PS ITEM #1
March 10, 2011
Worksession

MEMORANDUM

TO: Public Safety Committee

FROM: Justina J. Ferber, Legislative Analyst

SUBJECT: **Worksession:** Organizational Reform Commission – Recommendations on Liquor Control

Recommendations

In its report to the Council dated January 31, 2011, the Organizational Reform Commission (ORC), in ***Recommendations No. 17, No. 27 and No. 28*** recommended the County seek changes in Liquor Control operations.

The text of the recommendations is below.

Recommendation No. 17: Pursue options for establishing an independent "revenue authority" to be responsible for operation of the Department of Liquor Control, thereby generating more revenue for the General Fund and removing it from the Executive Branch."

Recommendation No. 27: Expand contracting of warehouse night loading operations at the Department of Liquor Control to all warehouse operations and improve retail services.

Recommendation No. 28: Contract out for a financial and performance audit of the Department of Liquor Control.

The full text of the ORC discussion and recommendations is at ©1-4.

Executive's Response

In a memorandum to the Council President dated February 21, 2011, the Executive responded to each of the 28 recommendations in the ORC report. The Executive's response to the Department of Liquor Control recommendations are listed below:

17. Pursue options for the Department of Liquor Control to become an independent "revenue authority."

County Executive's Position: **Support with Explanation**

The Department of Liquor Control (DLC) is a unique County agency with a specialized mission, and could benefit from potential efficiencies if it is recognized as an independent enterprise agency. The analogy with the County Revenue Authority used in the Commission report is instructive. DLC is different from most County government departments in several ways. DLC was created under Maryland state law in 1934, and pre-dates "Charter" government. The authority and oversight, organizational structure, financial management and revenue disposition of DLC and its operations are all mandated under Article 2B of the Maryland Code. Liquor Control is specifically treated differently than other County departments in the operating budget process due to its status under State law. DLC is also a non-tax-supported, self-sustaining enterprise agency whose net profit proceeds must be deposited as revenue into the County General Fund. For these reasons, acknowledging its unique status and granting DLC some degree of management flexibility in pursuit of its operational goals is warranted. Some of the potential efficiencies identified by the ORC report include improved responsiveness in facility management, procurement protocols, and human resource recruitment/hiring procedures.

However, formally designating DLC as a "Revenue Authority" would also constitute a significant time-consuming and potentially costly legislative undertaking. State law would have to be modified in a variety of ways by the Maryland General Assembly, and major revisions to the County Code would be required. Many of the potential operational efficiencies identified by the Commission would be more effectively achieved administratively through signed "Memorandum of Understanding" agreements between County departments. For example, the County Office of Human Resources has an MOU with the Office of the County Attorney (OCA) outlining the process for the recruitment and hiring of OCA personnel. The MC311 Office has Service Level Agreements with many different County departments regarding call taking and service response standards. The Office of the County Executive will form an interdepartmental taskforce to review the development of streamlined business practices for DLC to provide needed operational flexibility, with appropriate oversight mechanisms.

Council Staff Recommendation

Council staff recommends Council support of ORC recommendation #17. The Council should explore its options for state legislation for a "liquor authority" prior to the 2012 session in Annapolis. The Executive's option for "Memorandum of Understanding Agreements" with County departments will not accomplish what the ORC recommends which is to have an independent "liquor authority" that is not subject to Executive will.

27. Expand contracting of warehouse night loading operations at the Department of Liquor Control to all warehouse operations and improve retail services.

County Executive's Position: **No Position at This Time**

I am not making a recommendation on this particular ORC proposal because there is not a sufficient basis of data and analysis to support such a significant departure from current practice.

Replacing County employees with contract employees may provide short-term and long-term workforce cost savings. It also introduces potential risks in terms of service delivery and successful integration with other related County-controlled operations.

At this time, the potential amount of cost savings that might be realized is an order of magnitude estimate and would require additional research and analysis to develop a more comprehensive assessment of the likely costs and benefits of contracting out DLC wholesale operations. The County could engage the services of a qualified, independent consultant to provide validated estimates of potential personnel cost savings and risks associated with contracted service delivery. The consultant should possess expertise in warehouse operations, distribution, and management.

Council Staff Recommendation

Council staff recommends Council support of ORC recommendation #27 and recommends the Council request the Executive to proceed with an independent consultant evaluation as suggested. Staff believes the contracting out of all warehouse and delivery services should be considered if *substantial savings will take place.* Without extensive cost savings, a change from county provided services to contracted services is not beneficial and should not be considered.

28. Contract out for a financial and performance audit of the Department of Liquor Control.

County Executive's Position: **Support**

This recommendation resulted from questions posed by some Commission members regarding the format used by the County to report "enterprise agency" expenditures and revenues, including from DLC operations. The Commission wanted assurances that the accounting practices used by the County are accurate and consistent with other appropriate enterprise funds, and can be accurately compared with similar private sector accounting reports. The specific areas in question were County accounting practices relating to "debt service, Cash flow representations, other County-agency charge-backs, etc."

The County already has a contract for regular, independent audits and reviews of financial processes and reporting practices by qualified outside professionals. DLC does not perform any financial or accounting functions or processes inconsistent with established County procedures. DLC does not maintain any separate funds or accounts outside of the County financial network, including debt service payments. All fiscal processes and functions are coordinated with the Department of Finance and the Office of Management and Budget. The County currently follows all approved and recognized accounting practices. Any outside audit should be comprehensive and encompass all County financial practices. Audits and reviews including DLC and other County agencies will be coordinated through the Department of Finance.

Council Staff Recommendation

Council staff recommends Council support of ORC recommendation #28. The DLC should proceed with an outside financial and performance audit which will be beneficial in analyzing DLC operations and provide constructive observations.

This packet contains:	Circle #
ORC Discussion and Recommendations on DLC	1-4

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ORC Report 1/31/11

Liquor Control Recommendations:

- To increase sales by the County Department of Liquor Control, the ORC supports efforts to minimize the amount of alcohol purchased outside the County by County residents.
- We support the DLC's plans to study further the possibility of contracting out warehouse operations and to seek changes in State and County law that would provide the department with additional flexibility and independence to manage its operations.
- The ORC reviewed the issues associated with privatization and believes that more study is required to understand the potential impact of privatization, in terms of its potential impact on County finances and on retail prices and convenience for customers. These impacts should be compared to improvements that could be made to DLC, within the current environment, without any shift to privatization.

Department of Liquor Control

Issue: Should the County privatize Department of Liquor Control (DLC) operations or seek to increase DLC profits by contracting some operations?

Background:
Four Maryland counties are alcoholic beverage control counties: Montgomery, Somerset, Wicomico and Worcester. Eighteen states in the U.S. are control states. The government owns the product and licensing is a state function. In Maryland, licenses are regulated by State law.

In 1951, the State of Maryland passed a law creating the Montgomery County Department of Liquor Control (DLC). The DLC assumed control over alcoholic beverages through a monopoly on the wholesale of alcoholic beverages to licensees operating in the County and the retail of liquor for off-premises consumption in the County. As part of its wholesale operation, the County maintains a warehouse and distributes its products to licensees.

Under Maryland law, Maryland is a one-price state. Distributors must sell product to wholesalers at the same price. Over 90% of distilled spirits are handled by two distributors in Maryland. There are three large beer distributors and two large wholesale wine distributors, plus some small wine distributors. All alcohol laws in Maryland are State laws under Article 2B.

Within County government, DLC is an enterprise fund that records all of its expenses and revenues within the fund. DLC also reimburses the County for indirect and technology support costs. DLC predates Charter government, and state law dictates how DLC funds are generated, collected and disbursed. First, funds go to offset overhead costs; second, to debt reduction; and third, to the County General Fund.

Maryland law does not allow beer and wine sales in grocery stores, but four stores in the County are grandfathered. The County is a wholesaler. There are no liquor licenses in the County because liquor is sold in the County liquor stores, also known as dispensaries. The State has sole authority to tax alcohol and the County pays excise tax on liquor. The County owns the warehouse, while locations for the retail stores are leased. DLC assets consist of its inventory and the warehouse. There is a 28% markup on liquor and a 25% markup on wine. DLC prices are comparable to other Maryland jurisdictions. Washington, D.C. has the cheapest liquor prices in the United States because its excise taxes are the lowest.

Discussion

The ORC discussed liquor control issues with the DLC Director and a County resident who testified on and asked the Commission to explore the issue of privatizing the liquor department.

We asked for FY10 financial information for DLC, including a balance sheet and statement of cash flow. We also asked for information on allocation of indirect expenses, compliance with general accounting principles and the accounting basis for the DLC finances, independent audits of DLC, depreciation expenses, debt payments, cost of goods sold, personnel costs and sales per store. DLC also provided an organizational chart and a wage comparison for store workers at the County rate and living wage rate.

The ORC discussed DLC finances and the resident's view that the reported profits, adjustments and fund transfer numbers – if reported differently – could have changed outcomes.

- ***We recommend the contracting out of a financial and performance audit for the Department of Liquor Control.***

Conclusions

Privatization

The ORC discussed the privatization of DLC operations and acknowledged that State law would have to be amended for privatization to take place, and that Montgomery County would not necessarily have control over the outcome of any legislative amendments.

The sale of alcohol is a controversial issue. Some people feel that the County should not be in the liquor business, while others fear a liquor store on every corner. Those holding the former view are of the opinion that if the County withdrew from the business, the County retail stores would be operated more efficiently and that operators could save money by buying directly from suppliers. This argument is mitigated by the fact that Maryland is a one-price state that makes savings moot, though one could argue that the increase in retail stores would increase profits. Those concerned about privatizing the sale of liquor believe that incidents involving drunken behavior might increase, thereby leading to an increase in public safety concerns.

An argument against privatizing DLC operations is that the change could reduce the County's ability to control the wholesale, distribution and retail of alcoholic beverages in the County. Maintaining such control has been an essential element of the County's current policy regarding alcoholic beverage sales in the County. A counter-argument is that the licensing and enforcement functions would not disappear and that enforcement functions exist for the sale of tobacco.

Privatization would provide a one-time revenue infusion from the sale of the warehouse and the inventory. But under total privatization, it is unlikely that $25-30 million – the surplus revenues that DLC now transfers to the County's General Fund – could be generated from investment income, shared taxes from increased sales, and additional license fees.

The proposal for privatization brought to us by the resident who addressed this issue at our public forum would continue to provide the same level of surplus revenues currently generated by DLC operations. His assumptions include:

- Doubling of sales, due to increased retail convenience and selection.
- Imposing a 6% fee on wholesale sales.
- Requiring licenses for wholesalers.
- Imposing additional license fees from retailers.
- Increased revenue gained in property taxes from retail stores.
- Writing off the Crabbs Branch property, which DLC does not own.
- A gain of $47.6 million in transition assets.

While appreciating the considerable pro bono work performed by this individual, the ORC was not convinced that all these assumptions are entirely defensible. We believe that some are overly optimistic and that others would rely heavily on the raising of fees. The major argument made by this individual that appeared to have the most merit, was the comparatively low consumption – and hence, sales – rate for a county of our population size and median household income. The bottom line is we do not believe that privatization, at this juncture, would generate revenues sufficient to make up for the $25-$30 million that is transferred annually to the General Fund, under the existing system.

Contracting

Under contracting options, the County would continue to maintain effective control, provide adequate levels of service, and potentially increase surplus revenues through lowering costs. The ORC discussed contracting and the fact that the County had previously contracted out the operations of several of its retail stores. In 1997, a State bill limited the County's contracting of DLC retail operations to the stores under contract at that time. Currently, the Flower Avenue store is the only contracted retail store. State law would have to be amended to allow contracting of retail operations. Cost comparisons show that the County could save money on personnel costs if operations are contracted.

Warehouse operations are currently contracted for night-loading operations. The ORC discussed contracting out warehouse loading and delivery operations. There are 63 employee workyears associated with warehouse staff and 72 workyears total associated with warehouse and delivery operations. This is a potential area for savings in both reduced personnel costs and legacy costs.

The level of private sector interest in providing warehousing services is unknown. Contracting of warehouse operations would likely reduce costs because potential contractors would bid in accordance with current market wages and benefits paid for similar employment in the private sector. Contracting would allow the County to forgo costs related to breakage and pilferage because the contractor would be responsible for those costs.

From 1993 to 1997, the County successfully contracted the operations for four County retail stores and was considering the expansion of contracting to its other retail stores when State legislation was adopted prohibiting the County's ability to contract beyond those already under contract, which was limited to four stores.

- ***We recommend that the current practice of contracting out warehouse night-loading operations be expanded to include all warehouse operations.***

Establishment of a Revenue Authority

The ORC also discussed with DLC staff whether DLC could significantly increase its transfer to the General Fund if it had additional independence and flexibility, under the direction of an entity similar to the County's Revenue Authority. This is one recommendation that focuses on increasing revenue, not necessarily through increased consumption, but through an increase in sales and recapture of out-of-county sales.

- ***We recommend that the County pursue options for establishing an independent "revenue authority" for operation of DLC, thereby generating revenue and removing it from the Executive Branch.***

We asked DLC to provide further information regarding the potential savings that could be realized from this approach. We believe it would allow DLC to operate more like a business, hire its own employees, and possibly increase the number of available retail stores in those under-served areas of the County where consumers now often flee to neighboring jurisdictions for sustenance – with a resultant increase in sales.

The most immediate savings in a revenue authority scenario would be the flexibility to contract out the wholesale operations division. The annual savings are estimated conservatively at $1.7 million and the legacy savings would be considerable. The revenue authority could gain additional savings by either operating its own administrative functions or by negotiating a memorandum of understanding with the County government, for the provision of such services. The establishment of a new revenue authority would require a modification to state law and the need to memorialize the Department of Liquor Control in the County Code, similar to the Montgomery County Revenue Authority.