pennsylvania
LIQUOR CONTROL BOARD

Annual Report on Method and Rationale for Product Pricing

As Prescribed by Act 39 of 2016

March 31, 2017

COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA LIQUOR CONTROL BOARD
Northwest Office Building
Harrisburg, Pennsylvania 17124-0001

The Honorable Charles T. McIlhinney, Jr.
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 C. Adam Harris
Chairman, House Liquor Control Committee
115 Ryan Office Building
Harrisburg, PA 17120

The Honorable Paul Costa
Chairman, House Liquor Control Committee
333 Main Capitol Building
Harrisburg, PA 17120

Dear Chairmen:

As required by Act 39 of 2016, enclosed is the Pennsylvania Liquor Control Board's inaugural annual report related to the method and rationale for pricing products.

The flexible pricing authority provided by Acts 39 and 85 of 2016 remains in its infancy, and the beverage alcohol marketplace is still adjusting to this new way of conducting business in Pennsylvania. While results of the flexible pricing authority remain preliminary, the following report demonstrates our commitment to fairness and collaboration with suppliers in the interest of competitive retail prices for consumers and maximizing revenue for critical public services across Pennsylvania.

We look forward to the opportunity to further discuss our pricing decisions and policies, and to answer your questions, at the statutorily required public hearing regarding pricing before your respective committees.

Sincerely,

Tim Holden
Chairman

Mike Negra
Board Member

Michael Newsome
Board Member

STATUTORY PRICING RESTRICTIONS BEFORE AND AFTER ACT 39

Prior to Acts 39 and 85 of 2016, the Liquor Code significantly constrained the ability of the Pennsylvania Liquor Control Board (PLCB) to use its economies of scale – as one of the largest purchasers of wines and spirits – to negotiate the cost of wine and spirit products from suppliers or assess different markups on items based on demand or supply. These restrictions on pricing stemmed from a statutory requirement that mandated a "proportional" markup on items sold by the PLCB.

Section 207 of the Liquor Code mandated that the PLCB's prices "be proportional with prices paid by the board to its suppliers and shall reflect any advantage obtained through volume purchases by the board." Consequently, the PLCB was required to apply an equal percentage markup on all products. Immediately prior to Acts 39 and 85, the PLCB marked up wine and spirits with a 1 percent markup, a 30 percent standard markup, and a handling fee known as the Logistics, Transportation and Merchandising Factor (LTMF).[1] The statutorily mandated 18 percent liquor tax (also known as the Johnstown Flood Tax) is applied after the PLCB's markups are assessed, and is included in the PLCB's shelf price of an item.[2]

Suppliers used this rigid markup structure as a "calculator" to determine what freight on board (FOB) cost to quote the PLCB as the product acquisition cost for an item. Working backward from the manufacturer's suggested retail price (MSRP), suppliers calculated FOB cost based on the uniform markups and the 18 percent tax that is applied. Quoting a lower FOB cost would reduce the supplier's MSRP on that product relative to competitor products, which suppliers resisted since any deviation from their targeted MSRP would have been inconsistent with their national marketing plans. While the PLCB's buyers could have demanded a lower FOB cost from a supplier, due to the inflexible markup structure, the tax revenue and the PLCB's markup revenue from that item would have been reduced proportionally. Thus, a lower FOB cost would have resulted in less Commonwealth revenue.

Acts 39 and 85 provided the PLCB with exceptions to the proportional pricing requirement for best-selling items, limited purchase items and discontinued items. Act 39 amended section 207 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."

- Act 85 subsequently 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."

- Limited purchase items are defined as products "that the Board purchases on either a one-time or nonrecurring basis due to the product's limited availability or finite allocation."

- Discontinued items are defined as products the PLCB "has voted to delist at a public meeting."

Pricing for brands of wines and spirits not included among the "best-selling items" or that are not considered "limited purchase items" or "discontinued items" continue to be governed by the proportional pricing provision of section 207 of the Liquor Code.

[1] In 2006, the PLCB changed the markup calculations for bottles with a cost of more than $65. Under this policy, the 30 percent markup applied only on the first $65 of the cost of the product, and the cost in excess of that amount was subject only to a 10 percent markup. This policy remained in place until the enactment of Act 39.

[2] Proceeds from the liquor tax are remitted to the General Fund and are not considered as part of the PLCB's profits.

For the period from Jan. 1 through Jun. 30, 2016, the "best-selling items" of wine included 1,441 products, which represented 86 percent of unit sales and 85 percent of dollar sales. On the spirits side, the "best-selling items" of spirits included 1,451 products, representing 91 percent of unit sales and 89 percent of dollar sales.

Following is data regarding regular, listed wine and spirit items (the most popular and common wines and spirits available across the state) – from Jan. 1, 2016 through Jun. 30, 2016 – utilized to determine the "best-selling" wines and spirits:

Regular Listed Wine

	Number of Codes	Dollars	Units
Total 6-Month Sales	2,826	$368,347,150	30,108,957

	Number of Codes	6-Mos Dollars	6-Mos Units	Codes Percent of Total	Dollar Percent of Total	Units Percent of Total
Eligible Brands	1,441	$311,288,929	25,778,581	51%	85%	86%
Non-eligible Items	1,385	$57,058,221	4,330,376	49%	15%	14%

Regular Listed Spirits

	Number of Codes	Dollars	Units
Total 6-Month Sales	2,406	$597,152,775	35,914,279

	Number of Codes	6-Mos Dollars	6-Mos Units	Codes Percent of Total	Dollar Percent of Total	Units Percent of Total
Eligible Brands & Product Types	1,451	$532,092,655	32,794,863	60%	89%	91%
Non-eligible Items	955	$65,060,120	3,119,416	40%	11%	9%

The PLCB obtained data from both the National Alcohol Beverage Control Association (NABCA) and Nielsen to develop a data set to inform the agency's analysis of pre-Act 39 FOB costs and prices for products included in the "best-selling items." The NABCA data informed the PLCB about FOB costs, including data from other control states selling the same products. The PLCB contracted with Nielsen to conduct a survey of the retail prices of the top 100 wine and spirit items sold in bordering states: Delaware, Maryland, New Jersey, New York, Ohio, Virginia and West Virginia. This survey provided retail prices on the top 100 wine and spirits items within a 50-mile radius of Pennsylvania.

The data allowed the PLCB to evaluate the FOB costs it pays in relation to other states and identify where there may be opportunities to negotiate lower acquisition costs with each supplier. An analysis considering FOB cost opportunities, the retail price position relative to a brand's competitive set, and surrounding states' prices was completed on each item and brand family eligible for flexible pricing.

PLCB product selection category managers conducted meetings during September and October 2016 with the 77 suppliers of the "best-selling items." PLCB category managers asked each supplier to consider specific lower FOB costs for each item identified as having an opportunity for a lower cost based on the analysis of other states' FOB costs and the Nielsen data. In establishing the PLCB's initial requests for FOB cost reductions, pre-Act 39 gross margins for listed wine and spirits products were determined based on current FOB cost and retail price, and a category goal for gross margin was established. These category goals were created using the current average for each category and applying a certain percentage increase in order to return a margin benefit.

The goal of these meetings was to inform each supplier about the pricing implications of Acts 39 and 85, discuss the PLCB's basis and rationale for believing there are opportunities to increase margin through a reduction in FOB costs, and listen to supplier concerns and any counter proposals. The PLCB took a collaborative approach to these meetings – while we explored ways in which the Commonwealth could increase margin (in percent and dollars) on these products, we were open to compromise and discussing other avenues to achieve enhanced profitability. The PLCB evaluated counter proposals from suppliers based on margin increase and retail price change opportunities. While retail price adjustments were considered, the PLCB sought to limit retail price increases.

Certain suppliers notified the PLCB that they would not submit a response to the PLCB's request for cost concessions or responded with no FOB reductions. Board members and the PLCB's Executive Director had follow-up meetings with these suppliers in January and February 2017, further demonstrating the PLCB's commitment to collaborating with suppliers to reach a mutually beneficial outcome. These secondary meetings resulted in cost reductions from many of these suppliers.

With regard to "limited purchase items," luxury products that are sold in our Premium Collection stores; Chairman's Selection® and Chairman's Advantage® products; Wine Club items; and products in our e-commerce portfolio are purchased as individual "lot buys." The PLCB negotiates all lot buys with the goal of increasing margin either through reduced FOB cost or retail price adjustment. Acts 39 and 85 have allowed the PLCB to increase incremental margin on these products while continuing to provide these products at a tremendous value to customers.

The advent of high demand, limited release products – such as Buffalo Trace and Pappy Van Winkle whiskies – created another opportunity for the PLCB to utilize the pricing flexibility afforded under Acts 39 and 85 to improve margin while still providing a remarkable value to customers. In recent years, the PLCB developed a lottery system to ensure that all interested Pennsylvanians, regardless of their geographic location, would be afforded an equal opportunity to purchase limited-release products. In the past, the tremendous demand for these products, which historically have been sold at prices far below what consumers pay in other states due to the proportional pricing mandate, resulted in the items selling out within a few minutes. Since the enactment of Act 39, the PLCB has conducted very successful Limited-Release lotteries on two occasions where the PLCB was able to adjust its markup to reflect the high demand from the licensee community and the general public while still keeping prices very competitive relative to neighboring states.

FORWARD-LOOKING STRATEGY

Numerous strategies and marketing opportunities to grow PLCB gross margin and increase unit sales were discussed with each supplier during the portfolio review meetings. Some of these approaches are used in other control states and represent ways suppliers and the PLCB can collaborate to drive sales and revenue growth. Some examples include increasing the number of times per year an item may be discounted, increasing the number of new items approved each year, and offering an initial reduced cost for a limited time to introduce a new item.

Given Act 39's direction to price our "best-selling items and limited purchase items in a manner that maximizes the return on the sale of those items," negotiations with our suppliers will continue in perpetuity as we continue to explore opportunities in partnership with our suppliers. All proposed strategies will be evaluated based on the potential to enhance sales, add value for customers, and increase Commonwealth revenue.