



**MANDATORY UNBUNDLING:
BAD POLICY FOR PRISON PAYPHONES**

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I. Executive Summary

For both legal and policy reasons, American correctional facilities¹ make available to inmates the ability to make outgoing telephone calls. Generally, the services are provided through contracts between the correctional facility and a private firm specializing in inmate calling services (an “inmate service provider”). Such firms install and operate specialized telecommunications switches that not only permit inmates to make outbound (usually collect) calls, but also provide a variety of functions unique to the penal environment, such as call monitoring and the ability to block calls to all but an “approved” list of calling parties. Inmates do not have a choice of telecommunications providers; they may use only the service provided for by the correctional facility through the inmate service provider, including the inmate service provider’s long distance service or chosen long distance provider. Rates for local calls generally are capped by state regulatory authorities, but long distance rates are unregulated and often are higher than those paid by the general public.

The Federal Communications Commission (“FCC” or “Commission”) has authority to regulate various aspects of payphone service, and has imposed, among other rules, the requirement that public payphone providers permit callers to utilize their choice of long distance services when making InterLATA calls.² Traditionally, the Commission has recognized that inmate telephone services, while similar in some ways

¹ The terms “prison,” “confinement facility” and “correctional facility” are sometimes used interchangeably, whereas “jail” typically refers to local facilities that house inmates serving shorter sentences. As discussed below, there is a great deal of variability among facilities, both in general and with respect to their needs for inmate calling services. We adopt the generic phrase “correctional facility” simply for convenience of presentation.

² See, for example, *In the Matter of Billed Party Preference for InterLATA 0+ Calls, Second Report and Order on Reconsideration*, CC-Docket 92-77 (January 29, 1998).

to public payphone services, are in other ways very different, and thus deserving of different regulatory treatment. Specifically, it has declined to impose on providers of inmate payphone services the requirement that they provide a choice of multiple long distance services.

In October 2003, a petition was filed with the Commission proposing to change the manner in which phone service is provided to inmates and, in particular, to require that inmates be offered a choice of long distance services.³ Essentially, the proposal would require operators of prison telephone switches to permit multiple long distance carriers to interconnect with the local switch, at interconnection charges set by the Commission. The petitioners claim that allowing long distance choice would reduce or eliminate market power, and that their proposal would increase competition for the long distance component, resulting in lower rates, as well as reducing rates for local/switch service by imposing price cap regulation.

The proposal, if implemented, would not improve the efficiency of inmate telephone systems or lower the costs of providing telephone services in correctional facilities. Competition for long distance service will not increase because full competition already exists, albeit in a form not directly visible to the inmate. Costs for local switching service will not be reduced, because the bidding process by which vendors are selected already provides sufficient competition to drive costs down. Market power will not be eliminated, because the only source of market power is the

³ Petition for Rulemaking or, In the Alternative, Petition to Address Referral Issues in Pending Rulemaking (October 31, 2003). (Hereafter "Wright Petition.") The issues raised by the petition subsequently were incorporated by the FCC into the ongoing proceeding initiated by the Inmate Payphone NRPM. See FCC, *Implementation of Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, 69 FR 2697-8 (January 20, 2004).

penal system itself, which, as a matter of public policy, is supported in part by profits made on phone systems. In fact, the costs of providing phone systems to correctional facilities will rise under the proposal, because its implementation will shift the locus of competition from the correctional facility to the inmate and thus remove the correctional facilities' volume purchase power and increase the carriers' costs of marketing their services.

Costs will also rise because of a new regulatory layer imposed on top of a heretofore well-functioning market. Indeed, in proposing a new regulatory system for local/switch services, the proposal essentially argues for a second TELRIC process, much like that for UNEs, with the same complexities, opportunities for regulatory error and procedural costs, but spread over a much smaller (and in many ways more complex and diverse) market. The difficulties of implementing such a system are well illustrated by the petitioners' own expert affidavit, which in the course of attempting to estimate the cost of inmate telephone systems shows just how difficult and uncertain it would be for a regulatory body to set an appropriate rate.

Perhaps most importantly, the regulatory regime proposed in the Wright Petition would lead to precisely the same sorts of disincentives for investment and "free riding" on the investments made by incumbent firms as have been observed in the market for local broadband services under the UNE/TELRIC regime the Commission has imposed for local telecom services generally. The differences are that the Telecom Act specifically directed the Commission to open access to the local switch (which is not the case with inmate calling services), and that the potential benefits from opening the local

market to competition are significant (whereas there are virtually no apparent benefits from the forced sharing proposed in the Wright Petition).

In this study, we examine the market for inmate telephone services. Section II below describes the current system and the proposals now before the Commission for regulatory intervention. Section III explains why the benefits of competition are already being fully realized in the market and why the proposed regulatory intervention would not make the system more competitive or efficient. Section IV briefly outlines the difficulties of imposing the proposed form of price regulation. In Section V, we examine specifically the expert affidavit submitted with the Wright Petition and explain its many shortcomings. Section VI consists of a brief summary and conclusions.

II. The Current System and Proposals for FCC Intervention

Inmates in U.S. prisons are deprived of many rights most citizens take for granted. One privilege they are permitted is the use of pay telephones to allow them to remain in contact with attorneys, family members and others. As the FCC recognizes, the telephone services provided to inmates “are quite different from the public telephone services that non-incarcerated individuals use,” both in terms of the specific requirements of the service and in the ways in which they are funded. Generally, inmates are blocked from calling all but a small number of possible destination numbers, in order to protect innocent parties such as judges and witnesses and to avoid inappropriate use of the system, such as calls to “900” numbers. Call duration is typically constrained. Call pass-through is blocked so that an inmate cannot call a friendly destination and have the call forwarded to a restricted/blocked number. Prison

phone systems must also be designed to meet a variety of needs unique to the penal environment, including call monitoring and recording, customized call reporting for confinement facility officials, and voice overlays to notify the called party that the call is originating from a prison inmate.⁴

Prisoners pay for their calls by calling collect or (in a few prisons) by making use of debit cards or pre-paid accounts. Collect calls are the most common form of payment, and payment for such calls is handled on much the same basis as payment for collect calls made by the general public. Debit cards and/or pre-paid accounts may be paid for by the inmate or by family, friends, or counsel. In the case of local calls, the rates paid by inmates generally are subject to state-imposed ceilings. Interstate rates, on the other hand, are generally not regulated, except as set by contract between the confinement facility and the firm providing the telephone system.

Confinement facilities select suppliers of inmate telephone services through a bidding process, typically awarding contracts under which the supplier provides all of the equipment and other infrastructure necessary to meet the needs of both the facility and the inmates, as well as the communications services (both local and long distance) associated with inmate calls. It is useful to think of the services provided as having four components: the infrastructure platform and associated services, the connection to the local phone network, communications services (local, intra-LATA toll, and long distance), and billing and collection services. The infrastructure platform typically is highly specialized to meet the needs of the penal environment, and includes the phone

⁴ See Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket 96-128, Order on Remand & Notice of Proposed Rulemaking (February 12, 2002), ¶9. (Hereafter "Inmate Payphone NPRM.")

installations, the switch, and a local network and ports for connecting to local access lines. The core of the system is a specialized switch and associated software, which are specifically designed for use in correctional facilities, as standard enterprise switches and carrier-grade switches are generally not able to provide the complex services unique to the penal environment.

One set of firms focuses primarily or exclusively on serving this market. The largest of these firms include Evercom, T-NETIX and Global Tel Link . These companies either assemble unique combinations of off-the-shelf hardware and software to create the specialized switches needed for this purpose, or in some cases design their own customized components. They also operate sophisticated systems for credit validation and debt collection, which are especially significant issues in the penal environment. Long distance carriers and local carriers (e.g., AT&T, SBC) also bid for contracts to provide inmate phone services, usually in conjunction with a firm that specializes in providing such services to correctional facilities.

Contracts are awarded to inmate service providers through a competitive bidding process under which confinement facilities distribute formal Requests for Proposals and receive several bids. Contracts specify the services to be offered and generally include provisions for a commission (usually 30 percent or more of revenues) paid by the inmate service provider to the confinement facility.

Winning bidders generally are awarded fixed-term contracts, typically for five years. Thus, the confinement facility is assured of a reliable supply of the specialized services it needs, and the supplier can be assured of a minimum period over which it can recoup the facility-specific investments required. Suppliers recoup both their fixed

and variable costs by charging inmates (or, in the case of collect calls, the called parties) for calls placed over the system. Because of the unique costs associated with this market, long-distance rates for both collect and debit card-based calls from correctional facilities are typically higher than similar calls placed from payphones or residences.

The differential between commercial long distance rates and the rates paid for inmate calls has motivated a variety of inmate advocacy groups to propose, and the FCC to consider, the imposition of additional regulation on the market for inmate telephone services. The most recent such petition is the Wright Petition, filed in October 2003 by Martha Wright.

The Wright Petition, and an accompanying affidavit submitted by Mr. Douglas A. Dawson (“Dawson Affidavit”), assert that “prison inmates pay some of the highest long distance rates in the country,” and that these high rates are “the result of the exclusive service agreements that prison administrators typically enter into with telecommunications carriers for inmate calling services,” arrangements which “usually involve the payment of generous commissions to the prison facility by the winning service provider.”⁵ The petition requests that the FCC “prohibit exclusive inmate calling service agreements and collect only-call restrictions...and require such facilities to permit multiple long distance carriers to interconnect with prison telephone systems.”⁶ In place of the existing system, the petitioners suggest the FCC create a new regulatory system which would (a) impose “open access” or interconnection obligations on the

⁵ Wright Petition at 2.

⁶ Wright Petition at 3.

operators of local (in this case, prison-based) switch and (b) establish a regulated “benchmark access fee” capping the price that could be charged for interconnection. Petitioners also propose that inmate calling systems be required to offer inmates a choice between collect calls and debit cards, and that correctional facilities be prohibited from including commissions in their contracts with inmate service provider firms.

Based on calculations performed in the Dawson affidavit, the petitioners allege that the result would be to “reduce the overall cost of inmate long distance service by more than \$0.06 per minute.”⁷

For the reasons discussed below, the regulatory regime proposed by the Wright petitioners would not produce a desirable outcome. Specifically, it would not enhance competition or increase economic efficiency. To the contrary, by imposing a highly regulatory and necessarily imperfect regulatory regime on inmate payphone systems, it would distort economic incentives and result in a less efficient market for these services.

III. The Proposed Changes Would Not Enhance Competition or Increase Economic Efficiency

The main shortcoming of the petition is that it fails to distinguish between two different, but equally powerful, forms of competition. One type of competition is an ongoing process where sellers compete for every unit of business and buyers continually seek out the best value. Thus, sellers of telephone services compete for

⁷ Wright Petition, at 13.

each residence's long distance business, or for each collect call made from a payphone. Failing to find such atomistic competition in the market for inmate payphone services, the petition mistakenly concludes there is a lack of market disciplining competition of any kind.

But a second type of competition exists, one with bigger stakes, in which sellers and buyers both find it advantageous to lock in the benefits of competition up front, under a contract. Since the unit of business being competed for is larger, sellers have strong incentives to offer their best products and prices. Buyers, in turn, seek out these alternatives and choose to commit to the best deal with a long term contract. In this type of competition, the quantity of business is a volume rather than a single unit.

Both buyers and sellers benefit from the long term commitment, in fact have chosen the commitment because of the advantageous terms it leads to, in lower cost and better quality. Thus, upfront competition can be and is as vigorous as the traditional ongoing model. This vigor, however, is realized at the beginning, in a bidding market where sellers have the incentive to offer their best in order to win the richer reward of the larger volume over time. Long term contracting does not preclude low prices or new technologies or full investment; just the opposite, long term contracting often increases the incentives for competition in multiple dimensions. The current market for inmate telephone services, with telecom vendors bidding to be the sole provider of services for an individual correctional facility over the contract term, follows the latter competitive model.

In determining whether the inmate payphone market is competitive, one must first identify the buyers of the product. In the case of prison calls the payer and the

decision maker are not the same, as the inmate or his call recipients pay to use the system that the correctional facility has chosen to obtain. The Wright petition refers to inmates, perhaps tongue in cheek, as a “captive audience.” In fact, however, the more important point is that inmates, unlike the non-incarcerated population, are by definition not “sovereign consumers.” Their product consumption decisions are proscribed as a matter of course – they can’t choose their own food, clothing, or shelter; they cannot control what mail they receive or what television programs they watch. Often, they are charged fees for their own imprisonment, and they earn below-market wages for their labors. Similarly, their phone use is restricted. An inmate cannot choose freely whom to call, when to call, or how long to converse. In some circumstances, call privileges can be severely limited, or even withheld altogether.

Instead, the correctional facility chooses the system, and system providers compete for each facility’s business. The competition takes the form of bidding for each facility’s franchise. From those bids, the facility can choose the lowest rate, the highest commission; the best combination of rate and commission; the best combination of rate, commission, and call control technology; whatever is of greatest importance to that facility. Competition among all the bidding parties ensures that the facility gets to choose an efficient alternative. In turn, the inmate service provider chooses among numerous alternatives for long distance services, telephone hardware, switches and related devices, call monitoring technology, bad credit control systems, and so forth, including those alternatives produced in-house. The inmate service provider can choose to formally place business out for bid, or informally search and find

the best combination of price and quality, often to be purchased under long term contracts. Competition for a facility's inmate calling services business is vigorous.

Prisons face both economic and political pressures that compel them to find efficient inmate calling services. Prisons operate on budgets, and like most government programs, funds are usually scarce. For many correctional facilities, part of their general funding comes from the commissions obtained from inmate service providers. The incentive for correctional facilities to find the best deal is as strong as that of any telecommunications service purchaser. Thus, a correctional facility, although not a profit-making institution, will select an inmate service provider and sign a contract that minimizes the costs of inmate calling services of a specified quality.

Furthermore, correctional facilities have incentives in particular to choose the ideal number of long distance carriers. Petitioners and other parties have called for open access to multiple long distance carriers. Prisons, the buyers of inmate calling services, already have that option in placing their needs out for bid. They have not chosen to purchase systems with connection to multiple IXCs, because the costs of doing so, in terms of the increased complexities of switching, connection, verification and billing outweigh any benefits from lower long distance costs that may occur (but in practice do not because the inmate service provider is getting the lowest competitive bid in choosing the single IXC). The presence of only a single IXC in a facility's inmate calling system does not indicate the absence of competition.

Inmate service providers have strong incentives to find the most efficient alternatives for the various components of the system. First, in order to gain a facility's business, the inmate service provider must be able to offer the best combination of

commission, rates, and service quality in competition with other firms. To make its bids as strong as possible, an inmate service provider is compelled to find inexpensive hardware and long distance services and to provide the best possible validation and billing services. The inmate service provider will also incorporate its expectations of cost improvements over the course of the contract. Second, after a successful bid is locked into a contract, cost minimization is the only way to increase profits. Finally, inmate service providers constantly seek improvements in their systems so as to be ready with a competitive package when the next bidding opportunity appears.

Long distance service is also supplied in a competitive market. Prison long distance purchases are a small part of a sizeable market that is highly competitive, with pure IXCs competing with RBOCs, resellers, and the like. The price of long distance calling is not determined at the correctional facility level; rather, prisons (and inmates) benefit from the vigorous competition for all long distance services. That competition includes ongoing cost-cutting measures that continue to drive rates down. An inmate service provider purchases the needed long distance services at the same low rates as any other user with the same call volume. Thus, correctional facilities and inmates already benefit from access to a competitive market for long distance services.

Furthermore, petitioners fail to recognize the effects of their proposal on the vigor with which long distance carriers will compete. Under the current system, IXCs compete for the substantial call volume of a service facility. Under the proposed system, IXCs would have to sell their services separately to individual inmates or their call recipients. The only certain impact on the long distance market of transferring the

locus of competition from the inmate service provider to the individual inmate would be to increase marketing costs by forcing IXCs to market their services directly to inmates.

In its *Inmate Payphone NPRM*, the Commission expresses concern that “high inmate calling rates may be partially attributable to the absence of market forces” [because] “the correctional institution exercises exclusive control over access to the inmate calling market [and] can demand in location commissions the highest amounts the market will bear....”⁸ While it is true that correctional facilities exercise control over inmate telephone calls (including their choice of provider), and accept commissions from suppliers, it does not follow that there is an “absence of market forces.” Rather, as discussed above, market forces operate on both the demand and supply side of the market, providing strong incentives for both buyers and sellers to make economically efficient purchasing and production decisions. With respect specifically to long distance services, inmates have no more incentive, and probably less ability, to obtain low long distance rates than do inmate calling service firms.

Prohibiting confinement facilities from charging commissions, which the Wright petition also proposes, presumably would lower the rates paid by inmates and the parties they call. The effects on economic efficiency, however, are highly questionable. First, inmates are constrained in their use of telephone services by many factors other than price, including direct limits on the amount of calling time each inmate is permitted. Thus, it is not clear whether, or to what extent, lower prices would lead to an increase in the quantity consumed – and absent an increase in consumption, there can be no gain in overall economic efficiency. Indeed, as the Commission has noted, “higher

⁸ *Inmate Payphone NPRM*, ¶73.

commissions may give confinement facilities a greater incentive to provide access to telephone services,”⁹ so that higher commissions may actually increase the quantity supplied. Second, as the FCC also notes, “commission proceeds may be dedicated to a fund for inmate services or assigned to the state’s general revenue fund.”¹⁰ We are unaware of any research bearing directly on the relative efficiency (i.e., deadweight loss) of alternative means of financing incarceration facilities, but any efficiency gain that might result from lower commissions on inmate calling services would depend on the ability of states and/or correctional facilities themselves to replace lost revenues with a more efficient source of alternative funding. Third, as should be clear from the discussion above, commissions have no impact whatsoever on the suppliers’ incentives to minimize costs – indeed, suppliers can only win business by reducing costs so as to be able to provide the highest possible commission, and, once a contract is signed, can enhance their profits only by lowering costs still further.

Whatever the FCC may determine with respect to commissions, however, it should recognize that the commission issue is completely unrelated to exclusivity. In principle, commissions could be capped or eliminated altogether, and doing so would be a relatively simple matter. Imposing an open access regime, on the other, would be extremely cumbersome, as the discussion in the following section demonstrates.

⁹ Inmate NPRM, ¶73.

¹⁰ Inmate NPRM, ¶73.

III. The Proposed Intervention Would Be Highly Regulatory and Would Distort Economic Incentives

Petitioners, in the guise of competition, propose to enact a complex regulatory regime encompassing forced unbundling of a complex set of network elements, along with price cap regulation for the inmate service provider. And yet, there is substantial variation across facilities in inmate calling services, including the number of inmates, use of debit cards, extent of desired verification and call limiting services, and so forth. The inmate service provider varies facility by facility (unlike an RBOC which generally covers most or all of a state). Thus, such regulation would necessarily need to be implemented at the facility level. Further, setting the efficient access rate would require complex modeling of current and future costs. What petitioners have proposed is, essentially, TELRIC for prisons.

This proposal is roughly equivalent to regulating access in the general local calling market with a price cap, but at the level of individual switches. The FCC has been attempting to implement a TELRIC standard for local access by CLECs since the 1996 Telecommunications Act and has faced a host of implementation problems. The proposal here potentially leads to lengthy TELRIC-like proceedings for each facility, and would generate similar problems. Furthermore, the regulatory costs of solving those problems will be spread over many, many fewer minutes of phone use.

The Commission has long been well aware of the difficulties inherent in such endeavors, and reluctant to expand its regulatory reach unnecessarily. As former Chairman Bill Kennard said in the context of “open access” proposals for cable, “It is easy to say that government should write a regulation....It is quite another to write that

rule, to make it real and then to enforce it. You have to define what discrimination means. You have to define the terms and conditions of access. You have issues of pricing that inevitably will get drawn into these issues of nondiscrimination. You have to coalesce around a pricing model.... And then once you write all these rules you have to have a means to enforce them in a meaningful way.”¹¹

Chairman Kennard was speaking of proposals for the Commission to regulate access to cable broadband systems. The proposal now before the Commission would, arguably, involve far more complex and difficult regulatory issues than would have been the case had the Commission chosen to regulate the cable platform. Among the problems is the difficulty of estimating costs accurately for any particular facility, as shown in the next section. Further, rate setting for the phone-to-IXC elements of the system will inevitably result in prices that are sometimes too high and sometimes too low, often by considerable amounts (as they are in UNE regulation). As the Commission understands very well, regulation is a vastly more complex undertaking when it can only be implemented efficiently by taking into account variations among markets on a “granular” basis.

Regulatory error can, of course, lead to counterproductive results. Excessively high rates will cause the high rates that petitioners are trying to avoid. Excessively low rates will cause a variety of problems, including reduced innovation and investment in prison platforms. They would lead quickly to an undersupply of inmate calling systems,

¹¹ “Consumer Choice Through Competition,” Remarks by William E. Kennard, Chairman, FCC, at the National Association of Telecommunications Officers and Advisors, 19th Annual Conference, Atlanta, GA, September 17, 1999.

and over time to reduced investment and innovation that would diminish the quality of services available to both inmates and confinement facilities.

Indeed, the problems associated with the mandatory unbundling regime proposed here are well known to the Commission through its lengthy study of and deliberations relating to forced access to local telephone switches in general. As the Commission is well aware, regulatory regimes that impose forced sharing requirements create incentives for competitors to free-ride off the facilities-based investments made by others. In this case, the specialized capital invested by inmate calling service providers, including specialized hardware, software, and credit validation services, are especially prone to such behavior. And when such free-riding does occur, the impact is to reduce or eliminate returns to investment, including both current generation technology and the R&D needed to generate further improvements. As noted below, the Dawson Affidavit goes into some length to describe the technological changes that have taken place in the inmate calling marketplace in recent years, and the improvements (both for the confinement facilities and the inmates) that have resulted. By distorting and diminishing the incentives for continued technological progress, the regulatory regime proposed in the Wright Petition would reduce the quality and availability, and increase the price, of inmate calling features in the future.

Overall, there is little to gain and much to lose by destroying a competitive market in favor of price regulation. Strikingly, petitioners are proposing to implement such a regulatory burden on a system that is currently subject to a variety of competitive pressures.

IV. The Claimed Cost Savings Are Not Supported by the Evidence

The Wright petition implies that the process of establishing a “benchmark rate” for access to the local prison switch would be a simple matter. Indeed, it suggests the appropriate rate (7 cents per minute) is already known based on its expert affidavit, and remains only to be adopted by the Commission.¹² In fact, the Dawson Affidavit is seriously flawed, and serves only to illustrate the difficulties the FCC (or any other regulatory body) would have in setting an appropriate rate.

The Dawson Affidavit attempts to demonstrate that there exists a reasonable range of rates at which an inmate telephone system provider could operate an inmate calling system, make a reasonable profit and still have room for multiple interconnecting long distance carriers to compete for inmate long distance calling. To do so, he describes a hypothetical system under which multiple carriers would compete. Under his proposal, there would be a multi-carrier platform provided by an underlying service provider in each facility that would supply the telephone system hardware and software. This underlying provider would supply the switch and software, the phones, the management control system and any other required components of the calling system. The various carriers offering competitive long distance services to the inmates would interconnect with the underlying carrier’s prison phone system. Each competitive carrier would be responsible at its own cost to provide long distance transport facilities to the switch located at each facility. The transport facilities typically would consist of T-1 trunks that would go from the prison switch to the IXC’s point of presence. The underlying service provider would be compensated for providing the prison system by a charge imposed on the interconnecting competitive carrier based on the costs of installing and operating the platform. The charge would not include the cost of providing the long distance transmission. The underlying provider would recover its

¹² Wright Petition at 19.

costs through a per minute charge levied against all long distance calls placed from the correctional facility and carried by one of the competitive service providers. It is this charge that Dawson attempts to calculate, and which he claims would be lower than the rates currently being charged to inmates.

The Affidavit develops this charge by first identifying some of the components of a correctional facility phone system, and then applying a cost to each component. The components he identifies include the hardware that make up the prison phone system, maintenance, billing, administrative and sales, uncollectible bills, and the cost of providing long distance transmission and local termination. Once he derives the total costs, he divides the total by the call volume to come up with a rate per minute. Dawson's estimates are based on data from three specific facilities operated by the Corrections Corporation of America (the Central Arizona Detention Center in Florence Arizona, the Tarrant County Detention Facility in Estancia, New Mexico and the Northeast Ohio Correction Center in Youngstown Ohio, the three facilities which were the focus in *Wright, et al. v. Corrections Corporation of America, et al*). The affidavit asserts that the "calling services to those prisons are typical, with regard to the rates and methods used to bill long distance calls by prisoners, of most prison inmate calling services."¹³ Since the phone system for all three of the referenced facilities are provided and serviced by Evercom Systems, Inc., much of his cost data is extracted from Evercom's consolidated financial statements filed with the SEC. Other major sources of cost data are a Federal Bureau of Prisons (BOP) Request for Proposal and an attachment to a report from the Virginia State Corporation Commission titled *Analysis of the Federal Bureau of Prisons Inmate Telephone System and Applicability to the California Department of Corrections ("CDC Report")*.¹⁴

¹³ Dawson Affidavit ¶ 3.

¹⁴ Dawson Affidavit Exhibit 8.

As will be discussed below, Dawson's analysis has at least two major shortcomings. First he fails to account for the extreme disparity in costs among prison facilities of different sizes, and in failing to do so, relies on cost data inappropriate for a facility of a size on which he bases his model. Second, he fails to identify all of the major costs associated with a prison phone system, and fails to recognize that not all costs are common to all facilities. He attempts to model a "typical" prison and implies that the costs for all prisons will be the same. All prisons, however, are not the same size nor do they all have the same requirements. The requirements for the phone system for a 600-inmate minimum security prison located in a major metropolitan area are not going to be the same as for a 2000-inmate maximum security prison in a remote location. Nor are their cost structures going to be the same. For some costs, such as the fixed cost associated with a switch, the cost per minute may be higher for a smaller facility. For other costs, such as monitoring and recording, the cost per minute may be higher for a larger facility, and in fact may not even exist for some facilities. This disparity amongst facilities makes trying to model a typical prison facility a meaningless exercise.

Dawson develops his model using an assumed facility size of 1,743 inmates, the average size of the three facilities he references. This, however, can in no way be deemed reflective of a "typical" prison. According to Bureau of Justice Statistics, over 85% of all prisons have fewer than 1,500 inmates and over 60% have fewer than 750 inmates. Many of the costs associated with a prison phone system are the same irrespective of the size of the facility. For instance, the cost of software necessary to meet the needs of two facilities with similar requirements would be substantially the same for each facility. Thus the call volume through a given facility becomes critical in determining the cost per minute that a service provider must recoup. The charge per minute for a facility with half the call volume of another facility would need to be twice as high to recoup the same cost. Dawson recognizes this difficulty "(o)ne can easily

postulate that costs also vary by prison size, with larger prisons having lower per minute costs.”¹⁵), but does not make any effort to take it into account. Nor does he posit a mechanism by which scale economies could easily be taken into account. By his own admission, the estimates he presents reflect the lowest end of the possible cost range, in that they are based on confinement facilities that are in the top 15% in terms of the number of inmates.

The analysis is further distorted in that it fails to capture all costs associated with a prison system, and the costs it does capture are often based on faulty assumptions. His cost analysis is “based on my (his) knowledge of the industry, financial reports from Evercom, and evidence about Evercom’s and other inmates service providers’ costs from the public record in other cases... .”¹⁶ Much of his cost data is derived from the consolidated financial statements of Evercom filed with the SEC. Those statements, however, reflect the combined results of all activities of Evercom, activities which include far more than servicing 1,743 inmate prisons. Indeed, the Affidavit notes that “Evercom supplies switches to about 2000 prisons.”¹⁷ But the Bureau of Justice Statistics reflects only 1,668 prisons in total, of which only 241 prisons have at least 1,500 inmates, and all of these clearly are not serviced by Evercom. Presumably, the difference between the 2000 “prisons” serviced by Evercom and the number of Bureau of Justice “prisons” that they service represent local “jails” whose requirements, as the FCC has noted, are not analogous to those of prisons. Dawson himself recognizes this, stating his “analysis may not apply to locally-administered jails and other low-capacity prison facilities.”¹⁸ Because jails and other smaller facilities differ from larger prisons in

¹⁵ Dawson Affidavit ¶ 68.

¹⁶ Dawson Affidavit ¶ 52.

¹⁷ Dawson Affidavit ¶ 53.

¹⁸ Dawson Affidavit at footnote 46.

many ways, the direction of the bias introduced through use of the Evercom data cannot be determined. What is clear is that it is simply inappropriate to use Evercom's consolidated financial information as a source to derive data for the cost components of particular prison phone systems.

The use of BOP data is also misleading, and illustrates yet another source of complexity, namely the sensitivity of any cost estimates to call volume. As stated earlier, Dawson's rate range is dependent upon call volume from a given facility. As the affidavit says, "costs decrease with increased calling volume."¹⁹ The affidavit cites BOP data contained in the CDC Report that 242 minutes of calling per month, or approximately sixty minutes per week, which Dawson assumes to be the low end of the call volume range. But the same CDC report also indicates that California Department of Corrections inmates average only 76 minutes of calling per month, or less than one third of that of a BOP inmate.

Variations among facilities in size, call volume and system requirements are only three of the most obvious factors that would have to be taken into account in any prospective regulatory system. Additional complexity is introduced by a wide variety of additional factors, some of which the Dawson Affidavit attempts to quantify. As the following examples demonstrate, however, the analysis of each element is seriously flawed.

Billing and Collection: Dawson correctly points out that one of the major expenses associated with inmate call systems are uncollectibles, revenues that are billed but not collected from customers. A significant number of people who accept collect calls from inmates subsequently refuse or are unable to pay for the calls. The underlying calling provider must absorb the lost revenue from any calls that are not collected. Dawson's solution is the use of prepaid debit cards or accounts. Under such

¹⁹ Dawson Affidavit ¶ 66.

a system inmates, or inmates' families, put funds into an account from which the cost of calls are deducted each time a call is made. Since the calls are paid for in advance, theoretically the expense associated with uncollectibles disappears. He even goes so far as to say "(I)f prisons were to switch to debit calling only for inmate calls, billing costs would essentially disappear."²⁰

Some correctional facilities, as pointed out by Dawson, have not allowed debit calling. Prison administrators do not want the extra administrative burdens of handling cash for the debit payments, and they claim that debit accounts raise penalogical concerns, specifically, that creating an additional source of inmate funds might generate an additional possibility of extortion among inmates. Both of these claims are discounted by Dawson. He asserts that a debit system can meet the same penalogical requirements as a collect call system, and his solution to avoid additional costs or administrative burdens for the correctional facilities is to have them borne by the system providers.

With respect to penalogical requirements, this is an area that can only be assessed by the penal system administrators, presumably on a facility-by-facility basis, as there is likely significant variation across facilities (e.g., medium vs. maximum security). In any case, this is an area in which Mr. Dawson does not appear to be qualified to make expert judgments. Nor will it be addressed further in this study.

As to the increased costs and administrative burdens, whether they are borne by the correctional facilities or by the service providers, they must be accounted for. They are substantial, and in fact the analysis of such costs and administrative requirements were the subject of both the Virginia State Corporation Commission and the California Department of Corrections reports so frequently referred to by Dawson in his analysis. Not only do the reports indicate that the cost of maintaining such a system, such as

²⁰ Dawson Affidavit at ¶ 61.

staff required to establish the accounts and collect the funds, are significant, they conclude that it could take years to install a debit account program in a correctional facility or system of facilities that does not currently operate such a program. The viability of such a system also varies from facility to facility – for example, the mere costs associated with establishing an account would render a debit card program infeasible in facilities where inmates are held only for a short period of time prior to release or transfer.

Even if a debit system were to be adopted by a facility, Dawson's analysis of its effect on uncollectibles is overstated. He assumes a system in which there is a 50/50 split between debit and collect calls. What he fails to recognize is that a person who does not have funds to pay for a collect call is probably not going to fund a debit account. That person is more likely to continue using the collect call system. Thus, uncollectibles relating to the calls made on a collect basis would be expected to increase.

It is also a flawed assumption to assume there would be no uncollectibles associated with debit accounts. Most accounts would be funded either through checks or credit cards. In that there would be pressure to allow immediate access to the debit account on receipt of a check, the service provider runs the risk that there will be nonsufficient funds to cover the check. Furthermore, it is logical to assume that the person who questions a collect charge on his phone bill is the same person who will question a charge on his credit card.

Research and Development: A large portion of Dawson's affidavit is devoted to describing the technological advances that have taken place in the telecommunications industry and more specifically as they relate to inmate calling systems. It even predicts some of future developments. What the Affidavit fails to do, however, is to allow for the cost of such development. These costs are reflected both in service providers' own research and development efforts and in the cost of software and hardware they must

procure from others. These costs must be reflected in the price service providers charge for their services. To ignore such costs is unreasonable.

Choice of Multiple IXCs: The system proposed by Dawson would provide inmates or inmates' families with the ability to select the carrier of choice from a menu of available interconnecting carriers. It is his proposition that such side-by-side competition among multiple IXCs would lead to much lower long distance rates than those in place in correctional facilities today.

The affidavit fails to recognize, however, the additional costs associated with establishing and administering such a system. The proposed new system would require that the underlying carrier process a call up to the point where the call was handed off to an IXC for completion. The hand off would take place at the switch exclusively serving, and under the administrative control of, the correctional facility. As stated earlier, the interconnection to the switch would most likely be through T-1 trunks. The Dawson Affidavit completely ignores the costs associated with additional T-1 connections that would be required with multiple carriers. Furthermore, the service providers would incur additional costs associated with the increased requirements of the switch. A given IXC would arguably see no reduction in T-1 line cost and would have to spread that cost over a smaller calling volume resulting from the competition.

The Affidavit also ignores the system and software costs of establishing and administering such a system. Under the proposal, inmates would get a prompt asking them to select a carrier. The prompt would have to provide the inmate with both the types of calls allowed by a given carrier (ex. some carriers don't allow collect calls) as well as the rates. Such a system would require significant development costs as well as continuing costs to keep the system current. Dawson also assumes that "(t)he competitive carries would be free to market directly to the people who actually pay for

the long distance calls made by prisoners....”²¹ Access to the names to whom the carriers would want to market would raise a whole range of legal issues. The marketing itself introduces costs into the system that do not currently exist.

Allowing multiple carriers clearly introduces major technical and cost issues not addressed by Dawson in his analysis.

Estimated Payphone Equipment Cost: The Dawson Affidavit relies upon the CDC Report to support its estimate of one phone per 25 inmates, based on BOP data contained in the Report. The very same CDC Report indicates that the California Department of Corrections estimates one phone per 70 inmates. Using Dawson’s 1,743 inmate model prison, the California ratio would result in only 25 phones versus the 70 phones projected by Dawson. This would actually decrease the total costs needed to be recovered. The point, however, is that just as the number of inmates vary from facility to facility, so to does the number of phones per inmate. There is no standard for a “typical” prison that can be applied to all facilities.

Maintenance : Dawson derives his maintenance cost as a percentage of equipment cost. The percentage used is the maintenance expense as a percentage of equipment cost as reflected in Evercom’s consolidated financial statements. As previously discussed, Evercom’s statements cannot be used as a proxy for developing costs for a “typical” prison. That aside, the actual cost as a percentage of equipment costs could vary significantly from facility to facility. Maintenance expense includes spare parts, repairs and the personnel required not only to answer customer questions but to service the equipment and keep the systems working. The critical factors are thus the age of the equipment and the cost of a service call. It can logically be expected that the maintenance on older equipment will be higher than on newer equipment. Likewise, the cost of a service call to a remote location will be greater than

²¹ Dawson Affidavit ¶ 44.

the cost of a service call to a facility in close proximity to where the service technicians are located. Administration, General and Sales (S, G & A): As acknowledged by Dawson, one of the largest costs incurred by inmate calling service providers are “Administration, General and Sales” expenses. These would include salespeople who sell to correctional facilities and their related expenses, administrative salaries, accounting, legal, human resources, insurance, the cost of running company offices and other overhead costs. In his model, Dawson derives this cost based on a multiple of maintenance expense, again using the ratio reflected in Evercom’s consolidated financial statements. What he fails to do is give any explanation as to why S, G & A expenses should be tied to the incurring of maintenance expense. These are generally fixed expenses that are paid out of the contribution generated from the activities of a company as a whole, where contribution is defined as gross revenue less direct costs associated with generating that revenue. Assuming that the contribution margin is consistent throughout a company’s activities, these costs are often charged as a percentage of revenue. Since the fixed costs vary from company to company, the rate charged to recoup such costs will vary from company to company. To base the rate on a multiple of maintenance expense would not reflect business reality.

Reasonable Profit: Dawson states that “a reasonable profit for most carriers, after all costs, is roughly one cent per minute.” As has been demonstrated, cost per volume varies based on the size and varying requirements of the individual facilities. To say that the profit from two facilities requiring similar investments on the part of the platform service providers but with significantly different call volumes should be based on the same one cent per minute is unreasonable and would heavily distort the allocation of capital in favor of larger facilities (with higher minutes of use) while disadvantaging smaller facilities. Simply put, a “reasonable profit” standard based on a flat amount per minute of use is inherently unreasonable.

VI. Summary and Conclusions

Bringing the benefits of competition to consumers of telecommunications services is central to the FCC's mission. But the Commission should be leery of proposals to impose costly new regulatory regimes when the benefits of doing so are speculative or, as in this case, simply non-existent. Forced sharing of the platforms used to provide inmate payphone services will generate none of the benefits of competition, for it will not enhance the incentives of any market participants to reduce costs, increase service quality, lower prices or speed innovation. To the contrary, the sort of forced sharing regime proposed in the Wright Petition would distort economic incentives, create incentives for "free riding," and, in practice, require the Commission to engage in a complex regulatory undertaking the only certain outcome of which would be to increase burdens on both market participants and regulators.

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