A Special Performance Audit

Wine Kiosk Program of the Pennsylvania Liquor Control Board

August 2011

Jack Wagner, Auditor General

Pennsylvania Department of the Auditor General
Bureau of Special Performance Audits

August 30, 2011

The Honorable Patrick J. Stapleton III
Chairman
Pennsylvania Liquor Control Board
517 Northwest Office Building
Harrisburg, Pennsylvania 17124

Dear Chairman Stapleton:

Enclosed is our special performance audit of the Pennsylvania Liquor Control Board, or Board, regarding its wine kiosk initiative. The audit was conducted under the authority of Pennsylvania's Fiscal Code and in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence we obtained does provide such a reasonable basis for our findings and conclusions based on the audit objectives.

In looking at your written response to this audit (Appendix C of the enclosed report), I am struck by your continued references to innovation as the basis for the wine kiosk initiative. We agree that innovation should always be a top priority with regard to customer convenience, which was a specific goal of the kiosk program. However, the most fundamental innovation that needs to occur within the PLCB and state government—through action by the General Assembly—is greater customer convenience by opening *all* PLCB stores seven days a week, twelve hours a day, and by making more products (such as liquor) available at the kiosks. For greater customer convenience, the law must change, and the General Assembly must cooperate.

As you know, our report details six findings, abbreviated below:

- The Board used kiosk technology that effectively controlled the purchase of alcohol.
- The Board followed state procurement requirements, but the request for proposals did not enable fair and just competition.
- The Board and the sole responding vendor negotiated the kiosk contract in ways more advantageous to the vendor than necessary.

- Over two fiscal years, the Liquor Control Board spent $1.12 million more than it took in and has invoiced the vendor for the losses. But the vendor has not paid.
- The Board and the vendor lost credibility when the kiosks malfunctioned.
- The Board overstated the convenience of the kiosks.

Our overall conclusion is that the Board should take immediate steps to terminate the kiosk contract unless the kiosk operations can be modified to meet the originally stated objectives of providing greater customer convenience, reaching into underserved areas, minimizing Board costs, and increasing Board profitability. In addition, as indicated at the start of this letter, we have observed overall that the Board's attempts to provide greater customer convenience were hindered by state law restricting the number of Sunday openings at all stores, including the kiosks, and by policy of the Board limiting other days and hours that its stores are open.

Chief among our recommendations is that the Board should work aggressively with the General Assembly to pass legislation permitting all wine and spirits stores to be open seven days a week, 9 a.m. until at least 9 p.m., with the kiosks staying open until midnight if the kiosk contract continues and if they are housed in stores with those hours.

Please note that some of our 12 recommendations apply only if the Board does not terminate the kiosk contract. Regarding such termination, the Board is at a critical point where that decision must be made.

Sincerely,

JACK WAGNER
Auditor General

JW/SGM:sb

Enclosure

cc: Thomas F. Goldsmith, Member, Pennsylvania Liquor Control Board
Robert S. Marcus, Member, Pennsylvania Liquor Control Board
Joseph Conti, Chief Executive Officer, Pennsylvania Liquor Control Board
Faith S. Diehl, Chief Counsel, Pennsylvania Liquor Control Board
Joseph Lawruk, Comptroller, Pennsylvania Liquor Control Board

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Results in Brief

Includes overall audit conclusion and overall observation

The Pennsylvania Liquor Control Board (also referred to in this report as Liquor Control Board, Board, or LCB) began its wine kiosk initiative with the intention of attaining four specific goals, all while continuing to meet the LCB's primary charge and critical mandate to ensure the public's safety, health, and welfare by controlling the sale of alcohol.

LCB's overall mandate/goal:

- Ensure public safety, health, and welfare

Kiosk-specific goals:

- ✓ Provide greater customer convenience
- ✓ Reach into underserved areas
- ✓ Minimize LCB costs
- ✓ Increase LCB profitability

The results of our special performance audit show that, in implementing the wine kiosk initiative, the Board's overall mandate to control alcohol sales was not compromised. At the same time, however, the LCB failed to attain any of the four kiosk-specific goals, leading us to the following overall audit conclusion, as well as an overall observation:

Overall Audit Conclusion

Pennsylvania's wine kiosks used technology that effectively monitored and controlled the sale of alcohol, thus helping the Liquor Control Board meet its primary mandate to ensure public safety, health, and welfare. But the kiosk initiative has failed in its goals to provide greater customer convenience, availability in underserved areas, lower LCB costs, and higher LCB profitability. **The Board should therefore take immediate steps to terminate wine kiosk operations unless and until it can modify them to reach kiosk-specific goals while still meeting its primary mandate.**

Overall Observation

In attempting to provide greater customer convenience, **the Liquor Control Board was hindered not because of the wine kiosk initiative or because alcohol sales are state-controlled** but because (1) state law limits the number of Sunday openings at stores, including kiosks, and (2) many stores have limited days and hours during the rest of the week. Thus, to provide the greatest customer convenience, to enable increased sales, and to continue its effective performance in selling alcohol responsibly, the Board should take the steps necessary to establish uniform hours 7 days a week from 9 a.m. until at least 9 p.m. at *all* stores—and until midnight at the kiosks if the Board does not terminate that contract.

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Audit Results

The evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Effective public safety, health, and welfare. Whether a brick and mortar location or a kiosk *(see page xii for photographs of a wine kiosk)*, LCB stores represent critical points where sales can be prevented to underage customers or to customers who are already alcohol-impaired. In preventing such sales, the technology at the kiosks gives them a distinct advantage over traditional brick and mortar stores that sell wine and spirits.

Regarding customer identification, every customer at a kiosk must present photo identification that is transmitted electronically to an employee at the LCB's off-premises customer service center. The identification is verified by the LCB employee, who compares it to the customer's video image transmitted in real-time from the kiosk location. The LCB employee further authenticates identification by reconciling it to the customer-scanned credit or debit card data confirmed by three distinct technologies built into the scanner.

Regarding customer sobriety, LCB employees at the off-premises center can verify sobriety because each customer must pass a breathalyzer test prior to making a purchase. The results of that test, like the photo identification, are transmitted electronically to the customer service center.

On the other hand, at brick and mortar stores, the potential for prohibited sales is greater because employees there must rely on their personal judgment to detect customer sobriety, and also because any cash customers at the brick and mortar stores (cash sales are not allowed at the kiosks) are not subject to the same level of identification verification that takes place at the kiosks.

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Poor sales. Kiosk sales have never reached a profitability level, and the efforts to improve sales have not been successful.

- Net income from sales at the wine kiosks for the first nine months (July 2010 to March 2011) amounted to only $206,060.
- The majority of the kiosks (20 of the 32, or 63 percent) failed to meet the minimum weekly sales threshold as determined by the Board. This unmet sales threshold for each kiosk was 210 bottles a week, or 35 a day.
- Only 3 of the 32 kiosks had average sales that topped more than 210 bottles a week.
- The Board's profit for each bottle sold at a kiosk is 50 cents less than the profit for each bottle sold at the LCB's wine and spirits stores. This lesser profit is because the LCB pays the kiosk contractor a 50-cent advertising fee for each bottle sold at the kiosk. However, the Board did not run any advertisements until May 2011; by that time, the Board had paid more than $26,000 for advertising space it did not use.
- The Board has been slow to roll out 100 kiosks as originally planned; at most, 32 kiosks were operational during our audit period. At the time of this report, the number had dropped to 22 after Wegmans Food Markets pulled out of the program.

High operating costs. The Board has spent more than $1.1 million as of March 2011 for a supposedly "no-cost" contract. These high costs and poor sales have resulted in a net loss.

- The contract between the Board and the kiosk vendor, Simple Brands, LLC, (also referred to in this report as just Simple Brands, the vendor, or the kiosk contractor) requires the vendor to reimburse the Board for its net loss. The Board should ensure it continues to follow through with the vendor to get reimbursement.

- During our audit work, we projected the net loss to be approximately $1.2 million by June 30, 2011. Soon after that year-end date, the Board determined the net losses to be $1.12 million. The Board has demanded payment from Simple Brands for that total of $1.12 million. The first demand (made in May 2011) was for $255,077, representing losses in fiscal year 2009-10. The second demand (made in August 2011) was for $843,369, representing losses for fiscal year 2010-11; with that demand, the Board also included a request for $24,877 for 2009-10 losses not previously invoiced. The vendor had not yet paid any of these monies as this report was being finalized; if the vendor does not pay, the Board will have to make its claims against the vendor's letter of credit for each year.

- The *proposed* contract prior to negotiations required Simple Brands to obtain a $3 million performance bond, but Simple Brands negotiated a final contract that eliminated that requirement. Based on that final contract, Simple Brands is required to obtain a letter of credit as a reimbursement guaranty, albeit for the lesser amount of $1 million. Simple Brands initially established the $1 million letter of credit in May 2010 for the 2009-10 fiscal year; the letter was renewed for the 2010-11 fiscal year.

- Simple Brands negotiated other advantages as well—advantages at the expense of the Commonwealth. Three such examples: the Board agreed to remove language that allowed it to terminate the kiosk contract at the Board's convenience or for the vendor's poor performance; the Board agreed to pick up costs that it originally said (in its request for proposals document) would be paid by the vendor; the Board agreed to give the vendor advance notice of audits.

Erosion of customer confidence. The kiosks began malfunctioning almost immediately after they opened, and the malfunctions continued even after the kiosks were presumably repaired and subsequently reopened. These continued malfunctions eroded customer confidence, as evidenced by a drop in the already-poor sales and by the later pullout of Wegmans Food Markets from the program.

- Nearly 1,000 reported malfunctions occurred during the first seven months of operation. These much-publicized malfunctions forced the Board to shut down all kiosks in mid-December 2010 for about one month.
- Malfunctions continued even when the kiosks were reopened after the vendor purportedly repaired them.
- Sales have not since rebounded—not even to the already-low levels that existed prior to the kiosk shutdowns.

Overrated customer convenience. The convenience of the kiosks, a selling point highly promoted by the kiosk vendor and the Board, was highly overstated.

- Wine selection at the kiosks is limited when compared to selections at the brick and mortar stores.
- Kiosks are not open for business on Sundays. According to the Board, Sundays are the second busiest retail day of the week.
- The Board did not place kiosks in underserved areas as it announced it would do initially. Indeed, most of the kiosks are located within a mile or two of the brick and mortar stores.

Our recommendations, overall conclusion, and overall observation

Summary of overall conclusion: *Wine kiosk operations should be terminated unless and until the Liquor Control Board can modify those operations to meet the kiosk-specific goals.*

As demonstrated by our audit results, the Board is meeting its primary mandate regarding public safety, health, and welfare but is not meeting its kiosk-specific goals of providing greater convenience/availability for customers and higher profits/lower costs for the LCB. As we state in our overall conclusion, **the Board should take immediate steps to**

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terminate the wine kiosk operations unless and until it can modify those operations to meet the kiosk-specific goals while continuing to meet its primary mandate.

We offer several recommendations for the Liquor Control Board if it decides to continue the kiosk initiative.

If the Board continues to offer alcohol sales through kiosks, it must do the following:

- Continue to monitor and control the sale of alcohol effectively at the kiosks but explore other options for testing blood alcohol concentration levels.
- Be even more aggressive in holding the wine kiosk vendor accountable for ensuring that all kiosks are fully functional at all times. If the vendor is unable to achieve this critical functionality, the Board should terminate the contract and seek a different vendor or find a different solution.
- Work with the General Assembly toward passage of legislation that would permit all brick and mortar stores to be open seven days a week, 9 a.m. until at least 9 p.m., and all kiosks to be open seven days a week, 9 a.m. to midnight, if they are housed in stores that are open during those hours.
- Offer liquor for sale at the kiosks, as well as more local wines, to expand customer selection options and increase sales.
- Return to its goal of using kiosks to extend sales into underserved areas by reversing its questionable decision to place kiosks so close to brick and mortar stores. As part of this action, the Board should relocate the underperforming kiosks to areas not served by brick and mortar stores.
- Account for LCB personnel costs related to the kiosks in general—including kiosk decision-making, contract negotiations, and any kiosk operational matters overall. There should also be a specific breakout of personnel costs related to malfunctions, including the costs of personnel who test supposedly repaired kiosks and personnel who staff kiosks that reopen after a malfunction.
- Pay only for advertising space that it actually uses.

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We offer other recommendations for the Liquor Control Board whether or not the kiosk program continues.

Regardless of the Board's decision of whether or not to terminate the kiosk program, the Board should implement the following recommendations:

- The Board should require that the vendor's annual letter of credit be raised above its current level of $1 million to ensure that the letter of credit is sufficient to cover any operating shortfall.
- Immediately after the close of every fiscal year that the kiosks remain open, the Board should enforce the provision of the contract that permits the Board to request vendor reimbursement from Simple Brands for the operating shortfall. (During our audit work, the Board did make such a request for the 2009-10 and 2010-11 fiscal years.)
- The Board should ensure that its requests for proposals ensure fair and just competition, including providing adequate response time.
- The Board should ensure it protects the state's interest by not negotiating contract provisions that are more advantageous to the vendor than necessary; one such protection is always to include a "termination for convenience" provision in the final contract.

Summary of overall observation: *The Liquor Control Board has been hindered in providing customer convenience not because of the kiosks or because alcohol sales are state controlled, but by the lack of extended days and hours that all stores—including kiosks—are open for business.*

Regarding our overall observation, and regardless of whether or not continuing the kiosk initiative is a viable option, we refer our readers to the map illustrated on *page xi.* That illustration shows clearly that customers in many counties are limited in their access to wine and spirit stores, including both brick and mortar stores and kiosks, and are thus not experiencing the convenience that the Liquor Control Board could otherwise provide.

More specifically, we can see that it is only customers primarily in the populous southeastern Pennsylvania and Allegheny County areas who experience the convenience of multiple store locations, including kiosks, and who have access to the greatest concentration of stores with Sunday hours.

On the other hand, we can see that customers elsewhere are left with far fewer options, meaning little convenience and access, particularly customers in less populated areas.

It is entirely possible that kiosks might have been used more had they been placed in underserved areas to supplement brick and mortar stores that have limited hours, but we could not determine such potential because such areas had no kiosks for us to evaluate. However, as we discuss in our report, we did communicate with retail food establishments in locations where there are neither kiosks nor brick and mortar stores with extended hours. Unfortunately, the results were too mixed for us to find a discernable pattern. For example, some of the retail establishments we contacted (even small ones with limited floor space) wanted kiosks while others did not.

Overall, by looking at our map, readers can see for themselves (1) the lack of kiosks in visibly underserved areas, (2) the absence of seven-day-a-week stores in most counties, (3) the preponderance of stores open only five to six days a week, and (4) the scattering of stores open only three to four days.

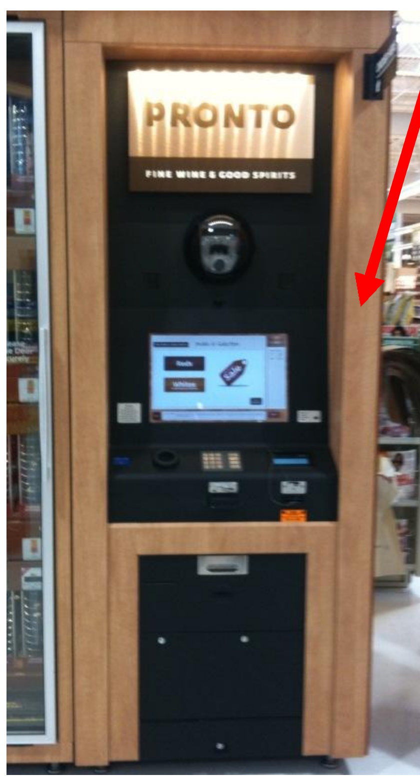
When combined with our audit work, our map enables us to observe that, in attempting to provide greater customer convenience, **the Liquor Control Board was hindered not because of the wine kiosk initiative itself or because the state controls the sale of alcohol** but because (1) state law restricts the number of Sunday openings at *all* stores, including kiosks, and (2) many stores have limited days and hours during the rest of the week.

Summary of recommendation based on our observation: *The Liquor Control Board should take the steps necessary to establish uniform hours at <u>all</u> stores 7 days a week, 9 a.m. until at least 9 p.m., and at kiosks until midnight if the kiosk program continues.*

We are thus compelled to recommend that, in order to provide the greatest customer convenience, enable increased sales, and continue its effective performance in selling alcohol responsibly, the Pennsylvania Liquor Control Board should take the steps necessary to establish uniform hours at *all* stores 7 days a week, 9 a.m. until at least 9 p.m.—and until midnight at the kiosks if the Board does not terminate the contract and if stores that house the kiosks are open during those hours.

Source: Based on LCB data from various websites as of July 15, 2011.

Wine kiosk, Giant Food Store, 2300 Linglestown Road, Harrisburg, PA 17110



Control panel/touch screen

Introduction and Background

Duties and mission of the Pennsylvania Liquor Control Board

The Pennsylvania Liquor Control Board (referred to in this report as Liquor Control Board, Board, or LCB) is an independent administrative entity that, according to state law, must "control the manufacture, possession, sale, consumption, importation, use, storage, transportation, and delivery of liquor, alcohol, and malt or brewed beverages"[1] within the Commonwealth. As part of its charge, the Board licenses and sells liquor (or spirits), wine, and beer.

The Board describes itself and its purpose in this mission statement:

> The mission of the Liquor Control Board is to regulate the alcohol beverage industry in a fair and consistent manner; to provide the best service to its customers through modern, convenient outlets, superior product selection and competitive prices in a controlled environment; and to provide factual information on alcohol and its effects through a comprehensive alcohol education program.[2]

All bottle sales of wines and spirits in Pennsylvania, with the exception of sales by licensed limited wineries, are made through approximately 625 state liquor stores established and operated by the Board. According to the *2011-12 Governor's Executive Budget*, the 625 stores included 155 stores that are open on Sundays, 6 outlet stores, 19 one-stop shops in grocery stores, 74 Premium Collection stores, one Wine Boutique, and 32 active kiosks.

It is important to note that, although accounted for separately, kiosks are considered stores.

It is also important to repeat that the preceding numbers were complete as of May 31, 2011. On that date, however, as this

[1] The Pennsylvania Liquor Code at 47 P.S. § 2-207(b).
[2] *Governor's Executive Budget 2011-2012*, page E29.1.

report was being written, the number of operating kiosks dropped from 32 to 22 when Wegmans Food Markets notified the LCB officials that it was pulling out of the kiosk program. The pullout was publicized widely.[3]

An official from the corporate office of Giant Eagle food stores, the chain with the highest number of kiosks at 14, confirmed to us in a phone call that the chain would continue its use of the kiosks. However, the official also said that Giant Eagle had no plans to increase the number beyond 14. Giant Eagle's continued participation was also publicized widely.[4]

The other supermarkets that host kiosks, Giant Food Stores (a different chain from Giant Eagle), Fresh Grocer, Shop 'n Save, and Brown's Shop Rite, plan to continue to use their kiosks, according to information that store management provided to our auditors in early June 2011. At that time, management from Fresh Grocer and Brown's Shop Rite told us they would be interested in expanding the kiosks into more of their stores; management from Giant Food Stores said the chain is not interested in expanding at this time; and management from Shop 'n Save did not provide an answer to that inquiry.

Organization and governance

The Board employs approximately 4,824 employees throughout the Commonwealth, including seasonal employees. The Harrisburg headquarters has a staff of 475, including the chief executive officer who reports to a Liquor Control Board chairman and two members. The Board chairman and the two members are appointed by the Governor, serve full time, and receive annual salaries of $72,094 for the chairman and $69,255 for each of the two members.

[3] Angela Couloumbis, "Wegmans nixes LCB wine kiosks," *Philadelphia Inquirer*, June 2, 2011.
[4] "Wine kiosks staying put in Giant Eagle, Shop 'n Save," *Pittsburgh Post-Gazette*, June 4, 2011.

Program funding

Revenues from wine and spirits sales cover the cost of merchandise sold in the stores, all costs of operating the Liquor Control Board, the cost of operating the Board's Office of the Comptroller, and the costs of the Pennsylvania State Police's Bureau of Liquor Control Enforcement. The revenues also provide funding to the Department of Health to support drug and alcohol programming and, finally, they supplement the Commonwealth's General Fund.[5]

In fiscal year 2010-11, the Board had $1.96 billion in sales and transferred $496 million in profits and taxes to the General Fund. In the prior fiscal year of 2009-10, the Board had $1.9 billion in sales and transferred $482 million to the General Fund.

Contract to provide wine kiosks

Effective January 29, 2009, the Liquor Control Board entered into a contract with Simple Brands, LLC, a Pennsylvania business based in Conshohocken. The ten-year contract between the Board and Simple Brands has five allowable one-year extensions.

On September 8, 2010, the contract was amended.

Key provisions of both the original contract and the amended contract are shown in the table on the next page. Finding Three discusses changes between the proposed contract and the 2009 contract.

[5] *Governor's Executive Budget 2011-2012,* page E29.5.

Key provisions of the wine kiosk contract

Simple Brands, LLC

Effective January 29, 2009:

- → will set up and install 100 kiosks.
- → will provide the kiosks on a no-cost basis to LCB [i.e., the LCB is not obligated to pay for them]
  - *Auditors' note: Board officials said the no-cost option was based on the recognition that the kiosk technology was novel and unproven. The contract states that "because there currently is no precedent for accurately assessing the fair market value associated with a retailer's use of the wine kiosk, the contractor is furnishing the equipment pursuant to this contract on a rent-free basis."*
- → will provide any and all maintenance services related to each wine kiosk at no cost to the LCB.
- → may charge a fee to wine suppliers if they use the kiosks' video monitors to promote specific wines. The fee must be the same for every supplier.
- → must establish a $1 million letter of credit to be used each fiscal year as necessary to reimburse the Liquor Control Board for any shortfall between actual operating expenses and gross profits. The contract also provides that Simple Brands would have to increase the letter of credit up to $2.2 million if the LCB determines that the $1 million letter of credit will not be sufficient to cover its operating shortfall.

Amendments effective September 8, 2010:

- → will set up and install *a minimum* of 100 wine kiosks.
- → may *vary* the fees it charges suppliers to promote their wines on the kiosks' video monitors.
- → collects a $1.00 fee for each transaction completed at the kiosks. This fee shows up on the customer receipt as "convenience fee," and the total amount (pre-tax) is $1.00 no matter how many or how few bottles of wine are purchased in the single transaction.
- → collects a $0.50 advertising fee for each bottle of wine purchased at each kiosk. This fee is incorporated into the price of each bottle and thus is not broken out on the receipt.
  - *Auditors' note: The contract provides that for each group of 100 kiosks, Simple Brands cannot collect more than a total of $1.5 million a year for this advertising fee.*
- → must display at least five 30-second LCB-created and -controlled advertisements each hour at every wine kiosk location.

LCB

Effective January 29, 2009:

- → will select kiosk locations.
- → will select wines to sell at the kiosks.
- → will stock and restock the wines at the kiosks.
- → will determine staffing levels needed for kiosk operations.

Amendments effective September 8, 2010:

- → will order 100 more wine kiosks from Simple Brands (these 100 kiosks are in addition to the minimum 100 kiosks specified in the contract amendment noted previously) if one of the two following conditions are met:
  - (1) the Board chooses to place the order *-- or --*
  - (2) the existing 100 kiosks generated $5 million in retail sales over a period of 90 consecutive days and, during that same period, properly (according to LCB specifications) verified the identification of customers and detected their levels of alcohol at the times of purchase.
- → may opt to purchase a quantity of fully functioning wine kiosks if Simple Brands should default on its contract or for any other reason mutually agreed upon by the LCB and Simple Brands.

Rollout schedule for opening the wine kiosks

The Board opened its first two kiosks in central Pennsylvania, one in Mechanicsburg and the other in Harrisburg, on June 21, 2010. These two kiosks were the only two until October 2010 when five more kiosks opened. By December 2010, 29 kiosks were in operation.

On December 21, 2010, the Board shut down all 29 kiosks to repair them for a variety of malfunction issues.

The Board began to reopen the 29 kiosks in January on a rolling basis. By February 2, 2011, the Board had reopened all 29 and added another 3 kiosks for a total of 32 operating kiosks. When presenting data about the kiosk operations throughout this report, we are careful to specify whether we are discussing the 29 kiosks opened prior to the shutdown or the 32 kiosks operating after the reopening. In either case, these numbers include the 10 kiosks that Wegmans asked to have removed.

Board officials told us that the Board approved the installation of wine kiosks at 23 Wal-Mart locations across the state. Those kiosks were initially expected to be in the Wal-Mart stores in the summer of 2011; however, as this report was nearing release, Wal-Mart announced that it would not proceed with the installations.

Even if Wal-Mart had proceeded with installing 23 kiosks as the Board expected, there would have been just 45 kiosks in operation after excluding those removed from Wegmans, in contrast with the Board's initial goal of opening 100 kiosks. Now, as of late August 2011, the Board has a total of only 22 kiosks in operation.

Finding One

In its wine kiosk initiative, the Liquor Control Board used technology that effectively monitored and controlled the purchase of alcohol.

In implementing the wine kiosk initiative, the Liquor Control Board had to ensure that its mandate to monitor and control alcohol sales was not compromised. So while the Board recognized the kiosks as a potential means to provide customers with increased convenience and availability, it had to pursue those means without compromising its core mission. In that regard, we found that the wine kiosks utilize technology that effectively provided the Board with sufficient measures and controls to meet that core mission.

The fact that this finding is positive does not mean the Board met other goals—i.e., those that were kiosk-specific, such as increased LCB profitability and customer convenience. Nevertheless, this positive finding is a significant one.

The fact that this finding is positive does not mean the Board met other goals—i.e., those that were kiosk-specific, such as increased LCB profitability and customer convenience. Those issues will be addressed in our subsequent findings but, first, we describe here how the kiosks were effective in helping the LCB meet its primary charge of monitoring and controlling alcohol sales. In that sense, this positive finding is significant.

Identifying the customer. To prevent underage people from purchasing alcohol at the kiosks, customers are required to provide identification, typically a driver's license, and insert it into a scanner at the kiosk for transmission to the Liquor Control Board's call center. Customers also swipe their debit or credit card information for transmission to the LCB's call center.[6]

Board officials explained to us that the identification scanner can read the text and images of driver's license formats from all 50 states, and from military identification cards as well. The officials also explained that the scanner, which is proprietary to the kiosk contractor, employs three distinct

[6] The call center is located in Harrisburg and is staffed by LCB employees who monitor and approve sales at the kiosk. The call centers are discussed in further detail on page 8.

technologies to verify the authenticity of the transmitted information.

Detecting whether customers are alcohol-impaired. Wine kiosk customers must pass a 20-second breathalyzer test to measure their blood alcohol concentration level before they can proceed with their purchase. This BreathAlcoholContent test, or BrAC, requires the customer to blow into a built-in screen-covered opening from about six inches away; the test results are immediately transmitted electronically to the Board's call center. In order for the purchase to proceed, the customer's blood alcohol concentration level must be less than 0.02 percent.

For comparative purposes, listed below is information about blood alcohol concentration levels as they apply to Pennsylvania drivers.[7]

Blood Alcohol Concentration (BAC)
applicable to Pennsylvania drivers

Pennsylvania has set **.08% BAC** as the legal limit for a Driving Under the Influence (DUI) conviction. Commercial drivers can be convicted of a DUI nationwide with a BAC level of .04%. You may be convicted of DUI at .05% and above if there is supporting evidence of driving impairment.

The **Zero Tolerance Law** (Section 3802e of the PA Vehicle Code) lowered the Blood Alcohol Content (BAC) for minors (persons under 21) to **.02%.**

Observing the customer. Each wine kiosk is equipped with two stationary cameras with targeted fields of view. One camera captures activity in front of the kiosk's access doors; the other targets the point-of-sale station where the customer stands. These cameras transmit their images to high-definition monitors at the call center, thus allowing call center personnel to observe customers as they make their purchases.

[7] Information from the LCB website accessed on March 15, 2011, at http://www.lcb.state.pa.us/portal/server.pt/community/alcohol___the_law/17511/alcohol_impairment_chart/611972. Verified June 23, 2011.

Controlling access to the wine. The kiosk setup includes a large display case—it houses the bottles of wine in a temperature-controlled environment—and a built-in pay station that includes the breathalyzer mechanism. The display case front (see page xii) has either three or four full-view glass doors through which customers can see the selection of wines.

Whether the display case includes three or four doors, all remain locked until the locks are de-activated from the call center. Even then, the only door that unlocks is the one housing the purchased item(s). Within the display case itself, the vending mechanism includes metal shields that surround each bottle to prevent the dispensing of wines that are not part of the purchase.

The door that accesses the purchased item(s) is supposed to re-latch and re-lock immediately when closed. However, during a test visit to a kiosk in Dauphin County, we found that the door did not fully close and thus did not re-lock. Even so, the machine's vending mechanism would not have enabled us to remove another bottle of wine other than the one already dispensed during our test purchase. Therefore, we did not consider this re-latch/re-lock failure to be significant.

Staffing the call center. LCB employees who staff the call center (also see pages 42-43) are critical to operating the kiosks. It is those employees who observe the customers on camera, authenticate their age and identification using the transmitted images and other data, check their sobriety level using the breathalyzer results, verify the method of payment, and allow access to the purchased alcohol. The number of employees who staff the call center at any one time varies depending on expected sales volume; there were five employees on duty when we visited the center during our audit work.

Liquor Control Board officials have emphasized the importance of their employees no matter where they work, whether in brick and mortar stores or in the call center far away from the kiosk locations. However, the officials noted that the technology used for the kiosk operations gives the call center employees a distinct advantage over the employees in the brick and mortar stores, particularly with the use of the breathalyzer technology to determine customer sobriety at the time of purchase. Clerks in the actual brick and mortar stores do not have the technology to detect sobriety and must therefore rely on their own judgment by observing customer appearance and behavior, including speech, and by noting whether there is an odor of alcohol.

During our observations and test visits to several kiosks, we did confirm that they worked as they were intended to work, with the one exception that we noted previously where the door did not immediately re-latch and re-lock.

Question: Does the technology that helps the LCB to control sales also serve to repel customers?

Overall, it is clear that the kiosk technology has helped prevent alcohol sales to underage and/or alcohol-impaired customers, and that our finding is correct in stating that the LCB used technology effectively to control such purchases.

In our work related to this finding, however, we became aware of consumer concerns that affect some of our other findings, including those that relate to customer convenience and LCB sales. In particular, we found numerous online postings from various venues in which bloggers commented that blowing into the breathalyzer screen was "degrading," "humiliating," and akin to "feeling like a criminal."

We mention this concern because it relates to a change made during contract negotiations with the kiosk vendor. As we note in Finding Three, the LCB said it opted to use the breathalyzer technology rather than the originally proposed transdermal technology in which blood-alcohol levels could be determined by having customers place their bare forearm on a pad with a built-in sensor that takes an infrared scan of the skin.

The LCB said that it opted to switch to the breathalyzer testing because it (the LCB) believed that customers would not be amenable to the transdermal testing. When we questioned why the LCB believed this way, officials told us that customers would consider it "invasive" to have to roll up their sleeves or take off their coats or suit jackets.

Summary and Recommendation

The Board uses technology that effectively prevents underage and alcohol-impaired persons from purchasing wine at the kiosks. In this regard, the Board has met its mandate to monitor and control alcohol sales. Specifically, the kiosks use an identification scanner to monitor the age of customers and a breathalyzer test to measure the blood alcohol concentration level. In addition, the bottles of wine are housed behind locked doors and are encased in a shield that lifts out of the way only after a purchase is made.

The Board utilizes employees at its centrally located customer service center/call center to observe customers via a video transmission and to authenticate their age and sobriety level based on the information transmitted to the center.

While this technology has been effective at controlling the sale of alcohol at the kiosks, the breathalyzer test appears to have repelled some potential customers.

Recommendation

1. If it does not terminate the kiosk contract, the Board should continue its effective monitoring and control of alcohol sales at the kiosks but explore other options for testing blood alcohol concentration levels.

Finding Two

The Liquor Control Board showed initiative and also followed state procurement requirements by seeking kiosk proposals from interested contractors. But the Board's request for proposals did not enable fair and just competition among qualified contractors because the request seemed tailored to the vendor who had proposed the kiosk idea in the first place.

The vendor chosen to implement the kiosk initiative is a company that was "formed specifically and exclusively" for the purpose of entering into the kiosk business with the Commonwealth.

In 2007, Simple Brands approached the Liquor Control Board with an idea to provide and install wine kiosks in grocery stores at no cost to the LCB. Based in Conshohocken near Philadelphia, the Pennsylvania company had been formed in October 2006 for the sole purpose of developing alcohol dispensing kiosks.[8] Simple Brands sells no products other than wine kiosks, and it has no other clients other than the LCB.

Simple Brands was open with the Commonwealth about the reason for its formation and existence, as evidenced by its written response to one of the questions asked by the LCB when the Board sought proposals for the kiosk initiative:

> The company is a special purpose limited partnership, formed specifically and exclusively for the purpose of this transaction.
>
> *-- Answer from Simple Brand, LLC, to Section II-8, "Financial Capability," of the LCB request for proposals for its wine kiosk initiative*

The LCB thought the kiosk idea had merit and would result in greater convenience to customers. At the same time, the Board understood the state's contracting requirements under which, with few exceptions, procurements must occur through an open bidding process.

Accordingly, on March 24, 2008, the Liquor Control Board issued a request for proposals for wine kiosks, with sealed bids

[8] Simple Brands formed a domestic limited liability company, Simple Brands, LLC, through the Pennsylvania Department of State's Corporation Bureau on January 10, 2007.

required six weeks later in early May. Specifically, the request invited interested parties to submit proposals "to lease, provide, maintain and service fully functional wine kiosks for the Board to place in locations throughout the Commonwealth designated by the Liquor Control Board as satellite wine store locations."

Simple Brands was the only contractor to submit a bid. Thus, the company who had developed the specific kiosk technology—and who had proposed that the Board use that technology in the first place—was the sole and winning bidder to negotiate the contract it had envisioned.

LCB officials were questioned widely about speculation surrounding the one-vendor bid—speculation based on reported political ties that the vendor's investors had to the then-Governor. During a media interview, the Board's chief executive officer acknowledged the LCB's concern about the perception, but he said that the bidding process had been open and fair and that other bidders might have been kept away by the newness of the kiosk technology.[9]

We, too, asked the Board why there were no other bidders. In its written response, the Board indicated that, while several vendors did contact the LCB to express interest in supplying some components or technologies related to the kiosks, no other vendor expressed interest in providing something "substantially similar to the wine kiosk unit proposed by Simple Brands."

Is bidding open and fair when the exclusive proposer is also the exclusive bidder?

Based on our audit work, we found that the Liquor Control Board did ensure that, as mandated by the state's Procurement

[9] *WTAE Channel 4 Action News*, Pittsburgh, published a transcript of Investigator Paul Van Osdol's report, "Team 4: Winning Wine Kiosk Bidder Has Rendell Connections," that aired July 30, 2009, during which Liquor Board CEO Joseph Conti answered questions about the wine kiosk bidder and its connections to the then-Governor. Accessed March 15, 2011, at http://www.wtae.com/news/20228816/detail.html.

Code, bidding was open to parties other than Simple Brands.[10] In addition, we found that, as required, the request for proposals was properly advertised and that a pre-proposal conference was held.

It was more difficult to assess whether the LCB's actions enabled fair and just competition as required. Our difficulty in making a definitive assessment arose because, as further discussed below, an agency—in this case, the LCB—could find it challenging to determine how general versus how specific a request for proposals document should be.

The LCB went afoul of the requirement that says request for proposal documents must be general in order to be fair and just . . .

As published by the Pennsylvania Department of General Services, the state's *Procurement Handbook* explains that a request for proposals document "establishes the common standard that ensures fair and just competition among qualified offerors. . . .[and] should provide offerors with all information needed to prepare proposals that meet the using agency's needs." [11]

Regarding the "agency's needs" in the case of the LCB and its wine kiosks, we know that those "needs" were to provide increased customer convenience and availability, decreased LCB costs, and greater LCB profitability. Thus, a reasonable person could question whether the LCB—by issuing a request for proposals document that, in effect, asked specifically for the wine kiosks that only Simple Brands had developed—went afoul of establishing a "common standard that ensures fair and just competition" in meeting those four needs:

[10] The state's procurement requirements are set forth in the Commonwealth Procurement Code, 62 Pa.C.S. § 101 *et seq.*, and the Department of General Services' *Procurement Handbook* to which the LCB is subject as an "independent administrative board" (*see* 47 P.S. § 2-201) pursuant to 62 Pa.C.S. § 301 and Part 1, Chapter 1, "General Provisions," of the handbook.

[11] *See* the Department of General Services' *Procurement Handbook*, Part 1, Chapter 6, page 8.

> This Request for Proposal ('RFP') provides interested parties with sufficient information to enable them to prepare and submit proposals for consideration by the Commonwealth of Pennsylvania ('Commonwealth'), Pennsylvania Liquor Control Board ('PLCB'), to lease, provide, maintain and service **fully functional wine kiosks** for the PLCB to place in locations throughout the Commonwealth designated by the PLCB as satellite wine store locations, at no cost to the Commonwealth/PLCB. The kiosks will be monitored via a PLCB-staffed customer service support center. [emphasis added]
>
> -- Page 1, Request for Proposal, RFP 20080318, Wine Kiosks, March 24, 2008, Issuing Office: PLCB

Stated another way, it would have been difficult for any other contractor to meet those four needs if the way of meeting them was only to provide "fully functional wine kiosks," kiosks proprietary to the contractor who developed the technology solely for the Pennsylvania Liquor Control Board. As we already discussed in the previous section, even the Board's CEO acknowledged that other bidders may have been kept away by the newness of the vendor's (i.e., Simple Brands') kiosk technology.

. . . but the LCB complied with another requirement that says request for proposals must be specific

Within the same section of the state's *Procurement Handbook* as just discussed, but actually at the other end of the spectrum, is the requirement that says a request for proposals document should *not* be general. Specifically, the handbook states that "the more precise and complete [the Work Statement] is, the greater the probability of receiving proposals that meet the needs of the issuing office."[12]

In the case of the LCB and its request for proposals document for wine kiosks, the LCB's work statement section of the request for proposal document first repeated the "general" information as we just spelled out from Page 1 of the request for proposals. But then the PLCB goes on to say the following:

> The PLCB's objective is to establish an automated, secure kiosk of similar-type vending machine capable of dispensing bottled wines to consumers. . . .Each wine kiosk will offer a minimum of five hundred (500) bottles representing a selection of approximately ten (10) to fifteen (15) different wines for purchase by adult consumers. . . .
>
> -- Page 49, Request for Proposal, RFP 20080318, Wine Kiosks, March 24, 2008, Issuing Office: PLCB

Our ultimate conclusion:
The LCB did not enable fair and just competition among qualified vendors

As auditors looking solely at issues of compliance that have yes or no answers, we found that, yes, the Board did seek competitive bids as required. There is no question about that part of the procurement requirement issue.

On the other hand, as we stated earlier and as we have just shown, it was difficult to assess whether the LCB's actions in seeking requests for proposals met the express *intent* of the procurement process. The question there does not have an easy yes or no answer. Again, this difficulty arises because of the LCB's challenge to determine how general versus how specific the request for proposals document should have been.

[12] *See* the Department of General Services' *Procurement Handbook*, Part 1, Chapter 6, page 9.

Nevertheless, the bottom line is that the state's *Procurement Handbook* requires request for proposals documents to establish "the common standard that ensures fair and just competition among qualified offerors. . . .[and] should provide offerors with all information needed to prepare proposals that meet the needs of an agency." Thus, in this case, fair and just competition should not exclude technologies or innovations that could have been proposed by potential competitors of Simple Brands. At the same time, the LCB still had to include in its request for proposals document the precise specifications needed to fulfill the overall proposal requirements.

Despite the LCB's challenge, and despite our own challenge in analyzing this issue, our concern remains that the request for proposals document seemed so tailored to one vendor that others were kept away.

The LCB did not meet the express intent of the procurement process to be fair and just among all potential vendors.

By adding two other factors to our analysis, we were led to our ultimate conclusion that, no, the LCB did *not* meet the express intent of the procurement process to be fair and just. These two additional factors are as follows:

- Factor #1 – The LCB allowed interested vendors only 45 calendar days to respond to the request for proposals document, a time frame far too limited for any vendor besides Simple Brands to come up with "fully functional wine kiosks" that could meet the other specific requirements laid out in the request for proposals document.

- Factor #2 – The LCB and the sole responding vendor negotiated the final contract in ways that, in our judgment, were more advantageous to the vendor than they should have been, and certainly more advantageous than necessary. Specifically, various requirements were changed, some significantly, that had been outlined in the proposed contract attached to the request for proposals document. This proposed contract was the one that all potential vendors would see; accordingly, any such vendors would expect that contract to be the one they would have to follow. Potential bidders might have responded to the request for proposals document had they been aware that so much negotiation was possible and that some of the basic but significant terms would be loosened as much as they were.

We address the preceding Factor #2 in the next finding. Before we move on, however, we have a final comment related to potential causes about *why* the Board did not meet the express intent of the procurement process to be fair and just. As we discussed previously, there has been repeated speculation about the Board's actions and whether they were related to political ties and/or pressure from outside the Board. It is important for us to note that, regardless of that speculation, we did not find sufficient documentary evidence during our audit work to determine the *cause* of the Board's actions. We do, however, believe that the Board proceeded with the kiosk initiative with the genuine *intent* of providing greater customer convenience by expanding opportunities for the public to purchase wine at additional locations.

Summary and Recommendation

The Board opened itself to speculation when it awarded the contract for the wine kiosks to the vendor who approached the Board with the wine kiosk concept a year before the request for proposals was issued. Other vendors did not have a real chance at competing in the procurement process since the request for proposals was designed based on one contractor's idea and proprietary technology. On the other hand, the Board was innovative and showed initiative in looking at a new way to increase sales. Other contractors could have approached the Board with their own ideas long before the request for proposals for kiosks was issued, just as the winning contractor had done.

Regardless of which position one takes, we found that the Liquor Control Board complied with the state's procurement requirement to open the bidding process publicly to other bidders. However, the Board did not ensure that the process was "fair and just" since there was really only one vendor who could meet the request for proposals requirements, especially within the stipulated six-week period.

Recommendation

2. The Board should ensure that its requests for proposals ensure fair and just competition, and with adequate response time for all interested parties.

Finding Three

The Liquor Control Board and the sole responding vendor negotiated the wine kiosk contract in ways that were more advantageous to the vendor than necessary.

According to its request for proposals, the LCB expected it would enter into a five-year contract for kiosks that would provide customer convenience, reach into underserved areas, minimize LCB costs, and increase LCB profitability, all without compromising the Board's monitoring and control of sales and the public's safety, health, and welfare.

With the preceding goals in mind, the LCB included a proposed contract in its request for proposals.

The Board described the contract negotiation process as "complicated."

The inclusion of a proposed contract in the request for proposals for wine kiosks was not unusual since the LCB routinely includes a proposed contract in its requests for proposals. Once bids are opened and a vendor is selected, the Board enters into contract negotiations with the selected vendor before finalizing the contract.

Board officials stated that the contract negotiations with Simple Brands lasted between six to eight months and resulted in various changes to the proposed contract. The Board also described these negotiations as "complicated."

According to the Board, the length and complexity of the negotiations occurred for several reasons. Simple Brands was a newly formed company, said Board officials, and did not have experience with state contracts. In addition, the officials noted that the contract negotiations included discussions on the technology related to the kiosks and, therefore, the Board's information technology staff had to be included.

It was during this contract negotiation period that certain provisions of the proposed contract were changed. Board officials told us that the changes were not disadvantageous to the Liquor Control Board, but in some cases we disagree with the Board's position.

Key changes are discussed in the narrative that begins below. Readers are also directed to the table on page 4 of the Introduction and Background section which details key provisions of the final contract, as well as the subsequent amendments.

Differences between the proposed contract and the first actual contract

The first contract between Simple Brands and the LCB became effective on January 29, 2009, with subsequent amendments effective September 8, 2010.

In this section, we discuss key changes agreed to by the LCB that differ from the provisions in the proposed contract. These changes became effective with the first contract that began on January 29, 2009.

- **Change in the "no cost to the Commonwealth" provision**

  Proposal: In the LCB's proposed contract attached to the request for proposals document, the contract language said this:

  > On the Effective Date [defined elsewhere in the contract], the Contractor shall lease, provide, maintain, and service fully functional wine kiosks for the [LCB] to place in locations throughout the Commonwealth designated by the [LCB] as satellite wine store locations, at no cost to the Commonwealth/PLCB.

  Change: The "no cost to the Commonwealth" provision was completely deleted—i.e., it is not in the final contract.

Our concerns. We find this change to be especially troubling, especially in light of even more specific language in the request for proposals document (I-4. "Problem Statement," page 3) stating the following:

> There will be no cost to the Commonwealth/PLCB for services, hardware and/or software provided by the selected contractor. Costs incurred by the PLCB related to merchandise stocking and restocking (except PLCB personnel salaries), networking and customer service support center set-up are to be borne by the selected contractor.

The removal of this language raises questions similar to those we raised in the previous finding. More specifically, how many other potential bidders might have responded had they known they would not be expected to bear virtually all costs?

- **Change in the requirement that the vendor must provide fully functional wine kiosks by a certain date**

  Proposal: As shown in the preceding bullet, the language in the proposed contract required the successful bidder to provide fully functional wine kiosks by a certain date.

  Change: Instead of requiring the vendor to provide fully functional kiosks by a certain date, the LCB agreed that the vendor would need only to "begin to take the steps necessary" to provide the fully functional kiosks. The LCB explained its position to us by saying that this change gave the Board an advantageous role in developing and testing the machines to ensure that the Board's underage identification and intoxication parameters were met. Regarding such testing, Simple Brands had earlier indicated in its proposal that, rather than using breathalyzer technology, it would test the intoxication levels of each potential customer by using transdermal technology, which would require each customer to place his or her bare forearm on a pad equipped with sensors. However, the LCB told us it believed that the general public would not be amenable to such a bare-skin test, and so the Board and Simple Brands negotiated to use the breathalyzer system that is currently part of the wine kiosks.

Our concerns. Regardless of the Board's position in explaining why it did not hold the chosen vendor to the effective date as publicized in the proposed contract, we ask nearly the same question as before: How many other potential bidders might have responded had they known they would not actually have to provide fully functioning wine kiosks by the date originally cited but instead would need only to "begin to take the steps necessary" to do so?

- **Change in proposed term**

  Proposal: The proposed term of the contract was set at five years.

  Change: LCB officials told us they agreed to the ten-year term that Simple Brands proposed to allow the company time to recoup the money the company anticipated spending to fulfill the contract's obligations.

  Our concerns. Why didn't the LCB consider this time frame in the first place? Once again, we ask what other vendors might have chosen to bid had they known that the Board was so amenable to a much longer contract.

- **Change that relieved Simple Brands of the requirement to obtain a performance bond in the amount of $3 million**

Proposal: The provision in the proposed contract required the successful bidder to obtain a $3 million performance bond.

Change: This provision was eliminated in the final contract and replaced with a provision requiring Simple Brands to obtain a letter of credit each year in the amount of $1 million. This new provision included an option for the Board to require an increase in the letter of credit up to $2.2 million.

Board officials explained their rationale for making that change by saying that, in the past, the Board had a difficult time collecting on performance bonds. According to the Board, the Department of General Services informed the Board that the Commonwealth has not been successful in collecting on performance bonds obtained by other vendors when the vendor defaulted on the contract. With this knowledge in mind, the Board said it was able to negotiate with Simple Brands to obtain the letter of credit instead. According to Board officials, the letter of credit is *guaranteed* to cover any operating loss incurred by the LCB, whereas the performance bond could have been tapped only for certain events.

Our concerns. Even if we assume that the Board's position is correct that the letter of credit is stronger, the Board still should not have agreed to accept a $1 million letter of credit rather than a $3 million letter of credit.

- **Elimination of the "termination for convenience" clause**

  Proposal: The proposed contract had a provision that allowed the LCB to terminate the contract for convenience.

  Change: This provision was eliminated in the final contract. Board officials told us that the letter of credit provides better protection to the LCB than terminating for convenience because, according to these Board officials, the "termination for convenience" argument is not often accepted by the Board of Claims[13] and is not a guaranteed win. Board officials said that, on the other hand, the letter of credit provides guaranteed funding to the LCB if the Board were to lose money on the wine kiosks.

It was for these reasons the officials thought there was no harm in removing the "termination for convenience" clause and in seeking Simple Brands' agreement to provide the letter of credit to pay the Board's operating shortfall.

The LCB also told us it will generally keep the "termination for convenience" clause in contracts with other vendors, unless the Board is offered better terms. However, in the case of the Simple Brands contract, the Board's position remains firm that obtaining the letter of credit offered a better level of protection and that eliminating the termination for convenience clause was not a problem.

<u>Our concerns</u>. We disagree with the Board's position. "Termination for convenience" clauses are long-established standard terms in government contracts that provide an agency with an extra layer of protection allowing for termination when it is in the agency's best interests. But such a clause is *not* the equivalent of a letter of credit. Therefore, regardless of whether the LCB would not be "guaranteed" a favorable outcome before the Board of Claims, the contract should have had both a "termination for convenience" clause *and* a provision requiring a letter of credit.

- **Change in the audit provision**

  <u>Proposal</u>: The proposed contract allowed for audits of the contractor's books and records at "reasonable times."

[13] The Board of Claims is an independent administrative agency that was created by the General Assembly that has jurisdiction to hear and determine contract claims against the Commonwealth that equal or exceed $300.

Change: The final contract changed this provision to allow for these audits "upon reasonable notice during normal business hours." The Board explained that it agreed to change this requirement to announced visits because such a change is not disadvantageous to the LCB. Stated another way, Board officials do not agree that an audit would be impaired simply because Simple Brands knew about the audit in advance.

Our concerns. Again, we disagree with the Board's position to accommodate the vendor. The Board should have access to the vendor's books at *any* time without giving advance notice.

Differences between the first contract and the amended 2010 contract

In this section, we discuss some of the changes agreed to by the LCB when the first (2009) contract was amended effective September 8, 2010.

The amended contract provided two additional revenue streams to Simple Brands that were not part of the original contract. In addition, the amendment modified the advertising fee that Simple Brands charges to wine suppliers. Specifically, the following were allowed:

- ✓ Simple Brands may *vary* the fees it charges suppliers to promote their wines on the kiosks' video monitors.
- ✓ Simple Brands collects a $1 fee for each transaction completed at the kiosks. This fee is a convenience fee paid by the customers.
- ✓ Simple Brands collects a 50-cent advertising fee from the LCB for each bottle of wine purchased at each kiosk.

When we spoke with the chief executive officer of Simple Brands on March 15, 2011, he stated that these advertising and transaction fees are the only revenue sources to Simple Brands from the wine kiosk contract. He also said that, as of March 15, 2011, Simple Brands had incurred approximately $14 million in costs from 2008 through the opening of the first kiosks on June 21, 2010. These costs, which were financed equally with debt and equity, included $5 million for development costs and $9 million for manufacturing costs.[14] The CEO stated that Simple Brands spends approximately $93,000 for the manufacture of each kiosk and approximately $4,700 on the installation of each machine.

According to the CEO's explanation, while advertising and transaction fees may provide a method for Simple Brands to recoup some of its investments, Simple Brands' costs to date have far exceeded the fees it has collected.

Our concerns related to each of these changes are discussed in the following sections.

Fee charged to wine suppliers. Simple Brands is able to charge wine suppliers a fee in exchange for providing promotional information on the kiosks' video monitors about specific brands of wine available for sale in the kiosks.

The original contract required Simple Brands to charge suppliers a *uniform* fee, but the amended contract allowed Simple Brands to charge suppliers a *variable* fee. According to the Board, this amendment was granted at the request of Simple Brands. The Board did not oppose this change since the agreements between Simple Brands and its wine suppliers are outside the purview of the LCB and do not affect the Board.

[14] Simple Brands only markets the machines; it does not develop or manufacture them. Simple Brands subcontracts with Flextronics International from Texas for both the development and manufacturing of the wine kiosks.

According to Simple Brands, the advertising fee paid by all wine suppliers is currently nine percent of the wholesale cost that the Board pays for each bottle of wine. To give a simplified example, the Board may purchase wine for $5 a bottle from a certain wine supplier. That $5 price is the Board's wholesale cost. In turn, in exchange for the placement of advertisements on the kiosks monitors, the wine supplier pays Simple Brands nine percent of that $5 price, or 45 cents a bottle.

<u>Our concerns</u>. We did not have concerns with this change because it did not cost the Board any additional monies.

$1 transaction fee. This fee shows up on the customer receipt as "convenience fee," and the total amount (pre-tax) is $1 regardless of the number of bottles of wine purchased in a single transaction.

The convenience fee is subject to state sales tax. Board officials stated that they contacted the Pennsylvania Department of Revenue regarding sales tax in June 2010, and that the Department of Revenue advised the Board that the transaction fee is considered part of the purchase price and should be added before the sales tax is calculated.

The Board began charging this transaction fee on October 1, 2010, and has collected and transferred $36,389 to Simple Brands for the transaction fee for the six months of October 2010 through March 2011.

<u>Our concerns</u>. This transaction fee might deter some potential customers from using the kiosks in order to avoid the fee, especially with many of the kiosks located so close to brick and mortar stores.

Advertising fee of $0.50. Simple Brands collects from the LCB an advertising fee of 50 cents for *each bottle* of wine successfully purchased at each wine kiosk. The contract amendment states that Simple Brands cannot collect more than $1.5 million annually for this advertising fee for each group of 100 kiosks.

The LCB incorporates this fee into the price of each bottle and thus, it is not broken out on the customer receipt. It should be noted that the Board does not increase the price of the wine sold at kiosks to cover this advertising fee. Rather, the Board's profit is 50 cents less on each bottle of wine sold at the kiosks as compared to selling that same wine at the wine and spirits stores.

In exchange for this advertising fee, Simple Brands must display at least five 30-second LCB-created and LCB-controlled advertisements each hour at every wine kiosk location. The Liquor Control Board has told us that displaying advertisements on the kiosks' video monitors should enhance sales.

The Board began to pay this advertising fee to Simple Brands on October 1, 2010. For the six months of October 2010 through March 2011, the Board has paid $26,091 in advertising fees to Simple Brands.

Although the LCB began paying such fees in October 2010, the Board stated at the same time that advertisements would not be ready for release until May 2011. Board officials confirmed that the advertisements did begin in May 2011, and the ads were deployed to all kiosks and cover a variety of topics including the Board's e-commerce website[15] and the Chairman's Selection program.

<u>Our concerns</u>. The Board paid $26,091 for advertising space it did not use. Equally important, but aside from how long it took the Board to develop ads that it paid for all along, our concern is that the Board's net profit for every bottle of wine sold at the

[15] http://www.finewineandgoodspirits.com

kiosk is 50 cents less than the net profit for the same bottle of wine sold at brick and mortar stores. In this regard, the Board is not meeting its kiosk goal to maximize Board profitability.

Summary and Recommendations

As discussed in Finding Two, the Board opened itself to speculation when it awarded the contract for wine kiosks to the vendor who approached the Board with the kiosk concept a year before the request for proposals was issued.

We identified our own concerns following our analysis of the contract changes made during the final negotiations and away from the public eye. We found that, after the sole respondent was selected, the Board and Simple Brands entered into a contract negotiation process that was likely more lengthy and arduous than necessary based on the number of significant deviations between the final contract and the proposed contract that was in the Board's public request for proposals.

The position of the Board is that it agreed to change only those terms it believed were not disadvantageous to the Board. The Board has noted that it was in a stronger position with the final contract because Simple Brands agreed to pay the Board for any operating shortfall through a secured letter of credit. The strength of the Board's position will be answered only in time.

While the addition of the operating shortfall provision in the contract *appears* to mitigate any concerns about the changes to the proposed contract, we cannot fully assess the validity of any such mitigation until we determine if the Board actually enforces that provision. In other words, the Board realized operating losses totaling more than $1.12 million over two fiscal years (as explained further in Finding Four); again, however, only time will tell if the Board can collect the money from Simple Brands or if, instead, the Board will have to attempt to call in the vendor's letter of credit for each fiscal year's losses.

We also found that, while the Board allowed for revenue sources to flow to Simple Brands through a 2010 contract amendment, that income from the transaction fees and advertising fees amounted to less than $62,500 through March 31, 2011. The Board began paying the advertising fee to Simple Brands in October 2010 but did not start using ads until May 2011, thus paying $26,091 for unused space.

Recommendations

3. The Board should ensure that it protects the state's interest by not negotiating contract provisions that are more advantageous to the vendor than necessary, and by always including a "termination for convenience" provision.

4. If it does not terminate the wine kiosk contract, the Board should pay only for advertising space that it actually uses.

Finding Four

Over two fiscal years, the Liquor Control Board spent $1.12 million more than it took in and has invoiced the vendor for the losses. But the vendor has not paid.

Our work shows that the Board failed to accomplish its goals of increased profitability and decreased costs.

Board officials have stated that the wine kiosks are designed to add a supplemental amount of income to the Board's overall bottom line without adding substantial operating costs. While the Board is correct that the income provided is supplemental to the sales generated at the wine and spirits stores, the Board incurred a $1.12 million loss for the kiosk operations from the inception of the program through June 30, 2011, or over two fiscal years.

This finding presents our analysis of the sales generated from the kiosks and the expenses incurred by the Board for the kiosks' installation and operation. Our work shows that the Board failed to accomplish its goals of increased profitability and decreased costs because, as explained in the following narrative, there is a significant shortfall between sales and expenses.

Board is counting on the vendor's letter of credit to make up for any losses

As of March 31, 2011, the Board spent more to operate the kiosks than it took in, resulting in an operating shortfall of $925,315.

Wine kiosks: A net loss *January 29, 2009, through March 31, 2011*	
Net income from sales	$206,060
Less start-up costs of $399,647 and recurring operating costs of $731,728	(1,131,375)
Net loss from sales	**($925,315)**

Source: Department of the Auditor General prepared this table using information provided by the Pennsylvania Liquor Control Board.

Based on our analysis at the time we conducted most of our field work, we projected that the Board's operating shortfall could amount to $1.2 million by June 30, 2011, for fiscal years 2009-10 and 2010-11. Our projection included start-up costs because the contract states that kiosk installation costs are part of operating costs and thus can be included in the calculation of the net loss. Not included in our projection were potential annual fees of $76,600 if and when the Board pays such fees to supermarkets hosting the kiosks. Those annual fees are discussed in further detail on page 44.

As we finalized this report, the Board was able to provide us with an update based on its own calculations. Those Board calculations show an operating loss of $1.12 million as of June 30, 2011, representing losses of $279,954 in fiscal year 2009-10 and $843,369 in 2010-11.

What the contract requires

The contract between the Board and the vendor requires the vendor to reimburse any operating shortfall up to $2.2 million, with the Board determining such a shortfall by calculating its actual operating expenses and its gross profits for the fiscal year just completed.

The contract defines shortfall, as well as operating expenses and gross profits, as follows:

Shortfall: the amount that actual operating expenses exceed the Board's gross profits

Actual operating expenses: those costs incurred by the Board in connection with both installation and operation of the wine kiosks

Gross profits: sales revenue less the Board's cost to purchase the wine, less sales tax, and less the 18 percent Johnstown flood tax[16]

The contract sets forth limits to this reimbursement, as follows:

- For the first year of the contract, the figure used for actual operating expenses cannot exceed $2,200,000 regardless of the actual amount spent.

- For each subsequent year, the figure used as actual operating expenses cannot exceed 110 percent of the figure used as actual operating expenses in the previous year.
- The Board must use reasonable efforts to minimize its actual operating expenses.

We obtained a copy of Simple Brands' original letter of credit, which was issued May 20, 2010, by Firstrust Bank, Philadelphia, naming the LCB as beneficiary. This letter of credit was for the sum not to exceed $1 million and was valid for one year. The original letter of credit, which expired May 20, 2011, was renewed to extend the expiration date to May 20, 2012, with all other terms and conditions remaining the same.

The contract allows the Board to direct Simple Brands to increase the letter of credit up to $2.2 million. Such a directive can be made after the first quarter of the 2011-12 fiscal year (which ends September 30, 2011), or as soon as October 1, 2011. Specifically, the contract states that, on a quarterly basis, the Board may elect to review its gross profits and, based on that review, if the Board reasonably determines that the existing letter of credit is not sufficient to cover any anticipated

[16]The Emergency Liquor Sales Tax Act, Act of June 9, 1936 (Special Session, P.L. 13), 47 P.S. § 794 et seq., provides that, as a result of the damage from the 1936 Johnstown flood, an emergency tax was imposed on all alcohol sold in the commonwealth for flood recovery and assistance to flood victims. This tax rate was originally 10 percent. The tax rate was raised to 15 percent in 1963, and then raised to 18 percent in 1968, where it remains. This tax is commonly referred to as the "liquor tax."

shortfall for that fiscal year, then the Board may direct Simple Brands to increase the letter of credit up to $2.2 million.

If the Board makes such a request, Simple Brands has 30 days to comply with the request to increase the letter of credit. Simple Brands' failure to do so is a breach of contract which permits the LCB to terminate the contract, but only *after* giving Simple Brands 45 days' written notice. Simple Brands thus has an additional 45 days to comply with the request to increase the letter of credit.

When we asked the Board how the amount of $1 million for the letter of credit was decided upon during contract negotiations with Simple Brands, Board officials stated that the Board estimated that its operating loss would not exceed $1 million but still negotiated for the right to increase the letter of credit up to $2.2 million in case the estimates proved incorrect.

What the Board invoiced Simple Brands

On May 19 and 20, 2011, the Board demanded that Simple Brands pay $255,077, representing a shortfall for fiscal year 2009-10. Simple Brands had 30 days of its receipt of the invoice, or until June 20, 2011, to remit that amount to the Board. Board officials confirmed that failure to do so would be a material breach of contract permitting Board officials to begin contract termination proceedings.

As of mid-August 2011, Simple Brands had refused to pay, and Board officials said that they and Simple Brands were in negotiations about the matter.

Also in mid-August, we learned that, on August 3, 2011, the Board sent Simple Brands another demand for payment, this one representing a shortfall of $843,369 (how much actual operating expenses exceeded gross profits) for fiscal year 2010-11. In that same demand for payment, the Board also requested $24,877 for additional losses from 2009-10 not included in the prior demand for payment.

According to the Board—and discussed in media reports as well—Simple Brands was disputing the amounts demanded and had not yet made *any* payments toward the combined \$1.12 million shortfall. Even so, the Board expects it can be paid by drawing on the original \$1 million letter of credit for the 2009-10 losses of \$279,954, and by drawing on a "re-set" \$1 million letter of credit for the 2010-11 losses of \$843,369.

The problem is that the original \$1 million letter of credit for fiscal year 2009-10 cannot be "re-set" until that year's shortfall is paid. Therefore, only time will tell if the Board will collect its two-year combined losses of \$1.12 million. In addition, if the kiosk contract continues, the likelihood of the LCB actually collecting any remaining or future shortfalls is arguable when we consider that the vendor's CEO told us that costs of the kiosk contract have far outweighed the vendor's revenue from advertising and transaction fees.

It is a logical question to ask, as we discussed in Finding Three, how contract negotiations between the Board and Simple Brands will affect the ultimate outcome of the kiosk initiative and the relationship between the two parties. For example, clearly the Board considered itself better protected from losses when it agreed to trade the \$3 million performance bond requirement for the annual \$1 million letter of credit requirement, which the Board considers to be stronger, or when Simple Brands negotiated the elimination of a "termination for convenience" provision in return for offering to compensate the Board for a shortfall of as high as \$2.2 million if needed. However, given that Simple Brands has refused to make the demanded payments, our discussion about the elimination of the \$3 million performance bond and of the "termination for convenience" clause, which the Board now agrees should be in every contract "absent extenuating circumstances" (see Appendix C for the Board's written response to this audit), reinforces our argument that, at a minimum, the contract should have had both a letter of credit and a "termination for convenience" clause. Again, only the passage of time will reveal the strength of the contract as it relates to how the Board recoups its losses.

Nearly 63 percent of kiosks failed to meet minimum sales thresholds of 210 bottles a week

The LCB projected that each kiosk should sell 35 bottles of wine each day as a minimum sales threshold in order for the machines to be considered profitable. Otherwise, according to the Board, the machines should be considered for relocation.

This 35-bottle-a-day threshold equates to 210 bottles sold in a six-day week, because the kiosks are closed on Sundays. Using that weekly figure, we determined that through March 31, 2011, **the majority of the kiosks (20 of the 32) never had one week of sales that met the weekly sales threshold of 210 bottles.**

During our audit work, we confirmed with Board officials that, for profitability purposes, they did indeed use the 35-bottle minimum daily sales threshold for each kiosk, or 210 bottles a week.

To determine if the kiosks were meeting their weekly threshold, we analyzed the Board's sales report showing weekly sales from June 21, 2010, through March 31, 2011, and found the following:

- 20 of the 32 kiosks did not have even one week of sales that met the 210 weekly sales threshold.
- Only 3 of the 32 kiosks sold on average more than 210 bottles of wine a week. These average weekly sales were as follows:
    - ✓ 253 bottles at Fresh Grocer at 4001 Walnut Street in Philadelphia (Philadelphia County)

- ✓ 231 bottles at Wegmans in Collegeville (Montgomery County)
- ✓ 226 bottles at Wegmans in Mechanicsburg (Cumberland County)

- Five of the kiosks had average weekly sales of ***fewer than 35 bottles a week***. These average weekly sales were as follows:
  - ✓ 32 bottles at Shop & Save in Carnegie (Allegheny County)
  - ✓ 29 bottles at Brown's Shop Rite in East Norriton (Montgomery County)
  - ✓ 27 bottles at Shop & Save in Bethel Park (Allegheny County)
  - ✓ 20 bottles at Shop & Save in West Mifflin (Allegheny County)
  - ✓ 18 bottles at Supervalu in Gibsonia (Allegheny County)
- The kiosk at Brown's Shop Rite in East Norriton never sold more than 50 bottles of wine each of the six weeks it was open through March 31, 2011.
- 18 of the 32 kiosks, or 59.4 percent, had average weekly sales of less than 100 bottles, well below the 210-bottle threshold.

Appendix B of this report lists the total number of bottles sold and the sales revenue for each kiosk for the period of June 21, 2010, through March 31, 2011. Also shown is the number of weeks each kiosk was opened through March 31, 2011, and the average number of bottles sold per week for each kiosk.

Only 60,000 bottles of wine sold through March 31, 2011, for net sales of $206,060

After all taxes and costs to purchase the wine were deducted, we found that total net sales at the kiosks for the period of June

21, 2010, through March 31, 2011, amounted to only $206,060, a low total when we consider the level of operating expenses. Since the opening of two kiosks on June 21, 2010, through March 31, 2011, when 32 kiosks were operational, total sales (minus sales tax) at the wine kiosks amounted to $639,213 for 60,058 bottles of wine. The next table provides sales details by month.

Summary of kiosk sales June 21, 2010 through March 31, 2011			
Month / Year	**Number of Kiosks**	**Sales Amount** [a/]	**Sales Quantity**
June 2010	2	$15,491	1,385
July 2010	2	$21,337	1,923
August 2010	2	$24,056	2,174
September 2010	2	$15,896	1,483
October 2010	7	$22,181	2,126
November 2010	28	$164,880	16,136
December 2010	29	$80,267	7,674
January 2011	29	$72,919	6,588
February 2011	32	$118,343	10,832
March 2011	32	$103,842	9,737
Total		**$639,213**[b/]	**60,058**

[a/] Sales amount does not include sales tax. In addition, the information from the LCB is reported on a weekly basis; therefore, the monthly information presented here does not always cleanly break at the start and end of each month.
[b/] Does not add due to rounding.

Source: Developed by Department of the Auditor General staff from information obtained from the Liquor Control Board.

Only two kiosks—the test sites in Mechanicsburg and Harrisburg—were open and operational from June through September 2010. But with the opening of 28 kiosks by November 2010, sales reached their peak level of nearly $165,000 for the month. Since the reopening of the kiosks, and even with the addition of three new kiosks, sales have not returned to their November peak. Specifically, sales have averaged approximately $111,000 for the months of February and March 2011.

To calculate total net sales, the Board must also deduct the 18 percent liquor tax, any refunds provided to customers, and the Board's total cost of purchasing the wine from suppliers. After these deductions, the net sales for the period of June 21, 2010, through March 31, 2011, are $206,060.

With net sales of just $206,060 for the period of June 21, 2010, through March 31, 2011, and with operating expenses of more than $1.1 million, the kiosks are underperforming. Furthermore, revenues will decline more with the closing of 10 kiosks located in the Wegmans Food Stores, especially when considering that the 10 kiosks accounted for almost 50 percent of all kiosk sales in that timeframe.

The LCB is at a critical decision point with the kiosk program. With nearly two-thirds of the kiosks not meeting the Board's minimum sales thresholds, and with the decrease in the number of kiosks, the Board must scrap the program if more cannot be done to increase sales.

Not a "no-cost" contract when the Board has spent nearly $1.5 million to operate the kiosks

The Board incurred more than $1.1 million in operating costs between January 2009 and March 31, 2011. By June 30, 2011, after the bulk of our audit work was completed, we found that the operating costs totaled nearly $1.5 million.

As stated previously, the Board's request for proposals said that the contractor would lease, provide, maintain, and service the kiosks "at no cost to the Commonwealth/LCB." The proposed contract that accompanied the request for proposals said essentially the same thing:

> The contractor shall lease, provide, maintain and service fully functional wine kiosks for the LCB to

> place in locations throughout the Commonwealth designated by the LCB as satellite wine store locations, at no cost to the Commonwealth/LCB.

While the final contract did not contain precisely that same language, it did contain provisions stating that the contractor, Simple Brands, would incur the costs for providing, servicing, and maintaining the kiosks.

The final contract also requires Simple Brands to reimburse the Board for its operating costs—a provision that, says the Board, makes the contract "cost-free." More specifically, however, the provision states that "the contractor is furnishing the equipment pursuant to this Contract on a rent-free basis." In short, the Board does not pay for the actual kiosks themselves. In a written response to our inquiries, the Board said it executed this cost-free provision to safeguard the Commonwealth against the risk of loss given the novelty of the wine kiosk project.

Finally, the contract states that "at all times during the term of this Contract, the Contractor shall provide any and all maintenance services related to each wine kiosk, at no cost to the LCB." This provision means that the Liquor Control Board did not incur any repair costs when the kiosks were closed for malfunctions since the repairs are the responsibility of Simple Brands. (We discuss the malfunctions in Finding Five.)

Based on the preceding provisions, we acknowledge that the LCB may not have paid for the wine kiosks themselves or for repairs during the shutdown of the kiosks. However, the contract is still not "cost-free" just because the Board didn't pay for display cases and for certain repairs.

Stated another way, the Board *has* incurred costs for installing the kiosks and operating them, including personnel costs. For example, personnel costs that occurred during the repairs include the Board's continued payment of kiosk customer service employees who performed work elsewhere; other personnel costs occurred when the LCB paid employees to sit next to the kiosks as they came back up after the supposed repairs.

We have calculated that the Board's operating expenses (including installation) total $1,131,375 through March 31, 2011, consisting of $399,647 in start-up costs and $731,728 in recurring operating costs (not including the personnel costs related to the malfunctions, which are discussed in Finding Five). Each category is explained next.

Start-up costs of almost $400,000. Defined by the Board as one-time costs for implementing the kiosk program, the Board's start-up costs for the kiosks totaled $399,647 between the start of the program and December 31, 2010.

The Board's start-up costs consisted primarily of computer and telecommunications equipment, as shown in the table below. Board officials told us they do not include personnel expenses in the start-up costs because they are instead considered recurring costs. The Board officials further noted they incurred no further start-up costs after December 31, 2010.

Total wine kiosk start-up costs from program inception in January 2009 through December 31, 2010

Expense	Expense item
$ 184,888	Routers, system cables, and other computer equipment to link the kiosks with the call center
$ 166,902	Telecommunication lines dedicated to the kiosks and the call center
$ 31,846	IT consultants
$ 8,303	500 totes with lids, plus freight
$ 4,622	Office supplies for the kiosk call center
$ 1,314	System cable repair
$ 1,256	Gasoline
$ 516	Leased cargo van
$ **399,647**	Total wine kiosk start-up costs

Source: Developed by Department of the Auditor General staff from information obtained from the Liquor Control Board.

Recurring operating costs of over $731,000. The LCB incurred $731,728 in operating costs categorized as "recurring costs," which are the routine, ongoing costs for the operation of the wine kiosks, from the inception of the wine kiosk program through March 31, 2011. The next table presents more detail of these costs.

Total wine kiosk operating costs from program inception in January 2009 through March 31, 2011

Expense	Expense item
$ 556,218	Personnel expenses
$ 62,130	Telecommunication expenses
$ 55,313	Leased cargo vans
$ 29,819	IT consultant
$ 20,570	Advertising expense
$ 7,677	Miscellaneous expenses
$ 731,728[a/]	Total wine kiosk operating costs

[a/] Does not add due to rounding.

Source: Developed by Department of the Auditor General staff from information obtained from the Liquor Control Board.

Personnel expenses. These were the largest recurring costs, as shown in the table above. These costs include, for example, salaries, wages, health benefits, hospitalization insurance, social security contributions, workers' compensation insurance, group life insurance, unemployment compensation, and leave payouts.

As of March 31, 2011, the personnel complement consisted of 15 salaried and 11 wage positions.[17] These 26 positions were all new Board positions. The jobs were posted across the state, and the Board said it filled as many of them with qualified

[17] According to the LCB, this staffing level is comparable to a medium-sized wine and spirits store. The staffing level of the large stores ranges from 15 to 30 salaried positions and 10 to 20 wage positions.

existing employees as it could. The remaining kiosk positions were filled using Civil Service lists. The vacancies created by moving existing employees were then re-filled through normal procedures.

The 15 salaried positions include 1 kiosk administrator, 11 persons responsible for stocking and restocking, and 3 persons in the call center. Annual salaries ranged from $22,181 to $65,115, with an average salary of $33,757. Benefits were provided only to salaried employees.

The 11 wage positions were all call center employees whose annual salaries amounted to either $21,320 or $22,181. Wage employees do not receive employer-paid benefits.

When we asked the Board if it will need to hire any additional employees if and when more kiosks open, Board officials stated that the Board's Bureau of Retail Operations has projected that the current staffing levels will be sufficient until the number of operating kiosk locations exceeds 50.

Vehicle costs. The Liquor Control Board has leased ten extended cargo vans for the restocking of the kiosks. The LCB stated that it does not have vehicles in its fleet appropriate for hauling large quantities of merchandise. Board officials also said that the state's Department of General Services would not allow the Board to purchase additional vehicles.

Invoices obtained from the Board show that the monthly lease costs are $1,150 for each van. Therefore, each month, expenses for the leased cargo vans amount to $11,500. Information on the invoices states that the vans are supposed to be used Monday through Friday, and that the price includes mileage, waiver, and supplemental liability protection.

With regard to vehicle expenses, the request for proposals stated that the vehicle costs associated with stocking and restocking the kiosks would be borne by the selected contractor. However, the language in the final contract states that the LCB—not the vendor—is responsible for stocking and restocking the wine kiosks. As a result, vehicle costs are yet another cost to the LCB for a "no-cost" contract. This change, from the request for proposals to the final contract, is just another example of the negotiated contract provisions that were more advantageous to Simple Brands, as we discussed in Finding Three.

Annual fees at kiosk locations. The Board will incur annual fees that have to be paid to the supermarkets housing the kiosks. However, Board officials stated that, as of April 2011, they had made no payments to the supermarkets because the supermarkets are still working with the LCB and the Department of General Services to register as Commonwealth "suppliers." Such registration is needed in order for the supermarkets to submit valid invoices for payment.

The annual fees negotiated between the supermarkets and the LCB are shown here:

Annual fee rates for each supermarket as of April 22, 2011			
Supermarket	**Annual fee**	**# of kiosks**	**Total cost**
Wegmans	$1,000	10	$10,000
Fresh Grocer	$3,000	2	$6,000
Browns' Shop Rite	$3,000	1	$3,000
Giant Eagle	$3,600	14	$50,400
Shop&Save(Supervalu)	$1,800	4	$7,200
Giant Food	To be determined	1	$0
Total		**32**	**$76,600**

Source: Information provided by the Pennsylvania Liquor Control Board.

We asked the Board why the annual fees varied among the supermarkets. Board officials explained that the LCB requested all supermarkets interested in housing a wine kiosk to provide the Board with any terms and conditions, including any fees that the supermarkets would impose for hosting a kiosk.

The proposals submitted by responding supermarkets contained a wide range of fees. This range narrowed once negotiations began, and the LCB clarified that it would pay a flat annual fee toward the provision of utilities. Differences in the rates, according to Board officials, are simply a reflection of the negotiations of each proposer based on issues such as the costs of electricity and data circuits, and the desirability of the respective locations.

As of April 22, 2011, the LCB had not entered into a final license agreement with Giant Food stores. As a result, Giant Foods operates under the no-fee agreement that was established as part of that supermarket operating as one of the original testing sites. It is not clear if the Board will be required to pay back fees when the final agreements are established.

Summary and Recommendations

Although the LCB characterized the kiosk contract as a "no-cost" or "cost-free" contract, it is only the kiosks themselves that were provided to the LCB at no cost. The Board clearly has incurred costs for kiosk start-ups and continued operations. As such, the LCB incurred at least $1.1 million in costs for kiosk operations through March 31, 2011, or nearly $1.5 million through June 30, 2011.

Through March 31, 2011, the Board's net income from sales amounted to just $206,060. Over 62 percent of the kiosks, or nearly two-thirds, never met the Board's minimum sales threshold. Given the levels of sales and expenses, the Board has failed to meet its kiosk-specific goals of increased profitability and decreased costs. We look for net income to drop still further based on the Board's loss of one-third of the kiosks in Wegmans Food Markets.

Overall, as of March 31, 2011, the Board had an operating shortfall of $925,315; by June 30, 2011, the shortfall was $1.12 million for the two fiscal years ended on that date. The Board has invoiced the vendor for that two-year shortfall of $1.12

million, but the vendor has not paid. If the vendor does not submit payment, the Board will attempt to draw on the vendor's original $1 million letter of credit for the 2009-10 losses of $279,954, and by drawing on a "re-set" $1 million letter of credit for the 2010-11 losses of $843,369.

Considering the figures that we have just presented, it is clear that the LCB is at a critical decision point. Either the kiosk program should be terminated, or it should be aggressively modified in a way to produce more sales. We note that aggressive modifications can be made only after the Board conducts a thorough analysis of poor-performing kiosks. Any such analysis must consider not only income and expense issues such as those discussed in this finding, but also other issues such as service areas, customer confidence, and hours of operation that we discuss in subsequent findings.

Recommendations

5. If it does not terminate the kiosk contract, the Board should request that the amount of the annual letter of credit be raised above its current level of $1 million to ensure that the letter of credit is sufficient to cover any operating shortfall.

6. Immediately after the close of each coming fiscal year in which the Board stays in the kiosk business, the Board should continue to enforce the contract provision permitting it to seek reimbursement from the vendor for operating shortfalls.

7. If it does not terminate the kiosk contract, the Board must make aggressive modifications to identify poor performers, analyze the reasons, and relocate such kiosks to underserved and/or more profitable locations as necessary.

Finding Five

Despite shutting the kiosks down for over a month to repair them after nearly 1,000 errors occurred, the Liquor Control Board and the kiosk vendor lost credibility and customer confidence when malfunctions continued after the kiosks reopened.

Nearly 1,000 reported malfunctions forced the Board to shut down the 29 kiosks on December 21, 2010. By the week of January 10, 2011, the Board reopened three of the kiosks after Simple Brands purportedly fixed them. Within a few weeks, by February 2, not only had the Board reopened all 29 kiosks, but it also opened three new ones.

Almost immediately, the kiosks began to malfunction again. There were 118 malfunctions during the first month of reopening, and the issues were essentially the same ones that caused the Board to shut down the kiosks in the first place.

Malfunctions were pervasive

Overall, we found that malfunctions—both before and after the shutdown in December 2010—were pervasive among all the operating kiosks throughout the state. Problems were not limited to any particular month, day, or time. The first problems occurred in June 2010, just after the first two machines became operational, and problems continued even as the Board rolled out each new kiosk.

By November 2010, with malfunctions occurring at all the machines, the vendor began a month-long fault analysis to determine the nature and cause of the problems. Simple Brands found the cause deep within its kiosks in the operating system and in the interactions with the hardware, including the dispensing mechanisms. As a result, the Board called for the

December 21 shutdown and directed Simple Brands to address the systemic issues.[18]

Our evaluation of malfunctions by type

To evaluate the types of malfunctions that occurred prior to the December 21 shutdown, we requested a copy of the Board's error log. The Board maintains this log that reports mechanical malfunctions at each kiosk location.

From June 21, 2010, when the first two kiosks became operational, through December 21, 2010, there were 919 reported malfunctions. We grouped these 919 malfunctions into nine categories and listed examples of the types of issues that occurred in each category. The table on the next page provides the details of the malfunctions.

In an effort to analyze the scope of the problems, we attempted to compare the 919 malfunctions to the number of successful transactions that occurred during the same time period. We were challenged in this analysis, however, because we immediately recognized that both numbers are limited. For example, not every one of the 919 malfunctions resulted in an unsuccessful sale. Furthermore, the Board did not have an exact number of successful transactions from that same time period of June through December.

What we could obtain was this: the total transaction fees from October through December 2010, which amounted to $17,551. Since the transaction fee is $1 for each transaction, we converted the fees paid to the number of transactions, after which we compared that result to the total number of malfunctions for that period.

[18] During the time that the kiosks were closed, Board officials stated that all 26 employees that work on kiosk operations were offered shifts in wine and spirits stores for the holiday period and until the kiosks were reopened. The Board also noted that, during this same timeframe, the stores that house inventory for the kiosk locations (hub stores) were inventoried and cleaned by kiosk staff. However, a few members of the call center staff elected to be off without pay during that period.

Stated another way, we found there were 826 malfunction transactions for the 17,551 total transactions at the kiosks from October through December 2010. Accordingly, we calculated that 1 of every 21 transactions was problematic.

Number and type of malfunctions at wine kiosks
June 21, 2010, through December 31, 2010

Category	Number	Examples of error messages
Kiosk not functioning	281	▪ Kiosk is frozen ▪ Kiosk is not responding ▪ Kiosk is locked up ▪ "Out of order" message on the screen
Door and dispensing issues	179	▪ Door did not unlock to dispense product ▪ Product not dispensed once door is open ▪ Door does not close tightly after sale*
ID issues	144	▪ Out-of-state license not recognized ▪ ID stuck in machine ▪ ID scanner not functioning
Receipt issues	97	▪ Not printing receipts
BrAC (breathalyzer) issues	70	▪ BrAC test shows no results ▪ BrAC not functioning ▪ BrAC hardware failure ▪ Customer has to take BrAC test several times
Audio/Visual issues	67	▪ Customer cannot hear call center clerk ▪ Volume so loud can be heard throughout store ▪ No audio from machine ▪ Overhead camera is facing out toward the store
Payment card issues	35	▪ Signature pad not working ▪ Not processing credit card
Out of stock error message	18	▪ "Out of stock" message on display screen but item is in the kiosk
Other	28	▪ Shelf doesn't stop blinking
Total	919	

* Auditors experienced this same malfunction on March 4, 2011, when they visited a store to observe the kiosks in operation.

Source: Developed by Department of the Auditor General staff from information obtained from the Liquor Control Board.

In most of the malfunctions listed in the table on the prior page, the malfunction did not allow a sale to begin (kiosk frozen), or it terminated a transaction with customers not receiving the wine they purchased (door wouldn't open).

In other malfunction instances, the sale was finalized, but the customer could not obtain a receipt for the transaction. A printed receipt is necessary for customers who retain receipts for recordkeeping and credit- or debit-card reconciliation. Furthermore, if customers wish to return or exchange a wine purchase, the LCB requires the receipt.[19] (Customers who want to return a bottle of wine purchased at a kiosk have the added inconvenience of having to make returns at wine and spirits stores since no returns can be made at the supermarket housing the kiosk.)

In whatever category they fell, these malfunctions affected customer confidence, a factor that certainly negatively affected sales when the kiosks reopened and the malfunctions continued to occur.

Board officials told us that the staff of Simple Brands attempted to address the malfunctions by rewriting the software related to four components of the kiosks: the touch screens, the identification scanners, the payment card swipes, and the printers. In addition, Simple Brands modified the power distribution to the dispensing system to remedy the non-dispensing issues related to the kiosk doors and the shields encasing the bottles of wine.

Board officials also told us that the LCB rigorously tested each kiosk to ensure that the problems were rectified before bringing the kiosks back into operations.

[19] The Board has a statutory responsibility to provide a customer with a paper receipt (47 P.S. § 3-305(f)). If the kiosk does not print a receipt, a customer can press the "help" button on the kiosk's display screen, and then the call center employee will work with the supermarket customer service center to print a receipt. Otherwise, a receipt can be emailed to a person's home.

Nonetheless, according to the Board's error log, there were 118 incidences of kiosk malfunctions from January 19 through February 22, 2011, at the reopened kiosks.

Of these 118 malfunctions, there were 31 in which the kiosk was "frozen" and 30 in which the wine was not dispensed. The remaining 57 malfunctions varied among the same other issues that occurred prior to the December 21 shutdown. These continued malfunctions further eroded consumer confidence, as we discuss next.

Lost customer confidence resulted in even lower sales

Since the kiosks reopened, sales at the kiosks have yet to return even to their already-low level that we discussed in Finding Four. The LCB did attempt to preempt the loss of customer confidence by stationing employees from its wine and spirits stores at each kiosk, but sales remained low.

The stationing of LCB employees at the reopened kiosks was a proactive move. According to the Board, these employees were available to assist customers with learning the functions of the kiosks, to interact with call center staff during the transaction, to serve as an on-site liaison with supermarket management, and to answer any questions that customers had during the transaction.

At the same time, however, this proactive move contradicts the previously stated position of the Board that it incurred no costs related to the malfunction itself. Clearly, the LCB did incur personnel costs as a direct result of the malfunctions.

We could not obtain the total of such personnel costs because the Board did not track them. For example, the Board could not provide the replacement staffing costs incurred by brick and mortar stores that gave up their own employees to staff the kiosks. Board officials stated that each store was handled individually, with some brick and mortar stores replacing the kiosk attendants and others not.

Despite the fact that sales remained low, Board officials stated that the onsite attendants were beneficial in improving consumer confidence. This may well be true, and we have no way of knowing if, without the attendants, sales would have been even lower.

The Board does plan to place employees at each new kiosk as it opens, including, for example, the 23 kiosks planned for Wal-Mart locations. Any such attendants will be stationed at the new kiosks for approximately 36 hours a week for four weeks, further adding to the operating costs.

Just as we found that the Board did not keep track of the staffing costs incurred by brick and mortar stores that gave up their own employees to staff the kiosks, we found a similar issue in that the Board did not account for personnel costs in the start-up of kiosks. We presented start-up costs on page 41, but noted there that the Board did not include personnel costs, when in fact Board staff spent numerous hours on kiosk decision-making and contract negotiations among other planning and administrative duties.

Summary and Recommendations

Simple Brands' malfunctioning kiosks clearly affected the ability of the Liquor Control Board to accomplish its kiosk-specific goals of providing customer convenience and increasing profits. The problems forced the LCB to shut down the kiosks for a month's time at the height of the December holiday season, a time when the goal of increased sales might otherwise have gotten a boost. Regarding the Board's goal of offering customer convenience, that goal, too, was compromised by the malfunctioning machines when customers could not complete a purchase, for example, or get a receipt. Customer convenience and confidence were even further eroded when the kiosks reopened but continued to malfunction after Simple Brands purportedly fixed them.

Simple Brands' poor-performing kiosks also created additional personnel costs for the LCB. First, the Board still incurred costs for call center employees whom it placed elsewhere. Second, the Board incurred costs for its employees who staffed the kiosks when they reopened. While the Board could not quantify these personnel expenses, they clearly contradict the idea of a "no-cost" contract.

We acknowledge that technology has an inherent risk of malfunction. Some malfunction can be expected. As it should have done, the Board relied on the vendor to make repairs and was aggressive in attempting to hold Simple Brands accountable for maintaining the kiosks at a fully operational level.

Customer confidence can be restored only after the public trusts that Simple Brands' kiosks will operate properly every time. If customer confidence is not restored based on Simple Brands' contract requirement to "provide any and all maintenance services related to each wine kiosk, at no cost to the PLCB,"[20] any malfunctions will continue to have a negative impact on LCB's profitability and credibility.

Recommendations

8. If it does not terminate the kiosk contract, the Board must be even more aggressive in holding Simple Brands accountable for ensuring that all the kiosks are fully functional and fully operational at all times. Such action requires the Board to constantly monitor the machines to readily identify all malfunctions and to remedy them immediately upon identification.

9. If it does not terminate the kiosk contract, the Board should account for LCB personnel costs related to the kiosks, not

[20] Contract No. 20080318 between the Pennsylvania Liquor Control Board and Simple Brands, LLC, effective January 29, 2009, amended effective on September 8, 2009, Paragraph 17, Section I, p. 51.

only for the malfunctions—including the costs of personnel who test presumably repaired kiosks and, those personnel who staff kiosks that reopen after a malfunction—but also for the kiosks in general, including kiosk decision-making and contract negotiations.

Finding Six

The Liquor Control Board promoted its kiosks as being convenient but overstated that convenience by not offering Sunday sales and expanded hours, by not placing any kiosks in underserved areas, and by not adding liquor to the product offerings.

According to its request for proposals, the LCB expected that it would enter into a five-year contract for kiosks that would provide customer convenience, reach into underserved areas, minimize LCB costs, and increase LCB profitability, all without compromising (1) the Board's monitoring and control of sales and (2) the public's safety, health, and welfare.

Specifically, the Board said this:

> The LCB recognizes an opportunity through these satellite wine stores to increase its installed base, reach and profitability and to serve underserved areas at a fraction of the cost of fitting out and operating a full-sized store, without compromising its ability to monitor and control sales. The purpose of the proposed satellite wine stores network is to provide convenience to the consumer without compromising the safety, health and welfare of the public.

Convenience to the customer can be truly attained not only with kiosks that function properly, but also with kiosks that (1) are open during peak shopping hours, including Sundays, (2) are located in all regions throughout the state, including areas presently underserved by brick and mortar stores, and (3) offer liquor products in addition to wines.

In this finding, we present our conclusions related to how well the kiosks are meeting those three issues of convenience.

No Sunday sales: an inconvenience to many consumers

The LCB stated in numerous responses to us that convenience to the customer is a primary feature of the wine kiosks. In addition, Board officials stated that the kiosks allow for impulse sales because customers are already in a supermarket purchasing other edible and complementary products.

Board officials stated that they would like to open the kiosks on Sundays since Sundays are top sales days for supermarkets. However, the Board is statutorily constrained in the number of stores it can open for business on Sundays. Specifically, the Liquor Code[21] allows the LCB to open up to 25 percent of the total number of Pennsylvania wine and spirits stores on Sundays between the hours of noon and 5 p.m. The wine kiosks are included in this 25 percent restriction because they are considered stores.

With the opening of the first 29 kiosks, the total number of stores operated by the Board increased, meaning the number of stores that can open on Sundays increased by five.

In selecting which of its stores to open on Sundays, the LCB could have chosen to open some of the kiosk "stores," but officials said instead they could generate more revenue through Sunday openings of brick and mortar stores.

We looked at Sunday sales data for the twelve months ended July 31, 2011, for the 164 brick and mortar stores open seven days a week. The Sunday sales at those 164 stores accounted for 8.3 percent of their total sales. Looking at a subset of 33 of those stores—i.e., 33 stores with the most Sunday sales, we found that Sunday sales accounted for at least 10 percent of the stores' total sales. Both the 8 percent and the 10 percent figures are significant when we consider that the 164 (or 33) stores are open for only five hours on Sundays, noon to 5 p.m.,

[21] 47 P.S. § 3-304(b).

as compared to being open 12 hours each day from Monday through Saturday.

It becomes clear that Sunday openings could provide a boost to sales, particularly if the Board were not restricted to having Sunday openings (1) at only at 25 percent of its stores and (2) for only a five-hour day. The January 2011 transition report from the Board to the state's newly elected Governor provided evidence of the conflict created by needing to parse out Sunday openings: "To achieve any meaningful success, kiosks must [be] open on Sundays, the second busiest retail day of the week." Without a change in law, the report noted, kiosks could open on Sundays only if the LCB decreased the number of brick and mortar stores that are now open on Sundays. The Board would also like a legislative change that would allow kiosks to remain open until 9:00 p.m. on Sundays, if Sunday hours are granted to kiosks.

In response to the Board's transition report, legislators introduced House Bill 160 on January 21, 2011. If passed, this bill would give the Liquor Control Board the authority to have as many stores open on Sundays as the Board deems necessary, rather than limit such openings to 25 percent of total stores. When it was introduced, House Bill 160 was referred to the House Liquor Control Committee, where it remained pending as of August 10, 2011.

Another bill to address issues identified in the Board's transition report was introduced on March 17, 2011. House Bill 260, Printer's No. 2159, would also allow the Board to open as many stores on Sundays as the Board deems necessary. In addition, this bill also would, among other things, allow wine and spirits stores to be open until 9:00 p.m. on Sundays rather than closing at 5:00 p.m. As of August 10, 2011, House Bill 260 was pending in the House Rules Committee.

On a related note, kiosks are not open for business past 9:00 p.m. Mondays through Saturdays, or on certain holidays. The 9:00 p.m. closing time is set by Board policy, as are the Monday-through-Saturday hours at the brick and mortar stores, while the holiday closings for the kiosks and wine and spirits stores are mandated by the Liquor Code.[22]

Whatever the Board has done thus far regarding Sunday hours at more stores than now—including both kiosk "stores" *and* brick and mortar stores—it is obvious that the Board must be more diligent and more aggressive in pursuing this issue with the General Assembly. Real convenience for customers will be achieved only when all brick and mortar stores are open 9:00 a.m. until at least 9 p.m. seven days a week. In the case of the kiosks, they could be open seven days a week for even longer hours—for example, from 9 a.m. until midnight—as long as they are housed in stores that are open during those hours as well.

Interestingly, had the Board followed its original stated strategy to place kiosks in underserved areas, it would have been logical to place kiosks close to brick and mortar stores *only* in cases where those stores—because of limited profitability—were open three to five days a week. Having kiosks nearby to supplement those limited-hours stores would have addressed the inconvenience faced by customers who wanted to purchase wine but instead encountered a "closed" sign on the door of their brick and mortar store. But the Board did not implement such a strategy. Instead, as our map on page *xi* shows, kiosks were placed in areas already served by stores that had extended hours and *not* in areas served by stores with limited hours.

We continue that discussion in the following section.

Kiosks not placed in underserved areas as originally intended

Wine and spirits store locations, including the wine kiosks, are established by the Liquor Control Board as mandated by the Liquor Code.[23]

[22] 47 P.S. §§ 1-102, 3-304(a), and 3-304(b).
[23] 47 P.S. § 3-305.

In its request for proposals, the LCB stated "the LCB recognizes an opportunity through these satellite wine stores. . . to serve underserved areas. . . ."

In its response to the request for proposals, Simple Brands stated that "In many cases the Kiosk will be placed in areas that would not warrant a [traditional] Wine & Spirits Shoppe from a population density standpoint."

Despite that language in the request for proposals, the final contract between the Liquor Control Board and Simple Brands did not contain the word "underserved," nor did it make any reference to population densities with regard to the kiosk locations. Rather, the contract simply said that the Board would have the discretion to determine the location and placement of the kiosks.

Our conclusion is this: Not only was the "underserved" goal removed from the language in the final contract, but the goal was also removed from the program implementation, as evidenced by the actual kiosk placements.

More specifically, upon obtaining the list of the locations for the first 29 kiosks, we found that every kiosk was placed in an urban or suburban area—*and* in close proximity to a wine and spirits store. *Indeed, Board officials confirmed that not one of the 29 kiosks was in a rural location.*

By way of further explanation, the officials told us that, even though several rural supermarkets had been interested in hosting a kiosk, the Board deemed those locations to be non-feasible based on size constraints of the interested stores.

In June 2011 we contacted ten store managers that represent 14 different stores in counties that presently have no wine kiosks. One of the store managers represents 4 of the stores, with each of the remaining managers representing one store each. Here is what we learned:

- 7 stores would be interested in having a kiosk. These stores are in the following counties: Clinton (2), Lycoming, Northumberland, McKean, Snyder, and Tioga.

- 3 stores would be interested in the kiosk if the kiosk could be smaller. In other words, they were not put off by selling alcohol or the technology, but just would want the machines to be smaller. These stores are in Cameron, Jefferson, and Forest counties.

- 4 stores are not interested in a kiosk, and nothing could convince them to have one. These stores are in Cameron, Elk, and Snyder (2) counties. Reasons for the non-interest were either that the store was too small, the machines were too big, or they did not agree with the selling of alcohol.

Board officials also told us that kiosks in rural areas may not be as successful as metropolitan areas because LCB sales history has shown that customers in rural areas prefer brown spirits (i.e., whiskey) and boxed and economy wines over bottled wines such as those sold in the kiosks. Regarding sales of "spirits," the Board has contemplated adding them but has not yet done so. Regarding the sale of boxed wines, the kiosks cannot stock them because their size and shape cannot be accommodated by the kiosks' capabilities.

Although the Board said it made a conscious decision not to place kiosks in locations in the same shopping center or within one-half mile of an existing wine and spirits store, and that locations were selected based upon household income, foot traffic, supporting demographics, and distance away from current brick and mortar stores, our findings show that the Board did otherwise. Specifically, we found that 16 of the 29 kiosks were located one-half mile or closer to wine and spirits stores:

- Two kiosks were in the same shopping complex as wine and spirits stores—i.e., within walking distance.

- Eight kiosks were less than one-half mile from wine and spirits stores, while six others were almost exactly one-half mile from the brick and mortar stores.

- The remaining 13 kiosks were one or more miles away from the closest wine and spirits stores, with the farthest being only 7.9 miles away.

When we questioned the Board about what it said versus what it did, Board officials replied that, as the rollout of the kiosk initiative proceeded, they adjusted what they now call the "initial" goal to not place kiosks within the same shopping center or within one-half mile of a brick and mortar store. This adjustment, according to the Board, was based on the determination that kiosk sales would not cannibalize the sales at brick and mortar stores, a determination that the Board said holds true today.

Even if the kiosk sales have indeed not cannibalized the sales at nearly brick and mortar stores, the placement of kiosks near those existing stores means that nearby customers have two close locations to purchase wine—a kiosk and a brick and mortar store—while those customers in rural areas do not have this dual option and thus remain underserved in contrast to their urban and suburban neighbors.

Making it even less convenient for the underserved citizens is the fact that their area brick and mortar stores often offer only scaled-back days and hours of service in contrast to the expanded hours in more populated areas.

Overall, then, through its kiosk initiative, the LCB ended up providing more convenience only to its urban and suburban customers who already had convenience.

At the beginning of this report we have included a map that illustrates our point of how kiosks were placed close to brick and mortar stores and *not* placed in areas where brick and mortar stores had a weaker presence. In considering the map, we note that our earlier discussion bears repeating here:

> Whatever the Board has done thus far regarding Sunday hours at more stores than now—including both kiosk "stores" *and* brick and mortar stores—it is obvious that the Board must be more diligent and more aggressive in pursuing this issue with the General Assembly. Real convenience for customers will be achieved only when all brick and mortar stores are open 9:00 a.m. until at least 9 p.m. seven days a week. In the case of the kiosks, they could be open seven days a week for even longer hours—for example, from 9 a.m. until midnight—as long as they are housed in stores that are open during those hours as well.

Limited product selection may keep some customers away

The LCB has kiosks in two different sizes. One size is the four-door style that offers between 50 and 55 different wines and can hold up to 696 bottles of wine at one time. Currently, the LCB has two of these kiosks and both are located in central Pennsylvania: one in Harrisburg, Dauphin County, and one in Mechanicsburg, Cumberland County (although that location is a Wegmans supermarket that has ended its participation in the kiosk initiative). The remaining kiosks are three-door machines that hold 504 bottles of wine and offer 25 to 30 different types of wine.

The wines offered in the kiosks are chosen exclusively by the Liquor Control Board. Board officials stated that selections are based on best-selling varieties from the wine and spirits stores. Since the wine selection is much more extensive in the wine and spirits stores based on their greater capacity as opposed to the smaller capacity of the kiosks, it makes sense to stock the kiosks with the best sellers from the brick and mortar stores. Unfortunately, however, the result is that kiosk customers are left with limited options.

The Board has had to modify the wine selections since the opening of the kiosks. An early complaint related to wine selection was that Pennsylvania wines were not available from the kiosks. Board officials stated that the Liquor Control Board now offers one Pennsylvania wine per kiosk. The Pennsylvania wine available in each kiosk is dependent on the geographic region of the wine kiosk, and the Board should consider offering more local wines in areas that have their own wineries.

In the section of this report immediately preceding this one, we noted that Board officials told us that, according to LCB sales data, customers in certain geographic areas prefer brown spirits (i.e., whiskey) and boxed and economy wines over bottled wines such as those sold in the kiosks. We acknowledge that a limitation of the kiosks is the unavailability of liquor; therefore, the LCB should consider liquor sales from the kiosks.

Because the kiosks are considered satellite stores and therefore have the same legal authority as wine and spirits stores, the Board is permitted to sell liquor at the kiosks. In fact, the majority of the license agreements between the Board and the host supermarket locations allow for the sale of liquor from the kiosks.

Early in the audit process, Board officials told us that while it had considered selling liquor in the kiosks, it had no plans in place to initiate such sales. The Board subsequently changed its mind as shown by its announcement on April 22, 2011, that it planned to run a pilot program offering liquor at certain kiosks. At the time of this announcement, Board officials said that it will still be "several more months" before liquor will be sold from the kiosks.[24]

[24] Elias, Joe, "Liquor will join wine in kiosks—but where?," *The Patriot-News*, April 22, 2011.

Summary and Recommendations

The Liquor Control Board said that it introduced wine kiosks as a means to generate additional sales, reach into underserved areas, and provide more convenience to customers. We found that the kiosks have not resulted in meeting any of these three goals.

First, sales have fallen far below the Board's expectations as we discussed in Finding Four. Second, the kiosks continue to malfunction as we discussed in Finding Five, and third, the Board has yet to place kiosks in rural or underserved areas. Finally, the limited operating hours—especially since kiosks are not open on Sunday—and the limited selections, including the lack of liquor at the kiosks, diminish the purported convenience of the wine kiosks.

The LCB has reached a point where the kiosk program must be re-evaluated. If the Board decides to continue with the kiosk program, then it must take more effective steps to meet the goals it set in the first place. A good starting point would be to implement the recommendations that follow.

Recommendations

10. The Board should work with the General Assembly to pass legislation permitting all brick and mortar stores to be open seven days a week, 9:00 a.m. until at least 9:00 p.m., and all kiosks until at least midnight if the Board does not terminate the kiosk contract and if the stores that house the kiosks are open during those same hours.

11. If it does not terminate the kiosk contract, the Board should offer liquor as an option, as well as more local wines.

12. If it does not terminate the kiosk contract, the Board should re-evaluate its questionable decision to place kiosks so close to brick and mortar stores and, instead, extend the reach of the kiosks into rural and other underserved areas.

Appendix A

Objectives, Scope, and Methodology

The Department of the Auditor General conducted this special performance audit in order to provide an independent assessment of the Liquor Control Board's wine kiosk program.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Objectives

The objective of this audit was to evaluate the Liquor Control Board's process of contracting for the kiosks. We also examined the extent to which the kiosks malfunctioned and how the Board addressed these malfunctions.

Scope

This audit report presents information beginning with the Board's contracting for the wine kiosks and actions taken by the Liquor Control Board related to the operations of the kiosks subsequent to January 1, 2008, through April 30, 2011, unless otherwise indicated.

Methodology

We performed the following procedures to accomplish our audit objectives:

- Obtained and reviewed the documents associated with the Board's contracting for the wine kiosks including the request for proposals, the response to the request for proposals submitted by Simple Brands, the final contract between the Board and Simple Brands, and the contract amendment.

- Obtained and reviewed documentation provided by other vendors expressing an interest in providing technologies to the Board.
- Reviewed and analyzed the Board's financial documents including revenue reports, operating expenditure reports, and the letter of credit associated with the kiosks' financial shortfall.
- Reviewed a sample of invoices supporting the Board's operating expenses related to kiosks.
- Interviewed Board officials responsible for the kiosks' operations.
- Interviewed the chief executive officer of Simple Brands, LLC.
- Reviewed and analyzed the Board's kiosk call issue log associated with reported malfunctions prior to December 21, 2010, as well as the issue log when the kiosks reopened in January 2011.
- Toured the Board's kiosk call center located in Harrisburg to observe the LCB employees monitoring sales at the kiosks.
- Obtained and reviewed the kiosk license agreements between the Board and supermarkets.
- Evaluated the Board's selection process for choosing the locations of the wine kiosks.
- Tested/observed kiosk operations by conducting a wine purchase at an actual kiosk.
- Interviewed store owners/managers of supermarkets that currently house a wine kiosk to determine if they had continued interest in the kiosk program, as well as those in rural areas of the state to determine their interest in wine kiosks.

Appendix A

Pennsylvania Department of the Auditor General
Jack Wagner, Auditor General
August 2011

Findings and Recommendations

We developed an overall conclusion and six findings during our review of the Board's performance related to the wine kiosks, and we present 12 recommendations. We expect to follow up within the next 12 to 24 months to determine the status of our findings and recommendations.

Our expectation is that the findings and recommendations presented herein will improve the Board's operations of the wine kiosk program and will provide a framework for corrective action where necessary.

Appendix B

Sales revenue and number of wine bottles sold, by kiosk from June 21, 2010, through March 31, 2011

Location	Sales revenue	Number of bottles sold	Number of weeks opened	Average number of bottles sold per week
Wegmans 6416 Carlisle Pike Mechanicsburg/Cumberland Co.	$89,331	8,144	36	226
Giant 2300 Linglestown Rd Harrisburg/Dauphin Co.	$53,759	5,156	36	143
Fresh Grocer 4001 Walnut St Philadelphia/Philadelphia Co.	$47,821	4,551	18	253
Wegmans 600 Commerce Dr Collegeville/Montgomery Co.	$46,253	4,158	18	231
Giant Eagle 100 Settler Ridge Center Dr Pittsburgh/Allegheny Co.	$36,606	3,381	17	199
Wegmans 3900 Tilghman St Allentown/Lehigh Co.	$33,667	3,137	18	174
Wegmans 1056 E. Lancaster Ave Downingtown/Chester Co.	$31,138	2,847	16	178
Giant Eagle 5550 Centre Ave Pittsburgh/Allegheny Co.	$29,132	2,815	15	188
Wegmans 5000 Wegmans Dr Bethlehem/Northampton Co.	$25,300	2,434	15	162
Wegmans 3791 Easton-Nazareth Hwy Easton/Northampton Co.	$21,922	2,031	18	113

Appendix B

Location	Sales revenue	Number of bottles sold	Number of weeks opened	Average number of bottles sold per week
Fresh Grocer 5000 State Rd Drexel Hill/Delaware Co.	$20,208	1,876	20	94
Giant Eagle 7000 Oxford Dr Bethel Park/Allegheny Co.	$20,161	1,872	16	117
Wegmans 1405 Main St Warrington/Bucks Co.	$19,248	1,778	16	111
Giant Eagle 155 Towne Centre Dr Wexford/Allegheny Co.	$17,149	1,515	10	152
Giant Eagle 420 E. Waterfront Dr Homestead/Allegheny Co.	$14,651	1,426	14	102
Wegmans 201 Williams St Williamsport/Lycoming Co.	$14,338	1,398	16	87
Giant Eagle 20111 Route 19 Cranberry/Butler Co.	$13,991	1,292	14	92
Wegmans 220 Highland Park Blvd Wilkes-Barre/Luzerne Co.	$11,935	1,144	17	67
Wegmans 1315 Scranton-Carbondale Hwy Scranton/Lackawanna Co.	$11,599	1,125	16	70
Giant Eagle 331 Washington Rd Washington/Washington Co.	$10,631	1,061	16	66
Giant Eagle 9805 McKnight Rd Pittsburgh/Allegheny Co.	$10,549	992	15	66
Giant Eagle 4010 Monroeville Blvd Monroeville/Allegheny Co.	$10,493	1,022	16	64

Location	Sales revenue	Number of bottles sold	Number of weeks opened	Average number of bottles sold per week
Giant Eagle 8901 Route 30 N. Huntingdon/Westmoreland Co.	$7,191	714	16	45
Giant Eagle 4007 Washington Rd McMurray/Washington Co.	$6,916	632	11	57
Giant Eagle 200 Tarentum Bridge Rd New Kensington/Westmoreland Co.	$6,841	712	16	45
Giant Eagle 910 Freeport Rd Pittsburgh/Allegheny Co.	$6,258	599	15	40
Giant Eagle 1671 Butler Plank Rd Glenshaw/Allegheny Co.	$5,657	541	10	54
Supervalu (Shop & Save) 2100 Washington Pike Carnegie/Allegheny Co.	$4,971	511	16	32
Supervalu (Shop & Save) 5001 Library Rd Bethel Park/Allegheny Co.	$4,923	517	19	27
Supervalu (Shop & Save) 2381 Mountain View Dr West Mifflin/Allegheny Co.	$3,338	342	17	20
Brown’s Shop Rite 55 E. Germantown Pike East Norriton/Montgomery Co.	$1,728	176	6	29
Supervalu 5375 William Flynn Hwy Gibsonia/Allegheny Co.	$1,508	159	9	18
Totals	**$639,213**	**60,058**		
Note: Sales revenue represents the full selling price of the wine; it does not include the $1.00 transaction fee or sales tax.				

Appendix C

Response from the Pennsylvania Liquor Control Board and the Department of the Auditor General's evaluation of that response

On pages 75 through 84, we have inserted the Liquor Control Board's 10-page letter (dated August 26, 2011) responding to our audit findings. A brief summary of the Board's response begins below with our evaluation of the response.

Overall Audit Conclusion

The summary of our overall conclusions is twofold. On one hand, the kiosk initiative used technology that effectively prevented the sale of alcohol to underage or alcohol-impaired customers. On the other hand, the initiative failed to meet its specific goals related to convenience, availability, costs, and profitability. We recommended that the Board should terminate the initiative unless and until it could modify it to reach the kiosk-specific goals while still controlling alcohol sales in accordance with its mandate. The Board's response to our overall conclusion is that it must honor the kiosk contract unless the vendor breaches it.

Overall Observation

We observed that the kiosk initiative was hindered because state law restricts Sunday openings at wine and spirits stores, including kiosks, and because Board policy restricts Monday through Saturday openings and hours. We recommended that the Board work diligently with the General Assembly to allow openings at all stores seven days a week, 9 a.m. until at least 9 p.m., and until midnight at kiosks if they remain in business and if they are housed in stores with those hours. In response, the Board said it would "attempt to take whatever steps it can to maximize the possibility that the kiosk program will succeed."

Finding One

- The Board concurs with our Finding One and agrees with the part of our Recommendation 1 to continue monitoring alcohol sales at all locations, including kiosks.
- The Board does not address the other part of our Recommendation 1 to "explore other options for testing blood alcohol concentration levels" at the kiosks if the kiosk contract is not terminated. The exploration of other options is important based on (1) anecdotal evidence strongly suggesting that consumers are put off by the breathalyzer test at kiosks and (2) another available testing option was initially proposed by which customers would need only to place a bare forearm on a pad that takes a scan of their skin.

Finding Two

- The Board disagrees that its request for proposals did not enable fair and just competition; the Board focuses its disagreement on the two factors that tipped our analysis to that conclusion. However, while the two mentioned factors did indeed tip our finding as we state, it is important to understand that they did not form the primary basis for our finding. As we discuss in the finding, the Board also did not meet the *Procurement Handbook* requirements that establish the "common standard" to ensure fair and just competition.
- Because the Board disagrees with us, it did not address our Recommendation 2 to ensure that all requests for proposals ensure such fair and just competition and that they include more response time for all interested parties.

Finding Three

- The Board disagrees with our Finding Three that says the Board and the vendor negotiated the final kiosk contract in ways more advantageous to the vendor than necessary. The

Board says we should have looked at the contract as a whole and not just at the provisions we cited in the report. However, the Board's response does not recognize that we did indeed evaluate the contract as a whole and that our report cites only certain "key provisions," as we call them, which we felt were the most problematic.

- Because the Board disagrees that it negotiated the contract more favorably to the vendor than necessary, the Board did not address that particular part of Recommendation 3. On the other hand, the Board did offer a qualified agreement with part of that same recommendation to always include a "termination for convenience" provision in its contracts.
- The Board agrees with Recommendation 4.

Finding Four

- In its response, the Board says its expenses will ultimately be covered "so long as [the vendor] and its bank honor the annual Letter(s) of Credit." If the vendor and the bank refuse, the Board says it will terminate the contract. The Board's response causes no change to our position, which is this: Because the vendor is resisting payment, only time will tell if the Board can actually recoup its losses.
- The Board agreed with our Recommendations 5 and 6 to raise the letter of credit and to seek reimbursement for expenses each fiscal year the kiosk contract is in effect. However, the Board did not address Recommendation #7 to make aggressive modifications to identify poor kiosk performers, analyze the reasons, and relocate such kiosks to underserved and/or more profitable locations as necessary.

Finding Five

- The Board neither agrees nor disagrees with this finding by saying that it is difficult to assess what effect the temporary kiosk shutdown had on customer confidence. On the other hand, the Board agreed that kiosks have not been as successful as hoped and that customer use declined after the shutdown.
- The Board concurs with Recommendation 8 to hold the vendor accountable for making kiosks fully functional. The Board agrees in general with Recommendation 9 by saying it will be vigilant in recouping any costs that the vendor is contractually obligated to reimburse.

Finding Six

- The Board appears to agree in general with this finding by "wholeheartedly" agreeing that the kiosks' success was hindered in part because existing law restricts Sunday openings and because liquor was not added to the kiosks' offerings. The Board does not address the part of our finding that says success was also hindered because kiosks were not placed in underserved areas.
- Regarding the recommendations applicable to this finding, the Board must be even more diligent in its attempts to get the General Assembly to be more business- and consumer-friendly by lifting the Sunday sales restrictions (Recommendation 10) and by agreeing to sell liquor at the kiosks if they remain open (Recommendation 11). Regarding Recommendation 12, the Board need only look at the map on *page xi* of our report to see that kiosks are not placed in areas that would be convenient for underserved customers.

Commonwealth of Pennsylvania
Pennsylvania Liquor Control Board
Harrisburg
17124-0001

PATRICK J. STAPLETON III
CHAIRMAN

August 26, 2011

The Honorable Jack Wagner
Auditor General
229 Finance Building
Harrisburg, PA 17120
VIA E-MAIL: Stephanie_Maurer@auditorgen.state.pa.us

Dear General Wagner:

On behalf of the Pennsylvania Liquor Control Board ("Board"), thank you for this opportunity to respond to your findings and recommendations relating to the wine kiosk program.

We regard the Auditor General's audit to be a thorough and fair-minded governmental audit of this initiative. As you will see in our detailed response, we agree with many of the Auditor General's findings. We have benefited in the past from the Auditor General's assessments of our work, and we will use this audit to help us to do better as well.

We particularly thank the Auditor General's office for its detailed affirmation of our efforts, throughout this initiative, to fulfill our most fundamental mandate – to ensure that the sale of alcoholic beverages is always within the law, to eliminate sales to underage Pennsylvanians, and prohibit sales to intoxicated persons. We appreciate your willingness to note that the kiosks actually enhanced this core function.

But the Auditor General's audit – which by its own admission, focuses on compliance with state laws and procurement regulations – does not look sufficiently at the larger context – a larger context that is essential, in our view, to a fair-minded assessment of this initiative.

Fundamentally, the wine kiosk initiative was about innovation. We aspired – within state law, and within government procurement guidelines – to do something very new, in an effort to provide new convenience to Pennsylvanians, and to generate new revenue for the state General Fund. The wine kiosk initiative was an effort to enable consumers to purchase wines in conjunction with their regular shopping – a major convenience, saving them an extra shopping stop. And it held the potential to increase sales at enhanced margins – generating more moneys for the General Fund.

The problem was that it had never been done before. And that can be a dangerous endeavor for a governmental agency, one that is judged in part by its compliance with bureaucratic procurement requirements. The surest way to make certain that government agencies comply with every bureaucratic procurement provision is to never innovate. Innovation inherently is about doing things that have not been done before. However, doing things that have not been done before carries risk. Taking such risks is a daily endeavor in the business world. But in the world of government, it more often is avoided.

The Board believes Pennsylvanians want it to innovate even if that involves some risk. If we can achieve ways, within the law, to serve Pennsylvania consumers more conveniently, or to generate more money for education or law enforcement or other key government services – Pennsylvanians want us to try. And that's what we did here. Sometimes, this Board must do so even when it is uncomfortable for our own staff. But we see that as one of our core responsibilities – to push for innovation – because that is what our customers want.

But we did not do so recklessly. We included, as the audit acknowledges, key protections to the Commonwealth. A contract is a collection of terms and provisions, and must be judged as a whole. As our response will show, taken as a whole, the provisions we negotiated for the Commonwealth were strong. We reject outright any suggestion that they were negotiated to advantage our vendor. They were negotiated to meet our overarching goals with this project – to move forward where no one had gone before, managing the risks as best we could.

The key to managing those risks is accountability. Our vendor, Simple Brands ("Simple"), has failed in meeting key accountabilities. And the Board has shown, and will continue to show, that it will spare no effort in making certain that Simple is held accountable, and that the Commonwealth is ultimately protected. This outcome does not mean it was wrong for us to try. We learned a great deal from this effort. Future innovation efforts will benefit from this experience. And our contract enables us to recover the costs of that learning. That was and is a risk worth taking.

Auditor General's Finding One

In its wine kiosk initiative, the Liquor Control Board used technology that effectively monitored and controlled the purchase of alcohol.

Auditor General's Recommendation

If it does not terminate the kiosk contract, the Board should continue its effective monitoring and control of alcohol sales at the kiosks but explore other options for testing blood alcohol concentration levels.

RESPONSE:

The Board concurs and appreciates this finding and, as recommended, will continue to monitor alcohol sales at all its locations, including the kiosks.

Auditor General's Finding Two

The Liquor Control Board showed initiative and also followed state procurement requirements by seeking kiosk proposals from interested contractors. But the Board's request for proposals did not enable fair and just competition among the qualified contractors because the request seemed tailored to the vendor who had proposed the kiosk idea in the first place.

Auditor General's Recommendation

The Board should ensure that its requests for proposals ensure fair and just competition, and with adequate response time for all interested parties.

RESPONSE:

The Board concurs with the finding to the extent that it finds that the Board showed initiative and followed state procurement requirements by seeking kiosk proposals from interested contractors. The Board must, however, respectfully disagree with the finding that its request for proposal ("RFP") did not enable fair and just competition.

Initially, the Board appreciates that the Auditor General's office acknowledges that the Board was in a difficult position when, having been approached by a potential vendor with an innovative idea, it attempted to draft an RFP that was specific enough to describe what was being sought (stand-alone kiosks) while being general enough to allow for competing proposals. The Auditor General's office candidly acknowledges that it had a difficult time assessing the Board's efforts on the RFP, but ultimately found that the Board's RFP did not allow for truly competitive bidding. It bases its finding on two facts: the length of time potential vendors were given to submit a proposal and the ultimate contract that was negotiated between Simple – the ultimate vendor – and the Board.

Again, the Board must respectfully disagree with the conclusions drawn from these two facts. As to the length of time potential bidders were given to respond – 45 days – the Board has issued RFPs that have provided both longer and shorter response times. Unfortunately, one of the disadvantages of attempting to be innovative is that there is no precedent to follow for ancillary issues like how much response time to give potential bidders. More telling to the Board is the fact that no one contacted the Board and asked for an extension of time, something the Board would have certainly entertained had it been requested. As to the ultimate contract entered into with Simple, the Board – as will be more fully set forth below – must respectfully disagree that it is as one-sided as the Auditor General's office believes.

Auditor General's Finding Three

The Liquor Control Board and the sole responding vendor negotiated the wine kiosk contract in ways that were more advantageous to the vendor than necessary.

Auditor General's Recommendations

The Board should ensure that it protects the state's interest by not negotiating contract provisions that are more advantageous to the vendor than necessary, and by always including a "termination for convenience" provision.

If it does not terminate the wine kiosk contract, the Board should pay only for advertising space that it actually uses.

RESPONSE:

The basis for this finding is several contract provisions that the Auditor General's office believes are unnecessarily advantageous to Simple:

- The elimination of the phrase "no cost to the Commonwealth/PLCB" from the final contract
- The change in when Simple was to provide fully functional wine kiosks
- Change in the length of the contract
- Elimination of the performance bond requirement
- Elimination of the "termination for convenience" clause
- Change in the audit provisions
- The addition of a transaction fee
- The addition of an advertising fee

The Board certainly understands how the Auditor General's office can, in retrospect, review certain provisions of this or any contract and question whether the Board could have negotiated better terms on individual provisions. The Board respectfully suggests that the better approach is to view the contract as a whole, since it is the contract as a whole that was entered into. Acquiring advantages for the Commonwealth under certain sections of the contract, and under the contract as a whole, sometimes required concessions by the Board in other areas.

In this case, the Board acquired the use of up to 100 kiosks for ten years. The Board did not have to pay anything for the use of the kiosks even though Simple has indicated that it has spent approximately fourteen million dollars to create and maintain them. In addition, Simple agreed to compensate the Board for more than two million dollars a year, for each of the ten years of the contract, if the Board's expenses in operating the wine kiosks exceeded its revenue. Subsequently, the Board agreed to pay a small fee for advertising and to forward a transaction fee charged to consumers. Respectfully, it is hard to view the contract terms as a whole as advantageous to Simple.

As to the specific points raised by the Auditor General's office, while it is true that the phrase "at no cost to the Commonwealth/PLCB" was removed from the final contract language, that does not alter the fact that Simple was to provide, and in fact did provide, wine kiosks at no cost to the Board. Respectfully, absent a change in the contract which required the Board to pay for the kiosks, the omission of the phrase "at no cost to the Commonwealth/PLCB" is immaterial. Indeed, it is important to also note that the final contract does specifically require Simple to provide services at no cost to the Board such as: bearing "any and all costs associated with [...] improvements, upgrades, enhancements or other features"; providing "any and all maintenance services related to each wine kiosk, at no cost" to the Board; and paying "to the [Board] any losses or costs incurred by the [Board] associated with payment card transactions conducted via the wine kiosks." Therefore, the Board must also respectfully disagree with the Auditor General's office (speculative) concern that the change in language may have affected the number of entities that bid on the RFP.

As to the change in the date of when fully functional wine kiosks were to be provided and the change in the length of the contract, again, one of the disadvantages of attempting to be innovative is the lack of precedent. Further, while it was not the Board's intent to limit the number of bidders to one, the fact that there had only been one bidder meant that the Board could not simply negotiate with another bidder if Simple asked to change a potential term in the contract; rather the Board's options were to either come to terms with Simple or cancel the entire project. Again, respectfully, if one looks at the contract as a whole, it cannot be reasonably interpreted as one-sided on behalf of Simple.

As to the elimination of the performance bond requirement, the Board simply notes that it has attempted to collect on one performance bond in recent history and that effort, initiated by the Board in 2002, is ongoing. Further, Simple's offer to provide a Letter of Credit and the fact that the Board was not paying for the kiosks made it unnecessary to acquire a performance bond.

As to the "termination for convenience" requirement, this was perhaps the most negotiated provision in the contract. Simple had indicated that it could not commit to spending millions of dollars to provide the Board with free (use of its) kiosks if the Board could simply terminate the contract at will. In turn, the Board was concerned that it would be forced to continue with the ancillary costs associated with operating the kiosk program, even if the kiosks did not turn out to be as popular as hoped, unless it could terminate for convenience. Ultimately, Simple offered to compensate the Board for more than two million dollars per year in otherwise uncompensated operating costs, if the Board would eliminate the "termination for convenience" provision from the final contract. This was in addition to providing the kiosks at no cost to the Board. Faced with the option of choosing between abandoning the kiosk program before it started or entering into a contract in which the kiosks would be provided for free and many of the Board's costs would be reimbursed, the Board opted for the latter. Again, respectfully, if one looks at the contract as a whole, it is difficult to view the contract as one-sided on behalf of Simple.

As to the change in the audit provision so that the Board would provide reasonable notice during normal business hours prior to any such audit, it seemed to the Board to be a reasonable accommodation. The Board does not dispute that it is more favorable to Simple than a provision that did not require the Board to provide reasonable notice, but again notes that the contract should be viewed in its entirety.

As to the collection of a transaction fee, the Board does not dispute that it may deter some potential customers from using the kiosk.

As to the addition of an advertising fee, the Board is now, in fact, advertising on the kiosks. While it is true that the fifty cents per bottle fee eliminates some of the profit to the Board, the contract as a whole is not one-sided on behalf of Simple.

Finally, the Board agrees that the "termination for convenience" clause should be in all its contracts, absent extenuating circumstances and that the Board should use all the advertising that it pays for.

Auditor General's Finding Four

Over Two fiscal years, the Liquor Control Board spent $1.12 million more than it took in and has invoiced the vendor for the losses. But the vendor has not paid.

Auditor General's Recommendations

If it does not terminate the kiosk contract, the Board should request that the amount of the annual letter of credit be raised above its current level of $1 million to ensure that the letter of credit is sufficient to cover any operating shortfall.

Immediately after the close of each coming fiscal year in which the Board stays in the kiosk business, the Board should continue to enforce the contract provision permitting it to seek reimbursement from the vendor for operating shortfalls.

If it does not terminate the kiosk contract, the Board must make aggressive modifications to identify poor performers, analyze the reasons, and relocate such kiosks to underserved and/or more profitable locations as necessary.

RESPONSE:

Respectfully, so long as Simple and its bank honor the annual Letter(s) of Credit, the Board's expenses will ultimately be covered. Specifically, as the Auditor General's report notes the $1.2

million constitute expenses covering two separate fiscal years. Specifically, the Board's actual operating expenses exceeded the Board's gross profits for the 2009-2010 Fiscal Year, (which ended on June 30, 2010) in the amount of two hundred seventy-nine thousand nine hundred-fifty four dollars ($279,954.00). The Board's actual operating expenses exceeded the Board's gross profits for the 2010-2011 Fiscal Year, (which ended on June 30, 2011) in the amount of eight hundred forty-three thousand three hundred-sixty nine dollars ($843,369.00). Simple has refused to pay the shortfall for fiscal year 2009-2010, and therefore the Board has made a claim against the one million dollar letter of credit.

In addition, the Board has made a claim for $843,369.00, for the 2010-2011 Fiscal Year. In that same demand for payment, the Board also requested twenty four thousand eight hundred seventy-seven dollars ($24,877) for additional losses from the 2009-2010 Fiscal Year not included in the prior demand for payment. Once payment is received for the 2009-2010 Fiscal Year claim, section 17(B) of the contract requires Simple to immediately reset the Letter of Credit to the amount of one million dollars ($1,000,000.00). As a result, there will then be sufficient funds in the Letter of Credit to fully cover the 2010-2011 Fiscal Year claim.

If Simple and/or its bank refuse to honor these claims or Simple refuses to reset the Letter of Credit, then Simple will be in breach of the contract and the contract will be terminated.

The Board intends to request that the Letter of Credit be raised as permitted under the contract and to aggressively seek reimbursement for expenses for each fiscal year the contract is in effect.

Auditor General's Finding Five

Despite shutting the kiosks down for over a month to repair them after nearly 1,000 errors occurred, the Liquor Control Board and the kiosk vendor lost credibility and customer confidence when malfunctions continued after the kiosk reopened.

Auditor General's Recommendations

If it does not terminate the kiosk contract, the Board must be even more aggressive in holding Simple Brands accountable for ensuring that all the kiosks are fully functional and fully operational at all times. Such action requires the Board to constantly monitor the machines to readily identify all malfunctions and to remedy them immediately upon identification.

If it does not terminate the kiosk contract, the Board should account for LCB personnel costs related to the kiosks, not only for the malfunctions – including the costs of personnel who test presumably repaired kiosks and, those personnel who staff kiosks that reopen after a malfunction – but also *for the kiosks in general, including kiosk decision-making and contract negotiations.*

RESPONSE:

While it is hard to assess the effect the temporary shutdown of the kiosks had on customer confidence, it is clear that the kiosks have not been as successful as hoped and that customer use declined after the kiosk went back into operation.

The Board will be vigilant in both holding Simple accountable for breakdowns of individual kiosks and in recouping any costs that Simple is contractually obligated to reimburse.

Auditor General's Finding Six

The Liquor Control Board promoted its kiosk as being convenient but overstated that convenience by not offering Sunday sales and expanded hours, by not placing any kiosks in underserved areas, and by not adding liquor to the product offerings.

Auditor General's Recommendations

The Board should work with the General Assembly to pass legislation permitting all brick and mortar stores to be open seven days a week, 9:00 a.m. until at least 9:00 p.m., and all kiosks until at least midnight if the Board does not terminate the kiosk contract and if the stores that house the kiosks are open during those same hours.

If it does not terminate the kiosk contract, the Board should offer liquor as an option, as well as more local wines.

If it does not terminate the kiosk contract, the Board should re-evaluate its questionable decision to place kiosks so close to brick and mortar stores and, instead, extend the reach of the kiosks into rural and other underserved areas.

RESPONSE:

The Board wholeheartedly agrees that the success of the wine kiosk program was hindered in part by the fact that the Board is statutorily precluded from opening more than 25% of its stores (including kiosks) on Sundays and then only for a few hours. In fact, the Board drafted legislation that would have allowed the kiosks to be open on Sundays and that language was part of Senate Bill 81 which was passed by both the House and the Senate during the 2009-2010 legislative session. Unfortunately, the Governor vetoed the legislation for reasons unrelated to the kiosk language.

As to offering liquor in the wine kiosks, the Board had approved a pilot program to test the viability of such offerings; however, the Board decided against pursuing the pilot program after the Republican and Democratic Chairmen of the Senate Law and Justice Committee (the Board's oversight committee in the Senate) issued a joint press release (on April 27, 2011) in opposition to the pilot program.

As to the placement of the kiosks, the Board continues to attempt to find locations that optimize their use by the public.

Overall Audit Conclusion

Pennsylvania's wine kiosks used technology that effectively monitored and controlled the sale of alcohol, this helping the Liquor Control Board meet its primary mandate to ensure public safety, health, and welfare. But the kiosk initiative has failed in its goals to provide greater customer convenience, availability in underserved areas, lower LCB costs, and higher LCB profitability. ***The Board should therefore take immediate steps to terminate wine kiosk operations unless and until it can modify them to reach kiosk-specific goals while still meeting its primary mandate.***

RESPONSE:

Respectfully, the Board entered into a contract with Simple, and must honor that contract unless Simple breaches it or the parties mutually agree to terminate the contract. The Board can however, require Simple to scrupulously honor its commitments to the Board and the Commonwealth.

Overall Observation

In attempting to provide greater customer convenience, ***the Liquor Control Board was hindered not because of the wine kiosk initiative or because alcohol sales are state-controlled*** *but because (1) state law limits the number of Sunday openings at stores, including kiosks, and (2) many stores have limited days and hours during the rest of the week. Thus, to provide the greatest customer convenience, to enable increased sales, and to continue its effective performance in selling alcohol responsibly, the Board should take the steps necessary to establish uniform hours 7 days a week from 9 a.m. until at least 9 p.m. at all stores – and until midnight at the kiosks if the Board does not terminate that contract.*

RESPONSE:

The Board appreciates the Auditor General's Office's acknowledgement that the kiosk program was hindered by state law. As it has done throughout this process, the Board will attempt to take whatever steps it can to maximize the possibility that the kiosk program will succeed.

On behalf of the Board, thank you again for this opportunity to respond to your special performance audit. I hope that these responses will give your office a more thorough understanding of the wine kiosk program, the underlying contract and the steps the Board has taken to help it succeed while at the same time honoring its obligation to the Commonwealth and its citizens.

Very truly yours,

PATRICK J. STAPLETON III
CHAIRMAN

cc: T. Goldsmith, Member
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