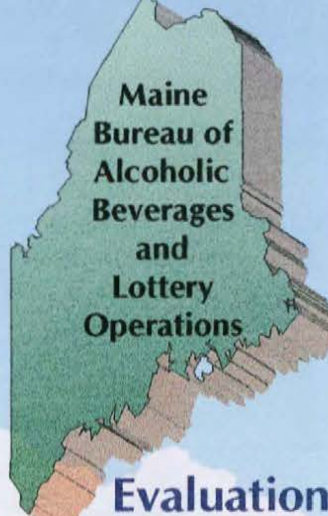

Maine Bureau of Alcoholic Beverages and Lottery Operations

Evaluation of the Impact of L.D. 1799, *An Act to Privatize Liquor Sales*

February 20, 1998

Stafford Business Advisors

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MAINE BUREAU OF
ALCOHOLIC BEVERAGES
AND LOTTERY OPERATIONS

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EXECUTIVE SUMMARY

Maine is one of 18 "Control States" nationally that maintain a state monopoly on the wholesale distribution of distilled beverage spirits. In Maine, the wholesale distribution is managed by the Bureau of Alcoholic Beverages and Lottery Operations (BABLO), which operates 28 retail state liquor stores and supplies 190 agency (private) retail liquor stores and on-premise licensees (bars and restaurants).

L.D. 1799 proposes to eliminate the current wholesale spirits distribution system by the state with a private sector system that mirrors the current beer and wine distribution network. The underlying assumption of the proposed bill is that the shift from centralized, monopolistic wholesale control to decentralized, private sector control would reduce retail prices and lead to a significant recapture of sales currently lost to New Hampshire. L.D. 1799 also proposes closing the state retail stores and lifting the cap on the number of private sector agency stores.

Both nationally and in Maine, consumption of distilled beverages is in a slow but steady decline which in the last ten years has averaged 2% per annum. This has been offset by growth of per capita consumption in non-alcoholic beverages - soft drinks, coffee and bottled waters - while both beer and wine consumption trends were relatively flat. Consumption in Maine tracks these national trends. However, Maine sales of distilled spirits are already slightly above the average rates for "Control States" and for the United States. Allowing for the addition of Maine residents' purchases in New Hampshire, Maine appears to be about 20% above the national average for per-capita consumption of spirits – though Maine consumption appears to be similar to the rates in other New England states once cross-border sales from New Hampshire are netted out. States with lower rates of spirits consumption (and the steepest rates of decline) include California, Florida, the Pacific Northwest and other "trend-setting" regions of the country, suggesting a continued decline in the future based on trends in lifestyles, fashion and tastes.

Given that spirits consumption is expected to continue to decline in the long term regardless of price changes, in the short term Maine could nevertheless increase its sales volume by recapturing sales made in New Hampshire to Maine residents and tourists. Maine's ability to do this depends on the ability to price spirits at or below New Hampshire's price level, currently between 20% and 25% below Maine's pricing (except at Kittery) when Maine's 6% sales tax is included in the price comparison.

To reduce Maine prices to levels comparable to New Hampshire would require, under a system such as proposed in L.D. 1799, that private Maine companies – both wholesale distributors and spirits retailers – would be willing to accept gross margins which we believe are both unsustainable in the long term and irrational in terms of profits foregone.

In per-gallon terms, and assuming (for the moment) that a number of (smaller) Maine distributors could purchase spirits at the same price as BABLO can today, the cost to a wholesaler under L.D. 1799 would average $27.97 (actual FY 1997 Maine costs including state premium tax, plus $3.50/gallon excise tax). The New Hampshire price level (as matched in the pricing at Maine's Kittery discount store) in the same period was $ 36.81. The difference of $ 8.84 per gallon amounts to a combined margin of 24% available to cover the costs of both wholesalers and retailers. This compares with 35% to 40% typical combined (wholesale plus retail) margins in non-controlled states.

If (as we expect) the delivered cost of spirits to a private Maine distributor would be higher than BABLO's cost, because purchase quantities are divided among many buyers and inbound freight costs are increased, these margins will shrink towards 20%. At New Hampshire retail pricing, the available margins cannot cover the costs of both retailers and wholesalers.

We assume that under a non-controlled environment such as proposed under L.D. 1799, companies would enter the spirits distribution business to make a profit, rather than to achieve public goals such as recapturing Maine purchases from New Hampshire. We therefore believe that spirits would be priced in Maine at levels which, in the long term, would allow both distributors and retailers to cover their costs and make a reasonable return on investment. We believe that Maine beer and wine wholesalers would require at least a 13% gross margin to break even from spirits sales. It is more likely that their margins would approach the 20% or so currently generated on table wines, the product closest to spirits in terms of value. The small potential volume gain from reduced pricing is not an incentive to cut margins at the wholesale level.

The actual retail price level achieved would be determined, in part, by the extent to which major chain retailers such as Hannaford, Shaw's, and Rite-Aid, choose to aggressively pursue market share in spirits retailing. Such major chains would be expected to operate with retail margins in the 12% to 14% range, compared to 15% to 25% (depending on size and turnover) for independent stores lacking the geographical "franchise" monopoly that agency status confers today. With many more retail outlets, average spirits sales per outlet would fall, and stores could not operate on a markup as low as the approximately 9% average discount provided today.

We conclude that in a retail spirits sales environment dominated by aggressive major chains, Maine spirits prices could fall by about 10% under a regime such as proposed by L.D. 1799. This implies that price levels would remain significantly above New Hampshire levels. It is likely that significant price differences could evolve across the state, although the major chains could choose to apply uniform state-wide pricing as part of a market share-driven strategy. Sales at the low pricing currently in effect at Kittery would not be profitable.

Before considering possible sales recapture from New Hampshire, the impact on Maine's General Fund of L.D. 1799 would be to eliminate $20.66 million of net revenue from BABLO operations (excluding premium taxes), and to introduce $5.99 million of new excise tax revenues, for a net loss to the state of $14.67 million (on FY 1997 gallons). This net loss would be partly offset by new revenues from the issue of retail and wholesale licenses, estimated at $687,400 in year 1 and $765,400 in subsequent years.

Based on our expected retail pricing, we expect that the most likely rate of recapture of New Hampshire sales would be around 55% of current spirits sales to Maine residents, offset by a loss of 50% of the Kittery store's retail sales. At 146,500 gallons, this additional volume would add around $1.09 million in excise, premium and sales taxes to Maine's General Fund, reducing the net loss before license fees to $ 13.82 million. After the initial year of introductory license fees, the net loss including license revenues will be approximately $13.11 million.

INTRODUCTION

> "The issue is older than well-aged scotch, and its details haven't changed much over the years: Supporters say keeping the state in the business preserves good-paying jobs and gives the state greater control of liquor sales; opponents say it is expensive and unnecessary -- the state does not have to actually sell the booze to control it."
>
> --*Bangor Daily News*, 1/20/98

The above statement reflects the attitudes in Maine about the role of the State in the distribution and sale of alcohol. That long-standing ambivalence is the genesis of L.D. 1799 which proposes to remove the State of Maine from the wholesale and retail aspects of the spirits business and to privatize Maine spirits distribution along the lines of the current beer and wine sales and distribution system.

L.D. 1799 would effect the following major changes:

- Close the state's remaining 28 retail liquor stores;
- Allow unrestricted numbers of private agency spirits retailers, licensed on similar lines to the current system of licensing beer and wine retailers;
- End state control of wholesale and retail pricing;
- Replace the state's central wholesale distribution system with distribution through the state's private beer and wine wholesalers;
- Impose a state excise tax of $3.50 per gallon on all spirits sold in Maine.

It is further contended by supporters of the bill that an additional consequence of the bill would be that the retail price of spirits would fall, leading to a recapture of sales lost to New Hampshire and increased sales within Maine.

The Maine Bureau of Alcoholic Beverages and Lottery Operations issued a Request for Proposals in November 1997 to analyze the economic impact of L.D. 1799, An Act to Privatize Liquor Sales. The Bureau selected Stafford Business Advisors (hereafter referred to as "the Consultant") to study the economic effects of L.D. 1799 and its impact on state revenues.

The following areas were researched for inclusion in this report:

- The current distribution network for spirits and state revenues from that system.
- The current beer and wine distribution network, which would become the basis for the distribution of spirits under L.D. 1799.
- Provisions and assumptions of L.D. 1799 and their revenue impacts.
- The spirits market in Maine, in other control states, and in the national arena.
- Price and non-price factors affecting the volume of liquor sales in Maine, including the number of retail outlets, and cross-border sales.
- The impact of L.D. 1799 on the wholesale and retail prices of spirits and on the volume of spirits sold in Maine.
- A comparison of state revenue projections under the current spirits distribution system versus the system proposed under L.D. 1799.

Interviews were conducted with representatives of:

- Maine Bureau of Alcoholic Beverages and Lottery Operations;
- Department of Administrative and Financial Services, Division of Financial and Personnel Services;
- beer and wine wholesalers;
- agency store operators;
- Department of Public Safety, Bureau of Liquor Enforcement;
- Fore River Warehouse, the contract operator of the state's bailment warehouse;
- SPC Transport, the contract distributor of spirits for BABLO;
- Maine Recycling, one of two contract processors of returned containers;
- Brokers representing major distillers, and the distillers' trade association, DISCUS.

Prior legislative studies in Maine regarding the privatization of alcohol were reviewed, as were national commentaries on privatization efforts in other states and Canadian provinces. Material submitted by supporters of L.D. 1799 was reviewed in detail, along with annual reports and other public information from BABLO.

This report does not attempt to set out a case for or against L.D. 1799, but to present a comparative financial analysis of the current state system and of the system proposed under L.D. 1799. Because the bill proposes an excise tax based on actual or 'wine' gallons (i.e. not gallons of proof alcohol), we use actual gallons throughout as the unit of measurement, rather than cases, bottles, proof gallons, or any other unit.

1.
MAINE'S CURRENT SYSTEM OF SPIRITS DISTRIBUTION

Maine is currently one of 18 "Control States", in which a state agency has a monopoly of the wholesale distribution of distilled beverage spirits. In addition to the centralized wholesaling and distribution function, at the retail level the off-premise sale of spirits are divided between 28 state liquor stores and 190 private businesses which are licensed agents of the State. The state retail stores play a dual role in the system, as both retailers and as a part of the wholesale distribution system with an important role in supplying agency stores and on-premise licensees. The current arrangements are commonly described as a three-tier system, including private suppliers (distillers, importers, and their local representatives – known as brokers - in Maine); the state as wholesaler, with private contractors for its bailment warehouse and truck distribution operations; and the mixed public and private retail tier with state stores and licensed agents, but state control of pricing. The state's roles are conducted by the Maine Bureau of Alcoholic Beverages and Lottery Operations (BABLO).

The five members of the State Liquor and Lottery Commission, who are appointed by the Governor for three-year terms, are responsible for the administration of alcohol policy as defined by state liquor laws. The Commission directs the operations of BABLO which implements the policy. The liquor division of BABLO has 116 employees including 10 office staff and 106 in the state stores. The Commission also determines the menu of products which will be sold in Maine. The Bureau of Liquor Enforcement within the Department of Public Safety enforces the state liquor laws and since 1993 has collected license fees and the Premium Tax and Excise Tax on beer and wine.

Two small exceptions to the state's monopoly exist where Federal jurisdiction prevails over the state: on military bases, and at duty-free stores selling to departing travelers along the Canadian border and at Bangor Airport. Otherwise, all spirits brought legally into Maine for sale must be shipped to BABLO's bailment warehouse in Portland, operated for the state under contract by Fore River Warehouse. These are sold either directly to the consumer through BABLO retail stores, or through BABLO's merchandising department to private agency retail outlets, the number of which is limited by law. On-premise (bar and restaurant) licensees must buy at the state-determined retail price from a state or agency store, but may determine their own markup and selling price.

Agency stores must sell spirits at the same price set for the state's retail stores, but purchase the liquor at a discount from BABLO. Limited territorial exclusivity for agency stores is guaranteed by the following legal parameters: a new agency store may not locate within 3 1/2 miles of an existing state store or an agency store licensed before 5/1/93; and three agency stores may locate within 10 miles of a state store that closes after 7/1/90. In practical terms, this has meant that three agency stores have been authorized for each state store closure. Agency stores are required to stock at least 100 product lines and, if located in a municipality with over 6,000 residents, must maintain a minimum stock value of $10,000 or more. Agency stores must also maintain a minimum of $1,000 in merchandise other than that allowed by the license issued by the Bureau of Liquor Enforcement, i.e. non-liquor merchandise.

BABLO contracts with a private supplier (currently Fore River Warehouse in Portland) for bailment warehousing, and all spirits sold in Maine must move through this warehouse. BABLO also contracts with a private trucking company to move spirits from the bailment warehouse to its destination. The State also establishes the retail price for spirits products because the number of state and agency stores is limited and each has territorial exclusivity. Public policy reasons given for the maintenance of state-regulated prices are (1) to allow the measurement of alcohol consumption for the benefit of policymakers in areas like health and public safety, and (2) to ensure state profits.

The present Maine spirits distribution system operates as follows. Costs reported here are from the FY 1997 BABLO report, converted to a per-gallon basis to build up to a total wholesale cost per gallon.

1. The Bailment Warehouse: Inbound Product Inventory and Handling.

The state's single bailment warehouse, operated by Fore River Distribution Center in Portland under contract to BABLO, holds the state's principal wholesale spirits inventory entirely at the expense of the supplying distillers or importers. Based on a Commission-generated list of products to be sold in Maine, distillers maintain approximately 75 days' supply of inventory at their own expense in Portland. BABLO monitors the inventory and may suggest replenishment if necessary. Total warehouse costs assumed by the distillers are estimated at $700,000 per year.

Under the terms of the contract with BABLO, all storage and handling costs are charged to the liquor suppliers, as follows:

- $.42 per case is charged on liquor delivery, to cover handling (both in and out).
- $.24 per case per month is charged for warehouse storage. For product received after the 15th of any month, the storage rate for the month of receipt is $.18 per case.
- Incidental rates include: (a) Documentation -- $6.14 per receiving, regardless of case count; (b) Recouperage or Extra Handling -- $37.61 per man hour, ½ hour minimum; (c) Labeling Bottles -- $1.53/case; (d) Labeling Cases -- $.88/case; and (e) Charges for Additional Reports -- $7.54 per Report.

[The above rates went into effect on 5/1/97 and are valid through 4/30/98.]

The state is billed for the liquor only after the product is shipped from the Fore River warehouse, with a delay of one or more days after dispatch, so that the state has no inventory carrying cost until liquor is actually at a retail store. In FY 1997, the actual purchase price paid by the state came to $40,307,000, or **$23.54 a gallon** on 1,712,500 gallons, including Federal Excise Taxes of $10.02 per gallon (paid by the distillers before delivery to Maine), and including all costs of inbound freight, plus the warehousing and handling costs assumed by the shippers.

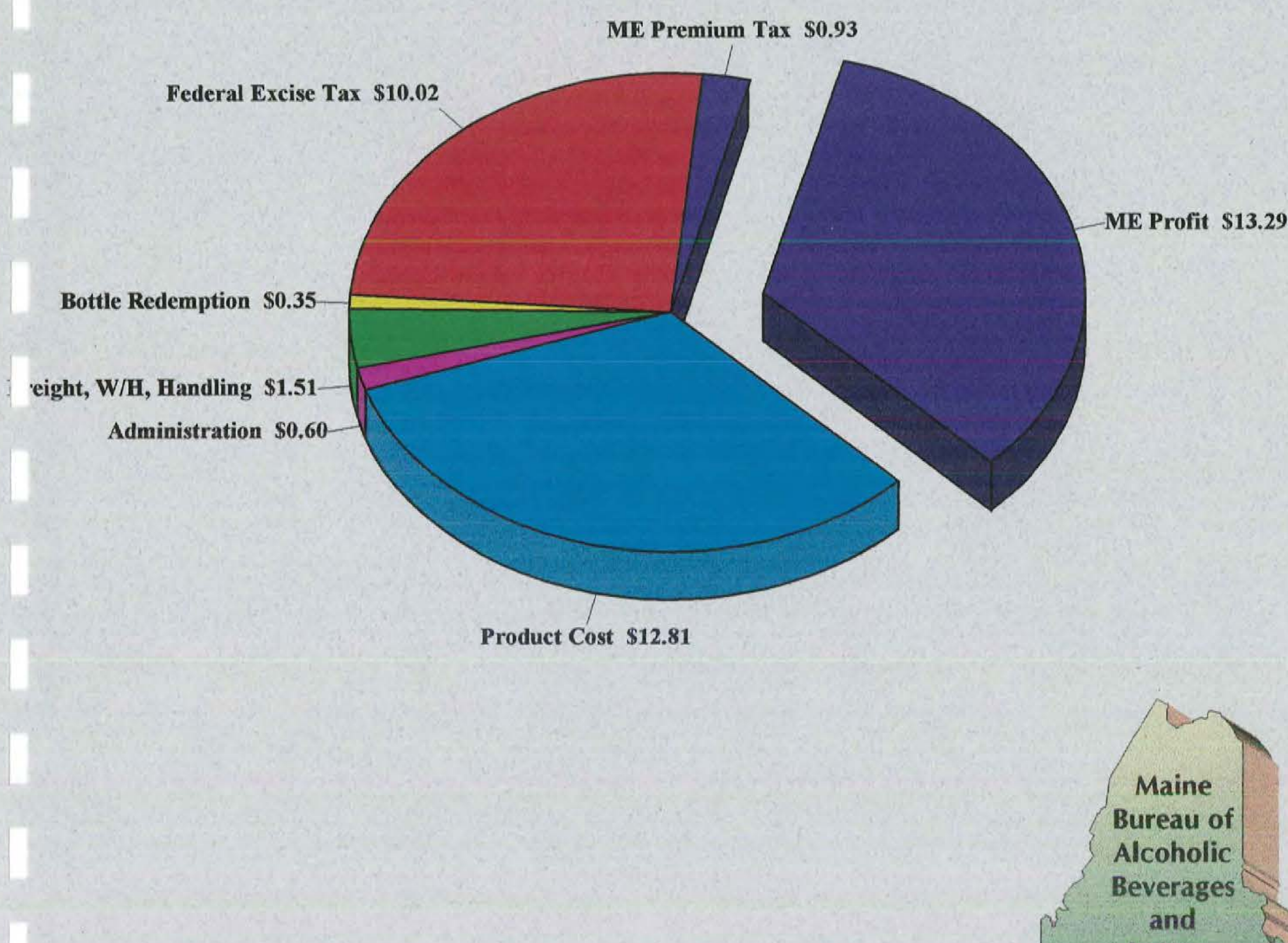
2. Wholesale Order Processing and Delivery.

BABLO's merchandising department takes orders from state and agency stores, accumulates these orders into a purchase order timed to match the truck delivery schedule, and then directs the packaging and authorizes the shipment of orders from the warehouse. BABLO consolidates shipments by truckload. Ownership of the product is transferred from the supplier to the State when the product is picked up by the trucking contractor and leaves the warehouse. If the product is ordered by an agency store, that store takes title to the product when it is delivered. BABLO is responsible for collecting payment from both state and agency stores. Agency stores must pay for product within three days of the date of delivery.

Chart 1

Components of Wholesale Price Under Current System

Wholesale Price of $39.50 Per Gallon



Maine Bureau of Alcoholic Beverages and Lottery Operations

SPC Transport Company, which has a recently-renewed contract with BABLO that runs from 2/1/98 through 1/31/01, operates scheduled delivery routes to state and agency stores. These schedules may vary with appropriate notice, but are generally set to deliver to every agency and state store at least every two weeks. The terms of the contract are as follows:

Effective date:	2/1/98	2/1/99	2/1/00
Rate per round trip mile:	$ 1.13	$ 1.19	$ 1.25
Rate per stop, excluding final:	$15.00	$16.00	$17.00
Per case handling charge:	$ .30	$ .31	$ .32

Mileage is increased for multiple stops in one municipality (3 miles per stop).

A fuel surcharge may be imposed, based on the New England price of diesel fuel as reported weekly by the U.S. Department of Energy. The fuel surcharge will be $.01 per mile for every $.05 per gallon over the base price of $1.20 per gallon.

In FY 1997, BABLO incurred $406,000 in delivery costs from Fore River to retail outlets, adding **$0.24 per gallon** to the wholesale cost of liquor. However, direct deliveries of full cases to state stores and agencies represent only part of the total delivery costs incurred in the system. Agency stores also pick up both full cases and (more often) less-than-full-case quantities of bottles from state liquor stores. Over half of all state store sales are in fact wholesale sales to agencies. Some state stores, such as those in Ellsworth, Waterville and Auburn, send over 70% of their throughput sales to regional agencies. These stores are effectively distribution sub-warehouses, with retail sales operations added. They fulfill the functions of break-bulk redistribution and inventory support for agency stores, which might not otherwise be expected to operate on 8% margins.

BABLO does not break down its store operating costs between 'wholesale,' 'licensee' and 'retail' elements, but we have allocated 20% of the total to 'wholesale' operations, or an additional **$0.57 per gallon** to be built into a wholesale cost. [See Table 3, 'Retail Store Costs,' page 12]

3. Overhead and Administration.

BABLO's overhead and administration costs are essentially those costs of liquor oversight and management at Augusta and systemwide that cannot be appropriately allocated to store operations or to any of the Bureau's contracted services, such as warehousing, trucking, or bottle redemption. They include an allocation to Alcoholic Beverages of costs shared in common with Lottery Operations. These include administrative personnel, contractual services such as accounting, data processing and legal services, insurance, administrative office cost and (to the limited degree this is undertaken) advertising. BABLO's Bureau of Alcoholic Beverages has just 10 people on its payroll who are not employed at one of the retail store operations.

Total overhead expense in FY 1997 came to $1,026,000, equal to **$0.60 per gallon**.

4. Bottle Redemption Operations.

The beer and wine wholesalers of Maine are the shareholders of the state's two beverage container recyclers, Maine Beverage Container Services (in Portland) and Maine Recycling (in Lisbon). These two companies divide the state between themselves roughly along the line of the Androscoggin River. Each is owned by the beer and wine distributors in their respective regions, and assigns each of their shareholders territories within which a single company will collect all used beverage containers from stores and redemption centers. These containers are then collected from the distributors' warehouses by Maine Beverage and Maine Recycling, brought to their processing centers, processed (ground or crushed) and sold as raw materials to manufacturers of new glass, metal and plastic containers. These companies also make a market in recycled glass, metal and plastic for Maine municipal recycling centers.

The two beverage container recyclers have recently renewed contracts with the state to handle returned spirits containers. The state incurs costs of $1.00 per case to handle returned containers, as follows:

	Cost per 12-bottle case:
Reimbursement to container redemption centers at 18 cents/bottle:	$ 2.16
Reimbursement to beer & wine wholesalers for collection:	$ 0.57
Fee to container recycling companies for crushing and disposal:	$ 0.07
Total billed to state by container recycling companies:	$ 2.80
Less: deposits received by state at point of sale at 15 cents/bottle:	($ 1.80)
NET COST TO STATE PER CASE:	$ 1.00

BABLO's total expenditures for bottle redemption expense amounted to $598,000 in FY1997, or a cost of **$ 0.35 per gallon**.

5. State Premium Tax collection.

BABLO also collects the premium tax on spirits ($1.25 per proof gallon) from the retail stores and transfers that revenue to the state's General Fund. In FY 1997, $1,588,700 of Premium Tax revenues were transferred to the General Fund. By law, an amount equal to the premium tax revenues must be appropriated by the Legislature to the Office of Substance Abuse for education and counseling services.

The Premium Tax added **$0.93 per gallon** to the wholesale cost of spirits in Maine in FY 1997.

6. Retail and wholesale pricing.

BABLO establishes a uniform retail list price for spirits sales statewide, with the exception of Kittery. Kittery pricing is generally set to match current New Hampshire prices, and Maine's 6% sales tax and the 15 cents container deposit are absorbed in the posted Kittery selling price. Until recent statutory changes, the uniform retail price had to average a 65% markup over the FOB warehouse price of the spirits product. With the recent change in law granting BABLO more pricing flexibility, the explicit 65% markup has been eliminated and replaced with the following language to define price setting: ".....the list price at which to sell all spirits and fortified wine that will produce an aggregate state liquor tax sufficient to pay all liquor related expenses of the Bureau of Alcoholic Beverages and Lottery Operations and to return to the General Fund an amount substantially equal to the amount of state liquor tax collected in the previous Fiscal Year."

On-premise licensees cannot purchase liquor wholesale under the present Maine system. They may purchase from state stores or agencies; if purchasing from the Kittery store, they must pay the uniform retail list price, not the discount price. In one minor deviation from uniform pricing, agency stores may charge more, but not less, than the established retail price to on-premise licensees. Such a premium may be applied to offset the cost of delivery service, for example, which state stores do not undertake.

Agency stores make their wholesale purchases from the state system at a discount of at least 8% from the current monthly list price. The base discount rate is 8% on all quantities and bottle prices, but with slightly higher rates for full cases of higher-priced bottles. In FY 1997, the average price discount to agency stores came to 8.70%. As of September 1, 1997, the following discount rates are in effect on full case lots purchased from the warehouse:

LIST PRICE PER BOTTLE	EXTRA DISCOUNT
$0 - $9.99	None (Standard 8% only)
$10.00 - $14.99	1% (9% total discount)
$15.00 - $24.99	2% (10% total discount)
$25.00 and over	4% (12% total discount)

From September 1, 1997 to January 1, 1998 with the above discounts in place, the net effective discount to agency stores increased to 9.56%. This higher rate may reflect the inventory adjustment effects of the introduction of reduced pricing on 1.75 liter bottles of premium brands in September 1997. We expect that the FY 1997 rate of 8.70% may be closer to the long-term rate of average discount.

Agency stores are allowed to purchase spirits from state stores and may do so for cash flow reasons or because they need single bottles instead of cases, but only the 8% base discount is then available to them. Licensed agency stores may also purchase spirits from other agents with no discount. On-premise licensees cannot buy spirits directly from the warehouse and must buy from state or agency stores.

The Kittery state discount store operates on a lower state markup (about 40% instead of the standard 65%) to keep retail prices lower and more competitive with New Hampshire in an effort to control cross-border shopping. Because the Kittery store includes both the 6% state sales tax and $.15 bottle deposit in its retail price, the effective discount is 31% off the established state price (Example: $10.00 bottle at agency store, priced at $7.50 in Kittery, minus 6% sales tax and $.15 bottle deposit equals $6.90 or 31% less than agency store price). BABLO made an administrative decision in September 1997 to move the Kittery store to a more visible site and to have it specialize in retail sales only. Sales to agency stores and to on-premise licensees have been transferred wherever possible from Kittery to the Kennebunk state store or to BABLO's merchandising department.

To allow a true systemwide evaluation, it is necessary to apply a common wholesale price per gallon to the state and agency retail stores. For the state stores, this represents an internal transfer price, as if the retail operations were truly a stand-alone profit center. The wholesale price of $39.50

per gallon reflects the discounts offered to agency stores and the state's blended average retail price. This in turn shows BABLO's wholesale margin of $13.29 after deducting all allocated wholesale costs.

The wholesale costs and margin generated in FY 1997 can be summarized as follows:

TABLE 1. Maine's 1997 wholesale costs and margins

Cost element	Total $, FY 1997	Per gallon, FY 1997
State of Maine purchase price	$ 40,307,000	$ 23.54
Delivery to retail locations	406,000	$ 0.24
Allocated store costs for redistribution to agencies	974,000	$ 0.57
Overhead and administration	1,026,000	$ 0.60
Bottle Redemption Costs	598,000	$ 0.35
State premium tax ($1.25/proof gallon)	1,589,000	$ 0.93
Wholesale cost	44,900,000	$ 26.22
Wholesale net margin	22,752,000	$ 13.29
Wholesale selling price	67,652,000	$ 39.50

BABLO's 28 remaining retail stores have a somewhat anomalous position in the distribution system. Many state stores were closed during the period 1993-94, being replaced with agency stores in the ratio of three agencies for each closed state store. The remaining 28 stores sold 52.4% of their 1997 throughput at wholesale prices to agency stores, 37.4% to the public, and the remaining 10.2% to on-premise licensees.

TABLE 2: Retail Store Sales

Type of sale	**All stores except Kittery**		**Kittery discount store**		**Total**	
	$ (000)	Gallons	$ (000)	Gallons	$ (000)	Gallons
Wholesale to agents	$ 20,280	511,400	$ 978	24,600	$21,258	536,000
Retail:						
- consumer	13,402	300,300	3,090	82,500	16,492	382,800
- licensee	4,282	99,400	227	5,300	4,511	104,700
TOTAL	**37,966**	**911,100**	**4,295**	**112,400**	**42,261**	**1,023,500**

To allow analysis of the retail store costs in the context of the larger system of spirits delivery, we allocated retail store operating costs among retail, wholesale and licensee business as shown in Table 3.

TABLE 3: Allocation of Retail Store Costs

Type of cost	All stores except Kittery		Kittery discount store		Total	
	$ (000)	%	$ (000)	%	$ (000)	%
Labor	$ 3,151		$ 432		$ 3,583	
Occupancy	770		233		1,003	
Other	142		81		223	
TOTAL	**4,063**		**746**		**4,809**	
Allocated to:						
Wholesale Sales:						
Labor	630	20%	93	22%	723	20%
Occupancy	154	20%	50	22%	204	20%
Other	28	20%	18	22%	46	21%
SUB-TOTAL	**813**	**20%**	**161**	**22%**	**974**	**20%**
Consumer Retail:						
Labor	1,890	60%	319	74%	2,209	62%
Occupancy	462	60%	172	74%	634	63%
Other	85	60%	60	74%	145	65%
SUB-TOTAL	**2,437**	**60%**	**551**	**74%**	**2,988**	**62%**
Licensee:						
Labor	631	20%	20	5%	651	18%
Occupancy	154	20%	11	5%	165	16%
Other	28	20%	3	4%	31	14%
SUB-TOTAL	**813**	**20%**	**34**	**5%**	**847**	**18%**

BABLO's revenue contributions to the state of Maine

Total Net Sales (excluding Premium Tax) by the state of spirits and fortified wine over the last four years have declined by 4.4%, or an average of 1.1% annually. Total gallonage of spirits has declined by 7.9% from 1994 to 1997, and the total number of bottles sold has declined by over 8.5% during that four-year period:

TABLE 4: Net Sales and Gallons, 1994-97

	NET SALES	TOTAL GALLONS	# OF BOTTLES
1994	$71,145,600	1,838,500	7,557,200
1995	$68,099,100	1,763,200	7,182,600
1996	$68,174,300	1,714,800	7,043,500
1997	$68,045,400	1,693,900	6,913,500

This decline in sales of spirits reflects national trends (discussed below in section XX, "The Spirits Market: Maine and Other States") which include reduced consumption of all forms of alcohol;

within alcoholic beverages, a shift from spirits to wine consumption; and within the spirits category, a shift to higher quality brands.

The total revenue from the sale of spirits and fortified wine by the state (including Premium Tax) is derived by deducting from Total Net Sales the following expenses: Cost of Goods, state store operations, administrative functions of BABLO, and the bottle redemption contract. Total Revenue Contribution in dollar terms (exclusive of the sales tax collected on retail sales at state stores) which is transferred to Maine's General Fund has shown a decline of 6.3% over the past four years. However, the revenue contribution per gallon has increased during that period by 2.7% because of the 6% increase in the sales price (including Premium Tax) per gallon from FY94 through FY 97. The Total Revenue Contribution as a percentage of the total retail value (including Premium Tax) of all gallons sold has remained relatively constant over the period.

TABLE 5. Contribution per gallon, 1994-97

	TOTAL REVENUE CONTRIBUTION	REVENUE PER GALLON	REVENUES AS %AGE OF RETAIL
1994	$23,749,700	$12.65	31.1%
1995	$21,785,700	$12.20	29.6%
1996	$23,085,000	$13.30	31.3%
1997	$22,250,500	$12.99	30.2%

BABLO recently received legislative approval for some pricing flexibility and for the ability to design effective marketing strategies to accomplish two goals: (1) to get Maine residents and visitors to buy spirits in Maine rather than in New Hampshire, and (2) to get customers to trade up to larger bottles or better brands. Two test efforts (vodka re-pricing and price reductions in larger sizes of 20 top sellers) have mixed results in profitability, but there is an early indication of some sales recapture. It may be premature to suggest what if any material impact on the system such pricing flexibility may have.

In addition to revenues collected by BABLO for the General Fund, Maine spirits sales also contribute sales taxes and license fees. The 6% sales tax, applied to both on-premise and off-premise sales, will not be directly impacted by L.D. 1799 but will be impacted indirectly to the extent that sales dollar volume changes. This is assessed in Chapter 5, Pricing Scenarios and Sales Volume, below. License fees, collected by the Bureau of Liquor Enforcement of the Department of Public Safety, are directly addressed in L.D. 1799. These are addressed in Chapter 4, LD 1799 and the Spirits Distribution System it envisions.

3.
MAINE'S CURRENT BEER AND WINE DISTRIBUTION SYSTEM

The beer and wine distribution network in Maine is also a three-tier system (manufacturer, wholesaler and retailer) but, unlike the spirits distribution system which has the state as an active player in the wholesale and retail tiers, in beer and wine distribution the state's role is one of licensing and regulatory control. The three tiers in the beer and wine distribution network are all in the private sector but competition at the wholesale level is limited and regulated by the state. One tier cannot give financial assistance to or have a financial interest in another tier. For example, a brewer cannot be vertically integrated with a wholesaler without special exceptions granted by the state.

The supplier tier includes breweries and wineries, importers, and their local broker representatives in Maine, licensed by the state through the Bureau of Liquor Enforcement. The wholesale tier includes private sector businesses which hold a franchise with a brewery or winery and are federally licensed with the Bureau of Alcohol, Tobacco and Firearms. There is no specific cap on the number of wholesalers who can be licensed by the state, but territorial parameters are set by suppliers through franchise agreements and the state forbids dual distribution (i.e., no overlapping territories). By establishing exclusive territories, access to the wholesale market is limited and competition is controlled, removing the possibility of cutthroat tactics. Wholesalers must also post prices and charge the same price to every retail customer, with no volume discounts. The retail tier includes 415 off-premise outlets and 1,352 on-premise outlets, all of which are private businesses licensed and monitored by the Bureau of Liquor Enforcement, which also collects all license fees and premium/excise taxes on beer and wine.

With a recent (January 1998) merger, the number of beer and wine wholesalers in Maine has been reduced to eleven companies. Each typically has a defined territory of specified counties in southern, central, or northern Maine for products of one of the three largest national breweries (Anheuser-Busch, Coors, and Miller), and also distributes a range of other beers, wine, and in some cases soft drinks and water in both their primary beer franchise territory and in other neighboring counties. Maine licensed beer and wine wholesalers at present are as follows:

TABLE 6. Maine Beer and Wine Wholesalers

Company	Warehouse location	Primary beer brand
Aroostook Beverage	Presque Isle	Coors, Miller
Central Distributors	Lewiston	Coors
Colonial Distributors	Waterville, Bangor (1)	Coors
Cumberland and York Distributors	Portland	Coors
Federal Distributors	Lewiston	Anheuser-Busch
Maine Distributors	Bangor	Anheuser-Busch
Nappi Distributors	Portland	Miller
National Distributors	South Portland	Anheuser-Busch
Pine State Distributors	Augusta	Miller
Solmon Distributors	Caribou	Anheuser-Busch
Valley Distributors	Oakland	Anheuser-Busch

(1) Upon completion of acquisition of Briggs, Inc., Bangor, announced in January 1998.

The beer and wine distribution industry in Maine has consolidated its numbers sharply in the last decade primarily due to the consolidation of major beer brands under the three largest national brewing groups. It has been suggested to us that further consolidation in Maine is unlikely as long as the "big three" brewers choose to retain their existing distributors, although the economic importance of the primary beer brand to a distributor may wane as higher-margin microbreweries, wines and other specialty products increase their overall shares of the beverage market.

If the beer and wine distribution industry were to add spirits as a third major product range, as proposed under L.D. 1799, the industry's experience in handling wines may suggest the pattern of distribution likely to evolve. Wine distribution, because of higher product value than beer and because of wholesale margins ranging above 20%, takes place over a wider geographical range than does beer. Wholesalers typically distribute wines into territories in which they are barred by their beer franchise arrangements. This is facilitated by the wide range of wine brands, meaning that there need be no overlap or competition for a single brand. However, the wine industry is also undergoing a consolidation nationally, with distillers moving to acquire major wine labels and market them nationally. The largest volume winery, Gallo, operates more like a brewer in terms of its distribution arrangements, with two exclusive distributors dividing Maine between them.

Because of distillers' growing ownership of wineries, many Maine beer and wine distributors already have a commercial relationship with one or more distillers. Whether these would lead to spirits distribution franchises with the same distillers is not clear, although L.D. 1799's restrictions on out-of-state companies' participation in Maine would tend to support such a pattern. In a number of states which have no such limitations on spirits distribution, major distillers have chosen to work through multi-state, specialty spirits distributors rather than through in-state beer and wine distributors. We accept, though, the hypothesis that in Maine under L.D. 1799, the most likely pattern of spirits distribution that would evolve would see major multi-brand distillers such as Seagrams and Brown-Forman select one to three exclusive distributors for state-wide coverage. Smaller distillers and importers might select a single state-wide distributor or might not grant any exclusivity, choosing to sell through any and all distributors.

Under L.D. 1799, on-premise licensees would be able to purchase at wholesale prices, as for beer and wine. A key difference between wines and spirits that is especially relevant to on-premise licensees is that brand loyalty is much weaker in wines. Thus a bar or restaurant may offer only one or two wine labels in a given category such as "chardonnay;" and it may freely change its labels in this category. In a spirits category such as scotch, however, it must stock up to a dozen nationally-advertised brands. This implies that a bar or restaurant would have to purchase from several different distributors in order to stock the necessary range of spirits brands, instead of dealing with one or two distributors for beer and wine as at present.

3.
THE SPIRITS MARKET: MAINE AND OTHER STATES

Maine and its neighboring states present a range of strategies for spirits distribution in both the public and private sectors which suggest a number of options when considering the future of Maine's system. Taking any example in isolation may be dangerous. For example, the marketing success and cost-effectiveness of New Hampshire's state system might suggest that a public sector monopoly is quite capable of beating the private sector in terms of efficiency and enterprise. Conversely, the problems encountered in Canada where a neighboring province like New Brunswick sees as much as 30% of its spirits market lost to illegal sales, suggest an urgent need for deregulation and privatization. We suggest that the overall picture is a complex one which does not lend itself easily to ideological simplification.

TABLE 7.
Reported Distilled Spirits Sales per Capita in Maine and Neighboring Jurisdictions, 1996

Jurisdiction	Total population	Spirits sales, gallons	Gallons per capita	Gallons per legal adult
U.S. TOTAL	259,000,000	326,105,000	1.26	1.78
MAINE	1,246,000	1,763,658	1.42	1.93
NEW HAMPSHIRE	1,148,000	4,181,484	3.64	5.07
VERMONT	587,000	756,812	1.29	1.80
MASSACHUSETTS	6,045,000	9,397,000	1.55	2.13
NEW YORK	18,228,000	20,725,000	1.14	1.59
NEW BRUNSWICK	738,000	(1) 744,460	1.01	1.30

(1) New Brunswick sales are for the year ending 3/97. New Brunswick reported sales are reduced by the size of the illegal market in spirits in that Province, estimated by the consultants at 30% of total distilled beverage consumption. This compares with the Canadian Federal government's estimate of total national illegal sales in Canada in excess of 35% of all consumption. Adding in estimated illegal sales brings New Brunswick's total up to 1.86 gallons per legal adult.

A. Maine

Maine, with a total population of 1,246,000 and a legal age population (adults 21 and over) of 888,000 (1995 estimates), was 4th in 1996 among the 18 Control States in adult per capita sales of spirits. Based on the industry's reporting measure of 9-liter cases per 1,000 adults, Maine's sale of total spirits was 814 cases, ahead of the averages for both Control States of 652 cases and for non-control states of 791 cases. The U.S. combined average in 1996 was 751 cases per thousand, or 7.74% less than Maine consumption.

In the fiscal year 1997, 1,712,500 gallons of spirits were sold in Maine in 6,913,600 bottles, with a total retail value of $73,766,400. When comparing all states by share of total alcohol consumption coming from spirits, Maine ranks 14th with a 30.9% share of spirits out of the state's total beverage alcohol market. Maine also ranked 3d nationally in 1996 in sales per capita of cordials and liqueurs, with sales of 226 cases per 1,000 adults as compared to a national average of 90 cases per 1,000 adults.

Using the measurement of wine gallons, the sale of spirits in Maine has dropped from 2,092,000 in 1986 to 1,762,000 in 1996, a fall of 15.77%. FY 1997 saw a further continuation of this trend, to 1,712,500 gallons. Nevertheless, Maine's reduction in consumption has been less than that of neighboring states such as Vermont, Massachusetts and New York. Part but not all of this is accounted for by population growth. Among possible additional factors are the "leakage" of spirits across the Canadian border, and competition with New Hampshire at the Kittery discount store.

Maine was 6th among the Control States in 1996 (21st among all states) in per capita sales of wine with 1,142 cases per 1,000 adults. The national average in wine consumption for 1996 was 1,113 cases per 1,000 adults. Maine ranked 20th in 1996 by share of proof alcohol coming from wine with a 12.6% share, and 36th by share of alcohol coming from beer with a 56.6% beer share.

B. Neighboring States

1. New Hampshire

New Hampshire has a population of 1,144,000 and a legal-age population of 812,000. New Hampshire has a state monopoly of the sale of wines and spirits through 72 state stores and two recently-authorized agency stores, which are considered experimental. Five highway superstores, designed to cater to visitors as well as New Hampshire residents, add considerable success to the state's goal of maximizing alcohol revenues. The wholesale and retail markets are controlled by a three-member Liquor Commission which, in addition to licensing and enforcement functions, is an aggressive marketer and merchandiser of spirits. As a testament to this aggressiveness, until recently the New Hampshire Legislature mandated that 80% of the Commission's advertising budget be spent out of state. That regulation was eliminated in 1996 to give the Commission more flexibility, but significant promotions are still targeted at residents of neighboring states.

The New Hampshire Liquor Commission has 304 full-time employees and 433 part-time employees. Those who are employed in the state stores work closely with suppliers to improve product presentation, through point-of-sale displays and merchandising programs, and to continue an effective shelf management system.

New Hampshire has also initiated a state-of-the-art $2.5 million point-of-sale software system designed to generate a centralized, real-time database of sales and inventory. The system will be year 2000-compliant, will accelerate credit card transactions, and should lead to reduced maintenance costs. It will add further efficiencies to an already much-envied system.

A 1993-94 study of New Hampshire sales requested liquor store customers' residential zip codes. Based on a 90% response rate, the study showed that while 55% New Hampshire customers were state residents, they bought only around 48% of total purchases by value. Out-of-state visitors purchased more per visit, and also purchased more expensive products on average.

In the absence of any publicly available, more recent detailed breakdown of New Hampshire sales, caution must be taken in assessing New Hampshire sales to Maine and other jurisdictions. The 1993-4 data does not, for example, break out spirits and wine; and it covers a period before the opening of the new Hampton 'superstore', targeted in large part at travelers to Maine on northbound I-95. Nevertheless we believe that the following table presents a reasonable approximation of New Hampshire's cross-border sales.

TABLE 8. New Hampshire Sales Breakdown by Jurisdiction

Residence jurisdiction	Percentage of total $ sales	Estimated 1997 spirits sales	Estimated 1997 spirits gallons
New Hampshire	48.0%	$ 76,800,000	2,027,000
Massachusetts	20.0%	$ 32,000,000	845,000
Canada	9.0%	$ 14,400,000	380,000
Maine	8.0%	$ 12,800,000	338,000
Vermont	5.0%	$ 8,000,000	211,000
New York	4.0%	$ 6,400,000	169,000
All other	6.0%	$ 9,600,000	253,000
All customers	100.0%	$ 160,000,000	4,224,000

SOURCE: Percentage sales by jurisdiction are from New Hampshire's 1993-4 Customer Origination Study, O'Neill Griffin & Associates for the New Hampshire Liquor Commission.
NOTE: Estimated sales for 1997 by state have not been adjusted for possible variations in spirits versus wine purchases by jurisdiction of residence. Wine sales account for 22% of New Hampshire sales volume.

Because of its large sales volume, New Hampshire has considerable purchasing leverage with its spirits suppliers (notably in promotional discounts and volume rebates). In wines, New Hampshire pricing is typically within 5% of the pre-tax prices prevailing in Maine (although there are wide variations, especially on deeply discounted promotions), while in spirits, New Hampshire prices are typically 20% or more below Maine prices before Maine sales tax is added. The success of New Hampshire's active marketing strategy is reflected by a small increase in alcohol sales over time – the only state in the northeast to show such an increase. Only eight states nationally (Arizona, Arkansas, Colorado, Idaho, Minnesota, New Hampshire, New Mexico and Wisconsin) showed an increase in gallonage sales of spirits from 1986 to 1996. However, New Hampshire's spirits gallonage increase was only 1.4% over that period, compared to a 22% growth in that state's population. Most of New Hampshire's volume and revenue growth has been in wine sales. A specialty wine program, initiated in 1984 at the Nashua store, has been a key growth strategy and systemwide wine sales grew 16.4% from 1996 to 1997. New Hampshire ranks third in the U.S. in per capita sales of wine, and wine sales represent about 22% of gross sales by New Hampshire liquor stores.

For the 1997 fiscal year, New Hampshire Liquor Commission revenues (from spirits and wines) totaled almost $240 million, up 7.6% on 1996. Gross profits to the state, including additional revenues such as on-premise license fees, totaled just over $71 million, up from $66.7 million in FY 1996.

2. Vermont

Vermont, a Control State with a population of 588,000 and a legal-age population of 411,000, has a total of 74 agency liquor stores statewide. The state's remaining retail stores were closed in 1995-96, but the state retains a wholesale monopoly and a single bailment warehouse. Beer and wine are sold as in Maine, by private wholesalers and a much larger number of licensed retailers.

The Department of Liquor Control, consisting of a three-member Liquor Control Board and a Commissioner appointed by the Board, controls spirits distribution in the state. Vermont's retail pricing is derived from a formula of delivered cost plus variable markup plus 25% gross receipts tax, with the bottle price rounded up to the nearest $0.05. Per capita sales of spirits in Vermont in 1996 were 1.80 gallons per adult (or 757 9-liter cases per 1,000 adults), with a rank of 8th among Control States. Like Maine, that consumption rate is above both the Control States' average rate (652 cases per 1,000) and the U.S. average (751 cases). However, Vermont consumption has fallen even faster than in Maine, by a total of 32.8% between 1986 and 1996. Retail price levels of spirits in Vermont are broadly comparable to those in Maine, with similar results in terms of cross-border "leakage" from New Hampshire.

Vermont's wine consumption rate is 9th nationally, and the state is 10th when ranked by share of proof alcohol coming from wine. However, Vermont's gallonage of wine sold steadily dropped from 1987 to 1996, from 1,970,000 to 1,683,000 gallons.

3. Massachusetts

Massachusetts, a non-controlled or "license state" with a population of 6,045,000 and a legal-age population of 4,416,000, sells spirits through 1,627 licensed retail outlets. Spirits sales have dropped from 13,184,000 wine gallons sold in 1986 to 9,397,000 in 1996, a fall of 28.7%. Despite this decline and the role of cross-border sales from New Hampshire, Massachusetts still exceeds the average per capita consumption rate for all licensed states (791 cases per 1,000 adults) and for the United States as a whole (895 cases).

A January 1998 federal court decision struck down a 50-year-old Massachusetts law that controlled the wholesale price of spirits; this required wholesalers to post their prices monthly and to allow adjustments to match, but not to beat, the prices of competitors. At the date of this report, appeal of the ruling is reportedly under consideration. Consumer advocates have argued that prices will be lowered by the repeal because of increased competition. Opponents of the repeal have argued that wholesale price posting prevents corruption and predatory selling tactics.

The effects of the end of wholesale price regulation are not yet apparent. Unscientific sampling suggests that Massachusetts spirits pricing is at around 10% to 15% higher than New Hampshire prices.

4. New York

New York, a "license state" with a population of 18,228,000 and a legal-age population of 13,053,000, is below the average for the U.S. and for all license states in per-capita consumption.

New York licenses 2,625 retail establishments that are allowed to sell only wines and spirits. Sales of spirits fell from 32,373,000 gallons in 1986 to 20,725,000 gallons in 1996, a drop of 35.98%. despite this fall, New York remains (because of population size) the third largest market for spirits nationally, after California and Florida.

New York residents accounted for less than 2% of New Hampshire customers during the 1993-4 study, but accounted for over 4% of dollar sales. Unscientific sampling suggests that New York State prices are around 10% above New Hampshire levels, before the addition of a 4% state sales tax. New York City residents must also pay municipal excise and sales taxes. New York residents' purchases in New Hampshire are very heavily seasonal, from summer vacationers and through travelers.

Potential recapture of sales from New Hampshire

The success of New Hampshire in capturing sales from its neighbors has generated much analysis and prompted competitive responses such as the Kittery discount liquor store. It is evident, though, that New Hampshire captures sales equally from "control" states (such as Maine and Vermont) and from "license" states (such as Massachusetts and New York). In license states such as Massachusetts and New York, retail pricing is generally higher than in New Hampshire, although generally lower than in Vermont and Maine.

Adjusting Maine consumption for the estimate that 8% of New Hampshire's spirits sales go to Maine residents gives the following figures:

TABLE 9. Adjusted Maine spirits consumption

	Maine sales	New Hampshire sales to Maine	Combined total
Total gallons, 1997	1,712,500	338,000	2,050,500
Total dollars, 1997	$ 73,896,000	$ 12,800,000	$ 86,696,000
Market share, gallons	83.52%	16.48%	100.00%
Gallons per capita	1.42	0.27	1.69
Gallons per legal adult	1.93	0.37	2.30

New Hampshire sales to Maine present the potential to increase sales in Maine by nearly 20% if Maine prices exactly match New Hampshire prices, or theoretically to increase by more if Maine prices undercut New Hampshire prices.

If Maine pricing were to be somewhere in between its present price levels and New Hampshire pricing, it is not possible to say with precision what kind of recapture rate would be achieved. Massachusetts has pricing somewhere in the middle of this range but still sees New Hampshire take a "market share" of around 8.25% of Massachusetts consumption; on the other hand, geography and demographics are different for Maine and Massachusetts. Massachusetts has a much higher population within an hour of New Hampshire; on the other hand, for most Massachusetts customers New Hampshire requires a special trip, while for many Maine customers a New Hampshire stop is a convenient layover on a trip to or from other destinations.

In the absence of other data, we suggest that a straight-line recapture function is the only appropriate assumption: at 50% of the current price differential, Maine would see a 50% reduction in sales lost to New Hampshire. Massachusetts' capture rate appears to support this assumption. It is necessary to make explicit some such assumption in order to assess the potential statewide impacts of L.D. 1799.

4.
PROVISIONS OF L.D. 1799
AND THE SPIRITS DISTRIBUTION SYSTEM IT ENVISAGES

L.D. 1799, An Act to Privatize Liquor Sales, was presented in April 1977 to the First Special Session of the 118th Maine Legislature and held over for consideration during the Second Regular Session in early 1998. The intent of the proposed bill is to remove the State from the spirits business, including wholesale and retail activity, and replace the current system of sales and distribution with a private delivery system.

The model for the new system is the one already in place in Maine for beer and wine. Indeed, while requiring separate wholesale licenses covering beer and wine and for spirits, L.D. 1799's provision requiring that a spirits licensee must have done business in Maine for five years suggests that only current beer and wine distributors are expected to be licensed as spirits distributors.

L.D. 1799 contains specific provisions to end the state's role in both retail and wholesale spirits distribution. These include:

<u>Administration:</u>

- Replaces the Director of the Bureau of Alcoholic Beverages and Lottery Operations with a Director of Lottery Operations.
- Eliminates the State Liquor Commission and shifts all licensing functions to the Bureau of Liquor Enforcement.
- Shifts responsibility for establishing rules and procedures for the administration of state liquor laws from the State Liquor Commission to the Bureau of Liquor Enforcement.

<u>Retail operations:</u>

- Closes all state retail liquor stores.
- Allows any established retailer to apply for a retail spirits license, without numerical restriction or geographical limitation;
- Imposes new retail license fees, while exempting existing agency stores from the renewal fee for one year:
- For retailers with annual sales of $400,000 or more: $1,200 initial fee; $1,000 renewal fee.
- For retailers with annual sales under $400,000: $600 initial fee; $500 renewal fee.
- Abolishes retail price control.

<u>Wholesale operations:</u>

- Closes the state's wholesale bailment warehouse and distribution functions, and permits wholesale licensees to deal directly with distillers and importers.
- Redefines the definition of "wholesaler" as a person who engages in the purchase and resale of liquor (broadened from malt or brewed beverages or wines, or both).
- Creates new wholesale license fees for spirits of $1,400 per year for a principal location and $600/year for each additional warehouse or distribution center.
- Restricts wholesale spirits licenses to persons resident in, or businesses operating in, Maine for five years (as opposed to six months for a beer and wine wholesale license).

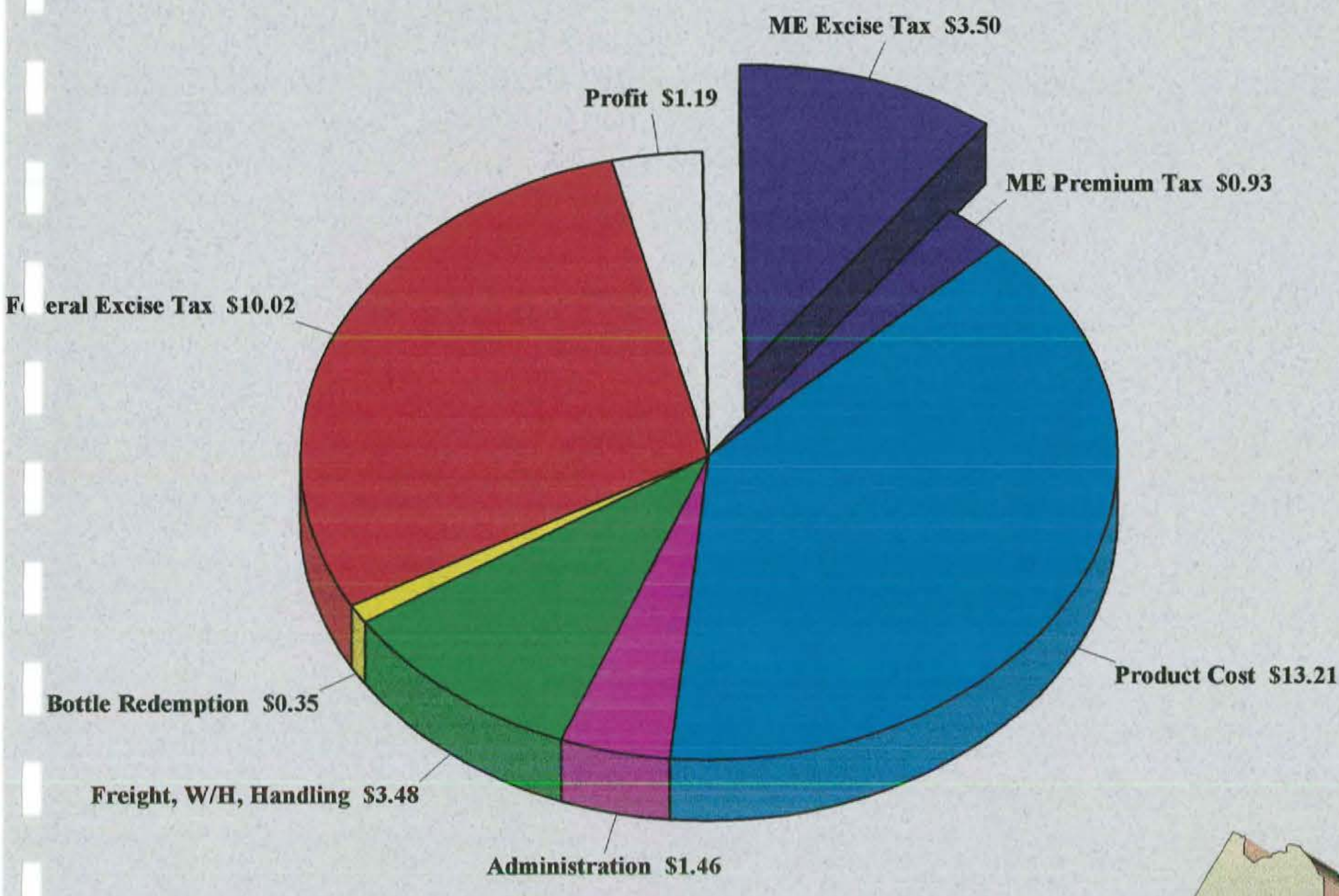
<u>Excise tax:</u>

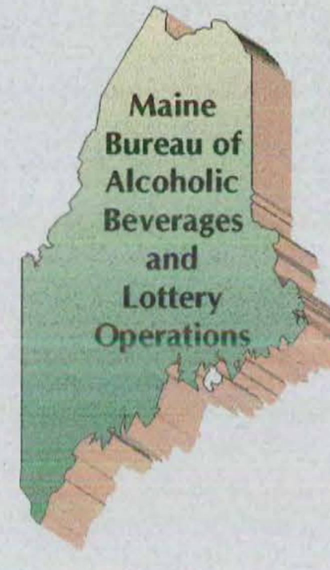
- Establishes a $3.50 per (wine) gallon excise tax on all spirits sold in Maine, to be paid by the manufacturer if located in Maine or by the importing wholesaler.

Chart 2

Components of Wholesale Price Under L.D. 1799

Wholesale Price of $34.14 Per Gallon





Costing under L.D. 1799

If L.D. 1799 were enacted by the Maine Legislature and the wholesale and retail functions of spirits distribution were to be assumed by the private sector, an analysis of the impact on costs within the system is critical to assessing Maine's ability to recapture sales from New Hampshire. Without a significant reduction in the retail price (possibly accompanied by significant promotional campaigns on a "Buy Maine" theme to alter ingrained habits), consumers cannot be expected to change their buying habits.

We here present a detailed review of the expected costs of placing spirits on retail shelves in Maine under the system proposed by L.D. 1799. It is important to be aware that while some of these costs have a wide range of possible outcomes (for example, the difference in retail net margins required by an independent village grocer and a multistate chain pharmacy or supermarket), others (for example, the warehouse costs of 11 wholesale operations instead of one) can be estimated with some accuracy from the actual costs of beer and wine wholesalers.

1. Wholesale cost

Under the present system, the Maine purchase price per gallon, including Federal excise tax, freight in, warehousing, handling, and supplier's product price net of promotional depletion allowances is $23.54 per gallon. To compare this with L.D. 1799, we call distributors' warehouse costs a component of purchase price, as these costs at the Fore River warehouse are absorbed by the manufacturers at present and are buried in the state's purchase price per gallon.

We project that the per-gallon wholesale purchase price under L.D. 1799 would range from $23.61 to $24.31, or an increase of between 1.7 and 6.7%. Note three differences under L.D. 1799:
(1) Higher costs from suppliers due to decreased buying leverage, and reduced volume-based promotional depletion allowances.
(2) Increased inbound freight costs, by virtue of: delivery to 11 locations instead of one; greater delivery distances (to warehouse locations north of Portland); and in many cases, the need to deliver by pallet instead of container, or partial truckload instead of truckload.
(3) Warehouse storage and handling costs are transferred from a component of the wholesale purchase price, as at present, to a component of the wholesaler's markup. We expect increased warehouse and handling costs due to the loss of economies of scale of the single state bailment warehouse. We are aware of only one Maine beer and wine distributor with surplus warehouse space today, and assume that additional warehousing costs would be incurred at the 11 or so warehouse locations.

It should be noted that, under the current system, suppliers carry the cost of inventory until product leaves the Fore River Warehouse; this cost would be shifted to the wholesalers under L.D. 1799. This cost is not separately shown under the L.D. 1799 model, but is assumed to be absorbed in the wholesalers' operating net margins.

Delivery to retailers is now handled by a state-contracted service provider at $0.24 a gallon. We project that privatization will add to these costs significantly. Instead of one entity delivering to 218 stores, the same gallonage would be spread over 11 distributors and 800 or more licensed retailers.

Based on information about beer and wine wholesalers' current distribution costs, we assert that a per-gallon delivery cost range of $0.70 to $0.88 is very conservative, and are only at this relatively low level because we assume some economies will be realized from combined delivery loads of beer, wine and spirits. It is important to remember that each retailer would now receive at least two or three separate deliveries instead of one, and that the average volume per stop will be greatly reduced because of the many more licensed retailers selling the state's spirits.

Overhead and administration are also assumed to increase by twofold to threefold the current costs. Again, this reflects the move from one to a probable 11 operations, with some offsetting economies from combining product ranges.

We assume constant bottle redemption costs ($0.35 per gallon) and premium tax ($0.93 per wine gallon), but add $3.50 for the excise tax proposed under L.D. 1799. This totals to a wholesale cost (before distributors' operating profit) of between $ 31.83 and $ 34.05, or an increase of between 21% and 30%. Excluding the $3.50 excise tax suggests a wholesale cost increase of between 8% and 17%, suggesting the loss of economies of scale from a single monopoly operation.

Table 8 on the following page shows the cumulative build-up of wholesale costs per gallon based on these assumptions, showing a "low range" and a "high range" within the expected range of values for a privatized system operating through Maine's existing beer and wine wholesalers. The table shows how a privatized system could potentially offset the increased costs it would be likely to incur, by accepting low levels of *net* margin, i.e. low rates of operating profit per gallon, in a competitive wholesale environment.

Our estimated rate of net margin (i.e. operating profit) at the wholesale level, 3.5%, is based on industry averages for the United States, and is confirmed by private information regarding Maine wine distribution. The more relevant number may be the gross margin percentage, i.e. the dollars available to the wholesaler to cover all expenses plus net operating profit. We estimate that the wholesalers' gross margin will be in the range of 15% to 18.5% at our forecast range of selling price.

TABLE 10.

COMPARISON OF WHOLESALE COSTS PER GALLON (CURRENT SYSTEM AND UNDER L.D. 1799)

Cost build-up element	**Current system**	**Under system proposed by L.D. 1799**	
		Low range	**High range**
Product cost (before inbound freight)	$13.34	13.41	13.70
Federal Excise Taxes (at $13.50/proof gallon)	10.02	10.02	10.02
Promotional Depletion Allowances	(0.53)	(0.41)	(0.29)
Freight-in (estimated)	0.29	0.58	0.88
Warehousing and handling (absorbed in price)	0.41	-	-
MAINE WHOLESALE PURCHASE PRICE	**23.54**	**23.61**	**24.31**
Warehousing and handling (estimated)	-	0.70	1.17
Delivery to retailers	0.24	0.70	0.88
Selling costs of beer and wine distributors	-	0.88	1.17
Allocated store costs for wholesale sales to agents	0.57	-	-
Overhead and administration	0.60	1.17	1.75
Bottle redemption expenses	0.35	0.35	0.35
State premium tax ($1.25/proof gallon)	0.93	0.93	0.93
L.D. 1799 Excise Tax ($3.50/wine gallon)	-	3.50	3.50
WHOLESALE COST	**26.22**	**31.83**	**34.05**
WHOLESALE NET MARGIN	13.29	1.15	1.23
WHOLESALE SELLING PRICE	**39.50**	**32.98**	**35.28**
Wholesale gross margin % (after taxes)	***37.47%***	***14.98%***	***18.54%***
Wholesale net margin % (operating profit)	***33.63%***	***3.5%***	***3.5%***

2. Retail markups and pricing

BABLO determines the selling price of spirits in Maine under the present system. At present the permitted retail markup is limited to the discount percentage available from BABLO to agency stores, with one exception: the additional markup permitted to agency stores when selling to licensees. This additional markup is not captured in BABLO reports; it is arguably a charge for delivery service.

The retail markup, on top of the wholesale price to the retailer, will determine the retail selling price under the system envisaged in L.D. 1799. The retail margin will be a function of a number of influences:

- The size and turn of the inventory, and especially the number of stocking units carried.
- Spirits sales volume, itself a function of:
  - Location of store
  - Number and location of competing stores
  - Sales volume of other product lines.
- The capitalization of the store's parent or owner.
- Market share and competitive strategy.

At present, the 190 agency stores operating on 8 to 9% margins are unable to profitably carry more than about 200 lines or stocking units. Hannaford supermarkets with agency outlets, for example, carry about 204 lines (including multiple sizes of the same brand). Many small, rural agency stores carry only 50 to 100 lines. This compares with the 800-plus lines carried by state stores. The difference, apart from state policy, is simply that at 8% margins only fast-moving inventory can be carried by private stores.

The margins required by retail stores will, we assume, have to be significantly more than the present average 8.7% margin if the number of licensed retailers is greatly expanded. In material circulated by supporters of L.D. 1799, the number of 742 additional retail outlets has been suggested, for a total of 932 including existing agencies. An alternative number would be the current number of beer and wine off-premise licensees, totaling 1,978 stores. Assuming that the lower number is closer to the likely initial outcome, the more than three-fold increase in the number of stores is certain to reduce average per-store volume.

Average retail margins in non-control states including Massachusetts and New York are reported to be in the 18% to 22% range. At this pricing level, we believe that independent grocery stores, for example, could profitably sell spirits and maintain a reasonable range of inventory, under the conditions of L.D. 1799. Applying these margins to the calculated wholesale price under LD 1799 leads to prices between 2% above and 10% below the current state store pricing before sales tax, as shown below in Table 11.

TABLE 11. Application of typical "license state" retail margins to Maine wholesale prices

(Prices per gallon)	Low range price estimate	High range price estimate
Wholesale selling price (see Table 10)	$ 32.98	$ 35.28
Retail gross margin	18%	22%
Retail price under L.D. 1799	$ 40.22	$ 45.23
Current state retail price	$ 44.50 (plus 6% sales tax = $ 47.17)	
Current Kittery/New Hampshire price	$ 36.81	

We are concerned, however, that L.D. 1799 is likely to facilitate a spirits sales regime which would quickly be dominated by a small number of major "chain" retailers, including those already investing heavily in an attempt to capture market share in Maine. Hannaford Brothers' supermarkets, their major competitor Shaw's (a subsidiary of U.K.-based J. Sainsbury PLC), and the Rite-Aid pharmacy group are all expected to be interested in adding a spirits license to each of their stores in Maine, or an addition of 128 licenses to the 43 agencies already operated by the three retailers. Other growing state-wide groups, such convenience-store operators as Cumberland Farms, Irving, and Big Apple, would be expected to add large numbers of spirits outlets, but do not typically compete on price.

We believe that a probable outcome of L.D. 1799, after a period of shakeout, would be the evolution of a two- or three-tier retail system somewhat resembling the current pattern of wine retailing, although with relatively few players.

- Tier One, with between 60% and 80% of the market, would consist of the three major chains mentioned, possibly with a number of IGA and other supermarkets and possibly even Wal-Marts and retail clubs. These would operate on 12 to 14% retail margins, effectively setting the price level in Maine. There are around 230 stores and supermarkets of these chains in Maine today. These would be expected to carry between 200 and 400 stocking units each.
- Tier Two, with between 15% and 30% of the market, would consist of 500 to 600 convenience stores and smaller markets. These would offer perhaps 20 to 40 'convenience' stocking units at prices significantly above supermarket prices; retail margins would be in the 20% to 30% range.
- Tier Three, at only 5% or so of the market, would include specialty wine and spirits stores and delicatessens in urban areas. These would be expected to carry a disproportionate range of stocking units relative to their size (for example, single malt whiskeys or liqueurs), but would need to earn high margins to cover their costs - say, 20% to 25%. There are at present around 50 such stores with significant wine sales in Maine; many of these could be expected to add spirits. A handful of dedicated wine-and-spirits stores might evolve in this area.

The Tier One retailers, operating on 12% to 14% retail margins, would lead to prevalent Maine pricing as follows:

TABLE 12. Application of expected Maine retail margins to Maine wholesale prices

(Prices per gallon)	Low range price estimate	High range price estimate
Wholesale selling price (see Table 10)	$ 32.98	$ 35.28
Retail gross margin	12%	14%
Retail price under L.D. 1799	$ 37.48	$ 41.02
Current state retail price	$ 44.50 (plus 6% sales tax = $ 47.17)	
Current Kittery/New Hampshire price	$ 36.81	

In this scenario, the price competition between powerful retailers effectively drives down the Maine spirits price for much of the state. As with other classes of retail goods, higher prices will prevail for consumers who will pay for convenience or for non-standard items, or who are unable (for example by lack of mobility) to access major stores.

This expectation, that retail competition will allow Maine to see lower prevailing retail prices for spirits under a regime such as proposed by L.D. 1799, would result in a significant degree of sales recapture from New Hampshire.

5.
EXPECTED SALES VOLUMES AND MAINE REVENUES

In section 4, we described the expected wholesale distribution costs under a system such as proposed under L.D. 1799, and described our expectations of a retail market with no restrictions on spirits sales licenses becoming dominated by a small number of major chain retailers.

While any competitive system without price regulation will incur sharp differences of price for the same item (for example, between supermarkets and convenience stores), we assume that the majority of retail sales will take place at price levels clustered around the low end of the price spectrum – that is, at prices set in effect by major chains whose strategies include:

- Heavy state-wide advertising;
- State-wide uniform pricing, at least for advertised lines;
- Market share-driven competitive pricing.

The effect of retail spirits prices finding a new level somewhere between today's Maine uniform prices and the New Hampshire (and Kittery) price level will, we assume, be to recapture sales for Maine from New Hampshire in proportion to the fall in price towards New Hampshire levels. A straight-line recapture function seems appropriate in the absence of any more plausible model, so that, for example, a 50% cut in the price differential between Maine and New Hampshire would result in recapture of 50% of the sales currently lost.

An exception, however, has to be made for sales at the Kittery discount store. We assume (in the absence of hard data) the Kittery store does 50% of its business at the expense of New Hampshire and 50% at the expense of other nearby Maine stores. Under L.D. 1799 we assume no such discount store could profitably operate, because its selling prices would be too close to wholesale prices to allow a profitable retail margin. We have therefore adjusted our estimate of Maine rates of recapture to net out the 50% of Kittery sales assumed to be captured at present from New Hampshire.

In Table 13, below, we summarize the recapture effects we foresee from retail price reduction. We add the expected range of retail margins at high-volume, chain-owned stores (12% to 14%) to the expected range of wholesale pricing, to create the parameters of the expected price range ("high price/low volume" and "low price/high volume"). We take a mid-point of this range as our "expected" case.

At this expected price level, the differential between Maine and New Hampshire pricing is cut by approximately 55%, and consequently we expect a 55% recapture of New Hampshire sales to Maine residents *net of* the loss of 50% of the Kittery store's retail gallonage. The effects on Maine sales and revenue are shown in Table 13.

TABLE 13. Calculation of Maine sales recapture from New Hampshire.

Current New Hampshire sales to Maine	$ 12,442,000		
Current New Hampshire gallons to Maine	338,000 gallons		
Current New Hampshire price per gallon	$ 36.81		
Current Maine uniform price per gallon	$ 44.50		
Current Maine price with 6% sales tax	$ 47.17		
	High price/low volume case	Median or expected case	Low price/high volume case
Expected Maine retail price per gallon	$ 40.67	$ 39.07	$ 37.47
Expected Maine price plus 6% sales tax	$ 43.11	$ 41.41	$ 39.72
Percentage reduction of price differential	39%	55%	72%
Expected gallons recaptured	131,820	187,786	243,060
Less: 50% of Kittery retail sales	(41,260)	(41,260)	(41,260)
Equals: net gallons recaptured	90,560	146,526	201,800
Expected additional $ sales	$3,683,075	$ 7,336,799	$ 7,561,446
Expected additional excise taxes at $3.50	$ 316,960	$ 512,841	$ 706,300
Expected additional premium taxes	$ 84,220	$ 136,269	$ 187,674
Expected additional sales taxes	$ 220,984	$ 440,208	$ 453,687
Total new revenue to General Fund	$ 622,164	$ 1,089,318	$ 1,347,661

The most likely revenue impact of this recapture is to add a total of around $1.09 million income to the state. This is a partial offset to the loss of BABLO earnings, which totaled $20,660,000 (before premium tax collections) in FY 1997.

License fee revenues

Under L.D. 1799, we have assumed the emergence of a "three-tier" spirits retail sector of major high-volume chains, convenience stores, and specialty stores. We indicated (page 28) our belief that the total number of outlets in the three categories would fall into the range of 700 to 900, perhaps after an initial period of shakeout.

To calculate license fee revenues, we assume that there will be a total of 800 off-premise licensees, of which 100 will be in the category of stores with retail sales under $400,000 per annum and $700,000 in the over-$400,000 sales category.

TABLE 14. Revenue effects of L.D. 1799 license fees

	Year 1	**Subsequent years**
Wholesale distributor licenses (11 @ $1,400)	$ 15,400	$ 15,400
Retail licenses: 190 existing agencies	$ 0	$ 190,000
Retail licenses: 510 additional stores over $400,000	$ 612,000	$ 510,000
Retail licenses: 100 additional stores under $400,000	$ 60,000	$ 50,000
TOTAL LICENSE INCOME	$ 687,400	$ 765,400

The annual license renewal income of $ 765,400 is a direct offset to the General Fund for part of the revenue loss from the end of BABLO's liquor operations.

CONCLUSIONS

The net loss of revenue to the state from the implementation of L.D. 1799 is a blend of :

- Lost state net margins from BABLO operations;
- Gains from a new excise tax of $3.50 a gallon;
- Gains from sales and premium taxes on additional sales recaptured from New Hampshire;
- Gains from new wholesale and retail license fees.

Table 15 summarizes these conclusions at the "most likely" retail price level we expect will evolve after passage of L.D. 1799. Two items not included in the summary table are:

- Sales tax collections from on-premise sales. We cannot forecast the future resale prices charged by on-premise licensees, though we expect little significant change in net bar and restaurant liquor sales and therefore tax collections.
- The initial inventory stock-up effect, as several hundred new retailers acquire their starting inventories; this will give a one-time, non-recurring boost to excise tax collections. Table 15 is intended to show the 'stable state' revenue we expect after an initial adjustment period of about one year.

TABLE 15: Expected revenue consequences of L.D. 1799 (after 1 year)

	Present system	Under L.D. 1799
Gallons sold	1,712,500	1,859,026
BABLO transfer to general Fund	$ 20,661,837	$ 0
Premium tax	$ 1,588,694	$ 1,728,894
Sales tax from off-premise sales	$ 4,163,054	$ 4,357,929
State excise tax at $3.50/gallon	$ 0	$ 6,506,591
License fees	$ 57,000	$ 765,400
TOTAL REVENUE	$ 26,470,585	$ 13,358,814

We forecast a net loss of revenue to the state of Maine of approximately $13.11 million from the passage of L.D. 1799.

It may be of interest to consider alternative levels of excise tax (other than the $3.50 per gallon proposed). The following Appendix presents spreadsheets showing the direct revenue effects to Maine of alternative levels of excise taxes. Case 4 shows that the breakeven level of excise tax would be approximately $ 12.93, implying a pre-sales tax retail price level $4 per gallon (9%) higher than at present in Maine. At price levels higher than current levels, we assume increased "leakage" of sales to New Hampshire in proportion to the percentage increase in the two states' price differential. At this revenue-neutral level of excise tax, Maine would lose almost 180,000 additional gallons to New Hampshire. Also of interest may be Case 3, showing the excise tax level which would be neutral in terms of gallons lost to or recaptured from New Hampshire. This is not the same as the excise tax level which would exactly replicate today's Maine retail price, because of the distorting effects of the Kittery discount store. We calculate that there would be zero recapture at an excise tax level of around $7.74 per gallon, for an average Maine retail price of $43.31 before sales tax.

Appendix 1

CALCULATION OF NET REVENUE GAIN OR LOSS TO MAINE FROM ALTERNATIVE RATES OF EXCISE TAX UNDER L.D. 1799

Maine
Bureau of
Alcoholic
Beverages
and
Lottery
Operations

Appendix 1: Cases 1 and 2

CALCULATION OF NET REVENUE GAIN OR LOSS TO MAINE FROM ALTERNATIVE RATES OF EXCISE TAX, SYSTEM AS UNDER L.D. 1799

FY 1997 Actual Gallons and Prices

Gallons sold by Maine (ex. Kittery)	1,629,980
Gallons sold at Kittery	82,520
Gallons sold from N.H. to Maine	338,000
Total gallons available to Maine	2,050,500

Maine retail price per gallon	$44.50
Maine retail plus 6% sales tax	$47.17
Kittery retail price per gallon	$36.81
N.H. retail price per gallon	$36.81

Case 1: Excise tax = $3.50 per gallon

Excise tax	**$3.50**
Retail price before sales tax	$39.07
Retail price plus sales tax	$41.41

Recapture rate from N.H.	55.56%
Recapture gallons from N.H.	187,786
Less 50% of Kittery gallons	-41,260
Net recapture from N.H.	146,526

Current revenue		**L.D. 1799 Revenue Excise =:**	**$3.50**
BABLO transfers to General Fund	$20,661,837	Revenue from excise tax	$6,506,590
Revenue from sales tax @ 6%	$4,163,054	Revenue from sales tax @ 6%	$4,357,928
Revenue from licenses	$57,000	Revenue from licenses	$765,400
Revenue from premium tax	$1,588,694	Revenue from premium tax	$1,728,894
Total revenue	$26,470,585	Total revenue	$13,358,812
		Net loss of revenue	$13,111,773

Case 2: Excise tax = $ 6.50

Excise tax	**$6.50**
Retail price before sales tax	$42.07
Retail price plus sales tax	$44.59

Recapture rate from N.H.	24.86%
Recapture gallons from N.H.	84,037
Less 50% of Kittery gallons	-41,260
Net recapture from N.H.	42,777

Current revenue		**L.D. 1799 Revenue Excise =:**	**$6.50**
BABLO transfers to General Fund	$20,661,837	Revenue from excise tax	$11,409,299
Revenue from sales tax @ 6%	$4,163,054	Revenue from sales tax @ 6%	$4,430,669
Revenue from licenses	$57,000	Revenue from licenses	$765,400
Revenue from premium tax	$1,588,694	Revenue from premium tax	$1,632,407
Total revenue	$26,470,585	Total revenue	$18,237,776
		Net loss of revenue	$8,232,809

Appendix 1: Cases 3 and 4

Case 3: Maine and N.H. volume - neutral; excise tax between $7.73 and $ 7.74

Excise tax	**$7.74**
Retail price before sales tax	$43.31
Retail price plus sales tax	$45.91

Recapture rate from N.H.	12.18%
Recapture gallons from N.H.	41,154
Less 50% of Kittery gallons	-41,260
Net recapture from (loss to) N.H.	-106

Current revenue	
BABLO transfers to General Fund	$20,661,837
Revenue from sales tax @ 6%	$4,163,054
Revenue from licenses	$57,000
Revenue from premium tax	$1,588,694
Total revenue	$26,470,585

L.D. 1799 Revenue Excise =:	**$7.74**
Revenue from excise tax	$13,253,928
Revenue from sales tax @ 6%	$4,449,826
Revenue from licenses	$765,400
Revenue from premium tax	$1,592,526
Total revenue	$20,061,681
Net loss of revenue	$6,408,904

Case 4: revenue neutrality at excise tax around $12.93.

Excise tax	**$12.93**
Retail price before sales tax	$48.50
Retail price plus sales tax	$51.41

Recapture rate from N.H.	-40.93%
Recapture gallons from N.H.	-138,332
Less: 50% of Kittery gallons	-41,260
Net recapture from (loss to) N.H.	-179,592

Current revenue	
BABLO transfers to General Fund	$20,661,837
Revenue from sales tax @ 6%	$4,163,054
Revenue from licenses	$57,000
Revenue from premium tax	$1,588,694
Total revenue	$26,470,585

L.D. 1799 Revenue Excise =:	**$12.93**
Revenue from excise tax	$19,820,500
Revenue from sales tax @ 6%	$4,460,762
Revenue from licenses	$765,400
Revenue from premium tax	$1,425,604
Total revenue	$26,472,266
Net loss of revenue	-$1,681