



Annual Report on Method and Rationale for Product Pricing

As Prescribed by Act 39 of 2016



April 1, 2020



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

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

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

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

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

Dear Chairmen:

The Pennsylvania Liquor Control Board (PLCB) is pleased to submit our fourth annual report on the method and rationale for product pricing as required by Act 39 of 2016.

The enclosed report summarizes the statutory background regarding the PLCB's product pricing processes; outlines the established metrics that guide the analysis of product prices and ongoing negotiations with suppliers; and addresses the agency's pricing strategy for 2020. The PLCB continues to prioritize our dual commitments to provide quality and value to our customers and to price products in a manner that maximizes revenue to fund important Commonwealth programs supported by the General Fund.

We look forward to discussing the agency's pricing methodology and strategy at the upcoming annual hearing on product pricing before your respective committees.

Sincerely,

Tim Holden
Chairman

Mike Negra
Board Member

Mary Isenhour
Board Member

STATUTORY PRICING REQUIREMENTS

Historical Background

Prior to Acts 39 and 85 of 2016, section 207 of the Liquor Code required the PLCB to utilize a proportional mark-up structure to determine the retail price of wines and spirits. The calculation of the proportional mark-up varied throughout the history of the PLCB. Before Act 39 became effective, the mark-up structure included two standard, straight percentage mark-ups (a one percent, then a 30 percent mark-up) and a handling fee known as the logistics, transportation and merchandising factor (LTMF). The statutory 18 percent liquor tax was applied to the retail price after the PLCB's mark-ups were assessed. The 30 percent mark-up had not been altered for more than two decades.

Pricing Reforms Under Acts 39 and 85 of 2016

Act 39 significantly amended the Liquor Code and specifically granted the PLCB with additional pricing authority. Section 207 of the Liquor Code allows the agency 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.” Act 85—which primarily amended the Fiscal Code, but also contained provisions impacting the Liquor Code—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.” The pricing authority authorized by Acts 39 and 85 is commonly referred to as flexible pricing.

Act 39 also altered the pricing structure for products in the PLCB’s special order portfolio, reducing the agency’s mark-up on special orders from 30 percent down to 10 percent. Therefore, special order items are not subject to flexible pricing. The special order portfolio includes more than 48,000 specialty items that are not stocked in Fine Wine & Good Spirits stores. While some retail customers purchase products from the special order catalog, it is primarily utilized by licensees. The pricing structure for products in the special order portfolio includes the LTMF.

All wine and spirits products sold by the PLCB remain subject to the 18 percent liquor tax (often referred to as the Johnstown Flood Tax), which is still applied after the PLCB’s mark-up and is included in the product’s retail shelf price. Wine and spirits not sold by the PLCB, such as wine or spirits sold by Pennsylvania licensed manufacturers and wine sold by direct wine shippers, are not subject to the liquor tax. The PLCB is statutorily required to sell products, except for items

offered through a customer relations management program, at the same retail price across Pennsylvania.

METHODOLOGY & RATIONALE

Overview

The flexible pricing reforms under Acts 39 and 85 allow the PLCB to negotiate product acquisition costs and improve margin based on targeted business metrics, rather than the one-size-fits-all mark-up structure that existed under proportional pricing. While the agency had discretion to determine the mark-up percentage, the proportional mark-up had to be applied uniformly across the product portfolio regardless of the supply and demand for a particular product. As a result, the mark-up was the same for a mass market sauvignon blanc or a high demand, limited-release bourbon. The 2016 flexible pricing reforms changed this model.

The PLCB's flexible pricing strategy prioritizes two goals. First, strive to provide a wide selection of products that deliver value, variety and quality to our retail and wholesale customers. Second, as a state-run enterprise that is responsible for returning significant cash transfers to the Commonwealth's General Fund each year, maximize revenue for the benefit of all Pennsylvanians.

All listed products, or the most popular and common wine and spirits items, are subject to flexible pricing. The below chart reflects the listed portfolio for calendar year 2019:

	Item Count	Dollar Sales	Unit Sales
Listed Spirits	2,278	\$1,413,080,062	88,118,936
Listed Wine	2,731	\$849,611,600	69,404,998
Total	5,009	\$2,262,691,662	157,523,934

Negotiation Process and Metrics

The PLCB's pricing methodology applies key business metrics and retail best practices to the process of purchase decisions and product pricing. Flexible pricing discussions with suppliers continue to involve a constant dialogue rather than one-time meetings. The agency's Bureau of Product Selection works closely with suppliers to assess products across their entire product portfolio based on a range of market-driven criteria. For example, product acquisition costs, incremental margin considerations, projected category trends and the product quality relative to the manufacturer's suggested retail price are all included as part of the evaluation process. Supplier-funded marketing support for products, especially new items, is also considered during negotiations. Incremental margin considerations are one element, in addition to others such as sales velocity, used to determine product shelf sets in Fine Wine & Good Spirits stores.

The PLCB continues to rigorously apply internal controls to assure the uniform application of pricing policies across the agency's product portfolio. A multi-tiered review process that begins with the PLCB's pricing coordinator and subsequently includes the director of product selection, the director of marketing and merchandising, the executive director and ultimately the three member board, helps to maintain consistency in product acquisition and pricing decisions. Furthermore, the agency is committed to the highest ethical standards for its employees to ensure that no supplier receives preferential treatment.

Retail Price Adjustments

The advent of flexible pricing provided the PLCB with the ability, like other retailers, to control the retail price of the products on its shelves. Retail price adjustments are determined on an item-by-item basis after examining retail price data in states bordering Pennsylvania, projected market demand, historical sales trends, key price point thresholds and comparison of an item's retail price to category peers. With respect to the retail price data from bordering states, the PLCB contracts with The Neilson Company, Inc. to gather retail price information on wine and spirits at convenience and mass-market retailers in Delaware, Maryland, New Jersey, New York, Ohio, Virginia and West Virginia. In 2019, this point of sale information was further supplemented by spirits data from the Virginia Alcohol Beverage Control Authority. The survey included more than 400 products. It is important to realize that any comparison of retail prices between states is inherently limited by differences in liquor and sales tax structures between states and the significant variability of retail prices between different types of retail outlets. Consequently, the PLCB uses this information in conjunction with other metrics to inform its analysis of retail pricing adjustments.

The PLCB ultimately determines a product's retail price; however, some price adjustments are implemented at the request of a supplier or as the result of a supplier's increase in the PLCB's product acquisition costs. All special pricing allowances, which are limited-time, supplier-funded product sales, are passed along directly to customers. The current retail price of products is accessible on FineWineAndGoodSpirits.com. Further, as required by Act 39, quarterly price listings dating back to October 2016 are posted on lcb.pa.gov.

Since the implementation of the flexible pricing reforms as authorized by Acts 39 and 85 in 2016, the agency has sought to perpetually engage suppliers and industry stakeholders in discussions about product pricing and respond to operational concerns about the implementation of retail price adjustments. This year the PLCB has extended supplier notification timelines, which were previously approximately 30 days, to address industry stakeholder concerns about the impact of retail price adjustments on their respective business plans.

In early March 2020, the PLCB sent correspondence to suppliers regarding the agency's intention to adjust retail prices on certain items in their respective portfolios. The notification

provided the suppliers with 60 days to respond and welcomed further negotiations. Any retail price adjustments associated with these discussions are planned to occur in early August 2020 or shortly thereafter depending on scheduled special promotions. The PLCB remains committed to notifying our wholesale customers of impending retail price adjustments and will continue this practice in 2020. These notifications benefit wholesale customers by allowing them to take advantage of the opportunity to forward buy products at a lower retail price.

Limited Purchase Items

Limited purchase items, such as those included in the luxury and Chairman’s Selection and Advantage portfolios, are purchased on a one-time buy basis and are also subject to flexible pricing. The Chairman’s programs are focused on delivering a constantly evolving, curated portfolio of products that are offered at a significant discount from nationally quoted retail prices as the result of negotiated lot buys by the PLCB. The below chart reflects the luxury and Chairman’s portfolios for calendar year 2019:

	Item Count	Dollar Sales	Unit Sales
Luxury Spirits	741	\$16,893,368	381,697
Luxury Wine	7,136	\$73,553,104	3,940,837
Chairman’s	417	\$72,483,157	6,174,359
Total	8,294	\$162,929,629	10,496,893

The PLCB evaluates limited purchase items based on a multitude of factors that include the product’s relative quality to value proposition, category growth trends, underrepresentation within the product segment and potential for incremental margin gains. The agency also has begun to pursue increased direct purchasing discussions with wine and spirits manufacturers. The acquisition of products directly from a manufacturer can often result in lower product acquisition costs for the PLCB and can provide our customers with access to unique products or vintages at excellent values.

Limited-Release Lottery Products

The PLCB continues to experience high demand for products sold through limited-release lotteries. The agency uses a lottery process to sell highly allocated products (i.e. products for which demand significantly outpaces the available supply from the manufacturer), to give all Pennsylvanians an equal opportunity to purchase these sought after products. Interested individuals and licensees, with a valid Pennsylvania address, enter the lotteries through FineWineAndGoodSpirits.com. Three limited-release lotteries were conducted in 2019.

With respect to the retail pricing of limited-release products, the flexible pricing reforms allow the PLCB to set more appropriate retail prices for these products based on the market demand rather than the rigid proportional mark-up, which undervalued these products. However, the significant continued demand for the limited-release lotteries demonstrates that individual customers and licensees still perceive the retail pricing for these products as a good value.

FORWARD-LOOKING STRATEGY

Flexible pricing remains a central element of the PLCB's business strategy, and the agency is committed to continued partnership with the supplier community. The PLCB's implementation of flexible pricing reforms is not a static process, and the agency will continue to engage in dialogue with suppliers to achieve mutually beneficial outcomes that also positively impact our retail and wholesale customers.

On February 29, 2020, Fine Wine & Good Spirits stores conducted our first "Leap Day" sale for retail customers. This 10-percent-off sale included all wines and spirits in the agency's stores across the state and represents one way the PLCB has passed along savings to consumers while strategically driving sales during a traditionally slow period for alcohol sales. The PLCB also holds one-day 10-percent-off sales for retail customers during the grand openings of Fine Wine & Good Spirits stores throughout Pennsylvania. Product sales such as these are a highly visible demonstration of the agency's continued commitment to provide value to our customers.

The e-commerce segment, while it still represents a small portion of total PLCB sales, continues to experience exponential sales growth as consumers gravitate to the convenience of online shopping. The agency has expanded the catalog of products sold at FineWineAndGoodSpirits.com and will improve the online customer experience with the launch of a new e-commerce website later this year. E-commerce provides the PLCB with another channel to sell products in the listed and limited purchase portfolios, as well as discounted products, while providing convenience to our customers and leveraging flexible pricing to improve margin and increase unit sales.

The 2016 flexible pricing reforms fundamentally changed the PLCB's authority to price products and the interaction between the agency and its suppliers. As both a wholesaler and retailer, the PLCB remains dedicated to fulfilling our responsibility to maximize revenue from the sale of wines and spirits while providing value to our customers through superior product selection, quality and competitive retail pricing.