FTI CONSULTING, INC.

REPORT IMPLEMENTING THE FCC MANDATORY DATA COLLECTION

ON BEHALF OF

TELMATE, LLC

August 18, 2014

I. EXECUTIVE SUMMARY

On June 17, 2014, the Commission issued its instructions for the inmate calling service *Mandatory Data Collection*.[1] FTI Consulting, Inc. ("FTI") has worked with Telmate, LLC ("Telmate") to gather critical data and respond to this request. FTI's work reveals that Telmate's overall company-wide cost of providing ICS in 2013 (the last full year of data available) is $0.1583 per minute of use, broken down as follows:

ADP Group		Average Cost per Minute of Use			
Facility	**ADP Group**	**Prepaid**	**Prepaid**	**Collect**	**Total**
Jails	0 - 99	[redacted]	[redacted]	[redacted]	[redacted]
	100 - 349	[redacted]	[redacted]	[redacted]	[redacted]
	350 - 999	[redacted]	[redacted]	[redacted]	[redacted]
	1,000 +	[redacted]	[redacted]	[redacted]	[redacted]
Prisons	0 – 4,999	[redacted]	[redacted]	[redacted]	[redacted]
	5,000 – 19,999	[redacted]	[redacted]	[redacted]	[redacted]
	20,000 +	[redacted]	[redacted]	[redacted]	[redacted]
Total		[redacted]	[redacted]	[redacted]	**$ 0.1583**

In performing its analysis, FTI has relied on the following assumptions:

- Site commission payments are excluded from the calculation of Telmate's costs[2];
- Shared costs (joint and common) are allocated based on revenue adjusted to remove the portion of revenue associated with site commission payments;
- Cost of capital has been set to the Commission's authorized 11.25% return on investment.[3]

The FTI effort was led by two well-established telecommunications cost experts, Steven E. Turner and Brian F. Pitkin. Messrs. Turner and Pitkin previously filed their qualifications and background on July 17, 2014 in their report on behalf of Securus Technologies, Inc. ("Securus"). FTI has followed the same methodology utilized for preparing the Securus filing, making adjustments only as necessary to address differences in data availability.

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1 *Rates for Interstate Inmate Calling Services,* WC Docket No. 12-375, Public Notice, Commission Announces Inmate Calling Services Data Due Date, June 17, 2014 ("*Mandatory Data Collection*").

2 Neither FTI nor Telmate is taking the position that site commission payments, demanded by correctional facilities and used, at least in part, to fund the deployment of and access to ICS, are not a cost of providing ICS; rather, because the Commission already has concluded that such costs ordinarily should not be recovered through interstate ICS rates, FTI excludes those costs here for the Commission's convenience. *See* Report and Order and Further Notice of Proposed Rulemaking, *Rates for Interstate Inmate Calling Services*, FCC 13-113, 28 FCC Rcd 14107 (2013) ("*ICS Order*").

3 Neither FTI nor Telmate takes a position as to the appropriate return for Telmate or other ICS providers, each of which has a different capital structure. For the Commission's convenience, FTI relies on the return stated in the Commission's *ICS Order* at n.203.

II. THE INMATE CALLING SERVICES INDUSTRY

As with FTI's work for Securus, the Telmate analysis confirms that ICS services are characterized as having relatively few "direct" investments. The vast majority of investments are shared between all product categories and services.

III. JUSTIFICATION

The FCC *Mandatory Data Collection* required that costs be broken down and reported in various ways. For each reference, we will refer to these reporting groupings as follows:

Service Category:	ICS or Ancillary.
Payment Method:	Debit, Prepaid, or Collect.
Cost Category:	Telecom, Equipment or Security.
ADP Group:	Jails 0–99; Jails 100–349; Jails 350–999; Jails 1,000+; Prisons 1–4,999; Prisons 5,000–19,999; or Prisons 20,000+.
Jurisdiction:	Local, State Intra-LATA, State Inter-LATA, Interstate, or International.

A. Types of Costs

The FCC's Instructions for Inmate Calling Services that accompany the *Mandatory Data Collection* specify that it "require[s] ICS providers to include direct and common costs incurred in providing inmate calling services for debit, prepaid, collect, and any other inmate calling services."

1. Direct Costs

The FCC recognized that "insofar as a substantial portion of ICS costs are joint and common … economic theory does not suggest a single correct way of allocating such costs."[4] Our analysis confirms this observation: virtually all costs reasonably and directly related to the provision of ICS services are, in fact, costs shared (joint and common) to provide service to a particular ICS Service Category, to a particular Payment Method, to a particular Cost Category *and* to a particular ADP Group.[5] As such, Telmate has no direct costs to present to the FCC.

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4 *ICS Order* at ¶80 & n.301.

5 To date, FTI has not found any costs that can be directly allocated to such a fine level of detail. While it theoretically might be possible to identify some minimal costs that can be reasonably and directly assigned in such a way, Telmate does not appear to have segregated those costs so as to reveal this level of granularity.

2. Shared Costs

The FCC has given some guidance on how to treat shared costs, indicating: "we require ICS providers to identify both the direct costs, and the joint and common costs. For the joint and common costs, we require providers to explain how these costs, and rates to recover them, are apportioned among the facilities they serve as well as the services that they provide."[6] The FCC also "acknowledge[d] that ICS providers will have to apportion their costs between interstate and intrastate ICS calls."[7] Following this general guidance, FTI has treated all costs as common costs allocated based on the methodology detailed below.

3. Return on Capital

The FCC explicitly determined that "costs that are reasonably and directly related to the provision of ICS … would likely include, for example, the cost of capital (reasonable return on investment)."[8] The FCC then expressly confirmed "our regulations are designed to allow providers to recover their costs of providing ICS, including a reasonable return on investment."[9] These returns are treated as shared costs.

a) Return on Debt

The FCC instructed the parties to include, as equipment costs, "depreciation expense … tax expense, interest expense, and extraordinary expense." FTI understands this to mean that the FCC clearly intended for the debt expenses to be reported as actually incurred. The FTI submission follows this guidance.

b) Return on Equity

The FCC did not provide any guidance on what it would consider to be a reasonable return on equity investment. The only guidance provided by the FCC is that "both cost studies used to establish the interim rate caps use an 11.25% rate of return to determine the cost of capital." While the FCC did not opine on the propriety of such a rate, it is the only guidance provided and we have incorporated an 11.25% overall cost of capital into the FTI submission.[10]

Telmate is a privately held company that has never been sold or involved in any transaction that can be used to determine its enterprise market value. To roughly estimate Telmate's value, we

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6 *ICS Order* at ¶125.

7 *ICS Order* at ¶53.

8 *ICS Order* at ¶53.

9 *ICS Order* at ¶103.

10 Neither FTI nor Telmate takes a position as to the appropriate return for Telmate or other ICS providers, each of which has a different capital structure.

relied on the only other public information we have seen for ICS transactions – an April 5, 2013 Bloomberg L.P. article on the Castle Harlan Inc. sale of Securus Technologies Inc. to ABRY Partners LLC.[11] This article provided information showing the total purchase price was approximately 7.58 times EBITDA.[12] Applying this 7.58 multiple to Telmate's 2013 EBITDA of $[redacted] results in an estimated enterprise market value of $[redacted].[13] Telmate currently has $[redacted] in debt with an effective interest rate of [redacted]%." The remaining $[redacted] was a cash equity investment, yielding a [redacted]% return on equity ($[redacted])[14] to result in an overall return on invested capital of 11.25%.

B. Cost Allocations

Approximately [redacted]% of Telmate's total costs relate to commission payments, which have been removed from any cost calculations. Approximately [redacted]% of Telmate's costs were able to be directly allocated to ICS services (but not to any particular payment method) and approximately [redacted]% of costs were able to be directly assigned to ancillary services. The remaining [redacted]% of costs are truly shared costs that could not be directly allocated to any particular Service Category.

1. Shared Cost Allocations

FTI addressed the allocation of shared costs in two ways. First, shared costs that were unable to be allocated to any Service Category (the [redacted]% of costs identified above) were allocated to the various Service Categories based on the proportion of revenue for each type of service, by year. Second, ICS services then required additional allocations to attribute the shared ICS costs (a portion of the [redacted]% allocated to ICS services plus the [redacted]% of costs directly allocated to ICS services but not to a particular Payment Method) to each of the Payment Methods. These costs have been allocated based on the revenue for each particular facility and Payment Method. For example, if $100 were directly assigned to ICS service and equipment cost (but not a Payment Method or ADP Group), we would assign that $100 to all facilities and Payment Methods based on that facility's proportion of revenue by Payment Method and facility.

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11 http://www.bloomberg.com/news/2013-04-05/castle-harlan-said-in-talks-to-sell-securus-for-640-million.html.

12 $490 million in debt divided by 5.8 debt to EBITDA ratio equals $84 million EBITDA. The total purchase price of $640 million divided by the $84 million in debt results in an enterprise value of 7.58 times EBITDA.

13 Telmate believes that its revenue and earnings growth, and minimal debt, justify a true enterprise market value greater than this multiple/number, but because it has had no reason to solicit or perform a detailed business valuation, we have relied on readily available and verifiable information to roughly approximate Telmate's enterprise market value.

14 $[redacted] * [redacted]% percent = $[redacted]. This amount must then be grossed up for taxes, resulting in $[redacted] pre-tax ($[redacted] / (100% - 39.25% tax rate). The 39.25% tax rate is based on the FCC's Synthesis Model (Hybrid Cost Proxy Model) from the FCC's TELRIC methodology.

2. Revenue Allocation Approach Justification

Given the large amount of ICS costs shared among multiple Payment Methods and between the ADP Groups, properly allocating these costs on a consistent basis was important to the integrity of the cost study. FTI identified only three categories of information that could be used for such allocations: (1) revenues, (2) minutes, or (3) calls.[15] There is no other information that Telmate has in its possession to allocate these shared costs in the short timeframe required by the *Mandatory Data Collection*.[16]

FTI quickly determined that revenues were the most reliable source of information to perform these allocations and is preferable to either minutes or calls. As a threshold matter, if shared costs were allocated based on minutes and then rates were to be determined on a per-minute basis, a minute-based allocation would produce almost identical rates for each Payment Method and each ADP Group. Practical experience shows this not to be the case. There is no question that the cost of providing ICS service, on a per-minute basis, would be substantially different for a facility with 10 minutes than for a facility with 10,000,000 minutes. As such, allocating costs on a per-minute basis is demonstrably incorrect. The same is true with calls.

Revenue-based allocations, on the other hand, properly reflect the real-world factors that Telmate employs every day in pricing its services. These will include factors such as facility-based costs, contract-based costs, connectivity costs, and demand.

Finally, in order to ensure that the revenue-based allocations are working properly and are not inflated by site commission payments at certain facilities, FTI has removed site commission payments by Payment Method and facility from the revenue data. In this way, facilities that do not have any site commission payments will not have fewer shared costs allocated to them than facilities that do have site commission payments.[17] Similarly, facilities that have been successful in negotiating large site commission payments in the past will not continue to be treated with a higher portion of costs being allocated to them because of those site commission payments. FTI believes that this normalized revenue data best serves to allocate shared costs among ICS Payment Methods and among ADP Groups.

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15 Ideally, cost based allocations would be used; but, given that only [redacted]% of all costs were allocated to any ICS service, such an allocation was not possible.

16 Other approaches to assign costs could be performed with significantly more time and effort. For example, studies could be performed to evaluate the portion of a computer server's processing capacity for various types of activities. Studies could be done to determine how much time and effort is being spent by employees within various departments. These studies and analyses are very costly, distracting to the company and its employees and, at least for the purposes of this *Mandatory Data Collection*, extremely time consuming. Nevertheless, while more accurate approaches might exist, we believe that the revenue-based cost allocation method is appropriate under the circumstances.

17 *See ICS Order* at ¶62 & n.228. "The state departments of correction that do not include commissions are Michigan, Missouri, Nebraska, New Mexico, New York, Rhode Island, and South Carolina."

IV. DESCRIPTION

In the following section, FTI identifies the step-by-step process used to categorize, allocate and prepare this submission.

A. Steps applicable to all Service Categories

1. Directly assign costs from Telmate's corporate-wide income statement to each FCC category: Service Category (plus shared), Payment Method (plus shared), and Cost Type.

2. Add the return on equity component to the shared costs identified above. This portion of the return is included as shared costs (not associated with any particular Service, Payment Method, or Cost Type).

3. Directly assign revenues from Telmate's corporate-wide income statement to each FCC Service Category. Derive, by year, the ratio of revenue assigned to ICS and Ancillary to the total revenue. These are the shared cost assignment percentages.

4. Allocate shared costs to the Services Categories based on the common cost assignment percentages, by year.

B. Steps applicable to ICS services

1. Gross up 2014 year-to-date costs (through June, 2014) to full-year 2014 using a straight-line ratio of 12 months / 6 months.[18]

2. Allocate shared costs by Payment Method and ADP group using the proportion of revenues for each Payment Method and facility (see explanation above).

3. Summarize facility-level data by contract, including allocated costs, the number of facilities by contract, commission payments by Payment Method and jurisdiction, revenue-producing minutes by Payment Method and Jurisdiction, revenue-producing calls by Payment Method and Jurisdiction, non-revenue-producing minutes by Payment Method and Jurisdiction, and non-revenue-producing calls by Payment Method and Jurisdiction.[19]

4. Summarize contract-level data by ADP Group, including each of the categories above.

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18 Telmate only retains certain records for a period of two years. As such, revenue-generating minutes, calls and commission data information for July through December of 2012 and these costs have similarly been grossed up using a straight-line ration of 12 months / 6 months.

19 Commission payment, minute and call data were provided by Telmate by facility, Payment Method and Jurisdiction. For 2014, Telmate provided data through June, and this data was grossed up to full-year 2014 using a straight-line ratio of 12 months / 6 months.

C. Steps applicable to Ancillary services[20]

1. Identify ancillary services revenues, by ancillary service type.

2. Gross up 2012 costs (July through December) to full-year 2012 using a straight-line ratio of 12 months / 6 months.

3. Gross up 2014 costs (January 1 through August 13) to full-year 2014 using a straight-line ratio of 7.4 months / 12 months.

4. Allocate shared costs among ancillary services according to each service's proportion of revenue to total ancillary service revenue. These allocations are reported as the common costs for ancillary services.

5. Allocate common costs to each state based on each state's proportion of revenue for that particular ancillary service.

6. The "total ancillary fee demand" is not populated in the FCC *Mandatory Data Collection* spreadsheet because the demand units for each of the ancillary services are different (*i.e.*, some demand units are based on calls, some based on accounts, and some based on the number of funding transactions). The table below summarizes the units associated with each charge type.[21]

Ancillary Fee Category	Units
Account Services Fees	Percent of Revenue
Carrier Cost Recovery Fee	Minutes
Collect Call Regulatory Fee	Minutes
Federal USF	Percent of Revenue
Funding Fee	Transactions
Regulatory Assessment Fee	Calls
Sales Tax	Percent of Revenue
State USF	Percent of Revenue

20 Telmate does not have assignable cost information for each of its ancillary services because some (including a-la-carte enhanced security services such as voice to text, verified deposit, etc.) are negotiated as reductions in site commission payments.

21 It is critical that any cost analysis properly reconcile the numerator and denominator to ensure that the costs in the numerator correspond to the demand in the denominator. Because ancillary services are provided on an a-la-carte basis at additional costs (*i.e.*, not part of the basic ICS platform), these costs cannot simply be incorporated into ICS costs and divided by total demand. This would incorrectly assume that all ancillary services costs are fixed and do not vary with demand.