

Fiscal Impact Review

2018 General Assembly Session

Date: February 21, 2018

Bill number: HB 536 (Introduced) Alcoholic beverage control; disposition of markup profits

Review requested by: Chairman Jones, House Appropriations Committee

JLARC Staff Fiscal Estimates

JLARC staff concur with the reduction in revenue estimated in the fiscal impact statement prepared by the Department of Planning and Budget (DPB) for FY19 and FY20, but estimate a smaller revenue reduction in later years. HB 536 would allow distillery stores to retain the markup imposed on distilled spirits by the Alcoholic Beverage Control Board. This markup is currently retained by the state. JLARC staff agree with the DPB estimate that HB 536 would result in a revenue reduction of approximately \$1.7 million and \$2.3 million (general funds) in FY19 and FY20, respectively. However, JLARC staff estimate a smaller revenue reduction of approximately \$2.7 million in FY21 and \$3.3 million in FY22. Growth in distillery store sales could increase at a faster rate than either the DPB and JLARC staff estimates assume. In that case, a larger amount of revenue would be forgone by the state.

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

Authorized for release:



Hal E. Greer, Director

Attachment

Bill summary

HB 536 would allow distilleries with stores on their licensed premises to retain the markup imposed by the Alcoholic Beverage Control Board (ABC) on distilled spirits (such as gin, whiskey, brandy, and rum) sold pursuant to § 4.1-235 A.2 of the Code of Virginia.

Fiscal implications

HB 536 would result in a reduction in general fund revenue because Virginia ABC would no longer retain any of the profits resulting from markups at distillery stores. JLARC staff concur with the reduction in revenue estimated in the DPB fiscal impact statement for FY19 and FY20, but estimate a lower revenue reduction for FY21 and FY22.

The difference between the JLARC staff estimate and the DPB estimate is due to differing assumptions about the growth of distillery store sales. (The analyses to develop both estimates assume that historical growth in distillery store sales will predict future growth rates.) The DPB fiscal impact statement assumes that distillery store sales would grow at a rate of 37 percent per year between FY19 and FY22. JLARC staff assume a slower growth that will be 32 percent in FY19 but will decline to 23 percent in FY22. The JLARC estimates of revenue loss are similar to the DPB estimates for FY19 and FY20, but the JLARC estimates are lower for FY21 and FY22.

It is important to note that growth in distillery stores sales would likely increase if HB 536 were adopted. This growth, however, is difficult to quantify and is not reflected in the JLARC staff estimates. Owners of several distillery stores indicate that the stores have not earned a profit and have no incentive to expand their store business. Allowing them to retain the markup would make distillery stores more profitable and allow them to expand their sales. In that case, sales growth could exceed the growth rates estimated by both DPB and JLARC staff, and result in larger amount of revenue forgone by the state. This would be partly offset by an increase in revenues from excise tax, sales tax, and income tax collections.

Under current law, Virginia ABC retains most of the markup from sales at distillery stores

Virginia ABC is authorized by the General Assembly to control the sale of distilled spirits. In Virginia, distilled spirits must be sold in a retail store operated by Virginia ABC or a store on the premises of a licensed distillery. Distilleries are required to enter into a contractual agreement with Virginia ABC to operate the distillery store.

Virginia ABC is required by statute to include a reasonable markup on the price of distilled spirits and other alcohol purchased by persons other than wholesalers, whether sold in

ABC stores or distillery stores. The markup provides the “profits” that Virginia ABC uses to cover its operating expenses and meet the profit requirement for the state general fund. Currently, Virginia ABC imposes the following markups on distilled spirits:

- \$2 handling charge per case of distilled spirits,
- A markup (generally 69 percent but varies by size of bottle and “proof,” or alcohol content) on the wholesale price,
- Rounding of price per bottle up to the nearest \$0.05 or \$0.09.

In addition to these markups, Virginia ABC includes the statutory excise tax on distilled spirits (20 percent) in the price of each bottle.

Under current law, Virginia ABC retains most of the markup from sales at distillery stores. Virginia ABC reimburses the distillery stores the case handling fee (\$2) and a commission (currently eight percent of sales) according to policy approved by the ABC board. Virginia distillery stores had \$3.9 million in gross sales in FY17. The gross profit to Virginia ABC because of the markup was approximately \$1.3 million. Of this profit, Virginia ABC retained approximately \$1 million and reimbursed the distillery stores \$32,680 in case handling fees and \$298,441 in commissions.

HB 536 would allow Virginia distillery stores to retain the markup that is currently retained by Virginia ABC. Virginia ABC staff indicated that the assumption is the ABC board would discontinue the current reimbursement policy because the stores would receive all profits from the markup.

JLARC staff estimate a lower revenue reduction between FY19 and FY22 due to slower assumed rate of growth in sales at distillery stores

JLARC staff estimate a slower rate of growth in sales at distillery stores than is estimated in the DPB fiscal impact statement. The rates of growth assumed by JLARC staff in FY19 and FY20 result in similar revenue losses as DPB for those years. However, the lower sales growth rate estimated by JLARC staff for FY21 and FY22 lead to a lower estimated revenue reductions compared to DPB. JLARC staff estimate revenue reductions of approximately \$2.7 million and \$3.3 million, in FY21 and FY22 respectively. If the growth in annual sales of distillery stores is less than the growth reported by DPB, there would also be a reduction in excise tax collections from distillery store sales.

TABLE 1

JLARC staff estimate the revenue reduction resulting from HB 536 would be less than estimated by DPB for FY21 and FY22

	Growth rate		Revenue reduction	
	DPB estimate	JLARC estimate	DPB estimate	JLARC estimate
FY19	37%	32%	\$1.7M	\$1.6M
FY20	37	31	2.3	2.1
FY21	37	29	3.2	2.7
FY22	37	23	4.3	3.3

SOURCE: JLARC analysis of information provided by ABC.

NOTE: Gross sales excludes revenue collected from the general retail sales and use tax. Estimates assume the markups and excise tax rates remain the same. Estimates assume that HB 536 would not affect growth and that future growth in sales reflects past trends.

JLARC staff estimates assume that (1) the annual growth rate of distillery store sales would gradually decline; (2) the ABC board would maintain the current markup structure; and (3) future growth in sales for distillery stores reflect past trends. (See attachment for methodology used to estimate growth rate of distillery store sales.)

Several factors suggest that distillery store sales may begin to grow at a slower rate after FY17 than the 37 percent estimated by DPB. Growth in distillery store sales between FY12 and FY17 are mainly from the opening of new distillery stores since FY15 that have experienced very high growth rates between their first and second years of sales. Distillery stores that first reported sales in FY15 or FY16 experienced sales growth of 50 to 54 percent on average, between their first and second years of sales.

While much of the growth in sales has been from new stores, this trend may not continue. At least seven new distillery stores opened and had sales each year between FY15 and FY17. However, total and average sales by new stores has declined over time (Table 2). As a result, new stores are contributing less to total sales and sales growth each year.

Annual sales in existing stores have also slowed, which may contribute to declining overall growth rates in distillery store sales. Distillery stores that were open prior to FY15 experienced sales growth of 65 percent between FY12 and FY13, on average, but sales growth of only four percent between FY16 and FY17 (Table 3).

TABLE 2

Total and average sales by new distillery stores have declined in recent years

	FY15	FY16	FY17	FY18
Number of new distillery stores	7	7	8	13
Sales, new stores	\$389,623	\$373,859	\$317,391	\$334,657
Average sales per store, new stores	\$55,660	\$53,408	\$39,674	\$25,743
Sales, new stores as a % of total sales	25%	13%	8%	6%

SOURCE: JLARC analysis of ABC annual reports (FY15-FY17) and sales for July through January of FY18.

NOTE: Sales excludes revenue collected from the general retail sales and use tax. ABC reports nine stores opening in FY17, but one store is excluded here because it reported no sales. FY18 sales are annualized.

TABLE 3

Annual sales growth at existing distillery stores have receded over time

	Average growth in annual sales				
	FY12-FY13	FY13-FY14	FY14-FY15	FY15-FY16	FY16-FY17
Stores opened prior to FY15	65%	34%	24%	13%	4%

SOURCE: JLARC analysis of ABC annual reports (FY10-FY17).

NOTE: Ten stores had opened prior to FY15 and are included in the analysis.

Interviews with representatives of distillery stores also suggest that, under current law, growth rates may decline for sales in distillery stores. Several distillery owners indicated that they were not actively trying to increase their distillery store sales because the stores have not earned a profit. At least one distillery with a store is actively looking to expand operations in another state where laws governing the sale of distilled spirits have become less stringent because the distillery store in Virginia has not earned a profit. Stakeholders also indicate that other distillery stores are on the verge of closing.

Budget amendment necessary? Yes

Agencies affected: Alcoholic Beverage Control Board and Department of Alcoholic Beverage Control

Prepared by: Ellen Miller

Date: February 21, 2018

ATTACHMENT

Methodology used for JLARC analysis

JLARC staff estimated the growth rate of distillery store sales between FY19 and FY22 using a different methodology than DPB. DPB estimated future growth rates by calculating the average annual rate of growth in store sales between FY12 and FY17 (Table A-1). FY17 sales were increased by 37 percent to obtain estimated sales in FY18. FY18 sales were then increased by 37 percent to obtain estimated sales in FY19. This step was repeated each year until FY22 estimates sales were obtained.

TABLE A-1

DPB calculated the average annual rate of growth in distillery store sales between FY12 and FY17 to estimate future growth in sales

	Actual sales	Change in sales from prior year (growth rate)
FY12	\$830,058	
FY13	1,127,396	36%
FY14	1,522,885	35
FY15	2,412,198	58
FY16	2,813,128	17
FY17	3,866,430	37
Average change in sales: 37%		

SOURCE: JLARC analysis of information provided by Virginia ABC.

JLARC staff used a different methodology to account for the fact that stores were experiencing different trends in their sales from year to year.

First, JLARC staff realigned annual sales data from a *fiscal year* basis to a *year-of-operation* basis. For example, if a distillery store opened in FY15 and had sales of \$10,000 in FY15, \$15,000 in FY16, and \$20,000 in FY17 then its sales were realigned so that it had \$10,000 in sales in year 1, \$15,000 in sales in year 2, and \$20,000 in sales in year 3 (Table A-2).

Next JLARC staff calculated the average and median growth in sales between years of operation (year 1 to year 2, year 2 to year 3, etc.) across distillery stores, and used the median growth rates in the analysis to estimate future sales by distillery store. The average and median rates were very similar between most years of operation except in a few instances with extreme outliers.

TABLE A-2

Sales for each distillery store were realigned from a fiscal year to year-of-operation basis

Fiscal year basis				
	FY14	FY15	FY16	FY17
Distillery store A		\$10,000	\$15,000	\$20,000
Distillery store B				30,000
Year-of-operation basis				
	Year 1	Year 2	Year 3	Year 4
Distillery store A	\$10,000	\$15,000	\$20,000	
Distillery store B	30,000			

SOURCE: JLARC analysis of information provided by Virginia ABC.

The remainder of the analysis was divided into two separate analyses to estimate the (1) sales for existing stores as of FY17 and (2) sales for new stores opening in FY18 and after. The estimates from each analyses were summed to obtain the total estimated sales of distillery stores between FY18 and FY22.

Existing stores: growth of sales between FY17 and FY22

JLARC staff estimated future growth in sales for each existing distillery store by identifying the number of years in operation as of FY17 and applying the appropriate growth rate to FY17 sales to obtain the FY18 sales amount. This step was repeated to obtain the sales amount through FY22 for each distillery store. For example, distillery store A had been in operation for three years in FY17 (Table A-2). The median growth rate between years 3 and 4 (21 percent) was applied to the FY17 sales (\$20,000) of distillery store A to obtain the estimated sales for FY18 (\$24,000) (Table A-3).

TABLE A-3

Method for estimating the future sales of existing distillery stores

	Years of operation in FY17	Sales FY17	Growth rate FY17-FY18	Sales FY18	Growth rate FY18-FY19	Sales FY19
Distillery store A	3	\$20,000	21%	\$24,000	8%	\$25,920
Distillery store B	1	30,000	166	79,800	22	97,356

SOURCE: JLARC analysis of information provided by Virginia ABC.

NOTE: Median growth rates between years: Year 1 and 2 = 166%; Years 2 and 3 = 22%; Years 3 and 4 = 21%; Years 4 and 5 = 8%; Years 5 and 6 = 28%; and years 6 and 7 = -13%.

The method described above and illustrated in Table A-3 was used for all but a few distillery stores that had been open for multiple years prior to FY17. The average growth rate for each of these stores in the past five fiscal years was used to calculate future sales for each year instead.

Total sales by existing stores was estimated to be \$5.5 million in FY19 and \$8.3 million in FY22 (Table A-4).

TABLE A-4
Estimated sales of existing distillery stores between FY18 and FY22

	FY18	FY19	FY20	FY21	FY22
Existing stores as of FY17	\$4.8M	\$5.5M	\$6.3M	\$7.4M	\$8.3M

SOURCE: JLARC analysis of information provided by Virginia ABC.

NOTE: Assumes none of these stores close between FY18 and FY22.

New stores: growth of sales between FY17 and FY22

In order to estimate the growth of sales of new distillery stores, the number of new stores that would open after FY17, and their sales, had to be estimated. JLARC staff estimated the total sales of new stores in FY18 by annualizing sales data of new stores provided by Virginia ABC for July through January of FY18 (Table A-5). JLARC staff estimated the total sales of new stores between FY19 and FY22 based on the average number of new stores per year and the average sales per store of new distillery stores between FY15 and FY18.

A similar method as used in Table A-3 was applied to the estimated total sales of new distillery stores (Table A-5) to estimate the total sales between FY18 and FY22 of all new stores that opened after FY17 (Table A-6). For example, the sales of stores that opened in FY18 was multiplied by the median growth rate in sales between year 1 and year 2 of operation to obtain their estimated sales in FY19.

TABLE A-5
Estimated number of new distillery stores per year and their average sales, FY18-FY22

	Number of new distillery stores	Average sales of new distillery stores	Total sales of new distillery stores
FY18	13.0	\$25,742	\$334,657
FY19-FY22	8.8	43,621	381,687

SOURCE: JLARC analysis of ABC Annual Reports (FY15-FY17) and information provided by Virginia ABC.

NOTE: ABC reports nine stores opening in FY17, but one store is excluded from the FY17 number because it reported no sales.

TABLE A-6
Estimated future sales of new distillery stores between FY18 and FY22

Year stores opened	Sales FY18	Sales FY19	Sales FY20	Sales FY21	Sales FY22
FY18	\$0.3M	\$0.9M	\$1.1M	\$1.3M	\$1.4M
FY19		0.4	1.0	1.2	1.5M
FY20			0.4	1.0	1.2
FY21				0.4	1.0
FY22					0.4
Total	\$0.3M	\$1.3M	\$2.5M	\$3.9M	\$5.5M

SOURCE: JLARC analysis of information provided by Virginia ABC.

NOTE: Median growth rates between years: Year 1 and 2 = 166%; Years 2 and 3 = 22%; Years 3 and 4 = 21%; Years 4 and 5 = 8%; Years 5 and 6 = 28%; and years 6 and 7 = -13%.