# Michigan's Liquor Distribution System—A Need for Change

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# Introduction

In 1997, Michigan made a fundamental change to its liquor distribution system. Prior to 1997, the state was the wholesale distributor of liquor. The state purchased liquor from producers, warehoused the liquor in state-owned or leased buildings staffed with state employees, and state employees delivered it to state-owned or leased regional stores—also operated by state employees.

All licensees who sold liquor to consumers—grocery stores, liquor stores, bars, and restaurants—were required to pick up the liquor from these state stores.

Public Act (PA) 440 of 1996 (which became effective in 1997) privatized the liquor distribution system. Under PA 440, the state left the liquor *distribution* business, closing state liquor warehouses, ending hauling contracts to state-operated regional stores, cancelling operation contracts for these sites, and eliminating many state jobs.

While the state maintained its position as the legal *wholesaler* of liquor under PA 440, it now contracts the warehousing and distribution functions to private entities known as authorized distribution agents, or ADAs. These ADAs receive deliveries from producers, warehouse the liquor, accept and reconcile orders from over 12,000 licensees, and make approximately 8,000 weekly deliveries. ADAs are paid a per case fee, currently $8.32, to cover the costs of this work. Michigan has three ADAs—National Wine and Spirits, with a 58 percent market share, General Wine and Liquor Co., with a 42 percent market share, and Chinese Import and Export, an extremely small distributor of specialty liquors.

National Wine and Spirits (NWS) hired Public Sector Consultants to review the liquor distribution system that was established in 1997. In preparing this report, we talked to entities representing all parts of the three-tiered system of liquor production, distribution, and sale, including producers, distributors, and retailers (known in Michigan as “off-premise” and “on-premise” licensees). We spoke to individuals who worked under the “old system” prior to PA 440 of 1996 and those who operate under the system put in place by PA 440. We reviewed data provided by national and state associations, looked at articles and legislation from other states, and talked to regulators and legislative staff familiar with the issue. This report outlines our research into the current liquor distribution system in Michigan, shows how prices are established throughout the system, details the state taxes and revenues that are generated by liquor, compares the Michigan distribution system to those of other states, and examines some of the problems in the current system. Finally, this report will offer some options that will allow for a sustainable liquor distribution system.

# The History of Liquor Distribution

## *The Three-tiered System and Control vs. License States*

The Twenty-first Amendment to the United States Constitution, which repealed Prohibition in 1933, gave states the explicit power to regulate alcohol imports, including beer, wine, and liquor. Although Prohibition was widely viewed as a failure, concerns about the over-consumption of alcohol remained a public safety issue, and even proponents of the repeal believed that states should adopt strict regimens to control the sale and consumption of alcoholic beverages.

Development of state regulations for alcohol was heavily influenced by John D. Rockefeller's report, *Toward Liquor Control,* released in 1933 (Peck 2009, 17). Rockefeller promoted repeal, but advocated for strict state control of alcohol through licensing of all entities involved in the production, distribution, and sale of alcohol—and high taxation. This report helped establish what is now referred to as the "three-tiered system" (see Exhibit 1). The three-tiered system segregates producers, wholesalers, and licensees,[1] and prohibits the participants of one tier from being involved in any other tier. Under this system, for example, a producer or wholesaler of alcohol cannot own a chain of bars, a liquor store, or any other retail outlet. The purpose of the three-tiered system was to prevent vertical monopolies and various promotional practices which existed prior to Prohibition and were viewed by prohibitionists as anticompetitive and promoting overconsumption. The three-tiered system was viewed as a check-and-balance compromise to which all parties could agree.

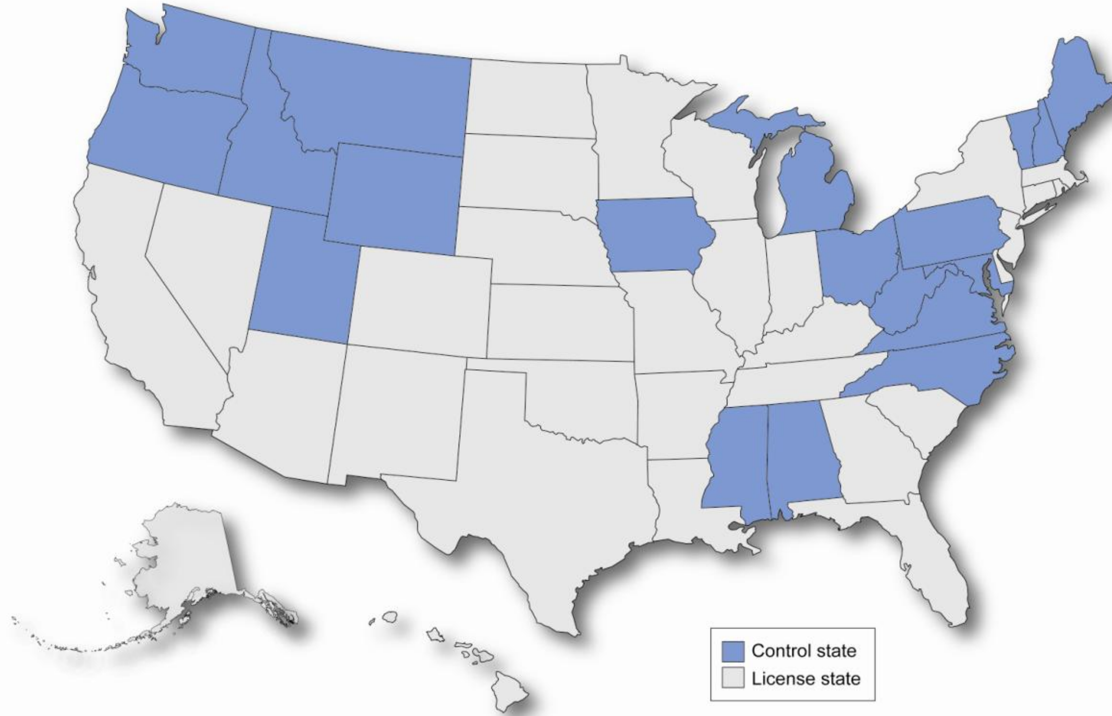
**EXHIBIT 1.** Three-tiered System

SOURCE: Public Sector Consultants Inc., 2011.

In addition to establishing the three-tiered system, states adopted the characteristics of either a "control" state or "license" state, based on the role of state government in the distribution and retail sale of alcohol. Eighteen states, including Michigan, became control states (see Exhibit 2). Under the control state model, the state acts as the wholesaler of liquor, buying directly from the producers, handling distribution, and, in some cases, handling direct retail sale to the public through state-owned stores. In the control state model, the price of liquor is set by the state, not the free market, and as Rockefeller advocated, with a very high tax imposed. The other 32 states became license states. These states rely on the free market to distribute, sell, and set prices, although they license entities in each of the three tiers.

[1] For the purposes of this paper we use the term "licensee" to refer to the retail tier of the three-tiered system. Licensees are either "on-premise" licensees, such as bars and restaurants where the alcohol is consumed on-site, or "off-premise" licensees like grocery stores or party-stores where alcohol is purchased for consumption elsewhere.

**EXHIBIT 2.** Map of Control and License States




SOURCE: National Alcohol Beverage Control Association Inc. (http://www.nabca.org/States/States.aspx) and Public Sector Consultants Inc., 2011.

Control states have several similarities other than just the role of government in the wholesale and/or licensee tiers. Although exceptions exist, consumption is generally lower in control states. Control states generally have higher state and local revenues from higher alcohol taxes than do license states (NABCA 2009). In fact, the amount of revenue generated by taxes in control states has been one of the main barriers to the privatization of liquor sales in the control states, particularly during recent periods of state budget difficulties around the country. This is because privatization proposals have had difficulty maintaining the level of state revenue these states receive under a control model.

While relatively lower consumption and relatively higher taxes are common in control states, they vary widely on the specifics of control. Fourteen fully control wholesale operations as well as retail outlets. Some states control the sale of wine as well as liquor (Michigan does not). Operational policies vary widely among the 18 control states and include differences in the number and kinds of products available to the consumer, whether licensees can order split cases, whether licensees who order split cases are required to pay a split case fee, minimum order size, frequency of delivery, delivery charges, and the number of outlets that receive delivery versus outlets that must pick up their orders.

# The Logistics of Liquor

*From Producer to Consumer*

The State of Michigan is the legal wholesaler in the state's three-tiered system and acts as the intermediary between the producer and the consumer. The state purchases liquor from the producer, authorizes distribution to licensees, and collects numerous state taxes—including a 65 percent markup of the wholesale price. Since the ADAs are responsible for actual physical distribution of liquor to more than 12,000 licensees across the state, the Michigan Liquor Control Commission (MLCC) must work closely with the ADAs throughout the distribution process. This process is described in Exhibits 3 and 4.

**EXHIBIT 3.** Description of Liquor Logistics

### Steps 1 & 2

Liquor is manufactured by producers who ship cases of liquor to warehouses operated by the ADAs. The ADAs provide a venue for producers to store their liquor prior to selling it to the state—a process known as bailment.

### Steps 3, 4 & 5

The state's 12,000 plus licensees place orders for liquor online, either through an ADA or directly to the MLCC. If placed through an ADA, orders are batch processed on a daily basis and transmitted nightly to the state. The state purchases the items ordered from the producer and sends confirmation to the ADA that the liquor is ready for distribution.

### Steps 6 & 7

The ADA packages the order, delivers it to the customer, and collects the appropriate fees.

### Step 8

The ADA makes a daily deposit to the state. The deposit consists of:

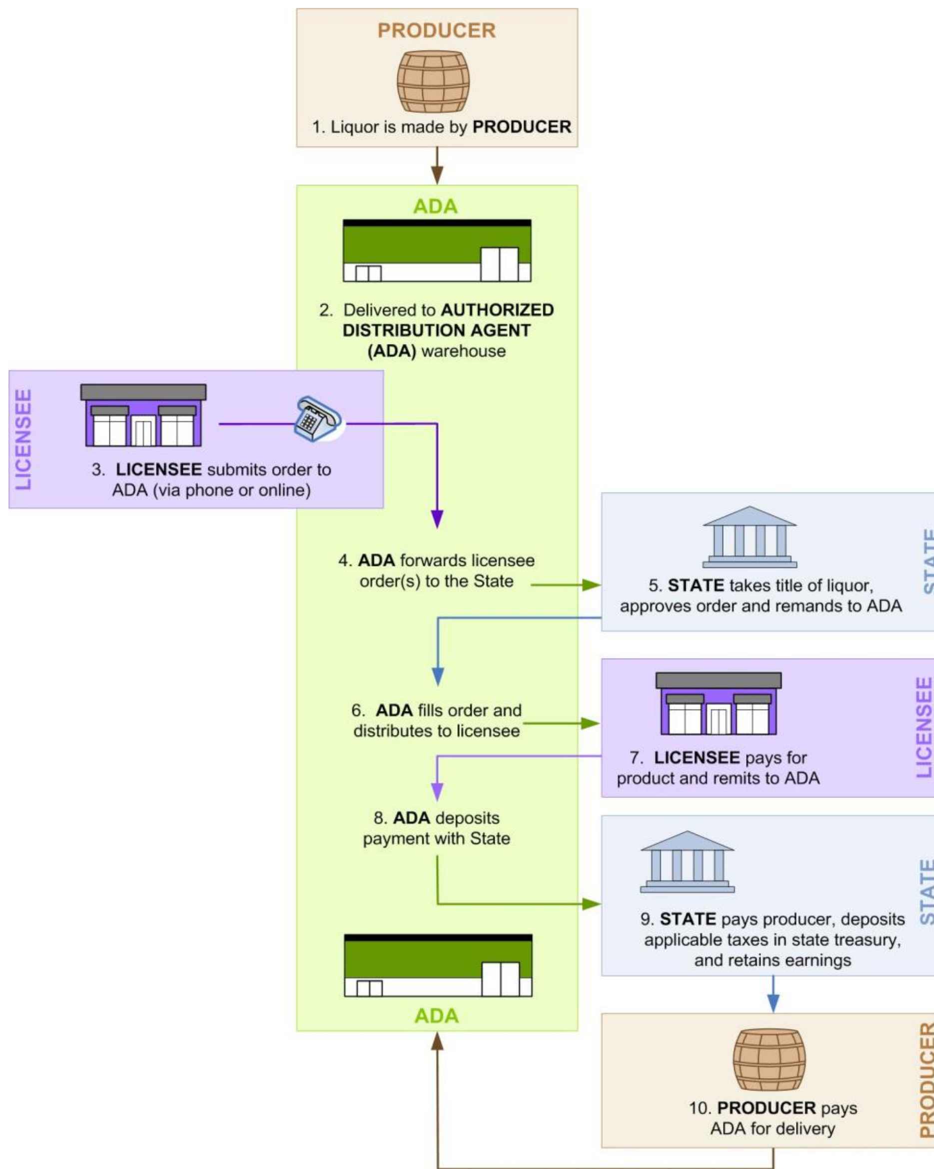
- Money collected from the licensee for the product
- Applicable taxes and fees collected by the state

### Steps 9 & 10

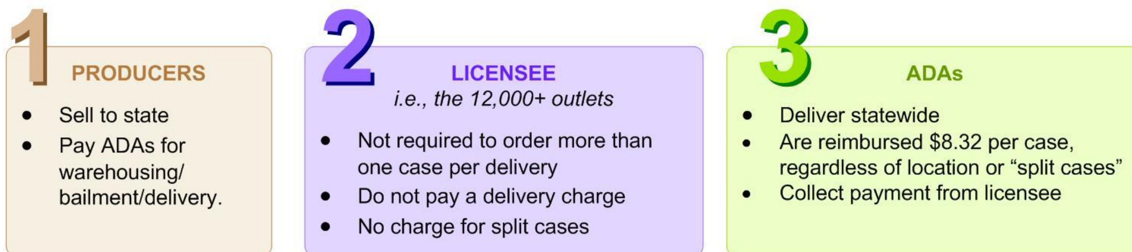
The state takes the deposit and pays the producer for the product **and** the state's share of the delivery fee (currently $6.97 per case). The producer adds an additional $1.35 per case to the state's share of the delivery fee and pays the ADA (on behalf of the state and producers) a total per case delivery fee of $8.32.

SOURCE: Public Sector Consultants Inc., 2011.

**EXHIBIT 4.** Visualizing Liquor Logistics




## Key Features of this System




SOURCE: Public Sector Consultants Inc., 2011.

# Michigan's Liquor Pricing System

Several key features of Michigan's liquor pricing system should be emphasized:

- Producers, with approval of the Michigan Liquor Control Commission, determine what prices they charge the state for wholesale liquor purchases.
- The state sets the minimum price of liquor that a consumer pays at an off-premise outlet. This is a feature that distinguishes control states from license states. It also distinguishes how liquor is priced in Michigan in comparison to beer and wine, where the price to the consumer is determined by the market, not the state.
- The state process for setting the consumer price determines the minimum revenue that off-premise licensees receive.
- On-premise licensees set their own consumer prices, by the drink.
- ADAs are paid a flat per case fee established by the MLCC.

The state realizes a significant amount of revenue from liquor consumption. Net revenue from the sale of liquor in FY 2009 was $286.3 million, with an additional $56.5 million collected in state sales tax.

## SETTING THE CONSUMER PRICE FOR LIQUOR

Liquor is sold to the consumer in a variety of prices, brands, and bottle sizes. To illustrate how prices are established—and the amount of taxes and state revenue—let us take an unnamed 750 ml bottle of liquor that has a shelf price of $35.96. After the states sales tax of 6 percent is applied, the consumer pays $38.12 to take that bottle home.

This bottle of liquor (*Bottle X*) was initially purchased from the producer by the MLCC for $19.15. The final take-home consumer price represents, therefore, an increase of almost 100 percent—a doubling of the acquisition price (see Exhibit 5).

To understand how the final consumer price is determined, how the state realizes revenue from a variety of state taxes on liquor, and how minimum licensee revenue is determined, one needs to focus on the four basic steps in Michigan's pricing system—in a sense, the four "prices":

1. Acquisition price
2. Base price
3. Minimum shelf price
4. Final consumer price

**EXHIBIT 5.** Producer Price vs. Markup and Taxes on a Bottle of Liquor (*Bottle X*)

SOURCE: Public Sector Consultants Inc., 2011.

### *Acquisition Price*

The acquisition price is set by the producer of liquor (with approval by the MLCC) and is what the MLCC as the state wholesaler pays. Our example uses a 750 milliliter bottle. The price is established on a per case basis and is public information. A case of *Bottle X* costs the state $229.76—and contains 12 bottles, each costing $19.15.

### *Base Price*

The base price is the acquisition price plus a 65 percent markup applied by the MLCC.[2] In the process of establishing the base price, the MLCC converts the per case acquisition price to a per bottle price and utilizes a rounding formula. In our example of *Bottle X*, this conversion results in a bottle price of $31.60. The base price is significant for a number of reasons beyond the 65 percent markup that goes to the MLCC:

1. **The base price is used to calculate a number of state taxes that are applied to each bottle of liquor sold in the state. These taxes are generally called the "four specific" liquor taxes:**
   - 4% convention and facilities[3] (base price x 4%) or $31.60 x .04 = $1.26
   - 4% School Aid Fund[4] (base price x 4%) or $31.60 x .04 = $1.26
   - 4% General Fund[5] (base price x 4%) or $31.60 x .04 = $1.26
   - 1.85% substance abuse tax[6] (base price x 1.85) or $31.60 x 1.85 = $0.58 (off-premise only)
   - The total taxes on *Bottle X* are $4.36

2. **The base price is also used to calculate the minimum licensee profit, or "licensee discount" (base price x 17%[7]). In this case, the licensee discount on a bottle of *Bottle X* is $31.60[8] x 17%, or $5.37. In other words, on off-premise licensee pays the state $35.96 - $5.37, or $30.59, for each bottle. Since on-premise licensees do not have to pay the 1.85% substance abuse tax (they must, however, pay the other three specific liquor taxes), an on-premise licensee pays the state $30.01 for each bottle of *Bottle X*.**

Out of the 65 percent markup that goes to the MLCC, the MLCC pays for administrative operations, the licensee discount (in this example $5.37), and the state's share of the ADA fee (in this example, $0.69 per bottle). After deducting the licensee discount and the state's share of the ADA fee, but prior to deducting its administrative expenses, the MLCC share of *Bottle X* equals $6.38.

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[2] MCL 436.1233.
[3] MCL 436.2207.
[4] MCL 436.2203.
[5] MCL 436.2201.
[6] MCL 463.2205.
[7] Statutory discount rate of 17 percent was set in 1980.
[8] MCL 436.1233.

### *Minimum Shelf Price*

Base price plus the four specific state taxes create the minimum shelf price for a bottle of liquor. This is the least amount on off-premise licensee can charge per bottle. In the *Bottle X* example, this is $35.96.

### *Consumer Price*

In addition to paying the 65 percent markup of wholesale and four specific liquor taxes totaling 13.85 percent against base price, consumers pay sales tax on each bottle of liquor they buy. In the *Bottle X* example, the sales tax on $35.96 is $2.16. Therefore, the total purchase price of a bottle of *Bottle X* is $38.12[9] (see Exhibit 6).

**EXHIBIT 6.** Consumer Price Breakdown on a Bottle of Liquor (*Bottle X)*

SOURCE: Public Sector Consultants Inc., 2011.

## WHERE THE MONEY GOES

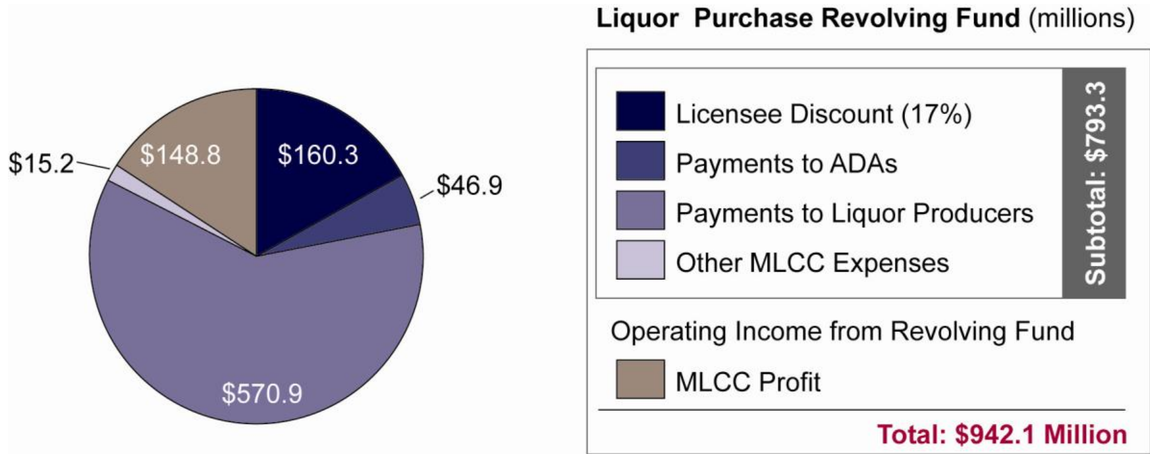
The previous section explained how liquor is priced in Michigan, leading ultimately to the final consumer price. Exhibits 7 and 8 show how much money is received from liquor sales in a given year (FY 2009), which entities receive how much of that money, and the amount available to the state from the MLCC markup and various state taxes.

Consumer sales of liquor generate almost one billion dollars a year in Michigan, as Exhibit 7 shows. Once payments are made to producers and distributors (i.e., the ADAs), licensees keep their share (i.e., the 17 percent licensee discount), and the MLCC pays all of its own operating expenses, $148.8 million remains as "MLCC profit" (financial statements from the MLCC label this as "Operating Income"), which is available to the state's General Fund.

In addition to this $148.8 million profit, various taxes generate additional revenue for the state. As explained in the previous section on pricing, four specific liquor taxes are assessed on the base price: a 4 percent Convention and Facilities tax ($37.7 million), a 4 percent School Aid Fund tax ($37.7 million), a 4 percent General Fund tax ($37.7 million), and a 1.85 percent Substance Abuse tax that is levied only on off-premise sales ($14.1 million). In addition, the final 6% state sales tax on liquor purchases generates $56.5 million.

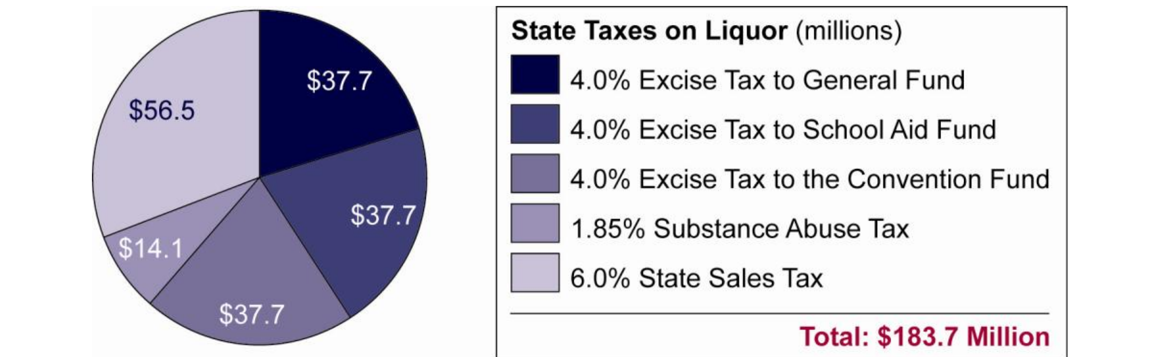
[9] Rounding calculations make the price $38.12 instead of $38.11.

**EXHIBIT 7.** Liquor Purchase Revolving Fund 2009
(Total: $942.1 Million)




SOURCE: MLCC, *Annual Financial Report 2009*, 2009.

**EXHIBIT 8.** 2009 State Taxes on Liquor
(Total: $183.7 Million)




SOURCE: MLCC, *Annual Financial Report 2009*, 2009.

# The 1997 Changes and the System Today

The 1997 changes made to Michigan's liquor distribution system were significant because three private companies—the ADAs—replaced state employees in performing some activities of the distribution tier in the three-tiered system. Michigan continues, however, to exhibit key features of a control state. For example, state government still sets the price of liquor, and state government continues to be the wholesaler of liquor.[10] Nevertheless, Michigan's large number of licensees that make liquor readily available to consumers is more characteristic of a license state—causing some observers to characterize Michigan as a hybrid.

PA 440 addressed a number of issues related to the transition to a new liquor distribution system,[11] as well as including several state mandates and prohibitions regarding delivery. ADAs are required, for example, to deliver at least once a week to every outlet in the state. They are not allowed to charge a delivery fee. They are not allowed to charge a split case fee. There are no limits on the number of split cases that can be ordered for delivery. And, while the law allows the MLCC flexibility in establishing minimum order requirements (not less than one case or more than a minimum of two cases per order)—current MLCC rules limit the minimum order requirement to a single case.

The prohibition on charging a delivery fee and a split case fee is in sharp contrast to what was originally proposed by the MLCC for the new distribution system. Prior to the introduction of legislation, the MLCC promulgated rules to establish the new system, and those rules allowed ADAs to charge both a split case fee and a delivery fee. Legislation was introduced, in part, because of opposition to these—and other—provisions set by the MLCC. The legislature ultimately decided that it did not want to defer to the MLCC to establish the new system, but rather wanted it created in statute.

Some of the other delivery requirements of the new system—weekly delivery, a low minimum order, and no limits or fees on the number of split cases ordered—are also significantly different than the old system. Under the old system, bars, restaurants, and other licensees who ordered product were required to make arrangements for picking up the product from the state stores. Many owners picked up the liquor themselves, and some contracted with private distribution firms to pick up the product and deliver it to their business—for which they were charged a delivery fee. No minimum order requirement existed under the older system, but split cases were not allowed for the 30 most frequently ordered products in the large, metropolitan state stores.

The current law does allow certain special exceptions to the normal ADA delivery schedule. For example, the law specifically allows a licensee to pick up orders at an ADA's warehouse rather than have it delivered (although this option is rarely exercised by licensees). A licensee is also allowed to make up to 12 "special emergency" orders to an ADA per calendar year—and for these "special emergency" orders, the ADA is allowed to charge a delivery fee of up to $20.

[10] It is the MLCC that actually buys liquor from producers. The MLCC sells liquor to licensees. An ADA never holds title to liquor.

[11] The pending loss of employment for 400 state employees, for example, was reflected in the law's requirement that the ADAs make a good faith effort to provide employment to those state employees who were terminated due to the privatization of the liquor distribution system. Concerns about maintaining the three-tiered system—i.e., that an entity involved in one tier must not be involved in any of the other two tiers—were addressed with the stipulation that an ADA may not have a direct or indirect interest in a producer of spirits or in a licensee, with a similar requirement that a producer of spirits or a licensee may not have a direct or indirect interest in an ADA.

Finally, on-premise retailers (bars and restaurants) may purchase up to nine liters of liquor from off-premise retail outlets per month, but must purchase these at the consumer price.

How to finance this new distribution system was a matter of much discussion—and change—during the course of the legislative debate in 1996. A plan proposed by the Chairman of the MLCC was to reduce the state markup from 65 percent to 58 percent, with the idea that the reduction in the state's markup would increase the producers' income and encourage them to apply the savings to the warehousing and delivery services provided by the ADA. This idea did not receive legislative support, primarily because it was tied to the cost of the product rather than the actual cost of delivery.

Under the theory that it was more appropriate to cover distribution costs on a per case basis, the statute created a per case offset, or fee. This per case offset is paid by the MLCC to the producer, who in turn pays the ADA for each case of liquor delivered by an ADA to a licensee. The statute allows the MLCC to set and pay this per case offset, within a range of a minimum of $4.50 and a maximum of $7.50 per case. The State Administrative Board has the authority to increase the $7.50 maximum "…each January to reflect reasonable increases in the authorized distribution agent's cost of warehousing and delivery." It is important to note that this per case offset paid to the ADA by the producer is shared by the MLCC and the producer—of the current $8.32 per case fee, $6.97 is paid by the MLCC and $1.35 is paid by the producer. The $7.50 maximum established in the statute refers to the state's share, so the current $6.97 is $0.53 below that ceiling. The state's share of the per case fee is paid from the revenue received by the MLCC through its 65 percent markup explained in a prior section of this report.

## THE ISSUE

The initial per case fee received by the ADAs was set at $6.50 in December 1996. Exhibit 9 shows the history of this fee over time. There was a period when regular increases occurred—up until April of 2006 (prior to April 2006, the fee increased an average of 2.8 percent every year). However, the per case fee has not been increased in the past five years, which is the longest period that ADAs have gone without an increase.

**EXHIBIT 9.** ADA Fees, 1996–2011

| Start date | End date | State | Producer | Total | Increase | % Increase | |
|---|---|---|---|---|---|---|---|
| Dec-96 | Jan-00 | $5.42 | $1.08 | $6.50 | | | |
| Jan-00 | Feb-01 | $5.94 | $1.08 | $7.02 | $0.52 | 8.0% | over 3 years |
| Feb-01 | Feb-02 | $6.24 | $1.08 | $7.32 | $0.30 | 4.3% | per year |
| Feb-02 | Feb-03 | $6.40 | $1.08 | $7.48 | $0.16 | 2.2% | per year |
| Feb-03 | Feb-04 | $6.52 | $1.08 | $7.60 | $0.12 | 1.6% | per year |
| Feb-04 | Oct-05 | $6.70 | $1.08 | $7.78 | $0.18 | 2.4% | for 20 months |
| Oct-05 | Jan-06 | $6.86 | $1.24 | $8.10 | $0.32* | 4.1% | for 3 months |
| Jan-06 | Apr-06 | $6.97 | $1.35 | $8.32 | $0.22* | 2.7% | for 3 months |

***No Increases since April 2006***

* ADA fee increase was shared by the producers and the State.
SOURCE: National Wine and Spirits, Fee History Chart, provided to Public Sector Consultants Inc., 2011.

The statute passed in 1996 is conspicuously silent about establishing any process for determining the per case fee, other than giving the authority to set it to the MLCC. The MLCC, in turn, has never promulgated any rule that establishes any sort of formula or guidelines for establishing the fee. In other words, there are no established procedures in place to which one can refer in

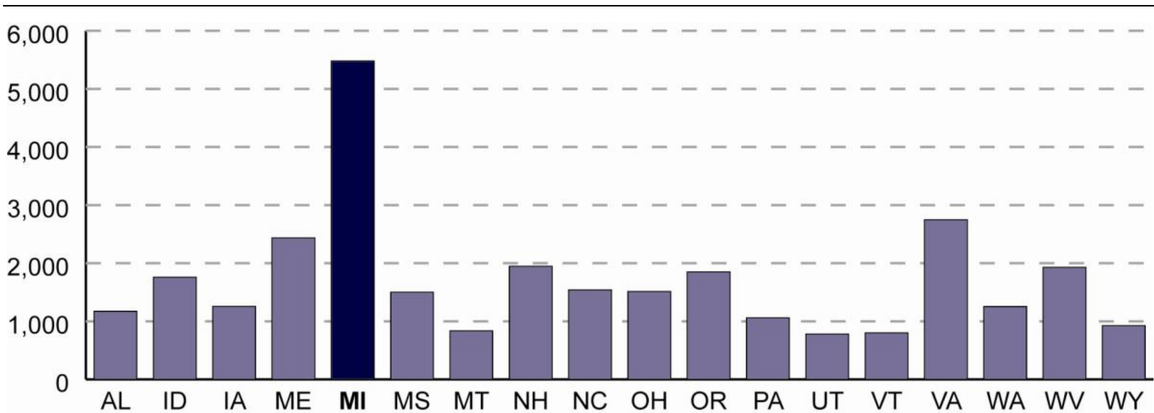
assessing whether the current fee is at the proper level. ADAs make regular requests for fee increases, citing cost increases, but the MLCC is not required to act upon those requests, or even respond to them.

The long lapse since the last adjustment to the per case fee, which finances the warehousing and delivery system, points to a fundamental flaw in the current system: the lack of a rational basis for determining fee increases in statute, rule, or agency guidelines. In other words, the adjustment of this fee—or lack thereof, is purely arbitrary. This flaw was not readily apparent during the first nine years of the new system since the fee was regularly adjusted. This flaw has become apparent, however, in the last five years, during which time no fee increases were granted, the cost of wages, healthcare, cardboard, and fuel increased dramatically, and the state was not held accountable against any standard or process for adjusting the fee level, in spite of a steady increase in MLCC revenue.

This long period with no fee increase, together with the absence of any standard for determining the per case fee level, exposes other oddities in Michigan's liquor distribution system. To be fair, the 18 control states are all unique in some way, as liquor control systems have evolved over time. However, Michigan stands out among the other control states in a number of ways that impact the costs of the distribution system.

Exhibit 10 compares Michigan to the other control states in terms of the number of products offered to consumers. Michigan has two to three times the number of products available in other states, and although this provides consumer benefits, it also has cost implications, particularly when combined with the delivery requirements established in state law, such as no split case fees, no delivery charges, and weekly deliveries.

**EXHIBIT 10.** Number of Products (Spirits) by Control State, 2010




SOURCE: Public Sector Consultants Inc., using data provided by National Alcohol Beverage Control Association, 2011.

Exhibit 11 compares Michigan to other control states that allow split case deliveries. Only two other control states (Oregon and Virginia) allow for split case orders but do not allow for a fee to cover the extra handling costs involved. Those two states, however, differ from Michigan in that they have far fewer outlets requiring delivery. Fewer delivery points and fewer products available can often lead to larger orders and a smaller percentage of split cases.

**EXHIBIT 11.** Matrix of Control States that Allow Split Case Deliveries

| | Split case | | Minimum | |
|---|---|---|---|---|
| State | Allowed? | Fee? | order size | Who delivers? |
| Idaho | Yes | Yes<br>.50/bottle | No | One statewide contractor |
| Iowa | Yes | Yes<br>.20/bottle | No | State delivery |
| **Michigan** | **Yes** | **No** | **Yes** | **Private distribution agent** |
| Mississippi | Yes | Yes<br>.50/bottle | Yes | Contract carrier |
| New Hampshire | Yes | Yes<br>.52/bottle<br>+.50/case | No | Contract carrier |

| State | Split case | | Minimum order size | Who delivers? |
|---|---|---|---|---|
| | Allowed? | Fee? | | |
| Oregon | Yes | No<br>. | Yes | Common carrier |
| Pennsylvania | Yes | Yes<br>.75/case avg. | | Warehouse operator |
| Virginia | Yes<br>(off- premise only) | No | No | Contract carrier |
| Wyoming | Yes | .40/bottle | | Contract carrier |

SOURCE: NABCA, *2009 Survey Book* 2; updated data provided by NABCA, 2011.

Exhibit 12 compares Michigan to all the other control states in terms of the number of licensees receiving delivery in the state. In addition to having the greatest number of delivery points, Michigan is one of only four states that requires on-premise delivery. In the vast majority of control states, on-premise licensees purchase their liquor from off-premise licensees.

In addition, Michigan is the only control state that has more than one company delivering products to licensees.

**EXHIBIT 12.** Number of Outlets and Products (Spirits) in Control States

| State | Split Case | | Number of Delivery Points | | Number of Products |
|---|---|---|---|---|---|
| | Allowed? | Fee? | On-premise | Off-premise | |
| Alabama | No | – | 0 | 161 | 1,173 |
| Idaho | Yes | Yes | 0 | 165 | 1,757 |
| Iowa | Yes | Yes | 0 | 492 | 1,255 |
| Maine | n/a | n/a | 0 | 246 | 2,434 |
| **Michigan** | **Yes** | **No** | **9,160** | **4,268** | **5,480** |
| Mississippi | Yes | Yes | 987* | 516 | 1,500 |
| Montana | Yes | No | 0 | 96 | 836 |
| New Hampshire | Yes | No | 1,311 | 77 | 1,945 |
| North Carolina | No | No | 0 | 404 | 1,539 |
| Ohio | No | N/A | 0 | 437 | 1,513 |
| Oregon | Yes | No | 0 | 243 | 1,849 |
| Pennsylvania | Yes | Yes | 0 | 634 | 1,058 |
| Utah | Yes | No | 0 | 157 | 779 |
| Vermont | No | No | 0 | 75 | 800 |
| Virginia | Yes<br>(off-premise only) | No | 0 | 335 | 2,747 |
| Washington | No | No | 0 | 315 | 1,254 |
| West Virginia | No | No | 0 | 142 | 1,929 |
| Wyoming | Yes | Yes | 1,150 | 124 | 924 |

SOURCE: NABCA, *2009 Survey Book* 2; updated data provided by NABCA, 2011.
*Full cases only.

**No other control state in the nation:**

- has such a large product offering to the consumer,
- has no limits on split cases,
- does not allow for a split case fee,
- requires delivery to as many outlets,
- has more than one entity delivering to licensees.

# Options Moving Forward

### *1. Reduce the Costs of Distribution*

Requirements imposed by the state impact the cost of the distribution system. Various proposals have been suggested to modify these requirements in order to help reduce costs. For example, the cost impact of the prohibition on split case fees could be reduced by requiring that the most frequently ordered products be ordered in full cases only (for example, the top 50 items). This would reduce the cost of packaging and labor/handling prior to shipping, because it would significantly reduce the number of split cases being delivered. This was recently proposed at a hearing before the MLCC, but was tabled over concerns that such policies would unfairly bias or favor certain brands.

Minimum order size could be increased to the statutorily allowed two-case minimum, rather than the one-case minimum currently allowed by the MLCC. This would cut down on deliveries. Another alternative would be to reduce the number of available products for "picking" and packaging. Michigan currently lists over 5,500 products for sale—more than any other control state—many of which have to be repackaged by hand in split cases by the ADA. Finally, Michigan could consider a fee on returned goods. Currently, a fee on returned goods is allowed only upon the fourth such occurrence in a six-month period. It is not an uncommon practice for licensees to return or refuse delivery, and Michigan could consider a more aggressive policy that creates a disincentive for licensees to refuse the acceptance of shipped items by allowing ADAs to charge a fee on all returned goods

These—and other—provisions are utilized in other control states to varying degrees. It is rare, for example, to allow unlimited split cases without an accompanying split case fee, as is the situation in Michigan. Collectively or singly, provisions such as these would reduce the handling and/or delivery costs for Michigan's ADAs. However, these efficiencies could negatively impact many of Michigan's licensees, particularly smaller outlets that have grown dependent on unlimited split cases or free delivery, or have limited storage space or limited cash flow. Some of these changes would also require amending the statute.

### *2. Move to a Single ADA*

Using one ADA has been suggested as an option for the state to consider as a way of addressing distribution problems. Although ADAs are unique to Michigan, utilizing a single ADA for warehousing and delivery would mirror the single entity delivery practice in all other control states. Certain efficiencies of scale could certainly be achieved with a single ADA for warehousing and delivery, but this option doesn't address the fundamental flaws in the current system—i.e., the cost structure created by state requirements related to delivery and the lack of any standard or process for establishing the per case fee as the method of paying for warehousing and distribution. For example, if the inability to charge a split case fee creates a problem in the current system, moving to a single ADA doesn't solve that problem.

The idea of a single ADA for the entire state surfaced in the summer of 2010 in the context of negotiations over resolving the state budget deficit. The budgetary appeal is a result of the assumption that the state might receive a one-time payment for the right to handle all of Michigan's liquor warehousing and distribution. It is difficult to imagine the appeal to potential applicants, however, unless the flaws related to costly distribution requirements and the process for establishing the per case fee are included in the change.

Licensees have also raised general concerns about the ability of one distributor to efficiently meet the needs of the whole state, and the possible negative customer service impact that limiting competition might create.

### *3. Limit On-Premise Delivery to Top 2,000 Accounts—All Other On-Premise Accounts Buy from Off-Premise*

Michigan has more than 12,000 delivery points for liquor—more than six times the other control states. The state will not accept an ADA contract that does not cover the entire state—meaning that delivery logistics must be equally capable of fulfilling a 1,000-case order for a Meijer in southeast Michigan and a single split case order for the Mariner Bar in Copper Harbor every week. This requirement, as well as Michigan's size and large number of small on-premise licensees, creates costly logistical hurdles for distribution companies.

One way to achieve cost savings would be to limit weekly delivery to the top 2,000 on-premise accounts in the state. In this way, efficiencies would be achieved through quantity, and delivery costs held constant. The smaller on-premise retailers (approximately 5,000) could then purchase from local stores (off-premise retailers), reducing split case and small orders by allowing smaller outlets to purchase "on demand." Limiting the number of delivery points is the practice of most Control states, as documented in Exhibit 12.

This option would certainly benefit the ADAs and may, in fact, present some benefits for smaller on-premise accounts. While free delivery would no longer be available from ADAs, these smaller, on-premise accounts, who currently find that the mandatory cash purchasing limits their ability to buy in quantity, could purchase by credit card, if desired. (Inability to purchase on credit and control delivery times are two of the biggest complaints heard from small licensees.) In this model, an equitable system for determining a fair price when not purchasing directly from the MLCC would have to be determined.

### *4. License State Model (Full Privatization)*

Going to a license state model is certainly a hypothetical option for Michigan as a way to address distribution issues. In such a model—currently utilized by 32 states—issues such as frequency of delivery, split cases and split case fees, delivery fees, and other distribution issues would be decided by private entities subject to market forces—not by government, as is the case in Michigan today.

Attempts in control states to fully privatize the distribution and retail sale of liquor have failed because of complex issues related to state revenue, social concerns about making alcohol more available, and the impact upon all entities currently involved and invested in the distribution and licensee tiers of the industry. Michigan itself is a good example of the difficulty of this transition. After a robust discussion of privatization in the 1990s, Michigan remains a control state today.

Three control states—Virginia, Pennsylvania, and Washington—are currently engaged in the debate to either become license states or to privatize a part of their liquor distribution and retail system. Newly elected Governor Robert McDonnell of Virginia originally proposed privatizing all aspects of the distribution and retail liquor industry in Virginia, essentially transforming Virginia from a control state to a license state. After this proposal failed to achieve support, Governor McDonnell has released a new proposal that maintains the state as the wholesaler, but replaces 332 state-owned liquor stores with 1,000 private retail outlets—not unlike the current Michigan structure. Governor McDonnell's original proposal suffered because of estimates that Virginia would lose $47 million each year compared to its current system. Advocates of his new

proposal claim that the state would actually collect $13.1 million more each year than under the current system. The Commonwealth of Virginia would also realize one-time revenue of $200 million from the sale of these 1,000 retail licenses.

The Pennsylvania legislature has also held hearings on a proposal that would transform Pennsylvania from a control state to a license state. Issues similar to those raised in Virginia—and in Michigan 14 years ago—have surfaced in Pennsylvania: potential revenue loss, the effects of increased alcohol availability, and state employee job loss. As in Virginia, alternatives to a full license state model are being proposed that would limit the change to the creation of private retail outlets that would replace state stores. As already noted, this is a feature that is characteristic of Michigan today.

Legislation has been introduced in the Washington state senate to privatize the distribution of liquor, an activity currently conducted by the state itself. This follows on the heels of a failed ballot initiative that appeared on the November 2, 2010, ballot in Washington that would have closed state liquor stores and authorized both the retail sale and distribution of liquor by private companies. Under the proposed legislation—a form of which has passed the Washington House of Representatives as part of its budget bill—the state would establish a competitive bidding process for the right to handle the distribution side of the state-run liquor business for the next 20 years. Supporters of this legislation believe that the state would receive an initial payment for the right to distribute liquor, followed by annual payments and profit-sharing over the course of the agreement. The legislation is being proposed, in part, as one way to help resolve a two-year deficit of $5 billion.

We are not aware of any control state that has made the full transition to a license state model since these regulatory structures were established as a response to the passage of the Twenty-first Amendment that ended Prohibition in 1933.

### *5. A Percentage-based Fee versus a Per Case Fee*

ADAs are the only players in the three-tiered system that are locked into a fixed-price reimbursement. Producers are able to price their product in response to market fluctuations. The state and licensees are insulated by percentage-based revenue.[12] ADAs, however, have a fixed reimbursement cost that can only be increased by a vote of the MLCC. If ADA fees were tied to a percentage of the cost of a bottle of liquor (which typically goes up, not down), ADAs might have a better shot at responding to increasing costs without regulatory action.

Obviously, there are potential downsides to this model. While the prices of different brands of liquor span a wide range, delivery costs per bottle are largely the same regardless of brand. (The exception to this is very high-end liquors where breakage during packaging is a risk.) Therefore, the producer's burden for delivery costs could vary significantly by brand, possibly leading to artificial shortages or supply issues for certain liquors.

A percentage-based fee system to cover delivery costs is essentially what was proposed by the Chairman of the MLCC in 1996. It was rejected by the Michigan legislature in favor of the current system for the simple reason that the costs of delivery are not directly related to the price of a particular bottle of liquor.

[12] This is not to say that licensees are pleased with the 17% discount. They emphasize that this percentage is not related to their costs of handling, shelving, and selling the liquor, which they claim has escalated beyond the price of liquor.

### *6. Establish Rates for Michigan's Liquor Distribution System Similar to the Way Rates Are Established for a Utility*

The per case fee that is shared by the state and the producer is the method by which the current system reimburses the ADAs for warehousing and delivery. The lack of an increase over the past five years, while certainly a problem, is indicative of a larger, more fundamental flaw in the distribution system created by the state 14 years ago: No requirement exists to review or adjust the fee on a regular basis. No process exists to apply for fee adjustments. Even if a process did exist, no standard exists to assess whether the fee is at an appropriate level. In spite of the vague reference in the statute to increasing the ADA fee as warehousing and delivery costs increase, no requirement, process, or standard, has ever been established to do this in a way that relates the costs of the ADA system to the level of the fee. In short, the state is not being held accountable to finance the system—and all its service requirements—it established 14 years ago.

The state could address this by adopting a fee or rate setting system similar to the way the state reviews and adjusts rates for Michigan utilities. Although the electric utility industry and the liquor distribution system are dramatically different, there are some similarities. Both the liquor distribution and the electric utility industry are highly regulated. Both have service requirements imposed by statute, regulation, order, and rule. Both are regulated by full-time commissions whose members are appointed by the governor—the Michigan Liquor Control Commission in the case of liquor and the Michigan Public Service Commission (MPSC) in the case of electric utilities. Both are dependent upon rates established or approved by government for their revenue.

Electric utilities, however, are allowed a certain rate of return on their investments, as well as the right to seek recovery of their variable costs. Utilities propose rate increases they believe are appropriate and submit supporting information; a process is in place—established by law, regulation, and MPSC orders—for the commission to decide on these proposals within a certain period of time. If a utility does not agree with the final decision on a rate increase, the right of appeal is also guaranteed.

In a similar fashion, a standard—such as one based on the various investments and costs that go into warehousing and delivery for liquor distribution—could be established, a process put into place, and timelines set to require regular review of the per case fee by the MLCC. This would not only correct the fundamental flaw of the system created by statute 14 years ago, but it would provide long-term stability to the system.

## IN CONCLUSION

Michigan's current liquor distribution system, established by a statute passed in 1996, is fundamentally flawed due to the absence of any requirement, process, or standard to review or adjust the ADA fee on a regular basis related to the cost of the service. With no procedures in place to assess whether the current fee is at the proper level, there is no way to hold either the state or the ADAs accountable for the cost of delivering the service. The statute or rules should be amended with a formal accountability structure set in place to regularly review and modify fees.

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