



Annual Report on Method and Rationale for Product Pricing

As Prescribed by Act 39 of 2016



April 1, 2019



COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA LIQUOR CONTROL BOARD

Northwest Office Building
Harrisburg, Pennsylvania 17124-0001

The Honorable Patrick J. Stefano
Chairman, Senate Law & Justice Committee
187 Main Capitol Building
Harrisburg, PA 17120

The Honorable James R. Brewster
Chairman, Senate Law & Justice Committee
458 Main Capitol Building
Harrisburg, PA 17120

The Honorable Jeffrey P. Pyle
Chairman, House Liquor Control Committee
216 Ryan Office Building
Harrisburg, PA 17120

The Honorable Daniel J. Deasy
Chairman, House Liquor Control Committee
304 Irvis Office Building
Harrisburg, PA 17120

Dear Chairmen:

As required by Act 39 of 2016, the Pennsylvania Liquor Control Board (PLCB) is pleased to submit its annual report regarding the method and rationale for product pricing.

Almost three years have elapsed since Act 39 was signed into law, and during this time flexible pricing has become an essential part of the PLCB's commitment to providing value to our retail and wholesale customers, while maximizing revenue for the benefit of all Pennsylvanians. The flexible pricing authority granted by Acts 39 and 85 has allowed the PLCB to strategically consider market dynamics and trends in establishing item-by-item product pricing. In short, flexible pricing represents a key element of the PLCB's business strategy.

The following report outlines the historical background regarding the PLCB's pricing structure, as well as the processes that continue to guide our analysis of product prices and inform our collaborative negotiations with suppliers.

We look forward to testifying and answering questions at the forthcoming annual hearing on product pricing before your respective committees.

Sincerely,


Tim Holden
Chairman


Mike Negra
Board Member

STATUTORY PRICING REQUIREMENTS
Historical Background & Restrictions After Acts 39 and 85 of 2016

Acts 39 and 85 of 2016 significantly amended the Pennsylvania Liquor Code and specifically provided the Pennsylvania Liquor Control Board (PLCB) with broad authority regarding pricing decisions. Before Act 39, section 207 of the Liquor Code mandated that the PLCB adhere to a proportional mark-up structure, which limited the Commonwealth's ability to negotiate with wine and spirits suppliers and to price products based on supply and demand. While the PLCB had discretion over the proportional pricing structure, which varied throughout the history of the agency, the lack of flexibility within the product portfolio resulted in pricing inefficiencies that negatively impacted consumers and Commonwealth revenue. Just prior to the law change, the proportional pricing formula included a one percent mark-up, a 30 percent standard mark-up, and a handling fee known as the logistics, transportation and merchandising factor (LTMF).

Act 39 amended section 207 of the Liquor Code to allow 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" and to "discount the price of discontinued items." Limited purchase items include products "that the Board purchases on either a one-time or nonrecurring basis due to the product's limited availability or finite allocation," and discontinued items include products the PLCB "has voted to delist at a public meeting." Subsequently, 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." 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 mark-up structure that existed under proportional pricing.

Act 39 also changed the statutory pricing for products in the special order portfolio, reducing the PLCB's mark-up to 10 percent. Consequently, special order items are not subject to flexible pricing. The special order portfolio includes specialty items that are not stocked in Fine Wine & Good Spirits (FW&GS) stores and is primarily used by licensee customers. Pricing for products in the special order portfolio still includes the LTMF.

All wine and spirits products sold by the PLCB continue to be subject to the 18 percent liquor tax (also known as the Johnstown Flood Tax), which is applied after the PLCB's mark-up is assessed and is included in the product's retail shelf price. The PLCB is statutorily required to sell products at the same retail price across Pennsylvania.

METHODOLOGY & RATIONALE

The PLCB's flexible pricing strategy continues to be guided by two priorities. First, as a retailer and wholesaler of wine and spirits, the PLCB uses its flexible pricing authority to provide a wide selection of products that deliver value, variety and quality to our customers. Second, the PLCB seeks to maximize revenue to support state programs and services funded through the PLCB's transfer to the General Fund.

Pursuant to the statutory pricing language included in Act 85, all items in the PLCB's listed product portfolio, which represents the most popular and common wines and spirits available across the Commonwealth, are eligible for flexible pricing. The following data regarding listed wine and spirit items, between July 1 and December 31, 2018, reflects the aggregate dollar sales and unit sales for listed products.

	Item Count	Dollar Sales	Unit Sales
Listed Spirits	2,098	\$725,562,539	43,939,151
Listed Wine	2,594	\$461,589,799	37,790,536
Total	4,692	\$1,187,152,338	81,729,687

Negotiating Process & Metrics

The PLCB's Bureau of Product Selection engages with our supplier partners on an ongoing basis to negotiate product purchases based on a variety of factors. Because all listed wines and spirits are eligible for flexible pricing as a result of Act 85, negotiations with respect to product acquisition costs or marketing opportunities can occur across a supplier's entire product portfolio, including new products that a supplier is seeking to introduce to the Pennsylvania marketplace.

While incremental margin considerations help to guide product acquisition decisions, our category managers work closely with suppliers to assess product purchases based a plethora of market and business considerations. Some of these additional metrics include: recent category growth trends; segment underrepresentation within the PLCB's overall product portfolio; product quality relative to the proposed price point; and the level of marketing support proposed by the supplier. Also, consideration is given to negotiations related to other product opportunities in a supplier's portfolio, such as unique one-time buys or low introductory product acquisition cost offers. The PLCB continues to integrate incremental margin considerations into its product shelf sets at FW&GS stores (i.e., the relative placement of individual items on store shelves).

The PLCB works closely with all licensees, including high-volume Wine Expanded Permit (WEP) holders, to obtain specific products for the listed portfolio at their request. Due to flexible pricing, the agency can negotiate the price of these products, which ultimately benefits the WEP holder. Further, this process allows the WEP holders to receive the 10 percent licensee discount on these products.

The PLCB is keenly aware of its role as a state-run enterprise and the importance of maintaining the highest procedural and ethical standards in purchasing more than \$1.4 billion of products annually. Consequently, the agency continues to utilize robust control processes to ensure that all product purchase orders and retail pricing decisions adhere to PLCB pricing standards and policies. After Act 39, the PLCB created a pricing coordinator position to help manage the agency's pricing efforts. The pricing coordinator reviews all purchase recommendations from the category managers based on the PLCB's goals regarding product selection and incremental margin gains. The initial setting of retail prices and all retail price changes are further reviewed by the Director of Product Selection and the Director of Marketing and Merchandising, and ultimately the three-member Board. This tiered approval process is intended to maintain the impartial and consistent application of flexible pricing policies.

Retail Price Adjustments

Prior to Act 39, a product's retail shelf price, as a practical matter, was largely determined by suppliers. The proportional pricing structure allowed suppliers to know precisely what the retail shelf price would be based on the PLCB's product acquisition cost. Therefore, a supplier could essentially set an item's retail price by calculating backward to determine its quoted product acquisition cost to the PLCB. Flexible pricing has changed this paradigm and gave the PLCB control over its retail prices, as is standard in the retail industry. Suppliers and the general public can review the PLCB's item-by-item product prices online, where current prices are available daily at FineWineAndGoodSpirits.com and are catalogued on a quarterly basis at lcb.pa.gov.

For items subject to flexible pricing, the initial retail pricing and any subsequent adjustments are determined through an individual analysis of various pricing metrics. During the initial product acquisition process, the Bureau of Product Selection reviews price points within the product's competitive set; compares prices in other beverage alcohol markets, including Nielsen pricing data; analyzes trends within the product category; and evaluates the supply of the product relative to the anticipated demand based on historical sales. Further, the PLCB constantly monitors category and individual item sales trends. The agency utilizes this wealth of business data to evaluate retail prices for both decreases and increases. In addition to the retail adjustments promulgated by the PLCB, retail price changes are requested by suppliers based on their own cost increases and/or alterations in their national business or marketing strategy. It is also important to note that retail prices temporarily change on a regular basis due to product sales known as special price allowances (SPA) and product clearances.

Limited Purchase Items

Act 39 also included "limited purchase items" under the PLCB's flexible pricing authority. Limited purchase items include products that are purchased on a one-time or nonrecurring basis due to the product's limited availability or finite allocation. For example, limited purchase items include luxury products sold in our Premium Collection stores; Chairman's Selection® and Chairman's Advantage® wines, and spirits within our Chairman's Spirits® collection; and products

in our e-commerce portfolio purchased as individual lot buys. Between July 1 and December 31, 2018, the PLCB's luxury and Chairman's programs portfolio included 7,525 wine items and 763 spirits items.

The PLCB continues to negotiate all limited purchase items with the goal of increasing margin, either through reduced product acquisition costs or retail price adjustments, while providing significant value to our customers. Chairman's Selection[®] and Chairman's Advantage[®] wine programs, as well as the newer Chairman's Spirits program[®], are prime examples of this strategy. Each of these programs are designed leverage the PLCB's purchasing power to negotiate substantial discounts from nationally quoted prices while over-delivering on quality for the respective price point.

The e-commerce channel continues to be an area of focus for the PLCB. E-commerce sales have seen significant growth since the agency began offering a wider selection of products online – now including both listed and limited purchase items – a few years ago. Previously, the e-commerce channel was primarily focused on high-end niche products. As consumer trends within the beverage alcohol marketplace continue to evolve in Pennsylvania, flexible pricing has become an ever more important tool to negotiate product acquisition costs for limited purchase items that provide a wide assortment of quality products both online and in FW&GS stores.

Limited-Release and Auction Products

Flexible pricing has allowed the PLCB to more appropriately price certain limited-release items based on customer demand. Proportional pricing prevented the PLCB from reflecting the demand for highly allocated products, such as Pappy Van Winkle whiskies, in the retail price. Act 39 allowed the PLCB to use consumer and licensee demand to inform its decisions regarding pricing highly allocated products. The PLCB uses a lottery process to give Pennsylvania residents and licensees the opportunity to purchase these products regardless of where they may reside in the Commonwealth. Limited-release lotteries generally occur three to four times each year. Even with the retail price adjustments on limited-release items, these products remain a great value in comparison to other markets, which is one reason the PLCB has continued to experience significant consumer interest in the lotteries.

Additionally, in 2019, the PLCB is conducting its first-ever product auction for two bottles of rare scotch whisky, allowing market demand to dictate purchase prices and maximize profitability.

FORWARD-LOOKING STRATEGY

The PLCB intends to continue executing its established flexible pricing processes and strategies while remaining responsive to changes in consumer preferences and the beverage alcohol marketplace in Pennsylvania. Acts 39 and 85 provided the PLCB with clear statutory guidance to price “best-selling items and limited purchase items in a manner that maximizes the return on the sale of those items.” During the past two and a half years of flexible pricing implementation, the

PLCB has sought to achieve that goal while continuing to provide value and quality to our customers. The agency is similarly committed to continued partnership with our suppliers to sustain sales growth and optimize marketing opportunities. Flexible pricing has been, and will continue to be, an essential tool as we seek to maximize revenue for the benefit of all Pennsylvanians through incremental margin gains, retail price adjustments and unit sales growth.