House Appropriations Committee Hearing –
February 27, 2012

REMARKS FOR THE RECORD SUBMITTED ON BEHALF OF THE PENNSYLVANIA LIQUOR CONTROL BOARD ("PLCB") BY

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Chairman Adolph, Chairman Markosek, Members of the House Appropriations Committee, good afternoon.

Thank you for the opportunity to address you this afternoon. I will briefly give you an overview of the PLCB's current sales and revenue information, and an overview of the agency's legislative initiatives which, in the aggregate, are designed to return an additional seventy-one million dollars ($71,000,000) annually to the Commonwealth.

FINANCIAL INFORMATION

Despite the ongoing weakness in the overall economy, PLCB sales continue to increase. Through its operation of approximately six hundred and nine (609) wine and spirits stores, the PLCB generated more than one billion five hundred seventy-one million dollars ($1,571,000,000) in sales (net of taxes) during Fiscal Year 2010-11, representing an increase of 4% over the previous fiscal year. In addition, the PLCB sold more than one hundred thirty-eight million (138,000,000) units, representing an increase of approximately 3.5% over the previous fiscal year. Total store sales for the first seven (7) months of the current fiscal year increased by forty-one million nine hundred eight thousand dollars ($41,908,000), representing a 4.4% increase in total store dollar sales.

The PLCB made a cash transfer of one hundred and five million dollars ($105,000,000) to the General Fund, and transferred more than three hundred ninety-one million dollars ($391,000,000) in tax revenue, in Fiscal Year 2010-11. In addition, the PLCB contributed more than twenty million dollars ($20,000,000) to the Pennsylvania State Police, Bureau of Liquor Control Enforcement, to fund its enforcement operations, and nearly one million seven hundred thousand dollars ($1,700,000) to the Department of Health's Drug and Alcohol Programs. Moreover, the PLCB awarded grants totaling nearly one million dollars ($1,000,000) to municipalities and universities to support initiatives aimed at preventing underage and dangerous drinking, impaired driving, and other alcohol-related problems. These figures do not include local tax revenue collected and transmitted back to Philadelphia and Allegheny County, which totaled nearly seven million four hundred thousand dollars ($7,400,000) in FY 2010-11.

More than four million five hundred thousand dollars ($4,500,000) in license fees were returned to municipal governments for their local alcohol enforcement efforts.

Over the past five (5) years, the PLCB has contributed more than two billion three hundred eighty-five million dollars ($2,385,000,000) to the State Treasury.

LEGISLATIVE INITIATIVES

Given the Commonwealth's current fiscal challenges, these proposals, which have long been advanced by the agency, should be given careful consideration. The PLCB is poised to implement changes to its practices and procedures to bring about this additional revenue, but the agency needs your help. These initiatives must be advanced and signed into law in order for the modernization of the agency to come to fruition.

A breakdown of how our initiatives would, with your help, provide the Commonwealth with an additional seventy-one million dollars ($71,000.000) is set forth below:

Sunday Sales	$10,000,000
Pricing	$25,000,000
Bailment	$12,000,000
Lottery	$ 8,000,000
Fines	$ 2,000,000
Fees	$14,000,000
TOTAL:	$71,000,000

I would first like to discuss the "3P" initiatives: pricing, procurement, and personnel. Then, I would like to turn your attention to the other revenue-enhancing initiatives of the PLCB which we would ask you to further incorporate into this bill. Collectively, these initiatives, many of which have already been voted out of the House Liquor Control Committee as part of other bills, will facilitate the modernization of the agency, allowing the PLCB to function more efficiently and effectively, and enabling the agency to return significant additional funds to the Commonwealth, for the benefit of all Pennsylvanians.

Pricing

First, with respect to pricing, the Board's authority to set prices generally and to change the manner in which it sets prices comes from the Liquor Code itself. Under section 207(b), the prices established by the PLCB must be "proportional" to the prices paid by the PLCB to its suppliers, with no reference to any other costs associated with the operation of a wholesale and retail business (such as labor, warehouse, transportation and storage costs). What this means in practical terms is that the PLCB must apply its markup (currently thirty percent (30%)) equally on all products. As an example, the PLCB must apply the same percentage markup on a very popular and relatively inexpensive bottle of vodka, and a rare, luxury wine which the PLCB was exclusively able to obtain due its market leverage and purchasing power.

This "one size fits all" approach to pricing is uncommon in the alcohol beverage industry, or in any other retail industry for that matter. Further, this statutorily-mandated approach is inefficient, and ultimately hinders the Board's ability to maximize the potential revenue which could be returned to the Commonwealth. Under section 207(b), the PLCB cannot exercise any discretion to adjust its mark-up of different products, regardless of the type of product, its relative demand and/or supply, or its marketability. If the PLCB chooses to increase its percentage mark-up on one (1) product, it must do so for all products; likewise, if it chooses to decrease its percentage mark-up on one (1) product, it must do so for all products. There is no flexibility in the current system.

The PLCB therefore recommends a legislative change which would allow for market-based pricing which would be uniform throughout the Commonwealth. This would allow the Board to adjust its mark-up on specific products, provided that the same product would cost the same in every part of the state. This proposal has already been approved by the House Liquor Control Committee as part of House Bill 11.

A few practical examples may assist in illustrating how a flexible pricing system could lead to increased profitability. First, and as mentioned earlier, the PLCB will mark-up a ten dollar ($10) bottle of wine in the same manner as it would a ten dollar ($10) bottle of spirits. Based on a pricing study recently conducted by the Nielsen Company, the Board's prices for spirits are more than competitive when compared to the prices in neighboring states, but less competitive with respect to wine. This is largely due to the wide variety in the quality and availability of wine products available in today's marketplace. While other retailers are able to adjust mark-ups between wine and liquor and within the spectrum of wine products offered for sale to account for their relative availability and overall quality, the PLCB must apply a "one size fits all" mark-up for all products offered for sale. Accordingly, flexibility would allow the Board to adjust mark-ups within the ever-evolving marketplace of the wine industry.

Second and as previously noted, while the Liquor Code references the costs of purchasing alcohol, it does not reference other costs associated with the operation of a retail business, such as labor costs, transportation costs, warehousing costs and the costs associated with operating retail locations such as leases and utilities. As many of you know, the Board allows consumers to purchase products through its "e-commerce" store, and allows customers to pick-up their orders at a designated wine and spirits store. Certain "luxury" items are exclusively offered for sale through the "e-commerce" store. Further, the Board has very recently embarked on an initiative in which select items may be purchased from the "e-commerce" store and be shipped directly to a resident's home or business address, provided that an adult signs for the delivery; shipping costs for such sales are passed through to the consumer. Such sales are less costly to the Board than having the product located at a brick and mortar store and, therefore, the Board would certainly want to encourage these types of sales, if it can. However, while there are fewer costs to the Board associated with such "e-commerce" sales, the Board cannot pass on those savings to consumers without modifying its mark-up on all items. Flexibility would allow the Board to adjust its mark-up to encourage such sales.

Finally, through what are termed Special Purchase Allowances ("SPAs") the Board is able to pass discounts from suppliers on certain targeted products straight through to Pennsylvania consumers. One hundred percent (100%) of the value from these SPAs are passed on to the consumer. With flexible pricing, the Board would be in a position to retain, and ultimately remit to the Commonwealth, some of the savings afforded by the Board's suppliers.

While it is difficult to quantify the actual fiscal impact of this initiative, granting the Board the discretion to make such pricing decisions could easily lead to an increase of more than twenty-five million dollars ($25,000,000) per year, depending on market conditions and the timing of implementation.

Finally, with respect to pricing, the PLCB is considering a significant change in its pricing structure that would eliminate the Logistics, Transportation and Merchandise Factor ("LTMF") and incorporate this operations fee into a more streamlined mark-up structure. While this is merely a proposal at this point, such alternatives are not possible without relief from the current statutory constraints. It should be noted that this initiative has already been approved by the House Liquor

Control Committee in House Bill 11, and has also been incorporated into Senate Bill 1287.

Personnel

With respect to the initiative involving personnel, restrictions imposed by the Civil Service Act and the Administrative Code impair the PLCB's ability to effectively hire the right employees with the right skill sets in a timely fashion, to remove under-performing or insubordinate employees, and to establish the right amount of pay and benefits for its employees. This is not to say that the PLCB is asking for unfettered discretion to make standardless, arbitrary hiring and compensation decisions for its employees. Rather, like other independent agencies, it believes that the standards to be employed and the implementation of such standards are best handled by the PLCB itself, rather than under a framework designed for more traditional agencies under the Governor's direct jurisdiction. Indeed, the PLCB intends to establish the same type of administrative controls that are currently in place outside the PLCB. These administrative controls – such as a salary board and written procedures for hiring, firing etc. – would derive from the equivalent structures and procedures currently existing in state government, with the additional advantage of being implemented by and tailored to the PLCB.

Accordingly, the PLCB seeks changes which would afford it flexibility in hiring employees outside the Civil Service system, to classify its own positions, and to set the compensation for its employees. The PLCB firmly believes that this will result in efficiencies across the agency, leading to cost savings, better service, and improved profitability. This proposal has already been approved by the House Liquor Control Committee as part of House Bill 1356, and has also been incorporated into SB 1287.

Procurement

With respect to the initiative involving procurement, the General Assembly, recognizing that the PLCB's legislatively-mandated functions are unique among other Commonwealth agencies, exempted the PLCB's purchases of wine and spirits from the Procurement Code. In addition to being one of the largest purchasers of wine and spirits in the United States, the PLCB has a significant need for supporting goods and services in carrying out its statutory functions. To acquire other goods and services, however, the PLCB must comply with the Procurement Code. Again, the PLCB seeks not unfettered discretion, but appropriate and knowledgeable decision-making. The PLCB can cite to numerous examples of instances in which the procedural dictates of the Procurement Code and the fact that final decisions are made elsewhere have resulted in lengthy delays and unfavorable results, reducing profitability. Accordingly, the PLCB seeks changes that would give it greater flexibility in acquiring all of its goods and services, thereby allowing the agency to exercise its significant market leverage in various markets in a more expeditious fashion, and, potentially, at more competitive prices. This proposal has already been approved by the House Liquor Control Committee as part of House Bills 11 and 1356, and has also been incorporated into Senate Bill 1287.

In addition, while the concept is not yet incorporated into Senate Bill 1287, the PLCB believes that it can capitalize more readily in the ever-changing commercial real estate market by entering into lease agreements for store and office locations on its own initiative. Currently, the PLCB must proceed through the Department of General Services ("DGS") as its agent, to lease, furnish and equip all of its locations. While the PLCB has a good and collaborative working relationship with DGS, the strictures of this process add significant delay in the procurement of leasing arrangements, and often result in additional leasing costs. Further, in situations in which the PLCB has had to close a particular store location for reasons involving health or safety, the current procedures hinder our ability to quickly relocate to another cost-effective location. A further amendment would be required to allow the agency to act on its own behalf in matters relating to leasing real property.

I would now like to focus on the other revenue-enhancing legislative proposals which would enable the Commonwealth to realize significant additional annual revenue under the PLCB's modernization initiatives.

Bailment Fees

As many of you know, the PLCB is in the process of changing its inventory management to a "bailment" system, so that the majority of its warehoused product will be owned by the supplier until it is sent to the PLCB's wine and spirits stores. Bailment is utilized by all eighteen (18) "control" states, except Pennsylvania and Wyoming. Under bailment, vendors/suppliers of liquor, including both wine and spirits, will retain title to merchandise through the importation and, subsequently, the storage of the merchandise in a warehouse operated by a PLCB contractor. Title will only pass to the PLCB when merchandise is actually sent to a store. The PLCB is now in the process of implementing bailment with its largest vendor, Diageo. It is anticipated that approximately eighty percent (80%) of the merchandise sold by the PLCB will be converted to bailment throughout 2012, as each of the PLCB's largest vendors "go live" with bailment during the year.

Many bailment states assess a "bailment fee," where manufacturers are charged a reasonable fee in order to store inventory at a warehouse which is operated by a warehouse operator under contract with the state. If such fees were assessed in Pennsylvania, the funds could be utilized to off-set any costs associated with maintenance of these warehouses. With respect to bailment fees, if the Board were to move to a bailment model, and were to charge suppliers a fee of one dollar ($1) per case per month (a figure that is in line with fees assessed in other states utilizing bailment), such a fee would generate more than one million dollars ($1,000,000) per month, or more than twelve million dollars ($12,000,000) per year, based on the number of cases currently moving through the PLCB's warehouses.

Sunday Sales

I would now like to turn to the issue of Sunday sales and Sunday hours. Currently, only twenty-five percent (25%) of stores are permitted to be open on Sundays, the second busiest retail day of the week. The PLCB suggests removing the current twenty-five percent (25%) restriction, allowing the Board the complete discretion to make necessary business decisions on whether to operate any given store on Sunday. Further, the Board also suggests allowing stores to operate until 9:00 p.m. on Sundays, instead of the current 5:00 p.m. closing time. Extending Sunday hours will offer greater customer convenience. It should be noted that, with the passage of Act 113 of 2011, certain retail licensees are permitted to sell alcohol two (2) hours earlier than previously allowed on Sundays, and distributors and importing distributors are permitted to sell malt or brewed beverages four (4) hours longer on Sundays, or until 9:00 p.m.

Currently the PLCB operates six hundred nine (609) wine and spirits stores, of which over one hundred fifty (150) are operated on Sunday. Expanding Sunday hours from 5:00 p.m. to 9:00 p.m. at stores currently able to sell on Sundays should increase sales between ten percent (10%) to twenty-five percent (25%) overall. Further, it is estimated that opening additional stores from 12:00 p.m. to 5:00 p.m. or longer in areas that currently do not have a store would increase Sunday sales by ten thousand dollars ($10,000.00) or more per store. In the aggregate, the PLCB estimates that affording the PLCB unfettered discretion to operate on Sundays until 9:00 p.m. would result in an additional ten million dollars ($10,000,000) in annual revenue. This proposal has already been approved by the House Liquor Control Committee as part of House Bills 11 and 1356.

Licensing Fees

Next, turning to the issue of licensing fees, it should be noted that the existing fee structure has remained the same since 1991, twenty-one (21) years ago. While most fees are set forth in the Administrative Code of 1929, some are defined by the Liquor Code or the PLCB's Regulations. Altogether, more than fifty-two thousand (52,000) individual fee transactions are processed through the PLCB's Bureau of Licensing ("Licensing") each year. The current fee schedule only partially funds the ever-increasing administrative costs associated with processing licensing applications, and has not been adjusted to account for the effects of inflation for more than two (2) decades.

In order to realize one hundred percent (100%) of the increased revenue associated with increasing licensing fees (as certain fees are returned to municipalities via the Liquor License Fund), it is recommended that an administrative fee be assessed for all license renewal and validation applications. If, for example, an additional seven hundred dollar ($700) administrative fee were assessed on all renewal and validation license applications, this would result in approximately fourteen million dollars ($14,000,000) in additional revenue per year. To cushion the impact of such licensing fee increases, the increases could be phased in over a number of years. After full implementation, subsequent increases could be tied to a reliable economic indicator, such as the Consumer Price Index.

Fines

Another legislative initiative proposed by the PLCB involves an increase to the monetary penalties, or fines, that are imposed on licensees which are found to have violated the Liquor Code, the Board's Regulations, or other provisions of Commonwealth law. The current fine structure in the Liquor Code has not been changed since 1987. The PLCB recently conducted a survey of the penalties imposed by the various fifty (50) states for violations of the more serious offense of selling or furnishing alcohol to a minor. When compared with the actual penalties imposed by the Office of the Administrative Law Judge for such serious infractions of the Liquor Code, licensees in Pennsylvania face relatively light monetary penalties and minimal suspensions. This is especially true in the case of repeat offenders.

The amount of fines collected fall significantly short of covering the costs of enforcement each year, a trend which continues to worsen each year. For example, in FY 2008-09, the total funds collected through enforcement efforts covered approximately 11.2% of the overall costs of enforcement, while in Fiscal Year

2010-11; the funds collected covered less than 8.2% of the overall costs of enforcement. It should be noted that the differences between funds collected and costs borne by the Board result in reduced contributions to the General Fund.

If all fines imposed in 2011 had merely been doubled by the OALJ, the Commonwealth would have realized an approximate increase in revenue of nearly two million dollars ($2,000,000). The exact amount of the increase to the fine structure is within your discretion. This proposal has already been approved by the House Liquor Control Committee as part of House Bills 11 and 260.

Lottery Sales

Lottery ticket sales are commonplace at the licensed liquor stores of other states. The State Lottery Law already allows "all departments, commissions, agencies and instrumentalities of the State" to be licensed as Lottery Sales Agents. However, the Liquor Code does not specifically authorize the PLCB to sell lottery tickets.

The PLCB has met with lottery representatives of the Pennsylvania Department of Revenue ("Revenue"), which agrees that the concept of allowing automated, self-service lottery machines on the premises of the PLCB's wine and spirits stores would increase the Commonwealth's revenue from lottery ticket sales, while adding to the convenience of the Pennsylvania consumer. Data submitted by Revenue indicates that if the PLCB were permitted to sell lottery tickets through counter sales and vending machines in its state store system, and retained the five percent (5%) retail commission (plus bonuses) as other lottery sales agents are permitted to retain, it could see an increase in revenue of approximately eight million dollars ($8,000,000) per year (or approximately two million dollars ($2,000,000) per year for sales through vending machines only).

Consumer Relations Marketing ("CRM") Program

The Liquor Code currently prevents the PLCB from recognizing and rewarding regular customers through the use of what is commonly referred to as a Consumer Relations Marketing ("CRM") program (e.g., supermarket or retailer loyalty programs). Such a CRM program would allow the PLCB to offer exclusive product coupons, award points to returning customers which could be redeemed for discounts on products, and alert customers to upcoming sales and promotions. New Hampshire, another control state, has a successful CRM program (including coupons), which has been well-received by consumers.

There are three (3) primary objectives for this initiative: 1) coupons and loyalty programs are industry-proved consumer drivers which get customers into stores; 2) offering discounts on slower selling lower velocity items allows the PLCB to sell inventory which may otherwise languish in its warehouses, while passing significant savings on to Pennsylvania consumers; and 3) offering discounts on higher-quality items may encourage buyers to "trade-up" for higher-priced items, yielding higher markups for the PLCB. As an example, following a recent e-mail blast advertising a sale on the PLCB's Sommelier Collection items, resulting sales totaled more than one hundred fifty thousand dollars ($150,000) and many of the sale items were depleted within a week. The actual fiscal impact of this initiative cannot be estimated at this time. This proposal has already been approved by the House Liquor Control Committee as part of House Bills 11 and 260.

<u>Direct Shipping / Direct Delivery</u>

For the convenience of Pennsylvania's residents, the PLCB proposes amending the Liquor Code to allow the direct shipment of wine to a resident's home by any licensed wine producer or retailer, without any restriction on quantity or availability in PLCB stores, provided that such wine is for personal consumption only. Licensees would <u>not</u> be able to obtain such wine for resale. The direct wine shipper license would be the exclusive means by which direct shipment of wine could occur. To minimize the risk of underage access, direct wine shippers must ensure that all containers be conspicuously labeled with: "CONTAINS ALCOHOL; SIGNATURE OF PERSON AGE 21 OR OLDER REQUIRED FOR DELIVERY;" and require, upon delivery of the wine, an adult signature that is verified by inspecting a valid form of ID.

In order to prevent significant Commonwealth revenue loss, it is suggested that the wine sold by direct shippers should be subject to both the six percent (6%) sales tax and the eighteen percent (18%) liquor tax. Further, direct shippers should be required to report regularly on such sales, remit all taxes collected, and, to ensure compliance with tax collection, secure a tax bond. Further, it is suggested that it should be a misdemeanor offense for a person to knowingly make, participate in, transport, import or receive a direct wine shipment in violation of the law.

To date, there are six (6) bills in the current legislative session which deal with direct shipping, although all of them vary greatly in terms of privileges afforded to direct shippers and taxes assessed on the products sold: House Bill 110, House Bill 430, House Bill 845, House Bill 1770, Senate Bill 790, and Senate Bill 886. It should be noted that House Bill 1770 models the PLCB's concept, noted above, except for the fact that it does not subject such direct sales to the eighteen percent

(18%) liquor tax. The actual fiscal impact of these proposals cannot be estimated at this time.

On a separate but related note, in November 2011, the PLCB implemented a "direct delivery" initiative, enabling consumers to purchase select wine and spirits over the internet through the Board's e-commerce store and have the products delivered to their homes or businesses. The decision by the PLCB to begin this home delivery initiative was made after the agency determined the necessary infrastructure was in place to meet the needs of consumers. Additionally, the PLCB implemented safeguards to ensure minors could not gain access to delivered wine and spirits. The PLCB has partnered with United Parcel Service ("UPS") on home and business deliveries. Shipments delivered to homes or businesses require the receiver to provide a valid ID proving that the person is of legal drinking age and requires an adult signature upon receipt.

The goal of the LCB is to provide an added convenience for consumers at the lowest possible cost. Customers ordering between one (1) and three (3) bottles of wine or spirits for home delivery are charged a shipping fee of fourteen dollars ($14), and for every additional bottle a one dollar ($1) charge per bottle is added. These shipping fees cover the PLCB's costs of service and do not provide a profit.

The PLCB respectfully asks that you consider giving the agency the authority to deliver or ship directly to residents and/or licensees of other states. As one (1) of the world's largest purchasers of wine and spirits, the PLCB believes that it can exercise its significant market leverage in other states' markets, representing a significant revenue opportunity for the Commonwealth. While direct delivery within Pennsylvania does not require legislation, a legislative change to section 207 may be prudent to authorize the Board to sell and deliver its products to out-of-state individuals and entities.

While the PLCB believes that direct delivery may yield significant revenue for the Commonwealth, the actual fiscal impact of this initiative cannot be estimated at this time. The agency has, however, identified more than a dozen states where it might be permitted to ship directly to residents and/or licensees, including California, provided that it complies with all state and federal requirements.

Thank you, and I would be happy to take any questions you may have on my testimony or any of the initiatives presented to this Committee.