

Analysis of Arthur Anderson's Adjustments To CUC's Damage Estimates

Introduction

On July 14, 1999, Central Utah Communications, L.C. (CUC) submitted an "offer to settle" CUC's breach of contract claims against Qwest Communications Corporation (Qwest). This "offer to settle" included CUC's preliminary estimate of its damages. On December 9, 1999, Qwest provided a summary discussion of various adjustments made by Arthur Andersen to CUC's analysis.

The adjustments made by Arthur Andersen reduced CUC's estimated damages associated with its "Affinity Marketing" plan and "WRLD Alliance" plan by 99.7% and 97.8%, respectively. This report addresses these adjustments and other key assumptions in Arthur Andersen's calculations. In addition, it provides an alternative damage estimate which corrects the major problems with Arthur Andersen's analysis. In preparing these alternative calculations we have generally used conservative assumptions, in an effort to facilitate settlement discussions.

Affinity Marketing Plan

CUC estimated approximately \$31.3 million in damages associated with its Affinity Marketing plan. Arthur Andersen made seven adjustments to CUC's analysis, reducing the estimate to approximately \$94,000. Correcting the major problems with the Arthur Andersen analysis, we estimate the damages resulting from Qwest's breach of contract total \$18.3 million.

Annual Usage

CUC's analysis included average monthly usage of approximately 20 minutes per month, per end user. Arthur Andersen's analysis included the same assumption, despite the fact that this is an inordinately

low figure. Data published by the FCC indicates that, during 1998, the average residential customer generated 71 minutes of outgoing interstate-interlata traffic per month, and 26 minutes of intrastate-interlata traffic, for a total of 97 minutes of outgoing interlata usage. This average includes customers with very little long distance usage, as well as customers with much higher usage patterns.

CUC correctly anticipated an important trend in the industry by establishing a fixed monthly fee along with a relatively low charge per minute. Because CUC's Affinity plan included a monthly fee of \$4.95 per month, it was not as attractive to low use customers as it was to customers with moderate to high usage patterns. For these customers, the low per-minute charge would be more important, and the monthly fee would be of less significance (especially since a portion of the fee was contributed to charity).

Arthur Andersen should have recognized that this plan would attract a disproportionate share of high-usage customers, who would be encouraged to talk even longer on the phone because of the low per-minute rates. Under these circumstances, Arthur Andersen should have recognized that the Affinity customers would have more traffic than the national average customer (97 minutes per month), and far more than the 19 minutes used in CUC's initial damage estimate.

For purposes of our alternative damage estimate, we have assumed that the typical Affinity customer will spend 25% more time on the telephone than the national norm. More specifically, we assume these customers will use 88.8 interstate minutes and 32.1 intrastate minutes per month.

2004 Estimated Minutes

CUC effectively used one month of estimated usage to calculate annual revenues and costs for 2004. Arthur Andersen corrected this error by substituting total estimated 2004 annual minutes for the monthly usage assumed in CUC's analysis. This adjustment was appropriate.

Monthly Growth Rates

CUC developed its usage estimates using varying growth rates for each year of its analysis. These figures were then converted into monthly growth rates by dividing by 12 (or the number of months for which the Qwest contract was valid for that year). Since this approach provided for monthly compounding, it resulted in substantially more growth in a given year than would have resulted if the “annual” growth rate had been used. Qwest complains that “this methodology creates a compounding of growth through the year and ultimately results in an actual annual growth rate much higher than the stated annual growth rate.”

Arthur Andersen changed CUC’s approach by eliminating the monthly compounding, but this was a purely mechanical modification. They made no effort to verify whether the resulting monthly growth rates, or resulting total demand levels, were reasonable. A mechanistic approach is not appropriate in this context. Arthur Andersen had no basis for assuming that CUC intended to project annual growth at the nominal rates used by Arthur Andersen, nor did they have any other justification for reducing the overall demand levels used in the CUC analysis.

The key question is what level of demand can reasonably be anticipated in each year of the analysis. The growth rates used in the analysis are simply devices which are used to generate demand estimates for each time period. Hence, it is not appropriate to modify the monthly growth rates, as Arthur Andersen proposes, without taking appropriate steps to ensure that the resulting demand levels are reasonable.

If Arthur Andersen believed the demand levels projected by CUC were too high or too low in particular years, it should have modified the starting point, as well as the growth rates, to ensure that the resulting demand levels were appropriate, rather than simply making a mechanistic change to one aspect of CUC’s demand analysis. Stated differently, Arthur Andersen should have developed its own estimates of the number of customers that can reasonably be anticipated for each time period. By arbitrarily cutting CUC’s demand estimates, Arthur Andersen has drastically reduced the amount of damage which it calculates, without demonstrating that the results are reasonable.

One cannot simply consider the frequency of compounding, the individual growth rates, or the initial demand level. Rather, it is necessary to consider the overall effect of all these assumptions working together. The key consideration is whether the projected number of subscribers to the Affinity plan is reasonable, given the circumstances.

In our alternative damage estimate, we used reasonable assumptions for each of these factors, resulting in overall demand levels which are quite conservative, given the size of the affinity organizations and the strong appeal of the Affinity program. For example, the Jaycees informed CUC that they had typically seen approximately 10% of their members participate in analogous programs within the first year after they were offered. It is reasonable to assume that the Affinity program would have achieved similar or greater participation levels within the first year it was offered (absent Qwest's breach of contract), and that participation would have continued to grow thereafter, because of the nature of the product and the structure of the program. Accordingly, for purposes of our alternative damage calculations, we conservatively estimated that approximately 10% of the Jaycee members would participate in the program after approximately one year, and that Jaycee participation in the program would peak at roughly double this level, approximately two years later. A similar approach was used in developing conservative demand estimates for each of the other groups.

Contract Termination Date

On February 12, 1998, CUC and Qwest signed a contract that gave CUC the ability to resell Qwest minutes for a period of two years with an automatic renewal of an additional two years at the conclusion of the "current period." Arthur Andersen assumed one renewal after the initial two years, for a total contract term of four years, thereby eliminating CUC's estimated damages incurred from March 1, 2002 through January 31, 2004. Arthur Andersen's adjustment appears inconsistent with the terms of the agreement, which is not limited to a single renewal. If the intent were to limit the contract to no more than four years, it would have been more appropriate to use the term "initial period" rather than "current period."

Moreover, regardless of the duration of the contract, Arthur Andersen's approach is flawed because it ignores the profits that CUC could have generated in future years as a result of establishing its relationship with the Affinity organizations and their members. Even if CUC had not renewed the Qwest contract, it would have benefitted from the goodwill and customer relationships it would have developed during the initial period of the Qwest contract. The damages suffered by CUC certainly extend beyond the brief period of 45 months assumed by Arthur Andersen. By arbitrarily limiting its analysis to this brief period, Arthur Andersen has artificially constrained the amount of damage which it calculates.

Our alternative damage calculations encompass the additional period from March 2002 through January 2004. During this period, we assume CUC would have experienced a moderate decline in demand, due to the introduction of more attractive pricing plans by competitors, increased wireless long distance usage, and other industry trends.

Median Growth Rates

In its fourth adjustment, Arthur Andersen contended that the rate of growth in Affinity Plan participation should not differ between affinity groups, even in situations where there are factual differences in the circumstances of each group. It replaced the disparate growth rates supplied by CUC with the median growth rate across all groups for each year of service.

The approach used by Arthur Andersen is not necessarily superior to that used by CUC. Here again, the key question is whether the overall demand estimates are reasonable. Depending upon the initial demand levels used in the analysis, it might or might not be reasonable to use uniform growth rates.

There is no reason why groups of different sizes, with different purposes, different core member characteristics and different degrees of affiliation, would necessarily participate in the Affinity program at precisely the same rate. Nor would participation necessarily grow at the same rate. For example, the Jaycees may have greater loyalty to their organization and its charitable mission than the members of

another organization. Similarly, Jaycee members may meet and talk on a more frequent basis than the teachers and parents in the Washington School District. Considering these and other potential differences, growth in participation would not necessarily be identical across all affinity groups.

CUC apparently anticipated some inconsistencies in participation rates. For instance, the CUC estimates reflect a 16% participation rate for the National High School Rodeo Association (NHSRA), a relatively small, tight-knit group of parents and students. In contrast, CUC's estimates reflect a first year participation rate of less than 1% for the Loyal Order of Moose, a large, national philanthropic organization.

Arthur Andersen was unclear as to why growth in Plan participation should have been "consistent" among the different groups. Arthur Andersen noted that many of the customers under the Plan would not be directly affiliated with an affinity group, and this is certainly true. One of the fundamental elements of the marketing plan was that participants would obtain a \$1 credit on their monthly bill (the "Customer Referral Bonus") for each additional customer they encouraged to join the program. This would encourage growth in the number of customers, and at least this aspect of the plan was common to all of the Affinity groups.

In any event, Arthur Andersen's use of a uniform growth rate is not necessarily unreasonable. As stated earlier, the key question is whether the estimated demand levels are reasonable. The assumed growth rate and the assumed starting point need to be evaluated in tandem, to ensure that the resulting overall participation rate is reasonable, given the size and characteristics of each Affinity group.

Arthur Andersen makes no mention of the participation rates resulting from its adjustments, nor did it take adequate steps to ensure that the overall demand levels resulting from its adjustments were reasonable. We believe that, at least for some of the groups, Arthur Andersen severely underestimated the rate of participation in the Affinity program, particularly in the later years.

For purposes of our alternative damage calculations, we have accepted Arthur Andersen's preference for uniform growth rates across all Affinity groups. However, we adjusted the individual starting demand levels for some of the groups, to be consistent with the growth assumptions, thereby ensuring that the overall demand levels for each group were reasonable.

Program Start Date

Arthur Andersen moved the Plan's start date from May 1, 1998 to July 1, 1998. Each one of the reasons it gave to support this adjustment was simply incorrect. Arthur Andersen first contended that "as of May 21, 1998, CUC had not commenced any activity related to the Affinity Marketing Plan even though it had met with the Jaycees, the Moose Club and the National High School Rodeo Association." On the contrary, by April 1, 1998, CUC had completed Plan start-up, contract negotiations, development and implementation of its business plan, testing of internal systems, and it had begun its sales and marketing program. Furthermore, by April 1, CUC had established, published and distributed its retail pricing plan to all of its key customers within the Affinity sales category. All of these actions were taken based on Qwest's agreement to "turn-up" the first Affinity customer by this date. Qwest did not fulfill this agreement. Instead, it delayed customer turn-up until May 21, 1998—the date it finally breached its contract with CUC.

Arthur Andersen seems to have been swayed by the fact that long distance traffic was not being generated by CUC between April 1 and May 21, but this was because Qwest had not followed through on its agreements, not because of any failure on CUC's part. To the contrary, it is our understanding that CUC had taken the necessary steps to enable it to serve its customers. Arthur Andersen contends that the May 1 start date was too early, because CUC had not adequately dealt with the logistical details of its plan. It is our understanding, however, that CUC had the necessary personnel and equipment in place to begin operations by this date.

The costs associated with these activities were not included in its damage estimate because, once Qwest reneged on its contract, these became sunk costs which are dealt with separately in CUC's

analysis of its damages. Assuring the logistics of the plan alone cost CUC in excess of \$400,000. In sum, Arthur Andersen's adjustment to change the start date for the Plan seems highly inappropriate, given the facts of the case. The delays that were encountered were primarily, if not exclusively, due to Qwest's failure to perform under the contract. Hence, these delays should be viewed as *contributing* to the damage incurred by CUC, rather than being treated as a factor that *reduces* CUC's damages, as proposed by Arthur Andersen.

In order to be conservative, we have used June 1, 1998 as the Plan's start date in our alternative damage calculations. While CUC believes it was ready to begin operations well before this date, it is reasonable to use a more conservative start date to facilitate settlement discussions.

Operating Expenses

Arthur Andersen noted that CUC failed to include certain operating expenses in its analysis. Arthur Andersen's "adjustment for operating expenses" included the addition of billing and collection costs, bad debt expenses, "switching costs," customer service expenses and fixed costs.

We agree that additional expenses should be included in the damage calculations, but we disagree with the specific cost levels assumed by Arthur Andersen. For instance, they included monthly billing and collection costs of \$1.34 per end user for 1998 and 1999, and \$1.44 per month thereafter. These cost estimates are excessive, given the nature of CUC's business plan. CUC had arranged for a third-party billing service which would debit end users' checking accounts on a monthly basis. Therefore the only "collection" expenses that CUC would incur were the fees to be paid to the third-party billing service, which amounted to just \$0.21 per customer bill.

Arthur Andersen included bad debt expenses of 5% of revenues, "based upon the assumption that billing would occur through a LEC, rather than a direct CUC billing arrangement, in which case the bad debt expense would be significantly higher." This assumption is inconsistent with CUC's actual third party billing arrangement, which provided it with the ability to automatically debit the customer's

checking account. This debit arrangement shifted virtually all of the bad debt risk to Welcome America, the party providing the debit service. It had agreed to guarantee payment even if there were insufficient funds in the customers checking account. CUC would only incur "bad debt" if it continued processing calls for a customer who had insufficient funds in their account. Since Welcome America would notify CUC when a customer's account didn't hold sufficient funds, and CUC would immediately cut off their long distance service, until the past due amount had been paid. Hence, the only "bad debt" that CUC could possibly incur would be if it made a mistake, and failed to disconnect a customer's long distance service after being notified of an insufficient funds condition by Welcome America.

Needless to say, given the terms of this arrangement, the 5% bad debt factor used by Arthur Anderson is grossly excessive. In developing our alternative damage estimate, we have used a more realistic factor of \$.0005 per minute.

Although CUC did not need to collect funds directly from its Affinity customers, it did plan to initially mail them copies of their bills, including calling detail. It would not be necessary to include a return envelope, nor would it be necessary to process incoming remittances. Hence, CUC's billing costs would be a fraction of the level assumed by Arthur Andersen. In developing our alternative damage estimate, we have assumed CUC would incur approximately \$0.65 per account per month for billing and collection. This is sufficient to cover the cost of pre sorted first class postage, an envelope, processing and printing of the bill, and the Welcome America fee.

These are not the only areas where Arthur Andersen included excessive cost estimates, due to an apparent misunderstanding of the Affinity program. It also included "switching" costs of \$5.00 per new customer, based on the assumption that "CUC will pay for new customers to switch long distance service to CUC, which is standard industry practice." Furthermore, Arthur Andersen assumed that CUC would have to sign up 1.25 customers for every net new customer retained. The \$5.00 Presubscribed Interexchange Carrier (PIC) charge was applied to the monthly gross number of new customers. While it is certainly true that many long distance carriers offer to reimburse the \$5.00 PIC charges incurred by their customers, all customers take the necessary steps to ensure that they receive

this reimbursement. Thus, even under “standard industry practice” it wouldn’t be appropriate to assume a cost of more than \$5.00 per new customer gained. More important, not all carriers offer to reimburse this cost. In fact, under CUC’s actual business plan, it did not intend to reimburse customers for this charge, and thus the PIC cost would remain the responsibility of the end user—not CUC.

Arthur Andersen also included customer service costs of 1% of revenues and \$50,000 in fixed costs per year. It is appropriate to include such costs, and Arthur Andersen’s estimates in this regard to are reasonable. In our alternative damage estimate we have also included an allowance for miscellaneous general, administrative and marketing costs of \$.50 per new customer, and \$.002 per minute.

Present Value and Interest

Arthur Andersen estimated the present value of all monthly profits, using a discount rate of 25% per annum. After discounting the profits back to the start date, Arthur Andersen then totaled all the discounted profits, and applied interest at 10% until December 31, 1999. Arthur Andersen claims its proposed 25% discount rate is “appropriate for the risk factors involved in CUC’s plan as well as the competitive nature of the telecommunications industry.” The interest rate used by Arthur Andersen is equal to the statutory rate applicable in Utah.

Arthur Andersen’s general approach of discounting the profits back to a single point in time and then escalating the profits forward based upon the statutory interest rate is reasonable. However, the 25% discount rate is clearly excessive. This unreasonably high discount rate has the effect of dramatically reducing the discounted amount of damage. Although Arthur Andersen claims that the discount rate is “appropriate for the risk factors involved in CUC’s plan as well as the competitive nature of the telecommunications industry,” we strongly disagree.

In our view, CUC’s business plan was not particularly risky. The only risk factor mentioned by Arthur Andersen is their mistaken impression that the CUC plan required end users to pay very high effective rates per minute. However, this conclusion is based upon a mistaken assumption concerning the number

of minutes which the typical customer would use each month. Using more reasonable assumptions concerning average calling volumes, the CUC plan did not involve particularly high rates per minute.

While Arthur Andersen seems skeptical of the \$4.95 per month fee, this was a reasonable element of the CUC plan, and in fact the industry has been trending toward this pricing approach. The monthly fee was particularly reasonable given that a substantial portion was being contributed to charity, and given that the opportunity existed for customers to offset the fee with a credit for each additional customer they encouraged to join the plan.

We would also disagree with the notion that the long distance business is unusually risky. The risks involved in CUC's business plan were moderate, particularly given the favorable contract it had negotiated with Qwest, and the innovative approach it was using to penetrate the market. In the absence of any justification for using a higher discount rate, it would be more reasonable to set the discount factor equal to the Utah statutory interest rate. Accordingly, in our alternative damage calculations, we discounted the lost profits back to June 1, 1998, using a 10% discount rate.

Conclusion

Our alternative damage calculations, which total \$18.3 million, are limited to the most readily identifiable consequences of Qwest's actions. They do not encompass the full amount of damage that CUC actually incurred. For instance, our calculations are limited to the specific organizations that CUC was initially targeting. Our calculations do not include any estimate of damages related to the lost opportunity to expand the Affinity program to encompass additional groups. Had Qwest performed as promised, CUC could have built upon the experience it gained working with the Jaycees and other groups, to offer its program to many other organizations, but this is not considered in our alternative damage calculations.

WRLD Alliance Plan

CUC estimated approximately \$8.95 million in damages associated with its WRLD Alliance plan. Arthur Andersen made seven adjustments to CUC's analysis, reducing the damage estimate to approximately \$196,000. Correcting the major problems with the Arthur Andersen analysis, we estimate the damages resulting from Qwest's breach of contract total \$6.9 million.

Rounding Differences

Arthur Andersen received a copy of CUC's damage estimate but was unable to exactly replicate the percentages CUC used to calculate inter- and intrastate revenues and costs. As a result, a small difference in damages remains present in the two estimates. Whether characterized as rounding differences or typographical errors, these discrepancies are not particularly significant. In any event, we used a somewhat different approach to calculating interstate and intrastate revenues and costs, thereby eliminating the need for this adjustment.

Contract Termination Date

Arthur Andersen next adjusted for the contract termination date according to its interpretation of the Qwest-CUC contract. As discussed above concerning the Affinity Plan, if the parties' intent was to limit the contract to no more than four years, it would have been more appropriate to use the term "initial period" rather than "current period."

Moreover, Arthur Andersen's approach ignores the profits that CUC could have generated in future years as a result of establishing its relationship with exchange carriers pursuant to the WRLD Alliance program. Even if CUC had not renewed the Qwest contract, it would have benefitted from the goodwill and customer relationships it would have developed during the first two years of offering the WRLD Alliance plan pursuant to the Qwest contract.

The damages suffered by CUC certainly extend beyond the brief period of 45 months which was assumed by Arthur Andersen. By arbitrarily limiting its analysis to this brief period, Arthur Andersen has

artificially constrained the amount of damage which it calculates. For purposes of our alternative damage calculations, we have assumed an end date of February 1, 2004. While the adverse impact of Qwest's breach will undoubtedly extend beyond this date, we have used a conservative ending date to facilitate settlement discussions.

Actual Usage

In its original damage estimate, CUC estimated the number of minutes it would have sold to each customer each month under the WRLD Alliance Plan. In addition, it supplied historical minute data for June 1998 through September 1999 for those carriers that eventually became CUC customers notwithstanding Qwest's failure to perform as promised. Arthur Andersen compared these estimated and actual data sets and concluded that the actual minute data was a more accurate representation of the traffic volumes that CUC could expect. Accordingly, Arthur Andersen replaced CUC's estimated minutes with the average actual monthly minutes of use for each CUC customer.

Arthur Andersen also computed an "average overstatement" factor from its comparison of actual and projected traffic, and used this factor to reduce CUC's traffic projections for the remaining customers included in CUC's damage estimates. Through these two interrelated adjustments, Arthur Andersen arrived at traffic volumes that are substantially lower than CUC's estimates for both its actual and potential customers.

The inherent flaw in this approach is that the volume of minutes actually sold by CUC was depressed *as a result* of Qwest's breach of contract. CUC had developed its minute estimates based on its analysis of market conditions and its ability to attract wholesale customers, given the terms of the Qwest contract. After Qwest decided not to perform under its contract, CUC was confronted with a fundamentally different situation. In particular, CUC was no longer in a position to offer a guaranteed price for a substantial period of time, because it could not be certain what it would be paying its supplier.

CUC was able to work out a stop gap arrangement with WorldCom shortly after Qwest breached the contract. However, this arrangement was month-to-month and WorldCom could void it at any time. Although WorldCom matched Qwest's per-minute charges, it refused to offer these prices on a guaranteed long term basis. This greatly affected CUC's business plan, since it was concerned that it could lose the WorldCom arrangement at any time, or WorldCom might increase its price significantly, if a substantial fraction of CUC's traffic originated in independent company service territories. As it turned out, these concerns were well founded. Only a few months after the contract was agreed to, WorldCom doubled the rates it charged to CUC for its minutes, which drastically affected the viability of its WRLD Alliance program. Under the guaranteed pricing provisions of the Qwest deal, CUC would not have encountered this problem, and thus it would have been in a fundamentally better position.

By its very nature, the WRLD Alliance program would generate high volumes of traffic in independent territories where switched access charges are above average. Under the terms of the Qwest contract, CUC was dealing with assured price levels, regardless of the mix of independent and RBOC traffic, and thus it could offer a fixed level of prices to its WRLD Alliance customers. In contrast, the WorldCom arrangement was vulnerable to rapid price changes if its WRLD Alliance program expanded rapidly and WorldCom decided the traffic wasn't sufficiently profitable.

Arthur Andersen made no effort to verify whether the overall volume of traffic estimated by CUC was reasonable, given the assumption that Qwest had performed as promised. To the extent CUC overestimated traffic volumes for some of its WRLD Alliance customers, this doesn't necessarily mean that it overestimated volumes for all of its customers. To the contrary, it may have underestimated traffic for some customers, while overestimating traffic for others. To the extent Arthur Andersen has doubts about CUC's traffic estimates, it should have gathered the necessary data to generate its own estimate of the volume of traffic which these customers would have generated if Qwest had fulfilled its contractual commitments.

We made such an effort in developing our alternative damage estimate. We obtained National

Exchange Carrier Association (NECA) data for the number of minutes and lines that each of the WRLD Alliance customers served in 1998. We assumed that, if Qwest had lived up to its contractual commitments, CUC would have been able to serve 40% of these customers' lines pursuant to the WRLD Alliance plan. We then multiplied these line quantities by FCC monthly minute data to obtain an estimate of the calling volume that CUC could reasonably expect from each of its WRLD Alliance customers. We then divided the resulting minutes into interstate and intrastate quantities, using ratios reported by the FCC.

This approach is far superior to the one used by Arthur Andersen. Our minute estimates are consistent with what CUC could have expected its customers to generate each month, if Qwest had not breached the contract.

Program Start Date

In a related adjustment, Arthur Andersen moved the program start date from May 1, 1998 to July 1, 1998. As discussed above in the context of the Affinity Plan, none of the reasons given by Arthur Andersen to support this delay in the start date are valid. Arthur Andersen seems to have been swayed by the fact that long distance traffic was not being generated by CUC between April 1 and May 21. However, this does not prove that CUC's customers were unable to generate traffic during this period, or that CUC would have been unable to bill its customers if Qwest had been able to handle the traffic as promised. To the contrary, CUC was concerned that Qwest was not ready to perform under the contract. It didn't want its WRLD Alliance customers to send traffic to Qwest before Qwest was ready.

Since CUC was relying upon a supplier who did not appear to be ready, it was prudent for CUC to delay the ramp-up of the WRLD Alliance program. By delaying the ramp-up process, CUC made an effort to ensure that everything went smoothly and the WRLD Alliance customers' traffic was handled properly.

Since the April 1 through May 21 time period was adversely impacted by CUC's concerns about Qwest's back office problems, the lack of traffic during this time period does not provide a valid indicator of CUC's ability to begin the program on its original schedule. Arthur Andersen contends that the May 1 start date was too early, because it believes CUC had not adequately dealt with the logistical details of its plan, it has not provided any evidence to support this contention. It is our understanding that CUC had the necessary personnel and equipment in place to begin operations by May 1. Accordingly, we see no merit to Arthur Andersen's decision to use a program start date of July 1.

In order to be conservative, we have used June 1, 1998 as the WRLD Alliance plan's start date in our alternative damage calculations. While CUC believes it was ready to begin operations well before this date, it is reasonable to use a more conservative start date to facilitate settlement discussions.

Carriers Without Contracts or Actual Business

Arthur Andersen's fifth and sixth adjustments are inappropriate for many of the same reasons that its adjustment of the usage levels and start date are invalid. In the fifth revision, Arthur Andersen removed any and all damages attributable to carriers that did not officially enter into a contract with CUC.

Arthur Andersen felt that, since these carriers did not do any business with CUC, there was no basis for determining damages. And further, since CUC provided no documentation to support its assertion that these carriers would have become customers if Qwest had performed as promised, Arthur Andersen assumed they would not have become CUC customers. In our view, this is not a sufficient basis for eliminating these carriers from the damage calculations.

CUC had entered into agreements with each of the carriers it included in its damage estimate to handle their traffic pursuant to its arrangement with Qwest. When Qwest failed to perform as promised, these carriers were alienated from CUC. Although CUC was able to work out a stop gap arrangement with WorldCom shortly thereafter, the lack of long term stability in this fallback arrangement was a fatal flaw from both CUC's perspective, and that of its potential WRLD Alliance customers. CUC was unable to provide long term assurances to its customers, and thus many of these carriers did not view this

“replacement” arrangement as an adequate alternative.

Given the facts of this litigation, the historic data does not provide a reliable indication of what CUC would have been able to do if Qwest had performed as promised. If a carrier refused to do business with CUC after Qwest failed to perform as promised, this refusal may be traced directly back to Qwest’s actions. This certainly doesn’t provide a valid basis for excluding a carrier from the damage calculations. To the contrary, Arthur Andersen should have realized that many of these carriers refused to do business with CUC as a consequence of Qwest’s performance failures.

The approach used by Arthur Andersen is fundamentally unsound, given the factual context, resulting in a gross understatement of the actual damages which resulted from Qwest’s failure to perform as promised. The very lack of revenues which Arthur Andersen relies upon to exclude carriers from the calculations should instead be viewed as confirmation that CUC’s reputation in the market was damaged by Qwest’s performance failures—damage that CUC was unable to overcome.

Actual Gross Profits

Arthur Andersen’s sixth adjustment appears to present a similar problem to that just discussed. Arthur Andersen extrapolated the actual gross profits that CUC “has received or would expect to receive” based upon an extrapolation of certain actual CUC profit data from the time period ending September 1999. Arthur Andersen has not clearly stated the rationale for this adjustment, nor has it provided a detailed description of the specific procedure it used in preparing this adjustment. Consequently, we are unable to fully evaluate the merits of this adjustment. However, we would note that the profit margins CUC was able to generate in the wake of Qwest’s breach of contract may be lower than what it could have achieved if Qwest had performed as promised.

While the price paid to WorldCom may have initially been the same as what would have been paid to Qwest, the volume of traffic was considerably lower, for the reasons discussed earlier, and this may have placed downward pressure on CUC’s profits. At least in the context of other adjustments, Arthur

Andersen has not been careful to exclude the impact of Qwest's performance failures in analyzing CUC's actual data. We have not been provided with the details of how they developed this adjustment, and thus cannot evaluate whether, or to what extent, a similar problem occurs in the way Arthur Andersen handled this issue.

We bypassed this problem by constructing an alternative damage estimate for the WRLD Alliance plan which uses reasonable assumptions concerning inter- and intrastate revenues and gross margins, as well as various other costs, including marketing bad debt, and billing. In this manner, we developed a conservative estimate of the profits which could have been generated by CUC if Qwest had performed as promised.

Present Value

Arthur Andersen's final revision was an adjustment for present value. We disagree with this adjustment for the same reasons provided our earlier discussion of the Affinity Plan. Although it is reasonable to discount the profits back to a single point in time, the 25% discount rate used by Arthur Andersen is clearly excessive. This unreasonably high discount rate has the effect of drastically reducing the discounted amount of damage. Although Arthur Andersen claims that the discount rate is "appropriate for the risk factors involved in CUC's plan as well as the competitive nature of the telecommunications industry," we strongly disagree.

In our view, CUC's business plan was not particularly risky. The only specific risk factor mentioned by Arthur Andersen doesn't even apply to the WRLD Alliance program. We would also disagree with the notion that the long distance business is unusually risky. The risks involved in CUC's business plan for the WRLD Alliance program were moderate, particularly given the favorable contract it had negotiated with Qwest, which provided a uniform price for traffic originating in both independent and RBOC service territories. In the absence of any justification for using a higher rate, it would be reasonable to set the discount factor equal to the Utah statutory interest rate. Accordingly, in our alternative damage calculations, we discounted the lost profits back to June 1, 1998, using a 10% discount rate.

Conclusion

Many of the same intangible consequences that we discussed in the context of the Affinity plan occurred under the WRLD Alliance plan as well, the injured party had merely changed. The small resellers that were CUC's customers under the WRLD Alliance plan, like the affinity groups, experienced great disappointment when faced with the loss of Qwest minutes. This disappointment then translated into a blow to CUC's reputation as a carrier in good standing. I again feel that, by virtue of the fact that our estimate does not put a dollar amount on these types of damages, our proposal is a conservative one.

Remarkably, the tangible and intangible damage associated with the Qwest breach has been so great that CUC had not achieved a profit on its WRLD Alliance plan until two months ago (July 2000). In total, it took CUC more than two years to recover financially, and even then most likely not to the level of profitability it would have been able to achieve under the Qwest contract.

We have estimated that monetary damages incurred by CUC for the WRLD Alliance plan total \$6.9 million in an attempt to compensate the company for all months in which it could have achieved profitability.