



Annual Report on Method & Rationale for Product Pricing

As Prescribed by Act 39 of 2016



April 1, 2022



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) sixth annual report on the method and rationale for product pricing. During 2021 the PLCB continued to adapt to the constantly evolving beverage alcohol marketplace—from global supply chain challenges to ongoing pandemic-related shifts in consumer preferences—to address the business needs of our licensee customers and the expectations of individual consumers.

The PLCB remains committed to pricing products in a manner that allows the agency to deliver quality, selection and value to our customers and meet our obligations to support the Commonwealth through the agency's transfers to the General Fund and funding provided to other beneficiaries. The following report includes historical background; outlines the standards used to guide cost negotiations with supplier partners and evaluate and establish retail prices; summarizes process changes to the administration of product promotions; and details the PLCB's 2022 pricing plans.

We look forward to further discussing the agency's method and rationale for product pricing at the upcoming joint public hearing before your respective committees.

Sincerely,

Tim Holden
Chairman

Mike Negra
Board Member

Mary Isenhour
Board Member

STATUTORY PRICING REQUIREMENTS

Historical Background

The pricing structure for wine and spirits sold by the 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 customers at Fine Wine & Good Spirits (FW&GS) stores and online at FWGS.com. Licensees receive a statutorily established 10 percent discount off the retail price.¹

Prior to the pricing reforms included in 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 markup to price products. The PLCB's markup structure, prior to the enactment of Acts 39 and 85, consisted of two straight percentage markups (a one percent, then a 30 percent markup), as well as a handling fee called the logistics, transportation and merchandising factor (LTMF). Subsequently, the 18 percent liquor tax was applied and then rounded to "the nearest nine" to determine the retail price.

The uniform markup structure prevented any consideration of product supply and demand or other marketplace factors in pricing decisions. Consequently, a mass market chardonnay had the same markup as a highly sought-after and limited-release bourbon. The proportional markup also allowed suppliers to set the retail price of products and maximize their margin by using the markup structure to work backward to calculate their product acquisition cost to the PLCB.

The PLCB did have the authority to set the markup and it varied throughout the history of the agency. However, prior to the enactment of Act 39, the 30 percent markup had not changed in more than two decades.

Pricing Reforms Under Acts 39 and 85 of 2016

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 of 2016—which amended the Fiscal Code, but contained provisions

¹ In early October 2021, the PLCB implemented a regulatory change to allow licensees to receive a discount on every wine and spirits purchase they make from the PLCB regardless of total amount. Previously, there was a \$50 minimum purchase requirement for licensees to utilize their 10 percent discount off retail prices.

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 markup on special order products was reduced from 30 percent to 10 percent. The pricing structure for special order products still includes the LTMF and these products are, by statute, not eligible for the 10 percent licensee discount. The special order portfolio consists of approximately 53,000 specialty items that are not stocked in FW&GS stores or licensee service centers. Licensee purchases generally account for 98 to 99 percent of total special order sales annually.

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 markup and is included in the product’s retail shelf price. The liquor tax is transferred to the General Fund and does not support the PLCB’s operations or annual cash transfers to the General Fund. Wine or spirits sold directly by Pennsylvania licensed manufacturers to individual consumers and licensees, as well as wine sold by licensed direct wine shippers, are not subject to the liquor tax.

METHODOLOGY & RATIONALE

The PLCB’s pricing philosophy remains focused on using its authority 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 for other state, local, community and industry beneficiaries. These goals are both supported by the standards that guide product evaluation processes and negotiations with suppliers.

Product Portfolio

Acts 39 and 85 pricing reforms allow the PLCB to negotiate product acquisition costs on all items in the listed, luxury and Chairman’s portfolios. Listed products are the wines and spirits most commonly purchased by retail and wholesale customers across the state. Items in the luxury portfolio, as well as the Chairman’s Selection program, are purchased and distributed as one-time buys and are also subject to flexible pricing.

The below chart reflects the listed portfolio for calendar year 2021:

| | Item Count | Dollar Sales | Unit Sales |
|-----------------------|-------------------|---------------------|-------------------|
| Listed Spirits | 2,346 | \$1,655,507,292 | 96,849,861 |
| Listed Wine | 2,977 | \$889,133,603 | 70,098,321 |
| Total | 5,323 | \$2,544,640,895 | 166,948,182 |

The below chart reflects the luxury and Chairman’s portfolios for calendar year 2021:

| | Item Count | Dollar Sales | Unit Sales |
|-----------------------|-------------------|---------------------|-------------------|
| Luxury Spirits | 891 | \$27,954,957 | 607,975 |
| Luxury Wine | 5,266 | \$82,715,015 | 4,526,515 |
| Chairman’s | 303 | \$60,596,001 | 5,202,385 |
| Total | 6,460 | \$171,265,973 | 10,336,875 |

Product Evaluation & Negotiation Process

The PLCB delivers selection and value to our customers by evaluating items on an individual basis to ensure our product assortment—in FW&GS stores, licensee service centers and online at FWGS.com—reflects constantly shifting and diverse consumer preferences across Pennsylvania. Generally, products enter the agency’s portfolio either through the listing process (listed portfolio) or as one-time buys (luxury and Chairman’s portfolios). While the metrics that guide the product acquisition process are similar regardless of the product portfolio, each portfolio serves a specific purpose within the PLCB’s overall product assortment. As a result, the product evaluation process emphasizes different criteria for each portfolio.

Products in the listed portfolio are evaluated by the PLCB, in partnership with suppliers, to identify items that have the potential to improve the PLCB’s product assortment and respond to industry trends. Specifically, the Bureau of Product Selection considers market-based criteria such as anticipated category growth; brand recognition; customer trade up opportunity; line or size extension of a successful brand; historical sales data; product innovation; segment underrepresentation within the current portfolio; and supplier marketing support when evaluating products for listing.

The PLCB negotiates product acquisition costs with suppliers and establishes retail prices by considering a variety of financial metrics together with market-based criteria. For example, gross margin potential, gross margin percentage relative to comparable items within the product category, manufacturer’s suggested retail price and the impact of key threshold price points on sales are all evaluated during the negotiation process.

Every recommended listing must provide value to the PLCB’s overall product portfolio. The agency reviews new item submissions for the listed portfolio twice a year. Sales of new listed products are regularly evaluated to determine if a product is underperforming.

The acquisition and retail pricing of products through one-time buys, such as those in the luxury and Chairman's portfolios, is assessed similarly to the listed portfolio, but are considered throughout the year. These opportunities leverage the PLCB's buying power and longstanding relationships with wineries, distilleries and suppliers across the globe to provide Pennsylvanians with access to high quality and unique products. One-time buys can be used to test market demand for new products before committing to a larger acquisition of product.

One-time buys in the luxury and Chairman's portfolios often present opportunities for incremental margin gains since every acquisition represents a new negotiation with a supplier. Product acquisitions and retail pricing for the Chairman's portfolio focus on over-delivering on the quality to value proposition for customers, offering products that exceed quality expectations at their respective price points. Additionally, the agency continues to engage in direct purchasing negotiations with wineries and distilleries, which can often result in lower product acquisition costs for the PLCB and provides customers with a greater selection of unique and quality items from smaller producers.

The PLCB uses a multi-tiered review process for establishment of product acquisition costs and retail prices for wines and spirits. 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. A pricing coordinator also evaluates pricing decisions across various categories and portfolios to ensure consistency in the agency's pricing practices. As required by Act 39, quarterly product price lists dating back to October 2016 are posted at lcb.pa.gov. Additionally, current retail prices are available at FWGS.com.

The PLCB remains keenly aware of its role as the sole avenue for certain suppliers and products to access the Pennsylvania marketplace. Consequently, the agency remains firmly committed to exercising its flexible pricing authority fairly, consistently and cooperatively. All PLCB employees must adhere to an employee code of conduct and vendors are subject to a vendor code of conduct to promote and preserve integrity.

Limited-Release Lottery Products

Flexible pricing also allows the PLCB to more appropriately price and fairly distribute through its limited-release lotteries the most sought after, highly popular products for which demand significantly outpaces supply.

Individuals and licensees register for the lotteries on FWGS.com and must provide a valid Pennsylvania address in order to enter to win the opportunity to purchase a rare bottle. In 2021, limited-release lotteries were held in January, May and November. Limited-release lotteries continue to experience tremendous interest from retail customers and licensees who appreciate that

these bottles are only made available to Pennsylvanians and are distributed through a random drawing process open to all interested residents.

Product Promotions

At the end of 2021, the PLCB began to change its administration and implementation of sale prices offered in FW&GS stores. For customers, these appear as monthly “save \$1/\$2/\$3/etc. off regular retail price” sale tags on certain products. Previously, temporary promotional sale prices, referred to as special pricing allowances (SPAs), were funded on a reimbursement basis by wine and spirits suppliers. After the SPA on an item concluded, the supplier would reimburse the agency for the full cost of the price discount based on actual sales totals. The amount and timing of SPAs were proposed by suppliers and approved by the PLCB.

Under the new approach to temporary sale prices, the PLCB will fund product discounts from the regular retail price through negotiated reductions in product acquisition costs. In proposing to suppliers a new, lower product acquisition cost to support regular and discounted prices throughout the year, the PLCB considers each product’s historical unit sales when subject to a SPA, as well as the dollar amount of past SPAs. Moving forward, the PLCB will determine the timing and discount levels of sale prices, with the intention of continuing product discounts at historical levels based on past unit sales. Consequently, the PLCB does not expect this procedural change to impact customers, who will continue to see hundreds of sale prices in FW&GS stores and at FWGS.com each month.

The PLCB is committed to an open dialogue with our supplier partners regarding these changes. Ultimately, the decision to support promotional sales discounts through reduced product acquisition costs rests with each supplier.

Retail Price Adjustments

The PLCB’s methodology, rationale and procedures regarding consideration of retail price adjustments remains unchanged: 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. To achieve this balance, the Bureau of Product Selection examines a variety of metrics to determine where there is opportunity to increase margin and set retail prices. 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 through direct-to-consumer channels, such as a manufacturer’s tasting room. While retail prices in other states are also considered, varying tax structures and the dynamic nature of retail prices create challenges when comparing prices across state lines.

Given the continued impact of the COVID-19 pandemic on licensees and retail customers, the PLCB did not unilaterally initiate retail price increases for a second consecutive year. However, in 2021, across the listed portfolio there were 553 items with product acquisition cost increases by suppliers and 534 items with retail price increases by the PLCB. Generally, these product acquisition cost increases from suppliers resulted in retail price increases by the PLCB, but in some cases suppliers sought adjustments to retail prices based on changes to the manufacturer's suggested retail price of an item or other aspects of their product marketing plans. Depending on current gross margin and potential shifting of a retail price beyond a key threshold price point, small increases in product acquisition costs by suppliers sometimes do not result in any adjustment to the retail price by the PLCB. Further, in 2021, there were 114 items with product acquisition cost decreases and 87 items with retail price decreases. PLCB-negotiated product acquisition cost decreases oftentimes result in retail price decreases; however, items are individually evaluated to balance the retail price with the opportunity for increased margin and the anticipated impact of any retail price change on unit sales.

During 2021, significant supply chain disruptions and limited supplier allocations for certain products resulted in the PLCB's imposition of purchase limits for a small number of products in the PLCB's portfolio. While flexible pricing afforded the PLCB the authority to increase the retail prices on these supply-constrained products to offset demand, the agency instead chose to implement purchase limits to most fairly distribute these products to retail customers and licensees across Pennsylvania. While these limits were new to certain products in 2021, the PLCB has imposed purchase limits on specific highly allocated products for years—both in store and online—to prevent a limited number of customers from hoarding product and to provide access to limited quantities of product to more customers.

Since its inception after Act 39, the PLCB's Office of Wholesale Operations has worked with licensees to address their specific business needs, especially the unique demands of high-volume wine expanded permit holders. With respect to pricing, the Wholesale Operations team continues to provide advanced notification to wholesale customers of forthcoming price adjustments. This allows licensees to plan purchases and their own retail pricing with the benefit of that knowledge.

FORWARD-LOOKING STRATEGY

For a third consecutive year, the PLCB does not plan to initiate any retail price increases in 2022. However, it is anticipated that current global inflationary pressures and continued supply chain challenges and raw material limitations will inspire more cost increases from suppliers, which will likely lead to higher retail prices. The uncertain economic environment heightens the importance of timely and open communication between suppliers and the PLCB as we all navigate the dynamic marketplace. The PLCB will continue to meet with industry stakeholders to discuss issues and collaboratively identify solutions.

The PLCB also plans to continue offering sales for customers like last year's 10 percent-off Cyber Monday sale, 10 percent-off sales in conjunction with the opening of new stores and clearance sales offering discounts of 20 to 50 percent. Recently, the PLCB offered a 20 percent store closing sale when a lessor terminated a lease and no local alternative was available, which both surprised and delighted customers and significantly reduced product relocation costs for the PLCB.

Following the successful implementation in January of the first, financials phase of a new enterprise resource planning (ERP) platform, the PLCB will continue work on the next, most transformative phase in 2022. The new ERP platform will support, with out-of-the-box, cloud-based technology, the new approach to managing the PLCB's promotional sales events. As a whole, the new ERP platform will enable the PLCB's business transformation from a traditional retail model to a wholesale/distribution, retail and e-commerce focused business, providing for improvements including standardization of wholesale and retail business processes and financial reporting according to industry best practices and out-of-the-box functionality; elimination of costly and resource-intensive system customizations; cloud-based software updates; standardized practices for inventory acquisition, allocation and sell-through; improved data integrity; standardized reporting and greater wholesale and retail efficiencies.

In closing, the agency will continue to use flexible pricing to collaboratively negotiate with suppliers on an item-by-item basis to improve margin and introduce mutually beneficial strategies to responsibly grow sales. The uncertain economic climate and ongoing supply chain issues pose challenges for both suppliers and the PLCB. Nonetheless, the agency remains committed to providing quality, selection and value to our retail and wholesale customers, and fulfilling our financial obligations to the Commonwealth.