Joint Hearing Convened by the
House Liquor Control Committee and Senate Law and Justice Committee
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Testimony of the Pennsylvania Liquor Control Board (PLCB)

Tim Holden, Chairman, testifying with
Mike Negra, Board Member
Michael Newsome, Board Member
Charlie Mooney, Executive Director

Chairman McIlhinney, Chairman Brewster, Chairman Harris, Chairman Costa, and members of the Senate Law and Justice Committee and House Liquor Control Committee, thank you for the opportunity to discuss pricing in the aftermath of Acts 39 and 85 of 2016. We submitted our first annual report on pricing on March 31st, which we hope you had a chance to review. It has been nine months since Act 39 went into effect, and we want to take this opportunity to share with you our perspective on how we approached pricing when the law went into effect, the lessons we learned since the initial pricing negotiations, and our future pricing strategy.

It is fair to say that Act 39 took the agency by surprise, just as it took our suppliers and licensees by surprise. In December 2015, House Bill 1690 was amended by the Senate and was sent back to the House for concurrence. Months passed, and with little notice, the measure was brought to a vote on June 7, 2016. Just one day later, on June 8th, the Governor signed the historic legislation. Act 39, an omnibus measure amending 35 sections of the Liquor Code and adding several new ones, became effective on August 8th, only 60 days later.

Act 39 completely altered the way the PLCB and liquor suppliers approached pricing. Before Act 39, the PLCB was limited in how it could price products. We were required to apply the same percentage mark up on a common bottle of red table wine as a very rare, highly-prized bourbon. This very rigid markup structure was very inefficient, resulting in missed opportunities for the Commonwealth to realize additional revenue and for licensees and retail customers of the PLCB to share in cost savings. If we had sought lower product costs from suppliers, it would have resulted in correspondingly reduced Commonwealth revenue due to the required application of flat percentage markups and taxes. There was no flexibility to the rigid language of the Liquor Code, preventing the PLCB from negotiating the best possible costs from suppliers on popular items and adjusting markups depending on the product, its availability and its demand.

As a result of Act 39, on August 8, 2016, the PLCB was afforded flexibility in how it determines prices of its best-selling items, limited purchase items and discontinued items. The law clearly provided that the PLCB was to establish prices of those items in a manner that "maximizes the return on the sale of those items" and provides competitive prices for Pennsylvania consumers. Basically, we were allowed to seek lower product costs and adjust markups on products to achieve a balance between maximizing Commonwealth revenue and keeping retail prices competitive.

The PLCB worked to quickly and efficiently implement the pricing changes of Act 39 before the effective date. Act 39 made it a very different world, for both us and our suppliers. Now that we had flexibility, we had to formulate a pricing strategy and then engage our suppliers in negotiations.

Immediately after the effective date of Act 39, we began using the flexibility we were afforded in pricing our limited purchase items, including luxury products sold in our Premium Collection stores, Chairman's Selection and Chairman's Advantage products, Wine Club items, and products in our e-commerce portfolio. We have always been able to negotiate with our suppliers to obtain great values on these products, but with Act 39 we have been able to price each item as appropriate based on our supply, the anticipated demand and current market conditions – in other words, in a way that makes business sense.

The "one size fits all" approach to pricing that existed before Act 39 was especially ill-fitted for high demand, limited release products—such as Buffalo Trace and Pappy Van Winkle whiskies. Before Act 39, these products were sold in Pennsylvania at prices significantly lower than other states because of the proportional pricing mandate. Act 39 allowed us to price these items to reflect market demand, while keeping them competitively priced relative to surrounding states. Our use of a lottery system ensures the fair distribution of these products to interested Pennsylvania residents and licensees. A recent lottery for 1,601 bottles of Pappy Van Winkle bourbons and whiskeys resulted in more than 78,000 eligible entries while, at the same time, significantly increasing the total revenue generated from the sales.

With regard to our "best-selling" items, Act 85 defined these as "the 150 most sold brands and product types of wine and the 150 most sold brands and product types of liquor." The initial calculation of "best-selling items" included 86 percent of wine unit sales and 91 percent of spirits unit sales. Pricing for other brands of wines and spirits continue to be governed by the proportional pricing requirement of the Liquor Code.

Our first step after the bill was signed into law was to conduct a review and analysis of our product acquisition costs and our retail prices of these "best-selling" items and determine how they compared to other states. We started gathering this information shortly after the bill was signed in June. With the assistance of a pricing consultant we hired from Deloitte, our product selection category managers analyzed product acquisition costs from other control states obtained from the National Alcohol Beverage Control Association (NABCA), and we contracted with Nielsen to survey retail prices for the top 100 wine and spirit products sold in states bordering Pennsylvania. We then compared the pricing information to identify opportunities to increase gross margin on certain brands by seeking lower product costs from suppliers. To further bolster our pricing expertise, in October 2016, the PLCB hired a full-time pricing coordinator to assist the product selection staff with pricing analysis and negotiations, allowing us to terminate the consultant contract.

In September and October 2016, our product selection category managers met with representatives from 77 suppliers. The purpose of the meetings was to discuss the results of our analysis, request product acquisition cost reductions, discuss potential retail price adjustments, and obtain constructive feedback from suppliers. Supplier counter proposals were evaluated and considered based on the potential impact on margin and feasibility. In certain situations, the PLCB accepted these counter proposals, while in others we either held to our initial request or collaboratively negotiated a mutually agreeable proposal.

We made some mistakes at the initial supplier meetings. We asked suppliers for significant reductions to their product costs to increase our margin, but we failed to take a few things into consideration. First, we asked them for cost changes just before the busy holiday season, after many of them had already approved their overall marketing spend for those brands through the end of calendar year 2016. As a result, a number of suppliers asked for more time until early 2017 to negotiate costs. Second, while we were focused on cost concessions, suppliers view such concessions as only one part of an overall marketing strategy to promote their brands. Accordingly, they wanted to negotiate other aspects of the marketing strategy, including how many times products could be listed as "on sale," consideration for new products they were introducing, the use of special purchase allowances, and other promotional strategies. Finally, we learned that some suppliers were more willing to entertain incremental cost reductions over time rather than all at once.

Results were positive but mixed for the initial round of supplier negotiations, with a number of suppliers readily agreeing to our initial asks for cost reductions or providing counter-proposals, while other suppliers refused to negotiate at all. We miscalculated

the reactions of some of the largest suppliers of our best-selling brands who refused to come to the table at all. As a result, in January and February 2017, the Board members and our Executive Director met directly with these suppliers to discuss negotiations. Many of these meetings reaped positive outcomes and further demonstrated the PLCB's pledge to work in collaboration with our suppliers.

We should note that many suppliers wanted us to consider increasing shelf prices as means to increase gross margins, and while we discussed and remain open to such opportunities, we initially wanted to focus on reducing product acquisition costs. In the listed portfolio (the most popular products available in all our stores), pricing flexibility has resulted in a reduction of product acquisition costs for almost 700 products, retail price decreases for more than 120 products and retail price increases of 125 products.

A specific example of the PLCB's success in the implementation of flexible pricing is the 4 percent gross margin improvement on a single mass-market brand 1.5L Pinot Grigio. Over the course of a running 12-month period, the incremental margin generated on this single product is projected to be more than $210,000 based on historical sales figures. Again, this is simply one product – one example.

Moving forward, armed with lessons learned from the initial negotiations, our strategy is to aggressively pursue lower product acquisition costs until we achieve our category margin targets. We will persuade those suppliers who have yet to enter into negotiations that it is in their best interests to find common ground, before they begin to lose market share in Pennsylvania. We will price our limited purchase items in a way that maximizes Commonwealth revenue but keeps them as great values to our licensees and retail customers. We will continue to seek opportunities to reduce shelf prices where appropriate, but we will also strategically increase shelf prices on certain items if we and our supplier agree that an increase is appropriate based on market conditions. Bearing in mind that both the PLCB and our suppliers are interested in growing volumetric sales, and that every supplier has a unique marketing strategy to achieve profitability for each brand, we will work collaboratively with suppliers on their suggested marketing strategies to grow sales, resulting in increased revenue for the Commonwealth and our supplier partners.

In anticipation of the next round of negotiations, we recently sent letters to all suppliers asking them to come to the table with their marketing strategies and reduced product costs. Negotiations with suppliers will be an ongoing, perpetual process for the PLCB and its suppliers.

A few final thoughts on our future pricing strategy. First, brands that are not within the statutory definition of "best-selling" wines and spirits continue to be governed by the proportional pricing requirement of the Liquor Code. For future legislative consideration, we recommend that the same pricing flexibility be extended on all products sold by the PLCB. Certain supplier industry groups we spoke with would be in favor of such a change, so that their entire product portfolio would be on equal footing in pricing negotiations.

Secondly, we have to consider the complex and interrelated impacts of the components of Acts 39, 85 and 166 on our overall business plan. For example, with licensed grocery stores and convenience stores selling wine "to go" and wineries shipping wine directly to consumers, we have to continually evaluate our store planning strategic plan, including the product mix in our stores, store layouts and store sizes, featured and discounted products, pricing strategies, etc. As a result, future pricing strategies will be developed based on performance and profitability in the post-Act 39 wine and spirits marketplace.

We hope it is evident that we are committed to actively and collaboratively partnering with our suppliers and industry stakeholders in the implementation of flexible pricing, both to optimize revenue for the Commonwealth and provide consumers with fair and competitive prices.

As we have mentioned at previous legislative hearings regarding Act 39, we would be remiss to not thank the devoted PLCB staff, in Harrisburg and across Pennsylvania, who have worked tirelessly to ensure that flexible pricing, and the plethora of other Act 39 reforms, were efficiently and effectively implemented.

Thank you again for the opportunity to address the committees, and we look forward to answering your questions.