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August 14, 2015

By ECFS & Hand Delivery
Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

RE: *Ex Parte Written Presentation*
Rates for Interstate Inmate Calling Services
WC Docket No. 12-375

Dear Ms. Dortch:

Pursuant to Section 1.1206(b) of the FCC's rules, Martha Wright, *et al.* (the "Petitioners"), hereby submits the attached memorandum providing an analysis of the Cost Study submissions by the ICS providers. Because certain information was provided by certain ICS providers on a confidential basis, a copy of the unredacted version has been filed with the Office of the Secretary, and a redacted version has been posted to WC Docket No. 12-375 through ECFS, pursuant to the Protective Order adopted in this proceeding.

Should there be any questions regarding this matter, please contact undersigned counsel.

Respectfully submitted,

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MEMORANDUM

TO: Lee Petro

FROM: Coleman Bazelon and Kristin Stenerson

SUBJ: Comments on Inappropriately Included Capital Costs

DATE: August 14, 2015

I. Overview

In our previous submissions in this Docket we have reviewed in detail the problems with the ICS Provider submissions for the Mandatory Data Collection. The most notable of which are: (1) inconsistent and inaccurate allocation of costs between ICS and other services; (2) incorrect calculation of financing charges; (3) inconsistent and inappropriate allocation of common costs with limited or no justification or description; (4) incorrect calculations for return on capital; and (5) incomplete description and justifications. As emphasized by GTL in their most recent filing, some of these inconsistencies may be due to the way in which the FCC designed the data collection.[1] Multiple providers commented on the data collection when it was first released, including Pay Tel who commented that the data collection could be improved with "a standardized data collection reporting template that requires backup data which ties to providers' audited books of account, as well as more comprehensive instructions for the accompanying Description and Justification."[2] In this memo, we discuss additional evidence that costs related to the provision of ICS services reported by a number of ICS Providers are overstated.

In the Report and Order and Further Notice of Proposed Rulemaking (Order), the Commission describes costs that are eligible for recovery through the ICS rate as:

> "only costs that are reasonably and directly related to the provision of ICS, including a reasonable share of common costs, are recoverable through ICS rates [….] Such compensable costs would likely include, for example, the cost of capital (reasonable return on investment); expenses for originating, switching, transporting, and terminating ICS calls; and costs associated with security features relating to the provision of ICS."[3]

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1 "WC Docket No. 12-375 - Global Tel*Link Corporation – Written Ex Parte Presentation," WC Docket No. 12-375, Cahill Gordon & Reindel LLP, August 10, 2015.

2 "Pay Tel Communications, Inc.'s Comments Regarding Proposed Data Collection Relating to the Commission's Inmate Calling Services Order," WC Docket No. 12-375, Pay Tel, May 19, 2014.

3 "Report and Order and Further Notice of Proposed Rule Making," WC Docket No. 12-375, September 26, 2013, p. 28, (hereafter, "Order")

The order also provides examples of costs that are not recoverable through the rate:

> "costs of non-regulated service, costs relating to general security features of the correctional facility unrelated to ICS, and costs to integrate inmate calling with other services, such as commissary ordering, internal and external messaging, and personnel costs to manage inmate commissary accounts."[4]

This guidance is consistent with rate regulation and is referred to as the "Prudence Concept" and "Used and Useful Concept" in Rate Regulation literature. Prudent means the "investment is reasonable based on cost-minimizing criteria" and Used and useful means "the plant is actually being used to provide service and that it is contributing to the provision of the service."[5] Rates should be set to aim to recover only costs related to a service being regulated, not all costs incurred by the provider.

This is especially important when considering the recoverable asset base upon which ICS providers should receive a reasonable return on investment. Through a further review of the Descriptions and Justifications provided by ICS Providers, We have found that providers often included costs that do not meet the definition of "reasonably and directly related to the provision of ICS."

II. Ambiguity in the Instructions

In the "Instructions for Inmate Calling Services Mandatory Data Collection", the Commission provided instructions on the types of cost that should be included under each category (telecom, equipment, security, and other). The Commission included interest expense related to equipment as a recoverable cost.[6] Such interest expenses are only appropriately recoverable costs in a limited number of instances, but the directions left ambiguity as to when such costs should be included. It seems, however, that carriers included interest expenses that should not be recoverable. Generally, the carrying cost of capital equipment is recovered through the cost of capital carrying charge (11.25% as used by most carriers.) To include interest expenses as a separate item in addition to the capital carrying charge is to recover the same expense twice.[7] In addition, interest expense from non-equipment items should not be included at all, but appear to have been in some cases.

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4 "Order", p. 29.

5 Jamison, Mark A., "Rate of Return: Regulation," Public Utility Research Center, University of Florida, <http://warrington.ufl.edu/centers/purc/purcdocs/papers/0528_jamison_rate_of_return.pdf>, p. 12-13, ("Rate of Return: Regulation").

6 "Instructions for Inmate Calling Services Mandatory Data Collection," WC Docket No. 12-375, ICS Mandatory Data Collection, 2013, p. 4.

7 The expense is recovered once as the actual interest cost and again as a charge for the opportunity cost of capital tied up in the investment.

III. Evidence from Provider's Description and Justifications

We now review evidence from D&J's submitted by ICS Providers for the Mandatory Data Collection of the overstatement of capital costs.

A. Securus and Telmate

In our submission on January 12, 2015 we review in detail the problems with Securus' calculation of financing costs.[8] Their return on capital is based on the company's purchase price which represents the whole company's value and projected future profits (including excess profits), rather than the assets/equipment used to provide ICS services. This methodology is also problematic because it is circular. The profitability of the company affects the asset value, which in turn affects profitability.[9] In our January 12, 2015 report, we re-estimate Securus' cost of capital based on its eligible asset base. In addition to the expenses we previously adjusted, Securus lists the following General Ledger expenses that have been categorized as "Shared Joint & Common": [10]

These additional cost items are not directly related to the cost of providing ICS service (with the possible exception of .) Most of them are financing items which would vary from provider to provider depending on how they chose to finance their operations, not tied to costs created from the provision of ICS services. Recovery of the opportunity cost of capital is captured by the cost of capital charge (which Securus recovers through the 11.25% return on capital) and including these financing costs is an example of recovering twice for the same underlying cost. Telmate's cost of capital was determined by FTI as well and thus follows a similar methodology and consequently suffers from the same type of overstatement.

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8 "Second Further Notice Declaration of Coleman Bazelon," WC Docket No. 12-375, January 12, 2015, p. 7.

9 "Rate of Return: Regulation", p. 9.

10 "FTI Consulting, Inc. Report Implementing the FCC Mandatory Data Collection on Behalf of Securus Technologies, Inc.," WC Docket No. 12-375, July 17, 2014, Attachment 3: Assignment of Securus General Ledger Expenses by Department to FCC Data Categories, p. 2.

B. GLOBAL TEL*LINK

As we discussed in the January 12, 2015 report, Global Tel*Link (GTL) does not include much information on how they calculate cost of capital. The only description provided is that "the market value of GTL's assets was determined on the basis of discussions with GTL executives regarding the sale and/or purchase of GTL and another ICS provider since 2011."[11] This language also seems to imply that the return on capital is being applied to the whole company's value, not the assets used to provide ICS value which would overstate the cost of capital. Even if limited to the current value of the assets, such an approach risks overcompensating GTL for those assets if their depreciated value is actually lower.

C. CENTURYLINK

In CenturyLink's discussion of equipment costs, they describe that they both include "interest expense" and "applied an 11.25% cost of capital to calculate the dollar cost of capital for each contract."[12] As discussed above, the 11.25% cost of capital already compensates providers for interest expense and thus CenturyLink is double counting that expense.

D. COMBINED PUBLIC

Combined Public appears to include interest expense, but not cost of capital charge. It is unclear if this under or over compensates for the carrying charge of capital, but if the interest expenses are for a larger base than just recoverable equipment expenses, such as interest related to financing other activities, then it may well overcompensate for such expenses.

E. OTHER CARRIERS

The following carriers did not provide information justifying how they accounted for recovery of capital expenses. In light of the ambiguity in the data-collection directions for ICS providers to include some interest expenses, and given the excess cost of other carriers discussed above, it is reasonable to conclude that the reporting ICS carriers are over-recovering their capital expenses.

- Correct Solutions
- ICSolutions
- NCIC
- Lattice Incorporated
- Custom Teleconnect

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11 "FCC Mandatory Data Collection Description & Justification for Global Tel*Link Corporation," WC Docket No. 12-375, Economists Incorporated, August 22, 2014, p. 11, footnote 11.

12 "CenturyLink Complete Response to Mandatory Data Collection," WC Docket No. 12-375, CenturyLink, September 16, 2014, p. 3.

IV. Conclusion

In the January 12, 2015 report, we propose a base rate of $0.08 based on adjustments to average costs reported by providers. We estimated adjustments to these reported costs which remove the overstated capital costs. The lack of visibility into the majority of the ICS providers' cost of capital methodologies prevents us from determining their recoverable asset base and calculating specific rate adjustments for them. However, the evidence of over estimation of capital costs in this memo demonstrates that costs reported in the Mandatory Data Collection are overstated and a rate lower than the average reported cost is appropriate.