



Annual Report on Method and Rationale for Product Pricing

As Prescribed by Act 39 of 2016



April 1, 2021



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

The Honorable Mike Regan
Majority Chairman
Senate Law & Justice Committee
172 Main Capitol Building
Harrisburg, PA 17120

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

The Honorable Carl Walker Metzgar
Majority Chairman
House Liquor Control Committee
115 Ryan Office Building
Harrisburg, PA 17120

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

Dear Chairmen:

As required by Act 39 of 2016, enclosed is the Pennsylvania Liquor Control Board's (PLCB) fifth annual report on the method and rationale for product pricing.

The COVID-19 pandemic impacted all facets of the PLCB's operations during 2020, and the economic impact of the pandemic altered our pricing plans for the year. The following report outlines those changes; details the statutory background governing the agency's pricing authority; describes the metrics that continue to inform the analysis of product prices and negotiations with our supplier partners; and summarizes the PLCB's 2021 pricing outlook.

While the COVID-19 pandemic changed many things in 2020, it did not change the principles that govern our approach to the agency's pricing practices. The PLCB remains dedicated to both providing value to our retail and wholesale customers and continuing to meet our responsibility to fund important Commonwealth programs supported by the agency's cash transfers to the General Fund.

We appreciate this opportunity to update your respective committees on the PLCB's method and rationale for product pricing.

Sincerely,

Tim Holden
Chairman

Mike Negra
Board Member

Mary Isenhour
Board Member

STATUTORY PRICING REQUIREMENTS

Historical Background

The pricing structure for products sold by the Pennsylvania Liquor Control Board (PLCB) has evolved throughout the history of the agency. The Liquor Code authorizes the PLCB to establish the prices for the alcohol products that it sells. The retail price is the shelf price paid by individual consumers at Fine Wine & Good Spirits stores and FWGS.com, while licensees are statutorily afforded a 10 percent discount off retail prices. There is pending legislation that would change the licensee discount. House Bill 427, which would temporarily increase the licensee discount to 15 percent for certain licensees, was recently reported favorably from the House Liquor Control Committee.

Before the pricing reforms under Acts 39 and 85 of 2016, section 207 of the Liquor Code mandated that retail prices had to be proportional with prices paid by the PLCB to its suppliers. As a practical matter, this provision required the agency to use a proportional mark-up structure to price products. The PLCB's mark-up structure, prior to the enactment of Acts 39 and 85, consisted of two straight percentage mark-ups (a one percent, then a 30 percent mark-up), as well as a handling fee called the logistics, transportation and merchandising factor (LTMF). Subsequently, the 18 percent liquor tax, also known as the Johnstown Flood tax, was applied and then rounded to the nearest nine to determine the retail shelf price.

The PLCB did have the authority to change the mark-up and it varied throughout the history of the agency. However, prior to the enactment of Act 39, despite natural growth in operational and regulatory costs incurred by the PLCB, the 30 percent mark-up had not changed in more than two decades.

Pricing Reforms Under Acts 39 and 85 of 2016

Recognizing the inefficiencies of a uniform mark-up that could not consider product supply or demand and hindered negotiations with suppliers, Act 39 significantly modified the PLCB's pricing authority. Specifically, section 207 of the Liquor Code was amended to allow 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." Subsequently, Act 85—which amended the Fiscal Code, but contained provisions impacting the Liquor Code—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 expanded pricing authority authorized by Acts 39

and 85 is commonly referred to as flexible pricing. The PLCB is required to sell products, except for items offered through a customer relations management program, at the same retail price across Pennsylvania.

Act 39 did not include items from the PLCB's special order portfolio in flexible pricing, but it did alter the pricing structure for these products. The mark-up on special order products was reduced from 30 percent to 10 percent. The pricing structure for special order products still includes the LTMF. The special order portfolio consists of approximately 53,000 specialty items that are not stocked in Fine Wine & Good Spirits stores or Licensee Service Centers. The special order catalog is primarily used by licensees.

All wine and spirits products sold by the PLCB remain subject to the 18 percent liquor tax, which is still applied after the PLCB's mark-up and is included in the product's retail shelf price. The liquor tax is transferred regularly to the General Fund and does not support the PLCB's operations or annual profit transfers to the General Fund. Wine or spirits sold by Pennsylvania licensed manufacturers and wine sold by licensed direct wine shippers are not subject to the liquor tax.

METHODOLOGY & RATIONALE

The PLCB remains committed to using flexible pricing to provide retail and wholesale customers with a wide selection of products that deliver value and quality while optimizing revenue to benefit all Pennsylvanians through annual cash transfers to the General Fund and financial support of other state, local, community and industry beneficiaries. Both these goals are supported by the PLCB's pricing process, methodology and rationale.

Listed Portfolio

Act 39 and 85 pricing reforms allow the PLCB to negotiate product acquisition costs on all items in the listed portfolio. Listed products are the most commonly purchased wine and spirits by retail and wholesale customers. The below chart reflects the listed portfolio for calendar year 2020:

	Item Count	Dollar Sales	Unit Sales
Listed Spirits	2,348	\$1,339,367,167	76,993,172
Listed Wine	2,817	\$895,819,410	73,724,311
Total	5,165	\$2,235,186,577	150,717,483

Product Evaluation & Negotiation Process

The PLCB negotiates product acquisition costs by partnering with suppliers, including manufacturers, to identify opportunities to bolster and adjust the agency's product portfolio. The Bureau of Product Selection evaluates potential product acquisitions and retail pricing based on market-driven criteria including brand recognition; segment and category growth trends; relative quality to value proposition; product innovation; segment underrepresentation within the current portfolio, customer trade up opportunity; and supplier marketing support. Consideration is also given to financial metrics like gross margin potential, gross margin percentage relative to comparable items within the category, manufacturer's suggested retail price and threshold price points.

Category managers initially negotiate product acquisition costs and retail prices with suppliers. Subsequently, these recommendations are reviewed by the division chief, director of product selection, chief merchandising officer, executive director, and finally the three-member board. Additionally, a pricing coordinator evaluates pricing decisions across various divisions to maintain consistency in the application of the agency's pricing policies.

The PLCB remains committed to exercising its flexible pricing authority in a fair and even-handed manner. All PLCB employees must adhere to a strict code of conduct, and vendors are subject to a vendor code of conduct to promote and preserve integrity.

As required by Act 39, quarterly product price lists dating back to October 2016 are posted at lcb.pa.gov. Current retail prices are available at FW&GS.com.

Retail Price Adjustments

As a result of the economic impact of the COVID-19 public health crisis on retail customers and licensees, the PLCB refrained from increasing any prices in 2020 outside increases initiated by suppliers. Before the extent of the pandemic's impact was known, the PLCB notified some suppliers of the agency's intention to adjust retail prices on certain products in 2020 and encouraged further negotiation on these items. Once the economic toll of the pandemic became apparent, the agency halted any further consideration of PLCB-initiated retail price adjustments during 2020.

While the PLCB did not pursue any retail price increases in 2020, some suppliers did request retail price increases or raise product acquisition costs. In the listed portfolio, which represents the most popular wine and spirits, there were 373 items with supplier-initiated retail price increases and 88 products with retail price decreases during 2020. Further, there were 372 cost increases and 96 cost decreases.

The COVID-19 pandemic altered the PLCB’s 2020 pricing plans, but it did not change the established methodology, rationale and procedures used to consider future retail price adjustments. Products are evaluated on an individual basis to determine opportunities for retail price adjustments. Fundamentally, any retail pricing decision must balance the goals of optimizing sales performance by providing value to our customers and maximizing revenue through gross margin. In order to achieve this balance, the Bureau of Product Selection examines a variety of metrics to set retail prices and determine where there is opportunity to increase gross margin. Some of these factors include assessing product quality in relation to the manufacturer’s suggested retail price; analyzing sales trends; comparing gross margin percentage to category peers; and considering product prices at the winery or distillery. While retail prices in other states are also considered, varying tax structures in other jurisdictions and the dynamic nature of retail prices create challenges when comparing prices across state lines.

The PLCB continues to engage suppliers in a dialogue about pricing and other industry issues. For example, the pandemic disrupted global supply chains in 2020 and resulted in significant supply limitations for certain products. The agency engaged in frequent conversations with suppliers to discuss challenges and service interruptions and worked to prioritize Pennsylvania when items became available. Additionally, PLCB executives meet regularly with industry groups to maintain open lines of communication and address concerns.

The PLCB’s Office of Wholesale Operations works closely with licensees to meet their business needs, especially high-volume wine expanded permit holders. With respect to pricing, the agency continues to provide advanced notification to wholesale customers of forthcoming price adjustments. This process allows licensees to forward buy products at a lower retail price.

Limited Purchase Items

The 2016 pricing reforms also made limited purchase items – including all luxury wines and spirits, as well as the Chairman’s Selection and Advantage programs – subject to flexible pricing. All these items are purchased as one-time buys. The below chart reflects the luxury and Chairman’s portfolios for calendar year 2020:

	Item Count	Dollar Sales	Unit Sales
Luxury Spirits	755	\$15,516,553	302,877
Luxury Wine	6,730	\$61,263,627	3,192,263
Chairman’s	402	\$61,355,520	5,032,796
Total	7,887	\$138,135,700	8,527,936

The Bureau of Product Selection considers the acquisition and pricing of limited purchase products similarly to the listed portfolio. However, limited purchase items often offer increased

opportunity for incremental margin gains, since every acquisition represents a new negotiation with a supplier. Product acquisitions and pricing for the Chairman's portfolio focuses particularly on the product's quality to value proposition. The Chairman's Selection and Advantage programs are intended to provide products that exceed the quality expectations at their respective price point. Furthermore, the agency continues to engage in direct purchasing negotiations with wineries and distilleries, which can result in lower product acquisition costs for the PLCB and provides customers with greater access to items with superior quality from smaller producers.

Limited-Release Lottery Products

Flexible pricing allows the PLCB to more appropriately price limited-release products from manufacturers based on supply and demand. Prior to Act 39, these highly allocated products had the same mark-up as ubiquitous mass market products, despite being extremely sought after by retail customers and licensees. The PLCB uses a lottery process to distribute limited-release products for which demand significantly outpaces supply. Individuals and licensees register for the lotteries on FW&GS.com and must provide a valid Pennsylvania address. The COVID-19 pandemic disrupted the normal cadence of limited-release lotteries conducted by the PLCB. However, limited-release lotteries were conducted in January and November 2020. Limited-release lotteries continue to experience significant interest from retail customers and licensees.

FORWARD-LOOKING STRATEGY

The PLCB does not plan to pursue significant agency-initiated retail price increases during 2021. The agency will continue to actively negotiate with suppliers on an item-by-item basis to improve incremental margin and drive sales growth.

In the interest of providing value to customers, the PLCB also invests in sales events like a Cyber Monday e-commerce sale and 10 percent-off sales celebrating all store grand openings. Grand opening sales have been extended from one to three days in order to reduce the potential for crowds during the COVID-19 pandemic.

To benefit licensees, the PLCB has submitted a proposed rulemaking to the Independent Regulatory Review Commission to eliminate the \$50 minimum purchase requirement for licensees to enjoy their 10 percent discount off retail prices. With this regulatory amendment, licensees will receive the licensee discount regardless of purchase amount.

The PLCB is currently embarking on a multi-year design and implementation project for a new enterprise resource planning (ERP) platform. One of the business goals of this project is to allow

the agency to more efficiently allocate and sell through products. This will improve the customer experience and provide financial benefits through improved efficiencies.

After almost five years of engaging in flexible pricing, negotiations regarding product acquisition costs and retail pricing have become a natural part of the perpetual dialogue between the PLCB and its suppliers. The agency's implementation of flexible pricing is not a static process, and the PLCB will continue to engage in conversations with suppliers to achieve mutually beneficial outcomes. The economic impact of the COVID-19 pandemic has made it more important than ever for the agency to provide quality and value to our wholesale and retail customers, while continuing to deliver a reliable source of revenue for the Commonwealth.