

Memorandum

To : Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice-Chairman
Honorable Bill Leonard
Honorable John Chiang
Honorable Steve Westly

Date : March 19, 2004

From : Timothy W. Boyer
Interim Executive Director



Subject : **Alternative Cigarette Tax Stamp (ACTS) Project Status Report
(March 23, 2004 Administrative Agenda)**

Background

As of January 1, 2005, SB 1701 requires the Board of Equalization (BOE) to implement a cigarette tax stamp or meter impression capable of being read by scanning or similar device, and, at a minimum, include specific data encrypted within the new stamp.

In anticipation of the proposed legislation, the BOE's Alternative Cigarette Tax Stamp (ACTS) Project team: 1) conducted a nationwide Market Interest Survey in February 2002; 2) met with these interested parties in May 2002 and solicited preliminary proposals; and 3) in October 2002 met with two vendors who presented their proposed cigarette tax stamps and stamping systems.

Since the Fall of 2002, the ACTS Project team has completed a Budget Change Proposal and Feasibility Study Report requesting funding and resources for the project, based on the assumption that current stamp costs could be used to offset the costs of a new stamp. At that time, the procurement cost for a new stamp was unknown. Approvals of these documents were received from the Department of Finance in December 2002, and January 2003, respectively.

In addition, the ACTS Project team met with other state and federal agency representatives to discuss current encryption techniques and to identify what current anti-counterfeiting techniques would be effective in BOE's stamp requirements. From these meetings, BOE and Department of General Services (DGS) staff documented specific program and technical requirements. In December 2003, the BOE and DGS released an Invitation for Bid (IFB). Two responses to the IFB were received by the DGS and evaluated by the BOE evaluation team. One response did not meet the requirements in the IFB and was deemed non-responsive. The other response exceeded the budgetary limitations of the BOE. As a result, the procurement was canceled.

During discussions of the ACTS Project at the February 18, 2004 Board Meeting, a number of concerns were raised and the Board directed staff to report at its next meeting. A summary of each of the issues follows, and if necessary, with more detailed explanations attached.

Funding (Attachment A)

Due to the significant funding needs identified by the IFB, the funding source issue must be resolved prior to proceeding with another solicitation and awarding a contract.

SB 1701 Stamp Requirements (Attachment B)

The minimum requirements identified in SB 1701, while providing some protection, lack essential controls and visual differentiation to meet the intent of the Legislature to mitigate cigarette tax evasion. SB 1701 requirements also fail to provide retailers/wholesalers with a method to validate stamps on cigarette purchases to protect their business investments.

Solicitation Document (IFB vs. RFP) (Attachment C)

During the procurement process, both recognized solicitation methods (IFB and RFP) were examined. After reevaluating, staff believes that an IFB is still the appropriate solicitation document since the procurement is for a tax stamp, which is considered a commodity acquisition.

The bid process restricts communication with potential bidders during the development of requirements and during the evaluation phase. However, if a contract had been brought before the Board in February for approval, the Board Members would have been informed of the details of the successful bid prior to being asked to approve.

IFB Bidder Discussions

Since the February 18th Board Meeting, BOE staff has met at least twice with each potential bidder to discuss the IFB process and requirements. Adjustments for any future solicitation have been recommended based on input from the bidders.

Revenue Estimates (Attachment D)

Further review of the Board's revenue estimate resulted in a slight increase in the total evasion dollars – from \$26.1 million to \$28.1 million – and was primarily due to an increase in the amount of additional sales tax. In addition, these numbers have been compared to estimates provided to us by one of the bidders.

Staff Recommendation

At this time, the staff recommendation regarding the Alternative Cigarette Tax Stamp project is to resolve the funding issue for the stamp and seek legislation for a delay in the implementation date. After the funding issue has been resolved, release of another solicitation could occur soon thereafter.

I will contact each of your offices before the March 23rd meeting date to discuss this matter. If you have any questions regarding this report, please contact David Gau at (916) 445-1516 or Dennis Maciel at (916) 327-3276.

TWB:rs
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Attachments

cc: Ms. Marcy Jo Mandel
Mr. Ramon J. Hirsig
Mr. David J. Gau
Ms. Raye Zentner
Mr. Dennis Maciel

Funding Issues

In discussions with the Department of Finance (DOF) staff, it was indicated that additional funding for a contract would have a very difficult time competing for General Fund money given the current fiscal situation. Further, it was explained that any proposal that would result in General Fund revenue should provide a 5:1 return of revenue to cost before DOF could consider funding an effort out of the General Fund. The following discusses the funding issues:

- The General Fund currently supports fifty-two percent of the Cigarette and Tobacco Products Program and receives eleven percent of the revenue captured.
- The Board Legal Staff reviewed the issue of using AB 71, the California Cigarette Tobacco Licensing Act of 2003, funds to help finance the new stamp. It was determined that these funds are not available for this purpose, and are solely for the purpose of implementing, enforcing, and administering AB 71.

Cigarette and Tobacco Tax Program Fund Allocations

Fund	2004-05 Governor's Budget Expenditures by Fund	Expenditure Percentage	87 Cent Cigarette Tax	Revenue Received Percentage
General Fund	\$4,130,000	52%	\$0.10	11.49%
Breast Cancer Fund	\$146,000	2%	\$0.02	2.30%
Cigarette and Tobacco Products Surtax Fund	\$1,997,000	25%	\$0.25	28.74%
California Children and Families First Trust Fund	\$1,703,000	21%	\$0.50	57.47%
Total Program	\$7,976,000	100%	\$0.87	100%

SB 1701 Stamp Requirements

Board staff does not believe the minimum requirements established under SB 1701 are sufficient enough, or offer enough internal controls, to deter cigarette tax evasion, as envisioned by the Legislature. BOE staff has identified additional needed security features, and at the direction of the Board Members, a security feature to provide retailers with a feature to help validate the stamp. These features are:

- A visual stamp indicator that can be differentiated by the naked eye;
- Encrypted unique number; and
- A covert feature not easily counterfeited, which can be used by retailers and wholesalers to protect their business investments.

Following is the rationale as to why the minimums identified in SB 1701 alone will not stop counterfeiting and justification for each of the BOE proposed additional features.

Visual State Stamp Indicator - SB 1701 provides for encrypted data alone, and does not provide for any marks or unique identifiers, visible to the naked eye, that indicate the stamps are unique to California. A visual indicator provides the following benefits:

- Consumers, retailers or BOE staff will be able to differentiate California State tax stamps from other states;
- If it becomes necessary to change the stamp due to security feature compromises or excise tax hikes, this feature is easily changed; and
- Visual indicators can also streamline scanning selection for field staff.

Encrypted Unique Stamp Number & Data Tracking System - SB 1701 only has the requirement that certain data, the denomination, unique distributor identifiers and date of stamp application be encrypted on the indicia. Board staff believes that, without a unique encrypted number, there will be no way to validate whether or not any vendor's encryption has been compromised, or whether or not the vendor is limiting stamp production to reported levels.

A unique stamp number, as well as a computerized stamp tracking system to track production and distribution of these numbers, would provide the following benefits:

- BOE investigators would be able to identify a compromise of the encryption if the numbers were duplicated, or produced out of an approved sequence;
- Maintain an accounting of all unique numbers issued to Licensed Cigarette Distributors (LCD);
- Validate numbers against retail scans;
- Allow for a reconciliation between the number of stamps authorized and sold; and
- Deter vendor, or unscrupulous employee collusion with one or more dishonest LCD.

Covert Retailer/Wholesaler/LCD Feature - A common theme expressed to Board Members during Board hearings on administratively seized cigarettes was that the retailer or wholesaler had no way to protect themselves against dishonest sellers of counterfeit stamped cigarettes. To the retailer/wholesaler the "tax stamp looked real." The new technology requested above will offer the retailer/wholesaler/distributor a means to validate the legitimacy of their purchases.

Solicitation Document

Approach

State procurement and contracting procedures generally provide for two formal solicitation methods:

- Invitation for Bid (IFB)
- Request for Proposal (RFP)

While there are distinctions between the two methods, state procurement policies do not allow the RFP for commodity acquisitions. Since cigarette tax stamps are considered a commodity, IFB is the appropriate solicitation method.

Process

To preserve the integrity of the bid process, once the invitation for bid was released, state procurement rules require that informal communication with potential bidders be curtailed while they prepare their proposals. Once proposals are submitted, the evaluation team is bound to confidentiality during the evaluation phase. However, once a contract is awarded, all bid proposals, and the evaluation process, are subject to public disclosure. Had the result of the bid been brought before the Board for approval, the Board Members would have been informed of the details of the successful bid prior to being asked to approve. Since the only responsive bid exceeded the Board's budget of \$1.3 million for the ACTS contract, Executive Management elected not to pursue Board approval of the contract, and related Finance Letter, but instead canceled the bid process. To protect the bidders' solutions, and possible trade secrets, immediately after cancellation of the bid process, all copies of bid proposals were returned to the bidders.

BOE Revenue Loss Estimate

	State & Local Tax @ 7.92%	State Tax Only @ 5.25%
	Millions	
Total Revenue Loss		
Excise Tax	\$ 292	\$ 292
Sales Tax ⁽¹⁾	\$ 63	\$ 42
Total	\$ 355	\$ 334
Less: Consumer Evasion	\$ 54	\$ 54
Sales Tax Adjustment ⁽²⁾	\$ 20	\$ 13
Total Adjustments	\$ 74	\$ 67
Net Loss Due to Counterfeit Stamps	\$ 281	\$ 267
Percentage Recoverable	10%	10%
Revenue due to Stamp	\$ 28.1	\$ 26.7

Assumptions

- 50% of all packs of cigarettes sold at retail without the proper tax stamp also evade the sales tax
- All packs sold at retail in CA where the excise tax is not paid, have a counterfeit stamp attached
- Assumes a \$4 per pack selling price of cigarettes

Notes

- ⁽¹⁾ The average State and Local Sales and Use Tax rate is 7.92% and is used in the BOE estimate of the evasion problem
- ⁽²⁾ Sales tax on Consumer Evasion must be adjusted out for consistency in arriving at evasion due to counterfeiting