

# Expert Report of Don J. Wood

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## Purpose

The purpose of this report is to present the results of my review and analysis of the issues set forth in the Commission’s 2014 *Second Further Notice of Proposed Rulemaking* (“2014 FNPRM”), as informed by the information obtained in the 2014 Mandatory Data Collection, and to provide a number of affirmative steps that should be taken to further the process of meaningful reform of the regulation of Inmate Calling Services (“ICS”).

The process for developing a proposal for meaningful reform of the markets consists of multiple – and equally essential – steps. First, it is necessary to review and consider the underlying legal and policy objectives.<sup>1</sup> Second, it is essential that the relevant markets be carefully analyzed, and for any sources of market failure to be correctly identified and understood.<sup>2</sup> Third, the best-available data should be analyzed (and adjusted if necessary) in order to gain an understanding of the market dynamics and of the likely impact of different regulatory alternatives.<sup>3</sup> Only after these initial steps have been taken can the fourth step – the development of an effective regulatory

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<sup>1</sup> To date, there has been no explicit analysis of how submitted proposals would support, or fail to support, these fundamental objectives. I will address this issue in the Proposed Regulatory Framework section of this Report.

<sup>2</sup> As I explain in the Market Analysis section of this Report, it is particularly important to distinguish between the *causes* of market failure and the *symptoms* of market failure in order to accurately predict the outcome of a particular proposal for regulatory reform.

<sup>3</sup> For the reasons set forth in the Analysis of 2014 Mandatory Data Collection section of this Report, the Commission now has in its possession a reliable (albeit imperfect) dataset for determining the level of costs to provide ICS services and for understanding how those costs are driven by the type and size of a particular confinement facility. It is critical that these data be fully considered when establishing cost-based regulatory constraints and when considering market-based regulatory alternatives.

framework or a determination of the merits of existing proposals – be undertaken in a meaningful way.

## Review of Stated Objectives

In its 2013 *Report and Order and Further Notice of Proposed Rulemaking* (“2013 Order”), the Commission identified a number of explicit objectives for its ICS reform efforts:

Reform should provide rate relief to those who pay for ICS services. The Commission specifically referred to the goal of eliminating “unjust and unreasonable” rates for inmate calling services, and “promoting the general welfare of our nation by making it easier for inmates to stay connected to their families and friends.”<sup>4</sup>

Reform must ensure fair compensation to ICS Providers. As the Commission points out, “Section 276 directs the Commission to ‘establish a per call compensation plan to ensure that all payphone service providers’ – which the statute defines to include providers of ICS – ‘are fairly compensated for each and every completed intrastate and interstate call’.”<sup>5</sup>

Reform must result in just and reasonable rates consistent with underlying costs. The Commission found that it “must take action to establish just, reasonable, and fair rates. As the Commission has previously explained, ‘the just and reasonable rates required by Sections 201 and 202 ... must ordinarily be cost-based, absent a clear

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<sup>4</sup> 2013 Order, ¶2. Throughout this Report, embedded footnotes have been removed to improve the readability of cited material.

<sup>5</sup> Id., ¶14.

explanation of the Commission’s reasons for a departure from cost-based ratemaking.’ Thus, although the Commission ‘is not required to establish purely cost-based rates,’ it ‘must, however, specifically justify any rate differential that does not reflect cost.’<sup>6</sup>

Reform should promote the widespread deployment of Inmate Calling Services.

As the Commission points out, “Section 276(b)(1) states that the Commission’s regulations implementing that provision should, among other things, ‘promote the widespread deployment of payphone services to the benefit of the general public’.”<sup>7</sup>

Widespread availability of ICS calling services provides a direct benefit to inmates and their families, and as the Commission concluded, widespread availability of ICS services at just and reasonable rates will benefit the public “more generally.”<sup>8</sup>

Reform should allow the cost-recovery needs of correctional facilities to be met.

The Commission specifically noted the need to adopt a regulatory framework that will take “full account of the security needs of correctional facilities.”<sup>9</sup> Some small facilities also rely on contributions from ICS providers in order to recover costs they incur to make calling services available. Mechanisms for the recovery of these costs are an integral part of a comprehensive approach to regulatory reform of ICS.

When considering each of these objectives, the Commission has emphasized the importance of striking a proper balance between the needs of inmates, ICS providers, and correctional facilities. In addition to the importance of taking into account security issues, the Commission explicitly found that “the interests of both the payphone service

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<sup>6</sup> Id., ¶45.

<sup>7</sup> Id., ¶51.

<sup>8</sup> Id.

<sup>9</sup> Id., ¶2.

providers and the parties paying the compensation must be taken into account,”<sup>10</sup> and “as the Commission has recognized, the concept of fairness encompasses both the compensation received by ICS providers and the cost of the call paid by the end user.”<sup>11</sup>

When developing a comprehensive regulatory framework – or when evaluating the merits of a submitted proposal – it is essential that each of these objectives be considered.

## **Market Analysis**

### *Issues Not in Dispute*

The following basic assumptions regarding the operation and regulation of the market for ICS are well established and should not be subject to dispute:

Reliance on market forces is preferable to regulation, if market forces can be relied upon to constrain prices and allow the stated policy objectives to be met. As noted in the *2013 Order*, “the Commission traditionally prefers to rely on market forces, rather than regulation, to constrain prices and ensure that rates are just and reasonable.”<sup>12</sup>

Existing market dynamics for ICS have failed to produce desired outcomes and justify intervention by the Commission. The fundamental failure of the ICS market is well documented in this proceeding, specifically the failure of market forces to constrain the rates paid by end users. In the *2013 Order*, the Commission correctly pointed out that

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<sup>10</sup> Id., ¶14.

<sup>11</sup> Id., ¶46.

<sup>12</sup> Id., ¶39. The Commission reiterates this preference at ¶3 of the *2014 FNPRM*.

the existing competitive bidding process “does not exert downward pressure on rates for consumers.”<sup>13</sup>

Further action is needed to achieve the stated objectives for reform. In the *2013 Order*, the Commission took initial, but limited, steps to begin the process of reform. These initial steps have produced tangible benefits to some end users of ICS services. But as the Commission correctly concludes in the *2014 FNPRM*, absent further action “the market will continue to fail to promote competition and ensure rates are just, reasonable and ensure fair compensation consistent with the dictates of the Communications Act,”<sup>14</sup> and seeks comment on the assertion that absent further reform, “achieving the statutory mandate of just and reasonable ICS rates and fair ICS compensation would be difficult, if not impossible, to achieve.”<sup>15</sup> Based on the record to date, there can be no serious argument against this basic proposition: just and reasonable rates for end users, and fair compensation for providers, can only be achieved through additional Commission action. The question that is open to legitimate debate, and that should be fully explored in this proceeding, is what form this further reform should take. In the *2013 Order*, the Commission concluded that a regulatory approach of requiring cost-based rates is fully supported, and that no deviation from this approach is warranted: the Commission noted that it “typically focuses on the costs of providing the underlying service when ensuring that rates for service are just and reasonable under section 201(b)...Although the Commission theoretically might deviate from such an approach,

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<sup>13</sup> Id., ¶41.

<sup>14</sup> Id., ¶26.

<sup>15</sup> Id., ¶30.

we find no basis to do so here and conclude that ICS rates...must be cost-based.”<sup>16</sup> In the *2014 FNPRM*, the Commission is also seeking comment on “moving to a market-based approach to encourage competition in order to reduce rates to just and reasonable levels and to ensure fair but not excessive ICS compensation.”<sup>17</sup> Such a market-based approach is feasible if, but only if, actions can be taken that will effectively address the underlying cause of market failure and do so in the near future. Otherwise, a prudent course of action will require that affirmative regulatory actions (such as the imposition of rate caps that reflect underlying costs) be adopted in the short run while additional information is collected in order to develop effective market-based reforms.

### *The Cause of ICS Market Failure*

In order to determine whether (1) direct regulation (mandating rate caps based on cost to provide ICS at confinement facilities of different types and sizes, for example), (2) a transition to market forces made possible by addressing the cause of market failure, or (3) a hybrid approach is likely to prove effective (and in order to determine the details of the form any of these options should take), it is first necessary to correctly identify and understand the root cause of failure in ICS markets.

At the most fundamental level, a “market” encompasses the forces generated by the buying and selling decisions of economic participants. The buyers of a good or service make purchasing decisions based on their needs and the willingness of a producer to provide the good or service at a given price. The producers of a good or service make production and pricing decisions based on their need to recover costs of production and

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<sup>16</sup> *Id.*, ¶50.

<sup>17</sup> *Id.*, ¶6.

the willingness of buyers to purchase the good or service at a given price. This interaction between buyers and sellers creates the basic market forces that constrain prices.

The market construct is based on the implicit assumption that buyers and sellers will interact. For this to happen, a “buyer” entity that makes the purchasing decision and that pays the price for the good or service must exist, and a “seller” entity that makes the selling decision and that receives the payment for the good or service, must exist. *These assumptions do not hold for ICS, because there is no “buyer” who makes the purchasing decision **and** pays for the good or service.* The manager of the confinement facility makes the purchasing decision by deciding which ICS provider will be the exclusive provider of ICS services at that facility, but does not pay for the ICS provided. A separate and unaffiliated end user (the inmate or inmate’s family) pays for ICS, but has no role in the selection of the ICS service provider. *It is this disconnect between the entity making the purchasing decision and the separate entity that must pay for the service that is the **cause** of the market failure.*<sup>18</sup>

A review of the incentives of ICS providers, confinement facility managers, and end users is instructive. ICS providers are motivated by the desire to sell ICS at a given confinement facility, and will seek to do so if the location will yield net revenues<sup>19</sup>

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<sup>18</sup> As I will address below, there are a number of symptoms of this market failure, including the payment of commissions to confinement facilities by ICS providers. But it is important that symptoms of market failure not be confused with the underlying cause. Eliminating such a symptom (such as prohibiting the payment of commission) may have merit from a public policy standpoint (and may represent one piece of a complete solution), but doing so will not cure the *cause* of the market failure, and will not result in a functioning market that will yield desired outcomes absent regulatory constraints.

<sup>19</sup> These net revenues may consist of gross revenues generated by ICS calling rates and ancillary fees, net of the cost to the ICS provider to provide the services and the value of the monetary and non-monetary commission payments made to the confinement facility.

sufficient to recover the costs of serving that location. An ICS provider cannot directly entice end users to purchase its service by offering a lower price, because the end user does not decide whether that particular ICS provider will be providing the service. Instead, an ICS provider has an incentive to entice the decision maker – here, the manager of the confinement facility – to select the ICS provider. This incentive has manifested itself in the form of monetary commission payments and a wide variety of non-monetary payments by ICS providers to confinement facilities. ICS providers today have two market roles: as a seller of ICS to end users, and as a purchaser of the right to provide ICS at a given confinement facility.

The manager of a confinement facility, while making a purchasing decision that will impact end users, is in reality acting as a seller in the ICS market. The RFP process has effectively become an auction for the right to provide ICS at a given facility. To be clear, many confinement facilities utilize payments from ICS providers to offset their costs of providing calling services and related security costs, and the record suggests that at least some payments from ICS providers have been used to fund worthwhile programs that are valuable to inmates and therefore to society at large. The policy question of whether funding should continue to be provided to confinement facilities is addressed in later sections of this Report. The point here is that confinement facilities have an economic incentive, consistent with that of any seller, to maximize the price they receive.

End users have an incentive to seek a lower price for ICS services, but no ability to do so. End users cannot choose from among multiple service providers at a given facility,<sup>20</sup> and inmates generally cannot choose the facility in which they are incarcerated.

### *Implications of the Cause of Market Failure*

The fundamental problem, as the Commission acknowledges at ¶6 of the 2014 *FNPRM*, is that the interests of correctional institutions and consumers are not aligned. End users are interested in a lower price for the ICS services that they purchase, and confinement facilities are interested in maximizing the price received through the sale of an exclusive right for an ICS provider to provide services at that facility.<sup>21</sup> The economically rational response of ICS providers to these incentives has been to increase the rates for the various forms of ICS, and many (though not all) ICS providers have introduced a large number of non-optional ancillary fees that are imposed on end users. The economically rational response of confinement facilities has been to encourage these actions by ICS providers by awarding contracts primarily, if not exclusively, on the basis of the level of promised commissions (both monetary and non-monetary). In a sense, the

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<sup>20</sup> The possibility of permitting multiple ICS providers at a given confinement facility raises multiple issues. Confinement facilities have identified a number of security concerns that appear to be valid. As I will address in the Analysis of 2014 Mandatory Data Collection section of this report, the way that costs are incurred by an ICS provider to serve a given location indicates that important economies of scale will be lost in a multiple-provider scenario, and at least for many jail locations only a single ICS provider can be supported. In order to address these cost issues, parameters for ICS carrier interconnection and resale (and corresponding rules) would need to be developed. Experience with the implementation of §§251 and 252 of the Act strongly suggests that such a process is likely to be time consuming and resource intensive. Thus, while a multiple-provider scenario may be considered as a potential part of a long-run strategy to address market failure, it cannot be relied upon over a short or intermediate time frame to address the cause of market failure or to provide rate relief to end users of ICS services.

<sup>21</sup> As noted above, acknowledging the existence of this economic incentive in no way suggests improper activity by confinement facilities. To the contrary, the record suggests that confinement facilities have responded rationally to the economic incentive presented to them.

identifiable “market” has performed exactly as expected: confinement facilities have offered a valuable commodity (an exclusive contract to provide ICS at a given facility), and ICS providers have responded by bidding up the price (though higher monetary and non-monetary commission payments). This is the market transaction that is currently taking place in the industry.

From a public policy standpoint, the problem is that the entities who must ultimately pay for ICS services have no role in the process of selecting the ICS provider. As a result, an ICS provider can increase rates (and if it chooses to do so, impose a virtually unlimited number of ancillary fees) in order to fund the commission payments to the confinement facility. Put simply, the end users of ICS are not a party to the market transaction that ultimately determines the level of ICS rates (and level and breadth of ancillary fees) that they must pay. In order to effectively address the level of ICS rates paid by end users – whether through direct regulatory action or market forces – it essential that this fundamental disconnect between the entity making the purchasing decision and the entity paying the rate be recognized and addressed.

There are a number of implications of this cause of market failure:

Reform must be comprehensive in order to be effective. In the *2013 Order*, the Commission took the initial step of placing interim caps on interstate ICS. But as the Commission correctly observed in the 2014 FNPRM, “failures in the ICS market continue.”<sup>22</sup> Because of the disconnect between the entity making the purchasing decision and the entity paying the rate remains, ICS providers retain an incentive to bid up the price of an exclusive right to offer service at a given confinement facility (and to

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<sup>22</sup> 2014 FNPRM, ¶20.

fund those bids through the rates charged to end users), and confinement facilities retain an incentive to award contracts based on the level of promised payments. The result, as the Commission notes, is that interstate reform at many locations “has been met by increased intrastate ICS rates and has not discouraged other practices that also increase the costs of ICS to consumers, such as excessive ancillary charges and an increase in the use of single call services.”<sup>23</sup> This experience confirms that in order for any reform effort – whether consisting of regulatory constraints, market forces, or a combination of the two – to be effective, it *must* encompass all ICS-related rates that are paid by end users.

Addressing a symptom of market failure, rather than addressing the cause, will not be effective. Throughout the 2014 FNPRM, the Commission refers to site commission payments as the “primary cause of ICS market failure,” and predicts that “prohibiting such payments will enable the market to perform properly and encourage selection of ICS providers” based on other factors, including prices to end users.<sup>24</sup> This assumption, and therefore the accompanying prediction, is simply incorrect. The payment of site commission is a *symptom* of the market dynamics described above, but it is not the *cause* of those dynamics. Prohibiting commission payments, while a potentially useful regulatory tool if used in conjunction with constraints such as rate caps reflective of underlying costs,<sup>25</sup> does not address the underlying cause of market failure and does not impact the *incentives* of ICS providers or confinement facilities.

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<sup>23</sup> Id.

<sup>24</sup> 2014 FNPRM, ¶¶21, 27, 32, 71, 78, 82.

<sup>25</sup> The Commission may elect to prohibit both monetary and non-monetary commission payments as a part of its reform efforts. The point here is that doing so will not address the cause of market failure and will not, by itself, ensure that the stated objectives of ICS reform are met.

As a result, confinement facilities would still be in the position of awarding a financially desirable contract, and would continue to have the *incentive* to seek some form of value from ICS providers in exchange. ICS providers would continue to have an *incentive* to provide something of value to confinement facilities as a way of bidding for a valuable contract.<sup>26</sup> There is no reason to expect that confinement facilities and ICS providers will do anything other than continue to act as rational economic actors, and to respond to these incentives. Confinement facilities have no economic incentive to award ICS contracts based on the level of end user rates, and ICS providers have no corresponding incentive to reduce end user rates as a method for winning a contract. It is unreasonable to expect that a prohibition on site commissions will set free latent market forces (specifically, forces that will result in reductions to end user prices), if those forces do not otherwise exist. Just as a cap on interstate services was in many cases met with an increase in the rates for intrastate services or ancillary fees, it is reasonable to expect that a prohibition of monetary commissions would result in non-monetary commissions. An attempt to prohibit all known kinds of non-monetary commissions would result in the development of new and different methods for the non-monetary transfer of value. The fact will remain, however, that lower prices for end users will continue to have value for end users, but have no direct value to confinement facilities. In order to meet its objective of lower prices to end users, the Commission cannot simply prohibit one symptom of market failure without also addressing the cause of the failure and the incentives of the entities involved.

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<sup>26</sup> End users, meanwhile, would continue to exert no influence over the purchasing decision that results in the rates that they must pay.

The cause of market failure directly impacts decisions regarding the structure of any rate caps adopted. At ¶70 of the 2014 FNPRM, the Commission addresses the potential strategy of “addressing site commission payments and allowing competition to drive rates closer to cost,” and seeks comment on whether such a strategy will eliminate the need for a tiered rate structure if price caps are implemented. As described above, prohibiting site commissions will not result in competition that will “drive rates closer to cost”: ICS providers compete for confinement facility contracts, not for end user customers, and confinement facilities have no economic incentive to award contracts based on prices to end users. This disconnect has implications for the overall level of end user rates (rates will not be bid down toward a provider’s cost as they would be in a competitive market), and also for the way in which rates would vary among confinement facilities of different types and sizes. In a market in which ICS providers competed directly for end user customers (i.e., one in which the end user customer who pays the rate also makes the purchasing decision), it is reasonable to expect that rates would align with the costs of providing service at a particular facility. But with the existing incentives (incentives that would not be changed by a prohibition of site commissions), there is no market mechanism that will ensure such an alignment of rates and costs at facilities with different characteristics.<sup>27</sup> In order for the stated objectives of ICS reform to be met, it will be essential that tiered rate caps be adopted sufficient to reflect differences in the costs of serving different types and sizes of confinement facilities. As

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<sup>27</sup> For the reasons set forth in the following section of this Report, the record now fully supports a conclusion that the cost to provide ICS services varies based on the type of facility (jails versus prisons) and, at least for jails, based on the size of the facility.

described in the following section of this Report, these cost differentials are now well established in the record and cannot be ignored.

## **Analysis of 2014 Mandatory Data Collection**

### *Objectives*

In the *2013 Order*, the Commission established interim rate caps that varied by call type but did not vary by facility type or size. No distinction for facility type (i.e. jails vs. prisons) was reflected in the interim rate caps because, according to the Commission, the record at that time did not permit the drawing of any clear distinctions.<sup>28</sup>

An explicit objective of the Mandatory Data Collection was to expand the record to include additional data specific to the type and size of facility at which ICS is being provided. The data collection form required ICS providers to identify costs specific to jail facilities (at 0-99, 100-349, 350-999, and 1000+ ADP sizes) and prisons (at 0-4999, 5000-19999, and 20000+ ADP sizes). If performed properly, a cost analysis at this level of disaggregation would provide meaningful data for the development of rate caps that reflect the underlying cost to provide ICS services at different types and sizes of facilities.

### *Overall Observations and Description of the Dataset Relied Upon*

At ¶14 of the *2104 FNPRM*, the Commission lists fourteen ICS providers who produced data in response to the Mandatory Data Collection process: ATN, CenturyLink, Combined Public Communications, Correct Solutions, Custom Teleconnect, Encartele, GTL, Lattice, ICSolutions, NCIC, Pay Tel Communications, Protocall, Securus, and

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<sup>28</sup> *2013 Order*, ¶17.

Telmate. Of these, I was unable to obtain the unredacted versions of the filings of ATN, Encartele, and Protocall and for this reason data for these three providers are not reflected in my analysis.

Because portions of the provider-specific data are confidential, in this section of my report I will only address the ICS provider costs on an aggregate basis that does not reveal details of the costs of any individual provider. A confidential description of my analysis is contained in Confidential Exhibit DJW-1.

A review of the filings of the eleven providers (inclusive of Pay Tel) whose confidential data I was able to obtain reveals that a wide range of effort went into the development of the cost studies and supporting documentation. Six of the eleven providers produced only a copy of the data collection template, with no description of how the study was performed and no supporting workpapers. Three providers produced a brief description of the overall methodology used in the study, but no supporting workpapers or calculations. Only two ICS providers, Pay Tel and Securus, produced supporting workpapers.<sup>29</sup>

Based on my review of the filings of these eleven providers, I identified three – Combined Public Communications, Custom Teleconnect, and Correct Solutions, as being unreliable for the purpose at hand.<sup>30</sup> These filings were removed from the working data set.

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<sup>29</sup> It is my assumption that since a complete copy of the filing was requested from the ICS providers, that their production to me represents the entirety of their production to the Commission.

<sup>30</sup> The rationale for this decision is described in Confidential Exhibit DJW-1.

Based on my review, I concluded that the filings of the remaining eight ICS providers – Pay Tel Communications, Securus, GTL, NCIC, Lattice, IC Solutions, Telmate, and CenturyLink – provide important and reliable information that should be relied upon by the Commission.<sup>31</sup> To be sure, a number of these studies are decidedly imperfect, and more complete documentation would certainly be desirable. That said, important elements of the results of these studies can be validated, and many of the reported results are consistent in ways that inform the Commission on issues of cost levels and variation. As described below, key results of these studies should be relied upon by the Commission when making any decisions regarding the level and structure of ICS costs.<sup>32</sup>

Cost data previously submitted to the Commission also represents a useful tool for validation. As noted in ¶60 of the *2014 FNPRM*, a Joint Provider 2008 study, a study performed by Securus in 2013, Pay Tel’s 2013 cost study for 2012-2015, and a cost summary by CenturyLink have previously been produced. These filings represent important opportunities for cross-checking and validation of the 2014 data submissions.

In addition, Pay Tel has produced data showing the ICS rates at prison (state DOC) locations in those states where site commissions have been prohibited and lower

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<sup>31</sup> Some of the data provided by CenturyLink is inconsistent with that of the remaining seven ICS providers and inconsistent with filings made by the company as recently as August 2013. While I have retained the CenturyLink study results in my working dataset, its provider-specific results should be treated cautiously and no conclusions should be drawn from them in isolation.

<sup>32</sup> For purposes of my analysis, I have relied on 2013 data (the most recent full year) produced by these providers.

rates have been mandated.<sup>33</sup> These rates are also useful for the validation of certain elements of the 2014 data submissions.

### *Cost Allocation Issues*

In the 2014 FNPRM, the Commission seeks comment on a number of issues related to the cost allocation methods used by ICS providers in their studies.<sup>34</sup> This focus on methods for allocating costs appears to be based on the following assumption: “A large proportion of costs reported by ICS providers are common costs, which is consistent with the fact that ICS providers typically use centralized calling platforms to process calls from the different facilities they serve.”<sup>35</sup> This assumption is demonstrably false.<sup>36</sup>

While it certainly requires less effort for a cost analyst to simply calculate total costs and to then allocate those costs across locations and services on some formulaic basis, this is not the only option available. Pay Tel’s 2014 cost analysis demonstrates that if cost analysts are willing to undertake the effort, location-specific and service-specific costs can be identified and quantified in a meaningful way. While some “common” costs remain after this process, they do not represent “a large portion” of an ICS provider’s costs – Pay Tel’s “common” costs represent only 15.3% of its total 2013 costs.

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<sup>33</sup> Pay Tel *Ex Parte* Presentation, “Response to Joint Filing,” October 2, 2014.

<sup>34</sup> 2014 FNPRM, ¶¶50-59.

<sup>35</sup> *Id.*, ¶51.

<sup>36</sup> This statement juxtaposes the concepts of common costs and shared investments. Common costs, by definition, do not vary with the volume or composition of a firm’s output. As a result, no method of allocating these costs is inherently meaningful. In direct contrast, shared investments do often vary based on the volume of output or mix of services produced. If shared investments can be purchased in increments that are exhaustible at levels of demand less than the firm’s total demand, the corresponding costs are causally related to a change in the volume or composition of the firm’s output. As a result, these costs are (by definition) not properly categorized as common costs.

Internal tracking systems identify the location of individual assets used to provide ICS, and time recording systems allow the time spent by technicians for service calls to be matched with the location where work is performed.<sup>37</sup> For each location served, the Pay Tel study considers multiple categories of information specific to that facility: equipment (including supporting equipment), wages for equipment installation and maintenance, the telecommunications facilities used, the cost of security measures and other third-party expenses, cost of sales (including post-sale support and client training), ongoing product support (provided to clients and to end user customers), billing costs, uncollectible/bad debt levels, and service-specific calling volumes and characteristics. Some additional equipment is used to provide service at multiple locations; ICS providers do utilize “centralized calling platforms,” but a closer review reveals that these systems contain multiple components that are modular in nature and whose capacity is exhaustible at levels of usage that are far smaller than the total demand served by the provider. The capital cost of this equipment, and its corresponding expenses, can be matched with a location based on that location’s contribution to the exhaustion of the capacity of each increment. At the end of this kind of rigorous exercise, there are relatively few costs remaining to simply be “allocated.”

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<sup>37</sup> Pay Tel maintains these kinds of internal systems, and information from these systems was used to perform the location specific cost analysis produced in this proceeding. While I have no direct knowledge of the capabilities of other ICS providers, it is unreasonable to assume that other providers do not use similar systems in order to understand their cost structure and make rational business decisions. A 2013 report produced on behalf of Securus suggests that “Securus maintains data that includes costs incurred” for the locations, and types of locations, that it serves (Expert Report of Stephen E. Siwek on behalf of Securus Technologies, Inc., March 25, 2013, ¶2.1). It is likely that other ICS providers have the ability to track cost information on a similar basis.

In the 2014 *FNPRM*, the Commission considers a number of approaches for “addressing apparent inconsistencies in the providers’ common cost allocation methodologies.”<sup>38</sup> Of course, the best means of addressing questions regarding cost allocations is to require ICS providers to perform a thorough analysis of location-specific and service-specific costs that will largely eliminate the need for such allocations. The instructions for future data collection efforts should be clear that location- and service-specific tracking of costs should be utilized whenever possible, and cost allocations should correspondingly be avoided whenever possible.

Jails vs. Prison Locations. In the 2014 *FNPRM*<sup>39</sup>, the Commission sets forth (and seeks comment on) a number of alternative allocation methodologies for allocating costs between jail and prison locations. These alternatives are speculative and unlikely to produce meaningful results. For example, the Commission notes that “ICS providers that served both jails and prisons generally allocated a higher proportion of their common costs to jails than would otherwise be warranted given the minutes of use (“MOU”) from those jails,” and proposes a reallocation of costs based on MOU. Of course, such a reallocation presupposes that MOUs are the only driver of ICS costs, and that no other factors specific to jails or prisons will cause costs to be different. As expected, Table One shows that the gap between the average costs to serve jails and the average cost to serve prisons is effectively eliminated using this methodology. But this result is tautological: a methodology based on the underlying assumption that costs vary only by usage will produce results that do not vary based on any other factor.

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<sup>38</sup> Id., ¶53 and Table One.

<sup>39</sup> Id.

Fortunately, the Commission need not speculate on the validity of various methodologies for allocating costs between prisons and jails, because it now has the data in hand to make a direct determination of the validity of the submitted costs. Of the eight ICS providers in the data set, five – Securus, GTL, IC Solutions, Telmate, and CenturyLink – provided service to both jail and prison locations in 2013. Each of these providers allocated costs, using slightly varying methods, between jails and prisons, and it would be useful to determine whether these facility-type allocations are reasonable. The remaining three ICS providers – Pay Tel, NCIC, and Lattice – only provided ICS to jail locations in 2013, and did not need to allocate costs between facility types. In order to determine whether the allocation between jails and prisons made by the five ICS providers who served both types of facilities is reasonable, it is instructive to compare the jail-specific costs calculated by these providers with the jail-specific costs calculated by the jail-only providers.

The five jail+prison providers report a total cost of providing ICS to jail locations of \$421,777,400, and total jail minutes of use of 2,196,270,939. This yields a per-MOU cost of \$0.1920. The three jail-only providers report a total cost of providing ICS to jail locations of \$28,426,314, and total jail minutes of use of 142,836,342. This yields a per-MOU cost of \$0.1990. This result demonstrates that the methodologies used by the jail+prison providers to allocate costs between jail and prison locations produce reasonable results:<sup>40</sup> a direct measure of jail-specific costs produces a cost of 19.9 cents

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<sup>40</sup> As noted above, an analysis of the costs that are caused by providing service to a type of facility (or to a given location) is preferable to any methodology of allocating costs by facility type or location; the point here is that the allocation methodologies used by the jail+prison

per MOU, while the allocated jail costs produce a cost of 19.2 cents per MOU. For the purpose of understanding the average cost to serve a jail location (and for understanding how that cost compares to serving other types of facilities), the results of both the jail-only group and the jail+prison group are reliable sources of cost information.

Once the validity of the allocation of costs to jails by the jail+prison providers has been established, it is instructive to examine the costs allocated to prisons. *If* the total costs calculated by a given provider are limited to those directly related to the provision of ICS (and properly included in an ICS cost study), then subtracting the jail-specific cost will leave a reasonable value for prison-specific costs.<sup>41</sup> The jail+prison providers report a total cost to provide ICS at prison locations of \$229,902,422, and total prison minutes of use of 2,227,353,419. This yields a per-MOU cost of \$0.1032, or 10.32 cents per MOU.

This analysis demonstrates that the average cost to provide ICS at jail locations significantly exceeds (by a ratio of approximately 2:1) the average cost to provide ICS at prison locations, and that the differential is *not* the result of cost allocation methodologies utilized by the jail+prison providers.

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providers have produced reasonable results for the per-MOU costs of serving jails that can be relied upon.

<sup>41</sup> As described below, evidence suggests that total costs may be overstated for some ICS providers, and that prison-specific costs may therefore be overstated. For purposes of this analysis, I am accepting the data collection files as submitted, without adjustment. Possible adjustments to the reported prison-specific costs may be appropriate, based on other sources of data in the record, as described below. The point here is that even without adjustment, the prison+jail providers report an average per-MOU cost to serve prisons that is only about 50% of their reported average cost to serve jail locations. This differential has important implications for the merits of rate proposals that fail to distinguish between prison facilities and jail facilities.

Sizes of Jail Locations. The data collection template requires separate entries for jail locations of four different ADP sizes: 0-99, 100-349, 350-999, and 1000+. As described above, Pay Tel conducted a rigorous bottom-up study of the costs caused by each location that it serves,<sup>42</sup> and aggregated these results into the four size groups on the data collection form. Based on this analysis, I was able to determine that Pay Tel’s costs vary by location size based on the following relationships:

**Table 1: Location Size Impact Reported by Pay Tel**

<u>Facility Size</u>	<u>Cost Ratio</u>
0-99	1.24
100-349	1.04
350-999	0.95
1000+	0.91
Total Jail	1.00

This analysis reveals that the smallest group of jail locations (those with an ADP of 0-99) cost Pay Tel 24% more to serve, on average, than an average jail location. The 100-349 group costs 4% more than average, while the 350-999 group costs only 95% of the average costs to serve jails, and the largest facilities (those with greater than 1000 ADP) cost 91% of the average amount.

An analysis of the other seven providers in the data set reveals a similar pattern.

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<sup>42</sup> As a part of its filing, Pay Tel produced workpapers showing the costs specific to each location. This location analysis was then aggregated to produce workpapers showing group-specific costs based on ADP size at the Commission’s specified breakpoints.

**Table 2: Location Size Impact Reported by Other ICS Providers**

<u>Facility Size</u>	<u>Cost Ratio</u>
0-99	1.92
100-349	1.38
350-999	1.00
1000+	0.86
Total Jail	1.00

For these other providers, costs likewise vary based on location size. On average, the smallest group of jail locations (those with an ADP of 0-99) cost the other providers 92% more to serve than an average jail location. The 100-349 group costs 38% more than average, while the cost to serve the 350-999 group is about the same as the average costs to serve jails. For these other providers, the largest jail facilities (those with greater than 1000 ADP) cost 86% of the average amount.

The allocation methodologies used by the other seven ICS providers in the dataset yields a greater variation in cost among location sizes than Pay Tel’s bottom up analysis of location-specific costs, but both sets of results provide useful information and demonstrate that smaller jail locations cost more to serve than larger jail locations. The ratios in Tables 1 and 2 provide a range of reasonableness for this variation.

*Additional Insight into the Cost to Provide ICS at Prison Locations*

As described above, the five ICS providers in the data set who serve prisons report an average cost of \$0.1032 to serve these locations. To the extent that the total costs of these providers have been overstated, these prison-specific costs will likewise be overstated. Available evidence suggests that this may be the case.

As noted at ¶60 of the *2104 FNPRM*, Securus previously produced the Expert Report of Stephen E. Siwek, dated March 25, 2013. In this Report, Mr. Siwek demonstrates that the costs incurred by Securus vary between prison and jail locations (what he calls DOC and non-DOC locations), and the costs further vary based on the size of the jail facility (non-DOC location) being served. He provides cost data that is disaggregated by three sizes of jail (non-DOC) facility and by DOC facilities. Costs are reported with site commissions included, but the report contains information regarding the average level of site commission for each category of facility studied, allowing ICS costs exclusive of commissions to be calculated.

For prison (DOC) locations, Mr. Siwek reports a total cost<sup>43</sup> to Securus to provide ICS (including site commissions) of \$0.1069 per MOU. For these prison (DOC) locations, he reports that Securus' site commissions "as a percent of average ICS cost) for these locations is 59.3%." This yields an average ICS cost for prison (DOC) locations, excluding site commissions, of \$0.0435 (about 4.4 cents per MOU).<sup>44</sup> This value is lower than the average cost per MOU for prison locations reported by Securus in its 2014 data submission and less than half the average cost to provide ICS at prison locations reported by the jail+prison group of providers (\$0.0435 is about 42% of \$0.1032).

The record in this proceeding also includes information associated with per-MOU rates for ICS in prison locations in states where site commissions have been prohibited

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<sup>43</sup> Mr. Siwek specifically states (¶2.1) that Securus maintains data regarding costs incurred for these locations, and reports (¶3.1) that these costs include (in addition to site commissions) telecom facilities and services, field technicians, customer services, validation, billing and collection, and bad debt.

<sup>44</sup> This result is consistent with the Commission's observation (*2014 FNPRM*, ¶ 60) that Securus has previously reported an average cost for ICS provided at prison locations of about \$0.04 per MOU, excluding site commissions.

and correspondingly lower rates have been mandated. A review of the rates in eight contracts for ICS provided in “no-commission” prison facilities is summarized below:

**Table 3: Rates from DOC Contracts With No Site Commission**

<u>Agency</u>	<u>Inmates</u>	<u>ICS Vendor</u>	<u>Average Rate Per Minute</u>
California DOC	122,179	GTL	\$0.120
Michigan DOC	43,704	GTL	\$0.044
Missouri DOC	32,371	Securus	\$0.050
Nebraska DOC	5,094	GTL	\$0.090
New Mexico DOC	3,950	Securus	\$0.050
New York DOC	54,865	GTL	\$0.050
Rhode Island DOC	3,160	GTL	\$0.054
S. Carolina DOC	21,712	GTL	\$0.075
Average			\$0.067

The average of \$0.067 per MOU for these contracts is also significantly less than the average cost to provide ICS at prison locations reported by the jail+prison group of providers (\$0.1032). I am not aware of any claim that these contract rates fail to permit the ICS provider to recover its costs to serve these locations.

*Conclusions Regarding Data Submissions*

In the *2013 Order*, the Commission adopted interim rate caps that varied by service but did not vary based on the type or size of the confinement facility being served. Through the Mandatory Data Collection, the Commission sought additional information regarding the way in which the costs to provide ICS vary based on the type and size of facility.

In response, the Commission received cost data from ICS providers that varies in quality and in the methodology used to develop disaggregated costs. Pay Tel conducted a bottom-up study of the cost to provide ICS at the locations that it serves (a methodology that directly identifies costs caused by specific locations and service types, and that requires the allocation of only a small percentage of total costs). Other carriers relied on various methods of allocation to assign costs to locations of service types.<sup>45</sup>

Based on my review, eight ICS providers produced cost data that collectively provides a reliable record to address the questions regarding cost variation posed by the Commission in the *2013 Order*. The cost information produced by these providers is consistent in a number of important respects.

First, there is now an extensive and consistent record regarding the variations in costs incurred to provide ICS at jail versus prison facilities. While the five jail+prison providers used various methodologies to allocate a portion of their costs to jail operations, the average cost/MOU produced by these methodologies (\$0.1920) is nearly identical to the average cost/MOU (\$0.1990) reported by the jail-only providers, who did not need to allocate costs between jail and prison operations. These consistent results strongly support a conclusion that the methods used by the jail+prison providers are reasonable, and that an average cost to provide ICS to jail locations is between 19 and 20 cents per MOU.

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<sup>45</sup> The cost filings also vary significantly in the level of supporting documentation. Pay Tel's submission, along with only a limited number of other providers, was accompanied by a complete set of workpapers. Some providers produced only a high level description of the methodology used, but no supporting workpapers. Other providers produced no documentation at all, and simply submitted the information necessary to populate the Commission's data collection template.

Data regarding the average cost/MOU to provide ICS at prison facilities comes from a number of sources in the record. In their cost filings, the jail+prison providers report an average cost of \$0.1032/MOU; about half the reported cost to provide service at jail locations. Other data sources strongly suggest that this cost for prisons should be treated as conservatively high. Securus independently reported an average cost of 4.4 cents per minute (inclusive of all costs except site commissions) for “all DOC facilities” it served in 2012. In addition, contracts to serve prison locations in states where commissions have been eliminated (and where corresponding rate reductions have been mandated) include rates that average \$0.067/MOU. Based on the record to date, it is reasonable to conclude that the cost to provide ICS at prisons averages between 4.4 and 10.3 cents per MOU, and that it is likely that an average rate of 6.7 cents per MOU will allow ICS providers to recover their costs (exclusive of site commissions) to provide ICS at prison locations.

This record fully supports a conclusion that the cost to provide ICS to jail locations differs fundamentally from the cost to provide ICS to prison locations. Pay Tel and other jail-only providers have provided an explanation of how key cost drivers vary based on the type of confinement facility being served. The cost submissions in the record – including those of jail-only providers and of jail+prison providers – consistently support this assertion and provide a means of quantifying the magnitude of the cost differential.

In addition, the cost submissions of jail-only and jail+prison providers consistently support a conclusion that when providing ICS to jail facilities, a provider’s cost varies based on the size of the facility. Pay Tel’s bottom-up, location-specific

analysis demonstrates that smaller jails (<99 ADP) cost about 25% more to serve than the average jail, while the largest jails (>1000 ADP) cost about 90% of the average. The average differential reported by other providers (using various allocation methodologies) is even greater, suggesting that the smallest locations cost over 90% more than average, while the largest jail locations costs only about 85% of the average. These two sets of results provide a range of possible values for the differences in cost caused by the size of a jail facility.

These well-documented cost differentials – between jails and prison facilities and between jail facilities of different sizes – must be fully reflected in any regulatory approach that relies on cost-based rates.

## **Elements of a Going-Forward Regulatory Framework for ICS**

### *Essential Factors to be Considered*

Based on the objectives articulated by the Commission in the *2013 Order*, an analysis of the market dynamics of ICS (and of the cause of market failure), and the broad record regarding the costs to provide ICS at various types and sizes of facilities now available to the Commission, I have developed a number of factors that should be considered when evaluating any proposal for regulatory reform.

Is the proposed reform sufficiently comprehensive to be effective? End users pay for ICS through a combination of intrastate calling rates, interstate calling rates, payment fees, and ancillary fees. Effective reform must address each category of rates and fees for two reasons. The first is to ensure just and reasonable rates for end users. The record demonstrates that adopting interim rate caps for interstate calls resulted in some ICS

providers increasing intrastate rates and/or implementing additional mandatory fees. Effective reform will need to address the entire way that end users pay for ICS.

A second, but equally critical, reason for comprehensive reform is to provide fair compensation to ICS providers. In a number of states, for example, local call rates at jails have been capped by state regulators at levels that are well below the cost to ICS providers of providing those calls. If the Commission adopts rate caps that reflect average costs for the combination of interstate and intrastate services provided, yet these below-cost rates remain in effect for certain intrastate calls, an ICS provider will not be able to recover its total costs and will not be fairly compensated.

Will the proposed reform bring rate relief to end users? In order to be effective, reform must accurately recognize the *cause* of market failure and address the incentives faced by ICS providers, confinement facilities, and end users. In particular, the viability of market based reforms must recognize these factors in a realistic way. Based on the record, it is clear that direct regulatory action will be required in the short run (including caps on ICS calling that reflect underlying costs at various facility types and sizes, and restrictions on any mandatory fees) in order to provide rate relief in the near term. As part of a longer term solution, the Commission should solicit and evaluate potential market-based reforms that address the incentives faced by all market participants.

Will the proposed reform result in cost-based rates? As the Commission noted in the *2013 Order*, “the just and reasonable rates required by Sections 201 and 202 ... must ordinarily be cost-based, absent a clear explanation of the Commission’s reasons for a departure from cost-based ratemaking.’ Thus, although the Commission ‘is not required to establish purely cost-based rates,’ it ‘must, however, specifically justify any rate

differential that does not reflect cost’.” While it is important that rates not vary absent a variation in cost, the converse is also true: where cost differentials are demonstrated to exist, a rate that fails to reasonably reflect these differentials does not meet a requirement to be just, reasonable, and fair. The record demonstrates that important cost differentials do exist, and cost-based rates for ICS must reflect these differentials between types (jails versus prisons) and sizes of facilities.

Will the proposed reform ensure fair compensation and promote widespread deployment of ICS? As the Commission noted in the *2013 Order*, “Section 276 directs the Commission to ‘establish a per call compensation plan to ensure that all payphone service providers’ – which the statute defines to include providers of ICS – ‘are fairly compensated for each and every completed intrastate and interstate call’.” The cost differentials demonstrated in the record indicate that the application of single rate cap will not permit this requirement to be met, unless that rate cap is set at the level of cost incurred by ICS providers to serve the highest cost facilities. In order to provide rate relief to end users and ensure fair compensation to providers, the structure of any rate caps adopted must reflect underlying cost differences. Otherwise, ICS providers will have no incentive to provide service at confinement facilities where costs are above average, and the availability of service at these facilities (particularly smaller jails) will be threatened.

Will the proposed reform permit confinement facilities to recover their costs related to ICS? The need for cost recovery by confinement facilities must be addressed in both short- and long-term reform solutions. Comprehensive rate caps based on ICS providers’ costs will eliminate the ability of those providers to pay site commissions. To

the extent the Commission finds that a portion of these site commissions has been used to offset facility costs associated with providing ICS and related security, an explicit means of cost recovery will need to be addressed. When considering longer term market-based solutions, the incentive of confinement facilities to seek compensation from ICS providers in order to recover these costs will need to be considered and addressed.

### *Analysis of the Joint Provider Proposal*

Joint Providers (Securus, GTL, and Telmate) have presented a proposal with three basic elements: (1) ICS rates at all confinement facilities (including all types and sizes, from the smallest jails to the largest prisons) capped at \$0.20 for debit and prepaid calls, and \$0.24 for collect calls; (2) the elimination of site commissions; and (3) modifications to ancillary fees. Information provided by these three providers in response to the Mandatory Data Collection permits a better understanding of the implications of this proposal. My calculations rely on consolidated information that does not reveal the confidential data associated with any individual carrier and could be included in a public filing. Out of an abundance of caution, however, I have moved the detailed description of these calculations to Confidential Exhibit DJW-2.

A review of the call volumes for each call type reported by these three carriers can be used to develop an aggregate percentage of call types, and applied the proposed rates of \$0.20 for debit+prepaid and \$0.24 for collect to determine the average revenue per MOU that the Joint Providers would receive if their proposal is adopted. I have calculated an average per-MOU cost based on the costs reported by these three carriers for all call types and locations average. Comparing these two values reveals the amount by which the proposed rates exceed the reported costs of the Joint Providers. The

aggregate number of annual MOUs reported by these three carriers provides the call volume for which the excess amount per MOU will be generated. Based on this total call volume and the inherent rate/cost relationship, the proposed rate caps would enable Securus, GTL, and Telmate to collectively receive over \$200 million per year in revenue in excess of their total reported cost to provide ICS.<sup>46</sup> ICS calling rates at the proposed levels, coupled with the proposal to eliminate the payment of site commissions, would alone generate an annual windfall of over \$200 million to these three providers; in other words, end users at facilities serviced by these three providers would be required to pay over \$200 million more than the level required to permit recovery of the reported costs.

Further analysis of the Joint Providers' reported costs on a disaggregated basis reveals that the windfall is not equally generated by end users at all types and sizes of facilities. I have calculated, on an aggregate basis, the annual shortfall that Securus, GTL, and Telmate would collectively face to serve jail facilities with an ADP of 0-99, the annual shortfall to serve jail facilities with an ADP of 100-349, and the annual shortfall of to serve jail facilities with an ADP of 350-999. This aggregate annual shortfall must be recovered through the rates charged to end users at larger facilities served by the Joint Providers. Of course, the entire windfall amount would also be borne by the end users of the larger facilities (jails with an ADP of 1000+ and all prison locations), so that end users at these locations would be required to pay almost \$240 million more per year than would be necessary for the recovery of the total costs reported by the Joint Providers.

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<sup>46</sup> This amount of revenue in excess of cost would be generated by the Joint Provider's proposed ICS calling rates; any additional revenue generated by the imposition of ancillary fees would increase this amount.

If the Joint Providers' proposal is adjusted to eliminate the \$200 million-plus annual windfall, the cross subsidy remains. If the average rate is set equal to the reported average per-MOU of the Joint Providers, the annual windfall will be zero. But the shortfall at jail locations served by these three carriers will be increased: based on their reported costs for each facility size, the Joint Providers would experience a significant annual shortfall to serve facilities with an ADP of 0-99, 100-349, 350-999, and 1000+. This aggregate annual shortfall of almost \$100 million for jails would be made up in higher charges to end users at the Joint Providers' prison locations.

This analysis – based on the costs reported by the three Joint Providers with no adjustment – reveals that the Joint Provider Proposal will not result in cost-based rates to end users or fair compensation to these three providers. Instead, the proposed rate caps would result in a more than \$200 million aggregate windfall for Securus, GTL, and Telmate, and excessive rates to the end users in the larger facilities (jails with an ADP of 1000+ and all prison locations) served by the Joint Providers. Even if the weighted average rate is reduced to the level of average per-MOU cost for ICS as reported by these providers, the proposal for a single rate to apply to all confinement locations of all types and sizes means that the end users of the Joint Providers' prison locations will pay excessive rates totaling almost \$100 million annually.

The Joint Provider Proposal provides a clear illustration of the problems inherent in a single rate proposal. In order to effectively address both the windfall and cross-subsidy problems, any rate caps adopted for ICS must reflect the reported differences in the cost to provide the services at confinement facilities of different types and sizes. A

record now exists for the Commission to develop and adopt cost-based rate caps on this basis.

## **Exhibits**

*Confidential DJW-1: Confidential data supporting cost analysis*

*Confidential DJW-2: Confidential data supporting analysis of Joint Provider Proposal*

*DJW-3: Statement of Qualifications*