JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION
Fiscal Impact Review
2011 Session

Bill Number: SB 1417
Review Requested By: Senator Puller

JLARC Staff Fiscal Estimates

JLARC staff concur that SB 1417 could generate at least $200 million in one-time revenues from auctioning retail licenses to sell distilled spirits and closing the existing State ABC stores. Generating the estimated revenue would require an average bid of $200,000 per license, assuming 1,000 licenses are issued. This revenue estimate appears feasible since the bill provides that licenses would be "in perpetuity" and could be re-sold by the winning bidders, and in FY 2010, ABC stores generated on average a net one-year profit of $461,000, with 24 stores in 15 localities having net profits of more than $1 million. A consultant retained by the Governor to review privatization generated estimates in the $300 million range, but also noted, "it is reasonable to plan on a $100 million variance—either high or low—from the $300 million estimate." Revenues could be reduced if not all licenses are sold or if (as permitted by the bill) the Tier 4 licensees pay their bids over four years. The method of auctioning the licenses (sealed bids versus an open-bid "eBay style" auction, for example) will be critical in maximizing revenue to the State.

Whether SB 1417 would generate the $13 million in annual ongoing revenue to the General Fund is more problematic because it is premised on a five percent increase in sales (by comparison, gallons sold by ABC over the past three years increased an average of 2.3 percent) as well as one-time savings from closing the State stores. The FY 2012 estimate assumes, for example, that 17 State-owned ABC stores would be sold for a total of $16.9 million in that year. With the uncertain real estate market this revenue may not be reliable within the tight timeframe. Ongoing ABC revenues to the General Fund are especially difficult to forecast for the transition period, expected to be in calendar year 2012 (overlapping FYs 2012 and 2013), when State stores are closing and the newly privatized outlets are starting up. No schedule has as yet been established for this transition.

The bill could have other consequences. For example, the consultant's report states their belief that retail prices "will average within one dollar per gallon of the current price," but this is speculative at best. Increased competition may reduce prices to the customer, perhaps increasing sales, although price increases could dampen sales and therefore revenues to the General Fund. Some localities that currently have an ABC store could go without if no bidders emerge (ABC stores in two localities generated less than $1,000 in net profits in FY 2010).

An explanation of the JLARC staff review is included on the following pages.

Authorized for Release:

Glen S. Tittermary
Director

JLARC offers Fiscal Impact Reviews in accordance with Item 30 of Chapter 874 (2010 Acts of Assembly). JLARC Fiscal Impact Reviews do not comment on the merits of the bill under review.

Bill Summary: SB 1417 directs the auction of up to 1,000 licenses for the retail sale of distilled spirits and the closure of the current 332 State-run stores. The bill would require the Department of Alcoholic Beverage Control (ABC) to develop a plan to publicly auction and grant licenses to successful private bidders, with all State-run stores closing by January 1, 2013. According to ABC staff, the new privately-owned retail stores could begin selling distilled spirits during calendar year 2012. Available licenses would be split into four tiers, which would be available to private entities based upon the physical size of their stores, the amount of shelf-space dedicated to distilled spirits, as well as the size of business presence within the Commonwealth. Licenses would be issued on a locality-specific basis, and the total number of licenses in each locality would be limited to one for every 8,000 residents. Under SB 1417, stores could be allowed to sell spirits from 6 a.m. until midnight, seven days a week. ABC would also retain its wholesale and distribution monopoly for distilled spirits. Revenues from the auction of retail licenses would be deposited in the Transportation Trust Fund.

Discussion of Fiscal Implications

Retail License Auction. SB 1417 appears to establish a system-wide reserve price of $200 million in revenue from the auction of all 1,000 retail licenses. Licenses would be made available for each locality at 1 per 8,000 residents, and would be granted in perpetuity to successful bidders. Licenses would be granted in one of four license tiers, as seen in Table 1. SB 1417 would prohibit any single licensee from owning more than 25 percent of available licenses available in any one tier. Unlike licenses for beer and wine retailers, distilled spirits licenses could be transferred and sold by the license holder.

Table 1: Anticipated Distribution and Description of Retail License Tiers Under SB 1417

License Tier	Anticipated Number of Licenses*	Description
Tier One	600	"Big Box Stores," 15,000+ square feet, minimum of 200 linear feet of shelf space for sales of distilled spirits
Tier Two	150	"Beverage Outlets," less than 30,000 square feet, minimum of 200 linear feet for sale of distilled spirits, 70 percent of gross revenues from distilled spirits sales
Tier Three	150	"Large Convenience Stores/Pharmacies," no more than 15,000 square feet, max of 200 linear feet of shelf space for distilled spirits sales
Tier Four	100	"Small Convenience Stores and Wine Shops," less than 3,000 square feet, maximum of 200 linear feet for distilled spirits, less than 50 employees statewide.

*SB 1417 does not specify the number of licenses in each tier. These numbers were used by the Governor's office in describing the previous proposal, and by PFM Group in generating revenue estimates for the bill.

The PFM Group's analysis of ABC privatization options estimated likely revenue from the auction of retail licenses to be greater than $300 million. The consultant's analysis of revenue from license auctions appears to use licensees' expected profits over a 5 to 20 year period (depending upon the size of the licensees' retail operations) to arrive at this estimate. For example, the consultant assumed that the value over 20 years of a perpetual distilled spirits retail license to the 375 largest spirits retailers is approximately $184.1 million (Table 2). The smallest 100 spirits retailers, however, would be expected to place a value of $2.7 million total on their licenses, assuming their time horizon is five years. While it may be the case that retailers of different sizes will amortize the costs of their license bid over different time horizons, the consultant did not provide the basis for choosing the particular assumptions used in its estimates.

Table 2: PFM Group's Estimated Value of Retail Licenses	
	Expected Value of Licenses at Auction
Largest 375 High-Volume Retailers @ 20 years	$184,146,941
Next Largest 200 High-Volume Retailers @ 15 years	73,658,776
Smallest 175 High-Volume Retailers @ 10 years	42,967,620
Largest 150 low-Volume Retailers @ 10 years	8,124,130
Smallest 100 Low-Volume Retailers @ 5 Years	2,708,043
Total	**$311,605,510**

PFM also noted, "it is reasonable to plan on a $100 million variance—either high or low—from the $300 million estimate." This may explain why SB 1417 references (in lines 21-22) the "guaranteed receipt" of "no less than $200 million in payments by successful bidders."

The bill thus establishes a system-wide reserve of $200 million in revenue from the auction of retail licenses, but there are no provisions for ABC to continue operating State stores if the $200 million threshold is not reached or if no bids are submitted in localities currently served by a State store. The bill does not authorize ABC to deny licenses to winning bidders, other than for failed background checks. Further legislation may be required should any of these outcomes occur.

SB 1417 provides 280 days for ABC to design a process for auction of retail licenses. The bill does not specify a design for this process. Administration staff indicate an open-bid "eBay style" auction may be used. Other methods, such as a sealed bid auction, may be more likely to maximize revenue to the State. ABC staff have not estimated the costs of contracting to create and implement the bidding process; however, the bill appears to stipulate that such costs would be covered through auction revenues. ABC staff anticipate multiple auction rounds will be necessary to obtain bids for all licenses.

SB 1417 indicates no reserve prices for individual licenses. It would theoretically be possible for a license to be sold for as little as $1 so long as aggregate revenue from license auction meets the $200 million threshold.

The bill would allow Tier 4 licensees to satisfy their bid payment to ABC over a period of 48 months. To the extent bidders exercise this option, first-year revenues will be reduced and subsequent-year revenues will be increased. In advance of the auction, there may be no way to know the extent of the first-year revenue reduction.

According to ABC staff, closure of retail operations could result in one-time Workforce Transition Act (WTA) costs of up to $28 million due to layoffs of staff at State-run retail stores. Under SB 1417, any WTA-related costs would be covered through the proceeds of the auction of retail licenses, reducing the net proceeds of the auction.

Revenues from the auction of retail licenses would be deposited in the Transportation Trust Fund.

<u>Ongoing Revenues.</u> The PFM Group estimated that SB 1417 would result in $12.8 million in FY 2012 and $13.2 million in FY 2013 in net new revenue to the Commonwealth. This increase is attributable to eliminating ABC's costs of running retail stores, information technology savings, and a five percent increase in gross sales of distilled spirits. The consultant's report compares estimated FY 2012 and FY 2013 revenues and expenditures under a privatized retail system to expected FY 2011 ABC sales. In an interview with legislative staff, the consultants indicated that revenues received in the transition years of FY 2012 and FY 2013 depend on many factors and that estimates for these years are uncertain.

According to the consultants' estimates, the anticipated FY 2012 surplus under SB 1417 depends primarily upon a reduction in the cost of ABC operations, as well as the ability of ABC to sell its real property assets within the fiscal year. The consultant estimates that the costs of ABC operations would decline by $34.1 million in FY 2012; this is primarily attributable to an estimated savings of $31.1 million as ABC's retail operation is phased out through the course of the year, as well as information technology savings. ABC's ability to achieve these savings hinges on detailed transition planning which has not been done, so these amounts are speculative.

Also included in the FY 2012 revenue estimate is the sale of ABC real property assets at their assessed value of $16.9 million. With the uncertainties of the real estate market and the question of whether the State would get the best price when selling under a tight deadline to generate revenue, the estimate may be somewhat higher than could reasonably be expected, and it could be spread over two or more fiscal years.

The primary factor in the expected surplus increase of $13.2 million in FY 2013 is savings related to ABC no longer operating retail establishments. According to the consultant's report, closure of all ABC retail outlets will result in $85.3 million in savings compared to the FY 2011 baseline. The Appropriation Act however provides $86.3 million for FY 2011 store operations. Other expected savings include $7.6 million related to information technology savings due to closing retail operations.

The consultant estimates that gross sales will increase by approximately 5.1 percent in FY 2013 after retail privatization efforts fully implemented. The consultant's report lists three main factors to support this forecast. First, the consultant claims that tripling the number of retail outlets offering distilled spirits will drive "convenience sales." Next, the report notes that for five percent statewide gross sales growth to occur, Northern Virginia stores must experience "a significant amount of repatriation from sales in Maryland and Washington, DC." Finally, the consultant assumes that per capita consumption levels in Northern Virginia would increase, moving halfway to the national average rate of distilled spirits consumption.

Using data from the consultant's report, JLARC staff estimate that FY 2013 revenues could be reduced to $9.2 million if no growth in gross sales occurs following retail privatization. This would reduce the expected increase in on-going revenues from $13.2 million to $9.3 million.

SB 1417 would reduce from 69 percent to 50 percent the wholesale markup assessed by ABC, and would preclude ABC from increasing the wholesale markup until July 1, 2014. This action would reduce revenues to the State, although the PFM Group assumed the decline would be partly offset by higher sales. According to the PFM Group report, the decreased markup was intended to allow for a private retail markup averaging 15.1 percent in order to keep average retail prices in a privatized retail environment as close to current prices as possible. This private markup is speculative and could be higher or lower.

SB 1417 would establish annual distilled spirits license fees, which may raise $2.825 million per year to pay for an additional 22 ABC enforcement officers. According to ABC staff, the additional officers will increase expenditures approximately $1.7 million per year. If not all licenses are sold, actual revenue from license fees could be less than the cost of the additional enforcement officers.

<u>Wholesale.</u> SB 1417 stipulates that ABC would retain its unique authority to wholesale and distribute distilled spirits in Virginia. ABC staff anticipate that under SB 1417 the costs of the Department's wholesale operations would increase by approximately $5.6 million per year. Due to the tripling of retail outlets, ABC expects its distribution contract with a trucking firm would

double in cost. ABC would also be required to add a second shift for warehouse personnel to keep pace with the increased demands of distribution under the private licensee model.

Budget Amendment Necessary: Amendments would be necessary for FYs 2012 and FY 2013 to account for the receipt of revenues from auctioning retail licenses and the expected changes in ongoing revenues.

Agencies Affected: Department of Alcoholic Beverage Control, Department of Transportation.
Date Released: 1/28/2011
Prepared By: David Reynolds, Walt Smiley.