

**House Liquor Control Committee
November 16, 2016**

**Written Remarks Submitted for the Record
on behalf of the Pennsylvania Liquor Control Board (PLCB)**

**Tim Holden, Board Chairman
Mike Negra, Board Member
Michael Newsome, Board Member**

Chairman Harris, Chairman Costa and members of the House Liquor Control Committee, thank you for the opportunity to offer remarks regarding the implementation of Act 39 of 2016. This is an exciting and dynamic time at the PLCB. We welcome the opportunity to share the progress our agency has made in executing the reforms included in Act 39, discuss where we go from here in the coming months, and answer any questions you may have regarding the agency's implementation of the various components of the Act.

Act 39 made historic reforms to the Pennsylvania Liquor Code and represents the most expansive change to the state's liquor laws since the end of Prohibition. From product procurement and marketing, to wholesale operations and licensing, Act 39 transformed the PLCB and the alcoholic beverage industry in Pennsylvania. With only 60 days to establish the necessary infrastructure and policies, the PLCB immediately set to work to ensure the Act was quickly and successfully implemented.

Given the significant breadth of the Act 39 reforms across the business and regulatory areas of the agency, the PLCB recognized the need for organizational changes to effectively manage resources and align our agency structure with the opportunities provided by the Act. The PLCB established a Program Management Office and contracted with a project manager to track tasks, budgets and progress for each Act 39 deliverable. A new Office of Wholesale Operations was created to manage the new wine-to-go wholesale business. We contracted with a consultant to advise the agency on the development and implementation of pricing policies, and we hired a full-time pricing coordinator to manage and execute pricing strategies and to assist the product selection category managers in supplier negotiations. We hired a consultant to assist the agency with developing its customer relationship management (CRM) program.

LICENSE APPLICATIONS

Before a single bottle of wine could be shipped under the new direct wine shipper license or sold under a wine expanded permit, the PLCB had to create the licensing applications

for all new licenses and permits that the act created. Prior to the bill being signed into law, the PLCB began a transition to an online regulatory and licensing system, known as PLCB+, which allows licensees to apply for permits and licenses 24/7 and has made the application process paperless. The myriad of licensing changes made by Act 39 required technical modifications to PLCB+. The PLCB's Bureau of Licensing coordinated with our vendor, Computronix, to make all the necessary changes before the effective date of the Act without any disruption to current licensing operations.

The agency hit the ground running and, on August 8th, the effective date of the Act, Licensing began accepting applications through PLCB+ for wine expanded permits, direct wine shipper licenses, eating place license conversions, casino liquor licenses, and a number of new permits for Pennsylvania producers. The task then turned to evaluating, investigating and approving all of these new permits and licenses. The efficiencies created by PLCB+ helped to ensure prompt implementation of the licensing provisions of Act 39.

WINE EXPANDED PERMITS / WHOLESALE OPERATIONS

On August 16th, only eight days after the Act became effective, the PLCB approved the first 81 wine expanded permits. About 280 wine expanded permits have been issued to restaurant licensees including, grocery stores, convenience stores, traditional restaurants, and hotels. Additionally, there are another 70 wine expanded permit applications pending, many of which are awaiting RAMP certification of the licensees. On average, Licensing has been able to approve a permit within 7-10 business days after an application is received, although individual circumstances factor into the turnaround time (e.g., date received, whether a licensee has yet to become RAMP-certified, etc.).

The advent of wine-to-go sales by permit holders created a new wine wholesale business for the PLCB. As previously mentioned, the agency established the Office of Wholesale Operations to act as a liaison to this new class of licensed customers. In addition to a director, this office consists of three wholesale business developers who manage the wholesale business accounts and serve as a resource to address the needs of our wholesale customers. In early August, the PLCB started meeting with grocery chains to begin collaboratively planning for wine-to-go sales across Pennsylvania. As a result of these meetings, a pilot program was developed to test and refine processes for forecasting product needs, planning replenishment orders and delivering wine.

Within two weeks of Act 39 becoming effective, a Pittsburgh Giant Eagle began selling wine-to-go as the first pilot store. Pilots with Wegmans, Shoprite, Acme, Giant, Weis, and others have followed. Full roll-out across multiple locations in each chain is currently underway. Of the approximately 280 wine expanded permit holders,

Wholesale Operations is collaboratively working with ⁹⁵~~106~~ grocery stores in Pennsylvania currently selling wine-to-go. Those numbers will significantly increase in the weeks and months ahead as the number of grocery stores rolling out wine sales continue to grow. As of last week, approximately 41,000 cases of wine have been delivered to permit holders.

Planning is the key to success as the PLCB adjusts its product procurement plans to accommodate both our Fine Wine & Good Spirits retail customers and our new class of wholesale customers. The PLCB's Licensee Online Order Portal (LOOP) and the Licensee Delivery Program (LDP), both developed in 2015, are essential to efficiently serving wholesale customers. High-volume licensees submit orders through LOOP, which can be done online 24/7 at the convenience of the licensee. Wholesale customers receive product either by direct delivery from a PLCB distribution center or by designating a Licensee Service Center as the pick-up location.

Partnership and communication with our wholesale wine-to-go customers is critical to delivering on our commitment to customer satisfaction both in Fine Wine & Good Spirits stores and wine-to-go businesses. The PLCB developed a wine-to-go guide and wholesale catalogue, both of which are available on our website, as resources for wholesale customers. These tools help permit holders understand assortment and forecast expectations, and they facilitate planning for both initial pipeline fill and ongoing product replenishment.

DIRECT SHIPMENT OF WINE

Act 39 allows in-state and out-of-state wine producers obtaining a direct wine shipper license to sell and deliver up to 36 cases of any wine per year to a resident's home or business address for his or her personal consumption. The first direct wine shipper license was issued on August 17th and, thus far, more than 670 licenses have been issued. Approximately 70 percent are represented by California wineries, 10 percent are Pennsylvania wineries, and 20 percent are from other states.

Consumers can easily discover if their favorite winery has obtained a direct wine shipper license by reviewing a list of all direct wine shipper licenses on our website, www.lcb.pa.gov.

SUNDAY SALES AND LOTTERY MACHINES

Act 39 allows the PLCB to open as many of our Fine Wine & Good Spirits stores on Sundays as we deem appropriate, and it gave us full discretion over hours of operation. Before Act 39, we could only open 25 percent of our stores on Sundays, and only from

noon to 5 p.m. The PLCB has aggressively moved to enhance consumer convenience through the opening of additional stores on Sundays. Prior to Act 39, we operated 188 stores on Sundays. That number now stands at 323, which represents more than 50 percent of our stores. Further, we have expanded Sunday store hours at those locations to 11 a.m. to 7 p.m. We will assess whether additional locations and expanded hours are necessary in the future, especially during the busy holiday season, to accommodate demand and enhance consumer convenience.

The sale of Pennsylvania Lottery tickets at Fine Wine & Good Spirits stores was also authorized by Act 39. The PLCB acted rapidly to establish the necessary infrastructure to implement this provision. The PLCB began discussions with the Pennsylvania Lottery in 2015 to develop the necessary requirements and procedures in anticipation of legislative authorization to permit lottery sales. Consequently, the PLCB was well-positioned to quickly execute this opportunity. As a result, there are currently 307 Fine Wine & Good Spirits stores with Lottery machines. We may add some additional stores by the end of the year, then engage in further discussions with Lottery regarding a plan for 2017.

AUCTION OF EXPIRED LICENSES

Act 39 of 2016, and subsequently Act 85, provided the PLCB with the authority to auction about 1,200 restaurant licenses that expired or lapsed since the year 2000. Act 85 gave the PLCB the discretion to decide how and when these auctions should be conducted. The first auction was publicly announced in September. This initial license auction was conducted through a sealed bid process, for the sake of expediency through a long-established process, and consisted of 40 licenses in 21 different counties.

The initial auction was intended to test the license marketplace in those counties and determine how the licenses were received, as well as the process itself. The 40 licenses included in the initial auction were chosen to maximize the financial return to the Commonwealth based on the anticipated demand for licenses in those counties. The PLCB did not want to flood the market with too many licenses at once and risk the devaluation of current licenses, or fail to maximize the financial return to the Commonwealth from the auction.

The sealed bids were publicly opened on October 31st. Notices of Selection were sent out to the highest bidders, who had until mid-November to submit bid payments or withdraw and allow the PLCB to proceed to the second highest bidder. Winning bids ranged from \$51,500 for a license in Somerset County to \$556,000 for a license in Cumberland County. The average winning bid was about \$212,000. As of yesterday, 36 (out of 37) bid payments totaling \$7.65 million have been received and placed in

escrow, and the final bid deadline was yesterday afternoon. Once a bid payment is received, each auction winner has six months to file a license application with the PLCB. Revenue from this auction cannot be totaled or realized until license approvals are granted and bid payments come out of escrow.

We are currently analyzing and evaluating the results of the first auction, so that we can decide the licenses, dates and procedures of the next auction.

PRICING

Prior to Acts 39 and 85, the Liquor Code limited the ability of the PLCB to use its economies of scale – as one of the largest buyers of wines and spirits in the world – to negotiate product acquisition costs or assess different markups on products. These restrictions on pricing largely stemmed from the provision in the Liquor Code that mandated a proportional markup on items sold by the PLCB. As a result of the proportional pricing provision, the PLCB was required to apply an equal percentage markup across its product portfolio. For listed items sold in our stores, suppliers used the uniform markup structure to work backward from their manufacturer’s suggested retail price (MSRP) to arrive at the product acquisition costs quoted to the PLCB. Acquisition costs were not negotiated at all, and the formulaic approach favored suppliers who were able to manipulate the formula.

Acts 39 and 85 provided exceptions to the proportional pricing mandate the PLCB’s best-selling, limited purchase, and discontinued items. Act 39 authorized the PLCB to “price its best-selling items and limited purchase items in a manner that maximizes the return on the sale of those items.” Act 85 further defined “best-selling items” as “the 150 most sold brands and product types of wine and the 150 most sold brands and product types of liquor as measured by the total number of units sold on a six-month basis calculated every January 1 and July 1.” The 150 best-selling items, as defined by Act 85, include 86 percent of the PLCB wine portfolio and 91 percent of the spirits portfolio (by dollar sales volume). These provisions allow our buyers to individually negotiate product acquisition costs and retail shelf prices with suppliers to maximize financial returns to the Commonwealth and achieve more competitive retail prices.

The PLCB obtained data lists regarding product acquisition costs and retail prices in border states of the top-selling wines and spirits. An analysis was then completed on each eligible item that considered product acquisition cost opportunities, the retail price position relative to a brand’s competitive set, and the prices of surrounding states. Our analysis of the data demonstrated that the real opportunity for increased margin is in reducing product acquisition costs.

PLCB product selection category managers conducted individual meetings during September and October with more than 80 suppliers of products eligible for flexible pricing under Acts 39 and 85. These meetings consisted of a review of the changes in the Liquor Code resulting from Acts 39 and 85; discussion of the opportunities for volumetric sales growth; and an examination of each supplier's portfolio of items eligible for flexible pricing with regard to product acquisition costs, sales volume and retail price. Category managers asked each supplier to consider lowering costs for each item identified as having opportunity for a reduced cost based on analysis of the data we obtained. Conversations included discussion of how to achieve these reductions through marketing plan changes, sale price allowance adjustments and innovative marketing to achieve sales growth. We approached each pricing meeting and negotiation as a collaborative partnership with each supplier, seeking to establish costs that are fair to all parties. Each supplier was asked to formally respond to our request for lower costs.

While many suppliers embraced the new pricing laws and have negotiated in good faith, some have simply refused to respond to our initial negotiations, including some of our largest vendors of top-selling products. As a result, we took the next step of sending letters to the CEOs of 16 suppliers asking them to meet with the three Board members to discuss pricing in the aftermath of Act 39 and once again attempt to engage in meaningful dialogue on reducing acquisition costs. We are pleased to report that we have already received several positive responses to our request for meetings, and we look forward to having those meetings over the next month. We will certainly keep you posted on our progress.

Two priorities have been stressed to us by the Governor and the General Assembly regarding flexible pricing: (1) to generate additional revenue; and (2) to achieve more competitive retail pricing, both of which we believe can be achieved through cost reductions – rather than broad price increases – assuming suppliers are willing to negotiate.

Our intent is not to broadly increase retail prices. As the negotiation process moves forward, there will be some products that will see an increase in shelf price where both the supplier and the PLCB determine it is appropriate for that product and the market can bear the increase. However, we also anticipate that consumers will see lower prices on certain products, especially if there is an opportunity to increase sales at a lower price point. We want to get better prices for these top-selling items from suppliers, and we believe the Commonwealth deserves that in light of the volume of purchases we make on their behalf. The cost savings realized from lower acquisition costs can be returned back to the Commonwealth and given back to the consumer in the form of reduced prices on certain products.

REVENUE ENHANCEMENT

In passing this legislation, you wanted consumers to have additional choices and improved convenience, but you also wanted the Commonwealth to generate additional revenue. The measure will significantly enhance Commonwealth revenue, but it is still early for us to give you a projection for some of the major initiatives. The easiest answers involve the license applications. For example, since August 8th, the PLCB has collected approximately \$1.85 million in license surcharges; approximately \$560,000 in approved WEP fees (not including fees for pending applications); approximately \$630,000 for approved applications to convert “E” to “R” licenses (not including fees for pending applications); and approximately \$170,000 for direct wine shipper license fees. As mentioned earlier, the PLCB has received \$7.65 million in bid payments from the initial license auction.

Increased profitability as a result of the pricing initiative remains to be seen, especially since we have yet to hear from a significant number of suppliers. Sunday sales have been increasingly significantly as a result of opening new locations and having expanded hours, but it remains too soon to tell the overall impact on sales.

NEXT STEPS

Two significant provisions of Act 39 are planned for implementation in 2017: (1) the creation of a customer relationship management (CRM) program; and (2) the development of an online special liquor order (SLO) platform.

Act 39 specifically allows the PLCB to develop a customer relationship management program, which often incentivizes membership and grows sales through loyalty programs and coupons. While we are just beginning to explore what a CRM program might look like for Fine Wine & Good Spirits, we are excited at new opportunities previously prohibited by the Liquor Code.

Also in 2017, the PLCB will be completing the development of a new, internet-based portal for Special Liquor Orders. As you know, Act 39 limited the PLCB’s markup on SLO items to 10 percent of the cost of the item, and also allowed orders to be sent directly to the customer rather than requiring SLOs to be picked up from Fine Wine & Good Spirits stores. The new online portal will replace the current system in which SLOs are placed by individual consumers or vendors by phone or directly at a Fine Wine & Good Spirits store. It will also allow, in accordance with Act 39, shipment of SLO orders directly to the customer if the vendor permits delivery.

CONCLUSION

In conclusion, we would like to take this opportunity to recognize and thank the dedicated staff of the PLCB. As we have outlined in these remarks, Act 39 has transformed the regulatory and business functions of the PLCB, and the dedication and expertise of the PLCB staff – both in Harrisburg and in our stores across the Commonwealth – has helped the agency to effectively and efficiently implement the act. Without the professionalism and commitment of the PLCB staff, the agency would not have been able to rise to the occasion and seize the opportunities presented by these new laws.

We thank the committee for the opportunity to offer these remarks, and we look forward to addressing your questions.