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September 17, 2014

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

RE: *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 in response to the submissions by the Inmate Calling Service (ICS) providers required by one-time mandatory data collection adopted by the FCC in the Report and Order in the instant proceeding.

The Memorandum is being provided in accordance with the requirements of the Protective Order in this proceeding, which requires the submission of a redacted version of the Memorandum via ECFS, and a confidential version of its response in hard copy to the Secretary's Office. In light of the terms of the Protective Order, a significant portion of the Memorandum has been redacted since it provides an in-depth study of the "confidential information" that was provided by the ICS providers. Since each of the ICS providers sought confidential treatment of their Data Submissions, the Petitioners have redacted the portions of the Memorandum that contain any of the ICS providers' data provided in their Data Submissions.

While very little provider-specific information remains un-redacted in the Memorandum, the Petitioners would like to highlight some general concerns with the data submissions:

- The average cost per minute of use is substantially less than the interim Interstate ICS hard rate caps adopted in August 2013;
- The ICS providers inconsistently allocated their costs among the four cost categories (Telecom, Equipment, Security, Other);
- The ICS providers used different methodologies to allocate costs to facilities and payment methods;
- The ICS providers followed different approaches in determining direct and common costs;

- Based on these differences in reporting costs, there is a significant reason to believe that the ICS providers' costs are over-reported; and
- The absence of revenue information from the ICS providers prevents a reasoned review of whether the various methods to determine the cost to provide service are appropriate.

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

Respectfully submitted,

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MEMORANDUM

TO: Lee Petro

FROM: Coleman Bazelon and Kristin Stenerson

SUBJ: FCC Mandatory Data Collection Further Notice

DATE: September 17, 2014

I. Summary

1. Across all ICS providers who submitted cost information for the Federal Communications Commission (FCC) Inmate Calling Service (ICS) Mandatory Data Collection, average cost per minute of use (MOU) is $.
2. Although these submissions provide some insight into the actual costs incurred by ICS providers, there are several problems with the submissions which limit the FCC's ability to use these data to set just, reasonable and fair cost-based rates. These problems are detailed in this memo.
3. Across the industry, reported costs are likely inflated. For example,
   - Cost of capital calculations could inflate total cost by as much as per minute,
   - Using revenue producing MOU rather than total MOU to calculate per MOU costs can add as much as per minute to costs, and
   - Overall lack of adequate justifications for methodology and consistency bring into question all reported costs.

II. Purpose

4. My name is Coleman Bazelon. Previously, I filed a Declaration[1] and Reply Declaration[2] in this Proceeding. This memo briefly reviews the FCC ICS Mandatory Data Collection,

[1] "Declaration of Coleman Bazelon," Martha Wright, et al, D.C. Prisoners' Legal Services Project, Inc., Cure, Prison Policy Initiative, and the Campaign for Prison Phone Justice, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996 et al., WC Docket No. 12-375, March 25, 2013, Exhibit C. (Hereinafter, "Bazelon Declaration".)

comments on the analyses and submissions completed by the ICS providers, discusses the goal of the data collection, and outlines additional information needed to accomplish that goal.

5. As part of an effort to ensure that ICS rates are just, reasonable and fair, the FCC released an order on September 26, 2013 which included the following reforms[3]:
    - It required ICS providers' interstate rates and charges to be cost based,
    - It adopted interim caps for interstate calling rates,
    - It adopted interim "safe harbor" rate levels,
    - It took action to help deaf and hard of hearing inmates and their families,
    - It ensured that security measures remain robust by ensuring that costs are recovered through ICS rates, and
    - It adopted robust enforcement measures.
6. To determine if additional reforms are necessary, the FCC requested comments on the proposed reforms and required ICS providers to file data on costs, rates, and usage with the FCC. The Mandatory Data Collection requires ICS providers to include direct and common costs incurred in providing inmate calling services for debit, prepaid, collect and any other ICS separated into telecommunications costs, equipment costs, security costs, ancillary costs, and other relevant costs. ICS providers were also required to report commissions paid, revenue and non-revenue producing minutes of use and calls, and average call durations.[4]

III. Discussion of Data Submissions

7. The FCC received submissions from nine ICS providers:
    - Lattice Incorporated (Lattice),
    - Pay Tel,
    - Network Communications International Corp. (NCIC),
    - Securus,

[2] "Reply Declaration of Coleman Bazelon," Martha Wright, et al, D.C. Prisoners' Legal Services Project, Inc., Cure, Prison Policy Initiative, and the Campaign for Prison Phone Justice, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996 et al., WC Docket No. 12-375, March 25, 2013, Exhibit C. (Hereinafter, "Bazelon Reply Declaration".)

[3] "Rates for Interstate Inmate Calling Services, WC Docket No. 12-375, Report and Order and Further Notice of Proposed Rulemaking," Released: September 26, 2013. (Hereinafter, "ICS Order".)

[4] "Instructions for Inmate Calling Services Mandatory Data Collection," WC Docket No. 12-375, ICS Mandatory Data Collection (2013). (Hereinafter, "Instructions".)

- Telmate,
- Inmate Calling Solutions (ICSolutions),
- Global Tel*Link (GTL),
- Century Link, and
- Custom Teleconnect

with varied levels of detail and analyses. To illustrate the comments in this memo, the following analysis uses the 2013 data provided in the FCC Mandatory Data Call. Figure 1 and Table 1 below show the average cost per minute of use (MOU) for each payment type for the ICS providers. Reported overall costs per minute averaged per minute[5] were extremely varied across the ICS providers, ranging from a low of per minute to a high of As expected, ICS providers reported the highest costs for collect calls at an average of (which have additional billing and bad debt costs) and similar costs (within the same provider) for debit and prepaid calls at an industry average of .[6]

[5] Weighted by total costs of each provider.

[6] FCC Mandatory Data Collection Submissions.

Figure 1: Average Cost Per Revenue Producing MOU by Payment Type

8. ICS providers were also asked to separate costs by facility size for both jails and prisons. Figure 2 and Table 2 below show average cost per MOU by facility size and type. Data from the providers generally showed that jails (run by local governments) had much larger average cost per MOU than prisons (run by state governments). In addition, data generally showed a decrease in average cost per MOU as facility size increased. However, the extent of the decrease in cost from increased facility size varied greatly. For example,

. At the other extreme,

cost per minute as and highest average cost per minute as . These differences likely reflect differences in cost allocation methodologies as much or more than actual cost differences in serving facilities of different types and sizes.

Figure 2: Average Cost Per Revenue Producing MOU by Facility Size

9. To further illustrate the reported variability in average cost per MOU by facility type, Table 3 below shows how average cost per MOU by facility size compares to the company wide average cost per MOU for the ICS providers. Reported cost per MOU for Jails were

on average than companywide cost per MOU while cost per MOU for prisons were on average

A. Allocation of Costs Between ICS and Other Services

10. The ICS providers that submitted responses to the FCC Mandatory Data Collection are a mix of companies that only provide ICS and companies that provide ICS as well as other services For companies that provide services other than ICS, the methodology used to determine which costs are not ICS costs obviously affects the reported levels of ICS costs. For example,

Thus, when the non-ICS lines of business are less profitable than ICS, using revenues to allocate costs between ICS and non-ICS services very likely over allocates common costs to ICS services.

B. Inconsistent Categorization of Costs into Equipment, Telecom, Security, Other, and Ancillary

11. In the Mandatory Data Collection Instructions, the FCC provided definitions and guidance on what costs should be categorized as Telecom, Equipment, Security, Other, and Ancillary:

- Telecom Costs are described as "all payments to third party telecommunications service providers for the origination, termination, interconnect and provision of ICS calls."[7]

[7] Instructions at p. 3.

- Equipment Costs are described as "costs incurred by the ICS provider […] such as, but not limited to, depreciation expense, rent expense, salaries and wages, administrative and general expense, operational and maintenance expense, tax expense, interest expense, and extraordinary expense."[8]
- Security Costs are described as "costs incurred by the ICS […] such as, but not limited to, voice biometrics technology and call recording and monitoring."[9]
- Other Costs are described as "costs not entered elsewhere incurred in the provision of inmate calling services."[10]
- Ancillary Charges are described as "charges on inmates and ICS call recipients that do not recover the cost of providing phone service but rather recover costs associated with functions ancillary to provisioning ICS such as initiating, maintaining and closing debit or prepaid ICS accounts, sending a paper bill or sending calls to a wireless number".[11]

12. Figure 3 below shows the percentage of each type of cost reported by the ICS providers. According to these submissions, ICS providers categorized the majority of their costs in the Equipment or Other categories and the fewest costs in the Security category.

[8] Instructions at p. 4.

[9] Instructions at p. 4.

[10] Instructions at p. 4.

[11] ICS Order at ¶167.

13. Figure 3 also demonstrates that how costs are assigned to each category varies greatly across ICS providers, often with no justification or description. For example, . In addition, some of the ICS providers, such as , conducted their analyses by categorizing services as ancillary if they were not part of the basic service provided to every facility even if they properly belonged in another category. Some of these incorrectly categorized costs include security and public safety related services which are defined as security features by the FCC such

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as automated information service, continuous voice verification, location validation, threads, and voice biometrics.[15] This inconsistency results in providers such as reporting the majority of costs in the other category compared to providers such as who report more than of their costs as equipment related.

14. In addition, although not all providers included information on how costs were assigned to categories, it is likely that many incorrectly included financing charges. For example, includes .[16] These financing expenses can be difficult to accurately reflect in the actual cost of providing ICS. For example, interest paid on bonds used to finance capital expenditures should not be included in costs, but the amortized capital consumption should be included. Including both—as it appears may have done—would double count this financing cost.

15. Table 4 below shows how costs in each category contribute to the total average cost per revenue-producing MOU for each ICS provider. The significant variation in cost within a category—for example, the difference between /MOU and /MOU—strongly suggests that costs are not being reported on an equivalent basis by different ICS providers.

Table 4: Average Cost Per Revenue Producing MOU by Cost Type

C. Direct vs Common costs

16. The FCC recognized that "a substantial portion of ICS costs are joint and common"[17] and many ICS providers reported to either have effectively no direct costs or to not track

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17 ICS Order at ¶80, footnote 301.

direct costs at the level mandated by the FCC.[18] In submissions, providers' either categorized certain common costs as direct and allocated them reported no direct costs or to report no common costs In addition, certain providers allocated common costs to the Telecom, Equipment, and Security categories while others left them as a lump sum Consequently, direct and common costs are incomparable across providers and may not accurately represent the contribution of costs that can be directly attributable to specific facilities or services compared to the contribution of common costs that are spread across multiple facilities and services. Figure 4 below shows average direct and common costs per revenue MOU by ICS provider. Table 5 shows the proportions of common and direct costs.

17. The majority of providers reported significantly more common costs than direct costs. Across all providers, common costs make up on average of all costs. In addition, these numbers are surely understated as some providers categorized some common costs as direct costs. This incredibly high share of costs that are common has important implications for any cost analysis. Namely, it undermines any significant variation in costs reported by ICS providers that vary across facilities, services or jurisdictional boundaries.[19]

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[18] Some providers, including , reported bad debt and billing for collect calls as the only direct costs tracked to the requested level (payment method, cost category, and contract size). reported and justified direct costs at a more in-depth level than any of the other ICS providers. reported all costs as direct costs but provided no methodology or information in the description and justification for this decision.

[19] The ICS providers were not asked to, and did not, report costs by the jurisdiction of the call: local, intra-LATA, inter-LATA, inter-state or international. Except for possibly international calls, there is no basis for significant cost differences across these jurisdictional boundaries.

Figure 4: Direct and Common Costs in Average Cost Per Revenue Producing MOU

Note: Avg. Proportions shows the average direct and common costs proportions across all ICS providers weighted by total cost of each provider.

D. Return on Capital Calculations

18. Many providers included return on capital (debt and equity) in their submissions. This is an important input into capital amortization calculations. However, only a few providers include methodology for determining this return. Those that do provide an explanation— —generally adopt the No effort was provided to validate that this was their actual cost of capital or was an economically reasonable rate to use.

19. At least two companies— —use the regulated cost of capital to back out a return on equity. For example, As an initial matter,

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this is not an economically appropriate way to calculate their actual return on equity because it mixes market information with a return on capital from other studies and does not correctly measure the firms' return on equity. But more important, they then appear to use the return on equity to estimate the costs associated with their actual invested capital. This is inappropriate because their invested equity is a financing cost that is properly compensated for as a fair return on their assets. Invested capital is not part of the asset base in calculating costs. Neither are interest expenses. Rather, the actual capital deployed amortized at the cost of capital plus returns to properly calculated working capital based on the cost of capital implicitly include all financing costs.

20. The ICS providers do not provide sufficient information for us to parse the appropriate from inappropriate costs. Nevertheless, to illustrate the importance of this issue, we recalculate the invested equity using the cost of capital instead of the (inappropriately) calculated cost of equity. (This is equivalent to assuming that the invested equity is an appropriate measure of working capital—an assumption that likely overestimates working capital and is not supported by the data submissions.)

E. Allocation Methodologies

21. The ICS providers generally used three metrics to allocate costs: 1) Revenue, 2) Minutes of Use (MOU), and 3) Invoices and Contracts. Table 6 below shows the methodology used by each provider.

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22. Depending on the level at which providers were able to track costs, they used different allocation methodologies. For example, used MOU to allocate costs to Payment types (Debit, Prepaid, and Collect) and then further allocated to facilities using contract level data. reported as direct both costs that they allocated based on MOU and costs that they were able to track to a specific payment type and facility. Thus, even for the providers that used MOU to allocate costs, it is not always possible to use MOU data to determine how they were allocated as there are other costs included that were not allocated by MOU.

23. Most providers indicated, but did not actually provide, the metric used to allocate costs (other than the providers who allocated by MOU). Without this information, it is impossible to assess whether the chosen allocation metric provides a reasonable proxy for costs in each category and the resulting implications. For example,

[25] However, without more information and disaggregated data it is impossible to assess whether this also indicates that it is more costly provide ICS to smaller jails.

[23]

[24] Small contract size refers to ADP Group 0-99.

[25]

F. INCOMPLETE DESCRIPTION AND JUSTIFICATIONS (D&J)

24. According to the instructions provided by the FCC, "Information provided in the D&J should fully explain the allocation of common costs."[26] However, D&J's received from the providers range from including no information on cost categorization and allocation methodologies to detailed descriptions. Without thorough cost categorization and allocation methodology descriptions and data to support the calculations, comparing costs across providers and understanding ICS cost drivers is not possible.

G. USE OF REVENUE PRODUCING MINUTES VS NON REVENUE PRODUCING MINUTES TO DETERMINE AVERAGE COST PER MINUTE

25. To calculate average per minute cost, ICS Providers use Revenue producing MOU. Non-revenue producing calls may include: calls to commissary, calls transferred to customer service, calls answered but not accepted, free calls to attorneys or other agencies, or complimentary free calls.[27] Some of those non-revenue producing MOU can be analogous to (in-kind) commission payments which are disallowed expenses. These calls contribute to the total cost borne by ICS providers but their MOU are not considered, thus it is possible that ICS providers that offer more free minutes may report higher average costs per MOU. Figure 5 below shows the proportion of total MOU that are revenue and non-revenue producing by provider. reported the highest percentage of non-revenue minutes and also reported the highest average cost per MOU . Table 7 below shows how average cost per MOU varies when considering only revenue producing MOU or all MOU. Although some of the non-revenue producing MOU may not be considered in-kind transfers, the ICS providers did not provide any information on these types of MOU. Consequently, the difference in cost per MOU with and without non-revenue producing MOU—which can be more than per minute—is only an upper bound on this cost differential. If in the future commissions were disallowed or limited, in-kind transfers such as non-revenue generating MOU would be a natural way for ICS providers to enhance the value of their contracts offered to prisons and jails.

[26] Instructions, p. 4.

[27]

IV. Goal of Data Submission

26. The Mandatory Data Collection is a step towards developing a permanent rate structure that will ensure that rates for all consumers are fair, just, and reasonable, while confirming that the ICS providers are able to adequately recover the additional unique requirements for security and public safety inherent in ICS.[28] In order to develop a permanent rate structure that is fair, just, reasonable, and cost based, the FCC needs to understand how different inputs (telecom, equipment, and security) drive total costs and which costs are recovered between all facilities or specific to each facility.

27. Two related issues arise in trying to determine if a given rate is cost based when significant costs are common costs. The first is whether or not the firm earns a competitive return on capital at a given proposed rate. To assess this, only total costs,

[28] ICS Order, ¶ 7 - ¶ 12

total revenues and an accurate calculation of the cost of capital are required. ICS providers will likely argue that such an assessment involves cross-subsidies which are not sustainable because the ICS provider will not continue to serve facilities where they lose money. Second, to properly assess whether or not a firm with significant joint production costs is losing money at a specific facility it is important to evaluate the *incremental costs* associated with serving that facility. So long as incremental costs at each facility are covered (and serving the facility generates some contribution to common costs), total costs are covered, and the firm is earning a competitive return on its investments, then serving the facility in question increases firm profitability. In that case, it is not credible to say the ICS provider will not serve the facility.

V. Additional Requirements to Accomplish Goal

28. Given the lack of easily attributable direct costs, variations in categorizations of costs, and limited insight into allocation methodologies and data, it is impossible to use the ICS providers Mandatory Data Collection submissions to determine a fair, just, reasonable, and cost based permanent safe harbors rate structure. To do so would require the following additional information:

A. Cost Categorization Details

29. If not provided in the Mandatory Data Collection Submission, ICS providers should compile data on:

- How all costs were assigned to the different cost categories,
- The dollar amount of costs that were assigned to cost categories and their sources,
- A calculation of working capital,
- Methodology for determining return on capital, and
- To the extent that any financing costs are provided, they should be segregated.

B. Basis for Cost Allocation

30. If not provided in the Mandatory Data Collection Submission, ICS providers should compile data on:

- Methodology used to allocate "direct" and common costs, and
- Disaggregated data on the metric used to allocate costs (i.e., if revenue was used to allocate costs, ICS providers should compile data on revenues by contract size, payment type, and jurisdiction).

C. Incremental Cost Information

31. Providers should also compile data on:

- The incremental costs of providing ICS to an additional facility,
- The incremental costs of providing an additional call, and
- An assessment of changes in the ICS provider's total profitability from serving an additional facility.