Commonwealth of Pennsylvania
Office of the Budget

Liquor Privatization Analysis

Final Report

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Executive Summary

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Introduction and Project Overview

Public Financial Management, Inc. (PFM) was retained by the Pennsylvania Governor's Budget Office to conduct an analysis of the current operations of the Pennsylvania Liquor Control Board (PLCB) and assess the potential for privatization of its wine and liquor wholesale and retail operations. PFM was also asked to evaluate various approaches to privatization and the fiscal, market and operational implications of the options.

To complete the analysis, PFM conducted extensive interviews with PLCB and Commonwealth officials and staff as well as industry and other external stakeholders. PFM conducted a wide-ranging review of PLCB and state data and reports and benchmarked other state operations. PFM also researched publicly available business data and metrics, and purchased other industry-specific information. In addition, PFM constructed multiple financial models to analyze and predict financial performance under a variety of scenarios.

Overview of the Current Pennsylvania Wine and Distilled Spirits Distribution System

States take varying approaches to alcoholic beverage operations but are primarily split into two categories: control (states that are responsible for some or all aspects of the wholesale and retail of wine and/or distilled spirits) or license (states that license private entities to handle the wholesale and retail sales operation of wine and distilled spirits). The majority of states (32) are classified as license states, while 18 are control states. The degree of involvement in the control states varies; Pennsylvania is one of two control states (the other being Utah) that maintains essential control of all aspects of the wholesale and retail distribution of wine and spirits. In comparison to other regional states, the Commonwealth is a significant outlier in that respect.

The PLCB wholesale operation is already essentially privatized, as there are private contracts in place to handle transportation and operations in its three warehouses. By contrast, the operations at the 613 state-run retail stores are handled entirely by state employees. In recent years, PLCB has sought to modernize and renovate its retail operation. In 2011, PLCB proposed changes that would allow it to function more like a private sector business, including direct shipping/delivery to Pennsylvania residents, removing Sunday sales restrictions and extending Sunday sales hours, allowing stores to be Pennsylvania lottery retailers and allowing market-based pricing; those initiatives are pending before the State Legislature.

Of course, PLCB's desire to function more like a private sector organization raises the fundamental question: why not simply fully privatize the system? While Pennsylvania has retained control of wholesale and retail operations since the end of Prohibition, system privatization has been considered on several occasions. Most notably, former Governors Thornburgh and Ridge developed separate privatization proposals, both focusing on privatizing retail and retaining the State's wholesale operation. In both cases, the plans were ultimately rejected.

PLCB Organizational and Financial Overview

PLCB is a large enterprise with significant functions – its nearly 5,700 full and part-time employees perform regulatory and licensing functions for approximately 20,000 liquor licenses and permits for establishments statewide. It also oversees three warehouse distribution centers and operates over 600 wine and liquor stores throughout the State with $1.5 billion in total sales in Fiscal Year 2009-10.

The system provides the State with recurring revenue, including transferring an average of $97 million annually to the General Fund. However, the system's profitability has declined in recent years, as expenses have grown faster than revenues. Based on PFM's PLCB baseline forecast, it is estimated that $80 million a year is a sustainable annual General Fund Transfer amount.

Over the last 10 years, revenue has grown at a compound annual growth rate (CAGR) of 3.5 percent, while expenses have grown at a CAGR of 5.5 percent. Some of the expense growth relates to expenditures for IT and other systems, as well as an internal reorganization. These changes have led to a significant increase in administrative expenses, which, over the last ten years, has grown faster than the other broad expenditure categories (store and warehouse and licensing and enforcement). The PFM baseline model predicts that expense growth will continue to be higher than revenue growth in the coming fiscal years. It goes without saying that if PLCB were a private sector firm, there would be concerns about its ability to remain as a viable business with expense growth outstripping revenue growth over a 10-year period.

PLCB recently started reporting on profit and losses by store. In Fiscal Year 2008-09, 25 stores were deemed unprofitable, and the count increased to 53 in Fiscal Year 2009-10. However, this profitability methodology does not allocate indirect costs to the stores and assumes 100 percent of product mark-up is attributed to retail operations. If indirect costs and wholesale mark-up are attributed to stores, nearly all PLCB stores would be unprofitable.

Benchmarking PLCB with Other States

PFM benchmarked Pennsylvania with other control and license states to gauge performance on a variety of key metrics. In terms of its retail system, Pennsylvania has significantly fewer stores per 10,000 drinking age residents than most of the benchmarked states. The Commonwealth also has relatively low levels of wine and spirits consumption per capita; it is likely that some of this is because Pennsylvania consumers are purchasing wine and spirits products in other states. Part of the motivation for cross-border purchasing may be the PLCB tax and mark-up structure, which results in a higher tax burden for both wine and spirits than most of the comparable states.

Comparatively, PLCB has high operating costs among control states; states that have privatized their retail systems but retain wholesale operations (Iowa, Ohio, Michigan) have a lower ratio of operating costs to total sales. PLCB's personnel costs as a percentage of total sales are also significantly higher than the control state average, as is its level of full time staff. This likely has an impact on profit as a percentage of total sales, where PLCB is well below average for the surveyed control states. In short, Pennsylvania fares poorly in comparison to both control and license states on key metrics.

Assessment of State Privatization Options

There are a number of possible privatization approaches, and the preferred method may depend on the key outcomes to be achieved. To help identify the scope of available options, PFM analyzed nine approaches ranging from a single vendor selected to either lease the exclusive right to retail in Pennsylvania or manage the public distribution system, known as a Public-Private Partnership (P3), to the State maintaining its wholesale distribution system and using private agents to sell its product. Besides analyzing a variety of privatization alternatives in between, PFM also considered the option of allowing the PLCB to operate more like a private-sector operation.

As noted above, the desired outcomes are important factors in weighing the differing approaches. The five key goals that PFM used to weigh the options were:

- Allow the free market to promote greater convenience and price competition for Pennsylvania consumers.
- Assure strict enforcement of reasonable regulations to protect the public and consumers.
- Achieve up-front value of the franchise transfer to help achieve other priority goals.
- Assure that the fiscal impact to the State is neutral going forward.
- Consider the careers and economic well-being of state employees impacted by the change.

While each of the nine considered options allows the State to achieve at least some of these goals, two approaches were deemed to meet all of the goals:

1. Full privatization of wholesale and retail with limits around the number or types of licenses.
2. Full privatization with limited licensing of wholesale, open licensing of retail.

While the first option would generate more up-front revenue, the second has the advantage of fewer market restrictions around retail licenses and reduced risk of a sub-optimal result associated with a large and complex auction of hundreds – if not thousands – of retail licenses. The wholesale licensing process, which will likely number in the range of 10 to 30 licenses, should be more manageable and should yield an effective result. On the larger retail side, the market is generally best able to sort out the optimal number of licenses – and license fees can be substantial enough to act as an impediment to over-saturation.

Fiscal Neutrality

The vast majority of PLCB revenue comes from two sources: mark-up of the cost of goods sold ($453 million in Fiscal Year 2009-10) and state taxes applied ($377 million). It is assumed that the State will continue to apply taxes to wine and distilled spirits in a privatized system, although the type may change. Much of this revenue supports PLCB operation expenses for wholesale and retail operations, and regulatory, licensing and administrative functions ($397 million in Fiscal Year 2009-10). PLCB also currently funds Pennsylvania State Police enforcement of compliance with alcoholic beverages laws ($20 million in Fiscal Year 2009-10) in addition to treatment and prevention programs for the Department of Health ($1 million); these expenses will require a funding source after privatization. As detailed in the table below, when also including the PLCB yearly general fund transfer, PFM estimates that in Fiscal Year 2012-13, total PLCB revenues will total $969 million while expenses will equal $561 million, providing a net fiscal impact of $408 million. To achieve Fiscal Neutrality, any privatization option must provide a net fiscal impact of $408 million through new and or enhanced revenues or additional reduced expenditures (beyond reductions based on eliminating PLCB wholesale and retail operations).

2012-13 Estimated Fiscal Impact

Item ($ in thousands)	2012-13 (estimated)
Revenue	
PLCB Program Revenue	$544,000
State Taxes Applied	$425,000
Total Revenue	**$969,000**
Expenses	
PLCB Operations	$458,000
GF Transfer	$80,000
PSP Enforcement	$22,000
DOH Programs	$1,000
Total Expenses	**$561,000**
Net Fiscal Impact	**$408,000**

It is possible to achieve Fiscal Neutrality through a combination of fees and taxes, and the choices, depending on many factors, may have an impact on consumer prices. As noted in the section on taxes, the order of operations (where taxes are calculated in relationship to the price of the product) can have a material impact on the tax burden and final price to consumers.

In the two options under consideration, the open market retail system will generate more on-going revenue from licensing, meaning the other alcohol taxes will not need to be as high to attain Fiscal Neutrality. All states using the license approach use a gallonage tax based on volume, which has a greater impact on lower-priced items than the State's current excise (based on value) tax. PLCB's current tax burden is high, and translating that level of revenue collected from the excise tax would make the State's gallonage tax rate problematic for certain products. That said, there are competitive aspects of the privatized system, particularly where high-volume low-margin retailers participate, that could mitigate these consequences.

Taxes

Pennsylvania currently imposes an 18 percent excise tax (the Johnstown Flood Tax) and a 6 percent state sales tax on products. Because the State controls the wholesale and retail operation, the excise tax is easy to administer and collect; most states do not retain this degree of control of their distribution system and instead use a gallonage tax. Because a gallonage tax is based on volume rather than price, it has a greater impact on lower-priced products and less on higher-priced items.

The State's existing tax burden, particularly for wine, is high compared to the benchmarked states. The recommended privatization options change the tax structure from an excise tax to a gallonage tax but do not materially increase or decrease the tax burden. A converted gallonage tax to raise the same amount of revenue as existing taxes would be the highest in the nation for wine, and spirits would rank 14th.

Price

As the sole wholesaler and retailer within the Commonwealth, PLCB pricing policies have a significant impact on the retail shelf prices of wine and liquor, which is predominantly driven by the tax structure and product mark-ups. While the tax structure is set by the State, mark-ups are generally controlled by the wholesaler and retailer, which in the current system is PLCB. The PLCB mark-up is significant - including a 1 percent prompt payment markup, a 30 percent standard markup and a logistics, transportation and merchandising factor (LTMF) that translates into a 15.5 percent on average additional mark-up. Factors present in the private sector that are not reflected in PLCB's current pricing model, such as variable pricing and volume discounts, may have an impact on price depending on the local market as well as the retailer's business model.

When examining the two privatization alternatives, the PFM static pricing model suggests price neutrality under the open licensing approach and some minor price increases under the auction retail approach based on a 'Fiscal Neutrality' tax structure, but most of the sales in the State will occur in highly competitive areas. Currently, 18 counties make up approximately 82 percent of total sales in Pennsylvania. These 18 counties are also among the top 20 counties in population density. There is a strong expectation that these will be the counties most likely to experience competitive price pressures. As a result, for the majority of sales in Pennsylvania, the product prices will be at or slightly lower than the results from the static model.

Sales and Consumption

The current baseline assumption for PLCB sales growth is 4 percent a year, which is below historic growth levels. It is generally accepted that higher prices on wine and distilled spirits will reduce demand (known as elasticity of demand). It is likely that the higher tax levels in the Commonwealth are reducing overall sales levels. It is also likely that the current system suffers from a lack of customer convenience and market-driven consumer choice that is also reducing sales.

Much of this sales loss is due to consumers making purchases in surrounding states, including Delaware, Maryland and New Jersey. Multiple studies of this 'border bleed' suggest that PLCB's lost sales to other states may be in the range of 10 to 30 percent of total sales in the Commonwealth. If the private system is able to recapture a portion of these sales, it should improve system profitability and create jobs to replace some of those displaced by PLCB store closures.

The demographics of Pennsylvania make a compelling case that market-driven customer convenience and choice should lead to repatriated sales in the higher income densely populated areas of south-central and southeastern Pennsylvania. Both of the considered options should provide this market-driven competition for customers and increase sales. Based on the correlation of higher income with higher dollar amounts purchased, and comparing that to current purchases in these areas, PFM estimates that additional sales from repatriation will be approximately $100 million once the retail system is transitioned.

Retail Licenses

The number and type of retail licenses may have an impact on the up-front revenue obtained. If maximizing up-front revenue is the paramount goal, sufficient license scarcity should be put in place to enhance the valuation of each individual license. Given the State's low number of off-premise retail locations per 10,000 drinking age population, it is possible to significantly increase the number of licensed establishments while maintaining scarcity. PFM believes that approximately 1,500 licenses would be a reasonable accommodation of consumer convenience and license scarcity. Under the open retail license approach, there would likely be 3,000 to 4,000 retail licenses issued.

States have numerous ways to categorize and allocate licenses. In some jurisdictions, licenses are based on store characteristics (square footage, linear shelf space devoted to product) or sales, while others rely on the types of product to be sold. Some states also limit the number of licenses on a per capita basis, either by state or locality. In other states, the only barrier to entry is to meet standard regulatory requirements.

In the analysis, the project team determined that if it is necessary to create individual license classes, the Commonwealth should seek to limit these to no more than two to prevent 'over-engineering' that could have unintended consequences. It also recommends that normal market determinants, like population density and historic sales, be used as much as possible in any license allocation to help create a system that provides consumer choice. This could also help achieve sales repatriation from other states – which would help attain Fiscal Neutrality and create job opportunities for Pennsylvania workers.

Wholesale Licenses

The wholesale industry is a consolidated industry with a relatively small number of wholesalers controlling a large portion of the national market. Many different regulations and control methods are found among the states; in particular, a franchise law and its impact on manufacturers and wholesalers can have a significant effect on the relationships in the three-tier system and on consumers.

PFM considered three alternatives for wholesaling in Pennsylvania. It was determined that auctioning wholesale licenses by brand was the best fit for the State. This option is likely to lead to 10-30 primary wholesalers providing the vast majority of product in the Commonwealth. This model is the same for both of the privatization alternatives analyzed throughout the report.

Valuation

Based on actions and activities in other states, wholesale and retail licensees will pay for the privilege of providing these services in the Commonwealth. The value of a license will be determined by the licensee's ability to generate profits from ownership. Potential licensees are likely willing to make substantial payments via up-front or on-going revenue, but not both.

The number and duration of licenses will have a material impact on valuation. If licenses are held in perpetuity and transfer rules are reasonable, the license may be treated as an investment whose value will appreciate over time; of course, the value will also be impacted by the number of licenses issued – more licenses are likely to reduce the perceived value of any single license, depending on a variety of factors. In the two alternatives analyzed, the open retail approach will eliminate any up-front retail auction license revenue, although both approaches should yield up-front revenue from the wholesale auction licensing process.

To evaluate the retail auction option's impact on valuation, PFM developed three different methods and models. Based on research, data and certain assumptions, the estimated valuation of retail (in the range of $730 million) and wholesale licenses (in the range of $575 million) is $1.1 to $1.6 billion. The upfront revenue related to auction of the wholesale operation would be generated in both privatization approaches.

Use of Proceeds

The auction of wholesale and/or retail licenses will provide the Commonwealth with significant up-front proceeds that can be dedicated to other key priorities. Based on estimated valuation, proceeds from auction of wholesale and retail licenses could generate between $1.1 and $1.6 billion; auction of wholesale licenses only could generate in the range of $575 million.

This should be put into the context of the overall Pennsylvania state budget, which, for Fiscal Year 2011-12 totals $64 billion for all funds and $27 billion for the general fund. To avoid creating budget shortfalls in future years, an optimal use of the proceeds would be for one-time purposes. Given this context, three logical uses would be to reduce the State's unfunded pension liability, use as incentives for economic development or use for investments in infrastructure. There are advantages and disadvantages to each of these approaches, and there are likely other possible uses as well. A detailed examination of all possible alternatives is outside the scope of this study.

Use of proceeds to reduce the State's unfunded pension obligation would be an appropriate use of one-time funds. However, the State faces a total unfunded liability of approximately $30 billion, and as a result this may not have a significant impact on the overall liability.

Use of proceeds for economic development incentives is also an appropriate use of one-time funds. To the extent they are dedicated to one-time grants or low or no-interest loans, they have the potential to help create jobs and economic activity. Given the funding reductions in this area in the Fiscal Year 2011-12 budget, this may be a way of coping with reductions (with the caveat that these proceeds will not be available in this fiscal year). That said, large-scale economic development incentive packages in other states can range into the hundreds of millions of dollars.

The use of proceeds for infrastructure improvements can be a vehicle both for immediate job creation and longer term economic development. A logical approach for the use of proceeds would be to capitalize the existing Pennsylvania Infrastructure Bank by providing direct or leveraged loan programs or credit enhancements. The State of Virginia envisions this approach for use of its up-front auction of licenses for retail sale of distilled spirits proceeds.

Social Impacts

Extensive research has been conducted around issues of alcohol price, outlet density and other factors and their impact on consumption and behavior. The outcome of this research is mixed and does not definitively answer questions about the impact of a privatized system in Pennsylvania. Studies in other states that have privatized their retail operations have also been mixed. In particular, the State of Iowa's experience (the first state to privatize sales of wine and distilled spirits since the end of Prohibition) has been the subject of numerous studies with remarkably differing conclusions.

Beyond the issue of impacts based on privatization, it has been suggested that control states are better able to restrict access to alcohol; however, empirical data for Pennsylvania and surrounding license states do not bear this out as it relates to alcohol-related and DUI motor vehicle fatalities and underage drinking rates. That said, there are alcohol-related regulation and enforcement measures that have been shown effective in dealing with social issues, and focusing on these can be a useful approach in either a license or control state environment.

Transition Issues

The process of transitioning from a public enterprise to the private sector, while maintaining consumer access and an uninterrupted tax revenue stream will be a challenging and complex process.

Moreover, privatization would have a significant impact on both PLCB and its displaced workers. For PLCB, its licensing and enforcement duties would remain and likely require some increase in staffing to accommodate additional licensing activities (although even in the open retail option, these licenses would be dwarfed by the nearly 20,000 licensees PLCB already regulates). It is estimated that retail and supply chain staff would be eliminated over a 14-month period, as private retailers phase in, and central office staffing levels would be significantly reduced in the final months of the transition. In the end, PLCB would likely consist of approximately 290 full-time equivalent positions, with approximately 3,200 separated from service.

Regardless of the retail privatization model, separation costs relating to unemployment compensation and paid leave will be significant. At the same time, a significant percentage of displaced workers will voluntarily retire, be placed in comparable state positions or find private employment. It is likely that additional opportunities for private employment will also exist in the open retail option.

Separate furlough rules must be considered for civil service, non-civil service, union and non-union employees. The Commonwealth can work through the Office of Administration, Civil Service Commission and the Department of Labor and Industry to help place furloughed employees. Other states can be looked to for guidance as to programs in place to assist displaced employees.

It is generally accepted that there can be multiplier effects within an economy from sales or job generation. Providing a definitive assessment of a positive (or negative) multiplier effect from privatization of the wholesale and retail sale of wine and liquor is outside the scope of this study and would require more specific knowledge of the composition of the private wholesale and retail industry that would replace PLCB. That said, it is likely that direct and indirect effects will depend on levels of retail activity compared to the current system; while a privatized system may have a negative impact on the induced sector, this should be mitigated by other consumption in a privatized system.

Summary and Recommendation

As one of the last states employing strict post-prohibition control over the sale of wine and spirits, PLCB has grown into a complex and expensive organization that endeavors to balance its dual role of regulator and retailer. PFM believes that the Governor's commitment to privatize PLCB's wholesale and retail operations, freeing them to concentrate solely on regulation and public safety, is well founded. Moreover, as demonstrated throughout the report, privatization of PLCB can unlock valuable resources for the Commonwealth to dedicate to achieve other policy goals, while providing economic opportunity to the private sector and enhanced convenience and choice to the state's consumers.

Given the policy goals the Governor established for conducting this analysis, the project team believes the most viable strategy is to privatize both the wholesale and retail operations through the issuance of licenses. On the wholesale side, this would involve the payment of an initial franchise fee along with on-going license fees that support the cost of regulation. On the retail side, two alternatives have been identified: either a highly-structured license issuance strategy accomplished through an auction process, or an open-market approach that would provide licensure opportunity to any qualified applicant. Both have advantages that policymakers should weigh. In either approach, significant licensure fees should be applied as a way to promote voluntary compliance with the State's Liquor Code.

In the end, however, the decision to privatize should, at its core, come down to a consideration of what is best for all citizens of the State and the consumers the system serves. Based on the benchmarking, financial analysis and evidence from other states, the project team believes that a privatized system affords the State the best opportunity to improve on the current system and optimize the financial benefits for its citizens.