ATTACHMENT 3

STATE OF ALASKA

THE REGULATORY COMMISSION OF ALASKA

Before Commissioners:	Mark K. Johnson, Chair Kate Giard Dave Harbour James S. Strandberg G. Nanette Thompson

In the Matter of the Petition by GCI COMMUNICATIONS CORP. d/b/a GENERAL COMMUNICATION, INC. and GCI for Arbitration Under Section 252 of the Telecommunications Act of 1996 with the MUNICIPALITY OFANCHORAGE d/b/a ATU TELECOMMUNICATIONS a/k/a ATU TELECOMMUNICATIONS for the Purpose of Instituting Local Competition.	U-96-89

PREFILED REBUTTAL TESTIMONY
OF
GREG CHAPADOS

ON BEHALF OF
GENERAL COMMUNICATION, INC. (GCI)

SEPTEMBER 29, 2003

I. INTRODUCTION

Q PLEASE STATE YOUR NAME AND THE PURPOSE OF YOUR TESTIMONY.

A. My name is Gregory F. Chapados. I am a Managing Director at Hoak Breedlove Wesneski & Co. ("HBW"), an investment bank based in Dallas, Texas. The views expressed herein are my own and not HBW's. Prior to joining HBW, I served as senior vice president – new business development at Crown Media, Inc., a top-20 cable multiple system operator ("MSO") with approximately one million subscribers. In the first Bush administration, I served as Assistant Secretary of Commerce for Communications and Information and Administrator of the National Telecommunications and Information Administration, which is the principal advisor to the President on communications policy. Prior to joining the Commerce Department, I served as chief of staff to Senator Ted Stevens of Alaska, where I was deeply involved in federal policy issues related to the development of long distance competition in the Alaska market.

The purpose of my testimony is to provide the Regulatory Commission of Alaska ("RCA") with information on the finances and operational performance of Alaska Communications Services Group ("ACS") that is relevant to various claims that ACS witnesses have made in the Anchorage arbitration in Docket U-96-89. For example, ACS claims that "below-cost UNE rates" in Anchorage both hindered ACS' efforts to secure capital for investment and discouraged ACS investment in

essential plant maintenance as well as in new technology and infrastructure. ACS also claims that existing Anchorage UNE rates have put ACS at an "unfair competitive disadvantage" that could lead to ACS' losing "virtually 100%" of that market. My testimony focuses on comparing these broadly drawn claims to the on-the-ground reality of ACS' finances and operational performance.

II. REBUTTAL TESTIMONY

Q. MR. CHAPADOS, VARIOUS ACS WITNESSES CLAIM THAT UNREASONABLY LOW UNE RATES ARE LEADING IT TO UNDER-INVEST IN ITS LOCAL TELEPHONE OPERATIONS BECAUSE IT CANNOT GET A DECENT RETURN ON ITS INVESTMENT AND ITS CASH FLOW HAS BEEN REDUCED. DO YOU AGREE WITH THESE CLAIMS?

A. No I do not. First, ACS has failed to prove that it is in under-investing. The only evidence offered is a reduction in plant maintenance expenditures from the 1998 historical period. This reduction proves nothing in itself. For one thing, since the late 1990s, ILECs nationwide have dramatically reduced all forms of cap-ex for numerous reasons, including the recession, the decline in demand for second telephone lines, the substitution of wireless for wireline service, less expensive technology, etc. Although the regulatory environment certainly can influence cap-ex levels, J.P. Morgan's telecom analysts have dismissed as a "myth" the idea that the UNE regulatory regime is solely or even primarily responsible for the decline in capital spending since the late 1990s by the largest ILECS, i.e., the RBOCs. For another thing, we should all keep in mind that ACS purchased ATU

in 1999 with the express goal of enhancing the operating and cap-ex efficiency of what it and its investment bankers characterized to investors as a gold-plated operation.

Second, I can find no reference to the alleged ACS local telephone cap-ex gap in ACS' 2003 SEC filings, the accuracy of which the Sarbanes-Oxley Act requires ACS' CEO and CFO to certify under pain of criminal sanctions. If such a gap really existed, a gap that jeopardized the viability of ACS' only truly successful line of business, the company would be obligated to disclose the gap to its public investors. Instead, the company has been touting to investors its recent success in winning back local telephone customers through local-long distance-DSL bundles. The inconsistencies between ACS' public investor story and its policymaker/regulator story raise serious questions about ACS' representations to the RCA.

Third, ACS continues to talk about sub-par returns in its local telephone operation without providing the RCA, GCI, or anyone else an explicit analysis of how it is calculating its investment in local telephone service and its return in Anchorage and what relevance that calculation has to the current proceeding. Crying wolf is not a substitute for proof.

Fourth, in the recent prospectus for its high-yield debt offering, ACS admits that its total cash flow (e.g., earnings before interest, taxes, depreciation, and amortization ("EBITDA")) has, in fact, increased substantially since 2000. In its offering, ACS stated:

> **Strong operating performance and solid credit profile.**
>
> We [ACS] operate a strong, stable business that has performed well in a difficult telecom environment. ***From 2000, the first full year after our management buyout, through 2002, we have grown revenue and EBITDA by approximately 10% and 19% respectively, through a combination of investment in new services and cost reductions in our traditional local telephone business.*** Our credit profile has also improved significantly since our management buyout, having reduced net debt (as defined) to EBITDA from 5.0x (based on 2000 operating performance) to 4.1x as of June 30, 2003, on a pro forma basis. Our liquidity on a pro forma basis continues to be strong, with $50 million expected to be available under our new bank credit facilities and $105 million expected in cash. The re-capitalization of our balance sheet described herein will decrease senior secured leverage from 3.1x EBITDA to 2.0x EBITDA on a pro forma basis for the twelve months ended June 20, 2003, extend the next significant maturities of our indebtedness to 2009, and increase our future financial flexibility.[1]

As the numbers set forth below illustrate, ACS is much stronger shape financially

ACS Financials (figures in millions except ratios)	2000	2001	2002	Pro Forma LTM 6/30/03
Total Revenue	$313.5	$332.2	$343.5	$309.7
EBITDA	$108.5	$128.7	$128.7	$106.1
Total Debt	$537.7	$555.6	$574.2	$431.6
Net Debt/LTM EBITDA Ratio	5.0x	4.3x	4.5x	4.1x
Total Liquidity (cash and undrawn credit)	$136.9	$116.0	$93.6	$171.8*

Source: ACS Draft High Yield Prospectus, August 2003.
*$17 million of net proceeds from disposition of remaining interest in its directory operation is included.

today than it was at the end of 2000.

Fifth, a quick review of ACS' financials (despite ACS' confusing business segment disclosure) reveals that ACS' local telephone operation is the crown jewel of its business operations. Not only does ACS' local telephone operation account for the vast majority of ACS' EBITDA, increases in the efficiency of ACS' local telephone operation also appear to account for the substantial majority of ACS' EBITDA growth since 2000. ACS' wireless, Internet, and interexchange operations have contributed little to EBITDA growth. In fact, ACS' Internet operation has become a money losing black hole, generating $14-plus million in negative EBITDA in 2002 alone.

The awful truth, which ACS spends much of its time trying to hide, is that its local telephone operation provides the vast majority of the cash flow that supports its $536 million in gross debt as well as providing the $100 million-plus that ACS has so far wasted in its misguided diversification efforts in interexchange and Internet services, which are also highly dependent on ACS' local telephone customer base. The growth in ACS' cash flow and liquidity over the past three calendar years would be even more impressive but for the exceptionally poor performance of its interexchange and Internet operations. ACS management's refusal to acknowledge this truth, its infatuation with poorly structured and executed

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[1] Source: ACS Draft High Yield Prospectus, August 2003 (emphasis supplied).

diversification schemes, its predilection for lush management compensation/bonus packages, and its legal obligation to make substantial payments to its private equity sponsor are far greater threats to ACS' cash flow and liquidity than GCI.

Sixth, ACS has no better place to invest its capital than in its local telephone operation (with the possible exception of its under-managed wireless operation or, perhaps, stock in a better managed telecom company). Rather than spin an unsupportable tale that it is going to starve its only truly successful business of capital and that it cannot compete with GCI under the existing UNE-L rates, ACS needs to deal with reality as the lower-48 RBOCs, which face stiff UNE-P competition, have. That means running the local telephone operation as efficiently as possible, investing in the marketing/bundling programs necessary to compete with GCI, and investing in local network technologies like DSL that support those marketing/bundling programs. GCI is not using UNE-L rates to compete with ACS on price. The two companies' basic local telephone rates are comparable everywhere but Anchorage, where ACS foolishly crammed a unilateral rate increase down the throats of its customers. If ACS feels like an underdog in local telephone competition, that is largely because ACS so far has not been willing to actually compete. Instead, ACS has wasted years trying to turn back the clock in the regulatory and legislative arenas to eliminate competition.

Seventh, ACS has plenty of capital to meet the investment needs of its local telephone operation. On a pro forma basis, including the recently announced sale of its remaining interest in its directory operations, ACS has cash on hand in excess of $122 million and an un-drawn credit line of $50 million. ACS pleads poverty to the RCA, but the fact is that the greatest financial risk to ACS' local telephone operation is fallout from management's reckless diversification strategy and a potential move by management to make a speculative acquisition or pay a massive special dividend that would hamstring the company financially.

Eighth, now that that ACS has raised the deferred maintenance cap-ex issue, the RCA should move immediately to determine the scope of the alleged problem and, if necessary, require ACS to remedy it. As the carrier of last resort, ACS should not be allowed to leverage the local telephone operation's cash flow to support a massive and unnecessary liquidity position (which in turn may be used for massive and unnecessary special dividends) and then refuse to make needed investment in that operation. In his pre-filed testimony, ACS' Senior Vice President of Operations states unequivocally "ACS does not replace defective or aged plant; it does not upgrade switches as frequently as it should; and it does not do substantial preventative maintenance." The RCA must act to protect the public interest immediately.

Q. MR. CHAPADOS, ACS CLAIMS THAT THE PRESENT UNE RATES IN ANCHORAGE ARE UNREASONABLY LOW, WHICH HURTS ACS

FINANCIALLY AND ALSO FAILS TO PROVIDE GCI AN INCENTIVE TO INVEST IN ITS OWN LOCAL NETWORK. ACS ALSO CLAIMS THAT GCI IS SIMULTANEOUSLY MOVING RAPIDLY TO DEPLOY CABLE TELEPHONY, WHICH IT ALLEGES WILL "FURTHER DEGRADE[E] [ACS'] FINANCIAL HEALTH." ACS ARGUES THAT THE APPROPRIATE REGULATORY RESPONSE IS FOR THE RCA TO APPROVE A SUBSTANTIAL UNE RATE INCREASE TO COMPENSATE ACS FOR RISKS ASSOCIATED WITH A COMPETITIVE ENVIRONMENT, INCLUDING ITS INCREASED COST OF CAPITAL, SHORTENED DEPRECIATIONS LIVES, ETC. DO YOU AGREE WITH THIS ARGUMENT?

A. No, I do not. ACS cannot use these two contradictory claims to justify its request for a massive UNE rate increase. If you read these two claims together, as ACS does, they imply that GCI is a corporation with multiple personalities pursuing radically different business strategies at the same time – one personality is a parasite that wants to live off ACS' infrastructure indefinitely, the other is the telecom equivalent of WalMart, aggressively deploying its own infrastructure to bypass and crush ACS' infrastructure. As usual, reality is substantially less lurid.

From the start of its entry into the local exchange market, GCI has planned to deploy cable telephony using packet technology. Unfortunately, since GCI is not a telecommunications equipment vendor, it has had to wait while the telecommunications equipment industry developed a reliable, financially viable, standards-based solution. Since GCI is a relatively small cable MSO, ranking 25th on the National Cable & Telecommunications Association's list of the top 25 U.S. cable MSOs, it was not in a position to force the vendors to move more

quickly. Now that a high-quality cable telephony solution is available, GCI is moving to deploy it.

ACS' policy prescription (i.e., massively raise Anchorage UNE-L rates to enable it to recover its allegedly increased cost of capital, etc.) makes no more sense than its 2001 decision to unilaterally raise Anchorage local telephone rates by 24%, a decision that led to the loss of 16% of its retail customers over the next six months. Unlike UNE-P competitors in the lower 48 states, GCI is not a captive customer of the ILEC in Anchorage. If ACS is permitted to massively raise UNE-L rates, then GCI will move even more quickly to cable telephony. As access lines shift from UNE-L to cable telephony, ACS will not only fail to receive the expected benefit from its UNE-L rate increase, it will also lose the existing UNE-L revenue that it received on these access lines. As a result of its steadfast refusal to understand how a competitive market works, including the need for it to look at GCI as a customer as well as a competitor, ACS would wind up dramatically worsening its own financial condition.

Q. MR. CHAPADOS, ACS ASSERTS THAT BECAUSE OF UNREASONABLY LOW UNE-L RATES AND THE INTRODUCTION OF CABLE TELEPHONY, THERE IS A REAL POSSIBILITY THAT GCI MAY DRIVE ACS OUT OF BUSINESS AND BECOME THE MONOPOLY PROVIDER OF LOCAL TELEPHONE SERVICE IN ANCHORAGE, FAIRBANKS, AND ANCHORAGE. DO YOU AGREE WITH THIS ASSERTION?

A. No, I do not. ACS' doomsday rhetoric (which again is apparently reserved only for regulators and legislators and not public investors) does not reflect the facts on the ground, which include the following:

- GCI has not used UNE-L rates to undercut ACS' local telephone rates in a predatory fashion. The two companies' basic local telephone rates are fairly close except in Anchorage, where ACS crammed a unilateral rate increase down the throats of its customers. GCI is competing with ACS primarily on the basis of marketing/bundling, innovation, and customer service. ACS clearly has the assets (including its wireless operation which GCI cannot match) and the financial resources to compete effectively with GCI in these areas.
- RBOCs like Verizon, BellSouth, and SBC face intense competition from UNE-P operators in the lower-48 states. Although they do not like UNE-P pricing in their service areas anymore than ACS likes UNE-L pricing in Alaska, the RBOCs have taken concrete steps, with real success, to meet their UNE-P competitors head-on in the market. Their latest move is to announce that they will add wireless to their service bundles.
- If we put aside the differences in size, the biggest difference between ACS and the RBOCs in the local telephone market is attitude. Unlike ACS, the RBOCs are not burying their head in the sand in the vain hope that the regulators and/or legislators will roll back the clock to monopoly days. They still work the legislative and regulatory process, but they work even harder on beating their UNE-P competitors in the market.

GCI has neither the intention nor the means to drive ACS out of the local telephone market. ACS is clearly under competitive pressure (that's the nature of a competitive market) but by and large, ACS' biggest problems are self-

created: an overpriced and overleveraged buyout based on irrationally exuberant assumptions, a misguided diversification effort that so far has devoured $100-plus million in precious capital, customer-alienating missteps like the unilateral Anchorage local telephone rate increase and the Infinite Minutes fiasco, and now the controversy over the state telecom contract. GCI will not put ACS out of business, but GCI cannot prevent ACS management from trying to put themselves out of business.

Q. ACS ARGUES THAT IN INVESTING IN LOCAL LOOPS, ACS BEARS RISKS THAT GCI DOES NOT, E.G., ACS COULD LOSE BOTH THE RETAIL CUSTOMER AND GCI AS A CUSTOMER AND THUS THE LOCAL LOOP INVESTMENT COULD BE "STRANDED." DO YOU AGREE?

A. No, I do not. First, ACS uses the term "stranded" in a very loose manner. In a situation where ACS loses a retail local telephone customer to GCI's cable telephony solution, the copper loop certainly goes out of use for an indefinite period but that does not mean that it is stranded investment. Stranded is better used to describe situations where an investment has been rendered entirely unusable or obsolete like an electromechanical switch in a world of digital switches. The fact that ACS does not always have a customer on a particular copper loop doesn't mean that its investment in that loop is stranded any more than the fact that GCI doesn't always have a subscriber on a given cable drop means that that its investment in that drop is stranded. Customers and subscribers move. CLECs win customers from ILECS. ILECs win back

customers from CLECs (which is exactly what ACS touted in its last investors' teleconference). Competition is a two-way street.

Second, ACS' martyrdom complex is blinding it to financial and economic realities. For example, GCI's local network infrastructure investment is at risk every bit as much as ACS'. ACS is currently marketing the DISH satellite television solution. When ACS captures a GCI cable subscriber and puts the subscriber on the DISH network, GCI faces exactly the sort of "foregone revenue" investment risk that ACS faces when GCI captures an ACS retail local telephone customer and puts the customer on its cable telephony platform. This is the kind of risk that all competitors share in a competitive market.

Q. ACS ASSERTS THAT ITS RISKY POSITION IN THE LOCAL TELEPHONE MARKET RESULTED IN ITS HAVING TO PAY A VERY HIGH EFFECTIVE INTEREST RATE OF 10.5% IN ITS RECENT HIGH-YIELD OFFERING. DO YOU AGREE?

A. No, I do not. First, ACS' local telephone operation was the primary basis on which the company was recently able to refinance its bank debt. The strength of the local telephone operation was the reason ACS was able to complete a $182 million high-yield offering at a time when the high yield market was in turmoil and other companies were pulling their deals.

Second, high-yield deals are always much more expensive than similarly sized senior secured bank financings or investment-grade corporate bond issuances. (Neither ACS nor GCI has ever had a investment-grade corporate rating.) According to TD Securities' High Yield Weekly, seven high-yield deals were priced the week that ACS priced its deal. The lowest rate paid was 8.5%. The average rate was 9.56%. There is no such thing as a cheap high-yield deal.

Third, the rate that ACS paid reflected all elements of the company's performance and prospects, including the competitive pressure on its local telephone operation and its disastrous diversification strategy, as well as overall market conditions, which were lousy. The assertion that investors focused solely or even primarily on Alaska UNE rates in pricing the deal doesn't wash. Investors were just as concerned about a number of other factors, including the fear (articulated by one of the two leading rating agencies, Moody's Investor Service) that ACS would squander its huge pile of cash on special dividends/stock buybacks or speculative acquisitions. Uncertainty over the fate of the telecommunications services contract with the State of Alaska also played a major role.

III. CONCLUSION

Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY

A. ACS appears to be in a state of denial over the realities of the competitive market in Anchorage. Rather than focusing its energy on the marketing/bundling, innovation, and customer service efforts needed to retain or win back retail customers and the development of a wholesale/UNE-L program that recognizes

that GCI is ACS' largest customer as well as its biggest competitor, ACS continues to present unsubstantiated doomsday arguments to the RCA and other policymakers in support of a massive UNE-L rate increase that would only worsen its financial condition by encouraging GCI to migrate faster to a cable telephony solution. A massive-UNE-P rate increase in the lower 48 states would be a tremendous boon to the RBOCs because its UNE-P competitors do not yet have an alternative last-mile solution to get to retail customers. If ACS believes that a massive UNE-L increase in Anchorage will have the same effect, it is mistaken. Such an increase could seriously impede the development of local telephone competition in the middle term and could disrupt the lives of many Anchorage residents. It would not, however, provide ACS the kind of long-term windfall that would allow it to ignore the requirements of a competitive market.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY AT THIS TIME?

A. Yes, it does