

**Testimony of
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House Bill 11 – Privatization of Wholesale and Retail Liquor Distribution Before the
House Liquor Control Committee
July 27, 2011**

Chairman Taylor, Chairman Santoni and members of the House Liquor Control Committee, thank you for holding this hearing today to allow me an opportunity to explain the contents and underpinnings of my legislation to privatize the sale of wine and spirits in the Commonwealth, House Bill 11.

Government has many responsibilities – providing a good education, ensuring safe streets, clean air and water. Selling wine and liquor is not one of them, let alone promoting alcohol use.

Government is supposed to serve the people, not serve them alcohol.

Let's sell off Pennsylvania's state stores.

House Bill 11 was drafted with Pennsylvania's conservative views on alcohol in mind; it retains tight regulatory control, strengthens law enforcement, clamps down on underage drinking, and promoting education.

House Bill 11 is a responsible plan; it would privatize wholesale and retail sales of wine and liquor in a consumer-friendly way without taking revenues away from the state budget.

House Bill 11 respects the current state workers.

It was drafted with three guiding principles:

1. Improving the buying experience for consumers.
2. Enhancing the financial value to the Commonwealth.
3. Strengthening public safety through education, enforcement and regulations.

I believe we have succeeded. It is time for the State of Pennsylvania, the government, to get out of the liquor business. It is not about the money, it is about the principle. Business and business opportunities belong to the people.

Divestiture:

The private sector will be given the ability to bid for 1,250 licenses for wine and spirit stores. The bidding process will be handled by the Department of General Services (DGS), as that is the agency already tasked with overseeing the divestiture of state assets. Further, they have no vested interest in maintaining the "status quo," they routinely engage in transactions with public and private interests, and the bulk of the leases for the State Stores are DGS contracts.

DGS would perform all the divestiture work; they would establish the market areas for these new licenses; ensure that the transition is fair and transparent; and oversee the background investigations for these newly licensed businesses.

The transition from a state-run “monopoly” to a private “license” market should take approximately twenty-four months. This time span includes setting up the new rules and establishing market areas. Part of this time includes the transitioning the state’s wholesale operation to private wholesalers who have a contractual relationship with a manufacturer or an importer, to be the wholesaler in all or part of Pennsylvania. Finally during this time, DGS would conduct two separate auctions – one for Class-A retail licenses and one for Class B retail licenses.

Wholesale Divestiture:

Wholesale licensees will be divested prior to the retail auctions to allow continual service to PLCB retail stores as they wind down operations, while at the same time, the wholesalers would build up their operations with existing retail licensees – like bars, restaurants, clubs and public venues.

Through our research, we found in states where wholesalers are licensed, it is typically done based on a contractual relationship with a manufacturer or an importer. We concluded that transitioning from a monopoly structure to licensure for wholesale does not lend itself to an auction process – there are too few bidders; and an auction could increase the cost of wine and spirits at wholesale.

House Bill 11 creates a wholesale structure similar to what can be found in other states. For example, the state of New York has basically three large wholesalers and a couple dozen small ones.

As in the majority of other states, under House Bill 11, manufacturers and importers would contract with an in-state wholesaler to distribute their product line (or portfolio) in Pennsylvania to Pennsylvania retailers. The wholesaler chosen by the manufacturer or importer must be a Pennsylvania resident or a recognized Pennsylvania business organization (e.g. a corporation or an L.L.C.) and must pass a background investigation of their finances, tax status and criminal history. The wholesaler must pay all fees and costs associated with their license prior to being given authority to do business.

In talking with stakeholders, and incorporating what is considered a “best practice,” we allow wholesalers to establish a distribution network which suits their business model; and, impose certain mandates on them.

A wholesale operation must: service and provide delivery of products to retail licensees; have a physical presence (i.e. warehousing facilities) in the Commonwealth approved by DGS and the Board; collect and remit the new “gallonage” tax and the sales taxes imposed on wine and spirits sold in the Commonwealth.

As you know, relationships change. Our legislation allows manufacturers and importers to change wholesale distributors, and vice versa.

Language aimed at preventing any one wholesaler from controlling more than half of the wholesale market is part of our legislation; this will produce a diversity of license holders similar to what has happened in other states – with two or three major wholesalers and any number of smaller ones.

From the biggest player in wholesale distribution all the way down to a niche operator with a contract for wholesaling a limited portfolio – we allow a responsible wholesaler to apply and be licensed. And, by keeping an “open door” approach to wholesaling (i.e. not limiting the number of wholesalers in the state), we ensure that Pennsylvania consumers will be more likely to experience new products and a broader selection than they would under a state monopoly.

Manufacturers and importers which have been shut out of the Pennsylvania market would have a chance to compete.

Wholesalers would be prohibited from engaging in “variable pricing” schemes. Variable pricing is defined as a wholesaler maintaining different price lists for different classes of retail licensee. Of course, retail licensees can benefit from volume discounts. But outside of that, wholesalers must treat all retailers equally.

If a licensee fails to abide by any of the conditions of licensure, they could be sanctioned, which could include revocation of their license. However, a wholesaler can continue to be licensed so long as they abide by the conditions of licensure and renew their license every two years.

As an aside, as you know, currently, the PLCB keeps an approximately \$300 million emergency inventory; each wholesale licensee would be required, as a condition of their license, to re-purchase all marketable product within their portfolio that is owned by the Board and sitting in the three distribution centers.

Also, as a condition of their license, the licensee would be required to pay the transfer fee (based on the value of their portfolio), license fee, the administrative costs of conducting their investigation and the cost to repurchase inventory from the LCB.

V. Retail Divestiture:

The divestiture of the LCB’s retail operations will be more labor intensive as it relates to the privatization effort. Pennsylvania being Pennsylvania, “one-size-fits-all” just would not work. We believe having classifications of licenses and imposing clear ownership restrictions is the best way to create a new Pennsylvania retail liquor system.

a. The License Structure:

Two classes of wine and spirits retail license.

- 750 Class-A licenses would be assigned to specific market areas by DGS based on historic liquor sales and population densities. They would be required to have: at least 15,000 square feet of total retail space and 600 linear feet of shelf space in the area where wine and spirits are sold. These licenses would most likely be bid upon by grocery stores and what some consider “big-box” retailers.
- 500 Class-B licenses would be assigned to individual counties by DGS and the Board based on the same objective standards to ensure adequate and reasonable liquor distribution. These licensees would have less than 15,000 square feet of retail space and would most likely be bid upon by independent operators and beer distributors.

The legislation imposes ownership limitations on these licenses to maximize the diversity in wine and spirits retail operations. Specifically, no *one* entity could hold more than 40 Class-A licenses; or 5 Class-B licenses. We also “drill down” to the county level to ensure diversity by prohibiting a licensee from holding no more than 10 percent of the total licenses in any county.

House Bill 11 prevents the over-saturation of licenses in any area of the Commonwealth. First, by establishing retail zones for Class-A licenses; and then, by prohibiting Class-B licenses from being located too closely together (a Class-B cannot be any closer than a quarter mile from any other wine and spirits retailer).

By creating retail market areas and overlaying niche or independent operators, we also ensure that residents in every corner of the Commonwealth will receive better service and selection than they do on a state run monopoly.

As to Cities of the First Class and the one municipality in this classification, which has a high population concentration within a reasonably small geographic area, under the existing monopoly structure, the Board has fifty-nine locations in which they sell wine and spirits – most of them are typical state stores. One location is a “special” store located *inside* a restaurant in the downtown area (Jose Garces); and there are a handful of “Wine Kiosks.”

House Bill 11 establishes no more than 60 retail zones in a City of the First Class to be auctioned off. We classify them as “A” licenses, but remove the minimum square footage requirements. No Class-B licenses could be located in a City of the First Class.

b. The Auction Process:

House Bill 11 establishes protocols to ensure a fair and transparent process, and consumers should experience no interruption in service.

The auction process starts with the Class-A licenses. All 750 zones would be auctioned off at one time. DGS and the Board are tasked with establishing 750 retail

market areas – 60 in a City of the First Class and the remaining 690 throughout the state.

DGS would automatically reject bids that failed to meet the minimum bid (or reserve) amount; they would select the three highest bids for each area and all bidders would receive notice of the three highest bids. Those three highest bidders for each license area would have an opportunity to offer a “best and final” bid (which could be no lower than the original bid). The winner for each market area would be the highest bidder.

Once the auction process for the Class-A licenses is completed, DGS would focus on the Class-B license auction. Because Class-B licenses are assigned on a county-by-county basis, the auction will be conducted for each county, based on the number of “B” licenses assigned.

The Class-B auction results, like the Class-A’s, would be open and transparent. Here, DGS would select the number of bidders for each license that equals twice the total number of licenses for each county. The bidders in the Class-B auction would be given notice and the selected bidders would have an opportunity to make a “best and final” offer. The winners for the licenses would be selected based on high bids for the total licenses in that county.

For example: Suppose that Dauphin County is assigned 5 Class-B licenses by DGS. And, based on the outcome of the auction, 20 bids meet the reserve price. DGS would select the top 10 bidders (twice the total number of licenses for the county) and give them an opportunity to make a “best and final” bid. Once this second round of bidding is completed, the top 5 bidders would be selected.

We also realize that there may be instances where no bidder meets the auction reserve amount in their bid. In such instances, House Bill 11 allows DGS to adjust or remove the minimum bid amount and re-auction the license.

We protect the integrity of the bidding process by establishing civil and criminal penalties for “bid rigging.” Bid rigging is defined in the legislation as “the concerted activity of two or more persons to determine in advance, or attempt to influence, the selected bidder for a wine and spirits retail license.” These sanctions include criminal prosecution for a felony of the third degree; civil penalties and fines; debarment from state contracts; and, loss of all licenses issued under the Liquor Code.

We believe that between the open and transparent nature of the bidding process we establish and the severe penalties for “gaming” the selection of winners, the Commonwealth can be assured that it will receive “fair market value” for these licenses.

The Reserve Price:

There has been a tremendous amount of speculation on how licenses should be valued.

The bill values retail licenses based on net sales (i.e. gross sales minus cost of goods sold and taxes) in the individual counties and pushes that number through a formula to arrive at the reserve price set for each Class-A license and for all Class-B licenses in each county.

There will be a wide range of reserve prices in either class of license. Class-A licenses will probably range in value from about \$100,000 up to \$1,250,000; while the smaller Class-B licenses could have reserve prices as low as \$25,000 or as high \$500,000. The historic sales figures for the local areas, either in a specific market area or in a particular county, and the license density (how many Class A and B licenses are allocated) will dictate the reserve amount.

Many people ask “What will you generate from the sale of these licenses?” And, that’s a difficult question to answer with any particularity. The fact is, until the auction actually happens and the market comes to the table to bid that we will know how much the state will actually make.

Former Governor Rendell said divestiture could be worth \$1.5 billion and current State Treasurer Rob McCord recently placed a value on divestiture of about \$1.7 billion. I personally believe that private industry will jump at the chance to sell wine and spirits in a big way, and, when you include the selling of the current inventory, we can reach as much as \$2 billion.

With that being said, we do a few things in this bill to assure bidders that they should bid with confidence on these new licenses.

First, we fix the total number of retail licenses at 1,250. Next, we allow these licenses to be placed in locations where reasonable people expect retail outlets like these to be placed. We ensure that no one market area can be inundated with licenses.

House Bill 11 allows for a licensee to remain in business so long as they don’t become a “nuisance operator” and continue to provide service to consumers. The bill allows a license to be transferred (i.e. sold to another for its fair value). And, finally, we provide for a five year moratorium on the issuance of any new retail licenses or any statutory changes in wholesale licenses.

Under this last provision, if the state violates the moratorium and creates more wine and spirits retail licenses, it would be obligated to return the amount it collected in the initial transfer of the license.

d. The Investigation Process:

Much like the wholesale license process of investigation, we require selected bidders to undergo an intensive post-selection investigation process. We look into their

backgrounds, their financing, and their criminal history to ensure that the selected bidder is a responsible and suitable licensee. If the selected bidder fails to meet license qualifications or exceeds the restrictions imposed on the number of licenses any one person can hold, DGS would move to the next highest bidder.

We also establish a post-qualification hearing process to allow for public input regarding the selected bidder's qualifications and the locations for these proposed new licensed premises. House Bill 11 requires hearings in six regions in the Commonwealth and requires that the testimony received relating to each proposed licensee be considered in the licensing process.

Selected bidders would be responsible to offset the costs to the Commonwealth for their investigation. And, prior to being granted a license, they must pay the auction price, the licensee fee incorporated in the bill and any of these administrative costs.

VI. The Transition:

As wholesalers come online, they will collect the gallonage tax from manufacturers and importers on the products they sell to licensed retailers. Until the Board fully divests itself of its retail operations, the Board will also buy its products from licensed wholesalers. However, for any liquor purchased by the Board from wholesalers, the Board would have no authority to levy the 18% Johnstown Flood Tax; and would not be permitted to mark-up these same products by more than 25%. This language ensures that consumers are not taxed under both the old and the new taxing structure.

Retail licensees are required to give the Board 30-days notice of when they plan to commence their retail operations. Once the Board receives notice, they would begin the process of winding down their store operations for state stores in that market area. The legislation requires state stores to close within 5 days of the opening of a wine and spirits retail operation in the same market area.

Remaining inventory and other tangible property in the state stores would be auctioned off to wholesale and retail licensees. Any real property no longer needed by the Board shall be disposed of consistent with the requirements of the Administrative Code (relating to surplus lands).

VII. Under a Market Based System:

There are fixed fees and costs built into the existing state monopoly that will not be "fixed" in a market driven distribution system. Currently, for example, the Board imposes an "LMTF fee" of between \$0.50 and \$2.00, depending on the bottle.

Typical 750 ml bottles of wine come in around \$1.30. That's a 13% mark-up on a \$10 bottle of wine at wholesale. Compounded by taxes, the \$1.30 quickly becomes \$1.63, or a 16% impact on the retail cost of that same bottle of wine. We recently found that the board assesses a "Prompt Payment Markup" of 1% to every wholesale cost of

every bottle of wine or spirits. Compounded by taxes and retail mark-up, the “Prompt Pay” cost goes from \$0.10 to \$0.16 on the same \$10 (at wholesale) bottle.

The Board also sets a fixed rate of 30% mark-up on every bottle of wine and spirits, regardless of the type of bottle, its cost or the level of demand. Then the Board assesses an 18% Flood Tax and a 6% sales tax (which causes that 30% mark-up to inflate to an end cost equal to 37.5%). The Board also engages in a practice called “rounding” which effectively adds \$0.06 to the cost of every bottle.

Under HB 11, the market will determine the most efficient manner to get products to retailers. The market will determine what mark-up is appropriate based primarily on demand and competition in the marketplace.

In our research, we found that wholesale mark-ups typically range from 10 to 20%, based on a number of factors – like the agreement between the manufacturer and the wholesaler, the type of product being sold and the volume of product being purchased. Certainly, there are cases where there is no mark-up from the wholesaler; and, others when the wholesale mark-up would exceed 20%. But the extremes are not the norm.

It’s worth noting, too, that causing a disparate wholesale price difference between like-marketed brands of the same wine or spirit would cause a strain in the relationship between a wholesaler and the manufacturer/importer whose products they sell. Manufacturers and importers expect that their products will find their way to market and meet certain price points. When that fails to happen, relationships between manufacturers/importers and their wholesalers dissolve.

Retail mark-ups are going to depend on a number of factors, as well. Such factors include business efficiencies; ability to purchase in volume; and competition among retailers for the sale of the same product. And, any number of variables will directly impact what a retailer will charge in mark-up. Normal retail mark-ups range from 5 to 20%.

In a free market economy, there is no fixed mark-up. But, by allowing for movement of product portfolios from one wholesaler to another; and, by doubling the number of retail outlets in the Commonwealth (at the same time, taking substantial steps to assure diversity in the marketplace), we strongly believe that wholesale and retail mark-ups will be like other license states – within the norms.

VIII. The Gallonage Tax:

Like its predecessor bill, House Bill 11 establishes a “gallonage tax” to replace the revenues generated from the 18% Johnstown Flood Tax. We chose a transition to the gallonage tax because a similar tax is imposed in 26 other states for spirits and 35 other states for wine. The tax rates would range from \$8.25 to \$12 per gallon based on type of liquor and alcohol content.

The gallonage tax is indexed to an inflation rate (the Consumer Price Index for Gross Domestic Products) after the first five (5) years to ensure that we continue to receive the same value that we do today.

This revised legislation ensures that the General Fund is “held harmless” – receiving at least as much revenue as is collected on taxes and “profit.” For the purposes of this legislation, an \$80 million profit is assumed (it should be understood, though, that the LCB’s financial statements clearly show that their actual profit on the sale of wine and spirits is substantially lower than that).

IX. Prevention and Enforcement:

The Board seems to thrive on the notion that only a state employee in a state monopoly system can sell wine or spirits in a responsible manner. The fact that so many states license wine and spirits retailers, yet have lower per capita incidents of alcohol related crime cut away at the underpinnings of the Board’s argument.

There are any number of studies that indicate that moving from a state run monopoly to a market-based license state has no cognizable affect on alcohol related crimes. And, for the last twenty years, these studies have found no correlation between privatization and alcohol related incidents.

A quick look at the Uniform Crime Reports for Pennsylvania and other jurisdictions bears this out – some states have lower alcohol related crime rates than Pennsylvania, some states are higher. Pennsylvania ranks about middle of the pack on this issue. It makes no difference whether it’s a state monopoly or a market driven system.

While doing our research, we were surprised to find that the LCB state stores have absolutely no outside verification of the job they do in preventing sales of alcohol to minors. The 20,000 state licensed bars, restaurants and beer distributors are all subject to “Age Compliance Checks” with undercover LCE officers. There are no similar checks being done at the state stores, leaving them to police themselves.

We spoke to a number of academicians and healthcare providers over the last year and found that alcohol-related incidents had virtually nothing to do with who sells the bottle of liquor. The keys to public protection from the ills of underage drinking, binge drinking, DUI and alcohol-related crime have to do with enforcement, proper regulation and education.

House Bill 11 responds by:

- Requiring people who sell alcohol be at least 21 years old.
- Requiring Responsible Alcohol Management Program (RAMP) training for managers and employees of wine and spirits retail licensees.
- Requiring wine and spirits be sold in a controlled area, capable of being secured during hours when liquor sales are not permitted.
- Requiring “swipe card” technology to verify the purchaser’s age.

Under this legislation, we will subject wine and spirits retailers to “Age Compliance Checks” just like every other liquor licensee in the state.

In simplest terms, enforcement will be stronger under HB 11 than it is under the current state monopoly. And frankly, selling the state stores will allow the PLCB to devote its energies to enforcement, education and compliance – rather than selling the stuff. Having the government do what it is supposed to do, will help the agency just do better.

Sales.

The plain fact is that the Pennsylvania monopoly sells fewer gallons of wine and spirits per capita than most states.

According to the Distilled Spirits Council of the U.S. (DISCUS), when it comes to per capita sales of wine and spirits, Pennsylvania routinely ranks below the majority of eight jurisdictions in this region (NY, NJ, PA, MD, OH, VA, WV, DC).

We place 6th in the region in per capita spirit sales, ahead of only Ohio and WV. Pennsylvania is 7th in the region in per capita wine sales, ahead of only WV.

These statistics make a compelling argument . . . for “border bleed.” The fact that residents routinely travel to NJ, DE, NY and MD to buy their wine and spirits is the worst kept secret in the Pennsylvania. Anyone who lives in the southeastern part of the Commonwealth need only drive 10 miles across the PA/DE boarder and sit in a certain Delaware wine and spirits retailer’s parking lot. The vast majority of cars in the lot have Pennsylvania plates.

So, “consumption” rates translate to a less-than-satisfactory buying experience in Pennsylvania – so much so, that we lose anywhere from 15 to 22% of our wine and spirits sales to neighboring states.

The Board realizes this fact. LCB Chairman Stapleton was on a WHTM, Harrisburg television news interview recently, stating that the Board needed to spend millions of dollars in advertising costs to convince Pennsylvanians to purchase their wine and spirits in from the Commonwealth.

The Board’s solution thus far has been to place Wine Kiosks in grocery stores. With their limited selection, questionable functionality and Orwellian nature, Pennsylvanians have soundly rejected what Ed Cloonan, Information Director for the Independent State Stores Union (ISSU) calls “*a Rube Goldberg-like contraption.*”

Our solution is for big government to stop pretending to be the free market. Privatization allows private industry to do what it does best – serve the consumer. We can do it responsibly, in a manner that puts the consumer first while still maintaining the public safety.

X. Displaced Employees:

We clearly have an obligation to help former PLCB employees find new jobs. Current PLCB employees must be treated fairly and respectfully once the Commonwealth divests itself of its wine and spirits operations.

House Bill 11 provides a range of services to displaced workers as the state transitions to a private-run system: tax credits, tuition assistance and/or civil service preference.

When looking for a job, these former PLCB employees can offer more than their work experience and skills, they will also have a tax credit... who else has that?

Anecdotally, I must tell you that I have gotten many e-mails and more phone calls than I can count from store employees and managers who cannot wait for the system to be privatized. Invariably, they tell me how dissatisfied they are with their current work situation and how much better off they would be under a private system.

XI. Conclusion:

By an overwhelming margin, Pennsylvanians want the state out of the liquor business. House Bill 11 will get state government out of the business of selling alcohol, while enhancing its role in enforcement, education and regulation.

The bill provides a practical roadmap to transition from the current state monopoly to a market-driven model – giving consumers, whether a business or individual the freedom to choose where and what they buy.

Our proposal will yield tremendous up-front revenue from the sale of wholesale licenses and the auction of retail licenses. It ensures a continued positive effect on the state's General Fund. Most importantly, Mr. Chairman, Pennsylvania consumers will finally find the selection, convenience and pricing that they routinely leave the state to experience.

Mr. Chairman, I am prepared to answer any question that you or members of your committee may have at this time.