

PLCB Flexible Pricing Authority: A Review of Consumer Impacts

Summary:

- This is the first comprehensive review of what has happened to wine and spirits pricing in Pennsylvania since Act 39 gave the PLCB flexible pricing authority.
- The PLCB has used its flexible pricing authority to increase markups and, in doing so, increase consumer prices.
- The average markup on distilled spirits has jumped from 57.9% to 63.5% (Jan 2016 to Dec 2018), an increase of 5.6 points or 9.8%.
- Naturally, higher markups have led to higher prices for consumers as the average consumer shelf price increased from \$168.03 to \$180.61, a 7.6% increase in the same date range.
- Similarly, the markup on the largest wine brands, those accounting for 50% of all volume, increased from 60.8% to 69.3%, an increase of 8.5 points or 14.0%.
- As a result, wine shelf prices also went up, increasing from \$50.09 to \$55.27 or 10.3% for the top 50 wines and from \$82.30 to \$88.13 or 7.1% for all wines.
- While shelf prices for both spirits and wine have increased since the PLCB began flexible pricing, nationally spirits prices have gone down, and wine prices have increased by less than 1%.
- The PLCB used its flexible pricing authority to consistently *increase* the markup on both distilled spirits and wine to the detriment of Pennsylvania consumers.

Introduction

Acts 39 and 85 granted the Pennsylvania Liquor Control Board (PLCB) permission to use flexible pricing to price the products sold to Pennsylvania consumers. That authority went into effect in August 2016. Prior to that time the PLCB was required to use proportional pricing through a set pricing formula.

To date, the PLCB has only made generic statements about the impact flexible pricing has had on the prices that consumers pay. However, statements like “For some products, average retail prices increased, others did not,” reveal little about consumer

impact. Both the Pennsylvania State Legislature and the general public have an interest in getting a more robust understanding of how flexible pricing has impacted the prices consumers pay.

S.E. Koontz Software, Inc. was engaged by the Distilled Spirits Council of the United States, the American Distilled Spirits Association and the Wine Institute to investigate what impact flexible pricing has had on consumer prices. We analyzed both distilled spirits and wine prices and markups in the two years prior to the implementation of flexible pricing (2015 and 2016) and the two years following (2017 and 2018). Data were taken from the National Alcoholic Beverage Control Association's SAM II database.

We analyzed two important metrics impacting the final shelf price paid by consumers; the cost of acquiring spirits and wine from suppliers (acquisition cost) and the markup imposed by the PLCB. For this exercise, we are using the "total markup" paid by the consumer. Thus, our total markup calculation includes the 18% Johnstown Flood Tax, the Logistics, Transportation and Marketing Fee, and the now variable markup that was set at 30% prior to passage of Act 39.

Acquisition costs and shelf prices will vary greatly by brand and bottle size. We have converted all acquisition costs and shelf prices into 9-liter case equivalents in order to have comparable units.

Distilled Spirits

Acquisition cost: The average cost per case paid by the PLCB for all spirits increased from \$106.30 (Jan 2016) to \$110.50 (Dec 2018) per 9-liters over the 2016-2018 period, an increase of \$4.20 (4.0%) or an annual rate of increase of only 1.3%. Over the same period the Consumer Price Index for All Urban Consumers (CPI-U) was increasing at an annual rate of 2.0%. Thus, supplier price increases were limited and generally did not keep pace with inflation. Some of this increase could be due to changes in product mix.

Markup: While there was little change in product acquisition cost, the same cannot be said for the markup charged by the PLCB. Over the study period, the PLCB's markup on spirits increased from 57.9% to 63.5% an increase of 5.6 points or 9.8%.

This is a rapid increase. As the chart below shows, most of this increase came in 2017, the first full year in which the PLCB had flexible pricing authority.

Figure 1

Rapid Increase in Mark-Up in First Full Year of Variable Mark-Up



Shelf Price: The shelf price is the most important component – it is what the consumer ends up paying. At the beginning of 2016 the average shelf price per 9-liters was around \$168.03. By the end of 2018 the shelf price had grown to \$180.84 – an increase \$12.81, or 7.6%. It should be noted that under the former fixed markup pricing system the shelf price would have been only \$175.20. Thus, of the \$12.81 increase in price per 9-liters \$7.17 accrued to the PLCB and \$5.64 was the result of flexible pricing.

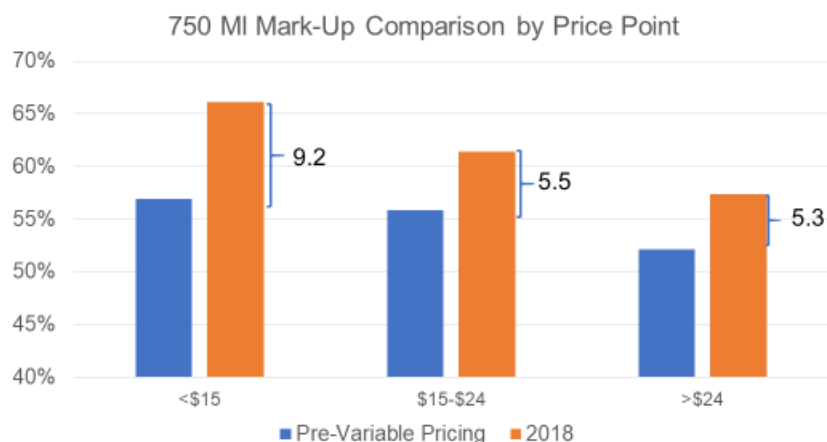
Increasing the average markup from 57.9% to 63.5% cost spirits consumers an additional \$49 million in 2019. While the PLCB was correct in saying that “for some products average retail prices increased, (and) others did not,” on average, prices went up noticeably. [$\$880M * (63.5\% - 57.9\%) = \$49M$]

It should be noted, that over the 2016-2018 period, the U.S. CPI-U for distilled spirits declined by 0.7%. Thus, while national spirits consumer enjoyed lower prices over the period analyzed, Pennsylvania shoppers were paid higher prices.

Other: While the above analysis looked at total spirits, markup increases were very arbitrary across product price point and product category. As Figure 1 shows, the lowest priced 750 Ml products (one of the most common bottle sizes) saw the biggest markup increases. Products retailing for more than \$24 per bottle saw a markup increase of only 5.3 points [from 52.1 to 57.4]. But products retailing for less than \$15 saw a much larger 9.2 point increase [56.9 to 66.1].

Figure 2

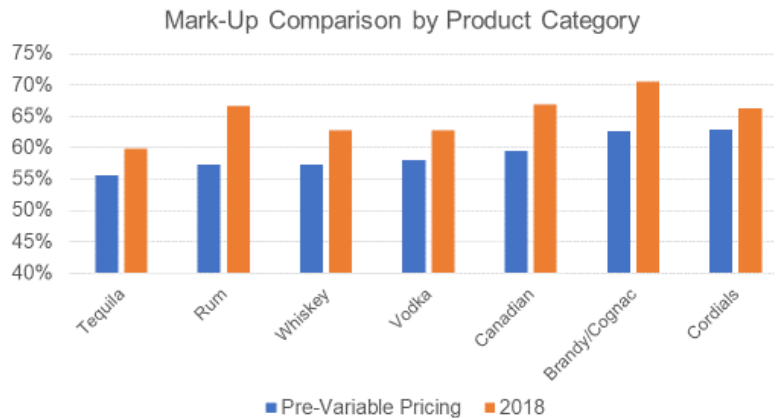
Lowest Price Products Saw Biggest Mark-Up Increases



Similarly, Figure 2 shows how arbitrary markup increases were across product categories. Tequila had the lowest composite markup before flexible pricing went into effect (55.5%) and saw an increase of 4.3 points. Brandy/Cognac had one of the higher composite markups initially (62.6%) but then saw the highest increase in markup post flexible pricing (70.5%).

Figure 3

Mark-up increase by product category varied greatly



Wine

The PLCB sells more than 16,000 wine brands, but only 177 foreign and domestic wines comprise 50% of all sales by volume. Thus, the consultants deleted imported wines in this top half and focused on 139 domestic wines that comprise the top 50% of all sales. These high-volume brands tend to be lower-priced, value labels. The consultants did a separate analysis for all the remaining domestic brands included in the analysis of the bottom 50% of all sales by volume. The large number of labels in the bottom half of the sales volume include wines at all price points. Recall that for the sake of comparison, products of all sizes have been converted to 9-liter case prices.

Top 50% of Domestic Wines by Volume

Acquisition cost (top 50%): Like spirits, acquisition costs of the top domestic wine brands increased from \$31.21 per 9-liters prior to implementation of flexible pricing to only \$32.67 in 2018. The resulting \$1.46 increase per 9-liters represents just a 4.7% increase over three years or an average of 1.6% annually, below the general inflation rate of 2.0% annually.

Markup (top 50%): The markup on the top 50% of wines increased dramatically over the study period, starting at 60.8% but climbing to 69.3% by end of 2018. This 8.5- point

increase represented a 14.0% increase in the PLCB’s markup on such wines. Like spirits, there was a dramatic increase in 2017.

Figure 4

Rapid Increase in Mark-Up in First Full Year of Variable Mark-Up



Shelf price (top 50%): The rapid increase in markup led to the average shelf price for 9-liters to increase from \$50.09 to \$55.27, a \$5.18 or an 10.3% increase.

Bottom 50% of Domestic Wines by Volume

Acquisition Cost (bottom 50%): The average acquisition cost of the bottom 50% declined slightly from \$66.22 per 9-liters to \$65.82, a \$0.40 drop over the study period.

Markup (bottom 50%): The markup on the bottom 50% of wines increased from 59.0% to 65.5%, while not as dramatic as the top 50%, still substantial and represents a 11.0% increase in the markup.

Shelf Price (bottom 50%): Because there was a reduction in acquisition costs, increases in shelf-prices were mitigated. However, since the markup increased by 11.0%, the shelf price still increased from \$105.26 to \$108.89.

Conclusion: The PLCB has used its flexible pricing authority to increase its markup on both spirits and wine and, in doing so, increase consumer prices. These price increases were not trivial. Shelf prices for the average spirits product increased by 7.6% over the study period while, nationally, prices declined 0.7 percent. Pennsylvania wine consumers suffered a similar fate. Average shelf prices for wine increased by 10.3% for the top 50% of wines by volume, while national wine prices increased by only 0.9%. In short, Pennsylvania consumers have not benefited from the PLCB's move to flexible pricing on spirits and wine.