

LEVEL 3 COMMUNICATIONS INC.
MGM'T'S PROPOSAL TO ISSUE ADDITIONAL SHARES
— AND WHY WE'RE VOTING AGAINST IT.

RESPONSIBILITY #1 HAS NOT BEEN MET —
TO EXPLAIN THE PROGRAM TO SHAREHOLDERS.

Last time, we gave you the ecstasy. Here's the agony....

In the April 23rd edition of *OID*, we devoted an unprecedented number of pages to a single idea — Level 3. In that edition, your editor and our contributor not only spoke very highly of the company (which we both own), but we also suggested that this management was very unlikely to ever do anything to disadvantage its shareholders.

Regrettably, we can no longer say that. While our outlook for Level 3's prospects remain basically unchanged (we still consider it to be a bargain and we still believe its management to be the best in the industry), we feel an obligation to inform you that we at *OID* are deeply concerned about potential dilution to shareholders from its so-called "outperform stock option" (OSO) program. And those concerns are sufficiently great that we intend to vote against management's proposal in the latest proxy to authorize additional shares to be made available for that plan despite the urging of management to the contrary. Plus, we're calling on management to reform that program.

Finally, we also intend to withhold our votes for the reelection to Level 3's board of David McCourt — who is the chairman and CEO of Commonwealth Telephone and RCN Communications.

Nobody seems to understand the program.

Here's some of our rationale:

- First, we don't think that shareholders understand the program. Why do we say that? Well, besides the fact that *we* didn't understand it, none of the contributors with whom we spoke about the program understood even its basic elements. (And that even included one contributor who had most of his family's liquid net worth in the stock.)

None of us fully understood the magnitude of the potential dilution or even that the shares issued to employees and board members under that program would not be purchased at a reduced price, but rather rewarded outright. (Incidentally, based on our conversation with a senior Level 3 representative, the only way anyone could have *begun* to understand the program would have been based on a single slide at their 1999 and 2000 analyst

conferences.) And given Level 3's historical experience prior to the 2001 OSO issuances, the program specifics were hardly anything that shareholders thought they *should* be concerned with.

But given the magnitude of potential dilution involved — potentially around 20% on the outstanding shares prior to the recent preferred issue to Longleaf, Legg Mason and Berkshire Hathaway from OSOs awarded in 2001 *alone* — we still find it more than a little amazing that even very sophisticated non-employee shareholders did not enjoy a proper understanding of the OSO program. In our view, this is no small point. In fact, the failure of management to impart a clear understanding of something so important to shareholders in our view *alone* provides *more* than sufficient grounds to reject its proposal.

(For management's perspective, you may refer to their "Open Letter To Shareholders" dated July 15th.)

FIFTY PERCENT DILUTION EVERY TWELVE YEARS?!
THAT STILL SEEMS CLEARLY EXCESSIVE TO US.

If it's broke, fix it. Don't take advantage of it.

- Second, in their proxy and in conversations with us and our contributors, management seems to acknowledge that the OSO program is broken. In part, that's because the price of the stock is in the denominator of the formula that determines the number of OSOs to be issued. In a formula that we understand has never been revealed to shareholders, the lower the stock price, the greater the number of OSOs issued. Don't ask us how a plan could ever be approved without disclosing the formula. However, because the creators of Level 3's OSO program never anticipated their stock would ever trade as low as it has — much less for any sustained period — the potential dilution from the program has become unacceptably great.

(And it continues.... Because the June 1st grant of OSOs will be based on Level 3's stock price as of May 30th, it will utilize a stock price of \$4.50 in the denominator of the formula.)

Yet the schedule of OSO awards in the 10-K suggests that not only did management take no apparent steps to prevent the unintended consequences (i.e., to unduly enrich themselves at shareholder expense) by reducing the unprecedentedly large regular issuances, but they even issued themselves large numbers of *special* grants.

To be fair, Level 3 CEO James Crowe and Executive Vice President/Vice Chairman Douglas Bradbury

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"irrevocably" waived their right to exercise any OSOs granted to them during 2001 and the first quarter of 2002; and 13 other members of top management including President/COO Kevin O'Hara and Executive Vice President/Vice Chairman Charles Miller "irrevocably" waived their right to exercise OSOs issued to them during that period to the extent that they would exceed an aggregate of 275,000 shares of Level 3 common stock per individual. However, they also state that the board of directors, each of whom was awarded more than 10,000 OSOs (which potentially represent an outright award of 65,000± shares per director) can reinstate those awards at any time for what amounts to any reason(s) they deem relevant.

Their definition of fixing and ours seem to be different....

• Third, although management in effect suggests that the program is broken and creates the potential for unintentionally great dilution, they propose no fix. They say: "The company intends to set OSO targets based on an aggregate number of OSOs to be granted.... This will appropriately control the percentage of outperformance value we share with employee owners under all growth scenarios and, therefore, appropriately control dilution."

But they provide no specifics (although they leave open for inference the conclusion that aggregate OSOs granted won't result in the need for more than a total of 101 million shares to be issued). However, even that limit seems to be a quite a stretch given that it's been estimated that currently outstanding OSOs would easily use up that 101 million share authorization if Level 3's stock price were to reach even \$12 per share (depending on your assumptions for S&P performance in the interim).

(P.S. If you do these calculations yourself, don't forget to adjust your calculation for the significant decline in the S&P since they were issued — which ratchets up the number of shares issued for each OSO quite significantly.)

When we spoke with a senior Level 3 representative, he suggested that 20% dilution (ownership transferred to employees and board members from the OSO program) every four years would be their targeted maximum dilution. We believe that still represents clearly excessive dilution — again, especially considering that those shares would be awarded without any cash consideration to the company whatsoever.

Incidentally, because of how those OSOs are awarded (using recent history as a guide), that 20% dilution might not only represent a *ceiling* on dilution, but also a *floor* — at least following a time when the stock price has cratered. We say that because of the way the multiplier works and because of how (as we mentioned earlier) that what management considers to be excessive OSO issuances are queued up, in effect, just in case (irrevocably waived, but reinstatable at any time by the board).

Obviously, based on only three such occurrences, in a mere 12 years, outside shareholders would find themselves diluted by something in the neighborhood of 50% — without so much as 1¢ being paid to the company for those shares by the recipients. And while we have no problem with them being fairly compensated for their contributions,

we think that it would be hard for anyone to argue that that would not be excessive.

Very little net "outperformance" is actually required....

Furthermore, because of the "multiplier" element within the plan and how it works, and because of how they value the OSOs for purposes of issuing them to management in lieu of cash for payment of bonuses, that clearly excessive dilution could occur were the stock merely to fluctuate wildly up and down several times — hardly an impossibility for a company with \$6-1/2 billion of debt (at par), much less one whose stock has been as high as \$132 and as low as \$1.89 in the last two years.

One might argue that the same kind of thing could happen with a traditional stock option program. However, because of the multiplier within Level 3's program, the effect is potentially much more dramatic. And because Level 3's program provides for outright *awards* of stock, unlike true options wherein the recipient pays something (usually something quite significant) for the stock he or she receives, potential dilution to non-employee shareholders is an order of magnitude or two different.

And while they leave open for inference the conclusion that the conversion of outstanding OSOs will result in the need for Level 3 to issue no more than 101 million shares, they don't speak at all to the *total* issuance of OSOs and the fact that those OSOs can be settled for *cash*.

DO WE BELIEVE IN CONSISTENCY? WHAT'S THAT?
WE USE WHAT MAXIMIZES OUR COMPENSATION.

Do they trust the market or don't they?

• Fourth, it was suggested that the rationale for the special awards of OSOs was to compensate management for 2001 performance that was in effect above and beyond without using precious cash. And we were informed that what seemed to us to represent excessive special awards — 600,000 OSOs to Mr. Crowe alone and 1.3 million OSOs to three other top officers (much less the regular awards of around 1.1 million OSOs to Mr. Crowe and 1.3 million OSOs to those same three) — was based on providing them with a value of awards which would give them an appropriate total compensation package by valuing those OSOs using the Black-Scholes model.

Well, we have several problems with their use of the Black-Scholes formula in this instance: First, the actions of the marketplace as of the date which the special awards were granted would scarcely suggest that the actions of management had been heroic. However, were the board willing and able to overlook the verdict of a stock market that didn't appreciate the outstanding accomplishments of their management, one would imagine that it would not fail to do the same when calculating the value of the OSOs which they awarded to them. And yet, their use of the Black-Scholes model to value those same OSOs and thereby determine how many would be granted suggests to us that they did *exactly* that.

This seems like even *more* of a disconnect given that Mr. Crowe has been an unabashed bull about the value of Level 3 stock exceeding the stock price — even when the stock was up around \$130 per share — and given that the company's chairman, Walter Scott, Jr. was purchasing

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warrants giving him the right to buy additional shares around the time that the special awards were issued. (Granted, we're told that those warrants do have a feature that protects them from dilution during their life.)

The only consistency? The whole thing is disgusting.

Incidentally, despite the presence of the multiplier and the extremely depressed state of Level 3's stock price, we understand that the company values its OSOs at something less than equivalent non-qualified options. And Charlie Munger and Buffett are on the record as saying, in effect, that Black-Scholes itself undervalues even those non-qualified stock options.

[From Berkshire's annual meeting this year:

Munger: ...If it's a long-term option and you think you know something, [Black-Scholes] is an insane way to value it. And Wall Street is full of people with I.Q.s of 150 using Black-Scholes to value options that shouldn't be tortured into the model. All of corporate America is using it to price stock options.... And they do that because it comes up with the lowest cost number.

Buffett: Well, they not only do that, but ... they'll do everything they can — and I've been in on these discussions — to make the number look as low as possible. It's that simple.

Munger: And they're using a phony process to determine the number [to issue] in the first place. So it's a Mad Hatter's tea party. The only thing that's consistent in it is that the whole thing is disgusting.]

THE "OUTPERFORMANCE" IN OSO DOESN'T REFER TO OUR STOCK PRICE.

Where are the shareholders' yachts?

•Sixth, we understand that a significant portion of the company's shares are owned by employees and retirees of Peter Kiewit Sons from which it was spun off. And certainly, many other shareholders paid between \$52 and \$104 per share — in part based on the enthusiasm of the management team which has generally remained quite enthusiastic to date. (The only major issuances of shares prior to 2001 were 28.75 million shares at \$52.17 in 1999 and 23 million shares at \$104.35 in 2000.)

Under those circumstances, we find it hard to believe that top management would be able to live with a system that could, in effect, transfer 20% or so of the company to themselves — thereby putting themselves ahead of their former fellow employees and long-suffering shareholders — were the stock merely to get back to 10 to 20% of the price at which it issued shares in 1999 and 2000.

Let them eat OSOs....

•Seventh, lest you think we're suggesting that we're not in favor of incentive compensation per se, we're not. What we are suggesting is that it's less a matter of *whether* than how *much*. For example, in Level 3's latest proxy, here was the schedule of OSOs awarded to Mr. Crowe:

Expiration Date	Number of OSOs Awarded
3/1/05	141,559
6/1/05	319,941
9/1/05	319,941
12/1/05	319,941
12/1/05	<u>597,372*</u>
	1,698,754

*(Special) Year-end OSO

As shown above, we understand Crowe was granted a total of approximately 1.7 million OSOs in 2001 — potentially equivalent to more than 10 million shares. However, even *without* that special award, he would still have received 1.1 million OSOs — potentially equivalent to more than 6 million shares.

Based on the OSOs granted to Crowe in the third and fourth quarters alone, were Level 3's stock to merely return to \$25 within 3-1/2 years — again, 25-50% of the price at which common was issued in 1999 and 2000 — his compensation from those two quarters' issuances alone would be more than \$200 million.

And obviously, given that so many shareholders would remain so far underwater, some might reasonably question how much "outperformance" there really had been.

We're hoping they have job openings for editors....

•Eighth, what about the rank and file? The company says that "[its] philosophy is to pay annual cash salary compensation that is moderately less than the annual salary cash compensation paid by competitors and an annual performance-based cash bonus, which, if the company's annual goals are met, when added to the annual cash salary, cash compensation results in a total that is moderately greater than the total cash compensation paid on average by competitors."

And given developments within the telecom industry, it's safe to say that their salaries are generally closer to bubble levels than telecom meltdown levels — when just *getting* a paycheck is a victory of sorts. (And we're told many ex-employees would be thrilled to get their old jobs back at Level 3 even *without* OSOs.)

If there's a good reason, they haven't yet told shareholders.

•Ninth, we can imagine circumstances which could require the aforementioned grants of OSOs to be issued. For example, were a particularly competitive labor market to require Level 3's management to pay its employees like a free agent in professional sports, such actions might not only be warranted but required to retain key talent.

However, to say that today's job market in telecom is not exactly robust is more than a bit of an understatement. Massive layoffs are the order of the day. And we suspect that OSOs are hardly at the top of the priority list for individuals in the field so much as a paycheck.

We could also well imagine some key individuals among the staff and/or key members of top management informing the company that they intended to go off on their own to try to take advantage of distressed opportunities within the telecom field. However, if management's claims

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about its network and technology are true (as we believe they are), that should be much more easily said than done. And aside from their understandable desire to be able “to retain and motivate existing employee[s]...” — very surprisingly to us — no rationale whatsoever was provided in their “Open Letter to Stockholders Concerning the Proxy Statement” dated July 15th. And none was offered to us when we spoke with Level 3 representatives four days later.

Finally, should the Level 3 franchise truly be so fragile as to be that vulnerable to that type of risk and should the remedy truly be that expensive, then perhaps that's something shareholders should be entitled to know.

“APPROVE THIS PROPOSAL OR ELSE.”
MAYBE IT'S ABOUT DISTORTED COGNITION.

Mgm't's last argument: Approve our proposal or else....

•Tenth and last, management suggests that to vote against their proposal to authorize additional shares would require the utilization of precious cash to fulfill the program. Well, that's true. But that posture comes across to some shareholders as something akin to extortion — “Approve our proposal (authorize our shares) or else.” And while it's hard to imagine that this management intends anything of the sort, giving shareholders the choice between potential enormous dilution and a cash drain at a very critical point in the company's existence is, in effect — in our view, at least — *exactly* that.

(And frankly, we know that some shareholders don't exactly find it heartwarming for management to be utilizing that same precious cash to hire a proxy solicitation firm to, in effect, expedite and justify their compensation.)

But by voting against the proposal and making some constructive suggestions for a long-term fix, we hope that we can encourage management to feel a sense of urgency to fix a program that they *themselves* say *needs* to be fixed. And we believe they must do it sooner rather than later because later its problems may require similar (only larger) share authorizations when that same management might, by virtue of today's awards, control an additional 20-50% of the vote and thereby be able to insist on just about anything it likes — in this matter or just about any other.

Appearance counts....

As we noted earlier, we also intend to withhold our votes for the reelection to Level 3's board of David McCourt — the chairman and CEO of Commonwealth Telephone and RCN Communications. Why? Among other reasons, he just had his RCN options — which, believe it or not, were also “outperformance stock options” — repriced downward from \$38-1/8 to \$1.95, down some 95% after his stock had fallen 90%. And according to RCN's proxy, the stock's market price at the time of repricing was \$4.10.

(If, as some of our contributors have suggested, repricing regular stock options borders on the criminal, repricing OSOs — it seems to us — should be a felony.)

And while it's true that McCourt is not an employee of Level 3, Level 3 and its chairman, Walter Scott, together

own approximately 38% of RCN's common shares. So given the aforementioned history, given what amounts to an interlocking directorate between the two companies and given that one member of RCN's compensation committee serves as a director of Level 3 while McCourt serves as one of four members of Level 3's compensation committee, well, need we say more? Obviously, McCourt should not be in a position to influence compensation decisions at Level 3 simply based on appearances and the apparent potential for a quid pro quo alone.

Level 3's OSO program flies in the face of human nature.

Lest we sound unduly harsh, we should mention that we believe for *any* company to have an open-ended plan that requires its management to take action in order to *keep* themselves from being unduly enriched is not fair to shareholders *or* management. It does not take into account either human nature or incentive-caused bias.

In one of his classic lectures on Worldly Wisdom (in the March 13, 1998 edition of *OID*), Charlie Munger says that it's unfair to put employees into an environment that tempts them to begin to engage in untoward behavior because it rewards bad behavior. Clearly, the temptations for top management today at nearly all companies — even those *without* a multiplier in their incentive compensation program — are enormous, so much so, in fact, that exemplars like Berkshire have become the rare exception.

Further, we suspect there are other factors at work at Level 3. One, we believe, is a force which Munger has coined a name for — “deprival super-reaction syndrome”. As Munger describes (from that same lecture), “it happens [A] when anything that you like is taken away from you and [B] when you almost have something you like and you ‘lose’ it. Either way, the result is a powerful, subconscious, automatic deprival super-reaction syndrome that distorts your cognition.”

Well, as “deprival super-reaction syndrome” sufferers ourselves, we can relate to anyone whose stock price has declined 98-1/2% from its high to its low and is still down 95% from its high. But as management readily admits, their program is flawed. However, whose fault is that? And whose responsibility is it to fix it and behave well in the interim — with distorted cognition or without — and avoid taking advantage of flaws in a system that it devised, proposed and implemented?

IT'S NOT ENOUGH TO TALK THE TALK.
THEY NEED TO BEGIN TO WALK THE WALK.

Eliminate the reward for cratering the stock price.

Again, we continue to retain our shares of Level 3 and believe it to be a bargain *despite* the aforementioned flaws. And we're hopeful that some of those flaws can be fixed — especially given the recent investment in Level 3 by Longleaf, Berkshire Hathaway and Legg Mason.

How can they be fixed? Any number of ways. However, here are some suggestions:

• First, place a floor on the minimum issue price and the stock price used in the denominator of the secret formula for calculating the number of shares to be granted. The floor should be some percentage of the maximum price at which shares have ever been issued in the past — say

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50% (not the *average* price because that would only create an incentive to issue shares when the stock was cheap).

And would it really be too much to ask for the owners of the company — the folks who provided the capital that allowed the company to exist and for the management and employees to be paid well (despite never having made 1¢ of profit) — to know the secret formula that management uses to determine the number of OSOs granted?

If shareholders are hurting, mgm't shouldn't be cashing in.

•Second, cap the multiplier or waive it altogether until and unless the stock price exceeds the highest price which any significant number of shares have been issued (that is, if the multiplier is left in place at all).

It *sounds* good to have a plan in effect whereby the OSOs only have value if the stock price outperforms the S&P 500. However, the reality is that usually, when the stock *doesn't* outperform the S&P 500, the value associated with an option on the stock probably wouldn't be all that exciting anyway. On the other hand, to have a multiplier of up to eight spring into effect when the stock *does* outperform the S&P — well, you can do the math.

It's basically "Heads, I lose; tails, I win big. And, oh, by the way, if it's heads and I *do* lose, I get many more OSOs with their magic multiplier for the next go round."

Is it just us, or is there something wrong with this picture? Don't regular options with all of their flaws provide the potential for excess aplenty?

Who needs the cash more? Certainly not the employees....

•Third, eliminate outright awards. Rather, make them what the name implies — "options" — the right to buy shares at a discount to the future price. (Obviously, dilution of x% per year is one thing when employees and directors pay something for their shares, as they do at the vast majority of American corporations, and quite another when they're just outright awards.)

Isn't liquidity a very important issue at this stage of Level 3's existence? Wouldn't the cash generated by the exercise of any stock options be like manna from heaven? Isn't structuring the incentive compensation program such that employees who receive total compensation above the going scale are awarded stock outright while the company issuing the stock is burning cash, is \$6-1/2 billion in debt, has fabulous uses for any cash it can get its hands on and is issuing stock at very cheap prices topsy-turvy? What's the brilliant logic behind structuring the plan so that the company doesn't get the cash that it would from a traditional plan? If there is any, frankly, it's lost on us.

(Along those lines, if the multiplier is left in place, perhaps they could at least limit the discount to 50% of the stock price at the time the option is exercised. A multiplier *plus* the absence of any cash consideration is ridiculous.)

With great compensation comes great responsibility.

•Fourth, take seriously the burden and responsibility of clearly and fully explaining the plan to shareholders such that the vast majority of them understand it clearly. Certainly, such an important issue would justify a very

clear explanation in materials sent to all shareholders and on conference calls wherein all interested shareholders could express their opinions and ask questions whenever management would like to modify the plan, the manner in which it's being implemented or even to review the existing plan if they become aware of important flaws therein.

It's not enough to talk the talk....

•Fifth, before awarding special awards over and above the amounts due under the formula, don't only talk the talk of being shareholder oriented, but walk the walk by first getting shareholder approval.

And avoid the appearance of intellectual dishonesty that results from ignoring the stock price when assessing managerial performance, but then turning around and trusting it totally and totally disregarding everything else when valuing it for purposes of determining the number of OSOs or options to be awarded.

Don't jam the program down the shareholders' throats.

•Sixth, immediately rescind the old plan and put any new plan up for a vote before implementing it. And make it clear management won't make any changes in the plan without first getting the approval of shareholders. Also, provide for the plan to have a sunset provision such that it automatically expires — say every five years or so — unless reauthorized by the vote of a majority of the shareholders. Given the potential dilution (i.e., transfer of wealth from non-employee shareholders to employees) that does not seem like an unreasonable burden.

Reputation for shareholder orientation = a premium price.

In our opinion, any company implementing the preceding would go a long way in reestablishing the bond of trust between itself and its shareholders which has been broken in so many companies throughout America. And we have to imagine that it would go a long way towards providing any such company with the reputation of being a shareholder-oriented company and help it obtain and, most importantly, deserve the premium valuation that such a reputation would likely bestow.

And of course, such actions would go a long way towards distancing that management from the image of the stereotypical greedy, self-serving managements which, unfortunately, exist at so many companies today and replacing it with that of a shareholder-oriented, caretaker management concerned for the welfare — and worthy of the trust — of *all* shareholders.

P.S. We apologize for the late hour of this piece. However, the travel schedules and general availability of several of our contributors was such that we were unable to reach two of them until the middle of last week and one of them until Monday (July 23rd). And given the gravity of the matter and the importance of not going off half cocked, despite the impending deadline for the vote, we didn't feel that it was appropriate for us to go to press with this piece before speaking with them. It most assuredly was not for lack of wanting or trying. Hopefully, better late than never.

—OID