HAWAII DISPENSARY ALLIANCE

HAWAI'I'S CANNABIS OLIGOPOLY

Hawai'i's Medical Cannabis Program is failing patients. Vertical integration and a lack of administrative direction have created a state-sponsored oligopoly. The system addresses the short-term business interests of the current eight dispensary licensees over the needs of the 18,619 patients that the program is intended to serve. A comparison to New York's dispensary program makes clear that removing Hawai'i's oligopoly is necessary. Only a switch to a horizontal program and the introduction of new licenses will provide an opportunity for the Hawai'i state government to work with the emerging cannabis industry to foster a medical cannabis *economy* that actually helps patients.

By Garrett Halydier & Kevin Whitton

In a state with 20 million people, New York's medical cannabis program was on the brink of failure due to over-regulation and extremely low patient participation. In August 2017, New York took legislative steps to address its challenges by expanding its industry. Hawai'i must do the same or its struggling program will continue to fail patients.

The State of Hawai'i Department of Health's (DOH) Medical Cannabis Program is failing patients. The causes are no mystery—a hastily created, vertically integrated industry and a lack of leadership at all levels of government. Governor Ige's lack of interest and long-term vision last legislative session continues to result in half-hearted legislation that extends the Medical Cannabis Dispensary Program's current inequities. Without support from the Governor's office, most legislators refuse to consider any progressive, or even common sense, cannabis legislation, effectively stalling industry growth. DOH's Dispensary Program is underfunded and understaffed, rendering the program under-committed with no sense of urgency or accountability, even as it creates excessive administrative regulations and regularly fails to hit critical program deadlines. For dispensary owners and patients, opportunity and hope have been supplanted by feelings of frustration.

What will become of Hawai'i's legitimate cannabis industry if we continue to enable a state-sponsored program of limited players, over-regulation, and no accountability? How long will the state-mandated oligopoly remain in place, continuing to stifle Hawai'i's legitimate cannabis *economy*? Will progressive legislators raise their voices against the status quo celebration of mediocrity?

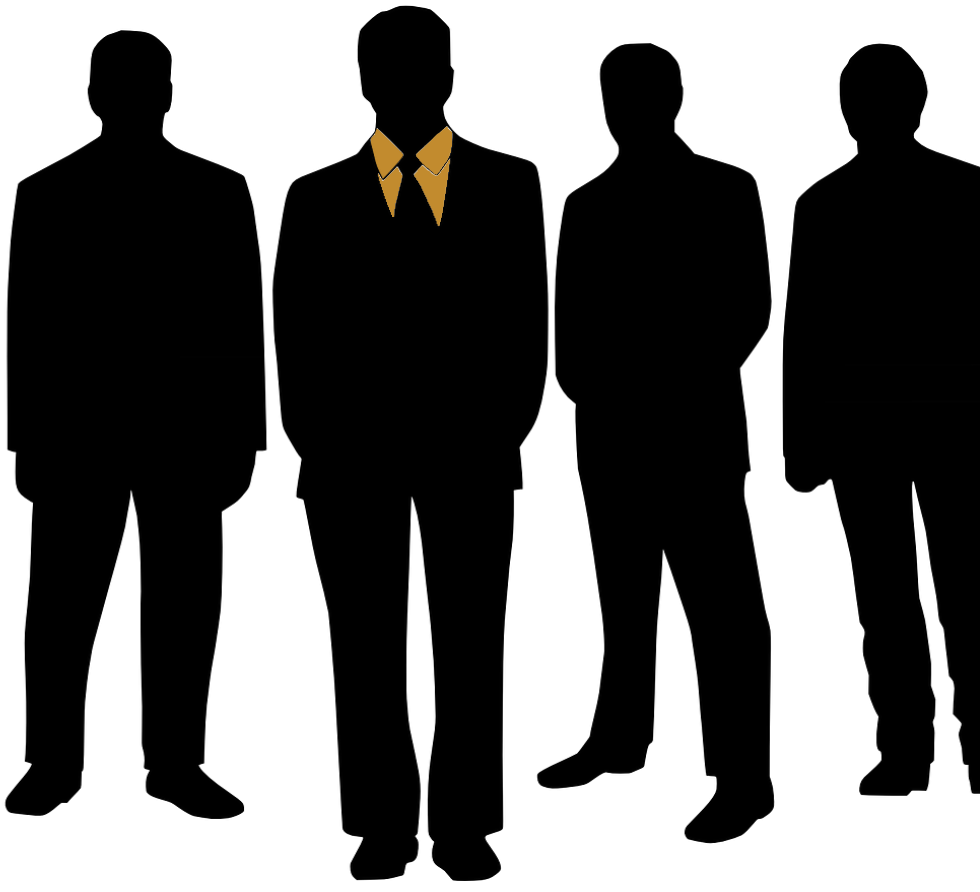
According to Representative Della Au Belatti at the August Act 230 Medical Cannabis Legislative Oversight Working Group meeting, Hawai'i should compare itself to New York's medical cannabis program, a program similar to Hawai'i's in scope and structure, to illuminate the risks and potential futures for Hawai'i. This article makes that comparison.

PATH TO A PROGRAM

In the year 2000, Hawai'i became the first state to legalize medical cannabis through the state legislature. Act 228 SLH 2000 created a medical cannabis registry program that allowed medical cannabis cardholders to grow their own cannabis or have a caretaker grow for them. The original law came at the tail end of a period of progressive innovation in the Hawai'i State Legislature. Optimism was in the air and decriminalization in Hawai'i seemed to be right around the corner. Unfortunately, a feeling of

OLIGOPOLY

A STATE OF LIMITED COMPETITION, IN WHICH A MARKET IS SHARED BY A SMALL NUMBER OF PRODUCERS OR SELLERS.



optimism is where the progress ended. The fledgling Medical Cannabis Registry Program was placed in the State of Hawai'i Department of Public Safety, where it sat latent for the next 15 years.

Hawai'i legislators finally took decisive action on 15 years of annually introduced medical cannabis legislation in 2015. This time, the goal was to move the Registry Program from the Department of Public Safety to the Department of Health to create a more patient-centric program and to concurrently establish the Medical Cannabis Dispensary Program to provide patients with safe and reliable access to medicine.

With the federal government unwilling to reverse a discriminatory, nearly century-old prohibition on cannabis, 29 states and the District of Columbia have passed medical cannabis legislation to provide legal protections for patients to use cannabis as medicine. California, Nevada, Oregon and Washington chose to implement progressive, horizontal programs out of the gate, creating sustainable, patient-centric industries. These horizontal programs award separate licenses to growers, manufacturers and retailers, or dispensary owners. Meanwhile, Colorado, Maine, New Mexico, Delaware, Massachusetts, Connecticut, Arizona, Rhode Island, Minnesota, New Hampshire, New Jersey, New York, and Hawai'i took a conservative approach to cannabis policy and implemented vertically integrated dispensary systems.

A vertically integrated system requires each dispensary owner to also own the grow and manufacturing facilities, and disallows most commerce between dispensary companies. These states continue to discover that this single, poor-policy decision produces ineffectual oligopolies mired with logistical problems. Colorado and Maine have since recognized that their legislation was killing the very industries they sought to create, and they transitioned to progressive and inclusive horizontal programs.

It is well documented by mainland industry and economics experts that an economically successful medical cannabis program best serves patients by operating via a horizontal licensing structure and by issuing a greater number of licenses. A horizontally integrated licensing structure allows for separate licenses to be issued for production, manufacturing, and retail operations. A robust dispensary program also has enough licensees to promote healthy market competition, driving down prices for patients and increasing the quality and diversity of avail-

Since the passage of Act 241, marked ambivalence and lack of administrative and legislative leadership continue to plague Hawai'i's dispensary program, hindering its development and ability to serve patients.

able medicine. Issuing enough licenses to ensure a healthy geographic distribution of retail outlets also ensures ample access to medicine.

Together, these requirements spell the difference between a successful medical cannabis program and a program that fails the patients, the dispensaries, and the state itself. Hawai'i has chosen a vertical system and it will follow the same path as other vertically integrated states, like New York. Hawai'i does not want to see its current dispensaries fail, but for its own sake, the state needs a greater number of licensees for the dispensary program to succeed.

VERTICAL INTEGRATION IS BAD POLICY

Vertical integration of an emerging cannabis market is one of the causes of dispensary failure, as shown by New York's struggling medical cannabis program. The New York State Medical Marijuana Program went into effect in 2014, with many of the same regulations set forth in Hawai'i's 2015 Dispensary Program, and has since been ineffectual for patients and dispensaries alike (one of its five dispensaries has already shut its doors). Comparing the markets, progress, and legislation of both states will reveal what could happen if Hawai'i's Dispensary Program remains vertically integrated.

When New York legislators drafted medical cannabis legislation in 2014, they placed an importance on public safety over public health. In other words, program regulations, often extremely restrictive and unreasonable, were deemed more important than a progressive, patient-centric structure with ample access protections for patients. Based on New York's experience, the choice of a vertical versus a horizontal dispensary system significantly impacts three elements critical to the success of a medical cannabis dispensary program: the economic sustainability of the program, affordable prices for patients, and a diverse product selection for patients.

VERTICAL INTEGRATION IS BAD ECONOMICS

New York's vertically integrated system of manufacturing licenses is the hallmark of its original program structure. Vertically integrated programs like this notoriously limit the number of dispensary licenses and effectively enshrine an oligopoly. New York's law only allowed for five manufacturer licenses. Each licensee was limited to operating one cultivation facility and four dispensaries, or retail outlets.

Similarly, as part of Act 241, Hawai'i established a vertically integrated licensing system and awarded eight licenses in the spring of 2016. Each licensee is responsible for the entire operation from seed to sale, and initially, each licensee was allowed two retail outlets and two production centers in the same county. Now, each licensee can open three dispensary retail outlets. The law calls for one licensee on Kaua'i, three on O'ahu, two on Maui, and two on the Big Island. Across the state, the lack of licenses and market competition amounts to a state-sponsored oligopoly, and in each county, even more restrictive market dynamics are at play. Factor in the restrictions on the transportation of medical cannabis between counties, and the oligopoly is, in essence, a monopoly on Kaua'i, a duopoly on Maui and Hawai'i Island, and a triopoly on O'ahu.

A vertically integrated system creates a precarious business climate favoring front-loaded investments and wealthy investors. In a vertically integrated system, license holders must come to the table with ample capital to establish the infrastructure for all of the very different divisions of their businesses—agriculture, manufacturing, and retail—staff these divisions, and weather extensive periods of

financial loss. A *MarketWatch* story published in January 2016 estimated that New York dispensary owners will be on the hook for $15 million to $30 million in total capital and operating costs in the first year alone. Yet in California, where dispensaries are not required to manufacture their own cannabis, legal dispensary owners spend between $30,000 and $500,000 to open a cannabis dispensary, a considerable cost savings.

Meanwhile, Hawai'i dispensary license applicants were required to show proof of liquid assets totaling $1.2 million, and they had to hold that money for 90 days before the application deadline. This was done in hopes of attracting vetted and knowledgeable industry players. However, the vertically integrated license requirements had the opposite effect and placed control of Hawai'i dispensaries into the hands of an elite few who lacked significant industry experience and who are now pushing the legislature hard to maintain the state-sponsored oligopoly, serving their own financial interests over those of their patients as they try to recoup their losses to date.

New York patients and industry players are seeing the shortcomings of vertical integration and a limited number of dispensaries first hand. In March 2015, a *Forbes* article stated that, "[New York's] program is designed to be a money losing proposition—much like New Jersey's program." The two main reasons: limited locations and a restricted patient population. The exact same scenario is playing out in Hawai'i. "Our company is not close to break-even yet," said Ari Hoffnung, president of New York dispensary Vireo Health in a March 2017 interview with *Buffalo News*. "And based on my understanding, no one has made a dime here in New York. Twenty percent of us have already failed."

Hawai'i dispensary owners

Hawai'i's vertically integrated medical cannabis program placed control of Hawai'i dispensaries into the hands of an elite few who push hard to maintain the state-sponsored oligopoly, serving their own financial interests over those of their patients.

have been tight-lipped about the extent of their losses to date, but we do know that Hawai'i's licensees took longer than anticipated by the legislature to find appropriate real estate and build out their production facilities and retail outlets. Today, most of the dispensary owners in Hawai'i are staring down two years of losses without a single sale. Some are losing over $100,000 a month.

With unrealistic obligations for owners and next to no opportunity for a diverse industry with many players, vertical integration, and the oligopoly it created, will ultimately lead to economic stagnation and industry failure. New York has already lost one of five dispensaries that could not keep up with its losses and Hawai'i has already seen a number of its dispensaries change hands or significantly modify their ownership structures since obtaining a license.

In an industry that is touted for job creation across the country, bringing in three dollars in state economic benefits for every dollar spent in a dispensary, Hawai'i's program structure is having the opposite effect. In essence, through this limited, vertically integrated system, the legislature declined to introduce the potential for thousands of new jobs in Hawai'i in the fields of agriculture, technology, medicine, and related industries that would benefit from servicing a robust medical cannabis *economy*.

VERTICAL INTEGRATION IS BAD FOR PATIENT AFFORDABILITY

All of the costs for dispensary owners in a vertical market translate to higher retail prices for patients at the dispensaries. In New York, the State Department of Health must approve product prices for each dispensary, essentially price-fixing the market. This state-sponsored oligopoly removes any competition from the marketplace, but it does have an upside. If implemented properly, price controls can keep the price of medicine at current market levels and provide patients with an effective alternative to the black market. At the same time, if prices are set too high, there remains the almost certain potential for

A lack of cultivar diversity, combined with high dispensary retail prices, will turn patients away from dispensaries in Hawai'i, just as it did in New York.

patients to continue to embrace the black market for medicine.

In Hawai'i, however, there are no controls to potentially keep prices low. The dispensaries will charge what they feel is necessary to recoup their extensive investment costs in an expensive, vertically integrated system, at the expense of the patients. In fact, recently reported prices at Hawai'i's open dispensaries range from $30 to $50 per eighth of an ounce of flower *higher* than current black-market prices. Without sufficient competition in each county to push prices down, prices will remain at double or triple the black-market prices as dispensary doors continue to open. Patients in Hawai'i will find little value in spending more money for a similar medicine they can already access. Just like in New York, where most patients visited a dispensary once and never went back due to high prices, if Hawai'i's patients do not find value at a dispensary, they will continue to use the black market for their medicine and Hawai'i's dispensaries will suffer.

Patients are the cornerstone of any medical cannabis program. They provide the demand that fuels the medical cannabis *economy*. The more registered patients, the more dispensaries and retail outlets that are needed, and in turn, the more robust the medical cannabis program. Small patient populations plague New York and Hawai'i (even with Hawai'i's broad list of qualifying conditions and 17-year-old program). For almost 20 million people in New York, there are only 24,555 patients, about 0.12 percent of the population. States with healthy medical cannabis industries show at bare minimum 1.60 percent of the total population are registered patients. California and Maine show about 3.83 percent of the population are patients.

Hawai'i has 18,619 registered patients, only 1.26 percent of the population. There are thousands of patients waiting to see if the Dispensary Program will meet their needs before they register. There is great potential for an increasing patient population in Hawai'i, but that number will rise very slowly if the current, vertically structured Dispensary Program continues.

Hawai'i patients have been very vocal about the extremely high prices and lack of quality and diversity at the dispensaries. Many patients are treating their visit to the dispensary as a novelty experience, one they will not repeat because they either cannot afford to, or they can source higher quality product from the black market.

VERTICAL INTEGRATION IS BAD FOR PRODUCT DIVERSITY

In a patient-centric dispensary program, dispensaries offer a wide range of cannabis available in different forms to cater to a wide variety of patients' medical needs. Cannabis can be smoked, eaten, vaporized and applied topically. Dispensaries should be able to offer flowers for smoking, oils for vaporizing, extractions for tinctures and salves, and edibles for eating. This allows patients to find the proper methods of ingestion and dosage amounts for their specific ailment. Since people respond differently to the varying chemical compositions of cannabis cultivars, a diverse assortment of THC/CBD profiles is imperative for a program to meet the needs of all of its patients most effectively.

For vertically integrated dispensary owners, extraction and other manufacturing equipment is a huge capital expenditure, adding to the exorbitant up-front costs of operating a dispensary and grow operation. This high cost discourages vertically integrated dispensaries from investing in diverse product delivery manufacturing methods, at the expense of medical diversity for patients.

Unfortunately for New York patients, in addition to the economic restraints on product diversity of

a vertically integrated system, the state only allows the sale of cannabis extracts. That means there is no flower for smoking and no edibles. Only oils for vaporizing, and tinctures and salves, are available for patients. This is one possible reason for New York's consistently low patient participation in the dispensary program. New York has another regulation on the books that only allows dispensaries to carry five brands, or THC/CBD profiles, which limits the potential for patients to find the right THC/CBD profile to treat their symptoms.

In Hawai'i, vertical integration resulted in restrictive product diversity even more directly. While New York restricted its dispensaries to only five cultivars—Hawai'i has no such restriction—yet the two open dispensaries in Hawai'i opened with only six cultivars of dried flower. There are over 2,000 cultivars of cannabis, and each has a unique THC/CBD profile that can alleviate specific symptoms. Dispensaries in states with truly patient-centric programs, like Washington and Oregon, carry hundreds of cannabis products, sourced from many growers and vendors. That level of diversity allows patients to research and find THC/CBD profiles that best alleviate their particular symptoms. Six cultivars out of a possible 2,000 is not sufficient diversity and cannot effectively serve the majority of Hawai'i's patients.

Offering only one or a few THC/CBD profiles of cannabis will not achieve the desired medical benefits for all patients. This lack of product diversity, combined with high dispensary retail prices, will turn patients away from dispensaries in Hawai'i, just as it did in New York. Patients will ultimately seek out the black market to acquire the proper cultivars to treat their illness. As recently seen on the West Coast, the black market continues to thrive alongside the legitimate market, and Hawai'i's dispensaries will need to actively entice patients away from illicit providers. If the current structure of the Dispensary Program continues to force the dispensaries to offer just a few products, priced two- to three-times higher than current "street values," the dispensaries will become their own worst enemy.

LEGISLATIVE DEVOTION TO VERTICAL INTEGRATION IS COUNTERPRODUCTIVE

In a state where Democrats dominate government, one would think that the Hawai'i State Legislature would create and adopt progressive and liberal medical cannabis legislation. Full legalization is even a part of Hawai'i's Democratic Party Platform: "We support legalization and regulation of marijuana and other cannabis derivatives."

Initially, in the original 2015 bill, the legislature did make every effort to create a progressive program, including language for a horizontally integrated dispensary license system, a minimum of 26 licenses, and a greater number of qualifying conditions. Unfortunately, that progress was thwarted by 11th-hour

At the beginning of the 2016–2017 legislative session, Governor Ige announced publicly that he would not look at any legislation pertaining to cannabis. In addition, DOH refuses to conduct activities to bring public awareness to the program.

changes to previously crafted "good policy." Behind closed doors, legislators replaced the proposed legislation with a vertically integrated system, only eight licenses, and fewer qualifying conditions. Since the passage of Act 241, marked ambivalence, lack of administrative and legislative leadership, and blind devotion to a vertically integrated system continue to plague the development of Hawai'i's dispensary program.

Recognizing the dangers of its small, vertically integrated system, New York's health department announced on August 2, 2017, that it doubled the number of dispensaries from five to ten licensees—at least initiating the process of expanding the industry. This was done even though three current dispensary owners in New York have lawsuits pending to prevent the additional licenses from being issued.

Unlike New York's attempts to rectify its program's roadblocks, the Hawai'i Dispensary Program suffers from a lack of executive leadership and support from Governor Ige and the Department of Health. At the beginning of the 2016–2017 legislative session, the Governor announced publicly that he would not look at any legislation pertaining to cannabis. Instead of leading legislators to a progressive and successful program, he put a literal freeze on the development of legislation to improve the program.

Taking the lead from their executive, DOH also took a wait-and-see approach towards the program. Plagued by slow hiring, underfunding, and a lack of leadership, DOH is over a year behind in meeting statutory requirements to facilitate the opening of Hawai'i's dispensary system. DOH has also refused to conduct activities to bring public awareness to the program.

The vertically integrated nature of the system is another key reason for DOH's reticence to act. In Hawai'i, the Dispensary Program generates revenue from licensee applications and renewal fees. It is obvious that more licenses provide the higher revenue necessary to administer the program. To make up for the low number of licenses and the income generated from them, New York and Hawai'i have some of the highest licensing fees in the industry. New York levies a $200,000 refundable application fee and a non-refundable $10,000 fee. Hawai'i has a $5,000 application fee, a $75,000 licensing fee, and a $50,000 annual renewal fee, which the dispensaries had to pay in 2017, even though they were not yet open. By making only a few licenses available, these state agencies are simultaneously undercutting their own program budgets.

Due to these budget constraints, Hawai'i's Dispensary Program is habitually understaffed and unable to hold the industry accountable. The Dispensary Program in DOH is supposed to have five full-time staff, but those positions have variously remained vacant since the inception of the program two years ago.

This lack of staffing contributed to the Dispensary Program's decision in 2017 to waive the audit requirements the licensees were supposed to pass prior to their first renewals. Without annual audits, there is no accountability. This contradicts both the legislature's and the Dispensary Program's stated goals of placing patient and public safety first. Further, as DOH's budgets are not met through application and renewal fees, DOH will turn to rule infractions and fines on the licensees to generate additional revenue, increasing medicine costs for patients.

The Governor's ambivalence to the Dispensary Program are echoed by the legislature as well. In the 2017 session, the Health Committees refused to consider the creation of any horizontal licensing scheme and postponed the issuing of any new dispensary licenses for an additional year. After the session, the Chairs of the Act 230 Medical Cannabis Legislative Oversight Working Group told the committee that due to public pressure they would consider the implementation of new licenses. But after several meetings of the Licensing Subcommittee, the Chairs' response to the Subcommittee's discussions cast significant doubt on the Working Group's willingness to even consider recommending either a horizon-

tal system of any sort or the introduction of new licenses in the coming years. With recent leadership shake-ups at the legislature, especially in the House, new legislation to reform Hawai'i's licensing system is very unlikely in the 2018 session.

High prices and low product diversity resulting from a vertically integrated system will prevent medical cannabis in Hawai'i from providing the tax revenue and patient access necessary to combat Hawai'i's budget shortfalls and the opioid crisis. Further, the promise of reciprocity with other state sponsored medical cannabis programs will not save the industry by adding additional patients to the mix to support the dispensaries. There are over eight million visitors to the islands each year, yet the Department of Health has expressed that it will not create a reciprocity program, despite its authorization to do so, until the legislature changes the current rules. By the Governor, Department of Health, and the legislature refusing to act based on the experience of other states, they are actively thwarting their own policy goals and preventing patients from accessing vital medications.

FROM PROGRAM TO ECONOMY

While many qualified business owners stand on the sidelines ready to enter the market via a dispensary license application or through an ancillary business, legislators are making certain they will be sitting out for at least another four years. Through strategic legislation passed during the past two sessions, legislators have purposefully given all market power to the eight dispensary licensees in the state's vertically integrated industry. The industry hears at every Working Group meeting that the legislature's priority is to ensure the current dispensaries recoup their investment. With limited competition written into the law, the patients will be the ones who continue to suffer from the program's shortcomings. Inflated prices for medicine, lack of diversity and quality of medicine, and lack of access to medicine are the antithesis of the legislature's purported patient-centric agenda.

Unfortunately, the prognosis for future industry growth is even worse. As of the publication of this report, only two of Hawai'i's eight dispensary licens-

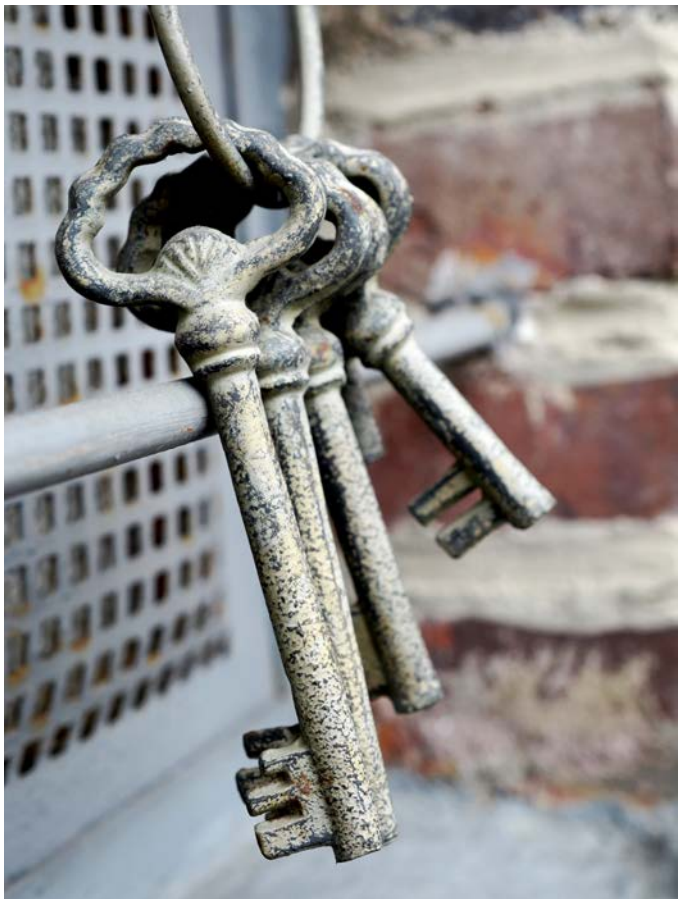
ees have opened a single retail outlet—one on Maui and one on O'ahu—and maybe half of the current dispensaries will open a single location before the end of the year. It is unlikely, even should the legislature authorize the issuance of new licensees to remedy the vertically integrated system, that any newly issued dispensaries could open before 2020.

The future of Hawai'i's Medical Cannabis Dispensary Program and the industry that it could become will continue to look bleak if steps are not taken to loosen regulations and retool the program to honor its initial patient-centric focus. As evidenced by the failure of New York's program, Hawai'i's industry is in dire need of a horizontal structure to allow more licensees to operate in the emerging market.

Breaking up the state-sponsored oligopoly will create sustainable revenue for any state-sponsored dispensary program. It will drive a competitive marketplace with many license holders, where patients will find reasonable prices and a diverse array of high-quality medicine.

As the Hawai'i Dispensary Alliance predicted in its White Paper (published in Spring 2016), Hawai'i legislators, Governor Ige, and dispensary owners are at a fork in the road with the current program and have three options: The industry can devolve into competing fiefdoms controlled by the licensees, where dispensaries have high medicine prices and little potential for industry growth; The industry players can work independently to build a small and insular, yet relatively profitable industry that might never develop due to the chief stakeholders' neglect of the big picture; Or the industry and government can work together to foster and sustain a medical cannabis *economy* that capitalizes on Hawai'i's inherent strengths—agriculture, tourism, research, patient care, and technology—to collaboratively transform Hawai'i.

The Hawai'i Dispensary Alliance urges you to join us in choosing the third option as we work tirelessly to push for a medical cannabis *economy* where industry and government work together to create a flourishing, sustainable, and inclusive patient-centric program.



"States should keep the production and retail sales of marijuana separate to ensure that the industry does not evolve into a group of politically and financially powerful vertically integrated businesses." —Editorial Board, *New York Times*