

# I. Executive Summary

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## I. Executive Summary

Today the use of Electronic Benefits Transfer (EBT) for the delivery of Food Stamp benefits to recipients is firmly established, and is considered to be an overall success. EBT is the predominant method for delivering Food Stamp benefits to recipients. Thirty-six states and the District of Columbia have implemented EBT statewide, while an additional four states are partially implemented. The remaining states are in various stages of EBT implementation, are in the negotiation process with an EBT vendor, or have just started going through the planning and procurement process.

While recognizing the unqualified success of EBT in delivering benefits to recipients, many of the stakeholders involved in implementing, supporting, and using EBT are expressing concern regarding EBT. The number of competitors involved in the EBT market has substantially declined. Some of the early EBT vendors have left the market or are in the process of leaving the market. A single EBT vendor is now the prime contractor for a large portion of the EBT business.

When reviewing the EBT market, it is important to consider the various stakeholders, specifically the state contracting for EBT services, the vendors providing EBT services to the states, and the retailers accepting Food Stamp benefits as payment for groceries. When considering the implementation of EBT as a benefit redemption mechanism for the Food Stamp Program, each of these respective stakeholders has differing objectives. These objectives are defined in the following table.

<b>Stakeholder Group</b>	<b>Primary Objective</b>	<b>Secondary Objective</b>
States	Service to Community	State Cost Neutrality (cost containment)
EBT Vendors	Profits	Service to States
Retailers	Service to consumers	Cost containment

States have usually selected the low cost vendor that will meet the minimum set of requirements.<sup>1</sup> EBT vendors had gone after the business with profits as the primary motive, although competition required that prices, and subsequently costs, needed to be contained. The primary objectives of retailers, the third major group of stakeholders, were both service to its customers and cost containment. Retailers saw EBT as a significant improvement over the previous method of food coupons, especially since the Food Stamp Act provided this alternative without increasing their costs.

As discussed later within the report, the winning EBT vendors made a number of errors in their pricing assumptions and models. The impact of this has been two-fold. First, the favorable pricing states received in their initial procurements has not been sustainable in the long run, as evidenced by the escalation in pricing occurring within states that are currently procuring EBT

<sup>1</sup> Although usually the case, there have been a few instances where the low cost vendor was not selected. In these cases, the winning vendor was judged superior based upon technical merit.

services and/or extending their existing contracts. Second, the initial lower prices have driven competitors from the market.

The EBT market is in a period of transition. The existing EBT vendors are modifying their behavior within the market in terms of pricing and pursuit of new business. States, in reaction, need to modify their behavior with respect to how they procure EBT services. In recognition of the transition within the EBT market and the various EBT stakeholders' concerns, the United States Department of Agriculture (USDA), Food and Nutrition Service (FNS) undertook two actions. The first was to hold a series of open-ended meetings with the various stakeholder groups to discuss the current state of the EBT industry. The second action was to hire a consultant to review and analyze the current EBT environment to determine the range of practical alternatives to the practices now used to acquire, operate, and manage EBT systems. This document is the resultant end product of the study.

## **A. ASSESSMENT OF THE CURRENT ENVIRONMENT AND POTENTIAL CHANGES**

### **Competitive Environment**

Four vendors emerged as players in the online market for EBT services. They are Citicorp Services, Inc. (CSI), Deluxe Corporation (Deluxe), Lockheed Martin IMS (Lockheed Martin), and Transactive Corporation (Transactive). Of these vendors, Transactive has formally announced it is leaving the EBT market and is currently completing its existing EBT contracts. In addition, because Lockheed Martin does not have EBT system processing capabilities, it has been forced to partner with one or another of the remaining EBT vendors, CSI or Deluxe.<sup>2</sup>

There was a natural winnowing of the market as certain competitors emerged as “winners” in capturing a larger share of the contracts awarded. An established contract base, as well as the operational experience obtained from these contracts, provided the remaining EBT vendors with an inherent advantage over new competitors. Another advantage is the economies of scale achieved by the volume of transactions processed. Because there is a high proportion of fixed to variable costs in EBT transaction processing, those vendors with large transaction volumes are able to leverage their fixed costs and increase profits from the economies of scale. In addition, the complexity of the cost per case month (CPCM) model and government procurement policies, as well as the capital investment required to enter the market, have contributed to the current limited competitive environment.

### **CPCM Pricing Model**

The current basis for pricing EBT services is the CPCM model. Although it is beneficial to state agencies acquiring EBT services, CPCM has distinct disadvantages for EBT vendors. Within a CPCM pricing model, the contracting state agency only pays for each active case (i.e., EBT

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<sup>2</sup> Recently Lockheed Martin announced that they are partnering with Total Systems to develop an EBT product offering to compete against CSI and Deluxe.

account) on the vendor's EBT system and typically receives no payments until the EBT system is implemented. The consequence of the pricing model is that it introduces a number of risks to the EBT vendor. These risks include:

- Requiring a large upfront investment to implement EBT, which must be recaptured over the life of the project through the CPCM payments;
- Providing services that have no relationship to the number of EBT accounts and the resultant CPCM payment mechanism, such as EBT retailer management and point-of-sale (POS) equipment deployment; and
- Caseload volume risks in both coalitions and standalone procurements, due to the inability to accurately forecast future caseload volumes.

### **EBT Pricing Escalation**

Since the contract awards for the Southern Alliance of States (SAS), Northeastern Coalition of States (NCS), and Western States EBT Alliance (WSEA) coalitions, there has been a steady and consistent escalation in the pricing received from the EBT vendors. Reasons for pricing escalation include a decrease in caseloads and better information regarding the true expenses for an EBT project. When bidding on the original EBT contracts, vendors made certain assumptions that proved to add unexpected costs to their projects. These assumptions caused the following problems:

- The number of retailers that would receive EBT-only POS equipment was underestimated;
- The number of calls made to the recipient help desk was underestimated;
- The expense to implement the individual projects was higher than anticipated; and
- The rollout of the states within the coalition was not as rapid as had been forecasted.

Even if caseloads had maintained their previous levels and the volume assumptions had been correct, pricing would still likely have increased from the CPCM pricing provided in the three multi-state coalitions, SAS, NCS, and WSEA. Specifically, the base pricing offered to the coalitions was not realistic when considered in the context of the actual expenses – fear of the competitors' possible price was probably the main driver for the aggressive bidding.

### **Procurement Models**

Once the requirements to deploy EBT were enacted by the federal government, states began to explore different approaches to the procurement of EBT services. These approaches, as well as the timing of the procurements, were based on a number of factors, including political, economic, technological, institutional and organizational constraints and resources. States elected to procure EBT services from full-service vendors as stand-alone systems dedicated to that particular state, as joint procurements through coalitions or by "coat tailing" onto the

procurement of a lead state, and as the state acting as the prime contractor, procuring individual services by function.

Due to the concern with pricing increases, the discussion of procurement models has validity in that some procurement approaches are better able to leverage pricing and/or economies of scale and offer different programmatic and technological advantages. Pricing is impacted by caseload volume and vendor competition, which tends to give states participating in a coalition procurement a CPCM pricing advantage. In addition, if the state is willing to act as prime contractor, it may trade added responsibilities with tighter management control and lower contracted costs. Faced with the second round of EBT procurements and/or contract negotiations and anticipated higher prices for EBT services, states are exploring those procurement options that will provide the best value and the best service for their EBT programs.

### **EBT Components**

The architecture of EBT systems being implemented by the EBT vendors has evolved along with the market. The early EBT systems were tightly integrated where all of the service requirements were provided within a single system. Examples of this were the EBT systems implemented for the State of Maryland by Deluxe and the system implemented for South Carolina by CSI. However, EBT vendors under the current architecture competitively subcontract individual EBT service components to the best service provider. An example of this is CSI changing its service provider for EBT transaction switching services from Deluxe to Electronic Data Systems (EDS). Another example is CSI using a combination of both Concord and Deluxe for government sponsored POS terminal driving.

The specific components of an EBT system can be delineated as follows:

1. Authorization Platform;
2. Government sponsored POS Terminal Driving and Retailer Management;
3. EBT Transaction Switching;
4. Client Help Desk Services; and
5. Card Production.

Settlement and reconciliation have also been mentioned as a specific component of EBT. However, from a functional perspective, it is not possible to isolate the requirements for settlement and reconciliation. Each of the first three components has a settlement and reconciliation requirement within the component that cannot be removed and performed in a standalone environment. Consequently, in terms of this analysis, settlement and reconciliation has not been considered a separate component.

In the various EBT projects currently implemented, the winning EBT vendor has subcontracted out at least one, and often more of the specific components of an EBT system to other service providers. The reason for this is economics. The EBT vendor is able to subcontract the component out more efficiently and less expensively than if it tried to perform the function itself.

## Policy and Regulations

Since 1993, a number of waivers to the federal regulations governing EBT have been granted. Most of the waivers requested are efforts to improve the operational efficiencies of the projects and, consequently, provide either cost containment or cost control. The most common waivers are:

- Providing a minimum monthly Food Stamp redemption floor in order for a retailer to receive a government sponsored POS terminal;
- Allowing state agencies the ability to assign personal identification numbers (PINs) to clients;
- Allowing group homes to be set up as FNS certified retailers so recipients' Food Stamp benefits can be deposited directly into the group homes' bank accounts;
- Allowing training by mail for recipients;
- Allowing a fee to be charged to the retailer for de-installation and reinstallation of EBT-only POS terminals under specific circumstances;
- Modifying the time period for delivering an EBT card to the recipient; and
- Allowing POS terminals to be mailed to retailers instead of delivered and set-up by the EBT vendor.

There are also federal regulations covering EBT system performance, which a number of EBT stakeholders felt should be re-evaluated and modified. Specifically mentioned were the requirement that 100 percent of transactions be completed within a certain time period and the definition of an inaccurate transaction.

Stakeholders also raised concern regarding the standards for the recipient help desk. EBT vendors felt the standards for the help desk were too high when compared to the commercial market and wanted the standards to be lowered. But federal regulations do not dictate the current standards that have been implemented for recipient help desk services. Instead, these standards have been defined by the state acquiring EBT services and negotiated directly with the EBT vendors.

## Commercial Gap Analysis

A continuing theme heard from the various stakeholders is that the requirements for an EBT system should be more closely aligned to the commercial market. An analysis was performed comparing the current requirements and practices within EBT to the existing commercial model for debit card transaction processing. The analysis showed that the technical requirements between EBT and the debit card environment are very closely aligned in terms of transaction acquiring and processing. There are two significant differences within transaction processing. The first difference is that EBT systems are required to have a processing alternative for retailers without POS equipment or when there is a breakdown somewhere within the automated system (albeit the EBT vendor, third party processor, or the telecommunication infrastructure). The

alternative implemented by the EBT vendors is a manual paper voucher mechanism. The second difference is the exemption for Regulation E coverage, as provided within the Welfare Reform Act of 1996.

There is also a significant difference from the commercial model in the backroom accounting and tracking of the recipient's Food Stamp benefits. In EBT systems, the government is the owner of the account, so reporting and tracking of EBT benefits are geared towards satisfying the government's requirements.

With the recently enacted FNS regulations on adjustments, adjustment processing is more closely aligned with the commercial model. The major difference is ownership of liability. Within the commercial world the card issuer carries the liability if there are insufficient funds in the cardholder's account to satisfy an adjustment claim. Under EBT, the acquirer carries the liability if there are insufficient funds in the recipient's EBT account to satisfy the claim.

## ***B. STAKEHOLDER COMMENTS AND CONCERNS***

Starting in summer of 1999, FNS held a series of meetings with representatives from the various EBT stakeholder groups to discuss their concerns and potential alternatives to the current practices used to obtain and manage EBT services. The stakeholder groups included the states acquiring EBT services, the vendors providing EBT services, and the retailers. Phoenix MAXIMUS conducted additional interviews with third party processors providing EBT services.

Some common recurring themes expressed by the stakeholder groups were:

- **Limited Competition in the EBT Marketplace.** Many of the state stakeholders felt this was the primary reason for the increasing costs of acquiring EBT services.
- **EBT Cost Model.** Specifically, the CPCM structure used to price EBT services is not always a true reflection of the expenses for providing EBT services. The problem exists in the uncertainty of caseload volumes, as well as the cost for providing customer service and retailer management. Consequently, using the CPCM to cover all expenses skews both the risk of providing EBT services by the EBT vendors and the cost to the states for obtaining EBT services.
- **Federal Regulations and Policy.** Stakeholders felt that current regulations have had a part in creating the current market environment. In particular, the processing standards required by regulation were believed to be problematic.
- **Role of FNS in EBT.** Stakeholders felt that FNS should be taking a more active role in EBT, particularly in reviewing and adjusting the federal regulations where experience has shown them to be in conflict with industry practice (i.e., transaction response times). Other stakeholders wanted FNS to assume responsibility for portions of the EBT environment (i.e., retailer management).



There was an interesting difference of opinion among stakeholders with regard to the costs assumed by retailers accepting Food Stamps under EBT, illustrating how the competing interests of the various stakeholders influence their perspective. The retailer stakeholders felt that they were being required to pay for EBT costs from which they were exempted within the Food Stamp Act of 1977, including all subsequent amendments. The state and EBT vendor stakeholders felt that retailers benefited greatly from EBT while not supporting their share of the costs.

## C. ALTERNATIVES

### Pricing Models

Alternative pricing models have been suggested and implemented in some of the EBT projects. These pricing models include:

- **Fee for Service.** This model requires the contracting agency to pay individually for the services provided. An example is paying separately for each EBT-only POS terminal deployed by the EBT vendor.
- **Tiered Pricing.** While the concept of tiered pricing is not new, what is new is the application of smaller and more meaningful tiers within the pricing model. For example, the tiers within the latest contract for the State of Alabama negotiated with CSI had tier breaks at 3,000 cases. In contrast, the SAS had tier breaks at 500,000 cases.
- **Caseload Floors.** In a caseload floor, the contracting state agency pays a CPCM price but guarantees a minimum caseload level that will be maintained on the EBT system. The minimum is paid regardless of the actual number of accounts on the vendor's EBT system.
- **Combination of Methods.** A CPCM pricing model is used with one or both of the alternatives of fee for service and/or caseload floors.

The combination method is attractive to the EBT stakeholder since it reduces pricing risk for the EBT vendors, which should result in lower prices to the contracting states. However, it can make it harder for the contracting states to accurately forecast expenses, as the expenses are no longer tied to caseload levels.

### EBT-Only Terminal Deployment Analysis

The Food Stamp Act requires the government to provide POS terminals at no cost to authorized food retailers who request the equipment. The analysis within this section looks at the impacts of various policy and implementation decisions on the number of retailers requiring government-sponsored POS devices. Specifically, the analysis explores the following factors:



- The differences in pricing and cost estimates between EBT vendors for government deployed POS equipment. Overall the biggest reason for pricing differences appeared to be processing efficiencies on the part of some EBT vendors (or the subcontractors that were performing the service);
- A cost-benefit analysis of the minimum monthly level of Food Stamp redemptions a retailer should have in order to qualify for a government-sponsored POS terminal. The \$100 minimum level currently used appears to be a valid cutoff;
- The percentage of EBT transactions being performed from government-deployed POS terminals in relation to the overall EBT transaction volumes within a number of states. Differences between states appear to be more related to demographic issues than any overt policy or implementation decisions; and
- The percentage of retailers requesting government-sponsored POS terminals in relation to the overall number of retailers within a number of states. Differences between states again appear to be more related to demographic issues than any overt policy or implementation decisions.

## Procurement

The methods for procuring EBT services have been consistent in that services have basically been acquired through a Request for Proposals (RFP) process. EBT services have either been acquired by individual stand-alone states or jointly through a consortium of states.

Based upon the existing conditions within the EBT market, states are beginning to look at different alternatives to procuring EBT services. These alternatives include direct negotiations with available EBT vendors or the state acting as a prime contractor and contracting out the different components required for EBT. Other procurement alternatives have been suggested, such as either a state or the federal government building and owning the EBT system software. In this scenario, the contracting state agency would then obtain a facilities management contract from a vendor to manage and run the EBT system. The advantage to the EBT marketplace is that it provides another option for obtaining EBT services to states, as well as additional control over the respective state's future in terms of how EBT is implemented.

Another alternative is for the federal government to obtain catalog pricing from vendors for some of the ubiquitous EBT services, such as government-deployed POS terminal support. States could then use the federal catalog price to obtain the service from a pre-qualified vendor. The advantage of this scenario is that it allows states to know ahead of time the vendors available to offer a specific service and the associated cost of the service. However, this approach requires the contracting state to utilize multiple vendors for the different service components of EBT and, consequently, could be a resource issue for some states.

## **Federal Involvement**

Various stakeholders have suggested that the federal government take over responsibility for providing one or more of the various components making up an EBT system. The components were the EBT Gateway, Retailer Management, Authorization Platform, Client Help Desk Services, and Settlement Services. Analysis was performed on all of these processing components, including an estimate of the potential cost to the government to perform the service. As could be expected, there were advantages and disadvantages to federal involvement in each of the components.

However, the biggest issue to resolve for federal involvement in EBT services was the processing of cash benefits. Because EBT is an integral part of the delivery of cash benefits within a large number of states, before any action can be taken by FNS to assume responsibility for a component of EBT, the issue of how to handle EBT cash transactions and EBT cash accounts needs to be resolved.

## **D. CONCLUSIONS**

The EBT market is in a period of transition, resulting in a shift in the paradigm for the states in the acquisition of EBT services. A number of alternatives and/or suggestions have been made that, while viable from a technical and cost/benefit standpoint, may be politically untenable to certain factions of the stakeholder group or require changes in funding and/or legislation to implement. While recognizing their existence, the conclusions being made do not address these political, funding, and legislative obstacles.

From a support standpoint, FNS should look at sponsoring a user group specifically for state stakeholders. This would provide a vehicle for the common sharing of information and experiences between the various states, as well as provide FNS with invaluable information and feedback regarding the current EBT environment within the states.

The pricing models within EBT should be adjusted away from the fixed CPCM price for the contract life. While recognizing that the transition from the single CPCM pricing model is already in place, a more proactive approach needs to be implemented that is a better reflection of the various operational components of EBT. Specifically, cost per service pricing should be applied to costs that are not related to the support of an EBT account, such as the deployment and driving of government-sponsored POS terminals. CPCM prices should continue to be used for EBT account pricing, but states should consider separate pricing and payments for implementation costs, especially when re-procuring EBT services. Without a separate accounting of the conversion cost, there is not a favorable comparison of the operational costs between an incumbent EBT provider and potential new EBT provider. Removal of the conversion costs from the CPCM pricing allows for “apples-to-apples” comparison of the pricing of EBT operations between vendors, as well as an understanding of the financial impact for changing EBT providers. Consequently, the pricing for the conversion should be requested as a separate line item of the EBT pricing received from bidders.

States are attempting different procurement approaches in obtaining EBT services. To the extent possible, FNS should encourage and support these approaches, as they will foster new competition within EBT. Specifically, different procurement approaches are being attempted in the States of Texas, Montana, and Wyoming. A federal catalog for standardized services, such as support for government-deployed POS equipment, would support these efforts.

As discussed above, direct federal involvement within EBT has been suggested. While this approach is not feasible for a number of the components within EBT, a business case can be made for the assumption of retailer management and deployment of government-sponsored POS terminals. FNS is already involved in many aspects of retailer management and can build the current activities performed by regional FNS staff and the State Tracking of Authorized Retailers System (STARS).<sup>3</sup> Consequently, the assumption of full responsibility for retailer management is an incremental increase in responsibilities (albeit a large increase) as opposed to a new responsibility.

If FNS does assume responsibility for Retailer Management, the approach could be expanded to also include the EBT Gateway processing environment. In addition to the resolution of interoperability and other issues, there are some synergies to be gained in assuming responsibility for both functions. However, the EBT Gateway involves new aspects of EBT management in which FNS has not been previously involved, as well as additional risks. External resources and support will be required in order to assume this responsibility. FNS will need to have a detailed understanding of the resource requirements, as well as the associated risks involved, before assuming responsibility for providing EBT transaction switching.

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<sup>3</sup> STARS is a system used for tracking authorized retailers by state.