1.0 FINANCIAL BENEFIT TO THE STATE

Revenue generated from the new Automated Collection Enhancement System (ACES) will bring in additional revenue to the State General Fund, Unemployment and Disability Insurance Funds and pay for project costs.

EDD has calculated that ACES will generate $583.4 million in benefits over 10 years.

- ✓ EDD's benefit calculations are based on the data gathered during the Employment Tax System Review (ETSR) Project. The ETSR looked at comparable integrated tax projects, compliance projects, and commercial sector best practices in other state tax agencies.
- ✓ Calculations are based on moderate projections using empirical data from other state tax agencies.
- ✓ Benefits will be driven from the implementation of a new automated collection system.

1.1 Benefit Sharing

Benefit sharing is a financing method that requires a vendor to provide the customer (State of California) with specific benefits, in this case, increased tax revenue. In benefits sharing, the State pays the vendor from the benefits generated by the project but only after implementation of the new system and after incremental revenues have been realized. The advantages of benefit sharing are:

- **No up front costs.** Allows the State to begin a major project without up-front outlays to its vendor partner. In a non-benefit sharing contract, the State would pay for some initial deliverables prior to actual production capabilities and resulting benefits.
- **Minimizes risk to the State.** The State doesn't pay for the solution unless benefits are achieved, so the risk is not entirely borne by the State. It also allows the State's goals to be reached with minimal outlays from the general fund.
- **Keeps management and project team on target.** The goal of a benefits sharing project is clear: to deliver a comprehensive solution on time and within budget that produces the expected benefits to the State.
- **Creates a strong partnership between State and vendor.** Benefits sharing aligns the goals of the State and vendor to allow both parties to work together to deal with tough decisions about implementations, issues involving competing priorities, and stakeholder issues.

1.2 Estimated Benefits and Reasoning Behind the Estimates

As part of the Employment Tax System Review (ETSR) Project conducted from July 2001 through December 2002, EDD, worked with an independent consultant and identified potential tax collection revenue benefits in the following areas:

- Aged Receivable Management Benefits (ARM)
- Tax Collection Benefits

Descriptions of these benefits are contained in Figure 1-1.

Benefit Type	Description	Examples for ways to increase revenue
Aged Receivable Management Collections	Increased revenue realized by collecting aged receivables. These are delinquent accounts that have been pursued using current collection tools without success and are nearing write-off status.	• Utilize decision analytic tools to prioritize outstanding accounts and assign accounts to the collection method most likely to result in payment. • Establish an interim process of automated asset identification and notices. • Automate access to other State and Federal databases and utilize up-to-date data retrieval technologies to maximize efficiency and effectiveness of collection resources.
Tax Collections	Increased revenue from collections by implementing an automated collections management system and improved maintenance of the accounts receivable balance.	• Automate the stratification of accounts based on customer characteristics, payment and reporting history and prior collection activity. Evaluate the risk and the probability of collections via statistical methods. • Develop a sophisticated account valuing system, which will identify and prioritize collection cases with potential for revenue collection of delinquent accounts. • Automate manual steps in collection process (i.e., liens, levies, earnings withholding orders, bankruptcy). • Automate data collection, storage and account management. • Automate collection activities for routine cases. • Automate the assignment and management of collection cases and other workloads based on staff profiles and available resources. • Perform customized collection actions based on individual account evaluation and collection functionality.

Figure 1-1. Benefit Type Description/Examples

For each benefit type, EDD:

- Obtained estimated benefits by reviewing, analyzing and comparing revenue benefits for similar projects in other revenue agencies (Figure 1-2).
- Calculated the estimated benefit, based on detailed discussions between ETSR project team members and Tax Branch staff from July 2002 through October 2002.

Benefit Type	Relevant Revenue Agencies
Aged Receivable Management	CA Franchise Tax Board (FTB) and Virginia
Tax Collection	FTB and Virginia

Figure 1-2. Relevant Revenue Agencies

1.2.1 Estimated Benefits – Aged Receivable Management (ARM)

We calculate that the Department will realize an estimated **$40.8 million** of ARM benefits the first year after implementation of the ARM system. This represents 10% of the approximately $408 million in aged receivables approaching write-off status. This is a one-time short-term revenue stream. To arrive at this benefit amount, we obtained information from FTB and Virginia that showed these agencies successfully used this method of establishing revenue streams early in their projects to help fund initial project costs. Market research disclosed that one vendor guaranteed a 10% collection rate for aged receivables in another state. Any revenue steam over and above this 10% baseline would revert entirely to the State.

1.2.2 Estimated Benefits – Tax Collections

We calculate that the Department will realize an estimated **$70 million** of tax collection benefits per year. Implementation of ACES is projected to increase collections over the baseline ($176.7 million) by 19.8% in year 3, 29.8% in year 4 and 39.6% in year 5 and every year thereafter. We estimated the revenue increases using actual benefits achieved by Virginia and information we received from FTB that showed they exceeded their original revenue benefit projections (Figure 1-4).

Agency	Annual Collections	Increased Collections	Percent Increase
Virginia Pre 1996[1]	$112.3M	$96.4M	85.8% (7/97-6/98)
Virginia 1996 - 1998[2]	$157M	$51.7M	33% (6/99-7/00)
FTB			45.8% (7/98-4/02)

[1] Prior to 1996, a manual collections environment in Virginia was similar to EDD Tax Branch.
[2] Between 1996 and 1998, an interim automated collections system was implemented.
[3] Actual collections in FTB exceeded projections by 45.8%.

Figure 1-4. Tax Collections Benefits Comparison

1.2.4 Other Potential Revenue Benefits

We identified EDD tax collection revenue benefit streams during the ETSR Project, however, there may be other revenue benefits that are identified by vendors who will be submitting proposals to implement EDD's new tax collection system. A potential area for additional revenue is in the area of collection of Department of Industrial Relations (DIR) penalties and fines due from employers. The reason why this was not included in the estimated benefits is because we were not able to establish an accurate baseline at this time for which to calculate increased revenue. Therefore, during the procurement process, vendors will have an opportunity to evaluate the DIR collection workloads and accounts receivables and include estimated benefits in their proposal for consideration by the State.

In addition, there will be opportunities for vendors to evaluate the revenue impact of imposing a collection fee to cover the cost of DIR collections. An imposition of a fee and a portion of the fee may be used to cover the costs of the system developed by a vendor.

Any additional revenue benefit streams that are identified prior to contracting with a vendor to implement EDD's new tax system will be considered, analyzed (including identification of baseline data), and negotiated with the vendor if the benefits appear realistic and measurable.

1.2.5 Recap of Revenue Benefits

As depicted in Figure 1-5, EDD estimates that the ACES project will generate $583.4 million in benefits over a ten-year period. These estimates are considered moderate projections in comparison to other state revenue agencies that have implemented similar tax systems. It is important to recognize that these are estimates only and are intended to show that there is an opportunity to generate new tax revenue. These estimates in no way limit vendors from submitting proposals that identify other revenue streams and/or revenue that exceeds our projections.

($ In Millions)

Year	ARM	Collections	Annual Benefits	Cumulative Benefits
2009/2010	$20.4		$20.4	$20.4
2010/2011	$20.4	$17.5	$37.9	$58.3
2011/2012		$43.8	$43.8	$102.1
2012/2013		$61.3	$61.3	$163.4
2013/2014		$70.0	$70.0	$233.4
2014/2015		$70.0	$70.0	$303.4
2015/2016		$70.0	$70.0	$373.4
2016/2017		$70.0	$70.0	$443.4
2017/2018		$70.0	$70.0	$513.4
2018/2019		$70.0	$70.0	$583.4
Totals	$40.8	$542.6	$583.4	$583.4

Figure 1-5. Estimated Benefits Over 10-Year Period

1.3 The Baseline

The baseline represents the amount of accounts receivables and revenue collected as of June 30, 2004. These amounts will be used to measure the amount of new revenue that is generated by the new tax system.

Revenue Sources - EDD's Tax Branch cashiered approximately $35.6 billion in SFY 03/04 in Personal Income Tax (PIT), Unemployment Insurance (UI) Contributions, Employment Training Tax (ETT), and Disability Insurance (DI) Contributions. Proportionately, the vast majority of the total received, $34.8 billion is in the form of tax deposits and payments that are remitted voluntarily by employers. Voluntary revenue is not available for benefits that will be paid to a vendor unless the vendor can substantiate that implementation of the new tax collection system results in increased voluntary compliance. The following is a high-level breakdown of the remittances cashiered by source:

Source Document	Explanation	SFY 03/04
DE 88	Employer tax deposits.	$ 34.8 billion
DE 3	Principally payments by employers who offer private DI coverage; also household employers.	$197.7 million
DE 2176	Employer Billing Statements.	$82.1 million
DE 350	Miscellaneous payments received without a source document. Usually the result of collection and audit actions.	$194.7 million
Reimbursable	Employers who pay for UI benefits on a "cost-of-benefits" basis.	$237.7 million
Other	School employees, elective coverage, and voluntary UI payments.	$101.9 million
Total		**$35.6 billion**

Figure 1-6. Revenue Sources

The revenue sources that will be most impacted by the new tax collection system and this benefit model are those received with DE 2176's, DE 350's and some reimbursable payments. These three categories consist of revenue received from collection actions.

1.3.1 Establishing the Baseline

Overall Accounts Receivables Baseline - EDD's accounts receivables totaled approximately $1.6 billion through June 2004.

EDD anticipates increased revenue as a result of implementation of ACES from two primary revenue streams:

- **Aged Accounts Receivables Baseline**. These are accounts that have been part of the ongoing collections management process, have not been collected, and are approaching write-off. Through December 31, 2004 these accounts total approximately **$408 million**.

- **Collections Baseline**. Average three year collections total **$177 million.** This is based on collections of account receivables that are over 60 days old and constitute the main core of EDD's annual collection activity. Annual collections from this pool over the last three years are as follows:

  SFY 01/02: $171,820,497
  SFY 02/03: $174,129,571
  SFY 03/04: $184,337,132

  Average three year collections = $176,762,400

The Tax Accounting System (TAS) provides only a very limited MIS capability and precludes a more detailed analysis of accounts receivable and revenue generated from specific types of collection activities. Tax Branch anticipates that, once a vendor is selected, a significant period of baseline validation and negotiation will ensue.

1.3.2 Factors that Impact Baseline

Tax Branch is committed to establishing a baseline that is dynamic rather than static and takes into consideration factors that can significantly change either accounts receivable balances or revenues collected. The goal in establishing a baseline is to ensure that the revenue increases that are attributable to the implementation of ACES are in fact a result of the system and business solution and not external factors. EDD will utilize the consultant hired to develop the Request for Proposal for a primary contractor to help develop quantifiable measures for factors that may impact the baseline. Among the external factors identified that could significantly alter the baseline and require a re-negotiation with a vendor are:

Increase or Decrease in Wages Paid

- Growth or reduction in employment
- Wage inflation or deflation
- Tax rate increases or decreases
- UI rate schedule changes

State Budget or Statutory Changes

- Taxable Wage limit increases
- Increase/Decrease in number of Auditors/Collectors
- Tax Amnesty
- New Legislative mandates
- A mandated program that diverts audit or collection staff to perform tasks that are either non- revenue producing or substantially less productive than normal work assignments
- There is any other anomaly that significantly changes the correlation between the baseline years and the period for which the baseline is being compared for purposes of measuring ACES benefits

The follow is a case scenario that demonstrates the advantage of establishing a dynamic baseline:

Baseline Scenario - Assume the account receivable baseline is $100 and with our current system we annually collect $15 or 15%. Assume now that a vendor replaces the system with a new system that collects 25% of the baseline annually, or $25. At the same time that the system is implemented, a new rate and taxable wage limit goes into effect, doubling the baseline account receivables to $200. After a year, the vendor's system is a success and collects $50. The vendor says that the increase was from $15 to $50, or a difference of $35. But the old system would have collected $30 (15% of the new baseline of $200) and therefore the vendor is entitled to count as increased revenue *only* the difference between $50, which the new system collected, and $30, which the old system *would* have collected. So, the increase in revenue attributable to the new system is $20.

Account Receivable Pool	Old System Annual Collections	New System Annual Collections	Increase Attributable to New System
100	$15 (15%)	$25 (25%)	$10
200	$30 (15%)	$50 (25%)	$20

1.4 Revenue Benefits Sharing Plan

The revenue benefits generated by the new employment tax system will be used to pay the vendor who designs, develops and implements the system. The benefits will be shared between the state and vendor as agreed to and documented in a business based procurement contract as prescribed by the Department of General Services. Any payments made to a vendor must be appropriated through a Budget Change Proposal (BCP) in order to establish the spending authority.

1.4.1 Revenue Benefits Determination

Revenue benefits will be determined by measuring the revenue generated by the new system against the baseline. The following is a conceptual overview of the steps describing how benefits will be verified, accumulated, and determined for the ACES project.

Step 1: Develop a process model for the new system.
Step 2: Compare process model of the new system with the process model of the current system.
Step 3: Determine factors that impact baseline and adjust baseline if necessary.
Step 4: Agree to the baseline with vendor.
Step 5: Develop benefits demonstration test for new system.
Step 6: Execute demonstration tests after system is in production. Repeat demo test every month until entire system is in production to ensure previously implemented system are not affected by subsequent systems. Frequency of testing may be negotiated with vendor.
Step 7: Identify total annual revenue from demo test associated with new subsystem.
Step 8: Subtract revenue in Step 7 from baseline in Step 4.
Step 9: Identify ACES Revenue Benefits.

The following is the basic formula for calculating the revenue benefits:

ACES Revenue - Baseline Revenue – Revenue from External Factors = ACES Benefits

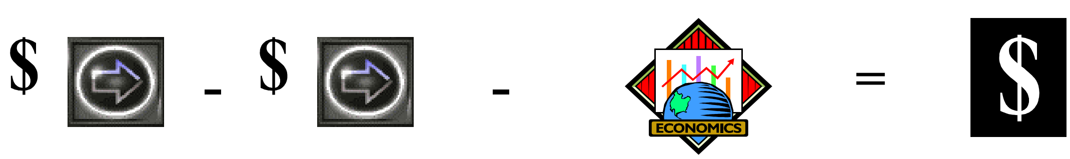

Figure 1-7. Revenue Benefit Calculation

Note: An alternative to subtracting "Revenue from External Factors," is to increase the Baseline by this amount.

1.4.2 Distribution of Benefits

Revenue benefits will bring in additional revenue to the State and pay for project costs. Not all the revenue benefits, however, are available to pay for project costs. The revenue that may be used to pay for project costs, including paying the vendor, consists of the following funds:

- Disability Insurance Fund (DF)
- Personal Income Tax Fund (PIT)
- Employment Training Fund (ETF)
- Contingency Fund (CF)

Revenue benefits that are generated and deposited into the Unemployment Insurance Fund (UIF) and Unemployment Administration Fund (UAF) cannot be used to fund the project. Although these revenues help contribute to the solvency of the UIF, these funds can only be used to pay Unemployment Insurance (UI) benefits and pay for the costs of administration of the UI program. Based on tax revenues for SFY 2003/2004 11.6% are for UI while 88.4% represent combined revenues for DF, PIT, and ETF and CF. Therefore, for purposes of determining how much revenue is available to pay project costs, we used 88.4%, referred to as "Benefits Available." The following chart displays the projected benefits versus the costs that will be funded through a BCP. It illustrates that:

- All out-of-pocket costs requested through a BCP will be covered by revenue benefits available.
- State project costs will be covered first.
- Payments to the vendor will be made over 3 years.
- Beginning in SFY 2010/2011 and continuing every year thereafter, revenue benefits exceed costs. Vendor reimbursement is capped at $46 million.

Costs Versus Benefits
($ In Millions)

	06/07-08/09	09/10	10/11	11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	TOTAL
PROJECT COSTS												
Pre-Implementation Costs	$8.0											$8.0
Prime Vendor Costs			$15.4	$24.5	$6.1							$46.0
Other State Costs (One-Time)		$10.0	$8.7	0.7								$19.4
State Costs (Continuing)		$0.3	$4.0	$5.4	$5.4	$5.4	$5.4	$5.4	$5.4	$5.4	$5.4	$47.5
TOTAL COSTS	$8.0	$10.3	$28.1	$30.6	$11.5	$5.4	$5.4	$5.4	$5.4	$5.4	$5.4	$120.9
PROJECT BENEFITS	$0	$20.4	$37.9	$43.8	$61.3	$70.0	$70.0	$70.0	$70.0	$70.0	$70.0	$583.4
Benefits Available (88.4%)	**$0**	**$18.0**	**$33.5**	**$38.7**	**$54.2**	**$61.9**	**$61.9**	**$61.9**	**$61.9**	**$61.9**	**$61.9**	**$515.8**
Net Benefits	$-8.0	$7.7	$5.4	$8.1	$42.7	$56.5	$56.5	$56.5	$56.5	$56.5	$56.5	$394.9
Cumulative Net Benefits	**$-8.0**	**$-0.3**	**$5.1**	**$13.2**	**$55.9**	**$112.4**	**$168.9**	**$225.4**	**$281.9**	**$338.4**	**$394.9**	**$394.9**

Figure 1-8. Cost versus Benefits

Payment Process - Beginning January 2010, EDD and the vendor will jointly calculate the benefits generated by the new system. Benefit determination will be made at the end of every six months starting January 2, 2010. Available benefits will be used to pay EDD costs and vendor costs. EDD and the vendor will agree on the amount of State costs to make sure they are reasonable.

The vendor will submit an invoice to EDD every six months after the benefits have been measured and confirmed. Benefits paid to the vendor will be based on the following assumptions:

- Collection of revenue from Phase II - ARM will begin January 2010.
- Collection of revenue from Phase III – Full Collection System will begin January 2011.
- Revenue available to pay the vendor will be evaluated and measured every six months starting January 2010.
- Revenue generated from ACES will be used to pay State costs first and 75% of the remaining benefits will be available to pay the vendor.
- The vendor will receive payment only for Phase II costs prior to implementation of Phase III.
- Payment to the vendor for Phase II costs will not exceed 10% of the total contract amount or $4.6 million.
- The vendor will be required to provide a detailed cost breakdown of Phase II and Phase III as part of their proposal and contract.
- The vendor will not receive payment in excess of the total cap of $46 million.

The following table shows the key milestones for implementation of all subsystems and revenue benefits determination.

Task or Activity	Time Period
Implement ARM.	July 2009 – December 2009
Implement Full Collection System.	July 2009 – December 2010
Start revenue benefits testing for ARM.	January 2010
Revenue benefits from ARM realized.	January 2010 – December 2010
Complete revenue benefits testing for ARM.	December 2010
Start revenue benefits testing for Full Collection System.	January 2011
Revenue benefits from Full Collection System realized.	January 2011 – On-going
Complete revenue benefits testing for Full Collection System.	December 2011
Revenue sharing and payments to vendor.	July 1, 2010 – June 30, 2013

The following is a timeline that shows implementation periods and revenue testing and revenue sharing timeframes.

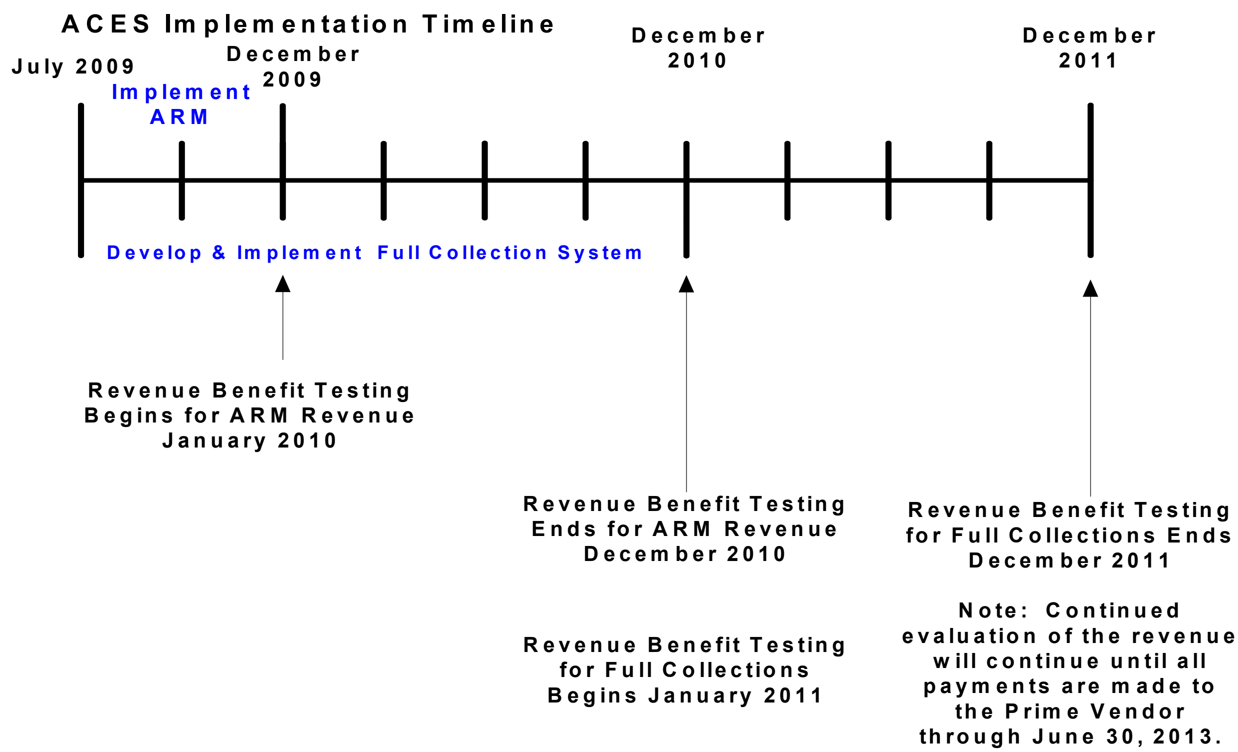

Figure 1-9

1.4.3 Benefit Assumptions

This revenue benefits model is based on the premise that the State will pay the vendor from the benefits generated by the new tax collection system but only after implementation of the new system and after incremental revenues have been realized. Benefit sharing and payments to the vendor will be based on the following assumptions:

- Vendor fronts the costs of the ARM implementation and does not receive initial benefits from this revenue stream. EDD may choose to negotiate with the vendor to allow some progress payments during the first two years of the project to help the vendor offset some of their initial costs.

- The vendor cannot receive more than $46 million for the full implementation of the new tax collection system. This amount is the total cap, however, a lesser cap may be established if the vendor contracts for less.
- The number of compliance staff (audit and collections) will remain constant throughout the duration of the project.
- The Department will implement recommendations to change work processes and/or methods that impact compliance collections.
- In the event that EDD has insufficient staff resources to carry out the project, the vendor will hire temporary resources that will work under the supervision of the project team.
- There will be no statutory changes that restrict/reduce current audit or collection authority.
- There will be no statutory changes that substantially modify or repeal, either retroactively or prospectively, tax laws governed by the Unemployment Insurance Code.
- There will be no statutory changes that impose an amnesty period.
- The current, weak economic conditions will not be prolonged and will not dramatically impact compliance revenues.
- The baseline will be modified as required to reflect changing economic conditions and other anomalies