DISTILLED SPIRITS COUNCIL OF THE UNITED STATES

AMERICAN DISTILLED SPIRITS ALLIANCE

January 24, 2022

To:
Majority Chairman Carl Metzgar (House Liquor Control)
Minority Chairman Daniel Deasy (House Liquor Control)

From:
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Matt Dogali, President and CEO, American Distilled Spirits Alliance

On behalf of the Distilled Spirits Council of the United States (DISCUS) and the American Distilled Spirits Alliance (ADSA), national trade associations collectively representing approximately 90 percent of the market share in the United States, thank you for giving us the opportunity to present our views on the question of whether Pennsylvania voters should privatize the Pennsylvania Liquor Control Board (PLCB). Before we do that, we would like to express our strong support for control state systems around the country. Our associations firmly believe in and support a state's right to choose how alcohol is regulated inside its borders, as envisioned by the 21st Amendment. As such, we take no formal position on the issue of privatization at this time. While we feel it is important for the governing bodies and citizens in each state to decide the best way to distribute and sell distilled spirits, we are not precluded from communicating our thoughts on how the current system in Pennsylvania is working overall.

PENNSYLVANIA

Mr. Chairman and members of the committee, we wish this was the first time we were before the legislature discussing our concerns. But regrettably the spirits supplier and Pennsylvania relationship remains tumultuous. The strained relationship is not a result of this new privatization effort. As mentioned in our introduction, we are not here to comment on the privatization effort. Rather, we would like to highlight the oddity of the difficult relationship we have with the PLCB, and how counter that is to our relationship with every other control state. Across the U.S. we expend time and association resources supporting and working with other control states to further their success. In control states like Alabama, Iowa, and Ohio, we are proud of the relationships we have and the work we have done to support these states' systems. This collaborative effort has led to better consumer service, even during a global pandemic.

From our perspective, the difference between the PLCB and other control states is that the PLCB outright ignores their greater responsibility to the citizens of the commonwealth as a government sanctioned monopoly. The PLCB has been given too much power and authority over its business partners. The PLCB, on an annual basis, is under great pressure to generate revenue for the commonwealth. Typically, or so we have been told by the PLCB on multiple occasions, the sitting governor and legislature tells them how much money they need to raise, and it's the PLCB's job to figure out how to do it. But with escalating employee and real estate costs, it is very difficult to meet that obligation. In turn, and unlike other control states, the PLCB has enacted anti-consumer, anti-industry measures to meet their goals. When every other control state in the U.S. is having banner sales years by collaborating with industry, the PLCB is having a banner year by squeezing industry at every turn with fines and price increases, all with little to no communication.

But how is the PLCB different? As we elaborate below, it's the actions the PLCB has taken and continues to take as a monopolistic governmental entity. The PLCB controls both the retailing of spirit products and the pricing of spirits products without any in-state competition. Retailing and pricing is what they do, and, in both cases, there needs to be dramatic reforms.

Retail Landscape

As we have stated before, the state needs more outlets. There is less than one store per 10,000 consumers in Pennsylvania; the national average is 3.39 outlets per 10,000 consumers. This translates to just a tick above 600 stores in Pennsylvania for a population of roughly 12 million people. Act 39 put wine, which is also state controlled, in R-licenses, exacerbating the disparity for spirits products. In addition, popular new ready-to-drink (RTD) cocktails are prohibited from being sold in stores outside of the PLCB system, while their malt- and wine-based counterparts with the exact same alcohol content enjoy this privilege.

The lack of stores and inadequate amount of spirits retailing opportunities puts a great deal of strain on the PLCB which in turn forces them to make business decisions which are not in the best interest of Pennsylvania consumers. Because of the pressure to raise revenue, the PLCB has been forced to manipulate their pricing policies, which unfortunately was authorized by the legislature via Act 39. While Pennsylvanians were celebrating the sale of wine in grocery stores, the PLCB was using their new power over pricing to do away with an even handed, transparent process that protected consumers. This has resulted in an unprecedented level of PLCB initiated price hikes, as well as the illegal collection of wine fees which will result in the PLCB being forced to reimburse millions of dollars to small business owners across the commonwealth.

Flexible Pricing

In June and September of 2019, we submitted testimony to the House Liquor Control Committee and the Senate Law and Justice Committee regarding Act 39. What we said then unfortunately still remains true in 2022. The reality is that since 2019 things have gotten worse, not better.

From our 2019 comments:

> "While we firmly believe in a state's right to control alcoholic beverages, we also believe we must always be serving the consumer with quality products at a fair price. Now that we have worked within the system for almost [five] years, we feel we can accurately state that Pennsylvania's system is no longer fair or balanced for the supplier and that the consumer in the commonwealth is paying the price with higher retail costs.
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> "Prior to Act 39, Pennsylvania had a strict pricing formula that required prices to be proportional, a fair system that treated all suppliers equally. Any discounts offered by a supplier would directly benefit consumers in Pennsylvania with a lower retail cost. The mechanics of the system were transparent. Suppliers were able to hit key retail price targets by using the fixed formula to calculate their unit cost or FOB. Consumers could expect stable, competitive prices.
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> "Retail pricing is a complex process. [Our] member companies spend a tremendous amount of time calculating their suggested retail prices, to both maximize value to the consumer and properly represent their products in the marketplace. A retail price can infer quality, it can drive sales, it can demonstrate value, and most importantly it allows consumers to have options.
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> "The creation of flexible pricing was championed by the PLCB as a way to more effectively negotiate with liquor suppliers and increase revenue. It was also purported to be a mechanism to give the PLCB better bargaining power with suppliers that would lower the consumer retail price. In actual practice, retail prices on dozens of members' products have been increased by the PLCB, increasing cost to consumers in the commonwealth. These prices have been raised against supplier request and recommendation, with limited notice from the PLCB and little room for negotiation. There is limited transparency in the new flexible pricing process, both for the suppliers and the consumers.
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> "Because the mechanics of the new flexible pricing process limit a supplier's ability to negotiate, we either accept the arbitrary PLCB retail price increases or we remove our product from the market. Act 39 has become a defacto tax increase on whatever products the PLCB choses. A tax increase not paid by the supplier, but rather one paid by the citizens of Pennsylvania at the cash register. For those that live close to a border, it could incentivize them to make their alcohol purchases in a neighboring state. For those that don't, they just have to pay more since the commonwealth is the only retailer of distilled spirits. It doesn't have to be this way."

Every word of our 2019 comment remains true today. And, in addition to the targeted price increases the PLCB was executing, in the Spring of 2020, they sent a broad stroke notice of price increases to industry members. In the middle of a global pandemic, where life was upended and businesses closed, the PLCB was trying to move forward with yet another round of price increases. DISCUS and ADSA wrote a joint letter to the PLCB asking to cancel the mid-pandemic price increases, and after mounting public pressure, the PLCB agreed. However, our concern remains - why did the PLCB feel the need for yet another round of price increases at all.

Fines and Fees

While the PLCB did indeed back off increasing prices in 2020, an area they have not made adjustments in and are likely collecting record money from is the implementation of out-of-stock fines. While the PLCB does have a "waiver" program in place to suspend targeted out-of-stock fines, the process and paperwork for both sides are onerous. While most other control states have suspended all out-of-stock fines due to the scope and depth of supply chain issues, the PLCB is collecting record fines for shipping and transport issues that are out of our control. We have previously requested and will continue to request the PLCB suspend out-of-stock fines. Other control states, in an effort to be good industry partners that are well aware of the global logistical issues and delays, have already done so. So, why not the PLCB?

Changing Special Pricing Allowances to Planned Sales Events

Special Pricing Allowances (SPA) are used in many control states as a means to offer consumers periodic discounts on selected products. The offering of SPA's benefits all parties - supplier, control state and consumer - by providing discounts to each tier based on sales volume during a set period of time. Before we dive into the reasoning behind why the PLCB eliminated SPA's, the bottom line is many other control states continue to run successful SPA programs today.

For unknown reasons, the PLCB initiated an inquiry with the Alcohol Tobacco Tax and Trade Bureau (TTB) asking if Industry Circular 87-2 (a kind of guidance document) issued in 1987 was still in effect. The TTB notified the PLCB that Industry Circular 87-2 was still in effect. The information contained in the Industry Circular discusses the concept of creating depletion allowances, a business arrangement where a spirits supplier agrees to offer a discount to a retailer when a certain amount of the product is sold. If the volume number is not met, then no discount is offered. This common sales incentive tactic is often called a SPA. The discussion in the document focuses on *could* this sales practice be seen as an inducement, but what is seemingly ignored by the PLCB is a) they are a control state, and b) the document does not affirmatively state this *is* an inducement, rather it *could* be an inducement.

While in open states concerns about inducements and anti-competitive behaviors are potential reasons the TTB may investigate, the monopolistic nature of the PLCB removes much of the concern around anti-competitive pricing tactics - the price of brand X vodka is the same in every single retail outlet across the commonwealth. If a discount is offered in one jurisdiction, it is offered in all of them.

In place of the popular and successful SPA program, the PLCB instituted the new Planned Sales Events (PSE). PSE's differ greatly from SPA's by:

- Eliminating supplier input on when sales occur and what the frequency is;
- Eliminating supplier input on the depth of the discount offered;
- Requiring suppliers to surrender all potential discounting dollars before the sale has even begun - with no guarantee that a specific volume will be sold AND that any discount offered is no longer required to be passed on the consumer;
- Eliminates all recourse if a supplier is unhappy with the results of the new process (suppliers cannot revert to old unit pricing if a sale goes poorly);
- Handicaps route to market and general sales strategies by eliminating a supplier's ability to adjust discounts to respond to consumer trends and demands;
- Allows for suppliers to opt out of the program, but if they choose to, they will likely be at a competitive disadvantage in the commonwealth.

These changes may temporarily increase revenue for the PLCB, but the change in no way benefits consumers in the commonwealth. And, in this instance, this change was not needed, yet the PLCB moved forward with it anyway.

Conclusion

Our products are sold in every state in the U.S., be it an open state or a control state. While we defer to each state to choose its preferred methods of wholesale and retail, we worry about consumer price, choice, access and breadth of product. Act 39 and the past actions of the PLCB have proven problematic for our member companies, and the group that will continue to suffer the most are the consumers of our products in Pennsylvania. We enjoy a fantastic working relationship with other control states, and it is our sincere hope we can move towards a better working relationship in Pennsylvania. To that effort, we are ready and willing to work with you, the legislature, and the PLCB to find a way to roll back some of these anti-consumer and anti-business policies.

We have outlined real solutions and ways to fix the current system - how you get there is up to you. Taking no action will leave us all with the same frustrations, and our strange and complicated relationship with the PLCB will unfortunately continue. Thank you for your time and consideration.

Sincerely,

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