Senior Notes due 2011. The Company also issued 123 million shares of common stock, valued at approximately \$688 million, as the stock portion of the purchase price to acquire Broadwing Corporation. Also in 2007, the Company issued 17 million shares of common stock in connection with the conversion of \$179 million of Broadwing's outstanding 3.125% Convertible Senior Debentures due 2026.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This document contains forward looking statements and information that are based on the beliefs of management as well as assumptions made by and information currently available to Level 3 Communications, Inc. and its subsidiaries ("Level 3" or the "Company"). When used in this document, the words "anticipate", "believe", "plan", "estimate" and "expect" and similar expressions, as they relate to the Company or its management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this document.

The following discussion should be read in conjunction with the Company's consolidated financial statements (including the notes thereto), included elsewhere herein.

Level 3 Communications, Inc., through its operating subsidiaries, is primarily engaged in the communications business, with additional operations in coal mining.

### ***Communication Services***

The Company is a facilities-based provider of a broad range of communications services. Revenue for communications services is recognized on a monthly basis as these services are provided. For contracts involving private line, wavelengths and dark fiber services, Level 3 may receive up-front payments for services to be delivered for a period of up to 20 years. In these situations, Level 3 defers the revenue and amortizes it on a straight-line basis to earnings over the term of the contract. At December 31, 2007, for contracts where up-front payments were received for services to be delivered in the future, the Company's weighted average remaining contract period was approximately 14 years.

The Company separates its communications services into three separate categories:

- Core Communications Services;
- Other Communications Services; and
- SBC Contract Services.

Each category of revenue is in a different phase of the service life cycle, requiring different levels of investment and focus and providing different contributions to the Company's Communications Adjusted EBITDA. Management of Level 3 believes that growth in revenue from its Core Communications Services is critical to the long-term success of its communications business. At the same time, the Company believes it must continue to manage effectively the positive cash flows from its SBC Contract Services and its Other Communications Services, including the Company's mature managed modem business and its related reciprocal compensation. For 2007, the Core Communications Services category included revenue from transport and infrastructure, IP and data services, voice and Level 3 Vyvx video and advertising distribution services. The Other Communications Services category

includes revenue from managed modem and related reciprocal compensation and the legacy managed IP service business. The SBC Contract Services category includes all the revenue related to the SBC Master Services Agreement, which was included in the acquisition of WilTel Communications Group, LLC ("WilTel").

The Company's transport and infrastructure services include metropolitan and intercity wavelengths, private line, ethernet private line, dark fiber, colocation services, professional services and transoceanic services. Growth in transport and infrastructure revenue is largely dependent on increased demand for bandwidth services and available capital of companies requiring communications capacity for their own use or in providing capacity as a service provider to their customers. These expenditures may be in the form of up-front payments or monthly payments for primarily private line, wavelength or dark fiber services. An increase in demand may be partially offset by declines in unit pricing.

IP and data services primarily include the Company's high-speed Internet access service, dedicated Internet access ("DIA") service, ATM and frame relay services, IP and ethernet virtual private network ("VPN") services, and content delivery network ("CDN") services, which includes streaming services. Level 3's high-speed Internet access service is a high quality and high-speed Internet access service offered in a variety of capacities. The Company's VPN services permit businesses of any size to replace multiple networks with a single, cost-effective solution that greatly simplifies the converged transmission of voice, video, and data. This convergence to a single platform can be obtained without sacrificing the quality of service or security levels of traditional ATM and Frame Relay offerings. VPN services also permit customers to prioritize network application traffic so that high priority applications, such as voice and video, are not compromised in performance by the flow of low priority applications such as email.

The Company believes that one of the largest sources of future incremental demand for the Company's Core Communications Services will be from customers that are seeking to distribute their feature rich content or video over the Internet. Revenue growth in this area is dependent on the continued increase in usage by both enterprises and consumers and the pricing environment. An increase in the reliability and security of information transmitted over the Internet and declines in the cost to transmit data have resulted in increased utilization of e-commerce or web based services by businesses. This market is currently characterized by significant price compression and very high levels of unit growth rates, resulting in growth in absolute revenue. The Company experienced price compression in the high-speed IP market of over 30% in 2007 and expects that its pricing for high-speed IP services will continue to decline in 2008 at similar rates.

The Company continues to experience pricing pressure for those transport and infrastructure customers that require simple, low quality, point-to-point services, as certain competitors aggressively pursued this business. However, Level 3 believes that competitors are less willing to discount these services if it requires investment in incremental capacity to meet the customer's requirements. For those customers that provide high quality content or require a combination of transport, IP and voice solutions on a regional or national platform, Level 3 is seeing moderate price compression and, in some cases, prices are increasing.

The Company offers voice services that target large and existing markets. The revenue potential for voice services is large; however, the revenue and margins are expected to continue to decline over time as a result of the new low-cost IP and optical-based technologies. In addition, the market for voice services is being targeted by many competitors, several of which are larger and have more financial resources than the Company.

The Company, through its Level 3 Vyvx business, provides audio and video programming for its customers over the Company's fiber-optic network and via satellite. It uses the Company's fiber-optic network to carry live traditional broadcast and cable television events from the site of the event to the network control centers of the broadcasters of the event.

For live events where the location is not known in advance, such as breaking news stories in remote locations, the Company provides an integrated satellite and fiber-optic network-based service to transmit the content to its customers. Most of Level 3's Vyvx's customers for these services contract for the service on an event-by-event basis; however, there are some customers who have purchased a dedicated point-to-point service which enables these customers to transmit programming at any time.

Level 3 Vyvx also distributes advertising spots to radio and television stations throughout the U.S., both electronically and in physical form. Customers for these services can utilize a network-based method for aggregating, managing, storing and distributing content for content owners and rights holders.

On December 19, 2007, Level 3 announced that it had reached a definitive agreement to sell the advertising distribution business of Vyvx, LLC ("Vyvx Ads") to DG FastChannel, Inc. for \$129 million in cash. The sale is expected to close in the second quarter of 2008. Revenue from the Vyvx Ads business totaled approximately \$36 million, \$35 million and less than \$1 million for the years ended December 31, 2007, 2006 and 2005, respectively. The results of operations for the Vyvx Ads business are included in continuing operations from when it was acquired as part of the WilTel transaction in December 2005. The pending disposal of the Vyvx Ads business does not meet the criteria under Statement of Financial Accounting Standard ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144") for presentation as discontinued operations since the business is not considered an asset group as defined in SFAS No. 144.

The Company expects to continue to develop its content distribution services through the acquisition of the Content Delivery Network ("CDN") services business (the "CDN Business") which it purchased on January 23, 2007 from SAVVIS, Inc. for approximately \$133 million in cash (including transaction costs) and the acquisition of Dublin, Ireland based Servecast Limited, which it purchased on July 11, 2007, for approximately \$46 million in cash (including transaction costs). The Company believes that the addition of the CDN Business with its strong, broad portfolio of patents will help the Company secure its commercial efforts in the heavily patented CDN market in which a number of competitors have significant, patented intellectual property. In early 2007 we embarked on a strategy to refine our capabilities to address the communications needs of those organizations that produce the content that individuals want to view over the Internet. This service offering includes high speed IP services, colocation services and services that cost effectively distribute the content that is produced for consumption over the Internet. We believe that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet.

The Company's Other Communications Services are mature services that are not areas of emphasis for the Company. Other Communications Services currently include managed modem, related reciprocal compensation and legacy managed IP services.

The Company and its customers continue to see consumers migrate from narrow band dial-up services to higher speed broadband services as the narrow band market matures. Additionally, America Online, a primary consumer of the Company's dial-up services, has been implementing a strategic change in its approach to its dial-up internet access business over the past 18 months that has accelerated the loss of its dial-up subscribers. During 2007, America Online's strategy accelerated the decline in Level 3 managed modem revenue and is expected to contribute to further declines in managed modem revenue in 2008. The Company recognized approximately \$179 million of managed modem revenue in 2007, an approximate 37% decline from the \$286 million of managed modem revenue recognized in 2006. The declines in managed modem revenue from America Online in 2007 have been offset to some extent by an increase in market share as a result of certain competitors exiting segments of this business in the second half of 2006 and the full year 2007. Level 3 believes that

the low-cost structure of its network will enable it to compete aggressively for new business in the declining, but still significant, managed modem market.

Level 3 receives compensation from other carriers when it terminates traffic originating on those carriers' networks. This reciprocal compensation is based on interconnection agreements with the respective carriers or rates mandated by the FCC. The Company earns the majority of its reciprocal compensation revenue from providing managed modem services. The Company also began to receive increasing amounts of reciprocal compensation from its voice services during 2007.

Legacy managed IP services primarily include low-speed services over ATM technology and frame technology, as well as managed security services. The Company's legacy Internet access business consists primarily of a business that was acquired in the Genuity transaction in 2003. To date, the Company has elected not to pursue additional customers and to limit the capital invested in this component of its business.

The SBC Master Services Agreement was an agreement between SBC Services Inc. and WilTel ("SBC Contract Services Agreement") and was obtained in the WilTel acquisition. SBC Services Inc. became a subsidiary of AT&T Inc., (together "SBC"). WilTel and SBC amended their agreement in June 2005 to run through 2009. The Company recognized \$303 million of revenue under the SBC Contract Services Agreement during 2007. The agreement provides a gross margin purchase commitment of \$335 million from December 2005 through the end of 2007, and \$75 million from January 2008 through the end of 2009 and stipulates that originating and terminating access charges paid to local phone companies get passed through to SBC in accordance with a formula that approximates costs and do not count against the gross margin purchase commitment. SBC fully satisfied the \$335 million gross margin purchase commitment during the third quarter of 2007. As a result of satisfying the initial gross margin purchase commitment, SBC's purchases of services that exceed the original \$335 million gross margin purchase commitment now count toward the \$75 million gross margin purchase commitment for the period from January 2008 through the end of 2009. As of December 31, 2007, SBC had satisfied \$39 million of the \$75 million gross margin purchase commitment. Level 3 expects that based on SBC's current level of spending, SBC will satisfy the remaining \$36 million of gross margin purchase commitment in the first half of 2008.

Additionally, the SBC Contract Services Agreement provides for the payment of \$50 million from SBC if certain performance criteria are met by Level 3. The Company met the required performance criteria and recorded annual revenue of \$25 million in both 2006 and 2007 under the agreement. Of the annual amounts, 50% was based on monthly performance criteria and the remaining 50% was based on performance criteria for the full years. The performance-based incentive provisions of the agreement ended on December 31, 2007. Level 3 will not earn performance-based incentives in 2008 under the SBC Contract Services Agreement.

As a result of the reductions in SBC Contract Services revenue and the overall increase in revenue from acquisition activity, concentration of revenue among a limited number of customers has decreased compared to previous periods. Level 3's top ten customers, including the SBC Contract Services revenue, represented 61% of total communications revenue in the first quarter of 2006, dropping to 36% of total communications revenue in the fourth quarter of 2007. Excluding the SBC Contract Services revenue, Level 3's top ten customers represented 39% of total communications revenue in the first quarter of 2006, dropping to 31% of total communications revenue in the fourth quarter of 2007. The Company expects the concentration of revenue from its top ten customers to continue to decline moderately in 2008 as the SBC Contract Services revenue continues to decline. However, if Level 3 would lose one or more major customers, or if one or more major customers significantly decreased its orders for Level 3 services, the Company's communications business would be materially and adversely affected.

Level 3's management continues to review all of the Company's existing lines of business and service offerings to determine how those lines of business and service offerings assist with the Company's focus on the delivery of communications services and meeting its financial objectives. To the extent that certain lines of business, business segments or service offerings are not considered to be compatible with the delivery of the Company's services or with obtaining financial objectives, Level 3 may exit those lines of business segments or stop offering those services.

The Company is focusing its attention on the following operational objectives:

- growing revenue in Core Communications Services;
- continuing to show improvements in Adjusted EBITDA as a percentage of revenue;
- achieving sustainable generation of free cash flow;
- completing the integration of acquired businesses;
- growing its content delivery network services;
- continuing to implement its metro network strategy; and
- managing cash flows provided by its Other Communications Services and SBC Contract Services.

Management of Level 3 believes the introduction of new services or technologies, as well as the further development of existing technologies, may reduce the cost or increase the supply of certain services similar to those provided by Level 3. The ability of the Company to anticipate, adapt and invest in these technology changes in a timely manner may affect the Company's future success.

The Company completed the initial planned deployment of the next generation of optical transport technology in its North American and European networks in the fourth quarter of 2005 and early in the first quarter of 2006, respectively. The Company decided to deploy the technology for additional routes in North America and Europe and completed the deployments on these routes in 2006. The Company completed an upgrade of its IP backbone technology in the fourth quarter of 2005. Level 3 believes that this deployment of new equipment to the existing network equipment will allow the Company to optimize the amount of traffic it carries over the network and lower its cost of providing its services.

To expand its service offerings in Europe, the Company invested approximately \$20 million for a dark fiber based expansion in Europe. During 2006, the Company obtained dark fiber primarily in those cities currently served by leased wavelength capacity and additionally in 2006 the Company completed an expansion of our European operations to nine additional cities. During 2007, the Company obtained dark fiber in three cities that had been served by leased wavelength capacity and additionally in 2007 the Company completed an expansion of its European operations to nine additional cities. In 2008, the Company expects to continue its European expansion to one additional city using leased wavelength capacity. The Company expects to use the dark fiber with appropriate transmission equipment to sell a full suite of transport and IP services.

The communications industry continues to consolidate. Level 3 has participated in this process with the acquisitions of WilTel in 2005; Progress Telecom, LLC ("Progress Telecom"); ICG Communications, Inc. ("ICG Communications"); TelCove, Inc. ("TelCove") and Looking Glass Networks Holding Co., Inc. ("Looking Glass") in 2006; and Broadwing Corporation ("Broadwing"); the CDN Business and Servecast in 2007. Level 3 will continue to evaluate consolidation opportunities and could make additional acquisitions in the future.



The successful integration of acquired businesses into Level 3 is important to the success of Level 3. The Company must integrate the networks and support organizations, while maintaining the service quality levels expected by customers in order to realize the anticipated benefits of these acquisitions. Successful integration of these acquired businesses will depend on the Company's ability to manage these operations, realize opportunities for revenue growth presented by strengthened service offerings and expanded geographic market coverage. If the Company is not able to efficiently and effectively integrate the acquired businesses or operations, the Company may experience material negative consequences to its business, financial condition or results of operations.

During the second and third quarters of 2007, the Company's service activation times increased as a result of the following issues.

- Continuing to use the multiple order entry and provisioning systems and processes that were operated by the acquired companies to provision end-to-end services.
- Insufficient training on the multiple systems for employees performing service activation functions.
- Lack of sufficient staffing levels in some service activation areas.
- Identifying and fixing service activation throughput issues was challenging as a result of decentralizing service activation functions across the customer facing groups.

This increase in service activation cycle time had a negative effect on the Company's service installation intervals and the rate of Core Communications Services revenue growth during the second, third and fourth quarters of 2007. During this same period, the Company also experienced challenges in its service management processes that resulted in longer response times to resolve customers' network service issues. As a result of consolidating key operational functions and organizations as part of the integration effort, the Company's operating environment became more complex in the first half of 2007.

During the second and third quarters, the Company implemented certain process and organizational changes that were expected to improve service activation times and allow it to achieve its previously forecasted revenue and Adjusted EBITDA growth. However these changes were not adequate to address the breadth of the problems encountered during the third quarter. As a result of these service activation and service management issues, the growth in Communications Services Revenue and Adjusted EBITDA was lower than expected for the full year 2007 and is expected to be lower than originally forecasted in 2007 for the full year 2008.

The Company has ongoing process and system development work that is being implemented as part of the integration efforts that is expected to address the service activation and service management issues described above as well as provide significant overall improvements to operations. The processes and systems under development remain largely on track with certain components deployed beginning in October 2007 and additional deployments scheduled through the end of 2008. While the operational benefits vary by each project, the Company expects to realize meaningful improvements in its operating environment during the second half of 2008. In addition, the Company is taking steps to improve its existing processes and systems to address the increase in service activation times and improve its service management. During the fourth quarter of 2007, the Company improved its provisioning capability by both increasing resources and through process improvement. The Company believes that its customers' experiences with Level 3 have improved and the Company continues to make process and organizational changes to improve its capabilities in 2008.

Level 3 has embarked on a strategy to expand its current metro presence. The strategy allows the Company to increasingly terminate traffic over its owned metro facilities rather than paying third parties to terminate the traffic. Level 3's ability to provide high-speed bandwidth directly to customer

facilities is expected to be a competitive advantage. The Company intends to offer a broad range of services in these markets and concentrate its sales efforts on the bandwidth intensive businesses. The expansion into new metro markets should also provide additional opportunities to sell services on the Company's national and international networks. This metro strategy included the acquisitions of Progress Telecom, ICG Communications, TelCove and Looking Glass. As part of its metro strategy and as a result of the acquisition of TelCove in 2006 and Broadwing in 2007, the Company is also targeting enterprise customers directly through its Business Markets Group described in more detail below. With the acquisition of the CDN Business and Servecast in 2007, Level 3 embarked on a strategy to expand its content delivery network services in both the United States and Europe.

The change in the composition of the Company's revenue requires the Company to manage operating expenses carefully and concentrate its capital expenditures on those technologies and assets that enable the Company to develop its Core Communications Services further and replace the decline in revenue and earnings from Other Communications Services and SBC Contract Services.

In the third quarter of 2006, Level 3 announced the formation of four customer-facing groups to better serve the changing needs of customers in growing markets and drive growth across the organization:

- The Wholesale Markets Group services the communications needs of the largest national and global service providers, including carriers, cable companies, wireless companies, and voice service providers. These customers typically integrate Level 3 services into their own products and services to offer to their end user customers. Revenue from the Wholesale Markets Group represented 56% of Core Communications Services revenue for 2007.
- The Business Markets Group targets enterprise customers and regional carriers who value a local, professional sales force. Specific customer markets include small, medium, and large businesses, local and regional carriers, state and local government entities, and higher education institutions and consortia. Revenue from the Business Markets Group represented 26% of Core Communications Services revenue for 2007.
- The Content Markets Group focuses on serving media and content companies with large and growing bandwidth needs. Customers in this market include video distribution companies, providers of gaming, mega-portals, software service providers, social networking providers, as well as more traditional media distribution companies such as broadcasters, television networks and sports leagues. Revenue from the Content Markets Group represented 11% of Core Communications Service revenue for 2007.
- The European Markets Group serves large European consumers of bandwidth, including the European and international carriers, large system integrators, voice service providers, cable operators, Internet service providers, content providers, and government and education sectors. Revenue from the European Markets Group represented 7% of Core Communications Services revenue for 2007.

The Company believes that the alignment around customer markets should allow it to drive growth while enabling it to better focus on the needs of its customers. Beginning in 2008, the Company will disclose Core Communications Services revenue in dollars and as a percentage of total Core Communications Services revenue for each of its market groups, Wholesale, Business, Content and Europe.

In addition to the operational objectives mentioned above, the Company has also been focused on improving its liquidity and financial condition, including efforts to extend the maturity dates of certain debt and lowering the effective interest rate on its outstanding debt.

In January 2007, in two separate transactions, the Company completed the exchange of \$605 million of outstanding principal of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of Level 3's common stock. The Company recognized a \$177 million loss on the exchanges in the first quarter of 2007.

In February 2007, Level 3 Financing, Inc., a wholly owned subsidiary of Level 3 ("Level 3 Financing") issued \$700 million of its 8.75% Senior Notes due 2017 and \$300 million of its Floating Rate Senior Notes due 2015 and received net proceeds of \$982 million. The proceeds from these private offerings were used to refinance certain Level 3 Financing debt and to fund the cost of construction, installation, acquisition, lease, development or improvement of other assets to be used in Level 3's communications business.

In March 2007, Level 3 Financing refinanced its senior secured credit agreement and received net proceeds of \$1.382 billion. The proceeds from this transaction were used to repay the existing \$730 million senior secured credit agreement and other debt. The effect of this transaction was to increase the amount of senior secured debt from \$730 million to \$1.4 billion, reduce the interest rate on that debt from the London Interbank Offering Rate ("LIBOR") plus 3.00% to LIBOR plus 2.25% and extend the final maturity from 2011 to 2014. The Company recognized a \$10 million loss on the extinguishment of the existing \$730 million Senior Secured Term Loan due 2011 due to recognition of the remaining unamortized debt issuance costs.

During the first quarter of 2007, the Company redeemed the entire outstanding principal of the following debt issuances totaling \$722 million:

- \$488 million of 12.875% Senior Notes due 2010 at a price equal to 102.146 of the principal amount;
- \$96 million of 11.25% Senior Notes due 2010 at a price equal to 101.875 of the principal amount; and
- \$138 million (€104 million) of 11.25% Senior Euro Notes due 2010 at a price equal to 101.875 of the principal amount.

Also during the first quarter of 2007, the respective issuers repurchased, through tender offers, \$941 million of the outstanding principal amounts of the following debt issuances:

- \$144 million of its outstanding Floating Rate Senior Notes due 2011 at a price equal to \$1,080 per \$1,000 principal amount of the notes, which included \$1,050 as the tender offer consideration and \$30 as a consent payment;
- \$59 million of its outstanding 11% Senior Notes due 2008 at a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which included \$1,024.28 as the tender offer consideration and \$30 as a consent payment;
- \$677 million of its outstanding 11.5% Senior Notes due 2010 at a price equal to \$1,115.26 per \$1,000 principal amount of the notes, which included \$1,085.26 as the tender offer consideration and \$30 as a consent payment; and
- \$61 million (€46 million) of its outstanding 10.75% Senior Euro Notes due 2008 at a price equal to €1,061.45 per €1,000 principal amount of the notes, which included €1,031.45 as the tender offer consideration and €30 as a consent payment.

The Company recognized a \$240 million loss associated with the redemptions and repurchases in the first quarter of 2007. The cash portion of the loss on redemptions and tenders totaled \$165 million and the remaining \$75 million consisted of unamortized debt issuance costs and unamortized discounts.

In the first quarter of 2007, for total cash consideration of \$106 million and equity consideration of 17 million shares of common stock (valued at \$97 million) all of Broadwing's outstanding \$180 million aggregate principal amount of 3.125% Convertible Senior Debentures due 2026 were retired. These debentures were issued by Broadwing prior to Level 3's acquisition of Broadwing on January 3, 2007. There was no gain or loss recognized due to the fact that, under purchase accounting, the liability for the notes was valued at the total cost to retire the obligation.

The Company will continue to look for opportunities to improve its financial position and focus its resources on growing revenue and managing costs for the communications business.

### ***Coal Mining***

Level 3, through its two 50% owned joint-venture surface mines in Montana and Wyoming, sells coal primarily through long-term contracts with public utilities. The long-term contracts for the delivery of coal establish the price, volume, and quality requirements of the coal to be delivered. Revenue under these and other contracts is recognized when coal is shipped to the customer.

### ***Information Services***

On November 30, 2005, the Company sold its wholly owned subsidiary, ( i )Structure, LLC, which provided computer outsourcing services primarily to small and medium-sized businesses. The Company also completed the disposition of its remaining subsidiary in the information services business, Software Spectrum, Inc. on September 7, 2006. The results of operations and financial position for ( i )Structure and Software Spectrum are reflected as discontinued operations for all periods presented in this report.

### **Critical Accounting Policies**

The Company has identified the policies below as critical to its business operations and the understanding of its results of operations. The effect of any associated risks related to these policies on the Company's business operations is discussed throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations where these policies affect the Company's reported and expected financial results.

#### ***Revenue***

Revenue for communications services, including voice, private line, wavelengths, colocation, Internet access, managed modem, data services, video and dark fiber revenue is recognized monthly as the services are provided. Communications services are provided either on a usage basis, which can vary period to period, or at a contractually committed amount.

Reciprocal compensation revenue is recognized when an interconnection agreement is in place with another carrier, or if an agreement has expired, when the parties have agreed to continue operating under the previous agreement until a new agreement is negotiated and executed; or at rates mandated by the FCC. Periodically, the Company will receive payment for reciprocal compensation services in excess of FCC rates and before an agreement is in place. These amounts are included in other current liabilities on the consolidated balance sheet until a final agreement has been reached and the necessary regulatory approvals have been received at which time the reciprocal compensation revenue is recognized. These amounts were insignificant to the Company in 2007 and 2006.

Revenue attributable to leases of dark fiber pursuant to indefeasible rights-of-use agreements ("IRUs") that qualify for sales-type lease accounting, and were entered into prior to June 30, 1999, was recognized at the time of delivery and acceptance of the fiber by the customer. Certain sale and long-term IRU agreements of dark fiber and capacity entered into after June 30, 1999, are required to be accounted for in the same manner as sales of real estate with property improvements or integral

equipment. This accounting treatment results in the deferral of revenue for the cash that has been received and the recognition of revenue ratably over the term of the agreement (currently up to 20 years).

Termination revenue is recognized when a customer disconnects service prior to the end of the contract period, for which Level 3 had previously received consideration and for which revenue recognition was deferred. Termination revenue is also recognized when customers make termination penalty payments to Level 3 to settle contractually committed purchase amounts that the customer no longer expects to meet or when a customer and Level 3 renegotiate a contract under which Level 3 is no longer obligated to provide product or services for consideration previously received and for which revenue recognition has been deferred. Termination revenue is reported in the same manner as the original product or service provided.

Accounting practice and guidance with respect to the accounting treatment of revenue continues to evolve. Any changes in the accounting treatment could affect the manner in which the Company accounts for revenue within its communications and coal businesses.

#### *Non-Cash Compensation*

The Company adopted SFAS No. 123R, "Share-Based Payment" ("SFAS No. 123R") effective January 1, 2006. SFAS No. 123R requires that compensation cost relating to share-based payment transactions be recognized in the financial statements based on the fair value of equity or liability instruments issued. The Company adopted the expense recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), in 1998. Therefore, the effect of applying the change from the original provisions of SFAS No. 123 on the Company's financial position or results of operations was insignificant. Although the recognition of the value of the instruments results in compensation or professional expenses in an entity's financial statements, the expense differs from other compensation and professional expenses in that these charges, though generally permitted to be settled in cash, are typically settled through the issuance of common stock, which would have a dilutive effect upon earnings per share, if and when such options are exercised. The determination of the estimated fair value used to record the compensation or professional expenses associated with the equity or liability instruments issued requires management to make a number of assumptions and estimates that can change or fluctuate over time.

#### *Long-Lived Assets*

Property, plant and equipment is stated at cost, reduced by provisions to recognize economic impairment in value when management determines that events have occurred that require an analysis of potential impairment. Costs associated directly with network expansions and the development of business support systems, primarily employee-related costs, are capitalized. The Company capitalized \$102 million, \$72 million and \$51 million of cost, primarily direct labor and related employee benefits, in 2007, 2006 and 2005, respectively.

Intercity network segments, gateway facilities, local networks and operating equipment that have been placed in service are being depreciated over their estimated useful lives, primarily ranging from 2-40 years. The total cost of a business support system is amortized over a useful life of three years. The useful lives of the Company's assets are estimates and actual in-service periods for specific assets could differ significantly from these estimates. Due to changes in technology and the competitive environment, these estimates require a significant amount of judgment. Management monitors and evaluates these estimates on an annual basis or as circumstances change that may indicate a change in estimate is required. During 2006 the Company extended the useful lives of its existing fiber assets from seven to 12 years, its existing transmission equipment from five to seven years and its existing IP equipment from three to four years.

The Company at least annually, or as events or circumstances change that could affect the recoverability of the carrying value of its long-lived assets, conducts a comprehensive review of the carrying value of its assets to determine if the carrying amount of the assets are recoverable in accordance with SFAS No. 144. This review requires the identification of the lowest level of identifiable cash flows for purposes of grouping assets subject to review. The estimate of undiscounted cash flows includes long-term forecasts of revenue growth, gross margins and capital expenditures. All of these items require significant judgment and assumptions. An impairment loss may exist when the estimated undiscounted cash flows attributable to the assets are less than their carrying amount. If an asset is deemed to be impaired, the amount of the impairment loss recognized represents the excess of the long-lived asset's carrying value as compared to its estimated fair value, based on management's assumptions and projections.

The Company assessed its communications long-lived assets for impairment in the fourth quarter of 2007, and determined that an impairment charge was not required. The communications network includes network equipment, fiber, multiple conduits, customer premise equipment and colocation facilities. The impairment analysis is based on a long-term cash flow forecast to assess the recovery of the communications assets over their estimated useful lives.

Level 3 also assesses the carrying value of goodwill on an annual basis in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets." (SFAS No. 142). The carrying value of the reporting unit is compared to its fair value. If the fair value does not exceed the carrying value of the reporting unit, an analysis is performed to determine if an impairment charge should be recorded. The Company also evaluates intangible assets with indefinite lives individually on an annual basis, or as events or circumstances change that could affect the recoverability of the carrying value of the asset, in accordance with SFAS No. 142. The Company did not record charges for the impairment of long-lived assets or goodwill in 2007, 2006 or 2005.

Management's estimate of the future cash flows attributable to its long-lived assets and the fair value of its businesses involve significant uncertainty. Those estimates are based on management's assumptions of future results, growth trends and industry conditions. The impairment analysis of long-lived assets also requires management to make certain subjective assumptions and estimates regarding the expected future use of certain additional conduits evaluated for impairment separately from the network asset group. Management will continue to assess the Company's assets for impairment as events occur or as industry conditions warrant. Given the significant uncertainty, judgment and assumptions involved in developing the estimates of future cash flows and the number of years of remaining useful life of certain of the Company's assets, it is possible that the Company may determine that an impairment charge is required in the future due to changes in these assumptions and estimates.

#### *Use of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The most critical estimates and assumptions are made in determining the allowance for doubtful accounts, revenue reserves, recovery of long-lived assets, useful lives of long-lived assets, accruals for estimated tax and legal liabilities, cost of revenue disputes for communications services, unfavorable contracts recognized in purchase accounting and asset retirement obligations. Actual results could differ from those estimates and assumptions.

In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109" ("FIN No. 48"), which was effective for Level 3 starting January 1, 2007. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes". FIN No. 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN No. 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods and disclosure. The Company's policy is to recognize interest and penalty expense associated with uncertain tax positions as a component of income tax expense in the consolidated statements of operations. The adoption of FIN No. 48 did not have an effect on the Company's consolidated results of operations or financial condition as of and for the year ended December 31, 2007.

In June 2006, the FASB ratified the consensus on EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement" ("EITF No. 06-3"), which was effective for Level 3 starting January 1, 2007. The scope of EITF No. 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, Universal Service Fund ("USF") contributions and some excise taxes. The Task Force concluded that entities should present these taxes in the income statement on either a gross or a net basis, based on their accounting policy, which should be disclosed pursuant to APB Opinion No. 22, "Disclosure of Accounting Policies". If such taxes are significant and are presented on a gross basis, the amounts of those taxes should be disclosed. The Company records USF contributions on a gross basis in its consolidated statements of operations, but records sales, use, value added and excise taxes billed to its customers on a net basis in its consolidated statements of operations. Communications revenue on the consolidated statements of operations includes USF contributions totaling \$45 million, \$19 million and \$7 million for the years ended December 31, 2007, 2006 and 2005, respectively. The adoption of EITF No. 06-3 did not have a material effect on the Company's consolidated results of operations or financial condition for year ended December 31, 2007, as the policy followed was consistent before and after adoption.

In September 2006, the FASB issued Statements of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS No. 157"), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. The adoption of SFAS No. 157 is not expected to have a material effect on the Company's consolidated results of operations or financial condition upon adoption on January 1, 2008.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" ("SFAS No. 141R"), which replaces SFAS No. 141, "Business Combinations." SFAS No. 141R retains the underlying concepts of SFAS No. 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting, but SFAS No. 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items including: (1) expensing acquisition related costs as incurred; (2) expensing changes in deferred tax asset valuation allowances and income tax

uncertainties after the acquisition date; (3) valuing noncontrolling interests at fair value at the acquisition date; and (4) expensing restructuring costs associated with an acquired business. SFAS No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R is to be applied prospectively to business combinations for which the acquisition date is on or after January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS No. 160"). SFAS No. 160 requires noncontrolling interests, previously referred to as minority interests, to be treated as a separate component of equity, not as a liability or other item outside of permanent equity and applies to the accounting for noncontrolling interests and transactions with noncontrolling interest holders in consolidated financial statements. SFAS No. 160 will be applied prospectively to all noncontrolling interests, including any that arose before the effective date except that comparative period information must be restated to classify noncontrolling interests in equity, attributed net income and other comprehensive income to noncontrolling interests, and provide other disclosures required by SFAS No. 160. This statement is effective for the Company beginning January 1, 2009. The Company is currently assessing the potential effect that the adoption of SFAS No. 160 will have on its consolidated results of operations or financial condition.



## Results of Operations 2007 vs. 2006

(dollars in millions)	Years Ended		
	December 31, 2007	December 31, 2006	Change %
<b>Revenue:</b>			
Communications	\$ 4,199	\$ 3,311	27%
Coal mining	70	67	4%
<b>Total revenue</b>	<b>4,269</b>	<b>3,378</b>	<b>26%</b>
<b>Costs and Expenses: (exclusive of depreciation and amortization shown separately below)</b>			
<b>Cost of revenue:</b>			
Communications	1,769	1,460	21%
Coal mining	64	57	12%
<b>Cost of revenue</b>	<b>1,833</b>	<b>1,517</b>	<b>21%</b>
Depreciation and amortization	942	730	29%
Selling, general and administrative	1,723	1,258	37%
Restructuring and non-cash impairment charges	12	13	(8)%
<b>Total costs and expenses</b>	<b>4,510</b>	<b>3,518</b>	<b>28%</b>
<b>Operating Loss</b>	<b>(241)</b>	<b>(140)</b>	<b>(72)%</b>
<b>Other Income (Expense):</b>			
Interest income	54	64	(16)%
Interest expense	(577)	(648)	11%
Loss on extinguishment of debt, net	(427)	(83)	(414)%
Other, net	55	19	189%
<b>Total other income (expense)</b>	<b>(895)</b>	<b>(648)</b>	<b>(38)%</b>
<b>Loss from Continuing Operations Before Income Taxes</b>	<b>(1,136)</b>	<b>(788)</b>	<b>(44)%</b>
<b>Income Tax Benefit (Expense)</b>	<b>22</b>	<b>(2)</b>	<b>1,200%</b>
<b>Loss from Continuing Operations</b>	<b>(1,114)</b>	<b>(790)</b>	<b>(41)%</b>
<b>Income from Discontinued Operations</b>	<b>—</b>	<b>46</b>	<b>(100)%</b>
<b>Net Loss</b>	<b>\$ (1,114)</b>	<b>\$ (744)</b>	<b>(50)%</b>

**Communications Revenue** is separated into three categories:

- Core Communications Services (including Transport and Infrastructure services, IP and Data services, Voice services and Level 3 Vyvx services);
- Other Communications Services (including Managed Modem and its related reciprocal compensation and legacy Managed IP services); and
- SBC Contract Services.

Revenue attributable to these service categories is provided in the following table:

(dollars in millions)	Year Ended		
	December 31, 2007	December 31, 2006	Change %
<b>Core Communications Services:</b>			
Transport and Infrastructure	\$ 1,716	\$ 1,014	69%
IP and Data	584	301	94%
Voice	1,182	536	121%
Level 3 Vyvx	140	122	15%
	<u>3,622</u>	<u>1,973</u>	<u>84%</u>
<b>Other Communications Services:</b>			
Managed Modem	179	286	(37)%
Reciprocal Compensation	73	102	(28)%
Managed IP	22	57	(61)%
	<u>274</u>	<u>445</u>	<u>(38)%</u>
<b>SBC Contract Services</b>	<u>303</u>	<u>893</u>	<u>(66)%</u>
<b>Total Communications Revenue</b>	<u>\$ 4,199</u>	<u>\$ 3,311</u>	<u>27%</u>

The 84% increase in Core Communications Services revenue for 2007 compared to 2006 is due to growth in the Company's revenue from existing services, as well as revenue from the Progress Telecom, ICG Communications, TelCove, Looking Glass, Broadwing, CDN Business and Servecast acquisitions. The Company purchased Progress Telecom in March 2006, ICG Communications in May 2006, TelCove in July 2006 and Looking Glass in August 2006. The Company purchased Broadwing and the CDN Business in January 2007 and Servecast in July 2007. From a financial reporting perspective, the Company integrated into the Level 3 business the operations of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass in 2006, and Broadwing and the CDN Business in the first half of 2007. As a result, separate revenue information by revenue category for these acquired companies is no longer reported other than for the SBC Contract Services revenue acquired from WilTel.

As described earlier, the growth in Core Communications Services revenue was lower than expected during the second, third and fourth quarters of 2007 as a result of an increase in service activation times and challenges in service management processes. Service activation times increased during the second and third quarters as a result of the following issues.

- Continuing to use the multiple order entry and provisioning systems and processes that were operated by the acquired companies to provision end-to-end services.
- Insufficient training on the multiple systems for employees performing service activation functions.
- Lack of sufficient staffing levels in some service activation areas.
- Identifying and fixing service activation throughput issues was challenging as a result of decentralizing service activation functions across the customer facing groups in the third quarter of 2006.

The Company has ongoing process and systems development work that is being implemented as part of the integration efforts that is expected to address the service activation and service management issues described above and provide significant overall improvements to operations. The processes and systems under development remain largely on track with certain components deployed beginning in October 2007 and additional deployments scheduled through the end of 2008. While the operational

benefits vary by each project, the Company expects to realize meaningful improvements in its operating environment during the second half of 2008. In addition, the Company is taking steps to improve its existing processes and systems to address the increase in service activation times and improve its service management. With respect to the latter, the Company has seen improvements in its service response times in the fourth quarter of 2007 and expects to see further improvements in the future.

Transport and infrastructure revenue increased 69% for 2007 compared to 2006. The increase was the result of growth in existing services and the recognition of a full year of revenue in 2007 for Progress Telecom, ICG Communications, TelCove and Looking Glass acquisitions completed in 2006, as well as the revenue from the Broadwing acquisition completed in January 2007. Increased demand in the cable and wireless market segments for complex nationwide solutions and colocation capacity in large markets contributed to the revenue growth in existing services in 2007 as compared to 2006.

IP and data revenue increased 94% for 2007 compared to 2006. The increase was the result of growth in existing services and the recognition of a full year of revenue in 2007 for Progress Telecom, ICG Communications, TelCove and Looking Glass acquisitions completed in 2006, as well as a full year of revenue from the Broadwing acquisition completed in early January 2007. IP and data revenue also increased in 2007 as a result of the CDN Business acquisition completed in January 2007 and the Servecast acquisition completed in July 2007. IP and data revenue also increased due to traffic growth in North America from new and existing customers that exceeded the rate of price compression experienced in 2007. During the second quarter of 2007, the Company also implemented new, reduced pricing under the terms of a contract renewal for its largest IP and data customer which partially offset the overall growth of IP and data revenue in the last half of 2007. Continued revenue growth in the Company's VPN service also contributed to the increase in IP and data revenue during 2007.

Level 3's voice revenue increased 121% for 2007 compared to 2006. The increase is primarily attributable to the operations acquired in the TelCove and Broadwing acquisitions, particularly domestic and international voice termination services, and growth in Level 3's existing wholesale and VoIP-related services including voice termination, local inbound, enhanced local and toll free services.

Level 3 Vyx revenue increased 15% for 2007 compared to 2006. The increase was a result of an increase in advertising distribution revenue and the continued demand for high-definition broadcast services in sports, news and entertainment.

Core Communications Services revenue for 2007 and 2006 includes \$8 million and \$9 million of termination revenue, respectively. The Company expects to recognize termination revenue in the future if customers desire to renegotiate contracts or are required to terminate service. The Company is not able to estimate the specific value of these types of transactions until they occur, but does not currently expect to recognize significant termination revenue for the foreseeable future.

Managed modem revenue declined 37% to \$179 million for 2007 compared to 2006 as a result of the continued migration from narrow band dial-up services to higher speed broadband services by end user customers, especially in large metropolitan areas. This change has resulted in a decline in the demand for managed modem ports. In addition to the port cancellation provisions, the contracts with America Online contain market-pricing provisions that have the effect of lowering revenue as Level 3 is obligated to provide America Online a reduced per port rate if Level 3 offers another customer better pricing for a lower volume of comparable services. The declines in managed modem revenue from America Online have been partially offset by increases in market share as a result of certain competitors exiting segments of the managed modem business in the first half of 2007. The Company expects managed modem revenue to continue to decline in the future primarily due to an increase in the number of subscribers migrating to broadband services and potential pricing concessions as contracts are renewed.

Reciprocal compensation revenue from managed modem services declined 28% to \$73 million for 2007 compared to 2006 as a result of the continuing decline in demand for managed modem services. The Company has historically earned the majority of its reciprocal compensation revenue from managed modem services. Level 3 has interconnection agreements in place for the majority of traffic subject to reciprocal compensation. The majority of the Company's interconnection agreements provided rate structures through 2007. Level 3 continues to negotiate new interconnection agreements or amendments to its existing interconnection agreements with local carriers. As a result of the Company's acquisitions of WilTel, TelCove and Broadwing, the Company has started to generate a portion of its reciprocal compensation revenue from voice services. For the full year ending December 31, 2007, the Company recognized \$26 million of reciprocal compensation revenue earned from voice services, which are included in Core Communications Services revenue. To the extent that the Company is unable to sign new interconnection agreements or signs new agreements containing lower rates, or there is a significant decline in the Company's managed modem dial-up business, or FCC or state regulations change such that carriers are not required to compensate other carriers for terminating ISP-bound traffic, reciprocal compensation revenue may decline significantly over time.

Managed IP services revenue declined 61% to \$22 million for 2007 compared to 2006. As discussed earlier, to date the Company has not invested in this service and the decline in revenue is attributable to the disconnection of service by existing customers. The Company's legacy managed IP services business consists primarily of a business that was acquired in 2003. The Company expects this trend to continue in 2008.

SBC Contract Services revenue decreased 66% to \$303 million for 2007 compared to 2006 as expected due to the migration of the SBC traffic to the AT&T network. The SBC Contract Services agreement was obtained in December 2005 as part of the WilTel acquisition. Under the terms of the agreement, SBC has gross margin purchase commitments through 2009. SBC fully satisfied the \$335 million gross margin purchase commitment for the period from December 2005 through December 2007 during the third quarter of 2007. As a result of satisfying the initial gross margin purchase commitment, SBC's purchases of services that exceed the original \$335 million gross margin purchase commitment now count toward the \$75 million gross margin purchase commitment for the period from January 2008 through the end of 2009. As of December 31, 2007, SBC had satisfied \$39 million of the \$75 million gross margin purchase commitment. Level 3 expects that, based on SBC's current level of spending, the remaining \$36 million of gross margin purchase commitment will be satisfied by SBC in the first half of 2008.

Additionally, the SBC Contract Services Agreement provided for the payment of \$50 million from SBC if certain performance criteria were met by Level 3. The Company met the required performance criteria and recorded annual revenue of \$25 million in both 2006 and 2007 under the agreement. Of the annual amounts, 50% was based on monthly performance criteria and the remaining 50% was based on performance criteria for the full year. The Company is no longer eligible for performance bonuses under the SBC Contract Services agreement after December 31, 2007. The Company expects SBC revenue to continue to decline in 2008. However, SBC must still comply with the minimum gross margin commitments under the terms of the contract unless satisfied sooner.

Beginning in the first quarter of 2008, the Company will change the way it reports Core Communications Services revenue and will aggregate revenue from Transport and Infrastructure, IP and Data, non-wholesale Voice and Level 3 Vyvx services and report those results as Core Network Services revenue. Domestic voice termination, international voice termination and toll free services will be

totalled and reported as Wholesale Voice Services revenue. Using this categorization, quarterly and full year 2007 Communications Services revenue would have been reported as shown in the table below:

	Quarter Ended				
(dollars in millions)	March 31, 2007	June 30, 2007	September 30, 2007	December 31, 2007	Year Ended December 31, 2007
Communications Services Revenue:					
Core Network Services	\$ 720	\$ 735	\$ 756	\$ 783	\$ 2,994
Wholesale Voice Services	150	153	153	172	628
Total Core Communications Services	870	888	909	955	3,622
Other Communications Services	84	71	63	56	274
SBC Contract Services	83	76	71	73	303
Total Communications Services Revenue	\$ 1,037	\$ 1,035	\$ 1,043	\$ 1,084	\$ 4,199

Core Network Services revenue represents higher margin services and Wholesale Voice Services represents lower margin services. The Company believes that given the increasing substitutability between Transport and Infrastructure services and IP and Data services, trends in the communications business are best gauged looking at revenue trends in Core Network Services.

Coal mining revenue increased 4% to \$70 million in 2007 compared to 2006. The increase was attributable to an increase in the tons of coal sold from the Black Butte mine, partially offset by a decrease in the tons of coal sold from the Decker mine. Overall, the price per ton for coal from both mines was up slightly in 2007 compared to 2006.

**Cost of Revenue** for the communications business, as a percentage of revenue, for 2007 and 2006 was 42% and 44%, respectively. The decrease in the 2007 cost of revenue, as a percentage of revenue, is primarily attributable to the continued decrease in SBC Contract Services revenue from 2006 to 2007. The margins for SBC Contract Services revenue are lower than the margins earned on other components included in Core and Other Communications Services revenue. Also contributing to the decrease in 2007 cost of revenue, as a percentage of revenue, are cost of revenue synergy savings that have been achieved as a result of acquisition integration efforts. The Company believes that cost of revenue synergy savings of \$80 million on an annualized basis have been achieved through integration efforts in 2007. The Company expects cost of revenue for the communications business, as a percentage of revenue, to decrease slightly in 2008 as compared to 2007.

Coal mining cost of revenue, as a percentage of revenue, increased to 91% for 2007 compared to 85% in 2006. The increase in cost of revenue, as a percentage of revenue, in 2007 as compared to 2006 was due to planned equipment maintenance costs at one mine and higher costs related to overburden removal at another mine.

**Depreciation and Amortization** expense increased 29% to \$942 million for 2007 compared to 2006. The increase is primarily attributable to the increased depreciation and amortization expense recognized on communications tangible and intangible assets that were acquired through acquisitions completed in 2006 and 2007, as well as depreciation expense on the approximately \$241 million increase in capital expenditures for 2007 compared to 2006.

In addition, during the second quarter of 2007, the Company reviewed and adjusted the estimated useful lives used for amortization of customer-related intangible assets for the ICG Communications, TelCove and Looking Glass acquisitions effective June 1, 2007. This resulted in increased amortization expense of \$9 million during the year ended December 31, 2007.

During the fourth quarter of 2007, the Company finalized the purchase price allocation for the Broadwing acquisition which resulted in reduced amortization expense related to intangible assets for the Broadwing acquisition from the date of acquisition totaling approximately \$18 million, as compared to the total amortization expense that would have been recognized for 2007 prior to the change in the valuation of the intangible assets.

The increase in depreciation expense for 2007 was partially offset by a \$44 million decrease in depreciation expense compared to the same period in 2006 attributable to the increase in estimated useful lives for network fiber and IP and transmission equipment implemented in the second and third quarters of 2006.

The Company expects depreciation and amortization expense to decrease in 2008 to a range of \$880 million to \$920 million compared to 2007 due to the offsetting effects of increased depreciation expense on incremental capital expenditures, overall reduced amortization expense on intangible assets as a result of the useful lives changes and valuation changes described above and reduced depreciation and amortization expense associated with shorter-lived tangible and intangible communications assets that were placed in service in prior years that are expected to become fully depreciated or amortized in 2008.

**Selling, General and Administrative** expenses increased 37% to \$1.723 billion in 2007 compared to 2006. This increase is primarily attributable to the expenses associated with the operations acquired in the Progress Telecom, ICG Communications, TelCove and Looking Glass transactions during 2006; the Broadwing and CDN Business transactions in January 2007; and the Servecast transaction in July 2007. Specifically, increases in compensation, bonus and employee related costs, network related costs and facility-based expenses all contributed to the increase in selling, general and administrative expenses in 2007. Offsetting the increases discussed above were selling, general and administrative expense synergy savings that have been achieved as a result of acquisition integration efforts. As of the end of 2007, the Company believes that it has achieved annualized run rate synergies in selling, general and administrative expenses totaling approximately \$105 million. Also offsetting the increase in selling, general and administrative expenses in 2007 compared to 2006 was a reduction in incentive-based compensation expense of \$32 million as a result of lower than expected financial performance in 2007.

Selling, general and administrative expenses for 2006 included a \$7 million property tax benefit related to the Company's facilities in the United Kingdom.

Included in selling, general and administrative expenses for 2007 and 2006 were \$122 million and \$84 million, respectively, of non-cash stock-based compensation expense related to grants of outperform stock options and restricted stock units and restricted stock shares. The increase in non-cash compensation expense in 2007 compared to 2006, is due to an increase in the number of restricted stock units and restricted stock shares issued to employees as a result of an increase in the number of employees eligible in 2007 compared to 2006, an increase in the 401(k) employee match and annual discretionary grant made to the 401(k) plan and an increase in non-cash compensation expense for those employees eligible for accelerated vesting of stock awards at retirement; with the overall increase partially offset by a reduction in the number of outperform stock options and units issued in 2007 compared to 2006. The number of employees eligible to participate in the Company's stock-based long-term incentive plan increased significantly from 2006 to 2007 as a result of the employees of acquired companies becoming eligible to participate in the long-term incentive plan at the beginning of 2007.

In 2007, the Company recognized additional non-cash stock-based compensation expense totaling approximately \$11 million for those employees eligible for accelerated vesting of stock awards at retirement. The Company provides accelerated vesting of stock awards at the date an employee retires if the employee meets certain age and years of service requirements and certain other requirements. Under SFAS No. 123R, the fair value of stock-based employee awards are expensed over the minimum

service period, which is from the grant date to the earliest vesting date. Therefore, the Company is required to fully expense at the grant date the value of stock awards made to those employees that already meet both the age and years of service requirements for accelerated vesting at retirement at the date of grant. If the employee will meet the age and years of service requirements for accelerated vesting at retirement sooner than the normal vesting period for the stock awards, then the Company is required to use that shorter period for recognition of the non-cash compensation expense associated with the grant.

Included in the 2006 non-cash compensation expense of \$84 million was \$6 million related to the revaluation of the October 2005 and January 2006 grants using May 15, 2006 as the revised grant date, in accordance with SFAS No. 123R. As stated in the Company's proxy materials for its 2006 Annual Meeting of Stockholders, over the course of the years since April 1, 1998, the compensation committee of the Company's Board of Directors had administered the 1995 Stock Plan under the belief that the action of the Company's Board of Directors to amend and restate that plan effective April 1, 1998 had the effect of extending the original term of the Plan to April 1, 2008. After a further review of the terms of the plan, however, the compensation committee determined that an ambiguity could exist as to the date of the expiration of the plan. To remove any ambiguity, the Board of Directors sought the approval of the Company's stockholders to amend the plan to extend the term of the plan by five years to September 25, 2010. This approval was obtained at the 2006 Annual Meeting of Stockholders held on May 15, 2006.

After taking into account the \$6 million increase in 2006 non-cash compensation expense for the grants revalued using a May 15, 2006 grant date and the \$11 million increase in 2007 non-cash compensation expense for the employees that are eligible for accelerated vesting at retirement as discussed above, non-cash compensation increased \$33 million for 2007 compared to 2006.

As part of a comprehensive review of its long-term compensation program completed in the first quarter of 2007, beginning with awards made on or after April 1, 2007, outperform stock options ("OSO") units are awarded monthly to employees in mid-management level and higher positions, have a three year life, will vest 100% on the third anniversary of the date of the award and will fully settle in net shares on that date. OSO units awarded beginning April 1, 2007 have exercise prices and are valued for non-cash compensation purposes based on the closing price of Level 3 common stock on the last day of each month. Recipients have no discretion on the timing to exercise OSO units granted on or after April 1, 2007, thus the expected life of all such OSO units is three years.

The Company expects selling, general and administrative expenses to decrease in 2008 on an overall basis compared to 2007. The expected reduction in overall 2008 selling, general and administrative expenses is a result of reduced selling, general and administrative expenses for integration activities, reductions in headcount related to continuing integration activities and the deployment of improved business processes and systems during 2008, offset by an increase in incentive-based compensation compared to 2007.

**Restructuring and Non-Cash Impairment Charges** declined 8% to \$12 million in 2007 compared to 2006. The Company recognized severance charges of \$11 million in 2007 and \$5 million in 2006, related to workforce reductions in the communications business in North America. The workforce reductions completed in 2007 were primarily related to the integration of companies acquired by Level 3 in 2006 and January 2007. As of December 31, 2007, the Company had remaining obligations of approximately \$4 million.

The Company recognized non-cash impairment charges of \$1 million and \$8 million in 2007 and 2006, respectively. The non-cash impairment charge of \$1 million in 2007 and \$4 million of the 2006 charge were primarily related to previously capitalized costs of certain information technology development projects no longer used by the Company. The costs incurred for these projects, including capitalized labor, were impaired as the Company did not expect to utilize the assets in the future. The

remaining \$4 million non-cash impairment charge in 2006 was related to excess land of the communications business deemed available for sale in Germany. This charge resulted from the difference between the recorded carrying value and the estimated market value of the land. During the third quarter of 2007, the Company reclassified the excess land in Germany to property, plant and equipment due to the fact the land had not been sold and was no longer being actively marketed for sale.

The Company expects to continue to record restructuring charges in 2008 in connection with the continued integration of businesses acquired in 2006 and 2007 and as a result of the deployment of improved business processes and systems during 2008 that should result in reduced headcount.

The Company continues to periodically conduct comprehensive reviews of the long-lived assets of its businesses, specifically communication assets deployed along its intercity and metro networks and in its gateway facilities. It is possible that assets may be identified as impaired and impairment charges may be recorded to reflect the realizable value of these assets in future periods.

**Adjusted EBITDA**, as defined by the Company, is net income (loss) from the consolidated statements of operations before (1) gain (loss) from discontinued operations, (2) income taxes, (3) total other income (expense), (4) non-cash impairment charges included within restructuring and impairment charges as reported in the consolidated statements of operations, (5) depreciation and amortization and (6) non-cash stock compensation expense included within selling, general and administrative expenses on the consolidated statements of operations.

Adjusted EBITDA is not a measurement under accounting principles generally accepted in the United States and may not be used by other companies. Management believes that Adjusted EBITDA is an important part of the Company's internal reporting and is a key measure used by management to evaluate profitability and operating performance of the Company and to make resource allocation decisions. Management believes such measures are especially important in a capital-intensive industry such as telecommunications. Management also uses Adjusted EBITDA to compare the Company's performance to that of its competitors. Management uses Adjusted EBITDA to eliminate certain non-cash and non-operating items in order to consistently measure from period to period its ability to fund capital expenditures, fund growth, service debt and determine bonuses.

Adjusted EBITDA excludes non-cash impairment charges and non-cash stock compensation expense because of the non-cash nature of these items. Adjusted EBITDA also excludes interest income, interest expense, income taxes and gain (loss) on extinguishment of debt because these items are associated with the Company's capitalization and tax structures. Adjusted EBITDA also excludes depreciation and amortization expense because these non-cash expenses reflect the impact of capital investments which management believes should be evaluated through consolidated free cash flow. Adjusted EBITDA excludes total other income (expense) because these items are not related to the primary operations of the Company.

There are limitations to using non-GAAP financial measures, including the difficulty associated with comparing companies that use similar performance measures whose calculations may differ from the Company's calculations. Additionally, this financial measure does not include certain significant items such as interest income, interest expense, income taxes, depreciation and amortization, non-cash impairment charges, non-cash stock compensation expense, gain (loss) on early extinguishment of debt and total other income (expense). Adjusted EBITDA should not be considered a substitute for other measures of financial performance reported in accordance with GAAP.

Note 19 of the consolidated financial statements provides a reconciliation of net income (loss) to Adjusted EBITDA for each of the Company's operating segments.

Adjusted EBITDA for the communications business was \$823 million and \$677 million in 2007 and 2006, respectively. The increase is primarily attributable to the Adjusted EBITDA contribution from the



operations acquired in the Progress Telecom, ICG Communications, TelCove, Looking Glass, Broadwing, CDN Business and Servecast acquisitions, growth in the Company's Core Communications Services revenue and the benefits of cost of revenue and operating expense synergies realized in 2007 from integration activities, partially offset by declines in other communications services revenue, SBC Contract Services revenue and costs of integration incurred during 2007 as compared to 2006.

Adjusted EBITDA for the coal mining business decreased to \$5 million in 2007 from \$8 million in 2006. The decrease is primarily attributable to an increase in the amount of coal sold from the Black Butte mine which has higher stripping ratios that result in higher overall costs and a planned increase in maintenance costs for mining equipment in 2007.

The Company expects Adjusted EBITDA to increase in 2008 compared to 2007 to a range of \$950 million to \$1.1 billion. The expected increase in Adjusted EBITDA is based on continued growth in Core Communications Services revenue, expected improvements in service delivery times, and the benefit of integration synergies in cost of revenue and selling, general and administrative expenses realized from the Broadwing acquisition.

**Interest Income** decreased 16% to \$54 million in 2007 compared to 2006. The decrease in interest income was primarily due to a decrease in the average invested balance partially offset by an increase in the average return on the portfolio. The Company's average return on its portfolio increased to 4.8% in 2007 compared to 4.3% in 2006. The average portfolio balance decreased to \$1.0 billion in 2007 compared to \$1.5 billion in 2006.

Pending the utilization of cash and cash equivalents, the Company invests its funds primarily in government and government agency securities, money market funds and commercial paper. The investment strategy generally provides lower yields on the funds than would be obtained on alternative investments, but reduces the risk to principal in the short term prior to these funds being used in the Company's business.

**Interest Expense** decreased 11% to \$577 million in 2007 compared to 2006. Interest expense decreased primarily as a result of the refinancing activities that were completed by the Company in the first quarter of 2007. The overall reduction in interest expense is a result of the offsetting interest expense effects attributable to the following debt issuances, debt for equity exchanges, debt redemptions and debt repurchase transactions.

Interest expense increased as a result of the following debt issuances:

- \$1.250 billion of 9.25% Senior Notes due 2014 issued in October and December 2006;
- \$1 billion of Senior Notes issued in February 2007 consisting of \$700 million of 8.75% Senior Notes due 2017 and \$300 million of Floating Rate Senior Notes due 2015; and
- \$1.4 billion Senior Secured Term Loan due 2014 entered into in March 2007 to refinance the previously existing \$730 million Senior Secured Term Loan due 2011.

The increase in interest expense from debt issuances described above was more than offset by the following debt for equity exchanges, debt redemptions and debt repurchases completed during the fourth quarter of 2006 and the first quarter of 2007:

- \$497 million of 10.75% Senior Notes due 2011 repurchased in December 2006;
- \$605 million of 10% Convertible Senior Notes due 2011 exchanged in January 2007 for 197 million shares of common stock;
- \$488 million of 12.875% Senior Notes due 2010 redeemed in March 2007;
- \$96 million of 11.25% Senior Notes due 2010 redeemed in March 2007;

- \$138 million (€104 million) of 11.25% Senior Euro Notes due 2010 redeemed in March 2007;
- \$144 million of Floating Rate Notes due 2011 repurchased in March 2007;
- \$59 million of 11% Senior Notes due 2008 repurchased in March 2007;
- \$677 million of 11.5% Senior Notes due 2010 repurchased in March 2007; and
- \$61 million (€46 million) of 10.75% Senior Euro Notes due 2008 repurchased in March 2007.

Level 3 expects quarterly interest expense in 2008 to be consistent with the level of interest expense in the second and third quarters of 2007 of \$138 million per quarter based on outstanding debt balances as of December 31, 2007.

**Loss on Extinguishment of Debt** was \$427 million in 2007 compared to \$83 million in 2006. The loss on extinguishment of debt for 2006 was primarily the result of a \$54 million loss from the repurchase of certain debt and a \$55 million loss on the amendment and restatement of Level 3 Financing's Senior Secured Term Loan due 2011, partially offset by a \$27 million gain realized on a debt exchange. The loss on extinguishment of debt for 2007 resulted from the following transactions.

- \$177 million loss recognized for the January 2007 exchange of \$605 million of 10% Convertible Senior Notes due 2011 for approximately 197 million shares of the Company's common stock. The loss included \$1 million of unamortized debt issuance costs.
- \$10 million loss recognized for the March 2007 refinancing of the Company's \$730 million Senior Secured Term Loan due 2011 into a \$1.4 billion Senior Secured Term Loan due 2014. The loss consisted of unamortized debt issuance costs associated with the previous \$730 million Senior Secured Term Loan due 2011.
- \$54 million loss recognized on the redemption of \$722 million of outstanding debt consisting of the following debt issuances:
  - \$12 million loss on the redemption of \$488 million of outstanding 12.875% Senior Notes due 2010 consisting of a \$10 million cash loss and \$2 million in unamortized debt issuance costs.
  - \$3 million loss on the redemption of \$96 million of outstanding 11.25% Senior Notes due 2010 consisting of a \$2 million cash loss and \$1 million in unamortized debt issuance costs.
  - \$39 million loss on the redemption of \$138 million (€104 million) of outstanding 11.25% Senior Euro Notes due 2010 consisting of a \$38 million cash loss and \$1 million of unamortized debt issuance costs.
- \$186 million loss recognized on the repurchase through tender offers of \$941 million of outstanding debt consisting of the following debt issuances:
  - \$18 million loss on the repurchase of \$144 million of outstanding Floating Rate Senior Notes due 2011 consisting of a \$12 million cash loss and \$6 million in unamortized debt issuance costs and unamortized discount.
  - \$3 million loss on the repurchase of \$59 million of outstanding 11% Senior Notes due 2008 consisting of a \$3 million cash loss and less than \$1 million in unamortized debt issuance costs.
  - \$141 million loss on the repurchase of \$677 million of outstanding 11.5% Senior Notes due 2010 consisting of a \$78 million cash loss and \$63 million in unamortized debt issuance costs and unamortized discount.

- \$24 million loss on the repurchase of \$61 million (€46 million) of outstanding 10.75% Senior Euro Notes due 2008 consisting of a \$24 million cash loss and less than \$1 million in unamortized debt issuance costs.

The Company may enter into additional transactions in the future to repurchase or exchange existing debt that may result in gains or losses on the extinguishment of debt.

**Other, net** increased 189% to \$55 million in 2007 compared to \$19 million in 2006. Other, net is primarily comprised of gains and losses on the sale of marketable securities and non-operating assets, realized foreign currency gains and losses and other income. The increase in 2007 compared to 2006 is primarily due to a gain of \$37 million recognized in the fourth quarter of 2007 on the sale of 80% of the Company's holdings of Infinera common stock.

**Income Tax Benefit (Expense)** was a \$22 million benefit in 2007 and was a \$2 million expense in 2006. The income tax benefit for 2007 was primarily the result of reversing \$23 million of the valuation allowance against the Company's deferred tax asset for certain state net operating loss carry forwards ("NOLs"). These state tax NOLs were converted to a state tax credit carry forward associated with a change in the state tax law that replaced the tax on net income with a tax on gross margin. The Company now expects it will be able to use this state tax credit carry forward against current and future state taxable gross margin.

The Company incurs income tax expense attributable to income in various Level 3 subsidiaries, including the coal business, that are required to file state or foreign income tax returns on a separate legal entity basis. The Company also recognizes accrued interest and penalties related to contingent tax benefits that have not been recognized in income tax expense, but have been recognized in the Company's tax returns.

As of December 31, 2007, Level 3 had net operating loss carry forwards of approximately \$9.5 billion for federal income tax purposes, including \$953 million of net operating loss carry forwards from acquired companies after limitations that existed at the date of acquisition or that resulted from the acquisitions or both. If certain transactions occur with respect to Level 3's capital stock that result in a cumulative ownership change of more than 50 percentage points by 5-percent stockholders over a three-year period as determined under rules prescribed by the U.S. Internal Revenue Code ("IRC") and applicable regulations, annual limitations would be imposed with respect to the Company's ability to utilize its net operating loss carry forwards and certain current deductions against any taxable income Level 3 achieves in future periods. Level 3 has entered into transactions over the last three years resulting in significant cumulative changes in the ownership of its capital stock. Additional transactions could cause the Company to incur a 50 percentage point ownership change by 5-percent stockholders and, if the Company triggers the above-noted IRC imposed limitations, could prevent it from fully utilizing net operating loss carry forwards and certain current deductions to reduce income taxes.

**Income (Loss) from Discontinued Operations** in 2006 of \$46 million was related to the discontinued operations of the Company's Information Services segment. The Company sold Software Spectrum, Inc. ("Software Spectrum") to Insight Enterprises, Inc. ("Insight") in September 2006. There were no gains or losses from discontinued operations recognized in 2007. Software Spectrum, Inc.'s results of operations resulted in income from discontinued operations of \$13 million in 2006. In addition, Level 3 recognized a gain on the sale of Software Spectrum to Insight in 2006 of \$33 million.

## Results of Operations 2006 vs. 2005

(dollars in millions)	Years Ended		
	December 31, 2006	December 31, 2005	Change %
<b>Revenue:</b>			
Communications	\$ 3,311	\$ 1,645	101%
Coal mining	67	74	(9)%
<b>Total revenue</b>	<b>3,378</b>	<b>1,719</b>	<b>97%</b>
<b>Costs and Expenses: (exclusive of depreciation and amortization shown separately below)</b>			
<b>Cost of revenue:</b>			
Communications	1,460	463	215%
Coal mining	57	53	8%
<b>Cost of revenue</b>	<b>1,517</b>	<b>516</b>	<b>194%</b>
Depreciation and amortization	730	647	13%
Selling, general and administrative	1,258	769	64%
Restructuring and non-cash impairment charges	13	23	(43)%
<b>Total costs and expenses</b>	<b>3,518</b>	<b>1,955</b>	<b>80%</b>
<b>Operating Loss</b>	<b>(140)</b>	<b>(236)</b>	<b>41%</b>
<b>Other Income (Expense):</b>			
Interest income	64	35	83%
Interest expense	(648)	(530)	(22)%
Loss on extinguishment of debt, net	(83)	—	100%
Other, net	19	29	(34)%
<b>Total other income (expense)</b>	<b>(648)</b>	<b>(466)</b>	<b>(39)%</b>
<b>Loss from Continuing Operations Before Income Taxes</b>	<b>(788)</b>	<b>(702)</b>	<b>(12)%</b>
<b>Income Tax Expense</b>	<b>(2)</b>	<b>(5)</b>	<b>60%</b>
<b>Loss from Continuing Operations</b>	<b>(790)</b>	<b>(707)</b>	<b>(12)%</b>
<b>Income from Discontinued Operations</b>	<b>46</b>	<b>69</b>	<b>(33)%</b>
<b>Net Loss</b>	<b>\$ (744)</b>	<b>\$ (638)</b>	<b>(17)%</b>

**Communications Revenue** for 2006 and 2005 is summarized as follows:

(dollars in millions)	Year Ended		
	December 31, 2006	December 31, 2005	Change %
<b>Core Communications Services:</b>			
Transport and Infrastructure	\$ 1,014	\$ 653	55%
IP and Data	301	186	62%
Voice	536	120	347%
Level 3 Vyvx	122	3	3,967%
	1,973	962	105%
<b>Other Communications Services:</b>			
Managed Modem	286	396	(28)%
Reciprocal Compensation	102	100	2%
Managed IP	57	83	(31)%
DSL Aggregation	—	79	(100)%
	445	658	(32)%
<b>SBC Contract Services</b>	893	25	3,472%
<b>Total Communications Revenue</b>	<b>\$ 3,311</b>	<b>\$ 1,645</b>	<b>101%</b>

The Company's Core Communications Services revenue increased 105% in 2006 compared to 2005. The growth in the Company's existing services as well as the acquisitions of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass contributed to the increase. During 2006, the Company recorded revenue, from the date of acquisition, attributable to Progress Telecom of \$49 million, ICG Communications of \$46 million, TelCove of \$166 million and Looking Glass of \$33 million. During 2006, the Company integrated a significant portion of WilTel into the business. As a result, separate revenue information for former WilTel customers is no longer available other than for SBC Contract Services.

Transport and infrastructure revenue increased 55% in 2006 primarily due to the acquisitions of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass. In addition, increased demand for complex nationwide solutions and colocation capacity in large markets contributed to the revenue growth in 2006. Termination revenue related to transport and infrastructure services decreased approximately \$129 million from \$131 million in 2005 to \$2 million in 2006. The termination revenue in 2005 was primarily attributable to the termination of dark fiber lease agreements with two customers.

IP and data revenue increased 62% in 2006 primarily due to customers obtained in the acquisitions of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass. IP and data revenue also increased due to traffic growth in North America from new and existing customers that exceeded the approximately 25% rate of price compression in 2006. Traffic growth was mitigated by one customer's migration of traffic to its own network which was acquired via a merger with another carrier. Improved market acceptance of the Company's VPN service and the continued growth of previously awarded contracts also contributed to the increase in IP and data revenue. IP and data revenue includes \$7 million of termination revenue in 2006.

Level 3's voice revenue increased 347% in 2006. The increase is primarily attributable to the operations acquired in the WilTel, TelCove and ICG Communications acquisitions, particularly domestic and international voice termination services, and growth in Level 3's existing wholesale and VoIP-related services including voice termination, local inbound, enhanced local and toll free services. On a combined basis, voice services experienced a 321% increase in minutes of use in the fourth quarter of 2006 compared to the same period in 2005.

Level 3 Vyx revenue increased to \$122 million in 2006 as a result of including a full year of Level 3 Vyx revenue in the Company's results. Vyx was acquired in December 2005 as part of the WilTel acquisition.

Managed modem revenue declined 28% in 2006 as a result of the continued migration from narrow band dial-up services to higher speed broadband services by end user customers. This change has resulted in a decline in the demand for managed modem ports. Managed modem revenue also declined in 2006 as a result of certain contracts being renewed or renegotiated at prices lower than were in effect in 2005. The declines in managed modem revenue have been partially offset by increases in market share as a result of certain competitors exiting segments of the managed modem business in the second half of 2006.

The Company did not recognize DSL aggregation revenue in 2006 due to the fact that the Company's primary DSL aggregation customer completed the migration of its DSL subscribers to its own network in the third quarter of 2005. In addition, the Company's other DSL contracts expired in 2005 and were not renewed.

Reciprocal compensation revenue increased \$2 million in 2006. The Company has historically earned the majority of its reciprocal compensation revenue from managed modem services. Level 3 has interconnection agreements in place for the majority of traffic subject to reciprocal compensation.

SBC Contract Services revenue increased significantly in 2006 as a result of including a full year of SBC Contract Services revenue in the Company's results. The SBC Contract Services agreement was acquired in December 2005 as part of the WilTel acquisition. Under the terms of the agreement, SBC has gross margin purchase commitments through 2009. As of December 31, 2006, the remaining minimum gross margin commitment under the agreement to be utilized during 2007 was approximately \$67 million, and \$75 million from January 2008 through the end of 2009. Additionally, the SBC Contract Services agreement provides for the payment of \$50 million if certain performance criteria are met by Level 3. Level 3 was eligible to earn \$25 million in 2006 and 2007. Of the annual amount, 50% is based on monthly performance and the remaining 50% is based on performance criteria for the full year. The Company met the required performance criteria and earned \$25 million in 2006.

Coal mining revenue decreased to \$67 million in 2006 compared to \$74 million in 2005. The decline in revenue for 2006 is attributable to a decline in the average price per ton of coal sold, partially offset by a slight increase in tons shipped. The price decline is attributable to coal sold under a contract that was renewed in 2005 and contained lower price per ton than the original contract.

**Cost of Revenue** for the communications business, as a percentage of revenue for 2006 and 2005 was 44% and 28%, respectively. The increase in 2006 cost of revenue, as a percentage of revenue, is primarily attributable to the recognition of termination revenue in 2005, with no corresponding cost of revenue, and the significant voice and SBC Contract Services revenue obtained in the WilTel acquisition. The margins for the voice and SBC Contract Services revenue are lower than the margins earned on other components included in Core and Other Communications Services revenue. Partially offsetting the lower WilTel margins were the margins earned by Progress Telecom, ICG Communications, TelCove and Looking Glass. Margins for these businesses were slightly higher in 2006 than those reported by the Company in 2005. In 2005, the Company recognized \$133 million of termination revenue with no corresponding cost of revenue, favorably affecting the cost of revenue percentage. Excluding the termination revenue, cost of revenue as a percentage of revenue would have been 31% in 2005.

Cost of revenue as a percentage of revenue for the coal mining business increased to 85% in 2006 from 72% in 2005. The increase in cost of revenue as a percentage of revenue for the coal mining business is due to a decline in the average price per ton of coal sold in 2006 compared to 2005 and due to increased product costs in 2006 related to changes in stripping ratios and increased tire and fuel

costs. In addition, in the second quarter of 2005, the Company was able to favorably resolve certain production tax issues. The resolution of this matter resulted in a \$5 million reduction in cost of revenue. Cost of revenue as a percentage of revenue for 2005 was 78% after excluding the effect of the \$5 million reduction in cost of revenue for the period.

**Depreciation and Amortization** expense was \$730 million in 2006, a 13% increase from 2005 depreciation and amortization expense of \$647 million. The increase is primarily attributable to the communications tangible and intangible assets that were acquired in the WilTel acquisition in December 2005, the Progress Telecom acquisition in March 2006, the ICG Communications acquisition in May 2006, the TelCove acquisition in July 2006 and the Looking Glass acquisition in August 2006. This increase was partially offset by an \$80 million decrease in depreciation expense attributable to the increase in estimated useful lives for network fiber and IP and transmission equipment.

**Selling, General and Administrative** expenses increased 64% to \$1.258 billion in 2006 from \$769 million in 2005. This increase is primarily attributable to the inclusion of expenses associated with the operations acquired in the WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass transactions in December 2005, March 2006, May 2006, July 2006 and August 2006, respectively. Specifically, increases in compensation, bonus and employee related costs, network related costs and facility-based expenses all contributed to the increase in selling, general and administrative expenses in 2006.

Included in operating expenses for 2006 and 2005 were \$84 million and \$51 million, respectively, of non-cash compensation and professional expenses recognized under SFAS No. 123R and SFAS No. 123, respectively, related to grants of outperform stock options, warrants and other stock-based compensation awards. The \$33 million increase in non-cash compensation expense in 2006 is primarily attributable to an increase in the number of outperform stock options granted to employees and an increase in the value of the options granted to employees associated with the increasing price of Level 3 common stock in 2006. These increases were partially offset by a reduction in the amount of restricted stock and restricted stock units granted in 2006 compared to 2005.

In addition, during the second quarter of 2006, the October 2005 and January 2006 outperform stock option grants were revalued using May 15, 2006 as the grant date, in accordance with SFAS No. 123R, and resulted in a \$6 million increase in non-cash compensation expense during the second quarter of 2006. As stated in the Company's proxy materials for its 2006 Annual Meeting of Stockholders, over the course of the years since April 1, 1998, the compensation committee of the Company's Board of Directors had administered the 1995 Stock Plan under the belief that the action of the Company's Board of Directors to amend and restate that plan effective April 1, 1998 had the effect of extending the original term of the Plan to April 1, 2008. After a further review of the terms of the plan, however, the compensation committee determined that an ambiguity could have existed that may have resulted in an interpretation that the expiration date of the plan was September 25, 2005. To remove any ambiguity, the Board of Directors sought the approval of the Company's stockholders to amend the plan to extend the term of the plan by five years to September 25, 2010. This approval was obtained at the 2006 Annual Meeting of Stockholders held on May 15, 2006 which resulted in a final measurement date of May 15, 2006 for the outperform options granted in October 2005 and January 2006.

**Restructuring and Impairment Charges** were \$13 million in 2006 and \$23 million in 2005. In 2006, the Company recognized \$5 million of restructuring charges related to workforce reductions in the communications business in North America. The employees impacted by this workforce reduction were Level 3 employees affected by the integration of companies acquired in 2005 and 2006. As of December 31, 2006, the Company had remaining obligations of less than \$1 million.

In 2005, the Company recognized \$15 million related to the workforce reductions in the communications business in North America and Europe. The employees affected by this workforce reduction provided support functions or worked directly on mature services. All obligations attributable to the 2005 restructuring activities were paid by December 31, 2005.

The Company recognized non-cash impairment charges of \$4 million in 2006 and \$9 million in 2005 resulting from the decision to terminate projects for certain voice services and IT projects in the communications business. In addition, 2005 included a \$1 million reduction in expected lease impairment obligations. These projects have identifiable costs which Level 3 can evaluate separately for impairment. The costs incurred for these projects, including capitalized labor, were impaired as the Company did not expect to utilize the assets in the future. In addition, during the second quarter of 2006, Level 3 recognized \$4 million of non-cash impairment charges related to excess land of the communications business deemed available for sale in Germany. This charge resulted from the difference between the recorded carrying value and the estimated market value of the land.

**Adjusted EBITDA** for the communications business was \$677 million and \$458 million for 2006 and 2005, respectively. The increase is primarily attributable to the Adjusted EBITDA contribution from the operations acquired in the WiTel, Progress Telecom, ICG Communications, TelCove and Looking Glass transactions and growth in the Company's Core Communications Services revenue partially offset by related costs. Partially offsetting these increases was a \$122 million reduction in termination and settlement revenue from 2005 to 2006.

Adjusted EBITDA for the coal mining business decreased to \$8 million in 2006 from \$16 million in 2005. The decrease is primarily attributable to the favorable resolution of certain production tax issues, which resulted in a \$5 million decrease in the cost of revenue for the mining business in the second quarter of 2005 and a decline in the average price per ton of coal sold in 2006 compared to 2005.

**Interest Income** was \$64 million in 2006, increasing \$29 million from \$35 million in 2005. The increase in interest income was due to an increase in the Company's average return on its portfolio to 4.3% in 2006 compared to 2.8% in 2005. The average portfolio balance was \$1.5 billion and \$1.2 billion in 2006 and 2005, respectively.

**Interest Expense** increased by \$118 million to \$648 million in 2006 compared to 2005. Interest expense increased primarily as a result of interest expense attributable to the issuance of \$880 million of 10% Convertible Senior Notes due 2012 issued in the second quarter of 2005, \$550 million of 12.25% Senior Notes due 2013 issued in the first half of 2006, \$150 million of Floating Rate Senior Notes due 2011 issued on March 14, 2006 and \$335 million of 3.5% Convertible Senior Notes due 2012 issued on June 13, 2006 and \$1.250 billion of 9.25% Senior Notes due 2014 issued in the fourth quarter of 2006. In addition, the Company exchanged portions of its 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 for new 11.5% Senior Notes due 2010 during the first quarter of 2006, thereby increasing the effective interest expense on this debt. The increase in interest expense from new debt issuances was partially offset by the July 13, 2006 redemption of the 9.125% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 and a 400 basis-point reduction in the interest rate on the \$730 million Senior Secured Term Loan due 2011 subsequent to its amendment in late June of 2006.

**Loss on Extinguishment of Debt** was \$83 million in 2006 and zero in 2005. In the fourth quarter of 2006, the Company realized a \$54 million loss from the repurchase of the \$497 million principal amount of Level 3 Financing's 10.75% Senior Notes due 2011 and in the second quarter of 2006, Level 3 realized a \$55 million loss on the amendment and restatement of Level 3 Financing's Senior Secured Term Loan due 2011. These losses were partially offset by the \$27 million gain realized on the debt exchange in the first quarter of 2006.



**Other, net** is primarily comprised of gains and losses on the sale of marketable securities and non-operating assets, realized foreign currency gains and losses and other income.

**Income Tax Expense** was \$2 million in 2006 compared to \$5 million in 2005.

**Income from Discontinued Operations** was \$46 million for 2006 and is comprised of \$13 million from the operations of Software Spectrum and a \$33 million gain from the sale of Software Spectrum to Insight in September, 2006. Income from discontinued operations was \$69 million for 2005 and is comprised of \$20 million from Software Spectrum and a \$49 million gain from the sale of ( i )Structure to Infocrossing.

Income from Discontinued Operations declined in 2006 versus the same period in 2005 due to the sale of Software Spectrum on September 7, 2006. Software Spectrum earns a disproportionate share of its revenue at the end of the quarter but incurs operating expenses ratably during the quarter. As a result of the sale in September 2006, operating expenses for Software Spectrum exceeded the gross profits earned on sales through the transaction date due to the cyclical nature of the Software Spectrum business.

Software Spectrum increased its sales and marketing efforts and resources targeting mid-market businesses over the last 18 months of its ownership by the Company resulting in higher revenue and profits for the period ending September 7, 2006 compared to the twelve months ended December 31, 2005. The increase in gross profits was partially offset by an increase in operating expenses, primarily for employee related costs, and the disproportionate level of operating expenses recognized for the partial third quarter of 2006.

Level 3 received gross proceeds of approximately \$353 million and recognized a gain on the sale of Software Spectrum, after transaction costs, of approximately \$33 million in the third quarter of 2006. During the fourth quarter of 2006, Level 3 paid \$2 million to Insight as a final post-closing working capital adjustment.

### Financial Condition—December 31, 2007

Cash flows provided by (used in) operating activities of continuing operations, investing activities and financing activities for the year ended December 31, 2007 and 2006, respectively are summarized as follows (dollars in millions):

(dollars in millions)	Years Ended		
	December 31, 2007	December 31, 2006	Change
Net Cash Provided by Operating Activities of Continuing Operations	\$ 231	\$ 221	\$ 10
Net Cash Used in Investing Activities	(961)	(648)	(313)
Net Cash (Used in) Provided by Financing Activities	(243)	1,689	(1,932)
Net Cash (Used in) Provided by Discontinued Operations	—	(43)	43
Effect of Exchange Rates on Cash and Cash Equivalents	6	10	(4)
Net Change in Cash and Cash Equivalents	\$ (967)	\$ 1,229	\$ (2,196)

### Operating Activities of Continuing Operations

Cash provided by operating activities of continuing operations increased by \$10 million in 2007 compared to 2006. The increase in cash provided by operating activities of continuing operations was primarily due to an increase in Adjusted EBITDA generated by the communications business in 2007 as compared to 2006, partially offset by fluctuations in working capital balances which resulted in an

incremental use of cash of \$153 million for working capital items in 2007 compared to 2006. The increase in cash used for working capital items is primarily due to the changes in accounts receivable, accounts payable and other current liabilities, partially offset by an increase in deferred revenue. The Company expects that cash provided by operating activities of continuing operations will increase over the course of 2008.

### ***Investing Activities***

Cash used in investing activities increased by \$313 million in 2007 compared to 2006. The increase in cash used in investing activities was primarily due to the fact that 2006 included cash totaling \$325 million related to the sale of the Software Spectrum business in September 2006. Cash used for acquisitions decreased \$73 million to \$676 million in 2007 compared to \$749 million for 2006. Cash used for acquisitions during 2007 includes the acquisitions of Broadwing for \$492 million (net of cash acquired of \$257 million), the CDN business for \$133 million, Servecast for \$45 million (net of cash acquired of \$1 million) and a minority investment in a private company for \$6 million. In addition, capital expenditures increased \$241 million from \$392 million in 2006 to \$633 million in 2007. The increase in capital expenditures was primarily for success based capital related to new customer installations and integration activities in the communications business. During 2007, \$288 million of marketable securities held by the Company matured, the Company received proceeds of \$45 million from the sale of approximately 80% of its investment in Infinera and restricted securities decreased by \$12 million. During 2006, the Company had net purchases of marketable securities totaling \$182 million. In 2007, an arbitrator ruled that Level 3 owed Infocrossing approximately \$2 million for working capital adjustments pertaining to the sale of ( i )Structure completed in 2005.

### ***Financing Activities***

Cash provided by financing activities decreased \$1.932 billion to a \$243 million use of cash in 2007 compared to 2006. Included in cash flows from financing activities is \$2.349 billion of net proceeds from the issuance of:

- \$300 million of Floating Rate Senior Notes due 2015 in February 2007;
- \$700 million of 8.75% Senior Notes due 2017 in February 2007; and
- \$1.4 billion Senior Secured Term Loan due 2014 in March 2007.

The Company used proceeds from these offerings along with cash on hand to retire or refinance approximately \$2.497 billion aggregate principal amount of debt. Total cash consideration paid to retire or refinance this debt was \$2.618 billion. Financing activities also include proceeds of \$26 million from the exercise of warrants associated with the Broadwing transaction and other equity-based instruments. During 2006, the Company raised \$543 million in net proceeds from an equity offering, raised \$2.256 billion in net proceeds from long-term debt offerings and repaid \$1.110 billion of debt.

The Company also issued approximately 214 million shares of its common stock, valued at \$879 million, to retire \$702 million of debt.

### **Liquidity and Capital Resources**

The Company incurred operating losses from continuing operations of \$1.114 billion and \$790 million in 2007 and 2006, respectively. The Company used \$402 million and \$171 million of cash for operating activities and capital expenditures in 2007 and 2006, respectively. The Company expects that the communications business will consume cash in 2008, with the largest use of cash occurring in the first quarter of 2008 as a result of reduced Adjusted EBITDA and increased use of cash for working capital in the quarter. The Company expects that the use of cash by the communications

business will be modest in subsequent quarters and decline overall by the end of 2008. The Company expects that the communications business will generate cash for the full year 2009.

The Company expects that to the extent it does consume cash in 2008, it will be primarily due to interest payments and capital expenditures. The Company expects Adjusted EBITDA to improve in 2008 to a range of \$950 million to \$1.1 billion primarily as a result of a full year of benefit from the integration related synergies associated with the acquisitions completed in 2006 and 2007, as well as moderate growth in Core Communications Services revenue that is expected to be partially offset by reductions in Other Communications Services and SBC Contract Services revenue. Interest payments are expected to be slightly lower than the \$545 million incurred in 2007 based on current debt outstanding and the financing and other capital markets transactions completed in 2007. Capital expenditures for 2007 are expected to be in the range of 12% to 14% of revenue and significantly lower than the \$633 million incurred in 2007 due to much lower integration-related capital expenditures. The majority of the Company's ongoing capital expenditures are expected to be success-based, or tied to incremental revenue. The Company does not have any significant principal amounts due on its outstanding debt until 2010. As of December 31, 2007, the Company had debt of \$32 million and \$366 million that matures in 2008 and 2009, respectively.

Level 3 has approximately \$723 million of cash, cash equivalents and marketable securities on hand at December 31, 2007. In addition, \$124 million of current and non-current restricted securities are used to collateralize outstanding letters of credit, long-term debt, certain operating obligations of the Company or certain reclamation liabilities associated with the coal business. Based on information available at this time, management of the Company believes that the Company's current liquidity and anticipated future cash flows from operations will be sufficient to fund its business for at least the next twelve months.

The Company may elect to secure additional capital in the future, at acceptable terms, to improve its liquidity or fund acquisitions. In addition, in an effort to reduce future cash interest payments, as well as future amounts due at maturity or to extend debt maturities, Level 3 or its affiliates may, from time to time, issue new debt, enter into debt for debt, debt for equity or cash transactions to purchase its outstanding debt securities in the open market or through privately negotiated transactions. Level 3 will evaluate any such transactions in light of then existing market conditions and the possible dilutive effect to stockholders. The amounts involved in any such transaction, individually or in the aggregate, may be material.

In January 2007, in two separate transactions, the Company completed the exchange of \$605 million of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of Level 3's common stock. The Company recognized a \$177 million loss on the exchanges in the first quarter of 2007.

In February 2007, Level 3 Financing issued \$700 million of its 8.75% Senior Notes due 2017 and \$300 million of its Floating Rate Senior Notes due 2015 and received net proceeds of \$982 million. The proceeds from these private offerings were used to refinance certain Level 3 Financing debt and to fund the cost of construction, installation, acquisition, lease, development or improvement of other assets to be used in Level 3's communications business.

In March 2007, Level 3 Financing refinanced its senior secured credit agreement and received net proceeds of \$1.382 billion. The proceeds from this transaction were used to repay the existing \$730 million Senior Secured Term Loan due 2011 and other debt. The effect of this transaction was to increase the amount of senior secured debt from \$730 million to \$1.4 billion, reduce the interest rate on that debt from LIBOR plus 3.00% to LIBOR plus 2.25% and extend the final maturity from 2011 to 2014. The Company recognized a \$10 million loss on this transaction related to unamortized debt issuance costs.

During the first quarter of 2007, the Company redeemed the outstanding principal amount of the following debt issuances totaling \$722 million:

- \$488 million of 12.875% Senior Notes due 2010 at a price equal to 102.146 of the principal amount;
- \$96 million of 11.25% Senior Notes due 2010 at a price equal to 101.875 of the principal amount; and
- \$138 million (€104 million) of 11.25% Senior Euro Notes due 2010 at a price equal to 101.875 of the principal amount.

Also during the first quarter of 2007, the respective issuers repurchased, through tender offers, \$941 million of the outstanding principal amounts of the following debt issuances:

- \$144 million of outstanding Floating Rate Senior Notes due 2011 at a price equal to \$1,080 per \$1,000 principal amount of the notes, which included \$1,050 as the tender offer consideration and \$30 as a consent payment;
- \$59 million of outstanding 11% Senior Notes due 2008 at a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which included \$1,024.28 as the tender offer consideration and \$30 as a consent payment;
- \$677 million of outstanding 11.5% Senior Notes due 2010 at a price equal to \$1,115.26 per \$1,000 principal amount of the notes, which included \$1,085.26 as the tender offer consideration and \$30 as a consent payment; and
- \$61 million (€46 million) of outstanding 10.75% Senior Euro Notes due 2008 at a price equal to €1,061.45 per €1,000 principal amount of the notes, which included €1,031.45 as the tender offer consideration and €30 as a consent payment.

The Company recognized a \$240 million loss associated with the redemptions and repurchases in the first quarter of 2007. The cash portion of the loss on redemptions and tenders totaled \$165 million and the remaining \$75 million consisted of unamortized debt issuance and discounts.

In the first quarter, for total cash consideration of \$106 million and equity consideration of 17 million shares of common stock (valued at \$97 million) all of Broadwing's outstanding \$180 million aggregate principal amount of 3.125% Convertible Senior Debentures due 2026 were retired. These debentures were issued by Broadwing prior to Level 3's acquisition of Broadwing on January 3, 2007. There was no gain or loss recognized due to the fact that under purchase accounting, the liability for the notes was valued at the total cost to retire the obligation.

In addition to raising capital through the debt and equity markets, the Company may sell or dispose of existing businesses, investments or other non-core assets. In 2005 and 2006, the Company completed the sale of its two businesses that comprised its Information Services segment for total cash proceeds of \$433 million and common stock from one of the purchasers valued at \$3 million.

On December 19, 2007, Level 3 announced that it had reached a definitive agreement to sell the advertising distribution business of Vyvx, LLC ("Vyvx Ads") to DG FastChannel, Inc. for \$129 million in cash. The sale is expected to close in the second quarter of 2008. Revenue from the Vyvx Ads business totaled approximately \$36 million, \$35 million and less than \$1 million for the years ended December 31, 2007, 2006 and 2005, respectively. The results of operations for the Vyvx Ads business are included in continuing operations from when it was acquired as part of the WiTel transaction in December 2005.

The communications industry continues to consolidate. Level 3 has participated in this process with the acquisitions of several companies in 2006, as well as Broadwing, the CDN Business and Servecast

during 2007. Level 3 will continue to evaluate consolidation opportunities and could make additional acquisitions in the future.

On January 3, 2007, Level 3 acquired Broadwing, a publicly held provider of optical network communications services. Under the terms of the merger agreement dated October 16, 2006, Level 3 paid \$8.18 of cash plus 1.3411 shares of Level 3 common stock for each share of Broadwing common stock outstanding at closing. In total, Level 3 initially paid approximately \$753 million of cash (including transaction costs) and issued approximately 123 million shares of Level 3 common stock, valued at \$688 million. As part of the transaction, approximately 4 million previously issued Broadwing warrants (valued at approximately \$4 million) became exercisable into approximately 5 million shares of Level 3 common stock. In the second quarter of 2007, the Company subsequently reduced the total consideration paid by \$4 million for insurance proceeds received in June 2007 that related to the settlement of an insurance claim that occurred prior to acquisition. In the fourth quarter of 2007, the Company incurred additional transaction costs of \$2 million related to the transaction.

On January 23, 2007, the Company acquired the Content Delivery Network services business of SAVVIS, Inc. Under the terms of the agreement, Level 3 paid \$133 million in cash (including transaction costs) to acquire certain assets, including network elements, customer contracts, and intellectual property used in the CDN Business.

On July 11, 2007, Level 3 acquired Servecast Limited, a Dublin, Ireland based provider of live and on-demand video management services for broadband and mobile platforms. Level 3 paid approximately €34 million, or \$46 million, including \$1 million of transaction costs, in cash to complete the acquisition of Servecast.

### Off-Balance Sheet Arrangements

Level 3 has not entered into off-balance sheet arrangements that have had, or are likely to have, a current or future material effect to its results of operations or its financial position.

### Contractual Obligations

The following table summarizes the contractual obligations and commercial commitments of the Company at December 31, 2007, as further described in the notes to the consolidated financial statements.

#### *Payments Due by Period*

	Total	Less than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years
<b>Contractual Obligations</b>					
Long-Term Debt, including current portion	\$ 6,857	\$ 32	\$ 1,337	\$ 968	\$ 4,520
Interest Expense Obligations	3,075	532	1,002	849	692
Asset Retirement Obligations	231	4	18	18	191
Operating Leases	727	126	193	147	261
Right of Way Agreements	1,352	101	176	157	918
Purchase Obligations	285	285	—	—	—
<b>Other Commercial Commitments</b>					
Letters of Credit	36	9	3	—	24

The Company's debt instruments contain certain covenants which, among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates. If the Company should fail to comply with these covenants, amounts due under the instruments may be accelerated at the note holder's discretion after the declaration of an event of default.

Long-term debt obligations reflect only amounts recorded on the balance sheet as of December 31, 2007 and exclude issue discounts and fair value adjustments.

Interest expense obligations assume interest rates on variable rate debt do not change from December 31, 2007. In addition, interest is calculated based on debt outstanding as of December 31, 2007 and on existing maturity dates.

Certain right of way agreements include provisions for increases in payments in future periods based on the rate of inflation as measured by the consumer price index. The Company has not included estimates for these increases in future periods in the amounts included above.

Certain right of way agreements are cancellable or can be terminated under certain conditions. However, in most cases cancellation or termination of the right of way agreement requires removal of the Company's network. Because the Company considers it unlikely that it would cancel or terminate its right of way agreements and remove its network, the payments due under these agreements have been included in the table above. Certain of these right of way agreements provide for automatic renewal on a periodic basis. For purposes of presenting future payment commitments under these agreements, the Company has included 18 years of future payments from January 1, 2008 in the table above.

Purchase obligations represent all outstanding purchase order amounts of the Company as of December 31, 2007.

The table above does not include other long-term liabilities, such as reserves for legal matters and income taxes, that are not contractual obligations by nature. The Company cannot determine with any degree of reliability the years in which these liabilities might ultimately be paid.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Level 3 is subject to market risks arising from changes in interest rates and foreign exchange rates. As of December 31, 2007, the Company had borrowed a total of \$1.706 billion under a Senior Secured Term Loan due 2014, Floating Rate Senior Notes due 2015 and Floating Rate Senior Notes due 2011 that bear interest at LIBOR rates plus an applicable margin. As the LIBOR rates fluctuate, so too does the interest expense on amounts borrowed under the debt instruments. The weighted average interest rate on the variable rate instruments at December 31, 2007 was approximately 7.80%.

On March 13, 2007, Level 3 Financing entered into two interest rate swap agreements to hedge the interest payments on \$1 billion notional amount of floating rate debt. The two interest rate swap agreements are with different counterparties and are for \$500 million each. The interest rate swap agreements are effective beginning April 13, 2007 and mature on January 13, 2014. Under the terms of the interest rate swap agreements, Level 3 Financing, Inc. receives interest payments based on rolling three month LIBOR terms and pays interest at the fixed rate of 4.93% under one arrangement and 4.92% under the other. Level 3 has designated the interest rate swap agreements as a cash flow hedges on the interest payments for \$1 billion of floating rate debt.

For the remaining variable rate debt, a hypothetical increase in the variable portion of the weighted average interest rate by 1 point (i.e. a weighted average rate of 8.80%) would increase annual interest expense of the Company by approximately \$7 million. At December 31, 2007, the Company had \$5.150 billion (excluding discounts) of fixed rate debt bearing a weighted average interest rate of 7.84%. A decline in interest rates in the future will not benefit the Company with respect to the fixed rate debt due to the terms and conditions of the loan agreements that would require the Company to repurchase the debt at specified premiums if redeemed early.

The Company's business plan includes operating telecommunications network businesses in Europe. As of December 31, 2007, the Company had invested significant amounts of capital in the

region for its communications business. The Company does not make use of financial instruments to minimize its exposure to foreign currency fluctuations.

Indicated changes in interest rates are based on hypothetical movements and are not necessarily indicative of the actual results that may occur. Future earnings and losses will be affected by actual fluctuations in interest rates and foreign currency rates.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Financial statements and supplementary financial information for Level 3 Communications, Inc. and Subsidiaries begin on page F-1.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, ("Exchange Act"). Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

### **Management's Report on Internal Control Over Financial Reporting**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, management assessed the effectiveness of internal controls over financial reporting as of December 31, 2007 based on the guidelines established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Our internal control over financial reporting includes policies and procedures that provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

Based on our assessment, management believes that our internal control over financial reporting was effective as of December 31, 2007. The results of management's assessment have been reviewed with the Audit Committee of the Company's Board of Directors.

The Company's independent registered public accounting firm, KPMG LLP, has issued an audit report on its assessment of the Company's internal control over financial reporting at December 31, 2007. This report appears on page F-3.

### **Changes in Internal Control over Financial Reporting.**

There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **ITEM 9B. OTHER INFORMATION**

None.

### **Part III**

#### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this Item 10 is incorporated by reference to our definitive proxy statement for the 2008 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission, however certain information is included in ITEM 1. BUSINESS above under the caption "Directors and Executive Officers."

#### **ITEM 11. EXECUTIVE COMPENSATION**

The information required by this Item 11 is incorporated by reference to our definitive proxy statement for the 2008 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

For information as of December 31, 2007, with respect to compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance, please see "Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER REPURCHASES OF EQUITY SECURITIES" above.

The information required by this Item 12 is incorporated by reference to our definitive proxy statement for the 2008 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this Item 13 is incorporated by reference to our definitive proxy statement for the 2008 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information required by this Item 14 is incorporated by reference to our definitive proxy statement for the 2008 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.



## Part IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

- (a) Financial statements and financial statement schedules required to be filed for the registrant under Items 8 or 15 are set forth following the index page at page F-1. Exhibits filed as a part of this report are listed below. Exhibits incorporated by reference are indicated in parentheses.
- 3.1 Certificate of Amendment to the Level 3 Communications, Inc. Certificate of Incorporation and the Level 3 Communications, Inc. Restated Certificate of Incorporation. (Exhibit 3 to the Registrant's Current Reports on Form 8-K filed on May 27, 2005 and May 17, 2006).
- 3.2 Specimen Stock Certificate of Common Stock, par value \$.01 per share (Exhibit 3 to the Registrant's Form 8-A filed on March 31, 1998).
- 3.3 Amended and Restated By-laws of Level 3 Communications, Inc. (Exhibit 3(ii) to the Registrant's Current Report on Form 8-K dated August 17, 2007).
- 4.1.1 Form of Senior Indenture (incorporated by reference to Exhibit 4.1 to Amendment 1 to the Registrant's Registration Statement on Form S-3 (File No. 333-68887) filed with the Securities and Exchange Commission on February 3, 1999).
- 4.1.2 First Supplemental Indenture, dated as of September 20, 1999, between the Registrant and IBJ Whitehall Bank & Trust Company as Trustee relating to the Registrant's 6% Convertible Subordinated Notes due 2009 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated September 20, 1999).
- 4.1.3 Second Supplemental Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 6% Convertible Subordinated Notes due 2010 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated February 29, 2000).
- 4.2 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 11% Senior Notes due 2008 (Exhibit 4.1 to the Registrant's Registration Statement on Form S-4 File No. 333-37362).
- 4.3 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 10<sup>3</sup> / 4 % Senior Euro Notes due 2008 (Exhibit 4.1 to the Registrant's Registration Statement on Form S-4 File No. 333-37364).
- 4.4 Amended and Restated Indenture dated as of July 8, 2003, by and between the Company and The Bank of New York, as successor to IBJ Whitehall Bank & Trust Company, as trustee (amends and restates the Senior Debt Indenture, a Form of which was filed as an Exhibit to the Company's Registration Statement on Form S-3-File No. 333-68887) (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed July 8, 2003).
- 4.5 First Supplemental Indenture, dated as of July 8, 2003, by and between the Company and The Bank of New York, as successor to IBJ Whitehall Bank & Trust Company, as Trustee (Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed July 8, 2003).
- 4.6 Indenture, dated as of October 1, 2003, by and between Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc. as Issuer and The Bank of New York as Trustee relating to the Level 3 Financing, Inc. 10.75% Senior Notes due 2011 (Exhibit 4.11 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2003).

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- 4.7.1 Indenture, dated as of October 24, 2003, by and between the Registrant and The Bank of New York as Trustee relating to the Registrant's 9% Convertible Senior Discount Notes due 2013 (Exhibit 4.12 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2003).

- 4.7.2 First Supplemental Indenture, dated as of February 7, 2005, by and between the Company and The Bank of New York, as Trustee relating to the Registrant's 9% Convertible Senior Discount Notes due 2013. (Exhibit 4.12.2 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2005).
- 4.8 Supplemental Indenture, dated as of October 20, 2004, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2014. (Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed October 22, 2004).
- 4.9 Supplemental Indenture, dated as of October 20, 2004 among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1 2003, among Level 3 Financing, Inc. as Issuer, Level 3 Communications, Inc. as Guarantor and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2011. (Exhibit 99.1 to the Registrant's Current Report on Form 8-K/A-1 filed October 22, 2004).
- 4.10 Indenture, dated December 2, 2004, among Level 3 Communications, Inc. and The Bank of New York. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 4.11 Supplemental Indenture, dated December 1, 2004, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York, as Trustee, relating to the Level 3 Financing 10.75% Senior Notes due 2011. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 4.12 Second Supplemental Indenture dated as of April 4, 2005, by and between Level 3 Communications, Inc. and the Bank of New York, as trustee (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed April 8, 2005).
- 4.13 Indenture, dated as of January 13, 2006, among Level 3 Communications, Inc. as Issuer and The Bank of New York, as Trustee relating to the 11.50% Senior Notes Due 2010 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated January 17, 2006).
- 4.14 Indenture, dated as of March 14, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the Floating Rate Senior Notes due 2011 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated March 16, 2006).
- 4.15 Indenture, dated as of March 14, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the 12.25% Senior Notes due 2013 of Level 3 Financing, Inc. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 16, 2006).
- 4.16 Third Supplemental Indenture between Level 3 Communications, Inc. and The Bank of New York, as Trustee, relating to up to \$345,000,000 aggregate principal amount of 3.5% Convertible Senior Notes due 2012, dated as of June 13, 2006 supplement to the Amended and Restated Indenture dated as of July 8, 2003 (Senior Debt Securities) (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 13, 2006).

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- 4.17 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2011 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.18 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, Supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2011 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated October 17, 2006).

- 4.19 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.20 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.21 Indenture, dated as of October 30, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer, and The Bank of New York, as Trustee, relating to the 9.25% Senior Notes due 2014 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated October 30, 2006).
- 4.22 Supplemental Indenture, dated as of December 27, 2006, among Level 3 Communications, Inc., Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., as Issuer, Level 3 Communications, Inc., as Guarantor, and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2011 2014 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated December 28, 2006).
- 4.23 Indenture, dated as of February 14, 2007, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the Floating Rate Senior Notes due 2015 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 4.24 Indenture, dated as of February 14, 2007, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the 8.75% Senior Notes due 2017 of Level 3 Financing, Inc. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated February 20, 2007).

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- 4.25 Supplemental Indenture, dated as of February 23, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York, as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., as Issuer, Level 3 Communications, Inc., as Guarantor, and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed February 26, 2007).
- 4.26 Supplemental Indenture, dated as of March 1, 2007, among Level 3 Communications, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of February 29, 2000, among Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Communications, Inc.'s 11% Senior Notes Due 2008 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated March 2, 2007).
- 4.27 Supplemental Indenture, dated as of March 1, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc., together with Level 3 Communications, Inc. and Level 3 Communications, LLC, as Guarantors and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, by and among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York as Trustee relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2011 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 2, 2007).

- 4.28 Supplemental Indenture, dated as of March 6, 2007, among Level 3 Communications, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of February 29, 2000, among Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Communications, Inc.'s 10<sup>3</sup> / 4 % Senior Euro Notes Due 2008 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated March 7, 2007).
- 4.29 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2011 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated March 16, 2007).

- 4.30 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Broadwing Financial Services, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2011 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.31 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes Due 2013 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.32 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Broadwing Financial Services, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes Due 2013 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.33 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of October 20, 2004 among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, and the supplemental Indenture dated December 1, 2004, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes Due 2011 (Exhibit 4.5 to the Registrant's Current Report on Form 8-K dated March 16, 2007).

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- 4.34 Amended and Restated Supplemental Indenture, dated as of March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Broadwing Financial Services, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of October 30, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, and the supplemental Indenture dated as of January 4, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.6 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.35 Supplemental Indenture, dated as of March 13, 2007, among Level 3 Communications, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated as of January 13, 2006, among Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Communications, Inc.'s 11.5% Senior Notes Due 2010 (Exhibit 4.7 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 4.36 Supplemental Indenture, dated as of April 9, 2007, among Level 3 Communications, LLC, Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated October 30, 2006, among Level 3 Financing, Inc., Level 3

Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated April 11, 2007).

- 4.37 Supplemental Indenture, dated as of April 9, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated October 30, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated April 11, 2007).
- 4.38 Supplemental Indenture, dated as of January 4, 2007, among Broadwing Financial Services, Inc., Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated October 30, 2006 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 9.25% Senior Notes Due 2014 (Exhibit 4.2 to the Registrant's Registration Statement on Form S-4/A File No. 333-139123-01).
- 4.39 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Communications, LLC, Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 8.75% Senior Notes Due 2017 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated May 31, 2007).
- 4.40 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 8.75% Senior Notes Due 2017 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated May 31, 2007).

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- 4.41 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Communications, LLC, Level 3 Communications, Inc., Level 3 Financing, Inc. and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2015 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated May 31, 2007).
  - 4.42 Supplemental Indenture, dated as of May 29, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated February 14, 2007 among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes Due 2015 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated May 31, 2007).
  - 10.1 Separation Agreement, dated December 8, 1997, by and among Peter Kiewit Sons', Inc., Kiewit Diversified Group Inc., PKS Holdings, Inc. and Kiewit Construction Group Inc. (Exhibit 10.1 to the Registrant's Form 10-K for 1997).
  - 10.2 Amendment No. 1 to Separation Agreement, dated March 18, 1997, by and among Peter Kiewit Sons', Inc., Kiewit Diversified Group Inc., PKS Holdings, Inc. and Kiewit Construction Group Inc. (Exhibit 10.1 to the Registrant's Form 10-K for 1997).
  - 10.3 Form of Aircraft Time-Share Agreement (Exhibit 10.7 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001).
  - 10.4 Warrant Agreement, dated as of April 15, 2002, between the Registrant and Walter Scott, Jr. (Exhibit 10.9 to the Registrant's Annual Report on Form 10-K for 2002).
  - 10.5 Confirmation of OTC Convertible Note Hedge, dated December 2, 2004, from Merrill Lynch International to Level 3 Communications, Inc. (Exhibit 10.8 to the Registrant's Current Report on

- 10.6 Confirmation of OTC Warrant, dated December 2, 2004, from Merrill Lynch International to Level 3 Communications, Inc. (Exhibit 10.9 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.7 Securities Purchase Agreement, dated as of February 18, 2005, among Level 3 Communications, Inc. and the Investors named therein (Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed February 22, 2005).
- 10.8 1995 Stock Plan of Level 3 Communications, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated December 20, 2007).
- 10.9.1 Outperform Stock Option Amended and Restated Master Award Agreement of Level 3 Communications, Inc. (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated December 20, 2007).
- 10.9.2 Form of OSO Master Award Agreement of Level 3 Communications, Inc. (Exhibit 10.3 to the Registrant's Current Report on Form 8-K dated December 20, 2007).
- 10.10 Form of Amended Master Deferred Issuance Stock Agreement of Level 3 Communications, Inc. (Exhibit 10.4 to the Registrant's Current Report on Form 8-K dated December 20, 2007).

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- 10.11 Form of Registration Rights and Transfer Restriction Agreement by and among Level 3 Communications, Inc., PT Holding Company LLC, Progress Telecommunications Corporation, Caronet, Inc., and EPIK Communications Incorporated to be entered into on the closing of the transaction contemplated by the Purchase Agreement 2006 (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated January 30, 2006).
  - 10.12 Registration Rights and Transfer Restriction Agreement, dated May 31, 2006, by and among Level 3 Communications, Inc., MCCC ICG Holdings LLC, Columbia Capital Equity Partners III(QP), L.P., Columbia Capital Partners III (Cayman), L.P., Columbia Capital Equity Partners III (AI), L.P., Columbia Capital Investors III, L.L.C., Columbia Capital Employees Investors III, L.L.C., M/C Venture Partners V, L.P., M/C Venture Investors, L.L.C., Chestnut Venture Partners, L.P., and Bear Investments, LLLP. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 1, 2006).
  - 10.13 Stock Purchase Agreement, dated July 20, 2006, among Level 3 Communications, Inc., Technology Spectrum, Inc. and Insight Enterprises, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated July 26, 2006).
  - 10.14 Registration Rights Agreement, dated as of August 2, 2006, between Level 3 Communications, Inc. and Cheshire Holding Corp., as agent for the security holders of Looking Glass Networks Holding Co., Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated August 3, 2006).
  - 10.15 Consent, dated as of August 7, 2006, by Level 3 Communications, Inc. relating to that certain Securities Purchase Agreement, dated as of February 18, 2005, by and among Level 3 Communications, Inc. and the Investors named on Exhibit A Thereto (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated August 7, 2006).
  - 10.16 Registration Agreement, dated October 30, 2006, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated, Credit Suisse Securities (USA) LLC, J.P. Morgan Securities Inc. and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s 9.25% Senior Notes due 2014 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated October 30, 2006).
  - 10.17 Registration Agreement, dated December 28, 2006, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated, Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc. and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s 9.25% Senior Notes due 2014 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated December 28, 2006).

- 10.18 Exchange Agreement, dated as of January 11, 2007, among Level 3 Communications, Inc., Southeastern Asset Management, Inc., on behalf of its investment advisory clients, and Legg Mason Opportunity Trust, a series of Legg Mason Investment Trust, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated January 17, 2007).
- 10.19 Registration Agreement, dated February 14, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc., Morgan Stanley & Co. Incorporated and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2015 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated February 20, 2007).

- 10.20 Registration Agreement, dated February 14, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc., Morgan Stanley & Co. Incorporated and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s 8.75% Senior Notes due 2017 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 10.21 Credit Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.22 Guarantee Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., the Subsidiaries of Level 3 Communications, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.23 Collateral Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc., the Subsidiaries of Level 3 Communications, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.3 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.24 Indemnity, Subrogation and Contribution Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc., the Subsidiaries of Level 3 Communications, Inc. and Merrill Lynch Capital Corporation (Exhibit 10.4 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.25 Omnibus Offering Proceeds Note Subordination Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc., Level 3 Communications, LLC, the Subsidiaries (Exhibit 10.5 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.26 Supplement No. 1 to Omnibus Offering Proceeds Note Subordination Agreement, dated as of March 13, 2007, among Level 3 Communications, Inc., Level 3 Communications, LLC, Level 3 Financing, Inc., the Subsidiaries (Exhibit 10.6 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.27 Amended and Restated Loan Proceeds Note, dated March 13, 2007, issued by Level 3 Communications, LLC to Level 3 Financing, Inc. (Exhibit 10.7 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.28 Amended and Restated Loan Proceeds Note Collateral Agreement, dated March 13, 2007, among Level 3 Financing, Inc., Level 3 Communications, LLC and Merrill Lynch Capital Corporation (Exhibit 10.8 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.29 Amended and Restated Loan Proceeds Note Guarantee Agreement, dated March 13, 2007, among Broadwing Financial Services, Inc., and Level 3 Financing, Inc. (Exhibit 10.9 to the Registrant's Current Report on Form 8-K dated March 16, 2007).
- 10.30 Retention Agreement, dated October 15, 2007, by and between Level 3 Communications, LLC and Sunit S. Patel (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated October 17, 2007).
- 10.31 Standstill Agreement, dated November 19, 2007, by and between Level 3 Communications, Inc. and Southeastern Asset Management, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated November 19, 2007).





- 21 List of subsidiaries of the Company.
- 23 Consent of KPMG LLP.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, this 29<sup>th</sup> day of February, 2008.

LEVEL 3 COMMUNICATIONS, INC.

By: /s/ JAMES Q. CROWE

Name: James Q. Crowe  
Title: *Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ WALTER SCOTT, JR.	Chairman of the Board	February 29, 2008
Walter Scott, Jr.		
/s/ JAMES Q. CROWE	Chief Executive Officer and Director	February 29, 2008
James Q. Crowe		
/s/ SUNIT S. PATEL	Group Vice President and Chief Financial Officer (Principal Financial Officer)	February 29, 2008
Sunit S. Patel		
/s/ ERIC J. MORTENSEN	Senior Vice President and Controller (Principal Accounting Officer)	February 29, 2008
Eric J. Mortensen		
/s/ DOUGLAS C. EBY	Director	February 29, 2008
Douglas C. Eby		
/s/ JAMES O. ELLIS, JR.	Director	February 29, 2008
James O. Ellis, Jr.		
/s/ RICHARD R. JAROS	Director	February 29, 2008
Richard R. Jaros		
/s/ ROBERT E. JULIAN	Director	February 29, 2008
Robert E. Julian		
/s/ MICHAEL J. MAHONEY	Director	February 29, 2008
Michael J. Mahoney		
/s/ ARUN NETRAVALI	Director	February 29, 2008
Arun Netravali		
/s/ JOHN T. REED	Director	February 29, 2008
John T. Reed		
/s/ MICHAEL B. YANNEY	Director	February 29, 2008
Michael B. Yanney		
/s/ ALBERT C. YATES	Director	February 29, 2008



## LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES

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Schedules not indicated above have been omitted because of the absence of the conditions under which they are required or because the information called for is shown in the consolidated financial statements or in the notes thereto.

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Level 3 Communications, Inc.:

We have audited the accompanying consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit) and comprehensive loss for each of the years in the three-year period ended December 31, 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Level 3 Communications, Inc. and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Level 3 Communications, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 29, 2008 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ **KPMG LLP**

Denver, Colorado  
February 29, 2008

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Level 3 Communications, Inc.:

We have audited Level 3 Communications, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Level 3 Communications, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Management's Report on Internal Control Over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Level 3 Communications, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit) and comprehensive loss for each of the years in the three-year period ended December 31, 2007, and our report dated February 29, 2008 expressed an unqualified opinion on those consolidated financial statements.

/s/ **KPMG LLP**

Denver, Colorado  
February 29, 2008

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
For the three year period ended December 31, 2007

	2007	2006	2005
	(dollars in millions, except per share data)		
Revenue:			
Communications	\$ 4,199	\$ 3,311	\$ 1,645
Coal mining	70	67	74
Total revenue	4,269	3,378	1,719
Costs and Expenses (exclusive of depreciation and amortization shown separately below):			
Cost of revenue:			
Communications	1,769	1,460	463
Coal mining	64	57	53
Total cost of revenue	1,833	1,517	516
Depreciation and amortization	942	730	647
Selling, general and administrative	1,723	1,258	769
Restructuring and impairment charges	12	13	23
Total costs and expenses	4,510	3,518	1,955
Operating Loss	(241)	(140)	(236)
Other Income (Expense):			
Interest income	54	64	35
Interest expense	(577)	(648)	(530)
Loss on early extinguishment of debt, net	(427)	(83)	—
Other, net	55	19	29
Total other income (expense)	(895)	(648)	(466)
Loss from Continuing Operations Before Income Taxes	(1,136)	(788)	(702)
Income Tax Benefit (Expense)	22	(2)	(5)
Loss from Continuing Operations	(1,114)	(790)	(707)
Discontinued Operations:			
Income from discontinued operations	—	13	20
Gain on sale of discontinued operations	—	33	49
Income from Discontinued Operations	—	46	69
Net Loss	\$ (1,114)	\$ (744)	\$ (638)
Earnings (Loss) Per Share of Common Stock (Basic and Diluted):			
Loss from Continuing Operations	\$ (0.73)	\$ (0.79)	\$ (1.01)
Income from Discontinued Operations	—	.05	0.10
Net Loss	\$ (0.73)	\$ (0.74)	\$ (0.91)

See accompanying notes to consolidated financial statements.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
December 31, 2007 and 2006

	2007	2006
	(dollars in millions, except per share data)	
<i>Assets</i>		
Current Assets:		
Cash and cash equivalents	\$ 714	\$ 1,681
Marketable securities	9	235
Restricted cash and securities	23	46
Receivables, less allowances for doubtful accounts of \$20 and \$17, respectively	395	326
Other	88	101
Total Current Assets	1,229	2,389
Property, Plant and Equipment, net	6,669	6,468
Restricted Cash and Securities	101	90
Goodwill	1,421	408
Other Intangibles, net	680	511
Other Assets, net	145	128
Total Assets	\$ 10,245	\$ 9,994
<i>Liabilities and Stockholders' Equity</i>		
Current Liabilities:		
Accounts payable	\$ 396	\$ 391
Current portion of long-term debt	32	5
Accrued payroll and employee benefits	97	92
Accrued interest	128	143
Current portion of deferred revenue	166	128
Other	139	156
Total Current Liabilities	958	915
Long-Term Debt, less current portion	6,832	7,357
Deferred Revenue, less current portion	763	767
Other Liabilities	622	581
Total Liabilities	9,175	9,620
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock, \$.01 par value, authorized 10,000,000 shares: no shares issued or outstanding	—	—
Common stock, \$.01 par value, authorized 2,250,000,000 shares: 1,537,862,685 issued and outstanding in 2007 and 1,178,423,105 issued and outstanding in 2006	15	12
Additional paid-in capital	11,004	9,305
Accumulated other comprehensive income (loss)	104	(4)
Accumulated deficit	(10,053)	(8,939)
Total Stockholders' Equity	1,070	374
Total Liabilities and Stockholders' Equity	\$ 10,245	\$ 9,994

See accompanying notes to consolidated financial statements.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
For the three year period ended December 31, 2007

	2007	2006	2005
	(dollars in millions)		
<b>Cash Flows from Operating Activities:</b>			
Net Loss	\$ (1,114)	\$ (744)	\$ (638)
Income from discontinued operations	—	(46)	(69)
Loss from continuing operations	(1,114)	(790)	(707)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities of continuing operations:			
Depreciation and amortization	942	730	647
Loss on debt extinguishments, net	427	83	—
Loss on impairments	1	8	9
Gain on sale of property, plant and equipment and other assets	(40)	(7)	(9)
Non-cash compensation expense attributable to stock awards	122	84	51
Amortization of debt issuance costs	15	19	16
Deferred income taxes	(23)	—	—
Accreted interest on long-term debt discount	22	38	33
Accrued interest on long-term debt	(5)	32	30
Change in working capital items net of amounts acquired:			
Receivables	21	131	3
Other current assets	18	8	(15)
Payables	(73)	(23)	(12)
Deferred revenue	17	(53)	(121)
Other current liabilities	(105)	(32)	(26)
Other, net	6	(7)	(17)
<b>Net Cash Provided by (Used in) Operating Activities of Continuing Operations</b>	<b>231</b>	<b>221</b>	<b>(118)</b>
<b>Cash Flows from Investing Activities:</b>			
Proceeds from sales and maturities of marketable securities	333	280	584
Purchases of marketable securities	—	(98)	(648)
Decrease (increase) in restricted cash and securities, net	12	(21)	(4)
Capital expenditures	(633)	(392)	(300)
Advances from discontinued operations, net	—	18	13
Acquisitions, net of cash acquired, and investments	(676)	(749)	(379)
Proceeds from sale of discontinued operations, net of cash sold	(2)	307	82
Proceeds from sale of property, plant and equipment, and other investments	5	7	11
<b>Net Cash Used in Investing Activities</b>	<b>\$ (961)</b>	<b>\$ (648)</b>	<b>\$ (641)</b>

(continued)

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
For the three year period ended December 31, 2007 (Continued)

	2007	2006	2005
	(dollars in millions)		
<b>Cash Flows from Financing Activities:</b>			
Long-term debt borrowings, net of issuance costs	\$ 2,349	\$ 2,256	\$ 943
Payments on and repurchases of long-term debt, including current portion and refinancing costs	(2,618)	(1,110)	(130)
Proceeds from warrants and stock-based equity plans	26	—	—
Equity offering	—	543	—
<b>Net Cash (Used in) Provided by Financing Activities</b>	<b>(243)</b>	<b>1,689</b>	<b>813</b>
<b>Discontinued Operations:</b>			
Net cash used in discontinued operating activities	—	(20)	(5)
Net cash used in investing activities	—	(23)	(22)
Net cash used in financing activities	—	—	(1)
Effect of exchange rates on cash and cash equivalents	—	—	(4)
<b>Net Cash Used in Discontinued Operations</b>	<b>—</b>	<b>(43)</b>	<b>(32)</b>
<b>Effect of Exchange Rates on Cash and Cash Equivalents</b>	<b>6</b>	<b>10</b>	<b>(13)</b>
<b>Net Change in Cash and Cash Equivalents</b>	<b>(967)</b>	<b>1,229</b>	<b>9</b>
<b>Cash and Cash Equivalents at Beginning of Year:</b>			
Cash and cash equivalents of continuing operations	1,681	379	338
Cash and cash equivalents of discontinued operations	—	73	105
<b>Cash and Cash Equivalents at End of Year:</b>			
Cash and cash equivalents of continuing operations	\$ 714	\$ 1,681	\$ 379
Cash and cash equivalents of discontinued operations	\$ —	\$ —	\$ 73
<b>Supplemental Disclosure of Cash Flow Information:</b>			
Cash interest paid	\$ 545	\$ 559	\$ 451
Income taxes paid	1	—	—
<b>Noncash Investing and Financing Activities:</b>			
Common stock issued for acquisitions	\$ 692	\$ 904	\$ 313
Equity issued to retire debt	879	—	—
Long-term debt retired by conversion to equity	702	—	—
Amendment and restatement of \$730 million credit agreement	—	730	—
Long-term debt issued in exchange transaction	—	619	—
Long-term debt retired in exchange transaction	—	692	—
Settlement of debt obligation and current liabilities with restricted securities	—	—	13
Decrease in deferred revenue related to acquisitions	—	10	2

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)**  
**For the three year period ended December 31, 2007**

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
			(dollars in millions)		
Balances at December 31, 2004	\$ 7	\$ 7,371	\$ 19	\$ (7,554)	\$ (157)
Common Stock:					
WiTel acquisition	1	312	—	—	313
Stock plan grants	—	37	—	—	37
Shareworks plan	—	24	—	—	24
401(k) plan	—	15	—	—	15
Net Loss	—	—	—	(638)	(638)
Other Comprehensive Loss	—	—	(70)	—	(70)
Balances at December 31, 2005	8	7,759	(51)	(8,192)	(476)
Adjustment for EITF No. 04-6	—	—	—	(3)	(3)
Adjusted balances at December 31, 2005	8	7,759	(51)	(8,195)	(479)
Common Stock:					
Acquisitions	2	902	—	—	904
Equity offering, net of offering costs	2	541	—	—	543
Stock plan grants	—	60	—	—	60
Shareworks plan	—	25	—	—	25
401(k) plan	—	18	—	—	18
Net Loss	—	—	—	(744)	(744)
Other Comprehensive Income	—	—	47	—	47
Balances at December 31, 2006	12	9,305	(4)	(8,939)	374
Common Stock:					
Acquisitions	1	691	—	—	692
Exercise of warrants and options and stock sales	—	26	—	—	26
Stock plan grants	—	77	—	—	77
401(k) plan	—	28	—	—	28
Debt conversion to equity	2	877	—	—	879
Net Loss	—	—	—	(1,114)	(1,114)
Other Comprehensive Income	—	—	108	—	108
Balances at December 31, 2007	\$ 15	\$ 11,004	\$ 104	\$ (10,053)	\$ 1,070

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**  
For the three year period ended December 31, 2007

	2007	2006	2005
	(dollars in millions)		
Net Loss	\$ (1,114)	\$ (744)	\$ (638)
Other Comprehensive Income (Loss) Before Income Taxes:			
Foreign currency translation	131	48	(69)
Unrealized appreciation (depreciation) of available-for-sale investment	7	1	(1)
Unrealized depreciation of interest rate swap	(37)	—	—
Other, net	7	(2)	—
Other Comprehensive Income (Loss), Before Income Taxes	108	47	(70)
Income Tax Benefit Related to Items of Other Comprehensive Income (Loss)	—	—	—
Other Comprehensive Income (Loss), Net of Income Taxes	108	47	(70)
Comprehensive Loss	\$ (1,006)	\$ (697)	\$ (708)

**SUPPLEMENTARY STOCKHOLDERS' EQUITY (DEFICIT) INFORMATION**

	Net Foreign Currency Translation Adjustment	Unrealized Appreciation (Depreciation) of Investment and Interest Rate Swap	Other	Total
	(dollars in millions)			
Accumulated Other Comprehensive Income (Loss):				
Balance at December 31, 2004	\$ 50	\$ —	\$ (31)	\$ 19
Change	(69)	(1)	—	(70)
Balance at December 31, 2005	(19)	(1)	(31)	(51)
Change	48	1	(2)	47
Balance at December 31, 2006	29	—	(33)	(4)
Change	131	(30)	7	108
Balance at December 31, 2007	\$ 160	\$ (30)	\$ (26)	\$ 104

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Summary of Significant Accounting Policies**

**Principles of Consolidation**

The consolidated financial statements include the accounts of Level 3 Communications, Inc. and subsidiaries (the "Company" or "Level 3") in which it has control, which are enterprises engaged in the communications and coal mining businesses. Fifty-percent-owned mining joint ventures are consolidated on a pro rata basis. All significant intercompany accounts and transactions have been eliminated.

Level 3 acquired WilTel Communications Group, LLC ("WilTel") on December 23, 2005; Progress Telecom, LLC ("Progress Telecom") on March 20, 2006; ICG Communications, Inc. ("ICG Communications") on May 31, 2006; TelCove, Inc. ("TelCove") on July 24, 2006; Looking Glass Networks Holding Co., Inc. ("Looking Glass") on August 2, 2006; Broadwing Corporation ("Broadwing") on January 3, 2007; the Content Delivery Network services business ("CDN Business") of SAVVIS, Inc. on January 23, 2007; and Servecast Limited ("Servecast") on July 11, 2007. As applicable, the Company also acquired these companies' operating subsidiaries. The results of operations, cash flows and financial position attributable to these acquisitions are included in the consolidated financial statements from the respective dates of their acquisition (See Note 2).

On September 7, 2006, Level 3 sold Software Spectrum, Inc. ("Software Spectrum"), the Company's software reseller business, to Insight Enterprises, Inc. ("Insight Enterprises"). On November 30, 2005, Level 3 sold ( i )Structure, LLC (" ( i )Structure"), Level 3's wholly owned IT infrastructure management outsourcing subsidiary, to Infocrossing, Inc. ("Infocrossing"). The two businesses comprised Level 3's information services segment. The results of operations, financial condition and cash flows for the Software Spectrum and ( i )Structure businesses have been classified as discontinued operations in the consolidated financial statements and related notes for all periods presented in this report (See Note 3).

On December 19, 2007, Level 3 announced that it had reached a definitive agreement to sell the advertising distribution business of Vyvx, LLC ("Vyvx Ads") to DG FastChannel, Inc. for \$129 million in cash. The sale is expected to close in the second quarter of 2008 subject to regulatory approval. The results of operations for the Vyvx Ads business are included in continuing operations from when it was acquired as part of the WilTel transaction in December 2005. The pending disposal of the Vyvx Ads business does not meet the criteria under SFAS No. 144 for presentation as discontinued operations since the business is not considered an asset group as defined in Statement of Financial Accounting Standard ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144").

**Communications**

The Company's communications business provides a broad range of integrated communications services primarily in the United States and Europe as a facilities-based provider (that is, a provider that owns or leases a substantial portion of the property, plant and equipment necessary to provide its services). The Company has created, through a combination of construction, purchase and leasing of facilities and other assets, an advanced international, end-to-end, facilities-based communications network. The Company has built, and continues to upgrade, the network based on optical and Internet Protocol technologies in order to leverage the efficiencies of these technologies to provide lower cost communications services.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

Revenue for communications services, including private line, wavelengths, colocation, Internet access, managed modem, voice, video and dark fiber, is recognized monthly as the services are provided based on contractual amounts expected to be collected. Management establishes appropriate revenue reserves using an analysis of historical credit activity to address, where significant, circumstances that at the time services are rendered, collection is not reasonably assured either due to credit risk, the potential for billing disputes or other reasons. Reciprocal compensation revenue is recognized when an interconnection agreement is in place with another carrier, or if an agreement has expired, when the parties have agreed to continue operating under the previous agreement until a new agreement is negotiated and executed; or at rates mandated by the FCC.

Certain sale and long-term infeasible right of use or IRU agreements of dark fiber and capacity are required to be accounted for in the same manner as sales of real estate with property improvements or integral equipment. This accounting treatment results in the deferral of the cash that has been received and the recognition of revenue ratably over the term of the agreement (currently up to 20 years).

Termination revenue is recognized when a customer discontinues service prior to the end of the contract period, for which Level 3 had previously received consideration and for which revenue recognition was deferred. Termination revenue is also recognized when customers are required to make termination penalty payments to Level 3 to settle contractually committed purchase amounts that the customer no longer expects to meet or when a customer and Level 3 renegotiate a contract under which Level 3 is no longer obligated to provide services for consideration previously received and for which revenue recognition has been deferred.

The Company is obligated under dark fiber IRUs and other capacity agreements to maintain its network in efficient working order and in accordance with industry standards. Customers are obligated for the term of the agreement to pay for their allocable share of the costs for operating and maintaining the network. The Company recognizes this revenue monthly as services are provided.

Level 3's customer contracts require the Company to meet certain service level commitments. If Level 3 does not meet the required service levels, it may be obligated to provide credits, usually in the form of free service, for a short period of time. The original services that resulted in the credits are not included in revenue and, to date, have not been material.

Cost of revenue for the communications business includes leased capacity, right-of-way costs, access charges and other third party costs directly attributable to the network, but excludes depreciation and amortization and related impairment expenses. The Company also includes in communications cost of revenue the satellite transponder lease costs, the package delivery costs and the blank tape media costs attributable to its video distribution business.

The Company recognizes the cost of network services as they are incurred in accordance with contractual requirements. The Company disputes incorrect billings from its suppliers of network services. The most prevalent types of disputes include disputes for circuits that are not disconnected by its supplier on a timely basis and usage bills with incorrect or inadequate information. Depending on the type and complexity of the issues involved, it may and often does take several quarters to resolve the disputes.

In determining the amount of the cost of network service expenses and related accrued liabilities to reflect in its financial statements, the Company considers the adequacy of documentation of



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

disconnect notices, compliance with prevailing contractual requirements for submitting these disconnect notices and disputes to the provider of the network services, and compliance with its interconnection agreements with these carriers. Significant judgment is required in estimating the ultimate outcome of the dispute resolution process, as well as any other amounts that may be incurred to conclude the negotiations or settle any litigation. Actual results could vary from the estimated amounts accrued for disputes.

*Concentration of Credit Risk*

The Company provides communications services to a wide range of wholesale and enterprise customers, ranging from well capitalized national carriers to smaller, early stage companies. The Company has in place policies and procedures to review the financial condition of potential and existing customers and concludes whether collectability of revenue and other out-of-pocket expenses is probable prior to the commencement of services. If the financial condition of an existing customer deteriorates to a point where payment for services is in doubt, the Company will not recognize revenue attributable to that customer until cash is received. As a result of the WilTel acquisition in 2005 and the Progress Telecom, ICG Communications, TelCove and Looking Glass acquisitions in 2006, the total number of customers increased to approximately 18,000 at December 31, 2006. As a result of the Broadwing, CDN Business and Servecast acquisitions in 2007, the total number of customers increased to approximately 34,000 at December 31, 2007. The policies and procedures for reviewing the financial condition of the additional customers related to the acquisitions remained consistent with those described above and as a result, the Company does not believe its overall credit risk has increased significantly. The Company has from time to time entered into agreements with value-added resellers and other channel partners to reach consumer and enterprise markets for voice services. The Company has policies and procedures in place to evaluate the financial condition of these resellers prior to initiating service to the final customer. The Company is not immune from the effects of downturns in the communications industry; however, management believes the concentration of credit risk with respect to receivables is mitigated due to the dispersion of the Company's customer base among different industries and geographic areas and remedies provided by the terms of contracts and statutes.

Approximately 34% of Level 3's communications revenue was concentrated among its top ten customers for the year ended December 31, 2007. Revenue attributable to AT&T, Inc. and subsidiaries, including SBC Communications, Bell South Communications and AT&T Mobility (formerly Cingular Wireless) amounted, on an aggregate basis, to approximately \$624 million and \$1.1 billion for the years ended December 31, 2007 and 2006, respectively. This represents approximately 15% and 32% of consolidated revenue for the years ended December 31, 2007 and 2006, respectively, and is included within the Communications segment in the consolidated statements of operations. Prior to the acquisition of WilTel in December 2005, AT&T, Inc. and subsidiaries was not a significant customer of the Company.

**Discontinued Information Services**

On September 7, 2006, Level 3 sold Software Spectrum, Inc. ("Software Spectrum"), the Company's software reseller business, to Insight. On November 30, 2005, Level 3 sold ( i )Structure, Level 3's wholly owned IT infrastructure management outsourcing subsidiary to Infocrossing. The two businesses comprised Level 3's information services segment. The results of operations, financial condition and cash flows for the Software Spectrum and ( i )Structure businesses have been classified as

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

discontinued operations in the consolidated financial statements and related footnotes for all periods presented in this report (See Note 3).

**Selling, General and Administrative Expenses**

Selling, general and administrative expenses include salaries, wages and related benefits (including non-cash charges for stock based compensation), property taxes, travel, insurance, rent, contract maintenance, advertising and other administrative expenses. Selling, general and administrative expenses also include network related expenses such as network facility rent, utilities and maintenance costs.

**Advertising Costs**

Level 3 expenses the cost of advertising as incurred. Advertising expense is included as a component of selling, general and administrative expenses in the accompanying consolidated statements of operations.

Advertising expense was \$16 million, \$8 million and \$6 million for the years ended December 31, 2007, 2006 and 2005, respectively.

**Stock-Based Employee Compensation**

The Company has accounted for stock-based employee compensation using a fair value based method pursuant to SFAS No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123") since 1998. For the year ended December 31, 2005, the Company recognized expense using the accelerated vesting methodology of FASB Interpretation No. 28 "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans" ("FIN 28") (See Note 16). Beginning January 1, 2006, Level 3 adopted the provisions of SFAS No. 123R, "Share-Based Payment" ("SFAS No. 123R"). Under SFAS No. 123R, the Company separates each award into vesting tranches and recognizes expense for each tranche over the vesting period in the same manner as under FIN 28. The adoption of SFAS No. 123R as of January 1, 2006 did not have a material effect on the Company's financial position or results of operations.

**Depreciation and Amortization**

Property, plant and equipment are recorded at cost. Depreciation and amortization for the Company's property, plant and equipment are computed on straight-line and accelerated (for certain coal assets) methods based on the following useful lives:

Facility and Leasehold Improvements	10 - 40 years
Network Infrastructure (including fiber and conduit)	12 - 25 years
Operating Equipment	4 - 7 years
Furniture, Fixtures, Office Equipment and Other	2 - 7 years

During 2006, Level 3 determined that the period it expects to use its existing fiber and certain equipment is longer than the remaining useful lives as originally estimated. As a result, the Company extended the depreciable life of its existing fiber from 7 years to 12 years, its existing transmission equipment from 5 years to 7 years and its existing IP equipment from 3 years to 4 years.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

Leasehold improvements are depreciated over the shorter of their estimated useful lives or lease terms that are reasonably assured.

**Earnings (Loss) Per Share**

Basic earnings (loss) per share have been computed using the weighted average number of shares outstanding during each period. Diluted earnings (loss) per share is computed by including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding convertible notes, stock options, stock based compensation awards and other dilutive securities. No such items were included in the computation of diluted loss per share in 2007, 2006 or 2005 because the Company incurred a loss from continuing operations in each of these periods and the effect of inclusion would have been anti-dilutive.

**Trade Accounts Receivable**

Trade accounts receivable are recorded at the invoiced amount and can bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on an analysis of its historical experience with bad debt writeoffs and aging of the accounts receivable balance. The Company reviews its allowance for doubtful accounts quarterly. Past due balances over 90 days and over a specified amount are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers.

**Restricted Cash and Securities**

The Company classifies any cash or investments that collateralize outstanding letters of credit, long-term debt, and certain operating or performance obligations of the Company as restricted cash. The Company also classifies cash and investments restricted to fund certain reclamation liabilities as restricted cash. The classification of restricted cash on the consolidated balance sheet as current or noncurrent is dependent on the duration of the restriction and the purpose for which the restriction exists.

**Long-Lived Assets**

The Company segregates identifiable intangible assets acquired in an acquisition from goodwill. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), goodwill is no longer amortized, and is evaluated for impairment at least annually.

Other intangible assets primarily include customer contracts, customer relationships, patents and technology acquired in business combinations. The intangible assets with estimated useful lives are amortized on a straight-line basis over the expected period of benefit, which ranges from 2 to 12 years. Certain intangibles acquired in the WilTel and TelCove transactions have an indefinite life. In accordance with SFAS No. 142, the Company evaluates its indefinite lived intangible assets for impairment annually or as circumstances change that could affect the recoverability of the carrying amount of the assets.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

The Company at least annually, or as events or circumstances change that could affect the recoverability of the carrying value of its long-lived assets, conducts a comprehensive review of the carrying value of its assets to determine if the carrying amount of the assets are recoverable in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets." This review requires the identification of the lowest level of identifiable cash flows for purposes of grouping assets subject to review. The estimate of undiscounted cash flows includes long-term forecasts of revenue growth, gross margins and capital expenditures. All of these items require significant judgment and assumptions. An impairment loss may exist when the estimated undiscounted cash flows attributable to the assets are less than their carrying amount. If an asset is deemed to be impaired, the amount of the impairment loss recognized represents the excess of the asset's carrying value as compared to its estimated fair value, based on management's assumptions and projections.

Management's estimate of the future cash flows attributable to its long-lived assets and the fair value of its businesses involve significant uncertainty. Those estimates are based on management's assumptions of future results, growth trends and industry conditions. The impairment analysis of long-lived assets also requires management to make certain subjective assumptions and estimates regarding the expected future use of certain empty conduits included in the network asset group and the expected future use of certain empty conduit evaluated for impairment separately from the network asset group.

**Accounting for Asset Retirement Obligations**

The Company follows the policy of providing an accrual for reclamation of mined properties in accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations" ("SFAS No. 143"), based on the estimated total cost of restoration of such properties to meet compliance with laws governing surface mining. These estimated costs are calculated based on the expected future risk adjusted cash flows to remediate such properties discounted at a risk-free rate. The Company also provides an accrual for obligations related to certain colocation leases and right-of-way agreements in accordance with SFAS No. 143, based on the estimated total cost of restoration of such properties to their original condition. These estimated obligations are calculated based on the expected discounted future cash flows using the Company's estimated weighted average cost of capital at the time the obligation is incurred and applying a probability factor for conditional restoration obligations. Changes in expected future cash flows are discounted at interest rates that were in effect at the time of the original estimate for downward revisions to such cash flows, and at interest rates in effect at the time of the change for upward revisions in the expected future cash flows.

**Income Taxes**

Deferred income taxes are provided for the temporary differences between the financial reporting and tax basis of the Company's assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The U.S. net operating losses not utilized can be carried forward for 20 years to offset future taxable income. The majority of the foreign jurisdiction net operating losses not utilized can be carried forward indefinitely. A valuation allowance has been recorded against the majority of the Company's deferred tax assets, as the Company has concluded that under relevant accounting standards, it is more likely than not that deferred tax assets will be not be realizable. The Company recognizes interest and penalty expense associated with uncertain tax positions as a component of income tax expense in the consolidated statements of operations.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

**Foreign Currencies**

Generally, local currencies of foreign subsidiaries are the functional currencies for financial reporting purposes. Assets and liabilities are translated into U.S. dollars at year-end exchange rates. Revenue, expenses and cash flows are translated using average exchange rates prevailing during the year. Gains or losses resulting from currency translation are recorded as a component of accumulated other comprehensive income (loss) in stockholders' equity (deficit) and in the statements of comprehensive loss. A significant portion of the Company's foreign subsidiaries have either British Pound or the Euro as the functional currency, both of which experienced significant fluctuations against the U.S. dollar during 2007, 2006 and 2005. As a result, the Company has experienced significant foreign currency translation adjustments that are recognized as a component of accumulated other comprehensive income (loss) in stockholders' equity (deficit) and in the statement of comprehensive loss in accordance with SFAS No. 52 "Foreign Currency Translation". The Company considers its investments in its foreign subsidiaries to be long-term in nature.

**Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. The most critical estimates and assumptions are made in determining the allowance for doubtful accounts, revenue reserves, recoverability of long-lived and indefinite-lived assets, useful lives of long-lived assets, accruals for estimated liabilities that are probable and estimatable, cost of revenue disputes for the communications business, unfavorable contract liabilities set up in purchase accounting, asset retirement obligations and the fair value of stock and option grants. Actual results could differ from those estimates and assumptions.

**Recently Issued Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109" ("FIN No. 48"), which was effective for Level 3 starting January 1, 2007. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes". FIN No. 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN No. 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods and disclosure. The Company's policy is to recognize interest and penalty expense associated with uncertain tax positions as a component of income tax expense in the consolidated statements of operations. The adoption of FIN No. 48 did not have an effect on the Company's consolidated results of operations or financial condition as of and for the year ended December 31, 2007.

In June 2006, the FASB ratified the consensus on EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement" ("EITF No. 06-3"), which was effective for Level 3 starting January 1, 2007. The scope of

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

EITF No. 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, Universal Service Fund ("USF") contributions and some excise taxes. The Task Force concluded that entities should present these taxes in the income statement on either a gross or a net basis, based on their accounting policy, which should be disclosed pursuant to APB Opinion No. 22, "Disclosure of Accounting Policies". If such taxes are significant and are presented on a gross basis, the amounts of those taxes should be disclosed. The Company records USF contributions on a gross basis in its consolidated statements of operations, but records sales, use, value added and excise taxes billed to its customers on a net basis in its consolidated statements of operations. Communications revenue on the consolidated statements of operations includes USF contributions totaling \$45 million, \$19 million and \$7 million for the years ended December 31, 2007, 2006 and 2005, respectively. The adoption of EITF No. 06-3 did not have a material effect on the Company's consolidated results of operations or financial condition for year ended December 31, 2007, as the policy followed was consistent before and after adoption.

In September 2006, the FASB issued Statements of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS No. 157"), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. The adoption of SFAS No. 157 is not expected to have a material effect on the Company's consolidated results of operations or financial condition upon adoption on January 1, 2008.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" ("SFAS No. 141R"), which replaces SFAS No. 141, "Business Combinations." SFAS No. 141R retains the underlying concepts of SFAS No. 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting, but SFAS No. 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items including: (1) expensing acquisition related costs as incurred; (2) expensing changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date; (3) valuing noncontrolling interests at fair value at the acquisition date; and (4) expensing restructuring costs associated with an acquired business. SFAS No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R is to be applied prospectively to business combinations for which the acquisition date is on or after January 1, 2009.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS No. 160"). SFAS No. 160 requires noncontrolling interests, previously referred to as minority interests, to be treated as a separate component of equity, not as a liability or other item outside of permanent equity and applies to the accounting for noncontrolling interests and transactions with noncontrolling interest holders in consolidated financial statements. SFAS No. 160 will be applied prospectively to all noncontrolling interests, including any that arose before the effective date except that comparative period information must be restated to classify noncontrolling interests in

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(1) Summary of Significant Accounting Policies (Continued)**

equity, attributed net income and other comprehensive income to noncontrolling interests, and provide other disclosures required by SFAS No. 160. This statement is effective for the Company beginning January 1, 2009. The Company is currently assessing the potential effect that the adoption of SFAS No. 160 will have on its consolidated results of operations or financial condition.

**Reclassifications**

Certain prior year amounts have been reclassified to conform to the December 31, 2007 presentation.

**(2) Acquisitions**

In 2006, the Company embarked on a strategy to expand its presence in metropolitan markets and began offering services to enterprise customers through its Business Markets Group. This strategy allows the Company to terminate traffic over its owned facilities rather than paying third parties to terminate the traffic. The expansion into new metro markets also provides additional opportunities to sell services to bandwidth intensive businesses on the Company's national and international networks. In order to expedite the expansion of its metro business, Level 3 acquired Progress Telecom, ICG Communications, TelCove and Looking Glass in 2006 and Broadwing in the first quarter of 2007. Level 3 has also embarked on a strategy to expand its content delivery network services with the acquisitions of the CDN Business in the first quarter of 2007 and Servecast in the third quarter of 2007. The results of operations attributable to each acquisition are included in the consolidated financial statements from the date of acquisition. The value of Level 3 common stock issued in connection with the acquisitions was determined based on the average closing price for Level 3 common stock two days before and two days after the date the acquisition was announced multiplied by the number of shares issued.

**Servecast Acquisition:** On July 11, 2007, Level 3 completed the acquisition of Servecast Limited, a Dublin, Ireland based provider of live and on-demand video management and streaming services for broadband and mobile platforms. Level 3 paid approximately €34 million, or \$46 million, in cash, including \$1 million of transaction costs, to complete the acquisition of Servecast.

**CDN Business Acquisition:** On January 23, 2007, Level 3 completed the acquisition of the Content Delivery Network services business of SAVVIS, Inc. Level 3 paid \$133 million in cash (including transaction costs) to acquire the assets of the CDN Business, including network elements, customer contracts and intellectual property used in the CDN Business. The purchase price was subsequently increased by less than \$1 million for working capital and other contractual matters. The Company paid this adjustment in April 2007.

**Broadwing Acquisition:** On January 3, 2007, Level 3 acquired Broadwing, a publicly held provider of optical network communications services. Under the terms of the merger agreement dated October 16, 2006, Level 3 paid \$8.18 of cash plus 1.3411 shares of Level 3 common stock for each share of Broadwing common stock outstanding at closing. In total, Level 3 paid approximately \$753 million of cash, including \$9 million of transaction costs, and issued approximately 123 million shares of the Company's common stock, valued at \$688 million. As part of the Broadwing acquisition, approximately 3.8 million previously issued Broadwing warrants (valued at approximately \$4 million) became exercisable for approximately 5.1 million shares of Level 3 common stock. In the second

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(2) Acquisitions (Continued)**

quarter of 2007, the Company subsequently reduced the total consideration paid by \$4 million for insurance proceeds received in June 2007 that related to the settlement of an insurance claim that occurred prior to the acquisition. In the fourth quarter of 2007, the Company incurred additional transaction costs of \$2 million related to the transaction.

In connection with the acquisition of Broadwing, the Company guaranteed \$180 million in aggregate principal amount of Broadwing Corporation's 3.125% Convertible Senior Debentures due 2026 (the "Broadwing Debentures") and the transaction included \$24 million in capital lease obligations related primarily to a metro fiber IRU agreement. As of February 16, 2007, the holders of \$179 million in aggregate principal amount of the Broadwing Debentures converted their Broadwing Debentures into a total of 17 million shares of Level 3 common stock and approximately \$105 million in cash pursuant to the terms of the indenture governing the Broadwing Debentures and the agreement whereby Level 3 acquired Broadwing. The remaining \$1 million in aggregate principal amount of the Broadwing Debentures was repurchased by Broadwing at 100% of par as required by the indenture governing the Broadwing Debentures.

**Looking Glass Acquisition:** On August 2, 2006, Level 3 completed the acquisition of Looking Glass, a privately held Illinois-based telecommunications company. The consideration paid by Level 3 consisted of approximately \$13 million in cash, including \$4 million of transaction costs, and approximately 21 million shares of Level 3 common stock valued at \$84 million. In addition, at the closing, Level 3 repaid approximately \$67 million of Looking Glass liabilities. The transaction purchase price is not subject to any post-closing adjustments.

Level 3 entered into certain transactions with Looking Glass prior to the acquisition of Looking Glass by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the Looking Glass transaction by \$2 million, the amount of the unamortized deferred revenue balance on August 2, 2006.

**TelCove Acquisition:** On July 24, 2006, Level 3 completed the acquisition of TelCove, a privately held Pennsylvania-based telecommunications company. Under terms of the agreement, Level 3 paid \$446 million in cash and issued approximately 150 million shares of Level 3 common stock, valued at \$623 million. In addition, Level 3 repaid \$132 million of TelCove debt and acquired \$12 million in capital leases in the transaction. Also, the Company paid third party costs of approximately \$15 million related to the transaction, which included certain costs incurred by TelCove.

Level 3 entered into certain transactions with TelCove prior to the acquisition of TelCove by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the TelCove transaction by \$3 million, the amount of the unamortized deferred revenue balance on July 24, 2006.

**ICG Communications:** On May 31, 2006, Level 3 acquired all of the stock of ICG Communications, a privately held Colorado-based telecommunications company, from MCCC ICG Holdings, LLC excluding certain assets and liabilities. Under the terms of the purchase agreement, Level 3 purchased ICG Communications for an aggregate consideration consisting of approximately



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(2) Acquisitions (Continued)**

26 million shares of Level 3 common stock, valued at \$131 million, and approximately \$45 million in cash. The Company also incurred costs of less than \$1 million related to the transaction. Post-closing adjustments, primarily working capital and other contractual matters resulted in additional consideration of approximately \$3 million.

Level 3 entered into certain transactions with ICG Communications prior to the acquisition of ICG Communications by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the ICG Communications transaction by \$1 million, the amount of the unamortized deferred revenue balance on May 31, 2006.

**Progress Telecom:** On March 20, 2006, Level 3 completed its acquisition of all of the membership interests of Progress Telecom from PT Holding Company LLC ("PT Holding") excluding certain specified assets and liabilities of Progress Telecom. Progress Telecom was owned by PT Holding which is jointly owned by Progress Energy, Inc. and Odyssey Telecorp, Inc. Under the terms of the purchase agreement, Level 3 purchased Progress Telecom for an aggregate purchase price consisting of approximately \$69 million in cash and approximately 20 million shares of Level 3 common stock, valued at \$66 million. The purchase price was subsequently reduced by \$2 million for working capital and other contractual matters. The Company received payment of the \$2 million adjustment in July 2006.

Level 3 entered into certain transactions with Progress Telecom prior to the acquisition of Progress Telecom by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the Progress Telecom transaction by \$4 million, the amount of the unamortized deferred revenue balance on March 20, 2006.

**WilTel:** On December 23, 2005, the Company completed the acquisition of WilTel from Leucadia National Corporation and its subsidiaries (together "Leucadia"). The consideration paid consisted of approximately \$390 million in cash (which included a \$16 million adjustment for estimated excess working capital), plus \$100 million in cash to reflect Leucadia's having complied with its obligation to leave that amount of cash in WilTel, and 115 million newly issued unregistered shares of Level 3 common stock, valued at \$313 million.

The Company also incurred costs of approximately \$7 million related to the transaction. The cash purchase price was subject to post-closing adjustments based on actual working capital and other contractual items as of the closing date. In March 2006, Leucadia and Level 3 agreed that the purchase price for WilTel should decrease by approximately \$27 million as a result of working capital and other contractual post-closing adjustments. Level 3 received payment of the \$27 million adjustment in April 2006.

The final valuation indicated that the fair value of the identifiable assets acquired exceeded the total of the purchase price paid and the liabilities assumed in the transaction. As a result, the excess value was applied against the fair value of the long-lived assets obtained in the transaction. The \$27 million post-closing adjustment resulted in an additional decrease in long-lived assets in the first quarter of 2006.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(2) Acquisitions (Continued)**

Level 3 entered into certain transactions with WilTel prior to the acquisition of WilTel by Level 3, whereby it received cash for communications services to be provided in the future. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and accordingly, reduced the purchase price applied to the net assets acquired in the WilTel transaction by \$2 million, the amount of the unamortized deferred revenue balance on December 23, 2005.

The acquisition included all of WilTel's communications business and WilTel's Vyvx video transmission business. The acquisition also included a multi-year contract between SBC Service, Inc. and WilTel ("SBC Contract Services Agreement"). SBC Services, Inc. became a subsidiary of AT&T Inc. ("AT&T") (together "SBC") and announced its intention to migrate the services provided by WilTel to the merged SBC Services, Inc. and AT&T network. WilTel and SBC amended the SBC Contract Services Agreement to run through 2009. The agreement provides a gross margin purchase commitment of \$335 million from December 2005 through the end of 2007, and \$75 million from January 2008 through the end of 2009. As of December 31, 2007, SBC fully satisfied the \$335 million of the December 2005 to the end of 2007 gross margin purchase commitment. SBC's purchases of services that exceed the original \$335 million gross margin purchase commitment now count toward the \$75 million gross margin purchase commitment for the period from January 2008 through the end of 2009. As of December 31, 2007, SBC had satisfied \$39 million of the \$75 million gross margin purchase commitment. Originating and terminating access charges paid to local phone companies are passed through to SBC in accordance with a formula that approximates cost. Additionally, the SBC Contract Services Agreement provides for the payment of \$50 million from SBC if certain performance criteria are met by Level 3. The Company met the required performance criteria and recorded annual revenue of \$25 million in both 2006 and 2007 under the agreement. Of the annual amounts, 50% was based on monthly performance criteria and the remaining 50% was based on performance criteria for the full year. The performance-based incentive provisions of the agreement ended on December 31, 2007. Level 3 will not earn performance-based incentives in 2008 under the SBC Contract Services Agreement.

As specified in the purchase agreement with Leucadia, WilTel transferred certain excluded assets to Leucadia and Leucadia assumed certain excluded liabilities. The excluded assets included all cash and cash equivalents in excess of \$100 million at closing, all marketable securities, WilTel's headquarters building located in Tulsa, Oklahoma and certain other miscellaneous assets. In addition, WilTel assigned to Leucadia all of its right to receive cash payments from SBC totaling \$236 million, pursuant to the Termination, Mutual Release and Settlement Agreement, dated June 15, 2005, among Leucadia, WilTel and SBC. The excluded liabilities include all of WilTel's long-term debt obligations, WilTel's obligations under its defined benefit pension plan, certain other employee related liabilities and other claims. The agreement required Leucadia to pay in full all of WilTel's obligations under its credit agreement and for Leucadia to release WilTel from any obligation under the outstanding mortgage note secured by its headquarters building. Level 3 entered into an agreement with Leucadia to lease a portion of the former WilTel headquarters building in Tulsa.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(2) Acquisitions (Continued)**

*Purchase Price Allocation*

Under business combination accounting, the total final purchase price for each of the acquired companies was allocated to the net tangible and identifiable intangible assets based on their estimated fair values as of the acquisition dates. The allocation of the purchase price was based upon valuations performed for each acquired company. The valuations for the WilTel, Progress Telecom, ICG Communications, TelCove, Looking Glass, Broadwing and CDN Business acquisitions have been finalized. The valuation for the Servecast acquisition is in the process of being finalized.

The valuations for the WilTel, Looking Glass and CDN Business acquisitions indicated that the fair value of the assets acquired exceeded the total of the purchase price paid and the liabilities assumed in the transactions. As a result, the excess value was applied against the estimated fair value of the long-lived assets in each transaction. The valuations for the Progress Telecom, ICG Communications and TelCove acquisitions in 2006 and the valuations for the Broadwing and Servecast acquisitions in 2007 indicated that the fair value of the assets acquired was less than the total of the purchase price paid and the liabilities assumed in the transactions. As a result, the excess purchase price was assigned to goodwill for each acquisition.

*Tangible and Intangible Long-Lived Assets*

In performing the purchase price allocation for each acquired company, the Company considered, among other factors, the intention for future use of acquired assets, analysis of historical financial performance and estimates of future performance of each acquired company's products. The fair value of assets was based, in part, on a valuation using either a cost, income, or in some cases, market valuation approach and estimates and assumptions provided by management. The tangible assets primarily include the real and personal property used to provide communications services, as well as video services in the case of the WilTel acquisition. In addition, tangible assets include the fair value of software purchased or developed by each company, if applicable. Intangible assets consist primarily of customer relationships, patents and developed technology and the Vyvx trademark. Management has established indefinite lives on the Vyvx trademark and certain other intangible assets, lives ranging from 6 to 12 years for the customer relationships and lives ranging from 10 to 12 years for patents and developed technology.

*Deferred Revenue*

The fair value of deferred revenue included in the final purchase price allocation for each acquired company was determined based on monthly amounts billed in advance for which services would be provided to customers in the period immediately following acquisition. Level 3 did not record deferred revenue for long-term contracts in which the acquired company had already received consideration from the customer as Level 3 does not expect to incur any direct and incremental costs associated with these contracts.

*Current and Noncurrent Obligations*

The fair value of each acquired company's current liabilities was determined based on the expected cash flows for the twelve months following the date of acquisition. Level 3 did not present value the cash flows as it does not expect the present values to be significantly different from the gross cash flows.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(2) Acquisitions (Continued)**

The noncurrent obligations assumed in each acquisition, if applicable, have been recorded at their present value using an appropriate interest rate. The Company has identified certain acquired facilities that it does not expect to utilize for the combined business. The Company has also revalued the asset retirement obligations of each acquired company using Level 3's weighted average cost of capital rather than the acquired company's weighted average cost of capital.

**Pro Forma Financial Information**

The unaudited financial information in the table below summarizes the combined results of operations of Level 3 and the acquired businesses, on a pro forma basis, as though the companies acquired in 2006 and 2007 had been combined as of the beginning of each of the periods presented. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of each of the periods presented. The pro forma financial information for all periods presented includes the business combination accounting effect on historical revenue of the acquired companies, adjustments to depreciation on acquired property, amortization charges from acquired intangible assets, restructuring costs and acquisition costs reflected in the historical statements of operations for periods prior to Level 3's acquisition.

	Unaudited Pro Forma Years ended December 31,	
	2007	2006
	(dollars in millions, except per share data)	
Revenue	\$ 4,273	\$ 4,595
Loss from Continuing Operations	\$ (1,115)	\$ (890)
Income from Discontinued Operations	—	46
Net Loss	\$ (1,115)	\$ (844)
Per common share:		
Loss from continuing operations	\$ (0.73)	\$ (0.69)
Income from discontinued operations	—	0.04
Net loss	\$ (0.73)	\$ (0.65)
Pro Forma Weighted Average Common Shares Outstanding (in thousands)	1,518,906	1,284,878

Included in the actual results and pro forma financial information for the year ended December 31, 2007 are certain amounts which affect the comparability of the results, including net losses of \$427 million as a result of the early extinguishments of certain long-term debt, a gain of \$37 million from the partial sale of the Company's investment in Infinera shares, a tax benefit of \$23 million as a result of recognizing a deferred tax benefit for the reversal of a valuation allowance, a workforce reduction charge of \$11 million and \$10 million of termination revenue.

Included in the actual results and pro forma financial information for the year ended December 31, 2006 are certain amounts which affect the comparability of the results, including net

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(2) Acquisitions (Continued)**

losses of \$83 million as a result of the early extinguishments of certain long-term debt, \$11 million of termination revenue, income from discontinued operations of \$46 million, a workforce reduction charge of \$5 million, and non-cash impairment charges of \$8 million that primarily resulted from the decision to terminate certain information technology projects in the Communications business.

The fair value of the assets acquired and the liabilities assumed in the Servecast transaction is based upon a preliminary valuation as of the acquisition date after reflecting other contractual purchase price adjustments and is subject to change due to further analysis of the assets acquired and liabilities assumed as well as integration plans. The fair value of assets acquired and liabilities assumed in the WilTel, Progress Telecom, ICG Communications, TelCove, Looking Glass, CDN Business and Broadwing transactions are based upon final valuations after reflecting other contractual purchase price adjustments.

During the third quarter of 2007, the preliminary valuation for the Servecast acquisition was completed. As a result, the Company recorded intangible assets for customer relationships totaling \$9 million and technology totaling \$8 million. Based on the purchase price allocation, goodwill totaling \$30 million was recorded for the Servecast transaction.

During the second and third quarters of 2007, the Company recorded purchase price allocation adjustments for the Broadwing acquisition that resulted in a net increase of \$1 million to goodwill. The purchase price allocation adjustments included increases in goodwill of \$4 million to record liabilities incurred by Broadwing prior to the acquisition and \$1 million for additional transaction costs; and decreases to goodwill for the receipt after the acquisition of \$4 million in insurance proceeds related to the settlement of an insurance claim that was made prior to the acquisition.

In addition, during the fourth quarter of 2007, the Company recorded purchase price allocation adjustments for the Broadwing acquisition that resulted in a net increase of \$98 million to goodwill. The adjustments in the fourth quarter of 2007 included a decrease in the identifiable intangible assets for Broadwing from \$254 million in the preliminary valuation to \$154 million as a result of additional analysis of the estimated cash flows expected to be generated for the customers acquired in the Broadwing acquisition. The decrease in the value of the identifiable intangible assets for Broadwing increased the goodwill originally recorded on the transaction by \$100 million. In addition, during the fourth quarter of 2007, there were miscellaneous adjustments to the assets and liabilities of Broadwing that resulted in a net decrease in goodwill of \$2 million. These adjustments included additional transaction costs, adjustments to the original property, plant and equipment value and reductions to accrued severance and other liabilities. The changes resulted in total goodwill of \$1.038 billion for the Broadwing acquisition as of December 31, 2007.

During the second quarter of 2007, the Company received a revised valuation for the CDN Business that indicated a significantly higher value for the identifiable intangible assets, primarily patents and customer-related intangible assets. The identifiable intangible assets for the CDN Business increased from \$23 million in the preliminary valuation to \$133 million in the revised valuation as a result of additional analysis of the estimated cash flows expected to be generated from the patents and customers acquired in the CDN Business acquisition. The increase in the value of the identifiable intangible assets for the CDN Business eliminated the \$110 million of goodwill originally recorded on the transaction. During the third quarter of 2007, the Company received the final valuation report for the CDN Business acquisition. The final valuation report did not result in any changes to the valuation of the CDN Business.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(2) Acquisitions (Continued)**

During the third quarter of 2007, the Company recorded net purchase price allocation adjustments for the Looking Glass acquisition totaling \$2 million related to the impairment of unutilized leased facilities assumed in the acquisition. During the third quarter of 2007, the Company completed its analysis of facilities leases acquired in the Looking Glass acquisition and determined that certain facilities under lease have not been used by the Company since the date of acquisition and would not be used by the Company in the future, while also concluding a settlement agreement on one of the previously-impaired lease holdings. The net result of recording these lease impairment adjustments was to increase other non-current liabilities and certain long-lived assets acquired by \$2 million since the fair value of the identifiable net assets acquired exceeds the consideration paid to the former owners in the Looking Glass acquisition.

During the second quarter of 2007, the Company received the final valuation for the ICG Communications acquisition that included revised valuations for both the identifiable tangible and intangible assets. The fixed assets acquired for ICG Communications increased from \$10 million in the preliminary valuation to \$93 million in the final valuation as a result of a detailed analysis to physically identify and estimate the fair value of the fixed assets acquired. As a result of the changes to the valuation of the fixed assets, the valuation of the identifiable intangible assets decreased from \$49 million in the preliminary valuation to \$18 million in the final valuation.

The adjusted fair values of the assets acquired and the liabilities assumed for the companies Level 3 acquired in 2006 and 2007 are as follows.

	Servecast	CDN Business	Broadwing	Looking Glass	TelCove	ICG Communications	Progress Telecom	WilTel
	(dollars in millions)							
Assets:								
Cash and cash equivalents	\$ 1	\$ —	\$ 257	\$ 3	\$ 3	\$ 6	\$ —	\$ 128
Marketable securities	—	—	46	—	—	—	—	—
Accounts receivable	1	—	82	8	23	7	3	257
Other current assets	—	—	19	2	5	2	2	22
Property, plant and equipment, net	1	2	239	185	796	93	77	629
Goodwill	30	—	1,038	—	179	73	30	—
Identifiable intangible assets	17	133	154	9	273	18	36	152
Other assets	—	—	31	1	—	5	—	26
Total Assets	50	135	1,866	208	1,279	204	148	1,214
Liabilities:								
Accounts payable	1	1	37	5	21	6	1	204
Accrued payroll	—	1	14	1	6	2	1	29
Other current liabilities	—	—	117	9	20	10	7	61
Current portion of capital leases	3	—	2	—	3	—	1	—
Long-term debt	—	—	203	—	—	—	—	—
Capital leases	—	—	22	—	9	3	8	—
Deferred revenue - Acquired Company	—	—	13	1	—	4	—	41
Deferred revenue - Level 3	—	—	—	(2)	(3)	(1)	(4)	(2)
Other Liabilities	—	—	15	30	7	2	—	98
Total Liabilities	4	2	423	44	63	26	14	431
Purchase Price	\$ 46	\$ 133	\$ 1,443	\$ 164	\$ 1,216	\$ 178	\$ 134	\$ 783

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(3) Discontinued Operations**

**Disposal of Information Services Segment**

The Company sold the two businesses, Software Spectrum and ( i )Structure, that comprised Level 3's information services segment and has presented the results of operations for those businesses as discontinued operations for all periods presented.

**Software Spectrum**

On September 7, 2006, Level 3 sold Software Spectrum to Insight, a leading provider of information technology products and services. In connection with the transaction, Level 3 received total proceeds of \$353 million in cash, consisting of a base purchase price of \$287 million and a working capital adjustment of approximately \$66 million. The purchase price was subject to working capital and certain other post-closing adjustments. During the fourth quarter of 2006, the Company paid \$2 million to Insight as the final working capital adjustment. Level 3 recognized a \$33 million gain on the transaction in the third quarter of 2006 after transaction costs.

The following is the summarized results of operations of the Software Spectrum business for the period from January 1, 2006 through September 7, 2006 and for the year ended December 31, 2005:

	January 1, Through September 7, 2006	Twelve Months Ended 2005
	(dollars in millions)	
Revenue	\$ 1,400	\$ 1,894
Costs and Expenses:		
Cost of revenue	1,269	1,717
Depreciation and amortization	8	10
Selling, general and administrative	111	143
Restructuring and impairment charges	1	—
Total costs and expenses	1,389	1,870
Income from Operations	11	24
Other Income (Expense)	5	(1)
Income Before Income Taxes	16	23
Income Tax Expense	(3)	(3)
Income from Discontinued Operations	\$ 13	\$ 20

**( i )Structure**

On November 30, 2005, Level 3 sold ( i )Structure to Infocrossing for proceeds of \$85 million which consisted of \$82 million in cash and \$3 million of Infocrossing common stock. Level 3 recognized a \$49 million gain on the transaction in the fourth quarter of 2005. The cash purchase price was subject to a post-closing adjustment based on actual working capital as of the closing date that was settled in the fourth quarter of 2007 for approximately \$2 million.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(3) Discontinued Operations (Continued)**

The following is the summarized results of operations of the ( i )Structure business for the eleven months ended November 30, 2005:

	January 1, Through November 30, 2005
	(dollars in millions)
Revenue	\$ 64
Costs and Expenses:	
Cost of revenue	47
Depreciation and amortization	8
Selling, general and administrative	9
Total costs and expenses	64
Income from Discontinued Operations	\$ —

**(4) Termination Revenue**

The Company recognized termination revenue totaling \$10 million, \$11 million and \$133 million in 2007, 2006 and 2005, respectively. Termination revenue is reported in the same manner as the original service provided.

On March 1, 2005, Level 3 entered into an agreement with 360networks in which both parties agreed to terminate a 20-year IRU agreement. Under the new agreement, 360networks returned the dark fiber originally provided by Level 3. Under the original IRU agreement, signed in 2000, the cash received by Level 3 was deferred and amortized to revenue over the 20-year term of the agreement. As a result of this transaction, Level 3 recognized the unamortized deferred revenue of approximately \$86 million as non-cash termination revenue in the first quarter of 2005.

On February 22, 2005, France Telecom and Level 3 finalized an agreement to terminate a dark fiber agreement signed in 2000. Under the terms of the agreement, France Telecom returned the fiber to Level 3. Under the original IRU agreement, the cash received by Level 3 was deferred and amortized to revenue over the 20-year term of the agreement. As a result of this transaction, Level 3 recognized the unamortized deferred revenue of approximately \$40 million as non-cash termination revenue in the first quarter of 2005.

**(5) Restructuring and Impairment Charges**

***Restructuring Charges***

During the period from December 23, 2005 through December 31, 2007, the Company initiated cumulative workforce reductions expected to affect approximately 2,200 employees in its North American communications business related to the integration of businesses acquired since December 2005. Of the 2,200 employees, approximately 23% were expected to be legacy Level 3 employees and approximately 77% were expected to be employees of acquired businesses.

In December 2005 and during 2006, the Company initiated cumulative workforce reductions expected to affect approximately 1,200 employees in its North American communications business



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(5) Restructuring and Impairment Charges (Continued)**

related to the integration of WilTel Communications Group, LLC ("WilTel"), Progress Telecom, ICG Communications, TelCove and Looking Glass into Level 3's operations. Of the 1,200 employees, approximately 22% were expected to be employees of legacy Level 3 and 78% were expected to be employees of the acquired companies. Separately, in January 2005, Level 3 initiated and completed workforce reductions affecting 472 employees in the legacy Level 3 business that were not related to integration of acquired businesses.

In the first quarter of 2007, Level 3 initiated additional workforce reductions expected to affect approximately 1,000 employees in its North American communications business related to the integration of Broadwing and the previous acquisitions. Of the 1,000 employees, approximately 25% were expected to be employees of legacy Level 3 and approximately 75% were expected to be employees of the acquired companies.

The accounting treatment for the severance costs associated with the workforce reductions is dependent on whether those individuals affected are former employees of the acquired companies or legacy Level 3 employees. For the period from January 1, 2006 through December 31, 2007, the Company had notified or terminated a total of 2,020 employees (729 employees of legacy Level 3 and 1,291 employees of acquired businesses) pursuant to integration activities.

The estimated severance costs earned by employees of the acquired companies as of the acquisition date are included as a liability in the balance sheet as of the acquisition date. The Company expects cumulative severance and related costs to total approximately \$60 million for former WilTel, Progress Telecom, ICG Communications, TelCove, Looking Glass and Broadwing employees. During the year ended December 31, 2007, Level 3 paid \$32 million of severance and related costs for these employees resulting in cumulative payments from January 1, 2006 to December 31, 2007 of \$51 million for severance and related charges.

The workforce reduction attributable to the WilTel integration activity was substantially complete by the end of 2006. The workforce reductions attributable to the Progress Telecom, ICG Communications, TelCove and Looking Glass integration activities were substantially completed in the third quarter of 2007. The workforce reductions attributable to the Broadwing integration activities are expected to be substantially completed in 2008.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(5) Restructuring and Impairment Charges (Continued)**

An analysis of the liability for the severance and related activity associated with the integration of the acquired companies follows:

	Severance and Related Costs for Acquired Company Employees	
	Number of Employees	Amount
		(in millions)
Balance December 31, 2004	—	\$ —
2005 Accruals	765	26
Balance December 31, 2005	765	26
2006 Accruals	445	12
2006 Change in Estimate	(277)	(8)
2006 Payments	(547)	(19)
Balance December 31, 2006	386	11
2007 Accruals	750	33
2007 Change in Estimate	(143)	(3)
2007 Payments	(744)	(32)
Balance December 31, 2007	249	\$ 9

Severance costs attributable to legacy Level 3 employees are recorded as a restructuring charge in the statement of operations once the employees are notified that their position will be eliminated and the severance arrangements are communicated to the employee. For the year ended December 31, 2007, the Company recorded approximately \$11 million in restructuring charges for affected legacy Level 3 employees. As of December 31, 2007, the Company had remaining obligations of \$4 million for those legacy Level 3 employees terminated or notified.

A summary of the restructuring charges and related activity for legacy Level 3 employees follows:

	Severance and Related Costs for Legacy Level 3 Employees		
	Number of Employees	Amount	Facilities Related Amount
		(in millions)	(in millions)
Balance December 31, 2004	—	\$ —	\$ 16
2005 Charges	472	15	(1)
2005 Payments	(472)	(15)	(3)
Balance December 31, 2005	—	—	12
2006 Charges	248	5	—
2006 Payments	(242)	(5)	(2)
Balance December 31, 2006	6	—	10
2007 Charges	481	11	—
2007 Payments	(348)	(7)	(1)
Balance December 31, 2007	139	\$ 4	\$ 9

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(5) Restructuring and Impairment Charges (Continued)**

**Impairments**

The Company at least annually, or as events or circumstances change that could affect the recoverability of the carrying value of its communications assets, conducts a comprehensive review of the carrying value of its communications assets to determine if the carrying amount of the communications assets are recoverable in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). For purposes of this review, Level 3 has historically separately evaluated colocation facilities, certain additional conduits and its communications network (including network equipment, fiber, conduits and customer premise equipment) as these were the lowest levels with separately identifiable cash flows for grouping of assets. Beginning in 2006, the Company stopped evaluating colocation assets separately and began including them in the communications network asset group due to changes in the nature of the cash flows from the delivery of colocation services. The majority of the Company's colocation customers now purchase other services in conjunction with their colocation services thereby reducing the independence of colocation services cash flows from other services. In addition, the percentage of colocation space used to support the network asset has increased over time. The impairment analysis is based on a long-term cash flow forecast to assess the recovery of the communications assets over the estimated useful life of the primary asset. The Company concluded that the assets were not impaired as of December 31, 2007. Management's estimate of the future cash flows attributable to its long-lived assets and the fair value of its businesses involve significant assumptions. Those estimates are based on management's assumptions of future results, growth trends and industry conditions. The impairment analysis of long-lived assets also requires management to make certain subjective assumptions and estimates regarding the expected future use of certain additional conduits included in the network asset group and the expected future use of certain empty conduit evaluated for impairment separately from the network asset group. Management will continue to assess the Company's assets for impairment as events occur or as industry conditions warrant.

The Company recognized \$8 million of non-cash impairment charges in 2006. Level 3 recognized \$4 million of non-cash impairment charges as a result of the decision to terminate projects for certain voice services and certain information technology projects in the communications business which had been previously capitalized. These projects have identifiable costs which Level 3 can separately evaluate for impairment. The costs incurred for these projects, including capitalized labor, were impaired as the carrying value of these projects were no longer expected to provide future benefit to the Company. In addition, Level 3 recognized \$4 million of non-cash impairment charges primarily related to excess land of the communications business held for sale in Germany. This charge resulted from the difference between the recorded carrying value and the estimated market value of the land. During the third quarter of 2007, the Company reclassified the excess land in Germany as property, plant and equipment due to the fact the land had not been sold and was no longer being actively marketed for sale.

The Company recognized \$9 million of non-cash impairment charges in 2005 that primarily resulted from the decision to terminate projects for certain voice services and certain information technology projects in the communications business which had been previously capitalized. These projects have identifiable costs which Level 3 can separately evaluate for impairment. The costs incurred for these projects, including capitalized labor, were impaired as the carrying value of these projects were no longer expected to provide future benefit to the Company.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(6) Loss Per Share**

The Company had a loss from continuing operations for each the three years in the period ended December 31, 2007. Therefore, the effect of the approximately 315 million, 481 million and 418 million shares issuable pursuant to the various series of convertible notes outstanding at December 31, 2007, 2006 and 2005, respectively, have not been included in the computation of diluted loss per share because their inclusion would have been anti-dilutive to the computation. In addition, the effect of the approximately 55 million, 54 million and 59 million stock options, outperform stock options, restricted stock units and warrants outstanding at December 31, 2007, 2006 and 2005, respectively, have not been included in the computation of diluted loss per share because their inclusion would have been anti-dilutive to the computation.

The following details the loss per share calculations for the Level 3 common stock (dollars in millions, except per share data):

	Year Ended December 31,		
	2007	2006	2005
Loss from Continuing Operations	\$ (1,114)	\$ (790)	\$ (707)
Income from Discontinued Operations (2006 and 2005 include gain on sale)	—	46	69
<b>Net Loss</b>	<b>\$ (1,114)</b>	<b>\$ (744)</b>	<b>\$ (638)</b>
Total Number of Weighted Average Common Shares Outstanding used to Compute Basic and Diluted Earnings Per Share (in thousands)	1,517,616	1,003,255	699,589
<b>Earnings (Loss) Per Share of Level 3 Common Stock (Basic and Diluted):</b>			
Loss from Continuing Operations	\$ (0.73)	\$ (0.79)	\$ (1.01)
Income from Discontinued Operations	—	0.05	0.10
<b>Net Loss</b>	<b>\$ (0.73)</b>	<b>\$ (0.74)</b>	<b>\$ (0.91)</b>

**(7) Disclosures about Fair Value of Financial Instruments**

The following methods and assumptions were used to determine classification and fair values of financial instruments:

**Cash and Cash Equivalents**

Cash equivalents generally consist of funds invested in highly liquid instruments with a maturity of three months or less from the purchase dates. The securities are stated at cost, which approximates fair value.

**Marketable and Restricted Securities**

At December 31, 2007, marketable securities totaling \$9 million consist of an investment in the common stock of Infinera Corporation ("Infinera"). In 2005, the Company invested \$10 million in Infinera and accounted for this investment using the cost method and included the investment in

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(7) Disclosures about Fair Value of Financial Instruments (Continued)**

long-term other assets. On June 7, 2007, Infinera completed its initial public offering ("IPO") and its common stock began trading publicly on the NASDAQ Global Market. As a result of the Infinera IPO, the Company began classifying the Infinera investment on its balance sheet as a current marketable security that is available for sale, subject to compliance with applicable U.S. federal securities laws.

The fair value of the Infinera investment as of December 31, 2007 is approximately \$9 million. For the year ended December 31, 2007, an unrealized gain of \$7 million was recorded on the investment in Infinera and is included in Other Comprehensive Income (Loss).

On November 5, 2007 the Company sold approximately 80% of its original Infinera investment as part of a secondary equity offering completed by Infinera. The Company received proceeds of approximately \$45 million and recognized a gain on the sale of \$37 million. The realized gain of \$37 million was previously included as an unrealized gain in Other Comprehensive Income (Loss) at September 30, 2007.

At December 31, 2006, marketable securities consist of U.S. Treasury securities that were characterized as held to maturity. These securities total \$235 million and are reflected as current assets on the consolidated balance sheet at December 31, 2006.

Restricted securities consist primarily of cash investments that serve to collateralize outstanding letters of credit and certain performance and operating obligations of the Company.

The cost of the securities used in computing unrealized and realized gains and losses is determined by specific identification. Fair values are estimated based on quoted market prices for the securities.

The net unrealized holding gains and losses for marketable securities classified as available for sale were included in accumulated other comprehensive income (loss) within stockholders' equity (deficit). Securities characterized as held to maturity are stated at cost. The unrealized holding gains and losses for securities characterized as held to maturity are not reflected in the consolidated financial statements.

At December 31, 2007 and 2006 the unrealized holding gains and losses on the marketable securities were as follows:

	Cost	Unrealized Holding Gains	Unrealized Holding Losses	Fair Value
	(dollars in millions)			
<b>2007</b>				
Marketable Securities:				
Equity Securities—Current	\$ 2	\$ 7	\$ —	\$ 9
	\$ 2	\$ 7	\$ —	\$ 9
<b>2006</b>				
Marketable Securities:				
U.S. Treasury Securities—Current	\$ 235	\$ —	\$ (1)	\$ 234
	\$ 235	\$ —	\$ (1)	\$ 234

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(7) Disclosures about Fair Value of Financial Instruments (Continued)**

The Company recognized \$37 million of realized gains from the sale of marketable equity securities in 2007, \$2 million of realized gains from the sale of marketable equity securities in 2006 and \$2 million of realized losses from the sale of marketable debt securities in 2005. These realized gains and losses are reflected in Other, net on the consolidated statement of operations for all periods presented.

Maturities for the restricted securities have not been presented, as the types of securities are either cash or money market mutual funds that do not have a single maturity date.

**Long-Term Debt**

The fair value of long-term debt was estimated using the December 31, 2007 and 2006 average of the bid and ask price for the publicly traded debt instruments. The CBRE Commercial Mortgage was not traded in an organized public manner. The fair value of this instrument is assumed to approximate the carrying value at December 31, 2007 as it was secured by underlying assets. The 9% Convertible Senior Discount Notes due 2013 included within Long-Term Debt are not traded in an organized public manner. The fair value of these notes was calculated using a convertible model, which uses the Black-Scholes valuation model to value the equity portion of the security and bond math to value the debt portion of the security (using market yields on other Level 3 traded debt). The 10% Convertible Senior Notes due 2011 included within Long-Term Debt are not traded in an organized public manner. Level 3 has obtained a market value from a third party broker for the 10% Convertible Senior Notes due 2011. The 11.5% Senior Notes due 2010, Floating Rate Notes due 2011 and the 10.75% Senior Notes due 2011 are not actively traded debt instruments. Level 3 has calculated the estimated fair value of these debt instruments using bond math and market yields on other Level 3 traded debt.

The carrying amount and estimated fair values of Level 3's financial instruments are as follows:

	December 31, 2007		December 31, 2006	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
(dollars in millions)				
Cash and Cash Equivalents	\$ 714	\$ 714	\$ 1,681	\$ 1,681
Marketable Securities—Current	9	9	235	234
Restricted Cash and Securities—Current	23	23	46	46
Restricted Cash and Securities—Noncurrent	101	101	90	90
Receivables less allowance for doubtful accounts (Note 8)	395	395	326	326
Investments (Note 13)	10	10	14	14
Accounts Payable	396	396	391	391
Long-term Debt, including current portion (Note 14)	6,864	6,345	7,362	8,578
Interest Rate Swap Liability (Note 14)	37	37	—	—

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(8) Receivables**

Receivables at December 31, 2007 and 2006 were as follows:

	Communications	Coal	Total
	(dollars in millions)		
<b>2007</b>			
Accounts Receivable—Trade	\$ 409	\$ 6	\$ 415
Allowance for Doubtful Accounts	(20)	—	(20)
	<u>389</u>	<u>6</u>	<u>395</u>
Total	\$ 389	\$ 6	\$ 395
	<u>389</u>	<u>6</u>	<u>395</u>
<b>2006</b>			
Accounts Receivable—Trade	\$ 337	\$ 6	\$ 343
Allowance for Doubtful Accounts	(17)	—	(17)
	<u>320</u>	<u>6</u>	<u>326</u>
Total	\$ 320	\$ 6	\$ 326
	<u>320</u>	<u>6</u>	<u>326</u>

The Company recognized bad debt expense in selling, general and administrative expenses of \$11 million, \$1 million, and less than \$1 million in 2007, 2006 and 2005, respectively. Level 3 received \$2 million, \$1 million and \$2 million of proceeds for amounts previously deemed uncollectible in 2007, 2006 and 2005, respectively. The Company reduced accounts receivable and the allowance for doubtful accounts by \$8 million in 2007 and less than \$1 million in both 2006 and 2005, for the write off of previously reserved amounts the Company deemed as uncollectible.

**(9) Other Current Assets**

At December 31, 2007 and 2006 other current assets consisted of the following:

	2007	2006
	(dollars in millions)	
Prepaid Assets	\$ 46	\$ 53
Debt Issuance Costs, net	16	18
Other	26	30
	<u>88</u>	<u>101</u>
	\$ 88	\$ 101
	<u>88</u>	<u>101</u>

Prepaid assets include insurance, software maintenance, rent and right of way costs.

**(10) Property, Plant and Equipment, net**

Costs associated directly with expansions and improvements to the communications network and customer installations, including employee related costs, have been capitalized. The Company generally capitalizes costs associated with network construction, provisioning of services and software development. Capitalized labor and related costs associated with employees and contract labor working on capital projects were approximately \$102 million, \$72 million and \$51 million for the years ended December 31, 2007, 2006 and 2005, respectively.

The Company continues to develop business support systems required for its business. The external direct costs of software, materials and services, and payroll and payroll related expenses for employees directly associated with the project incurred when developing the business support systems are

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(10) Property, Plant and Equipment, net (Continued)**

capitalized and included in the capitalized costs above. Upon completion of a project, the total cost of the business support system is amortized over an estimated useful life of three years.

Land primarily represents owned assets of the communications business, including land improvements.

Capitalized business support systems and network construction costs that have not been placed in service have been classified as construction-in-progress within property, plant and equipment below.

The cost and accumulated depreciation of property, plant and equipment has been reduced for impairments taken in current and prior years.

At December 31, 2007 and 2006, property, plant and equipment were as follows:

	Cost	Accumulated Depreciation	Book Value
	(dollars in millions)		
<b>December 31, 2007</b>			
Land	\$ 234	\$ (32)	\$ 202
Facility and Leasehold Improvements:			
Communications	1,856	(589)	1,267
Coal Mining	153	(151)	2
Network Infrastructure	5,591	(1,705)	3,886
Operating Equipment:			
Communications	3,455	(2,267)	1,188
Coal Mining	72	(64)	8
Furniture, Fixtures and Office Equipment	141	(117)	24
Other	27	(24)	3
Construction-in-Progress	89	—	89
	<u>\$ 11,618</u>	<u>\$ (4,949)</u>	<u>\$ 6,669</u>
<b>December 31, 2006</b>			
Land	\$ 214	\$ (28)	\$ 186
Facility and Leasehold Improvements:			
Communications	1,692	(482)	1,210
Coal Mining	151	(148)	3
Network Infrastructure	5,430	(1,409)	4,021
Operating Equipment:			
Communications	2,706	(1,799)	907
Coal Mining	71	(64)	7
Furniture, Fixtures and Office Equipment	132	(106)	26
Other	28	(24)	4
Construction-in-Progress	104	—	104
	<u>\$ 10,528</u>	<u>\$ (4,060)</u>	<u>\$ 6,468</u>

The value of property, plant and equipment related to the Servecast acquisition is based on a preliminary valuation. The value of property, plant and equipment related to the Progress Telecom,



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(10) Property, Plant and Equipment, net (Continued)**

ICG Communications, TelCove, Looking Glass, the CDN Business and Broadwing acquisitions is based on final valuations.

During 2006, Level 3 determined that the period the Company expects to use its existing fiber is longer than the remaining useful life as originally estimated. As a result, the Company extended the depreciable life of its existing fiber from 7 years to 12 years. This change in estimate, effective as of April 1, 2006, was accounted for prospectively, in accordance with SFAS No. 154 and reduced depreciation expense by \$54 million in 2006. This change in estimate reduced loss from continuing operations and net loss by \$54 million, or approximately \$0.05 per share for the year ended December 31, 2006.

In addition, during 2006, Level 3 determined that the period the Company expects to use its existing electronic equipment is longer than the remaining useful lives as originally estimated. As a result, the Company extended the depreciable life of its existing transmission equipment from 5 years to 7 years and existing IP equipment from 3 years to 4 years. This change in estimate, effective as of July 1, 2006, was accounted for prospectively, in accordance with SFAS No. 154, and reduced depreciation expense by \$26 million in 2006. In addition, this change in estimate reduced loss from continuing operations and net loss by \$26 million, or approximately \$0.03 per share for the year ended December 31, 2006.

Depreciation expense was \$838 million in 2007, \$652 million in 2006 and \$584 million in 2005.

**(11) Goodwill**

Goodwill attributable to each of the Company's acquisitions at December 31, 2007 and 2006 was as follows (dollars in millions):

	December 31, 2007	December 31, 2006
Servecast	\$ 31	\$ —
Broadwing	1,038	—
TelCove	179	179
ICG Communications	73	127
Progress Telecom	30	32
McLeod	40	40
XCOM	30	30
	<u>\$ 1,421</u>	<u>\$ 408</u>

The Company segregates identifiable intangible assets acquired in a business combination from goodwill. Goodwill is not amortized and the carrying amount of the goodwill must be evaluated at least annually for impairment using a fair value based test. An assessment of the carrying value of goodwill attributable to the communications business was performed as of December 31, 2007 and indicated that goodwill was not impaired.

The preliminary valuation for the Servecast acquisition indicated that the purchase price exceeded the fair value of the identifiable assets acquired and liabilities assumed and resulted in goodwill of \$31 million as of December 31, 2007.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Goodwill (Continued)**

As described in Note 2, the Company received a revised valuation report for the CDN Business in the second quarter of 2007 that resulted in increased valuations for patents and customer-related intangible assets and resulted in the elimination of the \$110 million of goodwill preliminarily recorded for the CDN Business acquisition in the first quarter of 2007. During the third quarter of 2007, the Company received the final valuation report for the CDN Business acquisition. The final valuation report did not result in any additional changes to the valuation of the CDN Business.

The preliminary valuation for the Broadwing acquisition indicated that the purchase price exceeded the fair value of the identifiable assets acquired and liabilities assumed and resulted in goodwill of \$939 million. As described in Note 2, the Company received a final valuation for Broadwing that resulted in a reduced valuation for customer-related intangible assets and an increase to goodwill totaling \$100 million in the fourth quarter of 2007. In addition, the Company made other purchase price allocation adjustments for the Broadwing acquisition during 2007 that resulted in a net decrease of \$1 million to the goodwill recorded for Broadwing.

The final valuation of the assets acquired and liabilities assumed in the Looking Glass transaction indicated that the fair value of the identifiable net assets acquired exceeded the consideration paid to the former owners by \$22 million, which reduced the fair value of long-lived assets acquired in the transaction on a pro-rata basis. During the third quarter of 2007, the Company recorded net purchase price allocation adjustments for the Looking Glass acquisition totaling \$2 million related to unutilized leased facilities assumed in the acquisition. The facilities underlying these leases have not been used by the Company since the date of acquisition and are not planned to be used by the Company in the future. The \$2 million adjustment to the purchase price of Looking Glass was recorded as an increase in the value of the long-lived assets.

The final valuations for the Progress Telecom, ICG Communications and TelCove acquisitions indicated that the purchase price exceeded the fair value of the identifiable assets acquired and liabilities assumed and resulted in goodwill of \$30 million, \$73 million and \$179 million, respectively. The final valuation for ICG Communications was received in the second quarter of 2007. As a result of the revisions to the fixed asset and customer-related intangible asset valuations described in Note 2, the goodwill recorded in connection with the ICG Communications acquisition was reduced from \$127 million based on the preliminary valuation to \$73 million based on the final valuation.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(11) Goodwill (Continued)**

**(12) Other Intangibles, net**

Other Intangibles, net attributable to each of the Company's acquisitions at December 31, 2007 and 2006 were as follows (dollars in millions):

	Initial Fair Value	Accumulated Amortization	Book Value
<b>December 31, 2007</b>			
Customer Contracts and Relationships:			
Servecast	\$ 9	\$ —	\$ 9
CDN Business	31	(5)	26
Broadwing	154	(14)	140
Looking Glass	9	(2)	7
TelCove	253	(41)	212
ICG Communications	18	(5)	13
Progress Telecom	36	(8)	28
WilTel	120	(33)	87
360networks	4	(2)	2
Sprint	31	(31)	—
Genuity	107	(107)	—
Trademarks:			
WilTel	32	—	32
Patents and Developed Technology:			
Servecast	8	—	8
CDN Business	102	(10)	92
Telverse	31	(27)	4
Other	20	—	20
	\$ 965	\$ (285)	\$ 680

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(12) Other Intangibles, net (Continued)**

	Initial Fair Value	Accumulated Amortization	Book Value
<b>December 31, 2006</b>			
Customer Contracts and Relationships:			
Looking Glass	\$ 9	\$ (1)	\$ 8
TelCove	253	(9)	244
ICG Communications	49	(2)	47
Progress Telecom	36	(3)	33
WiTel	120	(17)	103
360networks	4	(1)	3
Sprint	31	(26)	5
Genuity	107	(101)	6
Trademarks:			
WiTel	32	—	32
Technology:			
Telverse	31	(21)	10
Other	20	—	20
	\$ 692	\$ (181)	\$ 511

The Company segregates identifiable intangible assets acquired in a business combination from goodwill. Identifiable intangible assets are generally amortized (unless the useful life is determined to be indefinite) and the carrying amount of the identifiable intangible assets must be evaluated at least annually for impairment using a fair value based test. An assessment of the carrying value of identifiable intangible assets attributable to the communications business was performed in the fourth quarter of 2007 and indicated that the assets were not impaired.

On July 11, 2007, Level 3 completed the acquisition of Servecast. In the third quarter of 2007, the preliminary valuation of the assets acquired in the Servecast transaction indicated a value of \$9 million for customer relationships and \$8 million for technology with lives of 11 and 12 years, respectively.

On January 23, 2007, Level 3 completed the acquisition of the CDN Business. In the first quarter of 2007, the preliminary valuation of the assets acquired in the CDN Business transaction indicated a value of \$23 million for patents and customer-related intangible assets. As described in Note 2, during the second quarter of 2007 the Company received a revised valuation for the CDN Business that indicated a significant increase in the value of the identifiable intangible assets, primarily patents and customer-related intangible assets. The identifiable intangible assets for the CDN Business increased from \$23 million in the preliminary valuation to \$133 million in the revised valuation as a result of additional analysis of the estimated cash flows expected to be generated from the patents and customers acquired in the CDN Business acquisition. The increase in the value allocated to the identifiable intangible assets for the CDN Business eliminated the \$110 million of goodwill recorded on the transaction in the first quarter of 2007. The estimated useful lives for the patent and customer-related intangible assets range from four to ten years. The final valuation report did not result in any additional changes to the valuation of the CDN Business.

On January 3, 2007, Level 3 completed the acquisition of Broadwing. A preliminary valuation of the assets acquired in the Broadwing transaction indicated a value of \$254 million for wholesale and

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(12) Other Intangibles, net (Continued)**

enterprise customer-related intangible assets. Level 3 had initially assigned an estimated useful life of ten years to the customer-related intangible assets. During June 2007, the Company completed a review of the estimated useful lives of the customer-related intangible assets for the Broadwing acquisition that resulted in a reduction of the estimated useful lives from ten years to a range of six to eight years. This change in estimate, effected as of June 1, 2007, was accounted for prospectively and increased amortization expense by approximately \$4 million for the nine months ended September 30, 2007. Subsequent to September 30, 2007, and as described in Note 2, the Company received a revised valuation for Broadwing that indicated a significant decrease in the value of the identifiable customer-related intangible assets. The identifiable intangible assets for Broadwing decreased from \$254 million in the preliminary valuation to \$154 million in the revised valuation as a result of additional analysis of the estimated cash flows expected to be generated from the customers acquired in the Broadwing acquisition. The decrease in customer-related intangibles of \$100 million resulted in a corresponding increase in the goodwill recorded on the Broadwing transaction. As a result of the revised valuation of the customer-related intangible assets in the fourth quarter of 2007, the Company also reviewed the estimated useful lives of the customer-related intangible assets for the Broadwing acquisition again. The fourth quarter 2007 review of the useful lives of the Broadwing customer-related intangible assets resulted in increasing the useful lives from a range of six to eight years to a range of nine to twelve years. The increase in the useful lives from the analysis completed in the second quarter of 2007 to the analysis completed in the fourth quarter of 2007 was due to the underlying changes in the timing of estimated cash flows expected to be generated from the customers acquired in the Broadwing acquisition. Due to the fact that the valuation of the Broadwing customer-related intangible assets changed significantly in the revised valuation report, the Company recorded, in the fourth quarter, a cumulative catch up adjustment to recognize the amount of amortization expense that would have been recognized for the full year based on the revised valuation. This resulted in a net decrease in amortization expense of \$9 million in the fourth quarter of 2007.

On August 2, 2006, Level 3 completed the acquisition of Looking Glass. The final valuation of the assets acquired in the Looking Glass transaction as of the acquisition date indicated wholesale customer-related intangible assets of approximately \$9 million with an estimated useful life of eight years. During June 2007, the Company completed a review of the estimated useful life of the customer-related intangible assets for the Looking Glass acquisition that resulted in a reduction of the estimated useful life from eight years to six years. This change in estimate, effected as of June 1, 2007, was accounted for prospectively, in accordance with SFAS No. 154, and increased amortization expense by approximately \$1 million for year ended December 31, 2007. In addition, this change in estimate increased loss from continuing operations and net loss by \$1 million, or less than \$0.01 per share, for the year ended December 31, 2007.

On July 24, 2006, Level 3 completed the acquisition of TelCove. The final valuation of the assets acquired in the TelCove transaction as of the acquisition date indicated wholesale and enterprise customer-related intangible assets of approximately \$253 million, with lives ranging from nine to thirteen years and other intangible assets of approximately \$20 million with an indefinite life. During June 2007, the Company completed a review of the estimated useful lives of the customer-related intangible assets for the TelCove acquisition that resulted in a reduction of the estimated useful lives from a range of nine to thirteen years to a range of six to eight years. This change in estimate, effected as of June 1, 2007, was accounted for prospectively, in accordance with SFAS No. 154, and increased amortization expense by approximately \$9 million for the year ended December 31, 2007. In addition,

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(12) Other Intangibles, net (Continued)**

this change in estimate increased loss from continuing operations and net loss by \$9 million, or approximately \$0.01 per share, for the year ended December 31, 2007.

On May 31, 2006, Level 3 completed the acquisition of ICG Communications. A preliminary valuation of the assets acquired in the ICG Communications transaction indicated a value of \$49 million for wholesale customer-related intangible assets with an estimated useful life of 15 years. As described in Note 2, during the second quarter of 2007 the Company received the final valuation for both the identifiable tangible and intangible assets acquired in the ICG Communications acquisition that included revised valuations for those assets. As a result of the changes to the valuation of the fixed assets, the valuation of the identifiable intangible assets decreased from \$49 million in the preliminary valuation to \$18 million in the final valuation. During June 2007, the Company completed a review of the estimated useful life of the customer-related intangible assets for the ICG Communications acquisition that resulted in a reduction in the estimated useful life from fifteen years to six years. This change in estimate, effected as of June 1, 2007, was accounted for prospectively and decreased amortization expense by less than \$1 million for the year ended December 31, 2007 after taking into consideration the reduced valuation of the ICG Communications customer-related intangible assets.

On March 20, 2006, Level 3 completed the acquisition of Progress Telecom. A final valuation of the assets acquired in the Progress Telecom acquisition resulted in a value of \$36 million for customer-related intangible assets with an estimated useful life of eight years.

On December 23, 2005, Level 3 completed the acquisition of WiTel. A final valuation of the assets acquired indicated a value of \$152 million for identifiable intangible assets. The intangible assets primarily include customer relationships and the Vyvx trademark. The final valuation placed an indefinite life on the Vyvx trademark and lives ranging from 6 to 11 years for the customer relationships.

Intangible asset amortization expense was \$104 million, \$78 million and \$63 million for the years ended December 31, 2007, 2006 and 2005, respectively.

The amortization expense related to intangible assets currently recorded on the Company's books for each of the five succeeding years is estimated to be the following for the years ended December 31: 2008—\$100 million; 2009—\$95 million; 2010—\$95 million; 2011—\$94 million, 2012—\$72 million and thereafter—\$172 million.

**(13) Other Assets, net**

At December 31, 2007 and 2006 other assets consisted of the following:

	2007	2006
	(dollars in millions)	
Debt Issuance Costs, net	\$ 78	\$ 75
Deferred Tax Asset	23	—
Investments	10	14
Deposits	12	17
Other	22	22
	\$ 145	\$ 128

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(13) Other Assets, net (Continued)**

The Company had investments totaling \$10 million and \$14 million for the years ended December 31, 2007 and 2006, respectively. These investments are accounted for using the cost method.

See Note 14 below for a discussion of debt issuance costs included in other assets, net above.

**(14) Long-Term Debt**

At December 31, 2007 and 2006, long-term debt was as follows:

(dollars in millions)	2007	2006
	(dollars in millions)	
Senior Secured Term Loan due 2014 (7.493%)	\$ 1,400	\$ —
Senior Secured Term Loan due 2011	—	730
Senior Notes due 2008 (11.0%)	20	78
Senior Euro Notes due 2008 (10.75%)	5	65
Senior Discount Notes due 2010	—	488
Senior Euro Notes due 2010	—	137
Senior Notes due 2010	—	96
Senior Notes due 2010 (11.5%)	13	692
Fair value adjustment on Senior Notes due 2010	(1)	(60)
Senior Notes due 2011 (10.75%)	3	3
Floating Rate Senior Notes due 2011 (11.884%)	6	150
Issue discount on Senior Notes due 2011	—	(4)
Senior Notes due 2013 (12.25%)	550	550
Issue discount on Senior Notes due 2013	(2)	(2)
Senior Notes due 2014 (9.25%)	1,250	1,250
Issue premium on Senior Notes due 2014	10	11
Floating Rate Senior Notes due 2015 (9.15%)	300	—
Senior Notes due 2017 (8.75%)	700	—
Convertible Senior Notes due 2010 (2.875%)	374	374
Convertible Senior Notes due 2011 (5.25%)	345	345
Convertible Senior Notes due 2011 (10.0%)	275	880
Convertible Senior Notes due 2012 (3.5%)	335	335
Convertible Senior Discount Notes due 2013 (9.0%)	295	275
Convertible Subordinated Notes due 2009 (6.0%)	362	362
Convertible Subordinated Notes due 2010 (6.0%)	514	514
Commercial Mortgage due 2015 (6.86%)	69	70
Capital leases	41	23
	6,864	7,362
Less current portion	(32)	(5)
	\$ 6,832	\$ 7,357

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

*Debt Exchanges, Conversions, Redemptions and Repurchases*

**2007 Debt for Equity Exchanges**

In January 2007, in two separate transactions, Level 3 completed the exchange of \$605 million in aggregate principal amount of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of Level 3's common stock. The shares of the Company's common stock are exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. The Company recognized a \$177 million loss on extinguishment of debt for the exchanges. Included in the loss was approximately \$1 million of unamortized debt issuance costs.

**2007 Redemptions and Repurchases**

In March 2007, the Company redeemed using cash the entire \$722 million of outstanding principal amount of the following debt issuances and recognized a loss on extinguishment of debt totaling \$54 million on the redemption transactions.

- Redeemed \$488 million of outstanding 12.875% Senior Notes due 2010 at a price equal to 102.146% of the principal amount and recognized a \$12 million loss on extinguishment of debt consisting of a \$10 million cash loss and \$2 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million.
- Redeemed \$96 million of outstanding 11.25% Senior Notes due 2010 at a price equal to 101.875% of the principal amount and recognized a \$3 million loss on extinguishment of debt consisting of a \$2 million cash loss and \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million.
- Redeemed \$138 million (€104 million) of outstanding 11.25% Senior Euro Notes due 2010 at a price equal to €101.875 per €1,000 of principal amount and recognized a \$39 million loss on extinguishment of debt consisting of a \$38 million cash loss and \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million (less than €1 million).

In March 2007, the respective issuers repurchased using cash, through tender offers, \$941 million of the outstanding principal amounts of the following debt issuances and recognized a loss on extinguishment of debt totaling \$186 million on the repurchase transactions.

- Repurchased \$144 million of its outstanding Floating Rate Senior Notes due 2011 at a price equal to \$1,080 per \$1,000 principal amount of the notes, which included \$1,050 as the tender offer consideration and \$30 as a consent payment, and recognized an \$18 million loss on extinguishment of debt consisting of a \$12 million cash loss and \$6 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$8 million.
- Repurchased \$59 million of its outstanding 11% Senior Notes due 2008 at a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which included \$1,024.28 as the tender offer consideration and \$30 as a consent payment, and recognized a \$3 million loss on extinguishment of debt consisting of a \$3 million cash loss and less than \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$3 million.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

- Repurchased \$677 million of its outstanding 11.5% Senior Notes due 2010 at a price equal to \$1,115.26 per \$1,000 principal amount of the notes, which included \$1,085.26 as the tender offer consideration and \$30 as a consent payment, and recognized a \$141 million loss on extinguishment of debt consisting of a \$78 million cash loss and \$63 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$3 million.
- Repurchased \$61 million (€46 million) of its outstanding 10.75% Senior Euro Notes due 2008 at a price equal to €1,061.45 per €1,000 of principal amount of the notes, which included €1,031.45 as the tender offer consideration and €30 as a consent payment, and recognized a \$24 million loss on extinguishment of debt consisting of a \$24 million cash loss and less than \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$3 million (€2 million).

In connection with the tender offers completed in the first quarter of 2007, Level 3 and Level 3 Financing, Inc. ("Level 3 Financing"), a wholly owned subsidiary of the Company, obtained consents to certain proposed amendments to the respective indentures governing the notes that are subject to the tender offer transactions described above to eliminate substantially all of the covenants, amend certain repurchase rights, certain discharge rights and certain events of default and related provisions contained in those indentures.

On February 23, 2007, Level 3 Financing completed a consent solicitation with respect to certain amendments to the indenture governing Level 3 Financing's outstanding 12.25% Senior Notes due 2013 that allowed for the incurrence of debt based upon a multiple of cash flow available for fixed charges on a "pro forma" basis giving effect to any acquisition, merger or consolidation completed prior to February 1, 2007. Additional debt as permitted under the amended indenture was incurred in March 2007. In connection with the consent solicitation, the Company paid consent fees totaling approximately \$2 million which were capitalized as additional debt issuance costs and will be amortized over the remaining life of the related debt issuances using the effective interest method.

**2007 Conversion of Broadwing Corporation 3.125% Convertible Senior Debentures due 2026**

On February 17, 2007, Level 3's wholly-owned subsidiary, Broadwing, completed the repurchase of \$1 million aggregate principal amount of Broadwing's outstanding 3.125% Convertible Senior Debentures due 2026 (the "Debentures"). The indenture governing the Debentures required Broadwing to make the offer to repurchase the Debentures as a result of the Company's acquisition of Broadwing on January 3, 2007.

As a result of the acquisition, each \$1,000 principal amount of the Debentures was convertible at the option of the holder into \$492.77 in cash and 80.789 shares of Level 3 common stock, representing a conversion price equal to the consideration payable to Broadwing stockholders in the acquisition of (i) \$8.18 in cash per share of Broadwing, multiplied by 60.241, and (ii) 1.3411 shares of Level 3 common stock, multiplied by 60.241. Additionally, as a result of the acquisition, a make-whole premium was payable on Debentures converted prior to February 17, 2007, consisting of (i) 14.969 additional shares of Level 3 common stock and (ii) an additional \$91.31 in cash per \$1,000 principal amount of Debentures.

Holders owning \$179 million aggregate principal amount of the Debentures converted those Debentures into a total of approximately 17 million shares of Level 3 common stock and also received

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

approximately \$105 million in cash. As a result of these conversions and the repurchase discussed above, as of February 17, 2007, the Debentures are no longer outstanding. There was no gain or loss recognized due to the fact that, under purchase accounting, the liability for the notes was valued at the total cost to retire the obligation.

**2006 Debt Exchange**

On January 13, 2006, the Company completed private exchange offers to exchange a portion of its outstanding 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 (together the "2008 Notes") that were held by eligible holders in a private placement for cash and new 11.5% Senior Notes due 2010. The Company issued \$692 million aggregate principal amount of 11.5% Senior Notes due 2010 as well as paid \$46 million of cash consideration in exchange for the 2008 Notes tendered in the transactions. The Company also paid approximately \$13 million in cash for total accrued interest to the closing date on the 2008 Notes that were accepted for exchange.

Pursuant to the guidance in EITF No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments" ("EITF No. 96-19"), the Company accounted for the exchange of the 9.125% Senior Notes due 2008 and the 11% Senior Notes due 2008 as an extinguishment of debt and recognized a gain of approximately \$27 million in Other Income in the first quarter of 2006. The gain was determined using the fair value of the new 11.5% Senior Notes due 2010 at the time of issuance. The fair value of the 11.5% Senior Notes due 2010 was approximately \$73 million less than the face amount of the debt. The accretion of the \$73 million discount will be reflected as interest expense in future periods using the effective interest method. The 11.5% Senior Notes due 2010 were recorded at their fair value on the transaction date and will accrete to their face value at maturity. Premiums paid to holders of the 9.125% Senior Notes due 2008 and the 11% Senior Notes due 2010 of \$41 million reduced the gain on extinguishment of debt.

In accordance with EITF No. 96-19, the exchange of the 10.5% Senior Discount Notes due 2008 was accounted for as a modification of the existing debt. The premiums paid to the holders of the 10.5% Senior Discount Notes due 2008 of \$5 million were added to the existing debt issuance costs and will be amortized over the term of the 11.5% Senior Notes due 2010.

The Company incurred approximately \$5 million of third party costs associated with the exchange transaction. The costs were allocated to each tranche of debt based on the amount tendered for exchange. The \$4 million of fees allocated to the 9.125% Senior Notes due 2008 and the 11% Senior Notes due 2008 were capitalized and will be amortized to interest expense over the term of the respective notes. The \$1 million of costs allocated to the 10.5% Senior Discount Notes due 2008 were expensed in the first quarter of 2006.

The principal amount of 2008 Notes tendered is set forth in the table below (dollars in millions).

2008 Notes Exchanged	Aggregate Principal Amount Outstanding Before Exchange Offers	Aggregate Principal Amount Tendered	Aggregate Principal Amount of Old Notes that Remained Outstanding	Total Cash Premium Payment
9.125% Senior Notes due 2008	\$ 954	\$ 556	\$ 398	\$ 36
11% Senior Notes due 2008	132	54	78	5
10.5% Senior Discount Notes due 2008	144	82	62	5

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

The exchange offers were made only to qualified institutional buyers and institutional accredited investors inside the United States and to certain non-U.S. investors.

The 11.5% Senior Notes are senior unsecured obligations of the Company, ranking equal in right of payment with the old notes not tendered in the exchange offers as well as all other senior unsecured obligations of the Company. The 11.5% Senior Notes due 2010 mature on March 1, 2010, and bear interest at a rate per annum equal to 11.5%. Interest on the notes is payable on March 1 and September 1 of each year, beginning on September 1, 2006. The Company may redeem some or all of the 11.5% Senior Notes due 2010 at any time on or after March 1, 2009, at 100% of their principal amount plus accrued interest. As described above, on March 15, 2007, the Company repurchased \$677 million of its outstanding 11.5% Senior Notes due 2010.

The Company's exchange offer registration statement for these notes was declared effective by the Securities and Exchange Commission on August 8, 2006 and the exchange offer relating to these notes was subsequently completed.

**2006 Debt Tenders and Redemptions**

On July 13, 2006, Level 3 redeemed all of its outstanding 9.125% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 remaining after the debt exchange completed on January 13, 2006, described above. Aggregate principal, call premium and accrued interest totaled \$470 million.

The 9.125% Senior Notes due 2008 were redeemed at a redemption price equal to 100% of the principal amount of those notes plus accrued and unpaid interest. The aggregate principal amount of 9.125% Senior Notes due 2008 that were redeemed was \$398 million. The 10.5% Senior Discount Notes due 2008 were redeemed at a redemption price equal to 101.75% of the principal amount at maturity of those notes plus accrued and unpaid interest. The aggregate principal amount at maturity of 10.5% Senior Discount Notes due 2008 that were redeemed was \$62 million.

On December 27, 2006, Level 3 Financing purchased for cash \$497 million in total principal amount of its 10.75% Senior Notes due 2011, representing approximately 99.3% of the aggregate principal amount outstanding of all 10.75% Senior Notes Due 2011. Holders of the 10.75% Senior Notes due 2011 validly tendered and accepted for purchase by Level 3 Financing received \$1,092.21 per \$1,000 principal amount of the these notes, which included \$1,062.21 as the purchase price and \$30.00 as a consent payment. Level 3 Financing paid in cash approximately \$528 million to purchase the 10.75% Senior Notes due 2011 as well as a \$15 million consent payment and \$11 million for total accrued interest to the closing date of the tender offer. The Company recorded a \$54 million net loss on the early extinguishment of the debt, including unamortized debt issuance costs of \$8 million.

***Debt Issuances and Refinancings***

**2007 Senior Note Issuance**

On February 14, 2007, Level 3 Financing issued \$700 million of its 8.75% Senior Notes due 2017 and \$300 million of its Floating Rate Senior Notes due 2015 and received net proceeds of \$982 million. The proceeds from these private offerings were used to refinance certain Level 3 Financing debt and to fund the cost of construction, installation, acquisition, lease, development and improvement of other assets to be used in Level 3's communications business. See a detailed description of the notes below.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

**2007 Senior Secured Credit Agreement Refinancing**

In March 2007, Level 3 Financing refinanced its senior secured credit agreement and received net proceeds of \$1.382 billion. The proceeds from this transaction were used to repay the existing \$730 million Senior Secured Term Loan due 2011 and other debt. The effect of this transaction was to increase the amount of senior secured debt from \$730 million to \$1.4 billion, reduce the interest rate on that debt from the London Interbank Offering Rate ("LIBOR") plus 3.00% to LIBOR plus 2.25% and extend the final maturity from 2011 to 2014. The Company recognized a \$10 million loss on this transaction related to unamortized debt issuance costs. See a detailed description of the Senior Secured Term Loan due 2014 below.

**2007 Interest Rate Swaps**

Level 3 has floating rate long-term debt. These obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense also decreases. On March 13, 2007, Level 3 Financing entered into two interest rate swap agreements to hedge the interest payments on \$1 billion notional amount of floating rate debt. The two interest rate swap agreements are with different counterparties and are for \$500 million each. The transactions were effective beginning April 13, 2007 and mature on January 13, 2014. Under the terms of the interest rate swap transactions, Level 3 receives interest payments based on rolling three month LIBOR terms and pays interest at the fixed rate of 4.93% under one arrangement and 4.92% under the other. Level 3 has designated the interest rate swap agreements as a cash flow hedge on the interest payments for \$1 billion of floating rate debt. Level 3 evaluates the effectiveness of the hedge on a quarterly basis. The Company does not enter into derivative instruments for any purpose other than cash flow hedging.

The fair value of the interest rate swap agreements was a liability of \$37 million as of December 31, 2007. For the year ended December 31, 2007, unrealized losses of \$37 million were recorded on the interest rate swap agreements and are included in Other Comprehensive Income (Loss). The change in the fair value of the interest rate swap agreements is reflected in Other Comprehensive Income (Loss) due to the fact that the interest rate swap agreements are designated as an effective cash flow hedge of \$1 billion notional amount of the Company's floating rate debt.

**2006 Amendment and Restatement of Credit Facility**

On June 27, 2006, Level 3 Financing amended and restated its existing \$730 million senior secured credit facility (see Senior Secured Term Loan due 2011 below) to reduce the interest rate payable under the agreement by 400 basis points, modify the pre-payment provisions and make other specified changes.

The amendment of the credit facility was treated as an extinguishment of the existing debt instrument due to the significant change in lenders of the debt in accordance with EITF No. 96-19. The fair value of the amended and restated credit facility approximated the carrying value of the original credit facility as the interest rate of the amended and restated credit facility approximated current market rates. As part of the transaction, Level 3 Financing paid a prepayment premium of approximately \$42 million to existing debt holders. The prepayment premium along with the unamortized deferred debt issuance costs of \$13 million from the original offering, were recognized as a loss on the extinguishment of debt in the second quarter of 2006. The Company also incurred

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

\$11 million of third party costs to complete this transaction. These costs were reflected as deferred debt issuance costs and will be amortized to interest expense over the term of the debt using the effective interest method.

As described above, in March 2007, the Company refinanced its senior secured credit agreement and repaid the \$730 million Senior Secured Term Loan due 2011.

***Capital Leases***

As part of the Broadwing transaction completed on January 3, 2007, the Company now includes in its financial statements certain capital lease obligations of Broadwing totaling \$24 million, related primarily to a metro fiber IRU agreement. The capital leases mature at various dates through 2022.

***Debt Instruments***

At December 31, 2007, Level 3 was in compliance with the covenants on all outstanding debt issuances.

**Senior Secured Term Loan due 2014**

On March 13, 2007, Level 3, as guarantor, Level 3 Financing, as borrower, Merrill Lynch Capital Corporation, as administrative agent and collateral agent, and certain other agents and certain lenders entered into a Credit Agreement, pursuant to which the lenders extended a \$1.4 billion senior secured term loan ("Senior Secured Term Loan due 2014") to Level 3 Financing. The term loan matures on March 13, 2014 and has an interest rate of LIBOR plus an applicable margin of 2.25% per annum. The borrower has the option of electing one, two, three or six month LIBOR at the end of each interest rate period.

Interest on the Senior Secured Term Loan due 2014 accrues at the elected LIBOR rate plus 2.25% per annum and is payable in cash at the end of each LIBOR period elected in arrears, beginning July 13, 2007, provided that in the case of a six month interest period, interim interest payments are required at the end of the first three months. The interest rate was 7.493% at December 31, 2007. See discussion of the interest rate swap agreements earlier in this footnote.

Level 3 Financing's obligations under this term loan are, subject to certain exceptions, secured by certain assets of the Company and certain of the Company's material domestic subsidiaries that are engaged in the telecommunications business. The Company and these subsidiaries have also guaranteed the obligations of Level 3 Financing under the Senior Secured Term Loan due 2014. During the second quarter of 2007, Level 3 Communications, LLC and its material domestic subsidiaries obtained all material governmental authorizations and consents required in order for them to pledge certain of their assets and guarantee the Senior Secured Term Loan due 2014. The guarantee was entered into by Level 3 Communications, LLC and its material domestic subsidiaries on June 28, 2007.

The Senior Secured Term Loan due 2014 includes certain negative covenants which restrict the ability of the Company, Level 3 Financing and any restricted subsidiary to engage in certain activities. The Senior Secured Term Loan due 2014 also contains certain events of default. It does not require the Company or Level 3 Financing to maintain specific financial ratios or other financial metrics.

Level 3 used a portion of the original net proceeds after transaction costs to repay Level 3 Financing's \$730 million Senior Secured Term Loan due 2011 under that certain credit agreement

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

dated June 27, 2006. In addition, Level 3 used a portion of the net proceeds to fund the purchase of certain of its existing debt securities.

Debt issuance costs of \$18 million were capitalized and are being amortized to interest expense over the term of the Senior Secured Term Loan due 2014 using the effective interest method.

**11% Senior Notes due 2008**

In February 2000, Level 3 Communications, Inc. received \$779 million of net proceeds, after transaction costs, from a private offering of \$800 million aggregate principal amount of its 11% Senior Notes due 2008 ("11% Senior Notes"). As of December 31, 2007 a total of \$780 million aggregate principal amount of the 11% Senior Notes had been repurchased. Interest on the notes accrues at 11% per year and is payable semi-annually in arrears in cash on March 15 and September 15, beginning September 15, 2000. The 11% Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior debt. The 11% Senior Notes cannot be prepaid by Level 3 Communications, Inc., and mature on March 15, 2008.

In March 2007, the Company repurchased \$59 million of its outstanding 11% Senior Notes due 2008 at a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which included \$1,024.28 as the tender offer consideration and \$30 as a consent payment, and recognized a \$3 million loss on extinguishment of debt consisting of a \$3 million cash loss and less than \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$3 million.

Debt issuance costs of \$21 million were originally capitalized and are being amortized to interest expense over the term of the 11% Senior Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2007.

**10.75% Senior Euro Notes due 2008**

In February 2000, Level 3 Communications, Inc. received €488 million (\$478 million when issued) of net proceeds, after debt issuance costs, from an offering of €500 million aggregate principal amount 10.75% Senior Euro Notes due 2008 ("10.75% Senior Euro Notes").

In March 2007, the Company repurchased \$61 million (€46 million) of its outstanding 10.75% Senior Euro Notes due 2008 at a price equal to €1,061.45 per €1,000 of principal amount of the notes, which included €1,031.45 as the tender offer consideration and €30 as a consent payment, and recognized a \$24 million loss on extinguishment of debt consisting of a \$24 million cash loss and less than \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of repurchase totaled \$3 million (€2 million).

As of December 31, 2007, a total of €496 million aggregate principal amount of the 10.75% Senior Euro Notes had been repurchased. Interest on the notes accrues at 10.75% per year and is payable in Euros semi-annually in arrears on March 15 and September 15 each year beginning on September 15, 2000. The 10.75% Senior Euro Notes are not redeemable by Level 3 Communications, Inc. prior to their maturity on March 15, 2008. Debt issuance costs of €12 million were originally capitalized and are being amortized over the term of the 10.75% Senior Euro Notes. As a result of amortization and debt repurchases, the net capitalized debt issuance costs have been reduced to less than €1 million at December 31, 2007.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

The 10.75% Senior Euro Notes are senior, unsecured obligations of the Company, ranking pari passu with all existing and future senior debt.

**12.875% Senior Discount Notes due 2010**

In February 2000, Level 3 Communications, Inc. sold in a private offering \$675 million aggregate principal amount at maturity of its 12.875% Senior Discount Notes due 2010 ("12.875% Senior Discount Notes"). The sale proceeds of \$360 million, excluding debt issuance costs, were recorded as long-term debt. As of December 31, 2006, a total of \$187 million aggregate principal amount at maturity of the 12.875% Senior Discount Notes had been repurchased.

In March 2007, the Company redeemed the remaining \$488 million of outstanding 12.875% Senior Notes due 2010 at a price equal to 102.146% of the principal amount and recognized a \$12 million loss on extinguishment of debt consisting of a \$10 million cash loss and \$2 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million.

Debt issuance costs of \$9 million were originally capitalized and were being amortized to interest expense over the term of the 12.875% Senior Discount Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to zero at December 31, 2007.

**11.25% Senior Euro Notes due 2010**

In February 2000, Level 3 Communications, Inc. received €293 million (\$285 million when issued) of net proceeds, after debt issuance costs, from an offering of €300 million aggregate principal amount 11.25% Senior Euro Notes due 2010 ("11.25% Senior Euro Notes").

In March 2007, the Company redeemed the remaining \$138 million (€104 million) of outstanding 11.25% Senior Euro Notes due 2010 at a price equal to €101.875 per €1,000 of principal amount and recognized a \$39 million loss on extinguishment of debt consisting of a \$38 million cash loss and \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million (less than €1 million).

Debt issuance costs of €7 million were originally capitalized and were being amortized over the term of the 11.25% Senior Euro Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to zero at December 31, 2007.

**11.25% Senior Notes due 2010**

In February 2000, Level 3 Communications, Inc. received \$243 million of net proceeds, after transaction costs, from a private offering of \$250 million aggregate principal amount of its 11.25% Senior Notes due 2010 ("11.25% Senior Notes"). As of December 31, 2006, a total of \$154 million aggregate principal amount of the 11.25% Senior Notes had been repurchased.

In March 2007, the Company redeemed the remaining \$96 million of outstanding 11.25% Senior Notes due 2010 at a price equal to 101.875% of the principal amount and recognized a \$3 million loss on extinguishment of debt consisting of a \$2 million cash loss and \$1 million in unamortized debt issuance costs. Accrued interest paid at the time of redemption totaled less than \$1 million.

Debt issuance costs of \$7 million were originally capitalized and were being amortized to interest expense over the term of the 11.25% Senior Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to zero at December 31, 2007.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

**11.5% Senior Notes Due 2010**

In January 2006, Level 3 Communications, Inc. issued \$692 million aggregate principal amount of its 11.5% Senior Notes due 2010 in connection with the private exchange offers for a portion of its outstanding 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 as described above for the 2006 Debt Exchange. The fair value of the 11.5% Senior Notes due 2010 was approximately \$73 million less than the face amount of the debt. The accretion of the \$73 million discount will be reflected as interest expense in future periods using the effective interest method. The 11.5% Senior Notes due 2010 were recorded at their fair value on the transaction date and will accrete to their face value at maturity.

The 11.5% Senior Notes are senior unsecured obligations of the Company, ranking equal in right of payment with the old notes not tendered in the exchange offers as well as all other senior unsecured obligations of the Company. The 11.5% Senior Notes due 2010 mature on March 1, 2010, and bear interest at a rate per annum equal to 11.5%. Interest on the notes is payable on March 1 and September 1 of each year, beginning on September 1, 2006. The Company may redeem some or all of the 11.5% Senior Notes due 2010 at any time on or after March 1, 2009, at 100% of their principal amount plus accrued interest.

In March 2007, the Company repurchased \$677 million of its outstanding 11.5% Senior Notes due 2010 at a price equal to \$1,115.26 per \$1,000 principal amount of the notes, which included \$1,085.26 as the tender offer consideration and \$30 as a consent payment, and recognized a \$141 million loss on extinguishment of debt consisting of a \$78 million cash loss and \$63 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$3 million. As of December 31, 2007, a total of \$13 million aggregate principal amount remains outstanding.

Debt issuance costs of \$11 million were originally capitalized and were being amortized to interest expense over the term of the 11.5% Senior Notes due 2010. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2007.

**10.75% Senior Notes due 2011**

In October 2003, Level 3 Financing received \$486 million of net proceeds from a private placement offering of \$500 million aggregate principal amount of its 10.75% Senior Notes due 2011 ("10.75% Senior Notes"). As of December 31, 2006, a total of \$497 million aggregate principal amount of the 10.75% Senior Notes had been redeemed. Interest on the notes accrues at 10.75% per year and is payable in arrears on April 15 and October 15 each year in cash. These notes are guaranteed by Level 3 Communications, LLC and Level 3 Communications, Inc. (See Note 21).



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

The 10.75% Senior Notes are subject to redemption at the option of Level 3 Financing, in whole or in part, at any time or from time to time on or after October 15, 2007, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning October 15, of the years indicated below:

Year	Redemption Price
2007	105.375%
2008	102.688%
2009 and thereafter	100.000%

In connection with the tender offer and related consent solicitation on December 27, 2006, Level 3 Financing entered into a Supplemental Indenture, which modified the original indenture dated as of October 1, 2003 ("10.75% Note Indenture"), among Level 3, as Guarantor, Level 3 Financing, as issuer, and The Bank of New York, as Trustee, relating to the 10.75% Notes. Pursuant to the Supplemental Indenture, the 10.75% Note Indenture was amended to eliminate substantially all of the covenants, certain repurchase rights and certain events of default and related provisions contained in the 10.75% Note Indenture.

The 10.75% Senior Notes are senior, unsecured obligations of Level 3 Financing, ranking *pari passu* with all existing and future senior unsecured indebtedness of Level 3 Financing.

Debt issuance costs of \$14 million were originally capitalized and are being amortized to interest expense over the term of the 10.75% Senior Notes. As a result of amortization and the repurchase transaction, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2007.

**Floating Rate Senior Notes due 2011**

On March 14, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, as borrower, entered into an indenture with the Bank of New York, as trustee, and issued \$150 million aggregate principal amount of floating rate senior notes due 2011 ("Floating Rate Senior Notes due 2011") in a private offering. After transaction costs, the Company received net proceeds associated with this offering of \$142 million.

In March 2007, the Company repurchased \$144 million of its outstanding Floating Rate Senior Notes due 2011 at a price equal to \$1,080 per \$1,000 principal amount of the notes, which included \$1,050 as the tender offer consideration and \$30 as a consent payment, and recognized an \$18 million loss on extinguishment of debt consisting of a \$12 million cash loss and \$6 million in unamortized debt issuance costs and unamortized discount. Accrued interest paid at the time of repurchase totaled \$8 million.

As of December 31, 2007, a total of \$6 million aggregate principal amount remains outstanding. The Floating Rate Senior Notes due 2011 rank equal in right of payment with all other senior unsecured obligations of Level 3 Financing and have an initial interest rate equal to the six month London Interbank Offered Rate ("LIBOR"), plus 6.375%, which will be reset semi-annually. Interest on the notes is payable on March 15 and September 15 of each year, beginning on September 15, 2006. The interest rate was 11.88% at December 31, 2007. The Floating Rate Senior Notes due 2011 were priced at 96.782% of par and will mature on March 15, 2011. The discount, after the debt repurchase is

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

less than \$1 million and is reflected as a reduction in long-term debt and is being amortized as interest expense over the term of the Floating Rate Senior Notes due 2011 using the effective interest method. These notes are guaranteed by Level 3 Communications, Inc. and Level 3 Communications, LLC (See Note 21).

The Floating Rate Senior Notes due 2011 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after March 15, 2008 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning March 15, of the years indicated below:

Year	Redemption Price
2008	102.0%
2009	101.0%
2010	100.0%

Debt issuance costs of \$3 million were capitalized and are being amortized over the term of the Floating Rate Senior Notes due 2011 using the effective interest method. As a result of amortization and the debt repurchase, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2007.

**12.25% Senior Notes due 2013**

On March 14, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, as borrower, entered into an indenture with the Bank of New York, as trustee, and issued \$250 million aggregate principal amount of 12.25% senior notes due 2013 ("12.25% Senior Notes due 2013") in a private offering.

On April 6, 2006, the Company issued \$300 million aggregate principal amount of 12.25% Senior Notes due 2013 in a private offering. These notes together with the \$250 million aggregate principal amount of 12.25% Senior Notes due 2013 issued on March 14, 2006 are treated under the same indenture as a single series of notes. The Company received net proceeds of \$538 million associated with the 12.25% Senior Notes due 2013.

The 12.25% Senior Notes due 2013 are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. These notes are guaranteed by Level 3 Communications, Inc. and Level 3 Communications, LLC (See Note 21). The notes will mature on March 15, 2013. Interest on the notes accrues at 12.25% per year and is payable on March 15 and September 15 of each year, beginning on September 15, 2006. The \$250 million of 12.25% Senior Notes due 2013 issued on March 14, 2006 were priced at 96.618% of par. The \$300 million of 12.25% Senior Notes due 2013 issued on April 6, 2006 were priced at 102% of par. The resulting net discount for the two issuances of approximately \$2 million is reflected as a reduction in long-term debt and is being amortized as interest expense over the remaining term of the 12.25% Senior Notes due 2013 using the effective interest method.

The 12.25% Senior Notes due 2013 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after March 15, 2010 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

interest thereon to the redemption date, if redeemed during the twelve months beginning March 15, of the years indicated below:

Year	Redemption Price
2010	106.125%
2011	103.063%
2012	100.000%

The 12.25% Senior Notes due 2013 contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of approximately \$11 million were capitalized and are being amortized over the term of the 12.25% Senior Notes due 2013. As a result of amortization, the capitalized debt issuance costs have been reduced to \$10 million at December 31, 2007.

**9.25% Senior Notes Due 2014**

On October 30, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, Inc. as borrower, received \$588 million of net proceeds after transaction costs, from a private offering of \$600 million aggregate principal amount of its 9.25% Senior Notes due 2014 ("9.25% Senior Notes Due 2014"). On December 13, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, Inc. as borrower, received \$661 million of net proceeds after transaction costs and accrued interest, for a second offering of \$650 million aggregate principal amount of 9.25% Senior Notes due 2014. These notes together with the \$600 million aggregate principal amount of 9.25% Senior Notes due 2014 issued on October 30, 2006 were issued under the same indenture and will be treated as a single series of notes. The Company received total net proceeds of \$1.239 billion (excluding prepaid interest).

The 9.25% Senior Notes due 2014 are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. These notes are guaranteed by Level 3 Communications, Inc. (See Note 21). The notes will mature on November 1, 2014. Interest on the 9.25% Senior Notes Due 2014 accrues at 9.25% interest per year and is payable semi-annually in cash on May 1 and November 1 beginning May 1, 2007. The \$600 million of 9.25% Senior Notes due 2014 issued on October 30, 2006 were priced at par. The \$650 million of 9.25% Senior Notes due 2014 issued on December 13, 2006 were priced at 101.75% of par plus accrued interest from October 30, 2006, representing an effective yield of 8.86% to the purchasers of these senior notes. The resulting premium of the two issuances of approximately \$11 million is reflected as an increase to long-term debt and is being amortized as a reduction to interest expense over the remaining term of the 9.25% Senior Notes due 2014 using the effective interest method. As of December 31, 2007, the premium remaining was approximately \$10 million.

A portion of the proceeds were used to redeem \$497 million of the Company's 10.75% Senior Notes Due 2008 on December 27, 2006.

The 9.25% Senior Notes Due 2014 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after November 1, 2010 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

interest thereon to the redemption date, if redeemed during the twelve months beginning November 1, of the years indicated below:

Year	Redemption Price
2010	104.625%
2011	102.313%
2012	100.000%

At any time or from time to time on or prior to November 1, 2009, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the 9.25% Senior Notes Due 2014 at a redemption price equal to 109.25% of the principal amount of those notes so redeemed, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the 9.25% Senior Notes Due 2014 would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

The 9.25% Senior Notes due 2014 contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of approximately \$23 million were capitalized and are being amortized over the term of the 9.25% senior Notes Due 2014. As a result of amortization, the capitalized debt issuance costs have been reduced to \$21 million at December 31, 2007.

**Floating Rate Senior Notes Due 2015 and 8.75% Senior Notes Due 2017**

On February 14, 2007, Level 3 Financing received \$982 million of net proceeds after transaction costs, from a private offering of \$700 million aggregate principal amount of its 8.75% Senior Notes due 2017 (the "8.75% Senior Notes") and \$300 million aggregate principal amount of its Floating Rate Senior Notes due 2015 (the "2015 Floating Rate Senior Notes"). The 8.75% Senior Notes and the 2015 Floating Rate Senior Notes are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. Level 3 Communications, Inc. and Level 3 Communications, LLC have guaranteed the 8.75% Senior Notes and the 2015 Floating Rate Senior Notes. Interest on the 8.75% Senior Notes accrues at 8.75% interest per year and is payable semi-annually in cash on February 15th and August 15th beginning August 15, 2007. The principal amount of the 8.75% Senior Notes will be due on February 15, 2017. Interest on the 2015 Floating Rate Senior Notes accrues at LIBOR plus 3.75% per annum, reset semi-annually. The interest rate was 9.15% at December 31, 2007. Interest on the 2015 Floating Rate Senior notes is payable semi-annually in cash on February 15th and August 15th beginning August 15, 2007. The principal amount of the 2015 Floating Rate Senior Notes will be due on February 15, 2015.

At any time prior to February 15, 2012, Level 3 Financing may redeem all or a part of the 8.75% Senior Notes upon not less than 30 nor more than 60 days' prior notice, at a redemption price equal to 100% of the principal amount of the 8.75% Senior Notes so redeemed plus the 8.75% Applicable

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

Premium as of, and accrued and unpaid interest thereon (if any) to, the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date).

With respect to the 8.75% Senior Notes, "8.75% Applicable Premium" means on any redemption date, the greater of (1) 1.0% of the principal amount of such 8.75% Senior Notes and (2) the excess, if any, of (a) the present value at such redemption date of (i) 104.375% of the principal amount of such 8.75% Senior Notes plus (ii) all required interest payments due on such 8.75% Senior Notes through February 15, 2012 (excluding accrued but unpaid interest to the redemption date), computed using a discount rate equal to the Treasury Rate (as defined in the indenture governing the 8.75% Senior Notes) as of such redemption date plus 50 basis points, over (b) the principal amount of such 8.75% Senior Notes.

The 8.75% Senior Notes are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after February 15, 2012 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning February 15, of the years indicated below:

Year	Redemption Price
2012	104.375%
2013	102.917%
2014	101.458%
2015	100.000%

At any time or from time to time on or prior to February 15, 2010, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the 8.75% Senior Notes at a redemption price equal to 108.75% of the principal amount of the 8.75% Senior Notes so redeemed, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the 8.75% Senior Notes would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

At any time prior to February 15, 2009, Level 3 Financing may redeem all or a part of the Floating Rate Senior Notes, upon not less than 30 nor more than 60 days' prior notice, at a redemption price equal to 100% of the principal amount of the Floating Rate Senior Notes so redeemed plus the Applicable Premium as of, and accrued and unpaid interest thereon (if any) to, the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date).

With respect to the Floating Rate Senior Notes, "Applicable Premium" means, on any redemption date, the greater of (1) 1.0% of the principal amount of such Floating Rate Senior Notes and (2) the excess, if any, of (a) the present value at such redemption date of (i) the redemption price of 102% of

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

the principal amount of such Floating Rate Senior Notes, plus (ii) all required interest payments due on such Floating Rate Senior Notes through February 15, 2009 (excluding accrued but unpaid interest to the redemption date), such interest payments to be determined in accordance with the indenture governing the Floating Rate Senior Notes assuming that LIBOR in effect on the date of the applicable redemption notice would be the applicable LIBOR in effect through February 15, 2009, computed using a discount rate equal to the Treasury Rate (as defined in the indenture governing the Floating Rate Senior Notes) as of such redemption date plus 50 basis points, over (b) the principal amount of such Floating Rate Senior Notes.

The Floating Rate Senior Notes are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after February 15, 2009 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning February 15, of the years indicated below:

Year	Redemption Price
2009	102.0%
2010	101.0%
2011	100.0%

At any time or from time to time on or prior to February 15, 2009, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the Floating Rate Senior Notes at a redemption price equal to 100.0% of the principal amount of the Floating Rate Senior Notes so redeemed, plus a premium equal to the interest rate on the Floating Rate Senior Notes applicable on the date that notice of the redemption is given, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the Floating Rate Senior Notes would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

The 8.75% Senior Notes and the 2015 Floating Rate Senior Notes contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of approximately \$16 million were capitalized and are being amortized over the term of the 8.75% Senior Notes due 2017. As a result of amortization, the capitalized debt issuance costs have been reduced to approximately \$15 million at December 31, 2007.

Debt issuance costs of approximately \$6 million were capitalized and are being amortized over the term of the Floating Rate Senior Notes due 2015. As a result of amortization, the capitalized debt issuance costs have been reduced to approximately \$5 million at December 31, 2007.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

**2.875% Convertible Senior Notes due 2010**

In July 2003, Level 3 Communications, Inc. completed the offering of \$374 million aggregate principal amount of its 2.875% Convertible Senior Notes due 2010 ("2.875% Convertible Senior Notes") in an underwritten public offering pursuant to the Company's shelf registration statement. Interest on the notes accrues at 2.875% per year and is payable semi-annually in arrears in cash on January 15 and July 15, beginning January 15, 2004. The 2.875% Convertible Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured debt. The 2.875% Convertible Senior Notes contain limited covenants, which restrict additional liens on assets of the Company.

The 2.875% Convertible Senior Notes are convertible into shares of the Company's common stock at a conversion rate of \$7.18 per share, subject to certain adjustments. On or after July 15, 2007, Level 3, at its option, may redeem for cash all or a portion of the notes. Level 3 may exercise this option only if the current market price for the Level 3 common stock for at least 20 trading days within any 30 consecutive trading day period exceeds prices ranging from 170% of the conversion price on July 15, 2007 decreasing to 150% of the conversion price on or after July 15, 2009. Level 3 would also be obligated to pay the holders of the redeemed notes a cash amount equal to the present value of all remaining scheduled interest payments.

Debt issuance costs of \$13 million were originally capitalized and are being amortized to interest expense over the term of the 2.875% Convertible Senior Notes. As a result of amortization, the capitalized debt issuance costs have been reduced to \$4 million at December 31, 2007.

**5.25% Convertible Senior Notes due 2011**

On December 2, 2004, Level 3 Communications, Inc. completed the offering of \$345 million aggregate principal amount of its 5.25% Convertible Senior Notes due 2011 ("5.25% Convertible Senior Notes") in a private offering. Interest on the notes accrues at 5.25% per year and is payable semi-annually in arrears in cash on June 15 and December 15, beginning June 15, 2005. The 5.25% Convertible Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured debt of Level 3 Communications, Inc. The 5.25% Convertible Senior Notes contain limited covenants which restrict additional liens on assets of the Company.

The 5.25% Convertible Senior Notes are convertible, at the option of the holders, into shares of the Company's common stock at a conversion rate of \$3.98 per share, subject to certain adjustments. Upon conversion, the Company will have the right to deliver cash in lieu of shares of its common stock, or a combination of cash and shares of common stock. In addition, holders of the 5.25% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount plus accrued interest and a make whole premium.

On or after December 15, 2008, Level 3, at its option, may redeem for cash all or a portion of the notes. The 5.25% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than 60 nor less than 30 days' notice,

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

on or after December 15, 2008, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning December 15, of the years indicated below:

Year	Redemption Price
2008	102.250%
2009	101.500%
2010 and thereafter	100.750%

In connection with the issuance of the notes, Level 3 used approximately \$62 million of the net proceeds of the offering to enter into convertible note hedge and warrant transactions with respect to the Company's common stock to reduce the potential dilution from conversion of the notes. Level 3 used the remainder of the net proceeds from this offering to fund repurchases of its existing debt securities due in 2008.

Under the terms of the convertible note hedge arrangement (the "Convertible Note Hedge") with Merrill Lynch International ("Merrill"), Level 3 paid \$125 million for a forward purchase option contract under which it is entitled to purchase from Merrill a fixed number of shares of Level 3 common stock (at a current price per share of \$3.98). In the event of the conversion of the notes, this forward purchase option contract allows the Company to purchase, at a fixed price equal to the implicit conversion price of shares issued under the convertible notes, a number of shares equal to the shares that Level 3 issues to a note holder upon conversion. Settlement terms of this forward purchase option allow the Company to elect cash or share settlement based on the settlement option it chooses in settling the conversion feature of the notes. The Company accounted for the Convertible Note Hedge pursuant to the guidance in EITF No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Own Stock" ("EITF No. 00-19"). Accordingly, the \$125 million purchase price of the forward stock purchase option contract was recorded as a reduction to consolidated stockholders' equity.

Level 3 also sold to Merrill a warrant (the "Warrant") to purchase shares of Level 3 common stock. The Warrant is currently exercisable for 86,596,380 shares of Level 3 common stock at a current exercise price of \$6.00 per share. Level 3 received \$63 million cash from Merrill in return for the sale of this forward share purchase option contract. Merrill cannot exercise the Warrant unless and until a conversion event occurs. Level 3 has the option of settling the Warrant in cash or shares of Level 3 common stock. The Company accounted for the sale of the Warrant as the sale of a permanent equity instrument pursuant to the guidance in EITF No. 00-19. Accordingly, the \$63 million sales price of the forward stock purchase option contract was recorded as an increase to consolidated stockholders' equity.

The Convertible Note Hedge and the Warrant economically allow Level 3 to acquire sufficient shares of common stock from Merrill to meet its obligation to deliver common stock upon conversion by the holder, unless the common stock price exceeds \$6.00. When the fair value of the Level 3 common stock exceeds such price, the contracts have an offsetting economic impact and, accordingly, will no longer be effective as a hedge of the dilutive impact of possible conversion.

Debt issuance costs of \$11 million were originally capitalized and are being amortized to interest expense over the term of the 5.25% Convertible Senior Notes. As a result of amortization, debt issuance costs were \$6 million at December 31, 2007.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

**10% Convertible Senior Notes due 2011**

In April 2005, Level 3 Communications, Inc. received \$877 million of net proceeds, after giving effect to offering expenses, from an offering of \$880 million aggregate principal amount of its 10% Convertible Senior Notes due 2011 ("10% Convertible Senior Notes") to institutional investors. Interest on the notes accrues at 10% per year and will be payable semi-annually on May 1 and November 1 beginning on November 1, 2005. The 10% Convertible Senior Notes are unsecured unsubordinated obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future unsecured unsubordinated debt of Level 3 Communications, Inc. The 10% Convertible Senior Notes contain limited covenants which restrict additional liens on assets of the Company.

In January 2007, in two separate transactions, Level 3 completed the exchange of \$605 million in aggregate principal amount of its 10% Convertible Senior Notes due 2011 for a total of 197 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to these announced exchanges are exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. The Company recognized a \$177 million loss on extinguishment of debt for the exchanges. Included in the loss was approximately \$1 million of unamortized debt issuance costs.

The remaining 10% Convertible Senior Notes will be convertible by holders at any time after January 1, 2007 (or sooner if certain corporate events occur) into shares of Level 3 common stock at a conversion price of \$3.60 per share (subject to adjustment in certain events). This is equivalent to a conversion rate of approximately 277.77 shares per \$1,000 principal amount of notes. In addition, holders of the 10% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount of the notes plus accrued interest and a make whole premium.

On or after May 1, 2009, Level 3, at its option, may redeem for cash all or a portion of the notes. The 10% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than sixty nor less than thirty days' notice, on or after May 1, 2009, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning May 1, of the years indicated below:

Year	Redemption Price
2009	103.330%
2010 and thereafter	101.670%

Debt issuance costs of \$3 million were originally capitalized and are being amortized to interest expense over the term of the 10% Convertible Senior Notes. As a result of amortization and the debt repurchase, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2007.

**3.5% Convertible Senior Notes due 2012**

On June 13, 2006 Level 3 Communications, Inc. received \$326 million of net proceeds, after giving effect to offering expenses, from a public offering of \$335 million aggregate principal amount of its 3.5% Convertible Senior Notes due 2012 ("3.5% Convertible Senior Notes"). The 3.5% Convertible Senior Notes were priced at 100% of the principal amount. The notes are senior unsecured obligations

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

of the Company, ranking equal in right of payment with all the Company's existing and future unsubordinated indebtedness. The 3.5% Convertible Senior Notes will mature on June 15, 2012. Interest on the notes is payable semi-annually in arrears on June 15 and December 15 of each year, beginning on December 15, 2006. The 3.5% Convertible Senior Notes contain limited covenants which restrict additional liens on assets of the Company.

At any time before the close of business on June 15, 2012, the 3.5% Convertible Senior Notes are convertible by holders into shares of Level 3's common stock at a conversion price of \$5.46 per share (subject to adjustment in certain events). This is equivalent to a conversion rate of approximately 183.1502 shares of common stock per \$1,000 principal amount of these notes. Upon conversion, the Company will have the right to deliver cash in lieu of shares of its common stock, or a combination of cash and shares of common stock. In addition, holders of the 3.5% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount of the notes plus accrued interest. In addition, if a holder elects to convert its notes in connection with certain changes in control, Level 3 could be required to pay a make whole premium by increasing the number of shares deliverable upon conversion of the notes.

The 3.5% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than 60 nor less than 30 days' notice, on or after June 15, 2010, plus accrued and unpaid interest thereon (if any) to the redemption date, if redeemed during the twelve months beginning June 15, of the years indicated below:

Year	Redemption Price
2010	101.17%
2011	100.58%

Level 3 used a portion of the net proceeds from this offering and its common stock offering completed in the second quarter of 2006 to redeem certain debt securities maturing in 2008. The remaining proceeds were used for acquisitions and for general corporate purposes, including working capital and capital expenditures.

Debt issuance costs of \$9 million were originally capitalized and are being amortized to interest expense over the term of the 3.5% Convertible Senior Notes. As a result of amortization, the capitalized debt issuance costs have been reduced to approximately \$7 million at December 31, 2007.

**9% Convertible Senior Discount Notes due 2013**

In October 2003, Level 3 completed the exchange of approximately \$352 million (book value) of debt and accrued interest outstanding, as of October 24, 2003, for approximately 20 million shares of Level 3 common stock and \$208 million (book value) of a new issue of 9% Convertible Senior Discount Notes due 2013.

Level 3 Communications, Inc. issued \$295 million aggregate principal amount at maturity of 9% Convertible Senior Discount Notes due 2013. Interest on the 9% Convertible Senior Discount Notes accretes at a rate of 9% per annum, compounded semiannually, to an aggregate principal amount of \$295 million by October 15, 2007. Cash interest did not accrue on the 9% Convertible Senior Discount Notes prior to October 15, 2007. Commencing October 15, 2007, interest on the 9% Convertible Senior

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

Discount Notes accrues at the rate of 9% per annum and is payable in cash semiannually in arrears. Accreted interest expense of \$20 million for the year ended December 31, 2007 on the 9% Convertible Senior Discount Notes due 2013 was added to long-term debt.

The 9% Convertible Senior Discount Notes are convertible into shares of the Company's common stock at a conversion rate of \$9.99 per share, subject to certain adjustments. The total number of shares issuable upon conversion is approximately 30 million shares. On or after October 15, 2008, Level 3, at its option, may redeem for cash all or a portion of the notes. Level 3 may exercise this option only if the current market price for at least 20 trading days within any 30 consecutive trading day period exceeds 140% of the conversion price on October 15, 2008. This amount will be decreased to 130% and 120% on October 15, 2008 and 2010, respectively, if the initial holders sell greater than 33.33% of the notes. Level 3 is also obligated to pay the holders of the redeemed notes a cash amount equal to the present value of all remaining scheduled interest payments.

The 9% Convertible Senior Discount Notes will be subject to conversion into common stock at the option of the holder, in whole or in part, at any time or from time to time after October 15, 2007 at a conversion rate of 100.09 shares per \$1,000 of face value of the debt plus accrued and unpaid interest thereon to the conversion date.

These notes are senior unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured indebtedness of Level 3 Communications, Inc.

**6% Convertible Subordinated Notes due 2009**

In September 1999, the Company received \$798 million of proceeds, after transaction costs, from an offering of \$823 million aggregate principal amount of its 6% Convertible Subordinated Notes Due 2009 ("Subordinated Notes 2009"). The Subordinated Notes 2009 are unsecured and subordinated to all existing and future senior indebtedness of the Company. Interest on the Subordinated Notes 2009 accrues at 6% per year and is payable each year in cash on March 15 and September 15. The principal amount of the Subordinated Notes 2009 will be due on September 15, 2009. The Subordinated Notes 2009 may be converted into shares of common stock of the Company at any time prior to maturity, unless previously redeemed, repurchased or the Company has caused the conversion rights to expire. The conversion rate is 15.3401 shares per each \$1,000 principal amount of Subordinated Notes 2009, subject to adjustment in certain circumstances. On or after September 15, 2002, Level 3, at its option, may cause the conversion rights to expire. Level 3 may exercise this option only if the current market price exceeds approximately \$91.27 (which represents 140% of the conversion price) for 20 trading days within any period of 30 consecutive trading days including the last day of that period. As of December 31, 2007, less than \$1 million of debt had been converted into shares of common stock. As of December 31, 2007, a total of \$461 million aggregate principal amount of the Subordinated Notes 2009 had been repurchased or exchanged for common stock.

Debt issuance costs of \$25 million were originally capitalized and are being amortized to interest expense over the term of the Subordinated Notes 2009. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to \$2 million at December 31, 2007.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

**6% Convertible Subordinated Notes due 2010**

In February 2000, Level 3 Communications, Inc. received \$836 million of net proceeds, after transaction costs, from a public offering of \$863 million aggregate principal amount of its 6% Convertible Subordinated Notes due 2010 ("Subordinated Notes 2010"). The Subordinated Notes 2010 are unsecured and subordinated to all existing and future senior indebtedness of the Company. Interest on the Subordinated Notes 2010 accrues at 6% per year and is payable semi-annually in cash on March 15 and September 15 beginning September 15, 2000. The principal amount of the Subordinated Notes 2010 will be due on March 15, 2010.

The Subordinated Notes 2010 may be converted into shares of common stock of Level 3 Communications, Inc. at any time prior to the close of business on the business day immediately preceding maturity, unless previously redeemed, repurchased or Level 3 Communications, Inc. has caused the conversion rights to expire. The conversion rate is 7.416 shares per each \$1,000 principal amount of Subordinated Notes 2010, subject to adjustment in certain events.

On or after March 18, 2003, Level 3, at its option, may cause the conversion rights to expire. Level 3 may exercise this option only if the current market price exceeds approximately \$188.78 (which represents 140% of the conversion price) for at least 20 trading days within any period of 30 consecutive trading days, including the last trading day of that period. As of December 31, 2007, no debt had been converted into shares of common stock. As of December 31, 2007, a total of \$350 million aggregate principal amount of the Subordinated Notes 2010 had been repurchased.

Debt issuance costs of \$27 million were originally capitalized and are being amortized to interest expense over the term of the Subordinated Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to \$4 million at December 31, 2007.

**Commercial Mortgage**

In the third quarter of 2005, the Company completed a refinancing of the mortgage on its corporate headquarters. On September 27, 2005, HQ Realty, Inc. entered into a \$70 million loan at an initial fixed rate of 6.86% through 2010, the anticipated repayment date as defined in the loan agreement ("CBRE Commercial Mortgage"). After 2010 through maturity in 2015, the interest rate will adjust to the greater of 9.86% or the five year U.S. Treasury rate plus 300 basis points. HQ Realty, Inc. received \$66 million of net proceeds after transaction costs and has deposited \$6 million into restricted cash accounts as of December 31, 2007 for future facility improvements and property taxes. HQ Realty, Inc. was required to make interest only payments in the first year and began making monthly principal payments in the second year based on a 30-year amortization schedule.

Debt issuance costs of \$1 million were capitalized and are being amortized as interest expense over the term of the CBRE Commercial Mortgage. As a result of amortization, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2007.

The assets of HQ Realty, Inc. are not available to satisfy any third party obligations other than those of HQ Realty, Inc. In addition, the assets of the Company and its subsidiaries other than HQ Realty, Inc. are not available to satisfy the obligations of HQ Realty, Inc.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(14) Long-Term Debt (Continued)**

**Capital Leases**

As part of the Progress Telecom transaction completed on March 20, 2006, the Company assumed certain capital lease obligations of Progress Telecom for IRU dark fiber facilities of \$9 million. The capital leases mature at various dates through 2021. As of December 31, 2007 the capital lease obligation is approximately \$8 million.

As part of the ICG Communications transaction on May 31, 2006, the Company assumed certain capital lease obligations of ICG Communications for IRU dark fiber facilities of \$3 million. The capital leases mature at various dates through 2018. As of December 31, 2007 the capital lease obligation is approximately \$3 million.

As part of the TelCove transaction completed on July 24, 2006, the Company assumed certain capital lease obligations of TelCove primarily for IRU dark fiber facilities of \$13 million. The capital leases mature at various dates through December 2030. As of December 31, 2007 the capital lease obligation is approximately \$7 million.

As part of the Broadwing transaction completed on January 3, 2007, the Company assumed certain capital lease obligations of Broadwing totaling \$24 million, related primarily to a metro fiber IRU agreement. The capital leases mature at various dates through 2022. As of December 31, 2007 the capital lease obligations is approximately \$22 million.

***Future Debt Maturities:***

The Company's contractual obligations as of December 31, 2007 related to debt, including capital leases and excluding issue discounts and fair value adjustments, will require estimated cash payments during each of the five succeeding years as follows: 2008—\$32 million; 2009—\$366 million; 2010—\$971 million, 2011—\$631 million, 2012—\$337 million and \$4,520 million thereafter.

**(15) Asset Retirement Obligations**

Asset retirement obligation accretion expense of \$28 million, \$24 million and \$13 million was recorded during the years ended December 31, 2007, 2006 and 2005, respectively; resulting in total asset retirement obligations, including reclamation costs for the coal business, of \$231 million and \$202 million at December 31, 2007 and 2006, respectively. Total asset retirement obligation as of December 31, 2007 includes \$62 million related to WilTel, ICG Communications, Looking Glass and Broadwing. The total asset retirement obligation as of December 31, 2006 included \$46 million of asset retirement obligation related to WilTel, ICG Communications and Looking Glass.

Expense of \$25 million related to the communications business was recorded in selling, general and administrative expenses on the consolidated statement of operations for the year ended December 31, 2007. In addition, expense of \$4 million related to the Company's coal mining business was recorded in cost of revenue on the consolidated statement of operations for the year ended December 31, 2007. This was partially offset by less than \$1 million of gains recognized on settlement of obligations attributable to the use of internal resources rather than third parties to perform reclamation work. In addition, the coal mining business incurred \$4 million of additional reclamation liabilities as a result of expanded mining activities and incurred \$3 million of costs for work performed to remediate previously mined properties.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(15) Asset Retirement Obligations (Continued)**

Expense of \$21 million related to the communications business was recorded in selling, general and administrative expenses on the consolidated statement of operations for the year ended December 31, 2006. In addition, expense of \$3 million related to the Company's coal mining business was recorded in cost of revenue on the consolidated statement of operations for the year ended December 31, 2006. This was partially offset by less than \$1 million of gains recognized on settlement of obligations attributable to the use of internal resources rather than third parties to perform reclamation work. In addition, the coal mining business incurred \$2 million of additional reclamation liabilities as a result of expanded mining activities and incurred \$3 million of costs for work performed to remediate previously mined properties.

Also in 2006, Level 3 recorded a reduction in depreciation expense totaling approximately \$5 million as a result of a change in the estimated future asset retirement obligation costs associated with its 50% interest in the Decker coal mine. In accordance with SFAS No. 143, Level 3 recorded the full effect of the change in estimate in the fourth quarter of 2006.

Expense of \$10 million related to the communications business was recorded in selling, general and administrative expenses on the consolidated statement of operations for the year ended December 31, 2005. In addition, expense of \$3 million related to the Company's coal mining business was recorded in cost of revenue on the consolidated statement of operations for the year ended December 31, 2005. In addition, the coal mining business incurred \$3 million of additional reclamation liabilities as a result of expanded mining activities and incurred \$2 million of costs for work performed to remediate previously mined properties.

The Company had noncurrent restricted cash of approximately \$61 million and \$59 million set aside to fund the reclamation liabilities at December 31, 2007 and 2006, respectively.

**(16) Employee Benefit Plans**

The Company adopted the recognition provisions of SFAS No. 123 in 1998. Under SFAS No. 123, the fair value of an option or other stock-based compensation (as computed in accordance with accepted option valuation models) on the date of grant was amortized over the vesting periods of the option or stock grant.

Although the recognition of the value of the instruments results in compensation expense in an entity's financial statements, the expense differs from other compensation expense in that these charges may not be settled in cash, but rather, are generally settled through issuance of common stock.

Beginning January 1, 2006, the Company adopted SFAS No. 123R. SFAS No. 123R requires that estimated forfeitures be factored in the amount of expense recognized for awards that are not fully vested. The Company has historically recorded the effect of forfeitures of equity awards as they occur. The effect of applying the change from the original provisions of SFAS No. 123 on the Company's results of operations, basic and diluted earnings per share and cash flows for the year ended December 31, 2006 was not material.

The adoption of SFAS No. 123 resulted in material non-cash charges to operations since its adoption in 1998, and the adoption of SFAS No. 123R on January 1, 2006 continues to result in material non-cash charges to operations in the future. The amount of the non-cash charges will be dependent upon a number of factors, including the number of grants, the fair value of each grant estimated at the time of its award and the number of grants that ultimately vest.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

The Company recognized in loss from continuing operations a total of \$122 million, \$84 million and \$51 million of non-cash compensation in 2007, 2006 and 2005, respectively. Included in discontinued operations is non-cash compensation expense of zero, \$2 million and \$6 million in 2007, 2006 and 2005, respectively.

The Company provides an accelerated vesting of stock awards upon retirement if an employee meets certain age and years of service requirements and certain other requirements. Under SFAS No. 123R, if an employee meets the age and years of service requirements under the accelerated vesting provision, the award would be expensed at grant or expensed over the period from the grant date to the date the employee meets the requirements, even if the employee has not actually retired. The Company recognized \$11 million of non-cash compensation expense in 2007 for employees that met the age and years of service requirements for accelerated vesting at retirement.

During the second quarter of 2006, the October 2005 and January 2006 grants of Outperform Stock Option ("OSO") units were revalued using May 15, 2006 as the grant date, in accordance with SFAS No. 123R, and resulted in an additional \$6 million in non-cash compensation expense. As stated in the Company's proxy materials for its 2006 Annual Meeting of Stockholders, over the course of the years since April 1, 1998, the compensation committee of the Company's Board of Directors had administered the 1995 Stock Plan under the belief that the action of the Company's Board of Directors to amend and restate the plan effective April 1, 1998 had the effect of extending the original term of the Plan to April 1, 2008. After a further review of the terms of the plan, however, the compensation committee determined that an ambiguity could have existed that may have resulted in an interpretation that the expiration date of the plan was September 25, 2005. To remove any ambiguity, the Board of Directors sought the approval of the Company's stockholders to amend the plan to extend the term of the plan by five years to September 25, 2010. This approval was obtained at the 2006 Annual Meeting of Stockholders held on May 15, 2006.

The following table summarizes non-cash compensation expense and capitalized non-cash compensation for each of the three years ended years ended December 31, 2007.

	2007	2006	2005
	(dollars in millions)		
OSO	\$ 35	\$ 38	\$ 18
Restricted Stock	42	20	19
Shareworks Match Plan	—	—	(2)
401(k) Match Expense	30	18	15
401(k) Discretionary Grant Plan	16	12	9
	123	88	59
Capitalized Noncash Compensation	(1)	(2)	(2)
	122	86	57
Discontinued Operations	—	(2)	(6)
	\$ 122	\$ 84	\$ 51

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

***Outperform Stock Options***

In April 1998, the Company adopted an outperform stock option ("OSO") program that was designed so that the Company's stockholders would receive a market return on their investment before OSO holders receive any return on their options. The Company believes that the OSO program directly aligns management's and stockholders' interests by basing stock option value on the Company's ability to outperform the market in general, as measured by the Standard & Poor's ("S&P") 500 Index. Participants in the OSO program do not realize any value from awards unless the Company's common stock price outperforms the S&P 500® Index during the life of the grant. When the stock price gain is greater than the corresponding gain on the S&P 500® Index (or less than the corresponding loss on the S&P 500® Index for grants awarded before September 30, 2005), the value received for awards under the OSO plan is based on a formula involving a multiplier related to the level by which the Company's common stock outperforms the S&P 500 Index. To the extent that Level 3's common stock outperforms the S&P 500 Index, the value of OSO units to a holder may exceed the value of nonqualified stock options.

The initial strike price, as determined on the day prior to the OSO grant date, is adjusted over time (the "Adjusted Strike Price"), until the exercise date. The adjustment is an amount equal to the percentage appreciation or depreciation in the value of the S&P 500® Index from the date of grant to the date of exercise. The value of the OSO increases for increasing levels of outperformance. OSO units outstanding at December 31, 2006 have a multiplier range from zero to four depending upon the performance of Level 3 common stock relative to the S&P 500® Index as shown in the following table.

<b>If Level 3 Stock Outperforms the S&amp;P 500® Index by:</b>	<b>Then the Pre-multiplier Gain Is Multiplied by a Success Multiplier of:</b>
0% or Less	0.00
More than 0% but Less than 11%	Outperformance percentage multiplied by <sup>4</sup> / 11
11% or More	4.00

The Pre-multiplier gain is the Level 3 common stock price minus the Adjusted Strike Price on the date of exercise.

Upon exercise of an OSO, the Company shall deliver or pay to the grantee the difference between the Fair Market Value of a share of Level 3 common stock as of the day prior to the exercise date, less the Adjusted Strike Price (the "Exercise Consideration"). The Exercise Consideration may be paid in cash, Level 3 common stock or any combination of cash or Level 3 common stock at the Company's discretion. The number of shares of Level 3 common stock to be delivered by the Company to the grantee is determined by dividing the Exercise Consideration to be paid in Level 3 common stock by the Fair Market Value of a share of Level 3 common stock as of the date prior to the exercise date. Fair Market Value is defined in the OSO agreement, but is currently the closing price per share of Level 3 common stock on the NASDAQ exchange. Exercise of the OSO units does not require any cash outlay by the employee.

In August 2002, the Company modified the OSO program as follows:

- OSO targets are communicated in terms of number of OSO units rather than a theoretical dollar value.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

- The success multiplier was reduced from eight to four.
- Awards vest over 2 years and have a 4-year life. Fifty percent of the award vests at the end of the first year after grant, with the remaining 50% vesting over the second year (12.5% per quarter).

The vesting terms described above apply to outstanding OSO awards issued prior to March 31, 2007. As described below, the Company subsequently modified the OSO program effective as of April 1, 2007.

As part of a comprehensive review of its long-term compensation program completed in the second quarter of 2005, the Company temporarily suspended awards of OSO units in April 2005. During the second quarter of 2005, the Company granted participants in the plan restricted stock units, discussed below. Beginning in the third quarter 2005, the Company issued both restricted stock units and OSO units as part of its long-term compensation program. In the third quarter of 2005, the Company made a grant for 2005 of restricted stock units that vest ratably over four years.

As part of a comprehensive review of its long-term compensation program completed in the first quarter of 2007, beginning with awards made on or after April 1, 2007, OSO units are now awarded monthly to employees in mid-management level and higher positions, have a three year life, will vest 100% on the third anniversary of the date of the award and will fully settle on that date. OSO units awarded beginning April 1, 2007 are valued as of the first day of each month. Recipients have no discretion on the timing to exercise OSO units granted on or after April 1, 2007, thus the expected life of all such OSO units is three years.

As a result of the long-term compensation review that was being completed, OSO units were not awarded to participants during the first quarter of 2007. During the period from April 1, 2007 to December 31, 2007, the Company awarded 4.8 million OSO units to participants.

As of December 31, 2007, the Company had not reflected \$29 million of unamortized compensation expense in its financial statements for previously granted OSO units. The weighted average period over which this cost will be recognized is 2.35 years.

The fair value of the OSO units granted is calculated by applying a modified Black-Scholes model with the assumptions identified below. The Company utilized a modified Black-Scholes model due to the additional variables required to calculate the impact of the success multiplier of the OSO program. Beginning January 1, 2006, as a result of the adoption of SFAS No. 123R, the Company also considers the estimated forfeiture rate to measure the value of outperform stock options granted to employees. The Company believes that given the relative short life of the options and the other variables used in

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

the model, the modified Black-Scholes model provides a reasonable estimate of the fair value of the OSO units at the time of grant.

	Year Ended December 31,		
	2007	2006	2005
S&P 500 Expected Dividend Yield Rate	1.78%	1.78%	1.99%
Expected Life	3 years	3.4 years	2 years
S&P 500 Expected Volatility Rate	12%	12%	13%
Level 3 Common Stock Expected Volatility Rate	55%	55%	55%
Expected S&P 500 Correlation Factor	.28	.28	.30
Calculated Theoretical Value	146%	153%	116%
Estimated Forfeiture Rate	11.88%	10.19%	—

The fair value of each OSO grant equals the calculated theoretical value multiplied by the Level 3 common stock price on the grant date.

The expected life data was stratified based on levels of responsibility within the Company. The theoretical value used in 2006 was determined using the weighted average exercise behavior for these groups of employees. As described above, recipients have no discretion on the timing to exercise OSO units granted on or after April 1, 2007, thus the expected life of all such OSO units is three years. Upon adoption of SFAS No. 123R, the Company updated its calculation of the Expected Life. Volatility assumptions were derived using historical data as well as current market data.

The fair value under SFAS No. 123 and SFAS No. 123R for the approximately 5 million, 8 million and 6 million OSO units awarded to participants during the years ended December 31, 2007, 2006 and 2005, respectively, was approximately \$32 million, \$50 million and \$18 million, respectively.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

Transactions involving OSO units awarded are summarized in the table below. The Option Price Per Unit identified in the table below represents the initial strike price, as determined on the day prior to the OSO grant date for those grants.

	Units	Initial Strike Price Per Unit	Weighted Average Initial Strike Price	Aggregate Intrinsic Value  (in millions)	Weighted Average Remaining Contractual Term
Balance December 31, 2004	21,361,522	\$2.45 - \$25.31	\$ 6.61	\$ 5.3	1.59 years
Options granted	5,859,066	2.03 - 3.39	2.61		
Options cancelled	(1,048,494)	2.03 - 25.31	3.00		
Options expired	(11,841,490)	2.59 - 25.31	8.91		
Options exercised	(84,628)	2.45 - 3.02	2.86		
Balance December 31, 2005	14,245,976	2.03 - 6.66	3.34	\$ 9.3	2.34 years
Options granted	8,092,915	2.87 - 5.39	4.49		
Options cancelled	(1,101,849)	2.03 - 6.66	3.71		
Options expired	(3,010,367)	2.03 - 6.66	3.62		
Options exercised	(2,941,180)	2.03 - 4.44	2.97		
Balance December 31, 2006	15,285,495	2.03 - 6.66	3.93	\$ 82.7	2.54 years
Options granted	4,818,069	3.03 - 6.10	5.25		
Options cancelled	(631,603)	2.03 - 6.66	5.08		
Options expired	(1,767,687)	2.03 - 6.66	5.37		
Options exercised	(1,999,717)	2.03 - 5.39	2.87		
Balance December 31, 2007	15,704,557	\$2.03 - \$ 6.10	\$ 4.27	\$ 2.4	2.04 years
Options exercisable ("vested"):					
December 31, 2005	8,453,296	\$2.59 - \$ 6.66	\$ 3.88		
December 31, 2006	7,903,200	\$2.03 - \$ 6.66	3.48		
December 31, 2007	9,821,827	\$2.03 - \$ 5.70	\$ 3.72	\$ 2.4	1.75 years

	OSO units Outstanding at December 31, 2007			OSO units Exercisable at December 31, 2007		
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Life (years)	Weighted Average Initial Strike Price	Number Exercisable	Weighted Average Initial Strike Price	
\$2.03 - \$3.03	4,410,872	1.74	\$ 2.52	4,011,439	\$ 2.47	
\$3.36 - \$4.65	4,241,373	1.82	3.97	3,025,197	3.89	
\$5.18 - \$6.10	7,052,312	2.37	5.54	2,785,191	5.31	
	15,704,557	2.04	\$ 4.27	9,821,827	\$ 3.72	

In the table above, the weighted average initial strike price represents the values used to calculate the theoretical value of OSO units on the grant date and the intrinsic value represents the value of OSO units that have outperformed the S&P 500® Index as of December 31, 2007.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

The total realized value of OSO units exercised for the years ended December 31, 2007, 2006 and 2005 was \$19 million, \$20 million and \$6 million, respectively. For the years ended December 31, 2007, 2006 and 2005, respectively, the Company issued 3.2 million, 3.8 million and 2.7 million shares of Level 3 common stock upon the exercise of OSO units. The number of shares of Level 3 stock issued upon exercise of an OSO unit varies based upon the relative performance of Level 3's stock price and the S&P 500® Index between the initial grant date and exercise date of the OSO unit.

At December 31, 2007, based on the Level 3 common stock price and post-multiplier values, the Company was obligated to issue 0.8 million shares for those vested and exercisable OSOs for which the percentage increase in the Level 3 stock price exceeded the percentage increase in the S&P 500® Index.

***Restricted Stock and Units***

Employees continue to receive restricted stock units under the revised compensation program. In 2007, 2006 and 2005, approximately 12.0 million, 5.9 million and 24.6 million restricted stock shares or restricted stock units, respectively, were awarded to certain employees and non-employee members of the Board of Directors. The restricted stock units and shares were granted to the recipients at no cost. Restrictions on transfer lapse over one to four year periods. The fair value of restricted stock units and shares awarded for the years ended December 31, 2007, 2006 and 2005 totaled \$68 million, \$27 million and \$50 million and was calculated using the value of the Level 3 common stock on the grant date and is being amortized over the restriction lapse periods of the awards. As of December 31, 2007, the total compensation cost related to nonvested restricted stock or restricted stock units not yet recognized was \$50 million, and the weighted average period over which this cost will be recognized is 2.97 years.

The changes in restricted stock and restricted stock units are shown in the following table:

	Number	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2004	980,157	\$ 4.05
Stock and units granted	24,627,233	2.03
Lapse of restrictions	(719,716)	3.80
Stock and units forfeited	(1,510,831)	2.12
Nonvested at December 31, 2005	23,376,843	2.06
Stock and units granted	5,874,765	4.65
Lapse of restrictions	(7,225,744)	2.13
Stock and units forfeited	(2,575,137)	2.45
Nonvested at December 31, 2006	19,450,727	2.76
Stock and units granted	11,992,520	5.67
Lapse of restrictions	(6,997,946)	2.71
Stock and units forfeited	(2,173,989)	4.20
Nonvested at December 31, 2007	22,271,312	\$ 4.20

The total fair value of restricted stock and restricted stock units at the date the restrictions lapsed for the years ended December 31, 2007, 2006 and 2005 was \$19 million, \$15 million and \$2 million, respectively.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

***Non-qualified Stock Options and Warrants***

The Company has not granted non-qualified stock options ("NQSOs") since 2000. As of December 31, 2007, all NQSOs previously granted were fully vested and the compensation expense had been fully recognized in the consolidated statements of operations. At December 31, 2007, there were approximately 1.1 million NQSOs outstanding with exercise prices ranging from \$1.76 to \$8.00. The weighted average exercise price of the NQSOs outstanding was \$6.86 at December 31, 2007.

Transactions involving NQSOs are summarized as follows:

	Units	Exercise Price Per Unit	Weighted Average Exercise Price	Aggregate Intrinsic Value
				(in millions)
Balance December 31, 2004	8,559,864	\$0.12 - \$21.69	\$ 5.85	Less than \$1.0
Options granted	—	—	—	
Options cancelled	(606,150)	5.43 - 8.00	6.00	
Options exercised	(61,168)	0.12 - 0.12	0.12	
Options expired	(1,746,500)	4.04 - 21.69	6.36	
Balance December 31, 2005	6,146,046	1.76 - 8.00	5.75	Less than \$1.0
Options granted	—	—	—	
Options cancelled	(553,248)	1.76 - 8.00	6.29	
Options exercised	(689,250)	4.95 - 5.43	4.97	
Options expired	—	—	—	
Balance December 31, 2006	4,903,548	1.76 - 8.00	5.79	\$1.0
Options granted	—	—	—	
Options cancelled	(229,775)	5.43 - 8.00	6.11	
Options exercised	(1,485,000)	5.43 - 5.43	5.43	
Options expired	(2,046,825)	5.43 - 6.20	5.43	
Balance December 31, 2007	1,141,948	\$1.76 - \$ 8.00	\$ 6.86	Less than \$1.0
Options exercisable:				
December 31, 2005	6,146,046	\$1.76 - \$ 8.00	\$ 5.75	
December 31, 2006	4,903,548	1.76 - 8.00	5.79	
December 31, 2007	1,141,948	\$1.76 - \$ 8.00	\$ 6.86	

Range of Exercise Prices	Number Outstanding as of December 31, 2007	Options Outstanding and Exercisable Weighted Average Remaining Life (years)	Weighted Average Exercise Price
\$1.76 - \$1.76	2,348	0.28	\$ 1.76
\$6.20 - \$8.00	1,139,600	0.06	6.87
	1,141,948	0.06	\$ 6.86

At December 31, 2007, there were approximately 15.5 million warrants outstanding ranging in exercise price from \$4.00 to \$29.00. As of December 31, 2007, all of the warrants previously granted

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

were fully vested and the compensation expense had been fully recognized in the consolidated statements of operations. Of these warrants, all were exercisable at December 31, 2007, with a weighted average exercise price of \$7.64 per warrant.

In connection with the acquisition of Broadwing, approximately 4 million previously issued Broadwing warrants were converted into approximately 5 million shares of Level 3 common stock at a weighted average exercise price of \$5.76 per share of Level 3 common stock. During the first quarter of 2007, approximately 3 million of the Broadwing warrants were exercised to purchase approximately 4 million shares of Level 3 common stock and resulted in proceeds to the Company totaling approximately \$23 million. As of December 31, 2007, approximately 700,000 Broadwing warrants remain outstanding and are convertible into approximately 1 million shares of Level 3 common stock at a weighted average exercise price of \$5.38 per share.

***401(k) Plan***

The Company and its subsidiaries offer their qualified employees the opportunity to participate in a defined contribution retirement plan qualifying under the provisions of Section 401(k) of the Internal Revenue Code ("401(k) Plan"). Each employee is eligible to contribute, on a tax deferred basis, a portion of annual earnings generally not to exceed \$15,500 in 2007. The Company matches 100% of employee contributions up to 7% of eligible earnings or applicable regulatory limits.

The Company's matching contributions are made with Level 3 common stock based on the closing stock price on each pay date. The Company's matching contributions are made through units in the Level 3 Stock Fund, which represent shares of Level 3 common stock. The Level 3 Stock Fund is the mechanism that is used for Level 3 to make employer matching and other contributions to employees through the Level 3 401(k) plan. Employees are not able to purchase units in the Level 3 Stock Fund. Employees are able to diversify the Company's matching contribution as soon as it is made, even if they are not fully vested. The Company's matching contributions will vest ratably over the first three years of service or over such shorter period until the employee has completed three years of service at such time the employee is then 100% vested in all Company matching contributions, including future contributions. The Company made 401(k) Plan matching contributions of \$30 million, \$18 million and \$14 million for the year ended December 31, 2007, 2006 and 2005, respectively. The Company's matching contributions were recorded as non-cash compensation and included in selling, general and administrative expenses.

The Company made a discretionary contribution to the 401(k) plan in Level 3 common stock for the years ended December 31, 2007, 2006 and 2005 equal to three percent of eligible employees' earnings each year. The 2007 deposit is expected to be made into the employees' 401(k) accounts during the first quarter of 2008. The 2006 and 2005 deposits were made into the employees' 401(k) accounts during the first quarter of the subsequent year. Level 3 recorded an expense of \$16 million, \$11 million and \$8 million for the discretionary contribution in 2007, 2006 and 2005, respectively.

The WilTel Communications employees began contributing to the Level 3 plan on June 17, 2006. On July 3, 2006, the WilTel Communications plan assets were merged into the Level 3 plan. Prior to June 17, 2006, employees of WilTel Communications that participated in the WilTel 401(k) Plan received an employer matching cash contribution of 100% of employee contributions up to 6% of eligible earnings or regulatory limits. The Company made matching cash contributions of \$3 million for the period from January 1 through June 16, 2006.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(16) Employee Benefit Plans (Continued)**

The Progress Telecom employees began contributing to the Level 3 plan on March 20, 2006. The Progress Telecom plan assets were merged into the Level 3 plan on August 7, 2006.

The ICG Communications employees began contributing to the Level 3 plan on July 1, 2006. There were no matching cash contributions for ICG Communications for the period May 31, 2006, the date of acquisition, through July 1, 2006. The ICG Communications plan assets were merged into the Level 3 plan on September 1, 2006.

The TelCove and Looking Glass employees began contributing to the Level 3 plan on August 4, 2006 and September 9, 2006, respectively. The matching cash contributions made to the TelCove and Looking Glass plans for the period from the respective acquisition dates to the dates employees began contributing to the Level 3 plan was less than \$1 million each for TelCove and Looking Glass. The Looking Glass plan assets were merged into the Level 3 plan on November 1, 2006. The Company merged the TelCove plan assets into the Level 3 plan on January 2, 2007.

The Broadwing employees began contributing to the Level 3 plan on March 1, 2007. There were no matching cash contributions for Broadwing for the period January 3, 2007, the date of acquisition, through March 1, 2007. The Broadwing plan assets were merged into the Level 3 plan on March 1, 2007.

The CDN Business employees began contributing to the Level 3 plan on January 23, 2007, the date of acquisition. The CDN Business did not have a separate 401(k) plan and as a result no assets will be merged into the Level 3 plan.

**(17) Income Taxes**

An analysis of the income tax benefit (provision) attributable to loss from continuing operations before income taxes for each of the years in the three year period ended December 31, 2007 follows:

	2007	2006	2005
	(dollars in millions)		
<b>Current:</b>			
United States federal	\$ —	\$ —	\$ (4)
State	(3)	—	—
Foreign	2	(2)	(1)
	(1)	(2)	(5)
<b>Deferred, net of changes in valuation allowances:</b>			
United States federal	—	—	—
State	23	—	—
Foreign	—	—	—
<b>Income tax benefit (provision)</b>	<b>\$ 22</b>	<b>\$ (2)</b>	<b>\$ (5)</b>

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(17) Income Taxes (Continued)**

The United States and foreign components of income (loss) from continuing operations before income taxes follows:

	2007	2006	2005
	<u>          </u>	<u>          </u>	<u>          </u>
	(dollars in millions)		
United States	\$ (1,016)	\$ (710)	\$ (717)
Foreign	(120)	(78)	15
	<u>          </u>	<u>          </u>	<u>          </u>
	\$ (1,136)	\$ (788)	\$ (702)
	<u>          </u>	<u>          </u>	<u>          </u>

A reconciliation of the actual income tax benefit (provision) and the tax computed by applying the U.S. federal rate (35%) to the loss from continuing operations before income taxes for each of the three years ended December 31, 2007 follows:

	2007	2006	2005
	<u>          </u>	<u>          </u>	<u>          </u>
	(dollars in millions)		
Computed tax benefit at statutory rate	\$ 397	\$ 276	\$ 246
State income tax benefit	39	26	23
Stock option plan exercises	8	3	(3)
Disallowance of losses on extinguishments of debt	(62)	(3)	—
Other	(9)	—	(11)
Change in valuation allowance	(351)	(304)	(260)
	<u>          </u>	<u>          </u>	<u>          </u>
Income tax benefit (provision)	\$ 22	\$ (2)	\$ (5)
	<u>          </u>	<u>          </u>	<u>          </u>



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(17) Income Taxes (Continued)**

The components of the net deferred tax assets (liabilities) as of December 31, 2007 and 2006 were as follows:

	2007	2006
	(dollars in millions)	
<b>Deferred Tax Assets:</b>		
Fixed assets and intangible assets	\$ 59	\$ 66
Accrued payroll and related benefits	41	26
State tax credit carry forwards	23	—
Investment in securities	25	25
Investment in joint ventures	94	88
Unutilized tax net operating loss carry forwards	3,690	2,880
Accrued liabilities and deferred revenue	11	5
Other assets or liabilities	6	190
<b>Total Deferred Tax Assets</b>	<b>3,949</b>	<b>3,280</b>
<b>Deferred Tax Liabilities:</b>		
Fixed assets and intangible assets	—	—
Accrued liabilities and deferred revenue	—	—
<b>Total Deferred Tax Liabilities</b>	<b>—</b>	<b>—</b>
<b>Net Deferred Tax Assets before valuation allowance</b>	<b>3,949</b>	<b>3,280</b>
<b>Valuation Allowance</b>	<b>(3,926)</b>	<b>(3,280)</b>
<b>Net Non-Current Deferred Tax Asset after Valuation Allowance</b>	<b>\$ 23</b>	<b>\$ —</b>

The change in the net non-current deferred tax asset after valuation allowance of \$23 million in 2007 was primarily the result of reversing \$23 million of the valuation allowance against the Company's deferred tax asset for certain state tax loss carry forwards. These state tax loss carry forwards were converted to a state tax credit carry forward associated with a change in the state's tax law that replaced the tax on net income with a tax on gross margin. The change in this state's tax law primarily occurred in the second quarter of 2007. The Company now expects it will be able to use this state tax credit carry forward against current and future state taxable gross margin.

As a result of the acquisition of Broadwing on January 3, 2007, the Company recognized an increase in deferred tax assets related to unutilized tax net operating loss carry forwards totaling \$266 million.

The Company has recast certain of the deferred tax assets and liabilities presented in the table above as of December 31, 2006 to be comparable with the presentation as of December 31, 2007. These changes are primarily reclassifications and true ups of the 2006 income tax provision to conform with the current year presentation, but also include certain corrections of prior years' income tax provisions. These changes to the Company's net deferred tax assets as of December 31, 2006 had no impact on the Company's results of operations or financial condition since a full valuation allowance was recognized for the total net deferred tax asset balance as of December 31, 2006. The following is a

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(17) Income Taxes (Continued)**

summary of the more significant changes to the presentation of deferred tax assets and liabilities as of December 31, 2006:

- Deferred tax assets and liabilities related to fixed assets and intangible assets were decreased to correct basis differences related to foreign currency exchange rates, to reclassify basis differences that had been presented in the deferred taxes for accrued liabilities and deferred revenue and other assets or liabilities, and to correct prior period tax depreciation.
- Deferred tax assets related to accrued payroll and related benefits were decreased to correct the deferred tax asset related to outstanding stock based compensation awards.
- Deferred tax assets related to unutilized tax net operating loss carry forwards were increased to reflect adjustments to the unutilized tax net operating loss carry forwards of TelCove, ICG Communications and Looking Glass based on analyses of Section 382 limitations, to true up state tax net operating loss carry forwards, and to correct net operating loss carry forwards primarily related to depreciation.
- Deferred tax liabilities related to accrued liabilities and deferred revenue decreased primarily due to the reclassifications described above and a correction of tax basis deferred revenue.
- Deferred tax assets related to other assets or liabilities increased primarily due to the reclassifications described above and certain other immaterial adjustments.

The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. A valuation allowance has been recorded against deferred tax assets, as the Company has concluded that under relevant accounting standards it is more likely than not that the deferred tax assets are not realizable.

For U.S. federal income tax reporting purposes, the Company has approximately \$9.5 billion of tax loss carry forwards at December 31, 2007, net of previous carry backs, available to offset future U.S. federal taxable income. Net operating losses not utilized can be carried forward for 20 years for U.S. federal income tax purposes to offset future taxable income.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(17) Income Taxes (Continued)**

The U.S. federal tax loss carry forwards expire through 2027 and are subject to examination by the tax authorities until three years after the carry forwards are utilized. The U.S. federal tax loss carry forwards expire as follows (dollars in millions):

Expiring December 31	Amount
2018	\$ 3
2019	—
2020	656
2021	969
2022	1,570
2023	1,399
2024	1,239
2025	1,124
2026	1,093
2027	1,477
	<hr/>
	\$ 9,530

In addition, the Company has approximately \$98 million of tax loss carry forwards for controlled foreign corporations at December 31, 2007, the majority of which have no expiration period.

The Internal Revenue Code contains provisions which may limit the net operating loss carry forwards available to be used in any given year upon the occurrence of certain events, including significant changes in ownership interests. If certain transactions occur with respect to Level 3's capital stock that result in a cumulative ownership change of more than 50 percentage points by 5-percent stockholders over a three-year period as determined under rules prescribed by the U.S. Internal Revenue Code and applicable regulations, annual limitations would be imposed with respect to our ability to utilize our net operating loss carry forwards and certain current deductions against any taxable income it achieves in future periods.

Provisions of the Internal Revenue Code also allow the Company to utilize a limited amount of the tax loss carry forwards that were generated by Broadwing, Looking Glass, TelCove, and ICG Communications prior to the Company's acquisition of these companies. Accordingly, the Company has increased its tax loss carry forwards to include these tax losses. As a result, the Company's tax loss carry forwards increased by \$953 million, which includes \$694 million related to the acquisition of Broadwing in 2007.

The majority of the Company's foreign assets and operations are owned by entities that have elected to be treated for U.S. tax purposes as unincorporated branches of a U.S. holding company and, as a result, the taxable income or loss and other tax attributes of such entities are included in the Company's U.S. federal consolidated income tax return. However, the Company has some foreign subsidiaries that have not so elected and therefore are treated for U.S. tax purposes as controlled foreign corporations. With respect to such controlled foreign corporations, as of December 31, 2007, the Company has no plans to repatriate undistributed earnings of such controlled foreign corporations as any earnings are deemed necessary to fund ongoing European operations and planned expansion. Undistributed earnings of such controlled foreign corporations that are permanently invested and for which no deferred taxes have been provided are immaterial as of December 31, 2007 and 2006.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(17) Income Taxes (Continued)**

The Company adopted the provisions of FIN No. 48 on January 1, 2007. The adoption of FIN No. 48 did not affect the Company's liability for uncertain tax positions. The Company's liability for uncertain tax positions totaled \$18 million at December 31, 2007 and January 1, 2007. During 2007, the Company increased the liability for uncertain tax positions by \$3 million for possible indemnification of certain tax liabilities related to a business disposed of prior to 2007, increased the liability for uncertain tax positions by \$3 million to reflect liabilities for uncertain tax positions related to acquired companies and decreased the liability for uncertain tax positions by \$6 million for the recognition of tax positions related to matters favorably settled during 2007. All of these amounts also include the related accrued interest and penalties associated with the uncertain tax positions if applicable. The Company does not expect the liability for uncertain tax positions will change significantly during the twelve months ended December 31, 2008; however, actual changes in the liability for uncertain tax positions could be different than currently expected.

	Amount
(dollars in millions)	
Balance as of January 1, 2007	\$ 18
Gross increases—tax positions prior to 2007	3
Gross increases—during 2007	3
Gross decreases—tax positions prior to 2007	(6)
Balance as of December 31, 2007	\$ 18

The Company, or at least one of its subsidiaries, files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 1999. The Internal Revenue Service commenced an examination of the Company's U.S. income tax returns for 1999 through 2001. The audit is currently in the appeals process and a resolution is expected to be reached in 2008. The Company does not expect that any settlement or payment that may result from the audit will have a material effect on the Company's results of operations or cash flows.

The Company recognizes accrued interest and penalties related to uncertain tax positions in income tax expense in its consolidated statements of operations. The Company's liability for uncertain tax positions includes approximately \$9 million of accrued interest and penalties at December 31, 2007.

Included in the liability for uncertain tax positions at December 31, 2007 are \$3 million of uncertain tax positions related to acquired companies, the disallowance of which would affect the valuation of the assets and or liabilities acquired and therefore would not affect the annual effective income tax rate.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(18) Stockholders' Equity**

During 2006, Level 3 completed the sale of 125 million shares of its common stock, par value \$0.01 per share, at \$4.55 per share in an underwritten public offering. Level 3 received proceeds of \$543 million net of \$26 million in transaction costs.

The Level 3 1995 Stock Plan permits option holders to tender shares to the Company to cover income taxes due on option exercises.

Issuances of common stock, for option exercises, equity offerings and acquisitions for the three year period ended December 31, 2007 are shown below.

	Outstanding Common Shares
December 31, 2004	686,496,721
Option, Restricted Stock, Shareworks and 401(k) activity (Note 16)	16,271,097
WilTel Communications Group, LLC Acquisition (Note 2)	115,000,000
December 31, 2005	817,767,818
Option, Restricted Stock and 401(k) activity (Note 16)	18,737,450
Equity offering	125,000,000
2006 Acquisitions (Note 2)	216,917,837
December 31, 2006	1,178,423,105
Option, Restricted Stock and 401(k) activity (Note 16)	22,558,511
Debt conversion to equity (Note 14)	213,939,051
2007 Acquisitions (Note 2)	122,942,018
December 31, 2007	1,537,862,685

**(19) Industry and Geographic Data**

SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information" defines operating segments as components of an enterprise for which separate financial information is available and which is evaluated regularly by the Company's chief operating decision maker, or decision making group, in deciding how to allocate resources and assess performance. Operating segments are managed separately and represent separate strategic business units that offer different products and serve different markets. The Company's current reportable segments include: communications and coal mining (See Note 1). Other primarily includes corporate assets and overhead not attributable to a specific segment. In the third quarter of 2006, the Company exited the information services business as a result of the sale of Software Spectrum. Segment information has been revised due to reclassification of the information services businesses as discontinued operations in the consolidated financial statements (See Note 3).

Effective January 1, 2007, the Company has reflected cash, cash equivalents and marketable securities in the respective segments which hold the related cash, cash equivalents and marketable securities. Prior year balances have been reclassified to conform to the current period presentation.

Adjusted EBITDA, as defined by the Company, is net income (loss) from the consolidated statements of operations before (1) gain (loss) from discontinued operations, (2) income taxes, (3) total other income (expense), (4) non-cash impairment charges included within restructuring and impairment

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(19) Industry and Geographic Data (Continued)**

charges as reported in the consolidated statements of operations, (5) depreciation and amortization and (6) non-cash stock compensation expense included within selling, general and administrative expenses on the consolidated statements of operations.

Adjusted EBITDA is not a measurement under accounting principles generally accepted in the United States and may not be used by other companies. Management believes that Adjusted EBITDA is an important part of the Company's internal reporting and is a key measure used by Management to evaluate profitability and operating performance of the Company and to make resource allocation decisions. Management believes such measures are especially important in a capital-intensive industry such as telecommunications. Management also uses Adjusted EBITDA to compare the Company's performance to that of its competitors. Management uses Adjusted EBITDA to eliminate certain non-cash and non-operating items in order to consistently measure from period to period its ability to fund capital expenditures, fund growth, service debt and determine bonuses.

Adjusted EBITDA excludes non-cash impairment charges and non-cash stock compensation expense because of the non-cash nature of these items. Adjusted EBITDA also excludes interest income, interest expense, income taxes and gain (loss) on extinguishment of debt because these items are associated with the Company's capitalization and tax structures. Adjusted EBITDA also excludes depreciation and amortization expense because these non-cash expenses reflect the impact of capital investments which management believes should be evaluated through cash flow measures. Adjusted EBITDA excludes total other income (expense) because these items are not related to the primary operations of the Company.

There are limitations to using non-GAAP financial measures, including the difficulty associated with comparing companies that use similar performance measures whose calculations may differ from the Company's calculations. Additionally, this financial measure does not include certain significant items such as interest income, interest expense, income taxes, depreciation and amortization, non-cash impairment charges, non-cash stock compensation expense, gain (loss) on early extinguishment of debt and net other income (expense). Adjusted EBITDA should not be considered a substitute for other measures of financial performance reported in accordance with GAAP.

The data presented in the following tables includes information for the twelve months ended December 31, 2007, 2006 and 2005 for all statement of operations and cash flow information presented, and as of December 31, 2007 and 2006 for all balance sheet information presented. Information related to the acquired businesses is included from their respective acquisition dates. Revenue and the related expenses are attributed to countries based on where services are provided.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(19) Industry and Geographic Data (Continued)**

Industry and geographic segment financial information follows. Certain prior year information has been reclassified to conform to the 2007 presentation.

	Communications	Coal Mining	Other	Total
	(dollars in millions)			
2007				
Revenue:				
North America	\$ 3,941	\$ 70	\$ —	\$ 4,011
Europe	258	—	—	258
	\$ 4,199	\$ 70	\$ —	\$ 4,269
Adjusted EBITDA:				
North America	\$ 758	\$ 5	\$ (4)	
Europe	65	—	—	
	\$ 823	\$ 5	\$ (4)	
Capital Expenditures:				
North America	\$ 578	\$ 2	\$ —	\$ 580
Europe	53	—	—	53
	\$ 631	\$ 2	\$ —	\$ 633
Depreciation and Amortization:				
North America	\$ 861	\$ 7	\$ —	\$ 868
Europe	74	—	—	74
	\$ 935	\$ 7	\$ —	\$ 942
	Communications	Coal Mining	Other	Total
	(dollars in millions)			
2006				
Revenue:				
North America	\$ 3,121	\$ 67	\$ —	\$ 3,188
Europe	190	—	—	190
	\$ 3,311	\$ 67	\$ —	\$ 3,378
Adjusted EBITDA:				
North America	\$ 636	\$ 8	\$ (3)	
Europe	41	—	—	
	\$ 677	\$ 8	\$ (3)	
Capital Expenditures:				
North America	\$ 346	\$ 1	\$ —	\$ 347
Europe	45	—	—	45
	\$ 391	\$ 1	\$ —	\$ 392
Depreciation and Amortization:				
North America	\$ 661	\$ 1	\$ —	\$ 662
Europe	68	—	—	68

	\$	729	\$	1	\$	—	\$	730

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**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(19) Industry and Geographic Data (Continued)**

	Communications	Coal Mining	Other	Total
	(dollars in millions)			
<b>2005</b>				
Revenue:				
North America	\$ 1,496	\$ 74	\$ —	\$ 1,570
Europe	149	—	—	149
	<u>\$ 1,645</u>	<u>\$ 74</u>	<u>\$ —</u>	<u>\$ 1,719</u>
Adjusted EBITDA:				
North America	\$ 437	\$ 16	\$ (3)	
Europe	21	—	—	
	<u>\$ 458</u>	<u>\$ 16</u>	<u>\$ (3)</u>	
Capital Expenditures:				
North America	\$ 271	\$ 2	\$ —	\$ 273
Europe	27	—	—	27
	<u>\$ 298</u>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ 300</u>
Depreciation and Amortization:				
North America	\$ 560	\$ 5	\$ —	\$ 565
Europe	82	—	—	82
	<u>\$ 642</u>	<u>\$ 5</u>	<u>\$ —</u>	<u>\$ 647</u>

	Communications	Coal Mining	Other	Total
	(dollars in millions)			
<b>Identifiable Assets</b>				
<i>December 31, 2007</i>				
North America	\$ 9,189	\$ 115	\$ 11	\$ 9,315
Europe	930	—	—	930
	<u>\$ 10,119</u>	<u>\$ 115</u>	<u>\$ 11</u>	<u>\$ 10,245</u>
<i>December 31, 2006</i>				
North America	\$ 9,043	\$ 127	\$ 18	\$ 9,188
Europe	806	—	—	806
	<u>\$ 9,849</u>	<u>\$ 127</u>	<u>\$ 18</u>	<u>\$ 9,994</u>

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(19) Industry and Geographic Data (Continued)**

	Communications	Coal Mining	Other	Total
	(dollars in millions)			
<b>Long-Lived Assets (excluding Goodwill)</b>				
<i>December 31, 2007</i>				
North America	\$ 6,702	\$ 75	\$ —	\$ 6,777
Europe	818	—	—	818
	\$ 7,520	\$ 75	\$ —	\$ 7,595
<i>December 31, 2006</i>				
North America	\$ 6,362	\$ 88	\$ —	\$ 6,450
Europe	747	—	—	747
	\$ 7,109	\$ 88	\$ —	\$ 7,197
<b>Goodwill</b>				
<i>December 31, 2007</i>				
North America	\$ 1,390	\$ —	\$ —	\$ 1,390
Europe	31	—	—	31
	\$ 1,421	\$ —	\$ —	\$ 1,421
<i>December 31, 2006</i>				
North America	\$ 408	\$ —	\$ —	\$ 408
Europe	—	—	—	—
	\$ 408	\$ —	\$ —	\$ 408

Communications revenue is grouped into three categories: 1) Core Communications Services (including transport and infrastructure services, IP and data services, voice services and Level 3 Vyvx services) 2) Other Communications Services (including managed modem and its related reciprocal compensation, DSL aggregation, and legacy managed IP services), and 3) SBC Contract Services. This revenue reporting structure reflects how the Company's management invests in the communications

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(19) Industry and Geographic Data (Continued)**

business. Management invests in supporting the growth of Core Communications Services revenue and optimizing the cash flows from the Company's declining Other and SBC Contract Services Revenue.

	Communications Services			
	Core	Other	SBC Contract Services	Total
	(dollars in millions)			
Communications Revenue				
2007				
North America	\$ 3,366	\$ 272	\$ 303	\$ 3,941
Europe	256	2	—	258
	\$ 3,622	\$ 274	\$ 303	\$ 4,199
2006				
North America	\$ 1,787	\$ 441	\$ 893	\$ 3,121
Europe	186	4	—	190
	\$ 1,973	\$ 445	\$ 893	\$ 3,311
2005				
North America	\$ 818	\$ 653	\$ 25	\$ 1,496
Europe	144	5	—	149
	\$ 962	\$ 658	\$ 25	\$ 1,645

Transport and Infrastructure includes \$7 million, \$2 million and \$130 million of termination revenue for the years ended December 31, 2007, 2006 and 2005, respectively. IP and data includes less than \$1 million, \$7 million and \$1 million of termination revenue for the years ended December 31, 2007, 2006 and 2005, respectively. SBC Contract Services includes \$2 million of termination revenue for the years ended December 31, 2007 and 2006. No termination revenue was recorded for SBC in 2005.

In the third quarter of 2006, Level 3 announced the formation of four customer-facing groups to better serve the changing needs of customers in growing markets and drive growth across the organization:

- The Wholesale Markets Group services the communications needs of large national and global service providers, including carriers, cable companies, wireless companies, and voice service providers. These customers typically integrate Level 3 services into their own products and services to offer to their end user customers. Revenue from the Wholesale Markets Group represented 56% of Core Communications revenue for the year ended December 31, 2007.
- The Business Markets Group targets enterprise customers and regional carriers who value a local, professional sales force. Specific customer markets include small, medium, and large businesses, local and regional carriers, state and local government entities, and higher education institutions. Revenue from the Business Markets Group represented 26% of Core Communications revenue for the year ended December 31, 2007.
- The Content Markets Group focuses on serving media and content companies with large and growing bandwidth needs. Customers in this market include video distribution companies,

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(19) Industry and Geographic Data (Continued)**

providers of gaming, mega-portals, software service providers, social networking providers, as well as more traditional media distribution companies such as broadcasters, television networks and sports leagues. Revenue from the Content Markets Group represented 11% of Core Communications revenue in the year ended December 31, 2007.

- The European Markets Group serves large European consumers of bandwidth, including the largest European and international carriers, large system integrators, voice service providers, cable operators, Internet service providers, content providers, and government and education sectors. Revenue from the European Markets Group represented 7% of Core Communications revenue in the year ended December 31, 2007.

The Company believes that the alignment around customer markets should allow it to drive growth while enabling it to better focus on the needs of the customers.

The majority of North American revenue consists of services delivered within the United States. The majority of European revenue consists of services delivered within the United Kingdom, France and Germany. Revenue from transoceanic services allocated to Europe.

The following information provides a reconciliation of Net Income (Loss) to Adjusted EBITDA by reportable segment, as defined by the Company, for the years ended December 31, 2007, 2006 and 2005:

**2007**

	<b>Communications</b>	<b>Coal Mining</b>	<b>Other</b>	<b>Discontinued Information Services</b>
	<u>                    </u>	<u>                    </u>	<u>                    </u>	<u>                    </u>
	(dollars in millions)			
Net Income (Loss)	\$ (1,113)	\$ (3)	\$ 2	\$ —
Income from Discontinued Operations	—	—	—	—
Income Tax Provision (Benefit)	(17)	1	(6)	—
Total Other (Income) Expense	895	—	—	—
Non-Cash Impairment Charge	1	—	—	—
Depreciation and Amortization Expense	935	7	—	—
Non-Cash Compensation Expense	122	—	—	—
	<u>                    </u>	<u>                    </u>	<u>                    </u>	<u>                    </u>
Adjusted EBITDA	\$ 823	\$ 5	\$ (4)	\$ —
	<u>                    </u>	<u>                    </u>	<u>                    </u>	<u>                    </u>

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(19) Industry and Geographic Data (Continued)**

**2006**

	Communications	Coal Mining	Other	Discontinued Information Services
	(dollars in millions)			
Net Income (Loss)	\$ (800)	\$ 7	\$ 3	\$ 46
Income from Discontinued Operations	—	—	—	(46)
Income Tax Provision (Benefit)	4	—	(2)	—
Total Other (Income) Expense	652	—	(4)	—
Non-Cash Impairment Charge	8	—	—	—
Depreciation and Amortization Expense	729	1	—	—
Non-Cash Compensation Expense	84	—	—	—
Adjusted EBITDA	\$ 677	\$ 8	\$ (3)	\$ —

**2005**

	Communications	Coal Mining	Other	Discontinued Information Services
	(dollars in millions)			
Net Income (Loss)	\$ (720)	\$ 16	\$ (3)	\$ 69
Income from Discontinued Operations	—	—	—	(69)
Income Tax Provision (Benefit)	2	2	1	—
Total Other (Income) Expense	474	(7)	(1)	—
Non-Cash Impairment Charge	9	—	—	—
Depreciation and Amortization Expense	642	5	—	—
Non-Cash Compensation Expense	51	—	—	—
Adjusted EBITDA	\$ 458	\$ 16	\$ (3)	\$ —

**(20) Commitments, Contingencies and Other Items**

***Right of Way Litigation***

In April 2002, Level 3 Communications, Inc., and two of its subsidiaries were named as defendants in *Bauer, et. al. v. Level 3 Communications, LLC, et al.*, a purported class action covering 22 states, filed in state court in Madison County, Illinois. In July 2001, Level 3 was named as a defendant in *Koyle, et. al. v. Level 3 Communications, Inc., et. al.*, a purported two state class action filed in the U.S. District Court for the District of Idaho. In November of 2005, the court granted class certification only for the state of Idaho. In September 2002, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *Smith et. al. v. Sprint Communications Company, L.P., et al.*, a purported nationwide class action filed in the United States District Court for the Northern District of Illinois. In April 2005, the Smith plaintiffs filed a Fourth Amended Complaint which did not include Level 3 or Williams Communications, Inc. as a party, thus ending both companies' involvement in the Smith case. On February 17, 2005, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *McDaniel, et. al., v. Qwest Communications Corporation, et al.*, a purported class action covering 10 states filed in the United States District Court for the Northern District of Illinois. These

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(20) Commitments, Contingencies and Other Items (Continued)**

actions involve the companies' right to install its fiber optic cable network in easements and right-of-ways crossing the plaintiffs' land. In general, the companies obtained the rights to construct their networks from railroads, utilities, and others, and have installed their networks along the rights-of-way so granted. Plaintiffs in the purported class actions assert that they are the owners of lands over which the companies' fiber optic cable networks pass, and that the railroads, utilities, and others who granted the companies the right to construct and maintain their networks did not have the legal authority to do so. The complaints seek damages on theories of trespass, unjust enrichment and slander of title and property, as well as punitive damages. The companies have also received, and may in the future receive, claims and demands related to rights-of-way issues similar to the issues in these cases that may be based on similar or different legal theories. To date, other than as noted above, all adjudicated attempts to have class action status granted on complaints filed against the companies or any of their subsidiaries involving claims and demands related to rights-of-way issues have been denied.

It is still too early for the Company to reach a conclusion as to the ultimate outcome of these actions. However, management believes that the Company and its subsidiaries have substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend them vigorously if a satisfactory form of settlement is not approved.

***Other Litigation***

The Company and its subsidiaries are parties to many other legal proceedings. Management believes that any resulting liabilities for these legal proceedings, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could affect future cash flows.

***Operating Leases***

The Company is leasing rights-of-way, facilities and other assets under various operating leases which, in addition to rental payments, may require payments for insurance, maintenance, property taxes and other executory costs related to the lease. Certain leases provide for adjustments in lease cost based upon adjustments in the consumer price index and increases in the landlord's management costs.

The right-of-way agreements have various expiration dates through 2060. Payments under these right-of-way agreements were \$90 million in 2007, \$62 million in 2006 and \$30 million in 2005.

The Company has obligations under non-cancelable operating leases for certain colocation and office facilities, including lease obligations for which facility related restructuring charges have been recorded. The lease agreements have various expiration dates through 2099. Rent expense, including common area maintenance, under non-cancelable lease agreements was \$190 million in 2007, \$132 million in 2006 and \$76 million in 2005.

For those leases involving communications colocation and right-of-way agreements, the Company anticipates that it will renew these leases under option provisions contained in the lease agreements given the significant cost to relocate the Company's network and other facilities.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(20) Commitments, Contingencies and Other Items (Continued)**

Future minimum payments for the next five years under right-of-way agreements and non-cancelable operating leases for facilities (including common area maintenance) consist of the following at December 31, 2007 (dollars in millions):

	Right-of-Way Agreements	Facilities	Total
2008	\$ 101	\$ 126	\$ 227
2009	91	105	196
2010	85	88	173
2011	80	77	157
2012	77	70	147
Thereafter	918	261	1,179
<b>Total</b>	<b>\$ 1,352</b>	<b>\$ 727</b>	<b>\$ 2,079</b>

Certain right of way agreements include provisions for increases in payments in future periods based on the rate of inflation as measured by the consumer price index. The Company has not included estimates for these increases in future periods in the amounts included above.

Certain right of way agreements are cancellable or can be terminated under certain conditions. However, in most cases cancellation or termination of the right of way agreement requires removal of the Company's network. Because the Company considers it unlikely that it would cancel or terminate its right of way agreements and remove its network, the payments due under these agreements have been included in the table above. Certain of these right of way agreements provide for automatic renewal on a periodic basis. For purposes of presenting future payment commitments under these agreements, the Company has included 18 years of future payments from January 1, 2008 in the table above.

***Other***

It is customary in Level 3's industries to use various financial instruments in the normal course of business. These instruments include items such as letters of credit. Letters of credit are conditional commitments issued on behalf of Level 3 in accordance with specified terms and conditions. As of December 31, 2007 and 2006, Level 3 had outstanding letters of credit of approximately \$36 million and \$45 million, respectively, which are collateralized by cash which is reflected on the consolidated balance sheet as restricted cash and securities. The Company does not believe it is practicable to estimate the fair value of the letters of credit and does not believe exposure to loss is likely nor material.

**(21) Condensed Consolidating Financial Information**

As discussed in Note 14, Level 3 Financing has issued senior notes as described below:

- In October 2003, Level 3 Financing issued \$500 million of 10.75% Senior Notes due 2011. The 10.75% Senior Notes were registered with the Securities and Exchange Commission in 2005. The Company repurchased \$497 million of the 10.75% notes in 2006.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

- In March 2006, Level 3 Financing issued \$150 million of Floating Rate Senior Notes due 2011 and \$250 million of 12.25% Senior Notes due 2013. The Company repurchased \$144 million of the Floating Rate Senior Notes due 2011 in 2007.
- In April 2006, Level 3 Financing issued an additional \$300 million of 12.25% Senior Notes due 2013.
- In October 2006, Level 3 Financing issued \$600 million of 9.25% Senior Notes due 2014 and in December 2006 issued an additional \$650 million of 9.25% Senior Notes due 2014.
- In February 2007, Level 3 Financing issued \$700 million of 8.75% Senior Notes due 2017 and \$300 million of Floating Rate Senior Notes due 2015.

The notes discussed above are unsecured obligations of Level 3 Financing; however, they are also jointly and severally and fully and unconditionally guaranteed on an unsecured senior basis by Level 3 Communications, Inc. and Level 3 Communications, LLC.

In addition, Level 3 Financing's 12.25% Senior Notes due 2013, Floating Rate Senior Notes due 2011 and 9.25% Senior Notes due 2014 are jointly and severally and fully and unconditionally guaranteed by Broadwing Financial Services, Inc., a wholly owned subsidiary of Level 3 Communications, Inc. As a result of this guarantee, the Company has included Broadwing Financial Services, Inc. in the condensed consolidating financial information below for the periods subsequent to the acquisition of Broadwing on January 3, 2007.

In conjunction with the registration of the 10.75% Senior Notes, Floating Rate Senior Notes due 2011, 12.25% Senior Notes due 2013, 9.25% Senior Notes due 2014, 8.75% Senior Notes due 2017 and Floating Rate Senior Notes due 2015 the accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10 "Financial statements of guarantors and affiliates whose securities collateralize an issue registered or being registered."

Condensed Consolidating Statements of Operations for the three years ended December 31, 2007, 2006 and 2005 follow. Level 3 Communications, LLC leases equipment and certain facilities from other wholly owned subsidiaries of Level 3 Communications, Inc. These transactions are eliminated in the consolidated results of the Company. The operating activities of the separate legal entities included in the Company's consolidated financial statements are interdependent. The accompanying condensed consolidating financial information presents the results of operations, financial position and cash flows of each legal entity and, on an aggregate basis, the other non-guarantor subsidiaries based on amounts incurred by such entities, and are not intended to present the operating results of those legal entities on a stand-alone basis.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

**Condensed Consolidating Statements of Operations**  
**For the year ended December 31, 2007**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
	(dollars in millions)						
Revenue	\$ —	\$ —	\$ 1,439	\$ 27	\$ 2,994	\$ (191)	\$ 4,269
Costs and Expenses:							
Cost of Revenue	—	—	553	—	1,434	(154)	1,833
Depreciation and Amortization	—	—	345	—	597	—	942
Selling, General and Administrative	3	—	1,251	27	479	(37)	1,723
Restructuring and Impairment Charges	—	—	12	—	—	—	12
Total Costs and Expenses	3	—	2,161	27	2,510	(191)	4,510
Operating Income (Loss)	(3)	—	(722)	—	484	—	(241)
Other Income (Loss), net:							
Interest Income	2	1	43	—	8	—	54
Interest Expense	(202)	(365)	(1)	(1)	(8)	—	(577)
Interest Income (Expense) Affiliates, net	781	976	(1,818)	—	61	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(1,329)	(1,934)	444	—	—	2,819	—
Other Income (Expense)	(363)	(29)	7	—	13	—	(372)
Other Income (Loss)	(1,111)	(1,351)	(1,325)	(1)	74	2,819	(895)
Income (Loss) from Continuing Operations Before Income Taxes	(1,114)	(1,351)	(2,047)	(1)	558	2,819	(1,136)
Income Tax Benefit	—	22	—	—	—	—	22
Income (Loss) from Continuing Operations	(1,114)	(1,329)	(2,047)	(1)	558	2,819	(1,114)
Income (Loss) from Discontinued Operations	—	—	—	—	—	—	—
Net Income (Loss)	\$ (1,114)	\$ (1,329)	\$ (2,047)	\$ (1)	\$ 558	\$ 2,819	\$ (1,114)

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

**Condensed Consolidating Statements of Operations**  
**For the year ended December 31, 2006**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Other Subsidiaries	Eliminations	Total
	(dollars in millions)					
Revenue	\$ —	\$ —	\$ 1,304	\$ 2,270	\$ (196)	\$ 3,378
Costs and Expenses:						
Cost of Revenue	—	—	525	1,179	(187)	1,517
Depreciation and Amortization	—	—	358	372	—	730
Selling, General and Administrative	6	—	816	445	(9)	1,258
Restructuring and Impairment Charges	—	—	9	4	—	13
Total Costs and Expenses	6	—	1,708	2,000	(196)	3,518
Operating Income (Loss)	(6)	—	(404)	270	—	(140)
Other Income (Loss), net:						
Interest Income	16	1	40	7	—	64
Interest Expense	(432)	(207)	—	(9)	—	(648)
Interest Income (Expense) Affiliates, net	860	666	(1,572)	46	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(1,209)	(1,561)	141	—	2,629	—
Other Income (Expense)	27	(108)	7	10	—	(64)
Other Income (Loss)	(738)	(1,209)	(1,384)	54	2,629	(648)
Income (Loss) from Continuing Operations Before Income Taxes	(744)	(1,209)	(1,788)	324	2,629	(788)
Income Tax (Expense) Benefit	—	—	—	(2)	—	(2)
Income (Loss) from Continuing Operations	(744)	(1,209)	(1,788)	322	2,629	(790)
Income from Discontinued Operations	—	—	—	46	—	46
Net Income (Loss)	\$ (744)	\$ (1,209)	\$ (1,788)	\$ 368	\$ 2,629	\$ (744)

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

**Condensed Consolidating Statements of Operations**  
**For the year ended December 31, 2005**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Other Subsidiaries	Eliminations	Total
	(dollars in millions)					
Revenue	\$ —	\$ —	\$ 1,457	\$ 440	\$ (178)	\$ 1,719
Costs and Expenses:						
Cost of Revenue	—	—	575	104	(163)	516
Depreciation and Amortization	—	—	444	203	—	647
Selling, General and Administrative	4	—	640	140	(15)	769
Restructuring and Impairment Charges	—	—	21	2	—	23
Total Costs and Expenses	4	—	1,680	449	(178)	1,955
Operating Income (Loss)	(4)	—	(223)	(9)	—	(236)
Other Income (Loss), net:						
Interest Income	19	1	11	4	—	35
Interest Expense	(390)	(133)	—	(7)	—	(530)
Interest Income (Expense) Affiliates, net	784	527	(1,336)	25	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(1,048)	(1,492)	(1)	—	2,541	—
Other Income (Expense)	1	—	12	16	—	29
Other Income (Loss)	(634)	(1,097)	(1,314)	38	2,541	(466)
Income (Loss) from Continuing Operations Before Income Taxes	(638)	(1,097)	(1,537)	29	2,541	(702)
Income Tax Expense	—	—	—	(5)	—	(5)
Income (Loss) from Continuing Operations	(638)	(1,097)	(1,537)	24	2,541	(707)
Income from Discontinued Operations	—	49	—	20	—	69
Net Income (Loss)	\$ (638)	\$ (1,048)	\$ (1,537)	\$ 44	\$ 2,541	\$ (638)

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

Condensed Consolidating Balance Sheets as of December 31, 2007 and 2006 follow:

**Condensed Consolidating Balance Sheets**  
**December 31, 2007**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
(dollars in millions)							
<b>Assets</b>							
Current Assets:							
Cash and cash equivalents	\$ —	\$ 27	\$ 588	\$ —	\$ 99	\$ —	\$ 714
Marketable securities	8	—	—	—	1	—	9
Restricted cash and securities	—	—	14	—	9	—	23
Accounts receivable, net	—	—	80	—	315	—	395
Due from (to) affiliates	10,575	8,549	(20,897)	20	1,753	—	—
Other	7	8	32	—	41	—	88
<b>Total Current Assets</b>	<b>10,590</b>	<b>8,584</b>	<b>(20,183)</b>	<b>20</b>	<b>2,218</b>	<b>—</b>	<b>1,229</b>
Property, Plant and Equipment, net	—	—	3,256	—	3,413	—	6,669
Restricted Cash and Securities	18	—	17	—	66	—	101
Goodwill and Other Intangibles, net	—	—	151	—	1,950	—	2,101
Investment in Subsidiaries	(6,951)	(11,270)	4,481	—	—	13,740	—
Other Assets, net	16	47	17	—	65	—	145
<b>Total Assets</b>	<b>\$ 3,673</b>	<b>\$ (2,639)</b>	<b>\$ (12,261)</b>	<b>\$ 20</b>	<b>\$ 7,712</b>	<b>\$ 13,740</b>	<b>\$ 10,245</b>
<b>Liabilities and Stockholders' Equity (Deficit)</b>							
Current Liabilities:							
Accounts payable	\$ —	\$ —	\$ 170	\$ —	\$ 226	\$ —	\$ 396
Current portion of long-term debt	25	—	—	1	6	—	32
Accrued payroll and employee benefits	—	—	88	—	9	—	97
Accrued interest	33	95	—	—	—	—	128
Deferred revenue	—	—	91	—	75	—	166
Other	—	—	42	—	97	—	139
<b>Total Current Liabilities</b>	<b>58</b>	<b>95</b>	<b>391</b>	<b>1</b>	<b>413</b>	<b>—</b>	<b>958</b>
Long-Term Debt, less current portion	2,511	4,217	—	20	84	—	6,832
Deferred Revenue	—	—	644	—	119	—	763
Other Liabilities	34	—	213	—	375	—	622
Stockholders' Equity (Deficit)	1,070	(6,951)	(13,509)	(1)	6,721	13,740	1,070
<b>Total Liabilities and Stockholders' Equity (Deficit)</b>	<b>\$ 3,673</b>	<b>\$ (2,639)</b>	<b>\$ (12,261)</b>	<b>\$ 20</b>	<b>\$ 7,712</b>	<b>\$ 13,740</b>	<b>\$ 10,245</b>

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

**Condensed Consolidating Balance Sheets**  
**December 31, 2006**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Other Subsidiaries	Eliminations	Total
	(dollars in millions)					
Assets						
Current Assets:						
Cash and cash equivalents	\$ 15	\$ 12	\$ 1,592	\$ 62	\$ —	\$ 1,681
Marketable securities	235	—	—	—	—	235
Restricted cash and securities	—	—	31	15	—	46
Accounts receivable, net	—	—	97	229	—	326
Due from (to) affiliates	11,183	6,432	(18,631)	1,016	—	—
Other	17	6	41	37	—	101
Total Current Assets	11,450	6,450	(16,870)	1,359	—	2,389
Property, Plant and Equipment, net	—	—	3,268	3,200	—	6,468
Marketable Securities	—	—	—	—	—	—
Restricted Cash and Securities	17	—	—	73	—	90
Goodwill and Other Intangibles, net	—	—	44	875	—	919
Investment in Subsidiaries	(6,419)	(10,170)	2,639	—	13,950	—
Other Assets, net	43	41	12	32	—	128
Total Assets	\$ 5,091	\$ (3,679)	\$ (10,907)	\$ 5,539	\$ 13,950	\$ 9,994
Liabilities and Stockholders' Equity (Deficit)						
Current Liabilities:						
Accounts payable	\$ —	\$ 1	\$ 160	\$ 230	\$ —	\$ 391
Current portion of long-term debt	—	—	—	5	—	5
Accrued payroll and employee benefits	—	—	59	33	—	92
Accrued interest	93	49	—	1	—	143
Deferred revenue	—	—	84	44	—	128
Other	1	2	56	97	—	156
Total Current Liabilities	94	52	359	410	—	915
Long-Term Debt, less current portion	4,581	2,688	—	88	—	7,357
Deferred Revenue	—	—	642	125	—	767
Other Liabilities	42	—	199	340	—	581
Stockholders' Equity (Deficit)	374	(6,419)	(12,107)	4,576	13,950	374
Total Liabilities and Stockholders' Equity (Deficit)	\$ 5,091	\$ (3,679)	\$ (10,907)	\$ 5,539	\$ 13,950	\$ 9,994

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

Condensed Consolidating Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005 follow:

**Condensed Consolidating Statements of Cash Flows**  
**For the year ended December 31, 2007**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Broadwing Financial Services, Inc.	Other Subsidiaries	Eliminations	Total
	(dollars in millions)						
Net Cash Provided by (Used in)							
Operating Activities	\$ (229)	\$ (306)	\$ (146)	\$ (15)	\$ 927	\$ —	\$ 231
Cash Flows from Investing Activities:							
Proceeds from sale and maturity of marketable securities	280	—	—	—	53	—	333
Decrease in restricted cash and securities, net	—	—	1	—	11	—	12
Capital expenditures	—	—	(271)	—	(362)	—	(633)
Acquisitions, net of cash acquired and investments	—	—	(893)	—	217	—	(676)
Proceeds from sale of discontinued operations	—	(2)	—	—	—	—	(2)
Proceeds from sale of property, plant and equipment and other assets	—	—	2	—	3	—	5
Net Cash Provided by (Used in) Investing Activities	280	(2)	(1,161)	—	(78)	—	(961)
Cash Flows from Financing Activities:							
Long-term debt borrowings, net of issuance costs	—	2,349	—	—	—	—	2,349
Payments on and repurchases of long-term debt, including current portion and refinancing costs	(1,619)	(887)	—	(1)	(111)	—	(2,618)
Proceeds from warrants and stock-based equity plans	26	—	—	—	—	—	26
Increase (decrease) due from affiliates, net	1,527	(1,139)	300	16	(704)	—	—
Net Cash Provided by (Used in) Financing Activities	(66)	323	300	15	(815)	—	(243)
Effect of Exchange Rates on Cash and Cash Equivalents	—	—	3	—	3	—	6
Net Change in Cash and Cash Equivalents	(15)	15	(1,004)	—	37	—	(967)
Cash and Cash Equivalents at Beginning of the Year	15	12	1,592	—	62	—	1,681
Cash and Cash Equivalents at End of the Year	\$ —	\$ 27	\$ 588	\$ —	\$ 99	\$ —	\$ 714

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

**Condensed Consolidating Statements of Cash Flows**  
**For the year ended December 31, 2006**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Other Subsidiaries	Eliminations	Total
	(dollars in millions)					
Net Cash Provided by (Used in) Operating Activities of Continuing Operations	\$ (380)	\$ (183)	\$ 62	\$ 722	\$ —	\$ 221
Cash Flows from Investing Activities:						
Proceeds from sale and maturity of marketable securities	175	5	100	—	—	280
Purchases of marketable securities	—	—	(98)	—	—	(98)
Decrease (increase) in restricted cash and securities	1	2	(10)	(14)	—	(21)
Capital expenditures	—	—	(166)	(226)	—	(392)
Investments and acquisitions	—	—	(761)	12	—	(749)
Proceeds from sale of discontinued operations, net of cash sold	—	—	—	307	—	307
Advances from discontinued operations, net	—	—	—	18	—	18
Proceeds from sale of property, plant and equipment and other assets	—	—	6	1	—	7
Net Cash Provided by (Used in) Investing Activities	176	7	(929)	98	—	(648)
Cash Flows from Financing Activities:						
Long-term debt borrowings, net of issuance costs	326	1,930	—	—	—	2,256
Payments on long-term debt, including current portion (net of restricted cash)	(513)	(596)	—	(1)	—	(1,110)
Equity offering	543			—		543
Increase (decrease) due from affiliates, net	(174)	(1,154)	2,170	(842)	—	—
Net Cash Provided by (Used in) Financing Activities	182	180	2,170	(843)	—	1,689
Net Cash Used in Discontinued Operations	—	—	—	(43)	—	(43)
Effect of Exchange Rates on Cash and Cash Equivalents	—	—	14	(4)	—	10
Net Change in Cash and Cash Equivalents	(22)	4	1,317	(70)	—	1,229
Cash and Cash Equivalents at Beginning of Year (includes cash of discontinued operations)	37	8	275	132	—	452
Cash and Cash Equivalents at End of Year	\$ 15	\$ 12	\$ 1,592	\$ 62	\$ —	\$ 1,681

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(21) Condensed Consolidating Financial Information (Continued)**

**Condensed Consolidating Statements of Cash Flows**  
**For the year ended December 31, 2005**

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC	Other Subsidiaries	Eliminations	Total
	(dollars in millions)					
Net Cash Provided by (Used in) Operating Activities of Continuing Operations	\$ (306)	\$ (128)	\$ 226	\$ 90	\$ —	\$ (118)
Cash Flows from Investing Activities:						
Proceeds from sale and maturity of marketable securities	243	—	340	1	—	584
Purchases of marketable securities	(648)	—	—	—	—	(648)
Decrease (increase) in restricted cash and securities	—	3	(6)	(1)	—	(4)
Capital expenditures	—	—	(167)	(133)	—	(300)
Investments and acquisitions	(10)	—	(497)	128	—	(379)
Proceeds from sale of discontinued operations	—	82	—	—	—	82
Advances from discontinued operations, net	—	—	—	13	—	13
Proceeds from sale of property, plant and equipment and other assets	—	—	3	8	—	11
Net Cash Provided by (Used in) Investing Activities	(415)	85	(327)	16	—	(641)
Cash Flows from Financing Activities:						
Long-term debt borrowings, net of issuance costs	877	—	—	66	—	943
Payments on long-term debt, including current portion (net of restricted cash)	—	—	(26)	(104)	—	(130)
Increase (decrease) due from affiliates, net	(121)	34	170	(83)	—	—
Net Cash Provided by (Used in) Financing Activities	756	34	144	(121)	—	813
Net Cash Used in Discontinued Operations	—	—	—	(32)	—	(32)
Effect of Exchange Rates on Cash and Cash Equivalents	(1)	—	(13)	1	—	(13)
Net Change in Cash and Cash Equivalents	34	(9)	30	(46)	—	9
Cash and Cash Equivalents at Beginning of Year (includes cash of discontinued operations)	3	17	245	178	—	443
Cash and Cash Equivalents at End of Year (includes cash of discontinued operations)	\$ 37	\$ 8	\$ 275	\$ 132	\$ —	\$ 452



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(22) Unaudited Quarterly Financial Data**

	Three Months Ended							
	March 31,		June 30,		September 30,		December 31,	
	2007	2006	2007	2006	2007	2006	2007	2006
	(dollars in millions except per share data)							
Revenue	\$ 1,056	\$ 822	\$ 1,052	\$ 835	\$ 1,061	\$ 875	\$ 1,100	\$ 846
Operating Loss	(75)	(57)	(79)	(18)	(58)	(25)	(29)	(40)
Loss from Continuing Operations	(647)	(166)	(202)	(224)	(174)	(163)	(91)	(237)
Income (loss) from Discontinued Operations	—	(2)	—	23	—	25	—	—
Net Loss	(647)	(168)	(202)	(201)	(174)	(138)	(91)	(237)
Income (Loss) per Share (Basic and Diluted):								
Loss from Continuing Operations	\$ (0.44)	\$ (0.20)	\$ (0.13)	\$ (0.25)	\$ (0.11)	\$ (0.14)	\$ (0.06)	\$ (0.20)
Income from Discontinued Operations	—	—	—	0.02	—	0.02	—	—
Net Loss	\$ (0.44)	\$ (0.20)	\$ (0.13)	\$ (0.23)	\$ (0.11)	\$ (0.12)	\$ (0.06)	\$ (0.20)

Loss per share was calculated for each three-month period on a stand-alone basis. As a result of stock transactions during the periods, the sum of the loss per share for the four quarters of each year may not equal the loss per share for the twelve month periods. As a result of the sale of Software Spectrum in 2006, certain amounts previously included in the 2006 quarterly reports on Forms 10-Q have been reclassified from continuing operations to discontinued operations.

In the first quarter of 2007, the Company purchased Broadwing and the CDN Business. The Company also recognized a \$427 million net loss on the extinguishment of various debt instruments in several transactions.

In the third quarter of 2007, the Company purchased Servecast Limited.

In the fourth quarter of 2007, the Company recognized a \$37 million gain related to the partial sale of its investment in Infinera stock and recognized a tax benefit of \$23 million related to certain changes in state income tax law that primarily occurred in the second quarter of 2007.

In the first quarter of 2006, the Company purchased Progress Telecom. The Company also recognized a \$27 million gain related to a debt exchange.

In the second quarter of 2006, the Company purchased ICG Communications. The Company also recognized a \$55 million loss on the amendment and restatement of the Company's Senior Secured term Loan due 2011.

In the third quarter of 2006, the Company purchased TelCove and Looking Glass. The Company also recognized a \$33 million gain from the sale of Software Spectrum.

In the fourth quarter of 2006, the Company recognized a \$54 million loss on the extinguishment of debt.



LEVEL 3 COMMUNICATIONS, INC.  
STATEMENT REGARDING COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES AND  
PREFERRED STOCK DIVIDENDS

	Fiscal Year Ended				
	2007	2006	2005	2004	2003
Loss from Continuing Operations Before Income Taxes	\$ (1,136)	\$ (788)	\$ (702)	\$ (477)	\$ (746)
Earnings of Equity Investees	—	—	—	—	(3)
Interest on Debt, Net of Capitalized Interest	577	648	530	485	567
Amortization of Capitalized Interest	68	68	68	68	68
Interest Expense Portion of Rental Expense	63	44	25	29	31
Earnings (Losses) Available for Fixed Charges	<u>\$ (428)</u>	<u>\$ (28)</u>	<u>\$ (79)</u>	<u>\$ 105</u>	<u>\$ (83)</u>
Interest on Debt	\$ 577	\$ 648	\$ 530	\$ 485	\$ 567
Preferred Dividends	—	—	—	—	—
Interest Expense Portion of Rental Expense	63	44	25	29	31
Total Fixed Charges	<u>\$ 640</u>	<u>\$ 692</u>	<u>\$ 555</u>	<u>\$ 514</u>	<u>\$ 598</u>
Ratio of Earnings to Fixed Charges	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Deficiency	<u>\$ (1,068)</u>	<u>\$ (720)</u>	<u>\$ (634)</u>	<u>\$ (409)</u>	<u>\$ (681)</u>

**Significant Subsidiaries**

**As of and for the Fiscal Year ending December 31, 2007**

Level 3 Communications, Inc.

Level 3 Financing, Inc.

Level 3 Communications, LLC

Broadwing Corporation

Eldorado Acquisition Three, LLC

TelCove Operations, LLC

WilTel Communications Group, LLC

WilTel Communications, LLC

BTE Equipment, LLC

Level 3 International, Inc.

Level 3 Holdings, B.V.

Level 3 Communications Limited (UK)

Level 3 Communications GmbH (Germany)

Level 3 Holdings, Inc.

KCP, Inc.

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**Consent of Independent Registered Public Accounting Firm**

The Board of Directors  
Level 3 Communications, Inc.:

We consent to the incorporation by reference in the registration statements (Nos. 333-53914, 333-91899, 333-68887, 333-71713, 333-115062, 333-123703, 333-125030, 333-125262, 333-130710, 333-132695, 333-134668, 333-136413, 333-139836, and 333-139838) on Form S-3 and the registration statements (Nos. 333-79533, 333-42465, 333-68447, 333-58691, 333-52697, 333-115472, and 333-115751) on Form S-8 of Level 3 Communications, Inc. of our reports dated February 29, 2008, with respect to the consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations, cash flows, and changes in stockholders' equity (deficit) and comprehensive loss for each of the years in the three-year period ended December 31, 2007, and the effectiveness of internal control over financial reporting as of December 31, 2007, which reports appear in the December 31, 2007 annual report on Form 10-K of Level 3 Communications, Inc.

/s/ **KPMG LLP**

Denver, Colorado  
February 29, 2008

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**CERTIFICATIONS\***

I, James Q. Crowe, certify that:

1. I have reviewed this Form 10-K of Level 3 Communications, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 29, 2008

/s/ James Q. Crowe

James Q. Crowe  
Chief Executive Officer

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\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

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**CERTIFICATIONS\***

I, Sunit S. Patel, certify that:

1. I have reviewed this Form 10-K of Level 3 Communications, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 29, 2008

/s/ Sunit S. Patel

Sunit S. Patel

Group Vice President and Chief Financial Officer

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\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14 (a) and 15d-14(a).

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Form 10-K of Level 3 Communications, Inc. (the "Company") for the year ended December 31, 2007 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I James Q. Crowe, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all materials respects, the financial condition and results of operations of the Company.

/s/ James Q. Crowe

James Q. Crowe  
Chief Executive Officer  
February 29, 2008

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**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Form 10-K of Level 3 Communications, Inc. (the “Company”) for the year ended December 31, 2007 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I Sunit S. Patel, Group Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all materials respects, the financial condition and results of operations of the Company.

/s/ Sunit S. Patel

Sunit S. Patel

Group Vice President and Chief Financial Officer

February 29, 2008

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# LEVEL 3 COMMUNICATIONS INC

## FORM 10-K (Annual Report)

Filed 3/1/2007 For Period Ending 12/31/2006

Address	1025 ELDORADO BOULEVARD BLDG 2000 BROOMFIELD, Colorado 80021
Telephone	720-888-1000
CIK	0000794323
Industry	Communications Services
Sector	Services
Fiscal Year	12/31

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549  
**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2006

OR

☐ **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: 0-15658

**Level 3 Communications, Inc.**

(Exact name of Registrant as specified in its charter)

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

**1025 Eldorado Boulevard, Broomfield, Colorado**  
(Address of principal executive offices)

**47-0210602**  
(I.R.S. Employer  
Identification No.)

**80021-8869**  
(Zip code)

**(720) 888-1000**

(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:

**Common Stock, par value \$.01 per share**

**The NASDAQ Stock Market LLC**

Securities registered pursuant to section 12(g) of the Act:

**None**

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

☒ Large accelerated filer

☐ Accelerated filer

☐ Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

As of June 30, 2006 the aggregate market value of common stock held by non-affiliates of the registrant approximated \$3.53 billion based upon the closing price of the common stock as reported on the NASDAQ Global Select Market as of the close of business on that date. Shares of common stock held by each executive officer and director and by each entity that owns 10% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Title	Outstanding
Common Stock, par value \$.01 per share	1,521,501,829 as of February 23, 2007

**DOCUMENTS INCORPORATED BY REFERENCE**

List hereunder the following documents if incorporated by reference and the Part of the Form 10-K (e.g., Part I, Part II, etc.) into which the document is incorporated: (1) Any annual report to security holders; (2) Any proxy or information statement; and (3) Any prospectus filed pursuant to Rule 424(b) or (c) under the Securities Act of 1933. The listed documents should be clearly described for identification purposes (e.g., annual report to security holders for fiscal year ended December 24, 1980).

Portions of the Company's Definitive Proxy Statement for the 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K

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*Unless the context otherwise requires, when we use the words “Level 3,” “we,” “us” or “our company” in this Form 10-K, we are referring to Level 3 Communications, Inc., a Delaware corporation, and its subsidiaries, unless it is clear from the context or expressly stated that these references are only to Level 3 Communications, Inc. References to our subsidiaries exclude Broadwing Corporation, a Delaware corporation and its subsidiaries, which we acquired on January 3, 2007. In this Form 10-K, we may refer to Broadwing Corporation and its subsidiaries as “Broadwing.” In addition, we may refer to our former subsidiary Software Spectrum, Inc. and its subsidiaries as “Software Spectrum.”*

*The Level 3 logo and Level 3 are registered service marks of Level 3 Communications, Inc. in the United States and other countries. All rights are reserved. This Form 10-K refers to trade names and trademarks of other companies. The mention of these trade names and trademarks in this Form 10-K is made with due recognition of the rights of these companies and without any intent to misappropriate those names or marks. All other trade names and trademarks appearing in this Form 10-K are the property of their respective owners.*

**Cautionary Factors That May Affect Future Results  
(Cautionary Statements Under the Private Securities Litigation Reform Act of 1995)**

This Form 10-K contains forward-looking statements and information that are based on the beliefs of our management as well as assumptions made by and information currently available to us. When we use the words “anticipate”, “believe”, “plan”, “estimate” and “expect” and similar expressions in this Form 10-K, as they relate to us or our management, we are intending to identify forward-looking statements. These statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions.

Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, our actual results may vary materially from those described in this document. These forward-looking statements include, among others, statements concerning:

- our communications business, its advantages and our strategy for continuing to pursue our business;
- anticipated development and launch of new services in our business;
- anticipated dates on which we will begin providing certain services or reach specific milestones in the development and implementation of our business strategy;
- growth and recovery of the communications industry;
- expectations as to our future revenue, margins, expenses and capital requirements; and
- other statements of expectations, beliefs, future plans and strategies, anticipated developments and other matters that are not historical facts.

These forward-looking statements are subject to risks and uncertainties, including financial, regulatory, environmental, industry growth and trend projections, that could cause actual events or results to differ materially from those expressed or implied by the statements. The most important factors that could prevent us from achieving our stated goals include, but are not limited to, our failure to:

- integrate strategic acquisitions;
- increase the volume of traffic on our network;
- defend our intellectual property and proprietary rights;
- develop new services that meet customer demands and generate acceptable margins;
- successfully complete commercial testing of new technology and information systems to support new services;
- attract and retain qualified management and other personnel; and

- meet all of the terms and conditions of our debt obligations.

Except as required by applicable law and regulations, we undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. Further disclosures that we make on related subjects in our additional filings with the SEC or Securities and Exchange Commission should be consulted. For further information regarding the risks and uncertainties that may affect our future results, please review the information set forth below under “ITEM 1A. RISK FACTORS.”

## Part I

### ITEM 1. BUSINESS

*Unless the context otherwise requires, when we use the words “Level 3,” “we,” “us” or “our company” in this Form 10-K, we are referring to Level 3 Communications, Inc., a Delaware corporation, and its subsidiaries, unless it is clear from the context or expressly stated that these references are only to Level 3 Communications, Inc. Unless we state specifically to the contrary, references to our subsidiaries excludes Broadwing Corporation, a Delaware corporation and its subsidiaries, which we acquired on January 3, 2007. In this Form 10-K, we may refer to Broadwing Corporation and its subsidiaries as “Broadwing.” Throughout this Form 10-K we use various industry terms and abbreviations, which we have defined in the Glossary of Terms at the end of this description of our business.*

Through our operating subsidiaries, we engage primarily in the communications business.

We are a facilities based provider (that is, a provider that owns or leases a substantial portion of the plant, property and equipment necessary to provide its services) of a broad range of integrated communications services. We have created our communications network generally by constructing our own assets, but also through a combination of purchasing and leasing other companies and facilities. Our network is an advanced, international, facilities based communications network. We designed our network to provide communications services, which employ and take advantage of rapidly improving underlying optical, Internet Protocol, computing and storage technologies.

*Market and Technology Opportunity.* We believe that ongoing technology advances in both optical and Internet Protocol technologies have been revolutionizing the communications industry. We also believe that these advances have, and will continue to, facilitate decreases in unit costs for communications service providers that are able to most effectively take advantage of these technology advances. Service providers that can effectively take advantage of technology improvements and reduce unit costs will be able to offer lower prices, which, we believe, will stimulate substantial increases in the demand for communications services. We believe there are two primary factors that are continuing to drive this market dynamic:

- *Rapidly Improving Technologies.* Over the past few years, both Internet Protocol or IP and optical based networking technologies have undergone extremely rapid innovation, due, in large part, to market based development of underlying technologies. This rapid technology innovation has resulted in both an improvement in price-performance for optical and Internet Protocol systems, as well as rapid improvement in the functionality and applications supported by these technologies. For example, these improvements are enabling voice over IP services or VoIP that are challenging traditional telephone network or PSTN services. We believe that this rapid innovation will continue well into the future across a number of different aspects of the communications marketplace.
- *High Demand Elasticity.* We believe decreases in communications services costs and prices cause the development of new bandwidth-intensive applications, which, over time, result in even more significant increases in bandwidth demand. In addition, we believe that communications services are direct substitutes for other, existing modes of information distribution from sources such as

traditional broadcast entertainment and distribution of software, audio and video content using physical media delivered over motor transportation systems.

We believe that as communications services improve more rapidly than these alternative content distribution systems, significant demand will be generated from these sources of information. We also believe that high elasticity of demand from both these new applications and the substitution for existing distribution systems will continue for the foreseeable future. We believe that while high demand elasticity will be manifested over time, government regulation and communications supply chain inefficiencies may cause realization of demand to be delayed.

We also believe that there are significant implications that result from this market dynamic:

- *Incorporating Technology Changes.* Given the rapid rate of improvement in optical and Internet Protocol technologies, communications service providers that are most effective at rapidly deploying new services that take advantage of these technologies will have an inherent cost and service advantage over companies that are less effective at deploying new services that use these technologies.
- *Capital Intensity.* The rapid improvements in these technologies and the need to move to new technologies more quickly results in shortened economic lives of underlying assets. To achieve improvements in service capabilities and unit cost reductions, service providers must deploy new generations of technology sooner, resulting in a more capital-intensive business model. Those providers with the technical, operational and financial ability to take advantage of the rapid advancements in these technologies are expected to have higher absolute capital requirements, shortened asset lives, rapidly decreasing unit costs and prices, rapidly increasing unit demand and higher cash flows and profits.

### **Our Communications Business Strategy**

We are seeking to capitalize on the opportunities presented by the expanded coverage of our communications network in the United States and in Europe as well as the significant and rapid advancements in optical and Internet Protocol technologies. Key elements of our strategy include:

- *Offer a Comprehensive Range of Communications Services Over Our End-to-End Network.* We provide a comprehensive range of communications services designed to meet the needs of our customers over our network. During 2006, we expanded our targeted customer base to include enterprise or business customers through our recently completed acquisitions.

Our communications service offerings include: Softswitch and voice services including wholesale VoIP component services and consumer oriented VoIP services, enterprise or business voice services, managed modem for the dial-up access business, wholesale voice termination services; Internet Protocol and data services including Internet access and IP and Ethernet Virtual Private Networks and broadband transport services such as wavelengths, dark fiber and private line services including transoceanic, backhaul, intercity, metro and unprotected private line services; content distribution services including video broadcast services; and colocation services. The availability of these services varies by location.

For several years we have been developing services that take advantage of the investment that we have made in our network and that generally target large, existing markets for communications services. We have also expanded our existing markets for communications services through our recent acquisitions that enabled us to offer services directly to enterprise or business customers. Through these efforts we have increased significantly our addressable market by adding new targeted customers as well as new voice and data services that take advantage of the geographic coverage and cost advantages of our network.

With respect to our wholesale customers, we provide these customers with several options for accessing our intercity network—including our metropolitan networks and colocation facilities. Our metropolitan networks enable us to connect directly to points of high traffic aggregation. These traffic aggregation facilities are typically locations where our customers wish to interconnect with our intercity network. Our metropolitan networks allow us to extend our network services to these aggregation points at low costs. With respect to our enterprise customers, we provide these customers with access to our network either by directly connecting to their location or by serving that location with a connection from another communications services provider. As of December 31, 2006, and after giving effect to the acquisition of Broadwing, we have:

- approximately 73,000 intercity route miles in the United States and Europe;
- connecting 16 countries;
- with approximately 125 markets having metropolitan fiber networks containing approximately 25,000 route miles in the United States and Europe; and
- connecting approximately 6,500 traffic aggregation points and buildings in the aggregate.

We believe that providing colocation services in facilities directly connected to our network attracts communications intensive customers by allowing us to offer those customers reduced bandwidth costs, rapid provisioning of additional bandwidth, interconnection with other third party networks and improved network performance. Therefore, we believe that having colocation facilities in our larger network access locations that we refer to as Gateways, provides us with a competitive advantage. Additionally, our metropolitan networks allow us to compete for certain local communications traffic, which constitutes a significant percentage of the communications market. As of December 31, 2006, after giving effect to the acquisition of Broadwing, we had secured approximately 6.9 million square feet of space for our Gateway and transmission facilities and other technical space and had completed the build-out of approximately 4.6 million square feet of this space.

- *Target Top Global Bandwidth Customers.* With respect to our wholesale services offerings, our primary distribution strategy is to use a national, direct sales force focused on high bandwidth usage businesses. These businesses include incumbent local exchange carriers, international carriers also known as PTTs, major ISPs, broadband cable television operators, wireless providers, major interexchange carriers, the U.S. government and enhanced service providers. Providing communications services to these businesses is at the core of our market enabling strategy since bandwidth generally represents a substantial portion of these businesses' costs. We identify as wholesale customers those customers that purchase significant amounts of capacity to serve the needs of their customers.
- *Further Develop Existing Enterprise Customer Business .* With respect to our business markets customers, our primary distribution strategy is to use a locally based direct sales force to target business customers, state governments, higher education institutions and academic consortia with high demands for mission critical communications services. In this category we also target regional carriers that make communications services buying decisions locally.
- *Develop Market Leading Content Distribution Service Offerings .* At December 31, 2006, we operated one of the largest Internet Protocol backbones in the world. In other words, we operate one of the largest networks over which Internet content is transported from content sources to third party owned access networks connected directly to end users. As a result of this network scale, we embarked on a strategy to refine our capabilities to address the communications needs of those organizations that produce the content that individuals want to view over the Internet. This service offering includes high speed IP services, colocation services and services that cost effectively



distribute the content that is produced for consumption over the Internet. This strategy led us to purchase the content distribution network or CDN assets of SAVVIS, Inc. in January 2007. We believe that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet. Furthermore, we believe that we are the only services provider with a single source, full portfolio of end-to-end content distribution solutions, and that we are in a unique position to offer a range of building blocks to meet these customers' needs.

- *Expand Metropolitan Network Coverage* . We expect to selectively extend the current reach of our existing metropolitan networks by opportunistically adding additional connections to buildings and other traffic aggregation points from these networks to enable us to reach additional potential customers and reduce our costs for the termination of our customer's communications traffic on other carriers' networks.
- *Pursue Acquisition Opportunities*. For a number of years, we have engaged in significant acquisition activities. In evaluating potential acquisition opportunities, among other criteria, we evaluate the potential acquisition according to the transaction's ability to generate positive cash flow from high credit quality customers. For these opportunities, we generally look for companies with recurring revenue that comes predominantly from services we already provide, in geographic areas that are already served, with customers that are consistent with our existing customer base. It is this group of acquisitions that generally also provide significant synergy opportunities as a result of overlapping network and service offerings.

As we seek to expand the addressable market for our services, we also evaluate opportunities that would expand our service capabilities. Transactions that would be included in this category would expand the geographic scope of our network or would provide capabilities for additional services or distribution channels. For these opportunities, we generally consider whether the targeted company's distribution strategy is consistent with our strategy and whether management believes that the target's current and/or future revenues can be significantly increased and/or expenses can be significantly reduced as a result of a combination with our operations. Generally these acquisition opportunities will not provide the same level of synergy opportunity that the category of acquisitions describe above provide to us.

- *Develop Advanced Operational Processes and Business Support Systems*. We have developed and continue to develop substantial and scalable operational processes and business support systems specifically designed to enable us to offer services efficiently to our targeted customers. We believe that these systems offer our customers industry leading performance standards, reduce our operating costs, give our customers direct control over some of the services they buy from us and allow us to grow rapidly while minimizing redesign of our business support systems.
- *Provide Low Cost Backbone Services Through An Upgradeable Backbone Network*. Many portions of our originally constructed intercity and metropolitan networks were designed to provide high quality communications services at a lower cost. As we continue to integrate our recently acquired operations, our network and business processes will seek to enable us to cost effectively deploy future generations of optical and IP networking components (both fiber and transmission electronics and optonics) and thereby expand capacity and reduce unit costs. In addition, our strategy is to maximize the use of open, non-proprietary interfaces in the design of our network software and hardware. This approach is intended to provide the company with the ability to purchase the most cost effective network equipment from multiple vendors and allow us to deploy new technology more rapidly and effectively.

- *Attract and Motivate High Quality Employees.* We have developed programs designed to attract and retain employees with the technical and business skills necessary for our business. The programs include our long term incentive programs.

## **Our Strengths**

We believe that the following strengths will assist us in implementing our strategy:

- *Experienced Management Team.* We have assembled a management team that we believe is well suited for our business objectives and strategy. Our senior management has substantial experience in leading the development, marketing and sale of communications services and in managing, designing and constructing metropolitan, intercity and international networks.
- *A Comprehensive Range of Communications Services.* We provide a comprehensive range of communications services designed to meet the needs of our customers over our network. During 2006, we expanded our targeted customer base to include enterprise or business customers through our recently completed acquisitions.

Our communications service offerings include: Softswitch and voice services including wholesale VoIP component services and consumer oriented VoIP services, enterprise or business voice services, wholesale voice termination services, managed modem for the dial-up access business; Internet Protocol and data services including Internet access and IP and Ethernet Virtual Private Networks and broadband transport services such as wavelengths, dark fiber and private line services including transoceanic, backhaul, intercity, metro and unprotected private line services; content distribution services including video broadcast services; and colocation services. The availability of these services varies by location.

For several years we have been developing services that take advantage of the investment that we have made in our network and that generally target large, existing markets for communications services. We have also expanded our existing markets for communications services through our recent acquisitions that enabled us to offer services directly to enterprise or business customers. Through these efforts we have increased significantly our addressable market by adding new targeted customers as well as new voice and data services that take advantage of the geographic coverage and cost advantages of our network.

- *Significant metropolitan network platform .* As of December 31, 2006, and after giving effect to the acquisition of Broadwing, we have metropolitan fiber networks in approximately 125 markets in the United States and Europe, which contain approximately 25,000 route miles and connect in the aggregate approximately 6,500 traffic aggregation points and buildings. Our metropolitan networks enable us to connect directly to points of high traffic aggregation and customer locations and reduce our costs for the termination of our customer's communications traffic on other carriers' networks.
- *End-to-End Network Platform.* Our strategy has been and continues to be to deploy network infrastructure in major metropolitan areas and to link these networks with significant intercity and trans-oceanic networks in North America and Europe. We believe that the integration of our metropolitan and intercity networks with our colocation facilities will expand the scope and reach of our on-net customer coverage, facilitate the uniform deployment of technological innovations as we manage our future upgrade paths and allow us to grow or scale our service offerings rapidly. We believe that we are the only international communications service provider with the unique combination of 1) large fiber count metropolitan networks, 2) generally uniformly deployed multi-conduit intercity networks, 3) substantial colocation facilities and 4) significant content distribution technology and services.

- *Advanced IP Backbone.* We operate one of the largest international IP networks or backbones. Our IP services deliver a broad range of IP transit and network interconnection solutions tailored to meet the varied needs of high bandwidth companies.
- *Extensive Patent Portfolio.* Through both organic growth and acquisitions, we have developed an extensive patent portfolio, consisting of approximately 800 patents and patent applications filed in the United States and around the world. Our patent portfolio includes patents filed in each of the last three decades covering technologies ranging from data and voice services to content distribution to transmission and other networking equipment. Many of our patents that cover our core technologies and service offerings are not scheduled to expire for more than ten years. While our portfolio has only been used to date from a defensive perspective to resolve claims of infringement asserted against Level 3, we are exploring appropriate ways to enforce our rights against others. We will continue to file new patent applications as we enhance and develop products and services, and we will continue to seek opportunities to expand our patent portfolio through strategic acquisitions.
- *Softswitch based Co-Carrier Network.* Our experience in operating our Softswitch based co-carrier network is combined with a set of infrastructure and other management experiences, which include extensive local interconnection with local exchange carriers, experience in scaling a Softswitch based platform, and an ability to provide seamless interconnection to the traditional telephone network or PSTN. We believe that our extensive co-carrier network and Softswitch infrastructure provides us with a competitive advantage in the emerging voice over IP or VoIP marketplace.
- *A More Readily Upgradeable Network Infrastructure.* With respect to a substantial portion of our network, the network was designed to take advantage of technological innovations, incorporating many of the features that are not present in older communication networks, and provide us flexibility to take advantage of future developments and innovations. We designed the transmission network to optimize all aspects of fiber and optronics simultaneously as a system to deliver the lowest unit cost to our customers. As fiber and optical transmission technology changes, we expect to realize new unit cost improvements by deploying the most cost efficient technologies in our network. We believe that our network design will enable us to lower costs and prices while enjoying higher margins than our competitors.

## **Our Communications Services**

### *Customer Focused Organization*

In August 2006, we realigned the customer interacting or customer facing aspects of our communications business into four groups to focus more effectively on the needs of our customers. These four groups are:

- Wholesale Markets Group
- Business Markets Group
- Content Markets Group; and
- Europe

This realignment was implemented to enable those employees in these customer facing roles to develop and deliver high quality communications services that are based on the needs of the customers that the group is seeking to serve. Each of these groups is supported by dedicated employees in sales, marketing, service or product management and operations. Each of the groups is also supported by centralized global network services, metropolitan network services, engineering, information technology, and corporate functions including legal, finance, strategy and human resources. It is through the Wholesale

Markets, Business Markets, Content Markets and Europe groups that we offer a comprehensive range of communications services.

*Wholesale Markets Group.* The Wholesale Markets Group is focused on delivering communications services to meet the high bandwidth needs of many of the largest global communications services providers on a wholesale basis. The Wholesale Markets Group's customers will integrate or package our services into their own products and services to offer voice, video and data services to their end-user customers.

The market segments that the Wholesale Markets Group addresses include:

- domestic and international carriers;
- voice service providers, which include calling card companies, conferencing providers, and contact centers that use VoIP technology to better manage costs and enable advanced applications ;
- wireless providers;
- cable television companies;
- system integrators; and
- the U.S. government.

*Business Markets Group.* The Business Markets Group is focused on delivering communications services to meet the telecommunications needs of small, medium and large enterprises as well as local and regional carriers, higher education institutions and academic consortia as well as state and local governments. Local and regional carriers include ISPs, enhanced service providers, application service providers, wireless providers, mobile virtual network operators, VoIP providers as well as datacenters and hosting facilities. The Business Markets Group focuses on providing its targeted customers with the full suite of data, Internet, transport and voice services.

*Content Markets Group.* As we believe that one of the largest sources of future incremental demand for communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet, the Content Markets Group focuses on offering a range of end-to-end communications services building blocks to meet the content distribution needs of its customers. Customers that the Content Markets Group serves include:

- video distribution companies;
- providers of online gaming and mega-portals;
- software service providers;
- social networking providers;
- traditional media distribution companies including broadcasters, television networks and sports leagues.

*Europe.* The Europe group focuses on the communications needs of European customers and the European aspects of customers located outside of Europe. The Europe group target customers are similar to the target customers of the Wholesale Markets Group and the Content Markets Group.

#### *Service Offerings*

We offer a comprehensive range of communications services, which currently include the following services. All of these services are available to customers of each of the customer facing groups, however their availability varies by location.

- *Switched Services.* We pioneered and developed the Softswitch—a distributed computer system that emulates the functions performed by traditional circuit switches—which enables us to control

and process voice and data calls over an Internet Protocol network. We also offer several traditional circuit switch-based voice services. Our Switched Services include the following.

- *Level 3 Voice Termination* . Level 3 Voice Termination consists of long distance origination, transport and termination services, offered over a combination of a circuit switch and Softswitch technologies. These services are offered primarily to inter-exchange carriers (IXCs), local phone companies, cable companies and voice over IP providers.
- *Level 3 Toll Free* . Level 3 Toll Free consists of services that terminate toll free calls that are originated or placed on the traditional telephone network. These toll free calls are carried over either a circuit switch or Softswitch network and delivered to customers in Internet Protocol or traditional TDM format. Customers for these services include call centers, conferencing providers, and voice over IP providers.
- *Level 3 International Voice Termination* . Level 3 International Voice Termination service offers the termination of international voice traffic. Customers for these services include local phone companies, wireless companies, cable companies and voice over IP providers.
- *Level 3 VoIP Enhanced Local*. Level 3 VoIP Enhanced Local is a VoIP solution that enables broadband cable operators, IXCs, voice over IP providers, and other companies operating their own switching infrastructure to launch IP-based local and long-distance voice to residential and business customers via any broadband connection. With the purchase of Level 3 VoIP Enhanced Local service, a customer obtains the essential building blocks required to offer residential or business voice over IP phone service such as local phone numbers, local number portability, local and long distance calling, E-911, operator assistance, directory listings, and directory assistance.
- *Level 3 Local Inbound* . Level 3 Local Inbound service terminates traditional telephone network originated calls to Internet Protocol termination points. Customers, such as call centers, conferencing providers, and voice over IP service providers, can obtain telephone numbers from us or port-in local telephone numbers that the customer already controls. These local calls are then converted to IP and transported over our backbone to a customer's IP voice application at a customer-selected IP voice end point.
- *Level 3 E-911 Direct*. Level 3 E-911 Direct is a portfolio of E-911, or Enhanced 911, solutions, including a fixed-location solution with network connections to public safety answering points or PSAPs that serve approximately 70 percent of all U.S. households, and a solution for nomadic voice over IP providers that takes advantage of the same network connections as the fixed-location solution. Enhanced 911 service allows an emergency services operator to automatically receive information related to a 911 caller's registered address and callback phone number. A nomadic voice over IP provider is a company that permits its end user customer to use VoIP services from more than one location. Level 3 E-911 Direct provides the network capabilities that route and complete 911 calls to appropriate selective routers and PSAPs on the traditional telephone 911 network. PSAPs are provided with calling information that allows them to query appropriate databases to determine the subscriber's registered address and callback number. When used with the services provided by a third party VoIP Positioning Center, or VPC, to collect, update and report subscriber location information, our Level 3 E-911 Direct service enables VoIP service providers to supply 911 services to their subscribers. Level 3 E-911 Direct works in conjunction with Level 3 VoIP Enhanced Local and Level 3 Local Inbound services as well as on a stand alone basis.
- *Level 3 One Plus* . Level 3 One Plus service provides non-facilities-based resellers and regional carriers with a geographically limited ability to originate calls from the PSTN, and a complete end-to-end solution for their interstate, intrastate and international traffic. This service suite

features Automatic Number Identification (ANI)-based and Carrier Identification Code (CIC)-based services as well as a dedicated end-user service.

- *Level 3 Business Lines* . The Level 3 Business Lines service provides a feature rich telephone functionality. The service offering includes a PSTN line that connects to the customer's business location from our central office facility; the telephone number, which includes associated directory listing; standard services, which include operator services, directory assistance, and 911 services; and long-distance access, which provides equal access to all long-distance carriers, including Level 3.
- *Level 3 Switched Long Distance* . The Level 3 Switched Long Distance service offers customers reliable service at competitive prices with features that meet their business needs. These features include intrastate and interstate voice service at simple, cost-effective flat rates on interstate and intrastate calls with no monthly recurring or minimum-usage charges with access to over 290 international locations.
- *Level 3 Managed Modem*. Level 3 Managed Modem is an outsourced, turn-key infrastructure solution for the management of dial up access to the public Internet. ISPs comprise a majority of the customer base for Level 3 Managed Modem and are provided a fully managed dial up network infrastructure. As part of this service, Level 3 arranges for the provision of local network coverage, dedicated local telephone numbers, racks and modems as well as dedicated connectivity from the customer's location to the Level 3 Gateway facility.
- *Network and Internet Services*. We offer both wholesale-oriented communications services to enable large scale networks and high speed access to the Internet as well as similar services designed for the enterprise marketplace. We offer a portfolio of data communications services ranging from basic network infrastructure components such as dark fiber, wavelength, and private line services to higher level routed data services such as Ethernet, Internet Transit and IP VPN. Our Network and Internet Services include the following.
  - *Transport Services*. Transport services include wavelengths (Level 3 Intercity Wavelength Services and Level 3 Metro Wavelength Services) and private lines (Level 3 Intercity Private Line Services and Level 3 Metro Services). These services are available across our metropolitan and intercity fiber network. Wavelength services provide unprotected point-to-point connections of a fixed amount of bandwidth using a particular color of light on the fiber network. Wavelength services are available at 2.5 Gbps and 10 Gbps speeds, which represent the largest capacity of dedicated transport services. This service offering targets customers that require significant amounts of bandwidth, desire more direct control and provide their own network management. Private line services are also point to point connections of dedicated bandwidth but usually include SONET or SDH protection to provide resiliency to fiber or equipment outages. We also offer private line services on an "unprotected" basis, meaning the customer is responsible for providing additional resiliency, if needed. Private line services are available in a range of speeds: DS-1 (1.5 Mbps), DS-3, OC-3, OC-12 and OC-48, as well as SDH equivalents. Customers generally use our transport services to create their own SONET/SDH, ATM and IP networks. We typically offer transport services in annual contracts with monthly payments or long-term pre-paid agreements.

Level 3 also provides transport services within our transatlantic cable system connecting North America and Europe as well as via leased bulk capacity on other transoceanic systems. "International Backhaul" transport services, interconnecting cable landing stations and the terrestrial North American and European networks, are also available.

- *High Speed Internet Protocol (IP) Service.* Level 3 operates one of the largest international Internet backbones providing connectivity among customer IP, content and application networks. Built on our own intercity and metropolitan networks in North America and Europe, we provide customers with high performance, reliability and scalability. Access to the Internet is enabled through interconnection among our customers across our network as well as interconnections with other Internet Service provider “peers.” Level 3 High Speed IP offers a wide range of Ethernet and SONET access port speeds such as 100BaseT, GigE, DS-1, DS-3, OC-3 and OC-12, OC-48 and 10 GigE.
- *Level 3 Dedicated Internet Access .* Level 3 Dedicated Internet Access service provides a high-speed Internet over a Tier One Internet backbone service through a wide variety of access methods and speeds ranging from 56 Kbps to OC-48 and Gigabit Ethernet. The service also includes Domain Name services, primary, secondary and caching and is available as either a stand-alone service or as a compliment to our other communications services.
- *Ethernet and VPN Services.* Built on our optical transport and MPLS networks, we offer customers the ability to create private point-to-point, point-to-multipoint, and full-mesh networks based on Ethernet and IP VPN, ATM and Frame Relay technologies. These services allow service providers, corporations, government entities, and distribution businesses to replace multiple networks with a single, cost-effective solution that simplifies the transmission of voice, video, and data over a single or converged network. The service allows the customer to achieve this convergence without sacrificing the quality of service or security levels of traditional dedicated transport offerings. These solutions are used for service provider and corporate data and voice networks, data center networking, disaster recovery and out-of-region or redundant customer connectivity for other service providers. These services include Level 3 Ethernet VPN, Level 3 IP VPN, Level 3 Metro Ethernet Private Line, Level 3 ATM, and Level 3 Frame Relay.
- *Colocation Service.* We offer high quality, data center space where customers can locate servers, content storage devices and communications network equipment in a safe and secure technical operating environment. At our colocation sites, we offer high-speed, reliable connectivity to our network and to other networks, including metro and intercity networks, the traditional telephone network and the Internet. Critical components of this service offering are reliable AC/DC power, emergency back-up generator power, equipment cooling and fire protection. These sites are monitored and maintained 24 hours a day and incorporate advanced security access. We believe that our ability to complement a full range of communications services with quality data center space enables customers to build complete telecommunications and application solutions with us.
- *Dark Fiber Service.* Level 3 Intercity Dark Fiber and Level 3 Metro Dark Fiber provide carriers, service providers, government entities and large enterprises a complete infrastructure when a fiber solution is required based on unique applications, control or scale requirements. The services include fiber, colocation space in our Gateway and in our network facilities, power and physical operations and maintenance of the fiber and associated infrastructure.
- *Professional Services.* With Level 3 Professional Services, we offer field technical support services 24 hours a day to companies wishing to outsource their telecommunications equipment support at locations across North America and Europe. Customers can realize improved response time and cost savings using Level 3’s personnel instead of hiring their own dedicated technicians. We also provide design, implementation and ongoing network management services for complex network projects.

- *Content Distribution.* Our Content Distribution primary products and services include the following.
  - *Content Delivery Network.* Our content delivery network service is a unique configuration of our hosting and network assets located in approximately 25 countries, which is designed to improve the performance, reliability, and reach of web applications. Our caching services provide swift delivery of media content such as graphics, video, and voice, and provide efficient downloads of software releases and security patches. Our streaming services can be used to deliver single events or libraries of video, music or animated content. Our Intelligent Traffic Management software can be used to route traffic to individual servers based on business rules or continuously monitor systems and to reroute traffic should performance bottlenecks emerge.
  - *Fiber Optic and Satellite Video Transport Services .* We offer various products to provide audio and video feeds over fiber or satellite for broadcast and production customers. These products vary in capacity provided, frequency of use (that is, may be provided on an occasional or dedicated basis) and price. In 2004, Super Bowl® XXXVIII was the first live broadcast event ever carried using our new high definition (HD) transport product.
  - *Advertising Distribution Services .* These services include the following. Audio Distribution, where we send radio spots to stations via electronic and physical distribution. Spots are distributed to over 10,500 stations in North America via the Internet using no proprietary hardware. Video Distribution, where we have the capability to deliver video content electronically and physically to television stations, broadcast networks and cable networks across the United States.
  - *Storage .* We offer secure storage of media components in our climate-controlled storage facilities located in Burbank, California, Chicago, Illinois and Newark, Delaware.

Prior to our acquisition of Broadwing in January 2007, Broadwing offered many services that were similar to our services. In addition, Broadwing offered some services that were not similar to our services. As part of our integration activities, which we have recently begun, we will evaluate Broadwing's service offering to determine which services we will continue to offer and which services we will discontinue.

For a discussion of certain geographic information regarding our revenue from external customers and long-lived assets, please see the notes to our Consolidated Financial Statements appearing elsewhere in this Form 10-K. For a discussion of our communications revenue, please also see Management's Discussion and Analysis of Financial Condition and Results of Operations appearing later in this Form 10-K. Our management continues to review our existing lines of business and service offerings to determine how those lines of business and service offerings assist with our focus on the delivery of communications services and meeting our financial objectives. This exercise takes place both with respect to integration activities and in the ordinary course of our business. To the extent that certain lines of business or service offerings are not considered to be compatible with the delivery of communications or with obtaining our financial objectives, we may exit those lines of business or stop offering those services.

### **Our communications network**

Our network is an advanced, international, facilities based communications network. Today, we primarily provide services over our own facilities. At December 31, 2006, and after giving effect to the acquisition of Broadwing, our network encompasses:

- an intercity network covering approximately 67,000 miles in North America;
- local networks in approximately 116 North American markets;



- an intercity network covering approximately 4,200 miles across Europe;
- local networks in approximately 9 European markets;
- approximately 6.9 million square feet of Gateway and transmission facilities in North America and Europe; and
- a 1.28 Tbps capable transatlantic cable system currently equipped at 640 Gbps.

*Intercity Networks.* Our approximately 67,000 mile fiber optic intercity network in North America consists of the following:

- Multiple conduits. In approximately 30,000 miles of our intercity network, we have installed groups of multiple conduits. We believe that the availability of spare conduit will allow us to deploy future technological innovations in optical networking components as well as providing us with the flexibility to offer conduit to other entities.
- Initial installation of optical fiber strands designed to accommodate dense wave division multiplexing transmission technology. In addition, we believe that the installation of newer optical fibers will allow a combination of greater wavelengths of light per strand, higher transmission speeds and longer physical spacing between network electronics. We also believe that each new generation of optical fiber will allow increases in the performance of these network design aspects and will therefore enable lower unit costs.
- High speed SONET transmission equipment employing ring protection switching and designed for high quality and reliable transmission. We expect that over time, SONET equipped networks will be transitioned to employ a “mesh” architecture made possible by advances in optical technologies. A mesh architecture allows carriers to establish alternative protection schemes that reduce the amount of capacity required to be reserved for protection purposes.
- A design that maximizes the use of open, non-proprietary hardware and software interfaces to allow less costly upgrades as hardware and software technology improves.

During the first quarter of 2001, we completed our construction activities relating to our North American intercity network. Also during 2001, we completed the migration of customer traffic from our original leased capacity network to our completed North America intercity network. Deployment of the North American intercity network was accomplished through simultaneous construction efforts in multiple locations, with different portions being completed at different times. In 2003, we added approximately 2,985 miles to our North America intercity network as part of the Genuity transaction, and in 2005, we added approximately 30,000 miles (including IRUs) to our intercity network as part of the WiTel Communications transaction. In 2006 and January 2007, we added approximately 26,000 miles (including IRUs) to our North America intercity network as part of the various acquisitions during that period, (including the Broadwing transaction which closed early in the first quarter of 2007).

In Europe, we have completed construction of our fiber optic intercity network with characteristics similar to those of the North American intercity network in a multiple ring architecture. During 2000, we completed the construction of Ring 1 and Ring 2 of our European network. Ring 1, which is approximately 1,900 miles, connects the major European cities of Paris, Frankfurt, Amsterdam, Brussels and London and was operational at December 31, 2000. Ring 2, which is approximately 1,650 miles, connects the major German cities of Berlin, Cologne, Dusseldorf, Frankfurt, Hamburg, and Munich. Ring 2 became operational during the first quarter of 2001. Subsequently, we created two additional rings generally through IRU acquisitions to connect to our expanded operations in Europe that are described below. The first ring is approximately 2,150 miles and connects Copenhagen, Stockholm and Oslo and the second ring is approximately 1,700 miles and connects Milan, Zurich and Geneva.

During 2002, we completed an expansion of our European operations to seven additional cities. Our expansion to these additional locations was facilitated through the acquisition of available capacity from other carriers in the region. During 2003, we completed an expansion of our European operations to four additional cities. In addition, during 2004, we completed an expansion of our European operations to two cities. During 2005, we completed an expansion of our European operations to one city. During 2006, we obtained dark fiber primarily in those cities currently served by leased wavelength capacity and additionally in 2006 we completed an expansion of our European operations to 9 additional cities. In 2007, we expect to continue our European expansion to 5 cities in Central and Eastern Europe by obtaining dark fiber primarily in those cities currently served by leased wavelength capacity. We expect to use the dark fiber with appropriate transmission equipment to sell a full suite of transport and IP services.

Our European network is linked to our North American intercity network by the Level 3 transatlantic 1.28 Tbps capable cable system, which was also completed and placed into service during 2000. The transatlantic cable system—which we refer to as the Yellow system—has a current capacity available to us of 640 Gbps and is upgradeable to 1.28 Tbps. The deployment of the Yellow system was completed pursuant to a co-build agreement announced in February 2000, whereby Global Crossing Ltd. participated in the construction of, and obtained a 50% ownership interest in, the Yellow system. Under the co-build agreement, Level 3 and Global Crossing Ltd. each now separately own and operate two of the four fiber pairs on the Yellow system. We also acquired additional capacity on Global Crossing Ltd.'s transatlantic cable, Atlantic Crossing 1, during 2000 to serve as redundant capacity for our fiber pairs on the Yellow system. We also own capacity in the TAT14 cable system. In connection with the WilTel acquisition, we have secured additional capacity on Global Crossing's transatlantic cable, Atlantic Crossing 1, and TAT-14. In 2006, we purchased 300 Gigabits of transatlantic capacity with the right to purchase 300 Gigabits of additional capacity from Apollo Submarine Cable System Ltd. In January 2007 we purchased 150 Gigabits of the additional capacity available from Apollo Submarine Cable System Ltd. We are also now an owner on the Japan-US, and China-US cable systems and an IRU holder on Southern Cross cable system, all by virtue of the WilTel acquisition.

*Local Market Infrastructure.* Our local facilities include fiber optic metropolitan networks connecting our intercity network and Gateway's to buildings housing communications-intensive end users and traffic aggregation points - including ILEC and CLEC central offices, long distance carrier points-of-presence or POPs cable head-ends, wireless providers' facilities and Internet peering and transit facilities. As of December 31, 2006, and after giving effect to the acquisition of Broadwing, we had in the aggregate approximately 6,500 traffic aggregation points and buildings connected to our metropolitan networks. Our high fiber count metropolitan networks allow us to extend our services directly to our customers' locations at low costs, because the availability of this network infrastructure does not require extensive multiplexing equipment to reach a customer location, which is required in ordinary fiber constrained metropolitan networks.

After giving effect to the acquisition of Broadwing, we had secured approximately 6.9 million square feet of space for our Gateway and transmission facilities as of December 31, 2006, and had completed the buildout of approximately 4.6 million square feet of this space. Our initial Gateway facilities were designed to house local sales staff, operational staff, our transmission and Internet Protocol routing and Softswitch facilities and technical space to accommodate colocation services—that is, the colocation of equipment by high-volume Level 3 customers, in an environmentally controlled, secure site with direct access to Level 3's network generally through dual, fault tolerant connections. Some of our facilities are larger than our initial facilities and were designed to include a smaller percentage of total square feet for our transmission and Internet Protocol routing/Softswitch facilities and a larger percentage of total square feet to support colocation services. Availability of these services varies by location.

As of December 31, 2006, and after giving effect to the acquisition of Broadwing, we had operational, facilities-based, local metropolitan networks in 116 U.S. markets and 9 European markets.

As of December 31, 2006, and after giving effect to the acquisition of Broadwing, we had approximately 145 markets in service in North America and approximately 32 markets in service in Europe.

## **Our Content Delivery Network**

Content Delivery Network, or CDN, describes a system of computers networked together across the Internet to provide content to users in the most efficient manner to enable an optimal user experience. In a CDN, nodes or groups of computers are deployed in multiple locations closer to the end user, also known as the “edge of the network” and cooperate with each other to satisfy requests for content by end users, transparently moving content behind the scenes to optimize the delivery process. Requests for content are directed intelligently through sophisticated software applications to nodes that are optimal for the needs of the end users, such as a specific level of performance or cost efficiency. For example, when optimizing for performance, node locations that can serve content quickly to the user may be chosen, whereas, when optimizing for cost, node locations that are less expensive to serve from may be chosen instead.

Our content delivery network is a unique configuration of our hosting and network assets located in approximately 25 countries, which is designed to improve the performance, reliability, and reach of web applications.

We believe that as a result of the combination of our recently acquired CDN assets and our existing infrastructure, we are strongly positioned to grow the Level 3 market share in the CDN business. This belief is based on several factors.

- *Network Scale.* Because we own our own network, our ability to increase capacity to meet the needs of content providers is greater than other CDN providers who do not have the flexibility to quickly increase their available network capacity.
- *Network Reach .* Our customers reach global Internet destinations using an average number of “hops” that are fewer than with most any other provider, enabling our customers to easily reach their audiences and provide better performance. The fewer number of hops required by our customers to reach their Internet destinations serves to reduce latency and jitter.
- *Low Cost Position .* Because we own the underlying network infrastructure, we believe that we are positioned to offer cost advantages to our customers. By moving content at scale, our customers can take advantage of lower unit costs for bandwidth, colocation, servers and disk space.

### *CDN Applications*

There are an increasing number of applications for CDN, across many types of customers, particularly Internet-centric businesses and businesses that desire to accommodate increasingly larger file sizes for transmission over the Internet. Social Networking businesses require CDN to provide their customers with fast reliable music and video downloads. Likewise, through the use of CDN, software companies are able to provide software downloads for their customers. Online retailers and advertisers use CDN services to provide images and flash files and to download advertisements. The media and entertainment industries use CDN services to provide on-demand streaming and live streaming. Online gaming companies provide for game downloads, applications updates and delivery of demos and trailers through CDN.

### *Content Distribution Services Architecture*

The CDN platform uses our existing physical network and infrastructure, and is composed of the Edge server or computer, which provides caching and streaming functions and the Global server, which provides load balancing—that is, a computer that directs the traffic to the most efficient server to meet the end users request. The Edge server enables the storage of popular content in a location that is closer to the end

user and thereby reduces bandwidth requirements and improves client response times for content stored in the cache. The Global server or computer load balancing components of the CDN directs end user requests to the content source that is best able to serve the request of the particular end user, such as routing to the service noted that is closest to the end user or to the one with the most capacity, depending on the particular need of the end user.

We also transmit audio and video programming for our customers over our fiber-optic network and via satellite. We use our network to carry many live traditional broadcast and cable television events from the site of the event to the network control centers of the broadcasters of the event. These events include live sporting events of the major professional sports leagues. For live events where the location is not known in advance, such as breaking news stories in remote locations, we provide an integrated satellite and fiber-optic network based service to transmit the content to our customers. Most of our customers for these services contract for the service on an event-by-event basis; however, we have some customers who have purchased a dedicated point-to-point service, which enables these customers to transmit programming at any time.

We also distribute advertising spots to radio and television stations throughout the United States, both electronically and in physical form. Customers for these services can utilize a network-based method for aggregating, managing, storing and distributing content for content owners and rights holders.

### **Distribution Strategy**

Our communications services sales strategy with respect to our Wholesale Markets Group and Europe is to utilize a direct sales force focused on companies with high bandwidth and/or voice requirements. These businesses include incumbent local exchange carriers, established next generation carriers, international carriers also known as PTTs, major ISPs, broadband cable television operators, major interexchange carriers, wireless carriers, systems integrators, governments, emerging VoIP service providers, calling card providers, conferencing providers and call centers.

With respect to our Business Markets Group, medium to large enterprises will be serviced by a Major Markets Sales Force or a direct sales force. Smaller business opportunities will be serviced by the Small Business Sales Channel and will generally offer pre-defined bundles of services.

Our communications services sales strategy with respect to the Content Markets Group is also to utilize a direct sales force. Targeted customers include video distribution companies; providers of online gaming and mega-portals; software service providers; social networking providers; and traditional media distribution companies including broadcasters, television networks and sports leagues.

We have in place policies and procedures to review the financial condition of potential and existing customers. We apply these procedures to determine whether collectibility is probable prior to the time that we begin delivering services to a customer. If the financial condition of an existing customer deteriorates to a point where payment for services is in doubt, we will not recognize revenue attributable to that customer until we receive cash. Based on these policies and procedures, we believe our exposure to collection risk within the communications business and the possible effect on our financial statements is limited. We are not immune from the effects of possible downturns in the economy and specifically the telecommunications industry; however, we believe the concentration of credit risk with respect to receivables is mitigated due to the dispersion of our customer base among geographic areas and remedies provided by terms of contracts and statutes.

For the year ended December 31, 2006, our top ten customers represented approximately 54% of our consolidated total revenue. Revenue from our largest customer, AT&T Inc. and its subsidiaries, including SBC Communications, BellSouth and Cingular, (assuming those subsidiaries were wholly owned by AT&T for all of 2006), represented approximately 32.4% of our consolidated total revenue for 2006. The next

largest customer accounted for approximately 6.6% of our consolidated total revenue and most of the remaining top ten customers each account for 2% or less of our consolidated total revenue.

In connection with the acquisition of WilTel in December 2005, we acquired a large customer contract between WilTel and SBC Communications, a subsidiary of AT&T. We expect that the revenue generated under this contract will continue to decline over time as SBC Communications migrates its traffic from our network to the merged SBC and AT&T Communications network that SBC Communications acquired from the former AT&T.

### **Business Support Systems**

In order to pursue our sales and distribution strategies, we have developed and are continuing to develop and implement a set of integrated software applications designed to automate our operational processes. Through the development of a robust, scalable business support system, we believe that we have the opportunity to develop a competitive advantage relative to traditional telecommunications companies. In addition, we recognize that for the success of certain of our services that some of our business support systems will need to be easily accessible and usable directly by our customers.

Key design aspects of the business support system development program are:

- integrated modular applications to allow us to upgrade specific applications as new services are available;
- a scalable architecture that allows our customers and distributors direct access to certain functions that would otherwise have to be performed by our employees;
- phased completion of software releases designed to allow us to test functionality on an incremental basis;
- “web-enabled” applications so that on-line access to order entry, network operations, billing, and customer care functions is available to all authorized users, including our customers;
- use of a tiered, client/server architecture that is designed to separate data and applications, and is expected to enable continued improvement of software functionality at minimum cost; and
- use of pre-developed or “shrink wrapped” applications, where applicable, which will interface to our internally developed applications.

### **Our Employees**

As of December 31, 2006, and after giving effect to the acquisition of Broadwing, we had approximately 7,400 employees. We believe that our success depends in large part on our ability to attract and retain substantial numbers of qualified employees.

## Competition

The communications industry is highly competitive. A number of factors in recent years have increased the number of competitors in the market. First, the Telecommunications Act of 1996 created opportunities for non-incumbent providers to enter the marketplace. Second, the capital markets responded by making funding more available to new and existing competitors. Third, enthusiasm over the opportunities created by the rapid developments of the Internet led investors and market participants in general to overestimate the rate at which demand for communications services would grow. Finally, the emergence of new IP-based services has created prospects for new entrants with non-traditional business models to compete with legacy providers.

We believe that a confluence of these factors created an unsustainable level of competition in the market. We believe that this was evidenced by both the number of competitors vying for similar business and by the amount of inventory or capacity each brought to the market for many services. The result of these actions was an oversupply of capacity and an intensely competitive environment.

While we believe the current industry structure has improved significantly, we believe that further restructuring is likely. With the growth of communications demand, excess capacity is increasingly being absorbed. Similarly, some form of industry consolidation will continue to occur based on underlying economics. Given the large ongoing fixed costs associated with operating a backbone network, we believe that the natural industry structure will continue to evolve to a more limited number of competitors with each having high traffic scale across their networks.

While we believe that the long-run industry structure will evolve toward that described above, uncertainty surrounds how the existing competitive landscape will evolve toward this new structure. For example, while a number of next-generation and incumbent providers have been consolidated, we believe there are still a number of competitors operating fundamentally poor business models, with severe resource constraints, and are unlikely to be long-term survivors in their current forms. In addition, the ultimate impact of the recently completed transactions by AT&T and Verizon is yet to be known.

We believe that each competitor's long-run success in the market will be driven by its available resources (for example, financial, personnel, marketing, customers) and the effectiveness of its business model (for example, service focus and mix, cost effectiveness, ability to adapt to new technologies, channel effectiveness). We recognize that many of our existing and potential competitors in the communications industry have resources significantly greater than ours.

Our primary competitors are long distance carriers, incumbent local exchange carriers, competitive local exchange carriers, PTTs, Content Delivery Network companies, and other companies that provide communications services. The following information identifies key competitors for each of our product offerings.

Our key competitors for our voice service offerings are other providers of wholesale communications services including AT&T, Verizon, Sprint and competitive local exchange carriers. Our key competitors for managed modem services are other providers of dial up Internet access including Verizon and Qwest Communications.

For our IP and Data services, we compete with companies that include Verizon, Sprint, AT&T, Qwest Communications, Global Crossing, Cogent and XO in North America, and Sprint, Verizon, France Telecom, Deutsche Telecom, Global Crossing and Cogent in Europe.

For transport services, our key competitors in the United States are other facilities based communications companies including AT&T, Verizon, Sprint, Qwest Communications and XO. In Europe, our key competitors are other carriers such as PTTs, Telia International, Colt Telecom Group plc, Verizon, and Global Crossing.

Our key competitors for our colocation services are other facilities based communications companies, and other colocation providers such as web hosting companies and third party colocation companies. In the United States, these companies include AT&T, Savvis, Equinix, Switch & Data and Qwest Communications. In Europe, competitors include Global Switch, InterXion, Redbus, Telecity and Telehouse Europe.

For enterprise services, our key competitors include incumbent local exchange carriers (such as AT&T, Verizon and Qwest), long distance services providers (such as Sprint), and competitive local exchange carriers (such as Time Warner Telecom and XO).

For content distribution network or CDN services, our key competitors include Akamai Technologies and Limelight Networks.

The communications industry is subject to rapid and significant changes in technology. For instance, recent technological advances permit substantial increases in transmission capacity of both new and existing fiber, and the introduction of new products or emergence of new technologies may reduce the cost or increase the supply of certain services similar to those which we plan on providing. Accordingly, in the future our most significant competitors may be new entrants to the communications industry, which are not burdened by an installed base of outmoded or legacy equipment.

## **Regulation**

### *Federal Regulation*

The Federal Communications Commission or the FCC has jurisdiction over interstate and international communications services, among other things. The FCC imposes extensive regulations on common carriers that have some degree of market power such as incumbent local exchange carriers or ILECs. The FCC imposes less regulation on common carriers without market power, such as us. The FCC permits these non-dominant carriers to provide domestic interstate services (including long distance and access services) without prior authorization; but it requires carriers to receive an authorization to construct and operate telecommunications facilities and to provide or resell telecommunications services, between the United States and international points. We have obtained FCC approval to land our transatlantic cable in the United States. We have obtained FCC authorization to provide international services on a facilities and resale basis. Under the Telecommunications Act of 1996 or the 1996 Act, any entity, including cable television companies, electric and gas utilities, may enter any telecommunications market, subject to reasonable state regulation of safety, quality and consumer protection.

Generally speaking, CLEC access to ILEC networks and utility poles are implemented through individual negotiations, which are governed by the 1996 Act and applicable FCC Rules. Under the 1996 Act, CLEC access to ILEC networks is heavily regulated and the rules governing that access have been contentious. Over the past several years, however, the United States Supreme Court has affirmed FCC jurisdiction over ILEC unbundling, certain specific unbundling requirements and the FCC's authority to set the mechanism which governs the rates ILECs may charge for interconnection and unbundling.

The FCC has been gradually reducing the obligations on ILECs to provide unbundled network elements. In its most recent order in 2005, the FCC eliminated the obligation to provide local switching and identified circumstances under which an ILEC's unbundling obligations with regard to high capacity local loops and dedicated transport would also be eliminated. The availability of high capacity loops and transport depends upon tests based on the capacity of the facility, the business line density of incumbent wire centers, and the existence of collocated fiber providers in incumbent wire centers. We do not rely extensively on unbundled network elements purchased from ILECs but we do purchase special access provided by the ILECs under contracts or tariffs.

The FCC has pending a Notice of Proposed Rulemaking (“NPRM”) to initiate a comprehensive review of rules governing the pricing of special access service offered by ILECs subject to price cap regulation. Special access pricing by these carriers currently is subject to price cap rules, as well as pricing flexibility rules which permit these carriers to offer volume and term discounts and contract tariffs (Phase I pricing flexibility) and/or remove from price caps regulation special access service in a defined geographic area (Phase II pricing flexibility) based on showings of competition. In the NPRM the FCC tentatively concludes to continue to permit pricing flexibility where competitive market forces are sufficient to constrain special access prices, but undertakes an examination of whether the current triggers for pricing flexibility accurately assess competition and have worked as intended. The NPRM also asks for comment on whether certain aspects of ILEC special access tariff offerings (e.g., basing discounts on previous volumes of service; tying nonrecurring charges and termination penalties to term commitments; and imposing use restrictions in connection with discounts), are unreasonable. At this time, we have no indication when the FCC might conclude this rulemaking and we cannot predict the impact, if any, the NPRM will have on our network cost structure.

The 1996 Act also codifies the ILECs’ equal access and nondiscrimination obligations and preempts inconsistent state regulation.

As of August 1, 2001, our tariffs for interstate end user services were eliminated and our tariffs for international interexchange services were eliminated on January 28, 2002. Our rates must still be just and reasonable and nondiscriminatory. Our state tariffs remain in place. We have historically relied primarily on our sales force and marketing activities to provide information to our customers regarding these matters and expect to continue to do so. Further, in accordance with the FCC’s orders we maintain a schedule of our rates, terms and conditions for our domestic and international private line services on our web site.

*Intercarrier compensation.* Telecommunications carriers compensate one another for traffic carried on each other’s networks. Interexchange carriers pay access charges to local telephone companies for long distance calls that originate and terminate on local networks. Local telephone companies typically charge one another for local and Internet-bound traffic terminating on each other’s networks. The entire methodology by which carriers compensate one another for exchanged traffic, whether it be for local, intrastate or interstate traffic, is under review at the FCC.

Apart from this comprehensive review of intercarrier compensation, individual compensation issues have been the subject of FCC rulings. The issue of compensation to be paid for calls dialed to the Internet service providers has been a significant one in the regulatory areas. Beginning in June 1997, every RBOC advised CLECs that they did not consider calls in the same local calling area from their customers to the CLEC’s ISP customers to be local calls under the interconnection agreements between the RBOCs and the CLECs. The RBOCs claimed that these calls are exchange access calls for which exchange access charges would be owed. The RBOCs claimed, however, that the FCC exempted these calls from access charges so that no compensation is owed to the CLECs for transporting and terminating such calls. As a result, the RBOCs threatened to withhold, and in many cases did withhold, reciprocal compensation for the transport and termination of such calls. On February 25, 1999, the FCC issued a Declaratory Ruling on the issue of inter-carrier compensation for calls bound to ISPs. The FCC ruled that the calls are jurisdictionally interstate calls, not local calls.

The FCC, however, determined that this issue was not dispositive of whether intercarrier compensation is owed. That decision was appealed to the D.C. Circuit which held that the FCC had failed to adequately support its conclusions under the requirements of the 1996 Act. On April 18, 2001, the FCC adopted a new order regarding intercarrier compensation for ISP-bound traffic. In that Order, the Commission established a new intercarrier compensation mechanism for ISP-bound traffic with declining rates over a three year period. In addition to establishing a new rate structure, the Commission capped the



amount of ISP bound traffic that would be “compensable” and prohibited payment of intercarrier compensation for ISP-bound traffic to carriers entering new markets. The April 2001 order was appealed to the D.C. Circuit. On May 3, 2002, the D.C. Circuit found that the FCC had not provided an adequate legal basis for its ruling, and therefore remanded the matter to the FCC. In the interim, the court let the FCC’s rules stand. It is unclear when the FCC will issue revised findings in response to the latest remand. On October 8, 2004, the FCC adopted an order in response to a July 2003 Petition for Forbearance filed by Core Communications (“Core Petition”) asking the FCC to forbear from enforcing the rate caps, growth cap, and new market and mirroring rules of the ISP Remand Order. The FCC granted the Core Petition with respect to the growth cap and the new market rules, but denied the Petition as to the rate caps and mirroring rules (“Core Order”). That decision has been appealed to the D.C. Circuit.

Prior to 2004, we entered into agreements providing for payment of compensation for terminating ISP-bound traffic with Verizon, in its former Bell Atlantic operating territory, with SBC Corporation for the 13-state operating territory that includes its affiliates Pacific Bell, Southwestern Bell, Ameritech and Southern New England Telephone, and with BellSouth in its nine-state operating territory. We also entered into interconnection agreements with Qwest, Cincinnati Bell Telephone, and Sprint that reflect the intercarrier compensation rates adopted by the FCC in its ISP Remand Order. Given the general uncertainty surrounding the effect of the FCC decisions, appeals, and the remand, we may have to change how we treat the compensation we receive for terminating calls bound for ISP-bound traffic if the agreements under which compensation is paid provide for the incorporation of changes in FCC rules and regulations.

In May 2004, we reached a new interconnection agreement with Bell South, now AT&T, that incorporated the terms of the ISP Remand Order. BellSouth requested renegotiation of this agreement in early October 2006 however the parties continue to provide services and exchange payments under the agreement until a successor agreement is reached. In September 2004, Level 3 and Verizon amended our existing interconnection agreement to establish intercarrier compensation terms. The compensation section of that agreement expires in August 2007. Level 3 and Verizon will continue to provide services under this agreement until a successor agreement is reached. In late 2003, we reached an agreement with SBC, now AT&T, continuing payment for the exchange of ISP-bound traffic. In February 2005, we and SBC agreed to successor interconnection agreements which cover the payment for the exchange of ISP-bound traffic. The SBC agreement expired on December 31, 2006. Level 3 and SBC continue to provide services and exchange payments under that agreement until a successor agreement is reached.

We are negotiating new agreements with each of these carriers but at this time cannot predict what the final terms will be, including compensation for ISP-bound traffic.

*Universal Service.* Level 3 is subject to federal and state regulations that implement universal service support for access to communications services in rural, high-cost and low-income markets at reasonable rates; and access to advanced communications services by schools, libraries and rural health care providers. Currently, the FCC assesses Level 3 a percentage of interstate revenue it receives from retail customers as its contribution to the federal Universal Service Fund. The FCC is currently considering changing the method by which our contributions are assessed to a flat-fee charge, such as a per-line or per-number charge. Any change in the assessment methodology may affect Level 3’s revenues but at this time, it is not possible to predict the extent we would be affected if at all.

#### *State Regulation*

The 1996 Act is intended to increase competition in the telecommunications industry, especially in the local exchange market. With respect to local services, ILECs are required to allow interconnection to their networks and to provide unbundled access to network facilities, as well as a number of other pro-competitive measures. Because the implementation of the 1996 Act is subject to numerous state

rulemaking proceedings on these issues, it is currently difficult to predict how quickly full competition for local services will be realized.

State regulatory agencies have jurisdiction when our facilities and services are used to provide intrastate telecommunications services. A portion of our traffic may be classified as intrastate telecommunications and therefore subject to state regulation. We expect that we will offer more intrastate telecommunications services (including intrastate switched services) as our business and product lines expand. To provide intrastate services, we generally must obtain a certificate of public convenience and necessity from the state regulatory agency and comply with state requirements for telecommunications utilities, including state tariffing requirements. We currently are authorized to provide telecommunications services in all fifty states and the District of Columbia. In addition, we will be required to obtain and maintain interconnection agreements with ILECs where we wish to provide service. We expect that we should be able to negotiate or otherwise obtain renewals or successor agreements through adoption of others' contracts or arbitration proceedings, although the rates, terms, and conditions applicable to interconnection and the exchange of traffic with certain ILECs could change significantly in certain cases. The degree to which the rates, terms, and conditions may change will depend not only upon the negotiation and arbitration process and availability of other interconnection agreements, but will also depend in significant part upon state commission proceedings that either uphold or modify the current regimes governing interconnection and the exchange of certain kinds of traffic between carriers. In May 2004, we reached agreement on new interconnection agreements with BellSouth in all 9 of the BellSouth states. In September 2004, we reached new interconnection agreements with Verizon, and with SBC in February 2005.

States also often require prior approvals or notifications for certain transfers of assets, customers or ownership of certificated carriers and for issuances by certified carriers of equity or debt.

#### *Local Regulation*

Our networks are subject to numerous local regulations such as building codes and licensing. Such regulations vary on a city-by-city, county-by-county and state-by-state basis. To install our own fiber optic transmission facilities, we need to obtain rights-of-way over privately and publicly owned land. Rights-of-way that are not already secured may not be available to us on economically reasonable or advantageous terms.

#### *Regulation of Voice over Internet Protocol (VoIP)*

##### *Federal and State*

Due to the growing acceptance and deployment of VoIP services, the FCC and state public utility commissions are conducting regulatory proceedings that could affect the regulatory duties and rights of entities such as us or our affiliates that provide IP-based voice applications. There is regulatory uncertainty as to the imposition of access charges and other taxes, fees and surcharges on VoIP services that use the public switched telephone network. There is regulatory uncertainty as to the imposition of traditional retail, common carrier regulation on VoIP products and services.

The FCC is also considering several petitions filed by individual companies concerning the regulatory rights and obligations of providers of IP-based voice services, and networks that handle IP-based voice traffic or that exchange that traffic with operators of PSTN facilities.

On October 18, 2002, AT&T Corporation filed a petition with the FCC requesting a declaratory ruling that calls that originate and terminate on the PSTN, but which may be converted into IP during some part of the transmission, are exempt from access charges under existing FCC rules. On April 21,

2004, the FCC rejected AT&T's Petition, stating that the calls described by AT&T were telecommunications services subject to access charges under existing FCC rules.

On September 22, 2003, Vonage Holdings Corporation or Vonage filed a petition with the FCC requesting a declaration that its offerings, which originate on a broadband network in IP format and terminate on the PSTN, or vice versa, are interstate information services not subject to state regulation under the federal Communications Act and existing FCC rules. On November 10, 2004, the FCC adopted an order ruling that Vonage's service was an interstate service not subject to state regulation. The FCC did not rule whether the service is only an information service that is not subject to Title II under the Act. Appeals were filed in a number of circuits, which appeals were consolidated and assigned to the U.S. Court of Appeals for the 8th Circuit. Oral arguments were heard on January 12, 2006. A decision is pending. Until a decision is released, we cannot predict how a ruling might affect our provision of VoIP services.

On June 3, 2005, the FCC issued an order requiring all interconnected VoIP providers to deliver enhanced 911 capabilities to their subscribers by no later than November 28, 2005. We have modified our service offerings to VoIP providers in order to assist those providers in complying with the FCC mandate. A number of parties appealed this FCC order. On December 15, 2005, the DC Circuit Court of Appeals upheld the FCC VoIP 911 Order in its entirety. It is too early to predict how this outcome will affect customer demand for our 911 services.

A number of state public utility commissions are conducting regulatory proceedings that could impact our rights and obligations with respect to IP-based voice applications. Previously, the Minnesota Public Utilities Commission or MPUC ruled that Vonage's DigitalVoice service was a telephone service under state law, and ordered Vonage to obtain state certification, file tariffs, and comply with 911 requirements before continuing to offer the service in the state. Vonage filed a request in the Federal District Court for the District of Minnesota to enjoin the MPUC's decision. On October 16, 2003, a federal judge granted Vonage's request for an injunction, concluding that Vonage provides an information service immune from state regulation and thereby barring the MPUC from enforcing its decision. On December 22, 2004, the U.S. Court of Appeals for the Eighth Circuit affirmed the District Court's judgment on the basis of the FCC's determination that Vonage's service was interstate and noted that the MPUC would be free to challenge the injunction if it or another party prevailed on an appeal of the FCC's Vonage Order.

We cannot predict the outcome of any of these petitions and regulatory proceedings or any similar petitions and regulatory proceedings pending before the FCC or state public utility commissions. Moreover, we cannot predict how their outcomes may affect our operations or whether the FCC or state public utility commissions will impose additional requirements, regulations or charges upon our provision of services related to IP communications.

#### *European Regulation*

Unlike the United States which has a fractured regulatory scheme with respect to VoIP services, the European Union has adopted a more systematic approach to the convergence of networks and VoIP regulation specifically. The European Commission will oversee the implementation by its member-states of six new directives developed to regulate electronic communications in a technology and platform neutral manner. Implementation of the directives has not been uniform across the Member States of the European Union and it is difficult to predict when they will be implemented at the national level. Even with harmonization, the national regulatory agencies will continue to be responsible for issuing general authorizations and specific licenses.

The European Union's approach to the regulation of VoIP turns on whether VoIP is voice telephony. The European Commission has defined voice telephony to have four elements: (1) commercial offering as voice telephony; (2) provision to the public; (3) provision to and from the public switched telephone network termination points; and (4) direct speech transport and switching of speech in real time,

particularly at the same level of reliability and speech quality as provided by the PSTN. In its “Communication from the Commission, Consultation on Voice on the Internet” in June 2000, the European Commission directed that “Member States should continue to allow Internet access providers to offer voice over Internet protocol under data transmission general authorizations, and that specific licensing conditions are not justified.”

The European Commission has subsequently redefined its definitions to suggest that some VoIP offerings are voice telephony. In its December 2000 communication, the European Commission noted that increasing quality and reliability as well as marketing of voice capabilities with bundled services, made certain kinds of “voice over Internet” much more like voice services. While the current European Commission directives do not mandate the treatment of VoIP as voice telephony, the commission will continue to reevaluate the regulation of VoIP as service quality becomes the equivalent of traditional voice telephony.

In February 2003, the European Union adopted a new regulatory framework for electronic communications that is designed to address in a technologically neutral manner the convergence of communications across telecommunications, computer and broadcasting networks. The directives address: (1) framework (2) interconnection and access, (3) authorization and licensing, (4) universal service and (5) privacy. These directives and an additional decision on radio spectrum replace the existing 20 directives on electronic communications. Under the framework, voice telephony providers will face additional obligations, including specific licensing and universal service obligations. Others will likely face new regulation. One example could be VoIP. If it is classified as an electronic communications service, rather than voice telephony, it would still be subject to additional regulations to achieve regulatory parity with other electronic communications.

The United Kingdom was one of the first countries to fully implement the European Union’s new framework for electronic communications, which it did by July 25, 2003. At that time, certain provisions of the United Kingdom’s Telecommunications Act of 1984 were repealed. Pursuant to that framework, the licensing regime was replaced with a general authorization. Our existing licenses were canceled and replaced with a general authorization.

Under the regime, the United Kingdom regulates VoIP as an electronic communication service. The degree of regulation imposed on the service depends upon whether the service is considered to be a Publicly Available Telephone Service (PATS). A service is considered to be a PATS if the following conditions are met: it is marketed as a substitute for the traditional telephone service; the service appears to the customer to be a substitute for the traditional public telephone service over which they expect access to emergency services; or the service provides the customers sole means of access to the traditional circuit switched public telephone network.

While the Ofcom, the United Kingdom regulator, has established technical standards and interconnection rights for VoIP service providers, it has recently opened a consultation to assess the appropriate allocation of phone numbers to VoIP providers. We cannot predict the result of this proceeding and how it will affect our ability to provide services.

As we expand the deployment of our VoIP applications in Europe, we will have to consider the appropriate regulatory requirements for each nation before deploying services.

#### *Canadian Regulation*

The Canadian Radio-television and Telecommunications Commission, or the CRTC, has jurisdiction to regulate long distance telecommunications services in Canada. Regulatory developments over the past several years have terminated the historic monopolies of the regional telephone companies, bringing significant competition to this industry for both domestic and international long distance services, but also

lessening regulation of domestic long distance companies. Resellers, which, as well as facilities based carriers, now have interconnection rights, but which are not obligated to file tariffs, may not only provide transborder services to the U.S. by reselling the services provided by the regional companies and other entities but also may resell the services of the former monopoly international carrier, Teleglobe Canada or Teleglobe, including offering international switched services provisioned over leased lines. Although the CRTC formerly restricted the practice of “switched hubbing” over leased lines through intermediate countries to or from a third country, the CRTC lifted this restriction. The Teleglobe monopoly on international services and undersea cable landing rights terminated as of October 1, 1998, although the provision of Canadian international transmission facilities based services remains restricted to “Canadian carriers” with majority ownership by Canadians. Ownership of non-international transmission facilities are limited to Canadian carriers but we can own international undersea cables landing in Canada. We cannot, under current law, enter the Canadian market as a provider of transmission facilities based domestic services. In 2003, two committees of the Canadian House of Commons issued conflicting recommendations on whether to lift the foreign ownership restrictions that prohibit carriers like us from owning intra-Canadian transmission facilities. If the ownership restrictions are repealed, we anticipate that we will be able to expand our operations and service offerings in Canada. Recent CRTC rulings address issues such as the framework for international contribution charges payable to the local exchange carriers to offset some of the capital and operating costs of the provision of switched local access services of the incumbent regional telephone companies, in their capacity as ILECs, and the new entrant CLECs.

While competition is permitted in virtually all other Canadian telecommunications market segments, we believe that the regional companies continue to retain a substantial majority of the local and calling card markets. Beginning in May 1997, the CRTC released a number of decisions opening to competition the Canadian local telecommunications services market, which decisions were made applicable in the territories of all of the regional telephone companies. As a result, networks operated by CLECs may now be interconnected with the networks of the ILECs. Transmission facilities based CLECs are subject to the same majority Canadian ownership “Canadian carrier” requirements as transmission facilities based long distance carriers. CLECs have the same status as ILECs, but they do not have universal service or customer tariff-filing obligations. CLECs are subject to certain consumer protection safeguards and other CRTC regulatory oversight requirements. CLECs must file interconnection tariffs for services to interexchange service providers and wireless service providers. Certain ILEC services must be provided to CLECs on an unbundled basis and subject to mandatory pricing, including central office codes, subscriber listings, and local loops in small urban and rural areas. For a five-year period, certain other important CLEC services must be provided on an unbundled basis at mandated prices, notably unbundled local loops in large, urban areas. ILECs, which, unlike CLECs, remained fully regulated, are subject to price cap regulation in respect of their utility services and these services must not be priced below cost. Interexchange contribution payments are now pooled and distributed among ILECs and CLECs according to a formula based on their respective proportions of residential lines, with no explicit contribution payable from local business exchange or directory revenue. CLECs must pay an annual telecommunications fee based on their proportion of total CLEC operating revenue. All bundled and unbundled local services (including residential lines and other bulk services) may now be resold, but ILECs need not provide these services to resellers at wholesale prices. Transmission facilities based local and long distance carriers (but not resellers) are entitled to colocate equipment in ILEC central offices pursuant to terms and conditions of tariffs and intercarrier agreements. Certain local competition issues are still to be resolved. The CRTC has ruled that resellers cannot be classified as CLECs, and thus are not entitled to CLEC interconnection terms and conditions. The CRTC conducted a proceeding in 2004 to review issues relating to the introduction of VoIP technology. The CRTC has expressed a number of preliminary views about how it proposes to regulate VoIP services including the view that VoIP services (and service providers) should be regulated according to the CRTC’s existing rules. If the preliminary views are confirmed, then the rules for

VoIP-based services will depend on the category of service provider (ie., ILEC, CLEC or reseller), the nature of the service and the geographic area in which the service is provided.

## **Our Other Business**

Our company was incorporated as Peter Kiewit Sons', Inc. in Delaware in 1941 to continue a construction business founded in Omaha, Nebraska in 1884. In subsequent years, we invested a portion of the cash flow generated by our construction activities in a variety of other businesses. We entered the coal mining business in 1943, the telecommunications business in 1988, the information services business in 1990 and the alternative energy business in 1991. We have also made investments in several development-stage ventures.

In December 1997, our stockholders ratified the decision of the Board to effect the split-off separating our historical construction business from the remainder of our operations. As a result of the split-off, which was completed on March 31, 1998, we no longer own any interest in the prior construction business. In conjunction with the split-off, we changed our name to "Level 3 Communications, Inc.," and the entity that held the prior construction business changed its name to "Peter Kiewit Sons', Inc."

On November 30, 2005, we completed the sale of our ( i )Structure, LLC subsidiary to Infocrossing, Inc. for \$84.8 million in total consideration, including \$82.3 million in cash and \$2.5 million in Infocrossing common stock. Prior to the sale, ( i )Structure provided computer operations outsourcing to customers located primarily in the United States.

On September 7, 2006, we completed the sale of 100% of the capital stock of our indirect, wholly owned subsidiary, Software Spectrum, Inc., to Insight Enterprises, Inc. In connection with the transaction, we received total proceeds of approximately \$351 million in cash. Prior to the sale, Software Spectrum was a leading direct marketer of software and provider of software licensing services to corporations. With the completion of the sale of Software Spectrum, we exited the information services business.

### *Coal Mining*

We are engaged in coal mining through our subsidiary, KCP, Inc. ("KCP"). KCP has a 50% interest in two mines, which are operated by a subsidiary of Peter Kiewit Sons', Inc. ("PKS"). Decker Coal Company ("Decker") is a joint venture with Western Minerals, Inc., which is a subsidiary of Rio Tinto Energy America Inc. Black Butte Coal Company ("Black Butte") is a joint venture with Bitter Creek Coal Company, a subsidiary of Anadarko Petroleum Corporation. The Decker mine is located in southeastern Montana and the Black Butte mine is in southwestern Wyoming. The coal mines use the surface mining method.

The coal produced from the KCP mines is sold primarily to electric utilities, which burn coal to produce steam to generate electricity. Essentially all of the sales were made under long-term contracts. Approximately 37%, 44% and 59% of KCP's revenue in 2006, 2005 and 2004, respectively, were derived from long-term contracts with Commonwealth Edison Company (with Decker) and The Detroit Edison Company (with Decker). KCP has commitments to deliver approximately 12.2 million tons of coal through 2012 under contracts with Commonwealth Edison and Detroit Edison. KCP also has other sales commitments, including those with Sierra Pacific, Idaho Power, PacifiCorp, and Minnesota Power that provide for the delivery of approximately 9.3 million tons through 2009. The level of cash flows generated in recent periods by our coal operations will not continue because the delivery requirements under certain of our current long-term contracts decline significantly. Under a mine management agreement, KCP pays a subsidiary of PKS an annual fee equal to 30% of KCP's adjusted operating income. The fee for 2006 was approximately \$2 million.

The coal industry is highly competitive. KCP competes not only with other domestic and foreign coal suppliers, some of whom are larger and have greater capital resources than KCP, but also with alternative methods of generating electricity and alternative energy sources. In 2005, the most recent year for which information is available, KCP's production represented less than 1% of total U.S. coal production. Demand for KCP's coal is affected by economic, political and regulatory factors. For example, recent "clean air" laws may stimulate demand for low sulfur coal. KCP's western coal reserves generally have a low sulfur content (less than one percent) and are currently useful principally as fuel for coal-fired, steam-electric generating units.

KCP's sales of its coal, like sales by other western coal producers, typically provide for delivery to customers at the mine. A significant portion of the customer's delivered cost of coal is attributable to transportation costs. Most of the coal sold from KCP's western mines is currently shipped by rail to utilities outside Montana and Wyoming. The Decker and Black Butte mines are each served by a single railroad. Many of their western coal competitors are served by two railroads and such competitors' customers often benefit from lower transportation costs because of competition between railroads for coal hauling business. Other western coal producers, particularly those in the Powder River Basin of Wyoming, have lower stripping ratios (that is, the amount of overburden that must be removed in proportion to the amount of minable coal) than the Black Butte and Decker mines, often resulting in lower comparative costs of production. As a result, KCP's production costs per ton of coal at the Black Butte and Decker mines can be as much as four and five times greater than production costs of certain competitors. Because of these cost disadvantages, there is no assurance that KCP will be able to enter into additional long-term coal purchase contracts for Black Butte and Decker production. In addition, these cost disadvantages may adversely affect KCP's ability to compete for sales in the future.

We are required to comply with various federal, state and local laws and regulations concerning protection of the environment. KCP's share of land reclamation expenses for the year ended December 31, 2006 was approximately \$3 million. KCP's share of accrued estimated reclamation costs was \$96 million at December 31, 2006. We did not make significant capital expenditures for environmental compliance with respect to the coal business in 2006. We believe our compliance with environmental protection and land restoration laws will not affect our competitive position since our competitors in the mining industry are similarly affected by such laws. However, failure to comply with environmental protection and land restoration laws, or actual reclamation costs in excess of our accruals, could have an adverse effect on our business, results of operations, and financial condition.

## Glossary of Terms

access	Telecommunications services that permit long distance carriers to use local exchange facilities to originate and/or terminate long distance service.
access charges	The fees paid by long distance carriers to LECs for originating and terminating long distance calls on the LECs' local networks.
backbone	A high-speed network that interconnects smaller, independent networks. It is the through- portion of a transmission network, as opposed to spurs which branch off the through- portions.
ATM (asynchronous transfer mode)	An information transfer standard that is one of a general class of packet technologies that relay traffic by way of an address contained within the first five bytes of a standard fifty-three byte long packet or cell. The ATM format can be used by many different information systems, including LANs, to deliver traffic at varying rates, permitting a mix of data, voice and video.
CAP	Competitive Access Provider. A company that provides its customers with an alternative to the local exchange company for local transport of private line and special access telecommunications services.
caching	A process by which a Web storage device or cache is located between Web servers (or origin servers) and a user, and watches requests for HTML pages and objects such as images, audio, and video, then saves a copy for itself. If there is another request for the same object, the cache will use its copy, instead of asking the origin server for it again.
capacity	The information carrying ability of a telecommunications facility.
carrier	A provider of communications transmission services by fiber, wire or radio.
CDN	Content Distribution Network or CDN describes a system of computers networked together across the Internet that cooperate transparently to deliver various types of content to end users. The delivery process is optimized generally for either performance or cost. When optimizing for performance, locations that can serve content quickly to the user are chosen. When optimizing for cost, locations that are less expensive to serve from may be chosen instead.
central office	Telephone company facility where subscribers' lines are joined to switching equipment for connecting other subscribers to each other, locally and long distance.
CLEC	Competitive Local Exchange Carrier. A company that competes with LECs in the local services market.
co-carrier	A relationship between a CLEC and an ILEC that affords each company the same access to and right on the other's network and provides access and services on an equal basis.
common carrier	A government-defined group of private companies offering telecommunications services or facilities to the general public on a non-discriminatory basis.



conduit	A pipe, usually made of metal, ceramic or plastic, that protects buried cables.
DS-3	A data communications circuit capable of transmitting data at 45 Mbps.
dark fiber	Fiber optic strands that are not connected to transmission equipment.
dedicated lines	Telecommunications lines reserved for use by particular customers.
dialing parity	The ability of a competing local or toll service provider to provide telecommunications services in such a manner that customers have the ability to route automatically, without the use of any access code, their telecommunications to the service provider of the customers' designation.
equal access	The basis upon which customers of interexchange carriers are able to obtain access to their Primary Interexchange Carriers' (PIC) long distance telephone network by dialing "1", thus eliminating the need to dial additional digits and an authorization code to obtain such access.
facilities based carriers	Carriers that own and operate their own network and equipment.
fiber optics	A technology in which light is used to transport information from one point to another. Fiber optic cables are thin filaments of glass through which light beams are transmitted over long distances carrying enormous amounts of data. Modulating light on thin strands of glass produces major benefits including high bandwidth, relatively low cost, low power consumption, small space needs and total insensitivity to electromagnetic interference.
Gbps	Gigabits per second. A transmission rate. One gigabit equals 1.024 billion bits of information.
ILEC	Incumbent Local Exchange Carrier. A company historically providing local telephone service. Often refers to one of the Regional Bell Operating Companies (RBOCs). Often referred to as "LEC" (Local Exchange Carrier).
Interconnection	Interconnection of facilities between or among the networks of carriers, including potential physical colocation of one carrier's equipment in the other carrier's premises to facilitate such interconnection.
InterLATA	Telecommunications services originating in a LATA and terminating outside of that LATA.
Internet	A global collection of interconnected computer networks which use a specific communications protocol.
IntraLATA	Telecommunications services originating and terminating in the same LATA.
ISDN	Integrated Services Digital Network. An information transfer standard for transmitting digital voice and data over telephone lines at speeds up to 128 Kbps.

ISPs	Internet Service Providers. Companies formed to provide access to the Internet to consumers and business customers via local networks.
IXC	Interexchange Carrier. A telecommunications company that provides telecommunications services between local exchanges on an interstate or intrastate basis.
Kbps	Kilobits per second. A transmission rate. One kilobit equals 1,024 bits of information.
LATA	Local Access and Transport Area. A geographic area composed of contiguous local exchanges, usually but not always within a single state. There are approximately 200 LATAs in the United States.
leased line	An amount of telecommunications capacity dedicated to a particular customer along predetermined routes.
LEC	Local Exchange Carrier. A telecommunications company that provides telecommunications services in a geographic area. LECs include both ILECs and CLECs.
local exchange	A geographic area determined by the appropriate state regulatory authority in which calls generally are transmitted without toll charges to the calling or called party.
local loop	A circuit that connects an end user to the LEC central office within a LATA.
long distance carriers	Long distance carriers provide services between local exchanges on an interstate or intrastate basis. A long distance carrier may offer services over its own or another carrier's facilities.
Mbps	Megabits per second. A transmission rate. One megabit equals 1,024 million bits of information.
MPLS	MultiProtocol Label Switching. A standards-approved technology for speeding up network traffic flow and making it easier to manage. MPLS involves setting up a specific path for a given sequence of packets, identified by a label put in each packet, thus saving the time needed for a router or switch to look up the address to the next node to forward the packet to.
multiplexing	An electronic or optical process that combines a large number of lower speed transmission lines into one high speed line by splitting the total available bandwidth into narrower bands (frequency division), or by allotting a common channel to several different transmitting devices, one at a time in sequence (time division).
NAP	Network Access Point. A location at which ISPs exchange traffic with each other.
OC-3	A data communications circuit capable of transmitting data at 155 bps.
OC-12	A data communications circuit capable of transmitting data at 622 Mbps.
OC-48	A data communications circuit capable of transmitting data at approximately 2.45 Gbps.

peering	The commercial practice under which ISPs exchange traffic with each other. Although ISPs are free to make a private commercial arrangement, there are generally two types of peering. With a settlement free peering arrangement the ISPs do not need to pay each other for the exchange of traffic. With paid peering, the larger ISP receives payment from the smaller ISP to carry the traffic of that smaller ISP. Peering occurs at both public and private exchange points.
POP	Point of Presence. Telecommunications facility where a communications provider locates network equipment used to connect customers to its network backbone.
private line	A dedicated telecommunications connection between end user locations.
PSTN	Public Switched Telephone Network. That portion of a local exchange company's network available to all users generally on a shared basis (i.e., not dedicated to a particular user). Traffic along the public switched network is generally switched at the local exchange company's central offices.
Public Safety Answering Point	An answering location for 911 calls originating in a given area. PSAPs are typically a common bureau used to answer emergency calls and dispatch safety agencies such as police, fire, emergency medical, etc.
RBOCs	Regional Bell Operating Companies. Originally, the seven local telephone companies established as a result of the AT&T Divestiture.
reciprocal compensation	The compensation of a CLEC for termination of a local call by the ILEC on the CLEC's network, which is the same as the compensation that the CLEC pays the ILEC for termination of local calls on the ILEC's network.
resale	Resale by a provider of telecommunications services (such as a LEC) of such services to other providers or carriers on a wholesale or a retail basis.
router	Equipment placed between networks that relays data to those networks based upon a destination address contained in the data packets being routed.
selective router	Telephone switch or functional equivalent, controlled by the relevant local exchange carrier (LEC), which determines the PSAP to which a 911 call should be delivered based on the location of the 911 caller.
SONET	Synchronous Optical Network. An electronics and network architecture for variable bandwidth products which enables transmission of voice, data and video (multimedia) at very high speeds. SONET ring architecture provides for virtually instantaneous restoration of service in the event of a fiber cut or equipment failure by automatically rerouting traffic in the opposite direction around the ring.

special access services	The lease of private, dedicated telecommunications lines or “circuits” along the network of a local exchange company or a CAP, which lines or circuits run to or from the long distance carrier POPs. Examples of special access services are telecommunications lines running between POPs of a single long distance carrier, from one long distance carrier POP to the POP of another long distance carrier or from an end user to a long distance carrier POP.
streaming	Streaming is the delivery of media, such as movies and live presentations, over a network in real time. A computer (a streaming server) sends the media to another computer (a client computer), which plays the media as it is delivered.
switch	A device that selects the paths or circuits to be used for transmission of information and establishes a connection. Switching is the process of interconnecting circuits to form a transmission path between users and it also captures information for billing purposes.
Tbps	Terabits per second. A transmission rate. One terabit equals 1.024 trillion bits of information.
T-1	A data communications circuit capable of transmitting data at 1.544 Mbps.
unbundled	Services, programs, software and training sold separately from the hardware.
unbundled access	Access to unbundled elements of a telecommunications services provider’s network including network facilities, equipment, features, functions and capabilities, at any technically feasible point within such network.
VoIP	Voice over Internet Protocol
VPC	VoIP Positioning Center. An entity that maintains an end user location database and manages the technology including query keys and routing number pools used to deliver 911 calls to the correct PSAP for emergency handling.
web site	A server connected to the Internet from which Internet users can obtain information.
wireless	A communications system that operates without wires. Cellular service is an example.
world wide web or web	A collection of computer systems supporting a communications protocol that permits multimedia presentation of information over the Internet.
xDSL	A term referring to a variety of new Digital Subscriber Line technologies. Some of these new varieties are asymmetric with different data rates in the downstream and upstream directions. Others are symmetric. Downstream speeds range from 384 Kbps (or “SDSL”) to 1.5 to 8 Mbps (“ADSL”).

## Directors and Executive Officers

Set forth below is information as of February 28, 2007, about our directors and our executive officers. Our executive officers have been determined in accordance with the rules of the SEC.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Walter Scott, Jr.(1)	75	Chairman of the Board
James Q. Crowe(1)	57	Chief Executive Officer and Director
Kevin J. O'Hara	46	President and Chief Operating Officer
Charles C. Miller, III	54	Vice Chairman and Executive Vice President
Thomas C. Stortz	55	Executive Vice President, Chief Legal Officer and Secretary
Sunit S. Patel	45	Group Vice President and Chief Financial Officer
Sureel A. Choksi	34	President Wholesale Markets Group of Level 3 Communications, LLC
Brady Rafuse	43	President Content Markets Group of Level 3 Communications, LLC and President and CEO of Europe Operations
Eric J. Mortensen	48	Senior Vice President and Controller
Admiral James O. Ellis, Jr.(4)	59	Director
Richard R. Jaros(3)	55	Director
Robert E. Julian(2)	67	Director
Arun Netravali(3)	60	Director
John T. Reed(2)(4)	63	Director
Michael B. Yanney(1)(3)(4)	73	Director
Dr. Albert C. Yates(2)	65	Director

- (1) Member of Executive Committee
- (2) Member of Audit Committee
- (3) Member of Compensation Committee
- (4) Member of Nominating and Governance Committee

## Other Management

Set forth below is information as of February 28, 2007, about the following members of senior management of Level 3 Communications, LLC, except as otherwise noted.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Raouf F. Abdel	39	President Business Markets Group
John Neil Hobbs	47	President Global Network Services
Lynn E. Refer	47	President Metro Network Services
John F. Waters, Jr.	42	Executive Vice President, Chief Technology Officer
Donald H. Gips	47	Group Vice President
Kevin T. Hart	40	Group Vice President, Chief Information Officer
Joseph M. Howell, III	60	Group Vice President

Walter Scott, Jr. has been the Chairman of the Board of the Company since September 1979, and a director of the Company since April 1964. Mr. Scott has been Chairman Emeritus of Peter Kiewit Sons', Inc. ("PKS") since the split-off in 1998. Mr. Scott is also a director of PKS, Berkshire Hathaway Inc., MidAmerican Energy Holdings Company, and Valmont Industries, Inc. and Chairman of the Board of Commonwealth Telephone Enterprises, Inc. ("Commonwealth Telephone"). Mr. Scott is also the Chairman of the Executive Committee of the Board of Directors.

James Q. Crowe has been the Chief Executive Officer of the Company since August 1997, and a director of the Company since June 1993. Mr. Crowe was also President of the Company until February 2000. Mr. Crowe was President and Chief Executive Officer of MFS Communications Company, Inc. ("MFS") from June 1993 to June 1997. Mr. Crowe also served as Chairman of the Board of WorldCom from January 1997 until July 1997, and as Chairman of the Board of MFS from 1992 through 1996. Mr. Crowe is presently a director of Commonwealth Telephone. Mr. Crowe is also a member of the Executive Committee.

Kevin J. O'Hara has been President of the Company since July 2000 and Chief Operating Officer of the Company since March 1998. Mr. O'Hara was also Executive Vice President of the Company from August 1997 until July 2000. Prior to that, Mr. O'Hara served as President and Chief Executive Officer of MFS Global Network Services, Inc. from 1995 to 1997, and as Senior Vice President of MFS and President of MFS Development, Inc. from October 1992 to August 1995. From 1990 to 1992, he was a Vice President of MFS Telecom, Inc. ("MFS Telecom").

Charles C. Miller, III has been Vice Chairman and Executive Vice President of the Company since February 15, 2001. Mr. Miller was also a director from February 15, 2001 until May 18, 2004. Prior to that, Mr. Miller was President of Bellsouth International, a subsidiary of Bellsouth Corporation from 1995 until December 2000. Prior to that, Mr. Miller held various senior level officer and management position at BellSouth from 1987 until 1995.

Thomas C. Stortz has been Executive Vice President, Chief Legal Officer and Secretary since February 2004. Prior to that, Mr. Stortz was Group Vice President, General Counsel and Secretary of the Company from February 2000 to February 2004. Prior to that, Mr. Stortz served as Senior Vice President, General Counsel and Secretary of the Company from September 1998 to February 1, 2000. Prior to that, he served as Vice President and General Counsel of Peter Kiewit Sons', Inc. and Kiewit Construction Group, Inc. from April 1991 to September 1998. He has served as a director of Peter Kiewit Sons', Inc.

Sunit S. Patel has been Chief Financial Officer since May 2003 and a Group Vice President of the Company since March 13, 2003. Prior to that, Mr. Patel was Chief Financial Officer of Looking Glass Networks, Inc., a provider of metropolitan fiber optic networks, from April 2000 until March 2003. Mr. Patel was Treasurer of WorldCom Inc. and MCIWorldcom Inc., each long distance telephone services providers from 1997 to March 2000. From 1994 to 1997, Mr. Patel was Treasurer of MFS Communications Company Inc., a competitive local exchange carrier.

Sureel A. Choksi has been President Wholesale Markets Group since August 2006. Prior to that, Mr. Choksi was Executive Vice President of Switched Services from January 2006 to August 2006. Prior to this role, Mr. Choksi was Executive Vice President of Services from November 2004 to January 2006, responsible for developing and managing Level 3's communications services. Prior to that, Mr. Choksi was Executive Vice President Softswitch Services from January 2004 and Group Vice President Transport and Infrastructure from May 2003 until January 2004. Mr. Choksi was a Group Vice President and Chief Financial Officer of the Company from July 2000 to May 2003. Prior to that, Mr. Choksi was Group Vice President Corporate Development and Treasurer of the Company from February 2000 until August 2000. Prior to that, Mr. Choksi served as Vice President and Treasurer of the Company from January 1999 to February 1, 2000. Prior to that, Mr. Choksi was a Director of Finance at the Company from 1997 to 1998, an Associate at TeleSoft Management, LLC in 1997 and an Analyst at Gleacher & Company from 1995 to 1997.

Brady Rafuse has been President Content Markets Group since August 2006 and President and CEO of our European operations since January 2006. Prior to this role, Mr. Rafuse was Group Vice President and President of our European operations from August 2001 to January 2006 and Senior Vice President of European Sales and Marketing from December 2000 to August 2001. Prior to that, Mr. Rafuse served as Head of Commercial Operations for Concert, a joint venture between AT&T and British Telecom, from

September 1999 to December 2000, and in a variety of positions with British Telecom from 1987 until December 2000. His last position was as General Manager, Global Energy Sector which he held from August 1998 to September 1999 and prior to that he was Deputy General Manager, Banking Sector from April 1997 to August 1998.

Eric J. Mortensen has been Senior Vice President and Controller of the Company since 2003. Prior to that, Mr. Mortensen was Vice President and Controller of the Company from 1999 to 2003 and was the Controller of the Company from 1997 to 1999. Prior to that, Mr. Mortensen was Controller and Assistant Controller of Kiewit Diversified Group for more than five years.

Admiral James O. Ellis, Jr. U.S. Navy (ret.) has been a director of the Company since March 2005. Effective May 18, 2005, Admiral Ellis became the president and chief executive officer of the Institute of Nuclear Power Operations or INPO, a nonprofit corporation established by the nuclear utility industry in 1979 to promote the highest levels of safety and reliability in the operation of nuclear electric generating plants. Admiral Ellis most recently served as Commander, U.S. Strategic Command in Omaha, Nebraska, before retiring in July 2004 after 35 years of service in the U.S. Navy, as Commander of the Strategic Command. In his Naval career, he held numerous commands. A graduate of the U.S. Naval Academy, he also holds M.S. degrees in Aerospace Engineering from the Georgia Institute of Technology and in Aeronautical Systems from the University of West Florida. He served as a Naval aviator and was a graduate of the U.S. Naval Test Pilot School. Admiral Ellis is also a member of the Board of Directors of Lockheed Martin Corporation, Inmarsat PLC and The Burlington Capital Group, LLC. Admiral Ellis is a member of the Nominating and Governance committee.

Richard R. Jaros has been a director of the Company since June 1993 and served as President of the Company from 1996 to 1997. Mr. Jaros served as Executive Vice President of the Company from 1993 to 1996 and Chief Financial Officer of the Company from 1995 to 1996. He also served as President and Chief Operating Officer of CalEnergy from 1992 to 1993, and is presently a director of Commonwealth Telephone. Mr. Jaros is a member of the Compensation Committee.

Robert E. Julian has been a director of the Company since March 1998. From 1992 to 1995 Mr. Julian served as Executive Vice President and Chief Financial Officer of the Company. Mr. Julian is the Chairman of the Audit Committee.

Arun Netravali has been a director of the Company since April 2003. Prior to that, Mr. Netravali was Chief Scientist for Lucent Technologies, working with academic and investment communities to identify and implement important new networking technologies from January 2002 to April 2003. Prior to that position, Mr. Netravali was President of Bell Labs as well as Lucent's Chief Technology Officer and Chief Network Architect from June 1999 to January 2002. Bell Labs serves as the research and development organization for Lucent Technologies. Mr. Netravali is a director of Agere Systems Inc. Mr. Netravali is a member of the Compensation Committee.

John T. Reed has been a director of the Company since March 2003. Mr. Reed is also a Director of and Chairman of the Audit Committee of First National Bank of Omaha. Mr. Reed is also Chairman of the Board of Alegent Health, a health care system headquartered in Omaha, Nebraska and a member of the Board and Chairman of the Audit Committee of Father Flanagan's Boys' Home located in Boys Town, Nebraska. Mr. Reed was Chairman of HMG Properties, the real estate investment banking joint venture of McCarthy Group, Inc. from 2000 until February 2005. Prior to that, he was Chairman of McCarthy & Co., the investment banking affiliate of McCarthy Group. Prior to joining McCarthy Group in 1997, Mr. Reed spent 32 years with Arthur Andersen LLP. Mr. Reed is the Chairman of the Nominating and Governance Committee and a member of the Audit Committee.

Michael B. Yanney has been a director of the Company since March 1998. He has served as Chairman of the Board of The Burlington Capital Group, LLC (formerly known as America First Companies L.L.C.)

for more than the last five years. Mr. Yanney also served as President and Chief Executive Officer of The Burlington Capital Group, LLC. Mr. Yanney is the Chairman of the Compensation Committee and a member of the Executive Committee and the Nominating and Governance Committee.

Dr. Albert C. Yates has been a director of the Company since March 2005. Dr. Yates retired after 12 years as president of Colorado State University in Fort Collins, Colorado in June 2003. He was also a chancellor of the Colorado State University System until October 2003, and is a former member of the board of the Federal Reserve Board of Kansas City-Denver Branch and the board of directors of First Interstate Bank and Molson Coors Brewing Company. He currently serves as a director of Centennial Bank Holdings, Inc. and StarTek, Inc. Dr. Yates is a member of the Audit Committee.

Raouf F. Abdel has been President Business Markets Group since February 2007. Prior to that, Mr. Abdel was Group Vice President of Integration and Development Services from March 2006 to February 2007. Prior to those roles, Mr. Abdel was Senior Vice President of Integration and Development Services from November 2005 to March 2006, responsible for managing Level 3's integration and systems and process development. Prior to that, Mr. Abdel was Senior Vice President of Product Development from September 2003 to November 2005, responsible for developing and managing Level 3 product development activities. Prior to that, Mr. Abdel was Senior Vice President of M&A Integration from March 2002 to September 2003, responsible for managing the execution of Level 3's integration activities. From July 2000 until March 2002, Mr. Abdel was Senior Vice President of Network Deployment, and from September 1999 until July 2000, Mr. Abdel was Vice President of Colocation Services. Mr. Abdel joined Level 3 in February 1998 as Senior Director of Construction.

John Neil Hobbs has been President Global Network Services since August 2006. Prior to that, Mr. Hobbs was Executive Vice President Sales and Marketing from January 2006 to August 2006. Prior to that, Mr. Hobbs was Group Vice President Global Sales from September 2000 to January 2006. Prior to that, Mr. Hobbs was President, Global Accounts for Concert, a joint venture between AT&T and British Telecom from July 1999 until September 2000. Prior to that, Mr. Hobbs was Director Transition and Implementation for the formation of Concert representing British Telecom from June 1998 until July 1999. From April 1997 until June 1998, Mr. Hobbs was British Telecom's General Manager for Global Sales & Service and from April 1994 until April 1997, Mr. Hobbs was British Telecom's General Manager for Corporate Clients.

Lynn E. Refer has been President Metro Network Services since August 2006. Prior to that, Mr. Refer was Chief Executive Officer of Looking Glass Networks, Inc., a provider of metropolitan optical networking services, from April 2000 to August 2006. Prior to Looking Glass Networks, Mr. Refer was Senior Vice President of Network Planning and Engineering at MCIWorldCom from April 1999 to March 2000. From April 1997 until March 1999, Mr. Refer was Vice President and then Senior Vice President of Planning, Development and Business Analysis at WorldCom and MCIWorldCom. Mr. Refer also held Vice President and Senior Vice President positions at MFS Communications from 1993 to 1996.

John F. Waters, Jr. has been Executive Vice President, Chief Technology Officer since January 2004. Prior to that, Mr. Waters was Group Vice President and Chief Technology Officer of the Company from February 2000 to January 2004. Prior to that, Mr. Waters was Vice President, Engineering of the Company from November 1997 until February 1, 2000. Prior to that, Mr. Waters was an executive staff member of MCI Communications from 1994 to November 1997.

Donald H. Gips has been Group Vice President Corporate Strategy since January 2001. Prior to that, Mr. Gips was Group Vice President, Sales and Marketing of the Company from February 2000. Prior to that, Mr. Gips served as Senior Vice President, Corporate Development from November 1998 to February 2000. Prior to that, Mr. Gips served in the White House as Chief Domestic Policy Advisor to Vice President Gore from April 1997 to April 1998. Before working at the White House, Mr. Gips was at the Federal Communications Commission as the International Bureau Chief and Director of Strategic



Policy from January 1994 to April 1997. Prior to his government service, Mr. Gips was a management consultant at McKinsey and Company.

Kevin T. Hart has been Group Vice President Global Systems Development and Chief Information Officer since January 2005. Prior to that, Mr. Hart was Vice President of Telecommunications, Media & Entertainment at Capgemini (formerly Ernst & Young), a management consulting firms in Dallas, Texas, for over nine years. In that role, he was responsible for the overall growth and direction of the organization's Communications Operations Support Systems, Billing/Business Support Systems and the Network Management Systems service offerings and delivery. Prior to joining Capgemini's management consulting practice, he held the positions of Director of Strategic Planning at International Paper and Manager of Operations at SBC Communications.

Joseph M. Howell, III has been Group Vice President Corporate Marketing since February 2000. Prior to that, Mr. Howell served as Senior Vice President, Corporate Marketing from October 1997 to February 1, 2000. Prior to that, Mr. Howell was a Senior Vice President of MFS/WorldCom from 1993 to 1997.

Until the Annual Meeting of Stockholders in 2008, the Board will be divided into three classes, designated Class I, Class II and Class III. At our 2007 Annual Meeting of Stockholders, the term of office of the following directors will expire: Walter Scott, Jr., James Q. Crowe, Robert E. Julian, Arun Netravali, John T. Reed and Michael B. Yanney. The term of office of the following individuals will expire at our 2008 Annual Meeting of Stockholders: Admiral James O. Ellis, Jr., Richard R. Jaros and Dr. Albert C. Yates. At each annual meeting of stockholders, successors to the class of directors whose term expires at that annual meeting will be elected for a one-year term. Our officers are elected annually to serve until each successor is elected and qualified or until his or her death, resignation or removal.

We believe that the members of the Audit Committee are independent within the meaning of the listing standards of The NASDAQ Stock Market, LLC. The Board has determined that Mr. Robert E. Julian, Chairman of the Audit Committee, qualifies as a "financial expert" as defined by the Securities and Exchange Commission. The Board considered Mr. Julian's credentials and financial background and found that he was qualified to serve as the "financial expert."

### **Code of Ethics**

We have adopted a code of ethics that complies with the standards mandated by the Sarbanes-Oxley Act of 2002. The complete code of ethics is available on our website at [www.level3.com](http://www.level3.com). At any time that the code of ethics is not available on our website, we will provide a copy upon written request made to Investor Relations, Level 3 Communications, Inc., 1025 Eldorado Blvd., Broomfield, Colorado 80021. We caution you that any information that is included in our website is not part of this 10-K. If we amend the code of ethics, or grant any waiver from a provision of the code of ethics that applies to our executive officers or directors, we will publicly disclose such amendment or waiver as required by applicable law, including by posting such amendment or waiver on our website at [www.level3.com](http://www.level3.com) or by filing a Form 8-K with the Securities and Exchange Commission or SEC.

### **SEC Filings**

Our Form 10-K, along with all other reports and amendments filed with or furnished to the SEC are publicly available free of charge on the investor relations section of our website as soon as reasonably practicable after we file such materials with, or furnish them to, the SEC. We caution you that the information on our website is not part of this or any other report we file with, or furnishes to, the SEC.

## Section 16(a)—Beneficial Ownership Reporting Compliance

To our knowledge, no person that was a director, executive officer or beneficial owner of more than 10% of the outstanding shares of our common stock failed to timely file all reports required under Section 16(a) of the Securities Exchange Act of 1934.

## Employees

As of December 31, 2006, and after giving effect to the acquisition of Broadwing, we had approximately 7,400 total employees. We believe that our success depends in large part on our ability to attract and retain substantial numbers of qualified employees.

## Item 1A. RISK FACTORS

### Forward Looking Statements

We, or our representatives, from time to time may make or may have made certain forward-looking statements, whether orally or in writing, including without limitation statements made or to be made in this Form 10-K, our Quarterly Reports on Form 10-Q, information contained in other filings with the Securities and Exchange Commission, press releases and other public documents or statements. In addition, our representatives, from time to time, participate in speeches and calls with market analysts, conferences with investors or potential investors in our securities and other meetings and conferences. Some of the information presented at these speeches, calls, meetings and conferences may include forward-looking statements. We use words like “expects,” “anticipates” or “believes” to identify forward-looking statements.

We wish to ensure that all forward-looking statements are accompanied by meaningful cautionary statements, so as to ensure to the fullest extent possible the protections of the safe harbor established in the Private Securities Litigation Reform Act of 1995. Accordingly, all forward-looking statements are qualified in their entirety by reference to, and are accompanied by, the following discussion of certain important factors that could cause actual results to differ materially from those projected in such forward-looking statements. We caution the reader that this list of important factors may not be exhaustive. We operate in a rapidly changing business, and new risk factors emerge from time to time. We cannot predict every risk factor, nor can we assess the impact, if any, of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those projected in any forward-looking statements. Accordingly, forward-looking statements should not be relied upon as a prediction of actual results. Further, we undertake no obligation to update forward-looking statements after the date they are made to conform the statements to actual results or changes in our expectations.

### Risks Related to Our Businesses

#### *Communications Group*

**Our financial condition and growth depends upon the successful integration of our acquired businesses. We may not be able to efficiently and effectively integrate recently acquired operations, and thus may not fully realize the anticipated benefits from such acquisitions.**

Level 3 and Broadwing entered into the Broadwing merger with the expectation that our acquisition of Broadwing will result in benefits to each company. Achieving the anticipated benefits of the Broadwing merger will depend in part upon whether we can integrate our businesses in an efficient and effective manner.

In addition, since December 2005, we have acquired WilTel Communications Group, LLC, Progress Telecom, LLC, ICG Communications, Inc., TelCove, Inc., Looking Glass Networks Holding Co., Inc. and

the CDN services business of SAVVIS and from time to time we may acquire additional businesses in accordance with our business strategy. The integration of our acquired businesses and any future businesses that we may acquire involves a number of risks, including, but not limited to:

- demands on management related to the significant increase in size after the acquisition;
- the disruption of ongoing business and the diversion of management's attention from the management of daily operations to the integration of operations;
- loss of key personnel of the recently acquired operations;
- loss of customers post-integration;
- higher integration costs than anticipated;
- failure to fully achieve expected synergies and costs savings;
- difficulties in the assimilation and retention of highly qualified, experienced employees;
- resistance to the assimilation of different cultures and practices, and complexity in the assimilation of personnel and operations which are broadly geographically dispersed; and
- unanticipated impediments in the integration of departments, systems, including accounting systems, technologies, books and records and procedures, as well as in maintaining uniform standards, controls, including internal control over financial reporting required by the Sarbanes-Oxley Act of 2002, procedures and policies.

If we cannot efficiently and effectively integrate acquired businesses or operations, we would be likely to experience material negative consequences to our business, financial condition or results of operations. Successful integration of these acquired businesses or operations will depend on our ability to manage these operations, realize opportunities for revenue growth presented by strengthened service offerings and expanded geographic market coverage and, to some degree, to eliminate redundant and excess costs to fully realize the expected synergies. Because of difficulties in combining geographically distant operations, we may not be able to achieve the financial strength and growth we anticipate from the acquisitions.

We cannot be certain that we will realize our anticipated benefits from our recent acquisitions, or that we will be able to efficiently and effectively integrate the recently acquired operations as planned. If we fail to integrate the recently acquired operations efficiently or fail to realize the benefits we anticipate, it could have a material adverse effect on our business, financial condition, results of operations and future prospects.

**We need to continue to increase the volume of traffic on our network to become profitable.**

We must continue to increase the volume of Internet, data, voice and video transmissions on our communications network at acceptable prices in order to realize our targets for anticipated sales and revenue growth, cash flow, operating efficiencies and the cost benefits of our network. If we do not maintain or improve our current relationship with existing customers and develop new large volume and enterprise customers, we may not be able to substantially increase traffic on our network, which would adversely affect our ability to become profitable.

**Intellectual property and proprietary rights of others could prevent us from using necessary technology to provide our services or subject us to expensive intellectual property litigation.**

If technology that is necessary for us to provide our services was determined by a court to infringe a patent held by another entity that is unwilling to grant us a license on terms acceptable to us, we could be precluded by court order from using such technology and would likely be required to pay a significant

monetary damages award to the patent-holder. The successful enforcement of such patents, or our inability to negotiate a license for any such technology on acceptable terms, could force us to cease using the technology and offering services incorporating the technology. In the event that a claim of infringement was brought against us based on the use or sale of our technology or against any of our customers based on their use of our technology for which we would be obligated to indemnify, we could be subject to litigation to determine whether such use or sale of the relevant technology is, in fact, infringing. This litigation would be expensive and distracting, regardless of the outcome of the suit.

While our own extensive patent portfolio may deter other telecommunications providers from bringing such actions, patent infringement claims are increasingly being asserted by patent holding companies, whose sole business model is to enforce patents against operators, such as Level 3, for monetary gain. Because such patent holding companies do not provide services or use technology, the assertion of our own patents by way of counter-claim would be largely ineffective. We have already been the subject of time-consuming and expensive patent litigation brought by certain patent holding companies and we can reasonably expect that we will face further claims in the future.

**Our business requires the continued development of effective business support systems to implement customer orders and to provide and bill for services.**

Our business depends on our ability to continue to develop effective business support systems. This is a complicated undertaking requiring significant resources and expertise and support from third-party vendors. Business support systems are needed for:

- implementing customer orders for services;
- provisioning, installing and delivering these services; and
- monthly billing for these services.

Because our business provides for continued rapid growth in the number of customers that we serve and the volume of services offered, there is a need to continue to develop our business support systems on a schedule sufficient to meet proposed service rollout dates. The failure to continue to develop effective business support systems could materially adversely affect our ability to implement our business plans and meet our financial goals and objectives.

**Our revenue is concentrated in a limited number of customers.**

A significant portion of our communications revenue is concentrated among a limited number of customers. For the year ended December 31, 2006, our top ten customers represented approximately 54% of our consolidated total revenue. Revenue from our largest customer, AT&T Inc. and its subsidiaries, including SBC Communications, BellSouth and Cingular, (assuming those subsidiaries were wholly owned by AT&T for all of 2006), represented approximately 32.4% of our consolidated total revenue for 2006. The next largest customer accounted for approximately 6.6% of our consolidated total revenue and most of the remaining top ten customers each account for 2% or less of our consolidated total revenue. If we lost one or more of these major customers, or if one or more major customers significantly decreased orders for our services, our business would be materially and adversely affected.

In connection with the acquisition of WilTel in December 2005, we acquired a large customer contract between WilTel and SBC Communications, a subsidiary of AT&T. We expect that the revenue generated under this contract will continue to decline over time as SBC Communications migrates its traffic from our network to the merged SBC and AT&T Communications network that SBC Communications acquired from the former AT&T.

**We may lose customers if we experience system failures that significantly disrupt the availability and quality of the services that we provide.**

Our operations depend on our ability to avoid and mitigate any interruptions in service or reduced capacity for customers. Interruptions in service or performance problems, for whatever reason, could undermine confidence in our services and cause us to lose customers or make it more difficult to attract new ones. In addition, because many of our services are critical to the businesses of many of our customers, any significant interruption in service could result in lost profits or other loss to customers. Although we attempt to disclaim liability in our service agreements, a court might not enforce a limitation on liability, which could expose us to financial loss. In addition, we often provide our customers with guaranteed service level commitments. If we are unable to meet these guaranteed service level commitments as a result of service interruptions, we may be obligated to provide credits, generally in the form of free service for a short period of time, to our customers, which could negatively affect our operating results.

The failure of any equipment or facility on our network, including the network operations control center and network data storage locations, could result in the interruption of customer service until necessary repairs are effected or replacement equipment is installed. Network failures, delays and errors could also result from natural disasters, terrorist acts, power losses, security breaches and computer viruses. These failures, faults or errors could cause delays, service interruptions, expose us to customer liability or require expensive modifications that could significantly hurt our business.

**There is no guarantee that we will be successful in combining our existing service offering with our recently acquired content distribution services.**

As we believe that one of the largest sources of future incremental demand for our communications services will be derived from customers that are seeking to distribute their feature rich content or video over the Internet, we purchased the content distribution network or CDN assets of SAVVIS, Inc. in January 2007. As a result of this acquisition, we now need to combine this CDN service offering with our existing communications services—including high speed Internet access, transport and colocation services—to provide a single source, end-to-end content distribution solution. Although we have sold high speed Internet access, transport and colocation services since the late 1990's, we have only been selling our CDN services since the completion of the acquisition of the SAVVIS assets in January 2007. As a result, there are many difficulties that we may encounter, including customer acceptance, intellectual property matters, technological issues, developmental constraints and other problems that we may not anticipate. There is no guarantee that we will be successful in generating significant revenues from our CDN service offering.

**Rapid technological changes can lead to further competition.**

The communications industry is subject to rapid and significant changes in technology. In addition, the introduction of new services or technologies, as well as the further development of existing services and technologies may reduce the cost or increase the supply of certain services similar to those that we provide. As a result, our most significant competitors in the future may be new entrants to the communications industry. These new entrants may not be burdened by an installed base of outdated equipment. Our future success depends, in part, on our ability to anticipate and adapt in a timely manner to technological changes. Technological changes and the resulting competition could have a material adverse effect on our business.

**Failure to complete development, testing and introduction of new services, including VoIP services, could affect our ability to compete in the industry.**

We continuously develop, test and introduce new communications services that are delivered over our communications network. These new services are intended to allow us to address new segments of the communications marketplace and to compete for additional customers. In certain instances, the introduction of new services requires the successful development of new technology. To the extent that upgrades of existing technology are required for the introduction of new services, the success of these upgrades may be dependent on the conclusion of contract negotiations with vendors and vendors meeting their obligations in a timely manner. In addition, new service offerings may not be widely accepted by our customers. If our new service offerings are not widely accepted by our customers, we may terminate those service offerings and be required to impair any assets or information technology used to develop or offer those services. If we are not able to successfully complete the development and introduction of new services in a timely manner, our business could be materially adversely affected.

**During our communications business operating history, we have generated substantial losses, which we expect to continue.**

The development of our communications business required, and may continue to require, significant expenditures. These expenditures could result in substantial negative cash flow from operating activities and substantial net losses for the near future. For the fiscal years ended December 31, 2006 and December 31, 2005, we incurred losses from continuing operations of approximately \$790 million and \$707 million, respectively. We expect to continue to experience losses, and may not be able to achieve or sustain operating profitability in the future. Continued operating losses could limit our ability to obtain the cash needed to expand our network, make interest and principal payments on our debt or fund other business needs.

We will need to continue to expand and adapt our network in order to remain competitive, which may require significant additional funding. During 2005, we deployed a new generation of optical transmission equipment. Additional expansion and adaptations of our communications network's electronic and software components will be necessary in order to respond to:

- growing number of customers;
- the development and launching of new services;
- increased demands by customers to transmit larger amounts of data;
- changes in customers' service requirements;
- technological advances by competitors; and
- governmental regulations.

Future expansion or adaptation of our network will require substantial additional financial, operational and managerial resources, which may not be available at the time. If we are unable to expand or adapt our network to respond to these developments on a timely basis and at a commercially reasonable cost, our business will be materially adversely affected.

**The prices we are able to charge for certain of our communications services have been decreasing in the past and may decrease over time resulting in lost revenue for which we may be unable to compensate.**

Over the past few years, the prices that we are able to charge for certain of our communications services have been decreasing. These decreases resulted from downward market pressure and other factors including:

- increased transmission capacity by our competitors and us on our respective existing and new networks;
- our customer agreements containing volume based pricing or other contractually agreed upon decreases in prices during the term of the agreement; and
- technological advances or otherwise.

As our prices for communications services decrease for whatever reason, if we are unable to increase traffic volume through additional services from which we can derive additional revenue or if we are unable to reduce our operating expenses, our operating results will decline.

Excluding the effects of acquisitions, we also continue to expect managed modem related revenue to continue to decline primarily due to:

- an increase in the number of subscribers migrating to broadband services;
- continued pricing pressures; and
- declining customer obligations under existing contractual arrangements.

**We may be liable for the material that content providers distribute over our network.**

The law relating to the liability of private network operators for information carried on or disseminated through their networks is still unsettled. We may become subject to legal claims relating to the content disseminated on our network. For example, lawsuits may be brought against us claiming that material on our network on which one of our customers relied was inaccurate. Claims could also involve matters such as defamation, invasion of privacy and copyright infringement. In addition, there are other issues such as online gambling where the legal issues remain unclear. Content providers operating private networks have been sued in the past, sometimes successfully, based on the content of material. If we need to take costly measures to reduce our exposure to these risks, or are required to defend ourselves against such claims, our financial results could be negatively affected.

**Because our VoIP services are relatively new services there is no guarantee that these services will gain broad market acceptance.**

Although we have sold Softswitch based services since the late 1990's, we have only been selling our Voice over Internet Protocol (or VoIP) services for a limited period of time. As a result, there are many difficulties that we may encounter, including regulatory hurdles, technological issues, intellectual property matters, developmental constraints and other problems that we may not anticipate. To date, our revenue from the sale of VoIP services has not been significant relative to our total consolidated revenues and there is no guarantee that we will be successful in generating significant VoIP revenues.

**The success of our subscriber based VoIP services is dependent on the growth and public acceptance of VoIP telephony in general.**

The success of our subscriber based VoIP services is dependent upon future demand for VoIP telephony services in general in the marketplace. In order for the IP telephony market to continue to grow, several things need to occur, including the following:

- Telephone and cable service providers must continue to invest in the deployment of high speed broadband networks to residential and commercial customers.
- VoIP networks must continue to improve quality of service for real-time communications, managing effects such as packet jitter, packet loss and unreliable bandwidth, so that toll-quality service can be provided.
- VoIP telephony equipment and services must achieve a similar level of reliability that users of the public switched telephone network have come to expect from their telephone service, including emergency calling features and capabilities.
- VoIP telephony service providers must offer cost and feature benefits to their customers that are sufficient to cause the customers to switch away from traditional telephony service providers.

If any or all of these factors fail to occur, our VoIP services business may not continue or grow as expected.

**The need to obtain additional capacity for our network from other providers increases our costs.**

We use network resources owned by other companies for portions of our network both in the United States and in Europe. We obtain the right to use such network portions, including both telecommunications capacity and rights to use dark fiber, through operating leases and IRU agreements in which we pay for the right to use such other companies' fiber assets and through agreements in which we exchange the use of portions of our network for the use of portions of such other companies' networks. In several of those agreements, the counter party is responsible for network maintenance and repair. If a counter party to a lease, IRU or an exchange suffers financial distress or bankruptcy, we may not be able to enforce our rights to use such network assets or, even if we could continue to use such network assets, we could incur material expenses related to maintenance and repair. We could also incur material expenses if we were required to locate alternative network assets. We may not be successful in obtaining reasonable alternative network assets if needed. Failure to obtain usage of alternative network assets, if necessary, could have a material adverse impact on our ability to carry on business operations. In addition, some of our agreements with other providers require the payment of amounts for services whether or not those services are used.

In the normal course of business, we need to enter into interconnection agreements with many domestic and foreign local telephone companies, but we are not always able to do so on favorable terms. Costs of obtaining local service from other carriers comprise a significant proportion of the operating expenses of long distance carriers. Similarly, a large proportion of the costs of providing international service consists of payments to other carriers. Changes in regulation, particularly the regulation of local and international telecommunication carriers, could indirectly, but significantly, affect our competitive position. These changes could increase or decrease the costs of providing our services.

**We may be unable to hire and retain sufficient qualified personnel; the loss of any of our key executive officers could adversely affect on our business.**

We believe that our future success will depend in large part on our ability to attract and retain highly skilled, knowledgeable, sophisticated and qualified managerial, professional and technical personnel. We



have experienced significant competition in attracting and retaining personnel who possess the skills that we are seeking. As a result of this significant competition, we may experience a shortage of qualified personnel.

Our businesses are managed by a small number of key executive officers, particularly James Q. Crowe, Chief Executive Officer, Kevin J. O'Hara, President and Chief Operating Officer and Charles C. Miller, III, Vice Chairman and Executive Vice President. The loss of any of these key executive officers could have a material adverse effect on our business.

**We must obtain and maintain permits and rights-of-way to operate our network.**

If we are unable, on acceptable terms and on a timely basis, to obtain and maintain the franchises, permits and rights-of-way needed to expand and operate our network, our business could be materially adversely affected. In addition, the cancellation or non-renewal of the franchises, permits or rights-of-way that are obtained could materially adversely affect our business. Our communications operating subsidiaries are defendants in several lawsuits that, among other things, challenge the subsidiaries' use of rights-of-way. The plaintiffs have sought to have these lawsuits certified as class actions. It is likely that additional suits challenging use of our rights-of-way will occur and that those plaintiffs also will seek class certification. The outcome of this litigation may increase our costs and adversely affect our operating results.

**Termination of relationships with key suppliers could cause delay and costs.**

Our business is dependent on third-party suppliers for fiber, computers, software, optronics, transmission electronics and related components that are integrated into our network. If any of these relationships is terminated or a supplier fails to provide reliable services or equipment and we are unable to reach suitable alternative arrangements quickly, we may experience significant additional costs. If that happens, our business could be materially adversely affected.

**Increased industry capacity and other factors could lead to lower prices for our services.**

Additional network capacity available from our competitors may cause significant decreases in the prices for the services that we offer. Prices may also decline due to capacity increases resulting from technological advances and strategic acquisitions. Increased competition has already led to a decline in rates charged for various telecommunications services.

**Recent acquisitions by AT&T and Verizon will create a tendency for the ILEC acquirer to favor their wholly owned or fully integrated interexchange carrier.**

We acquire a significant portion of our access, the connection between our owned network and the customer premises, from ILECs. With the recent ILEC acquisitions of major interexchange carriers, the ILECs now compete directly with our business and may have a tendency to favor themselves and their affiliates to our detriment. It is not yet clear what effect, if any, will result from the constraints agreed to by the ILECs to protect independent interexchange carriers against this discrimination in the procurement of the bottleneck local access circuits. The ILECs favoring themselves in access could have a material adverse effect on our ability to obtain and retain customers because access is often necessary in most cases to connect enterprise customers and carrier customers to our network. Network access represents a very large portion of our total costs and if we face less favorable pricing and provisioning, we will be at a competitive disadvantage versus the ILECs.

**The opportunity to obtain access from competitive access providers to the ILECs has been significantly reduced as a result of the AT&T and Verizon mergers.**

A principal method of connecting with our customers is through local transport and last mile circuits we purchase from the ILEC. Another method is our purchasing such circuits from competitive access providers like AT&T and MCI. We believe that competitive access providers are the only entities that exert competitive pricing pressure on the ILECs. While the likely result of the acquisitions by AT&T and Verizon is higher prices for special access over time, it is not possible to determine at this time how adverse the long term effect on us will be.

**We are subject to significant regulation that could change in an adverse manner.**

Communications services are subject to significant regulation at the federal, state, local and international levels. These regulations affect our business and our existing and potential competitors. Delays in receiving required regulatory approvals (including approvals relating to acquisitions or financing activities), completing interconnection agreements with incumbent local exchange carriers or the enactment of new and adverse regulations or regulatory requirements may have a material adverse effect on our business. In addition, future legislative, judicial and regulatory agency actions could have a material adverse effect on our business.

Federal legislation provides for a significant deregulation of the U.S. telecommunications industry, including the local exchange, long distance and cable television industries. This legislation remains subject to judicial review and additional Federal Communications Commission, or FCC, rulemaking. As a result, we cannot predict the legislation's effect on our future operations. Many regulatory actions are under way or are being contemplated by federal and state authorities regarding important items. These actions could have a material adverse effect on our business.

States also often require prior approvals or notifications for certain transfers of assets, customers or ownership of certificated carriers and for issuances by certified carriers of equity or debt.

**Canadian law currently does not permit us to offer services directly in Canada.**

Ownership of facilities that originate or terminate traffic in Canada is currently limited to Canadian carriers. This restriction hinders our entry into the Canadian market unless appropriate arrangements can be made to address it.

**Potential regulation of Internet service providers in the United States could adversely affect our operations.**

The FCC has, to date, treated Internet service providers as enhanced service providers. In addition, Congress has, to date, not sought to heavily regulate the provision of IP-based services. Both Congress and the FCC are considering proposals that involve greater regulation of IP-based service providers. Depending on the content and scope of any regulations, the imposition of such regulations could have a material adverse effect on our business and the profitability of our services.

**The communications industry is highly competitive with participants that have greater resources and a greater number of existing customers.**

The communications industry is highly competitive. Many of our existing and potential competitors have financial, personnel, marketing and other resources significantly greater than us. Many of these competitors have the added competitive advantage of a larger existing customer base. In addition, significant new competition could arise as a result of:

- the consolidation in the industry, led by AT&T and Verizon;
- allowing foreign carriers to compete in the U.S. market;

- further technological advances; and
- further deregulation and other regulatory initiatives.

If we are unable to compete successfully, our business could be significantly hurt.

**We may be unable to successfully identify, manage and assimilate future acquisitions, investments and strategic alliances, which could adversely affect our results of operations.**

We continually evaluate potential investments and strategic opportunities to expand our network, enhance connectivity and add traffic to our network. In the future, we may seek additional investments, strategic alliances or similar arrangements, which may expose us to risks such as:

- the difficulty of identifying appropriate investments, strategic allies or opportunities;
- the possibility that senior management may be required to spend considerable time negotiating agreements and monitoring these arrangements;
- the possibility that definitive agreements will not be finalized;
- potential regulatory issues applicable to the telecommunications business;
- the loss or reduction in value of the capital investment;
- the inability of management to capitalize on the opportunities presented by these arrangements; and
- the possibility of insolvency of a strategic ally.

There can be no assurance that we would successfully overcome these risks or any other problems encountered with these investments, strategic alliances or similar arrangements.

**Revenue under our agreement with SBC Services is expected to continue to decline materially.**

As part of our acquisition of the communications business of WilTel Communications Group, LLC, or WilTel, we acquired a multi-year contract with SBC Services, Inc. which we refer to as the SBC Contract Services Agreement. Recently, SBC Services Inc. became a subsidiary of AT&T Inc. and announced its intention to migrate the services provided by WilTel to the merged SBC Services, Inc. and AT&T network. WilTel and SBC amended the SBC Contract Services agreement to run through 2009 and it provides a remaining gross margin purchase commitment of \$67 million through the end of 2007, and \$75 million from January 2008 through the end of 2009. Originating and terminating access charges paid to local phone companies are passed through to SBC in accordance with a formula that approximates cost. Additionally, the SBC Master Services Agreement provides for the payment of \$25 million in 2007 from SBC if we meet certain performance criteria. We expect the revenue generated by the SBC Contract Services agreement to decline materially in 2007.

***Other Operations***

**Environmental liabilities from our historical operations could be material.**

Environmental liabilities from our historical operations could be material. Our operations and properties are subject to a wide variety of laws and regulations relating to environmental protection, human health and safety. These laws and regulations include those concerning the use and management of hazardous and non-hazardous substances and wastes. We have made and will continue to make significant expenditures relating to our environmental compliance obligations. Despite our best efforts, we may not at all times be in compliance with all of these requirements.

In connection with certain historical operations, we have responded to or been notified of potential environmental liability at approximately 148 properties as of February 15, 2007. We are engaged in addressing or have liquidated 70 of those properties. Of these: (a) we have formal commitments or other potential future costs at 15 sites; (b) there are 10 sites with minimal future costs; (c) there are 11 sites with unknown future costs and (d) there are 34 sites with no likely future costs. The remaining 78 properties have been dormant for several years. We could be held liable, jointly or severally, and without regard to fault, for such investigation and remediation. The discovery of additional environmental liabilities related to historical operations or changes in existing environmental requirements could have a material adverse effect on our business.

**Potential liabilities and claims arising from coal operations could be significant.**

Our coal operations are subject to extensive laws and regulations that impose stringent operational, maintenance, financial assurance, environmental compliance, reclamation, restoration and closure requirements. These requirements include those governing air and water emissions, waste disposal, worker health and safety, benefits for current and retired coal miners, and other general permitting and licensing requirements. Despite our best efforts, we may not at all times be in compliance with all of these requirements. Liabilities or claims associated with this non-compliance could require us to incur material costs or suspend production. Mine reclamation costs that exceed reserves for these matters also could require us to incur material costs.

***General***

**If we are unable to comply with the restrictions and covenants in our debt agreements, there would be a default under the terms of these agreements, and this could result in an acceleration of payment of funds that have been borrowed.**

If we were unable to comply with the restrictions and covenants in any of our debt agreements, there would be a default under the terms of those agreements. As a result, borrowings under other debt instruments that contain cross-acceleration or cross-default provisions may also be accelerated and become due and payable. If any of these events occur, there can be no assurance that we would be able to make necessary payments to the lenders or that we would be able to find alternative financing. Even if we were able to obtain alternative financing, there can be no assurance that it would be on terms that are acceptable.

**We have substantial debt, which may hinder our growth and put us at a competitive disadvantage.**

Our substantial debt may have important consequences, including the following:

- the ability to obtain additional financing for acquisitions, working capital, investments and capital or other expenditures could be impaired or financing may not be available on acceptable terms;
- a substantial portion of our cash flow will be used to make principal and interest payments on outstanding debt, reducing the funds that would otherwise be available for operations and future business opportunities;
- a substantial decrease in cash flows from operating activities or an increase in expenses could make it difficult to meet debt service requirements and force modifications to operations;
- We have more debt than certain of our competitors, which may place us at a competitive disadvantage; and
- substantial debt may make us more vulnerable to a downturn in business or the economy generally.

We had substantial deficiencies of earnings to cover fixed charges of approximately \$722 million for the fiscal year ended December 31, 2006. We had deficiencies of earnings to cover fixed charges of \$634 million for the fiscal year ended December 31, 2005, \$409 million for the fiscal year ended December 31, 2004, \$681 million for the fiscal year 2003 and \$936 million for the fiscal year 2002.

**We may not be able to repay our existing debt; failure to do so or refinance the debt could prevent us from implementing our strategy and realizing anticipated profits.**

If we were unable to refinance our debt or to raise additional capital on acceptable terms, our ability to operate our business would be impaired. As of December 31, 2006, not taking into account capital markets transaction that we engaged in during the first quarter 2007, we had an aggregate of approximately \$7.362 billion of long-term debt on a consolidated basis and including current maturities, and approximately \$374 million of stockholders' equity.

Our ability to make interest and principal payments on our debt and borrow additional funds on favorable terms depends on the future performance of the business. If we do not have enough cash flow in the future to make interest or principal payments on our debt, we may be required to refinance all or a part of our debt or to raise additional capital. We cannot be sure that we will be able to refinance our debt or raise additional capital on acceptable terms.

**Restrictions and covenants in our debt agreements limit our ability to conduct our business and could prevent us from obtaining needed funds in the future.**

Our debt and financing arrangements contain a number of significant limitations that restrict our ability to, among other things:

- borrow additional money or issue guarantees;
- pay dividends or other distributions to stockholders;
- make investments;
- create liens on assets;
- sell assets;
- enter into sale-leaseback transactions;
- enter into transactions with affiliates; and
- engage in mergers or consolidations.

**If certain transactions occur with respect to our capital stock, we may be unable to fully utilize our net operating loss carryforwards to reduce our income taxes.**

As of December 31, 2006, we had net operating loss carryforwards of approximately \$7.0 billion for federal income tax purposes. If certain transactions occur with respect to our capital stock that result in a cumulative ownership change of more than 50 percentage points by 5-percent stockholders over a three-year period as determined under rules prescribed by the U.S. Internal Revenue Code and applicable regulations, annual limitations would be imposed with respect to our ability to utilize our net operating loss carryforwards and certain current deductions against any taxable income it achieves in future periods.

We have entered into transactions over the last three years resulting in significant cumulative changes in the ownership of our capital stock. Additional transactions that we enter into as well as transactions by existing 5% stockholders that we do not participate in could cause us to incur a 50 percentage point ownership change by 5% stockholders and, if we trigger the above-noted Internal Revenue Code imposed

limitations, such transactions would prevent us from fully utilizing net operating loss carryforwards and certain current deductions to reduce income taxes.

**The unpredictability of our quarterly results may adversely affect the trading price of our common stock.**

Our revenue and operating results will vary significantly from quarter to quarter due to a number of factors, many of which are outside of our control and any of which may cause the price of our common stock to fluctuate. The primary factors, among other things, that may affect our quarterly results include the following:

- The timing of costs associated with our integration activities with respect to our recently completed acquisitions;
- demand for communications services;
- loss of customers or the ability to attract new customers;
- changes in pricing policies or the pricing policies of our competitors;
- costs related to acquisitions of technology or businesses;
- changes in regulatory rulings; and
- general economic conditions as well as those specific to the communications and related industries.

A delay in generating revenue or the timing of recognizing revenue and expenses could cause significant variations in our operating results from quarter to quarter. It is possible that in some future quarters our results may be below analysts and investors expectations. In these circumstances, the price of our common stock will likely decrease.

**Increased scrutiny of financial disclosure, particularly in the telecommunications industry in which we operate, could adversely affect investor confidence, and any restatement of earnings could increase litigation risks and limit our ability to access the capital markets.**

Congress, the SEC, other regulatory authorities and the media are intensely scrutinizing a number of financial reporting issues and practices. Although all businesses face uncertainty with respect to how the U.S. financial disclosure regime may be impacted by this process, particular attention has been focused recently on the telecommunications industry and companies' interpretations of generally accepted accounting principles.

If we were required to restate our financial statements as a result of a determination that we had incorrectly applied generally accepted accounting principles, that restatement could adversely affect our ability to access the capital markets or the trading price of our securities. The recent scrutiny regarding financial reporting has also resulted in an increase in litigation in the telecommunications industry. There can be no assurance that any such litigation against us would not materially adversely affect our business or the trading price of our securities.

**Terrorist attacks and other acts of violence or war may adversely affect the financial markets and our business.**

Since the September 11, 2001 terrorist attacks and subsequent events, there has been considerable uncertainty in world financial markets. The full effect on the financial markets of these events, as well as concerns about future terrorist attacks, is not yet known. They could, however, adversely affect our ability to obtain financing on terms acceptable to us, or at all.

There can be no assurance that there will not be further terrorist attacks against the United States or U.S. businesses. These attacks or armed conflicts may directly affect our physical facilities or those of our customers. These events could cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and world financial markets and economy. Any of these occurrences could materially adversely affect our business.

**Our international operations and investments expose us to risks that could materially adversely affect the business.**

We have operations and investments outside of the United States, as well as rights to undersea cable capacity extending to other countries, that expose us to risks inherent in international operations. These include:

- general economic, social and political conditions;
- the difficulty of enforcing agreements and collecting receivables through certain foreign legal systems;
- tax rates in some foreign countries may exceed those in the U.S.;
- foreign currency exchange rates may fluctuate, which could adversely affect our results of operations and the value of our international assets and investments;
- foreign earnings may be subject to withholding requirements or the imposition of tariffs, exchange controls or other restrictions;
- difficulties and costs of compliance with foreign laws and regulations that impose restrictions on our investments and operations, with penalties for noncompliance, including loss of licenses and monetary fines;
- difficulties in obtaining licenses or interconnection arrangements on acceptable terms, if at all; and
- changes in U.S. laws and regulations relating to foreign trade and investment.

**Additional issuances of equity securities by us would dilute the ownership of our existing stockholders**

We may issue equity in the future in connection with acquisitions or strategic transactions, to adjust our ratio of debt to equity, including through repayment of outstanding debt, to fund expansion of our operations or for other purposes. We may issue shares of our common stock at prices or for consideration that is greater than or less than the price at which we are offering our common stock in this offering. To the extent we issue additional equity securities, your percentage ownership of our common stock would be reduced.

**If a large number of shares of our common stock is sold in the public market, the sales could reduce the trading price of our common stock and impede our ability to raise future capital**

We cannot predict what effect, if any, future issuances by us of our common stock will have on the market price of our common stock. In addition, shares of our common stock that we issue in connection with an acquisition, may not be subject to resale restrictions. The market price of our common stock could drop significantly if certain large holders of our common stock, or recipients of our common stock in connection with an acquisition, sell all or a significant portion of their shares of common stock or are perceived by the market as intending to sell these shares other than in an orderly manner. In addition, these sales could impair our ability to raise capital through the sale of additional common stock in the capital markets.

## **Anti-takeover provisions in our charter and by-laws could limit the share price and delay a change of management**

Our restated certificate of incorporation and by-laws contain provisions that could make it more difficult or even prevent a third party from acquiring us without the approval of our incumbent board of directors. These provisions, among other things:

- prohibit stockholder action by written consent in place of a meeting;
- limit the right of stockholders to call special meetings of stockholders; limit the right of stockholders to present proposals or nominate directors for election at annual meetings of stockholders; and
- authorize the board of directors to issue preferred stock in one or more series without any action on the part of stockholders.

In addition, the terms of most of our long term debt require that upon a “change of control,” as defined in the agreements that contain the terms and conditions of the long term debt, we make an offer to purchase the outstanding long term debt at either 100% or 101% of the aggregate principal amount of that long term debt.

These provisions could limit the price that investors might be willing to pay in the future for shares of our common stock and significantly impede the ability of the holders of our common stock to change management. Provisions and agreements that inhibit or discourage takeover attempts could reduce the market value of our common stock.

## **The market price of our common stock has been subject to volatility and, in the future, the market price of our common stock may fluctuate substantially due to a variety of factors**

The market price of our common stock has been subject to volatility and, in the future, the market price of our common stock may fluctuate substantially due to a variety of factors, including:

- the depth and liquidity of the trading market for our common stock;
- quarterly variations in actual or anticipated operating results;
- changes in estimated earnings by securities analysts;
- market conditions in the communications services industry;
- announcement and performance by competitors;
- regulatory actions; and
- general economic conditions.

In addition, in recent months the stock market generally has experienced significant price and volume fluctuations. Those market fluctuations could have a material adverse effect on the market price or liquidity of our common stock.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

Our headquarters are located on 46 acres in the Interlocken Advanced Technology Environment within the City and County of Broomfield, Colorado. The campus facility, which is owned by our wholly owned subsidiary HQ Realty, Inc., encompasses approximately 850,000 square feet of office space.



Additionally, we lease approximately 121,180 square feet of office and technical space in a building located at 180 Peachtree Street, NW in Atlanta, Georgia. As part of the WilTel acquisition, we also lease approximately 213,594 square feet of office and technical space in the building known as One Technology Center located at 100 South Cincinnati Avenue in Tulsa, Oklahoma. As part of the TelCove acquisition in 2006, we also lease approximately 54,000 square feet of office space in the Southpointe office park in Canonsburg, Pennsylvania, comprised of approximately 42,500 square feet in the building located at 121 Champion Way and approximately an additional 11,300 square feet in the building located at 601 Technology Drive. As part of the Broadwing acquisition in the first quarter of 2007, we lease approximately 130,000 square feet of office space in a building located at 1122 South Capital of Texas Highway in Austin, Texas. In Europe, we have approximately 211,000 square feet of office space in the United Kingdom, approximately 10,000 square feet of office space in Germany, and approximately 3,000 square feet of office space in France.

Properties relating to our network operations in the communications business are described under “ITEM 1. BUSINESS—Our Communications Network” above.

Our Gateway facilities are designed to house local sales staff, operational staff, our transmission and IP routing/switching facilities and technical space to accommodate colocation of equipment by high-volume Level 3 customers. We ended 2006, after giving effect to the acquisition of Broadwing, with approximately 6.9 million square feet of space for our Gateway and transmission facilities and have completed construction on approximately 4.6 million square feet of this space. Our Gateway space is either owned by us or is held pursuant to long-term lease agreements.

We have entered into various agreements regarding our unused office and technical space in order to reduce our ongoing operating expenses regarding such space.

Properties relating to our coal mining segment are described under “ITEM 1. BUSINESS—Our Other Businesses” above. In connection with certain existing and historical operations, we are subject to environmental risks.

### **ITEM 3. LEGAL PROCEEDINGS**

#### *Right of Way Litigation*

In April 2002, Level 3 Communications, Inc., and two of its subsidiaries were named as a defendant in *Bauer, et. al. v. Level 3 Communications, LLC, et al.*, a purported class action covering 22 states, filed in state court in Madison County, Illinois. In July 2001, Level 3 was named as a defendant in *Koyle, et. al. v. Level 3 Communications, Inc., et. al.*, a purported two state class action filed in the U.S. District Court for the District of Idaho. In November of 2005, the court granted class certification only for the state of Idaho, which decision is on appeal. In September 2002, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *Smith et. al. v. Sprint Communications Company, L.P., et al.*, a purported nationwide class action filed in the United States District Court for the Northern District of Illinois. In April 2005, the Smith plaintiffs filed a Fourth Amended Complaint which did not include Level 3 or Williams Communications, Inc. as a party, thus ending both companies’ involvement in the Smith case. On February 17, 2005, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *McDaniel, et. al., v. Qwest Communications Corporation, et al.*, a purported class action covering 10 states filed in the United States District Court for the Northern District of Illinois. These actions involve the companies’ right to install its fiber optic cable network in easements and right-of-ways crossing the plaintiffs’ land. In general, the companies obtained the rights to construct their networks from railroads, utilities, and others, and have installed their networks along the rights-of-way so granted. Plaintiffs in the purported class actions assert that they are the owners of lands over which the companies’ fiber optic cable networks pass, and that the railroads, utilities, and others who granted the

companies the right to construct and maintain their networks did not have the legal authority to do so. The complaints seek damages on theories of trespass, unjust enrichment and slander of title and property, as well as punitive damages. The companies have also received, and may in the future receive, claims and demands related to rights-of-way issues similar to the issues in these cases that may be based on similar or different legal theories. To date, other than as noted above, all adjudicated attempts to have class action status granted on complaints filed against the companies or any of their subsidiaries involving claims and demands related to rights-of-way issues have been denied.

It is still too early for the Company to reach a conclusion as to the ultimate outcome of these actions. However, management believes that the Company and its subsidiaries have substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend them vigorously if a satisfactory form of settlement is not approved.

#### *Broadwing Class Action*

Between May 7, 2001 and June 15, 2001, nine class action lawsuits were filed in the United States District Court for the Southern District of New York relating to the Broadwing Corporation initial public offering on behalf of all persons who purchased the Broadwing stock between July 28, 2000 and the filing of the complaints. Each of the complaints named as defendants: Broadwing, its directors and officers who signed the registration statement in connection with its initial public offering, and certain of the underwriters that participated in the initial public offering. Broadwing's directors and officers have since been dismissed from the case, without prejudice. The complaints allege that the registration statement and prospectus relating to the Broadwing initial public offering contained material misrepresentations and/or omissions in that those documents did not disclose (1) that certain of the underwriters had solicited and received undisclosed fees and commissions and other economic benefits from some investors in connection with the distribution of the Broadwing common stock in the initial public offering and (2) that certain of the underwriters had entered into arrangements with some investors that were designed to distort and/or inflate the market price for the Broadwing common stock in the aftermarket following the initial public offering. The complaints ask the court to award to members of the class the right to rescind their purchases of Broadwing's common stock (or to be awarded rescissory damages if the class member has sold the Broadwing stock) and prejudgment and post-judgment interest, reasonable attorneys' and experts witness' fees and other costs.

On February 15, 2005, the Judge granted preliminary approval of a proposed settlement agreement between the plaintiffs and defendants, including Broadwing. The proposed settlement is a \$1 billion guaranteed settlement. The insurance companies for the defendants agreed to pay up to \$1 billion dollars in total to the extent that judgment is rendered for the plaintiffs. If plaintiffs succeed in recovering more than \$1 billion from the underwriters, the companies that went public, such as Broadwing, will not have to pay any additional amounts. The defendants' insurance companies will be paying the settlement that is subject to the final approval of the district court.

On August 31, 2005 the Judge issued an order clarifying certain provisions of the proposed settlement and set deadlines for its final approval. On April 21, 2006, one of the underwriters sued in this class action, JPMorgan Chase, announced a settlement with plaintiffs for \$425 million. On April 24, 2006, a fairness hearing on the proposed settlement was held in which the Judge did not rule on the proposed settlement, but instead took the proposed settlement under advisement. Should the Judge not grant final approval of the settlement agreement, we believe that we have meritorious defenses to plaintiffs' allegations and will vigorously defend ourselves.

In an appeal by a series of underwriters from the District Court decision to grant class certification in this matter the Second Circuit Court of Appeals ("Second Circuit") issued an opinion on December 5, 2006 reversing the District Court and de-certifying the class. The District Court has indicated

that it will hold in abeyance a final decision concerning granting approval of the settlement agreement pending the resolution of petitions seeking clarification by the Second Circuit of its decision and the impact that such decision will have on the ability of this matter to proceed as a class action. On January 7, 2007 plaintiffs filed a petition for rehearing and rehearing en banc with the Second Circuit with respect to the class certification issue. On January 24, 2007 the Second Circuit entered an order permitting the defendant underwriters to brief the issues raised in the petition for rehearing within 14 days. No hearing has been scheduled on the petition as of February 23, 2007.

The Company and its subsidiaries are parties to many other legal proceedings. Management believes that any resulting liabilities for these legal proceedings, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could effect future cash flows.

#### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders, through the solicitation of proxies or otherwise.

### **Part II**

#### **ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

*Market Information.* Our common stock is traded on the NASDAQ Global Select Market of The NASDAQ Stock Market LLC under the symbol "LVL.T." As of February 23, 2007, there were approximately 7,990 holders of record of our common stock, par value \$.01 per share. The table below sets forth, for the calendar quarters indicated, the high and low per share closing sale prices of our common stock as reported by the NASDAQ Global Select Market of The NASDAQ Stock Market LLC.

<u>Year Ended December 31, 2006</u>	<u>High</u>	<u>Low</u>
First Quarter	\$ 5.60	\$ 2.73
Second Quarter	5.72	3.78
Third Quarter	5.46	3.44
Fourth Quarter	6.02	4.93
<u>Year Ended December 31, 2005</u>	<u>High</u>	<u>Low</u>
First Quarter	\$ 3.34	\$ 1.90
Second Quarter	2.44	1.62
Third Quarter	2.35	1.90
Fourth Quarter	3.90	2.06

**Equity Compensation Plan Information.** We have only one equity compensation plan—The 1995 Stock Plan, as amended—under which we may issue shares of our common stock to employees, officers, directors and consultants. This plan has been approved by our stockholders. The following table provides information about the shares of our common stock that may be issued upon exercise of awards under the 1995 Stock Plan as of December 31, 2006.

<u>Plan Category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u>	<u>Weighted-average exercise price of outstanding options, warrants and rights</u>	<u>Number of securities remaining available for future issuance under equity compensation plans</u>
Equity compensation plans approved by stockholders	39,546,330 <sup>†</sup>	\$ 4.39 <sup>†‡</sup>	101,722,946
Equity compensation plans not approved by stockholders	0	\$ 0.00	0

<sup>†</sup> Includes awards of Outperform Stock Options (“OSOs”). For purposes of this table, these securities are considered to use a single share of our common stock from the total number of shares reserved for issuance under the 1995 Stock Plan.

<sup>‡</sup> Includes weighted-average exercise price of outstanding OSOs at the date of grant. The exercise price of an OSO is subject to change based upon the performance of our common stock relative to the performance of the S&P 500 ® Index from the time of the grant of the award until the award has been exercised.

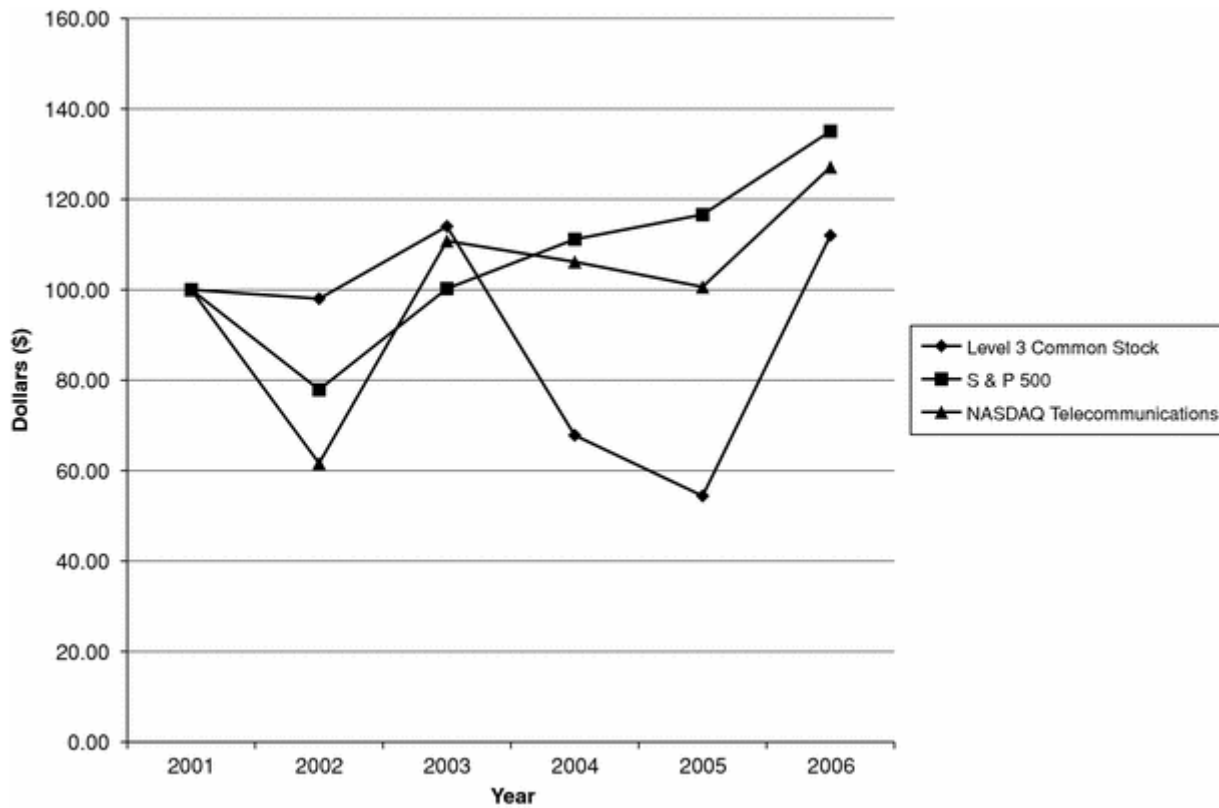
**Dividend Policy.** Our current dividend policy, in effect since April 1, 1998, is to retain future earnings for use in our business. As a result, our directors and management do not anticipate paying any cash dividends on shares of our common stock in the foreseeable future. In addition, we are effectively restricted under certain debt covenants from paying cash dividends on shares of our common stock.

#### *Performance Graph.*

The following performance graph shall not be deemed to be incorporated by reference by means of any general statement incorporating by reference this Form 10-K into any filing under the Securities Act of 1933, as amended or the Securities Exchange Act of 1934, except to the extent that the company specifically incorporates such information by reference, and shall not otherwise be deemed filed under such acts.

The graph compares the cumulative total return of our common stock for the five year period from 2002 through 2006 with the S&P® 500 Index and the Nasdaq Telecommunications Index. The graph assumes that the value of the investment was \$100 on December 31, 2001, and that all dividends and other distributions were reinvested.

**Comparison of Five Year Cumulative Total Return  
Among Our Common Stock, the S&P® 500 Index  
and the Nasdaq Telecommunications Index**



	12/01	12/02	12/03	12/04	12/05	12/06
Level 3 Common Stock	100.00	98.00	114.00	67.80	57.40	112.00
S&P 500® Index	100.00	77.90	100.24	111.15	116.61	135.03
NASDAQ Telecommunications	100.00	61.62	110.79	106.16	100.63	127.11

**ITEM 6. SELECTED FINANCIAL DATA**

The Selected Financial Data of Level 3 Communications, Inc. and its subsidiaries appear below.

	Fiscal Year Ended(1)				
	2006	2005	2004	2003	2002
	(dollars in millions, except per share amounts)				
<b>Results of Operations:</b>					
Revenue	\$ 3,378	\$ 1,719	\$ 1,776	\$ 2,027	\$ 1,215
Loss from continuing operations(2)	(790)	(707)	(478)	(695)	(872)
Income (loss) from discontinued operations(3)	46	69	20	(21)	14
Net loss	(744)	(638)	(458)	(711)	(858)
<b>Per Common Share:</b>					
Loss from continuing operations(2)	(0.79)	(1.01)	(0.70)	(1.23)	(2.14)
Income (loss) from discontinued operations(3)	0.05	0.10	0.03	(0.04)	0.03
Net loss	(0.74)	(0.91)	(0.67)	(1.26)	(2.11)
Dividends(4)	—	—	—	—	—
<b>Financial Position:</b>					
Total assets	9,994	8,277	7,544	8,302	8,972
Current portion of long-term debt(5)	5	—	143	124	3
Long-term debt, less current portion(5)	7,357	6,023	5,067	5,249	6,102
Stockholders' equity (deficit)(6)	374	(476)	(157)	181	(240)

- (1) The operating results of Software Spectrum, Inc. ("Software Spectrum") which was acquired in 2002 and sold in 2006, (i)Structure, LLC ("i)Structure"), which was sold in 2005, the Midwest Fiber Optic Network business acquired from Genuity, Inc. in 2003 and sold in 2003, as well as Software Spectrum's contact service business obtained in the Software Spectrum acquisition in 2002 and sold in 2003 are included in discontinued operations for all periods presented for which Level 3 owned each business.

The Company purchased substantially all of the assets and operations of Genuity, Inc. in February 2003. The Company also purchased Telverse Communications, Inc. in July 2003.

The Company acquired the managed modem businesses of ICG Communications, Inc. and Sprint Communications Company, L.P. on April 1, 2004 and October 1, 2004, respectively.

The Company purchased WilTel Communications Group, LLC ("WilTel") on December 23, 2005, and recorded approximately \$38 million of revenue attributable to this business in 2005. The Company purchased Progress Telecom, LLC ("Progress Telecom") on March 20, 2006, ICG Communications, Inc. ("ICG Communications") on May 31, 2006, TelCove, Inc. ("TelCove") on July 24, 2006 and Looking Glass Networks Holding Co., Inc. ("Looking Glass") on August 2, 2006. The WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass results of operations and financial position are included in the consolidated financial statements from the respective dates of their acquisition. During 2006, the Company recorded revenue attributable to Progress Telecom of \$49 million, ICG Communications of \$46 million, TelCove of \$166 million and Looking Glass of \$33 million.

- (2) In 2002, the Company recognized approximately \$76 million of termination and settlement revenue, \$181 million of impairment and restructuring charges, a gain of approximately \$191 million from the sale of Commonwealth Telephone Enterprises, Inc. common stock, \$88 million of induced conversion expenses attributable to the exchange of the Company's convertible debt securities, \$120 million of federal tax benefits due to legislation enacted in 2002 and a gain of \$255 million as a result of the early extinguishment of long-term debt.

In 2003, the Company recognized approximately \$346 million of termination and settlement revenue, \$45 million of impairment and restructuring charges, a gain of approximately \$70 million from the sale

of “91 Express Lanes” toll road assets, \$200 million of induced conversion expenses attributable to the exchange of the Company’s convertible debt securities, and recognized a gain of \$41 million as a result of the early extinguishment of long-term debt.

In 2004, the Company recognized a gain of \$197 million as a result of the early extinguishments of certain long-term debt and \$113 million of termination revenue.

In 2005, the Company recognized \$133 million of termination revenue and approximately \$23 million of impairment and restructuring charges.

In 2006, the Company recognized \$11 million of termination revenue, approximately \$13 million of impairment and restructuring charges, and recognized a net loss on early extinguishment of debt of \$83 million as a result of the amendment and restatement of its senior secured credit facility and certain debt exchanges and redemptions.

- (3) In 2005, the Company sold ( i )Structure and recognized a gain on the sale of \$49 million. For fiscal years 2005 and 2004, ( i )Structure revenues approximated costs. Losses attributable to the operations of ( i )Structure for fiscal years 2003 and 2002 were \$17 million and \$6 million, respectively.

In 2006, the Company sold Software Spectrum and recognized a gain on the sale of \$33 million. The income (loss) from the operations of Software Spectrum including the contact services business sold in 2003 were \$13 million, \$20 million, \$20 million, \$(16) million and \$20 million for the fiscal years 2006, 2005, 2004, 2003 and 2002, respectively.

- (4) The Company’s current dividend policy, in effect since April 1998, is to retain future earnings for use in the Company’s business. As a result, management does not anticipate paying any cash dividends on shares of common stock in the foreseeable future. In addition, the Company is effectively restricted under certain covenants from paying cash dividends on shares of its common stock.
- (5) In 2002, the Company received net proceeds of \$488 million from the issuance of \$500 million of 9% Junior Convertible Subordinated Notes due 2012. Also in 2002, the Company repurchased, using cash and common stock, approximately \$705 million face amount of its long-term debt and recognized a gain of approximately \$255 million as a result of the early extinguishment of debt.

In 2003, the Company received net proceeds of \$848 million from the issuance of \$374 million of 2.875% Convertible Senior Notes due 2010 and the issuance of \$500 million of 10.75% Senior Notes due 2011. The Company completed a debt exchange whereby the Company issued \$295 million (face amount) of 9% Convertible Senior Discount Notes due 2013 and common stock in exchange for \$352 million (book value) of long-term debt. In addition, Level 3 using cash on hand, restricted cash and the proceeds from the issuance of the 10.75% Senior Notes due 2011, repaid in full, the \$1.125 billion purchase money indebtedness outstanding under the Senior Secured Credit Facility. Also in 2003, the Company repurchased, using common stock, approximately \$1.007 billion face amount of its long-term debt and recognized a gain of approximately \$41 million as a result of the early extinguishment of debt.

In 2004, the Company received net proceeds of \$987 million from the issuance of a \$730 million Senior Secured Term Loan due 2011 and the issuance of \$345 million of 5.25% Senior Convertible Notes due 2011. The Company used the net proceeds to repay portions of its 9.125% Senior Notes due 2008, 11% Senior Notes due 2008, 10.5% Senior Discount Notes due 2008 and 10.75% Senior Euro Notes due 2008. The Company repurchased portions of the outstanding notes at prices ranging from 83 percent to 89 percent of the repurchased principal balances. The net gain on the early extinguishment of the debt, including transaction costs, realized foreign currency losses and unamortized debt issuance costs, was \$50 million for these transactions. Also in 2004, the Company paid approximately \$54 million and assumed obligations to extinguish a capital lease obligation and recognized a gain of \$147 million on the transaction.

In 2005, the Company received net proceeds of \$877 million from the issuance of \$880 million of 10% Convertible Senior Notes due 2011. Also in 2005, a wholly-owned subsidiary of the Company received net proceeds of \$66 million from the completion of a refinancing of the mortgage of its corporate headquarters. The subsidiary entered into a new mortgage loan of \$70 million at an initial fixed rate of 6.86% through 2010.

In 2006, the Company received net proceeds of \$142 million from the issuance of \$150 million of Floating Rate Senior Notes due 2011, net proceeds of \$538 million from the issuance of \$550 million of 12.25% Senior Notes due 2013, net proceeds of \$326 million from the issuance of \$335 million of 3.5% Convertible Senior Notes due 2012 and net proceeds of \$1.239 billion (excluding prepaid interest) from the issuance of \$1.250 billion of 9.25% Senior Notes due 2014. Also in 2006, the Company exchanged a portion of its outstanding 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 for \$46 million of cash and \$692 million aggregate principal of new 11.5% Senior Notes due 2010. In addition, the Company redeemed the remaining outstanding 9.125% Senior Notes due 2008 totaling \$398 million, 10.5% Senior Discount Notes due 2008 totaling \$62 million and 99.3% of the 10.75% Senior Notes due 2011 totaling \$497 million.

- (6) In 2002, the Company issued approximately 47 million shares of common stock, valued at approximately \$466 million, in exchange for long-term debt. Included in the value of common stock issued, are induced conversion premiums of \$88 million for convertible debt securities.

In 2003, the Company issued approximately 216 million shares of common stock, valued at approximately \$953 million, in exchange for long-term debt. Included in the value of common stock issued, are induced conversion premiums of \$200 million for convertible debt securities.

In 2004, the Company realized \$95 million of foreign currency losses on the repurchase of its Euro denominated debt. The unrealized foreign currency losses had been recorded in Other Comprehensive Income within Stockholders' Equity (Deficit).

In 2005, the Company issued 115 million shares of common stock, valued at approximately \$313 million, as the stock portion of the purchase price paid to acquire WilTel.

In 2006, the Company issued approximately 125 million shares of common stock in a public offering, valued at approximately \$543 million.

In 2006, the Company issued 20 million shares of common stock, valued at approximately \$66 million, as the stock portion of the purchase price paid to acquire Progress Telecom; 26 million shares of common stock, valued at approximately \$131 million, as the stock portion of the purchase price paid to acquire ICG Communications; 150 million shares of common stock, valued at approximately \$623 million, as the stock portion of the purchase price paid to acquire TelCove; and 21 million shares of common stock, valued at approximately \$84 million, as the stock portion of the purchase price paid to acquire Looking Glass.



## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This document contains forward looking statements and information that are based on the beliefs of management as well as assumptions made by and information currently available to Level 3 Communications, Inc. and its subsidiaries ("Level 3" or the "Company"). When used in this document, the words "anticipate", "believe", "plan", "estimate" and "expect" and similar expressions, as they relate to the Company or its management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this document.

The following discussion should be read in conjunction with the Company's consolidated financial statements (including the notes thereto), included elsewhere herein.

Level 3 Communications, Inc., through its operating subsidiaries, is primarily engaged in the communications business, with additional operations in coal mining.

### *Communication Services*

The Company is a facilities based provider of a broad range of integrated communications services. Revenue for communications services is recognized on a monthly basis as these services are provided. For contracts involving private line, wavelengths and dark fiber services, Level 3 may receive up-front payments for services to be delivered for a period of up to 20 years. In these situations, Level 3 will defer the revenue and amortize it on a straight-line basis to earnings over the term of the contract. At December 31, 2006, for contracts where up-front payments were received for services to be delivered in the future, the Company's weighted average remaining contract period was approximately 15 years.

The Company separates its communications services into three separate categories: 1) Core Communications Services, 2) Other Communications Services, and 3) SBC Contract Services. Each category of revenue is in a different phase of the service life cycle, requiring different levels of investment and focus and providing different contributions to the Company's Adjusted OIBDA. Adjusted OIBDA is defined by the Company as operating income (loss) from the consolidated statements of operations, less depreciation and amortization expense, less non-cash compensation expense included within selling, general and administration expense on the consolidated statements of operations, and less the non-cash portion of restructuring and impairment charges. Management of Level 3 believes that growth in revenue from its Core Communications Services is critical to the long-term success of its communications business. At the same time, the Company believes it must continue to manage effectively the positive cash flows from its SBC Contract Services and its Other Communications Services including the Company's mature managed modem business and its related reciprocal compensation. Core Communications Services includes transport and infrastructure, IP and data services, voice and Vyvx video and advertising distribution services. Other Communications Services includes managed modem and related reciprocal compensation and legacy managed IP service business. In 2005, Other Communications Services included DSL aggregation services which are no longer provided. SBC Contract Services includes all the revenues related to the SBC Contract Services Agreement contract, which was obtained in the December 23, 2005 acquisition of WilTel.

The Company's transport and infrastructure services include colocation services, wavelength, private line, dark fiber and transoceanic services. Growth in transport and infrastructure revenue is largely dependent on increased demand for bandwidth services and available capital of companies requiring communications capacity for their own use or in providing capacity as a service provider to their customers.

These expenditures may be in the form of up-front payments or monthly payments for private line, wavelength or dark fiber services. An increase in demand may be partially offset by declines in unit pricing.

IP and data services primarily include the Company's high-speed Internet access service and Ethernet and IP Virtual Private Network ("VPN") services. Level 3's high-speed Internet access service is a high quality and high-speed Internet access service offered in a variety of capacities. The Company's VPN services permit businesses of any size to replace multiple networks with a single, cost-effective solution that greatly simplifies the converged transmission of voice, video, and data. This convergence to a single platform can be obtained without sacrificing the quality of service or security levels of traditional ATM and Frame Relay offerings. VPN services also permit customers to prioritize network application traffic so that high priority applications, such as voice and video, are not compromised in performance by the flow of low priority applications such as email.

The conversion from narrow band dial-up services to higher speed broadband services is expected to increase demand for the Company's Core Communications Services. Revenue growth in this area is dependent on the continued increase in usage by both enterprises and consumers and the pricing environment. An increase in the reliability and security of information transmitted over the Internet and declines in the cost to transmit data have resulted in increased utilization of e-commerce or web based services by businesses. The Company, however, continues to experience lower revenue growth due to price compression for its IP and data services. These declines were partially offset by an increase in billable IP and data traffic for 2006 compared to 2005. This increase in billable IP data traffic is partially due to acquisitions made in 2006. Current high levels of available capacity and the numerous companies competing in this market have resulted in a very competitive pricing environment.

In 2006, the Company continued to experience pricing pressure for IP and data services with the average price per megabyte declining approximately 25%. The Company experienced price compression of approximately 30% in 2005 for IP and data services. In addition to pricing pressures, the decline in the Company's average price per megabyte was attributable to higher traffic from larger customers and customers continuing to move to higher speed services with a lower price per megabyte. The larger customers have a lower price per megabyte due to higher volume commitments.

The Company continues to experience pricing pressure for those transport and infrastructure customers that require simple, low quality, point-to-point services, as competitors aggressively pursued this business. However, Level 3 believes that competitors are less willing to discount these services if it requires investment in incremental capacity to meet the customer's requirements. For those customers that provide high quality content or require a combination of transport, IP and voice solutions on a regional or national platform, Level 3 is seeing that price compression is starting to moderate and, in many cases, prices are starting to increase. Level 3 intends to remain disciplined in its approach to pricing for its transport and IP services.

The Company has developed voice services that target large and existing markets. The Company believes that the efficiencies of Level 3's IP and optical-based network, including its Softswitch technology, will provide customers a lower cost alternative than the existing circuit-switched networks. The Company is moving to develop both its capability to market and sell in the voice market and develop the internal systems and processes necessary to support the new services being launched. The revenue potential for voice services is large; however, the revenues and margins are expected to continue to decline over time as a result of the new low-cost IP and optical-based technologies. In addition, the market for voice services is being targeted by many competitors, several of which are larger and have more financial resources than the Company.

Vyvx provides audio and video programming for its customers over the Company's fiber-optic network and via satellite. It uses the Company's fiber-optic network to carry live traditional broadcast and cable television events from the site of the event to the network control centers of the broadcasters of the event.

For live events where the location is not known in advance, such as breaking news stories in remote locations, Vyvx provides an integrated satellite and fiber-optic network-based service to transmit the content to its customers. Most of Vyvx's customers for these services contract for the service on an event-by-event basis; however, Vyvx has some customers who have purchased a dedicated point-to-point service which enables these customers to transmit programming at any time.

Vyvx also distributes advertising spots to radio and television stations throughout the U.S., both electronically and in physical form. Customers for these services can utilize a network-based method for aggregating, managing, storing and distributing content for content owners and rights holders.

The Company expects to continue to develop its content distribution services through the acquisition of the SAVVIS Content Delivery Network ("CDN") services business ("SAVVIS CDN Business") which it purchased in the first quarter of 2007 for \$132.5 million in cash. The Company believes that the addition of the SAVVIS CDN Business with its strong, broad portfolio of patents will help the Company secure its commercial efforts in the heavily patented CDN market.

The Company's Other Communications Services are mature services that are not areas of emphasis for the Company. Other Communications Services currently include managed modem, related reciprocal compensation and legacy managed IP services.

The Company and its customers continue to see consumers migrate from narrow band dial-up services to higher speed broadband services as the narrow band market matures. Additionally, America Online, a primary consumer of the Company's dial-up services, announced a strategic change in its approach to its dial-up internet access business that has accelerated the loss of its dial-up subscribers. During the fourth quarter of 2006, the America Online strategy began having the effect of accelerating the decline in managed modem revenues and is expected to contribute to further declines in managed modem revenue in 2007 and beyond. The Company recognized approximately \$286 million of managed modem revenue in 2006, an approximate 28% decline from the \$396 million of managed modem revenue recognized in 2005. The declines in managed modem revenue in 2006 have been offset to some extent by an increase in market share as a result of certain competitors exiting segments of this business in the second half of 2006. Level 3 believes that the low-cost structure of its network will enable it to compete aggressively for new business in the IP-based market.

Level 3 receives compensation from other carriers when it terminates traffic originating on those carriers' networks. This reciprocal compensation is based on interconnection agreements with the respective carriers or rates mandated by the FCC. The Company earns the majority of its reciprocal compensation revenue from providing managed modem services.

Legacy managed IP services primarily include low-speed services which utilize ATM technology, as well as VPN and managed security services. The Company's legacy Internet access business consists primarily of a business that was acquired in the Genuity transaction in 2003. The Company has elected not to pursue additional customers and to limit the capital invested in this component of its business.

The SBC Contract Services Agreement was an agreement between SBC Services Inc. and WilTel and was obtained in the WilTel acquisition in December 2005. Recently, SBC Services Inc. became a subsidiary of AT&T Inc., (together "SBC"). WilTel and SBC amended their agreement in June 2005 to run through 2009. The Company recognized approximately \$893 million of revenue under the SBC Contract Services Agreement during 2006. The agreement provides a gross margin purchase commitment of \$335 million from December 2005 through the end of 2007, and \$75 million from January 2008 through the end of 2009. SBC had satisfied \$268 million of the December 2005 to end of 2007 gross margin purchase commitment through December 31, 2006. The remaining minimum gross margin commitment under the agreement as of December 31, 2006 was approximately \$67 million for the period through the end of 2007, and \$75 million from January 2008 through the end of 2009. Originating and terminating access charges paid to local phone companies are passed through to SBC in accordance with a formula that approximates cost.

Additionally, the SBC Contract Services Agreement provides for the payment of \$50 million from SBC if certain performance criteria are met by Level 3. The Company met the required performance criteria and recorded revenue of \$25 million in 2006 under the agreement. Level 3 is eligible to earn another \$25 million in 2007 if it meets the performance criteria. Of the annual amounts, 50% is based on monthly performance criteria and the remaining 50% is based on performance criteria for the full year. The Company expects to earn the performance payment in 2007.

Given the expected reduction in the SBC Contract Services revenue and the overall increase in revenue from acquisition activity, concentration of revenue among a limited number of customers is expected to be reduced in periods subsequent to 2006. However, if Level 3 would lose one or more major customers, or if one or more major customers significantly decreased its orders for Level 3 services, the Company's communications business would be materially and adversely affected.

Level 3's management continues to review all of the Company's existing lines of business and service offerings to determine how those lines of business and service offerings assist with the Company's focus on delivery of communications services and meeting its financial objectives. This exercise takes place both with respect to integration activities and in the normal course of business. To the extent that certain lines of business or service offerings are not considered to be compatible with the delivery of communications services or with obtaining financial objectives, Level 3 may exit those lines of business or stop offering those services.

Management focuses on Adjusted OIBDA, cash flows from operating activities and capital expenditures to assess the operating performance of the communications business. Management believes that Adjusted OIBDA, when viewed over time, reflects the operating trends and performance of its communications business. Adjusted OIBDA, or a similar measure, also is an indicator of performance used by Level 3's competitors and is used by management in evaluating relative performance.

Management of Level 3 believes the introduction of new services or technologies, as well as the further development of existing technologies, may reduce the cost or increase the supply of certain services similar to those provided by Level 3. The ability of the Company to anticipate, adapt and invest in these technology changes in a timely manner may affect the future success of the Company.

The Company completed the initial planned deployment of the next generation of optical transport technology in its North American and European networks in the fourth quarter of 2005 and early in the first quarter of 2006, respectively. The Company has decided to deploy the technology for additional routes in North America and Europe and completed the deployments on these routes in 2006. The Company completed an upgrade of its IP backbone technology in the fourth quarter of 2005. Level 3 believes that this deployment of new equipment to the existing network equipment will allow the Company to optimize the amount of traffic it carries over the network and lower the cost of providing services.

To expand its service offerings in Europe, the Company expects to invest approximately \$20 million for a dark fiber based expansion in nine European markets. Portions of this expansion were completed in 2006 and the Company expects to complete the remainder of the expansion in 2007. The dark fiber is expected to replace or supplement existing wavelength capacity.

The communications industry continues to consolidate. Level 3 has participated in this process with the acquisitions of WiTel in 2005; Progress Telecom, ICG Communications, TelCove and Looking Glass in 2006; and Broadwing Corporation ("Broadwing") and the SAVVIS CDN Business in January 2007. Level 3 will continue to evaluate consolidation opportunities and could make additional acquisitions in the future.

The successful integration of these businesses into Level 3 is important to the success of Level 3. The Company must quickly identify synergies, integrate the networks and support organizations, while maintaining the service quality levels expected by customers in order to realize the anticipated benefits of

these acquisitions. Successful integration of these acquired businesses will depend on the Company's ability to manage these operations, realize opportunities for revenue growth presented by strengthened service offerings and expanded geographic market coverage and, to some degree, to eliminate redundant and excess costs to fully realize the expected synergies. If the Company is not able to efficiently and effectively integrate the acquired businesses or operations, the Company may experience material negative consequences to its business, financial condition or results of operations.

Level 3 has embarked on a strategy to expand its current metro presence. The strategy will allow the Company to terminate traffic over its owned metro facilities rather than paying third parties to terminate the traffic. Level 3's ability to provide high-speed bandwidth directly to customer facilities is expected to be a competitive advantage as local exchange companies often do not provide this service. The Company intends to offer the traditional set of services in these markets and concentrate its sales efforts on the bandwidth intensive businesses. The expansion into new metro markets should also provide additional opportunities to sell services on the Company's national and international networks. This new metro strategy includes the acquisitions of Progress Telecom, ICG Communications, TelCove and Looking Glass. As part of its metro strategy and as a result of the acquisition of TelCove in the third quarter of 2006 and Broadwing in the first quarter of 2007, the Company is also targeting enterprise customers directly through its newly created Business Markets Group described in more detail below. With the acquisition of the SAVVIS CDN services business, Level 3 embarked on a strategy to expand its content delivery network services.

The Company is focusing its attention on 1) growing revenue through Core Communications Services, 2) completing the integration of acquired businesses, 3) developing its metro network strategy and enterprise business, 4) continuing to show improvements in Adjusted OIBDA as a percentage of revenue, and 5) managing cash flows provided by its Other Communications Services and SBC Contract Services. The anticipated change in the composition of the Company's revenue will require the Company to manage operating expenses carefully and concentrate its capital expenditures on those technologies and assets that will enable the Company to develop its Core Communications Services further and replace the decline in revenue and earnings from Other Communications Services and SBC Contract Services.

In the third quarter of 2006, Level 3 announced the formation of four customer-facing groups to better serve the changing needs of customers in growing markets and drive growth across the organization:

- The Wholesale Markets Group services the communications needs of the largest global service providers, including carriers, cable companies, wireless companies, and voice service providers. These customers typically integrate Level 3 services into their own products and services to offer to their end user customers.
- The Content Markets Group focuses on serving media and content companies with large and growing bandwidth needs. Customers in this market include video distribution companies, providers of gaming, mega-portals, software service providers, social networking providers, as well as more traditional media distribution companies such as broadcasters, television networks and sports leagues.
- The Business Markets Group targets enterprise customers and regional carriers who value a local, professional sales force. Specific customer markets include small, medium, and large businesses, local and regional carriers, state and local government entities, and higher education institutions and consortia.
- The European Markets Group serves the largest European consumers of bandwidth, including the largest European and international carriers, large system integrators, voice service providers, cable operators, Internet service providers, content providers, and government and education sectors.

The Company believes that the alignment around customer markets should allow it to drive growth while enabling it to better focus on the needs of the customers. Each group will be supported by the

dedicated sales, marketing, service management, customer facing operations, and necessary support resources required to execute and increase revenue in these key markets.

In addition to the operational metrics mentioned above, the Company is also focusing on improving its liquidity and financial condition and extending the maturity dates of certain debt and lowering the effective interest rate on its outstanding debt over the long term. In January 2006, the Company completed the exchange of several tranches of its debt maturing in 2008 for a new tranche of debt maturing in 2010. The Company was able to extend the maturity date of approximately \$692 million of debt due in 2008 to 2010.

In March 2006, Level 3 Financing issued \$150 million of Floating Rate Senior Notes due in 2011 and \$250 million of 12.25% Senior Notes due in 2013. In April 2006, Level 3 Financing issued an additional \$300 million of the 12.25% Senior Notes due in 2013. The proceeds from these offerings were used to fund the cash portion of the WiTel and Progress Telecom acquisitions as well as fund the cost of construction, installation, acquisition, lease, development or improvement of other assets to be used in Level 3's communications business.

In an underwritten public offering in June 2006, Level 3 issued \$335 million of 3.5% Convertible Senior Notes due 2012. The Company also completed the underwritten public offering of 125 million shares of its common stock for which it received \$543 million in net proceeds. Level 3 used a portion of these proceeds to redeem selected series of its debt securities maturing in 2008. In July 2006, Level 3 redeemed all of its 9.125% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 for total consideration of \$461 million, excluding accrued interest. The remaining proceeds were used to fund acquisitions and for general corporate purposes, including working capital and capital expenditures.

In June 2006, Level 3 Financing amended and restated its existing \$730 million senior secured credit facility to reduce the interest rate payable under the agreement by 400 basis points, modify the prepayment provisions and make other specified changes. The Company paid approximately \$42 million to existing lenders and \$11 million to third parties in costs to complete the transaction.

Level 3 Financing issued \$600 million and \$650 million of 9.25% Senior Notes due 2014 in October 2006 and December 2006, respectively. The Company received net proceeds of \$1,239 million after transaction costs from the two issuances. On December 28, 2006, Level 3 Financing used a portion of the proceeds to complete a tender offer to repurchase \$497 million of 10.75% Senior Notes for total consideration of \$543 million, excluding accrued interest. The remaining proceeds were used to fund the cost of construction, installation, acquisition, lease, development or improvement of other assets to be used in Level 3's communications business.

In January 2007, in two separate transactions, the Company completed the exchange of \$605 million of its 10% Convertible Senior Notes due 2011 for a total of 196.8 million shares of Level 3's common stock.

On February 8, 2007, Level 3 announced that it is seeking to refinance Level 3 Financing's \$730 million Senior Secured Term Loan. In addition to increasing the loan amount to up to \$1.4 billion, the Company is also seeking, among other things, to reduce the interest rate payable under the agreement and extend the maturity from 2011 to 2014. The refinancing of the Senior Secured Term Loan is expected to close in mid-March 2007.

On February 14, 2007, Level 3 Financing issued \$700 million of its 8.75% Senior Notes due 2017 and \$300 million of its Floating Rate Senior Notes due 2015 and received net proceeds of \$982 million.

On February 15, 2007, Level 3 announced calls for redemption of all of its outstanding \$488 million aggregate principal amount of 12.875% Senior Notes due 2010, all of its outstanding \$96 million aggregate principal amount of 11.25% Senior Notes due 2010 and all of its outstanding € 104 million of 11.25% Senior Euro Notes due 2010. Also on February 15, 2007, Level 3 announced tender offers to purchase for cash any and all of Level 3 Financing's outstanding \$150 million aggregate principal amount of Floating

Rate Notes due 2011 and any and all of Level 3's outstanding \$78 million aggregate principal amount of 11% Senior Notes due 2008.

On February 20, 2007, Level 3 announced tender offers to purchase for cash any and all of the outstanding \$692 million aggregate principal amount of its 11.5% Senior Notes due 2010, and to purchase for cash any and all of its outstanding € 50 million aggregate principal amount of 10.75% Senior Euro Notes due 2008.

On February 23, 2007, Level 3 Financing completed a consent solicitation with respect to certain amendments to the indenture governing Level 3 Financing's outstanding 12.25% Senior Notes due 2013 that allow for the incurrence of debt based upon a multiple of cash flow available for fixed charges on a "pro forma" basis giving effect to any acquisition, merger or consolidation completed prior to February 1, 2007.

The Company will continue to look for opportunities to improve its financial position in 2007 and focus its resources on growing revenue, integrating the acquired businesses and managing costs, including the realization of expected synergies from the acquired businesses, for the communications business.

### ***Coal Mining***

Level 3, through its two 50% owned joint venture surface mines in Montana and Wyoming, sells coal primarily through long-term contracts with public utilities. The long-term contracts for the delivery of coal establish the price, volume, and quality requirements of the coal to be delivered. Revenue under these and other contracts is recognized when coal is shipped to the customer.

### ***Information Services***

On November 30, 2005, the Company sold its wholly owned subsidiary, ( i )Structure, LLC, which provided computer outsourcing services primarily to small and medium-sized businesses. The Company also completed the disposition of its remaining subsidiary in the information services business, Software Spectrum, Inc. on September 7, 2006. The results of operations and financial position for ( i )Structure and Software Spectrum are reflected as discontinued operations for all periods presented in this report.

### **Critical Accounting Policies**

The Company has identified the policies below as critical to its business operations and the understanding of its results of operations. The effect of any associated risks related to these policies on the Company's business operations is discussed throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations where these policies affect the Company's reported and expected financial results.

#### ***Revenue***

Revenue for communications services, including voice, private line, wavelengths, colocation, Internet access, managed modem, data services, video and dark fiber revenue is recognized monthly as the services are provided. Communications services are provided either on a usage basis, which can vary period to period, or at a contractually committed amount.

Reciprocal compensation revenue is recognized only when an interconnection agreement is in place with another carrier, or at rates mandated by the FCC. Periodically, the Company will receive payment for reciprocal compensation services in excess of FCC rates and before an agreement is in place. These amounts are included in other current liabilities on the consolidated balance sheet until a final agreement has been reached and the necessary regulatory approvals have been received at which time the reciprocal compensation revenue is recognized. These amounts were insignificant to the Company in 2006 and 2005.

Revenue attributable to leases of dark fiber pursuant to indefeasible rights-of-use agreements (“IRUs”) that qualify for sales-type lease accounting, and were entered into prior to June 30, 1999, was recognized at the time of delivery and acceptance of the fiber by the customer. Certain sale and long-term IRU agreements of dark fiber and capacity entered into after June 30, 1999, are required to be accounted for in the same manner as sales of real estate with property improvements or integral equipment. This accounting treatment results in the deferral of revenue for the cash that has been received and the recognition of revenue ratably over the term of the agreement (currently up to 20 years).

Termination revenue is recognized when a customer disconnects service prior to the end of the contract period, for which Level 3 had previously received consideration and for which revenue recognition was deferred. Termination revenue is also recognized when customers make termination penalty payments to Level 3 to settle contractually committed purchase amounts that the customer no longer expects to meet or when a customer and Level 3 renegotiate a contract under which Level 3 is no longer obligated to provide product or services for consideration previously received and for which revenue recognition has been deferred. Termination revenue is reported in the same manner as the original product or service provided.

Accounting practice and guidance with respect to the accounting treatment of revenue continues to evolve. Any changes in the accounting treatment could affect the manner in which the Company accounts for revenue within its communications and coal businesses.

#### *Non-Cash Compensation*

The Company adopted SFAS No. 123R, “Share-Based Payment” (“SFAS No. 123R”) effective January 1, 2006. SFAS No. 123R requires that compensation cost relating to share-based payment transactions be recognized in the financial statements based on the fair value of equity or liability instruments issued. The Company adopted the expense recognition provisions of SFAS No. 123, “Accounting for Stock-Based Compensation” (“SFAS No. 123”), in 1998. Therefore, the effect of applying the change from the original provisions of SFAS No. 123 on the Company’s financial position or results of operations for the year ended December 31, 2006 was insignificant. Although the recognition of the value of the instruments results in compensation or professional expenses in an entity’s financial statements, the expense differs from other compensation and professional expenses in that these charges, though generally permitted to be settled in cash, are typically settled through the issuance of common stock, which would have a dilutive effect upon earnings per share, if and when such options are exercised. The determination of the estimated fair value used to record the compensation or professional expenses associated with the equity or liability instruments issued requires management to make a number of assumptions and estimates that can change or fluctuate over time.

#### *Long-Lived Assets*

Property, plant and equipment is stated at cost, reduced by provisions to recognize economic impairment in value when management determines that events have occurred that require an analysis of potential impairment. Costs associated directly with network expansions and the development of business support systems, primarily employee-related costs are capitalized. The Company capitalized \$72 million, \$51 million and \$66 million of cost, primarily direct labor and related employee benefits, in 2006, 2005 and 2004, respectively.

Intercity network segments, gateway facilities, local networks and operating equipment that have been placed in service are being depreciated over their estimated useful lives, primarily ranging from 2-40 years. The total cost of a business support system is amortized over a useful life of three years. The useful lives of the Company’s assets are estimates and actual in-service periods for specific assets could differ significantly from these estimates. Due to changes in technology and the competitive environment, these estimates require a significant amount of judgment. Management monitors and evaluates these estimates on an



annual basis or as circumstances change that may indicate a change in estimate is required. During 2006 the Company extended the total useful lives of its existing fiber assets from seven to 12 years, its existing transmission equipment from five to seven years and its existing IP equipment from three to four years.

The Company at least annually, or as events or circumstances change that could affect the recoverability of the carrying value of its long-lived assets, conducts a comprehensive review of the carrying value of its assets to determine if the carrying amount of the assets are recoverable in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets." This review requires the identification of the lowest level of identifiable cash flows for purposes of grouping assets subject to review. The estimate of undiscounted cash flows includes long-term forecasts of revenue growth, gross margins and capital expenditures. All of these items require significant judgment and assumptions. An impairment loss may exist when the estimated undiscounted cash flows attributable to the assets are less than their carrying amount. If an asset is deemed to be impaired, the amount of the impairment loss recognized represents the excess of the asset's carrying value as compared to its estimated fair value, based on management's assumptions and projections.

The Company assessed its communications long-lived assets for impairment at December 31, 2006, and determined that an impairment charge was not required. The communications network includes network equipment, fiber, multiple conduits, customer premise equipment and colocation facilities. Historically, Level 3 has evaluated colocation facilities, certain additional conduits and its communications network assets as separate asset groupings. Beginning in 2006, the Company stopped evaluating colocation assets separately and began including them in the communications network asset group due to changes in the nature of the cash flows from the delivery of colocation services. The majority of the Company's colocation customers now purchase other services in conjunction with their colocation services thereby reducing the independence of colocation services cash flows from other services. In addition, the percentage of colocation space used to support the communications network asset has increased over time. The impairment analysis is based on a long-term cash flow forecast to assess the recovery of the communications assets over their estimated useful lives.

Level 3 also assesses the carrying value of goodwill on an annual basis in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets." (SFAS No. 142). The carrying value of goodwill is compared to its fair value. If the fair value does not exceed the carrying value of the goodwill, an analysis is performed to determine if an impairment charge should be recorded. The Company also evaluates intangible assets with indefinite lives individually on an annual basis, or as events or circumstances change that could affect the recoverability of the carrying value of the asset, in accordance with SFAS No. 142. The Company did not record charges for the impairment of long-lived assets or goodwill in 2006, 2005 or 2004.

Management's estimate of the future cash flows attributable to its long-lived assets and the fair value of its businesses involve significant uncertainty. Those estimates are based on management's assumptions of future results, growth trends and industry conditions. The impairment analysis of long-lived assets also requires management to make certain subjective assumptions and estimates regarding the expected future use of certain additional conduits evaluated for impairment separately from the network asset group. Management will continue to assess the Company's assets for impairment as events occur or as industry conditions warrant. Given the significant uncertainty, judgment and assumptions involved in developing the estimates of future cash flows and the number of years of remaining useful life of certain of the Company's assets, it is possible that the Company may determine that an impairment charge is required in the future due to changes in these assumptions and estimates.

#### *Use of Estimates*

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

liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most critical estimates and assumptions are made in determining the allowance for doubtful accounts, revenue reserves, recovery of long-lived assets, useful lives of long-lived assets, accruals for estimated tax and legal liabilities, cost of revenue disputes for communications services, unfavorable contracts recognized in purchase accounting and asset retirement obligations. Actual results could differ from those estimates and assumptions.

#### *Recently Issued Accounting Pronouncements*

The Company adopted Emerging Issues Task Force (“EITF”) Issue No. 04-6, “Accounting for Stripping Costs Incurred during Production in the Mining Industry” (“EITF No. 04-6”) effective January 1, 2006. EITF No. 04-6 concluded that stripping costs incurred during the production phase of a mine are variable production costs that should be included in the costs of the inventory produced during the period that the stripping costs are incurred. EITF No. 04-6 further defines inventory produced as mineral that has been extracted. As a result, stripping costs related to exposed, but not extracted mineral must be expensed as incurred rather than deferred until the mineral is extracted. The Company’s coal mining business had previously deferred stripping costs and amortized these costs over the period in which the underlying coal is mined. The Company’s adoption of EITF No. 04-6 on January 1, 2006 required it to adjust beginning retained earnings (accumulated deficit) for the amount of prepaid stripping costs previously deferred. The Company decreased beginning equity by \$3 million as a result of the adoption of EITF No. 04-6.

The FASB issued SFAS No. 153, “Exchanges of Non-Monetary Assets”, which was effective for Level 3 starting January 1, 2006. Under SFAS No. 153, the Company will measure assets exchanged at fair value, as long as the transaction has commercial substance and the fair value of the assets exchanged is determinable within reasonable limits. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The adoption of SFAS No. 153 did not have a material effect on the Company’s financial position or results of operations as Level 3 is a party to a limited number of non-monetary transactions and those transactions have not been material.

In June 2006, the FASB issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109” (“FIN No. 48”). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, “Accounting for Income Taxes.” FIN No. 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN No. 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of FIN No. 48 is not expected to have a material effect on the Company’s financial position or results of operations.

In June 2006, the FASB ratified the consensus on EITF Issue No. 06-3, “How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement” (“EITF No. 06-3”). The scope of EITF No. 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, Universal Service Fund (“USF”) contributions and some excise taxes. The Task Force affirmed its conclusion that entities should present these taxes in the income statement on either a gross or a net basis, based on their accounting policy, which should be disclosed pursuant to APB Opinion No. 22, “Disclosure of Accounting Policies.” If such taxes are significant, and are presented on a gross basis, the amounts of those taxes should be disclosed. The consensus on EITF No. 06-3 will be effective for interim and annual reporting periods beginning after December 15, 2006. The Company currently records USF contributions on a gross basis in its consolidated statements of

operations, but records sales, use, value added and excise taxes billed to its customers on a net basis in its consolidated statements of operations. The adoption of EITF No. 06-03 is not expected to have a material effect on the Company's financial position and results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements." SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. The Company adopted SAB No. 108 for the year ended December 31, 2006. The adoption of SAB No. 108 did not have a material effect on the Company's results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. The Company is currently assessing the potential effect that the adoption of SFAS No. 157 will have on its financial statements.

On December 21, 2006, the FASB issued FASB Staff Position No. EITF 00-19-2, "Accounting for Registration Payment Arrangements" ("FSP EITF 00-19-2"). FSP EITF 00-19-2 addresses an issuer's accounting for registration payment arrangements. FSP EITF 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with SFAS No. 5, "Accounting for Contingencies" ("SFAS No. 5"). A "registration payment arrangement" is defined as an arrangement that specifies that the issuer will endeavor (1) to file a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the Securities and Exchange Commission. The arrangement requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. FSP EITF 00-19-2 specifies that if the transfer of consideration under a registration payment arrangement is probable and can be reasonably estimated at inception, the contingent liability under the registration payment arrangement shall be included in the allocation of proceeds from the related financing transaction using the measurement guidance in SFAS No. 5. FSP EITF 00-19-2 also requires certain disclosures about the terms of each registration payment arrangement, even if the likelihood of the issuer having to make any payments under the arrangement is remote. FSP EITF 00-19-2 is effective immediately for registration payment arrangements entered into after December 21, 2006 and for fiscal years beginning after December 31, 2006, and interim periods within those fiscal years, for registration payment arrangements entered into prior to the issuance of FSP EITF 00-19-2. The Company adopted FSP EITF 00-19-2 for the year ended December 31, 2006. The adoption of FSP EITF 00-19-2 did not have a material effect on the Company's results of operations and financial condition.

## Results of Operations 2006 vs. 2005

Revenue for 2006 and 2005 is summarized as follows:

	<u>2006</u>	<u>2005</u>
	(dollars in millions)	(dollars in millions)
Communications	\$ 3,311	\$ 1,645
Coal Mining	67	74
	<u>\$ 3,378</u>	<u>\$ 1,719</u>

Communications revenue is separated into three categories: 1) Core Communications Services (including transport and infrastructure services, wholesale IP and data services, voice services and Vyvx services), 2) Other Communications Services (including managed modem and its related reciprocal compensation, legacy managed IP services and DSL aggregation), and 3) SBC Contract Services. Revenue attributable to these service groupings is provided in the following table:

	<u>2006</u>	<u>2005</u>
	(dollars in millions)	(dollars in millions)
Core Communications Services:		
Transport and Infrastructure	\$ 1,014	\$ 653
Wholesale IP and Data	301	186
Voice	536	120
Vyvx	122	3
	<u>1,973</u>	<u>962</u>
Other Communication Services:		
Managed Modem	286	396
Reciprocal Compensation	102	100
Managed IP	57	83
DSL Aggregation	—	79
	<u>445</u>	<u>658</u>
SBC Contract Services	893	25
Total Communications Revenue	<u>\$ 3,311</u>	<u>\$ 1,645</u>

The Company's Core Communications Services revenue increased 105% in 2006 compared to 2005. The growth in the Company's existing services as well as the acquisitions of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass contributed to the increase. During 2006, the Company recorded revenue from the date of acquisition attributable to Progress Telecom of \$49 million, ICG Communications of \$46 million, TelCove of \$166 million and Looking Glass of \$33 million. During 2006, the Company integrated a significant portion of WilTel into the business. As a result, separate revenue information for former WilTel customers is no longer available other than for SBC Contract Services.

Transport and infrastructure revenue increased 55% in 2006 primarily due to the acquisitions of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass. In addition, increased demand for complex nationwide solutions and colocation capacity in large markets contributed to the revenue growth in 2006. Termination revenue related to transport and infrastructure services decreased approximately \$129 million from \$131 million in 2005 to \$2 million in 2006. The termination revenue in 2005 was primarily attributable to the termination of dark fiber lease agreements with two customers.

Wholesale IP and data revenue increased 62% in 2006 primarily due to customers obtained in the acquisitions of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass. Wholesale IP and data revenue also increased due to traffic growth in North America from new and existing customers that exceeded the approximately 25% rate of price compression in 2006. Traffic growth was mitigated by one customer's migration of traffic to its own network which was acquired via a merger with another carrier. Improved market acceptance of the Company's VPN service and the continued growth of previously awarded contracts also contributed to the increase in wholesale IP and data revenue. Wholesale IP and data revenue includes \$7 million of termination revenue in 2006.

Level 3's voice revenue increased 347% in 2006. The increase is primarily attributable to the operations acquired in the WilTel, TelCove and ICG Communications acquisitions, particularly domestic and international voice termination services, and growth in Level 3's existing wholesale and VoIP-related services including voice termination, local inbound, enhanced local and toll free services. On a combined basis, voice services experienced a 321% increase in minutes of use in the fourth quarter of 2006 compared to the same period in 2005.

Vyvx revenue increased to \$122 million in 2006 as a result of including a full year of Vyx revenue in the Company's results. Vyx was acquired in December 2005 as part of the WilTel acquisition.

The Company expects to recognize termination revenue in the future if customers desire to renegotiate contracts or are required to terminate service. The Company is not able to estimate the specific value of these types of transactions until they occur, but does not currently expect to recognize significant termination revenue for the foreseeable future. The Company expects Core Communications Services revenue to increase in 2007 as a result of the Progress Telecom, ICG Communications, TelCove and Looking Glass acquisitions completed in 2006, the Broadwing and SAVVIS CDN Business acquisitions completed in January 2007 and expected increases in demand for the Company's Core Communications Services.

Managed modem revenue declined 28% in 2006 as a result of the continued migration from narrow band dial-up services to higher speed broadband services by end user customers. This change has resulted in a decline in the demand for managed modem ports. America Online, the Company's largest managed modem customer, continued to reduce the number of ports it purchases from Level 3 in 2006. In addition to the port cancellation provisions, the contracts with America Online contain market-pricing provisions that have the effect of lowering revenue as Level 3 is obligated to provide America Online a reduced per port rate if Level 3 offers another customer better pricing for a lower volume of comparable services. Managed modem revenue also declined in 2006 as a result of certain contracts being renewed or renegotiated at prices lower than were in effect in 2005. The declines in managed modem revenue have been partially offset by increases in market share as a result of certain competitors exiting segments of the

managed modem business in the second half of 2006. The Company expects managed modem revenue to continue to decline in the future primarily due to an increase in the number of subscribers migrating to broadband services and the potential pricing concessions as contracts are renewed.

The Company did not recognize DSL aggregation revenue in 2006 due to the fact that the Company's primary DSL aggregation customer completed the migration of its DSL subscribers to its own network in the third quarter of 2005. In addition, the Company's other DSL contracts expired in 2005 and were not renewed. The Company does not expect to recognize DSL aggregation revenue in the foreseeable future.

Reciprocal compensation revenue increased \$2 million in 2006. The Company has historically earned the majority of its reciprocal compensation revenue from managed modem services. Level 3 has interconnection agreements in place for the majority of traffic subject to reciprocal compensation. The majority of the Company's interconnection agreements provide rate structures through 2007. Level 3 continues to negotiate new interconnection agreements or amendments to its existing interconnection agreements with its local carriers. As a result of the Company's acquisitions of TelCove and Broadwing, the Company has started to generate a portion of its reciprocal compensation revenue from voice services. By the end of 2007, up to 25% of its total reciprocal compensation revenue is expected to be earned from voice services which is included in Core Communications Services revenue. To the extent that the Company is unable to sign new interconnection agreements or signs new agreements containing lower rates, or there is a significant decline in the Company's managed modem dial-up business, or FCC or state regulations change such that carriers are not required to compensate other carriers for terminating ISP-bound traffic, reciprocal compensation revenue may decline significantly over time.

The Company's legacy Managed IP business consists primarily of a business that was acquired in the Genuity transaction in 2003. The Company has not invested in this service and is not actively looking for new customers. The decline in revenue is attributable to the disconnection of service by existing customers. The Company expects this trend to continue in 2007.

SBC Contract Services revenue increased significantly in 2006 as a result of including a full year of SBC Contract Services revenue in the Company's results. The SBC Contract Services agreement was obtained in December 2005 as part of the WilTel acquisition. Under the terms of the agreement, SBC has gross margin purchase commitments through 2009. As of December 31, 2006, the remaining minimum gross margin commitment under the agreement to be utilized during 2007 was approximately \$67 million, and \$75 million from January 2008 through the end of 2009. Additionally, the SBC Contract Services provides for the payment of \$50 million if certain performance criteria are met by Level 3. Level 3 is eligible to earn \$25 million in 2006 and 2007. Of the annual amount, 50% is based on monthly performance and the remaining 50% is based on performance criteria for the full year. The Company met the required performance criteria and earned \$25 million in 2006. SBC has begun to migrate its traffic to the AT&T network acquired in 2005. As a result, the Company expects SBC revenue to decline significantly in 2007 and beyond. However, SBC must still comply with the minimum gross margin commitments under the terms of the contract.

**Coal mining** revenue decreased to \$67 million in 2006 compared to \$74 million in 2005. The decline in revenue for 2006 is attributable to a decline in the average price per ton of coal sold, partially offset by a slight increase in tons shipped. The price decline is attributable to coal sold under a contract that was renewed in 2005 and contained lower price per ton than the original contract.

**Cost of Revenue** for the communications business, as a percentage of revenue for 2006 and 2005 was 44% and 28%, respectively. The increase in 2006 cost of revenue, as a percentage of revenue, is primarily attributable to the recognition of termination revenue in 2005, with no corresponding cost of revenue, and the significant voice and SBC Contract Services revenue obtained in the WilTel acquisition. The margins for the voice and SBC Contract Services revenue are lower than the margins earned on other components included in Core and Other Communications Services revenue. Partially offsetting the lower WilTel

margins were the margins earned by Progress Telecom, ICG Communications, TelCove and Looking Glass. Margins for these businesses were slightly higher in 2006 than those reported by the Company in 2005. In 2005, the Company recognized \$133 million of termination revenue with no corresponding cost of revenue, favorably affecting the cost of revenue percentage. Excluding the termination revenue, cost of revenue as a percentage of revenue would have been 30% in 2005. The Company expects cost of revenue as a percentage of revenue to increase in the first half of 2007 as the Company begins including lower margin revenue from the Broadwing business acquired in January 2007 and then to decline in the second half of 2007 and on an overall basis for 2007 as the lower margin revenue under SBC Contract Services declines and expected cost of revenue synergies from the acquisitions are realized.

Cost of revenue as a percentage of revenue for the coal mining business increased to 85% in 2006 from 72% in 2005. The increase in cost of revenue as a percentage of revenue for the coal mining business is due to a decline in the average price per ton of coal sold in 2006 compared to 2005 and due to increased product costs in 2006 related to changes in stripping ratios and increased tire and fuel costs. In addition, in the second quarter of 2005, the Company was able to favorably resolve certain production tax issues. The resolution of this matter resulted in a \$5 million reduction in cost of revenue. Cost of revenue as a percentage of revenue for 2005 was 78% after excluding the effect of the \$5 million reduction in cost of revenue for the period. The Company expects cost of revenue for the coal mining business in 2007 to be comparable with 2006.

**Depreciation and Amortization** expense was \$730 million in 2006, a 13% increase from 2005 depreciation and amortization expense of \$647 million. The increase is primarily attributable to the communications tangible and intangible assets that were acquired in the WilTel acquisition in December 2005, the Progress Telecom acquisition in March 2006, the ICG Communications acquisition in May 2006, the TelCove acquisition in July 2006 and the Looking Glass acquisition in August 2006. This increase was partially offset by an \$80 million decrease in depreciation expense attributable to the increase in estimated useful lives for network fiber and IP and transmission equipment.

Due to the acquisitions of: Progress Telecom in the first quarter of 2006; ICG Communications in the second quarter of 2006; TelCove and Looking Glass in the third quarter of 2006; and Broadwing and the SAVVIS CDN Business in the first quarter of 2007, Level 3 expects depreciation and amortization expenses to increase in 2007.

**Selling, General and Administrative** expenses increased 64% to \$1.258 billion in 2006 from \$769 million in 2005. This increase is primarily attributable to the inclusion of expenses associated with the operations acquired in the WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass transactions in December 2005, March 2006, May 2006, July 2006 and August 2006, respectively. Specifically, increases in compensation, bonus and employee related costs, network related costs and facility-based expenses all contributed to the increase in selling, general and administrative expenses in 2006.

Included in operating expenses for 2006 and 2005 were \$84 million and \$51 million, respectively, of non-cash compensation and professional expenses recognized under SFAS No. 123R and SFAS No. 123, respectively, related to grants of outperform stock options, warrants and other stock-based compensation awards. The \$33 million increase in non-cash compensation expense in 2006 is primarily attributable to an increase in the number of outperform stock options granted to employees and an increase in the value of the options granted to employees associated with the increasing price of the Level 3 common stock in 2006. These increases were offset by a reduction in the amount of restricted stock and restricted stock units granted in 2006 compared to 2005.

In addition, during the second quarter of 2006, the October 2005 and January 2006 outperform stock option grants were revalued using May 15, 2006 as the grant date, in accordance with SFAS No. 123R, and resulted in a \$6 million increase in non-cash compensation expense during the second quarter of 2006. As

stated in the Company's proxy materials for its 2006 Annual Meeting of Stockholders, over the course of the years since April 1, 1998, the compensation committee of the Company's Board of Directors had administered the 1995 Stock Plan under the belief that the action of the Company's Board of Directors to amend and restate that plan effective April 1, 1998 had the effect of extending the original term of the Plan to April 1, 2008. After a further review of the terms of the plan, however, the compensation committee determined that an ambiguity could have existed that may have resulted in an interpretation that the expiration date of the plan was September 25, 2005. To remove any ambiguity, the Board of Directors sought the approval of the Company's stockholders to amend the plan to extend the term of the plan by five years to September 25, 2010. This approval was obtained at the 2006 Annual Meeting of Stockholders held on May 15, 2006 which resulted in a final measurement date of May 15, 2006 for the outperform options granted in October 2005 and January 2006.

The Company expects selling, general and administrative expenses to increase in 2007 on an overall basis as a result of the inclusion of a full year of expenses for the 2006 acquisitions of Progress Telecom, ICG Communications, TelCove and Looking Glass and the January 2007 acquisitions of Broadwing and the SAVVIS CDN Business. The Company expects the increase in selling, general and administrative expenses will be higher in the first half of 2007. In the second half of 2007, the Company expects that savings from integration synergies from the Broadwing acquisition will result in reduced selling, general and administrative expenses as compared to the first half of 2007.

**Restructuring and Impairment Charges** were \$13 million in 2006 and \$23 million in 2005. In 2006, the Company recognized \$5 million of restructuring charges related to workforce reductions in the communications business in North America. The employees impacted by this workforce reduction were Level 3 employees affected by the integration of companies acquired in 2005 and 2006. As of December 31, 2006, the Company had remaining obligations of less than \$1 million.

In 2005, the Company recognized \$15 million related to the workforce reductions in the communications business in North America and Europe. The employees affected by this workforce reduction provided support functions or worked directly on mature services. All obligations attributable to the 2005 restructuring activities were paid by December 31, 2005.

The Company expects to record restructuring charges in 2007 in connection with the integration of the metro businesses acquired in 2006 and the Broadwing acquisition completed in January 2007.

The Company recognized non-cash impairment charges of \$4 million in 2006 and \$9 million in 2005 resulting from the decision to terminate projects for certain voice services and IT projects in the communications business. In addition, 2005 included a \$1 million reduction in expected lease impairment obligations. These projects have identifiable costs which Level 3 can evaluate separately for impairment. The costs incurred for these projects, including capitalized labor, were impaired as the Company did not expect to utilize the assets in the future. In addition, during the second quarter of 2006, Level 3 recognized \$4 million of non-cash impairment charges related to excess land of the communications business deemed available for sale in Germany. This charge resulted from the difference between the recorded carrying value and the estimated market value of the land.

**Adjusted OIBDA** is defined by the Company, as operating income (loss) from the consolidated statements of operations, less depreciation and amortization expense, less non-cash compensation expense included within selling, general and administration expense on the consolidated statements of operations, and less the non-cash portion of restructuring and impairment charges. Adjusted OIBDA is not a measurement under accounting principles generally accepted in the United States and may not be used by other companies. Management believes that Adjusted OIBDA is an important part of the Company's internal reporting and is an indicator of profitability and operating performance used by the chief operating decision maker or decision making group, especially in a capital-intensive industry such as telecommunications. Adjusted OIBDA excludes interest expense and income tax expense and other



gains/losses not included in operating income. Excluding these items eliminates the expenses associated with the Company's capitalization and tax structures. Note 18 of the consolidated financial statements provides a reconciliation of Adjusted OIBDA for each of the Company's operating segments.

Adjusted OIBDA for the communications business was \$677 million and \$458 million for 2006 and 2005, respectively. The increase is primarily attributable to the Adjusted OIBDA contribution from the operations acquired in the WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass transactions and growth in the Company's Core Communications Services revenue partially offset by related costs. Partially offsetting these increases was a \$122 million reduction in termination and settlement revenue from 2005 to 2006.

Adjusted OIBDA for the mining business decreased to \$8 million in 2006 from \$16 million in 2005. The decrease is primarily attributable to the favorable resolution of certain production tax issues, which resulted in a \$5 million decrease in the cost of revenue for the mining business in the second quarter of 2005 and a decline in the average price per ton of coal sold in 2006 compared to 2005.

The Company expects Adjusted OIBDA to increase in 2007 based on the inclusion of a full year of results in 2007 for Progress Telecom, ICG Communications, TelCove and Looking Glass and the inclusion of the results of the January 2007 acquisitions of Broadwing and the SAVVIS CDN Business and continued growth in Core Communications Services.

**Interest Income** was \$64 million in 2006, increasing \$29 million from \$35 million in 2005. The increase in interest income was due to an increase in the Company's average return on its portfolio to 4.3% in 2006 compared to 2.8% in 2005. The average portfolio balance was \$1.5 billion and \$1.2 billion in 2006 and 2005, respectively. Pending utilization of cash and cash equivalents, the Company invests its funds primarily in government and government agency securities and money market funds. The investment strategy generally provides lower yields on the funds than on alternative investments, but reduces the risk to principal in the short term prior to these funds being used in the Company's business.

**Interest Expense, net** increased by \$118 million to \$648 million in 2006 compared to 2005. Interest expense increased primarily as a result of interest expense attributable to the issuance of \$880 million of 10% Convertible Senior Notes due 2012 issued in the second quarter of 2005, \$550 million of 12.25% Senior Notes due 2013 issued in the first half of 2006, \$150 million of Floating Rate Senior Notes due 2011 issued on March 14, 2006 and \$335 million of 3.5% Convertible Senior Notes due 2012 issued on June 13, 2006 and \$1.250 billion of 9.25% Senior Notes due 2014 issued in the fourth quarter of 2006. In addition, the Company exchanged portions of its 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 for new 11.5% Senior Notes due 2010 during the first quarter of 2006, thereby increasing the effective interest expense on this debt. The increase in interest expense from new debt issuances was partially offset by the July 13, 2006 redemption of the 9.125% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 and a 400 basis-point reduction in the interest rate on the \$730 million Senior Secured Term Loan due 2011 subsequent to its amendment in late June of 2006.

Level 3 expects interest expense to decrease in 2007 based on the overall net effect of the 2005 and 2006 financing transactions described above; the December 27, 2006 repurchase of \$497 million of 10.75% Senior Notes due 2011; the January 2007 exchange of \$605 million of 10% Convertible Senior Notes due 2011 for 196.8 million shares of Level 3 common stock; the February 14, 2007 issuance of \$700 million of 8.75% Senior Notes due 2017 and \$300 million of Floating Rate Senior Notes due 2015; the February 15, 2007 announced calls for redemption of all of its outstanding \$488 million of 12.875% Senior Notes due 2010, all of its outstanding \$96 million of 11.25% Senior Notes due 2010 and all of its outstanding € 104 million of 11.25% Senior Euro Notes due 2010; the February 15, 2007 announced and currently pending tender offers to purchase for cash any and all of Level 3 Financing's \$150 million of Floating Rate Notes due 2011 and any and all of its \$78 million of 11% Senior Notes due 2008; and the February 20, 2007 announced and currently pending tender offers to purchase for cash any and all of its outstanding

\$692 million of 11.5% Senior Notes due 2010 and any and all of its outstanding € 50 million of 10.75% Senior Euro Notes due 2008.

**Loss on Extinguishment of Debt** was \$83 million in 2006 and zero in 2005. In the fourth quarter of 2006, the Company realized a \$54 million loss from the repurchase of the \$497 million principal amount of Level 3 Financing's 10.75% Senior Notes due 2011 and in the second quarter of 2006, Level 3 realized a \$55 million loss on the amendment and restatement of Level 3 Financing's Senior Secured Term Loan due 2011. These losses were partially offset by the \$27 million gain realized on the debt exchange in the first quarter of 2006.

In January 2007, in two separate transactions, the Company exchanged \$605 million of its 10% Convertible Senior Notes due 2011 for approximately 196.8 million shares of the Company's common stock and expects to recognize a \$177 million loss associated with these exchanges.

On February 15, 2007, Level 3 Communications, Inc. called for redemption of all of its outstanding \$488 million aggregate principal amount of 12.875% Senior Notes due 2010 at a price equal to 102.146% of the principal amount thereof, all of its outstanding \$96 million of 11.25% Senior Notes due 2010 at a price equal to 101.875% of principal amount thereof and all of its outstanding € 104 million of 11.25% Senior Euro Notes due 2010 at a price equal to 101.875% of principal amount thereof. Level 3 will pay accrued and unpaid interest on the senior notes to, but not including, the redemption date. All of these senior notes will be redeemed by Level 3 on March 16, 2007. The Company expects to recognize a loss of approximately \$49 million associated with these redemptions in the first quarter of 2007.

Level 3 also announced four tender offers for cash in February 2007 that were pending as of March 1, 2007. On February 15, 2007, Level 3 Financing, Inc. commenced a tender offer to purchase for cash any and all of the outstanding \$150 million aggregate principal amount of its Floating Rate Notes due 2011 for a price equal to \$1,080.00 per \$1,000 principal amount of the notes, which includes \$1,050.00 as the tender offer consideration and \$30.00 as a consent payment. Additionally, Level 3 Communications, Inc. commenced a tender offer to purchase for cash any and all of its outstanding \$78 million aggregate principal amount of 11% Senior Notes due 2008 for a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which includes \$1,024.28 as the tender offer consideration and \$30.00 as a consent payment. The Company expects to recognize a loss associated with these tender offers in the first quarter of 2007, the amount of which will depend on the amounts tendered for each issuance.

On February 20, 2007, Level 3 Communications, Inc. commenced a tender offer to purchase for cash any and all of the outstanding \$692 million aggregate principal amount of its 11.5% Senior Notes due 2010 for a price equal to \$1,115.26 per \$1,000 principal amount of the 11.5% Senior Notes due 2010, which includes \$1,085.26 as the purchase price and \$30.00 as a consent payment. Level 3 Communications, Inc. also commenced a tender offer to purchase for cash any and all of the outstanding €50 million aggregate principal amount of its 10.75% Senior Euro Notes due 2008 for a price equal to € 1,061.45 per € 1,000 principal amount of the Senior Euro Notes due 2008, which includes € 1,031.45 as the purchase price and € 30.00 as a consent payment. The Company expects to recognize a loss associated with these tender offers in the first quarter of 2007, the amount of which will depend on the amounts tendered for each issuance. Each of these tender offers were pending as of March 1, 2007.

The Company may enter into additional transactions in 2007 to repurchase or exchange existing debt that may result in gains or losses on the extinguishment of debt.

**Other, net** is primarily comprised of gains and losses on the sale of marketable securities and non-operating assets, realized foreign currency gains and losses and other income.

**Income Tax Expense** was \$2 million in 2006 compared to \$5 million in 2005. The Company incurs income tax expense attributable to income in various Level 3 subsidiaries, including Coal, that are required to file state or foreign income tax returns on a separate legal entity basis.

As of December 31, 2006, Level 3 had net operating loss carryforwards of approximately \$7.0 billion for federal income tax purposes, including \$298 million of net operating loss carryforwards from acquired companies after limitations that resulted from the acquisitions. If certain transactions occur with respect to Level 3's capital stock that result in a cumulative ownership change of more than 50 percentage points by 5-percent shareholders over a three-year period as determined under rules prescribed by the U.S. Internal Revenue Code ("IRC") and applicable regulations, annual limitations would be imposed with respect to the Company's ability to utilize its net operating loss carryforwards and certain current deductions against any taxable income Level 3 achieves in future periods. Level 3 has entered into transactions over the last three years resulting in significant cumulative changes in the ownership of its capital stock. Additional transactions could cause the Company to incur a 50 percentage point ownership change by 5-percent shareholders and, if the Company triggers the above-noted IRC imposed limitations, could prevent it from fully utilizing net operating loss carryforwards and certain current deductions to reduce income taxes.

**Income from Discontinued Operations** was \$46 million for 2006 and is comprised of \$13 million from the operations of Software Spectrum and a \$33 million gain from the sale of Software Spectrum to Insight Enterprises, Inc. ("Insight") in September, 2006. Income from discontinued operations was \$69 million for 2005 and is comprised of \$20 million from Software Spectrum and a \$49 million gain from the sale of (i) Structure to Infocrossing.

Income from Discontinued Operations declined in 2006 versus the same period in 2005 due to the sale of Software Spectrum on September 7, 2006. Software Spectrum earns a disproportionate share of its revenue at the end of the quarter but incurs operating expenses ratably during the quarter. As a result of the sale in September 2006, operating expenses for Software Spectrum exceeded the gross profits earned on sales through the transaction date due to the cyclical nature of the Software Spectrum business.

Software Spectrum increased its sales and marketing efforts and resources targeting mid-market businesses over the last 18 months of its ownership by the Company resulting in higher revenues and profits for the period ending September 7, 2006 compared to the twelve months ended December 31, 2005. The increase in gross profits was partially offset by an increase in operating expenses, primarily for employee related costs, and the disproportionate level of operating expenses recognized for the partial third quarter of 2006.

Level 3 received gross proceeds of approximately \$353 million and recognized a gain on the sale of Software Spectrum, after transaction costs, of approximately \$33 million in the third quarter of 2006. During the fourth quarter of 2006, Level 3 paid \$2 million to Insight as a final post-closing working capital adjustment.

## Results of Operations 2005 vs. 2004

**Revenue** for 2005 and 2004 is summarized as follows:

	<u>2005</u>	<u>2004</u>
	(dollars in millions)	
Communications	\$ 1,645	\$ 1,685
Coal Mining	74	91
	<u>\$ 1,719</u>	<u>\$ 1,776</u>

	<u>2005</u>	<u>2004</u>
	(dollars in millions)	
<b>Core Communications Services:</b>		
Transport and Infrastructure	\$ 653	\$ 574
IP and data	186	167
Voice	120	53
Vyvx	3	—
	<u>962</u>	<u>794</u>
<b>Other Communication Services:</b>		
Managed Modem	396	488
DSL aggregation	79	138
Reciprocal Compensation	100	150
Managed IP	83	115
	<u>658</u>	<u>891</u>
<b>SBC Contract Services</b>	<u>25</u>	<u>—</u>
<b>Total Communications Revenue</b>	<u>\$ 1,645</u>	<u>\$ 1,685</u>

Transport and infrastructure revenue increased in 2005 primarily due to increased demand for colocation space in large markets in North America and Europe, and an increase in wavelength revenue due to sales to 360Networks, France Telecom and other new and existing customers. Transport and infrastructure revenue in 2005 includes \$4 million attributable to WiTel. In addition, termination revenue related to transport and infrastructure services increased approximately \$23 million in 2005. The termination revenue in 2005 was primarily attributable to agreements reached with France Telecom and 360networks relating to the termination of existing dark fiber lease agreements with those customers described below.

On February 22, 2005, France Telecom and Level 3 finalized an agreement to terminate a dark fiber agreement signed in 2000. Under the terms of the agreement France Telecom returned the fiber to Level 3. Under the original IRU agreement, the cash received by Level 3 was deferred and amortized to revenue over the 20-year term of the agreement. As a result of this transaction, Level 3 recognized unamortized deferred revenue of approximately \$40 million as non-cash termination revenue in the first quarter of 2005. The wavelength sales described above were a part of this transaction.

On March 1, 2005, Level 3 entered into an agreement with 360networks in which both parties agreed to terminate a 20-year IRU agreement. Under the new agreement 360networks returned the dark fiber originally provided by Level 3. Under the original IRU agreement, signed in 2000, the revenue associated with the cash received by Level 3 was deferred and amortized to revenue over the 20-year term of the agreement. As a result of this transaction, Level 3 recognized the unamortized deferred revenue of approximately \$86 million as non-cash termination revenue in the first quarter of 2005. The wavelength sales described above were a part of this transaction.

IP and data revenue increased in 2005 primarily due to traffic growth from new and existing customers that exceeded the rate of price compression as well as improved market acceptance of the Company's new VPN service. In addition, 2005 IP and data revenue includes \$1 million attributable to WiTel.

Level 3's voice revenue, excluding WiTel, increased 117% in 2005. The increase is primarily attributable to the Company's wholesale voice products including voice termination and local inbound services. Voice termination and local inbound services experienced a 35% and 49%, respectively, increase in minutes of use in the fourth quarter of 2005 compared to the same period in 2004. The Company also recorded voice revenue of \$5 million attributable to WiTel for the period Level 3 owned WiTel in the fourth quarter of 2005.

The Vyvx business was acquired on December 23, 2005 as part of the WilTel transaction. Revenue of \$3 million is included from the acquisition date through the end of the year.

Managed modem revenue declined in 2005 as a result of the continued migration from narrow band dial-up services to higher speed broadband services by end user customers. This change resulted in a decline in the demand for managed modem ports. America Online, the Company's largest managed modem customer, reduced the number of ports it purchased from Level 3 by approximately 25% in the second half of 2004 and decreased the number of ports purchased by an additional 30% primarily in the second half of 2005.

Partially offsetting this decline in managed modem revenue in 2005 was the revenue purchased in the acquisitions of the managed modem businesses from ICG Communications and Sprint completed in the second and fourth quarter of 2004, respectively.

DSL aggregation revenue decreased significantly in 2005 as the Company's primary DSL aggregation customer began to migrate its DSL subscribers to its own network beginning in the first quarter of 2005. The customer completed the migration of its subscribers in the third quarter of 2005. In addition, the Company's other DSL contracts expired in 2005 and were not renewed.

Reciprocal compensation revenue declined from 2004 levels primarily due to a settlement with a major carrier in the third quarter of 2004, which did not recur in 2005. The settlement resolved rate issues for 2004 and prior periods and resulted in the recognition of \$31 million of revenue for services provided in prior periods. This revenue had been deferred as the Company did not have an interconnection agreement in place and approved by the relevant authorities. In addition to this agreement, the Company signed interconnection agreements with other carriers in 2004 and 2005 that resulted in the Company receiving a lower rate per minute for terminating traffic. The majority of the Company's interconnection agreements provide rate structures through 2006. The Company earns the majority of its reciprocal compensation revenue from managed modem services.

The Company's legacy Managed IP business consists primarily of a business that was acquired in the Genuity transaction in 2003. The Company has not invested in this service and is not actively looking for new customers. The decline in revenue is attributable to the disconnection of service by existing customers.

The SBC Contract Services revenue was obtained in the WilTel transaction. Under the terms of the agreement, SBC has gross margin purchase commitments through 2009. Level 3 earned revenue of approximately \$25 million attributable to this contract in 2005.

**Coal mining** revenue decreased to \$74 million in 2005 compared to \$91 million in 2004. The decline in revenue for 2005 was attributable to a significant reduction in coal required to be purchased in 2005 under a contract with Detroit Edison from 2004 levels. The Company has signed new agreements with Detroit Edison, but with lower tonnage requirements and lower prices.

**Cost of Revenue** for the communications business, as a percentage of revenue for 2005 and 2004 was 28% and 27%, respectively. In 2005, the Company recognized \$133 million of termination revenue, primarily related to 360networks and France Telecom in the first quarter. In 2004, termination revenue was \$113 million, most of which was attributable to the McLeod transaction in the fourth quarter. An increase in termination revenue with no corresponding cost of revenue, positively affected the percentage in both years. Excluding termination revenue in 2005 and 2004, the cost of revenue, as a percentage of revenue, would have been 30% and 28%, respectively. The increase in 2005 is attributable to the increase in voice services for which the corresponding cost of revenue is generally higher than Level 3's other services.

Cost of revenue, as a percentage of revenue, for the coal mining business was relatively consistent for 2005 and 2004 at 72% and 73%, respectively. The decrease in cost of revenue as a percentage of revenue is attributable to the favorable resolution of certain production tax issues related to prior periods that

resulted in a \$5 million decrease in the cost of revenue for the mining business in the second quarter of 2005.

**Depreciation and Amortization** expenses were \$647 million in 2005, a 4% decrease from 2004 depreciation and amortization expenses of \$671 million. The decrease is primarily attributable to shorter-lived communications assets that were placed in service in prior years becoming fully depreciated during 2004 and 2005.

**Selling, General and Administrative** expenses decreased 6% to \$769 million in 2005 from \$822 million in 2004. This decrease was primarily attributable to lower compensation and employee related costs resulting from the workforce reduction for the communications business which occurred in the first quarter of 2005. Declines in base compensation, bonus, travel, recruiting and facilities expenses all contributed to the decrease in selling, general and administrative expenses in 2005 for the communications business. Also contributing to the decline in operating expenses were lower advertising, marketing and bad debt expenses. Partially offsetting the reduction in communications expenses was an increase in operating expenses for WilTel since its acquisition in the fourth quarter of 2005.

Included in operating expenses for 2005 and 2004 were \$51 million and \$43 million, respectively, of non-cash compensation and professional expenses recognized under SFAS No. 123 related to grants of stock options, warrants and other stock-based compensation awards. The \$8 million increase in non-cash compensation expense was primarily attributable to the restricted stock units granted by the Company in second quarter of 2005 resulting in increased value of the stock based compensation distributed to employees associated with an increasing price of the Level 3 common stock.

**Restructuring and Impairment Charges** were \$23 million in 2005 and \$14 million in 2004. The Company recognized \$15 million related to the workforce reductions of the communications business in North America and Europe in 2005. The employees affected by this workforce reduction provided support functions or worked directly on mature services. All obligations attributable to the 2005 restructuring activities were paid by December 31, 2005.

During 2005, the Company recognized \$9 million in non-cash impairment charges resulting from the decision to terminate projects for certain voice services and IT projects in the communications business. The costs incurred for these projects, including capitalized labor, were impaired as the carrying value of these projects exceeded their estimated fair value.

The Company recorded real property lease impairment charges of \$14 million for leases in North America and Europe in the fourth quarter of 2004. The charge resulted from ceased use of certain space, the signing of subleases for existing vacant space at lower than estimated rates, and extending the estimated sublease dates for other vacant properties due to market conditions.

**Adjusted OIBDA** for the communications business was \$458 million and \$463 million for 2005 and 2004, respectively. The decline in 2005 is primarily attributable to the decline in communications revenue partially offset by higher termination revenue recognized by the Company in 2005. The termination revenue recognized by the Company in 2005 was \$133 million versus \$113 million in 2004. The decline in revenue was offset by a reduction in operating expenses primarily attributable to lower compensation and employee related costs resulting from the workforce reduction for the communications business which occurred in the first quarter of 2005 and lower advertising, marketing and bad debt expenses.

Adjusted OIBDA for the mining business decreased to \$16 million in 2005, from \$18 million in 2004. The decrease was due to the expiration of higher margin contracts in 2004 which were replaced by contracts at lower prices and lower tonnage in 2005.

Adjusted OIBDA for the Company's other businesses decreased from negative \$1 million in 2004, to negative \$3 million in 2005. This change was due to the increase in professional fee expenses in 2005.

**Interest Income** was \$35 million in 2005 increasing \$22 million from \$13 million for 2004. The increase in interest income was due to the increase in the Company's average return on its portfolio to 2.8% in 2005 from 1.3% in 2004. The average portfolio balance increased to \$1.2 billion in 2005 from \$1.0 billion in 2004.

The Company elected to take advantage of the yield curve and purchase longer-term U.S. government securities. The maturity dates on the government securities ranged from November 2006 through February 2008. Due to the WiTel acquisition and expected liquidity requirements, the Company classified certain government securities, previously classified as held to maturity, as available for sale which means they are reported at market value instead of cost at the end of the reporting period. The Company has characterized its remaining securities as held to maturity.

**Interest Expense, net** increased by \$45 million to \$530 million in 2005 compared to 2004, primarily as a result of increased interest expense from the issuance of the Company's \$880 million of 10% Convertible Senior Notes due 2011 in the second quarter of 2005. In addition, there was an increase in interest expense due to the accretion on discount notes and higher interest rates on the variable rate debt. This was partially offset by the refinancing transaction that occurred in the fourth quarter of 2004. Level 3 Financing entered into a \$730 million Senior Secured Term Loan due 2011 and the Company issued \$345 million of 5.25% Senior Convertible Notes due 2011 in the fourth quarter of 2004. The Company used the proceeds from these transactions to repurchase approximately \$1.1 billion of the Company's public debt due in 2008. Overall, the refinancing transaction in the fourth quarter of 2004 reduced the Company's annual interest expense by approximately \$16 million in 2005 compared to the same period in 2004.

In addition, the extinguishment of the Allegiance capital lease obligation, assumed in the Genuity acquisition, in the second quarter of 2004 resulted in a decrease in interest expense in 2005.

**Gain on Extinguishment of Debt** was zero in 2005 and \$197 million in 2004. In the fourth quarter of 2004, the Company repurchased portions of its 9.125% Senior Notes due 2008, 11% Senior Notes due 2008, 10.5% Senior Discount Notes due 2008 and 10.75% Senior Euro Notes due 2008. The Company repurchased portions of the outstanding notes at prices ranging from 83 percent to 89 percent of the repurchased principal balances. The net gain on the early extinguishment of the debt, including transaction costs, realized foreign currency losses and unamortized debt issuance costs, was \$50 million for these transactions. In the second quarter of 2004, the Company paid approximately \$54 million and assumed certain obligations to extinguish the Allegiance capital lease obligation and recognized a gain of \$147 million on the transaction.

**Income Tax Expense** was \$5 million in 2005 compared to \$1 million in 2004. In 2005, the communications business incurred additional tax expense attributable to increased income in various Level 3 subsidiaries, including Coal, that are required to file state income tax returns on a separate legal entity basis.

**Income from Discontinued Operations** was \$69 million for 2005 and is comprised of \$20 million from Software Spectrum and a \$49 million gain from the sale of ( i )Structure to Infocrossing. In 2004, discontinued operations of Software Spectrum resulted in net operating income of \$20 million.

Revenue for Software Spectrum and ( i )Structure increased 1% from \$1.936 billion in 2004 to \$1.958 billion in 2005 primarily as a result of sales to a systems integrator on behalf of the Department of Navy in addition to increased sales to the small-medium business market customers. This was partially offset by an increase in sales under software publishers' agency licensing programs that result in only a service fee being recognized as revenue, rather than the selling price of the software. The software reseller industry is seasonal, with revenue and operating income typically being higher in the second and fourth quarters of the Company's fiscal year.

Software Spectrum began experiencing an increase in sales under Microsoft's 6.0 licensing program and similar programs offered by other suppliers in 2003. Under these programs, new enterprise-wide licensing arrangements are priced, billed and collected directly by the software publishers. Software Spectrum continued to provide sales and support services related to these transactions and earns a service

fee directly from publishers for these activities. The Company recognized the service fee it receives as revenue and not the entire value of the software under this program. Software Spectrum recorded approximately \$74 million and \$54 million of revenue attributable to these types of contracts in 2005 and 2004, respectively. The estimated selling price of the software sold under these agreements was \$1.235 billion and \$975 million for the corresponding periods.

The cost of revenue for Software Spectrum and ( i )Structure, as a percentage of its revenue, was 90% for 2005 and 91% for 2004. Software Spectrum is very reliant on rebates received from software publishers to improve its operating results. In 2005 and 2004, Software Spectrum earned approximately \$40 million and \$42 million, respectively, in rebates which reduced cost of revenue. Software Spectrum does not earn rebates from Microsoft on agency program sales.

Selling, general and administrative expenses for the Software Spectrum and ( i )Structure businesses increased from \$134 million in 2004 to \$152 million in 2005 primarily as a result of an increase in headcount at Software Spectrum.

## Liquidity and Capital Resources

Cash flows provided by (used in) continuing operations for the years ended December 31, 2006 and 2005, respectively are as follows (dollars in millions):

	Year Ended December 31,	
	2006	2005
Communications**	\$207	\$ (120)
Other	14	2
Total	<u>\$ 221</u>	<u>\$ (118)</u>

\*\* Includes interest expense net of interest income

The improvement in communications operating cash flows for 2006 is primarily attributable to improved operating results after excluding the effects of \$129 million of non-cash termination revenue in the first quarter of 2005. The improved results are directly attributable to the operations of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass which were acquired late in 2005 and the first nine months of 2006, and additional revenue from Core Communications Services. Fluctuations in working capital balances resulted in an incremental source of cash of \$67 million in 2006 compared to 2005. An increase in cash provided by accounts receivable was partially offset by an increase in cash used for accounts payable and other current liabilities and a decline in deferred revenue. The increase in cash provided by accounts receivable was, in part, due to a decline in the accounts receivable balance for SBC Contract Services at the end of the year as they migrated traffic to their own network. Partially offsetting the increase in cash provided by operations and working capital fluctuations were higher cash interest payments in 2006. Cash interest payments increased by \$108 million in 2006 compared to 2005.

The increase in operating cash flows for the other businesses is primarily attributable to fluctuations in working capital accounts and other noncurrent liabilities, partially offset by a decrease in operating earnings.

Cash used for investing activities in 2006 primarily included cash used for the acquisitions of Progress Telecom—\$68 million, ICG Communications—\$39 million, TelCove—\$590 million and Looking Glass—\$77 million. In addition, \$392 million was used for capital expenditures primarily for the communications business, and \$98 million to purchase short-term marketable securities. The Company also increased its restricted securities by \$21 million, primarily for its coal business and acquired companies. In the second quarter of 2006, the Company received \$27 million from Leucadia for the WilTel



purchase price adjustment and \$5 million of proceeds from the sale of Infocrossing shares received in the ( i )Structure transaction. In the fourth quarter of 2006, \$275 million of marketable securities held by the Company matured. The Company received net proceeds of \$307 million from the sale of Software Spectrum in 2006. The Company also received distributions from Software Spectrum of \$18 million during 2006.

Financing sources in 2006 consisted of \$680 million of net proceeds from the issuance of: the Floating Rate Senior Notes due 2011 and 12.25% Senior Notes due 2013; \$326 million from the offering of 3.5% Convertible Senior Notes due 2012; \$1,249 from the offering of 9.25% Senior Notes due 2014; and \$543 million of proceeds from the offering of 125 million shares of common stock. Financing uses included the \$46 million of premiums paid to holders of the exchanged notes and \$5 million of third-party costs associated with the debt exchange transaction in January 2006. The \$730 million Senior Secured Term Loan amendment and restatement required the payment of \$53 million in fees to lenders and third parties. In July and December 2006, respectively, the Company used \$461 million of cash to redeem all the outstanding 9.125% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008, excluding accrued interest of \$9 million, and Level 3 Financing used \$543 million of cash to repurchase \$497 million of its 10.75% Senior Notes due 2011.

Cash flows used in discontinued operating activities increased as a result of lower earnings and fluctuations in working capital.

The Company incurred losses from continuing operations of \$790 million for the year ended December 31, 2006. The Company used \$171 million of cash for operating activities and capital expenditures in 2006. The Company expects that the communications business will continue to consume cash in 2007; however, the amount of cash consumed is expected to decline during the year, excluding the timing effects of working capital requirements and interest payments. In 2007, the Company expects its costs will continue to exceed revenue and it will continue to consume cash primarily due to interest payments and capital expenditures. The Company expects Adjusted OIBDA to improve in 2007 primarily as a result of the WilTel, Progress Telecom, ICG Communications, TelCove, Looking Glass, Broadwing and SAVVIS CDN Business acquisitions and the growth in Core Communications Services revenue partially offset by reductions in Other and SBC Contract Services revenue. Interest payments are expected to decrease in 2007 based on financing and other capital markets transactions completed or announced through the time of this filing. Capital expenditures for 2007 are expected to range from \$600 million to \$650 million and will consist of \$100 million to \$150 million of base capital expenditures (estimated capital required to keep the network operating efficiently and product development), approximately \$75 million to \$100 million of capital expenditures for integration and approximately \$400 million to \$425 million of success-based capital expenditures associated with incremental revenue. The majority of the Company's ongoing capital expenditures are expected to be success-based, that is, tied to incremental revenue. In total, the Company expects that cash required for operating activities and capital expenditures will range from \$225 million to \$335 million in 2007, excluding fluctuations in working capital. The Company does not have any significant principal amounts due on its outstanding debt until 2008. As of December 31, 2006, the Company had debt (excluding capital lease payments) of \$144 million and \$363 million that matures in 2008 and 2009, respectively.

Level 3 has approximately \$1.916 billion of cash, cash equivalents and marketable securities on hand at December 31, 2006. In addition, \$136 million of current and non-current restricted securities are used to collateralize outstanding letters of credit, long-term debt, certain operating obligations of the Company or certain reclamation liabilities. Based on information available at this time, management of the Company believes that the Company's current liquidity, anticipated future cash flows from operations and the financing activities completed or announced in the first quarter of 2007, will be sufficient to fund its business including the acquisitions of Broadwing and the SAVVIS' CDN Business.

The Company may elect to secure additional capital in the future, at acceptable terms, to improve its liquidity or fund acquisitions. In addition, in an effort to reduce future cash interest payments, as well as future amounts due at maturity or extend debt maturities, Level 3 or its affiliates may, from time to time, issue new debt, enter into debt for debt, debt for equity or cash transactions to purchase its outstanding debt securities in the open market or through privately negotiated transactions. Level 3 will evaluate any such transactions in light of then existing market conditions and the possible dilutive effect to stockholders. The amounts involved in any such transaction, individually or in the aggregate, may be material.

In January 2006, the Company completed private exchange offers to exchange a portion of its outstanding 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 (together the “2008 Notes”) that were held by eligible holders in a private placement for cash and new 11.5% Senior Notes due 2010. The Company issued \$692 million aggregate principal amount of 11.5% Senior Notes due 2010 as well as paid \$46 million of cash consideration in exchange for the 2008 Notes tendered in the transactions. The Company also paid approximately \$13 million in cash for total accrued interest on the 2008 Notes that had been accepted for exchange to the closing date and \$5 million in transaction costs.

In March 2006, Level 3 Financing issued \$150 million of Floating Rate Senior Notes due in 2011 and \$250 million of 12.25% Senior Notes due in 2013. In April 2006, Level 3 Financing issued an additional \$300 million of the 12.25% Senior Notes due in 2013. The proceeds from these offerings were used to fund the cash portion of the WiTel and Progress Telecom acquisitions as well as to fund the cost of construction, installation, acquisition, lease, development or improvement of other assets to be used in Level 3’s communications business.

In June 2006, Level 3 issued \$335 million of 3.5% Convertible Senior Notes due 2012. The Company also completed the offering of 125 million shares of its common stock for which it received \$543 million in net proceeds. Net proceeds were used to redeem all of its 9.125% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 for total consideration of \$461 million, excluding accrued interest of \$9 million. The remaining proceeds were used for acquisitions and for general corporate purposes, including working capital and capital expenditures.

On June 27, 2006, Level 3 Financing amended and restated its existing \$730 million senior secured credit agreement to reduce the interest rate payable under the agreement by 400 basis points, modify the prepayment provisions and make other specified changes. Level 3 Financing paid approximately \$42 million to existing debt holders and \$11 million to third parties in transaction costs to complete the transaction.

Level 3 Financing issued \$600 million and \$650 million of 9.25% Senior Notes due 2011 in October and December 2006, respectively, and received net proceeds of \$1.239 billion (excluding prepaid interest) after transaction costs. Level 3 Financing used a portion of the proceeds to complete a tender offer to repurchase \$497 million of 10.75% Senior Notes due 2011 for total consideration of \$543 million, excluding accrued interest. The remaining proceeds were used to fund the cost of construction, installation, acquisition, lease, development or improvement of other assets to be used in Level 3’s communications business.

In January 2007, in two separate transactions, the Company completed the exchange of \$605 million of its 10% Convertible Senior Notes due 2011 for a total of 196.8 million shares of Level 3’s common stock.

On February 8, 2007, Level 3 Financing announced that it is seeking to refinance its \$730 million senior secured credit agreement into a loan amount of up to \$1.4 billion. In addition to increasing the loan amount, Level 3 Financing is also seeking, among other things, to reduce the interest rate payable under the agreement and extend the maturity from 2011 to 2014. The refinancing of the senior secured credit facility is expected to close in mid-March 2007.

On February 14, 2007, Level 3 Financing issued \$700 million of its 8.75% Senior Notes due 2017 and \$300 million of its Floating Rate Senior Notes due 2015 and received net proceeds of \$982 million. The proceeds from these offerings are expected to be used to refinance certain Level 3 Financing debt and to fund the cost of construction, installation, acquisition, lease, development or improvement of other assets to be used in Level 3's communications business.

On February 15, 2007, Level 3 Communications, Inc. called for redemption of all of its outstanding \$488 million aggregate principal amount of 12.875% Senior Notes due 2010 at a price equal to 102.146% of the principal amount thereof, all of its outstanding \$96 million aggregate principal amount of 11.25% Senior Notes due 2010 at a price equal to 101.875% of principal amount thereof and all of its outstanding € 104 million aggregate principal amount of 11.25% Senior Euro Notes due 2010 at a price equal to 101.875% of principal amount thereof. Level 3 will pay accrued and unpaid interest on the senior notes to but not including the redemption date. All of these senior notes will be redeemed by Level 3 on March 16, 2007.

Level 3 also announced on February 15, 2007 that Level 3 Financing, Inc. has commenced a tender offer to purchase for cash any and all of the outstanding \$150 million aggregate principal amount of its Floating Rate Notes due 2011 for a price equal to \$1,080 per \$1,000 principal amount of the notes, which includes \$1,050 as the tender offer consideration and \$30.00 as a consent payment. Additionally, Level 3 Communications, Inc. commenced a tender offer to purchase for cash any and all of its outstanding \$78 million aggregate principal amount of 11% Senior Notes due 2008 for a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which includes \$1,024.28 as the tender offer consideration and \$30.00 as a consent payment (together the "Tender Offers").

On February 20, 2007, Level 3 Communications, Inc. commenced a tender offer to purchase for cash any and all of the outstanding \$692 million aggregate principal amount of its 11.5% Senior Notes due 2010 for a price equal to \$1,115.26 per \$1,000 principal amount of the 11.5% Senior Notes due 2010, which includes \$1,085.26 as the purchase price and \$30.00 as a consent payment. Level 3 Communications, Inc. also commenced a tender offer to purchase for cash any and all of the outstanding €50 million aggregate principal amount of its 10.75% Senior Euro Notes due 2008 for a price equal to € 1,061.45 per € 1,000 principal amount of the Senior Euro Notes due 2008, which includes € 1,031.45 as the purchase price and € 30.00 as a consent payment.

As a result of the financing transactions completed or announced after December 31, 2006, the Company's future debt payment obligations have changed significantly. The following summarizes on a pro forma basis the Company's contractual payment obligations as of December 31, 2006 related to debt, excluding capital leases and excluding issue discounts and fair value adjustments and including those financing transactions subsequently announced and closed as of March 1, 2007, that will require estimated cash payments during each of the five succeeding years as follows: 2007—\$1 million; 2008—\$144 million; 2009—\$363 million; 2010—\$1,647 million, 2011—\$1,503 million and \$3,410 million thereafter. These pro forma debt payments do not include the effects of the Company's pending tender offers or the pending refinancing of Level 3 Financing's Senior Secured Term Loan.

In addition to raising capital through the debt and equity markets, the Company may sell or dispose of existing businesses, investments or other non-core assets. In 2005, the Company completed the sale of the (i) Structure business to Infocrossing for approximately \$85 million in cash and Infocrossing common stock. On September 7, 2006, Level 3 completed the sale of Software Spectrum for \$351 million in cash to Insight.

The communications industry continues to consolidate. Level 3 has participated in this process with the acquisitions of WilTel, Progress Telecom, ICG Communications, TelCove, Looking Glass, Broadwing and SAVVIS CDN Business acquisitions. Level 3 will continue to evaluate consolidation opportunities and could make additional acquisitions in the future.

On December 23, 2005, the Company completed the acquisition of WiTel from Leucadia National Corporation and its subsidiaries. The consideration paid consisted of approximately \$363 million in cash (including \$27 million of post-closing working capital and other adjustments which reduced the total purchase price), plus \$100 million in cash to reflect Leucadia's having complied with its obligation to retain that amount of cash with WiTel, and 115 million shares of Level 3 common stock valued at \$313 million. The Company also incurred costs of approximately \$7 million related to the transaction.

On March 20, 2006, Level 3 completed the acquisition of Progress Telecom. Under the terms of the agreement, Level 3 issued approximately 20 million shares, valued at approximately \$66 million, and \$69 million in cash. The Company also incurred approximately \$1 million of costs attributable to the transaction. The purchase price was reduced by \$2 million in the second quarter due to post-closing adjustments based on actual working capital as of the closing date.

Progress Telecom is a regional wholesale network services company. Progress Telecom's network spans 9,000 miles, includes 29 metro networks and connects to international cable landings in south Florida and 31 mobile switching centers in the southeastern region of the United States. Progress Telecom serves approximately 200 customers with a significant concentration of international and wireless carrier customers.

On May 31, 2006, the Company completed the acquisition of ICG Communications, a privately held Colorado-based telecommunications company. Under terms of the agreement, Level 3 paid total consideration of \$178 million, consisting of approximately 26 million shares of Level 3 common stock, valued at \$131 million, and \$45 million in cash. The Company also incurred costs of less than \$1 million related to the transaction. Post-closing adjustments, primarily working capital and other contractual matters resulted in additional consideration of approximately \$3 million, of which \$1 million was paid in the third quarter of 2006 and \$2 million was recorded as a liability at December 31, 2006 and was paid in the first quarter of 2007.

ICG Communications primarily provides transport, Internet Protocol ("IP") and voice services to wireline and wireless carriers, Internet service providers and enterprise customers. ICG Communications' network has more than 2,000 metro and regional fiber miles in Colorado and Ohio and includes approximately 500 points of presence. ICG Communications serves more than 1,600 customers.

On July 24, 2006, Level 3 completed the acquisition of TelCove, a privately held Pennsylvania-based telecommunications company. Under terms of the agreement, Level 3 paid \$446 million in cash and issued approximately 150 million shares of Level 3 common stock valued at \$623 million. In addition, Level 3 repaid \$132 million of TelCove debt and acquired \$13 million in capital leases in the transaction. Also, the Company paid third party costs of approximately \$15 million related to the transaction, which included certain costs incurred by TelCove.

TelCove is a leading facilities-based provider of metropolitan and regional communications services including transport, Internet access and voice services. TelCove's network has more than 22,000 local and long haul route miles serving 70 markets across the eastern United States with approximately 4,000 buildings on net. TelCove has over 13,000 customers.

On August 2, 2006, Level 3 completed the acquisition of Looking Glass, a privately held Illinois-based telecommunications company. The Company paid consideration of approximately \$13 million in cash, including transaction costs of \$4 million and approximately 21 million shares of Level 3 common stock valued at \$84 million. In addition, at the closing, Level 3 repaid approximately \$67 million of Looking Glass liabilities.

Looking Glass provides data transport services including SONET/SDH, wavelength and Ethernet as well as dark fiber and carrier-neutral collocation. Looking Glass' network includes approximately 2,000

route miles serving 14 major metro markets, with lit fiber connectivity to approximately 215 buildings. Looking Glass also has dark fiber connectivity to approximately 250 additional buildings.

After integration, the Progress Telecom, ICG Communications, TelCove and Looking Glass' metropolitan and regional networks will connect Level 3's national backbone network directly to traffic aggregation points. These aggregation points include other carriers' points of presence, local telecommunications companies' central offices, wireless providers' switch centers, colocation and data centers, cable company head ends, and high-bandwidth enterprise locations. Prior to the acquisitions of Progress Telecom, ICG Communications and TelCove, Level 3 had an extensive metro infrastructure in 36 markets, connecting to approximately 900 traffic aggregation points, and Level 3 believes that these facilities have been a source of considerable competitive advantage. With the acquisition of Progress Telecom, ICG Communications, TelCove and Looking Glass, the number of Level 3's traffic aggregation points increased to approximately 5,100 in the U.S. and approximately 5,300 globally.

On January 3, 2007, Level 3 acquired Broadwing Corporation, a publicly held provider of optical network communications services. Under the terms of the merger agreement dated October 16, 2006, Level 3 paid \$8.18 of cash plus 1.3411 shares of Level 3 common stock for each share of Broadwing common stock outstanding at closing. In total, Level 3 paid approximately \$744 million of cash and issued approximately 122 million shares of the Company's common stock, valued at \$688 million. In connection with the acquisition of Broadwing, the Company guaranteed \$180 million in aggregate principal amount of Broadwing Corporation's 3.125% Convertible Senior Debentures due 2026 (the "Broadwing Debentures"). As of February 16, 2007, the holders of \$179 million in aggregate principal amount of the Broadwing Debentures had converted their Broadwing Debentures into a total of 17 million shares of Level 3 common stock and approximately \$106 million in cash pursuant to the terms of the indenture governing the Broadwing Debentures and the agreement whereby Level 3 acquired Broadwing. The remaining \$1 million in aggregate principal amount of the Broadwing Debentures was repurchased by Broadwing at 100% of par as required by the indenture governing the Broadwing Debentures.

Broadwing delivers data, voice and media solutions to enterprises and service providers over its 19,000 mile intercity fiber network. Approximately half of Broadwing's revenue comes from the wholesale market, with business customers comprising the remaining revenue.

On January 23, 2007, the Company acquired the Content Delivery Network services business of SAVVIS, Inc. Under the terms of the agreement, Level 3 paid \$132.5 million in cash to acquire certain assets, including network elements, customer contracts, and intellectual property used in the SAVVIS CDN Business. The purchase price is subject to certain customary post closing working capital adjustments.

The SAVVIS CDN Business provides solutions that improve performance, reliability, scalability and reach of customers' online content. Initially developed in 1996 as Sandpiper Networks, the division developed, deployed and operated the world's first content delivery network. It has a globally distributed infrastructure in more than 20 countries.

#### **Off-Balance Sheet Arrangements**

Level 3 has not entered into off-balance sheet arrangements that have had, or are likely to have, a current or future material effect to its results of operations or its financial position.

## Contractual Obligations

The following tables summarize the contractual obligations and commercial commitments of the Company at December 31, 2006, as further described in the notes to the financial statements.

### Payments Due by Period

	Total	Less than 1 Year	1-3 Years	4 - 5 Years	After 5 Years
<b>Contractual Obligations</b>					
Long-Term Debt, including current portion	\$ 7,417	\$ 5	\$ 513	\$ 4,479	\$ 2,420
Interest Expense Obligations	3,308	632	1,294	875	507
Asset Retirement Obligations	202	4	9	18	171
Operating Leases	865	116	216	160	373
Purchase Obligations	152	152	—	—	—
<b>Other Commercial Commitments</b>					
Letters of Credit	45	14	2	1	28

The Company's debt instruments contain certain covenants which, among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates. If the Company should fail to comply with these covenants, amounts due under the instruments may be accelerated at the note holder's discretion after the declaration of an event of default.

Long-term debt obligations reflect only amounts recorded on the balance sheet as of December 31, 2006 and exclude issue discounts and fair value adjustments. As of December 31, 2006, the outstanding obligation of \$275 million of 9% Convertible Senior Discount Notes due in 2013 had not accreted to its face value. These notes will accrete to their full face value of \$295 million in the fourth quarter of 2007.

Interest expense obligations assume interest rates on variable rate debt do not change from December 31, 2006. In addition, interest is calculated based on debt outstanding as of December 31, 2006 and on existing maturity dates.

Purchase obligations represent all outstanding purchase order amounts of the Company as of December 31, 2006.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Level 3 is subject to market risks arising from changes in interest rates and foreign exchange rates. As of December 31, 2006, the Company had borrowed a total of \$880 million under a Senior Secured Term Loan and Floating Rate Senior Notes due 2011. Amounts drawn on these debt instruments bear interest at LIBOR rates plus an applicable margin. As the LIBOR rates fluctuate, so too will the interest expense on amounts borrowed under the debt instruments. The weighted average interest rate on the variable rate instruments at December 31, 2006, was approximately 8.95%. A hypothetical increase in the variable portion of the weighted average rate by 1% (i.e. a weighted average rate of 9.95%) would increase annual interest expense of the Company by approximately \$9.0 million. At December 31, 2006, the Company had \$6.538 billion (excluding discounts and premiums) of fixed rate debt bearing a weighted average interest rate of 8.87%. A decline in interest rates in the future will not benefit the Company with respect to the fixed rate debt due to the terms and conditions of the loan agreements that require the Company to repurchase the debt at specified premiums.

The Company's business plan includes operating telecommunications network businesses in Europe. As of December 31, 2006, the Company had invested significant amounts of capital in the region for its communications business. In two separate debt issuances, the Company issued a total of € 800 million ( € 154 million outstanding at December 31, 2006) in Senior Euro Notes in February 2000 as an economic

hedge against its net investment in its European subsidiaries at the time. As of December 31, 2006, the Company held enough foreign-denominated currency to fund its current working capital obligations and remaining interest payments on its Euro denominated debt. The Company has not made significant use of financial instruments to minimize its exposure to foreign currency fluctuations.

The change in interest rates is based on hypothetical movements and is not necessarily indicative of the actual results that may occur. Future earnings and losses will be affected by actual fluctuations in interest rates and foreign currency rates.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Financial statements and supplementary financial information for Level 3 Communications, Inc. and Subsidiaries begin on page F-1.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, ("Exchange Act"). Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

### **Management's Report on Internal Control Over Financial Reporting**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, management assessed the effectiveness of internal controls over financial reporting as of December 31, 2006 based on the guidelines established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). As permitted by applicable rules and regulations, the Company has excluded from its evaluation the internal control over financial reporting of ICG Communications, Inc. acquired May 31, 2006, TelCove, Inc., acquired July 24, 2006 and Looking Glass Networks Holding Co., Inc. acquired August 2, 2006. Total revenues excluded for these acquired businesses from their acquisition dates to December 31, 2006 represented approximately 7.3% of the Company's consolidated total revenues for the year ended December 31, 2006. Total assets excluded for these acquired businesses at December 31, 2006 represented approximately 12.8% of the Company's consolidated total assets as of December 31, 2006.

Our internal control over financial reporting includes policies and procedures that provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

Based on our assessment, management believes that our internal control over financial reporting was effective as of December 31, 2006. The results of management's assessment have been reviewed with the Audit Committee of the Company's Board of Directors.

The Company's independent registered public accounting firm, KPMG LLP, has issued an audit report on its assessment of the Company's internal control over financial reporting at December 31, 2006. This report appears on page F-3.

#### **Changes in Internal Control over Financial Reporting.**

As a result of the acquisitions of WiTel Communications Group, LLC on December 23, 2005; Progress Telecom, LLC on March 20, 2006; ICG Communications, Inc. on May 31, 2006; TelCove, Inc. on July 24, 2006; and Looking Glass Networks Holding Co., Inc. on August 2, 2006, the Company has expanded its internal controls over financial reporting to include consolidation of the results of operations as well as acquisition related accounting and disclosures for each acquisition. As a result of the integration activities associated with the acquisitions, the Company has also expanded its internal controls over financial reporting to include certain processes and systems of the acquired companies that were integrated during the year. There were no other changes in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

#### **ITEM 9B. OTHER INFORMATION**

None.

### **Part III**

#### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this Item 10 is incorporated by reference to our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission, however certain information is included in ITEM 1. BUSINESS above under the caption "Directors and Executive Officers."

#### **ITEM 11. EXECUTIVE COMPENSATION**

The information required by this Item 11 is incorporated by reference to our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

For information as of December 31, 2006, with respect to compensation plans (including individual compensation arrangements) under which our equity securities are authorized for issuance, please see "Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER REPURCHASES OF EQUITY SECURITIES" above.

The information required by this Item 12 is incorporated by reference to our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

#### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by this Item 13 is incorporated by reference to our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.



## ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item 14 is incorporated by reference to our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission.

### Part IV

## ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

- (a) Financial statements and financial statement schedules required to be filed for the registrant under Items 8 or 15 are set forth following the index page at page F-1. Exhibits filed as a part of this report are listed below. Exhibits incorporated by reference are indicated in parentheses.
- 3.1 Certificate of Amendment to the Level 3 Communications, Inc. Certificate of Incorporation and the Level 3 Communications, Inc. Restated Certificate of Incorporation. (Exhibit 3 to the Registrant's Current Reports on Form 8-K filed on May 27, 2005 and May 17, 2006).
  - 3.2 Specimen Stock Certificate of Common Stock, par value \$.01 per share (Exhibit 3 to the Registrant's Form 8-A filed on March 31, 1998).
  - 3.3 Amended and Restated By-laws of Level 3 Communications, Inc. (Exhibit 3(ii) to the Registrant's Current Report on Form 8-K dated May 17, 2006).
  - 4.1.1 Form of Senior Indenture (incorporated by reference to Exhibit 4.1 to Amendment 1 to the Registrant's Registration Statement on Form S-3 (File No. 333-68887) filed with the Securities and Exchange Commission on February 3, 1999).
  - 4.1.2 First Supplemental Indenture, dated as of September 20, 1999, between the Registrant and IBJ Whitehall Bank & Trust Company as Trustee relating to the Registrant's 6% Convertible Subordinated Notes due 2009 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated September 20, 1999).
  - 4.1.3 Second Supplemental Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 6% Convertible Subordinated Notes due 2010 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated February 29, 2000).
  - 4.2 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 11% Senior Notes due 2008 (Exhibit 4.1 to the Registrant's Registration Statement on Form S-4 File No. 333-37362).
  - 4.3 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 11 <sup>1</sup>/<sub>4</sub> % Senior Notes due 2010 (Exhibit 4.2 to the Registrant's Registration Statement on Form S-4 File No. 333-37362).
  - 4.4 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 12 <sup>7</sup>/<sub>8</sub> % Senior Discount Notes due 2010 (Exhibit 4.3 to the Registrant's Registration Statement on Form S-4 File No. 333-37362).
  - 4.5 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 10 <sup>3</sup>/<sub>4</sub> % Senior Euro Notes due 2008 (Exhibit 4.1 to the Registrant's Registration Statement on Form S-4 File No. 333-37364).
  - 4.6 Indenture, dated as of February 29, 2000, between the Registrant and The Bank of New York as Trustee relating to the Registrant's 11 <sup>1</sup>/<sub>4</sub> % Senior Euro Notes due 2010 (Exhibit 4.2 to the Registrant's Registration Statement on Form S-4 File No. 333-37364).

- 4.7 Amended and Restated Indenture dated as of July 8, 2003, by and between the Company and The Bank of New York, as successor to IBJ Whitehall Bank & Trust Company, as trustee (amends and restates the Senior Debt Indenture, a Form of which was filed as an Exhibit to the Company's Registration Statement on Form S-3-File No. 333-68887) (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed July 8, 2003).
- 4.8 First Supplemental Indenture, dated as of July 8, 2003, by and between the Company and The Bank of New York, as successor to IBJ Whitehall Bank & Trust Company, as Trustee (Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed July 8, 2003).
- 4.9 Indenture, dated as of October 1, 2003, by and between Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc. as Issuer and The Bank of New York as Trustee relating to the Level 3 Financing, Inc. 10.75% Senior Notes due 2011 (Exhibit 4.11 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2003).
- 4.10.1 Indenture, dated as of October 24, 2003, by and between the Registrant and The Bank of New York as Trustee relating to the Registrant's 9% Convertible Senior Discount Notes due 2013 (Exhibit 4.12 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2003).
- 4.10.2 First Supplemental Indenture, dated as of February 7, 2005, by and between the Company and The Bank of New York, as Trustee relating to the Registrant's 9% Convertible Senior Discount Notes due 2013. (Exhibit 4.12.2 to the Registrant's Annual Report on Form 10-K for the year ending December 31, 2005).
- 4.11 Supplemental Indenture, dated as of October 20, 2004, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2014. (Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed October 22, 2004).
- 4.12 Supplemental Indenture, dated as of October 20, 2004 among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1 2003, among Level 3 Financing, Inc. as Issuer, Level 3 Communications, Inc. as Guarantor and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2011. (Exhibit 99.1 to the Registrant's Current Report on Form 8-K/A-1 filed October 22, 2004).
- 4.13 Indenture, dated December 2, 2004, among Level 3 Communications, Inc. and The Bank of New York. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 4.14 Supplemental Indenture, dated December 1, 2004, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York, as Trustee, relating to the Level 3 Financing 10.75% Senior Notes due 2011. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 4.15 Second Supplemental Indenture dated as of April 4, 2005, by and between Level 3 Communications, Inc. and the Bank of New York, as trustee (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed April 8, 2005).
- 4.16 Indenture, dated as of January 13, 2006, among Level 3 Communications, Inc. as Issuer and The Bank of New York, as Trustee relating to the 11.50% Senior Notes Due 2010 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated January 17, 2006).

- 4.17 Indenture, dated as of March 14, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the Floating Rate Senior Notes due 2011 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated March 16, 2006).
- 4.18 Indenture, dated as of March 14, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the 12.25% Senior Notes due 2013 of Level 3 Financing, Inc. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 16, 2006).
- 4.19 Third Supplemental Indenture between Level 3 Communications, Inc. and The Bank of New York, as Trustee, relating to up to \$345,000,000 aggregate principal amount of 3.5% Convertible Senior Notes due 2012, dated as of June 13, 2006 supplement to the Amended and Restated Indenture dated as of July 8, 2003 (Senior Debt Securities) (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 13, 2006).
- 4.20 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2011 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.21 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, Supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2011 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.22 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.23 Supplemental Indenture, dated as of October 12, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., Level 3 Communications, Inc. and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 4.24 Indenture, dated as of October 30, 2006, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer, and The Bank of New York, as Trustee, relating to the 9.25% Senior Notes due 2014 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated October 30, 2006).
- 4.25 Supplemental Indenture, dated as of December 27, 2006, among Level 3 Communications, Inc., Level 3 Financing, Inc., Level 3 Communications, LLC and The Bank of New York as Trustee, supplementing the Indenture dated as of October 1, 2003, among Level 3 Financing, Inc., as Issuer, Level 3 Communications, Inc., as Guarantor, and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 10.75% Senior Notes due 2011 2014 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated December 28, 2006).

- 4.26 Indenture, dated as of February 14, 2007, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the Floating Rate Senior Notes due 2015 of Level 3 Financing, Inc. (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 4.27 Indenture, dated as of February 14, 2007, among Level 3 Communications, Inc., as Guarantor, Level 3 Financing, Inc., as Issuer and The Bank of New York, as Trustee, relating to the 8.75% Senior Notes due 2017 of Level 3 Financing, Inc. (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 4.28 Supplemental Indenture, dated as of February 23, 2007, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC, Broadwing Financial Services, Inc. and The Bank of New York, as Trustee, supplementing the Indenture dated as of March 14, 2006, among Level 3 Financing, Inc., as Issuer, Level 3 Communications, Inc., as Guarantor, and The Bank of New York as Trustee, relating to Level 3 Financing, Inc.'s 12.25% Senior Notes due 2013 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed February 26, 2007).
- 10.1 Separation Agreement, dated December 8, 1997, by and among Peter Kiewit Sons', Inc., Kiewit Diversified Group Inc., PKS Holdings, Inc. and Kiewit Construction Group Inc. (Exhibit 10.1 to the Registrant's Form 10-K for 1997).
- 10.2 Amendment No. 1 to Separation Agreement, dated March 18, 1997, by and among Peter Kiewit Sons', Inc., Kiewit Diversified Group Inc., PKS Holdings, Inc. and Kiewit Construction Group Inc. (Exhibit 10.1 to the Registrant's Form 10-K for 1997).
- 10.3 Form of Aircraft Time-Share Agreement (Exhibit 10.7 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001).
- 10.4 Warrant Agreement, dated as of April 15, 2002, between the Registrant and Walter Scott, Jr. (Exhibit 10.9 to the Registrant's Annual Report on Form 10-K for 2002).
- 10.5 Assignment and Amendment Agreement, dated as of June 27, 2006, by and among Level 3 Financing, Inc., Level 3 Communications, Inc., Merrill Lynch Capital Corporation and the lenders named therein (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 30, 2006).
- 10.6 Guarantee Agreement, dated December 1, 2004, among Level 3 Communications, Inc., the Subsidiaries party thereto and Merrill Lynch Capital Corporation. (Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.7 Collateral Agreement, dated December 1, 2004, among Level 3 Financing, Inc., Level 3 Communications, Inc., Level 3 Communications, LLC and Merrill Lynch Capital Corporation. (Exhibit 10.3 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.8 Indemnity, Subrogation and Contribution Agreement, dated December 1, 2004, among Level 3 Communications, Inc., Level 3 Financing, Inc., the Subsidiaries party thereto and Merrill Lynch Capital Corporation. (Exhibit 10.4 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.9 Offering Proceeds Note Subordination Agreement, dated December 1, 2004, among Level 3 Communications, Inc., Level 3 Communications, LLC and Level 3 Financing, Inc. (Exhibit 10.5 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.10 Loan Proceeds Note, dated December 1, 2004, issued by Level 3 Communications, LLC to Level 3 Financing. (Exhibit 10.6 to the Registrant's Current Report on Form 8-K filed December 7, 2004).

- 10.11 Loan Proceeds Note Collateral Agreement, dated December 1, 2004, among Level 3 Financing, Inc., Level 3 Communications, Inc. and Merrill Lynch Capital Corporation. (Exhibit 10.7 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.12 Confirmation of OTC Convertible Note Hedge, dated December 2, 2004, from Merrill Lynch International to Level 3 Communications, Inc. (Exhibit 10.8 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.13 Confirmation of OTC Warrant, dated December 2, 2004, from Merrill Lynch International to Level 3 Communications, Inc. (Exhibit 10.9 to the Registrant's Current Report on Form 8-K filed December 7, 2004).
- 10.14 Special Retention Bonus Agreement, dated February 28, 2006, by and between Software Spectrum, Inc. and Keith R. Coogan (filed as Exhibit 10.14 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2005).
- 10.15 Securities Purchase Agreement, dated as of February 18, 2005, among Level 3 Communications, Inc. and the Investors named therein (Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed February 22, 2005).
- 10.16 The 1995 Stock Plan (Amended and Restated April 1, 1998) as amended as of May 15, 2006 (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated May 17, 2006).
- 10.17 Form of Master Deferred Issuance Stock Agreement of Level 3 Communications, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed May 27, 2005).
- 10.18 Form of Level 3 Communications, Inc. Outperform Stock Option Master Award Agreement (Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed June 30, 2005).
- 10.19 Purchase Agreement by and among Level 3 Communications, LLC, PT Holding Company LLC, Progress Telecommunications Corporation, EPIK Communications Incorporated, Florida Progress Corporation, Odyssey Telecorp, Inc. and Level 3 Communications, Inc. dated as of January 25, 2006 (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated January 30, 2006).
- 10.20 Form of Registration Rights and Transfer Restriction Agreement by and among Level 3 Communications, Inc., PT Holding Company LLC, Progress Telecommunications Corporation, Caronet, Inc., and EPIK Communications Incorporated to be entered into on the closing of the transaction contemplated by the Purchase Agreement 2006 (Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated January 30, 2006).
- 10.21 Agreement and Plan of Merger by and among Level 3 Communications, Inc., Eldorado Acquisition Three, LLC and TelCove, Inc. dated as of April 30, 2006. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated April 19, 2006).
- 10.22 Registration Rights and Transfer Restriction Agreement, dated May 31, 2006, by and among Level 3 Communications, Inc., MCCC ICG Holdings LLC, Columbia Capital Equity Partners III(QP), L.P., Columbia Capital Partners III (Cayman), L.P., Columbia Capital Equity Partners III (AI), L.P., Columbia Capital Investors III, L.L.C., Columbia Capital Employees Investors III, L.L.C., M/C Venture Partners V, L.P., M/C Venture Investors, L.L.C., Chestnut Venture Partners, L.P., and Bear Investments, LLLP. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 1, 2006).
- 10.23 Stock Purchase Agreement, dated July 20, 2006, among Level 3 Communications, Inc., Technology Spectrum, Inc. and Insight Enterprises, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated July 26, 2006).

- 10.24 Registration Rights Agreement, dated as of August 2, 2006, between Level 3 Communications, Inc. and Cheshire Holding Corp., as agent for the security holders of Looking Glass Networks Holding Co., Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated August 3, 2006).
- 10.25 Consent, dated as of August 7, 2006, by Level 3 Communications, Inc. relating to that certain Securities Purchase Agreement, dated as of February 18, 2005, by and among Level 3 Communications, Inc. and the Investors named on Exhibit A Thereto (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated August 7, 2006).
- 10.26 Agreement and Plan of Merger among Level 3 Communications, Inc., Level 3 Services, LLC, Level 3 Colorado, Inc. and Broadwing Corporation, dated as of October 16, 2006 (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated October 17, 2006).
- 10.27 Registration Agreement, dated October 30, 2006, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated, Credit Suisse Securities (USA) LLC, J.P. Morgan Securities Inc. and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s 9.25% Senior Notes due 2014 (Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated October 30, 2006).
- 10.28 Agreement and Plan of Merger, dated as of October 16, 2006, as Amended by the First Amendment to Agreement and Plan of Merger Dated as of November 21, 2006, among Level 3 Communications, Inc., Level 3 Services, LLC, Level 3 Colorado, LLC (n/k/a Level 3 Colorado, Inc.) and Broadwing Corporation (attached as Annex A to the proxy statement/prospectus included in the registrant's Registration Statement on Form S-4 (333-138462) (Incorporated by reference to Exhibit 2.1 to the Registrant's Registration Statement on Form S-4 (333-138462)). (Exhibit 10.1 to the Registrant's Current Report on Form 8-K/A dated November 27, 2006).
- 10.29 Registration Agreement, dated December 28, 2006, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated, Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc. and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s 9.25% Senior Notes due 2014 (Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated December 28, 2006).
- 10.30 Exchange Agreement, dated as of January 11, 2007, among Level 3 Communications, Inc., Southeastern Asset Management, Inc., on behalf of its investment advisory clients, and Legg Mason Opportunity Trust, a series of Legg Mason Investment Trust, Inc. (Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated January 17, 2007).
- 10.31 Registration Agreement, dated February 14, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc., Morgan Stanley & Co. Incorporated and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s Floating Rate Senior Notes due 2015 (Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 10.32 Registration Agreement, dated February 14, 2007, among Level 3 Communications, Inc., Level 3 Financing, Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Credit Suisse Securities (USA) LLC, Citigroup Global Markets Inc., Morgan Stanley & Co. Incorporated and Wachovia Capital Markets, LLC relating to Level 3 Financing, Inc.'s 8.75% Senior Notes due 2017 (Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated February 20, 2007).
- 12 Statements re computation of ratios.
- 21 List of subsidiaries of the Company.

- 23 Consent of KPMG LLP.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, this 1<sup>st</sup> day of March, 2007.

LEVEL 3 COMMUNICATIONS, INC.

By: /s/ JAMES Q. CROWE  
Name: James Q. Crowe  
Title: *Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>/s/ WALTER SCOTT, JR.</u> Walter Scott, Jr.	Chairman of the Board	March 1, 2007
<u>/s/ JAMES Q. CROWE</u> James Q. Crowe	Chief Executive Officer and Director	March 1, 2007
<u>/s/ SUNIT S. PATEL</u> Sunit S. Patel	Group Vice President and Chief Financial Officer (Principal Financial Officer)	March 1, 2007
<u>/s/ ERIC J. MORTENSEN</u> Eric J. Mortensen	Senior Vice President and Controller (Principal Accounting Officer)	March 1, 2007
<u>/s/ JAMES O. ELLIS, JR.</u> James O. Ellis, Jr.	Director	March 1, 2007
<u>/s/ RICHARD R. JAROS</u> Richard R. Jaros	Director	March 1, 2007
<u>/s/ ROBERT E. JULIAN</u> Robert E. Julian	Director	March 1, 2007
<u>/s/ ARUN NETRAVALI</u> Arun Netravali	Director	March 1, 2007
<u>/s/ JOHN T. REED</u> John T. Reed	Director	March 1, 2007
<u>/s/ MICHAEL B. YANNEY</u> Michael B. Yanney	Director	March 1, 2007
<u>/s/ ALBERT C. YATES</u> Albert C. Yates	Director	March 1, 2007



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
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Schedules not indicated above have been omitted because of the absence of the conditions under which they are required or because the information called for is shown in the consolidated financial statements or in the notes thereto.

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Level 3 Communications, Inc.:

We have audited the accompanying consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit), and comprehensive loss for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Level 3 Communications, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Level 3 Communications, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 1, 2007 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

/s/ **KPMG LLP**

Denver, Colorado  
March 1, 2007

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Level 3 Communications, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Level 3 Communications, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Level 3 Communications, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Level 3 Communications, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Level 3 Communications, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Level 3 Communications, Inc. acquired ICG Communications, Inc. on May 31, 2006; Telcove, Inc. on July 24, 2006; and Looking Glass Networks Holding Co., Inc. on August 2, 2006. Management excluded from its assessment of Level 3 Communications, Inc.'s internal control over financial reporting as of December 31, 2006, these acquired businesses' internal control over financial reporting associated with total assets of \$1.3 billion and total revenues of \$246 million included in the consolidated financial statements of Level 3 Communications, Inc. and subsidiaries as of and for the year ended December 31,

2006. Our audit of internal control over financial reporting of Level 3 Communications, Inc. also excluded an evaluation of the internal control over financial reporting of ICG Communications, Inc., Telcove, Inc., and Looking Glass Networks Holding Co., Inc.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Level 3 Communications, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit), and comprehensive loss for each of the years in the three-year period ended December 31, 2006, and our report dated March 1, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ **KPMG LLP**

Denver, Colorado

March 1, 2007

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**For each of the three years ended December 31, 2006**

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(dollars in millions, except per share data)		
Revenue:			
Communications	\$ 3,311	\$ 1,645	\$ 1,685
Coal mining	<u>67</u>	<u>74</u>	<u>91</u>
Total revenue	3,378	1,719	1,776
Costs and Expenses (exclusive of depreciation and amortization shown separately below):			
Cost of revenue:			
Communications	1,460	463	436
Coal mining	<u>57</u>	<u>53</u>	<u>67</u>
Total cost of revenue	1,517	516	503
Depreciation and amortization	730	647	671
Selling, general and administrative	1,258	769	822
Restructuring and impairment charges	<u>13</u>	<u>23</u>	<u>14</u>
Total costs and expenses	3,518	1,955	2,010
Operating Loss	(140)	(236)	(234)
Other Income (Expense):			
Interest income	64	35	13
Interest expense	(648)	(530)	(485)
Gain (loss) on early extinguishment of debt, net	(83)	—	197
Other, net	<u>19</u>	<u>29</u>	<u>32</u>
Total other income (expense)	(648)	(466)	(243)
Loss from Continuing Operations Before Income Taxes	(788)	(702)	(477)
Income Tax Expense	<u>(2)</u>	<u>(5)</u>	<u>(1)</u>
Loss from Continuing Operations	(790)	(707)	(478)
Discontinued Operations:			
Income from discontinued operations	13	20	20
Gain on sale of discontinued operations	<u>33</u>	<u>49</u>	<u>—</u>
Income from Discontinued Operations	46	69	20
Net Loss	<u>\$ (744)</u>	<u>\$ (638)</u>	<u>\$ (458)</u>
Earnings (Loss) Per Share of Common Stock (Basic and Diluted):			
Loss from Continuing Operations	\$ (0.79)	\$ (1.01)	\$ (0.70)
Income from Discontinued Operations	<u>.05</u>	<u>0.10</u>	<u>0.03</u>
Net Loss	<u>\$ (0.74)</u>	<u>\$ (0.91)</u>	<u>\$ (0.67)</u>

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**December 31, 2006 and 2005**

	2006	2005
	(dollars in millions,	except per share
	data)	
Assets		
Current Assets:		
Cash and cash equivalents	\$ 1,681	\$ 379
Marketable securities	235	176
Restricted cash and securities	46	34
Receivables, less allowances for doubtful accounts of \$17 and \$17, respectively	326	392
Current assets of discontinued operations	—	597
Other	101	92
Total Current Assets	2,389	1,670
Property, Plant and Equipment, net	6,468	5,632
Marketable Securities	—	234
Restricted Cash and Securities	90	75
Goodwill and Other Intangibles, net	919	291
Noncurrent Assets of Discontinued Operations	—	264
Other Assets, net	128	111
Total Assets	\$ 9,994	\$ 8,277
Liabilities and Stockholders' Equity (Deficit)		
Current Liabilities:		
Accounts payable	\$ 391	\$ 367
Current portion of long-term debt	5	—
Accrued payroll and employee benefits	92	79
Accrued interest	143	102
Deferred revenue	142	199
Current liabilities of discontinued operations	—	539
Other	156	137
Total Current Liabilities	929	1,423
Long-Term Debt, less current portion	7,357	6,023
Deferred Revenue	753	737
Other Liabilities	581	570
Commitments and Contingencies		
Stockholders' Equity (Deficit):		
Preferred stock, \$.01 par value, authorized 10,000,000 shares: no shares outstanding	—	—
Common stock, \$.01 par value, authorized 2,250,000,000 shares: 1,178,423,105 outstanding in 2006 and 817,767,818 outstanding in 2005	12	8
Additional paid-in capital	9,305	7,759
Accumulated other comprehensive income (loss)	(4)	(51)
Accumulated deficit	(8,939)	(8,192)
Total Stockholders' Equity (Deficit)	374	(476)
Total Liabilities and Stockholders' Equity (Deficit)	\$ 9,994	\$ 8,277

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For each of the three years ended December 31, 2006**

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	<u>(dollars in millions)</u>		
<b>Cash Flows from Operating Activities:</b>			
Net Loss	\$ (744)	\$ (638)	\$ (458)
Income from discontinued operations	(46)	(69)	(20)
Loss from continuing operations	(790)	(707)	(478)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities of continuing operations:			
Depreciation and amortization	730	647	671
(Gain) loss on debt extinguishments, net	83	—	(197)
Loss on impairments	8	9	—
Gain on sale of property, plant and equipment, Commonwealth Telephone shares and other assets	(7)	(9)	(30)
Non-cash compensation expense attributable to stock awards	84	51	43
Deferred revenue	(53)	(121)	(66)
Amortization of debt issuance costs	19	16	16
Accreted interest on long-term debt discount	38	33	75
Accrued interest on long-term debt	32	30	(27)
Change in working capital items net of amounts acquired:			
Receivables	131	3	(6)
Other current assets	8	(15)	13
Payables	(23)	(12)	(16)
Other current liabilities	(32)	(26)	(117)
Other	(7)	(17)	(3)
<b>Net Cash Provided by (Used in) Operating Activities of Continuing Operations</b>	<b>221</b>	<b>(118)</b>	<b>(122)</b>
<b>Cash Flows from Investing Activities:</b>			
Proceeds from sales and maturities of marketable securities	280	584	70
Purchases of marketable securities	(98)	(648)	(410)
Decrease (increase) in restricted cash and securities, net	(21)	(4)	21
Capital expenditures	(392)	(300)	(272)
Advances (to) from discontinued operations, net	18	13	7
Acquisitions, net of cash acquired, and investments	(749)	(379)	(69)
Proceeds from sale of discontinued operations, net of cash sold	307	82	—
Proceeds from sale of Commonwealth shares	—	—	41
Proceeds from sale of property, plant and equipment, and other investments	7	11	19
<b>Net Cash Used in Investing Activities</b>	<b>\$ (648)</b>	<b>\$ (641)</b>	<b>\$ (593)</b>

(continued)

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
For each of the three years ended December 31, 2006

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(dollars in millions)		
<b>Cash Flows from Financing Activities:</b>			
Long-term debt borrowings, net of issuance costs	\$ 2,256	\$ 943	\$ 985
Payments on and repurchases of long-term debt, including current portion and refinancing costs	(1,110)	(130)	(1,027)
Equity offering	543	—	—
<b>Net Cash Provided by (Used in) Financing Activities</b>	<b>1,689</b>	<b>813</b>	<b>(42)</b>
<b>Discontinued Operations (Revised—See Note 1):</b>			
Net cash provided by (used in) discontinued operating activities	(20)	(5)	58
Net cash used in investing activities	(23)	(22)	(4)
Net cash used in financing activities	—	(1)	(1)
Effect of exchange rates on cash and cash equivalents	—	(4)	3
<b>Net Cash Provided by (Used in) Discontinued Operations</b>	<b>(43)</b>	<b>(32)</b>	<b>56</b>
<b>Effect of Exchange Rates on Cash and Cash Equivalents</b>	<b>10</b>	<b>(13)</b>	<b>15</b>
<b>Net Change in Cash and Cash Equivalents</b>	<b>1,229</b>	<b>9</b>	<b>(686)</b>
<b>Cash and Cash Equivalents at Beginning of Year:</b>			
Cash and cash equivalents of continuing operations	379	338	1,080
Cash and cash equivalents of discontinued operations	73	105	49
<b>Cash and Cash Equivalents at End of Year:</b>			
Cash and cash equivalents of continuing operations	<u>\$ 1,681</u>	<u>\$ 379</u>	<u>\$ 338</u>
Cash and cash equivalents of discontinued operations	<u>\$ —</u>	<u>\$ 73</u>	<u>\$ 105</u>
<b>Supplemental Disclosure of Cash Flow Information:</b>			
Cash interest paid	\$ 559	\$ 451	\$ 421
Income taxes paid	—	—	11
<b>Noncash Investing and Financing Activities:</b>			
Common stock issued for acquisitions	\$ 904	\$ 313	\$ —
Amendment and restatement of \$730 million credit agreement	730	—	—
Long-term debt issued in exchange transaction	619	—	—
Long-term debt retired in exchange transaction	692	—	—
Settlement of debt obligation and current liabilities with restricted securities	—	13	—
Decrease in deferred revenue related to acquisitions	10	2	—

See accompanying notes to consolidated financial statements.



**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)**  
For each of the three years ended December 31, 2006

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss) (dollars in millions)	Accumulated Deficit	Total
Balances at December 31, 2003	\$ 7	\$ 7,360	\$ (90)	\$ (7,096)	\$ 181
Common Stock:					
Stock plan grants	—	22	—	—	22
Shareworks plan	—	34	—	—	34
401(k) plan	—	17	—	—	17
Convertible Note Hedge and Warrant (See Note 15)	—	(62)	—	—	(62)
Net Loss	—	—	—	(458)	(458)
Other Comprehensive Income	—	—	109	—	109
Balances at December 31, 2004	7	7,371	19	(7,554)	(157)
Common Stock:					
WiTel acquisition	1	312	—	—	313
Stock plan grants	—	37	—	—	37
Shareworks plan	—	24	—	—	24
401(k) plan	—	15	—	—	15
Net Loss	—	—	—	(638)	(638)
Other Comprehensive Loss	—	—	(70)	—	(70)
Balances at December 31, 2005	8	7,759	(51)	(8,192)	(476)
Adjustment for EITF No. 04-6	—	—	—	(3)	(3)
Adjusted balances at December 31, 2005	8	7,759	(51)	(8,195)	(479)
Common Stock:					
Acquisitions	2	902	—	—	904
Equity offering, net of offering costs	2	541	—	—	543
Stock plan grants	—	60	—	—	60
Shareworks plan	—	25	—	—	25
401(k) plan	—	18	—	—	18
Net Loss	—	—	—	(744)	(744)
Other Comprehensive Income	—	—	47	—	47
Balances at December 31, 2006	<u>\$ 12</u>	<u>\$ 9,305</u>	<u>\$ (4)</u>	<u>\$ (8,939)</u>	<u>\$ 374</u>

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

For each of the three years ended December 31, 2006

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(dollars in millions)		
Net Loss	\$ (744)	\$ (638)	\$ (458)
Other Comprehensive Income (Loss) Before Income Taxes:			
Foreign currency translation income (losses)	45	(72)	29
Unrealized holding gains (losses) on marketable equity securities and other arising during period	(1)	(1)	(2)
Reclassification adjustment for losses included in net loss	3	3	82
Other Comprehensive Income (Loss), Before Income Taxes	47	(70)	109
Income Tax Benefit Related to Items of Other Comprehensive Income (Loss)	—	—	—
Other Comprehensive Income (Loss), Net of Income Taxes	47	(70)	109
Comprehensive Loss	<u>\$ (697)</u>	<u>\$ (708)</u>	<u>\$ (349)</u>

**SUPPLEMENTARY STOCKHOLDERS' EQUITY (DEFICIT) INFORMATION**

	Net Foreign		
	Currency Translation Adjustment	Other	Total
		(dollars in millions)	
Accumulated other comprehensive income (loss):			
Balance at December 31, 2003	\$ (84)	\$ (6)	\$ (90)
Change	134	(25)	109
Balance at December 31, 2004	50	(31)	19
Change	(69)	(1)	(70)
Balance at December 31, 2005	(19)	(32)	(51)
Change	48	(1)	47
Balance at December 31, 2006	<u>\$ 29</u>	<u>\$ (33)</u>	<u>\$ (4)</u>

See accompanying notes to consolidated financial statements.

**LEVEL 3 COMMUNICATIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Summary of Significant Accounting Policies**

**Principles of Consolidation**

The consolidated financial statements include the accounts of Level 3 Communications, Inc. and subsidiaries (the “Company” or “Level 3”) in which it has control, which are enterprises primarily engaged in communications and coal mining. Fifty-percent-owned mining joint ventures are consolidated on a pro rata basis. All significant intercompany accounts and transactions have been eliminated.

On December 23, 2005, Level 3 acquired WilTel Communications Group, LLC and its operating subsidiaries (“WilTel”). In addition the Company acquired Progress Telecom, LLC (“Progress Telecom”) on March 20, 2006, ICG Communications, Inc. (“ICG Communications”) on May 31, 2006, TelCove, Inc. (“TelCove”) on July 24, 2006 and Looking Glass Networks Holding Co., Inc. (“Looking Glass”) on August 2, 2006. The WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass results of operations, cash flows and financial position are included in the consolidated financial statements from the respective dates of their acquisition (See Note 2).

On September 7, 2006, Level 3 sold Software Spectrum, Inc. (“Software Spectrum”), the Company’s software reseller business, to Insight Enterprises, Inc. (“Insight Enterprises”). On November 30, 2005, Level 3 sold ( i )Structure, LLC (“( i ) Structure”), Level 3’s wholly owned IT infrastructure management outsourcing subsidiary to Infocrossing, Inc. (“Infocrossing”). The two businesses comprised Level 3’s information services segment. The results of operations, financial condition and cash flows for the Software Spectrum and ( i )Structure businesses have been classified as discontinued operations in the consolidated financial statements and related footnotes for all periods presented in this report (See Note 3).

**Communications**

The Company’s communications business provides a broad range of integrated communications services primarily in the United States and Europe as a facilities-based provider (that is, a provider that owns or leases a substantial portion of the property, plant and equipment necessary to provide its services). The Company has created, through a combination of construction, purchase and leasing of facilities and other assets, an advanced international, end-to-end, facilities-based communications network. The Company has built, and continues to upgrade, the network based on optical and Internet Protocol technologies in order to leverage the efficiencies of these technologies to provide lower cost communications services.

Revenue for communications services, including private line, wavelengths, colocation, Internet access, managed modem, voice, video and dark fiber, is recognized monthly as the services are provided based on contractual amounts expected to be collected. Management establishes appropriate revenue reserves to address, where significant, circumstances that at the time services are rendered, collection is not reasonably assured either due to credit risk, the potential for billing disputes or other reasons. Reciprocal compensation revenue is recognized only when an interconnection agreement is in place with another carrier.

Certain sale and long-term infeasible right of use or IRU agreements of dark fiber and capacity are required to be accounted for in the same manner as sales of real estate with property improvements or integral equipment. This accounting treatment results in the deferral of the cash that has been received and the recognition of revenue ratably over the term of the agreement (currently up to 20 years).

Termination revenue is recognized when a customer discontinues service prior to the end of the contract period, for which Level 3 had previously received consideration and for which revenue recognition was deferred. Termination revenue is also recognized when customers are required to make termination penalty payments to Level 3 to settle contractually committed purchase amounts that the customer no longer expects to meet or when a customer and Level 3 renegotiate a contract under which Level 3 is no longer obligated to provide services for consideration previously received and for which revenue recognition has been deferred. Termination revenue is reported in the same manner as the original service provided, and amounted to \$11 million, \$133 million and \$113 million and in 2006, 2005 and 2004, respectively (See Note 4).

The Company is obligated under dark fiber IRUs and other capacity agreements to maintain its network in efficient working order and in accordance with industry standards. Customers are obligated for the term of the agreement to pay for their allocable share of the costs for operating and maintaining the network. The Company recognizes this revenue monthly as services are provided.

Level 3's customer contracts require the Company to meet certain service level commitments. If Level 3 does not meet the required service levels, it may be obligated to provide credits, usually in the form of free service, for a short period of time. The original services that resulted in the credits are not included in revenue and, to date, have not been material.

Cost of revenue for the communications business includes leased capacity, right-of-way costs, access charges and other third party costs directly attributable to the network, but excludes depreciation and amortization and related impairment expenses. The Company also includes in communications cost of revenue the satellite transponder lease costs, the package delivery costs and the blank tape media costs attributable to its video distribution business.

The Company recognizes the cost of network services as they are incurred in accordance with contractual requirements. The Company disputes incorrect billings from its suppliers of network services. The most prevalent types of disputes include disputes for circuits that are not disconnected by its supplier on a timely basis and usage bills with incorrect or inadequate information. Depending on the type and complexity of the issues involved, it may and often does take several quarters to resolve the disputes.

In determining the amount of the cost of network service expenses and related accrued liabilities to reflect in its financial statements, the Company considers the adequacy of documentation of disconnect notices, compliance with prevailing contractual requirements for submitting these disconnect notices and disputes to the provider of the network services, and compliance with its interconnection agreements with these carriers. Significant judgment is required in estimating the ultimate outcome of the dispute resolution process, as well as any other amounts that may be incurred to conclude the negotiations or settle any litigation. Actual results could vary from the estimated amounts accrued for disputes.

Although it has not done so recently, the Company may periodically enter into agreements to acquire network assets from other telecommunications service carriers. These carriers may in turn acquire network assets from Level 3. Transactions in which Level 3 transfers network assets to and acquires network assets from the same third party at or about the same time are referred to as "contemporaneous transactions." These transactions would generally be recorded as non-monetary exchanges of similar assets at book value, as these transactions do not represent the culmination of an earnings process. Contemporaneous transactions do not result in the recognition of revenue. Net cash or other monetary assets paid or received in contemporaneous transactions are recorded as an adjustment to the book value of the transferred property. The adjusted book value becomes the carrying value of the transferred property, plant and equipment. The Company did not enter into these types of agreements during the three years ended December 31, 2006. Beginning January 1, 2006, the Company measures non-monetary assets exchanges at fair value in accordance with SFAS No. 153, "Exchanges of Non-Monetary Assets", ("SFAS No. 153").

### *Concentration of Credit Risk*

The Company provides communications services to a wide range of wholesale and enterprise customers, ranging from well capitalized national carriers to smaller, early stage companies. The Company has in place policies and procedures to review the financial condition of potential and existing customers and concludes that collectibility of revenue and other out-of-pocket expenses is probable prior to the commencement of services. If the financial condition of an existing customer deteriorates to a point where payment for services is in doubt, the Company will not recognize revenue attributable to that customer until cash is received. As a result of the WiTel acquisition in 2005 and the Progress Telecom, ICG Communications, TelCove and Looking Glass acquisitions in 2006, the total number of customers increased to approximately 18,000 at December 31, 2006. A significant portion of WiTel's revenue is attributable to SBC Services, Inc., a wholly owned subsidiary of AT&T Inc. ("SBC") and as a result, due to the credit worthiness of SBC, the Company does not believe its overall credit risk has increased significantly. The policies and procedures for reviewing the financial condition and recognizing revenues of these additional customers related to the acquisitions remained consistent with those described above. The Company has from time to time entered into agreements with value-added resellers and other channel partners to reach consumer and enterprise markets for voice services. The Company has policies and procedures in place to evaluate the financial condition of these resellers prior to initiating service to the final customer. The Company is not immune from the effects of the downturn in the communications industry; however, management believes the concentration of credit risk with respect to receivables is mitigated due to the dispersion of the Company's customer base among different industries and geographic areas and remedies provided by the terms of contracts and statutes.

A significant portion of Level 3's communications service revenue was concentrated among a limited number of customers through the end of 2006. Revenue attributable to AT&T Inc. and subsidiaries, including SBC Communications, Bell South Communications and Cingular Wireless (assuming those companies were subsidiaries for all of 2006), amounted, on an aggregate basis, to \$1.1 billion for the year ended December 31, 2006, representing approximately 32 percent of consolidated revenue for the year and is included within the Communications segment in the consolidated statements of operations. Prior to the acquisition of WiTel in December 2005, AT&T Inc. and subsidiaries was not a significant customer of the Company. Revenue from Time Warner Inc. and subsidiaries, including America Online, amounted, on an aggregate basis, to \$220 million, \$288 million and \$374 million for the years ended December 31, 2006, 2005 and 2004, respectively, representing approximately 7 percent, 8 percent and 10 percent of consolidated revenue for the respective years and is included within the Communications segment in the consolidated statements of operations. Given the expected reduction in the SBC Contract Services revenue and the overall increase in revenue from acquisition activity concentration of revenue among a limited number of customers is expected to be reduced in periods subsequent to 2006. However, if Level 3 would lose one or more major customers, or if one or more major customers significantly decreased its orders for Level 3 services, the Company's communications business would be materially and adversely affected.

The Company's DSL aggregation services were primarily provided to a single customer on an exclusive basis in certain markets, which exclusivity expired at the end of the first quarter of 2005. The customer completed the migration of its existing DSL customers to its own network during the third quarter of 2005 .

### **Discontinued Information Services**

On September 7, 2006, Level 3 sold Software Spectrum, Inc. ("Software Spectrum"), the Company's software reseller business, to Insight. On November 30, 2005, Level 3 sold ( i )Structure, Level 3's wholly owned IT infrastructure management outsourcing subsidiary to Infocrossing. The two businesses comprised Level 3's information services segment. The results of operations, financial condition and cash flows for the Software Spectrum and ( i )Structure businesses have been classified as discontinued

operations in the consolidated financial statements and related footnotes for all periods presented in this report (See Note 3).

Software Spectrum is a global reseller of business software, primarily to large and medium sized businesses. Revenue is recognized as either an agency fee, whereby sales under certain licensing programs permit Software Spectrum to recognize only a service fee paid by the software publisher as revenue, or on a “gross” basis in which case the Company recognizes the full value of the software sold as revenue. Accounting literature provides guidance to enable companies to determine whether revenues from the reselling of goods and services should be recorded on a “gross” or “net” basis. The Company believes that the facts and circumstances, particularly those involving pricing and credit risk indicate that the majority of Software Spectrum’s sales should be recorded on a “gross” basis. The latitude and ability of Software Spectrum to establish the selling price to the customer is an important indication of “gross” revenue reporting. The assumption of credit risk is another important factor in determining “gross” versus “net” reporting. Software Spectrum has the responsibility to pay suppliers for all products ordered, regardless of when, or if, it collects from its customers. Software Spectrum is also solely responsible for determining the creditworthiness of its customers.

Microsoft Corporation, a significant supplier of software to Software Spectrum, changed certain licensing programs in 2001 whereby new enterprise-wide licensing arrangements are priced, billed and collected directly by Microsoft. In 2003, several other suppliers, for whom Software Spectrum resells products and services, began adopting this type of program. Software Spectrum will continue to provide sales and support services related to these transactions and will earn a service fee directly from the software publishers for these activities. Under this licensing program, Software Spectrum only recognizes the service fee paid by the software publisher as revenue and not the entire value of the software. The Company continues to sell products under various licensing programs, but beginning in 2003, has experienced an increase in the level of sales under these new programs and management expects further adoption of agency licensing programs in the future. If Microsoft and other software publishers are able to successfully implement and sell a significant amount of software under this program, or it is determined that the accounting for reselling of the software should be recorded on a “net” basis, the Company may experience a significant decline in information services revenue, but will also experience a comparable decline in cost of revenue.

Microsoft is the primary provider of business software to the Company’s Software Spectrum business. If Microsoft should successfully implement programs for the direct sale of software through volume purchase agreements or other arrangements intended to exclude the distribution or resale channel, Software Spectrum’s results of operations would be materially and adversely affected.

In 2005, Microsoft notified Software Spectrum of proposed changes to Microsoft’s sales agency program which, after being finalized by Microsoft, went into effect for customer contracts entered into after July 1, 2006. All contracts completed prior to July 1, 2006, were grandfathered under the previously existing sales agency program. Under the revised program for agency type sales as currently drafted, the number of performance metrics against which Software Spectrum is measured and the standard of performance on those metrics are expected to increase. Based on a preliminary evaluation of Microsoft’s proposed program changes, Software Spectrum expects that the amount of agency fees it earns from Microsoft will be reduced over the three-year period in which it is implemented. Due to the grandfathering of existing sales agency program sales, however, Software Spectrum anticipates that the program changes will not have a significant effect on Software Spectrum’s results of operation or financial position in 2006.

Revenue is recognized from software sales at the time of product shipment, or in accordance with the terms of licensing contracts, when the price to the customer is fixed, and collectibility is reasonably assured. Revenue from maintenance contracts is recognized when invoiced, the license period has commenced, when the price to the customer is fixed, and collectibility is reasonably assured, as Software Spectrum has

no future obligations associated with future performance under these maintenance contracts. Advance billings are recorded as deferred revenue until services are provided.

Cost of revenue for Software Spectrum includes direct costs of the licensing activity and costs to purchase and distribute software. The costs directly attributable to advance billings are deferred and included in other current and noncurrent assets in the consolidated balance sheet. Rebate income received from software publishers is recognized as a reduction of cost of revenue in the period in which the rebate is earned based on a systematic allocation of the total rebate income considered probable of being realized.

#### *Concentration of Credit Risk*

The Company's customer base consists of several thousand accounts including corporations, government agencies, educational institutions, non-profit organizations and other business entities. For the year ended December 31, 2005, no single customer represented more than 10 percent of information services revenue.

### **Coal Mining**

Historically, coal sold by Level 3's coal mining operations has been sold primarily under long-term contracts with public utilities, which burn coal in order to generate steam to produce electricity. A substantial portion of Level 3's coal revenue was earned from long-term contracts during 2006, 2005 and 2004. The remainder of Level 3's sales are made on the spot market. Costs of revenue related to coal sales include costs of mining and processing, estimated reclamation costs, royalties and production taxes.

The long-term contracts for the delivery of coal establish the price, volume, and quality requirements of the coal to be delivered. The contracts also contain provisions for periodic price adjustments through the use of indices for items such as materials, supplies and labor. Other portions of the price are adjusted for changes in production taxes, royalties and changes in cost due to new legislation or regulation. These contractual adjustments are recognized in revenue as the changes occur and become billable to the customers.

The terms and conditions of the long-term contracts generally require the customer to meet annual contractual commitments. Thus, the customer has the ability to defer or accelerate coal shipments during the year to meet its requirements. Revenue under these contracts is recognized when coal is actually shipped to the customer.

#### *Concentration of Credit Risk*

Level 3's coal sales contracts are concentrated with several electric utility and industrial companies. In the event that these customers do not fulfill contractual responsibilities, Level 3 could pursue the available legal remedies.

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses include salaries, wages and related benefits (including non-cash charges for stock based compensation), property taxes, travel, insurance, rent, contract maintenance, advertising and other administrative expenses. Selling, general and administrative expenses also include network related expenses such as network facility rent, utilities and maintenance costs.

### **Advertising Costs**

Level 3 expenses the cost of advertising as incurred. Advertising expense is included as a component of selling, general and administrative expenses in the accompanying consolidated statements of operations.

Advertising expense was \$8 million, \$6 million and \$17 million for the years ended December 31, 2006, 2005 and 2004, respectively.

### **Rent Expense**

The Company recognizes rent expense on a straight-line basis over the term of the lease based on the future minimum rental payments during the lease term.

### **Stock-Based Employee Compensation**

The Company has accounted for stock-based employee compensation using a fair value based method pursuant to SFAS No. 123 “Accounting for Stock-Based Compensation” (“SFAS No. 123”) since 1998. For the years ended December 31, 2005 and 2004, the Company recognized expense using the accelerated vesting methodology of FASB Interpretation No. 28 “Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans” (“FIN 28”) (See Note 15). Beginning January 1, 2006, Level 3 adopted the provisions of SFAS No. 123R, “Share-Based Payment” (“SFAS No. 123R”). Under SFAS No. 123R, the Company separates each award into vesting tranches and recognizes expense for each tranche over the vesting period in the same manner as under FIN 28. The adoption of SFAS No. 123R did not have a material effect on the Company’s financial position or results of operations.

### **Depreciation and Amortization**

Property, plant and equipment are recorded at cost. Depreciation and amortization for the Company’s property, plant and equipment are computed on straight-line and accelerated (for certain coal assets) methods based on the following useful lives:

Facility and Leasehold Improvements	10 - 40 years
Network Infrastructure (including fiber and conduit)	12 - 25 years
Operating Equipment	4 - 7 years
Furniture, Fixtures, Office Equipment and Other	2 - 7 years

During 2006, Level 3 determined that the period it expects to use its existing fiber and certain equipment is longer than the remaining useful lives as originally estimated. As a result, the Company extended the depreciable life of its existing fiber from 7 years to 12 years, its existing transmission equipment from 5 to 7 years and its existing IP equipment from 3 years to 4 years.

Leasehold improvements are depreciated over the shorter of their estimated useful lives or lease terms that are reasonably assured.

Depletion on mineral properties is provided on a units-of-extraction basis determined in relation to coal committed under sales contracts. The Company’s coal mining business does not use its coal reserve estimates for purposes of depletion but, rather, depletes the properties over the estimated recoverable tons of coal that are required to be delivered under existing coal contracts.

### **Earnings (Loss) Per Share**

Basic earnings (loss) per share have been computed using the weighted average number of shares outstanding during each period. Diluted earnings (loss) per share is computed by including the dilutive effect of common stock that would be issued assuming conversion or exercise of outstanding convertible notes, stock options, stock based compensation awards and other dilutive securities. No such items were included in the computation of diluted loss per share in 2006, 2005 or 2004 because the Company incurred a loss from continuing operations in each of these periods and the affect of inclusion would have been anti-dilutive.



## **Trade Accounts Receivable**

Trade accounts receivable are recorded at the invoiced amount and can bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on an analysis of the aging of the accounts receivable balance. The Company reviews its allowance for doubtful accounts quarterly. Past due balances over 90 days and over a specified amount are reviewed individually for collectibility. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers.

## **Restricted Cash and Securities**

The Company classifies any cash or investments that collateralize outstanding letters of credit, long-term debt, or certain operating or performance obligations of the Company as restricted cash. The Company also classifies cash or investments restricted to fund certain reclamation liabilities as restricted cash. The classification of restricted cash on the consolidated balance sheet as current or noncurrent is dependent on the duration of the restriction and the purpose for which the restriction exists.

## **Long-Lived Assets**

The Company segregates identifiable intangible assets acquired in an acquisition from goodwill. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), goodwill is no longer amortized, and is evaluated for impairment at least annually.

Other intangible assets primarily include customer contracts, customer relationships and technology acquired in business combinations. The intangible assets with estimated useful lives are amortized on a straight-line basis over the expected period of benefit which ranges from 2 to 15 years. Certain intangibles acquired in the WiTel and TelCove transactions have an indefinite life. In accordance with SFAS No. 142, the Company evaluates its indefinite lived intangible assets for impairment annually or as circumstances change that could affect the recoverability of the carrying amount of the assets.

The Company at least annually, or as events or circumstances change that could affect the recoverability of the carrying value of its long-lived assets, conducts a comprehensive review of the carrying value of its assets to determine if the carrying amount of the assets are recoverable in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets." This review requires the identification of the lowest level of identifiable cash flows for purposes of grouping assets subject to review. The estimate of undiscounted cash flows includes long-term forecasts of revenue growth, gross margins and capital expenditures. All of these items require significant judgment and assumptions. An impairment loss may exist when the estimated undiscounted cash flows attributable to the assets are less than their carrying amount. If an asset is deemed to be impaired, the amount of the impairment loss recognized represents the excess of the asset's carrying value as compared to its estimated fair value, based on management's assumptions and projections.

For purposes of this review, Level 3 has historically separately evaluated colocation facilities, certain additional conduits and its communication network (including network equipment, fiber, conduits and customer premise equipment) as these were the lowest levels with separately identifiable cash flows for the grouping of assets. Beginning in 2006, the Company stopped evaluating colocation assets separately and began including them in the communications network grouping due to changes in the nature of the cash flows from the delivery of colocation services. The majority of the Company's colocation customers now purchase other services in conjunction with their colocation services thereby reducing the independence of colocation services cash flows from other services. In addition, the percentage of colocation space used to support the communications network asset has increased over time.

Management's estimate of the future cash flows attributable to its long-lived assets and the fair value of its businesses involve significant uncertainty. Those estimates are based on management's assumptions of future results, growth trends and industry conditions. The impairment analysis of long-lived assets also requires management to make certain subjective assumptions and estimates regarding the expected future use of certain empty conduits included in the network asset group and the expected future use of certain empty conduit evaluated for impairment separately from the network asset group.

### **Accounting for Asset Retirement Obligations**

The Company follows the policy of providing an accrual for reclamation of mined properties in accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations" ("SFAS No. 143"), based on the estimated total cost of restoration of such properties to meet compliance with laws governing surface mining. These estimated costs are calculated based on the expected future risk adjusted cash flows to remediate such properties discounted at a risk-free rate. The Company also provides an accrual for obligations related to certain colocation leases and right-of-way agreements in accordance with SFAS No. 143, based on the estimated total cost of restoration of such properties to their original condition. These estimated obligations are calculated based on the expected future discounted cash flows using the Company's estimated weighted average cost of capital at the time the obligation is incurred and applying a probability factor for conditional restoration obligations. Changes in expected future cash flows are discounted at interest rates that were in effect at the time of the original estimate for downward revisions to such cash flows, and at interest rates in effect at the time of the change for upward revisions in the expected future cash flows.

### **Income Taxes**

Deferred income taxes are provided for the temporary differences between the financial reporting and tax basis of the Company's assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The U.S. net operating losses not utilized can be carried forward for 20 years to offset future taxable income. The majority of the foreign jurisdiction net operating losses not utilized can be carried forward indefinitely. A valuation allowance has been recorded against deferred tax assets, as the Company is unable to conclude under relevant accounting standards that it is more likely than not that deferred tax assets will be realizable.

### **Comprehensive Income (Loss)**

Comprehensive income (loss) includes income (loss) and other non-owner related changes in equity not included in income (loss), such as unrealized gains and losses on marketable securities classified as available for sale, foreign currency translation adjustments related to foreign subsidiaries, and other adjustments.

### **Foreign Currencies**

Generally, local currencies of foreign subsidiaries are the functional currencies for financial reporting purposes. Assets and liabilities are translated into U.S. dollars at year-end exchange rates. Revenue, expenses and cash flows are translated using average exchange rates prevailing during the year. Gains or losses resulting from currency translation are recorded as a component of accumulated other comprehensive income (loss) in stockholders' equity (deficit) and in the statements of comprehensive loss. A significant portion of the Company's foreign subsidiaries have the Euro as the functional currency, which experienced significant fluctuations against the U.S. dollar during 2006, 2005 and 2004. As a result, the Company has experienced significant foreign currency translation adjustments that are recognized as a component of accumulated other comprehensive income (loss) in stockholders' equity (deficit) and in the

statement of comprehensive loss in accordance with SFAS No. 52 “Foreign Currency Translation.” The Company considers its investments in its foreign subsidiaries to be long-term in nature.

### **Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most critical estimates and assumptions are made in determining the allowance for doubtful accounts, revenue reserves, recoverability of long-lived assets, useful lives of long-lived assets, accruals for estimated liabilities that are probable and estimatable, cost of revenue disputes for the communications services, unfavorable contract liabilities set up in purchase accounting and asset retirement obligations. Actual results could differ from those estimates and assumptions.

### **Recently Issued Accounting Pronouncements**

The FASB issued SFAS No. 153, “Exchanges of Non-Monetary Assets”, which was effective for Level 3 starting January 1, 2006. Under SFAS No. 153, the Company will measure assets exchanged at fair value, as long as the transaction has commercial substance and the fair value of the assets exchanged is determinable within reasonable limits. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The adoption of SFAS No. 153 did not have a material effect on the Company’s financial position or results of operations as Level 3 is a party to a limited number of non-monetary transactions and those transactions have not been material.

Emerging Issues Task Force (“EITF”) Issue No. 04-6, “Accounting for Stripping Costs Incurred during Production in the Mining Industry” (“EITF No. 04-6”) establishes appropriate accounting for stripping costs incurred during the production phase and is effective for fiscal years beginning after December 15, 2005. EITF No. 04-6 concludes that stripping costs incurred during the production phase of a mine are variable production costs that should be included in the costs of the inventory produced during the period that the stripping costs are incurred. EITF No. 04-6 further defines inventory produced as mineral that has been extracted. As a result, stripping costs related to exposed, but not extracted mineral are expensed as incurred rather than deferred until the mineral is extracted. The Company’s coal mining business previously deferred stripping costs and amortized these costs over the period in which the underlying coal is mined. The Company’s adoption of EITF No. 04-6 required it to adjust by \$3 million beginning retained earnings (accumulated deficit) for the amount of prepaid stripping costs previously deferred as of January 1, 2006.

In June 2006, the FASB issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109,” (“FIN No. 48”). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, “Accounting for Income Taxes.” FIN No. 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN No. 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of FIN No. 48 is not expected to have a material effect on the Company’s consolidated results of operations or financial condition.

In June 2006, the FASB ratified the consensus on EITF Issue No. 06-3, “How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement”

("EITF No. 06-3"). The scope of EITF No. 06-3 includes any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer and may include, but is not limited to, sales, use, value added, Universal Service Fund ("USF") contributions and some excise taxes. The Task Force concluded that entities should present these taxes in the income statement on either a gross or a net basis, based on their accounting policy, which should be disclosed pursuant to APB Opinion No. 22, "Disclosure of Accounting Policies." If such taxes are significant and are presented on a gross basis, the amounts of those taxes should be disclosed. The consensus on EITF No. 06-3 will be effective for interim and annual reporting periods beginning after December 15, 2006. The Company currently records USF contributions on a gross basis in its consolidated statements of operations, but records sales, use, value added and excise taxes billed to its customers on a net basis in its consolidated statements of operations. The adoption of EITF No. 06-3 is not expected to have a material effect on the Company's consolidated results of operations or financial condition.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements." SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. The Company adopted SAB No. 108 for the year ended December 31, 2006. The adoption of SAB No. 108 did not have a material effect on the Company's results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. The Company is currently assessing the potential effect that the adoption of SFAS No. 157 will have on its financial statements.

On December 21, 2006, the FASB issued FASB Staff Position No. EITF 00-19-2, "Accounting for Registration Payment Arrangements" ("FSP EITF 00-19-2"). FSP EITF 00-19-2 addresses an issuer's accounting for registration payment arrangements. FSP EITF 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with SFAS No. 5, "Accounting for Contingencies" ("SFAS No. 5"). A "registration payment arrangement" is defined as an arrangement that specifies that the issuer will endeavor (1) to file a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the SEC. The arrangement requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. FSP EITF 00-19-2 specifies that if the transfer of consideration under a registration payment arrangement is probable and can be reasonably estimated at inception, the contingent liability under the registration payment arrangement shall be included in the allocation of proceeds from the related financing transaction using the measurement guidance in SFAS No. 5. FSP EITF 00-19-2 also requires certain disclosures about the terms of each registration payment arrangement, even if the likelihood of the issuer having to make any payments under the arrangement is remote. FSP EITF 00-19-2 is effective immediately for registration payment arrangements entered into after December 21, 2006 and for fiscal years beginning after December 31, 2006, and interim periods within those fiscal years, for registration payment arrangements entered into prior to the issuance of FSP EITF 00-19-2. The Company adopted FSP EITF 00-19-2 for the

year ended December 31, 2006. The adoption of FSP EITF 00-19-2 did not have a material effect on the Company's results of operations and financial condition.

## **Reclassifications**

Certain current and prior year amounts have been reclassified to conform to the December 31, 2006 presentation.

The Company has separately disclosed the operating, investing and financing portion of the cash flows attributable to its discontinued operations for all periods presented.

## **(2) Acquisitions**

In 2006, the Company embarked on a strategy to expand its presence in metropolitan markets and began offering services to enterprise customers through its Business Markets Group. This strategy will allow the Company to terminate traffic over its owned facilities rather than paying third parties to terminate the traffic. The expansion into new metro markets should also provide additional opportunities to sell services to bandwidth intensive businesses on the Company's national and international networks. In order to expedite the expansion of its metro business, Level 3 acquired Progress Telecom, ICG Communications, TelCove and Looking Glass in 2006. The results of operations attributable to each acquisition are included in the consolidated financial statements from the date of acquisition.

**Looking Glass Acquisition:** On August 2, 2006, Level 3 completed the acquisition of Looking Glass, a privately held Illinois-based telecommunications company. The consideration paid by Level 3 consisted of approximately \$13 million in cash, including \$4 million of transaction costs, and approximately 21 million shares of Level 3 common stock valued at \$84 million. In addition, at the closing, Level 3 repaid approximately \$67 million of Looking Glass liabilities. The transaction purchase price is not subject to any post-closing adjustments.

Level 3 entered into certain transactions with Looking Glass prior to the acquisition of Looking Glass by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the Looking Glass transaction by \$2 million, the amount of the unamortized deferred revenue balance on August 2, 2006.

**TelCove Acquisition:** On July 24, 2006, Level 3 completed the acquisition of TelCove, a privately held Pennsylvania-based telecommunications company. Under terms of the agreement, Level 3 paid \$446 million in cash and issued approximately 150 million shares of Level 3 common stock, valued at \$623 million. In addition, Level 3 repaid \$132 million of TelCove debt and acquired \$13 million in capital leases in the transaction. Also, the Company paid third party costs of approximately \$15 million related to the transaction, which included certain costs incurred by TelCove. The transaction price is not subject to any post-closing adjustments.

Level 3 entered into certain transactions with TelCove prior to the acquisition of TelCove by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the TelCove transaction by \$3 million, the amount of the unamortized deferred revenue balance on July 24, 2006.

**ICG Communications:** On May 31, 2006, Level 3 acquired all of the stock of ICG Communications, a privately held Colorado-based telecommunications company, from MCCC ICG Holdings, LLC excluding certain assets and liabilities. Under the terms of the purchase agreement, Level 3 purchased ICG Communications for an aggregate consideration consisting of approximately 26 million shares of Level 3 common stock, valued at \$131 million, and approximately \$45 million in cash. The Company also incurred costs of less than \$1 million related to the transaction. Post-closing adjustments, primarily working capital and other contractual matters resulted in additional consideration of approximately \$3 million, of which \$1 million was paid in the third quarter of 2006 and \$2 million was recorded as a liability at December 31, 2006 and paid in the first quarter of 2007.

Level 3 entered into certain transactions with ICG Communications prior to the acquisition of ICG Communications by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the ICG Communications transaction by \$1 million, the amount of the unamortized deferred revenue balance on May 31, 2006.

**Progress Telecom:** On March 20, 2006, Level 3 completed its acquisition of all of the membership interests of Progress Telecom from PT Holding Company LLC (“PT Holding”) excluding certain specified assets and liabilities of Progress Telecom. Progress Telecom was owned by PT Holding which is jointly owned by Progress Energy, Inc. and Odyssey Telecorp, Inc. Under the terms of the purchase agreement, Level 3 purchased Progress Telecom for an aggregate purchase price consisting of approximately \$69 million in cash and approximately 20 million shares of Level 3 common stock, valued at \$66 million. The purchase price was subsequently reduced by \$2 million for working capital and other contractual matters. The Company received payment of the \$2 million adjustment in July 2006.

Level 3 entered into certain transactions with Progress Telecom prior to the acquisition of Progress Telecom by Level 3, whereby Level 3 received cash for communications services to be provided in the future and which was originally recognized as deferred revenue. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and, accordingly, reduced the purchase price applied to the net assets acquired in the Progress Telecom transaction by \$4 million, the amount of the unamortized deferred revenue balance on March 20, 2006.

**WilTel:** On December 23, 2005, the Company completed the acquisition of WilTel from Leucadia National Corporation and its subsidiaries (together “Leucadia”). The consideration paid consisted of approximately \$390 million in cash (which included a \$16 million adjustment for estimated excess working capital), plus \$100 million in cash to reflect Leucadia’s having complied with its obligation to leave that amount of cash in WilTel, and 115 million newly issued unregistered shares of Level 3 common stock, valued at \$313 million.

The Company also incurred costs of approximately \$7 million related to the transaction. The cash purchase price was subject to post-closing adjustments based on actual working capital and other contractual items as of the closing date. In March 2006, Leucadia and Level 3 agreed that the purchase price for WilTel should decrease by approximately \$27 million as a result of working capital and other contractual post-closing adjustments. Level 3 received payment of the \$27 million adjustment in April 2006.

The final valuation indicated that the fair value of the identifiable assets acquired exceeded the total of the purchase price paid and the liabilities assumed in the transaction. As a result, the excess value was applied against the fair value of the long-lived assets obtained in the transaction. The \$27 million post-closing adjustment resulted in an additional decrease in long-lived assets in the first quarter of 2006.

Level 3 entered into certain transactions with WilTel prior to the acquisition of WilTel by Level 3, whereby it received cash for communications services to be provided in the future. As a result of the acquisition, Level 3 can no longer amortize this deferred revenue into earnings and accordingly, reduced the purchase price applied to the net assets acquired in the WilTel transaction by \$2 million, the amount of the unamortized deferred revenue balance on December 23, 2005.

The acquisition includes all of WilTel's communications business and WilTel's Vyvx video transmission business. The acquisition also includes a multi-year contract between SBC Service, Inc. and WilTel ("SBC Contract Services Agreement"). Recently, SBC Services, Inc. became a subsidiary of AT&T Inc. ("AT&T") (together "SBC") and announced its intention to migrate the services provided by WilTel to the merged SBC Services, Inc. and AT&T network. WilTel and SBC amended the SBC Contract Services Agreement to run through 2009. The agreement provides a gross margin purchase commitment of \$335 million from December 2005 through the end of 2007, and \$75 million from January 2008 through the end of 2009. SBC has satisfied \$268 million of the December 2005 to the end of 2007 gross margin purchase commitment through December 31, 2006. As of December 31, 2006, the remaining minimum gross margin commitment under the agreement to be utilized in 2007 was approximately \$67 million, and \$75 million from January 2008 through the end of 2009. Originating and terminating access charges paid to local phone companies are passed through to SBC in accordance with a formula that approximates cost. Additionally, the SBC Contract Services Agreement provides for the payment of \$50 million from SBC if certain performance criteria are met by Level 3 in 2006 and 2007. The Company met the required performance criteria and recorded revenue of \$25 million in 2006 under the agreement. Level 3 is eligible to earn another \$25 million in 2007 if it meets the performance criteria.

As specified in the purchase agreement with Leucadia, WilTel transferred certain excluded assets to Leucadia and Leucadia assumed certain excluded liabilities. The excluded assets included all cash and cash equivalents in excess of \$100 million at closing, all marketable securities, WilTel's headquarters building located in Tulsa, Oklahoma and certain other miscellaneous assets. In addition, WilTel assigned to Leucadia all of its right to receive cash payments from SBC totaling \$236 million, pursuant to the Termination, Mutual Release and Settlement Agreement, dated June 15, 2005, among Leucadia, WilTel and SBC. The excluded liabilities include all of WilTel's long-term debt obligations, WilTel's obligations under its defined benefit pension plan, certain other employee related liabilities and other claims. The agreement required Leucadia to pay in full all of WilTel's obligations under its credit agreement and for Leucadia to release WilTel from any obligation under the outstanding mortgage note secured by its headquarters building. Level 3 entered into an agreement with Leucadia to lease a portion of the former WilTel headquarters building in Tulsa.

**ICG:** On April 1, 2004, the Company acquired the wholesale dial access customer contracts of ICG Communications, Inc. ("ICG"). The Company agreed to pay approximately \$35 million in cash to acquire the contracts and related equipment, which provide dial-up Internet access to various large customers and other leading ISPs. The terms of the agreement required Level 3 to pay \$25 million at closing and additional payments of \$5 million on both July 1, 2004 and October 1, 2004. The purchase price was subject to post-closing adjustments, but those adjustments were not material. Level 3 migrated the traffic from the customer contracts acquired from ICG onto its own network infrastructure and the migration was substantially complete by the end of 2004.

**Sprint :** On October 1, 2004, the Company acquired the wholesale dial Internet access business of Sprint Communications Company, L.P. ("Sprint"). Level 3 paid \$34 million in cash to acquire the business, which provides dial-up Internet access to leading Internet service providers ("ISPs") throughout the United States and agreed to provide discounted services to Sprint that were valued at \$5 million, which was accounted for as part of the purchase price. Level 3 and Sprint entered into a transition services agreement for the migration of customers onto the Level 3 network, which Level 3 completed in the third quarter of 2005. During the migration period, until such time as a customer contract was assumed or assigned,

amounts received for services provided by Sprint were accounted for as a reduction in purchase price as opposed to revenue. The net amount received prior to the assumption or assignment of these contracts totaled \$5 million through December 31, 2005 and therefore reduced the purchase price to \$29 million. With the completion of the migration activities, Level 3 recognizes as revenue, amounts received from all customer contracts acquired in this transaction. The results of operations attributable to the Sprint assets acquired and liabilities assumed are included in the consolidated financial statements from the date of assumption or assignment of contracts.

#### *Purchase Price Allocation*

Under business combination accounting, the total final purchase price for each of the acquired companies was allocated to the net tangible and identifiable intangible assets based on their estimated fair values as of the acquisition dates. The allocation of the purchase price was based upon valuations performed for each acquired company. The valuations for the WilTel and the Progress Telecom acquisitions have been finalized. The valuations for the ICG Communications, TelCove and Looking Glass acquisitions are in the process of being finalized.

The valuations for the WilTel and Looking Glass acquisitions indicated that the fair value of the assets acquired exceeded the total of the purchase price paid and the liabilities assumed in the transactions. As a result, the excess value or negative goodwill was applied against the fair value of the long-lived assets in 2006. The valuations for the Progress, ICG Communications and TelCove acquisitions indicated that the fair value of the assets acquired was less than the total of the purchase price paid and the liabilities assumed in the transactions. As a result, the excess purchase price was assigned to goodwill for each acquisition in 2006.

#### *Tangible and Intangible Long-Lived Assets*

In performing the purchase price allocation for each acquired company, the Company considered, among other factors, the intention for future use of acquired assets, analyses of historical financial performance and estimates of future performance of each acquired company's products. The fair value of assets was based, in part, on a valuation using either a cost, income or in some cases market valuation approach and estimates and assumptions provided by management. The tangible assets primarily include the real and personal property used to provide communications and video services in the case of WilTel. In addition, tangible assets include the fair value of software purchased or developed by each company if applicable. Intangible assets consist primarily of customer relationships and the Vyvx trademark. Management has established an indefinite life on the Vyvx trademark and lives ranging from 6 to 15 years for the customer relationships.

#### *Deferred Revenue*

The fair value of deferred revenue included in the final purchase price allocation for each acquired company was determined based on monthly amounts billed in advance for which services would be provided to customers in the period immediately following acquisition. Level 3 did not record deferred revenue for long-term contracts in which the acquired company had already received consideration from the customer as Level 3 does not expect to incur any direct and incremental costs associated with these contracts.

#### *Current and Noncurrent Obligations*

The fair value of each acquired company's current liabilities was determined based on the expected cash flows for the twelve months following the date of acquisition. Level 3 did not present value the cash flows as it does not expect the present values to be significantly different than the gross cash flows.



The noncurrent obligations assumed in each acquisition, if applicable, have been recorded at their present value using an appropriate interest rate. The Company has identified certain acquired facilities that it does not expect to utilize for the combined business. The Company has also revalued the asset retirement obligations of each acquired company using Level 3's weighted average cost of capital rather than the acquired company's weighted average cost of capital.

The unaudited financial information in the table below summarizes the combined results of operations of Level 3 and the acquired businesses, on a pro forma basis, as though the companies acquired in 2005 and 2006 had been combined as of the beginning of each of the periods presented. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of each of the periods presented. The pro forma financial information for all periods presented includes the preliminary business combination accounting effect on historical revenues of the acquired companies, adjustments to depreciation on acquired property, amortization charges from acquired intangible assets, restructuring costs and acquisition costs reflected in the historical statements of operations for periods prior to Level 3's acquisition.

	<b>Unaudited Pro Forma Years ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(dollars in millions, except per share data)</b>	
Revenue	\$ 3,676	\$ 3,939
Loss from Continuing Operations	(815)	(661)
Income from Discontinued Operations	46	69
Net Loss	(769)	(592)
Per share:		
Loss from continuing operations	\$ (0.70)	\$ (0.64)
Net loss	\$ (0.66)	\$ (0.58)
Pro Forma Weighted Shares Outstanding (in thousands)	1,157,692	1,028,639

Included in the actual results and pro forma financial information for the year ended December 31, 2006 are certain amounts which affect the comparability of the results, including net losses of \$83 million as a result of the early extinguishments of certain long-term debt, \$11 million of termination revenue, a gain of approximately \$33 million from the sale of Software Spectrum, a workforce reduction charge of \$5 million, and non-cash impairment charges of \$8 million that primarily resulted from the decision to terminate certain information technology projects in the Communications business.

Included in the actual results and pro forma financial information for the year ended December 31, 2005 are certain amounts which affect the comparability of the results, including termination revenue of \$133 million, a gain on the sale of ( i )Structure of \$49 million, a workforce reduction charge of \$15 million, and non-cash impairment charges of \$9 million that primarily resulted from the decision to terminate projects for certain voice products in the Communications business.

The fair value of the assets acquired and the liabilities assumed in the ICG Communications, TelCove and Looking Glass transactions are based upon preliminary valuations as of their respective acquisition dates after reflecting other contractual purchase price adjustments and are subject to change due to further analysis of the assets acquired and liabilities assumed as well as integration plans. The fair value of assets acquired and liabilities assumed in the WiTel and Progress Telecom transactions are based upon a final valuation after reflecting other contractual purchase price adjustments. The fair values of the assets acquired and the liabilities assumed for the companies Level 3 acquired are as follows.

	Looking Glass	TelCove	ICG Communications (dollars in millions)	Progress Telecom	WiTel	Sprint	ICG Managed Modem
<b>Assets:</b>							
Cash and cash equivalents	\$ 3	\$ 3	\$ 6	\$ —	\$ 128	\$—	\$—
Accounts receivable	8	23	7	3	257	—	—
Other current assets	2	5	2	2	22	3	2
Property, plant and equipment, net	183	796	10	77	629	—	—
Goodwill	—	179	127	32	—	—	—
Identifiable intangible assets	9	273	49	36	152	31	37
Other assets	1	—	4	—	26	—	—
<b>Total Assets</b>	<b>206</b>	<b>1,279</b>	<b>205</b>	<b>150</b>	<b>1,214</b>	<b>34</b>	<b>39</b>
<b>Liabilities:</b>							
Accounts payable	5	20	6	1	204	—	—
Accrued payroll	1	6	2	1	29	—	—
Other current liabilities	9	20	10	7	61	—	4
Current portion of capital leases	—	3	—	1	—	—	—
Capital leases	—	10	3	8	—	—	—
Deferred revenue— Acquired Company	1	—	4	2	41	—	—
Deferred revenue— Level 3	(2)	(3)	(1)	(4)	(2)	5	—
Other liabilities	28	7	3	—	98	—	—
<b>Total Liabilities</b>	<b>42</b>	<b>63</b>	<b>27</b>	<b>16</b>	<b>431</b>	<b>5</b>	<b>4</b>
<b>Purchase Price</b>	<b>\$ 164</b>	<b>\$ 1,216</b>	<b>\$ 178</b>	<b>\$ 134</b>	<b>\$ 783</b>	<b>\$ 29</b>	<b>\$ 35</b>

### (3) Discontinued Operations

The Company sold the two businesses, Software Spectrum and ( i )Structure, that comprised Level 3's information services segment and are presented as discontinued operations.

#### Software Spectrum

On September 7, 2006, Level 3 sold Software Spectrum, Inc. to Insight, a leading provider of information technology products and services. In connection with the transaction, Level 3 received total proceeds of \$353 million in cash, consisting of a base purchase price of \$287 million and a working capital adjustment of approximately \$66 million. The purchase price was subject to working capital and certain other post-closing adjustments. During the fourth quarter of 2006, the Company paid \$2 million to Insight as the final working capital adjustment. Level 3 recognized a \$33 million gain on the transaction in the third quarter of 2006 after transaction costs.

The following is the summarized results of operations of the Software Spectrum business for the period from January 1, 2006 through September 7, 2006 and for the years ended December 31, 2005 and 2004:

	January 1, Through September 7, 2006	Twelve Months Ended	
		2005	2004
	(dollars in millions)		
Revenues	\$ 1,400	\$ 1,894	\$ 1,861
Costs and Expenses:			
Cost of revenue	1,269	1,717	1,705
Depreciation and amortization	8	10	11
Selling, general and administrative	111	143	125
Restructuring and impairment charges	1	—	2
Total costs and expenses	1,389	1,870	1,843
Income from Operations	11	24	18
Other Income (Expense)	5	(1)	7
Income from Operations Before Income Taxes	16	23	25
Income Tax Expense	(3)	(3)	(5)
Income from Discontinued Operations	<u>\$ 13</u>	<u>\$ 20</u>	<u>\$ 20</u>

The following is summarized financial information for the Software Spectrum business as of December 31, 2005:

	December 31, 2005
	(dollars in millions)
Assets	
Current Assets:	
Cash and cash equivalents	\$ 73
Receivables	431
Other	93
Total Current Assets	597
Property, Plant and Equipment, net	6
Goodwill and Other Intangible Assets, net	242
Other	16
Total Assets	861
Current Liabilities:	
Accounts payable	420
Accrued payroll and employee benefits	17
Deferred revenue	67
Other	35
Total Current Liabilities	539
Deferred Revenue	11
Other Noncurrent Liabilities	12
Total Liabilities	562
Net Assets	<u>\$ 299</u>

### ( i )Structure

On November 30, 2005, Level 3 sold ( i )Structure to Infocrossing for proceeds of \$85 million which consisted of \$82 million in cash and \$3 million of Infocrossing, Inc. common stock. The cash purchase price is subject to post-closing adjustments based on actual working capital as of the closing date. The Company and Infocrossing are in the process of completing the working capital adjustments through arbitration. Level 3 recognized a \$49 million gain on the transaction in the fourth quarter of 2005.

The following is the summarized results of operations of the ( i )Structure business for the eleven months ended November 30, 2005 and the year ended December 31, 2004:

	January 1, Through November 30, 2005	Twelve Months Ended 2004
	(dollars in millions, except per share data)	
Revenues	\$ 64	\$ 75
Costs and Expenses:		
Cost of revenue	47	53
Depreciation and amortization	8	13
Selling, general and administrative	9	9
Total costs and expenses	64	75
Income from Discontinued Operations	—	—
Gain on Sale of Discontinued Operations	49	—
Income from Discontinued Operations	<u>\$ 49</u>	<u>\$ —</u>

### (4) Termination Revenue

On March 1, 2005, Level 3 entered into an agreement with 360networks in which both parties agreed to terminate a 20-year IRU agreement. Under the new agreement, 360networks returned the dark fiber originally provided by Level 3. Under the original IRU agreement, signed in 2000, the cash received by Level 3 was deferred and amortized to revenue over the 20-year term of the agreement. As a result of this transaction, Level 3 recognized the unamortized deferred revenue of approximately \$86 million as non-cash termination revenue in the first quarter of 2005.

On February 22, 2005, France Telecom and Level 3 finalized an agreement to terminate a dark fiber agreement signed in 2000. Under the terms of the agreement, France Telecom returned the fiber to Level 3. Under the original IRU agreement, the cash received by Level 3 was deferred and amortized to revenue over the 20-year term of the agreement. As a result of this transaction, Level 3 recognized the unamortized deferred revenue of approximately \$40 million as non-cash termination revenue in the first quarter of 2005.

Level 3 and McLeodUSA Incorporated (“McLeod”) entered into an agreement on November 1, 2004, whereby McLeod returned certain intercity dark fiber provided by Level 3 under a 1999 agreement and provides discounted network services to Level 3 in exchange for cash and other consideration. Cash received under the 1999 agreement was deferred and amortized to revenue over the 20-year term of the agreement. Level 3 had no further service obligations with respect to the fiber and therefore recognized the \$98 million of remaining unamortized deferred revenue for the fiber returned as non-cash termination revenue in 2004. The Company allocated the amounts paid to McLeod to fiber and prepaid network expenses. The value of the fiber returned was determined based on the capital costs that would be avoided in pulling additional fiber in certain segments of the Company’s intercity network where fiber inventory would need to be replenished in the next three years. The prepaid network expense was valued based on

the amount of discounted network expense services the Company expects to realize through purchases of these services on McLeod's network.

#### **(5) Restructuring and Impairment Charges**

In 2006, the Company initiated workforce reductions that are expected to affect approximately 1,200 employees in its North American communications business related to the integration of WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass into Level 3's operations. The accounting treatment for the severance costs is dependent on whether those individuals affected are former employees of the acquired companies or Level 3 employees. The estimated severance costs earned by employees of the acquired companies as of the acquisition date are included as a liability in the balance sheet as of the acquisition date. The Company expects to incur approximately \$30 million of severance and related costs for former WilTel, Progress Telecom, ICG Communications, TelCove and Looking Glass employees. As of December 31, 2006, the Company paid \$19 million of severance and related costs for these employees. Severance costs attributable to Level 3 employees are recorded as a restructuring charge in the statement of operations once the employees are notified that their position will be eliminated and the severance arrangements are communicated to the employee.

As of December 31, 2006, the Company had notified or terminated approximately 797 employees (248 for Level 3 and 549 for acquired businesses) pursuant to these activities. During 2006, the Company recorded approximately \$5 million in restructuring charges for affected Level 3 employees. As of December 31, 2006, the Company had remaining obligations of less than \$1 million for those Level 3 employees terminated or notified. The workforce reduction attributable to the WilTel integration activity was substantially complete by the end of 2006. The workforce reductions attributable to the Progress Telecom, ICG Communications, TelCove and Looking Glass integration activities are expected to be completed in 2007.

In the first quarter of 2005, the Company initiated a workforce reduction of approximately 470 employees in its North American and European communications business and as a result recognized severance and related charges of approximately \$15 million. As of December 31, 2005, the Company had satisfied its remaining obligations associated with the workforce reduction.

During 2005, the Company identified additional communications facilities that it no longer required and would not provide any future economic benefit to the Company. Also during the year, the Company revised its lease impairment analysis to reflect improvements in sublease income for communications facilities impaired in prior periods. In total, the Company reduced its expected lease impairment obligations by \$1 million in 2005.

The communications business recorded lease impairment charges of \$14 million for real property leases in North America and Europe in the fourth quarter of 2004. The charge resulted from ceasing use of certain leased space, the signing of subleases for existing vacant space at lower than estimated rates, and extending the estimated sublease dates for other vacant properties due to market conditions.

A summary of the restructuring charges and related activity follows:

	<u>Severance and Related</u>		<u>Facilities Related</u>
	<u>Number of</u>	<u>Amount</u>	
	<u>Employees</u>	<u>(in millions)</u>	<u>Amount</u>
			<u>(in millions)</u>
Balance December 31, 2003	60	\$ 4	\$ 6
2004 Charges	80	—	14
2004 Payments	(140)	(4)	(4)
Balance December 31, 2004	—	—	16
2005 Charges(Benefit)	472	15	(1)
2005 Payments	(472)	(15)	(3)
Balance December 31, 2005	—	\$ —	\$ 12
2006 Charges	248	5	—
2006 Payments	(242)	(5)	(2)
Balance December 31, 2006	<u>6</u>	<u>\$ —</u>	<u>\$ 10</u>

The Company paid approximately \$2 million, \$3 million and \$4 million of facilities related costs in 2006, 2005 and 2004, respectively. The remaining lease termination obligations of \$10 million are expected to be paid over the terms of the impaired leases, which extend to 2015, if the Company is unable to negotiate a buyout of the leases.

### Impairments

The Company at least annually, or as events or circumstances change that could affect the recoverability of the carrying value of its communications assets, conducts a comprehensive review of the carrying value of its communications assets to determine if the carrying amount of the communications assets are recoverable in accordance with SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets” (“SFAS No. 144”). For purposes of this review, Level 3 has historically separately evaluated colocation facilities, certain additional conduits and its communication network (including network equipment, fiber, conduits and customer premise equipment) as these were the lowest levels with separately identifiable cash flows for grouping of assets. Beginning in 2006, the Company stopped evaluating colocation assets separately and began including them in the communications network asset group due to changes in the nature of the cash flows from the delivery of colocation services. The majority of the Company’s colocation customers now purchase other services in conjunction with their colocation services thereby reducing the independence of colocation services cash flows from other services. In addition, the percentage of colocation space used to support the network asset has increased over time. The impairment analysis is based on a long-term cash flow forecast to assess the recovery of the communications assets over the estimated useful life of the primary asset. The Company concluded that the assets were not impaired as of December 31, 2006. Management’s estimate of the future cash flows attributable to its long-lived assets and the fair value of its businesses involve significant uncertainty. Those estimates are based on management’s assumptions of future results, growth trends and industry conditions. The impairment analysis of long-lived assets also requires management to make certain subjective assumptions and estimates regarding the expected future use of certain additional conduits included in the network asset group and the expected future use of certain empty conduit evaluated for impairment separately from the network asset group. Management will continue to assess the Company’s assets for impairment as events occur or as industry conditions warrant.

The Company recognized \$8 million of non-cash impairment charges in 2006. Level 3 recognized \$4 million of non-cash impairment charges as a result of the decision to terminate projects for certain voice services and certain information technology projects in the communications business which had been previously capitalized. These projects have identifiable costs which Level 3 can separately evaluate for

impairment. The costs incurred for these projects, including capitalized labor, were impaired as the carrying value of these projects were no longer expected to provide future benefit to the Company. In addition, Level 3 recognized \$4 million of non-cash impairment charges primarily related to excess land of the communications business held for sale in Germany. This charge resulted from the difference between the recorded carrying value and the estimated market value of the land.

The Company recognized \$9 million of non-cash impairment charges in 2005 that primarily resulted from the decision to terminate projects for certain voice services and certain information technology projects in the communications business which had been previously capitalized. These projects have identifiable costs which Level 3 can separately evaluate for impairment. The costs incurred for these projects, including capitalized labor, were impaired as the carrying value of these projects were no longer expected to provide future benefit to the Company. The Company did not incur asset impairment expenses in 2004.

#### (6) Loss Per Share

The Company had a loss from continuing operations for the three years ended December 31, 2006. Therefore, the effect of the approximately 481 million, 418 million and 171 million shares issuable pursuant to the five, four and three series of convertible notes outstanding at December 31, 2006, 2005 and 2004, respectively, have not been included in the computation of diluted loss per share because their inclusion would have been anti-dilutive to the computation. In addition, the effect of the approximately 54 million, 59 million and 49 million stock options, outperform stock options, restricted stock units and warrants outstanding at December 31, 2006, 2005 and 2004, respectively, have not been included in the computation of diluted loss per share because their inclusion would have been anti-dilutive to the computation.

The following details the loss per share calculations for the Level 3 common stock (dollars in million, except per share data):

	Year Ended December 31,		
	2006	2005	2004
Loss from Continuing Operations	\$ (790)	\$ (707)	\$ (478)
Income from Discontinued Operations (2006 and 2005 include gain on sale)	46	69	20
Net Loss	<u>\$ (744)</u>	<u>\$ (638)</u>	<u>\$ (458)</u>
Total Number of Weighted Average Shares Outstanding used to Compute Basic and Diluted Earnings Per Share (in thousands)	1,003,255	699,589	683,846
Earnings (Loss) Per Share of Level 3 Common Stock (Basic and Diluted):			
Loss from Continuing Operations	\$ (0.79)	\$ (1.01)	\$ (0.70)
Income from Discontinued Operations	0.05	0.10	0.03
Net Loss	<u>\$ (0.74)</u>	<u>\$ (0.91)</u>	<u>\$ (0.67)</u>

#### (7) Disclosures about Fair Value of Financial Instruments

The following methods and assumptions were used to determine classification and fair values of financial instruments:

##### Cash and Cash Equivalents

Cash equivalents generally consist of funds invested in highly liquid instruments purchased with an original maturity of three months or less. The securities are stated at cost, which approximates fair value.

## Marketable and Restricted Securities

At December 31, 2006, marketable securities consist entirely of U.S. Treasury securities that were characterized as held to maturity. These securities total \$235 million and are reflected as current assets on the consolidated balance sheet at December 31, 2006.

At December 31, 2005, marketable securities consist of U.S. Treasury securities and the Infocrossing shares received in the ( i )Structure transaction which were valued at quoted market prices. For most of 2005, the Company characterized the U.S. Treasury securities as held to maturity. As a result of the acquisition of WilTel and expected cash flow requirements in 2006, the Company designated certain Treasury securities as available for sale in the fourth quarter of 2005. These securities totaled \$173 million, stated at fair value since they were available for sale, and were reflected as current assets on the consolidated balance sheet at December 31, 2005. The Infocrossing shares and U.S. Treasury securities characterized as available for sale were sold in 2006.

Restricted securities consist primarily of cash investments that serve to collateralize outstanding letters of credit and certain performance and operating obligations of the Company.

The cost of the securities used in computing unrealized and realized gains and losses is determined by specific identification. Fair values are estimated based on quoted market prices for the securities.

The net unrealized holding gains and losses for marketable securities classified as available for sale were included in accumulated other comprehensive income (loss) within stockholders' equity (deficit). Securities characterized as held to maturity are stated at cost. The unrealized holding gains and losses for securities characterized as held to maturity are not reflected in the consolidated financial statements.

At December 31, 2006 and 2005 the unrealized holding gains and losses on the marketable securities were as follows:

	<u>Cost</u>	<u>Unrealized Holding Gains</u>	<u>Unrealized Holding Losses</u>	<u>Fair Value</u>
		<u>(dollars in millions)</u>		
<b>2006</b>				
Marketable Securities:				
U.S. Treasury securities—Current	\$ 235	\$ —	\$ (1)	\$ 234
	<u>\$ 235</u>	<u>\$ —</u>	<u>\$ (1)</u>	<u>\$ 234</u>
<b>2005</b>				
Marketable Securities:				
U.S. Treasury securities—Current	\$ 173	\$ —	\$ —	\$ 173
Equity Securities—Current	3	—	—	3
U.S. Treasury securities—Noncurrent	234	—	(2)	232
	<u>\$ 410</u>	<u>\$ —</u>	<u>\$ (2)</u>	<u>\$ 408</u>

The Company recognized \$2 million of realized gains from the sale of marketable equity securities in 2006, \$2 million of realized losses from the sale of marketable debt securities in 2005 and \$23 million of realized gains from the sale of marketable equity securities in 2004. These realized gains and losses are reflected in Other, net on the consolidated statement of operations for all periods presented.

Maturities for the restricted securities have not been presented, as the types of securities are either cash or money market mutual funds that do not have a single maturity date.



## Long-Term Debt

The fair value of long-term debt was estimated using the December 31, 2006 and 2005 average of the bid and ask price for the publicly traded debt instruments. The CBRE Commercial Mortgage was not traded in an organized public manner. The fair value of this instrument is assumed to approximate the carrying value at December 31, 2006 as it was secured by underlying assets. The 9% Convertible Senior Discount Notes due 2013 included within Long-Term Debt are not traded in an organized public manner. The fair value of these notes was calculated using a convertible model, which uses the Black-Scholes valuation model to value the equity portion of the security and bond math to value the debt portion of the security (using market yields on other Level 3 traded debt). The 10% Convertible Senior Notes due 2011 included within Long-Term Debt are not traded in an organized public manner. Level 3 has obtained a market value from a third party broker for the 10% Convertible Senior Notes due 2011.

The carrying amount and estimated fair values of Level 3's financial instruments are as follows:

	<b>2006</b>		<b>2005</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Carrying Amount</b>	<b>Fair Value</b>
	<b>(dollars in millions)</b>			
Cash and Cash Equivalents (excluding discontinued operations)	\$1,681	\$1,681	\$ 379	\$ 379
Marketable Securities—Current	235	234	176	176
Marketable Securities—Noncurrent	—	—	234	232
Restricted Securities—Current	46	46	34	34
Restricted Securities—Noncurrent	90	90	75	75
Receivables less allowance for doubtful accounts (Note 8)	326	326	392	392
Investments (Note 12)	14	14	15	15
Accounts Payable	391	391	367	367
Long-term Debt, including current portion (Note 13)	7,362	8,578	6,023	5,266

## (8) Receivables

Receivables at December 31, 2006 and 2005 were as follows:

	<b>Communications</b>	<b>Coal</b>	<b>Total</b>
	<b>(dollars in millions)</b>		
<b>2006</b>			
Accounts Receivable—Trade	\$ 337	\$ 6	\$ 343
Allowance for Doubtful Accounts	(17)	—	(17)
Total	<u>\$ 320</u>	<u>\$ 6</u>	<u>\$ 326</u>
<b>2005</b>			
Accounts Receivable—Trade	\$ 400	\$ 9	\$ 409
Allowance for Doubtful Accounts	(17)	—	(17)
Total	<u>\$ 383</u>	<u>\$ 9</u>	<u>\$ 392</u>

The Company recognized bad debt expense in selling, general and administrative expenses of \$1 million, less than \$1 million and \$3 million in 2006, 2005 and 2004, respectively. Level 3 received \$1 million, \$2 million and \$2 million of proceeds for amounts previously deemed uncollectible in 2006, 2005 and 2004, respectively. The Company reduced accounts receivable and the allowance for doubtful accounts by less than \$1 million, less than \$1 million and \$8 million in 2006, 2005 and 2004, respectively, for the write off of previously reserved amounts the Company deemed as uncollectible.

## (9) Other Current Assets

At December 31, 2006 and 2005 other current assets consisted of the following:

	<u>2006</u>	<u>2005</u>
	(dollars in	
	millions)	
Prepaid Assets	\$ 52	\$ 55
Debt Issuance Costs, net	18	16
Other	31	21
	<u>\$ 101</u>	<u>\$ 92</u>

Prepaid assets include insurance, software maintenance, rent and right of way costs.

## (10) Property, Plant and Equipment, net

Costs associated directly with expansions and improvements to the communications network and customer installations, including employee related costs, have been capitalized. The Company generally capitalizes costs associated with network construction, provisioning of services and software development. Capitalized labor and related costs associated with employees and contract labor working on capital projects were approximately \$72 million, \$51 million and \$66 million for the years ended December 31, 2006, 2005 and 2004, respectively. Included in capitalized labor and related costs was \$2 million of capitalized non-cash compensation costs related to options and warrants granted to employees for each of the years ended December 31, 2006, 2005 and 2004, respectively.

The Company continues to develop business support systems required for its business. The external direct costs of software, materials and services, and payroll and payroll related expenses for employees directly associated with the project incurred when developing the business support systems are capitalized and included in the capitalized costs above. Upon completion of a project, the total cost of the business support system is amortized over an estimated useful life of three years.

The Company reviews its capitalized projects at least annually or when events and circumstances indicate that the assets may be impaired. When previously capitalized software development costs are considered to be impaired, the Company calculates and recognizes an impairment loss in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

Included in Land and Mineral Properties are mineral properties related to the coal business with a cost basis of approximately \$5 million for each of the years ended December 31, 2006 and 2005. The remaining Land and Mineral Properties balance of approximately \$209 million and \$205 million for the years ended December 31, 2006 and 2005, respectively, represent owned assets of the communications business, including land improvements. The coal mineral properties include owned and leased assets. The various coal lease agreements require minimum lease payments and provide for royalty or overriding royalty payments based on the tons of coal mined or sold from the properties. Depletion on the mineral properties is provided on a units-of-extraction basis determined in relation to coal committed under sales contracts.

Capitalized business support systems and network construction costs that have not been placed in service have been classified as construction-in-progress within property, plant and equipment below.

The cost and accumulated depreciation of property, plant and equipment has been reduced for impairments taken in current and prior years.

At December 31, 2006 and 2005, property, plant and equipment were as follows:

	<u>Cost</u>	<u>Accumulated Depreciation</u> (dollars in millions)	<u>Book Value</u>
<b>December 31, 2006</b>			
Land and Mineral Properties	\$ 214	\$ (28)	\$ 186
Facility and Leasehold Improvements:			
Communications	1,692	(482)	1,210
Coal Mining	151	(148)	3
Network Infrastructure	5,430	(1,409)	4,021
Operating Equipment:			
Communications	2,706	(1,799)	907
Coal Mining	71	(64)	7
Furniture, Fixtures and Office Equipment	132	(106)	26
Other	28	(24)	4
Construction-in-Progress	104	—	104
	<u>\$ 10,528</u>	<u>\$ (4,060)</u>	<u>\$ 6,468</u>
<b>December 31, 2005</b>			
Land and Mineral Properties	\$ 210	\$ (26)	\$ 184
Facility and Leasehold Improvements:			
Communications	1,532	(355)	1,177
Coal Mining	153	(149)	4
Network Infrastructure	4,705	(1,126)	3,579
Operating Equipment:			
Communications	2,156	(1,528)	628
Coal Mining	69	(62)	7
Furniture, Fixtures and Office Equipment	111	(96)	15
Other	22	(19)	3
Construction-in-Progress	35	—	35
	<u>\$ 8,993</u>	<u>\$ (3,361)</u>	<u>\$ 5,632</u>

The value of property, plant and equipment related to the ICG Communications, TelCove and Looking Glass acquisitions are based on preliminary valuations. The value of property, plant and equipment related to WiTel and Progress Telecom, is based on a final valuation.

During 2006, Level 3 determined that the period the Company expects to use its existing fiber is longer than the remaining useful life as originally estimated. As a result, the Company extended the depreciable life of its existing fiber from 7 years to 12 years. This change in estimate, effective as of April 1, 2006, was accounted for prospectively, in accordance with SFAS No. 154 and reduced depreciation expense by \$54 million in 2006. In addition, this change in estimate reduced net loss from continuing operations and net loss by \$54 million, or approximately \$0.05 per share for the year ended December 31, 2006.

In addition, during 2006, Level 3 determined that the period the Company expects to use its existing electronic equipment is longer than the remaining useful lives as originally estimated. As a result, the Company extended the depreciable life of its existing transmission equipment from 5 years to 7 years and existing IP equipment from 3 years to 4 years. This change in estimate, effective as of July 1, 2006, was accounted for prospectively, in accordance with SFAS No. 154, and reduced depreciation expense by \$26 million in 2006. In addition, this change in estimate reduced net loss from continuing operations and net loss by \$26 million, or approximately \$0.03 per share for the year ended December 31, 2006.

Depreciation expense was \$652 million in 2006, \$584 million in 2005 and \$613 million in 2004.

**(11) Goodwill and Other Intangibles, net**

Goodwill and Other Intangibles, net at December 31, 2006 and 2005 were as follows (dollars in millions):

	<u>Goodwill</u>	<u>Other Intangibles</u>
<b>December 31, 2006</b>		
360networks	\$ —	\$ 3
Sprint	—	5
Telverse	—	10
Genuity	—	6
WilTel	—	135
Progress Telecom	32	33
ICG Communications	127	47
TelCove	179	264
Looking Glass	—	8
McLeod	40	—
XCOM	30	—
	<u>\$ 408</u>	<u>\$ 511</u>
<b>December 31, 2005</b>		
360networks	\$ —	\$ 4
Sprint	—	16
ICG	—	4
Telverse	—	16
Genuity	—	30
WilTel	—	151
McLeod	40	—
XCOM	30	—
	<u>\$ 70</u>	<u>\$ 221</u>

The Company segregates identifiable intangible assets acquired in a business combination from goodwill. In accordance with SFAS No. 142, Goodwill is no longer amortized and the carrying amount of the goodwill must be evaluated at least annually for impairment using a fair value based test. An assessment of the carrying value of the goodwill attributable to the communications business indicated that the assets were not impaired as of December 31, 2006.

On December 23, 2005, Level 3 completed the acquisition of WilTel. A final valuation of the assets acquired indicated a value of \$152 million for intangible assets. The intangible assets primarily include customer relationships and the Vyvx trademark. The final valuation placed an indefinite life on the Vyvx trademark and lives ranging from 6 to 11 years for the customer relationships.

On March 20, 2006, Level 3 completed the acquisition of Progress Telecom. A final valuation of the assets acquired in the Progress Telecom acquisition resulted in a value of \$36 million for customer-related intangible assets with an estimated useful life of 8 years. The final purchase price valuation indicated that the purchase price exceeded the fair value of the identifiable assets acquired and liabilities assumed by \$32 million.

On May 31, 2006, Level 3 completed the acquisition of ICG Communications. A preliminary valuation of the assets acquired in the ICG Communications transaction indicated a value of \$49 million for customer-related intangible assets with an estimated useful life of 15 years.

On July 24, 2006, Level 3 completed the acquisition of TelCove. A preliminary valuation of the assets acquired in the TelCove transaction as of the acquisition date, indicates customer-related intangible assets of approximately \$253 million, with lives ranging from 9 to 13 years and other assets of approximately \$20 million with an indefinite life.

On August 2, 2006, Level 3 completed the acquisition of Looking Glass. A preliminary valuation of the assets acquired in the Looking Glass transaction as of the acquisition date, indicates customer-related intangibles of approximately \$9 million with an estimated useful life of 8 years. Based on the valuation, Level 3 adjusted its preliminary estimate of the amount initially allocated to customer intangibles from \$41 million at the end of the third quarter of 2006 to \$9 million. Also, during the fourth quarter of 2006 Level 3 recorded a \$24 million liability for unfavorable leases attributable to Looking Glass.

The preliminary purchase price valuations for ICG Communications and TelCove indicated that the purchase price exceeded the fair value of the identifiable assets acquired and liabilities assumed and resulted in goodwill of \$127 million and \$179 million, respectively. The preliminary valuation of the assets acquired and liabilities assumed in the Looking Glass transaction indicates that the fair value of the identifiable net assets acquired exceeds the consideration paid to the former owners and resulted in negative goodwill of \$24 million which reduced the fair value of long-lived assets acquired in the transaction on a pro-rata basis.

During the first quarter of 2005, Level 3 purchased a customer contract from 360networks for cash and future services valued at \$4 million. The total purchase price was recorded as an intangible asset and will be amortized over the remaining four-year term of the customer contract.

At December 31, 2006 and 2005 identifiable intangible assets were as follows (dollars in millions):

	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Book Value</u>
<b>December 31, 2006</b>			
Customer Contracts:			
Sprint	\$ 31	\$ (26)	\$ 5
ICG	37	(37)	—
Genuity	28	(22)	6
McLeod	49	(49)	—
Customer Relationships:			
Genuity	79	(79)	—
360networks	4	(1)	3
WilTel	120	(17)	103
Progress Telecom	36	(3)	33
ICG Communications	49	(2)	47
Looking Glass	9	(1)	8
TelCove	253	(9)	244
Trademarks:			
WilTel	32	—	32
Technology:			
Telverse	31	(21)	10
Other:	20	—	20
	<u>\$ 778</u>	<u>\$ (267)</u>	<u>\$ 511</u>

	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Book Value</u>
<b>December 31, 2005</b>			
Customer Contracts:			
Sprint	\$ 31	\$ (15)	\$ 16
ICG	37	(33)	4
Genuity	28	(17)	11
McLeod	49	(49)	—
Customer Relationships:			
Genuity	79	(60)	19
360networks	4	—	4
WilTel	120	(1)	119
Trademarks:			
WilTel	32	—	32
Technology:			
Telverse	31	(15)	16
	<u>\$ 411</u>	<u>\$ (190)</u>	<u>\$ 221</u>

Intangible asset amortization expense was \$78 million, \$63 million and \$58 million for the years ended December 31, 2006, 2005 and 2004, respectively.

The amortization expense related to intangible assets currently recorded on the Company's books for each of the five succeeding years is estimated to be the following for the years ended December 31: 2007—\$66 million; 2008—\$52 million; 2009—\$48 million; 2010—\$47 million; 2011—\$47 million and thereafter—\$199 million.

#### (12) Other Assets, net

At December 31, 2006 and 2005 other assets consisted of the following:

	<u>2006</u>	<u>2005</u>
	(dollars in millions)	
Debt Issuance Costs, net	\$ 75	\$ 54
Investments	14	15
Deposits	17	22
Other	22	20
	<u>\$ 128</u>	<u>\$ 111</u>

In 2005, the Company invested \$10 million in Infinera Corporation, a privately-held communications equipment company. Level 3 is accounting for this investment using the cost method.

See Footnote 13 below for a discussion of debt issuance costs included in other assets, net above.

### (13) Long-Term Debt

At December 31, 2006 and 2005, long-term debt was as follows:

	2006	2005
	(dollars in millions)	
Senior Secured Term Loan (8.37% due 2011)	\$ 730	\$ 730
Senior Notes (11.0% due 2008)	78	132
Senior Notes (9.125%)	—	954
Senior Discount Notes (10.5%)	—	144
Senior Euro Notes (10.75% due 2008)	65	59
Senior Discount Notes (12.875% due 2010)	488	488
Senior Euro Notes (11.25% due 2010)	137	123
Senior Notes (11.25% due 2010)	96	96
Senior Notes (11.5% due 2010)	692	—
Fair value adjustment on Senior Notes	(60)	—
Senior Notes (10.75% due 2011)	3	500
Floating Rate Senior Notes (11.8% due 2011)	150	—
Issue discount on Senior Notes	(4)	—
Senior Notes (12.25% due 2013)	550	—
Issue discount on Senior Notes	(2)	—
Senior Notes (9.25% due 2014)	1,250	—
Issue premium on Senior Notes	11	—
Convertible Senior Notes (2.875% due 2010)	374	374
Convertible Senior Notes (5.25% due 2011)	345	345
Convertible Senior Notes (10.0% due 2011)	880	880
Convertible Senior Notes (3.5% due 2012)	335	—
Convertible Senior Discount Notes (9.0% due 2013)	275	252
Convertible Subordinated Notes (6.0% due 2009)	362	362
Convertible Subordinated Notes (6.0% due 2010)	514	514
Commercial Mortgage (6.86% due 2015)	70	70
Capital leases assumed in acquisitions	23	—
	7,362	6,023
Less current portion	(5)	—
	<u>\$ 7,357</u>	<u>\$ 6,023</u>

#### *Debt Exchanges, Amendments and Repurchases*

##### **2006 Debt Exchange**

On January 13, 2006, the Company completed private exchange offers to exchange a portion of its outstanding 9.125% Senior Notes due 2008, 11% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 (together the “2008 Notes”) that were held by eligible holders in a private placement for cash and new 11.5% Senior Notes due 2010. The Company issued \$692 million aggregate principal amount of 11.5% Senior Notes due 2010 as well as paid \$46 million of cash consideration in exchange for the 2008 Notes tendered in the transactions. The Company also paid approximately \$13 million in cash for total accrued interest to the closing date on the 2008 Notes that were accepted for exchange.

Pursuant to the guidance in EITF No. 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments” (“EITF No. 96-19”), the Company accounted for the exchange of the 9.125% Senior Notes due 2008 and the 11% Senior Notes due 2008 as an extinguishment of debt and recognized a gain of

approximately \$27 million in Other Income in the first quarter of 2006. The gain was determined using the fair value of the new 11.5% Senior Notes due 2010 at the time of issuance. The fair value of the 11.5% Senior Notes due 2010 was approximately \$73 million less than the face amount of the debt. The accretion of the \$73 million discount will be reflected as interest expense in future periods using the effective interest method. The 11.5% Senior Notes due 2010 were recorded at their fair value on the transaction date and will accrete to their face value at maturity. Premiums paid to holders of the 9.125% Senior Notes due 2008 and the 11% Senior Notes due 2010 of \$41 million reduced the gain on extinguishment of debt.

In accordance with EITF No. 96-19, the exchange of the 10.5% Senior Discount Notes due 2008 was accounted for as a modification of the existing debt. The premiums paid to the holders of the 10.5% Senior Discount Notes due 2008 of \$5 million were added to the existing debt issuance costs and will be amortized over the term of the 11.5% Senior Notes due 2010.

The Company incurred approximately \$5 million of third party costs associated with the exchange transaction. The costs were allocated to each tranche of debt based on the amount tendered for exchange. The \$4 million of fees allocated to the 9.125% Senior Notes due 2008 and the 11% Senior Notes due 2008 were capitalized and will be amortized to interest expense over the term of the respective notes. The \$1 million of costs allocated to the 10.5% Senior Discount Notes due 2008 were expensed in the first quarter of 2006.

The principal amount of 2008 Notes tendered is set forth in the table below (dollars in millions).

2008 Notes	Aggregate Principal Amount Outstanding Before Exchange Offers	Aggregate Principal Amount Tendered	Aggregate Principal Amount of Old Notes that Remained Outstanding	Total Cash Premium Payment
<b>Exchanged</b>				
9.125% Senior Notes due 2008	\$ 954	\$ 556	\$ 398	\$ 36
11% Senior Notes due 2008	132	54	78	5
10.5% Senior Discount Notes due 2008	144	82	62	5

The exchange offers were made only to qualified institutional buyers and institutional accredited investors inside the United States and to certain non-U.S. investors located outside the United States.

The 11.5% Senior Notes are senior unsecured obligations of the Company, ranking equal in right of payment with the old notes not tendered in the exchange offers as well as all other senior unsecured obligations of the Company. The 11.5% Senior Notes due 2010 mature on March 1, 2010, and bear interest at a rate per annum equal to 11.5%. Interest on the notes is payable on March 1 and September 1 of each year, beginning on September 1, 2006. The Company may redeem some or all of the 11.5% Senior Notes due 2010 at any time on or after March 1, 2009, at 100% of their principal amount plus accrued interest.

The Company's exchange offer registration statement for these notes was declared effective by the Securities and Exchange Commission on August 8, 2006 and the exchange offer relating to these notes was subsequently completed.

## 2006 Debt Tenders and Redemptions

On July 13, 2006, Level 3 redeemed all of its outstanding 9.125% Senior Notes due 2008 and 10.5% Senior Discount Notes due 2008 remaining after the debt exchange completed on January 13, 2006, described above. Aggregate principal, call premium and accrued interest totaled \$470 million.

The 9.125% Senior Notes due 2008 were redeemed at a redemption price equal to 100% of the principal amount of those notes plus accrued and unpaid interest. The aggregate principal amount of



9.125% Senior Notes due 2008 that were redeemed was \$398 million. The 10.5% Senior Discount Notes due 2008 were redeemed at a redemption price equal to 101.75% of the principal amount at maturity of those notes plus accrued and unpaid interest. The aggregate principal amount at maturity of 10.5% Senior Discount Notes due 2008 that were redeemed was \$62 million.

On December 27, 2006, Level 3 Financing, Inc. ("Level 3 Financing") a wholly owned subsidiary of the Company, purchased for cash \$497 million in total principal amount of its 10.75% Senior Notes due 2011, representing approximately 99.3% of the aggregate principal amount outstanding of all 10.75% Senior Notes Due 2011. Holders of the 10.75% Senior Notes due 2011 validly tendered and accepted for purchase by Level 3 Financing received \$1,092.21 per \$1,000 principal amount of the these notes, which included \$1,062.21 as the purchase price and \$30.00 as a consent payment. Level 3 Financing paid in cash approximately \$528 million to purchase the 10.75% Senior Notes due 2011 as well as a \$15 million consent payment and \$11 million for total accrued interest to the closing date of the tender offer. The Company recorded a \$54 million net loss on the early extinguishment of the debt, including unamortized debt issuance costs of \$8 million.

#### ***Amendment and Restatement of Credit Facility***

On June 27, 2006, Level 3 Financing amended and restated its existing \$730 million senior secured credit facility (see Senior Secured Term Loan due 2011 below) to reduce the interest rate payable under the agreement by 400 basis points, modify the pre-payment provisions and make other specified changes.

The amendment of the credit facility was treated as an extinguishment of the existing debt instrument due to the significant change in lenders of the debt in accordance with EITF No. 96-19. The fair value of the amended and restated credit facility approximated the carrying value of the original credit facility as the interest rate of the amended and restated credit facility approximated current market rates. As part of the transaction, Level 3 Financing paid a prepayment premium of approximately \$42 million to existing debt holders. The prepayment premium along with the unamortized deferred debt issuance costs of \$13 million from the original offering, were recognized as a loss on the extinguishment of debt in the second quarter of 2006. The Company also incurred \$11 million of third party costs to complete this transaction. These costs were reflected as deferred debt issuance costs and will be amortized to interest expense over the term of the debt using the effective interest method.

#### ***Debt Instruments***

At December 31, 2006, Level 3 was in compliance with the covenants on all outstanding debt issuances.

#### **Senior Secured Term Loan due 2011**

On December 1, 2004, Level 3 Communications, Inc., as guarantor, Level 3 Financing, as borrower, and certain lenders entered into a credit agreement ("Credit Agreement") pursuant to which the lenders extended a \$730 million senior secured term loan ("Senior Secured Term Loan") to Level 3 Financing. The term loan matures in 2011 and had a current interest rate of the London Interbank Offering Rate ("LIBOR") plus an applicable margin of 700 basis points. On June 27, 2006, Level 3 Financing amended and restated the Senior Secured Term Loan to reduce the interest rate payable under the agreement by 400 basis points, modify the pre-payment provisions and make other specified changes.

Interest on the note accrues at the three month LIBOR and is payable in cash on March 5, June 5, September 5 and December 5 of each year, in arrears, beginning March 1, 2005. The interest rate was 8.37% at December 31, 2006 and was determined at the commencement of the interest period beginning December 5, 2006.

Level 3 Financing's obligations under this term loan are, subject to certain exceptions, secured by certain assets of the Company; and certain of the Company's material domestic subsidiaries that are engaged in the telecommunications business. The Company and these subsidiaries have also guaranteed the obligations of Level 3 Financing under the Senior Secured Term Loan. Level 3 Communications, LLC and its material domestic subsidiaries have guaranteed and have pledged certain of their assets to secure the obligations under the Senior Secured Term Loan. Certain of the initial subsidiary guarantors have been released from their pledge and guarantee obligations under the Senior Secured Term Loan.

The Credit Agreement includes certain negative covenants which restrict the ability of the Company, Level 3 Financing and any restricted subsidiary to engage in certain activities. The Credit Agreement also contains certain events of default. It does not require the Company or Level 3 Financing to maintain specific financial ratios.

Level 3 used the original net proceeds after transaction costs to fund the purchase of certain of its existing debt securities outstanding at the time.

Debt issuance costs of \$17 million were originally capitalized and were being amortized to interest expense over the term of the Senior Secured Term Loan. As part of the amendment and restatement of the Senior Secured Term Loan, the remaining original debt issuance costs were written off and are included in the loss on the extinguishment of debt. The transaction costs to amend and restate the Senior Secured Term Loan in June 2006 of \$11 million were capitalized and are being amortized to interest expense over the remaining term of the Senior Secured Term Loan. After amortization, debt issuance costs were approximately \$10 million at December 31, 2006.

See Subsequent Events (Note 21) regarding the February 9, 2007 announcement to refinance the Senior Secured Term Loan.

### **11% Senior Notes due 2008**

In February 2000, Level 3 Communications, Inc. received \$779 million of net proceeds, after transaction costs, from a private offering of \$800 million aggregate principal amount of its 11% Senior Notes due 2008 ("11% Senior Notes"). As of December 31, 2006 a total of \$722 million aggregate principal amount of the 11% Senior Notes had been repurchased. Interest on the notes accrues at 11% per year and is payable semi-annually in arrears in cash on March 15 and September 15, beginning September 15, 2000. The 11% Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior debt. The 11% Senior Notes cannot be prepaid by Level 3 Communications, Inc., and mature on March 15, 2008. The 11% Senior Notes contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of \$21 million were originally capitalized and are being amortized to interest expense over the term of the 11% Senior Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2006.

See Subsequent Events (Note 21) regarding the February 15, 2007 announcement of the Company's tender offer to purchase the 11% Senior Notes due 2008.

### **10.75% Senior Euro Notes due 2008**

In February 2000, Level 3 Communications, Inc. received € 488 million (\$478 million when issued) of net proceeds, after debt issuance costs, from an offering of € 500 million aggregate principal amount 10.75% Senior Euro Notes due 2008 ("10.75% Senior Euro Notes"). As of December 31, 2006, a total of €450 million aggregate principal amount of the 10.75% Senior Euro Notes had been repurchased. Interest on the notes accrues at 10.75% per year and is payable in Euros semi-annually in arrears on March 15 and

September 15 each year beginning on September 15, 2000. The 10.75% Senior Euro Notes are not redeemable by Level 3 Communications, Inc. prior to maturity. Debt issuance costs of € 12 million were originally capitalized and are being amortized over the term of the 10.75% Senior Euro Notes. As a result of amortization and debt repurchases, the net capitalized debt issuance costs have been reduced to less than € 1 million at December 31, 2006.

The 10.75% Senior Euro Notes are senior, unsecured obligations of the Company, ranking *pari passu* with all existing and future senior debt. The 10.75% Senior Euro Notes contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

The issuance of the € 500 million 10.75% Senior Euro Notes has been designated as, and is effective as, an economic hedge against the investment in certain of the Company's foreign subsidiaries. Therefore, foreign currency gains and losses resulting from the translation of the debt have been recorded in other comprehensive income (loss) to the extent of translation gains or losses on such investment. The 10.75% Senior Euro Notes were valued, based on current exchange rates, at \$65 million in the Company's consolidated financial statements at December 31, 2006. The difference between the carrying value at December 31, 2006 and the value at issuance, after repurchases, is recorded in other comprehensive income.

See Subsequent Events (Note 21) regarding the February 20, 2007 announcement of the Company's tender offer to purchase the 10.75% Senior Euro Notes due 2008.

### **12.875% Senior Discount Notes due 2010**

In February 2000, Level 3 Communications, Inc. sold in a private offering \$675 million aggregate principal amount at maturity of its 12.875% Senior Discount Notes due 2010 ("12.875% Senior Discount Notes"). The sale proceeds of \$360 million, excluding debt issuance costs, were recorded as long-term debt. As of December 31, 2006, a total of \$187 million aggregate principal amount at maturity of the 12.875% Senior Discount Notes had been repurchased, leaving \$488 million aggregate principal amount outstanding. Interest on the 12.875% Senior Discount Notes accreted at a rate of 12.875% per year, compounded semi-annually, to 100% of their principal amount on March 15, 2005, which is an aggregate principal amount of \$488 million. Cash interest did not accrue on the 12.875% Senior Discount Notes prior to March 15, 2005. Commencing March 15, 2005, interest on the 12.875% Senior Discount Notes accrues at the rate of 12.875% per year and is payable in cash semi-annually in arrears.

The 12.875% Senior Discount Notes are subject to redemption at the option of Level 3 Communications, Inc., in whole or in part, at any time or from time to time on or after March 15, 2005. Level 3 Communications, Inc. may redeem the 12.875% Senior Discount Notes at the redemption prices set forth below, plus interest, if any, to the redemption date. The following prices are for 12.875% Senior Discount Notes redeemed during the 12-month period commencing on March 15 of the years set forth below and are expressed as percentages of principal amount.

<u>Year</u>	<u>Redemption Price</u>
2006	104.292%
2007	102.146%
2008 and thereafter	100.000%

The 12.875% Senior Discount Notes are senior, unsecured obligations of the Company, ranking *pari passu* with all existing and future senior debt. The 12.875% Senior Discount Notes contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of \$9 million were originally capitalized and are being amortized to interest expense over the term of the 12.875% Senior Discount Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to \$2 million at December 31, 2006.

See Subsequent Events (Note 21) regarding the February 15, 2007 announcement of the Company's call notice to redeem the 12.875% Senior Discount Notes due 2010.

### 11.25% Senior Euro Notes due 2010

In February 2000, Level 3 Communications, Inc. received € 293 million (\$285 million when issued) of net proceeds, after debt issuance costs, from an offering of € 300 million aggregate principal amount 11.25% Senior Euro Notes due 2010 ("11.25% Senior Euro Notes"). As of December 31, 2006, a total of €196 million aggregate principal amount of the 11.25% Senior Euro Notes had been repurchased. Interest on the notes accrues at 11.25% per year and is payable semi-annually in arrears in Euros on March 15 and September 15 each year beginning September 15, 2000.

The 11.25% Senior Euro Notes are subject to redemption at the option of Level 3 Communications, Inc., in whole or in part, at any time or from time to time on or after March 15, 2005. The 11.25% Senior Euro Notes may be redeemed at the redemption prices set forth below, plus accrued and unpaid interest, if any, to the redemption date. The following prices are for 11.25% Senior Euro Notes redeemed during the 12-month period commencing on March 15 of the years set forth below, and are expressed as percentages of principal amount.

<u>Year</u>	<u>Redemption Price</u>
2006	103.750%
2007	101.875%
2008 and thereafter	100.000%

Debt issuance costs of € 7 million were originally capitalized and are being amortized over the term of the 11.25% Senior Euro Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to € 1 million at December 31, 2006. The 11.25% Senior Euro Notes are senior, unsecured obligations of the Company, ranking *pari passu* with all existing and future senior debt. The 11.25% Senior Euro Notes contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

The issuance of the € 300 million 11.25% Senior Euro Notes has been designated as, and is effective as, an economic hedge against the investment in certain of the Company's foreign subsidiaries. Therefore, foreign currency gains and losses resulting from the translation of the debt have been recorded in other comprehensive income (loss) to the extent of translation gains or losses on such net investment. The 11.25% Senior Euro Notes were valued, based on current exchange rates, at \$137 million in the Company's financial statements at December 31, 2006. The difference between the carrying value at December 31, 2006 and the value at issuance, after repurchases, is recorded in other comprehensive income.

See Subsequent Events (Note 21) regarding the February 15, 2007 announcement of the Company's call notice to redeem the 11.25% Senior Euro Notes due 2010.

### 11.25% Senior Notes due 2010

In February 2000, Level 3 Communications, Inc. received \$243 million of net proceeds, after transaction costs, from a private offering of \$250 million aggregate principal amount of its 11.25% Senior Notes due 2010 ("11.25% Senior Notes"). As of December 31, 2006, a total of \$154 million aggregate principal amount of the 11.25% Senior Notes had been repurchased. Interest on the notes accrues at

11.25% per year and is payable semi-annually in arrears on March 15 and September 15 in cash beginning September 15, 2000.

The 11.25% Senior Notes are subject to redemption at the option of Level 3 Communications, Inc., in whole or in part, at any time or from time to time on or after March 15, 2005. Level 3 Communications, Inc. may redeem the 11.25% Senior Notes at the redemption prices set forth below, plus accrued and unpaid interest, if any, to the redemption date. The following prices are for 11.25% Senior Notes redeemed during the 12-month period commencing on March 15 of the years set forth below:

<u>Year</u>	<u>Redemption Price</u>
2006	103.750%
2007	101.875%
2008 and thereafter	100.000%

The 11.25% Senior Notes are senior, unsecured obligations of the Company, ranking *pari passu* with all existing and future senior debt. The 11.25% Senior Notes contain certain covenants, which among other things, limit additional indebtedness, dividend payments, certain investments and transactions with affiliates.

Debt issuance costs of \$7 million were originally capitalized and are being amortized to interest expense over the term of the 11.25% Senior Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to \$1 million at December 31, 2006.

See Subsequent Events (Note 21) regarding the February 15, 2007 announcement of the Company's call notice to redeem the 11.25% Senior Notes due 2010.

### **10.75% Senior Notes due 2011**

In October 2003, Level 3 Financing received \$486 million of net proceeds from a private placement offering of \$500 million aggregate principal amount of its 10.75% Senior Notes due 2011 ("10.75% Senior Notes"). As of December 31, 2006, a total of \$497 million aggregate principal amount of the 10.75% Senior Notes had been redeemed. Interest on the notes accrues at 10.75% per year and is payable in arrears on April 15 and October 15 each year in cash. These notes are guaranteed by Level 3 Communications, LLC and Level 3 Communications, Inc. (See Note 20).

The 10.75% Senior Notes are subject to redemption at the option of Level 3 Financing, in whole or in part, at any time or from time to time on or after October 15, 2007, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning October 15, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2007	105.375%
2008	102.688%
2009 and thereafter	100.000%

In connection with the tender offer and related consent solicitation on December 27, 2006, Level 3 Financing entered into a Supplemental Indenture, dated as of October 1, 2003 ("10.75% Note Indenture"), among Level 3, as Guarantor, Level 3 Financing, as issuer, and The Bank of New York, as Trustee, relating to the 10.75% Notes. Pursuant to the Supplemental Indenture, the 10.75% Note Indenture was amended to eliminate substantially all of the covenants, certain repurchase rights and certain events of default and related provisions contained in the 10.75% Note Indenture.

The 10.75% Senior Notes are senior, unsecured obligations of Level 3 Financing, ranking *pari passu* with all existing and future senior unsecured indebtedness of Level 3 Financing.

Debt issuance costs of \$14 million were originally capitalized and are being amortized to interest expense over the term of the 10.75% Senior Notes. As a result of amortization and the repurchase transaction, the capitalized debt issuance costs have been reduced to less than \$1 million at December 31, 2006.

### **Floating Rate Senior Notes due 2011**

On March 14, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, as borrower, entered into an indenture with the Bank of New York, as trustee, and issued \$150 million aggregate principal amount of floating rate senior notes due 2011 ("Floating Rate Senior Notes due 2011") in a private offering. After transaction costs, the Company received net proceeds associated with this offering of \$142 million.

The Floating Rate Senior Notes due 2011 rank equal in right of payment with all other senior unsecured obligations of Level 3 Financing and have an initial interest rate equal to the six month London Interbank Offered Rate ("LIBOR"), plus 6.375%, which will be reset semi-annually. Interest on the notes is payable on March 15 and September 15 of each year, beginning on September 15, 2006. The interest rate was 11.8% at December 31, 2006. The Floating Rate Senior Notes due 2011 were priced at 96.782% of par and will mature on March 15, 2011. The discount of \$4 million is reflected as a reduction in long-term debt and is being amortized as interest expense over the term of the Floating Rate Senior Notes due 2011 using the effective interest method. As of December 31, 2006, these notes are guaranteed by Level 3 Communications, Inc. and Level 3 Communications, LLC (See Note 20).

The Floating Rate Senior Notes due 2011 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after March 15, 2008 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning March 15, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2008	102.0%
2009	101.0%
2010	100.0%

On March 14, 2006, Level 3, Level 3 Financing and the initial purchasers of the Floating Rate Senior Notes due 2011 entered into a registration rights agreement relating to the Floating Rate Senior Notes due 2011 pursuant to which Level 3 and Level 3 Financing agreed to file an exchange offer registration statement with the Securities and Exchange Commission. The Company's exchange offer registration statement for these notes was declared effective by the Securities and Exchange Commission on August 8, 2006 and the exchange offer relating to these notes was subsequently completed.

Debt issuance costs of \$3 million were capitalized and are being amortized over the term of the Floating Rate Senior Notes due 2011 using the effective interest method. As a result of amortization, the capitalized debt issuance costs have been reduced to approximately \$3 million at December 31, 2006.

See Subsequent Events (Note 21) regarding the February 15, 2007 announcement of Level 3 Financing's tender offer to purchase the Floating Rate Senior Notes due 2011.

### 12.25% Senior Notes due 2013

On March 14, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, as borrower, entered into an indenture with the Bank of New York, as trustee, and issued \$250 million aggregate principal amount of 12.25% senior notes due 2013 ("12.25% Senior Notes due 2013") in a private offering.

On April 6, 2006, the Company issued \$300 million aggregate principal amount of 12.25% Senior Notes due 2013 in a private offering. These notes together with the \$250 million aggregate principal amount of 12.25% Senior Notes due 2013 issued on March 14, 2006 will be treated under the same indenture as a single series of notes. The Company received net proceeds of \$538 million associated with the 12.25% Senior Notes due 2013.

The 12.25% Senior Notes due 2013 are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. As of December 31, 2006, these notes are guaranteed by Level 3 Communications, Inc. and Level 3 Communications, LLC (See Note 20). The notes will mature on March 15, 2013. Interest on the notes accrues at 12.25% per year and is payable on March 15 and September 15 of each year, beginning on September 15, 2006. The \$250 million of 12.25% Senior Notes due 2013 issued on March 14, 2006 were priced at 96.618% of par. The \$300 million of 12.25% Senior Notes due 2013 issued on April 6, 2006 were priced at 102% of par. The resulting net discount of the two issuances of approximately \$2 million is reflected as a reduction in long-term debt and is being amortized as interest expense over the remaining term of the 12.25% Senior Notes due 2013 using the effective interest method.

The 12.25% Senior Notes due 2013 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after March 15, 2010 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning March 15, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2010	106.125%
2011	103.063%
2012	100.000%

On March 14, 2006, Level 3 Communications, Inc., Level 3 Financing and the initial purchasers of the 12.25% Senior Notes due 2013 entered into a registration rights agreement regarding the 12.25% Senior Notes due 2013 pursuant to which Level 3 Communications, Inc. and Level 3 Financing agreed to file an exchange offer registration statement with the Securities and Exchange Commission. The Company's exchange offer registration statement for these notes was declared effective by the Securities and Exchange Commission on August 8, 2006 and the exchange offer relating to these notes was subsequently completed.

The debt represented by the 12.25% Senior Notes due 2013 together with the Floating Rate Notes due 2011 constitutes purchase money indebtedness under the indentures of Level 3.

Debt issuance costs of approximately \$11 million were capitalized and are being amortized over the term of the 12.25% Senior Notes due 2013. As a result of amortization, the capitalized debt issuance costs have been reduced to \$10 million at December 31, 2006.

### 9.25% Senior Notes Due 2014

On October 30, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, Inc. as borrower, received \$588 million of net proceeds after transaction costs, from a private offering of \$600 million aggregate principal amount of its 9.25% Senior Notes due 2014 ("9.25% Senior Notes Due 2014"). On December 13, 2006, Level 3 Communications, Inc., as guarantor and Level 3 Financing, Inc. as borrower, received \$661 million of net proceeds after transaction costs and accrued interest, for a second

offering of \$650 million aggregate principal amount of 9.25% Senior Notes due 2014. These notes together with the \$600 million aggregate principal amount of 9.25% Senior Notes due 2014 issued on October 30, 2006 were issued under the same indenture and will be treated as a single series of notes. The Company received total net proceeds of \$1.239 billion (excluding prepaid interest).

The 9.25% Senior Notes due 2014 are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. As of December 31, 2006, these notes are guaranteed by Level 3 Communications, Inc. (See Note 20). The notes will mature on November 1, 2014. Interest on the 9.25% Senior Notes Due 2014 accrues at 9.25% interest per year and is payable semi-annually in cash on May 1 and November 1 beginning May 1, 2007. The \$600 million of 9.25% Senior Notes due 2014 issued on October 30, 2006 were priced at par. The \$650 million of 9.25% Senior Notes due 2014 issued on December 13, 2006 were priced at 101.75% of par plus accrued interest from October 30, 2006, representing an effective yield of 8.86% to the purchasers of these senior notes. The resulting premium of the two issuances of approximately \$11 million is reflected as an increase to long-term debt and is being amortized as a reduction to interest expense over the remaining term of the 9.25% Senior Notes due 2014 using the effective interest method.

The debt represented by the 9.25% Senior Notes Due 2014 constitutes purchase money indebtedness under the indentures of Level 3 Communications, Inc. A portion of the proceeds were used to redeem \$497 million of the Company's 10.75% Senior Notes Due 2008 on December 27, 2006. Gross proceeds from this offering that exceed the amount necessary to repurchase or refinance the 10.75% Senior Notes Due 2008 constitutes purchase money indebtedness and will be used solely to fund the cost of construction, installation, acquisition, lease, development or improvement of any assets to be used in the Company's communications business, including the cash purchase price of any past, pending or future acquisitions.

The 9.25% Senior Notes Due 2014 are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after November 1, 2010 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning November 1, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2010	104.625 %
2011	102.313 %
2012	100.000 %

At any time or from time to time on or prior to November 1, 2009, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the 9.25% Senior Notes Due 2014 at a redemption price equal to 109.250% of the principal amount of those notes so redeemed, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the 9.25% Senior Notes Due 2014 would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

The 9.25% Senior Notes Due 2014 are not currently registered under the Securities Act of 1933 or any state securities laws and, unless so registered, may not be offered or sold except pursuant to an applicable exemption from the registration requirements of the Securities Act of 1933 and applicable state securities laws. On October 30, 2006 and December 28, 2006, Level 3, Level 3 Financing and the initial purchasers of the 9.25% Senior Notes Due 2014 entered into registration rights agreements relating to the 9.25% Senior



Notes Due 2014 pursuant to which Level 3 and Level 3 Financing agreed to file an exchange offer registration statement with the Securities and Exchange Commission. The registration statement has been filed but not yet declared effective.

Under the terms of the registration rights agreements, Level 3 Financing may be required to pay “Special Interest” in the event of a registration default. Special Interest will accrue at a rate of 0.50% per annum on the principal amount during the 90-day period after the occurrence of the registration default and will increase by 0.25% per annum at the end of each subsequent 90-day period. In no event will the rate exceed 1.00% per annum on the principal amount. If the exchange offer is completed on the terms and within the period contemplated by the registration rights agreements, no special interest will be payable. A registration default may occur if the Company fails to file with the Securities and Exchange Commission and have declared effective the exchange offer registration statement by certain dates as specified in the registration rights agreement. The Company believes that the likelihood of having to make Special Interest payments under the terms of the registration rights agreement is remote and, as a result, has not accrued a liability for any obligation under the agreement.

Debt issuance costs of approximately \$23 million were capitalized and are being amortized over the term of the 9.25% senior Notes Due 2014. As a result of amortization, the capitalized debt issuance costs have been reduced to \$22 million at December 31, 2006.

### **2.875% Convertible Senior Notes due 2010**

In July 2003, Level 3 Communications, Inc. completed the offering of \$374 million aggregate principal amount of its 2.875% Convertible Senior Notes due 2010 (“2.875% Convertible Senior Notes”) in an underwritten public offering pursuant to the Company’s shelf registration statement. Interest on the notes accrues at 2.875% per year and is payable semi-annually in arrears in cash on January 15 and July 15, beginning January 15, 2004. The 2.875% Convertible Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured debt. The 2.875% Convertible Senior Notes contain certain covenants, which among other things, limit additional liens on assets of the Company.

The 2.875% Convertible Senior Notes are convertible into shares of the Company’s common stock at a conversion rate of \$7.18 per share, subject to certain adjustments. On or after July 15, 2007, Level 3, at its option, may redeem for cash all or a portion of the notes. Level 3 may exercise this option only if the current market price for the Level 3 common stock for at least 20 trading days within any 30 consecutive trading day period exceeds prices ranging from 170% of the conversion price on July 15, 2007 decreasing to 150% of the conversion price on or after July 15, 2009. Level 3 would also be obligated to pay the holders of the redeemed notes a cash amount equal to the present value of all remaining scheduled interest payments.

Level 3 used the net proceeds of \$361 million, after transaction costs, for working capital, capital expenditures and other general corporate purposes, including new product development, debt repurchases and acquisitions.

Debt issuance costs of \$13 million were originally capitalized and are being amortized to interest expense over the term of the 2.875% Convertible Senior Notes. As a result of amortization, the capitalized debt issuance costs have been reduced to \$6 million at December 31, 2006.

### **5.25% Convertible Senior Notes due 2011**

On December 2, 2004, Level 3 Communications, Inc. completed the offering of \$345 million aggregate principal amount of its 5.25% Convertible Senior Notes due 2011 (“5.25% Convertible Senior Notes”) in a private offering. Interest on the notes accrues at 5.25% per year and is payable semi-annually in arrears in cash on June 15 and December 15, beginning June 15, 2005. The 5.25% Convertible Senior Notes are senior, unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and

future senior unsecured debt of Level 3 Communications, Inc. The 5.25% Convertible Senior Notes contain certain covenants which limit additional liens on assets of the Company.

The 5.25% Convertible Senior Notes are convertible, at the option of the holders, into shares of the Company's common stock at a conversion rate of \$3.98 per share, subject to certain adjustments. Upon conversion, the Company will have the right to deliver cash in lieu of shares of its common stock, or a combination of cash and shares of common stock. In addition, holders of the 5.25% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount plus accrued interest and a make whole premium.

On or after December 15, 2008, Level 3, at its option, may redeem for cash all or a portion of the notes. The 5.25% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than 60 nor less than 30 days' notice, on or after December 15, 2008, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning December 15, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2008	102.250%
2009	101.500%
2010 and thereafter	100.750%

In connection with the issuance of the notes, Level 3 used approximately \$62 million of the net proceeds of the offering to enter into convertible note hedge and warrant transactions with respect to the Company's common stock to reduce the potential dilution from conversion of the notes. Level 3 used the remainder of the net proceeds from this offering to fund repurchases of its existing debt securities due in 2008.

Under the terms of the convertible note hedge arrangement (the "Convertible Note Hedge") with Merrill Lynch International ("Merrill"), Level 3 paid \$125 million for a forward purchase option contract under which it is entitled to purchase from Merrill a fixed number of shares of Level 3 common stock (at a current price per share of \$3.98). In the event of the conversion of the notes, this forward purchase option contract allows the Company to purchase, at a fixed price equal to the implicit conversion price of shares issued under the convertible notes, a number of shares equal to the shares that Level 3 issues to a note holder upon conversion. Settlement terms of this forward purchase option allow the Company to elect cash or share settlement based on the settlement option it chooses in settling the conversion feature of the notes. The Company accounted for the Convertible Note Hedge pursuant to the guidance in EITF No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Own Stock" ("EITF No. 00-19"). Accordingly, the \$125 million purchase price of the forward stock purchase option contract was recorded as a reduction to consolidated stockholders' equity.

Level 3 also sold to Merrill a warrant (the "Warrant") to purchase shares of Level 3 common stock. The Warrant is currently exercisable for 86,596,380 shares of Level 3 common stock at a current exercise price of \$6.00 per share. Level 3 received \$63 million cash from Merrill in return for the sale of this forward share purchase option contract. Merrill cannot exercise the Warrant unless and until a conversion event occurs. Level 3 has the option of settling the Warrant in cash or shares of Level 3 common stock. The Company accounted for the sale of the Warrant as the sale of a permanent equity instrument pursuant to the guidance in EITF No. 00-19. Accordingly, the \$63 million sales price of the forward stock purchase option contract was recorded as an increase to consolidated stockholders' equity.

The Convertible Note Hedge and the Warrant economically allow Level 3 to acquire sufficient shares of common stock from Merrill to meet its obligation to deliver common stock upon conversion by the holder, unless the common stock price exceeds \$6.00. When the fair value of the Level 3 common stock

exceeds such price, the contracts have an offsetting economic impact and, accordingly, will no longer be effective as a hedge of the dilutive impact of possible conversion.

Debt issuance costs of \$11 million were originally capitalized and are being amortized to interest expense over the term of the 5.25% Convertible Senior Notes. As a result of amortization, debt issuance costs were \$8 million at December 31, 2006.

### 10% Convertible Senior Notes due 2011

In April 2005, Level 3 Communications, Inc. received \$877 million of net proceeds, after giving effect to offering expenses, from an offering of \$880 million aggregate principal amount of its 10% Convertible Senior Notes due 2011 ("10% Convertible Senior Notes") to institutional investors. Interest on the notes accrues at 10% per year and will be payable semi-annually on May 1 and November 1 beginning on November 1, 2005. The 10% Convertible Senior Notes are unsecured unsubordinated obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future unsecured unsubordinated debt of Level 3 Communications, Inc. The 10% Convertible Senior Notes contain certain covenants which limit additional liens on assets of the Company.

The 10% Convertible Senior Notes will be convertible by holders at any time after January 1, 2007 (or sooner if certain corporate events occur) into shares of Level 3 common stock at a conversion price of \$3.60 per share (subject to adjustment in certain events). This is equivalent to a conversion rate of approximately 277.77 shares per \$1,000 principal amount of notes. In addition, holders of the 10% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount of the notes plus accrued interest and a make whole premium.

On or after May 1, 2009, Level 3, at its option, may redeem for cash all or a portion of the notes. The 10% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than sixty nor less than thirty days' notice, on or after May 1, 2009, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning May 1, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2009	103.330%
2010 and thereafter	101.670%

Debt issuance costs of \$3 million were originally capitalized and are being amortized to interest expense over the term of the 10% Convertible Senior Notes. As a result of amortization, the capitalized debt issuance costs have been reduced to \$1 million at December 31, 2006.

See Subsequent Events (Note 21) regarding the January 2007 debt for equity exchange of the Company's 10% Convertible Senior Notes due 2011.

### 3.5% Convertible Senior Notes due 2012

On June 13, 2006 Level 3 Communications, Inc. received \$326 million of net proceeds, after giving effect to offering expenses, from a public offering of \$335 million aggregate principal amount of its 3.5% Convertible Senior Notes due 2012 ("3.5% Convertible Senior Notes"). The 3.5% Convertible Senior Notes were priced at 100% of the principal amount. The notes are senior unsecured obligations of the Company, ranking equal in right of payment with all the Company's existing and future unsubordinated indebtedness. The 3.5% Convertible Senior Notes will mature on June 15, 2012. Interest on the notes will be payable semi-annually in arrears on June 15 and December 15 of each year, beginning on December 15, 2006.

At any time before the close of business on June 15, 2012, the 3.5% Convertible Senior Notes are convertible by holders into shares of Level 3's common stock at a conversion price of \$5.46 per share (subject to adjustment in certain events). This is equivalent to a conversion rate of approximately 183.1502 shares of common stock per \$1,000 principal amount of these notes. Upon conversion, the Company will have the right to deliver cash in lieu of shares of its common stock, or a combination of cash and shares of common stock. In addition, holders of the 3.5% Convertible Senior Notes will have the right to require the Company to repurchase the notes upon the occurrence of a change in control, as defined, at a price of 100% of the principal amount of the notes plus accrued interest. In addition, if a holder elects to convert its notes in connection with certain changes in control, Level 3 could be required to pay a make whole premium by increasing the number of shares deliverable upon conversion of the notes.

The 3.5% Convertible Senior Notes are subject to redemption at the option of Level 3, in whole or in part, at any time or from time to time, on not more than 60 nor less than 30 days' notice, on or after June 15, 2010, plus accrued and unpaid interest thereon (if any) to the redemption date, if redeemed during the twelve months beginning June 15, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2010	101.17%
2011	100.58%

Level 3 used a portion of the net proceeds from this offering and its common stock offering completed in the second quarter of 2006 to redeem certain debt securities maturing in 2008. The remaining proceeds were used for acquisitions and for general corporate purposes, including working capital and capital expenditures.

Debt issuance costs of \$9 million were originally capitalized and are being amortized to interest expense over the term of the 3.5% Convertible Senior Notes. As a result of amortization, the capitalized debt issuance costs have been reduced to approximately \$9 million at December 31, 2006.

### **9% Convertible Senior Discount Notes due 2013**

In October 2003, Level 3 completed the exchange of approximately \$352 million (book value) of debt and accrued interest outstanding, as of October 24, 2003, for approximately 20 million shares of Level 3 common stock and \$208 million (book value) of a new issue of 9% Convertible Senior Discount Notes.

Level 3 Communications, Inc. issued \$295 million aggregate principal amount at maturity of 9% Convertible Senior Discount Notes. Interest on the 9% Convertible Senior Discount Notes accretes at a rate of 9% per annum, compounded semiannually, to an aggregate principal amount of \$295 million by October 15, 2007. Cash interest will not accrue on the 9% Convertible Senior Discount Notes prior to October 15, 2007; however, Level 3 Communications, Inc. may elect to commence the accrual of cash interest on all outstanding 9% Convertible Senior Discount Notes on or after October 15, 2004, in which case the outstanding principal amount at maturity of each 9% Convertible Senior Discount Note will, on the elected commencement date, be reduced to the accreted value of the 9% Convertible Senior Discount Note as of that date and cash interest shall be payable on that Note on April 15 and October 15 thereafter. Commencing October 15, 2007, interest on the 9% Convertible Senior Discount Notes will accrue at the rate of 9% per annum and will be payable in cash semiannually in arrears. Accrued interest expense for the year ended December 31, 2006 on the 9% Convertible Senior Discount Notes of less than \$1 million was added to long-term debt.

The 9% Convertible Senior Discount Notes are convertible into shares of the Company's common stock at a conversion rate of \$9.99 per share, subject to certain adjustments. The total number of shares issuable upon conversion will range from approximately 25 million to 30 million shares depending upon the total accretion prior to conversion. On or after October 15, 2008, Level 3, at its option, may redeem for

cash all or a portion of the notes. Level 3 may exercise this option only if the current market price for at least 20 trading days within any 30 consecutive trading day period exceeds 140% of the conversion price on October 15, 2008. This amount will be decreased to 130% and 120% on October 15, 2008 and 2009, respectively, if the initial holders sell greater than 33.33% of the notes. Level 3 is also obligated to pay the holders of the redeemed notes a cash amount equal to the present value of all remaining scheduled interest payments.

The 9% Convertible Senior Discount Notes will be subject to conversion into common stock at the option of the holder, in whole or in part, at any time or from time to time after 180 days after the issue date at the following conversion prices (expressed as percentages of accreted value) plus accrued and unpaid interest thereon to the conversion date, of the time periods indicated below:

<u>Year</u>	<u>Redemption Price</u>
October 15, 2006 - April 14, 2007	91.656%
April 15, 2007 - October 14, 2007	95.780%
October 15, 2007 and thereafter	100.090%

These notes are senior unsecured obligations of Level 3 Communications, Inc., ranking *pari passu* with all existing and future senior unsecured indebtedness of Level 3 Communications, Inc.

#### **6% Convertible Subordinated Notes due 2009**

In September 1999, the Company received \$798 million of proceeds, after transaction costs, from an offering of \$823 million aggregate principal amount of its 6% Convertible Subordinated Notes Due 2009 ("Subordinated Notes 2009"). The Subordinated Notes 2009 are unsecured and subordinated to all existing and future senior indebtedness of the Company. Interest on the Subordinated Notes 2009 accrues at 6% per year and is payable each year in cash on March 15 and September 15. The principal amount of the Subordinated Notes 2009 will be due on September 15, 2009. The Subordinated Notes 2009 may be converted into shares of common stock of the Company at any time prior to maturity, unless previously redeemed, repurchased or the Company has caused the conversion rights to expire. The conversion rate is 15.3401 shares per each \$1,000 principal amount of Subordinated Notes 2009, subject to adjustment in certain circumstances. On or after September 15, 2002, Level 3, at its option, may cause the conversion rights to expire. Level 3 may exercise this option only if the current market price exceeds approximately \$91.27 (which represents 140% of the conversion price) for 20 trading days within any period of 30 consecutive trading days including the last day of that period. As of December 31, 2006, less than \$1 million of debt had been converted into shares of common stock. As of December 31, 2006, a total of \$461 million aggregate principal amount of the Subordinated Notes 2009 had been repurchased or exchanged for common stock.

Debt issuance costs of \$25 million were originally capitalized and are being amortized to interest expense over the term of the Subordinated Notes 2009. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to \$3 million at December 31, 2006.

#### **6% Convertible Subordinated Notes due 2010**

In February 2000, Level 3 Communications, Inc. received \$836 million of net proceeds, after transaction costs, from a public offering of \$863 million aggregate principal amount of its 6% Convertible Subordinated Notes due 2010 ("Subordinated Notes 2010"). The Subordinated Notes 2010 are unsecured and subordinated to all existing and future senior indebtedness of the Company. Interest on the Subordinated Notes 2010 accrues at 6% per year and is payable semi-annually in cash on March 15 and September 15 beginning September 15, 2000. The principal amount of the Subordinated Notes 2010 will be due on March 15, 2010.

The Subordinated Notes 2010 may be converted into shares of common stock of Level 3 Communications, Inc. at any time prior to the close of business on the business day immediately preceding maturity, unless previously redeemed, repurchased or Level 3 Communications, Inc. has caused the conversion rights to expire. The conversion rate is 7.416 shares per each \$1,000 principal amount of Subordinated Notes 2010, subject to adjustment in certain events.

On or after March 18, 2003, Level 3, at its option, may cause the conversion rights to expire. Level 3 may exercise this option only if the current market price exceeds approximately \$188.78 (which represents 140% of the conversion price) for at least 20 trading days within any period of 30 consecutive trading days, including the last trading day of that period. As of December 31, 2006, no debt had been converted into shares of common stock. As of December 31, 2006, a total of \$350 million aggregate principal amount of the Subordinated Notes 2010 had been repurchased or exchanged for common stock.

Debt issuance costs of \$27 million were originally capitalized and are being amortized to interest expense over the term of the Subordinated Notes. As a result of amortization and debt repurchases, the capitalized debt issuance costs have been reduced to \$5 million at December 31, 2006.

### **Commercial Mortgage**

In the third quarter of 2005, the Company completed a refinancing of the mortgage on its corporate headquarters. On September 27, 2005, HQ Realty, Inc. entered into a \$70 million loan at an initial fixed rate of 6.86% through 2010, the anticipated repayment date as defined in the loan agreement ("CBRE Commercial Mortgage"). After 2010 through maturity in 2015, the interest rate will adjust to the greater of 9.86% or the five year U.S. Treasury rate plus 300 basis points. HQ Realty, Inc. received \$66 million of net proceeds after transaction costs and has deposited \$4 million into restricted cash accounts for future facility improvements and property taxes. HQ Realty, Inc. was required to make interest only payments in the first year and began making monthly principal payments in the second year based on a 30-year amortization schedule.

Debt issuance costs of \$1 million were capitalized and are being amortized as interest expense over the term of the CBRE Commercial Mortgage. As a result of amortization, the capitalized debt issuance costs have been reduced to \$1 million at December 31, 2006.

The assets of HQ Realty, Inc. are not available to satisfy any third party obligations other than those of HQ Realty, Inc. In addition, the assets of the Company and its subsidiaries other than HQ Realty, Inc. are not available to satisfy the obligations of HQ Realty, Inc.

### **Capital Leases**

As part of the Progress Telecom transaction completed on March 20, 2006, the Company assumed certain capital lease obligations of Progress Telecom for IRU dark fiber facilities of \$9 million. The capital leases mature at various dates through 2021. As of December 31, 2006 the capital lease obligation is \$8 million.

As part of the ICG Communications transaction on May 31, 2006, the Company assumed certain capital lease obligations of ICG Communications for IRU dark fiber facilities of \$3 million. The capital leases mature at various dates through 2018. As of December 31, 2006 the capital lease obligation is approximately \$3 million.

As part of the TelCove transaction completed on July 24, 2006, the Company assumed certain capital lease obligations of TelCove primarily for IRU dark fiber facilities of \$13 million. The capital leases mature at various dates through December 2030. As of December 31, 2006 the capital lease obligation is approximately \$12 million.

**Future Debt Maturities:**

The Company's contractual obligations as of December 31, 2006 related to debt, including capital leases and excluding issue discounts and fair value adjustments will require estimated cash payments during each of the five succeeding years as follows: 2007—\$5 million; 2008—\$148 million; 2009—\$365 million; 2010—\$2,369 million, 2011—\$2,110 million and \$2,420 million thereafter.

**(14) Asset Retirement Obligations**

Asset retirement obligation accretion expense of \$24 million, \$13 million and \$11 million was recorded during the years ended December 31, 2006, 2005 and 2004, respectively; resulting in total asset retirement obligations, including reclamation costs for the coal business, of \$202 million and \$181 million at December 31, 2006 and 2005, respectively. The total asset retirement obligation as of December 31, 2006 includes \$46 million of asset retirement obligation related to WilTel, ICG Communications and Looking Glass. The total asset retirement obligation as of December 31, 2005 includes WilTel's asset retirement obligation of \$35 million.

Expense of \$21 million related to the communications business was recorded in selling, general and administrative expenses on the consolidated statement of operations for the year ended December 31, 2006. In addition, expense of \$3 million related to the Company's coal mining business was recorded in cost of revenue on the consolidated statement of operations for the year ended December 31, 2006. This was partially offset by less than \$1 million of gains recognized on settlement of obligations attributable to the use of internal resources rather than third parties to perform reclamation work. In addition, the coal mining business incurred \$2 million of additional reclamation liabilities as a result of expanded mining activities and incurred \$3 million of costs for work performed to remediate previously mined properties.

Level 3 recorded a reduction in the 2006 depreciation expense totaling approximately \$5 million as a result of a change in the estimated future asset retirement obligation costs associated with its 50% interest in the Decker coal mine. In accordance with SFAS No. 143, Level 3 recorded the full impact of the change in estimate in the current period.

Expense of \$10 million related to the communications business was recorded in selling, general and administrative expenses on the consolidated statement of operations for the year ended December 31, 2005. In addition, expense of \$3 million related to the Company's coal mining business was recorded in cost of revenue on the consolidated statement of operations for the year ended December 31, 2005. In addition, the coal mining business incurred \$3 million of additional reclamation liabilities as a result of expanded mining activities and incurred \$2 million of costs for work performed to remediate previously mined properties.

Expense of \$7 million related to the communications business was recorded in selling, general and administrative expenses on the consolidated statement of operations for the year ended December 31, 2004. Expense of \$4 million related to the Company's coal mining business was recorded in cost of revenue on the consolidated statement of operations for the year ended December 31, 2004. In addition, the coal mining business incurred \$4 million of additional reclamation liabilities as a result of expanded mining activities and incurred \$1 million of costs for work performed to remediate previously mined properties.

The Company had noncurrent restricted cash of approximately \$59 million and \$56 million set aside to fund the reclamation liabilities at December 31, 2006 and 2005, respectively.

**(15) Employee Benefit Plans**

The Company adopted the recognition provisions of SFAS No. 123 in 1998. Under SFAS No. 123, the fair value of an option or other stock-based compensation (as computed in accordance with accepted option valuation models) on the date of grant was amortized over the vesting periods of the options.

Although the recognition of the value of the instruments results in compensation or professional expenses in an entity's financial statements, the expense differs from other compensation and professional expenses in that these charges may not be settled in cash, but rather, are generally settled through issuance of common stock.

Beginning January 1, 2006, the Company adopted SFAS No. 123R. SFAS No. 123R requires that estimated forfeitures be factored in the amount of expense recognized for awards that are not fully vested. The Company has historically recorded the effect of forfeitures of equity awards as they occur. The effect of applying the change from the original provisions of SFAS No. 123 on the Company's results of operations, basic and diluted earnings per share and cash flows for the year ended December 31, 2006 was not material.

The adoption of SFAS No. 123 has resulted in material non-cash charges to operations since its adoption in 1998, and the adoption of SFAS No. 123R on January 1, 2006 will continue to result in material non-cash charges to operations in the future. The amount of the non-cash charges will be dependent upon a number of factors, including the number of grants, the fair value of each grant estimated at the time of its award and the number of grants that ultimately vest.

The Company recognized in net loss from continuing operations a total of \$84 million, \$51 million and \$43 million of non-cash compensation in 2006, 2005 and 2004, respectively. Included in discontinued operations is non-cash compensation expense of \$2 million, \$6 million and \$3 million in 2006, 2005 and 2004, respectively. During the second quarter of 2006, the October 2005 and January 2006 grants were revalued using May 15, 2006 as the grant date, in accordance with SFAS No. 123R, which resulted in an additional \$6 million increase in non-cash compensation expense. As stated in the Company's proxy materials for its 2006 Annual Meeting of Stockholders, over the course of the years since April 1, 1998, the compensation committee of the Company's Board of Directors had administered the 1995 Stock Plan under the belief that the action of the Company's Board of Directors to amend and restate the plan effective April 1, 1998 had the effect of extending the original term of the Plan to April 1, 2008. After a further review of the terms of the plan, however, the compensation committee determined that an ambiguity could have existed that may have resulted in an interpretation that the expiration date of the plan was September 25, 2005. To remove any ambiguity, the Board of Directors sought the approval of the Company's stockholders to amend the plan to extend the term of the plan by five years to September 25, 2010. This approval was obtained at the 2006 Annual Meeting of Stockholders held on May 15, 2006. In addition, the Company capitalized \$2 million a year in 2006, 2005 and 2004, respectively, of non-cash compensation for those employees and contractors directly involved in the construction of the network, installation of customers or development of the business support systems.

SFAS No. 123R requires the benefit of tax deductions in excess of recognized compensation expense be reported as a financing cash flow if the tax benefits are expected to be realizable. As the Company is currently in a net operating loss position and does not expect to generate net income in the near term, Level 3's management does not expect to realize tax benefits from share-based compensation for the foreseeable future.



The following table summarizes non-cash compensation expense and capitalized non-cash compensation for each of the three years ended December 31, 2006.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(dollars in millions)		
OSO	\$ 38	\$ 18	\$ 16
C-OSO	—	—	1
Restricted Stock	20	19	4
Shareworks Match Plan	—	(2)	4
401(k) Match Expense	18	15	18
401(k) Discretionary Grant Plan	12	9	5
	<u>88</u>	<u>59</u>	<u>48</u>
Capitalized Noncash Compensation	(2)	(2)	(2)
	<u>86</u>	<u>57</u>	<u>46</u>
Discontinued Operations	(2)	(6)	(3)
	<u>\$ 84</u>	<u>\$ 51</u>	<u>\$ 43</u>

### *Non-qualified Stock Options and Warrants*

The Company has not granted non-qualified stock options (“NQSOs”) since 2000. As of December 31, 2006, all NQSOs previously granted were fully vested and the compensation expense had been fully recognized in the consolidated statements of operations. At December 31, 2006, there were approximately 4.9 million NQSOs outstanding with exercise prices ranging from \$1.76 to \$8.00. The weighted average exercise price of the NQSOs outstanding was \$5.79 at December 31, 2006.

Transactions involving NQSOs granted are summarized as follows:

	<u>Units</u>	<u>Exercise Price Per Unit</u>	<u>Weighted Average Exercise Price</u>	<u>Aggregate Intrinsic Value (in millions)</u>
Balance December 31, 2003	8,921,364	\$ 0.12 - \$84.75	\$ 5.95	
Options granted	—	—	—	
Options cancelled	(361,500)	5.43 - 84.75	8.23	
Options exercised	—	—	—	
Balance December 31, 2004	<u>8,559,864</u>	0.12 - 21.69	5.85	Less than \$1.0
Options granted	—	—	—	
Options cancelled	(606,150)	5.43 - 8.00	6.00	
Options exercised	(61,168)	0.12 - 0.12	0.12	
Options expired	<u>(1,746,500)</u>	4.04 - 21.69	6.36	
Balance December 31, 2005	<u>6,146,046</u>	1.76 - 8.00	5.75	Less than \$1.0
Options granted	—	—	—	
Options cancelled	(553,248)	1.76 - 8.00	6.29	
Options exercised	(689,250)	4.95 - 5.43	4.97	
Options expired	—	—	—	
Balance December 31, 2006	<u>4,903,548</u>	\$ 1.76 - \$ 8.00	\$ 5.79	\$1.0
Options exercisable:				
December 31, 2004	8,559,864	\$ 0.12 - \$21.69	\$ 5.85	
December 31, 2005	6,146,046	1.76 - 8.00	5.75	
December 31, 2006	4,903,548	\$ 1.76 - \$ 8.00	\$ 5.79	

<u>Range of Exercise Prices</u>	<u>Number Outstanding as of December 31, 2006</u>	<u>Options Outstanding and Exercisable Weighted Average Remaining Life (years)</u>	<u>Weighted Average Exercise Price</u>
\$1.76 – \$1.76	2,348	1.28	\$ 1.76
5.43 – 5.43	3,654,825	0.78	5.43
\$6.20 – \$8.00	1,246,375	1.06	6.89
	<u>4,903,548</u>	0.85	\$ 5.79

At December 31, 2006, there were approximately 14.6 million warrants outstanding ranging in exercise price from \$4.00 to \$29.00. As of December 31, 2006, all of the warrants previously granted were fully vested and the compensation expense had been fully recognized in the consolidated statements of operations. Of these warrants, all were exercisable at December 31, 2006, with a weighted average exercise price of \$7.79 per warrant.

During the second quarter of 2004, the Company issued approximately 374,000 warrants to a consultant as payment for future consulting financial advisory services. The warrants allow the consultant to purchase common stock at \$4.00 per share. The warrants vested equally in quarterly installments over twelve months. The warrants expire on April 1, 2011. The Company recorded less than \$1 million of expense during 2004 for these warrants. As of December 31, 2004, these warrants were fully expensed.

### ***Outperform Stock Options***

In April 1998, the Company adopted an outperform stock option (“OSO”) program that was designed so that the Company’s stockholders would receive a market return on their investment before OSO holders receive any return on their options. The Company believes that the OSO program aligns directly management’s and stockholders’ interests by basing stock option value on the Company’s ability to outperform the market in general, as measured by the Standard & Poor’s (“S&P”) 500 Index. Participants in the OSO program do not realize any value from awards unless the Company’s common stock price outperforms the S&P 500 Index during the life of the grant. When the stock price gain is greater than the corresponding gain on the S&P 500 Index (or less than the corresponding loss on the S&P 500 Index for grants awarded before September 30, 2005), the value received for awards under the OSO plan is based on a formula involving a multiplier related to the level by which the Company’s common stock outperforms the S&P 500 Index. To the extent that Level 3’s common stock outperforms the S&P 500 Index, the value of OSO units to a holder may exceed the value of nonqualified stock options.

In August 2002, the Company modified the OSO program as follows:

- OSO targets are communicated in terms of number of OSO units rather than a theoretical dollar value.
- The success multiplier was reduced from eight to four.
- Awards will vest over 2 years and have a 4-year life. Fifty percent of the award will vest at the end of the first year after grant, with the remaining 50% vesting over the second year (12.5% per quarter).

The initial strike price, as determined on the day prior to the OSO grant date, is adjusted over time (the “Adjusted Strike Price”), until the exercise date. The adjustment is an amount equal to the percentage appreciation or depreciation in the value of the S&P 500 Index from the date of grant to the date of exercise. The value of the OSO increases for increasing levels of outperformance. OSO units outstanding

at December 31, 2006 have a multiplier range from zero to four depending upon the performance of Level 3 common stock relative to the S&P 500 Index as shown in the following table.

<b>If Level 3 Stock Outperforms the S&amp;P 500 Index by:</b>	<b>Then the Pre-multiplier Gain Is Multiplied by a Success Multiplier of:</b>
0% or Less	0.00
More than 0% but Less than 11%	Outperformance percentage multiplied by $\frac{4}{11}$
11% or More	4.00

The Pre-multiplier gain is the Level 3 common stock price minus the Adjusted Strike Price on the date of exercise.

Upon exercise of an OSO, the Company shall deliver or pay to the grantee the difference between the Fair Market Value of a share of Level 3 common stock as of the day prior to the exercise date, less the Adjusted Strike Price, the “Exercise Consideration”. The Exercise Consideration may be paid in cash, Level 3 common stock or any combination of cash or Level 3 common stock at the Company’s discretion. The number of shares of Level 3 common stock to be delivered by the Company to the grantee is determined by dividing the Exercise Consideration to be paid in Level 3 common stock by the Fair Market Value of a share of Level 3 common stock as of the date prior to the exercise date. Fair Market Value is defined in the OSO agreement, but is currently the closing price per share of Level 3 common stock on the NASDAQ exchange. Exercise of the OSO units does not require any cash outlay by the employee.

OSO awards are granted quarterly to eligible participants. Awards outstanding at December 31, 2006 have a 4-year life and vest 50% at the end of the first year after the grant, with the remaining 50% vesting over the second year (12.5% per quarter).

The fair value of the OSO units granted is calculated by applying a modified Black-Scholes model with the assumptions identified below. The Company utilized a modified Black-Scholes model due to the additional variables required to calculate the impact of the success multiplier of the OSO program. Beginning January 1, 2006, as a result of the adoption of SFAS No. 123R, the Company also considers the estimated forfeiture rate to measure the value of outperform stock options granted to employees. The Company believes that given the relative short life of the options and the other variables used in the model, the modified Black-Scholes model provides a reasonable estimate of the fair value of the OSO units at the time of grant.

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
S&P 500 Expected Dividend Yield Rate	1.78%	1.99%	1.54%
Expected Life	3.4 years	2 years	2 years
S&P 500 Expected Volatility Rate	12%	13%	15%
Level 3 Common Stock Expected Volatility Rate	55%	55%	56%
Expected S&P 500 Correlation Factor	.28	.30	.19
Calculated Theoretical Value	153%	116%	120%
Estimated Forfeiture Rate	10.19%	—	—

The fair value of each OSO grant equals the calculated theoretical value multiplied by the Level 3 common stock price on the grant date.

The expected life data was stratified based on levels of responsibility within the Company. The theoretical value used in 2006 was determined using the weighted average exercise behavior for these groups of employees. Upon adoption of SFAS No. 123R, the Company updated its calculation of the Expected Life. Volatility assumptions were derived using historical data as well as current market data.

As part of a comprehensive review of its long-term compensation program, the Company temporarily suspended awards of OSO units in April 2005. During the second quarter of 2005, the Company granted participants in the plan restricted stock units, discussed below.

Beginning in the third quarter 2005, the Company issued both restricted stock units and OSO units as part of its long-term compensation program. In the third quarter of 2005, the Company made a grant for 2005 of restricted stock units that vest ratably over four years.

The fair value under SFAS No. 123 and SFAS No. 123R for the approximately 8 million, 6 million and 5 million OSO units awarded to participants during the year ended December 31, 2006, 2005 and 2004, respectively, was approximately \$50 million, \$18 million and \$22 million, respectively. As of December 31, 2006, the Company had not reflected \$26 million of unamortized compensation expense in its financial statements for previously granted OSO units. The weighted average period over which this cost will be recognized is 1.48 years.

Transactions involving OSO units awarded are summarized in the table below. The Option Price Per Unit identified in the table below represents the initial strike price, as determined on the day prior to the OSO grant date for those grants.

	Units	Initial Strike Price Per Unit	Weighted Average Initial Strike Price	Aggregate Intrinsic Value (in millions)	Weighted Average Remaining Contractual Term
Balance December 31, 2003	21,483,414	\$ 2.45 - \$113.87	\$ 15.36		
Options granted	5,394,056	2.59 - 5.70	3.36		
Options cancelled	(211,876)	2.45 - 113.87	4.80		
Options expired	(4,873,816)	3.02 - 113.87	41.94		
Options exercised	(430,256)	2.45 - 5.58	3.64		
Balance December 31, 2004	21,361,522	2.45 - 25.31	6.61	\$ 5.3	1.59 years
Options granted	5,859,066	2.03 - 3.39	2.61		
Options cancelled	(1,048,494)	2.03 - 25.31	3.00		
Options expired	(11,841,490)	2.59 - 25.31	8.91		
Options exercised	(84,628)	2.45 - 3.02	2.86		
Balance December 31, 2005	14,245,976	2.03 - 6.66	3.34	\$ 9.3	2.34 years
Options granted	8,092,915	2.87 - 5.39	4.49		
Options cancelled	(1,101,849)	2.03 - 6.66	3.71		
Options expired	(3,010,367)	2.03 - 6.66	3.62		
Options exercised	(2,941,180)	2.03 - 4.44	2.97		
Balance December 31, 2006	15,285,495	\$ 2.03 - \$6.66	\$ 3.93	\$ 82.7	2.54 years
Options exercisable ("vested"):					
December 31, 2004	15,507,847	\$ 2.45 - \$25.31	\$ 7.75		
December 31, 2005	8,453,296	2.59 - 6.66	3.88		
December 31, 2006	7,903,200	\$ 2.03 - \$6.66	\$ 3.48	\$ 52.5	1.78 years

Range of Exercise Prices	OSO units Outstanding at December 31, 2006			OSO units Exercisable at December 31, 2006	
	Number Outstanding	Weighted Average Remaining Life (years)	Weighted Average Initial Strike Price	Number Exercisable	Weighted Average Initial Strike Price
\$2.03 - \$3.02	5,422,623	2.61	\$ 2.46	3,673,073	\$ 2.43
3.39 - 4.90	4,744,598	2.22	4.02	2,897,904	3.76
5.16 - 6.66	5,118,274	2.76	5.41	1,332,223	5.75
	<u>15,285,495</u>	2.54	\$ 3.93	<u>7,903,200</u>	\$ 3.48

In the table above, the weighted average initial strike price represents the values used to calculate the theoretical value of OSO units on the grant date and the intrinsic value represents the value of OSO units that have outperformed the S&P 500 Index as of December 31, 2006.

The total realized value of OSO units exercised for the years ended December 31, 2006, 2005 and 2004 were \$20 million, \$6 million and \$10 million, respectively. For the twelve months ended December 31, 2006, 2005 and 2004, respectively, the Company issued 3.8 million, 2.7 million and 2.1 million shares of Level 3 common stock upon the exercise of OSO units. The number of shares of Level 3 stock issued upon exercise of an OSO unit varies based upon the relative performance of Level 3's stock price and the S&P 500 Index between the initial grant date and exercise date of the OSO unit.

At December 31, 2006, based on the Level 3 common stock price and post-multiplier values, the Company was obligated to issue 9.4 million shares for vested and exercisable OSOs as the percentage increase in the S&P 500 Index exceeded the percentage increase in the Level 3 stock price for all grants.

In July 2000, the Company adopted a convertible outperform stock option program ("C-OSO") as an extension of the existing OSO plan. The program was a component of the Company's ongoing employee retention efforts and offered similar features to those of an OSO, but provided an employee with the greater of the value of a single share of the Company's common stock at exercise, or the calculated OSO value of a single OSO at the time of exercise.

C-OSO awards were made to eligible employees employed on the date of the grant. The awards were made in September 2000, December 2000, and September 2001. The awards granted in 2000 vested over three years as follows:  $\frac{1}{6}$  of each grant at the end of the first year, a further  $\frac{2}{6}$  at the end of the second year and the remaining  $\frac{3}{6}$  in the third year. The September 2001 awards vested in equal quarterly installments over three years. Each award was immediately exercisable upon vesting. Awards expired four years from the date of the grant.

As of December 31, 2005, the Company had fully amortized the compensation expense in its financial statements for C-OSO units awarded in 2000 and 2001. The final series of C-OSO units granted to employees expired in 2005. There are no C-OSO units outstanding at December 31, 2005.

Transactions involving C-OSO units are summarized below:

	<u>Units</u>	<u>Option Price Per Unit</u>	<u>Weighted Average Option Price</u>
Balance December 31, 2003	4,064,682	\$ 3.82 - \$87.23	\$ 15.38
Options cancelled	(24,029)	3.82 - 87.23	3.82
Options expired	(101,096)	3.82 - 87.23	33.38
Options exercised	(1,162,778)	3.82 - 87.23	41.67
Balance December 31, 2004	2,776,779	3.82 - 3.82	3.82
Options cancelled	—	—	—
Options expired	(137,980)	3.82 - 3.82	3.82
Options exercised	(2,638,799)	3.82 - 3.82	3.82
Balance December 31, 2005	—	\$ —	\$ —
Options exercisable:			
December 31, 2004	2,776,779	\$ 3.82 - 3.82	\$ 3.82
December 31, 2005	—	—	—

### ***Restricted Stock and Units***

In 2006, 2005 and 2004, approximately 5.9 million, 24.6 million and 0.8 million restricted stock shares or restricted stock units, respectively, were awarded to employees and non-employee members of the Board of Directors. The restricted stock units and shares were granted to the recipients at no cost. Restrictions on transfer lapse over one to four year periods. The fair value of restricted stock units and shares awarded in 2006 of \$27 million was calculated using the value of the Level 3 common stock on the grant date and is being amortized over the restriction lapse periods of the awards. The fair value of restricted stock units and shares awarded in 2005 and 2004 of \$50 million and \$2 million, respectively, was calculated using the value of the Level 3 common stock the day prior to the award and is being amortized over the restriction lapse periods of the awards. As of December 31, 2006, the total compensation cost related to nonvested restricted stock or restricted stock units not yet recognized was \$29 million, and the weighted average period over which this cost will be recognized is 2.9 years.

The changes in restricted stock and restricted stock units are shown in the following table:

	<u>Number</u>	<u>Weighted Average Grant Date Fair Value</u>
Nonvested at December 31, 2003	787,358	\$ 5.35
Stock and units granted	696,947	3.52
Lapse of restrictions	(472,020)	5.42
Stock and units forfeited	(32,128)	4.15
Nonvested at December 31, 2004	980,157	4.05
Stock and units granted	24,627,233	2.03
Lapse of restrictions	(719,716)	3.80
Stock and units forfeited	(1,510,831)	2.12
Nonvested at December 31, 2005	23,376,843	2.06
Stock and units granted	5,874,765	4.65
Lapse of restrictions	(7,225,744)	2.13
Stock and units forfeited	(2,575,137)	2.45
Nonvested at December 31, 2006	19,450,727	\$ 2.76

The Weighted Average Grant Date Fair Value of restricted stock and restricted stock units granted during the years ended December 31, 2006, 2005 and 2004 were \$4.65, \$2.03 and \$3.52, respectively. The

total fair value of restricted stock and restricted stock units vested during the years ended December 31, 2006, 2005 and 2004 was \$15 million, \$2 million and \$2 million, respectively.

### ***Shareworks and 401(k) Plans***

The Company had two plans under its Shareworks program: the Match Plan and the Grant Plan. In December 2002, in order to provide employees opportunities to diversify their investments in Company-sponsored savings and retirement plans, the Company decided to enhance the 401(k) plan by introducing a Company match on employee contributions. At the same time the Company determined that, effective January 1, 2003, the Shareworks Match Plan would be discontinued and the Shareworks Grant Plan would be rolled into the 401(k) plan.

**Match Plan** —The Match Plan was suspended on January 1, 2003. Prior to this date, the Match Plan allowed eligible employees to defer between 1% and 7% of their eligible compensation to purchase Level 3 common stock at the average stock price for the quarter. Full time employees of the communications business and certain information services businesses were considered eligible on the first day of the calendar quarter after their hire. The Company matched the shares purchased by the employee on a one-for-one basis. Stock purchased with payroll deductions was fully vested. Stock purchased with the Company's matching contributions vested three years after the end of the quarter in which it was made. Effective January 1, 2003, past contributions to the Match Plan continued to vest, however, there will be no further contributions to the Plan by employees or the Company.

The Company's quarterly matching contribution was amortized to compensation expense over the vesting period of 36 months.

As of December 31, 2005 the Company had fully amortized to compensation expense the value of the matching contributions and all matching contributions were fully vested. During the second quarter of 2005, the Company reversed \$3 million of non-cash expense in Europe attributable to the discontinuance of certain equity compensation programs.

**401(k) Plan** —The Company and its subsidiaries offer their qualified employees the opportunity to participate in a defined contribution retirement plan qualifying under the provisions of Section 401(k) of the Internal Revenue Code ("401(k) Plan"). Each employee is eligible to contribute, on a tax deferred basis, a portion of annual earnings generally not to exceed \$15,000 in 2006. The Company matches 100% of employee contributions up to 7% of eligible earnings or applicable regulatory limits for employees of the communications businesses.

The Company's matching contributions are made with Level 3 common stock based on the closing stock price on each pay date. Employees are able to diversify the Company's matching contribution as soon as it is made, even if they are not fully vested. The Company's matching contributions will vest ratably over the first three years of service or over such shorter period until the employee has completed three years of service at such time the employee is then 100% vested in all Company matching contributions. The Company made 401(k) Plan matching contributions of \$18 million, \$14 million and \$18 million for the year ended December 31, 2006, 2005 and 2004, respectively. The Company's matching contributions were recorded as selling, general and administrative expenses.

The Company made a discretionary contribution to the 401(k) plan in Level 3 common stock for the years ended December 31, 2006, 2005 and 2004 equal to three percent, three percent and two percent of eligible employees' earnings each year, respectively. The 2006 deposit is expected to be made into the employees' 401(k) accounts during the first quarter of 2007. The 2005 and 2004 deposits were made into the employees' 401(k) accounts during the first quarter of the subsequent year. Level 3 recorded an expense of \$11 million, \$8 million and \$7 million attributable for the discretionary contribution in 2006, 2005 and 2004, respectively.

The WilTel Communications employees began contributing to the Level 3 plan on June 17, 2006. On July 3, 2006, the WilTel Communications plan assets were merged into the Level 3 plan. Prior to June 17, 2006, employees of WilTel Communications that participated in the WilTel 401(k) Plan received an employer matching cash contribution of 100% of employee contributions up to 6% of eligible earnings or regulatory limits. The Company made matching cash contributions of \$3 million for the period from January 1 through June 16, 2006.

The Progress Telecom employees began contributing to the Level 3 plan on March 20, 2006. The Progress Telecom plan assets were merged into the Level 3 plan on August 7, 2006.

The ICG Communications employees began contributing to the Level 3 plan on July 1, 2006. There were no matching cash contributions for ICG Communications for the period of May 31, 2006, the date of acquisition, through July 1, 2006. The ICG Communications plan assets were merged into the Level 3 plan on September 1, 2006.

The TelCove and Looking Glass employees began contributing to the Level 3 plan on August 4, 2006 and September 9, 2006, respectively. The matching cash contributions made to the TelCove and Looking Glass plans for the period from the respective acquisition dates to the dates employees began contributing to the Level 3 plan was less than \$1 million each for TelCove and Looking Glass, respectively. The Looking Glass plan assets were merged into the Level 3 plan on November 1, 2006. The Company merged the TelCove plan assets into the Level 3 plan on January 2, 2007.

## (16) Income Taxes

An analysis of the income tax provision attributable to loss from continuing operations before income taxes for each of the three years ended December 31, 2006 follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	<u>(dollars in millions)</u>		
Current:			
United States Federal	\$ —	\$ (4)	\$ —
State	—	—	(1)
Foreign	(2)	(1)	—
	<u>(2)</u>	<u>(5)</u>	<u>(1)</u>
Deferred, net of changes in valuation allowances:			
United States Federal	—	—	—
State	—	—	—
Foreign	—	—	—
	<u>—</u>	<u>—</u>	<u>—</u>
Income Tax Provision	<u>\$ (2)</u>	<u>\$ (5)</u>	<u>\$ (1)</u>

The United States and foreign components of income (loss) from continuing operations before income taxes follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	<u>(dollars in millions)</u>		
United States	\$ (710)	\$ (717)	\$ (300)
Foreign	(78)	15	(177)
	<u>\$ (788)</u>	<u>\$ (702)</u>	<u>\$ (477)</u>



A reconciliation of the actual income tax provision and the tax computed by applying the U.S. federal rate (35%) to the loss from continuing operations before income taxes for each of the three years ended December 31, 2006 follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(dollars in millions)		
Computed Tax Benefit at Statutory Rate	\$ 276	\$ 246	\$ 167
State Income Tax Benefit	26	23	16
Stock Option Plan Exercises	3	(3)	(19)
Taxes on Extinguishments of Debt	(3)	—	(1)
Other	—	(11)	33
Change in Valuation Allowance	(304)	(260)	(197)
Income Tax Provision	<u>\$ (2)</u>	<u>\$ (5)</u>	<u>\$ (1)</u>

The components of the net deferred tax assets (liabilities) for the years ended December 31, 2006 and 2005 were as follows:

	<u>2006</u>	<u>2005</u>
	(dollars in millions)	
Deferred Tax Assets:		
Fixed assets	\$ 630	\$ 790
Accrued payroll and related benefits	309	299
Investment in securities	24	27
Investment in joint ventures	89	82
Unutilized tax net operating losses	2,673	2,249
Other assets or liabilities	30	38
Total Deferred Tax Assets	3,755	3,485
Deferred Tax Liabilities:		
Accrued liabilities and deferred revenue	(158)	(105)
Intangible assets from acquisitions	(72)	—
Total Deferred Tax Liabilities	(230)	(105)
Net Deferred Tax Assets before valuation allowance	3,525	3,380
Valuation Allowance Components:		
Net Deferred Tax Assets	(3,450)	(3,305)
Stockholders' Equity (primarily tax benefit from option exercises)	(75)	(75)
Net Non-Current Deferred Tax Assets after Valuation Allowance	<u>\$ —</u>	<u>\$ —</u>

Deferred income taxes are provided for the temporary differences between the financial reporting and tax basis of the Company's assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Net operating losses not utilized can be carried forward for 20 years to offset future taxable income. A valuation allowance has been recorded against deferred tax assets, as the Company is unable to conclude under relevant accounting standards that it is more likely than not that deferred tax assets will be realizable. The change in valuation allowance of \$304 million in the reconciliation of the computed tax benefit at statutory rate to the actual income tax provision excludes the reduction of valuation allowance associated with net deferred tax liabilities of businesses acquired during 2006 and the NOL utilized to offset the taxable gain on sale of Software Spectrum. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. The Company considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment.

For federal income tax reporting purposes, the Company has approximately \$7.0 billion of net operating loss carryforwards at December 31, 2006, net of previous carrybacks, available to offset future federal taxable income.

The net operating loss carryforwards expire through 2026 and are subject to examination by the tax authorities. The U.S. net operating loss carryforwards expire as follows (dollars in millions):

<u>Expiring December 31</u>	<u>Amount</u>
2018	\$ 3
2019	2
2020	660
2021	978
2022	1,329
2023	1,001
2024	974
2025	1,346
2026	741
	<u>\$ 7,034</u>

In addition, the Company has approximately \$52 million of net operating loss carryforwards for foreign locations at December 31, 2006, the majority of which have no expiration period.

The Internal Revenue Code contains provisions which may limit the net operating loss carryforwards available to be used in any given year upon the occurrence of certain events, including significant changes in ownership interests. If certain transactions occur with respect to Level 3's capital stock that result in a cumulative ownership change of more than 50 percentage points by 5-percent stockholders over a three-year period as determined under rules prescribed by the U.S. Internal Revenue Code and applicable regulations, annual limitations would be imposed with respect to our ability to utilize our net operating loss carryforwards and certain current deductions against any taxable income it achieves in future periods.

As of December 31, 2006, the Company has no plans to repatriate undistributed earnings of foreign subsidiaries as any earnings are deemed necessary to fund ongoing European operations and planned expansion. Undistributed earnings of foreign subsidiaries that are permanently invested, and for which no deferred taxes have been provided, amounted to zero and \$15 million as of December 31, 2006 and 2005, respectively.

#### **(17) Stockholders' Equity**

During 2006, Level 3 completed the sale of 125 million shares of its common stock, par value \$0.01 per share, at \$4.55 per share in an underwritten public offering. Level 3 received proceeds of \$543 million net of \$26 million in transaction costs.

During 2004, the Company's stockholders approved a proposal at the Company's 2004 annual meeting for the reservation of an additional 80 million shares of common stock under the Company's 1995 Stock Plan.

The Level 3 1995 Stock Plan permits option holders to tender shares to the Company to cover income taxes due on option exercises.

Issuances of common stock, for option exercises, equity offerings and acquisitions for the three years ended December 31, 2006 are shown below.

	<u>Outstanding Common Shares</u>
December 31, 2003	677,828,634
Option, Shareworks and 401(k) Activity	8,668,087
December 31, 2004	686,496,721
Option, Shareworks and 401(k) Activity	16,271,097
WilTel Communications Group, LLC Acquisition	115,000,000
December 31, 2005	817,767,818
Equity Offering	125,000,000
Option, Shareworks and 401(k) Activity	18,737,450
2006 Acquisitions	216,917,837
December 31, 2006	<u>1,178,423,105</u>

#### (18) Industry and Geographic Data

SFAS No. 131 “Disclosures about Segments of an Enterprise and Related Information” defines operating segments as components of an enterprise for which separate financial information is available and which is evaluated regularly by the Company’s chief operating decision maker, or decision making group, in deciding how to allocate resources and assess performance. Operating segments are managed separately and represent separate strategic business units that offer different products and serve different markets. The Company’s current reportable segments include: communications and coal mining (See Note 1). Other primarily includes corporate assets and overhead not attributable to a specific segment. In the third quarter of 2006, the Company exited the information services business as a result of the sale of Software Spectrum. Segment information has been revised due to reclassification of the information services businesses as discontinued operations in the consolidated financial statements (See Note 3).

Adjusted OIBDA, as defined by the Company, consists of operating income (loss) before (1) depreciation and amortization expense, (2) stock-based compensation expense included within selling, general and administrative expenses on the consolidated statements of operations and (3) any non-cash impairment costs included within restructuring and impairment expenses all as reported on the consolidated statements of operations. The Company excludes stock-based compensation due to the recording of non-cash compensation expense under the provisions of SFAS No. 123R. Adjusted OIBDA is an important part of the Company’s internal reporting and is an indicator of profitability and operating performance used by the chief operating decision maker or decision making group to evaluate performance and allocate resources. It is a commonly used indicator in the capital-intensive communications industry to analyze companies on the basis of operating performance over time. Adjusted OIBDA is not intended to represent net income or cash flow for the periods presented, is not calculated consistently with the commonly used metric “EBITDA”, and is not recognized under generally accepted accounting principles (“GAAP”) but is used by management to assess segment results and allocate resources.

The data presented in the following tables includes information for the twelve months ended December 31, 2006, 2005 and 2004 for all statement of operations and cash flow information presented, and as of December 31, 2006 and 2005 for all balance sheet information presented. Information related to the acquired businesses is included from their respective acquisition dates. Revenue and the related expenses are attributed to countries based on where services are provided.

Industry and geographic segment financial information follows. Certain prior year information has been reclassified to conform to the 2006 presentation.

	<u>Communications</u>	<u>Coal Mining</u>	<u>Other</u>	<u>Total</u>
	(dollars in millions)			
<b>2006</b>				
Revenue:				
North America	\$ 3,121	\$ 67	\$ —	\$ 3,188
Europe	190	—	—	190
Asia	—	—	—	—
	<u>\$ 3,311</u>	<u>\$ 67</u>	<u>\$ —</u>	<u>\$ 3,378</u>
Adjusted OIBDA:				
North America	\$ 636	\$ 8	\$ (3)	
Europe	41	—	—	
Asia	—	—	—	
	<u>\$ 677</u>	<u>\$ 8</u>	<u>\$ (3)</u>	
Net Capital Expenditures:				
North America	\$ 346	\$ 1	\$ —	\$ 347
Europe	45	—	—	45
Asia	—	—	—	—
	<u>\$ 391</u>	<u>\$ 1</u>	<u>\$ —</u>	<u>\$ 392</u>
Depreciation and Amortization:				
North America	\$ 661	\$ 1	\$ —	\$ 662
Europe	68	—	—	68
Asia	—	—	—	—
	<u>\$ 729</u>	<u>\$ 1</u>	<u>\$ —</u>	<u>\$ 730</u>

	<u>Communications</u>	<u>Coal Mining</u>	<u>Other</u>	<u>Total</u>
	(dollars in millions)			
<b>2005</b>				
Revenue:				
North America	\$ 1,496	\$ 74	\$ —	\$ 1,570
Europe	149	—	—	149
Asia	—	—	—	—
	<u>\$ 1,645</u>	<u>\$ 74</u>	<u>\$ —</u>	<u>\$ 1,719</u>
Adjusted OIBDA:				
North America	\$ 437	\$ 16	\$ (3)	
Europe	21	—	—	
Asia	—	—	—	
	<u>\$ 458</u>	<u>\$ 16</u>	<u>\$ (3)</u>	
Net Capital Expenditures:				
North America	\$ 271	\$ 2	\$ —	\$ 273
Europe	27	—	—	27
Asia	—	—	—	—
	<u>\$ 298</u>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ 300</u>
Depreciation and Amortization:				
North America	\$ 560	\$ 5	\$ —	\$ 565
Europe	82	—	—	82
Asia	—	—	—	—
	<u>\$ 642</u>	<u>\$ 5</u>	<u>\$ —</u>	<u>\$ 647</u>

	<u>Communications</u>	<u>Coal Mining</u>	<u>Other</u>	<u>Total</u>
	(dollars in millions)			
<b>2004</b>				
Revenue:				
North America	\$ 1,546	\$ 91	\$ —	\$ 1,637
Europe	139	—	—	139
Asia	—	—	—	—
	<u>\$ 1,685</u>	<u>\$ 91</u>	<u>\$ —</u>	<u>\$ 1,776</u>
Adjusted OIBDA:				
North America	\$ 459	\$ 18	\$ (1)	
Europe	4	—	—	
Asia	—	—	—	
	<u>\$ 463</u>	<u>\$ 18</u>	<u>\$ (1)</u>	
Net Capital Expenditures:				
North America	\$ 240	\$ 2	\$ —	\$ 242
Europe	30	—	—	30
Asia	—	—	—	—
	<u>\$ 270</u>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ 272</u>
Depreciation and Amortization:				
North America	\$ 571	\$ 6	\$ —	\$ 577
Europe	94	—	—	94
Asia	—	—	—	—
	<u>\$ 665</u>	<u>\$ 6</u>	<u>\$ —</u>	<u>\$ 671</u>

	<u>Communications</u>	<u>Discontinued Information Services</u>	<u>Coal Mining</u>	<u>Other</u>	<u>Total</u>
	(dollars in millions)				
<b>Identifiable Assets</b>					
<i>December 31, 2006</i>					
North America	\$ 7,193	\$ —	\$ 98	\$ 1,897	\$ 9,188
Europe	777	—	—	29	806
Asia	—	—	—	—	—
	<u>\$ 7,970</u>	<u>\$ —</u>	<u>\$ 98</u>	<u>\$ 1,926</u>	<u>\$ 9,994</u>
<i>December 31, 2005</i>					
North America	\$ 5,782	\$ 631	\$ 90	\$ 810	\$ 7,313
Europe	716	206	—	18	940
Asia	—	24	—	—	24
	<u>\$ 6,498</u>	<u>\$ 861</u>	<u>\$ 90</u>	<u>\$ 828</u>	<u>\$ 8,277</u>

	<u>Communications</u>	<u>Discontinued Information Services</u> (dollars in millions)	<u>Coal Mining</u>	<u>Other</u>	<u>Total</u>
<b>Long-Lived Assets (excluding Goodwill)</b>					
<i>December 31, 2006</i>					
North America	\$ 6,362	\$ —	\$ 88	\$ —	\$ 6,450
Europe	747	—	—	—	747
Asia	—	—	—	—	—
	<u>\$ 7,109</u>	<u>\$ —</u>	<u>\$ 88</u>	<u>\$ —</u>	<u>\$ 7,197</u>
<i>December 31, 2005</i>					
North America	\$ 5,502	\$ 68	\$ 75	\$ —	\$ 5,645
Europe	696	1	—	—	697
Asia	—	1	—	—	1
	<u>\$ 6,198</u>	<u>\$ 70</u>	<u>\$ 75</u>	<u>\$ —</u>	<u>\$ 6,343</u>
<b>Goodwill(1)</b>					
<i>December 31, 2006</i>					
North America	\$ 408	\$ —	\$ —	\$ —	\$ 408
Europe	—	—	—	—	—
Asia	—	—	—	—	—
	<u>\$ 408</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 408</u>
<i>December 31, 2005</i>					
North America	\$ 70	\$ 194	\$ —	\$ —	\$ 264
Europe	—	—	—	—	—
Asia	—	—	—	—	—
	<u>\$ 70</u>	<u>\$ 194</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 264</u>

- (1) The December 31, 2005 Discontinued Information Services presented in the table above includes \$194 million of goodwill related to Software Spectrum. This goodwill is included in the Consolidated Balance Sheet in Noncurrent Assets of Discontinued Operations.

Communications revenue is grouped into three categories: 1) Core Communications Services (including transport and infrastructure services, wholesale IP and data services, voice services and Vyvx services) 2) Other Communications Services (including managed modem and its related reciprocal compensation, DSL aggregation, and legacy managed IP services), and 3) SBC Contract Services. This revenue reporting structure reflects how the Company's management currently invests and manages cash flows in the communications business.

		Services			
		Core	Other (dollars in millions)	SBC Contact Services	Total
Communications Revenue					
2006					
North America		\$ 1,787	\$ 441	\$ 893	\$ 3,121
Europe		186	4	—	190
Asia		—	—	—	—
		<u>\$ 1,973</u>	<u>\$ 445</u>	<u>\$ 893</u>	<u>\$ 3,311</u>
2005					
North America		\$ 818	\$ 653	\$ 25	\$ 1,496
Europe		144	5	—	149
Asia		—	—	—	—
		<u>\$ 962</u>	<u>\$ 658</u>	<u>\$ 25</u>	<u>\$ 1,645</u>
2004					
North America		\$ 664	\$ 882	\$ —	\$ 1,546
Europe		129	10	—	139
Asia		—	—	—	—
		<u>\$ 793</u>	<u>\$ 892</u>	<u>\$ —</u>	<u>\$ 1,685</u>

Transport and Infrastructure includes \$2 million, \$130 million and \$107 million of termination revenue for the years ended December 31, 2006, 2005 and 2004, respectively. Wholesale IP and data includes \$7 million, \$1 million and \$5 million of termination revenue for the years ended December 31, 2006, 2005 and 2004, respectively. SBC Contract Services includes \$2 million of termination revenue for the year ended December 31 2006. No termination revenue was recorded for SBC in 2005 and 2004.

The majority of North American revenue consists of services delivered within the United States. The majority of European revenue consists of services delivered within the United Kingdom but also includes France and Germany. Transoceanic revenue is allocated to Europe.

The following information provides a reconciliation of Net Income (Loss) to Adjusted OIBDA by operating segment, as defined by the Company, for the years ended December 31, 2006, 2005 and 2004:

## 2006

	<u>Communications</u>	<u>Discontinued Information Services</u> (dollars in millions)	<u>Coal Mining</u>	<u>Other</u>
Net Income (Loss)	\$ (800 )	\$ 46	\$ 7	\$ 3
Income from Discontinued Operations	—	(46)	—	—
Income Tax Provision (Benefit)	4	—	—	(2)
Total Other (Income) Expense	652	—	—	(4)
Operating Income (Loss)	(144 )	—	7	(3)
Non-Cash Impairment Charge	8	—	—	—
Depreciation and Amortization Expense	729	—	1	—
Non-Cash Compensation Expense	84	—	—	—
Adjusted OIBDA	<u>\$ 677</u>	<u>\$ —</u>	<u>\$ 8</u>	<u>\$ (3)</u>

## 2005

	<u>Communications</u>	<u>Discontinued Information Services</u> (dollars in millions)	<u>Coal Mining</u>	<u>Other</u>
Net Income (Loss)	\$ (720)	\$ 69	\$ 16	\$ (3)
Income from Discontinued Operations	—	(69)	—	—
Income Tax Provision	2	—	2	1
Total Other (Income) Expense	474	—	(7)	(1)
Operating Income (Loss)	(244)	—	11	(3)
Non-Cash Impairment Charge	9	—	—	—
Depreciation and Amortization Expense	642	—	5	—
Non-Cash Compensation Expense	51	—	—	—
Adjusted OIBDA	<u>\$ 458</u>	<u>\$ —</u>	<u>\$ 16</u>	<u>\$ (3)</u>

## 2004

	<u>Communications</u>	<u>Discontinued Information Services</u> (dollars in millions)	<u>Coal Mining</u>	<u>Other</u>
Net Income (Loss)	\$ (509)	\$ 20	\$ 11	\$ 20
Income from Discontinued Operations	—	(20)	—	—
Income Tax Provision	—	—	1	—
Total Other (Income) Expense	264	—	—	(21)
Operating Income (Loss)	(245)	—	12	(1)
Depreciation and Amortization Expense	665	—	6	—
Non-Cash Compensation Expense	43	—	—	—
Adjusted OIBDA	<u>\$ 463</u>	<u>\$ —</u>	<u>\$ 18</u>	<u>\$ (1)</u>



## **(19) Commitments, Contingencies and Other Items**

### *Right of Way Litigation*

In April 2002, Level 3 Communications, Inc., and two of its subsidiaries were named as a defendant in *Bauer, et. al. v. Level 3 Communications, LLC, et al.*, a purported class action covering 22 states, filed in state court in Madison County, Illinois. In July 2001, Level 3 was named as a defendant in *Koyle, et. al. v. Level 3 Communications, Inc., et. al.*, a purported two state class action filed in the U.S. District Court for the District of Idaho. In November of 2005, the court granted class certification only for the state of Idaho, which decision is on appeal. In September 2002, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *Smith et. al. v. Sprint Communications Company, L.P., et al.*, a purported nationwide class action filed in the United States District Court for the Northern District of Illinois. In April 2005, the Smith plaintiffs filed a Fourth Amended Complaint which did not include Level 3 or Williams Communications, Inc. as a party, thus ending both companies' involvement in the Smith case. On February 17, 2005, Level 3 Communications, LLC and Williams Communications, LLC were named as defendants in *McDaniel, et. al., v. Qwest Communications Corporation, et al.*, a purported class action covering 10 states filed in the United States District Court for the Northern District of Illinois. These actions involve the companies' right to install its fiber optic cable network in easements and right-of-ways crossing the plaintiffs' land. In general, the companies obtained the rights to construct their networks from railroads, utilities, and others, and have installed their networks along the rights-of-way so granted. Plaintiffs in the purported class actions assert that they are the owners of lands over which the companies' fiber optic cable networks pass, and that the railroads, utilities, and others who granted the companies the right to construct and maintain their networks did not have the legal authority to do so. The complaints seek damages on theories of trespass, unjust enrichment and slander of title and property, as well as punitive damages. The companies have also received, and may in the future receive, claims and demands related to rights-of-way issues similar to the issues in these cases that may be based on similar or different legal theories. To date, other than as noted above, all adjudicated attempts to have class action status granted on complaints filed against the companies or any of their subsidiaries involving claims and demands related to rights-of-way issues have been denied.

It is still too early for the Company to reach a conclusion as to the ultimate outcome of these actions. However, management believes that the Company and its subsidiaries have substantial defenses to the claims asserted in all of these actions (and any similar claims which may be named in the future), and intends to defend them vigorously if a satisfactory form of settlement is not approved.

The Company and its subsidiaries are parties to many other legal proceedings. Management believes that any resulting liabilities for these legal proceedings, beyond amounts reserved, will not materially affect the Company's financial condition or future results of operations, but could affect future cash flows.

### *Operating Leases*

The Company is leasing rights-of-way, facilities and other assets under various operating leases which, in addition to rental payments, may require payments for insurance, maintenance, property taxes and other executory costs related to the lease. Certain leases provide for adjustments in lease cost based upon adjustments in the consumer price index and increases in the landlord's management costs.

The rights-of-way agreements have various expiration dates through 2049. Payments under these right-of-way agreements were \$62 million in 2006, \$30 million in 2005 and \$31 million in 2004.

The Company has obligations under non-cancelable operating leases for certain colocation and office facilities, including lease obligations for which facility related restructuring charges have been recorded. The lease agreements have various expiration dates through 2072. Rent expense, including common area maintenance, under non-cancelable lease agreements was \$132 million in 2006, \$76 million in 2005 and \$88 million in 2004.

For those leases involving communications colocation and right-of-way agreements, the Company anticipates that it will renew these leases under option provisions contained in the lease agreements given the significant cost to relocate the Company's network and other facilities.

Future minimum payments, including common area maintenance, for the next five years under right-of-way agreements and non-cancelable operating leases consist of the following at December 31, 2006 (dollars in millions):

	<b>Right-of-Way</b>		<b>Other</b>	
	<b>Agreements</b>	<b>Facilities</b>	<b>Assets</b>	<b>Total</b>
2007	\$ 61	\$ 116	\$ 2	\$ 179
2008	58	118	5	181
2009	49	98	—	147
2010	45	84	—	129
2011	43	76	—	119
Thereafter	597	373	—	970
<b>Total</b>	<b>\$ 853</b>	<b>\$ 865</b>	<b>\$ 7</b>	<b>\$ 1,725</b>

#### *Other*

It is customary in Level 3's industries to use various financial instruments in the normal course of business. These instruments include items such as letters of credit. Letters of credit are conditional commitments issued on behalf of Level 3 in accordance with specified terms and conditions. As of December 31, 2006 and 2005, Level 3 had outstanding letters of credit of approximately \$45 million and \$19 million, respectively, which are collateralized by cash and are reflected on the consolidated balance sheet as restricted cash. The Company does not believe it is practicable to estimate the fair value of the letters of credit and does not believe exposure to loss is likely nor material.

#### **(20) Condensed Consolidating Financial Information**

As discussed in Note 13, in October 2003, Level 3 Financing issued \$500 million 10.75% Senior Notes due in 2011. These notes are unsecured obligations of Level 3 Financing, however, they are also jointly and severally and fully and unconditionally guaranteed on an unsecured senior basis by Level 3 Communications, Inc. and Level 3 Communications, LLC (a wholly owned subsidiary). The 10.75% Senior Notes were registered with the Securities and Exchange Commission in 2005.

In March 2006, Level 3 Financing issued \$150 million Floating Rate Senior Notes due 2011 and \$250 million 12.25% Senior Notes due 2013. In addition, on April 6, 2006, Level 3 Financing issued an additional \$300 million of 12.25% Senior Notes due 2013. Level 3 Financing issued \$600 million of its 9.25% Senior Notes due 2014 in October 2006 and issued an additional \$650 million of its 9.25% Senior Notes due 2014 in December 2006. These notes are unsecured obligations of Level 3 Financing, however, they are fully and unconditionally guaranteed on an unsecured senior basis by Level 3 Communications, Inc. and with respect to the Floating Rate Senior Notes due 2011 and the 12.25% Senior Notes due 2013, Level 3 Communications, LLC. Upon receipt of all applicable state regulatory approvals that are currently being obtained, Level 3 Communications, LLC will also severally and fully and unconditionally guarantee on an unsecured basis the 9.25% Senior Notes due 2014.

In conjunction with the registration of the 10.75% Senior Notes, Floating Rate Senior Notes due 2011, 12.25% Senior Notes due 2013 and the expected registration of the 9.25% Senior Notes due 2014, the accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10 "Financial statements of guarantors and affiliates whose securities collateralize an issue registered or being registered."

Condensed Consolidating Statements of Operations for the years ended December 31, 2006, 2005 and 2004 follow. Level 3 Communications, LLC leases equipment and certain facilities from other wholly owned subsidiaries of Level 3 Communications, Inc. These transactions are eliminated in the consolidated results of the Company.

**Condensed Consolidating Statements of Operations**

**For the year ended December 31, 2006**

**(unaudited)**

	<u>Level 3 Communications, Inc.</u>	<u>Level 3 Financing, Inc.</u>	<u>Level 3 Communications, LLC</u> (dollars in millions)	<u>Other Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
Revenue	\$ —	\$ —	\$ 1,304	\$ 2,270	\$ (196)	\$ 3,378
Costs and Expenses:						
Cost of Revenue	—	—	525	1,179	(187)	1,517
Depreciation and Amortization	—	—	358	372	—	730
Selling, General and Administrative	6	—	816	445	(9)	1,258
Restructuring and Impairment Charges	—	—	9	4	—	13
Total Costs and Expenses	6	—	1,708	2,000	(196)	3,518
Operating Income (Loss)	(6)	—	(404)	270	—	(140)
Other Income (Loss), net:						
Interest Income	16	1	40	7	—	64
Interest Expense	(432)	(207)	—	(9)	—	(648)
Interest Income (Expense) Affiliates, net	860	666	(1,572)	46	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(1,209)	(1,561)	141	—	2,629	—
Other Income (Expense)	27	(108)	7	10	—	(64)
Other Income (Loss)	(738)	(1,209)	(1,384)	54	2,629	(648)
Income (Loss) from Continuing Operations Before Income Taxes	(744)	(1,209)	(1,788)	324	2,629	(788)
Income Tax (Expense) Benefit	—	—	—	(2)	—	(2)
Income (Loss) from Continuing Operations	(744)	(1,209)	(1,788)	322	2,629	(790)
Income from Discontinued Operations	—	—	—	46	—	46
Net Income (Loss)	<u>\$ (744)</u>	<u>\$ (1,209)</u>	<u>\$ (1,788)</u>	<u>\$ 368</u>	<u>\$ 2,629</u>	<u>\$ (744)</u>

**Condensed Consolidating Statements of Operations**

**For the year ended December 31, 2005**

**(unaudited)**

	<u>Level 3 Communications, Inc.</u>	<u>Level 3 Financing, Inc.</u>	<u>Level 3 Communications, LLC</u> (dollars in millions)	<u>Other Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
Revenue	\$ —	\$ —	\$ 1,457	\$ 440	\$ (178)	\$ 1,719
Costs and Expenses:						
Cost of Revenue	—	—	575	104	(163)	516
Depreciation and Amortization	—	—	444	203	—	647
Selling, General and Administrative	4	—	640	140	(15)	769
Restructuring and Impairment Charges	—	—	21	2	—	23
Total Costs and Expenses	4	—	1,680	449	(178)	1,955
Operating Income (Loss)	(4)	—	(223)	(9)	—	(236)
Other Income (Loss), net:						
Interest Income	19	1	11	4	—	35
Interest Expense	(390)	(133)	—	(7)	—	(530)
Interest Income (Expense) Affiliates, net	784	527	(1,336)	25	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(1,048)	(1,492)	(1)	—	2,541	—
Other Income (Expense)	1	—	12	16	—	29
Other Income (Loss)	(634)	(1,097)	(1,314)	38	2,541	(466)
Income (Loss) from Continuing Operations Before Income Taxes	(638)	(1,097)	(1,537)	29	2,541	(702)
Income Tax Expense	—	—	—	(5)	—	(5)
Income (Loss) from Continuing Operations	(638)	(1,097)	(1,537)	24	2,541	(707)
Income from Discontinued Operations	—	49	—	20	—	69
Net Income (Loss)	<u>\$ (638)</u>	<u>\$ (1,048)</u>	<u>\$ (1,537)</u>	<u>\$ 44</u>	<u>\$ 2,541</u>	<u>\$ (638)</u>

# Condensed Consolidating Statements of Operations

For the year ended December 31, 2004

(unaudited)

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC (dollars in millions)	Other Subsidiaries	Eliminations	Total
Revenue	\$ —	\$ —	\$ 1,514	\$ 554	\$ (292)	\$ 1,776
Costs and Expenses:						
Cost of Revenue	—	—	692	85	(274)	503
Depreciation and Amortization	—	—	423	248	—	671
Selling, General and Administrative	7	—	681	152	(18)	822
Restructuring and Impairment Charges	—	—	6	8	—	14
Total Costs and Expenses	7	—	1,802	493	(292)	2,010
Operating Income (Loss)	(7)	—	(288)	61	—	(234)
Other Income (Loss), net:						
Interest Income	—	—	11	2	—	13
Interest Expense	(405)	(61)	(13)	(6)	—	(485)
Interest Income (Expense) Affiliates, net	809	396	(1,206)	1	—	—
Equity in Net Earnings (Losses) of Subsidiaries	(907)	(1,243)	(1)	—	2,151	—
Other Income (Expense)	52	1	150	26	—	229
Other Income (Loss)	(451)	(907)	(1,059)	23	2,151	(243)
Income (Loss) from Continuing Operations Before Income Taxes	(458)	(907)	(1,347)	84	2,151	(477)
Income Tax Expense	—	—	—	(1)	—	(1)
Income (Loss) from Continuing Operations	(458)	(907)	(1,347)	83	2,151	(478)
Income from Discontinued Operations	—	—	—	20	—	20
Net Income (Loss)	<u>\$ (458)</u>	<u>\$ (907)</u>	<u>\$ (1,347)</u>	<u>\$ 103</u>	<u>\$ 2,151</u>	<u>\$ (458)</u>

Condensed Consolidating Balance Sheets as of December 31, 2006 and 2005 follow:

**Condensed Consolidating Balance Sheets**  
**December 31, 2006**  
(unaudited)

	<u>Level 3 Communications, Inc.</u>	<u>Level 3 Financing, Inc.</u>	<u>Level 3 Communications, LLC</u> (dollars in millions)	<u>Other Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
<b>Assets</b>						
Current Assets:						
Cash and cash equivalents	\$ 15	\$ 12	\$ 1,592	\$ 62	\$ —	\$ 1,681
Marketable securities	235	—	—	—	—	235
Restricted cash and securities	—	—	31	15	—	46
Accounts receivable, net	—	—	97	229	—	326
Due from (to) affiliates	11,183	6,432	(18,631)	1,016	—	—
Other	17	6	41	37	—	101
Total Current Assets	11,450	6,450	(16,870)	1,359	—	2,389
Property, Plant and Equipment, net	—	—	3,268	3,200	—	6,468
Marketable Securities	—	—	—	—	—	—
Restricted Cash and Securities	17	—	—	73	—	90
Goodwill and Other Intangibles, net	—	—	44	875	—	919
Investment in Subsidiaries	(6,419)	(10,170)	2,639	—	13,950	—
Other Assets, net	43	41	12	32	—	128
Total Assets	<u>\$ 5,091</u>	<u>\$ (3,679)</u>	<u>\$ (10,907)</u>	<u>\$ 5,539</u>	<u>\$ 13,950</u>	<u>\$ 9,994</u>
<b>Liabilities and Stockholders' Equity (Deficit)</b>						
Current Liabilities:						
Accounts payable	\$ —	\$ 1	\$ 160	\$ 230	\$ —	\$ 391
Current portion of long-term debt	—	—	—	5	—	5
Accrued payroll and employee benefits	—	—	59	33	—	92
Accrued interest	93	49	—	1	—	143
Deferred revenue	—	—	98	44	—	142
Other	1	2	56	97	—	156
Total Current Liabilities	94	52	373	410	—	929
Long-Term Debt, less current portion	4,581	2,688	—	88	—	7,357
Deferred Revenue	—	—	628	125	—	753
Other Liabilities	42	—	199	340	—	581
Stockholders' Equity (Deficit)	374	(6,419)	(12,107)	4,576	13,950	374
Total Liabilities and Stockholders' Equity (Deficit)	<u>\$ 5,091</u>	<u>\$ (3,679)</u>	<u>\$ (10,907)</u>	<u>\$ 5,539</u>	<u>\$ 13,950</u>	<u>\$ 9,994</u>

# Condensed Consolidating Balance Sheets

December 31, 2005

(unaudited)

	Level 3 Communications, Inc.	Level 3 Financing, Inc.	Level 3 Communications, LLC (dollars in millions)	Other Subsidiaries	Eliminations	Total
<b>Assets</b>						
Current Assets:						
Cash and cash equivalents	\$ 37	\$ 8	\$ 275	\$ 59	\$ —	\$ 379
Marketable securities	173	3	—	—	—	176
Restricted cash and securities	—	3	20	11	—	34
Accounts receivable, net	—	—	84	308	—	392
Due from (to) affiliates	10,117	4,613	(14,853)	123	—	—
Current assets of discontinued operations	—	—	—	597	—	597
Other	16	4	29	43	—	92
Total Current Assets	10,343	4,631	(14,445)	1,141	—	1,670
Property, Plant and Equipment, net	—	—	3,409	2,223	—	5,632
Marketable Securities	234	—	—	—	—	234
Restricted Cash and Securities	16	—	—	59	—	75
Goodwill and Other Intangibles, net	—	—	85	206	—	291
Investment in Subsidiaries	(6,251)	(9,651)	802	—	15,100	—
Noncurrent Assets of Discontinued Operations						
Operations	—	—	—	264	—	264
Other Assets, net	44	21	14	32	—	111
Total Assets	<u>\$ 4,386</u>	<u>\$ (4,999)</u>	<u>\$ (10,135)</u>	<u>\$ 3,925</u>	<u>\$ 15,100</u>	<u>\$ 8,277</u>
<b>Liabilities and Stockholders' Equity (Deficit)</b>						
Current Liabilities:						
Accounts payable	\$ —	\$ 1	\$ 141	\$ 225	\$ —	\$ 367
Current portion of long-term debt	—	—	—	—	—	—
Accrued payroll and employee benefits	—	—	46	33	—	79
Accrued interest	83	18	—	1	—	102
Deferred revenue	—	—	138	61	—	199
Current liabilities of discontinued operations	—	—	—	539	—	539
Other	1	2	50	84	—	137
Total Current Liabilities	84	21	375	943	—	1,423
Long-Term Debt, less current portion	4,722	1,230	—	71	—	6,023
Deferred Revenue	—	—	633	104	—	737
Other Liabilities	56	1	196	317	—	570
Stockholders' Equity (Deficit)	(476)	(6,251)	(11,339)	2,490	15,100	(476)
Total Liabilities and Stockholders' Equity (Deficit)	<u>\$ 4,386</u>	<u>\$ (4,999)</u>	<u>\$ (10,135)</u>	<u>\$ 3,925</u>	<u>\$ 15,100</u>	<u>\$ 8,277</u>



**Condensed Consolidating Statements of Cash Flows**  
**For the year ended December 31, 2006**  
(unaudited)

	<u>Level 3 Communications, Inc.</u>	<u>Level 3 Financing, Inc.</u>	<u>Level 3 Communications, LLC</u> (dollars in millions)	<u>Other Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
Net Cash Provided by (Used in)						
Operating Activities of Continuing Operations	\$ (380)	\$ (183)	\$ 62	\$ 722	\$ —	\$ 221
Cash Flows from Investing Activities:						
Proceeds from sale and maturity of marketable securities	175	5	100	—	—	280
Purchases of marketable securities	—	—	(98)	—	—	(98)
Decrease (increase) in restricted cash and securities	1	2	(10)	(14)	—	(21)
Capital expenditures	—	—	(166)	(226)	—	(392)
Investments and acquisitions	—	—	(761)	12	—	(749)
Proceeds from sale of discontinued operations, net of cash sold	—	—	—	307	—	307
Advances to discontinued operations, net	—	—	—	18	—	18
Proceeds from sale of property, plant and equipment and other assets	—	—	6	1	—	7
Net Cash Provided by (Used in) Investing Activities	176	7	(929)	98	—	(648)
Cash Flows from Financing Activities:						
Long-term debt borrowings, net of issuance costs	326	1,930	—	—	—	2,256
Payments on long-term debt, including current portion (net of restricted cash)	(513)	(596)	—	(1)	—	(1,110)
Equity offering	543	—	—	—	—	543
Increase (decrease) due from affiliates, net	(174)	(1,154)	2,170	(842)	—	—
Net Cash Provided by (Used in) Financing Activities	182	180	2,170	(843)	—	1,689
Net Cash Used in Discontinued Operations	—	—	—	(43)	—	(43)
Effect of Exchange Rates on Cash and Cash Equivalents	—	—	14	(4)	—	10
Net Change in Cash and Cash Equivalents	(22)	4	1,317	(70)	—	1,229
Cash and Cash Equivalents at Beginning of Year (includes cash of discontinued operations)	37	8	275	132	—	452
Cash and Cash Equivalents at End of Year	<u>\$ 15</u>	<u>\$ 12</u>	<u>\$ 1,592</u>	<u>\$ 62</u>	<u>\$ —</u>	<u>\$ 1,681</u>

**Condensed Consolidating Statements of Cash Flows**

**For the year ended December 31, 2005**

**(unaudited)**

	<u>Level 3 Communications, Inc.</u>	<u>Level 3 Financing, Inc.</u>	<u>Level 3 Communications, LLC</u> (dollars in millions)	<u>Other Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
Net Cash Provided by (Used in)						
Operating Activities of						
Continuing Operations	\$ (306)	\$ (128)	\$ 226	\$ 90	\$ —	\$ (118)
Cash Flows from Investing						
Activities:						
Proceeds from sale and maturity of						
marketable securities	243	—	340	1	—	584
Purchases of marketable						
securities	(648)	—	—	—	—	(648)
Decrease (increase) in						
restricted cash and securities	—	3	(6)	(1)	—	(4)
Capital expenditures	—	—	(167)	(133)	—	(300)
Investments and						
acquisitions	(10)	—	(497)	128	—	(379)
Proceeds from sale of discontinued						
operations	—	82	—	—	—	82
Advances to discontinued						
operations, net	—	—	—	13	—	13
Proceeds from sale of property,						
plant and equipment and other						
assets	—	—	3	8	—	11
Net Cash Provided by (Used in)						
Investing Activities	(415)	85	(327)	16	—	(641)
Cash Flows from Financing						
Activities:						
Long-term debt borrowings,						
net of issuance costs	877	—	—	66	—	943
Payments on long-term						
debt, including current portion						
(net of						
restricted cash)	—	—	(26)	(104)	—	(130)
Increase (decrease) due from						
affiliates, net	(121)	34	170	(83)	—	—
Net Cash Provided by (Used in)						
Financing Activities	756	34	144	(121)	—	813
Net Cash Used in Discontinued						
Operations	—	—	—	(32)	—	(32)
Effect of Exchange Rates on						
Cash and Cash Equivalents	(1)	—	(13)	1	—	(13)
Net Change in Cash and Cash						
Equivalents	34	(9)	30	(46)	—	9
Cash and Cash Equivalents at						
Beginning of Year (includes						
cash of discontinued						
operations)	3	17	245	178	—	443
Cash and Cash Equivalents at						
End of Year (includes cash of						
discontinued operations)	<u>\$ 37</u>	<u>\$ 8</u>	<u>\$ 275</u>	<u>\$ 132</u>	<u>\$ —</u>	<u>\$ 452</u>

**Condensed Consolidating Statements of Cash Flows**

**For the year ended December 31, 2004**

**(unaudited)**

	<u>Level 3 Communications, Inc.</u>	<u>Level 3 Financing, Inc.</u>	<u>Level 3 Communications, LLC</u> (dollars in millions)	<u>Other Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
Net Cash Provided by (Used in)						
Operating Activities of						
Continuing Operations	\$ (379)	\$ (26)	\$ (30)	\$ 313	\$ —	\$ (122)
Cash Flows from Investing						
Activities:						
Proceeds from sale and						
maturity of marketable						
securities	—	—	70	—	—	70
Purchases of marketable						
securities	—	—	(410)	—	—	(410)
Decrease (increase) in						
restricted cash and						
securities	7	21	(4)	(3)	—	21
Capital expenditures	—	—	(174)	(98)	—	(272)
Acquisitions	—	—	(69)	—	—	(69)
Advances to discontinued						
operations, net	—	—	—	7	—	7
Proceeds from sale of property,						
plant and equipment, and						
other assets	—	—	9	51	—	60
Net Cash Provided by (Used in)						
Investing Activities	7	21	(578)	(43)	—	(593)
Cash Flows from Financing						
Activities:						
Long-term debt borrowings,						
net of issuance costs	272	713	—	—	—	985
Payments and repurchases of						
long-term debt, including						
current portion (net of						
restricted cash)	(949)	—	(75)	(3)	—	(1,027)
Increase (decrease) in due from						
affiliates, net	1,049	(706)	341	(684)	—	—
Net Cash Provided by (Used in)						
Financing Activities	372	7	266	(687)	—	(42)
Net Cash Provided by						
Discontinued Operations	—	—	—	56	—	56
Effect of Exchange Rates on Cash						
and Cash Equivalents	2	—	5	8	—	15
Net Change in Cash and Cash						
Equivalents	2	2	(337)	(353)	—	(686)
Cash and Cash Equivalents at						
Beginning of Year (includes						
cash of discontinued						
operations)	1	15	582	531	—	1,129
Cash and Cash Equivalents at End						
of Year (includes cash of						
discontinued operations)	<u>\$ 3</u>	<u>\$ 17</u>	<u>\$ 245</u>	<u>\$ 178</u>	<u>\$ —</u>	<u>\$ 443</u>

## **(21) Subsequent Events**

### **Broadwing Acquisition**

On January 3, 2007, Level 3 acquired Broadwing Corporation, a publicly held provider of optical network communications services. Under the terms of the merger agreement dated October 16, 2006, Level 3 paid \$8.18 of cash plus 1.3411 shares of Level 3 common stock for each share of Broadwing common stock outstanding at closing. In total, Level 3 paid approximately \$744 million of cash and issued approximately 122 million shares of the Company's common stock, valued at \$688 million. In connection with the acquisition of Broadwing, the Company guaranteed \$180 million in aggregate principal amount of Broadwing Corporation's 3.125% Convertible Senior Debentures due 2026 (the "Broadwing Debentures"). As of February 16, 2007, the holders of \$179 million in aggregate principal amount of the Broadwing Debentures had converted their Broadwing Debentures into a total of 17 million shares of Level 3 common stock and approximately \$106 million in cash pursuant to the terms of the indenture governing the Broadwing Debentures and the agreement whereby Level 3 acquired Broadwing. The remaining \$1 million in aggregate principal amount of the Broadwing Debentures was repurchased by Broadwing at 100% of par as required by the indenture governing the Broadwing Debentures.

Broadwing is a provider of optical network communications services. Broadwing delivers data, voice and media solutions to enterprises and service providers over its 19,000 mile intercity fiber network. Approximately half of Broadwing's revenue comes from the wholesale market, with business customers comprising the remaining revenue.

### **SAVVIS CDN Services Business Acquisition**

On January 23, 2007, Level 3 completed the acquisition of the SAVVIS Content Delivery Network ("CDN") services business of SAVVIS, Inc. ("SAVVIS CDN Business"). Under the terms of the agreement, Level 3 paid \$132.5 million in cash to acquire certain assets, including network elements, customer contracts, employees and intellectual property used in SAVVIS's CDN Business. The purchase price is subject to certain customary post closing working capital adjustments.

SAVVIS's CDN Business provides solutions that improve performance, reliability, scalability and reach of customers' online content. Initially developed in 1996 as Sandpiper Networks, the division developed, deployed and operated the world's first content delivery network. It has a globally distributed infrastructure in more than 20 countries.

### **2007 Debt Exchange**

In January 2007, in two separate transactions, Level 3 completed the exchanges of \$605 million in aggregate principal amount of its 10% Convertible Senior Notes due 2011 for a total of 196.8 million shares of Level 3's common stock. The shares of the Company's common stock issued pursuant to these announced exchanges are exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933, as amended. The Company expects to recognize a \$177 million loss on the early extinguishment of debt for the exchanges.

### **Senior Secured Term Loan Refinancing**

On February 8, 2007, Level 3 announced that its subsidiary, Level 3 Financing, Inc. is seeking to refinance its existing \$730 million amended and restated Senior Secured Term Loan due 2011 with a new Senior Secured Term Loan due 2014. The Company is seeking, among other things, to increase the principal to up to \$1.4 billion, reduce the interest rate payable under the agreement and extend the maturity from 2011 to 2014. There is no assurance that Level 3 will be successful in the refinancing of its Senior Secured Term Loan due 2011.

## **Issuance of 8.75% Senior Notes Due 2017 and Floating Rate Senior Notes Due 2015**

On February 14, 2007, Level 3 Financing, Inc. received \$982 million of net proceeds after transaction costs, from a private offering of \$700 million aggregate principal amount of its 8.75% Senior Notes due 2017 (the “8.75% Senior Notes”) and \$300 million aggregate principal amount of its Floating Rate Senior Notes due 2015 (the “2015 Floating Rate Senior Notes”). The 8.75% Senior Notes and the 2015 Floating Rate Senior Notes are senior unsecured obligations of Level 3 Financing, ranking equal in right of payment with all other senior unsecured obligations of Level 3 Financing. Level 3 Communications, Inc. has guaranteed the 8.75% Senior Notes and the 2015 Floating Rate Senior Notes. Interest on the 8.75% Senior Notes accrues at 8.75% interest per year and is payable semi-annually in cash on February 15th and August 15th beginning August 15, 2007. The principal amount of the 8.75% Senior Notes will be due on February 15, 2017. Interest on the 2015 Floating Rate Senior Notes accrues at LIBOR plus 3.75% per annum, reset semiannually. The interest rate was 9.15% as determined at the commencement of the interest period beginning February 15, 2007. Interest on the 2015 Floating Rate Senior notes is payable semi-annually in cash on February 15th and August 15th beginning August 15, 2007. The principal amount of the 2015 Floating Rate Senior Notes will be due on February 15, 2015.

The 8.75% Senior Notes and the 2015 Floating Rate Senior Notes are not currently registered under the Securities Act of 1933 or any state securities laws and, unless so registered, may not be offered or sold except pursuant to an applicable exemption from the registration requirements of the Securities Act of 1933 and applicable state securities laws. On February 14, 2006, Level 3, Level 3 Financing and the initial purchasers of the 8.75% Senior Notes and the 2015 Floating Rate Senior Notes entered into a registration rights agreement relating to the 8.75% Senior Notes and the 2015 Floating Rate Senior Notes pursuant to which Level 3 and Level 3 Financing agreed to file an exchange offer registration statement with the Securities and Exchange Commission.

Under the terms of the registration rights agreement, Level 3 Financing may be required to pay “Special Interest” in the event of a registration default. Special Interest will accrue at a rate of 0.50% per annum on the principal amount during the 90-day period after the occurrence of the registration default and will increase by 0.25% per annum at the end of each subsequent 90-day period. In no event will the rate exceed 1.00% per annum on the principal amount. If the exchange offer is completed on the terms and within the period contemplated by the registration rights agreement, no special interest will be payable. A registration default may occur if the Company fails to file with the Securities and Exchange Commission and have declared effective the exchange offer registration statement by certain dates as specified in the registration rights agreement. The Company believes that the likelihood of having to make Special Interest payments under the terms of the registration rights agreement is remote and, as a result, has not accrued a liability for any obligation under the agreement.

A portion of the debt represented by the 8.75% Senior Notes and the 2015 Floating Rate Senior Notes will constitute purchase money indebtedness under the indentures of Level 3 Communications, Inc. and the portion of the net proceeds that constitutes purchase money indebtedness will be used solely to fund the cost of construction, installation, acquisition, lease, development or improvement of any assets to be used in the Company’s communications business, including the cash purchase price of any past, pending or future acquisitions.

The 8.75% Senior Notes are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after February 15, 2012 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning November 1, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2012	104.375%
2013	102.917%
2014	101.458%
2015	100.000%

At any time or from time to time on or prior to February 15, 2010, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the 8.75% Senior Notes at a redemption price equal to 108.75% of the principal amount of the 8.75% Senior Notes so redeemed, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the 8.75% Senior Notes would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

The Floating Rate Senior Notes are subject to redemption at the option of Level 3 Financing in whole or in part, at any time or from time to time, on or after February 15, 2009 at the redemption prices (expressed as a percentage of principal amount) set forth below, plus accrued and unpaid interest thereon to the redemption date, if redeemed during the twelve months beginning November 1, of the years indicated below:

<u>Year</u>	<u>Redemption Price</u>
2009	102.0%
2010	101.0%
2011	100.0%

At any time or from time to time on or prior to February 15, 2010, Level 3 Financing may redeem up to 35% of the original aggregate principal amount of the 8.75% Senior Notes and the Floating Rate Senior Notes at a redemption price equal to 100.0% of the principal amount of the Floating Rate Senior Notes so redeemed, plus a premium equal to the interest rate on the Floating Rate Senior Notes applicable on the date that notice of the redemption is given, plus accrued and unpaid interest thereon (if any) to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date), with the net cash proceeds contributed to the capital of Level 3 Financing of one or more private placements to persons other than affiliates of Level 3 or underwritten public offerings of common stock of Level 3 resulting, in each case, in gross proceeds of at least \$100 million in the aggregate; provided, however, that at least 65% of the original aggregate principal amount of the 8.75% Senior Notes and the Floating Rate Senior Notes would remain outstanding immediately after giving effect to such redemption. Any such redemption shall be made within 90 days of such private placement or public offering upon not less than 30 nor more than 60 days' prior notice.

Each of Level 3 Communications, Inc. and Level 3 Financing has agreed to endeavor in good faith using commercially reasonable efforts to cause Level 3 Communications, LLC to obtain all material

governmental authorizations and consents required in order for it to guarantee the 8.75% Senior Notes and the 2015 Floating Rate Senior Notes at the earliest practicable date and to enter into a guarantee of these notes promptly thereafter. However, there can be no assurance that Parent and the Issuer will be successful in obtaining the required regulatory approvals to permit Level 3 Communications, LLC to guarantee these notes.

### **Redemptions and Tender Offers**

On February 15, 2007, Level 3 Communications, Inc. called for redemption all of its outstanding \$488 million aggregate principal amount of 12.875% Senior Notes due 2010 at a price equal to 102.146% of the principal amount thereof, all of its outstanding \$96 million aggregate principal amount of 11.25% Senior Notes due 2010 at a price equal to 101.875% of principal amount thereof and all of its outstanding € 104 million aggregate principal amount of 11.25% Senior Euro Notes due 2010 at a price equal to 101.875% of principal amount thereof. Level 3 will pay accrued and unpaid interest on the senior notes to but not including the redemption date. All of these senior notes will be redeemed by Level 3 on March 16, 2007. The Company expects to recognize a loss of approximately \$49 million associated with these redemptions in the first quarter of 2007.

Level 3 also announced on February 15, 2007 that Level 3 Financing, Inc. has commenced a tender offer to purchase for cash any and all of the outstanding \$150 million aggregate principal amount of its Floating Rate Senior Notes due 2011 for a price equal to \$1,080 per \$1,000 principal amount of the notes, which includes \$1,050 as the tender offer consideration and \$30.00 as a consent payment. Additionally, Level 3 Communications, Inc. commenced a tender offer to purchase for cash any and all of its outstanding \$78 million aggregate principal amount of 11% Senior Notes due 2008 for a price equal to \$1,054.28 per \$1,000 principal amount of the notes, which includes \$1,024.28 as the tender offer consideration and \$30.00 as a consent payment (together the “February 15th Tender Offers”). The Company expects to recognize a loss associated with these tender offers in the first quarter of 2007, the amount of which will depend on the amounts tendered for each issuance.

In connection with the February 15th Tender Offers, Level 3 Communications, Inc. and Level 3 Financing, Inc. are soliciting consents to certain proposed amendments to the respective indentures governing the notes that are subject to the February 15th Tender Offers to eliminate substantially all of the covenants, certain repurchase rights, certain discharge rights and certain events of default and related provisions contained in those indentures.

The February 15th Tender Offers are also subject to the satisfaction or waiver of certain other conditions as set forth in the Offer to Purchase. It is a condition to the consummation of the February 15th Tender Offers that the holders of at least a majority of the outstanding aggregate principal amount of the notes consent to the amendments to the indenture governing those notes.

On February 20, 2007, Level 3 Communications, Inc. commenced a tender offer to purchase for cash any and all of the outstanding \$692 million aggregate principal amount of its 11.5% Senior Notes due 2010 for a price equal to \$1,115.26 per \$1,000 principal amount of the 11.5% Senior Notes due 2010, which includes \$1,085.26 as the purchase price and \$30.00 as a consent payment (the “11.5% Notes Tender Offer”). Level 3 Communications, Inc. also commenced a tender offer to purchase for cash any and all of the outstanding € 50 million aggregate principal amount of its 10.75% Senior Euro Notes due 2008 for a price equal to € 1,061.45 per € 1,000 principal amount of the Senior Euro Notes due 2008, which includes € 1,031.45 as the purchase price and € 30.00 as a consent payment (the “Euro Tender Offer” and together with the 11.5% Notes Tender Offer, the “February 20th Tender Offers”). The Company expects to recognize a loss associated with these tender offers in the first quarter of 2007, the amount of which will depend on the amounts tendered for each issuance.

In connection with the February 20th Tender Offers, Level 3 is soliciting consents to certain proposed amendments to the respective indentures governing these notes that are subject to the February 20th Tender Offers to eliminate substantially all of the covenants, certain repurchase rights, certain discharge rights and certain events of default and related provisions contained in those indentures.

The February 20th Tender Offers are also subject to the satisfaction or waiver of certain other conditions as set forth in the applicable Offer to Purchase. It is a condition to the consummation of the February 20th Tender Offers that the holders of at least a majority of the outstanding aggregate principal amount of each series of notes consent to the amendments to the applicable indenture governing those notes.

On February 23, 2007, Level 3 Financing completed a consent solicitation with respect to certain amendments to the indenture governing Level 3 Financing's outstanding 12.25% Senior Notes due 2013 that allow for the incurrence of debt based upon a multiple of cash flow available for fixed charges on a "pro forma" basis giving effect to any acquisition, merger or consolidation completed prior to February 1, 2007.

### **Conversion of Broadwing Corporation 3.125% Convertible Senior Debentures due 2026**

On February 20, 2007, Level 3's wholly owned subsidiary, Broadwing Corporation, completed the repurchase of \$1.0 million aggregate principal amount of Broadwing's outstanding 3.125% Convertible Senior Debentures due 2026 (the "Debentures"). The indenture governing the Debentures required Broadwing to make the offer to repurchase the Debentures as a result of the Company's acquisition of Broadwing on January 3, 2007 (see discussion of acquisition above).

As a result of the acquisition, each \$1,000 principal amount of the Debentures was convertible at the option of the holder into \$492.77 in cash and 80.789 shares of Level 3 common stock, representing a conversion price equal to the consideration payable to Broadwing stockholders in the acquisition of (i) \$8.18 in cash per share of Broadwing, multiplied by 60.241, and (ii) 1.3411 shares of Level 3 common stock, multiplied by 60.241. Additionally, as a result of the acquisition, a make-whole premium was payable on Debentures converted prior to February 17, 2007, consisting of (i) 14.969 additional shares of Level 3 common stock and (ii) an additional \$91.31 in cash per \$1,000 principal amount of Debentures.

Holders owning \$179 million aggregate principal amount of the Debentures converted those Debentures into a total of approximately 17 million shares of Level 3 common stock and also received approximately \$106 million in cash. As a result of these conversions and the repurchase discussed above, as of February 17, 2007, the Debentures are no longer outstanding.



**(22) Unaudited Quarterly Financial Data**

	Three Months Ended							
	March 31,		June 30,		September 30,		December 31,	
	2006	2005	2006	2005	2006	2005	2006	2005
	(dollars in millions except per share data)							
Revenue	\$ 822	\$ 527	\$ 835	\$ 390	\$ 875	\$ 384	\$ 846	\$ 418
Operating Income (Loss)	(57)	26	(18)	(75)	(25)	(89)	(40)	(98)
Loss from Continuing Operations	(166)	(78)	(224)	(196)	(163)	(207)	(237)	(226)
Income (loss) from Discontinued Operations	(2)	1	23	8	25	3	—	57
Net Loss	(168)	(77)	(201)	(188)	(138)	(204)	(237)	(169)
Income (Loss) per Share (Basic and Diluted):								
Loss from Continuing Operations	\$ (0.20)	\$ (0.11)	\$ (0.25)	\$ (0.28)	\$ (0.14)	\$ (0.29)	\$ (0.20)	\$ (0.32)
Income from Discontinued Operations	—	—	0.02	0.01	0.02	—	—	0.08
Net Loss	<u>\$ (0.20)</u>	<u>\$ (0.11)</u>	<u>\$ (0.23)</u>	<u>\$ (0.27)</u>	<u>\$ (0.12)</u>	<u>\$ (0.29)</u>	<u>\$ (0.20)</u>	<u>\$ (0.24)</u>

Loss per share was calculated for each three-month period on a stand-alone basis. As a result of stock transactions during the periods, the sum of the loss per share for the four quarters of each year may not equal the loss per share for the twelve month periods. As a result of the sale of (i) Structure and Software Spectrum in 2005 and 2006, respectively, certain amounts previously included in the 2005 and 2006 quarterly reports on Forms 10-Q have been reclassified from continuing operations to discontinued operations.

In the first quarter of 2006, the Company recognized \$27 million gain related to a debt exchange.

In the second quarter of 2006, the Company recognized a \$55 million loss on the amendment and restatement of the Company's Senior Secured term Loan due 2011.

In the third quarter of 2006, the Company recognized a \$33 million gain from the sale of Software Spectrum.

In the fourth quarter of 2006, the Company recognized a \$54 million loss on the extinguishment of debt and \$8 million of termination revenue.

In the fourth quarter of 2005, the Company recognized a \$49 million gain from the sale of ( i )Structure.

In the first quarter of 2005, the Company recognized \$86 million and \$40 million of termination revenue related to 360networks (USA), Inc. and France Telecom Long Distance USA, LLC, respectively. The Company also recognized \$15 million in severance and related charges as a result of a workforce reduction of approximately 470 employees in the first quarter of 2005.

LEVEL 3 COMMUNICATIONS, INC.  
STATEMENT REGARDING COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES AND  
PREFERRED STOCK DIVIDENDS

	Fiscal Year Ended				
	2006	2005	2004	2003	2002
Loss from Continuing Operations Before Income Taxes	\$ (790)	\$ (702)	\$ (477)	\$ (746)	\$ (991)
(Earnings) Losses of Equity Investees	—	—	—	(3)	(13)
Interest on Debt, Net of Capitalized Interest	648	530	485	567	560
Amortization of Capitalized Interest	68	68	68	68	68
Interest Expense Portion of Rental Expense	44	25	29	31	20
Earnings (Losses) Available for Fixed Charges	<u>\$ (30)</u>	<u>\$ (79)</u>	<u>\$ 105</u>	<u>\$ (83)</u>	<u>\$ (356)</u>
Interest on Debt	\$ 648	\$ 530	\$ 485	\$ 567	\$ 560
Preferred Dividends	—	—	—	—	—
Interest Expense Portion of Rental Expense	<u>44</u>	<u>25</u>	<u>29</u>	<u>31</u>	<u>20</u>
Total Fixed Charges	<u>\$ 692</u>	<u>\$ 555</u>	<u>\$ 514</u>	<u>\$ 598</u>	<u>\$ 580</u>
Ratio of Earnings to Fixed Charges	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Deficiency	<u>\$ (722)</u>	<u>\$ (634)</u>	<u>\$ (409)</u>	<u>\$ (681)</u>	<u>\$ (936)</u>

**Significant Subsidiaries**

**As of and for the Fiscal Year ending December 31, 2006**

Level 3 Communications, Inc.

Level 3 Financing, Inc.

Level 3 Communications, LLC

Eldorado Acquisition Three, LLC

WilTel Communications Group, LLC

WilTel Communications, LLC

BTE Equipment, LLC

Level 3 International, Inc.

Level 3 Holdings, B.V.

Level 3 Communications Limited (UK)

Level 3 Communications GmbH (Germany)

Level 3 Holdings, Inc.

KCP, Inc.

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Consent of Independent Registered Public Accounting Firm

The Board of Directors  
Level 3 Communications, Inc.:

We consent to the incorporation by reference in the registration statements (Nos. 333-53914, 333-91899, 333-68887, 333-71713, 333-115062, 333-123703, 333-125030, 333-125262, 333-130710, 333-132695, 333-134668, 333-136413, 333-139836, and 333-139838) on Forms S-3, the registration statements (Nos. 333-79533, 333-42465, 333-68447, 333-58691, 333-52697, 333-115472, and 333-115751) on Forms S-8, and the registration statement (No. 333-134324) on Form S-4 of Level 3 Communications, Inc. of our reports dated March 1, 2007, with respect to the consolidated balance sheets of Level 3 Communications, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, cash flows, changes in stockholders' equity (deficit), and comprehensive loss for each of the years in the three-year period ended December 31, 2006, management's assessment of the effectiveness of internal control over financial reporting as of December 31, 2006 and the effectiveness of internal control over financial reporting as of December 31, 2006, which reports appear in the December 31, 2006 annual report on Form 10-K of Level 3 Communications, Inc.

/s/ KPMG LLP

Denver, Colorado  
March 1, 2007

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**CERTIFICATIONS\***

I, James Q. Crowe, certify that:

1. I have reviewed this Form 10-K of Level 3 Communications, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 1, 2007

/ s/ James Q. Crowe

James Q. Crowe  
Chief Executive Officer

\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

**CERTIFICATIONS\***

I, Sunit S. Patel, certify that:

1. I have reviewed this Form 10-K of Level 3 Communications, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 1, 2007

/ s/ Sunit S. Patel

Sunit S. Patel

Group Vice President and Chief Financial Officer

\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Form 10-K of Level 3 Communications, Inc. (the "Company") for the year ended December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I James Q. Crowe, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all materials respects, the financial condition and results of operations of the Company.

/ s/ James Q. Crowe

James Q. Crowe  
Chief Executive Officer  
March 1, 2007

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**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Form 10-K of Level 3 Communications, Inc. (the "Company") for the year ended December 31, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I Sunit S. Patel, Group Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- 1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- 2) The information contained in the Report fairly presents, in all materials respects, the financial condition and results of operations of the Company.

/ s/ Sunit S. Patel

Sunit S. Patel

Group Vice President and Chief Financial Officer

March 1, 2007

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