House Bill 71
Testimony Before House Ways and Means Committee

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Chairman Schaffer, Vice-chairman Lipps, Ranking Member Rogers and members of the committee, thank you for the opportunity to present testimony on House Bill 71.

The Keilson Dayton Company has been in business for more than 100 years, and I am the third generation owner of the company. We have 51 employees between our main warehouse in Dayton and our Columbus location. We are a supplier of foods, bottled drinks [non-alcoholic], paper products and cigarettes/tobacco to convenience stores and similar retailers in Ohio. It's not an easy business. We are constantly challenged by manufacturer contract terms to be a supplier, our customer needs and other wholesalers who are in-state and out-of-state and who want to take retail accounts from our business.

Ohio and 25 other states utilize a minimum markup law on cigarettes to prevent predatory pricing practices on the sale of cigarettes. Ohio's minimum markup law dates back to the 1940s with just a few changes since then. As with many older laws, from time to time changes in behavior and trade actions in the marketplace require updating or clarifying sections to preserve the law's original intent.

I do find it ironic that I am here today testifying for the need to make changes to preserve the original intent of a law that my late grandfather, Gregg H. Wellinghoff, helped to implement more than 70 years ago when he worked for the Keilson family. Changes in this industry and trade practices dictate that this law needs updates, this time to address gray areas that are loopholes to get around the original intent of the law.

When the law was originally written, wholesalers purchased cigarettes from manufacturers, applied the tax stamp and then sold the cigarettes directly to retailers. There was no reason for the law to address how the mark-up would apply to sales of cigarettes between wholesalers because by the nature of the distribution channel at that time, wholesalers were not selling cigarettes to each other. However, over the past 20 or so years, new wholesalers who can not buy directly from major cigarette manufacturers have become established businesses by buying already tax paid cigarettes from wholesalers who buy directly from the manufacturer. These new wholesalers often serve niches of the market that may be unserved or underserved by wholesalers today. As these are new businesses, they create new jobs and it often does work well for all of us in this business when the intent of the minimum mark-up law is respected.

House Bill 71 takes the long overdue step of recognizing sales between wholesalers for purposes of the mark-up. Specifically, it puts into law an information release issued by the Tax Department that says in sales between wholesalers, the first wholesaler does not have to apply the mark-up but the later wholesaler [secondary wholesaler] does have to apply the mark-up before selling to retailers. This is consistent with how many of these arrangements were already dealing with the mark-up without the Department's guidance and it's also consistent with how some other states have addressed wholesale to wholesale in their laws.

Following up on that, it's important that in the "cost to the wholesaler" definition, the reference to "invoice" clearly says "manufacturer gross invoice". This is the base on which the wholesale mark-up is applied and it's important for the intent of the law that it be clear. It was understood to be the

manufacturer invoice when the law was originally written and wholesalers only sold to retailers but, as I already explained, now there are sales between wholesalers.

Because the law doesn't specifically say "manufacturer gross" invoice, secondary wholesalers have a loophole that can be exploited to bypass applying the mark-up to the manufacturer gross invoice, by instead applying it to the invoice cost from the wholesaler from whom they buy the cigarettes. Despite the historical understanding of "invoice" being manufacturer gross invoice, the Tax Department for enforcement purposes errs on the side of the specific words not being in current law, thereby creating a loophole for wholesalers to completely get around the minimum markup law.

Example:

Wholesaler A buys a major brand of cigarettes **from the manufacturer**

- Manufacturer's gross invoice cost to the wholesaler is $48.64/carton
- Manufacturer provides a discount of 2% to the wholesaler if the wholesaler is in compliance with the various programs the manufacturer offers.
- Manufacturer provides the wholesaler with an additional 31 cents/carton at the end of any quarter in which the wholesaler assisted the manufacturer with various promotional activity as determined by the manufacturer and changed from time to time.
- State of Ohio cigarette tax on a carton of cigarettes is $16/carton.

Wholesaler A has to apply the minimum markup of 3.5% to the manufacturer's invoice cost before selling this product to retail. 3.5% x 48.64 = $1.71 mark-up.

The lowest price Wholesaler A can sell to retail is $66.35
48.64 (mfg invoice) + 1.71 (mark-up) + 16 (excise tax) = $66.35

If Wholesaler A decides to sell to Wholesaler B, consistent with the Tax Department information release being codified in HB 71, Wholesaler A can sell to B at any price and Wholesaler B has to apply the markup before selling to retail.

Wholesaler A decides to sell to Wholesaler B at Wholesaler A's net cost of $63.36
Net cost = $48.64 – (2% mfg discount x 48.64) + $16 tax - .31 mfg quarterly = 63.36

Because the law is not clear that "invoice" is the manufacturer invoice, **Wholesaler B** applies the markup to the invoice from Wholesaler A and **sells to retail at $65.02.**
63.36/invoice from Wholesaler A – $16 tax = 47.36 x/+ 3.5% = 1.66 markup + 63.36 = 65.02

By applying the mark-up to the invoice from Wholesaler A instead of applying it to the intended and historically understood manufacturer invoice, Wholesaler B price circumvents the mark-up law and undercuts any other wholesaler who is buying from the manufacturer.

Unfortunately, the potential for abuse of this loophole does not stop with the example above. Wholesaler A may even form a subsidiary, call this Wholesaler C. Wholesaler A can then sell to Wholesaler C at any price, including at a loss, and Wholesaler C can use that below cost price from Wholesaler A as the base when calculating the mark-up to retail. With cigarette sales being more than 70% of a typical wholesalers sales and the top moving item in c-stores, this predatory pricing practice can be lucrative for Wholesaler A and C because it would be driving business away from other wholesalers. Adding the clarifying language that requires all wholesalers to use the manufacturer gross invoice cost as the starting point for calculating the cigarette markup closes this loophole.

There are legal ways that a wholesaler can use a markup that is less than the 3.5% wholesale markup stated in the law. The 3.5% is presumed to be the wholesaler's costs. If a wholesaler can show the Tax Department that their cost of doing business is less than 3.5%, then that wholesaler can use the lower markup. Twice in the past two years, wholesalers have presented cost studies to the Department

detailing lower costs of doing business and their lower mark-up, based on their lower costs of doing business, were approved by the Department and notifications were issued to the industry. As a result, those wholesalers can offer to sell cigarettes to retailers using the approved lower markup. At the same time, other wholesalers like my company can meet those competitors' lower prices without violating the law.

That said, the practice of meeting a competitor's price is abused frequently in the current market environment.

Example: Today Wholesaler A can lodge a complaint with the Tax Department against Wholesaler B for selling below markup. When the Department contacts Wholesaler B to investigate the complaint, Wholesaler B says they were simply meeting the price of Wholesaler C and provides a written statement to that effect. At that point, the case is closed in the eyes of the Department because the law does not clearly state that the competitor price has to be a legal price [ie. following the statutory 3.5% or if it's a lessor mark-up, the lessor mark-up has been approved by the department]. This is frustrating for wholesalers and the Department which is why the clarifications are in House Bill 71.

Updating the law to make it clear that wholesalers can meet a competitor's "legal" price would ensure that any wholesaler lowering their price under the guise of meeting competition can only meet a legal price. This will help the Department to more effectively follow-up on complaints of unfair trade practices and make the intent of the law clear for wholesalers.

Mr. Chairman and members of the committee, I hope this helps you understand the need for these few changes to the cigarette minimum markup law. I welcome any questions or further discussion any of you may wish to have on this issue.