

Joint Hearing on Product Pricing
Convened by the Senate Law & Justice & House Liquor Control Committees
May 31, 2018

Testimony of the Pennsylvania Liquor Control Board (PLCB)

Tim Holden, Chairman
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 and House Liquor Control Committees, thank you for this opportunity to provide an update on the PLCB's method and rationale for product pricing under the flexible pricing authority granted by Acts 39 and 85 of 2016. We are pleased to have this opportunity to outline the continued evolution of our collaborative pricing negotiations over the past year, as well as the business strategies that guide our pricing decisions and other related initiatives.

Acts 39 and 85 expressly provided the PLCB with the flexibility to determine the prices for its best-selling, limited purchase and discontinued items. These legislative changes allowed the PLCB to negotiate product acquisition costs and achieve incremental margin gains based on key business metrics rather than the inefficient and inflexible markup structure that existed under "proportional" pricing.

Throughout the implementation of flexible pricing, the PLCB has been dedicated to the dual goals of providing excellent customer value while also fulfilling our responsibility to provide a significant financial return to support the Commonwealth's vital General Fund programs. Equally important has been the PLCB's commitment to partnering with industry stakeholders—from suppliers to trade associations. Our supplier community is crucial to our success and we have sought to engage in an open dialogue to achieve the shared goal of increasing sales growth.

Tasked with this new authority in August 2016, we had to completely overhaul the way we purchase wine and spirits. This meant changing the way our buyers approached meetings with suppliers and, most importantly, negotiating product costs and retail prices for the first time. We are very mindful that this also had a significant impact on the beverage alcohol industry, represented by a diverse group of stakeholders. Because of the complexity of these changes, a natural adjustment period occurred for both the PLCB and suppliers after the passage of Act 39. It is important to quickly summarize how we have progressed since the initial implementation of flexible pricing.

The PLCB engaged in a preliminary round of meetings with our suppliers in September and October 2016 to outline our plan for flexible pricing and to open a dialogue about product acquisition costs. The PLCB conducted an item-by-item market analysis of the products eligible for flexible pricing and sought lower product acquisition costs on certain items. While these initial discussions proved fruitful, admittedly, we made some mistakes and learned valuable lessons as we navigated through the challenges posed by implementing new pricing practices.

Many of our suppliers were unprepared to consider adjusting product acquisition costs immediately before the busy 2016 holiday season. We were still formulating our pricing strategy with respect to related marketing and pricing requests, which were frequently made by suppliers during those initial discussions. While we immediately sought to achieve meaningful financial results from flexible pricing, negotiations, like all good things, take time. With the benefit of time, we have been able to continue conversations with many of our previously intransigent suppliers and collaboratively negotiate product acquisition cost reductions, and other related marketing and retail price adjustments, that meet the needs and goals of both the PLCB and our suppliers.

During the past year, the PLCB has further developed and refined its pricing negotiation process. After the initial round of pricing meetings, negotiations have become a perpetual two-way dialogue with suppliers, rather than one-off meetings. As a result, negotiations have simply become one part of the product acquisition process conducted by the PLCB's category managers. We quickly recognized that it is unrealistic to expect continual reductions in product acquisition costs from suppliers. Consequently, product acquisition costs are only one element of the numerous criteria that the PLCB's category managers use to make product procurement decisions. All product acquisition decisions are based on a diverse set of criteria, which include an assessment of quality and value of the product within its competitive set; projected customer demand; and incremental margin considerations.

The evolution of flexible pricing beyond a narrow discussion regarding product acquisition costs can be best illustrated by an example of a collaborative negotiation with a large wine supplier. The wine supplier lowered the cost on all 1.5L bottles of a popular brand and added an extra supplier-funded promotional sale period for the brand. The intended result was an increase in sales volume of that particular brand. Consequently, the regular retail price dropped \$2, but the PLCB's margin increased by 1 percent. This is a prime example of how flexible pricing can result in added value for all parties involved, including the customer. With more than a full year of Act 39 implementation behind us, we can confidently state that both the PLCB and suppliers have adapted to the new dynamics of the beverage alcohol marketplace.

In addition to negotiations with suppliers of products in the listed portfolio, the PLCB has continued to actively negotiate one-time buys and limited purchase items—such as those in our Chairman’s Selection[®] and Chairman’s Advantage[®] categories. With robust 24 percent sales growth in our Chairman’s Selection and Chairman’s Advantage categories in fiscal year 2016-17, achieving significant incremental margin gains from this program remains a focus of our comprehensive pricing and marketing strategies.

Acts 39 and 85 allow us more flexibility to price items for which demand is significantly greater than supply. These products continue to be sold through the PLCB’s limited-release lottery process. We are more efficiently managing our product portfolio and distribution. For example, many new products are now purchased as one-time buys to assess sales performance before the agency makes a more significant commitment to the product through the listing process.

The consistent and fair application of our flexible pricing policies continues to be a priority for the agency. To ensure that flexible pricing policies are applied uniformly across the product portfolio, the PLCB instituted clear control processes that include a multi-tiered review of product orders and retail pricing recommendations by our pricing coordinator, the Directors of Product Selection and Marketing and Merchandising, the Executive Director and ultimately the three-member board.

As we continue ongoing negotiations as part of the product acquisition process, one challenge we have encountered is the retention of proportional pricing for some of the products in our listed portfolio. Based on unit sales from the most recent six-month period, 12 percent of wine and 8 percent of spirits in the listed portfolio were still priced using the rigid pre-Act 39 pricing formula. Many suppliers view a control state market, such as Pennsylvania, holistically across all brands and product types in their respective portfolio. Product acquisition costs are simply one piece of a comprehensive business and marketing plan that the suppliers have for an individual market. As a result, suppliers often take a global perspective across various brands when engaging in negotiations. However, products that remain in proportional pricing have produced retail pricing disparities within an item’s competitive set, which has hindered comprehensive flexible pricing negotiations with suppliers in certain situations. Since this inefficiency does not inure to the benefit of suppliers, the Commonwealth or our customers, we have begun discussions with our suppliers regarding product acquisition costs and retail pricing across their entire portfolio of brands and product types. Taking such an all-inclusive approach would resolve the current disparity and allow the PLCB to handle pricing consistently across all of a supplier’s listed products.

In passing Acts 39 and 85, the General Assembly and the Governor clearly set the goals of improving customer convenience and value, while maximizing the return on the sale of wine and spirits. These priorities continue to guide our pricing strategies related to retail price adjustments. The PLCB considers retail price changes based on an analysis of market conditions and trends; prices in bordering states; supply and demand considerations; and suppliers' requests for retail price changes. The PLCB has continued to contract with Nielsen to provide point of sale data from retailers in states surrounding Pennsylvania, so that we can make informed decisions that keep our prices competitive with those in neighboring states. Also, as it is statutorily required, the PLCB posts a quarterly price listing on our website.

Any assessment of the fiscal impact of flexible pricing is complex because of the many interconnected changes from the 2016 liquor reforms. It is also important to recognize that not all elements of Act 39, such as wine-to-go sales by wine expanded permit holders, direct wine shipping and the reduced markup on special order sales, help the PLCB's bottom line. Despite these challenges, gross profit from sales, which includes the impact of flexible pricing, has continued an upward trend.

We want to take this opportunity to update you on several additional initiatives. Prevailing retail trends continue to demonstrate the importance of the e-commerce marketplace and the need to respond to customers' desire to have products shipped directly to their doorsteps. To respond to customer demand, the PLCB has expanded the number of products available at www.FineWineAndGoodSpirits.com, our e-commerce site that had previously focused primarily on high-end, niche and limited-supply items. A new Fine Wine & Good Spirits website is currently under development, and an expanded facility more than seven times the size of the current e-commerce fulfillment center is expected to be operational this fall. Improvements to the e-commerce platform will enhance product search features, streamline the checkout process for customers and increase the efficiency of the PLCB's e-commerce fulfillment process.

The PLCB continues to explore options for both third-party delivery and a customer relations management (CRM) program. The ability to increase customer convenience and create incremental revenue gains are the driving business considerations as we assess the potential costs and benefits for these programs.

Thank you for the opportunity to address you on these important issues.