Testimony of David M. Ozgo, Chief Economist
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House Liquor Control Committee
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I would like to thank the committee for this opportunity to speak before you today. My name is David Ozgo and I am the chief economist for the Distilled Spirits Council.

Act 39 was passed with great fanfare in 2016. It was touted as the first major consumer friendly modernization of beverage alcohol laws in Pennsylvania, probably since the state began to allow "self-service." Unfortunately, the "flexible pricing provision in Act 39 was anything but consumer friendly.

Prior to the implementation of flexible pricing, the PLCB had to follow a strict pricing formula that required prices to be proportional. Retail prices were determined by a set mark-up formula that included a known logistics, transportation and marketing fee, a known mark-up of 31% and an 18% tax rate.

Under this pricing formula anytime suppliers offered discounted prices the PLCB was required to pass savings onto the consumer. This offered the consumer a level of protection.

Now that the PLCB has flexible pricing authority the PLCB is free to increase its 31% markup, increasing the PLCB's profit margin. While it is true that retailers in Open states do vary their mark-up according to market conditions, Open state retailers also face competition. If an Open state retailer raises his or her mark-up too high, they will lose business to competitors.

But, the PLCB faces no such competition and is not constrained by market discipline. Without market discipline flexible pricing gives the PLCB enormous market power to the detriment of consumers and suppliers. That is why the PLCB was traditionally required to use proportional pricing and had a set mark-up formula.

By allowing the PLCB carte blanche to increase its mark-up as it desires we now have a state sponsored entity that is neither constrained by competition nor any kind of government regulation – essentially the worst kind of economic outcome for consumers.

What have been the practical implications of flexible pricing?

The PLCB will notify a supplier that it intends to increase the retail price on certain items. These notifications are arbitrary and will often conflict with supplier marketing plans developed sometimes over a year in advance. The supplier must then decide whether to accept the PLCB's retail price increase. If the supplier accepts the price increase, higher prices are foisted onto the consumer and the supplier will see reduced sales. The PLCB, however, collects higher margins.

If the supplier, instead, lowers the FOB price it charges to the PLCB, the supplier must take reduced margins. Naturally, suppliers have budgets that they must meet and any reduction in planned supplier margin must be made up elsewhere. Typically, the supplier will make up for lost margin by reducing the funds allocated to Special Purchase Allowances or SPAs. SPAs are the funds that suppliers use for price promotions throughout the year. To be clear, these funds

are provided solely by suppliers. Traditionally, when a supplier used SPA funds they were to benefit consumers. But, with flexible pricing, SPA funds are more and more used to pay for the PLCB's higher profit margins.

In some instances, the PLCB will ask for price increases on one bottle size for a brand and a short-time later ask for a price increase on the same brand, but a different bottle size, also impacting a supplier's ability to plan.

Because agreed upon retail prices are subject to such random changes, the unpredictability of prices has caused consumers to trade down from premium price points to lower priced value brands or to take their business to neighboring states.

Additionally, when it comes to new listings, one-time buys and luxury listings, suppliers long used the traditional PLCB pricing formula to derive a fair FOB price and a fair retail price. With flexible pricing suppliers submit a fair price to the PLCB, only to be met by PLCB efforts to drive down supplier margins. If suppliers do not give the PLCB the margin that they demand, new listings simply are not approved. With reduced product selection, it is the consumer that, again, ends up losing.

There are many special edition products or products sold on allocation. As you might imagine, when supplies are limited, such products are allocated to markets where the supplier can generate their highest margins. Increasingly, as the PLCB squeezes supplier margins, Pennsylvania consumers are losing access to these sought-after products.

It is ironic that the flexible pricing provision in Act 39 was part of a market modernization bill. The increased PLCB mark-ups that flexible pricing has allowed are anything but market modernization. Across the country retailer margins are declining in Open states, not going up. Whereas we once assumed an average retail mark-up of 25%, including discounts, many large retailers take advantage of economies of scale and offer every day mark-ups in the 20-22% range and promotional mark-ups in the 10-15% range.

From the perspective of the PLCB's customers, far from modernizing the marketplace, flexible pricing that allows the PLCB to increase its margins at the expense of consumers is a step backward. In the interest of fairness to consumers we urge you end the PLCB's flexible pricing authority.

Pennsylvania can, however, generate new revenues in a consumer-friendly fashion. Currently, Pennsylvania has one of the lowest outlet densities of any Control State. Many Control States use what are known as agency stores to increase outlet density in a risk free, low cost fashion. We urge the committee to consider this consumer-friendly option.