



Annual Report on Method and Rationale for Product Pricing

As Prescribed by Act 39 of 2016



March 30, 2018



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 (PLCB) second annual report related to the method and rationale for pricing products.

During the past year the beverage alcohol marketplace has adjusted to the flexible pricing authority provided by Acts 39 and 85 of 2016. The negotiations permitted by flexible pricing represented a new way of conducting business for both the PLCB and suppliers. After the initial round of negotiations, the PLCB and suppliers have become accustomed to engaging in an ongoing dialogue regarding product pricing as part of the shared goals of driving sales and revenue growth.

As the following report demonstrates, the PLCB remains committed to providing excellent value to our consumers and maximizing revenue for critical public programs throughout the Commonwealth. The agency also continues to be dedicated to fairness and partnership in our dealings with suppliers and other industry partners.

Thank you for the opportunity to update your respective committees on the processes and rationale that undergird the PLCB's flexible pricing strategy.

Sincerely,

Handwritten signature of Tim Holden in black ink.

Tim Holden
Chairman

Handwritten signature of Mike Negra in black ink.

Mike Negra
Board Member

Handwritten signature of Michael Newsome in black ink.

Michael Newsome
Board Member

STATUTORY PRICING RESTRICTIONS AFTER ACTS 39 AND 85

Acts 39 and 85 of 2016 significantly amended the Pennsylvania Liquor Code and specifically provided the Pennsylvania Liquor Control Board (PLCB) with certain exceptions to the Liquor Code's proportional pricing requirement. Before Act 39, the Liquor Code mandated that the PLCB adhere to a proportional mark-up structure, which hampered the Commonwealth's ability to negotiate with wine and spirits suppliers and to price products based on supply and demand.

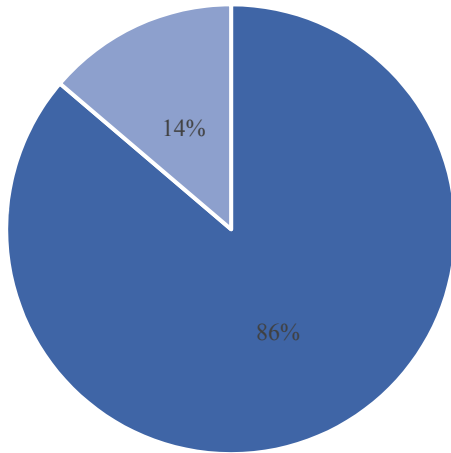
Act 39 amended section 207 of the Liquor Code to allow the PLCB to "price its best-selling items and limited purchase items in a manner that maximizes the return on the sale of those items" and to "discount the price of discontinued items." Limited purchase items include products "that the Board purchases 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 contained language that 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."

Pricing for brands of wines and spirits not subject to flexible pricing continues to be governed by the proportional pricing provision of section 207 of the Liquor Code. Such brands are subject to a one percent markup, a 30 percent standard markup, and a handling fee known as the Logistics, Transportation and Merchandising factor (LTMF). All wine and spirits products sold by the PLCB are subject to the 18 percent liquor tax (also known as the Johnstown Flood Tax), which is applied after the PLCB's markup is assessed and is included in the shelf price.

METHODOLOGY- Products That Are Subject To Flexible Pricing

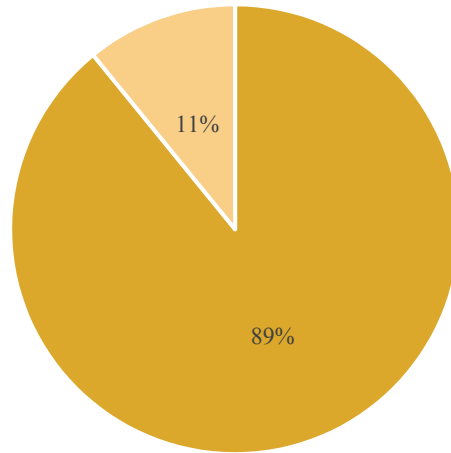
Items eligible for flexible pricing represent a sizable portion of the PLCB's listed product portfolio, which are the most popular and common wines and spirits available across the Commonwealth. For the period from July 1 through December 31, 2017, 1,388 stock keeping units (SKUs, or items of inventory) of wine were subject to flexible pricing, which represented 88 percent of wine unit sales and 86 percent of dollar sales. In the same period, 1,235 SKUs of spirits were subject to flexible pricing, representing 92 percent of spirits unit sales and 89 percent of dollar sales.

Listed Wine Sales (dollars)



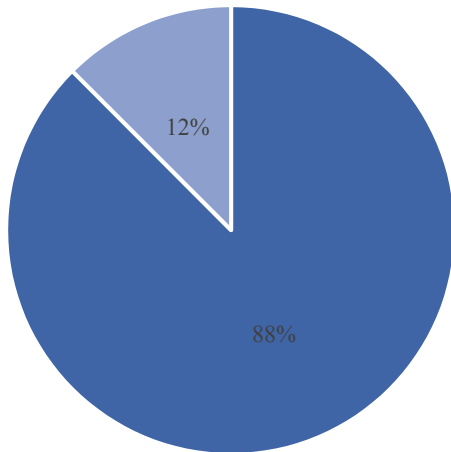
- Items Subject to Flexible Pricing
- Items Subject to Proportional Pricing

Listed Spirit Sales (dollars)



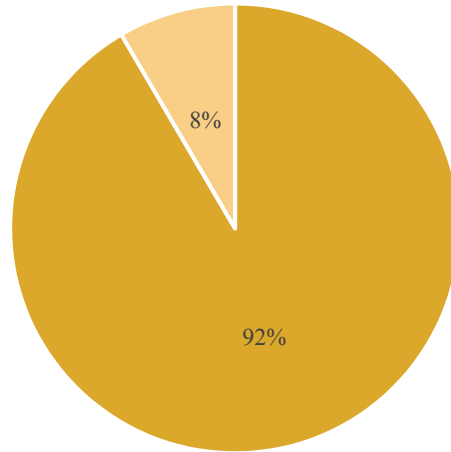
- Items Subject to Flexible Pricing
- Items Subject to Proportional Pricing

Listed Wine Sales (units)



- Items Subject to Flexible Pricing
- Items Subject to Proportional Pricing

Listed Spirit Sales (units)



- Items Subject to Flexible Pricing
- Items Subject to Proportional Pricing

The following data regarding listed wine and spirit items, between July 1 and December 31, 2017, reflects the aggregate item counts and sales numbers for the products subject to flexible and proportional pricing.

Listed Spirits

	Item Count	Sales Amount	Sales Quantity
Items Subject to Flexible Pricing	1,235	\$622,443,093	37,214,057
Items Subject to Proportional Pricing	883	\$75,983,721	3,433,820
Total	2,118	\$698,426,814	40,647,877

Listed Wine

	Item Count	Sales Amount	Sales Quantity
Items Subject to Flexible Pricing	1,388	\$392,518,750	32,918,071
Items Subject to Proportional Pricing	1,116	\$62,702,492	4,696,097
Total	2,504	\$455,221,242	37,614,168

RATIONALE & ONGOING IMPLEMENTATION OF FLEXIBLE PRICING

The PLCB is committed to a flexible pricing strategy that achieves two goals: 1) providing value to our customers through competitive pricing on a diverse selection of quality products; and 2) maximizing revenue to support the important programs funded through the PLCB's transfer to the General Fund.

Negotiating Process & Metrics

The negotiation process has evolved since the initial round of post-Act 39 pricing meetings with suppliers. At these initial meetings, the PLCB formally outlined its plan for the implementation of flexible pricing and began the negotiation process for lower product acquisition, or "free/freight on board" (FOB), costs. Since these initial meetings, discussions involving FOB costs are simply one component of the overall dialogue that the PLCB's Bureau of Product Selection has with suppliers regarding items subject to flexible pricing. While the agency's category managers consistently engage with suppliers to ensure the Commonwealth is obtaining the best possible deals when purchasing these popular brands, we also understand that it is unrealistic to expect continuous cost concessions from suppliers on the same products.

The dialogue between category managers and suppliers has broadened to include incremental margin considerations within the numerous criteria used to assess acquisition of products eligible

for flexible pricing. These criteria include both market-driven considerations—such as category growth, high quality for the value and segment underrepresentation—and internal business considerations like potential for high-dollar profit, opportunity for customer trade-up and strong marketing support proposed by the supplier. Additionally, incremental margin considerations have been integrated into the multitude of considerations (such as sales volume and velocity) that inform shelf sets for Fine Wine & Good Spirits stores.

The PLCB has also implemented strong control processes to ensure that all product purchase orders and retail pricing decisions conform to PLCB pricing policies. The PLCB’s pricing coordinator reviews and evaluates all purchase decisions based on the agency’s goals regarding product selection and incremental margin gains. Further, the Director of Product Selection and the Director of Marketing and Merchandising, and ultimately the three-member Board, review the initial setting of retail prices and all retail price changes in accordance with PLCB pricing policies. These uniform product purchasing and retail pricing processes ensure the fair and consistent application of flexible pricing policies.

Retail Price Adjustments

Retail pricing for items subject to flexible pricing is assessed on an item-by-item basis. Product pricing is evaluated by the Bureau of Product Selection based on many factors, including: key price points within the competitive set; comparison to prices in surrounding states and other markets, including Nielsen pricing data; category trends; product supply and anticipated demand; and negotiations related to other opportunities, such as unique one-time buys or lower introductory FOB offers. As with any retail business, the PLCB regularly evaluates retail prices for both decreases and increases. Suppliers also regularly request retail price adjustments based on changes in their own business strategy and marketing plans. Further, as required by Act 39, the PLCB posts a quarterly price listing on its website.

Limited Purchase Items

Flexible pricing also applies to “limited purchase items,” which includes luxury products sold in our Premium Collection stores; Chairman’s Selection[®] and Chairman’s Advantage[®] wines, and spirits within our Chairman’s Spirits[®] collection; wine club items; and products in our e-commerce portfolio purchased as individual lot buys. The PLCB continues to negotiate all lot buys with the goal of increasing margin, either through reduced FOB costs or retail price adjustments, while passing along significant discounts to our customers. The Chairman’s programs continue to be an area of increased focus and profitability for the PLCB. The Chairman’s Selection[®] program offers vintage- and appellation-specific wines that are purchased at a significant discount from nationally-quoted prices, while the Chairman’s Advantage[®] program offers wines that over-deliver in quality for less than \$10 per bottle. The Chairman’s Spirits[®] program extends the value proposition of the Chairman’s brand to the spirits side with quality products at excellent prices. Acts 39 and 85 allowed the PLCB to increase incremental margin on these products while

continuing to provide limited-purchase items at retail prices that represent an incredible value to customers.

Limited-Release Lottery Products

Products for which consumer demand exceeds limited supply—for example, Buffalo Trace and Pappy Van Winkle whiskies—continue to drive high levels of interest in the PLCB’s Limited-Release Lotteries. These events, which happen about four times a year, provide a fair and equitable system for distributing highly popular products with finite allocations to Pennsylvania consumers and licensees. Since the enactment of Act 39, the PLCB has used consumer demand for such products to guide its decisions related to lottery pricing decisions, adjusting retail prices for items offered through Limited-Release Lotteries to reflect the significant demand from licensees and the public. Nonetheless, the retail prices for these products continue to be competitive relative to neighboring states and other markets.

FORWARD-LOOKING STRATEGY

Acts 39 and 85 created opportunities for the PLCB to increase customer value and generate additional revenue for the Commonwealth. The PLCB remains committed to increasing gross margin through unit sales growth, incremental margin gains and retail price adjustments to adhere to Act 39’s mandate to price “best-selling items and limited purchase items in a manner that maximizes the return on the sale of those items.” 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 continue to work collaboratively with suppliers on their suggested marketing strategies to grow sales. The beverage alcohol marketplace in Pennsylvania continues to evolve, and the PLCB is dedicated to working with our suppliers to achieve our shared goals of providing value to consumers and enhancing sales and revenue.

As noted earlier, however, not all products are subject to flexible pricing. Brands that are not deemed “best-selling items” are governed by the proportional pricing requirement of the Liquor Code. Currently, a supplier may have some products in a single category subject to flexible pricing, while others remain subject to the rigid markup structure. This can make it difficult for a supplier to negotiate costs while keeping related products at the same retail price or at a desired level relative to competitors. Therefore, for future legislative consideration we recommend extending pricing flexibility to all products sold by the PLCB.

