A Study of Iowa's Liquor Wholesale System

Fiscal Year 2003

Fiscal Year 2009

ALCOHOLIC BEVERAGES DIVISION
State of Iowa

Prepared by

The Iowa Alcoholic Beverages Division

A STUDY

OF IOWA'S

LIQUOR WHOLESALE SYSTEM

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EXECUTIVE SUMMARY

Stakeholders and policy makers periodically question the Iowa Alcoholic Beverages Division (ABD) regarding the financial and regulatory effects of the state being involved in the liquor wholesale business. The primary question generally centers on whether Iowa would be better off financially to "sell off" the liquor business and turn the system over to privately-owned liquor wholesalers.

The attached study and statistics regarding Iowa's direct role in liquor wholesaling prove the following:

- Iowa makes a *net* profit of nearly $65 million annually from wholesale liquor operations. Iowa keeps profit that would otherwise channel to private sector wholesalers.

  Annual profit generated from the wholesale liquor operation is used for substance abuse treatment efforts; distributed to cities and counties for local use; and deposited in the state general fund to bankroll important state projects and programs.

- Iowa saves the cost associated with auditing private sector wholesalers to ensure tax compliance.

- By law, the ABD treats all retailers equally in regards to product pricing, regardless of quantity purchased. The "level playing field" practice enabled over 310 smaller independent retailers to successfully compete with over 280 chain operations in Iowa. The level playing field is particularly important to retailers and consumers located in smaller cities and in rural areas.

- Proponents of liquor privatization propose that the state could apply a low rate "flat" tax per gallon on liquor that would generate the same revenue by increasing the number of gallons sold.

  Proponents of liquor privatization argue if the state placed a gallon tax that is more in line with the tax rates of the states bordering Iowa, all Iowa consumers would stay home to make their liquor purchases and, in fact, some residents of bordering states would be enticed to Iowa by cheaper liquor prices. The tax rates of the states bordering Iowa range from $2.00 to $5.03 per 80-proof gallon.

  Obviously, to keep <u>*all*</u> Iowans at home to make liquor purchases and to attract out-of-state buyers, the tax would have to match the lowest regional competition: Missouri at $2.00 per 80-proof gallon. <u>*At $2.00 per gallon, total raw gallon sales in Iowa would have to increase 661%, from 4,196,218 to 37,447,094 gallons, in order to maintain current annual revenue of $65 million.*</u> <u>*At that sale rate, Iowa's adult per capita sales would be 18.26 gallons, highest in the United States and over nine times the national average of 2.00 gallons per adult.*</u>

If Iowa elected to match the highest regional tax rate, Minnesota at $5.03 per 80-proof gallon, the argument of all Iowa consumers purchasing at home and attracting out-of-state buyers is lost. *Even so, at $5.00 per 80-proof gallon, total raw gallon sales in Iowa would have to increase 257%, from 4,196,218 to 14,978,837 gallons, in order to maintain current annual revenue of $65 million.* *At that sales rate, Iowa's adult per capita sales would be 7.30 gallons; highest in the United States and over three-and-a-half times the national average of 2.00 gallons per adult.*

It is unrealistic to expect that liquor gallon sales could be increased sufficiently under a lower private wholesaling "flat" tax system to replace the current level of state revenue.

- If Iowa privatized wholesale liquor sales and set a "revenue neutral" tax rate ($15.61 per raw gallon) in an attempt to preserve current state revenue, liquor prices to the Iowa consumer would increase 15-20% due to the addition of the new wholesalers' profit markup. The price increase also would have an adverse affect on sales.

  If, on the other hand, Iowa attempted to privatize the wholesale liquor system under a "price neutral" scheme ($8.62 per raw gallon), the state would lose $29,361,015 million in FY09 and would still have the highest tax rate of any of the "License States" in the U.S.

- Privatization of the state liquor wholesale distribution system would result not in "price competition" but rather "brand competition." The ABD projects that 2-3 wholesalers would initially take over the wholesaling function and the field would eventually be whittled to two wholesalers (The State of California has two major wholesalers serving a population of 35 million.)

  The likely wholesalers already serve as supplier brokers in Iowa and have business and financial ties with major liquor suppliers. Liquor suppliers do not offer product lines to multiple wholesalers within a state unless forced to do so by law; the preferred method by suppliers is to franchise with one wholesaler to carry the supplier's entire product portfolio. Consequently, Iowa retailers will not be able to "shop" different wholesalers for the best price on any particular product. Retailers will be forced to purchase a particular brand from a particular wholesaler. In effect, Iowa would be trading a "public" monopoly for a "private" monopoly.

- The state may not realize any privatization "windfall" from the sale of assets, particularly the sale of the liquor warehouse facility in Ankeny. The level of occupancy still remaining after privatization and the highly-publicized fact that the state needs additional office / storage space, indicate that the state would continue to utilize the facility as opposed to an outright sale. See Section 10 for additional detail.

In summary, all states exact revenue from the sale of liquor, either by applying a flat tax per gallon on sales made by private sector wholesalers or by directly wholesaling liquor to retailers.

The, through the operations of the Iowa Alcoholic Beverages Division, has created an efficient wholesaling system that maximizes revenue for state and local government programs and substance abuse treatment efforts, minimizes the cost of industry regulation and creates a level competitive playing field for Iowa retailers.

Privatization of Iowa's liquor wholesale system would either result in the loss of millions of dollars annually or would result in significantly higher liquor prices to the Iowa consumer.

FOR ADDITIONAL INFORMATION REGARDING THIS STUDY, CONTACT STEVER LARSON AT 515-281-7402 LARSON@IOWAABD.COM OR RICK SWIZDOR AT 515-281-7366 SWIZDOR@IOWAABD.COM

INTRODUCTION

Should the State of Iowa be directly involved in the sale and distribution of spirits? The question has been debated since the repeal of the 18th Amendment and the end of Prohibition.

Iowa's involvement in liquor sales began in 1934 as a complete monopolistic system of the wholesale and retail sale of wine and spirits through state-operated liquor stores. Today, the State wholesales and distributes spirits only to privately-owned retail stores through the Iowa Alcoholic Beverages Division (ABD).

Iowa is directly involved in liquor sales for four primary reasons:

1. ***TO MAXIMIZE THE REVENUE RECEIVED FROM LIQUOR SALES.***

All states tax from the sale of spirits. The main difference is the method used by each state to collect revenue. Direct involvement in the sale and distribution of spirits allows Iowa to retain profit that would otherwise go to private sector wholesalers (See flow chart below).

Currently, 18 states and one county in Maryland are directly involved in the sale of spirits and are referred to as "Control States." The Control States were formed at the end of Prohibition and chose direct state involvement as the method for distributing alcoholic beverages to control the trafficking within their respective borders and to maximize the profit from the sale of alcohol. Although changes and improvements have been made to operations in the various Control States, none of the original 19 jurisdictions have abandoned the Control State System.

The other 32 states are referred to as "License States" where alcoholic beverage products are trafficked by privately-owned wholesalers. The License States, through respective Alcohol Beverage Commissions, usually apply a "flat tax" on each gallon sold by a wholesaler to a retailer.

The following depicts the "typical flow" of spirit products / tax collections in a Control State versus License State environment:

CONTROL STATE SYSTEM	LICENSE STATE SYSTEM
Tier 1 Liquor Supplier	**Tier 1 Liquor Supplier**
Tier 2 State Wholesaler (tax markup)	**Tier 2 Tax Paid to State Liquor Board**
Tier 3 Licensed Retailer	**Tier 3 Private Wholesaler (profit markup)**
Tier 4 ---	**Tier 4 Licensed Retailer**

The Control State operations, in effect, act as “non-profit” entities, transferring all profit made from liquor sales over to state treasuries. The License States collect a flat tax on each gallon sold and the wholesale markup (profit) is retained by the private sector wholesaler.

Iowa’s 50% markup on wholesale spirit sales generates over $65 million in net income as an annual source of revenue and is used for substance abuse treatment programs; distributed to cities and counties for local use; and deposited in the state general fund to fund important state projects and programs.

2. TO HELP CONTROL THE TRAFFICKING, SALES AND CONSUMPTION OF SPIRITS IN IOWA.

The ABD does not promote the sale or use of spirits to Iowa consumers. The ABD provides a needed service by delivering liquor to retailers and, at the same time, collecting the “tax” on behalf of the state. Private wholesalers conduct the sale and delivery functions for one primary reason: to make a profit. Under a private wholesale system, there would be pressure applied on wholesalers by liquor suppliers to “sell more product” without regard to the social consequences of increased liquor consumption in Iowa.

3. TO PROMOTE AND MAINTAIN A LEVEL PLAYING FIELD FOR THE IOWA RETAILER.

Under current law (Iowa Code § 123.24) the ABD charges the same price for liquor to all Iowa retailers “regardless of the quantity purchased or the distance for delivery.” Such would not be the case under a private wholesale system. Private wholesalers would give price discounts to large volume and chain retailers at the expense of the individual business owner. Consequently, retailers and consumers in smaller market areas would pay more for liquor purchases. Also, retailers who purchase smaller quantities or, who are located in rural areas, would not receive as frequent service as the state currently provides.

4. TO FOREGO THE STATE EXPENSE ASSOCIATED WITH THE REGULATION AND AUDITING OF PRIVATE SECTOR WHOLESALERS.

If Iowa was not directly involved in the wholesaling of spirits, the ABD would have to regulate the business transactions between private sector wholesalers and retailers to ensure the accurate collection of a state-mandated gallonage tax. As a rural state, Iowa has elected to assure its citizens with comparable pricing on alcohol.

Iowa could get out of the liquor business but at an increased cost to regulate business transactions and collect tax from private sector wholesalers.

Iowa could tax sales made by new wholesalers to create a “revenue neutral” situation to the general fund, but at the cost of higher liquor prices to the Iowa consumer. Or, some will argue that the state could apply a tax rate that is “competitive” to Iowa’s neighboring states and increase liquor sales to the point where no state money is lost. **However, statistics indicate**

Iowa would have to have the highest per capita adult sales rate in the United States for this to happen.

The bottom line is Iowa could privatize wholesale liquor sales but to do so would translate into either the loss of millions of dollars every year or the marked inflation of liquor prices to the consumer.

The following pages will address the financial aspects of Iowa's continued involvement in the wholesale liquor business.

SECTION 1

HISTORICAL OVERVIEW

HISTORICAL OVERVIEW

With the repeal of Prohibition in 1933, individual states gave great consideration regarding the best method of making alcohol beverages available to it's citizenry. Some states still did not agree that ending prohibition was a wise policy decision and most were frustrated that enforcement efforts during prohibition were only minimally successful.

After studying several systems of other countries and of those taking shape in the United States, Iowa along with seventeen other states and one county in Maryland, decided to be directly involved in the distribution of alcohol beverages to consumers. In most cases, these jurisdictions also were involved in the direct sale of alcohol to consumers through state-operated retail liquor stores. The jurisdictions soon became known as the "Control States."

Iowa policymakers decided that by placing state government in direct control of the distribution and sale of alcohol, three goals would be realized:

- The criminal element that was prevalent in the liquor business during prohibition would be effectively curtailed.
- Greater control over citizen consumption of the now legal drug would be better achieved by a state-run system as opposed to a profit-driven free market system that would inherently promote greater liquor consumption.
- Any revenue derived from the state-run system would be used to promote moderation in the consumption of alcohol, aid substance abuse treatment efforts and help fund other state and local programs.

With those goals in mind, the 1934 Iowa General Assembly created the Iowa Liquor Control Commission charged with the mission of "protecting the welfare, health, peace, morals and safety of the people of the state."

The commission opened its first five state-operated liquor stores on June 19, 1934, in Atlantic, Des Moines, Marshalltown, Mason City and Oelwein. The locations were known as "counter stores" in which customers would record their selection on a piece of paper and hand it to a clerk who would retrieve the selection from the back room of the store. The clerk would record the purchase in the customer's state-issued "individual liquor permit" booklet. State stores had limited shopping hours, were not open on Sundays or holidays, and did not take checks or credit cards. Effective in helping to control consumption, but not always well received by the Iowa consumer.

By the early 1970s, attitudes had changed. Consumers wanted the freedom to shop for their own purchases at their own convenience. As a result, counter stores gave way to self-serve stores. State revenue increased significantly under the self-serve system.

As the 1980s rolled around, society began to take a less tolerant view of the excessive alcohol use. Consumers were increasingly health conscious and states began enacting tougher drinking and driving laws. The sale and use of alcohol in Iowa, along with the rest of the country, was in decline. Although Iowa's state-store system continued to serve consumers and continued to pour millions of dollars into state coffers, store expenses increased and profits declined.

After careful study, the 1986 Iowa General Assembly elected to preserve the State's role in the wholesaling of spirits in order to maintain revenue to the general fund but decided to allow private sector stores to sell bottles of spirits to consumers. So in 1987, 54 years after the end of Prohibition, the last bottle of liquor was sold from a state-operated liquor store. The last of the 220 state stores was closed on June 30, 1987.

Today, over 590 privately-owned outlets sell liquor to consumers as well as to bars, restaurants and other on-premises locations. Stores are allowed to sell liquor seven days a week, including holidays. Most accept checks and major credit cards for consumer purchases… quite a change from 1934 operations.

The Iowa Alcoholic Beverages Division wholesales spirits to the over 590 privately owned liquor outlets at a 50% markup over the division's cost. The Division warehouses and delivers products to retailers on a weekly basis. The Division will deliver an order as small as 5 cases, while some large volume retailers receive deliveries twice weekly.

By law (Iowa Code § 123.24), the Division offers the same price on spirits to all retailers regardless of the quantity purchased. The Division also offers the same terms on delivery to all retailers regardless of their location in Iowa. Such practices have enabled over 310 small independently-owned stores to co-exist and compete with large volume chain stores.

SECTION 2

CURRENT IOWA STATE WHOLESALE LIQUOR GROSS REVENUE

GROSS REVENUE DERIVED FROM STATE LIQUOR WHOLESALING FY09 ESTIMATE

The following shows the estimated gross liquor wholesaling revenue generated in FY 2009. The ABD applies a 50% wholesale markup on the supplier product cost before selling to privately-owned package liquor stores. Due to the fact that suppliers increase their product price to the state each year (inflation / supply & demand, etc.), the state can make increased profits even when gallon sales stay constant or even slightly decrease. The mark-up paradigm also ensures that the tax collected on spirits stays constant with inflation. Such would not be the case if a flat per gallon tax were affixed to sales. As an example, FY08 dollar sales collected increased 6.38% while gallons sold were up only 3.23%. If Iowa applied a flat per gallon tax, collections would have increased only 3.23%.

FY09	Gross Liquor Sales	$200,890,170
	Cost of Goods Sold	132,840,674
	Gross Wholesale Profit	$ 68,049,496
	Plus Other Wholesale Revenues. . .	
	Bailment Fee	$ 1,096,344
	Split Case Fee	520,973
	Miscellaneous Income	346,439
	Bottle Deposit Fee	815,367
	Bottle Recycle Surcharge	652,294
TOTAL GROSS WHOLESALE PROFIT		**$ 71,480,913**

SEE SECTION 8 FOR ESTIMATE DETAIL

SECTION 3

STATE COST OF LIQUOR WHOLESALING

BUDGET COMPARISON UNDER PRIVATE WHOLESALE SYSTEM

Expenses avoided by privatizing state liquor wholesale operations would likely be significantly offset by the cost associated with regulating the privately-owned distributors and for ensuring the timely and accurate collection of a liquor gallon tax. See derivation of expense projections in Section 9 beginning on page 45.

Although the Division applies a straight 50% markup to the cost of goods sold, when all other fees and revenue generated by the wholesaling system (bailment fee, split-case fee, etc.) are factored, the equivalent profit markup is 51.2%. The $3.2 million expense reduction expected under a private wholesaling system would still require the equivalent of a 50.8% markup (tax) for the state to break even with current revenue production.

		FY09 ABD BUDGET (With State as Wholesaler)		**FY09 ABD BUDGET (Under Private Wholesale System)**	
		$	**FTE**	**$**	**FTE**
1001	Commission	2,180	0.00	2,180	0.00
1002	Administration	604,827	5.00	604,827	5.00
1003	Accounting	464,544	6.00	464,544	6.00
1004	Maintenance	50,055	1.00	50,055	1.00
1005	Information Technology	302,300	3.00	183,124	1.00
1006	Licensing	377,023	7.00	377,023	7.00
1007	Products	355,275	7.00	0	0.00
1008	Building & Grounds	154,017	0.00	154,017	0.00
6000	Tobacco Enforcement	1,310,000	10.00	1,310,000	10.00
RM09	Routine Maintenance	78,168	0.00	78,168	0.00
	Subtotal	**$3,698,389**	**39.00**	**$3,223,938**	**30.00**
	Other Expenditures:				
	Warehousing/Delivery	$3,964,715	40.00		
	Bottle Deposit Refunds	522,765			
	Bottle Recycle Expense	963,373			
	Grand Total Expense	**$9,149,242**	**79.00**	**$3,223,938**	**30.00**
	Expenditure Reduction Under Private Liquor Wholesaling:			**$5,925,304**	**49.00 FTE**

SECTION 4

REVENUE NEUTRAL TAX

TAX NEEDED TO ACHIEVE REVENUE NEUTRALITY

Past plans to privatize wholesale liquor sales in Iowa have called for a flat per gallon tax to replace state revenue. Usually the plans have called for a dollar amount based on an 80 or 100-proof rate per gallon (industry standards). The current average sale made by the Division, however, is only 70-proof alcohol. Based on current net revenue of $65.5 million, and the “raw” average sale of 70-proof per gallon, a $15.61 per 70-proof gallon tax would be necessary to achieve revenue neutrality (see below). Consequently, any plan that called for an 80 or 100-proof tax rate would require a higher dollar rate to achieve neutrality since it takes more sales of 70-proof alcohol to equal an 80 or 100-proof gallon.

Also, a flat per gallon tax rate will only generate more revenue when gallon sales increase; whereas, the state’s 50% markup increases revenue when supplier prices go up, when consumers purchase higher priced product and also when gallon sales increase.

FY09 Gross Income Under State Wholesale System (page 15)			**$71,457,718**
Reduction in FY09 Division Expense Due to Wholesale Privatization (page 19)			**$5,925,304**
Tax Needed to Replace State Wholesale Liquor Revenue			**$65,532,414**
<u>Tax Needed per Gallon to Break Even</u> **(Projected FY09 raw gallons of 4,196,218 sold @ current 70 proof average)**			**<u>$15.61 per raw gal.</u>**
		OR	**$17.84 per 80 proof gal.**
		OR	**$20.07 per 100 proof gal.**

SECTION 5

INCREASED CONSUMPTION
VS
REVENUE NEUTRAL TAX

INCREASE CONSUMPTION?

Could the state privatize wholesale liquor sales and sufficiently increase gallon sales at a low tax rate to match current state revenue? Some proponents of privatization argue that Iowa is losing sales to neighboring states via cross border sales due to high liquor prices and that a "revenue neutral" tax is not necessary to net the state the same revenue collected under the current system. Proponents argue that if Iowa lowered its tax rate on liquor, Iowa consumers would stay home to shop and that neighboring state consumers may even be attracted to Iowa by low liquor prices.

Following is a comparison of the tax rates of states contiguous to Iowa.

2001 TAX RATE BASED ON 80 PROOF GALLON (SOURCE "ADAMS 2008 LIQUOR HANDBOOK)			
Illinois*	$4.50	South Dakota*	$3.93
Missouri	2.00	Minnesota**	5.03
Nebraska	3.75	Wisconsin	3.36

*Different rates also applicable according to alcohol content, place of production, size of container, place purchased (on- or off-premise or on board airlines).
**Includes case fees and/or bottle fees, which may vary with the size of container.

To keep *all* Iowans "at home", and, to attract out-of-state liquor buyers, Iowa would have to at least match the lowest rate in the region of $2.00 per 80-proof gallon.

At a $2.00 per 80 proof gallon rate, total liquor gallon sales in Iowa would have to increase 792% to 37,447,094 gallons each year to maintain current state net profit. Iowa's Adult "Per Capita" consumption rate would have to increase from 2.00 to 18.26 gallons, nearly four times the current highest state rate in the United States (New Hampshire / 4.85 gals.). The current U.S. average is 2.00 gallons consumed annually per adult. (Source: 2008 Adams Liquor Handbook)

The charts on the following 4 pages demonstrate the amount of Iowa liquor consumption increase necessary at tax rates of $2.00, $3.00, $4.00 and $5.00 per gallon for the State of Iowa to privatize wholesale liquor sales and achieve revenue neutrality.

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $2.00 TAX PER 80-PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$65,532,414	=	FY2009 Net Revenue From State Wholesaling
4,196,218	=	FY2009 70 Proof Gallons Sold
$15.61	=	FY2009 State Profit per 70 Proof Gallon Sold
$65,532,414	=	Tax Required to Replace State Revenue
If $2.00	=	Tax on 80-Proof Gallon, Then ….
32,766,207	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
26,212,966	=	The Number of 100 Proof Gallon Sales
Divided by 70%	=	Conversion to 70 Proof =
37,447,094	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-4,196,218	=	FY09 Projected **70** Proof Gallons Sold =
33,250,876	=	**Gallon Increase in 70 Proof Gallon Sales Needed To Break Even @ a $2.00 Per 80 Proof Gallon Tax Rate**

792% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $3.00 TAX PER 80-PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$65,532,414	=	FY2009 Net Revenue From State Wholesaling
4,196,218	=	FY2009 70 Proof Gallons Sold
$15.61	=	FY2009 State Profit per 70 Proof Gallon Sold
$65,532,414	=	Tax Required to Replace State Revenue
If $3.00	=	Tax on 80-Proof Gallon, Then ….
21,844,138	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
17,475,310	=	The Number of 100 Proof Gallon Sales
Divided by 70%	=	Conversion to 70 Proof =
24,964,729	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-4,196,218	=	FY09 Projected **70** Proof Gallons Sold =
20,768,511	**=**	**The Increase in 70 Proof Gallon Sales Needed To Break Even @ a $3.00 Per 80 Proof Gallon Tax Rate**

495% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $4.00 TAX PER 80 PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$65,532,414	=	FY2009 Net Revenue From State Wholesaling
4,196,218	=	FY2009 70 Proof Gallons Sold
$15.61	=	FY2009 State Profit per 70 Proof Gallon Sold
$65,532,414	=	Tax Required to Replace State Revenue
If $4.00	=	Tax on 80-Proof Gallon, Then ….
16,383,104	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
13,106,731	=	The Number of 100 Proof Gallon Sales
Divided by 70.00%	=	Conversion to 70 Proof =
18,723,901	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-4,196,218	=	FY03 Projected **70** Proof Gallons Sold =
14,527,683	**=**	**The Increase in 70 Proof Gallon Sales Needed To Break Even @ a $4.00 Per 80 Proof Gallon Tax Rate**

346% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $5.00 TAX PER 80 PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$65,532,414	=	FY2009 Net Revenue From State Wholesaling
4,196,218	=	FY2009 70 Proof Gallons Sold
$15.61	=	FY2009 State Profit per 70 Proof Gallon Sold
$65,532,414	=	Tax Required to Replace State Revenue
If $5.00	=	Tax on 80-Proof Gallon, Then ….
13,106,483	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
10,485,186	=	The Number of 100 Proof Gallon Sales
Divided by 70%	=	Conversion to 70 Proof =
14,978,837	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-4,196,218	=	FY03 Projected **70** Proof Gallons Sold =
10,782,619	**=**	**The Increase in 70 Proof Gallon Sales Needed To Break Even @ a $5.00 Per 80 Proof Gallon Tax Rate**

257% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

SECTION 6

EFFECT ON CONSUMER PRICES

EFFECT ON CONSUMER BOTTLE PRICE UNDER "REVENUE NEUTRAL" & "PRICE NEUTRAL" PRIVATE WHOLESALE SYSTEM

In order to maintain current net liquor revenue, consumer prices under a private wholesale system would increase because of the addition of another profit layer – the wholesaler's markup (See flow chart page 5). According to industry members, private sector wholesalers in License States attempt to average a 16-20% wholesale markup on sales made to retailers. For purposes of this exercise, the ABD used an average wholesale markup of 18%. The following exercise shows how the current average consumer bottle price would increase by over 17% due to the added profit layer.

Est. FY09	Average Cost per Bottle ($132,840,674 cost of goods / 16,307,348 FY09 est. bottle sales)	$8.15
Est. FY09	Average Size Bottle Sold (4,196,218 gallons / 16,307,348 bottle sales)	32.94 oz. (or 25.7% of a gal.)
Tax per Bottle Necessary to Achieve Revenue Neutrality*		$4.01 (25.7% of $15.61 gal. tax)

***The exercise below is based on a flat tax per raw gallon sold. A tax set on sales of 80 or 100 proof gallons would require an even higher tax rate to achieve revenue neutrality.**

	Current State Pricing	Private Wholesaling Pricing
Avg. Cost per Bottle	8.15	8.15
State 50% Markup	4.08	--
State Gallon Tax under Privatization (Per Avg. Bottle)	--	4.01
Private Wholesaler Average Markup 18%	--	2.19
Cost to Retailer	12.23	14.35
Average Retailer Markup (18%)	2.20	2.58
Consumer Price	14.43	16.93
Price Increase to Consumer	**$0.00**	**$2.50 / 17.3%**

Should the state privatize wholesale liquor sales using a gallon tax based on an 80 or 100-proof gallon, the tax rates for the average bottle size sold would be $4.58 and $5.73 respectively. At those rates, the price of an average bottle would increase 24% to the consumer at the 80-proof rate and would increase 36% at the 100 proof rate.

If Iowa decided to privatize wholesale liquor sales without raising the average bottle price to the consumer, a tax rate of $7.12 per gallon sold would be required (See following "price neutral" exercise).

Est. FY09 Average Cost per Bottle $8.15
($132,840,674 cost of goods / 16,307,348 FY09 est. bottle sales)

Est. FY09 Average Size Bottle Sold 32.94 oz. (or 25.7% of a gal.)
(4,196,218 gallons / 16,307,348 bottle sales)

Tax per Bottle Necessary to Maintain
Current Consumer Price $2.22 (25.7% of $8.62 gal. tax)

	Current State Pricing	**Private Wholesaling Pricing**
Avg. Cost per Bottle	8.15	8.15
State 50% Markup	4.08	--
State Gallon Tax under Privatization (Per Avg. Bottle)	--	2.22
Private Wholesaler Average Markup 18%	--	1.87
Cost to Retailer	12.23	12.23
Average Retailer Markup (20%)	2.20	2.20
Consumer Price	14.43	14.43
Price Increase to Consumer	**$0.00**	**$0.00**

Current Net Liquor Revenue: $65,532,414
Revenue under a "Price Neutral" System: -$36,171,399
(FY09 gallons 4,196,218 x $8.62 per gallon = $36,171,399)

FY09 Loss under Price Neutral System: $29,361,015

Note: At a rate of $8.62 per gallon, Iowa would lose $29,361,015 in FY09 and would still have the highest tax rate of any of the "License States" in the U.S.

SECTION 7

COMPETITION

A LEVEL PLAYING FIELD

With the privatization of liquor sales in 1987, the Iowa General Assembly envisioned a statewide network of privately-owned retail liquor stores that would be free to compete in an atmosphere of uniform regulation by state government. The legislature crafted legislation that would not only help promote creation of many small businesses, but also help ensure small business success against high-volume chain operations by adding the following language:

> "…The division shall offer the **same price** on alcoholic liquor to all class "E" liquor control licensees **without regard for the quantity of purchase or the distance for delivery**…"

[Emphasis added.] <u>See</u> Iowa Code §123.24.

The fact that over 310 independently owned liquor stores are still in operation 21 years after privatization, and, in competition with over 280 chain outlets, is proof that the legislative language has worked as intended. Without the language, high volume operators would have driven small independent operators from the marketplace long ago, to the disadvantage of the Iowa consumer. The Iowa Alcoholic Beverages Division is convinced of the fact because, as wholesaler, the Division is approached frequently by representatives of large distilleries who lobby the Division to exact a change in law that would allow discount pricing on large volume purchases made by chain retailers…purchase amounts that most independent operators could not afford to make.

The Division realizes that in some cases it is not government's responsibility to ensure the success of small business. But, as long as state government seeks to maintain current state liquor revenue and promote small business by uniform regulation, then the Iowa Alcoholic Beverages Division operation seems to be the best way to accomplish both.

Who would the new wholesalers be under a private system? Currently, three brokerage firms are positioned to initially take over the wholesaling of spirits to Iowa retailers. The three brokerage firms already have ties with liquor distillers in the respect that the firms represent the distillers' products in Iowa and make a fee for each case of liquor sold. Two of the three are already in the warehousing / distribution business operating as wine wholesalers. All three have corporate headquarters outside of Iowa. Some initial investment would be required for these entities to take over the wholesaling market. Whatever investment "gain" that would be made by these businesses would at least be partially offset by the loss of investment currently made by the ABD's private sector warehousing company.

The ABD believes that the Iowa market is not large enough to satisfy three liquor wholesalers. California, with over 35 million people, can support only 2 wholesalers. Michigan, which sells almost 5 times the amount of liquor as Iowa, has two large and one smaller volume wholesalers. Within a short period of time, one – three years, Iowa would likely be left with 2 liquor wholesalers. The two remaining wholesalers would likely have franchise ties to specific suppliers and would carry competing brands. Consequently, there would be no “price” competition, but rather “brand” competition, from which retailers could choose. In effect, the state would be trading a “public” monopoly for a “private” monopoly.

SECTION 8

Derivation of Revenue Projections

(Detail of revenue as shown on page 11)

DERIVATION OF REVENUE PROJECTIONS

(As shown on page 11)

Assumptions
Liquor dollar sales will increase 6.38% in FY09
Liquor volume will increase 3.23% in FY09.

Gross Liquor Sales

FY2008 actual sales were $188,842,047, an increase of 6.38% over FY07. Growth of 6.38% is projected for FY09.

FY08 Actual	$188,842,047
FY09 Projected at 6.38% growth	$200,890,170

Cost of Goods Sold *

FY08 average markup rate of 51.2264% used to project cost of goods sold for FY09.

FY09 projected sales of $200,890,170 divided by 1.512264 equals $132,863,869 for projected cost of goods sold.

Bailment Fee

FY08 case sales of 1,516,172 projected to grow at 3.0%. Actual FY08 case volume increase was 3.0%.

FY09 case sales of 1,566,206 x $.70 per case =$1,096,344

Split Case Fee

FY08 actual collections of $498,296 projected to grow at 4.55%.

FY08 Actual	$498,296
FY09 Projected	$520,973

***Although the ABD applies a 50% across-the-board wholesale markup on product sold, the application of price increases to product already owned by the state and the state's purchase of supplier discounted product for resale at regular price, creates the equivalent of a 51.2% average wholesale markup.

Miscellaneous Income

Income from various incidental charges, such as re-palleting product and deposit sticker application totaled, in FY08, $346,439.

Bottle Deposit Fee

FY08 actual of $786,884 increased 1.5% for FY03.

FY09 projected at 3.62% growth = $815,367

Bottle Recycle Surcharge

FY08 actual of $314,753 increased 3.62% for FY09.

The per bottle surcharge was increased from $0.02 to $0.04
FY09 projected at 3.62% bottle growth = $652,294

SECTION 9

Derivation of Expense Projections

(Detail of expense as shown on page 13)

DERIVATION OF EXPENSE PROJECTIONS

(SHOWN ON PAGE 13)

GENERAL DISCUSSION

Liquor wholesaling activity is one of four core functions performed by the Iowa Alcoholic Beverages Division. The other core functions performed are:

- The licensing of all businesses that manufacture, import, wholesale or retail alcoholic beverages products in Iowa.

- Regulate the business / financial transactions conducted between the various tiers of the alcoholic beverages industry in Iowa. This includes the collection and auditing of beer and wine excise taxes and regulating the federal and state “Fair Trade Practices” statutes that define the legal transactions allowed between a supplier / wholesaler and a retailer.

- Enforce Iowa’s tobacco laws by conducting compliance checks of tobacco retailers and providing for youth tobacco sales prevention education for retailers, law enforcement and local officials. It should be noted that funding for the ABD tobacco enforcement program comes entirely from the state tobacco settlement trust.

The ABD assumes that the above-mentioned non-wholesaling functions would continue to be performed by the ABD under a private wholesale system.

Under current operations only 49 of the 79 FTE’s are completely dedicated to liquor wholesaling activities.

The remaining 30 FTE’s are dedicated to licensing activities, tobacco enforcement, accounting, information technology, building maintenance and administration.

Following is a discussion and estimate of the budgetary and personnel resources required under a private wholesaling system.

FY09 ABD BUDGET UNDER A PRIVATE WHOLESALE SYSTEM
See page 19 for financial detail.

1001, Alcoholic Beverages Commission
Original FY09 Budget: $2,180 Revised Budget: $2,180

The ABD assumes that the Alcoholic Beverages Commission would remain intact to provide direction and to set policy for remaining division operations and to meet other statutory requirements.

1002, Administration
Original FY09 Budget: $604,827 Revised Budget: $604,827

The Administration Section has 5 full-time employees whose primary duties consist of:

- Implementing policy and operations as directed by the Alcoholic Beverages Commission and the administrator.
- Regulation of the trade practices between suppliers / wholesalers and retailers.
- Coordinate all administrative hearings resulting from appeals of licensing actions and licensee violation of state laws and rules.
- Prepare and manage agency budget.
- Prepare all documents, requests for information and fiscal note requests from the Legislature, Governor's Office, other state agencies, media, and requests for information from the public.
- Coordinate all educational efforts conducted by the division.
- Draft all administrative rules for the division.
- Initiate all personnel actions.
- Coordinate and participate in enterprise level programs including the "Accountable Government Act" and the "Administrative Rules Review Process" and other programs relating to information technology and facility maintenance.
- Provide direct supervision for the licensing, accounting, information technology, facility maintenance, tobacco enforcement and wholesaling sections of the ABD.

Except for the supervision of the 7 employees in the 1007, Products Section, all other activities performed by the Administration Section would remain unchanged under a private system of liquor wholesaling. Although there would be no changes in the administrative staff, a share of miscellaneous expense items would be saved by the elimination of the Products Section and reductions made in the Information Technology Section.

Independent of the liquor warehouse operation, the ABD has a total of 39 FTEs with 10 FTEs dedicated to tobacco enforcement and education initiatives. The tobacco enforcement budget has been excluded from this analysis. Of the remaining 29 FTEs, ABD has determined that 9 could be eliminated under private liquor wholesaling system; the 7 FTEs in the 1007, Products Section and 2 FTEs in the 1005, Information Technology Section. This represents a 31% reduction in the remaining ABD staff, and a 12% reduction to appropriated funds. Some future minor expense savings may also be realized in the areas of printing costs and reimbursements to other state agencies.

1003, Accounting Section
Original FY09 Budget: $464,544 Revised Budget: $464,544

Although there would be a reduction in the accounting services associated with liquor accounts payable / receivable, there would be an increase in the activities associated with the auditing of new liquor wholesalers for tax compliance on sales made to Iowa's 590 liquor retailers. Consequently, no change is made to the budget or in personnel resources required in the Accounting Section.

1004, Maintenance Section
Original FY09 Budget: $50,055 Revised Budget: $50,055

1008, Building & Grounds Section
Original FY09 Budget: $154,017 Revised Budget: $154,017

RM09 Routine Maintenance Funding
Original FY09 Budget $78,168 Revised Budget: $78,168

Two employees and approximately $280,000 is dedicated to front office utilities, maintenance, and upkeep to the Department of Commerce facility located in Ankeny. The amount listed for Routine Maintenance is a carry-over from FY 08. Due to the level of occupancy that would remain after privatization, as well as the highly publicized fact that the state needs additional office / storage space, it is questionable if it would be in the state's best interest to sell the facility (See "Sale of Assets", Section 10, page 51).

Consequently, no change is made to the three cost center budgets that support facility maintenance.

1005, Information Technology Section
Original FY09 Budget: $302,300 Revised Budget: $183,124

The ABD has determined that two of the three current information technology specialists could be eliminated under a private wholesaling system. The remaining specialist would maintain programs associated with liquor licensing, tobacco enforcement, regulation and tax software programs and web page maintenance.

1006, Licensing Section
Original FY09 Budget: $377,023 Revised Budget: $377,023

With the exception of the addition of 2-3 new wholesale licenses to issue, activity in the licensing section would remain unchanged.

1007, Products Section
Original FY09 Budget: $355,275 Revised Budget: $0

The entire section and 7 employees would be eliminated under a private wholesale system.

OTHER EXPENDITURES:

Warehousing/Delivery

The warehousing and delivery function is funded from liquor revenues. The loaded budget information represents costs of $3,964,715 for FY09

.

Bottle Deposit Refunds

Refunds experienced in FY08 projected to grow 3.0% in FY09.

FY08 Actual	$507,539
FY09 Projected	$522,765

Bottle Recycle Expense

The cost of retrieving empty liquor bottles from retailers for recycling is projected to grow 7.6% in FY09 due to contractual rate increases and projected redemption increases.

FY08 Actual	$895,328
FY09 Projected	$963,373

Section 10

Sale of Assets

Sale of Assets

Liquor warehouse facility, 1918 SE Hulsizer Rd, Ankeny

Discussion has ensured regarding potential revenue generated by the sale of the liquor warehouse facility located in Ankeny.

The facility is located north of the I80 - I35 interchange in the industrial section of Ankeny and consists of a 175,000 square foot building divided into a 150,000 square foot warehouse and a 25,000 square foot office area. The building sits on approximately 11 acres of land with seven acres dedicated to the facility, truck parking (warehouse area) and office / visitor parking. There are four “landlocked” acres behind the facility that were initially platted as an expansion area for the warehouse should the need arise.

The original land purchase and building construction cost was financed by the sale of $4.4 million in special liquor revenue bonds, which have subsequently been retired. The facility, completed in 1980, has been well-maintained.

In addition to the ABD operation and employees, the facility is also occupied by the following:

- The Professional Licensing Bureau of the Banking Division of the Department Commerce, approximately 6,500 square feet office space.

- The Iowa Lottery Warehouse Operation, approximately 12,500 square feet warehouse space.

Considering the level of occupancy still in place after liquor wholesale privatization, the current real estate and market conditions and, the highly-publicized fact that the state has a need for additional office / storage space, it is unlikely to be in the state’s best interest to sell the facility for a “one-time windfall” to the general fund at the possible expense of increased rent costs in future years to house continuing operations.

Should the decision be made to sell the facility, consideration should also be given to the timing of any expected windfall receipt. It is probable that the sale of the facility would not occur until some future fiscal year after the privatization of the liquor wholesaling system.

Sale of Inventory

The ABD operates under a “bailment inventory” system in that the distiller / supplier maintains ownership of the inventory until the ABD sells the product. Consequently, the state has virtually no investment in liquor inventory except for a small amount invested in split case inventory (less than full case quantities) and in discounted product. Should the decision be made to privatize the liquor wholesaling system, the eventual sale of whatever inventory was owned by the state would result in a one-time small cash flow increase to the state general fund.

A STUDY

OF IOWA'S

LIQUOR WHOLESALE SYSTEM

Fiscal Year 2003

ALCOHOLIC
BEVERAGES
DIVISION
State of Iowa

Prepared By

The Iowa Alcoholic Beverages Division
August 2002

Table of Contents

EXECUTIVE SUMMARY

The Iowa Alcoholic Beverages Division (ABD) is frequently questioned regarding the financial and regulatory effects of the state being involved in the business of wholesaling liquor. Usually the question centers on the state's continued involvement in the liquor wholesaling business and whether "Iowa would be better off financially to "sell off" the liquor business and turn the system over to privately-owned liquor wholesalers."

The following study and statistics prove the following:

- Iowa makes a *net* profit of over $39 million annually from wholesale liquor operations. By being directly involved in liquor wholesaling, Iowa keeps the profit that would otherwise go to private sector wholesalers.

  The annual profit generated from wholesale liquor operations is used for substance abuse treatment efforts; distributed to cities and counties for local use; and deposited in the state general fund to fund important state projects and programs.

- By being directly involved in the wholesaling of liquor, Iowa saves the cost associated with auditing private sector wholesalers to ensure tax compliance.

- By law, the ABD treats all retailers equally in regards to product pricing, regardless of quantity purchased. This "level playing field" practice has enabled over 200 smaller independent retailers to successfully compete with over 200 chain operations in Iowa. This is particularly important to retailers / consumers located in smaller cities and in rural areas.

- Proponents of liquor privatization propose that the state could apply a low rate "flat" tax per gallon on liquor that would generate the same revenue by increasing the number of gallons sold.

  Proponents of liquor privatization argue if the state placed a gallon tax that is more in line with the tax rates of the states bordering Iowa, that all Iowa consumers would "stay home" to make their liquor purchases and, in fact, some residents of bordering states would be enticed to Iowa by cheaper liquor prices. The tax rates of the states bordering Iowa range from $2.00 to $5.03 per 80 proof gallon.

  Obviously, to keep <u>*all*</u> Iowans at home to make liquor purchases and to attract out-of-state buyers, the tax would have to match the lowest regional competition: Missouri at $2.00 per 80 proof gallon. <u>*At $2.00 per gallon, total raw gallon sales in Iowa would have to increase 661%, from 2,943,446 to 22,389,030 gallons, in order to maintain current annual revenue of $39.2 million.*</u> <u>*At that sale rate, Iowa's adult per capita sales would be 10.71 gallons, highest in the United States and over six times the national average of 1.76 gallons per adult.*</u>

If Iowa decided to match the highest regional tax rate, Minnesota at $5.03 per 80 proof gallon, the argument of all Iowa consumers purchasing at home and attracting out-of-state buyers is lost. *Even so, at $5.00 per 80 proof gallon, total raw gallon sales in Iowa would have to increase 204%, from 2,943,446 to 8,955,613 gallons, in order to maintain current annual revenue of $39.2 million.* *At that sale rate, Iowa's adult per capita sales would be 4.28 gallons, second highest in the United States and nearly two and one-half times the national average of 1.76 gallons per adult.*

It is unrealistic to expect that liquor gallon sales could be increased sufficiently under a lower private wholesaling "flat" tax system to replace the current level of state revenue.

- If Iowa privatized wholesale liquor sales and set a "revenue neutral" tax rate ($13.31 per raw gallon) in an attempt to preserve current state revenue, liquor prices to the Iowa consumer would increase 15-20% due to the addition of the new wholesalers' profit markup. The price increase also would have an adverse affect on sales.

  If, on the other hand, Iowa attempted to privatize the wholesale liquor system under a "price neutral" scheme ($7.12 per raw gallon), the state would lose $18.2 million in FY03 and would still have the highest tax rate of any of the "License States" in the U.S.

- There would not be "price competition" but rather "brand competition" under a private wholesale system. The ABD projects that 2-3 wholesalers would initially take over the wholesaling function and the field would eventually be whittled to two wholesalers (The State of California has two major wholesalers serving a population of 35 million.)

  The projected wholesalers, who already serve as supplier brokers in Iowa, have business and financial ties with major liquor suppliers. Liquor suppliers do not offer their product lines to multiple wholesalers within a state unless forced to do so by law; the preferred method by suppliers is to franchise with one wholesaler to carry the supplier's entire product portfolio. Consequently, Iowa retailers will not be able to "shop" different wholesalers for the best price on any particular product. Retailers will be forced to purchase a particular brand from a particular wholesaler. In effect, Iowa would be trading a "public" monopoly for a "private" monopoly.

- It is questionable if the state would realize any privatization "windfall" from the sale of assets, particularly the sale of the Department of Commerce facility in Ankeny. The level of occupancy still remaining after privatization and the highly-publicized fact that the state needs additional office / storage space, indicate that the state would continue to utilize the facility as opposed to an outright sale. See Section 10 for additional detail.

In summary, all states exact revenue from the sale of liquor, either by applying a flat tax per gallon on sales made by private sector wholesalers or by directly wholesaling liquor to retailers.

Iowa, through the operations of the Alcoholic Beverages Division, has created an efficient wholesaling system that maximizes revenue for state and local government programs and substance abuse treatment efforts, minimizes the cost of industry regulation and creates a level competitive playing field for Iowa retailers.

Privatization of Iowa's liquor wholesale system would either result in the loss of millions of dollars annually or would result in significantly higher liquor prices to the Iowa consumer.

FOR ADDITIONAL INFORMATION REGARDING THIS STUDY, CONTACT STEVE LARSON AT 515-281-7402 *LARSON@IOWAABD.COM* OR RICK SWIZDOR AT 515-281-7366 *SWIZDOR @IOWAABD.COM*

INTRODUCTION

Should the State of Iowa be directly involved in the sale and distribution of spirits? This question has been debated since the repeal of the 18th Amendment and the end of Prohibition.

Iowa's involvement in liquor sales began in 1934 as a complete monopolistic system of the wholesale and retail sale of wine and spirits through state-operated liquor stores. Today, the State wholesales and distributes spirits only to privately-owned retail stores through the Iowa Alcoholic Beverages Division (ABD). The ABD currently uses a private sector warehousing contractor to receive, store and deliver spirits on behalf of the State.

Iowa is directly involved in liquor sales for four primary reasons:

*1. **TO MAXIMIZE THE REVENUE RECEIVED FROM LIQUOR SALES.***

By being directly involved in the sale and distribution of spirits, Iowa keeps the profit that would otherwise go to private sector wholesalers (<u>See</u> flow chart below). All states collect tax from the sale of spirits. The main difference is the method used by each state to collect liquor revenue.

There are 18 states and one county in Maryland that are directly involved in the sale of spirits and are referred to as the "Control States". The control jurisdictions formed at the end of Prohibition and chose this method for distributing alcoholic beverages to control the trafficking within their respective borders and to maximize the profit from the sale of alcohol. Although changes and improvements have been made to operations in the various Control States, none of the original 19 jurisdictions has abandoned the Control State System.

The other 32 states are referred to as "License States" and alcoholic beverage products are trafficked by privately-owned wholesalers. The License States, through their respective Alcohol Beverage Commissions, usually apply a "flat tax" on each gallon sold by a wholesaler to a retailer.

The following depicts the "typical flow" of spirit products / tax collections in a Control State versus License State environment:

CONTROL STATE SYSTEM		LICENSE STATE SYSTEM
Tier 1	Liquor Supplier	Liquor Supplier
↓	↓	↓
Tier 2	State Wholesaler (tax markup)	Tax Paid to State Liquor Board
↓	↓	↓
Tier 3	Licensed Retailer	Private Wholesaler (profit markup¯
↓	↓	↓
Tier 4	---	Licensed Retailer

The Control State operations, in effect, act as "non-profit" entities in the respect that all profit made from liquor sales are turned over to state treasuries. The License States collect a flat tax on each gallon sold and the wholesale markup (profit) is maintained by the private sector wholesaler.

Iowa's 50% markup on wholesale sales generates over $39.2 million in net income as an annual source of revenue and is: used for substance abuse treatment programs; distributed to cities and counties for local use; and deposited in the state general fund to fund important state projects and programs.

2. TO HELP CONTROL THE TRAFFICKING, SALES AND CONSUMPTION OF SPIRITS IN IOWA.

The ABD does not promote the sale or use of spirits to Iowa consumers. The ABD provides a needed service by delivering liquor to retailers by use of a contract carrier and, at the same time, collecting the "tax" on behalf of the state. Private wholesalers conduct the sale and delivery functions for one primary reason: to make a profit. Under a private wholesale system, there would be pressure applied on wholesalers by liquor suppliers to "sell more product" without regard to the social consequences of increased liquor consumption in Iowa.

3. TO PROMOTE AND MAINTAIN A LEVEL PLAYING FIELD FOR THE IOWA RETAILER.

Under current law (Iowa Code § 123.24) the ABD charges the same price for liquor to all Iowa retailers "regardless of the quantity purchased or the distance for delivery." Such would not be the case under a private wholesale system. Private wholesalers would give price discounts to large volume and chain retailers at the expense of the individual business owner. Consequently, retailers and consumers in smaller market areas would pay more for liquor purchases. Also, retailers who purchase smaller quantities or, who are located in rural areas, would not receive as frequent service as the state currently provides.

4. TO FOREGO THE STATE EXPENSE ASSOCIATED WITH THE REGULATION AND AUDITING OF PRIVATE SECTOR WHOLESALERS.

If Iowa was not directly involved in the wholesaling of spirits, the ABD would have to regulate the business transactions between private sector wholesalers and retailers to ensure the accurate collection of a state-mandated gallonage tax. As a rural state, Iowa has elected to assure its citizens with comparable pricing on alcohol.

Iowa could get out of the liquor business but at an increased cost to regulate business transactions and collect tax from private sector wholesalers.

Iowa could tax sales made by new wholesalers to create a "revenue neutral" situation to the general fund, but at the cost of higher liquor prices to the Iowa consumer. Or, some will argue that the state could apply a tax rate that is "competitive" to Iowa's neighboring states and increase liquor sales to the point where no state money is lost. **However, statistics indicate that Iowa would have to have the highest per capita adult sales rate in the United States for this to happen.**

The bottom line is Iowa could privatize wholesale liquor sales but to do so would translate into either the loss of millions of dollars every year or the marked inflation of liquor prices to the consumer.

The following pages will address the financial aspects of Iowa's continued involvement in the wholesale liquor business.

SECTION 1

HISTORICAL OVERVIEW

HISTORICAL OVERVIEW

At the end of Prohibition in 1933, individual states gave great consideration as to the best method of making alcohol beverages available to its citizenry. Some states still did not agree that ending prohibition was a wise policy decision and most were frustrated that enforcement efforts during prohibition were only minimally successful.

After studying several systems of other countries and of those taking shape in the United States, Iowa along with seventeen other states and one county in Maryland, decided to be directly involved in the distribution of alcohol beverages to consumers. In most cases, these jurisdictions also were involved in the direct sale of alcohol to consumers through state-operated retail liquor stores. These jurisdictions soon became known as the “Control States.”

Iowa policymakers decided that by placing state government in direct control of the distribution and sale of alcohol that three main goals would be realized:

- The criminal element that was prevalent in the business during prohibition would be effectively curtailed.

- Greater control over citizen consumption of this now legal drug would be better achieved by a state-run system as opposed to a profit-driven free market system that would inherently promote greater liquor consumption.

- Any revenue that was derived from the state-run system would be used to promote moderation in the consumption of alcohol, aid substance abuse treatment efforts and help fund other state and local programs.

With those goals in mind, the 1934 Iowa General Assembly created the Iowa Liquor Control Commission charged with the mission of “protecting the welfare, health, peace, morals and safety of the people of the state.”

The commission opened its first five state-operated liquor stores on June 19, 1934 in Atlantic, Des Moines, Marshalltown, Mason City and Oelwein. They were known as “counter stores” in which customers would record their selection on a piece of paper and hand it to a clerk who would retrieve the selection from the back room of the store. The clerk would record the purchase in the customer’s state-issued “individual liquor permit” booklet. State stores had limited shopping hours, were not open on Sundays or holidays, and did not take checks or credit cards. Effective in helping to control consumption, but not always well received by the Iowa consumer.

By the early 1970’s, attitudes had changed. Consumers wanted the freedom to shop for their own purchases at their own convenience. Counter stores gave way to brightly lit self-serve stores. Due to this freedom, state revenue increased significantly under the self-serve system.

As the 1980's rolled around, consumer attitudes again changed. Society began to take a less tolerant view of the excessive use of alcohol. Consumers were becoming more health conscious and states began enacting tougher drinking and driving laws. The sale and use of alcohol in Iowa, and throughout the country, was in decline. Although Iowa's state-store system continued to serve consumers and continued to pour millions of dollars into state coffers, store expenses increased and profits began to decline.

After careful study, the 1986 Iowa General Assembly elected to preserve the State's role in the wholesaling of spirits in order to maintain revenue to the general fund but decided to allow private sector stores to sell bottles of spirits to consumers. So in 1987, 54 years after the end of Prohibition, the last bottle of liquor was sold from a state-operated liquor store. The last of the 220 state stores was closed on June 30, 1987.

Today, there are over 460 privately-owned outlets that sell liquor to consumers as well as to bars, restaurants and other on-premises locations. Stores are allowed to sell liquor seven days a week, including holidays. Most accept checks and major credit cards for consumer purchases… quite a change from 1934 operations!

The Iowa Alcoholic Beverages Division wholesales spirits to the over 460 privately owned liquor outlets at a 50% markup over the division's cost. The Division uses a private contractor to warehouse and deliver products to retailers on a weekly basis. The Division will deliver an order as small as 5 cases, while some large volume retailers receive deliveries twice weekly.

By law (Iowa Code § 123.24), the Division offers the same price on spirits to all retailers regardless of the quantity purchased. It also offers the same terms on delivery to all retailers regardless of their location in Iowa. These practices have enabled over 200 small independently-owned stores to coexist and compete with large volume chain stores.

SECTION 2

CURRENT IOWA STATE WHOLESALE LIQUOR GROSS REVENUE

GROSS REVENUE DERIVED FROM STATE LIQUOR WHOLESALING FY03 ESTIMATE

The following shows the estimated gross liquor wholesaling revenue that Iowa will receive in FY 2003. The ABD applies a 50% wholesale markup on the supplier product cost before selling to privately-owned package liquor stores. Due to the fact that suppliers increase their product price to the state each year (inflation / supply & demand, etc.), the state can make increased profits even when gallon sales stay constant or even slightly decrease. Such would not be the case if a flat per gallon tax were affixed to sales. As an example, FY02 dollar sales collected increased 3.4% while gallons sold were up only 1.2%. If Iowa applied only a flat per gallon tax, collections would have increased only 1.2%.

FY03	Gross Liquor Sales	$117,559,683
	Cost of Goods Sold	77,138,900
	Gross Wholesale Profit	$ 40,420,783
	Plus Other Wholesale Revenues. . .	
	Bailment Fee	$ 755,418
	Split Case Fee	400,683
	Miscellaneous Income	61,000
	Bottle Deposit Fee	556,865
	Bottle Recycle Surcharge	222,746
TOTAL GROSS WHOLESALE PROFIT		**$ 42,417,495**

See Section 8 for estimate detail

SECTION 3

STATE COST OF LIQUOR WHOLESALING

BUDGET COMPARISON UNDER PRIVATE WHOLESALE SYSTEM

Although overall state expense would decrease under a private wholesale system, there would be an increase in cost for regulating the privately-owned distributors and for ensuring the timely and accurate collection of a liquor gallon tax. See derivation of expense projections in Section 9 beginning on page 31.

Although the Division applies a straight 50% markup to the cost of goods sold, when all other fees and revenue generated by the wholesaling system (bailment fee, split-case fee, etc.) are factored, the equivalent profit markup is 55%. The $3.2 million expense reduction expected under a private wholesaling system would still require the equivalent of a 50.8% markup (tax) for the state to break even with current revenue production.

		FY03 ABD BUDGET (With State as Wholesaler)		**FY03 ABD BUDGET (Under Private Wholesale System)**	
		$	**FTE**	**$**	**FTE**
1001	Commission	6,000	0.00	6,000	0.00
1002	Administration	572,597	5.00	545,317	5.00
1003	Accounting	320,652	5.00	320,652	5.00
1004	Maintenance	72,810	1.00	72,810	1.00
1005	Information Technology	278,159	3.00	123,965	1.00
1006	Licensing	284,945	6.00	284,945	6.00
1007	Products	242,764	5.00	0	0.00
1008	Building & Grounds	85,000	0.00	85,000	0.00
6000	Tobacco Enforcement	1,000,000	8.00	1,000,000	8.00
RM02	Routine Maintenance	10,000	0.00	10,000	0.00
	Subtotal	$**2,872,927**	**33.00**	**$2,448,689**	**26.00**
	Other Expenditures:				
	Warehousing/Delivery	$2,036,392		(	
	Bottle Deposit Refunds	326,949		(	
	Bottle Recycle Expense	441,381		(	
	Miscellaneous Expense	7,732		(	
	Grand Total Expense	**$5,685,381**	**33.00**	**$2,448,689**	**26.00**
	Expenditure Reduction Under Private Liquor Wholesaling:			**$3,236,692**	**7.00 FTE**

SECTION 4

REVENUE NEUTRAL TAX

TAX NEEDED TO ACHIEVE REVENUE NEUTRALITY

Plans in the past to privatize wholesale liquor sales in Iowa have called for a flat per gallon tax to replace state revenue. Usually the plans have called for a dollar amount based on an 80 or 100 proof rate per gallon (industry standards). The current average sale made by the Division, however, is only 70 proof alcohol. Based on current net revenue of $39.2 million, and the "raw" average sale of 70 proof per gallon, a $13.31 per 70 proof gallon tax would be necessary to achieve revenue neutrality (see below). Consequently, any plan that called for an 80 or 100 proof tax rate would require a higher dollar rate to achieve neutrality since it takes more sales of 70 proof alcohol to equal an 80 or 100 proof gallon.

Also, a flat per gallon tax rate will only generate more revenue when gallon sales increase; whereas, the state's 50% markup increases revenue when supplier prices go up, when consumers purchase higher priced product and also when gallon sales increase.

FY03 Gross Income Under State Wholesale System (page 11)		**$42,417,495**
Reduction in FY03 Division Expense Due to Wholesale Privatization (page 13)		**$3,236,692**
Tax Needed to Replace State Wholesale Liquor Revenue		**$39,180,803**
<u>Tax Needed per Gallon to Break Even</u> **(Projected FY03 raw gallons of 2,943,446 sold @ current 70 proof average)**		**<u>$13.31 per raw gal.</u>**
	OR	**$15.21 per 80 proof gal.**
	OR	**$19.02 per 100 proof gal.**

SECTION 5

INCREASED CONSUMPTION
VS
REVENUE NEUTRAL TAX

INCREASE CONSUMPTION?

Could the state privatize wholesale liquor sales and sufficiently increase gallon sales at a low tax rate to match current state revenue? Some proponents of privatization argue that Iowa is losing sales to neighboring states due to high liquor prices and that a "revenue neutral" tax is not necessary to net the state the same money it is making under the current system. Proponents argue that if Iowa lowered its tax rate on liquor, Iowa consumers would "stay home" to shop and that neighboring state consumers may even be attracted to Iowa by low liquor prices.

Following is a comparison of the tax rates of states contiguous to Iowa.

2001 TAX RATE BASED ON 80 PROOF GALLON (SOURCE "ADAMS 2002 LIQUOR HANDBOOK)			
Illinois*	$4.50	South Dakota*	$3.93
Missouri	2.00	Minnesota**	5.03
Nebraska	3.00	Wisconsin	3.25

*Different rates also applicable according to alcohol content, place of production, size of container, place purchased (on- or off-premise or on board airlines).
**Includes case fees and/or bottle fees, which may vary with the size of container.

To keep *all* Iowans "at home", and, to attract out-of-state liquor buyers, Iowa would have to at least match the lowest rate in the region of $2.00 per 80 proof gallon.

At a $2.00 per 80 proof gallon rate, total liquor gallon sales in Iowa would have to increase 661% to 22,389,030 gallons each year to maintain current state net profit. Iowa's Adult "Per Capita" consumption rate would have to increase from 1.41 to 10.71 gallons, over double the current highest state rate in the United States (New Hampshire / 4.45 gals.). The current U.S. average is 1.76 gallons consumed annually per adult. (Source: 2002 Adams Liquor Handbook)

The charts on the following 4 pages demonstrate the amount of Iowa liquor consumption increase necessary at tax rates of $2.00, $3.00, $4.00 and $5.00 per gallon for the State of Iowa to privatize wholesale liquor sales and achieve revenue neutrality.

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $2.00 TAX PER 80 PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$39,180,803	=	FY2003 Net Revenue From State Wholesaling
2,943,446	=	FY2003 70 Proof Gallons Sold
$13.31	=	FY2003 State Profit per 70 Proof Gallon Sold
$39,180,803	=	Tax Required to Replace State Revenue
If $2.00	=	Tax on 80 Proof Gallon, Then ….
19,590,402	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
15,672,321	=	The Number of 100 Proof Gallon Sales
Divided by 70%	=	Conversion to 70 Proof =
22,389,030	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-2,943,446	=	FY03 Projected **70** Proof Gallons Sold =
19,445,584	=	**Gallon Increase in 70 Proof Gallon Sales Needed To Break Even @ a $2.00 Per 80 Proof Gallon Tax Rate**

661% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $3.00 TAX PER 80 PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$39,180,803	=	FY2003 Net Revenue From State Wholesaling
2,943,446	=	FY2003 70 Proof Gallons Sold
$13.31	=	State Profit per 70 Proof Gallon Sold
$39,180,803	=	Tax Required to Replace State Revenue
If $3.00	=	Tax on 80 Proof Gallon, Then ….
13,060,268	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
10,448,214	=	The Number of 100 Proof Gallon Sales
Divided by 70%	=	Conversion to 70 Proof =
14,926,020	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-2,943,446	=	FY03 Projected **70** Proof Gallons Sold =
11,982,574	**=**	**The Increase in 70 Proof Gallon Sales Needed To Break Even @ a $3.00 Per 80 Proof Gallon Tax Rate**

407% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $4.00 TAX PER 80 PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$39,180,803	=	FY2003 Net Revenue From State Wholesaling
2,943,446	=	FY2003 70 Proof Gallons Sold
$13.31	=	State Profit per 70 Proof Gallon Sold
$39,180,803	=	Tax Required to Replace State Revenue
If $4.00	=	Tax on 80 Proof Gallon, Then ….
9,795,201	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
7,836,161	=	The Number of 100 Proof Gallon Sales
Divided by 70.00%	=	Conversion to 70 Proof =
11,194,516	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-2,943,446	=	FY03 Projected **70** Proof Gallons Sold =
8,251,070	**=**	**The Increase in 70 Proof Gallon Sales Needed To Break Even @ a $4.00 Per 80 Proof Gallon Tax Rate**

280% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

LIQUOR GALLON CONSUMPTION INCREASE NECESSARY TO ACHIEVE REVENUE NEUTRALITY AT $5.00 TAX PER 80 PROOF GALLON

(Iowa's Current Average Gallon Sold is 70 Proof)

$39,180,803	=	FY2003 Net Revenue From State Wholesaling
2,943,446	=	FY2003 70 Proof Gallons Sold
$13.31	=	State profit per 70 Proof Gallon Sold
$39,180,803	=	Tax Required to Replace State Revenue
If $5.00	=	Tax on 80 Proof Gallon, Then ….
7,836,161	=	The Number of **80** Proof Gallon Sales Needed to Break Even Under Private System
80% of Above Total	=	Conversion Formula to 100 Proof =
6,268,929	=	The Number of 100 Proof Gallon Sales
Divided by 70%	=	Conversion to 70 Proof =
8,955,613	=	The Number of **70** Proof Gallon Sales Needed to Break Even Under Private System
-2,943,446	=	FY03 Projected **70** Proof Gallons Sold =
6,012,167	**=**	**The Increase in 70 Proof Gallon Sales Needed To Break Even @ a $5.00 Per 80 Proof Gallon Tax Rate**

204% INCREASE IN GALLON SALES NEEDED TO ACHIEVE REVENUE NEUTRALITY

SECTION 6

EFFECT ON CONSUMER PRICES

EFFECT ON CONSUMER BOTTLE PRICE UNDER "REVENUE NEUTRAL" & "PRICE NEUTRAL" PRIVATE WHOLESALE SYSTEM

As long as Iowa wishes to maintain current net liquor revenue, consumer prices under a private wholesale system would increase because of the addition of another profit layer – the wholesaler's markup (See flow chart page 4). According to industry members, private sector wholesalers in License States attempt to average a 16-20% wholesale markup on sales made to retailers. For purposes of this exercise, the ABD used an average wholesale markup of 18%. The following exercise shows how the current average consumer bottle price would increase by nearly 19% due to the added profit layer.

Est. FY03 Average Cost per Bottle ($77,138,900 cost of goods / 11,144,663 FY03 est. bottle sales)	$6.92
Est. FY03 Average Size Bottle Sold (2,943,446 gallons / 11,144.663 bottle sales)	33.8 oz. (or 26.4% of a gal.)
Tax per Bottle Necessary to Achieve Revenue Neutrality*	$3.51 (26.4% of $13.31 gal. tax)

***The exercise below is based on a flat tax per raw gallon sold. A tax set on sales of 80 or 100 proof gallons would require an even higher tax rate to achieve revenue neutrality.**

	Current State Pricing	**Private Wholesaling Pricing**
Avg. Cost Per Bottle	6.92	6.92
State 50% Markup	3.46	--
State Gallon Tax Under Privatization (Per Avg. Bottle)	--	3.51
Private Wholesaler Average Markup 18%	--	1.88
Cost to Retailer	10.38	12.31
Average Retailer Markup (20%)	2.08	2.46
Consumer Price	12.46	14.77
Price Increase to Consumer	**$0.00**	**$2.31 / 18.5%**

If the state privatized wholesale liquor sales using a gallon tax based on an 80 or 100 proof gallon, the tax rates for the average bottle size sold would be $4.02 and $5.02 respectively. At those rates, the price of an average bottle would increase 24% to the consumer at the 80 proof rate and would increase 36% at the 100 proof rate.

If Iowa decided to privatize wholesale liquor sales without raising the average bottle price to the consumer, a tax rate of $7.12 per gallon sold would be required (See following "price neutral" exercise).

Est. FY03	Average Cost per Bottle ($77,138,900 cost of goods / 11,144,663 FY03 est. bottle sales)	$6.92
Est. FY03	Average Size Bottle Sold (2,943,446 gallons / 11,144.663 bottle sales)	33.8 oz. (or 26.4% of a gal.)
Tax per Bottle Necessary to Maintain Current Consumer Price		$1.88 (26.4% of $7.12 gal. tax)

	Current State Pricing	**Private Wholesaling Pricing**
Avg. Cost Per Bottle	6.92	6.92
State 50% Markup	3.46	--
State Gallon Tax Under Privatization (Per Avg. Bottle)	--	1.88
Private Wholesaler Average Markup 18%	--	1.58
Cost to Retailer	10.38	10.38
Average Retailer Markup (20%)	2.08	2.08
Consumer Price	12.46	12.46
Price Increase to Consumer	**$0.00**	**$0.00**

Current Net Liquor Revenue: $39,180,803
Revenue Under a "Price Neutral" System: -$20,957,336
(FY03 gallons 2,943,446 x $7.12 per gallon = $20,957,336)

FY03 Loss Under Price Neutral System: $18,223,467

Note: At a rate of $7.12 per gallon, Iowa would lose $18,223,467 in FY03 and would still have the highest tax rate of any of the "License States" in the U.S.

SECTION 7

COMPETITION

A LEVEL PLAYING FIELD

When retail liquor sales were privatized in 1987, the Iowa General Assembly envisioned a statewide network of privately-owned retail liquor stores that would be free to compete in an atmosphere of uniform regulation by state government. The legislature crafted legislation that would not only help promote the creation of many small businesses, but also help ensure their success against high-volume chain operations by adding the following language:

> "…The division shall offer the **same price** on alcoholic liquor to all class "E" liquor control licensees **without regard for the quantity of purchase or the distance for delivery**…" [emphasis added.] <u>See</u> Iowa Code §123.24.

The fact that over 200 independently owned liquor stores are still in operation 15 years after privatization, and, in competition with over 200 chain outlets, is proof that the legislative language has worked as intended. Without it, high volume operators would have driven small independent operators from the marketplace long ago, to the disadvantage of the Iowa consumer. The Iowa Alcoholic Beverages Division is convinced of this because, as wholesaler, it is approached frequently by representatives of large distilleries who lobby the division to exact a change in law that would allow discount pricing on large volume purchases made by chain retailers…purchase amounts that most independent operators could not afford to make.

The Division realizes that in some cases it is not government's responsibility to ensure the success of small business. But, as long as state government wishes to maintain current state liquor revenue and promote small business by uniform regulation, then the Iowa Alcoholic Beverages Division operation seems to be the best way to accomplish both.

Who would the new wholesalers be under a private system? There are currently 3 brokerage firms that are positioned to initially take over the wholesaling of spirits to Iowa retailers. The three brokerage firms already have ties with liquor distillers in the respect that the firms represent the distillers' products in Iowa and make a fee for each case of liquor sold. Two of the three are already in the warehousing / distribution business operating as wine wholesalers. All three have corporate headquarters outside of Iowa. Some initial investment would be required for these entities to take over the wholesaling market. Whatever investment "gain" that would be made by these businesses would at least be partially offset by the loss of investment currently made by the ABD's private sector warehousing company.

The ABD believes that the Iowa market is not large enough to satisfy three liquor wholesalers. California, with over 35 million people, can support only 2 large wholesalers. Michigan, which sells almost 5 times the amount of liquor as Iowa, has two large and one smaller volume wholesalers. It is estimated that within a short period of time, one – three years, Iowa would be left with 2 liquor wholesalers. Additionally, these two remaining wholesalers would have "franchise" ties to specific major suppliers and would carry only competing brands. Consequently, there would be no "price" competition, but rather "brand" competition, from which retailers could choose. In effect, the state would be trading a “public” monopoly for a “private” monopoly.

SECTION 8

Derivation of Revenue Projections

(Detail of revenue as shown on page 11)

DERIVATION OF REVENUE PROJECTIONS

(As shown on page 11)

Assumptions
Liquor dollar sales will increase 3% in FY03
Liquor volume will increase 1.5% in FY03.

Gross Liquor Sales

FY2002 actual sales were $114,135,615, an increase of 3.4% over FY01. Growth of 3.0% is projected for FY03.

FY02 Actual	$114,135,615
FY03 Projected at 3.0% growth	$117,559,683

Cost of Goods Sold *

FY02 average markup rate of 52.4% used to project cost of goods sold for FY03.

FY03 projected sales of $117,559,683 divided by 1.524 equals $77,138,900 for projected cost of goods sold.

Bailment Fee

FY02 case sales of 1,063,221 projected to grow at 1.5%. Actual FY02 case volume increase was 1.8%.

FY03 case sales of 1,079,169 x $.70 per case =$755,418

Split Case Fee

FY02 actual collections of $394,761 projected to grow at 1.5%.

FY02 Actual	$394,761
Fy03 Projected	$400,683

***Although the ABD applies a 50% across-the-board wholesale markup on product sold, the application of price increases to product already owned by the state and the state's purchase of supplier discounted product for resale at regular price, creates the equivalent of a 52.4% average wholesale markup.

Miscellaneous Income

Represents income from various operations. FY02 total miscellaneous income was $93,196.91. Of this total, an estimated $61,000 was generated from wholesaling activities.

Bottle Deposit Fee

FY02 actual of $548,635 increased 1.5% for FY03.

FY03 projected at 1.5% growth = $556,865

Bottle Recycle Surcharge

FY02 actual of $219,454 increased 1.5% for FY03.

FY03 projected at 1.5% growth = $222,746

SECTION 9

Derivation
of
Expense Projections

(Detail of expense as shown on page 13)

DERIVATION OF EXPENSE PROJECTIONS

(AS SHOWN ON PAGE 13)

GENERAL DISCUSSION

The liquor wholesaling activity is one of four core functions performed by the Iowa Alcoholic Beverages Division. The other core functions performed are:

- The licensing of all businesses that manufacture, import, wholesale or retail alcoholic beverages products in Iowa.

- Regulate the business / financial transactions conducted between the various tiers of the alcoholic beverages industry in Iowa. Included is the collection and auditing of beer and wine excise taxes and regulating the federal and state "Fair Trade Practices" statutes that define the legal transactions allowed between a supplier / wholesaler and a retailer.

- Enforce Iowa's tobacco laws by conducting compliance checks of tobacco retailers and providing for youth tobacco sales prevention education for retailers, law enforcement and local officials. It should be noted that funding for the ABD tobacco enforcement program comes entirely from the state tobacco settlement trust.

The ABD assumes that the above-mentioned non-wholesaling functions would continue to be performed by the ABD under a private wholesale system.

Under current operations only 7 of the 33 full-time ABD employees are completely dedicated to liquor wholesaling activities.

The warehousing and delivery functions are performed entirely by a private sector contractor.

The remaining 26 employees are dedicated to licensing activities, tobacco enforcement, accounting, information technology, building maintenance and administration.

Following is a discussion and estimate of the budgetary and personnel resources required under a private wholesaling system.

FY03 ABD BUDGET UNDER A PRIVATE WHOLESALE SYSTEM
See page 13 for financial detail.

1001, Alcoholic Beverages Commission
Original FY03 Budget: $6,000 Revised Budget: $6,000

The ABD assumes that the Alcoholic Beverages Commission would remain intact to provide direction and to set policy for remaining division operations and to meet other statutory requirements.

1002, Administration
Original FY03 Budget: $572,597 Revised Budget: $545,317

The Administration Section has 5 full-time employees whose primary duties consist of:

- Implementing policy and operations as directed by the Alcoholic Beverages Commission and the administrator.
- Regulation of the trade practices between suppliers / wholesalers and retailers.
- Coordinate all administrative hearings resulting from appeals of licensing actions and licensee violation of state laws and rules.
- Prepare and manage agency budget.
- Prepare all documents, requests for information and fiscal note requests from the Legislature, Governor's Office, other state agencies, media, and requests for information from the public.
- Coordinate all educational efforts conducted by the division.
- Draft all administrative rules for the division.
- Initiate all personnel actions.
- Coordinate and participate in enterprise level programs including the "Accountable Government Act" and the "Administrative Rules Review Process" and other programs relating to information technology and facility maintenance.
- Provide direct supervision for the licensing, accounting, information technology, facility maintenance, tobacco enforcement and wholesaling sections of the ABD.

Except for the supervision of the 5 employees in the 1007, Products Section, all other activities performed by the Administration Section would remain unchanged under a private system of liquor wholesaling. Although there would be no changes in the administrative staff, a pro rata share of certain expense items would be saved by the elimination of the Products Section and reductions made in the Information Technology Section.

The ABD has a total of 33 full-time employees with 8 employees dedicated to tobacco enforcement and education initiatives. The 6000 Tobacco Enforcement Section is eliminated from the pro rata expense equation due to the fact the employees and support costs in the section are entirely funded separately and expensed separately from other division operations. Of the remaining 25 employees, ABD has determined that 7 could be eliminated under private liquor wholesaling system; the 5 employees in the 1007, Products Section and 2 employees in the 1005, Information Technology Section. This represents a 28% reduction in the remaining ABD staff. A reduction of 28% is used to determine the pro rata reduction of certain expense items in the

Administration Section. The 28% reduction is applied to the following areas: office supplies, outside services and workers compensation costs. A 50% reduction was applied to in-state travel expense. Some future minor expense savings may also be realized in the areas of printing costs and reimbursements to other state agencies.

1003, Accounting Section
Original FY03 Budget: $320,652 Revised Budget: $320,652

Although there would be a reduction in the accounting services associated with liquor accounts payable / receivable, there would be an increase in the activities associated with the auditing of new liquor wholesalers for tax compliance on sales made to Iowa's 460 liquor retailers. Consequently, no change is made to the budget or in personnel resources required in the Accounting Section.

1004, Maintenance Section
Original FY03 Budget: $72,810 Revised Budget: $72,810

1008, Building & Grounds Section
Original FY03 Budget: $85,000 Revised Budget: $85,000

RM02 Routine Maintenance Funding
Original FY03 Budget $10,000 Revised Budget: $10,000

There is one employee and approximately $168,000 dedicated to the maintenance of the Department of Commerce facility located in Ankeny. Due to the level of occupancy that would remain after privatization, and, the highly publicized fact that the state needs additional office / storage space, it is questionable if it would be in the state's best interest to sell the facility (See "Sale of Assets", Section 10, page 36). In fact the ABD, in conjunction with the Department of General Services, has been working to fill existing available office space and there are plans to make 15,000-20,000 square feet available for state use.

Consequently, no change is made to the three cost center budgets that support facility maintenance.

1005, Information Technology Section
Original FY03 Budget: $278,159 Revised Budget: $123,965

The ABD has determined that two of the three current information technology specialists could be eliminated under a private wholesaling system. The remaining specialist would maintain programs associated with liquor licensing, tobacco enforcement, regulation and tax software programs and web page maintenance.

1006, Licensing Section
Original FY03 Budget: $284,945   Revised Budget: $284,945

With the exception of the addition of 2-3 new wholesale licenses to issue, activity in the licensing section would remain unchanged.

1007, Products Section
Original FY03 Budget: $242,764   Revised Budget: $0

The entire section and 5 employees would be eliminated under a private wholesale system.

OTHER EXPENDITURES:

Warehousing/Delivery

FY03 price paid to J.A. Jones Management Services is $1.887 per case, delivered.

FY03 case sales are projected to be 1,079,169 cases, an increase of 1.5% compared to FY02.

1,079,169 cases at the rate of $1.887 equals FY03 cost of $2,036,392.

Bottle Deposit Refunds

Refunds experienced in FY02 projected to grow 1.5% in FY03.

FY02 Actual	$322,117
FY03 Projected	$326,949

Bottle Recycle Expense

The cost of retrieving empty liquor bottles from retailers for recycling is projected to grow 1.5% in FY03.

FY02 Actual	$434,858
FY03 Projected	$441,381

Miscellaneous Expense

Actual FY02 total of $7,618 projected to grow 1.5% in FY03.

FY02 Actual	$7,618
FY03 Projected	$7,732

Section 10

Sale of Assets

Sale of Assets

Department of Commerce Facility, 1918 SE Hulsizer Rd, Ankeny

There has been discussion regarding the potential for revenue by the sale of the Department of Commerce facility located in Ankeny.

The facility is located north of the I80 - I35 interchange in the industrial section of Ankeny and consists of a 175,000 square foot building divided into a 150,000 square foot warehouse and a 25,000 square foot office area. The building sits on approximately 11 acres of land with 7 acres dedicated to the facility, truck parking (warehouse area) and office / visitor parking. There are 4 "landlocked" acres behind the facility that were initially platted as an expansion area for the warehouse should the need arise.

The original land purchase and building construction cost was financed by the sale of $4.4 million in special liquor revenue bonds, which have subsequently been retired. The facility, completed in 1980, has been relatively well-maintained.

In addition to the ABD operation and employees, the facility is also occupied by the following:

- The Professional Licensing Division of Commerce, approximately 6,500 square feet office space.
- The Iowa Lottery Warehouse Operation, approximately 12,500 square feet warehouse space.
- The Iowa Department of Public Safety, approximately 600 square feet warehouse space.

In addition to the current operations housed in the facility, there are plans to locate the state's archival records and documents currently stored under the management of the Departments of Revenue & Finance and Cultural Affairs. The ABD, in conjunction with the Department of General Services, is planning to make approximately 15,000-20,000 square feet available for record storage and other uses as determined by General Services.

There is also approximately 6,000 square feet of office space that was recently vacated by the decentralization of the Administrative Services Division of Commerce (July 2002). The Department of General Services is currently assessing this space for use by another state division / agency with the goal of reducing overall state lease expense.

Considering the level of occupancy that would still be in place after liquor wholesale privatization, and, the highly-publicized fact that the state has a need for additional office / storage space, it is questionable if it would be in the state's best interest to sell the facility for a "one-time windfall" to the general fund at the possible expense of increased rent costs in future years to house continuing operations.

Should the decision be made to sell the facility, consideration should also be given to the timing of any expected windfall receipt. It is possible, in fact probable, that the sale of the facility would not occur until some future fiscal year after the privatization of the liquor wholesaling system.

Sale of Inventory

The ABD operates under a "bailment inventory" system in that the distiller / supplier maintains ownership of the inventory until the ABD sells the product. Consequently, the state has virtually no investment in liquor inventory except for a small amount invested in split case inventory (less than full case quantities) and in discounted product. Should the decision be made to privatize the liquor wholesaling system, the eventual sale of whatever inventory was owned by the state would result in a one-time small cash flow increase to the state general fund.