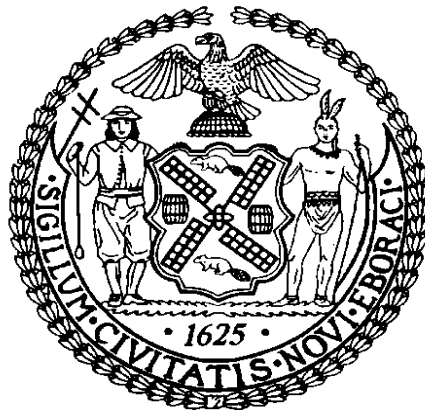


CITY OF NEW YORK OFFICE OF THE COMPTROLLER

John C. Liu
COMPTROLLER

FINANCIAL AUDIT
H. Tina Kim
Deputy Comptroller for Audit



Audit Report on the Compliance of
Level 3 Communications, Inc.
With Its City Franchise Agreement
January 1, 2007–December 31, 2008

FN10-055A

October 28, 2010



THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER
1 CENTRE STREET
NEW YORK, N.Y. 10007-2341

John C. Liu
COMPTROLLER

October 28, 2010

To the Residents of the City of New York

My office has audited the compliance of Level 3 Communications, Inc. (Level 3) with its City Franchise Agreement. We audit entities such as this as a means of ensuring that they comply with the terms of their agreements, properly report and allocate revenues, and comply with established policies and procedures.

Level 3 is a provider of a broad range of high-capacity integrated communications. Under a 15-year franchise agreement with the Department of Information Technology and Telecommunications (DoITT), Level 3 provides telecommunications services in the City for which it pays the City a franchise fee consisting of the greater of either \$200,000 or five percent of its annual gross revenue.

Level 3 did not maintain separate books and records in sufficient detail to determine whether all revenue was properly reported to the City. While it was not possible to ascertain whether all revenue attributable to the franchise agreement was reported and all fees paid to the City, based on the available records, the audit concluded that Level 3 underreported gross revenue by \$7,430,114. The audit recommended that Level 3 pay fees and late charges due from understated revenue, submit for DoITT's approval a revenue allocation methodology, and maintain accounts and records in a manner that allows the City to determine Level 3's revenue reporting compliance. The report recommended that DoITT ensure that Level 3 pays the City the fees and charges due and complies with the report's other recommendations.

The results of our audit, which are presented in this report, have been discussed with Level 3 and DoITT officials, and their comments have been considered in preparing this report. Their complete written responses are attached to this report.

If you have any questions concerning this report, please email my audit bureau at audit@comptroller.nyc.gov.

Sincerely,

A handwritten signature in black ink, appearing to read "John C. Liu".

John C. Liu

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*The City of New York
Office of the Comptroller
Financial Audit*

**Audit Report on the Compliance of
Level 3 Communications, Inc.
With Its City Franchise Agreement**

FN10-055A

AUDIT REPORT IN BRIEF

On January 5, 1999, the City of New York through the Department of Information Technology and Telecommunications (DoITT) entered into a 15-year franchise agreement with Level 3 Communications, Inc. (Level 3) to provide local high-capacity telecommunications services in the City. Level 3 is a provider of a broad range of high-capacity integrated communications. Its services include Internet Protocol (IP), broadband transport, collocation services, and patented Softswitch-based managed modem and voice services. Level 3 provides telecommunications services to approximately 458 customers in the City.

Under the franchise agreement, Level 3 is required to report to the City all gross revenue from telecommunications services that originate in and/or terminate in the City. Based on the agreement, Level 3 is required to pay the City a franchise fee consisting of the greater of either \$200,000 or five percent of its annual gross revenue. In addition, Level 3 is required to maintain a minimum combined amount of \$50 million in insurance for bodily injury and property damage, and an unconditional letter of credit and surety bond deposit totaling \$1 million.

Audit Findings and Conclusions

Level 3 did not maintain separate books and records in sufficient detail to allow us to determine whether all revenue was properly reported to the City, particularly with respect to revenue generated from services that either originate or terminate in the City. Therefore, we were unable to ascertain whether all revenue attributable to the franchise agreement was reported, and all franchise fees were paid to the City. Nevertheless, based on the available records, we determined that Level 3 underreported gross revenue in the amount of \$7,430,114. Consequently, Level 3 owes the City at least \$510,910 in franchise fees and late charges as detailed in Appendices I and II. Additionally, our review found that Level 3 did not consult with the City in determining a methodology to allocate its revenue and, as a result, it may not have reported to the City a significant amount of revenue from services with one endpoint outside the City.

Level 3, however, complied with the other non-revenue requirements of the franchise agreement, such as maintaining the required \$50 million property and liability insurance that named the City as an additional insured party and the required \$1 million in a security deposit.

Audit Recommendations

Based on our findings, we recommend that Level 3:

- Pay the City \$510,910 in franchise fees and late charges due from understated revenue, and ensure that all revenue from customer accounts is properly included in its revenue reports submitted to the City.
- Submit to DoITT for its review and approval a methodology for allocating revenue for services that either originate or terminate in the City in accordance with the franchise agreement and pay to the City the amount it is owed using such methodology (plus late charges as appropriate).
- Maintain separate books of accounts and records of all City business activity in a manner that would allow the City to determine whether Level 3 is reporting all its revenue in compliance with the franchise agreement.

We recommend that DoITT:

- Ensure that Level 3 pays the City the \$510,910 in franchise fees and late charges due from understated revenue assessed in this report.
- Ensure that Level 3 pays the City a “fair and equitable allocation” as determined for revenue generated from partial use of the System for the period covering 2007 and 2008, and that the allocation is performed based on a methodology in compliance with the proper City review and approval process as required in the agreement.
- Ensure that Level 3 submits separate accounting records and financial statements to determine whether all compensation is being paid to the City.
- Establish procedures and controls to review Level 3’s revenue reporting and franchise fee payment calculations.

INTRODUCTION

Background

Level 3 Communications, Inc. (Level 3) is a provider of a broad range of high-capacity integrated communications. Its services include Internet Protocol (IP), broadband transport, collocation services, and patented Softswitch-based managed modem and voice services. Level 3 operates one of the largest communications and Internet backbones in North America and Europe. Its customers include long distance carriers, wireless communications companies, and organizations in the healthcare, finance, higher education, manufacturing, and hospitality industries, as well as state and local government organizations.

On January 5, 1999, the City of New York through the Department of Information Technology and Telecommunications (DoITT) entered into a 15-year franchise agreement with Level 3 to provide local high-capacity telecommunications services in the City. Subject to the terms and conditions of the 15-year agreement, the City grants Level 3 a nonexclusive franchise providing the right and consent to install, operate, repair, maintain, remove, and replace cable, wire, fiber, or other transmission media that may be used in lieu of cable, wire, or fiber for the same purposes, and related equipment and facilities on, over, and under the inalienable property of the City. Level 3 is to provide telecommunications services that originate or terminate in or that transit the franchise area. DoITT is responsible for monitoring Level 3's compliance with the franchise agreement.

Under the franchise agreement, Level 3 is required to report to the City all gross revenue from telecommunications services that originate in and/or terminate in the City. Level 3 is also required to pay the City a franchise fee consisting of the greater of either \$200,000 or five percent of its annual gross revenue, and to submit to the City quarterly gross franchise fee calculation reports with payments made no later than 45 days after the last day of March, June, September, and December. Furthermore, the agreement requires Level 3 to keep comprehensive itemized records of all revenues received and of all services provided and to do so in sufficient detail to enable the City to determine whether all compensation owed the City is being paid. In addition, Level 3 is required to comply with major non-revenue terms, such as maintaining a minimum combined amount of \$50 million in insurance for bodily injury and property damage, and maintaining an unconditional letter of credit and surety bond deposit totaling \$1 million.

Level 3 provides telecommunications services to approximately 458 customers in the City. For the audit period January 1, 2007, through December 31, 2008, Level 3 submitted gross revenue totaling \$17.5 million and related franchise fee payments totaling \$874,272 in its revenue reports to the City.

Objectives

To determine whether Level 3:

- accurately reported its gross revenue, properly calculated and paid the appropriate fees due the City, and paid fees on time, and
- complied with certain non-revenue-related requirements of its agreement (i.e., maintained the required insurance and maintained the proper letter of credit and surety bond).

Scope and Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

The scope of this audit was January 1, 2007, through December 31, 2008. To accomplish our audit objectives, we reviewed the telecommunications franchise agreement between Level 3 and the City and identified the relevant terms and conditions. We reviewed Level 3's correspondence and franchise fee calculation reports on file with DoITT to ascertain whether Level 3 submitted the required revenue reports and paid the fees due the City on time.

We evaluated the adequacy of Level 3's internal controls over its revenue recording and reporting functions. To obtain an understanding of Level 3's operating procedures, we interviewed Level 3 officials, identified key control processes, and familiarized ourselves with the sales, billing, accounting, and record-keeping functions. We also reviewed Level 3's chart of accounts and trial balance and performed a preliminary review of its RevMart¹ billing report to identify any unusual trends and to provide a basis for our detailed testing. We documented our understanding of Level 3's operations and internal control processes with flowcharts and memoranda.

In assessing the reliability of Level 3's financial data reported to the City, we considered the opinion issued by KPMG, LLP on the fairness of Level 3's financial statements and the effectiveness of its internal controls over financial reporting for calendar year 2008.² We were not able to trace the revenue reported to the City to Level 3's financial statements since those statements consolidate revenue derived from all services, including those that do not originate or terminate in the City. Nor, according to Level 3 officials, do they prepare individual financial statements for the City. Level 3's revenue data is generated by Oracle ERP accounting and reporting system. We did not test the reliability of this system. Therefore, our data reliability test was limited to the data reported in Level 3's RevMart billing report.

Based on our review of Level 3's RevMart billing report, we conducted a limited test of controls over revenue transactions. For our preliminary evaluation, we judgmentally selected the monthly customer billing statements of five customer accounts (including those with the highest and the lowest fluctuations in total billings) for the year 2008, and traced the amounts to the billing reports for completeness and accuracy. Based on the results of our preliminary sample test, we expanded our sample by judgmentally selecting an additional 50 customer accounts with

¹ RevMart is a revenue database designed by Level 3 to disseminate revenue data reporting within the organization.

² The opinion issued by KPMG, LLP stated, "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."

the highest billed revenue representing \$16.1 million (50 percent) of the \$32.3 million in total gross revenue before allocation that Level 3 reported in its books and records for calendar year 2008.

To determine whether Level 3 properly reported its gross revenue to the City in accordance with the agreement, we identified and reviewed all revenue accounts in Level 3's chart of accounts and traced each account to the billing reports for completeness. We then summarized the revenue recorded on Level 3's billing reports and compared the totals to the revenue reported to the City for the period January 1, 2007, through December 31, 2008.

To ascertain the accuracy and reasonableness of Level 3's allocation of certain revenue to the City, we reviewed Level 3's billing reports, and identified and reviewed all the revenue accounts that were subject to the allocation. We also reviewed Level 3's methodology and analyzed the revenue from services that originated or terminated in the City as reported in Level 3's billing reports. We then compared the results to the amounts Level 3 reported in the quarterly franchise fee calculation reports submitted to the City.

To determine whether Level 3 complied with the other terms and conditions of its agreement, we reviewed insurance certificates to determine whether Level 3 maintained the required insurance coverage. Finally, we reviewed surety bond records to determine whether Level 3 maintained the required security deposit with the City.

The results of our tests, while not projected to the populations from which the samples were drawn provide reasonable assurance that we have obtained sufficient and appropriate evidence to determine Level 3's compliance with the franchise agreement in reporting applicable revenue.

Discussion of Audit Results

The matters covered in this report were discussed with Level 3 officials during and at the conclusion of this audit. A preliminary draft report was sent to Level 3 and DoITT officials and discussed at an exit conference held on July 29, 2010. After the exit conference, Level 3 officials provided us with additional information regarding the issues addressed in the preliminary report. On August 30, 2010, we submitted a draft report to Level 3 and DoITT officials with a request for comments.

We received a written response from Level 3 officials on September 14, 2010. In their response, Level 3 officials disagreed with the audit findings.

We received a written response from DoITT officials on September 17, 2010. DoITT officials generally concurred with our audit findings and stated that they will undertake a follow-up review to verify and determine all amounts due. DoITT officials also stated that "DoITT will pursue a revised approach to franchise compensation using a more objective, measurable and certain methodology than that which is currently set forth in the agreement."

The full texts of the Level 3 and DoITT responses are included as addenda to this final report.

FINDINGS

Level 3 did not maintain separate books and records in sufficient detail to allow us to determine whether all revenue was properly reported to the City, particularly with respect to revenue generated from services that either originate or terminate in the City. Therefore, we were unable to ascertain whether all revenue attributable to the franchise agreement was reported, and all franchise fees were paid to the City. Nevertheless, based on the available records, we determined that Level 3 underreported gross revenue in the amount of \$7,430,114. Consequently, Level 3 owes the City at least \$510,910 in franchise fees and late charges as detailed in Appendices I and II.

Additionally, our review found that Level 3 did not consult with the City in determining a methodology to allocate its revenue and, as a result, it may not have reported to the City a significant amount of revenue from services with one endpoint outside the City.

Level 3, however, complied with the other non-revenue requirements of the franchise agreement, such as maintaining the required \$50 million property and liability insurance that named the City as an additional insured party and the required \$1 million in a security deposit.

These matters are discussed in detail in the following sections of this report.

Understated at least \$7,430,114 in Revenue It Received from Customers

Our reconciliation of the revenue reported in Level 3's RevMart 2008 billing report (Level 3's basis for reporting revenue to the City) and the customers' bills we sampled found that not all the revenue related to telecommunications services that was received from Level 3's customers was properly included in the billing report. While the New York City customers' bills show revenue activities for telecommunications services, Level 3 RevMart billing report did not include all such revenue activity. According to Level 3 officials, the discrepancy was the result of a migration of customer account numbers following Level 3's acquisition of other companies and the consolidation of customer accounts. However, even after taking into consideration the consolidation of certain accounts, our review of the customers' bills identified a total of \$7,430,114 in additional revenue that was not recorded on Level 3's RevMart billing report and consequently not reported to the City. Therefore, Level 3 owes the City at least an additional \$510,910 in franchise fees and late charges, as detailed in Appendix I.

Level 3 Response: "Level 3 disagrees that it owes additional fees to the City for the audit period. Level 3's initial analyses of the data in the preliminary draft audit report consisted of queries from the revenue reports previously provided to the City audit team. The under reporting claimed by the City audit team appears to be driven by the inclusion of revenue streams to which the City is not entitled under the definition of Telecommunications Services in the Franchise Agreement. One non-telecom product alone, electrical power resold to the customer, accounts for almost 10% of the stated discrepancy."

Auditor Comment: We continue to affirm that the revenue in question represents reportable revenue to the City. After providing Level 3 with our analysis of its revenue data for review, at Level 3's request, Level 3 provided us no additional documentation that would contradict our results or would support Level 3's claim that the City is not entitled to this revenue under the franchise agreement. Additionally, Level 3 failed to provide us its "initial analyses" of this revenue despite our numerous requests. Furthermore, contrary to Level 3's position, based on Level 3's billing records, the revenue derived from electrical power resold to customers is directly tied to Level 3's provision of collocation revenue and, as such, it should be reported to the City according to the gross revenue definition of the franchise agreement, which states that "Gross Revenue derived from the sale or lease of equipment and/or facilities provided by the Company or any affiliated person if such facilities and/or equipment are required for and integrated with the Services provided by the Company within the franchise area." Therefore, we reaffirm our position that the \$7,430,114 represents additional revenue that Level 3 improperly excluded from its revenue reports to the City. As a result, DoITT should seek to ensure that Level 3 pays the City at least the \$510,910 in franchise fees and late charges as assessed in this report.

DoITT Response: "To verify whether Level 3 in fact owes the City franchise compensation due to underreporting, DoITT will undertake further analysis. Specifically, DoITT will request from the Comptroller's Office the supporting data for the Draft Audit; and, upon reviewing such data, will meet with Level 3 to understand the company's own, detailed interpretation regarding those revenue streams from which it believes the City is not entitled to receive franchise compensation."

Auditor Comment: We are pleased that DoITT officials agree to undertake their own review of the revenue data. We also welcome the opportunity to provide our supporting data to assist DoITT in performing such a review. As noted, Level 3 received a significant amount of additional revenue from services provided in connection with its franchise agreement and never reported it to the City. As also noted in our review, Level 3 did not provide supporting detail information to substantiate its claim regarding the exclusion of this revenue from the reports it submits to the City. Our audit results were based on a sample of customer bills; therefore, DoITT should seek to obtain and review Level 3's revenue analyses to identify all the revenue Level 3 generates from services provided to New York customers, and determine what amounts Level 3 is entitled to exclude, if any, based on the terms of the franchise agreement.

Inappropriate Methodology in the Allocation of Its Revenue to the City

Based on our review of the available Level 3's books and records, we determined that Level 3 did not comply with its obligations under the franchise agreement to develop and submit to the City for its review and approval a revenue allocation methodology for the revenue it

generates from services that either originate or terminate in the City (i.e., that use part of Level 3's System), which methodology must comport with the "fair and equitable" standard in the agreement. Specifically, our review found that, for calendar years 2007 and 2008, Level 3 generated gross revenue totaling at least \$61,556,829 from telecommunications services that use part of Level 3's System. However, Level 3 reported that it obtained only \$7,095,539 in gross revenue for those services—a mere 12 percent of actual revenue—of which it paid the City franchise fees totaling \$354,777, less than one percent of its total revenue.

According to the definition of gross revenue in §1.15 of the franchise agreement, "Gross Revenue shall include all revenue . . . that is received directly or indirectly by the Company or by any Affiliated person from or in connection with any Telecommunications Services provided in accordance with this Agreement which originate in and/or terminate in the City (which shall include a proportional allocation, which allocation shall be fair and equitable, of revenues received by, or that should have been received by, the Company, any Affiliated person or any other Person for Services utilizing any part of the System, provided, however that such proportional allocation shall in no case be less than the fair market value for such Service). The Company shall within two years following the Effective Date, submit to the City for the City's review and approval the method by which such allocation is to be made."

We assert that Level 3's methodology for allocating the revenue it receives in connection with services that originate or terminate in the City is neither fair nor equitable and was never reviewed or approved by the City as required in the franchise agreement. Level 3's telecommunications services that originate or terminate in the City may only extend short distances outside the City's borders or may extend hundreds or thousands of miles beyond City limits, but Level 3's methodology for allocating revenue to the City arbitrarily "assumes a distance of 12.8 miles as the longest distance between two circuits within the City limits." In other words, the amount of revenue attributable to the City that is derived from any given circuit (i.e., cable, wire, fiber or other means of transmission) may never be greater than a relatively short part of that circuit (i.e., 12.8 miles).

Level 3 did not provide us with documentation that would support its basis for a methodology that assumes a distance of 12.8 miles. In a prior audit of another telecommunication franchise, we noted that revenue received from services utilizing part of the System is equally allocated among the two end points using a 50 percent allocation. However, although Level 3's franchise agreement includes the same provisions regarding the two end points, Level 3 did not allocate its revenue using the 50-percent methodology, which would have resulted in Level 3 having to report at least an additional \$23,682,908 in revenue to the City. Level 3 should therefore submit to DoITT for its review and approval a methodology for a "fair and equitable" allocation of this type of revenue, including a detailed justification for the proposed methodology.

Level 3 Response: "Level 3 disagrees that it is not following a 'fair and equitable' revenue allocation methodology as set forth in the Franchise Agreement. In accordance with Section 1.15 of the Franchise Agreement, Level 3 submits payments based on a fair and equitable allocation methodology. Level 3's methodology allocates revenue by the proportionate length of any such circuit

within the City’s jurisdiction. Level 3’s allocation favors the City by assuming all circuits are the maximum length of any two points within the City, i.e. 12.8 miles.”

Auditor Comment: Level 3’s contention that its allocation methodology is not only fair and equitable, but favors the City is not based on the requirements of the franchise agreement. One of the key provisions of the revenue allocation requirement is that the methodology for allocating the revenue received in connection with services that originate or terminate in the City be submitted to the City for its review and approval. Level 3 never obtained the required approval from the City. As noted in our review, Level 3 generated a total of \$61,556,829 from telecommunications services that use part of Level 3’s System in the City. However, it reported only \$7,095,539 in gross revenue for those services, and paid the City less than one percent of its total revenue in related franchise fees totaling \$354,777. Therefore, we again assert that because Level 3 did not adhere to the revenue allocation requirement of its franchise agreement, potential revenue amounts may not have been reported to the City.

DoITT Response: “DoITT generally concurs. However, it should be recognized that significant advancements in telecommunications technology have occurred since the Level 3 franchise was entered into in January 1999. These changes have made measuring where and how much of a telecommunications service ‘originates’ and ‘terminates’ a particularly difficult exercise, and highly dependent on the particular methodology being used. . . . DoITT will explore with Level 3 the potential for implementing an alternative methodology that is more objective, measurable and certain.”

Auditor Comment: We are pleased that DoITT officials agree to explore the potential for implementing a more appropriate methodology that would better help to determine what is a fair and equitable revenue amount in accordance with the agreement.

**Did Not Maintain Its Books and Records
As Required by the Franchise Agreement**

Level 3 did not maintain its books and records in a manner that would allow us to accurately determine whether all the revenue generated from customers with telecommunications services that originate or terminate in the City was reported to the City. During the course of our audit, we requested accounting reports and financial statements to review and determine whether Level 3 reported all its revenue and paid the appropriate fees to the City. However, Level 3 was unable to provide financial records to properly account for its City revenue activity. Specifically, Level 3’s accounting reports, such as trial balance and general ledger, are prepared on a consolidated basis. As stated in §7.1.3 of the franchise agreement, “the Company shall keep comprehensive itemized records of all revenues received and of all services provided, in sufficient detail to enable the City to determine whether compensation owed the City . . . is being paid to the City.” The commingling of various regional revenues in Level 3’s financial records

prevented us from determining whether all revenue generated in connection with its City agreement was reported to the City as required in the agreement. Because of the complexity of Level 3's operations as a multi-national organization, it should ensure that separate books and records are maintained for its City revenue activity. Therefore, Level 3 should restructure its reporting process to ensure that revenue derived from doing business with the City is separately maintained and reported to the City. Separate reporting would enable the City to confirm that Level 3 is reporting all revenue to the City and that the company is in compliance with the franchise agreement.

Level 3 Response: “Level 3 disagrees that it has not maintained records in accordance with the Franchise Agreement. Level 3's records are maintained in accordance with Section 7.1.3 of the Franchise Agreement. Section 7.1.3 of the Franchise Agreement obligates Level 3 to ‘keep comprehensive itemized records of all revenues received and of all Services provided, in sufficient detail to enable the City to determine whether all compensation owed the City pursuant to Section 7.1 is being paid to the City’ rather than maintain separate books of account and records of all City business activity as described and recommended in the Audit Report. In particular, Level 3 maintains unique identifiers for each dollar of revenue generated on a circuit terminating or originating in the City. Using existing accounting systems, revenue generated within the City and the associated records can be readily accessed by querying the broader revenue data set. Level 3 uses these systems to ensure it captures all revenue activity within the City.”

Auditor Comment: Despite Level 3's response disclosing the existence of certain reports and Level 3's ability to generate such reports, Level 3 has never made such reports or documents available to us for review. During the course of our audit, we were expressly informed that Level 3's Accounting Department was unable to supply us with requested financial records, including its general ledger and trial balance for the New York market because, according to Level 3 officials, only consolidated reports were maintained.

In addition, we identified transparency issues in Level 3's reporting of its revenue that need to be addressed. For example, Level 3 failed to provide us with its own revenue analyses that would determine the amount of revenue Level 3 deems reportable to the City. Level 3 reports to the City only the revenues it deems to be reportable and reports revenue only after applying an allocation that the City has not approved. As stated in Section 8.7.2 of the franchise agreement, “The Company shall also maintain and provide additional books and records as the Comptroller or Commissioner deem reasonably necessary to ensure proper accounting of all payments due the City.” Due to the lack of adequate records, we were not able to ascertain whether Level 3 properly accounted for all payments to the City under the franchise agreement. Therefore, we strongly recommend that Level 3 complies with the agreement and maintains separate accounting records that would allow the City to ascertain at all times that all revenue derived from doing business with the City is properly accounted for and reported to the City.

DoITT Response: “DoITT concurs that Level 3 should separately account for revenues properly attributable to its operations pursuant to the franchise, and will require such reporting.”

Auditor Comment: We are pleased that DoITT officials agree with our position.

Other Issue

DoITT’s Oversight of Level 3

DoITT did not ensure that it properly monitored Level 3’s performance to determine whether the revenue reported and franchise fees submitted to the City were in compliance with the franchise agreement.

Under the City Charter, the agency designated to have primary expertise and responsibility for the franchise must monitor the performance of the grantee and enforce the terms and conditions of the franchise under its jurisdiction. The agreement between Level 3 and the City requires Level 3 to establish and maintain managerial and operational records, standards, procedures, and controls to enable it to prove in reasonable detail and to the reasonable satisfaction of the oversight agency, in this case DoITT, that Level 3 is in compliance with the agreements at all times throughout the term. In addition, the agreement requires that when Level 3 generates revenue from services that either originate or terminate in the City (i.e., that use part of Level 3’s System), Level 3 should submit to the City for its review and approval a revenue allocation methodology.

However, our review found that Level 3 allocated a significant portion of its revenue without obtaining City’s approval. Furthermore, we found no evidence that DoITT has required Level 3 to submit detailed financial records to support the revenue reported to the City. Instead, DoITT accepted the amounts Level 3 reported as well as the related payments made without exercising the proper oversight review. Such oversight review would have determined the accuracy and completeness of the revenue amounts that Level 3 reported to the City.

In recent audits of other telecommunication franchise agreements, we also found DoITT deficient in its enforcement of the terms of the franchise agreements. Specifically, a recent audit contained similar findings regarding the proportional allocation of revenue. In its response to that audit, dated May 22, 2009, DoITT stated that it “intends to have further discussions on [the issue of proportional allocation of revenue with an end point outside the City] during upcoming franchise negotiations with other current and potential franchisees with the objective of clarifying issues related to calculation of franchise fees that would reduce the likelihood of further disputes with regards to such matters going forward.” DoITT is in continuous talks with franchisees regarding this and other telecommunications issues; however, a resolution of this issue has not been reached. With some franchise agreements already expired and operating under temporary agreements, and others soon to expire, DoITT should avoid future revenue loss by resolving the matter in a timely and effective manner.

RECOMMENDATIONS

We recommend that Level 3:

1. Pay the City \$510,910 in franchise fees and late charges due from understated revenue, and ensure that all revenue from customer accounts is properly included in its revenue reports submitted to the City.
2. Submit to DoITT for its review and approval a methodology for allocating revenue for services that either originate or terminate in the City in accordance with the franchise agreement and pay to the City the amount it is owed using such methodology (plus late charges as appropriate).
3. Maintain separate books of accounts and records of all City business activity in a manner that would allow the City to determine whether Level 3 is reporting all its revenue in compliance with the franchise agreement.

Level 3 Response: Level 3 did not directly address the report's recommendations; however, it generally disagreed with the audit findings as discussed in the report.

We recommend that DoITT:

4. Ensure that Level 3 pays the City the \$510,910 in franchise fees and late charges due from understated revenue assessed in this report.

DoITT Response: "DoITT will pursue from Level 3 payment of all past due amounts and late charges that the Agency determines the City is entitled to receive."

5. Ensure that Level 3 pays the City a "fair and equitable allocation" as determined for revenue generated from partial use of the System for the period covering 2007 and 2008, and that the allocation is performed based on a methodology in compliance with the proper City review and approval process as required in the agreement.

DoITT Response: "DoITT generally concurs with this recommendation as discussed above in response to recommendation 2."

6. Ensure that Level 3 submits separate accounting records and financial statements to determine whether all compensation is being paid to the City.

DoITT Response: "DoITT concurs and will require submission of such accounting records and financial statements."

7. Establish procedures and controls to review Level 3's revenue reporting and franchise fees payment calculations.

DoITT Response: "DoITT has well established and effective procedures and controls in this regard and will continue to review them to ensure proper revenue reporting and franchise payments by its franchisees."

Level 3 Communications, Inc.

**Schedule of Total Franchise Fees Due from Revenue Excluded
From Services with Both Endpoints in the City
January 1, 2008, through December 31, 2008**

Calendar Year 2008	A Revenue Reported on Sampled Customer Bills	B Revenue Reported on RevMart Billing Report	C = A - B Revenue Excluded from Amounts Reported to the City	D = C x 5% 5% Franchise Fees Due
1 st Quarter	\$ 1,975,415	\$ 492,754	\$ 1,482,661	\$ 74,133
2 nd Quarter	2,120,080	514,212	1,605,868	80,293
3 rd Quarter	2,034,375	680,193	1,354,182	67,709
4 th Quarter	3,379,359	391,956	2,987,403	149,370
Total	\$ 9,509,229	\$ 2,079,115	\$ 7,430,114	\$ 371,505
Total Late Charges (See Appendix II)				\$ 139,405
Total Franchise Fees and Late Charges Due				\$ 510,910

Level 3 Communications, Inc.

**Schedule of Late Fee Calculations for Revenue Excluded
From Services with Both Endpoints in the City
January 1, 2008, through December 31, 2008**

Date	Additional 5% Fees Due City	Accumulated Balance Due	Payment Due Date	Cover Period		Number of Days Overdue	(a)	(b)
				From	To		Interest Rate	Late Interest Charge
2008								
1 st Quarter	\$ 74,133	\$ 74,133 77,535	5/15/2008	5/16/2008	8/14/2008	91	18.00%	\$ 3,402
2 nd Quarter	80,293	157,828 165,152	8/14/2008	8/15/2008	11/14/2008	92	18.00%	7,324
3 rd Quarter	67,709	232,861 243,667	11/14/2008	11/15/2008	2/14/2009	92	18.00%	10,805
4 th Quarter	149,370	393,037	2/14/2009	2/15/2009	7/31/2010	532	18.00%	117,874
Total	\$ 371,505							\$ 139,405

(a) Section 7.4 of the Franchise agreement requires that “in the event that any payment required by this Agreement is not actually received by the City on or before the applicable dated fixed in this Agreement, interest thereon shall accrue from such date until received at a rate equal to rate of interest then in effect charged by the City for late payment of real estate taxes.”

(b) Late interest charges were calculated through July 31, 2010.



September 13, 2010

Via UPS Overnight Service and Email

City of New York
Office of the Comptroller
Mrs. Tina Kim
One Center Street, Room 1100
New York, NY 10007-2341

**RE: *Response to the Draft Audit Report of the Level 3 Communications, LLC ("Level 3")
Franchise Agreement***

Dear Mrs. Kim,

This letter is in response to the City's draft audit report dated August 30, 2010 (the "Audit Report"). As discussed in prior meetings with the City, Level 3 disagrees with the findings but is willing to continue to work with the City's Department of Information Technology and Telecommunications ("DoITT") to ensure compliance under the Franchise Agreement.

First, Level 3 would like to note that material discrepancies exist between the supporting data for the preliminary draft audit report and the Audit Report. Level 3 and the City discussed the preliminary draft audit report and its supporting data in great detail. Level 3 provided a response to that data, disagreeing with the City's findings, on August 4, 2010. Level 3 is unclear as to how the findings and associated support in the Audit Report were determined due to the material changes in the supporting data. Level 3 can only assume that the factors driving the discrepancies between Level 3's reporting during the audited years and those found by the City are similar to those discussed with the City during the preliminary draft audit review. As such, Level 3 will restate its objections to the Audit Report based on this assumption.

The Audit Report cites three areas of concern: revenue reported, revenue allocation, and recordkeeping. Level 3 disagrees with the findings in each of these areas for the reasons below.

Revenue Reported

Level 3 disagrees that it owes additional fees to the City for the audit period. Level 3's initial analyses of the data in the preliminary draft audit report consisted of queries from the revenue reports previously provided to the City audit team. The under reporting claimed by the City audit team appears to be driven by the inclusion of revenue streams to which the City is not entitled under the definition of Telecommunications Services in the Franchise Agreement. One non-telecom product alone, electrical power resold to the customer, accounts for almost 10% of the stated discrepancy.

September 13, 2010

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Allocation Methodology

Level 3 disagrees that it is not following a “fair and equitable” revenue allocation methodology as set forth in the Franchise Agreement. In accordance with Section 1.15 of the Franchise Agreement, Level 3 submits payments based on a fair and equitable allocation methodology. Level 3’s methodology allocates revenue by the proportionate length of any such circuit within the City’s jurisdiction. Level 3’s allocation favors the City by assuming all circuits are the maximum length of any two points within the City, i.e. 12.8 miles.

Recordkeeping

Level 3 disagrees that it has not maintained records in accordance with the Franchise Agreement. Level 3’s records are maintained in accordance with Section 7.1.3 of the Franchise Agreement. Section 7.1.3 of the Franchise Agreement obligates Level 3 to “keep comprehensive itemized records of all revenues received and of all Services provided, in sufficient detail to enable the City to determine whether all compensation owed to the City pursuant to Section 7.1 is being paid to the City” rather than maintain separate books of account and records of all City business activity as described and recommended in the Audit Report. In particular, Level 3 maintains unique identifiers for each dollar of revenue generated on a circuit terminating or originating in the City. Using existing accounting systems, revenue generated within the City and the associated records can be readily accessed by querying the broader revenue data set. Level 3 uses these systems to ensure it captures all revenue activity within the City.

Notwithstanding anything herein, Level 3 continues to believe that this Franchise Agreement between Level 3 and the City, and the fees assessed thereunder, may violate the Telecommunications Act of 1996, 47 USC § 253. Accordingly, Level 3 reserves all of its rights as a certified telecommunications provider in the State of New York under applicable state and federal law.

Should you have any questions concerning this submission, please do not hesitate to contact me. Level 3 looks forward to resolving these matters promptly.

Sincerely,



Steve Gordon

Senior Director, Network Infrastructure Services

Cc: Charles Wesley, Senior Corporate Counsel
Alma Fana, City of New York, Bureau of Audit
Joseph Bonanno, City of New York, Bureau of Audit



**Information
Technology &
Telecommunications**

Carole Post
Commissioner
75 Park Place
New York, NY 10007
212-788-6600

September 17, 2010

Ms. Tina Kim
Deputy Comptroller for Audit
The New York City Office of the Comptroller
Audits, Accounts & Contracts
1 Centre Street, Room 1100
New York, NY 10007

Re: **Audit Report on the Compliance of
Level 3 Communications, Inc.
With Its City Franchise Agreement
January 1, 2007 – December 31, 2008
FN10-055A**

Dear Deputy Comptroller Kim:

I am writing in response to the above-captioned draft audit report ("draft audit") dated August 30, 2010. DoITT has reviewed the draft audit's findings and recommendations and would like to comment on the recommendations that pertain both to Level 3 Communication's compliance with its high-capacity telecommunications franchise obligations and to DoITT's oversight of the Level 3 franchise.

RECOMMENDATIONS PERTAINING TO LEVEL 3

Recommendation 1: Level 3 should "[p]ay the City \$510,910 in franchise fees [\$371,505] and late charges [\$139,405] due from understated revenue, and ensure that all revenue from customer accounts is properly included in its revenue reports submitted to the City."

DoITT Response: To resolve this matter, DoITT will undertake a follow-up review. We note that Level 3 disputes the draft audit finding that it underreported revenues to the City. Specifically, Level 3 asserts that the alleged underreporting is "driven by the inclusion of revenue streams to which the City is not entitled." Level 3 claims that "material discrepancies exist between the supporting data for the preliminary draft audit report and the Audit Report." Level 3 suggests that inasmuch as it believes the preliminary draft erroneously included certain categories of revenues in the base, the audit report likely has the same flaw. Level 3 specifies only one such category of revenue, namely resold electrical power, which it claims accounts for almost 10% of

the "discrepancy." To verify whether Level 3 in fact owes the City franchise compensation due to underreporting, DoITT will undertake further analysis. Specifically, DoITT will request from the Comptroller's office the supporting data for the Draft Audit; and, upon reviewing such data, will meet with Level 3 to understand the company's own, detailed interpretation regarding those revenue streams from which it believes the City is not entitled to receive franchise compensation.

Recommendation 2: Level 3 should "[s]ubmit to DoITT, for its review and approval, a methodology for allocating revenue for services that either originate or terminate in the City in accordance with the franchise agreement and pay to the City the amount it is owed using such methodology (plus late charges as appropriate.)"

DoITT Response: DoITT generally concurs. However, it should be recognized that significant advancements in telecommunications technology have occurred since the Level 3 franchise was entered into in January 1999. These changes have made measuring where and how much of a telecommunications service "originates" and "terminates" a particularly difficult exercise, and highly dependent on the particular methodology being used. Indeed, Level 3 reports that 12% of its revenue originated or terminated in the City; the draft audit, using a different methodology believes that 50% is a more appropriate figure. DoITT will explore with Level 3 the potential for implementing an alternative methodology that is more objective, measurable and certain. Such discussion may be joined with a determination of the past due amount that is fairly owed to the City.

Recommendation 3: Level 3 should "[m]aintain separate books of accounts and records of all City business activity in a manner that would allow the City to determine whether Level 3 is reporting all its revenue in compliance with the franchise agreement."

DoITT Response: DoITT concurs that Level 3 should separately account for revenues properly attributable to its operations pursuant to the franchise, and will require such reporting.

RECOMMENDATIONS PERTAINING TO DoITT

Recommendation 4: DoITT should "[e]nsure that Level 3 pays the City \$510,910 in franchise fees and late charges due from understated revenue assessed in this report."

DoITT Response: DoITT will pursue from Level 3 payment of all past due amounts and late charges that the Agency determines the City is entitled to receive. As discussed in more detail above, with reference to Recommendation 1, DoITT will request from the Comptroller's office access to the supporting data for the Draft Audit, and thereafter meet with Level 3 to ensure that the City has received franchise compensation from all revenue streams on which Level 3 was obligated to pay.

Recommendation 5: DoITT should "[e]nsure that Level 3 pays the City a "fair and equitable allocation" as determined for revenue generated from partial use of the System for the period covering 2007 and 2008, and that the allocation is performed based on a methodology in compliance with the proper City review and approval process as required in the agreement."

DoITT Response: DoITT generally concurs with this recommendation as discussed above in response to Recommendation 2. Specifically, DoITT will pursue a revised approach to franchise

compensation using a more objective, measurable and certain methodology than that which is currently set forth in the agreement.

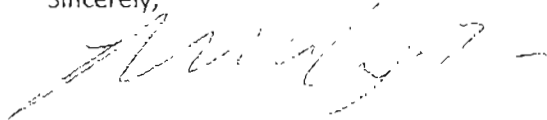
Recommendation 6: DoITT should “[e]nsure that Level 3 submits separate accounting records and financial statements to determine whether all compensation is being paid to the City.”

DoITT Response: DoITT concurs and will require submission of such accounting records and financial statements.

Recommendation 6: DoITT should “[e]stablish procedures and controls to review Level 3’s revenue reporting and franchise fee payment calculation.”

DoITT Response: DoITT has well established and effective procedures and controls in this regard and will continue to review them to ensure proper revenue reporting and franchise payments by its franchisees.

Sincerely,



Mitchel Ahlbaum

- c: Carole Post, Commissioner/NYC DoITT
- Stanley Shor, Assistant Commissioner/NYC DoITT
- George Davis III, Deputy Director/NYC Operations
- Bruce Regal, Senior Counsel/NYC Law Department