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June 1, 2015

ELECTRONICALLY FILED

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: **WC Docket No. 12-375: Rates for Interstate Inmate Calling Services**

Dear Ms. Dortch:

Pursuant to 47 C.F.R. § 1.1206(b)(1), the undersigned submits the attached written *ex parte* presentation, entitled "How to Save the FCC's Inmate Calling Rules from Being Reversed in Court ," for filing in the above-referenced docket.

Sincerely,

/s/ Andrew D. Lipman

Andrew D. Lipman

Enclosure

How to Save the FCC's Inmate Calling Rules from Being Reversed in Court

Andrew D. Lipman
June 1, 2015

HOW TO SAVE THE FCC'S INMATE CALLING RULES FROM BEING REVERSED IN COURT

In 2013, the FCC took the historic step of limiting rates for interstate inmate calling services ("ICS"), to protect consumers against excessive rates for a service that, for many, provides the only regular connection to an incarcerated family member or friend. *Rates for Interstate Inmate Calling Services*, 28 FCC Rcd 14107 (2013) ("*2013 Inmate Calling Order*"). In so doing, the FCC set interim rate caps based on a cost study that expressly excluded any consideration of site commission payments by ICS providers, on the ground that such payments constitute an allocation of profit rather than a cost of service. *Id.*, ¶¶ 54-58. The rules left ambiguous, at best, the status of site commission payments required under existing and future contracts between ICS providers and correctional facilities.[1] However, the FCC's rule requiring rates to be based on "cost," as so defined, was stayed pending appeal by the United States Court of Appeals for the District of Columbia Circuit.[2]

The Commission currently is considering proposed rules that would extend rate caps to intrastate ICS, among other things. *Rates for Interstate Inmate Calling Services*, Second Further Notice of Proposed Rulemaking, 29 FCC Rcd 13170 (2014) ("*Second FNPRM*"). This further rulemaking proceeding gives the FCC an opportunity to revisit its treatment of site commissions

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[1] The record reflects disagreement whether the FCC's 2013 *Inmate Calling Order* prohibits the payment of site commissions. *Compare* Letter from D. Baker, Alabama Public Service Commission, Attachment 2 at p.2 (filed Jan. 30, 2015) and Letter from C. Kiser, Counsel for Global Tel*Link, to Marlene H. Dortch, FCC, at 8 (filed April 3, 2015). *See also* Public Notice, *Rates for Interstate Inmate Calling Services*, 29 FCC Rcd 10043, 10044 at 2 (2014). Although the FCC explained that paying site commissions on interstate ICS revenues could be the basis of a finding that a provider's interstate rates are unjust and unreasonable, some parties argue this does not prohibit payment of site commissions because the FCC also found such payments are a sharing of profit, *2013 Inmate Calling Order*, 28 FCC Rcd at 14135 ¶ 54. In any case, it is clear that the current rules apply only to interstate, not intrastate, rates, so at least commission payments based on intrastate revenue continue to be unrestricted.

[2] *Securus Techs. v. FCC*, No. 13-1280, Order (D.C. Cir. Jan. 13, 2014).

and ICS rates. However, if the Commission fails to clarify the status of site commissions, or fails to authorize rates that provide a reasonable opportunity for recovery of allowable site commission payments, it risks another stay, or even worse, reversal of its entire ICS regulatory scheme. This paper outlines how the Commission can adopt rules that will avoid that fate.

I. Introduction and Background

Section 276 of the Communications Act empowers the FCC to regulate both "the provision of inmate telephone service in correctional institutions, and any ancillary services."47 U.S.C. § 276(d). Under § 276(b)(1)(A), the FCC is responsible for ensuring that all payphone service providers—including inmate calling providers—are "fairly[,]" not excessively, "compensated for … intrastate and interstate call[s] using their payphone[s]." 47 U.S.C. § 276(b)(1)(A).

In the *2013 Inmate Calling Order*, the FCC examined in detail the rates charged by providers of ICS and the costs they incurred in order to provide service. The FCC found that ICS rates "in far too many cases greatly exceed the reasonable costs of providing service." 28 FCC Rcd at 14110 ¶ 3. The FCC further discovered that a "significant factor driving … excessive rates [is] site commission[s]" that ICS providers must pay to correctional facilities in order to obtain the "exclusive right to provide inmate phone service." *Id*. The FCC determined that site commissions can account for nearly 90 percent of consumer rates, *id*. ¶ 34, and that such payments to correctional facilities are used for numerous non-call-related functions including "inmate welfare to salaries and benefits, states' general revenue funds, and personnel training." *Id.* ¶ 3, at 14125 ¶ 34.

In an effort to reduce ICS rates, the FCC required that ICS rates "be based only on costs that are reasonably and directly related to the provision of [ICS]." 47 C.F.R. § 64.6010. The FCC then found that site commissions were not costs directly related to the provision of ICS. *2013*

Inmate Calling Order, 28 FCC Rcd at 14135 ¶ 54.. Instead, the FCC determined that site commissions are "an apportionment of profit" between ICS providers and correctional facilities. *Id.* and at nn.199–200 (citing *2002 Order*, 17 FCC Rcd 3248, 3254–55, 3262–63 ¶¶ 15, 38). The FCC based this conclusion on the fact that site commission payments are used "for a wide range of purposes, most or all of which have no reasonable and direct relation to the provision of [inmate calling]." *2013 Inmate Calling Order*, 28 FCC Rcd at 14135-36 ¶ 54-55.

To reach this conclusion, the FCC focused on how correctional facilities use site commission revenues. For example, the FCC found that correctional institutions regularly use the site commissions to fund corrections-related activities and expenses such as "employee salaries and benefits, equipment, building renewal funds, … and personnel training." *2013 Inmate Calling Order*, 28 FCC Rcd at 14125 ¶ 34 & n.132. The FCC further discovered some jurisdictions where a significant percentage, or even all, of the site commissions that correctional facilities collect are treated as general governmental revenue.[3] The FCC further found that that some correctional facilities use portions of the commissions they collect to fund inmate welfare programs, *but explained that* such programs have no connection to the provision of ICS. *2013 Inmate Calling Order*, 28 FCC Rcd at 14135-36 ¶¶ 54–55.

The FCC thus determined that no direct action to reduce site commission payments was needed, instead relying on state government to rein in their growth. *See 2013 Inmate Calling Order*, 28 FCC Rcd at 14137 ¶ 56. Some states have limited or eliminated the practice but many have not. *See id*. at 14138 ¶ 58 n. 220. Thus, the Order failed to take any action that would

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[3] *2013 Inmate Calling Order*, 28 FCC Rcd at 14110 ¶ 3 n.13 ("commissions paid to the [Massachusetts] Department of Correction are transferred to the General Fund"); *see also* Wright Petitioners' Reply Comments, WC Docket No. 12-375, Exh. H (Apr. 22, 2013) (citing Fla. Stat. § 945.215(b) (2012), Tex. Gov't Code Ann. § 495.027 (2012), and Wis. Stat. § 3[01].105 (2013) as directing substantial portions of site-commission payments to their respective general treasuries).

reduce the largest factor in unreasonably high ICS rates — correctional institution site commissions.

The D.C. Circuit stayed certain aspects of the Order, including the rule requiring that interstate ICS rates "must be based only on costs that are reasonably and directly related to the provision of ICS." 47 C.F.R. § 64.6010. Other aspects of the *2013 Inmate Calling Order*, including interim rate caps, remain in effect pending a final decision on review. That review, however, has been abated, pending resolution of the FCC's subsequent attempt to reduce the unreasonably high charges for ICS.

The *Second FNPRM* demonstrates that the FCC understands the role site commissions play in unreasonably high ICS rates. Even after the FCC adopted interim rate caps on ICS, "failures in the ICS market continue[d]." *Second FNPRM*, 29 FCC Rcd at 13180 ¶ 20. The primary source of market failure is the "pressure to pay site commissions that exceed the direct and reasonable costs incurred by the correctional facility in connection with the provision of ICS continues to disrupt and even invert the competitive dynamics of the industry." *Id*.

Although the FCC's rate caps have been effective only for a short period, the FCC recognizes that the interim rate caps "did not completely address the problems in the ICS marketplace." *Id.* 29 FCC Rcd at 13180 ¶ 21. Indeed, the "record is clear that site commissions are the primary reason ICS rates are unjust and unreasonable and ICS compensation is unfair, and that such payments have continued to increase." *Id*.

The "payment of site commissions distorts the ICS marketplace by creating 'reverse competition' in which the financial interests of the entity making the buying decision (the correctional institution) are aligned with the seller (the ICS provider) and not the consumer (the incarcerated person or a member of his or her family)." *Id.* at 13180-1 ¶ 22. This reverse compe-

tition exists because "site commission payments are the chief criterion many correctional institutions use to select the ICS provider for their facilities and are thus the main cause of the dysfunction of the ICS marketplace." *Id*. at 13182 ¶ 24.

It is therefore self-evident that reducing or eliminating site commissions would "enable the market to perform properly and encourage selection of ICS providers based on price, technology and services rather than on the highest site commission payment." *Id*.

And it is further obvious that the rate caps adopted in the *2013 Order* have not reduced site commissions. In fact it is the opposite: the FCC found that the level of site commissions *increased* since it developed the record for the *2013 Order*. "Recent contracts show commission payments as high as 96% of gross revenue." *Second FNPRM*, 29 FCC Rcd at 13182 ¶ 26.

As the FCC correctly suggested, "[e]liminating the competition-distorting role site commissions play in the marketplace should enable correctional institutions to prioritize lower rates and higher service quality as decisional criteria in their RFPs, thereby giving ICS providers an incentive to offer the lowest end-user rates." *Id*. at 13183 ¶ 27.

II. The FCC Cannot Put Its Head in the Sand on the Site Commissions Issue

The FCC's second attempt to rein in unreasonable rates for ICS will fail unless it addresses "site commissions [—] the primary reason ICS rates are unjust and unreasonable." *See Second FNPRM*, 29 FCC Rcd at 13180 ¶ 21. As discussed in the following two sections, rules that cap rates on costs that exclude site commissions, but do not prevent correctional facilities from continuing to demand such commissions, would almost certainly be reversed by the Court of Appeals.

First, failing to address site commissions, which the record demonstrates and the FCC declares to be the predominant factor resulting in unreasonably high ICS rates, would be arbi-

trary and capricious. A regulatory agency cannot "entirely fail[] to consider an important aspect of the problem, offer[] an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (internal citations omitted). Site commissions, as those on both sides of the issue readily acknowledge, are an "important aspect" of the ICS problem. *See Second FNPRM*, 29 FCC Rcd at 13180 ¶ 21.[4]

Second, imposing rate caps on ICS providers that do not permit ICS providers to recover the costs of site commissions while at the same time doing nothing to end the practice of site commissions would necessarily result in rates that are confiscatory in violation of the Fifth Amendment to the Constitution. The Commission cannot set rates at levels so low that they make it impossible for service providers to recover their costs *and* provide a reasonable return on capital to their investors. Excluding site commissions from costs, without any offsetting opportunity for recovery, guarantees this prohibited result.

A. It Would Be Arbitrary and Capricious to Adopt ICS Rate Rules that Fail to Reduce or Eliminate Site Commissions — the Primary Cause of Unreasonably High Rates

In 2013, the FCC decided to ignore an entire category of expenditures by ICS providers — site commissions — by concluding that they are profits, not a cost of service. *2013 Inmate Calling Order*, 28 FCC Rcd at 14135 ¶ 54. The FCC's analysis of whether site commissions are direct costs of providing ICS, however, focused exclusively on whether they recover communications-related costs incurred by correctional facilities (correctly concluding that they do not).

[4] *See, e.g.*, Reply Comments of Lattice, Inc. at 9 (filed Jan. 27, 2015) (noting how "site commissions affect access to ICS").

But it ignored the fact that paying site commissions is an unfortunate cost of doing business for ICS providers, *2013 Inmate Calling Order*, 28 FCC Rcd at 14125 ¶ 34 n.132, ¶ 3 n.13, despite recognizing that these commissions make up an extraordinary high percentage of the expenses ICS providers incur. *Id*. It is therefore puzzling that the FCC would consider adopting rate caps based on a cost study that does not consider at all the impact of site commissions on ICS provider expenditures. To ignore such a significant component of ICS provider expenses in setting rates is plainly arbitrary.

The FCC is well aware how curbing site commissions will benefit the ICS marketplace. It found that "[e]liminating the competition-distorting role site commissions play in the marketplace should enable correctional institutions to prioritize lower rates and higher service quality as decisional criteria in their RFPs, thereby giving ICS providers an incentive to offer the lowest end-user rates." *Second FNPRM,* 29 FCC Rcd at 13183 ¶ 27. But the FCC has not yet taken any action that would rein in site commissions. Instead its plan seems to be to wait until state governments decide to prohibit the use of site commissions. Given that many states have used ICS rates to raise funds for their general treasuries, *2013 Inmate Calling Order,* 28 FCC Rcd at 14110 ¶ 3 n.13, it seems unlikely that many states will be rushing to enact ICS rate reforms that the FCC itself refuses to adopt.

Further, it is arbitrary for the FCC to establish a compensation regime where regulated carriers are effectively guaranteed an economic loss due to site commission payments. *See AT&T v. FCC*, 836 F.2d 1386, 1391-92 (D.C. Cir. 1988). As Securus has explained, "under the Rate Caps, it is economically impossible to continue paying commissions while covering the cost of

service and without passing through commissions to end users in the calling rates."[5] In *AT&T*, the D.C. Circuit rejected the FCC's rate of return refund rule, which required carriers to refund any actual returns in excess of the threshold established by the agency. 836 F.3d at 1391. It did so because the FCC's refund rule did not allow carriers to offset gains against periods where their actual rate of return was lower than the threshold, and therefore was inconsistent with the rest of the regulatory scheme. *Id*. at 1390-91. The rule seemed to "guarantee the regulated company an economic loss." *Id*. at 1391. Absent a prohibition on site commission payments, the same principle would apply to ICS providers.

Nor can the FCC claim that it lacks the authority to bar ICS providers from entering into contracts to pay site commissions.[6] The FCC has previously prohibited other common carriers from entering into exclusive arrangements with non-carriers. For example, telecommunications carriers and MVPDs are barred from entering into exclusive contacts with multi-tenant buildings in order to preclude competition.[7] Similarly, the FCC disfavors revenue sharing agreements between LECs and other entities that share the LECs' access revenues. *See* 47 C.F.R. § 61.3(bbb)(i); 47 C.F.R. § 61.26(g). There is no reason the FCC cannot enact similar rules that bar carriers from entering into site commission agreements, or establish limits on the permissible range of payments.

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[5] Letter from S. Joyce, counsel for Securus Technologies, Inc. to Marlene H. Dortch, FCC, at 2 (filed May 4, 2015).

[6] *See* Letter from Andrew D. Lipman, Morgan Lewis & Bockius LLP, to Marlene H. Dortch, FCC, at 1-7, (filed April 8, 2015); Reply Comments of Lattice, Inc., (filed Jan. 27, 2015).

[7] 47 C.F.R. § 64.2500; *Promotion of Competitive Networks in Local Telecommunications Markets*, Opinion, 23 FCC Rcd 5385, 5391 ¶ 15 (2008); *Promotion of Competitive Networks in Local Telecommunications Markets*, First Report and Order and Further Notice of Proposed Rulemaking, 15 FCC Rcd 22983, 23000 ¶ 35 (2000).

The FCC has broad statutory authority to prohibit the use of site commissions and other practices that result in ICS users being forced to pay unreasonable charges for ICS.[8] In particular, § 276(b) provides express authority to prohibit practices that result in unfair compensation. *Id*. Section 276(b)(1)(A) requires the FCC to ensure that payphone providers (which include ICS providers) are "fairly" compensated. The FCC has construed the term "fairly" under the statute to encompass both end user rates and compensation flowing to providers. *2013 Inmate Calling Order*, 28 FCC Rcd at 14115 ¶ 14. Because site commissions result in rates to users that are "unfair[,]" the FCC plainly has express regulatory authority to prevent carriers from entering into agreements that have this result.

And even if the FCC lacked direct authority under § 276(b), it plainly has ancillary authority to impose such a prohibition. The FCC's ancillary authority rests in § 4(i) of the Act, which provides that the FCC "may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with this chapter, as may be necessary in the execution of its functions." 47 U.S.C. § 154(i). Under this provision, the FCC may regulate when the "general jurisdictional grant under Title I [of the Communications Act] covers the regulated subject and (2) the regulations are reasonably ancillary to the [FCC's] effective performance of its statutorily mandated responsibilities." *American Library Ass'n v. FCC*, 406 F.3d 689, 692 (D.C. Cir. 2005). The regulation of ICS providers' contracts for and payment of site commissions easily falls under this framework.

Plainly, ICS is "communication by wire and radio" and thus within the FCC's general grant of authority under Title I of the Act. Correctional facilities argue that payment of site commissions is "too remote from" the provision of ICS to fall within the ambit of the communi-

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[8] *See* note 6, *supra*.

cation by wire and radio jurisdictional grant.[9] There is nothing "remote" about regulating the practices of entities, such as ICS providers, that are "engaged in communication by wire or radio." *Accuracy in Media, Inc. v. FCC*, 521 F.2d 288, 293 (D.C. Cir.1975). Because site commissions are "imposed on ICS providers as a condition of offering ICS, they become part of the cost structure of ICS" and "are among the 'charges, practices, classifications, and regulations for and in connection with' communications services."[10] Thus site commissions easily come under the FCC's jurisdiction over the "fair compensation" of ICS providers that offer such service using wire or radio communication.

The cases where courts have found the FCC's regulation did not fall within the Act's general grant simply do not apply. For example, in *Am. Library Ass'n*, the FCC found the FCC lacked authority to regulate television receivers even when such receivers were not providing or receiving communication by either wire or radio. 406 F.3d at 703. Similarly, the Seventh Circuit upheld the FCC's refusal to assert authority over the construction of the Sears Tower in Chicago, which purportedly interfered with television transmissions. *Ill. Citizens Comm. for Broadcasting v. FCC*, 467 F.2d 1397, 1400 (7th Cir. 1972). Such precedent does not apply here as ICS providers are plainly engaged in communication by wire or radio.

Regulating ICS providers' agreements for and payment of site commission also satisfies the second part of the test for the FCC's ancillary authority because it is "reasonably ancillary" to the FCC's performance of its statutorily mandated responsibilities, namely those set forth in Sections 201(b) and 276(b) that charge the FCC with ensuring that carrier rates remain just and reasonable. FCC "regulation of site commissions is necessary to promote the statutory policy

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[9] *See* Georgia Department of Corrections Comments at p. 11 (filed Jan.12, 2015.).

[10] Lattice Comments, at 5 (filed Jan 12, 2015) *citing* 47 U.S.C. § 201(b).

goals of wide availability of ICS and fair compensation "for each and every completed intrastate and interstate call" using correctional facility payphones."[11]

Further, there is no specific provision of the Communications Act that directly contradicts such an assertion of authority, unlike the assertion of ancillary authority found wanting in *National Ass'n of Regulatory Utility Commissioners v. FCC*, 533 F.2d 601, 612 (D.C. Cir. 1976) ("*NARUC*"), and *FCC v. Midwest Video Corp*., 440 U.S. 689, 700-702 (1979).[12] In *NARUC*, the D.C. Circuit rejected the FCC's claim that its assertion of ancillary jurisdiction over two-way cable data communications was related to its statutory duties pertaining to broadcasting. 533 F.2d at 612, 615. In *Midwest Video*, the Supreme Court rejected the FCC's assertion of ancillary authority to compel cable companies to make channels available for public access because it conflicted with language in the Act that prohibited the FCC from imposing common carriage regulation on broadcasters. 440 U.S. 689, 700-702. No such prohibition applies here.

Section 276(b), if it does not directly authorize the FCC to regulate site commission payments, certainly does not prohibit the FCC from adopting such regulations. Prohibiting ICS providers from entering into agreements to pay site commissions, or imposing limits on the permissible range of payments, is plainly a regulation that is "reasonably ancillary" to the FCC's performance of its statutorily mandated responsibilities under sections 201(b) and 276(b) to ensure that the rates ICS users pay are just and reasonable.

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[11] Lattice Comments at 6.

[12] In both cases, the FCC's jurisdiction over cable television services was predicated on and thus ancillary to its substantive statutory responsibility over broadcasting since the Act did not, until 1984, directly authorize the FCC to regulate cable television. *See United States v. Southwestern Cable Co.*, 392 U.S. 157, 178 (1968)

B. Rate Caps that Ignore Site Commissions Without Restraining the Amount of Site Commissions Will Result in Confiscatory Rates Barred by the Fifth Amendment

The Fifth Amendment to the Constitution protects regulated entities from regulations that are "so unjust as to be confiscatory." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989), *citing Covington & Lexington Turnpike Road Co.*, 164 U.S. 578, 597 (1896). *Duquesne* established that to prevail on a claim of a confiscatory regulation, the regulated company must show that the regulation will "jeopardize the financial integrity of the company[y], either by leaving [it] insufficient operating capital or by impeding [its] ability to raise future capital," or that the regulation results in rates that "are inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme." *Duquesne*, 488 U.S. at 312.

Here, the FCC has established rate caps based on ICS provider costs studies that specifically exclude the cost of paying site commissions, even though those commission payments are the primary reason for excessive rates. *Second FNPRM*, 29 FCC Rcd at 13180 ¶ 21. Thus the rate caps limit the ability of ICS providers to obtain revenues that exceed their cost. Accordingly, ICS providers will not be able to remain in business if they must comply with the FCC's rate caps, while using the revenues from those regulated rates to pay site commissions to the correctional facility.[13]

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[13] *See, e.g.*, Letter from S. Joyce, counsel for Securus Technologies, Inc. to Marlene H. Dortch, FCC, at 2 (filed May 4, 2015) (explaining that for Securus "under the Rate Caps, it is economically impossible to continue paying commissions while covering the cost of service and without passing through commissions to end users in the calling rates."); Letter from C. Kiser, Counsel for Global Tel*Link, to Marlene H. Dortch, FCC at 18 (filed April 3, 2015) ("To achieve both just and reasonable rates for consumers and fair compensation to ICS providers, the Commission must ensure that reductions in ICS rates and ICS provider proposed changes to ancillary fees are implemented over the same timeframe as site commission reform").

The standard for reviewing whether agency ratemaking is confiscatory is well-settled. "Price control is 'unconstitutional … if arbitrary [or] discriminatory.'" *Permian Basin Rate Cases*, 390 U.S. 747, 769-770 (1968), *quoting Nebbia v. People of State of New York*, 291 U.S. 502, 539 (1934). The Court's focus in reviewing agency ratemaking decisions is whether the regulated rates permit the entity to obtain a return on its investment "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). Adopting regulations that force companies to exit the business are unconstitutional; it is axiomatic that the "power to regulate is not a power to destroy." *Permian Basin Area Rate Cases*, 390 U.S. at 769, *citing Stone v. Farmers' Loan & Trust Co*., 116 U.S. 307, 331 (1886).

ICS rate caps that do not permit recovery of site commissions would specifically deprive ICS providers of the ability to recover their expenses, including a reasonable return on capital, through the rates they charge for service. The expenses excluded from the FCC's cost analysis are not insignificant. In some cases they amount to 96% of the revenue ICS providers obtain from serving a particular correctional facility. *Second FNPRM*, 29 FCC Rcd at 13172 ¶ 3. It is impossible to imagine rational investors willingly lending capital to an enterprise that is subject to rates that prohibit the recovery of such significant costs and is guaranteed to lose money in the process. This is the essence of confiscatory ratemaking.

The FCC's treatment of site commissions as an "allocation of profit" rather than "costs" in an economic sense will not save its decision. The Supreme Court has made it clear that the review of whether a regulation is confiscatory considers whether the "rate order 'viewed in its entirety' … produce[s] a just and reasonable 'total effect' on the regulated business." *Hope Natural Gas*, 320 U.S. at 602. (internal citations omitted) "It is not the theory but the impact of

the rate order which counts." *Id*. Therefore, a maximum rate that prevents an ICS provider from charging enough to cover its economic costs plus site commission payments, and still pay some reasonable return to its investors, would be unconstitutional. The FCC cannot rationally separate out the direct costs ICS providers incur to provide service and the expenditures they make on site commissions. *See AT&T*, 836 F.2d at 1392 ("[i]nvestors in a carrier, after all, must invest in the carrier as a whole …."). Like the FCC's rate of return refund rule overturned in *AT&T*, the FCC's proposed rate caps are impermissible because they "guarantee the regulated compan[ies] an economic loss." *Id*. at 1390-91.

Even if the FCC maintains that site commissions are profit sharing, it must adjust its rate of return prescription to account for the ICS providers' obligation to make these payments. The D.C. Circuit explained the FCC's process for setting the rate of return in *AT&T*:

> Under the Communications Act … the [FCC] regulates the rates a carrier may charge for interstate telecommunications service. 47 U.S.C. §§ 201-205 (1982). As part of that task, the [FCC] sets the rate of return on capital that the carrier may use in setting its rates. *See, e.g., Nader v. FCC,* 520 F.2d 182, 191-92 (D.C.Cir.1975) … The carrier then calculates its rates so that projected revenues will cover projected operating expenses plus the authorized return on capital.

AT&T, 836 F.2d at 1388. Fixing a rate of return requires the FCC to balance investor and consumer interests. *Duquesne*, 320 U.S. at 603. The "investor …has a legitimate concern with the financial integrity of the company whose rates are being regulated … including that "there be enough revenue … for operating expenses …[and] the capital costs of the business." *Id*. Under this standard, the return should be "commensurate with returns on investments in other enterprises having corresponding risks." *Id*. Further such return "should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain …credit and attract capital." *Id*.

The "commensurate" rate of return for ICS must thus take into account the reduced return available to ICS providers where the correctional facilities are not prohibited from imposing site

commissions as a cost of doing business. While the FCC can state that site commission "costs" are not direct costs of providing ICS, it cannot exclude them from its calculation of a reasonable rate of return that is "commensurate" with the risks in other similarly situated enterprises.

The FCC made no such analysis of the rate of return in formulating its interstate ICS rules, and instead relied on the 11.25 percent return assumed in the submitted cost studies, which expressly excluded all site commissions. *2013 Inmate Calling Order*, 28 FCC Rcd at 14136 n.203. The FCC must do more than "accept[] the figures in the cost study." *Id*. It must determine whether the rate of return used in the cost study is sufficient to ensure investor confidence in the business once the rate rules are applied. In determining the appropriate level of ICS rate caps, the FCC must make an independent judgment on whether the cost study developed by parties strikes the appropriate balance between consumers and investors.[14] And unless the rate of return expressly considers the commission payments ICS providers must make to obtain contracts to provide ICS, the rate of return will fail to strike the appropriate balance and lead to confiscatory rates.

III. The FCC Still Has Options

There are a variety of ways the FCC can adopt rules that would limit ICS rates without falling afoul of the problems explored in the preceding sections.

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[14] *See Texas Office of Pub. Util. Counsel v. FCC*, 265 F.3d 313, 328 (5th Cir. 2001) (rejecting FCC decision to set universal service fund level at $650 million based solely on consensus of parties below since "agency abdicates its role as a rational decision-maker if it does not exercise its own judgment, and instead cedes near-total deference to private parties' estimates-even if the parties agree unanimously as to the estimated amount"); *Laclede Gas Co. v. FERC*, 997 F.2d 936, 947 (D.C. Cir. 1993) (FERC was required to exercise independent judgment in approving a settlement even though the figure was within the range pleaded by comments in the agency proceeding below).

First, the FCC could prohibit ICS providers from paying any site commissions whatsoever, either immediately or after some reasonable transition period (designed to allow them to migrate from existing contracts). Although this action would be within the FCC's legal authority as explained above, it would not necessarily be in the public interest. As many parties have noted in comments, correctional facilities do incur some level of expense to make ICS available to their inmates, and it is in the public interest that this service continue to be available.[15] It is therefore reasonable for the FCC to permit some level of site commissions, to the extent that facilities are permitted under State law to receive such payments,[16] so that correctional facilities will continue to have an incentive to make adequate ICS facilities available on their premises.

Second, at the other extreme, the FCC could adopt no restrictions at all on site commissions, but in that case it would have to allow ICS providers to increase their interstate and intrastate rates to allow them to recover *both* the economic costs of the service, including a reasonable return on investment, *and* the additional economic rent imposed by the site commission obligations. This would be tantamount to having no limits on ICS rates (except in those States that have acted on their own to restrain or prohibit site commissions), since there would be no limits on the payments that correctional facilities could demand, which also would not appear to be consistent with the public interest.

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[15] *See, e.g.*, letter from Lee G. Petro, Counsel for Petitioners, to Marlene H. Dortch at p. 1, filed April 20, 2015; letter from Chérie R. Kiser, Counsel for Global Tel*Link Corporation ("GTL"), to Marlene H. Dortch, filed April 3, 2015; Reply Comments of CenturyLink, at 19 (filed Jan. 27, 2015); Georgia Dept. of Corrections Reply Comments at 17; Reply Comments of Praeses LLC at 26 (filed Jan. 27, 2015).

[16] The FCC should state expressly that it is not pre-empting State and local laws that prevent correctional facilities in some jurisdictions from demanding or receiving commission payments, to avoid any implication that such laws are pre-empted as inconsistent with its regulations under 47 U.S.C. § 276(c).

Third, the FCC could adopt a middle-ground approach that allows ICS providers to enter into contracts (where permitted by State law) to pay reasonable, but not excessive, site commissions to correctional facilities, and to charge interstate and intrastate rates to their customers that include recovery of these site commission payments in addition to their direct economic costs. As suggested in the undersigned's May 1, 2015, written *ex parte* submission, the Commission should prohibit commission payments computed as a percentage or share of revenue, as these give both correctional facilities and ICS providers a direct incentive to overcharge consumers. The FCC should, however, permit commission payments that are based on minutes of use and similar cost drivers, up to a reasonable maximum. As also suggested in that previous filing, the Commission may prefer to adopt a sliding-scale maximum based on facility size (measured by Average Daily Population), as the record shows that smaller facilities, such as local jails, tend to have disproportionately higher costs than larger ones.[17]

If the Commission adopts this approach, though, it is essential that it also adopt a similar sliding-scale maximum rate for interstate and intrastate ICS calls, so that ICS providers will be able to recover the expense of paying site commissions, along with their other costs. It would be particularly difficult for the FCC to justify to a reviewing court a rule that expressly permits ICS providers to pay a certain level of commissions, yet precludes them from recovering these payments from the users of their service. Such a scheme would be internally inconsistent, and therefore almost certainly reversed as arbitrary and capricious.

To ensure that its rules will withstand judicial review, the FCC must adopt a consistent approach that harmonizes rate caps and site commissions. If ICS providers are obligated to pay

[17] Nonetheless, the mere designation of a facility as a jail rather than a prison, by itself, does not indicate much about its likely costs. Some jails, for example, house state prisoners under long-term contracts and therefore have cost patterns that more closely resemble those of prisons. *See* Reply Comments of Petitioners Martha Wright *et al.* at 15-16 (filed Jan. 13, 2014).

site commissions, they must be equally entitled to charge rates that will allow them to fulfill that obligation. If the FCC ignores this essential relationship, its laudable efforts to rein in ICS rates will be doomed to fail.

Respectfully submitted,

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