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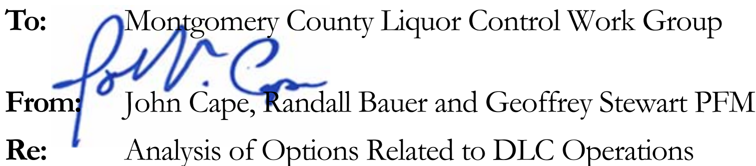
November 14, 2016

Memorandum

To: Montgomery County Liquor Control Work Group



From: John Cape, Randall Bauer and Geoffrey Stewart PFM

Re: Analysis of Options Related to DLC Operations

Background

The structure of control of alcoholic beverages in the United States goes back to the repeal of Prohibition in 1933, which left it to each state to decide how to regulate their reborn alcohol businesses. Most jurisdictions became "licensed states," where wholesalers and retailers were granted licenses to buy and sell alcoholic beverages. However, a minority of states chose to maintain larger degrees of control over the wholesale and/or retail system. Eight decades later, 17 states remain "control states," meaning that the state government controls some or all aspects of wholesale distribution and retail sales of beer, wine and/or distilled spirits. While the State of Maryland is considered a licensee state, it gives local governments the option of imposing regulatory controls over the system. As a result, Montgomery County is one of the few local governments in the US to operate on the control model. Besides its monopoly on distribution, the County owns 25 liquor stores that are the only places to buy distilled spirits for off-premise consumption.

The US Census Bureau reports that Montgomery County accounts for 11 percent of the Washington area's bars and restaurants. But measured by alcohol sales per resident, the county underperforms by 20 percent, with $789 sales per capita versus $989 in the region as a whole. Moreover, the County's bars and restaurants employ 23 percent fewer workers, as a percentage of its population.

Issues related to the County's Department of Liquor Control (DLC), its alcohol distribution to restaurants and retail beer and wine stores, and its operation of stores that sell beer, wine and spirits have long been a subject of debate in the County. In recent years, concerns about access, service, selection and price have prompted a renewed examination of the role of the DLC. In 2015, the Montgomery County Council established an Ad Hoc Committee on Liquor Control to examine alternatives to the current DLC system. Also in 2016, there were state legislative proposals for changes to DLC and for a referendum on privatization. While no action was taken in the Maryland General Assembly, County Executive Isiah Leggett appointed a DLC Privatization Work Group to evaluate different models of liquor control, distribution, and wholesale and retail operations. The

County Executive identified two clear evaluation criteria: any option would have to be fiscally neutral and not negatively impact the existing liquor revenue bonds.
On August 24, 2016 Public Financial Management was retained to assist the County in the analysis of a variety of identified options for reform of the County's control of alcoholic beverages. During the initial phase of engagement, PFM's primary focus was on answering two fundamental questions related to the options under consideration by the Work Group: (a) is the option fiscally neutral to the County's finances, and if not what steps could be taken to make it neutral; and (b) what impact, if any, would implementation of the option have on the outstanding bonds supported by DLC revenue.

This memo was first drafted for presentation to the Working Group to provide additional data and information pursuant to its discussion at their meeting on September 15, 2016. The memo was updated to provide additional analysis on a sixth option (use of Agency Stores) and to provide additional information and analysis where needed as a result of feedback from and after the Working Group meeting.

Working Group Options

The Working Group has identified a series of options, which formed the basis for the preliminary review by PFM. These options include:

1. Privatize wholesale distribution of:
    a. All products to on-premise establishments
    b. Beer and wine to both on and off-premise establishments
    c. Beer only to both on and off-premise establishments
    d. Special-order beer and wine to both on and off-premise establishments
2. Private management
    a. Private-management contract
    b. Maine-model P3 contract
3. Establish a County liquor authority
4. Full privatization (license jurisdiction)

In addition, based on PFM's prior experience working with liquor control jurisdictions, an additional option was proposed, which is also analyzed:

5. Bailment approach for warehouse

In addition, after discussion at the Working Group meeting, PFM was directed to provide a similar level of analysis for an additional option:

6. Augment DLC retail stores with limited agency stores

Methodology

The Department of Liquor Control (DLC) and the County Office of Management and Budget have provided PFM with a broad range of data, including:

- Structure of product pricing,
- DLC operational and administrative revenues and expenses,
- Performance data on inventory, sales and profitability,
- Cashflow metrics, and
- Structure of payments in support of debt service and transfers to the County treasury.

Using this data as a starting point, PFM created Microsoft Excel models to organize and analyze the data to estimate (to the extent possible) the fiscal impact for each option analyzed. To do so, PFM created a baseline profile of existing revenues and expenditures and then applied a series of specific analytical adjustments that quantify how the financial base will be impacted by the option. The specific assumptions and resulting analytical adjustments are described in the data and analysis sections for each option under discussion.

It should be noted that PFM used actual revenue and expense data for the analysis; it is understood that the current DLC leadership is engaged in implementing system changes that will impact on both the revenue and expenditure side of the existing financial statements. However, the nature and impact of these changes is difficult to assess given the range of possible results (and the timing of those changes).

Additionally, PFM financial advisors reviewed the existing liquor bond official statements, bond covenants and other documentation and reviewed the impact analysis for each option with respect to whether the option will negatively impact the existing liquor revenue bonds.

Finally, should the option not be revenue neutral and/or negatively impact the existing liquor bonds, PFM provided input on the types of actions that could be taken to make the option revenue neutral or not impact on the liquor revenue bonds, as well as a brief discussion of policy and market implications of these actions.

DLC fiscal profile

The following table shows the relevant data for the sales of alcoholic beverage product during the fiscal year ending June 30, 2016. **This and the following tables are based on preliminary, unaudited financial data and is subject to change.**[1]

[1] The project team used average markup data and sales allocations to make revenue estimates. Actual results may vary from this analysis.

Montgomery County DLC Product Pricing Structure DLC Fiscal Year Ending 2016- Preliminary Unaudited: Subject to Change											
	DLC Stores			Off-Premise			On-Premise			Other[1]	
Price Component	Spirits	Wine	Beer	Spirits	Wine	Beer	Spirits	Wine	Beer		TOTALS
Cost of Goods Sold (COGS)	$54,682,237	$32,282,291	$5,584,258	$205,977	$31,782,975	$51,502,255	$9,633,608	$13,922,047	$12,909,062	$491,484	$212,996,194
State Alcohol Tax	$1,440,964	$438,395	$18,520	$6,658	$472,091	$233,139	$274,721	$155,462	$39,630	-	$3,079,580
Freight	$543,928	$1,011,918	$88,082	$2,230	$802,069	$1,291,000	$86,421	$225,840	$177,981	$18,164	$4,247,632
Total Laid-In Cost @ Warehouse	**$56,667,129**	**$33,732,604**	**$5,690,860**	**$214,865**	**$33,057,134**	**$53,026,394**	**$9,994,751**	**$14,303,348**	**$13,126,673**	**$509,648**	**$220,323,407**
Wholesale Mark-up[2]	$14,635,817	$6,846,613	$1,411,186	$77,104	$7,606,223	$14,432,432	$2,809,319	$3,453,544	$7,324,398	$2,534,182	$61,130,817
Total Wholesale Sales	**$71,302,946**	**$40,579,217**	**$7,102,046**	**$291,969**	**$40,663,357**	**$67,458,826**	**$12,804,070**	**$17,756,892**	**$20,451,071**	**$3,043,829**	**$281,454,224**
Retail Mark-up[3]	$8,740,102	$12,338,810	$631,898	-	-	-	-	-	-	-	$21,710,810
Total Gross Sales	**$80,043,049**	**$52,918,027**	**$7,733,943**	**$291,969**	**$40,663,357**	**$67,458,826**	**$12,804,070**	**$17,756,892**	**$20,451,071**	**$3,043,829**	**$303,165,034**
State Sales Tax[4]	$7,203,874	$4,762,622	$696,055	-	-	-	-	-	-	-	$12,662,552
Total Gross Sales + State Sales Tax	**$87,246,923**	**$57,680,649**	**$8,429,998**	**$291,969**	**$40,663,357**	**$67,458,826**	**$12,804,070**	**$17,756,892**	**$20,451,071**	**$3,043,829**	**$315,827,586**

Assumptions

1. Other includes: Store supply, dunnage, non-alcoholic beverages, and other uncategorized sales
2. Average spirits wholesale markup is estimated at 27.4%, Average wine wholesale markup is estimated at 23.4%, Average beer wholesale markup is estimated at 25.9%
3. Average spirits retail markup is estimated at 13.8%, Average wine retail markup is estimated at 33.5%, Average retail beer markup is estimated at 10.0%
4. State sales tax is 9% and is remitted to State
5. Licensee sales made at DLC stores were estimated (approximately 10%) and allocated to off premise and on premise totals

For Fiscal Year 2016, DLC reported a total gross profit from alcohol sales of about $82.8 million, including:

- Gross profit from wholesale markups that averaged about 27.7%, yielding $61.1 million
- Gross profit from retail markups that averaged approximately 18.3%, or $21.7 million

The following table shows the relevant revenue data for DLC:

Revenue	Total ($)
Alcohol Sales	$82,841,627
Liquor Licenses	$1,805,302
Other Fines/Forfeitures	$194,402
Other Licenses/Permits	$88,220
Investment Income	$30,700
Misc. Revenues	$54,221
Other Charges/Fees	$19,220

Total	**$85,033,692**

For Fiscal Year 2016 revenues, DLC reported:

- Total revenue from all sources of more than $85.0 million
- Revenue from alcohol sales accounted for 97.4% of total revenue ($82.8 million)

The following table shows the relevant expenditure data for DLC:

Expenses	Total ($)
Director's Office	$3,197,691
Administration	$5,332,684
Licensure	$1,908,685
Retail Operations	$24,101,855
Wholesale Operations	$11,560,190
Delivery Operations	$5,734,201
Other	$3,679
Total Operating Expenses	**$51,838,985**
Debt Service (Liquor Bonds)	**$9,828,000**
Debt Service (Master Lease)	**$881,400**
TOTAL EXPENSES	**$62,548,385**

For Fiscal Year 2016 expenses, DLC reported:

- Total operating expenses in excess of $51.8 million
- Total payroll of about $24. 3 million, which supported approximately 427 FTE positions
- Net revenues available for the General Fund of $33.2 million represents total revenues of $85.0 million less total operating expenses of $51.8 million
- Net remaining revenues for the General Fund of $22.5 million represents net revenues available for the General Fund less required debt service for liquor bonds and master lease payments of $10.7 million

Fiscal Impact Methodology

All of the options were analyzed to determine their fiscal impact to the County. Fiscal impact was determined by reviewing the proposed changes to current DLC operations and estimating their impact on current expenses and revenues. Most recent available data, FY2016 estimated actuals, was used for this analysis. The project team used readily available data and high-level analyses to determine fiscal impact. If an option is to be considered for implementation, additional analysis is recommended to determine exact fiscal impacts of each option.

Expenses were estimated as prorated percentage of total product volume. Volume was considered a better predicator of workload than total sales. For options involving changes to wholesale operations, total wholesale operational expense was allocated by product type (beer/wine/liquor), by product order type (stock/special order) and by sale type (on/off premise). Pro-rated reductions to indirect expenses (e.g., Administration, Directors Office) were also estimated for each option. The table below details DLC volume breakdown.

2016 DLC Volume by Product

Product	Quantity (cases/kegs)	%
Beer/Kegs		
On-Premise Stock	515,700	9.4%
Off-Premise Stock	3,200,564	58.6%
On/Off Premise Stock	82,381	1.5%
On-Premise Special Order	18,412	0.3%
Off- Premise Special Order	78,684	1.4%
On/Off Premise Special Order	2,749	0.1%
subtotal- Beer	**3,898,490**	**71.4%**
Wine		0.0%
On-Premise Stock	79,896	1.5%
Off-Premise Stock	709,697	13.0%
On/Off Premise Stock	8,726	0.2%
On-Premise Special Order	81,206	1.5%
Off- Premise Special Order	193,323	3.5%
On/Off Premise Special Order	11,664	0.2%
subtotal- Wine	**1,084,511**	**19.9%**
Liquor		0.0%
On-Premise Stock	37,540	0.7%
Off-Premise Stock	363,417	6.7%
On/Off Premise Stock	0	0.0%
On-Premise Special Order	4,853	0.1%
Off- Premise Special Order	68,644	1.3%
On/Off Premise Special Order	0	0.0%
subtotal- Liquor	**474,455**	**8.7%**
Total Beer/Wine/Liquor Volume	**5,457,456**	**100.0%**

Changes to revenues were estimated using available sales data. The project team was provided granular sales data that detailed total sales by product type (beer/wine/liquor), by product order type (stock/special order) and by sale type (on/off premise). In some cases it was necessary for the project team to use averages to estimate gross sales and sales allocated to a particular product or sales type.

2016 DLC Gross Sales by Product

Outlet	Product Type	Gross Sales	% of Total
DLC Stores	Spirits	$80,043,049	26.4%
	Wine	$52,918,027	17.5%
	Beer	$7,733,943	2.6%
	Subtotal	**$140,695,019**	**46.4%**
Off-Premise	Spirits	$291,969	0.1%
	Wine	$40,663,357	13.4%
	Beer	$67,458,826	22.3%
	Subtotal	**$108,414,152**	**35.8%**
On-Premise	Spirits	$12,804,070	4.2%
	Wine	$17,756,892	5.9%
	Beer	$20,451,071	6.7%
	Subtotal	**$51,012,033**	**16.8%**
Other	other	$3,043,829	1.0%
	Total	**$303,165,034**	**100.0%**

DLC Debt Profile

The County has issued tax exempt revenue bonds to acquire and equip the DLC warehouse and for a variety of transportation capital projects in the County. Currently, about $105 million in bonds are outstanding, with an annual debt service of about $9.8 million. The debt is secured by an irrevocable pledge of net revenues from the sale of alcoholic beverages.

$ 46,765,000	Series 2009	Warehouse purchase ($32.7 million); Road projects ($16.3 million)
$ 34,360,000	Series 2011	Warehouse renovation ($5.0 million; Road projects ($30.7 million)
$ 46,645,000	Series 2013	Warehouse renovation ($15.0 million); Road projects ($32.0 million)
$127,770,000	Total bonds issued	

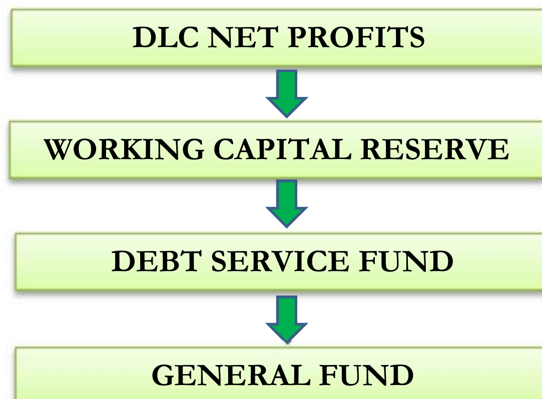
$ 34,725,000	Series 2009	Callable April 2019 @ par
$ 28,305,000	Series 2011	Callable April 2021 @ par
$ 41,600,000	Series 2013	Callable April 2021 @ par
$104,630,000	Total bonds outstanding	

The principal amortizes in annual installments over 20 years. The bonds are structured for level annual debt service requirements, and annual debt service is $9.84 million through 2029, declining thereafter, with a final maturity in 2033.

The bonds are issued under a trust agreement, dated May 1, 2009, between the County and U.S. Bank N.A., the trustee. Debt service is payable solely from the trust estate, which consists of the pledged revenues, the balance held on deposit under the trust agreement, and any other property rights and interests granted to the trustee. The additional bonds test (ABT) requires that pledged revenues for the most recent bond year must equal or exceed 150% of debt service on the existing bonds in that year plus the maximum annual debt service (MADS) on the proposed bonds and that the estimated pledged revenues projected for the succeeding five bond years are no less than 150% of MADS on the outstanding and proposed bonds. There is no rate covenant and no debt service reserve fund.

All net profits from the DLC sale of alcoholic beverages are first applied to maintain the working capital reserve, and the remaining net profits are applied to the debt service fund via a transfer to the County's general fund. The net profits transferred to the general fund are the pledged revenues for debt service. On a quarterly basis, proportional payments are deposited with the trustee to first fund principal and interest on the bonds prior to transfers to the general fund. Working capital contributions are determined annually by the County Finance Director and the Director of the DLC, subject to approval of the County Executive. In 2001, criteria were established to calculate the annual working capital contribution, which includes amounts equal to one month's operating expenses, $1.5 million for inventory purchases, and other projected short-term expenses.

The following illustrates the flow of funds:



In Fiscal Year 2016, net revenues available for the General Fund was $33.2 million, or more than three times the debt service requirement.

Other tax-exempt equipment debt of $4.72 million is also outstanding, principally related to ERP expenses and fork lift purchases. These generated about $881,400 of debt service costs in 2016.

The trust agreement defines Pledged Revenues as "all revenues of the Montgomery County Department of Liquor Control as and when transferred to the general fund" so the County is limited as to what could be used as additional Pledged Revenues. The bondholders are also secured by "all moneys and securities held under the trust agreement. This would allow the deposit of other money with the trustee to secure the bonds. However, if those revenues are to replace or substitute, they would need to be as continuous and dependable as the original revenues – which are derived from a near monopoly over the sale of alcohol. In short, there may be revenue that meets this hurdle, but it is a high hurdle.

With that in mind, when evaluating the impact of each alternative, it will be important to determine whether the proposed changes are material to (i) existing bond holders, (ii) rating agencies and (iii) the trustee. Any material change to the underlying Pledged Revenues that results in a lesser level of security than that "monopoly control" will likely require:

- Bond holder consent which can be time consuming, expensive and there is no guarantee a majority will agree to the proposed changes;
- Bond counsel review and approval;
- Trustee review and approval (unlikely without bond holder and bond counsel approval.

Material changes that reduce Pledged Revenues securing repayment of the bonds are likely to have varying adverse impacts, which may impact the County in both the current and future events. For example:

- Negative rating action(s), including single or multi-notch downgrades and an assignment of negative outlook;
- Publication of a material event notice to bond holders on www.emma.msrb.org;
- Potential for bond holder litigation;
- Potential lasting negative impact on investor relations and tarnish County's excellent reputation in capital markets.

Further, when evaluating the fiscal impact of each alternative, it will be important to consider how the alternative may impact the status of the outstanding tax-exempt debt. Federal tax law strictly limits the extent to which tax-exempt bond proceeds and tax-exempt financed assets may be used for non-governmental purposes. Use in excess of the limits established under federal tax law may cause the bonds to be treated as "private activity" bonds, and consequently, no longer be treated as

federally tax-exempt. Bonds are considered private activity bonds if the bonds meet the ***private business use test*** and the ***private security or payment test***.

Private Business Use – Private business use means the direct or indirect use of tax-exempt financed property in a trade or business by any person other than a governmental unit or the general public.[2] This includes tax-exempt non-profit organizations and the Federal government. For purposes of applying the private business use test to qualified 501(c)(3) bonds, governmental units include the activities of 501(c)(3) organizations that are not treated as unrelated trade or business.[3]

Private Business Use Summary	
Private Business Use	Direct or indirect use of tax-exempt financed property in a trade or business by any person other than a governmental unit or the general public
Private Business Use Test	Met if more than 10% of the proceeds of an issue are used for a private business use If the private business use is unrelated or is disproportionate to the governmental use of the proceeds, then the 10 percent limitation is reduced to 5 percent. The 5 percent limitation also applies to qualified 501(c)(3) bonds
Private Payment or Security Test	Met if the payment of debt service on more than 10 percent of the proceeds of the issue is directly or indirectly: (1) secured by property used or to be used for a private business use, or payments in respect of such property, or (2) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use

Private Business Use Test – The private business use test is met if more than 10 percent of the proceeds of the issue are to be used for any private business use. If the private business use is unrelated or is disproportionate to the governmental use of the proceeds, then the 10 percent limitation is reduced to 5 percent. The 5 percent limitation also applies to qualified 501(c)(3) bonds (e.g., bonds issued to finance the facilities of institutions of higher education and non-profit hospitals).

Private Security or Payment Test –The private security or payment test is met if the payment of debt service on more than 10 percent of the proceeds of the issue is directly or indirectly: (1) secured by property used or to be used for a private business use, or payments in respect of such property,

[2] See Internal Revenue Code Section 141(b)(6).

[3] See federal regulations section 1.145-2(b).

or (2) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use.[4]

Exceptions to Private Business Use – Several exceptions to private business use are established in the federal regulations. IRS Revenue Procedures establish safe harbors under which management and certain other service agreements do not result in private business use.

Bond counsel should be consulted to determine if any exceptions to private business use apply. Bond counsel should also review all management and service contracts to determine if they result in private business use. In certain circumstances, if the deliberate action is the sale of a tax-exempt financed asset, the issuer may be permitted to allocate the disposition proceeds (the proceeds received from the sale of the asset) to qualified expenditures, such as to obtain a replacement asset, in lieu of defeasing bonds or establishing an irrevocable defeasance escrow to defease bonds.[5]

Option One: Privatize Wholesale Distribution

The primary issues to analyze are the differences in revenue and expenditures for three approaches including servicing off-premise establishments (between a and b), beer in its entirety (c) or only special order beer and wine (d).

Alternatives:

a. **Switch to private wholesale distribution of all products to on-premise establishments.**

The assumption of this approach is that it will increase licensee selection and price performance, which in turn promotes growth of the dining and entertainment industry in the County. Under this approach, private wholesalers will service the on-premises industry (including, bars, restaurants, hotels, etc.) in the County. For purposes of the fiscal impact analysis, the DLC Cost of Goods plus freight and tax (Laid-in cost) is eliminated for the on-premises market as well as that portion of the wholesale mark-up, warehouse operations and delivery costs. It should be noted that the private wholesale system will then pass along its version of these costs to the on-premise establishments.

DLC data was aggregated and formatted for analysis. Expenditure data related to warehouse and wholesale distribution was cost-allocated based on the units of product delivered to the on-premises customers as a percentage of all products delivered to DLC stores and all license types.

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[4] See Internal Revenue Code Section 141(b).

[5] See federal regulations section 1.141-12(e) and 1.142-2(c)(4).

The shift of this relatively small portion of the DLC wholesale book of business, while feasible from a logistics perspective has supply chain risks. Private wholesalers may be reluctant to pick up only this small and relatively delivery-intensive element of the business, or may not offer optimal pricing for this component. If this option is selected, discussion with the wholesale supplier community prior to implementation is advised.

In fact, discussions involving wholesalers at the Working Group meeting indicated that there would be substantial wholesaler resistance to this change. In particular, beer wholesalers believe that any splitting of the franchise within the County (between the County itself and other beer wholesalers) would be contrary to the practice in the rest of the state and would resist it. There was also reluctance by other (non-beer) wholesalers as well, which likely means that the proposal is unworkable.

Fiscal Impact

It is estimated that this option will result in a net reduction of $10.5 million to the County. Divesting of on-premise wholesale sales will reduce revenue from alcohol sales by $13.5 million. Expenses can be expected to be reduced by approximately $3 million to account for reduced volume handled by the wholesale operations.

Liquor Control- 2016		
EXPENSES	**Current Operations**	**Option 1a.**
Director's Office	$3,197,691	$3,037,670
Administration	$5,332,684	$5,065,823
Licensure	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$24,101,855
Wholesale Operations	$11,560,190	$9,826,161
Delivery Operations	$5,734,201	$4,874,070
Other	$3,679	$3,679
Total	**$51,838,985**	**$48,817,944**

REVENUES	**Current Operations**	**Option 1a.**
Alcohol Sales	$82,841,627	$69,254,366
Liquor Licenses	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220
Investment Income	$30,700	$25,481
Misc. Revenues	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220
Total	**$85,033,692**	**$71,441,212**

Net Revenues Available for the General Fund	**$33,194,707**	**$22,623,268**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**
Less Debt Service (master lease)	**$881,400**	**$881,400**
Net Remaining Revenues for the General Fund	**$22,485,307**	**$11,913,868**

It is difficult to determine how redesigning processes in a distribution chain may impact on overall system expenditures. Removing on-sale premises from the wholesale distribution process is a significant change, and the resulting wholesale distribution system will be quite different (with far fewer locations for deliveries). It is possible that the extrapolation done for expenses does not capture part of what will remain (in terms of expenditures) after a system redesign. Of course, any savings that might result from those system changes are likely to materialize over time and would not be immediately realized by the County. It is also notable that should the employee complement be reduced, there will likely be one-time costs associated with vacation and other pay-outs.

Debt Impact

Material changes to Pledged Revenues requires majority bond holder approval, trustee approval, and carries the risks of a credit rating downgrade and bondholder legal action. Bond Counsel involvement will be necessary. The debt impact is significant, including a likely credit rating downgrade. Unless lower net profits are balanced by additional expenditure efficiencies or revenues, the result will be lower debt service coverage, but still greater than 2.0x MADS. As with other changes that carve out some of the existing system monopoly, bond counsel involvement will be necessary.

It should also be noted that the trust agreement defines Pledged Revenues as "all revenues of the Montgomery County Department of Liquor Control as and when transferred to the general fund'; so the County is limited by definition to what could be used as additional Pledged Revenues. The bondholders are also secured by "all moneys and securities held under the trust agreement. This would allow the deposit of other money with the trustee to secure the bonds, but without an amendment to the trust agreement it would not be included in the 150% pledged revenue calculation.

Alternatives for Fiscal Neutrality

To make this option fiscally neutral requires approximately $10.5 million in additional revenue, lower expenses, or some combination. This option results in the loss of a lot of DLC customers, but proportionally less sales (about 15% of sales). While reductions of about $3 million are already assumed, largely in warehouse and

delivery operations, it is possible that some additional savings in operational expense can be achieved.

Additionally, the use of more aggressive sales management techniques may also produce additional profit. These actions may include allowing the use of differential mark-up by brand and re-evaluation of the mark-down budget. These strategies might contribute to gap-closing, however, it is unlikely that this gap can be closed without supplemental revenue.

Other Impacts
Impact on customers is hard to assess and will likely vary. On-premise establishments in other counties in the State are already being served by private wholesalers, so there is a reasonable expectation that the system could function without major disruption. However, it is notable that at least one bar/restaurant owner who provided input at the Working Group meeting preferred the existing system, because it provides for one supplier and invoice as opposed to dealing with multiple beer, wine and liquor suppliers. The impact on price is difficult to determine and will likely vary on a case-by-case basis. There have been various analyses of price impacts from forms of privatization, but none have focused on this specific carve-out of business.

b. Switch to private wholesale distribution of all beer and wine to both on and off-premise establishments.

The assumption of this approach is that it will provide enhanced service, selection and pricing through private-sector wholesale. Under this approach, private beer and wine wholesalers will service all of the DLC customers. The DLC Cost of Goods plus freight and tax (Laid-in cost) of both beer and wine is eliminated as well as that portion of the wholesale mark-up, warehouse operations and delivery costs associated with beer and wine. As in Virginia, DLC would continue to provide wholesale and retail distribution and off-premises sale of distilled spirits. This proposal is also closest to the Chamber of Commerce proposal, however the Chamber proposal goes one step further and allows for private wholesale (and sale) of beer, wine **and distilled spirits.**

Fiscal Impact
It is estimated this option will result in a net reduction of $22.7 million to the County. Divesting of on/off-premise wholesale sales of beer and wine will reduce revenue from alcohol sales by $41.1 million. Expenses can be expected to be reduced by approximately $18.4 million to account for reduced volume handled by wholesale operations.

Liquor Control- 2016		
EXPENSES	**Current Operations**	**Option 1b.**
Director's Office	$3,197,691	$2,223,630
Administration	$5,332,684	$3,708,275
Licensure	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$24,101,855
Wholesale Operations	$11,560,190	$1,005,008
Delivery Operations	$5,734,201	$498,514
Other	$3,679	$3,679
Total	**$51,838,985**	**$33,449,647**

REVENUES	**Current Operations**	**Option 1b.**
Alcohol Sales	$82,841,627	$41,767,232
Liquor Licenses	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220
Investment Income	$30,700	$9,210
Misc. Revenues	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220
Total	**$85,033,692**	**$43,937,806**
Net Revenues Available for the General Fund	**$33,194,707**	**$10,488,159**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**
Less Debt Service (Master Lease)	**$881,400**	**$881,400**
Net Remaining Revenues for the General Fund	**$22,485,307**	**($221,241)**

As with the prior option, it is difficult to determine how redesigning processes in a distribution chain may impact on overall system expenditures. Removing on- and off-sale premises from the wholesale distribution process for beer and wine is a very large change, and the resulting wholesale distribution system will be quite different (with far fewer locations for deliveries). It is possible that the extrapolation done for expenses does not capture what will remain (in terms of expenditures) after a system redesign. Of course, any savings that might result from those system changes are likely to materialize over time and would not be immediately realized by the County. It is also notable that should the employee complement be reduced, there will likely be one-time costs associated with vacation and other pay-outs.

The other key issue is how to address the possibility that a new, privatized system will lead to a significant amount of recaptured (often referred to as 'repatriated') sales to County residents that currently occur in other jurisdictions.

This topic is explored in a later section of the memo. However, as discussed in that section, there are significant impediments in this particular option to full-scale repatriation on a level that would recoup this revenue loss. It is unlikely that this gap can be closed without supplemental revenue.

Debt Impact
Material changes to Pledged Revenues requires majority bond holder approval, trustee approval, and carries the risks of a credit rating downgrade and bondholder legal action. Bond Counsel involvement will be necessary. The debt impact is very significant, and would result in multi-notch credit rating downgrade, possibly below investment grade. There is also the risk of possible default with net profits barely providing 1.0x debt service coverage. As with other changes that carve out some of the existing system monopoly, bond counsel involvement will be necessary.

Alternatives for Fiscal Neutrality
To make this option fiscally neutral requires nearly $23 million in additional revenue, lower expenses, or some combination of the two. It is unlikely that this wide of a gap can be closed without significant supplemental revenue.

The use of the various management tools discussed in Option 1a would have to be used aggressively and be supplemented by significant use of one or more of the alcohol-related revenue initiatives outlined. In considering the use of these revenue initiatives, it will be important to consider the impact on product price.

Price elasticity of alcoholic beverages can vary depending on a variety of market factors. Additional analysis would be necessary to determine the extent to which the alcohol-related initiatives can yield sufficient revenue to close the gap, or whether other County revenue sources may have to be utilized as well.

Other Impacts
The model of privatized wine and beer while maintaining a control system for distilled spirits is in place in multiple other jurisdictions, including the State of Virginia. As a result, there is a fair amount of experience that suggests no major likely service disruptions and a reasonable opportunity for the two systems to co-exist. That said, there is still likely to be some variable impact on customers. At least one bar/restaurant owner who provided input at the Working Group meeting preferred the existing system, because it provides for one supplier and invoice as opposed to dealing with multiple beer, wine and liquor suppliers. The impact on price is difficult to determine and will likely vary on a case-by-case basis.

c. Switch to private wholesale distribution of beer only to both on and off-premise establishments

The assumption of this approach is that it will provide enhanced service, selection and pricing through private-sector supplier competition. Beer is a unique alcoholic beverage commodity. It is perishable, comes in a variety of formats, including kegs, and has a relatively short shelf life. This approach would eliminate DLC from the beer wholesale and retail sale county-wide. The DLC Cost of Goods plus freight and tax (Laid-in cost) of beer is eliminated as well as the wholesale mark-up, warehouse operations and delivery costs, retail mark-up, sales tax and any discrete retail operations costs related to case beer and kegs.

Fiscal Impact
It is estimated this option will result in a net reduction of $8.8 million to the County. Divesting of on/off-premise wholesale sales of beer will reduce revenue from alcohol sales by $23.2 million. Expenses can be expected to be reduced by approximately $14.4 million to account for reduced volume handled by wholesale operations.

Liquor Control- 2016		
EXPENSES	**Current Operations**	**Option 1c.**
Director's Office	$3,197,691	$2,435,627
Administration	$5,332,684	$4,061,815
Licensure	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$24,101,855
Wholesale Operations	$11,560,190	$3,302,261
Delivery Operations	$5,734,201	$1,638,021
Other	$3,679	$3,679
Total	**$51,838,985**	**$37,451,944**

REVENUES	Current Operations	Option 1c.
Alcohol Sales	$82,841,627	$59,673,611
Liquor Licenses	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220
Investment Income	$30,700	$20,569
Misc. Revenues	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220
Total	**$85,033,692**	**$61,855,545**
Net Revenues Available for the General Fund	**$33,194,707**	**$24,403,601**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**
Less Debt Service (Master Lease)	**$881,400**	**$881,400**
Net Remaining Revenues for the General Fund	**$22,485,307**	**$13,694,201**

As with the prior two options, it is difficult to determine how redesigning processes in a distribution chain may impact on overall system expenditures. Removing beer from the wholesale distribution process is a significant change, and the resulting wholesale distribution system will be quite different (with far fewer locations for deliveries, and different types of deliveries).

That said, beer is a different product from wine and spirits in a number of respects. First, it is the primary reason that the warehouse (and delivery trucks) are climate controlled. Eliminating these requirements will have some impact on overall costs (or warehouse requirements) that are not captured in this analysis. It will also eliminate the need for certain types of trucks and lengthen the useful life for the remaining fleet. It is likely that the extrapolation done for expenses does not capture these savings or what will remain (in terms of expenditures) after a system redesign. Of course, any savings that might result from those system changes are likely to materialize over time and would not be immediately realized by the County.

Debt Impact

Material changes to Pledged Revenues requires majority bond holder approval, trustee approval, and carries the risks of a credit rating downgrade and bondholder legal action. The debt impact is significant, including a likely credit rating downgrade of one or more notches. Unless lower net profits are balanced by additional expenditure efficiencies or revenues of the DLC, the result will be lower debt service coverage, but still greater than 2.0x MADS. As with other changes that carve out some of the existing system monopoly, bond counsel involvement will be necessary.

It is notable (discussed in the section on revenue) that there may well be additional one-time revenue generated for the County from sale of beer franchise rights within the County. This revenue could be used to either reduce the outstanding debt or make debt service payments. However, this revenue is expected to be substantially less than the existing outstanding debt and is not a sufficient replacement for the existing Pledged Revenues.

Alternatives for Fiscal Neutrality
To make this option fiscally neutral requires approximately $8.8 million in additional revenue, lower expenses, or some combination. Gap-closing approaches for this amount are similar to those outlined in the discussion of fiscal neutrality alternative options for Option 1a. They include a variety of sales management actions and/or imposition of new revenues. However, it is unlikely that this gap can be closed without supplemental revenue.

Other Impacts
Impact on customers is hard to assess and will likely vary. There is already private competition for beer products, and there is an indication from the DLC that they have intentionally not sought to carry a wider variety of product in their stores so as to not undercut private stores. On-premise sale establishments in other counties in the State are already being served by private wholesalers, so there is a reasonable expectation that the system could function without major disruption. Beer as a product already operates on thin profit margins, and it is likely that price changes in this area will not be significant. It is notable that at least one bar/restaurant owner who provided input at the Working Group meeting preferred the existing system, because it provides for one supplier and invoice as opposed to dealing with multiple beer, wine and liquor suppliers.

d. Special-order beer and wine to both on and off-premise establishments

The assumption of this approach is that it will provide enhanced service and selection through private-sector suppliers that can be more responsive to the needs of licensees and consumers.

This alternative would result in the direct delivery of any beer or wine product, not in-stock in the DLC warehouse, to on-premises establishments and to DLC retail stores for pick-up by individual consumers. The DLC Cost of Goods plus freight and tax (Laid-in cost) of special order beer and wine is eliminated as well as the wholesale mark-up, warehouse operations and delivery costs associated with these items. The retail mark-up and collection of sales tax by the DLC retail stores remains.

The shift of this relatively small portion of the DLC wholesale book of business, while feasible, even positive, from a logistics perspective poses possible supply chain risks. Private wholesalers may be reluctant to pick up only this small and relatively labor-intensive element of the business, or may not offer optimal pricing for this component. If this option is selected, discussions with the wholesale supplier community prior to implementation are advised.

Fiscal Impact

It is estimated this option will result in a net reduction of $6.1 million to the County. Divesting of on/off premise special order beer and wine will reduce revenue from alcohol sales by $7.6 million. Expenses can be expected to be reduced by approximately $1.4 million to account for reduced volume handled by wholesale operations.

Liquor Control- 2016		
EXPENSES	**Current Operations**	**Option 1d.**
Director's Office	$3,197,691	$3,122,230
Administration	$5,332,684	$5,206,840
Licensure	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$24,101,855
Wholesale Operations	$11,560,190	$10,742,471
Delivery Operations	$5,734,201	$5,328,587
Other	$3,679	$3,679
Total	**$51,838,985**	**$50,414,347**
REVENUES	**Current Operations**	**Option 1d.**
Alcohol Sales	$82,841,627	$75,258,994
Liquor Licenses	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220
Investment Income	$30,700	$26,095
Misc. Revenues	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220
Total	**$85,033,692**	**$77,446,453**
Net Revenues Available for the General Fund	**$33,194,707**	**$27,032,107**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**
Less Debt Service (Master Lease)	**$881,400**	**$881,400**
Net Remaining Revenues for the General Fund	**$22,485,307**	**$16,322,707**

As with the other options in this category, it is difficult to determine how redesigning processes in a distribution chain may impact on overall system expenditures. Removing special orders is not as significant a component of overall sales as the other options in this category, but it may very well be more time consuming than other types of orders (because of its 'special' nature). It is likely that the extrapolation done for expenses does not fully capture the entirety of the time spent for this type of order. Of course, any savings that might result are likely to materialize over time and would not be immediately realized by the County. It is also notable that should the employee complement be reduced, there will likely be one-time costs associated with vacation and other pay-outs.

Debt Impact

Material changes to Pledged Revenues requires majority bond holder approval, trustee approval, and carries the risks of a credit rating downgrade and bondholder legal action. The debt impact is significant, including a likely credit rating downgrade. Unless lower net profits are balanced by additional expenditure efficiencies or revenues of the DLC, the result will be lower debt service coverage, but still greater than 2.0x MADS. As with other changes that carve out some of the existing system monopoly, bond counsel involvement will be necessary.

Alternatives to Fiscal Neutrality

To make this option fiscally neutral requires slightly more than $6 million in additional revenue, lower expenses, or some combination. Gap-closing approaches for this amount are similar to those outlined in the discussion of fiscal neutrality alternative options for Option 1a. They include a variety of sales management actions and/or imposition of new revenues, however it is unlikely that this gap can be closed without supplemental revenue.

Other Impacts

There is significant complexity related to changes in product lines that will be difficult to manage under this approach. For example, products get listed and delisted on a regular basis, and how those changes would impact on who provides product would be hard to track – for customers, private wholesalers and the DLC. The result may well be service disruptions that the process is meant to eliminate or ameliorate.

Experience with other control systems is that they generally stock a larger number of SKUs and will more readily do special orders than privatized systems. It is an open question as to whether the process (or selection) would be improved with private wholesale. However, there may be specialty wine providers who can expedite the process. Based on system requirements, however, this usually comes at a cost that

must be passed along to consumers. In some cases, however, this may be an acceptable pass through in return for better product availability.

As with an earlier option, there are likely to be wholesalers who will be unwilling to participate in this option. Beer wholesalers in particular have the same concern as previously expressed, this option would create a different wholesale playing field in Montgomery County than exists in the rest of the State. While some wholesalers have indicated a willingness to participate, it is likely that there will be a need for the County to remain in the special order business, which will ameliorate any cost savings as well.

Option Two: Private Management/Public-Private Partnership

a. Private Management Contract:

The assumption of this approach is to allow for a range of activities related to the administration and management of DLC operations and functions to be performed by a private partner experienced in the sale and distribution of spirits, wine and beer.

Under this approach, a management contract would be executed with a private provider to provide industry-experienced senior management level personnel to assume the responsibilities of the day-to-day management of the distribution and sale of spirits, wine and beer on behalf of the DLC consistent with industry standards.

The private provider would develop a marketing and retail outlet expansion plan and strategy to optimize the controlled and socially responsible sale of spirits, wine and beer. They would be authorized to procure separate from the County's procurement process for equipment, retail space, technology, vehicles, product, etc. The private provider would assume full responsibility and accountability for DLC facilities, physical assets, equipment, vehicles and product inventory; the County would retain ownership of all DLC assets and retain control over DLC policy decisions, enforcement of liquor laws, license approvals, labor relations and collective bargaining.

There would be no change in DLC employee salary or benefits, and the private provider would be subject to the terms of any collective bargaining agreement applicable to these employees.

The County would compensate the private provider directly from revenues generated by the DLC by either a fixed administrative/management fee, bonus system or a combination of both, subject to IRS restrictions.

It is notable that no control jurisdiction has engaged a private management company to provide the recommended scope of services. There are private contracts for services within control states for various components of the wholesale and/or retail operation (including warehouse, transportation and retail sales) but none that offer the full scope of services as proposed.

An example of private management that involves significant control of a public sector asset relates to convention centers. In many (if not most) cases, convention centers are public facilities that are constructed with a major (and in some cases primary) source of funding coming from the issuance of tax exempt bonds. That funding mechanism contains notable IRS restrictions on private management contracts for these facilities; in many respects, that is a situation that is similar to what exists in Montgomery County, because tax exempt bonds were issued to construct the existing DLC warehouse.

The IRS regulations in this area were recently revised (effective August 22, 2016). The new regulations are more flexible than those that had been in place since 1997. Most notably, the new regulation permits any type of reasonable fixed or variable compensation for services provided pursuant to a management contract with a term of up to the lesser of 30 years or 80% of the weighted average reasonably expected economic life of the managed property.

It is also notable that the County must be able to demonstrate that it has a significant degree of control over the use of the managed property. This requirement is met if, with respect to the managed property, the contract requires the County to approve the annual budget, capital expenditures, each disposition of related property, rates charged for use, and the general nature and type of use (e.g., the type of services provided to the managed property).[6]

Fiscal Impact

Because of the lack of other examples of private management in the liquor control industry, it is difficult to determine a likely fee (or possible performance-based compensation) for such a private management operation. It is likely, however, that the private management partner would replace some of the duties currently held by DLC executives, which means that the overall fiscal impact will, in some respects, be mitigated. There can also be some expectation that the private management provider may be able to initiate system improvements that will balance out some of

[6] See, for example, “Management Contracts and Private Business Use: IRS Releases Favorable Guidance,” The National Law Review, September 9,2016, accessed electronically at http://www.natlawreview.com/article/management-contracts-and-private-business-use-irs-releases-favorable-guidance.

the cost of the contract – and if they cannot, one of the primary rationales for the approach is lost.

Examples of existing private management contracts for convention center management:

- Hartford Convention Center $170,000 plus performance incentives for revenue growth over benchmark up to 100 percent of base fee
- LA Convention Center $175,000 plus performance incentives up to 50 percent of base fee
- Palm Springs Convention Center $210,000 plus performance incentives up to 100 percent of base fee
- Pennsylvania Convention Center $300,000 plus performance incentives up to 100 percent of base fee
- Oklahoma City Convention Center $319,400 plus performance incentives up to 65 percent of base fee.

It is notable that several of these facilities are union facilities, such as the Pennsylvania Convention Center and the LA Convention Center. In this respect, the private management company deals with many of the same challenges as the DLC in Montgomery County.

While the examples provide some indication of private management contracts and the performance-based components, there is no real way to determine what would be the likely similar sort of contract for a liquor control system.

This lack of experience or expertise related to private management of a liquor control system is a concern. It is possible that some of the 'economies of scale' savings from some private management operations would not materialize as a result of this lack of sector involvement. As with any of these types of agreements, identifying tangible performance criteria for incentive compensation is a critical issue.

In fact, Working Group participants expressed significant doubt about the comparability of the convention center industry with the liquor business. It is an unsettled question as to whether an appropriately skilled and experienced vendor could be identified with the expertise needed to succeed at this business (and obtain the cost and efficiency savings the County desires). It is also unclear as to whether companies that might have this background would be willing to bid on such a contract, particularly if it creates conflict of interest issues for other related liquor business with the County.

Debt Impact
Unclear based on the lack of prior history. The management contract itself will need to be thoroughly vetted by bond/tax counsel.

Alternatives to Fiscal Neutrality
Some combination of management approaches already discussed could be used.

Other Impact
This is, of course, primarily a change in the manner in which the organization functions and where decision making resides. At the same time, there are costs associated with a private provider that don't necessarily exist in the public sector. To the extent that a well-structured contract has performance-based metrics and the chosen provider has the ability to attain them, there is a reasonable expectation of positive impacts. However, this is necessarily unclear based on the lack of prior history.

b. Maine Model

The assumption of this approach is that the County would enter into a Public-Private Partnership (P3) for a private partner to provide warehousing and transportation services for the DLC in return for a percentage share of DLC receipts. This is the model that Maine has used for two 10-year P3 contracts.

In 2004, the State of Maine signed a 10-year lease with Maine Beverage Company to be responsible for warehousing and delivery of distilled spirits and fortified wines to agency stores throughout Maine. According to a variety of published reports, Maine Beverage was awarded the contract for an upfront payment of $125 million. The contract guaranteed Maine Beverage payments of 36.8 percent of annual sales. From 2004 through 2012, the company collected about $339 million in gross profits, after revenue sharing, according to data provided by the state. According to one report, the state received about $190 million over the 10-year contract, including the upfront payment of $125 million.[7]

There was, in following years, significant dissatisfaction with the financial terms of the 2004 contract. The State commissioned a study, done by Deloitte and Touche LLP, which was released in March 2009. Based on their research and analysis, Deloitte and Touche arrived at a blended fair market value of $378 million. According to the report, 'this represents the cash consideration that could be negotiated for a sale of the whole

[7] See 'Maine Awards Wholesale Liquor Contract to Augusta Company," Maine Sunday Telegram, January 10, 2014, accessed electronically at http://www.pressherald.com/news/State_awards_wholesale_liquor_contract_.html?pagenum=full

business between a willing buyer and willing seller as of January 1, 2009, irrespective of the terms of the current Contract.'[8]

After an RFP process, in February 2014, the State awarded a contract to Pine State Trading Company for warehousing and distribution services for the next 10 years, effective on July 1, 2014. At the time of the agreement, the new contract was expected to yield up to $450 million in revenue over the next 10 years.[9] The additional revenue is expected to result from a lower-cost wholesale distribution deal. Under the new contract, Pine State will be paid a fee equal to a percentage of net sales but the state will receive the profits.[10]

In fact, the first year totals for the new contract surpassed expectations. The first year of the contract (for the fiscal year ending June 30, 2015), saw a 4.6 percent sales increase over the previous year and generated a $46 million operating profit, based on sales of $155.5 million. For the fiscal year, the State paid Pine State roughly $9.5 million.[11]

The Maine contract is split into two components: Part A covers warehousing and distribution and Part B covers marketing and related activities. The cost of the contract for Part A is 4.7 percent of net sales; Part B is approximately 1.5 percent of net sales.[12]

It should be noted that the Maine P3 provider runs a private warehouse. The employees in both the warehouse and transportation operations are not State employees.

It is, of course, difficult to make a determination of what terms Montgomery County might obtain if it were to seek a contract similar to Maine's 2014 contract. Montgomery County gross sales (net of taxes) were $300.1 million in FY2016; 6.2 percent of Montgomery County's gross sales for FY2016 would have totaled $18.6 million. From a review of current budgets, approximately $18.2 million is dedicated to these activities in Montgomery County (not including associated indirect costs).

[8] Deloitte and Touche LLP, "State of Maine Liquor Business Analysis and Valuation Final Report," March 11, 2009, p. 23. Accessed electronically at http://www.mainebiz.biz/assets/pdf/ma175121.pdf

[9] Email to PFM from Tim Poulin, Acting Director, Maine Bureau of Alcoholic Beverages and Lottery Operations, April 14, 2014.

[10] "Maine Awards New 10-year Liquor Contract, Expects to Double Return," Bangor Daily News, April 6, 2014.

[11] It is notable that in September 2013, Maine pledged its future profits from the sale of liquor as collateral for a $220 million revenue bond that was used to repay $183.5 million in outstanding debt to Maine hospitals. "Maine gets $46 million from liquor sales in first year of new contract," Portland Press Herald, September 17, 2015, accessed electronically at http://www.pressherald.com/2015/09/17/maine-liquor-sales-exceed-expectations/

[12] Email to PFM from Tim Poulin, Acting Director, Maine Bureau of Alcoholic Beverages and Lottery Operations, April 14, 2014.

There are several factors that suggest a straight calculation based on gross sales in Maine and Montgomery County is not an 'apples to apples' comparison of likely costs. First, Maine has 425 Agency Stores,[13] which is not readily comparable to Montgomery County's 25 retail off-premise stores, as more stores means more deliveries. Finally, Maine is a much, much larger geographic area – with 30,842 square miles it dwarfs the size of Montgomery County. It should be noted that Maine's wholesale vendor maintains a bailment warehouse and charges fees for handling and storage (up to $1.00 per case for handling); Montgomery County has not done so in the past.

Given these differences, it would appear reasonable to expect that Montgomery County might be able to obtain a gross sales percentage rate that is lower than 6.2 percent. Based on FY2016 sales net of taxes, the following table suggests a possible range of costs for private provision of services:

Range of Costs for DLC Services Based on Percentage of Gross Sales

Sales Net of Taxes, 2016	Wholesale Percent of Gross Sales	Cost for Services
$300,000,000	6.2 percent	$18,600,000
$300,000,000	3.6 percent	$10,800,000
$300,000,000	1.8 percent	$5,400,000

It should also be kept in mind that the Maine 2014 contract includes fees for bailment at the vendor's private warehouse, and those bailment fees are to be paid to the State of Maine. Those fees are generally in the range of $1 per case; the State of Maine estimates that they will generate $1-2 million a year from bailment fees.[14]

There are already private wholesalers providing wine and beer to licensees for off-premise consumption; it may well be that there would be interest from these operators in provide similar services but there is no guarantee that this will be the case.

There are a number of issues that would have to be clarified to determine impacts from this approach. It is not clear, for example, whether the P3 would continue to use the County warehouse and County employees or whether the P3 company would use its own facilities and employees. This will, of course, change the likely percentage of revenue that a P3 company would negotiate for its services. It would also change the labor dynamic for the County.

[13] Maine Beverage Company, http://www.mainebeverage.com/absolutenm/templates/faq.aspx?articleid=17&zoneid=13

[14] Phone interview with Maine Bureau of Alcoholic Beverages and Lottery Operations Acting Director Tim Poulin, April 18, 2014.

Fiscal Impact

Under the approach used for the Maine P3, all DLC warehousing and distribution activities would cease and only its retail operations would remain. The DLC Cost of Goods plus freight and tax (Laid-in cost) is eliminated as well as the wholesale mark-up, warehouse operations and delivery costs. Retail operations costs as well as retail mark-up and sales tax revenues would remain. The final fee structure will determine the estimated fiscal impact. Removing wholesale operations and associated indirect costs reduces expenses by $20.1 million. If the private fee for wholesale operations was 6.2% of gross sales, then the private fee would equal $18.6 million.

Liquor Control- 2016		
EXPENSES	**Current Operations**	**Option 2b.**
Director's Office	$3,197,691	$2,130,885
Administration	$5,332,684	$3,553,608
Licensure	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$24,101,855
Wholesale Operations	$11,560,190	$0
Delivery Operations	$5,734,201	$0
Other	$3,679	$3,679
Total	**$51,838,985**	**$31,698,712**
REVENUES	**Current Operations**	**Option 2b.**
Alcohol Sales	$82,841,627	$82,841,627
Liquor Licenses	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220
Investment Income	$30,700	$30,700
Misc. Revenues	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220
Total	**$85,033,692**	**$85,033,692**
Net Revenues Available for the General Fund	**$33,194,707**	**$53,334,979**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**
Less Debt Service (Master Lease)	**$881,400**	**$881,400**
Less Private Management Fee	**$0**	**($18,600,000)**
Net Remaining Revenues for the General Fund	**$22,485,307**	**$24,025,579**

Debt Impact

Could be significant, depending on the share of revenues shared with the P3 company. Private use issues would need to be thoroughly vetted by bond/tax counsel and would depend on the terms and conditions of the P3. May require a partial or full defeasance of outstanding tax-exempt debt.

Other Impacts
The system is in many respects a hybrid of a control system with private sector engagement at the wholesale level but with contract requirements (as opposed to market-based functioning) to address performance. Of course, those who like/dislike the current County retail store operation will likely continue to have the same views on the revised system. A P3 contract will still need strong performance standards – there are metrics in the Maine contract related to delivery times, errors, orders, handling, etc. There is no guarantee, of course, that the private vendor will provide good service – and there are control states that have switched back from, for example, private transportation to state owned fleets because of concerns about service and cost effectiveness.

Option Three: Establish a Liquor Authority

The assumption of this approach is to formally separate the alcoholic beverage enterprise and its related debt from the County government by creating a public benefit corporation that could in some ways be similar to the Montgomery County Revenue Authority (although, for example, labor characteristics might be different). In addition to the formal separation, creation of a separate public corporation would retain the transparency and control of a government entity while recognizing the unique mission of the agency and providing it with the necessary flexibility to effectively serve the public.

Under this approach, all DLC warehousing and distribution and retail operations would continue to operate in basically the same fashion, albeit under the auspices of a public authority. The advantages of this approach lie in more efficient procurement of products, more flexibility in the hiring process, and the opportunity for innovation in pricing, merchandising and management.

The new public corporation would be created as an instrumentality of Montgomery County, with a Board appointed by the County Executive and a CEO appointed by the Board. While the Authority employees would retain their current collective bargaining rights and representation, the Authority would be able to institute, or bargain for, some flexibility such as use of part-time and/or contract employees that could help achieve scheduling efficiencies.

Prior adopted and proposed County Authorities have adopted different models related to collective bargaining and civil service. The issue of whether or not this Authority would have unionized employees and would be subject to collective bargaining would need to be determined. It is envisioned that the Authority would be exempt from many County procurement regulations.

To preserve accountability, the Authority would devise public reporting and other transparency actions. The Authority would have control of all current DLC marketing, distribution and sales operations, but not the Department's regulatory or licensing activities, which would remain with DLC.

The Authority would continue to have a monopoly on the provision of alcoholic beverages and retail stores that sell the combination of beer, wine and liquor. It would be authorized to issue taxable and tax exempt debt, secured by the net profit of alcohol sales. Initially, this Authority debt may replace the current liquor bonds. The authority model is intended to increase DLC's market and operational agility. For example, it could streamline actions such as procurement or disposal of real property, vehicles, materials and equipment as well as purchase of alcoholic beverage products.

While there is no hard data to analyze, it is possible that there would be some operational efficiencies as a result of an enhanced capacity to bargain with vendors and impose some operational efficiency, which would have a slight positive impact financially. The cost of debt service is discussed later. The determination of the Authority model as it relates to union employees and collective bargaining may also directly impact on the Authority cost structure.

The DLC Cost of Goods plus freight and tax (Laid-in cost) is essentially unchanged, as is the wholesale mark-up, warehouse operations and delivery costs. Retail operations costs as well as retail mark-up and sales tax revenues would also remain.

Fiscal Impact
Neutral to slightly positive. The DLC Cost of Goods plus freight and tax (Laid-in cost) is essentially unchanged, as is the wholesale mark-up, warehouse operations and delivery costs. Retail operations costs as well as retail mark-up and sales tax revenues would also remain. There should be a marginal increase in sales and efficiency as a result of an enhanced capacity to bargain with vendors and impose some operational efficiency, which would have a slight positive impact financially. However, without more definition of the Authority's structure and operational data, the exact fiscal impact cannot be calculated.

Debt Impact
Not significant if done right. Debt would continue to be treated as self-supporting revenue debt and would not impact tax-supported debt or debt affordability measures. This option may require , or the Authority may elect to execute, a partial or full defeasance of the current outstanding tax-exempt debt . In such a case, the new Authority-issued debt would provide all of the funds necessary to complete the transaction.

Other Impacts

There is little change to the current system, so existing impacts would likely continue – at least in the short-term. The goal, of course, would be better operations that ameliorate present concerns, but there is no guarantee of that.

Option Four: Full Privatization

The assumption of this approach is to entirely privatize the wholesale distribution and retail sale of alcoholic beverages in Montgomery County. This would align the County with most other counties in Maryland. Additionally, this move would eliminate the perceived conflict between DLC's regulatory and consumer/public protection roles and at the same time having a business relationship with licensees.

While there are many variations, the approach selected for this analysis would call for the creation of County licenses for the wholesale sale and distribution of alcoholic beverages and for the retail sale of beer, wine and spirits for off-premises consumption. These new licenses would be issued by DLC and the number of retail licenses would be limited based on certain per capita population limits.

Under this approach, after appropriate state and local legislation is in place, there would be some transition period that would allow for the smooth transfer of wholesale supply and retail outlets to private entities, along with the disposition of DLC inventory in the warehouse and stores and the transition of the 427 full time equivalent employees. This "unwinding" process will take from 12 to 24 months to complete, depending on a variety of factors.[15]

The wholesale supply chain is already in place in the District of Columbia and surrounding counties. Maryland law is also pretty clear governing wholesalers. Accordingly, from a market perspective, this is likely to be the easiest component of the transition (and license if the County chooses). This transition also involves a smaller component of employees (about 150 FTEs between warehouse and delivery operations).

Retail stores are the most complex transition because it involves the need to quantify, license and develop the retail outlet infrastructure and then manage a phase in/phase out process that assures continued consumer access. At about 240 FTEs,

[15] It is notable that the State of Washington entirely privatized its system in less than a year, under timelines that were specified in the ballot measure that privatized the state system. Earlier, the State of Iowa dismantled the majority of its retail system in a one-month time period.

retail employees are also the largest component of DLC personnel. Additionally, lease termination and inventory management can be demanding during this process.

Lastly, administration and "back office" positions are typically the last part of the transition as they are required to manage the transition process and liquidation of assets.

Post transition, DLC would become a policy, regulatory and enforcement agency with about 30 employees (depending on decisions made to enhance the enforcement staffing).

It is notable that the Chamber of Commerce proposal is something of a hybrid: it also privatizes wholesale in its entirety and allows private retail of all three products (beer, wine and distilled spirits). It does not, however, require the County to divest itself of its retail stores.

Fiscal Impact

Very Significant. To determine the fiscal impact, PFM examined a large volume of information supplied by DLC. PFM also used Montgomery County budget and CAFR documents. To discuss the potential issues and impacts, a significant amount of research was reviewed regarding other control jurisdictions, including those such as Washington State that has recently changed their system. Lastly, PFM reviewed the other presentations already made to the Working Group.

Post transition, DLC will have expenditures in the range of $4 million and revenues of $2.0 – $2.5 million, requiring net County funding of around $1.5 - $2 million. From the FY 2016 baseline, the County would lose all of the $32.6 million transfer/debt service payment. Combined with the operational funding need, this change would represent roughly a $34.6 million budget loss.

Liquor Control- 2016		
EXPENSES	**Current Operations**	**Option 4.**
Director's Office	$3,197,691	$644,161
Administration	$5,332,684	$1,074,246
Licensure	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$0
Wholesale Operations	$11,560,190	$0
Delivery Operations	$5,734,201	$0
Other	$3,679	$3,679
Total	**$51,838,985**	**$3,630,771**

REVENUES	Current Operations	Option 4.
Alcohol Sales	$82,841,627	$0
Liquor Licenses	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220
Investment Income	$30,700	$0
Misc. Revenues	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220
Total	**$85,033,692**	**$2,161,365**
Net Revenues Available for the General Fund	**$33,194,707**	**($1,469,406)**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**
Less Debt Service (Master Lease)	**$881,400**	**$881,400**
Net Remaining Revenues for the General Fund	**$22,485,307**	**($12,178,806)**

The one-time revenues from asset sales, mainly the DLC warehouse facility and fleet, as well as revenue from the auction of wholesale and/or retail licenses would be used to mitigate the cost of debt refinancing discussed below and potentially to reduce the principal amount. One-time receipts from liquidation of other vehicles and equipment, store fixtures and residual inventory is expected to be offset by one-time expenses of lease penalties as well as unemployment and other costs of severance.

The question remains regarding the level of increased revenue resulting from new economic activity in alcohol sales and expansion of the hospitality industry in Montgomery County. This topic is explored in a following section of the memo.

Based on an analysis of the existing State law and the surrounding market environment, PFM does not believe that economic activity will compensate for the budget loss of over $40 million annually. Consequently, in order to make privatization fiscally neutral, the County will need to enact additional revenue measures.

Debt Impact

Very Significant. Outstanding tax-exempt debt allocable to the warehouse would need to be (i) paid off, (ii) refinanced with taxable bonds payable from a new funding source. Outstanding tax-exempt debt allocable to road projects would need to be (i) paid off, or (ii) refinanced with tax-exempt bonds payable from a new funding source. As noted above, proceeds from a privatization / long-term lease concession of the warehouse as well as possible license auction revenue may be used to pay off the debt.

Alternatives to Fiscal Neutrality
There are some opportunities to gain additional revenue through licenses of retail operations. The following table identifies retail licenses in other Maryland Counties:

County	Class A License	Sunday Sales (additional)
Anne Arundel	$720	
Baltimore	$900	
Howard	$700	$200
Prince George's	$910	$2,590
Queen Anne	$2,000	

PFM has analyzed opportunities to obtain higher license fees when a system privatizes. If it is possible to go to a fee of, for example, $5,000 for a class A license, it may be possible to generate $1-2 million from this source. Of course, this is still insignificant versus the overall lost revenue, but it could be part of a developed revenue package.

In short, full privatization will require – at least in the short-term (and likely much longer) -- the use of additional revenues.

Other Impacts
There are a variety of impacts that can be considered both positive and negative based on one's perspective. Key impacts generally relate to system changes that impact price and convenience.

On convenience, most privatized systems result in an increase in retail outlets. This varies depending on the regulations put in place, including possible quotas on the number and type of retail locations. On the other hand, some states do not impose any restrictions on the number of licenses (other than the ability to meet license requirements and qualifications). Besides location, the system hours of operation are a key consideration for convenience; often the privatized system will provide greater hours of operation – particularly in systems where grocery and other stores are major retailers and tend to be open later hours than control stores.

On price, the most recent evidence, in the State of Washington, is that there was a significant price increase in the first year – according to the State Department of Revenue, approximately 12.5 percent. However, prices stayed level in the second and beginning of the third year.[16] This was largely the result of new taxes imposed to make the new system revenue neutral. It is notable that spirits sales in the new system rose just 1.5 percent from FY2012 to FY2014; of course, this is likely a

[16] Washington State Department of Revenue, various datasets.

combination of price increases mitigating sales growth (there was evidence of increased cross border sales in both Oregon and Idaho) and greater convenience.

It is notable that when PFM has modeled price changes with system change to privatization, some of the efficiencies that can be obtained by use of grocery stores and other large retailers (who already have supply chains in place and efficient staffing models) are not possible because of Maryland prohibitions on size of retail space for liquor and types of businesses that can obtain retail licenses.

Option Five: Bailment approach for warehouse

The goal of this option would be to shift costs associated with maintaining the liquor control's inventory from the County to manufacturers of beer, wine and distilled spirits. This is commonly known in the industry as a bailment model.

The term "bailment" refers to the delivery of personal property by a bailor (in this case the manufacturer or supplier of wine and distilled spirits) to a bailee (in this case, the DLC) for specific purposes under an express or implied agreement of both parties.[17] In the case of alcohol stored in the County warehouse, the manufacturer ships sufficient quantities of product to the liquor control warehouse but still owns the product until it is transported to a retail location for sale.[18] Bailment is considered an industry standard practice, as it improves operational cash flow by reducing the investment in inventory.

The bailment method is commonly used by states that control the wholesale operation. In fact, Pennsylvania was the last control state to switch to the bailment method, which it accomplished in 2012. In the case of Pennsylvania, their liquor control board does not assume ownership of the product until it is picked for shipment in its state warehouse. According to the Pennsylvania Liquor Control Board, its switch to bailment resulted in a reduction in its working capital of approximately $100 million in Fiscal Year 2012.[19]

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[17] Definition taken from Iowa Alcoholic Beverages Division, http://www.iowaabd.com/alcohol/features/listing/bailment_invent_system

[18] It is notable that the exact point in time where the liquor control jurisdiction takes ownership varies. In some jurisdictions, it is at the point when the product leaves the warehouse; in other locations, it is not until it has been sold at the retail location.

[19] Prior to bailment, Pennsylvania typically held between $120 and $200 million in warehouse inventory (with annual sales of over $2 billion). A discussion of the switch to bailment can be found at http://www.supplychainbrain.com/content/research-analysis/supply-chain-innovators/single-article-page/article/alcohol-control-authority-toasts-vendor-managed-inventory-system-1/

Besides the inventory investment savings, several bailment states charge manufacturers rent based on the product stored in their facility (generally on a per case basis). Those fees are generally in the range of $1 per case.[20]

For Montgomery County, one method to deal with concerns about the length of time to fill special orders would be to increase its listing of regularly stocked items. Because under bailment the County would not own the product, slow moving items would not carry the same opportunity cost as they currently do. In this case, it would be the manufacturer that would bear this cost. Given the fact that the County's annual liquor revenue is comparable with some of the smaller control states, this would seem to be a viable option.

It would also be worth considering if the County would wish to modify its current policy of only ordering quantities by the case. Montgomery County is one of only five jurisdictions that require full case orders from manufacturers.[21] Among the States that permit ordering and shipment of split cases, there are a variety of rules and requirements related to minimum and maximum orders, frequency of delivery and additional charges. While seven states do not charge for these orders,[22] five do.[23] The most common charge (imposed by three of the five states) is $0.50 per bottle.

Of course, warehouse space is limited, and increasing the SKUs may create storage issues, particularly for slow moving inventory. If combined with other changes – particularly moving out of the wholesale beer business – this could be an alternative that is cost effective and benefits consumers.

Fiscal Impact

Likely a one-time positive impact. It is likely that the system holds about 1/10th of its annual sales as inventory, and some portion of that (depending on age and other characteristics) could be liquidated over time.

Debt Impact

No significant impact.

Other Impact

To the extent it reduces special orders, it should have a positive impact on that aspect of the system.

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[20] According to the NABCA 2012 Survey book (pp. 244-245), state bailment fees per case are $0.90 (Alabama), $1.00 (Iowa), $1.10 (Maine),$1.20 (New Hampshire), and $1.60 (North Carolina). This equates to an average of $1.16 per case.

[21] NABCA Survey Book 2012, pp 251-252. The five are the States of Alabama, Iowa, North Carolina and Pennsylvania and Montgomery County, Maryland.

[22] Ibid. The states that do not charge for split cases are Maine, Michigan, Montana, Oregon, and Utah.

[23] Ibid. The states that charge for split cases are Idaho, Iowa, Mississippi, New Hampshire and Wyoming.

Option Six: Augment DLC retail stores with limited agency stores

Control states, such as Maine, Oregon, Ohio and Vermont, retain significant oversight of retail liquor operations provided by private contractors through the use of agents. The types of retail facilities that agents operate varies by the preferred approach within the state.

For example, agents in Ohio are generally grocery stores (such as Kroger's) or stand-alone liquor stores. In Vermont, with a generally much smaller population base, agents run the gamut from convenience stores, gas stations, drugstores and supermarkets to stand-alone businesses. The State of Oregon uses a model with two different approaches, independent contractors that are exclusive or non-exclusive. Exclusive stores are generally located in metropolitan areas and are high volume businesses whose primary function is selling liquor. Exclusive stores may also sell authorized related items such as glassware, mixers and items used in preparing a drink. Non-exclusive stores are operated in conjunction with another business such as hardware, drug or grocery stores. Non-exclusive stores usually serve smaller communities.

The primary difference between a private retail and an agency model is that the County still maintains significant control of its agents: the products sold are determined by the County, as are the prices and the hours of operation.

In this approach, the state generally applies a percentage commission on an initial volume of sales, with a smaller, additional percentage for volume increments above the initial volume. This option shares cost risk between the state and agent. Another approach is to apply a flat percentage commission to the total volume of sales, as is done in Ohio and Vermont. A third alternative is to sell the goods at a discounted percentage. Maine applies a varying discount rate based upon the price of the product sold. In this structure, the cost risk resides mostly with the agent in terms of sale of product, with payment up-front at the discounted price.[24]

The financial aspects of the relationship can also extend to ownership of the product. In Vermont and Oregon, the State retains ownership of all product until it is purchased by consumers at the licensed agent's store; this is unlike some states,

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[24] In Maine, if the price of product is under $15.00, a 9 percent commission in the form of a discount at time of purchase from wholesale is applied; if the price of product is $15.01 to $24.99, a 10 percent commission in the form of a discount at time of purchase from wholesale is applied; and if the price of product is $25.00 or greater, a 12 percent commission in the form of a discount at time of purchase from wholesale is applied.

where agents take possession of product upon delivery to their location. Most states permits advertising of product within the parameters established under federal law.

This approach would augment current DLC stores with additional agent-run stores while retaining the wholesale operation and nearly all associated revenues. Additional benefits of this approach include incenting performance in the form of commissions to the agents, a shift in some of the cost risk to the agent (depending upon methodology) and maintaining some of the County's ability to control the market (hours, operation requirements, pricing, etc. could be structured by regulation).

Agent Commissions vary by control state. In Vermont, agent commission is 6.7% of gross sales plus the agent's total earned incentive points. Incentive points are built on performance objectives earned and can amount to as much as 1.5%. Total possible commission can be as much as 8.2%.[25] In Ohio, the Agent's commission rate for sales is fixed at 6% for retail sales and 4% for wholesale sales. Commission payments are based upon gross sales of spirituous liquor reported to DOLC, minus state and county sales tax, which are included in the selling price. [26] Oregon utilizes a fixed base allowance plus variable commission for exclusive and non-exclusive agents, and total commission payouts are capped by the state legislature.[27]

Control State Agent Commissions Overview

State	Ohio	Oregon	Vermont
Agent Commission	6% retail, 4% wholesale	Fixed base allowance plus variable sales commission-- 8.15% retail, 6.36% wholesale. Average agent commission capped at 8.93% by state legislature	6.7% (base commission)-8.2% (agents are eligible for an additional 1.5% of performance based commission)

If Montgomery County employed a similar approach, it is estimated that the County would incur an agent commission expense of $1.0-$1.5 million. The addition of agent stores wouldn't likely add operating expense to the DLC budget and it is expected agent commissions would be covered through increased sales by the agent stores to underserved areas. While agent stores could cannibalize some sales from

[25] http://liquorcontrol.vermont.gov/sites/dlc/files/documents/Licensing/Forms/Form_Retail_Liquor_Agency.pdf

[26] http://www.com.ohio.gov/documents/LIQR_8051.pdf

[27] Per OLCC, Oregon utilizes two different pay structures: exclusive and non-exclusive. An exclusive retail liquor location can sell distilled spirits by the bottle and related items from an approved list (mixers, ice, stemware, tobacco, etc.). A non-exclusive retail liquor location can sell distilled spirits by the bottle and does not have a limit on the other items that are sold.

current DLC stores, recapturing 5% of spirit sales through strategically placed agent stores would likely cover any new agent commission expense.

To estimate the number of agent stores appropriate for Montgomery County, the project team reviewed other control states, and their underlying jurisdictions with comparable demographics. Ohio has been using agents to sell liquor since the 1990s, and comparable Ohio counties around urban centers like Cuyahoga (Cleveland), Franklin (Columbus), and Hamilton (Cincinnati) Counties lend themselves to comparison. The following table estimates the number of agent store licenses issued in Montgomery County if similar per capita ratios were followed. The restrictions on what type of businesses can hold an agent license and other DLC policies would affect the actual number of agent licenses issued.

County	Total Stores	>21 Population	>21 Population per Store
Cuyahoga County, Ohio	48	939,045	19,563
Franklin County, Ohio	34	827,875	24,349
Hamilton County, Ohio	27	576,191	21,340
Ohio County Average			**21,751**
Montgomery County- Current	26	710,287	27,319
Montgomery County- @ Ohio County Comp. Average	33	-	-
Total Agent Stores Needed	7		

Fiscal Impact

It is estimated that this option will have little fiscal impact, and could potentially have a positive fiscal impact depending on sales repatriation realized through the new agent stores. This option assumes no new operating expenses and new agent sales are minimally expected to offset agent commission expense.

It is notable that some estimates suggest that adding additional stores will have a material positive impact on revenue. However, it is very difficult to make a determination of how much additional impact would occur from such a small number of additional locations. It is much easier to make the argument for higher revenue with a larger overall increase in the percentage of stores, as individual location decisions will be less important.

With an additional seven stores (which is a fairly small number), factors such as specific locations, market considerations, type of store and square footage will have a much larger impact on overall results. There are other exogenous variables, related to facility management, length of time from licensing to facility opening and time of

year when facilities will open, that will have a significant impact given the relatively small number of additional locations.

Of course, consideration should be given to the counter-argument: there will be existing locations that will face additional competition, and this may reduce their overall levels of sales. This, of course, exists in any private business or sector. At the same time, if it is accepted that there will be additional revenue from additional locations, then all of that revenue cannot be because of cannibalization. As long as locations with the possibility of serving underserved markets are picked, the impact on existing businesses should be mitigated (but, granted, not totally eliminated).

There are opportunities to limit some of this impact. The most obvious is to choose existing wine and beer retail licensees as agents. In this instance, they will be adding additional products (distilled spirits) without adding additional competition. Of course, this does not actually add additional locations.

Liquor Control- 2016		
EXPENSES	**Current Operations**	**Option 6.**
Director's Office	$3,197,691	$3,197,691
Administration	$5,332,684	$5,332,684
Licensure	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$24,101,855
Wholesale Operations	$11,560,190	$11,560,190
Delivery Operations	$5,734,201	$5,734,201
Other	$3,679	$3,679
Total	**$51,838,985**	**$51,838,985**
REVENUES	**Current Operations**	**Option 6.**
Alcohol Sales	$82,841,627	$83,841,627
Liquor Licenses	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220
Investment Income	$30,700	$30,700
Misc. Revenues	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220
Total	**$85,033,692**	**$86,033,692**

Net Revenues Available for the General Fund	**$33,194,707**	**$34,194,707**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**
Less Debt Service (master lease)	**$881,400**	**$881,400**
Less Private Management Fee	**$0**	**$0**
Less Agent Commissions		**$1,000,000**
Net Remaining Revenues for the General Fund	**$22,485,307**	**$22,485,307**

Debt Impact

None. Since there is no change to the expense structure and the revenue structure is expected to remain the same or potentially improve, there is no debt impact expected under this option.

Other Impacts

It is possible that adding agent stores will have a positive impact on customers. Adding more retail outlets to underserved areas will provide for better access and can help recapture lost sales. If the County chooses to follow other control jurisdiction agent models like Ohio and Vermont, price will not be impacted as product pricing will continue to be controlled by DLC. Product availability would generally remain the same as well, as DLC would retain control over product selection/listing.

As noted in the discussion of other state approaches, if the County wishes to maintain similar types of locations for agency sales, it can restrict licensing to independent operations and/or limit square footage. Given Maryland's restrictions on sales in grocery stores, it is likely that the model would gravitate to independent operations. One alternative would be (as previously mentioned) to seek existing private licensees with beer and wine retail licenses; these would be logical candidates, as they are familiar with the business, are already established and have what are most likely suitable locations.

The actual agent commission rate implemented would largely be predicated on the rules and regulations regarding what type of business can obtain an agent license. Generally, fewer restrictions on agents will result in lower commission rates. For example, a business who sells other products besides liquor and only intends to dedicate a percentage of shelf space to liquor would likely accept a lower commission rate than a retailer who exclusively sells liquor products and relies on it as their primary business income.

Repatriation

A major crux of the argument for the various privatization approaches is that it will lead to a significant increase in sales in Montgomery County that currently occur in other jurisdictions. This 'recapture' is referred to in the industry as 'repatriation.'

Repatriation is a complex topic that requires a careful analysis of a variety of factors. The general argument for repatriation is that, in particular, sales of beer and distilled spirits in the County are below those of other comparable counties, and based on per capita income, Montgomery County residents are likely making additional purchases in other jurisdictions. It is generally the case that consumer expenditure surveys (such as that conducted by the BLS) suggest that higher income individuals spend a greater share of their income on alcohol, and these surveys would support an argument that Montgomery County residents are purchasing alcohol in other jurisdictions.

However, identifying the fact that Montgomery County residents are likely making purchases outside the County does not provide direct evidence for how much repatriation might occur from a system change. This is a complex issue that relies on an analysis of price, convenience, location and the ability of those factors to alter consumer behavior. Claims that privatization alone would, for example, return Montgomery County's purchasing patterns to those of similarly high income counties are overly simplistic. Still, repatriation should not be dismissed out of hand – many sophisticated analyses make a strong case for some level of restored sales in a different system (particularly where convenience is increased and price increases are mitigated), but the actual level is often overstated by reliance on the general rather than the specific instance.

In a December 22, 2015 report by the State Comptroller's Bureau of Revenue Estimates, *The Economic Impact Analysis: Private Sector Competition, Montgomery County Alcohol Sales and Distribution,* the Comptroller argues that, "By removing these barriers to brand competition, it is expected that Maryland would experience an estimated $193.7 million in new economic activity. Moreover, it is estimated that 1,364 jobs will be created, generating $52.6 million in new wages." This appears to be the sort of 'straight-line extrapolation' that does not take into account unique features of the County and the State. Some of the factors that suggest this extrapolation is overly optimistic follow.

First, repatriation will be influenced by County policy decisions such as license density (how many licenses will be permitted in the County). The 25 existing DLC stores represent about one store for approximately every 40,000 people or 25,000 people over 21. The County could chose to limit off-premises licenses to the existing ratio, lower the ratio or place no limit at all and let market forces dictate the level of outlets. Should restrictions be put in place, it will limit convenience. Further, Maryland law places restrictions on the types of stores that are eligible for Class A licenses, including no big box retailers and limited grocery

chains, etc. This will have a significant impact on factors that impact consumer behavior, as well as on efficient pricing.

These restrictions also limit the County's revenue options by reducing the capacity for licensees to absorb alcoholic beverage related taxes or fees. To absorb additional costs, beverage retailers need to have either pricing power or the ability to create efficiencies. The fact that Montgomery County borders a number of jurisdictions with competing private systems that already have a portion of the Montgomery consumer market makes passing along additional governmental costs in the retail price problematic. Moreover, the types of retailers most able to achieve efficiencies are big box retailers, grocery and large format wine and liquor outlets – all of which are heavily restricted under Maryland law.

Other factors come into consideration as well. For example, it will be impossible to entirely repatriate sales occurring in the District of Columbia (DC). In nearly every discussion of locations where per capita 'consumption' does not equate with typical statistics, DC and Las Vegas are generally at the top of the list. These are destination cities where individuals go for activities and entertainment, and there is a significant share of Montgomery residents who work in DC and thus find it convenient to make purchases there. Unlike the 'per capita' approach that is often used to support increased sales, sophisticated retail operations construct gravity models that determine consumer purchasing behavior based on factors like travel patterns, size and amenities of the retail location and substitution inducements. In particular, the DC market has significant factors that give it the sort of 'gravitational pull' that the Montgomery County retail market for alcohol will likely never be able to match – and suggesting the County will get to 'normal' per capita levels of spending is thus fundamentally flawed.

There are also specific options where repatriation claims are overstated because of the resulting business model. For example, the option to privatize wholesale and retail for beer and wine overlooks the fact that there is already significant private competition for the sale of these products. As a result, issues of convenience (a key factor that generally supports increased revenue from private retail) are already mitigated. Unlike distilled spirits, where they may be purchased for off-premise consumption at just 25 locations, there are 150 Class A licenses that have been issued to private retailers of beer and wine.[28] It is also notable that per capita consumption (expressed as purchases) of wine in Montgomery County (2.40 per capita gallons) is already much closer to that of its benchmarked counties than is the case for distilled spirits.

Finally, Maryland's state tax structure also contributes to non-competitiveness, and Montgomery County privatization will not eliminate that. The State already collects both a

[28] "Alcohol and Tobacco Tax Annual Report, Fiscal Year 2015," Comptroller of Maryland, page 36, accessed electronically at http://finances.marylandtaxes.com/static_files/revenue/alcoholtobacco/annual/AnnualReportFY2015.pdf

gallonage tax and a 9% sales and use tax, and changes to the distribution system at the county level will not change that.

Coupled with the fact that any changes based on economic activity would occur over time and not become an immediate revenue source, PFM finds general estimates of dollar amounts that may be repatriated to be lacking in sufficient detail for use in current calculations of fiscal neutrality.

Revenue Alternatives

At the outset, it has to be noted that Maryland local governments are prohibited from imposing an alcohol tax. Local governments cannot tax alcohol by the gallon nor by a sales and use tax on alcoholic beverages.[29] These are taxes that the State of Maryland reserves for the exclusive use of the state government.

It is contextually important to accept the fact that Montgomery County has far less ability to impact some aspects of its business results than most liquor control jurisdictions. The analysis of liquor control operations is almost entirely a review of State operations, which have relatively unfettered taxing authority. Montgomery County, as a local government, is limited in its taxing authority by Maryland State Statute.

The relationship between state and local governments (including Counties) throughout much of the US (including Maryland) is characterized by legal standards set out in two court cases in 1868. They set out what has become known as Dillon's rule and affirmed the previously held, narrow interpretation of a local government's authority, in which a sub-state government may engage in an activity only if it is specifically sanctioned by the state government.

The U.S. Supreme Court upheld Dillon's Rule in 1903 and again in 1923. Since then, it has become a cornerstone of American local government law and has been applied to local government powers in most states. Dillon's Rule allows a state legislature to control local government structure, methods of financing its activities, its procedures and the authority to undertake functions. Maryland is one of 39 states that applies Dillon's Rule to local governments.[30]

[29] "Alcohol and Tobacco Tax Annual Report, Fiscal Year 2015," Comptroller of Maryland, page 1, accessed electronically at http://finances.marylandtaxes.com/static_files/revenue/alcoholtobacco/annual/AnnualReportFY2015.pdf

[30] "Local Government Authority," National League of Cities, accessed electronically at http://www.nlc.org/build-skills-and-networks/resources/cities-101/city-powers/local-government-authority

In Maryland, an Alcohol Beverages Tax is imposed by the State on each gallon at the following rates:

Distilled Spirits	$1.50
Wine	$0.40
Beer and Hard Cider	$0.09

Besides the Alcoholic Beverages Tax, the State also imposes a 9% sales and use tax on alcoholic beverages (for both on and off-premise consumption, including those that are a mixture of alcoholic and non-alcoholic beverages).[31] This is imposed in lieu of the State's general 6% sales and use tax.

As a result, the County's revenue alternatives – without obtaining state cooperation – are limited. It is possible for the County to impose licenses or other fees related to conducting business within the County, but those must reflect the 'cost of doing business' for the County as it relates to regulation and other activities associated with the industry. If charges do not align with the services provided, the charges are then a tax that requires State authority to impose and collect.

Within the revenue option, one source might be wholesale license fees, but this is not likely to be a large revenue source. For one, the state already issues wholesale licenses statewide and collects revenue (249 wholesale licenses issued in FY2015 and total revenue of approximately $193,000). It is unlikely that a Montgomery County license would be accepted as a new County revenue source – at least in any significant amount.

There may be the opportunity to impose a beer franchise fee. This would be one-time revenue, and it would require a state law change. Based on one method of system valuation (multiple of gross profit), it is possible that an amount in the range of $25-$50 million might be obtained (one-time, not on an ongoing basis) from this fee.

It should be noted that the County's range of acceptable ongoing alternate revenues at the current time is limited. For example, the County has already increased its property tax levy, which makes it unlikely that it could do so again in the near future. Second, the County is at its statutory limit related to the county income tax. Finally, the County Council has a history and has made it a priority to roll back the energy tax.

Another significant concern about any change in tax law is the fact that it requires the state to be a willing partner. While getting the tax approved in the first place is a concern, there is

[31] The 9% rate applies to sales of alcoholic beverages as defined in Tax-General Article §5-101(b). This includes sales of beer, distilled spirits, and wine, as well as any beverage or cocktail that may contain a mixture of both alcoholic and non-alcoholic components, including an alcoholic mixed drink, a frozen alcoholic cocktail, an alcoholic coffee drink, and a gelatin shot containing an alcoholic beverage.

a legitimate ongoing concern as to whether the State will follow through over time on any form of shared revenue.

The State has been known to rescind shared revenue when its own budget situation gets difficult. This is a serious threat to the County's finances, as it is often the case that the State budget encounters difficulties during the same types of difficult economic times that also endanger the County budget. For example, the following were county revenue sources that were reduced or eliminated during the 1990s:

1. Liquor tax revenue sharing: eliminated; loss of $4.4 million to counties
2. Beer tax revenue sharing: eliminated; loss of $4.2 million to counties
3. Tobacco tax revenue sharing: eliminated; loss of $12.7 million to counties
4. Property tax grant: eliminated; loss of $82.5 million to counties
5. Teacher social security: eliminated; loss of $145 million
6. Financial institution franchise tax sharing: eliminated; loss of $17 million to counties
7. Transportation taxes revenue sharing (not highway user): eliminated; loss of $19.6 million to counties
8. Abandoned property revenues: eliminated, loss of $5 million to counties
9. Corporate filing fee revenues: eliminated; loss of $1.6 million to counties
10. Security interest filing fee revenues: eliminated; loss of $1 million to counties

In recent years, the State has phased out or shifted other costs to the counties:

1. Utility property tax grant – phased out
2. Teacher pensions – all normal costs shifted to counties
3. Highway user – practically eliminated for counties (Montgomery County used to get about $40 million; currently, the County receives between $4-5 million a year)[32]

Alternate taxes may also raise equity issues. The current DLC revenue from product mark-up is ultimately paid by those who provide and/or consume alcoholic beverages. Should broader revenue sources (such as property, income or non-alcohol excise taxes) be used to replace revenue, it will transfer the tax burden to other county taxpayers who may not substantially benefit from the shift.

Finally, many of the suggested alternatives are relatively small revenue sources. While they may be a part of a package of revenue raisers, they are not likely to off-set the entirety of lost revenue from major system changes.

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[32] Source: Office of Intergovernmental Relations, Montgomery County, Maryland.

Fiscal Impact by Option

Liquor Control- 2016

EXPENSES	Current Operations	Option 1a.	Option 1b.	Option 1c.	Option 1d.	Option 2a.	Option 2b.	Option 3.	Option 4.	Option 5.	Option 6.
Director's Office	$3,197,691	$3,037,670	$2,223,630	$2,435,627	$3,122,230	$3,197,691	$2,130,885	$3,197,691	$644,161	$3,197,691	$3,197,691
Administration	$5,332,684	$5,065,823	$3,708,275	$4,061,815	$5,206,840	$5,332,684	$3,553,608	$5,332,684	$1,074,246	$5,332,684	$5,332,684
Licensure	$1,908,685	$1,908,685	$1,908,685	$1,908,685	$1,908,685	$1,908,685	$1,908,685	$1,908,685	$1,908,685	$1,908,685	$1,908,685
Retail Operations	$24,101,855	$24,101,855	$24,101,855	$24,101,855	$24,101,855	$24,101,855	$24,101,855	$24,101,855	$0	$24,101,855	$24,101,855
Wholesale Operations	$11,560,190	$9,826,161	$1,005,008	$3,302,261	$10,742,471	$11,560,190	$0	$11,560,190	$0	$11,560,190	$11,560,190
Delivery Operations	$5,734,201	$4,874,070	$498,514	$1,638,021	$5,328,587	$5,734,201	$0	$5,734,201	$0	$5,734,201	$5,734,201
Other	$3,679	$3,679	$3,679	$3,679	$3,679	$3,679	$3,679	$3,679	$3,679	$3,679	$3,679
Total	**$51,838,985**	**$48,817,944**	**$33,449,647**	**$37,451,944**	**$50,414,347**	**$51,838,985**	**$31,698,712**	**$51,838,985**	**$3,630,771**	**$51,838,985**	**$51,838,985**
REVENUES	Current Operations	Option 1a.	Option 1b.	Option 1c.	Option 1d.	Option 2a.	Option 2b.	Option 3.	Option 4.	Option 5.	Option 6.
Alcohol Sales	$82,841,627	$69,254,366	$41,767,232	$59,673,611	$75,258,994	$82,841,627	$82,841,627	$82,841,627	$0	$82,841,627	$83,841,627
Liquor Licenses	$1,805,302	$1,805,302	$1,805,302	$1,805,302	$1,805,302	$1,805,302	$1,805,302	$1,805,302	$1,805,302	$1,805,302	$1,805,302
Other Fines/Forfeitures	$194,402	$194,402	$194,402	$194,402	$194,402	$194,402	$194,402	$194,402	$194,402	$194,402	$194,402
Other Licenses/Permits	$88,220	$88,220	$88,220	$88,220	$88,220	$88,220	$88,220	$88,220	$88,220	$88,220	$88,220
Investment Income	$30,700	$25,481	$9,210	$20,569	$26,095	$30,700	$30,700	$30,700	$0	$30,700	$30,700
Misc. Revenues	$54,221	$54,221	$54,221	$54,221	$54,221	$54,221	$54,221	$54,221	$54,221	$54,221	$54,221
Other Charges/Fees	$19,220	$19,220	$19,220	$19,220	$19,220	$19,220	$19,220	$19,220	$19,220	$19,220	$19,220
Total	**$85,033,692**	**$71,441,212**	**$43,937,806**	**$61,855,545**	**$77,446,453**	**$85,033,692**	**$85,033,692**	**$85,033,692**	**$2,161,365**	**$85,033,692**	**$86,033,692**
Net Revenues Available for the General Fund	**$33,194,707**	**$22,623,268**	**$10,488,159**	**$24,403,601**	**$27,032,107**	**$33,194,707**	**$53,334,979**	**$33,194,707**	**($1,469,406)**	**$33,194,707**	**$34,194,707**
Less Debt Service (Liquor Bonds)	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**	**$9,828,000**
Less Debt Service (Master Lease)	**$881,400**	**$881,400**	**$881,400**	**$881,400**	**$881,400**	**$881,400**	**$881,400**	**$881,400**	**$881,400**	**$881,400**	**$881,400**
Less Private Management Fee	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$18,600,000**	**$0**	**$0**	**$0**	**$0**
Less Agent Commissions	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$1,000,000**
Net Remaining Revenues for the General Fund	**$22,485,307**	**$11,913,868**	**($221,241)**	**$13,694,201**	**$16,322,707**	**$22,485,307**	**$24,025,579**	**$22,485,307**	**($12,178,806)**	**$22,485,307**	**$22,485,307**