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Instituting "pricing flexibility" in commissaries

Items for consideration by Defense and Congressional policy makers

DoD proposal

The Department of Defense is proposing and Congress is considering changes to existing law that would allow for flexible pricing to generate profits from patrons to offset appropriations for commissaries.

This is a change from the current practice (and law) of selling products to patrons at cost.

DoD is proposing a "Category-based pilot" that would create profit margins and a "Store-based pilot" that would adjust prices within a store. DoD's stated intent is to "maintain the current level of savings to patrons today."

ALA position

ALA was operating under the assumption that there would be a limited pilot and an opportunity for review and comment prior to full-scale implementation. Now, it appears that that thorough review requirement and opportunity is falling by the wayside. We now are presenting these items for consideration:

- Adhere to a deliberate review and comment process prior to full-scale and irreversible implementation.
- Provide for a thorough review of all legal and regulatory implications (see attached summary of these considerations) of moving away from the cost plus five percent pricing model that has been the model for commissary operations for decades.
- DoD is proceeding with testing concepts that should be presented to Congress and groups representing patrons and evaluated prior to fielding.
- Congress should establish a patron advisory council to review this concept to avoid a Trojan horse of price increase and ensure adherence to Congressional and

Administration stated policy and proposed law that mandates no degradation of the existing commissary benefit for patrons.

- The pilot authority included in the fiscal year 2016 NDAA should not be expanded to permanent authority until the test is completed and objectively evaluated.
- Existing law should not be permanently changed until a test is conducted and objectively evaluated along these lines:
    1. Establish clear parameters and success measures (numbers and timeline) prior to test execution.
    2. The test should be limited in scope and duration.
    3. Limit tests to smallest possible geographies/fewest categories to allow DeCA to effectively measure the cost versus return (ROI).
    4. Closely define the parameters for any test of variable pricing to ensure a proper evaluation of the model is reviewed and accepted before expansion. We would suggest no more than one or two product categories are included in a test for evaluation. Patron savings levels must exceed current patron savings levels in the test categories.

Concerns and background supporting the ALA position

DoD and stated and Congress has mandated that any pricing changes should not result in any degradation of the benefit by increasing prices to patrons. The President's Commission on Military Compensation and Retirement Modernization adopted this principle.

Further, there are considerable legal and regulatory considerations that come into play when variable pricing is imposed on items being purchased by the Government. These argue for a thorough GAO review prior to implementation. Does increasing the price on one item give favorable treatment to another item where the price is not increased? Do contracting officers have the authority under the Competition in Contracting Act or other statute? (See attached legal and regulatory paper on policy considerations for variable pricing).

The pilots may seek to make changes to the way negotiating lower cost of goods sold. Two issues here:

1) Under price warranties, manufacturers already have to give commissaries the best price, and

2) If the purpose of private label is to provide deep discounted non-name brand products, you defeat the purpose by raising the prices to increase margin to offset appropriated fund expenditures.

We will be very interested in how these pilots are structured because right now it's tough to see how you reconcile margin increases while maintaining overall patron savings. DoD may propose increasing prices on some products and decreasing prices on others or raise and lower prices depending on geographic region. It's tough to see how this will generate funding without diminishing patron savings and we are going to very interested in how geographic pricing variations do not diminish savings for military personnel who are all paid the same wherever they serve.

The Administration is proposing to have an "Alternative Pricing Program" to allow for raising and lowering prices. We are not opposed to testing this concept through a pilot program but we believe that Congress should not grant carte blanche authority to the DoD to determine whether this program does not impact on patron savings. While the legislative proposal calls for "Specific, measurable benchmarks", Congress should retain its oversight role and charge GAO or another independent body with verifying that the alternative pricing proposals do not diminish the current level of benefits provided to patrons.

Consider:

Under price warranties, manufacturers already have to give commissaries the best price:

- If the purpose of private label is to provide deep discounted non-name brand products, you defeat the purpose by <u>raising the prices</u> to increase margin to offset appropriated fund expenditures.
- How do you reconcile margin increases while maintaining overall patron savings?

DoD may propose increasing prices on some products and decreasing prices on others or raise and lower prices depending on geographic region:

- It's tough to see how this will generate funding without diminishing patron savings
- How will any geographic pricing variations not diminish savings for military personnel who are all paid the same wherever they serve?
- In order to manage all of this, there will be a big learning curve for DeCA category managers who must fundamentally change the way they do business and conduct product negotiations.

With regard to pricing pilots, a major factor to consider is patron confusion:

- Military folks move from base to base. Will they see one model in one commissary and a different model in another? How can we expect patrons to understand what is going on?
- What is to be gained by increasing prices in one category and dropping them in another?

If you raise prices on a product, people buy less of it:

- If you raise prices on one category and lower them on another, you generally come out the same.
- If you regionalize prices, you have to regionalize pay if you want to keep the benefit equitable.

And, it depends on what you base savings on. The Military Coalition said it best when testifying before the House Armed Services Committee in January 2016:

> "*One concern we have is possible changes to the calculation of savings based on a newly defined market basket. DeCA calculates their average savings of 30% on an annual market basket study of the pricing of thousands of items compared against other grocery stores, regionally.*[6] *However, the BCG study used a different market basket analysis using 50 key items compared locally, and calculated that the average savings was only 16-21%.*[7] *A new market basket benchmark could potentially reduce savings to patrons if limited compared to DeCA's broad measure. We ask that DeCA's annual market basket methodology be retained to ensure savings levels are measured accurately against the current savings benefit.*"

A number of legal issues arise when introducing variable pricing procurement practices into the Federal acquisition framework to include endorsing commercial products and implications on existing resale ordering agreements with manufacturers. (See attached on legal ramifications of instituting this practice).

Further, there are implications on the Robinson Pitman Act when the commissary agency acts as a profit making entity in they eye of the commercial retail trade. (See attached on Robinson Patman Implications).

According to a DeCA-commissioned study by Willard Bishop and Dove Consulting in 2004, any gains from lowering product acquisition costs, marking up products and using the proceeds to offset operating costs resulted in major losses in vendor promotional and stocking support. The report recommended against changing the business model for DeCA.

A Department of Defense-sponsored consulting report found that the commissary agency could do a better job of "leveraging" its suppliers to reduce COG. DeCA is not that important to the overall food business to expect leverage suppliers to reduce COG. DeCA is recognized by suppliers for providing a military benefit by selling grocery products at cost and doing business requires a contractual commitment. The reality is that each supplier is required to sign a Resale Ordering Agreement (ROA) to provide DeCA with the best pricing available taking into account the incremental cost associated with doing business with DeCA versus other retailers. In addition, it can be argued that DeCA receives, in some cases, better pricing than retail because 100% of promotional monies are currently passed along to customers. This situation is not always the case with a retailer working on margin. The net effect is DeCA's COG is lower than it would be in a margin business model like retail outside the gate.

It should be noted that DeCA has the ability to influence its COG though distribution and promotional mix. It is also important to note that DeCA's third party distribution system allows for DeCA to compete favorably in COGs versus large grocery retailers as product purchased for DeCA is mixed with other retailer needs thus sourced at best pricing. The favorable shipping rates would not usually apply to products designed just for DeCA. For example, best sourced pricing would not apply to a private label branded product.

The highest margins in grocery stores are in non-food products that commissaries are prevented form selling due to the potential impact that this expansion of categories would have on exchange operations.

The shopping experience has changed dramatically over the recent past and today's supermarkets are much more than just a place to buy food products. There are coffee shops, cut flowers, extensive beer and wine offerings, gifting solutions as well as a variety of nonfood categories. While there are differences of opinion as whether this make sense for the military resale system in its entirety, there appears to be a potential benefit for the military patron to add these exchange categories to DeCA's stock assortment.

Following is data that suggest potential incremental revenue from adding a few popular categories typically stocked in a retail grocery store. The assumptions are the category could achieve 1 % of retail food category volume with a 15% up charge.

Geography : Total US - Food						
Time : Latest 52 Weeks Ending 06-14-15	TOTAL US FOODS		DeCA TOTAL -RMA - MILITARY		DeCA PPOTENTIAL SALES	GROSS PROFITS
PRODUCT	RETAIL RANK	TOTAL CATEGORY SIZE	TOTAL CATEGORY SIZE	DeCA % of RETAIL	1% OF RETAIL SALES	15% MARKUP
BEER/ALE/ALCOHOLIC CIDER	3	$ 9,871,306,530	$479,534	0.0%	$ 98,713,065	$ 14,806,960
WINE	7	$ 7,356,070,133	$69,763	0.0%	$ 73,560,701	$ 11,034,105
SPIRITS/LIQUOR	26	$ 3,094,778,352	$0	0.0%	$ 30,947,784	$ 4,642,168
TOTAL ALCOHOL & CIDER		$ 20,322,155,015	$ 549,298		$ 203,221,550	$ 30,483,233
COSMETICS - EYE	188	$ 226,971,350	$0	0.0%	$ 2,269,713	$ 340,457
COSMETICS - FACIAL	202	$ 177,930,541	$73,001	0.0%	$ 1,779,305	$ 266,896
COSMETICS - NAIL	209	$ 155,900,223	$489,891	0.3%	$ 1,559,002	$ 233,850
HAIR ACCESSORIES	210	$ 153,431,218	$301,227	0.2%	$ 1,534,312	$ 230,147
COSMETICS ACCESSORIES	237	$ 90,213,760	$628,972	0.7%	$ 902,138	$ 135,321
COSMETICS - LIP	238	$ 79,186,998	$2,779	0.0%	$ 791,870	$ 118,780
TOTAL HAIR ACCESSORIES & COSMETICS		$ 883,634,090	$ 1,495,871		$ 8,836,341	$ 1,325,451
CHILDREN'S ART SUPPLIES	238	$ 89,528,365	$66,001	0.1%	$ 895,284	$ 134,293
WRITING INSTRUMENTS	244	$ 80,512,390	$2,257	0.0%	$ 805,124	$ 120,769
TOTAL CHILDREN ART & WRITING SUPPLIES		$ 170,040,755	$ 68,257		$ 1,700,408	$ 255,061
AUTOMOBILE FLUIDS/ANTIFREEZE		$ 70,797,113	$11,314	0.0%	$ 707,971	$ 106,196
MOTOR OIL		$ 60,874,854	$6,926	0.0%	$ 608,749	$ 91,312
AUTOMOBILE WAXES/POLISHES		$ 25,537,368	$59,622	0.2%	$ 255,374	$ 38,306
TOTAL AUTO CARE		$ 157,209,334	$ 77,862		$ 1,572,093	$ 235,814

In the US commissaries, non Direct Store Delivery (DSD) products are delivered to the stores via a distribution network, which the supplier pays. In the end, the patron pays for this service as suppliers include this charge into their price reflected at the shelf. This is a huge benefit of the third party distribution system to the government. Not only is there is no direct delivery cost to the government, no need for an expensive distribution system to include warehousing and distribution costs, but patrons also receive the benefit of best delivered pricing models as distributors can combine DeCA product needs with other suppliers to receive best bracket pricing. Since DeCA stores are spread throughout the US, there would be a need for 8 to 10 Commissary Distribution Centers (CDCs) to support efficiently these stores. In many cases an individual supplier's volume in each of these CDCs would not secure best pricing but combined with retail orders it does receive better pricing. This saving can be in the 3% to 5% range or more. It is also important to note that distribution efficiencies do not necessarily apply to items or brands unique to the military. For example, a private label product designed just for the military, will probably incorporate incremental distribution cost into retail price versus a retailer whose DC services a significant amount of stores in a consolidated geographical area.

Normalizing Pricing across Categories and Regions implies a potentially high degree of sophistication in pricing/margin management. There are different levels of patron savings both by area of the country as well as by category by area of the country. DeCA would be required to normalize patron savings by charging more in some geographical areas and charging less in others.

The best example would be Hawaii. The average patron savings in Hawaii is reported in excess of 40%. The average patron savings in the US Commissaries is closer to 20 to 25%. Prices could be raised in Hawaii by 20% that theoretically would raise $50,000,000 in profit that could be used to offset lowering prices in other area of the country where patron savings is not as high.

	Potential Impact on Hawaii with Regional Markup Management				
	Baseline	Incremental Price Increase			
	Hawaii Zone	5%	10%	15%	20%
DeCA Annual Sales	$ 250,000,000	$ 262,500,000	$ 275,000,000	$287,500,000	$300,000,000
45% Savings	38%	34%	31%	28%	25%
Retail Equilavent Sales	$ 400,000,000	$ 400,000,000	$ 400,000,000	$400,000,000	$400,000,000
Net Savings To Patron	$ 150,000,000	$ 137,500,000	$ 125,000,000	$112,500,000	$100,000,000
Change in Savings vs Base		$ (12,500,000)	$ (25,000,000)	$ (37,500,000)	$ (50,000,000)

In this forecasting model, Hawaii DeCA patrons will pay $50,000,000 more for groceries. There is an assumption in this model that patrons are receiving a disproportionate benefit. It doesn't take into account other higher cost of living like energy or housing cost in Hawaii, which might necessitate the higher patron, savings percentage. These savings projections don't address potential migration of consumers from DeCA to other retailers as a result of reduced patron savings that could be significant.

Variable Pricing Across the Board

The small incremental margin added to the retail price as suggested in the BCG report at first look seems harmless (1% to 3%). We dispute the claim that DeCA can offset an increase of this type of COG increase because of reasons already identified. If the government buys into these recommendations it will result in price increases which could have an identifiable impact that will put negative pressure on overall sales volume.

Changing Title 10, to add a pricing lever, could allow for future changes which could ultimately render the military resale system's ability to save patrons money; eliminating the military family's most important benefit.

Past commissary studies suggest price elasticity ranges from 2% to 3% or higher. Price elasticity is defined as the change in percent sales decline attributed to a percentage price increase. For example a 2 times (X) price elasticity suggests a 1% decline in patron savings results is 2% decline in sales. The following charts detail the impact of reduction in patron savings with different price elasticity factors.

	Projected Annual Volume at Various Markup Rates					
2 X Price Elasticity*	Baseline	1% Markup	2% Markup	3% Markup	4% Markup	5% Markup
DeCA Sales	$ 5,600,000,000	$5,488,000,000	$ 5,376,000,000	$ 5,264,000,000	$ 5,152,000,000	$ 5,040,000,000
DeCA Nte Profits	0	$ 54,880,000	$ 107,520,000	$ 157,920,000	$ 206,080,000	$ 252,000,000
DeCA Gross Sales	$ 5,600,000,000	$5,542,880,000	$ 5,483,520,000	$ 5,421,920,000	$ 5,358,080,000	$ 5,292,000,000
2 X Price Elasticity*	Price decline 2 % for every 1 % decline in patron savings vs retail on a collective basis.					

	Projected Annual Volume at Various Markup Rates					
3 X Price Elasticity**	Baseline	1% Markup	2% Markup	3% Markup	4% Markup	5% Markup
DeCA Sales	$ 5,600,000,000	$5,432,000,000	$ 5,264,000,000	$ 5,096,000,000	$ 4,928,000,000	$ 4,760,000,000
DeCA Nte Profits	0	$ 54,320,000	$ 105,280,000	$ 152,880,000	$ 197,120,000	$ 238,000,000
DeCA Gross Sales	$ 5,600,000,000	$5,486,320,000	$ 5,369,280,000	$ 5,248,880,000	$ 5,125,120,000	$ 4,998,000,000
3 X Price Elasticity**	Price decline 3 % for every 1 % decline in patron savings vs retail on a collective basis.					

	Projected Annual Volume at Various Markup Rates					
4 X Price Elasticity***	Baseline	1% Markup	2% Markup	3% Markup	4% Markup	5% Markup
DeCA Sales	$ 5,600,000,000	$5,376,000,000	$ 5,152,000,000	$ 4,928,000,000	$ 4,704,000,000	$ 4,480,000,000
DeCA Nte Profits	0	$ 53,760,000	$ 4,739,840,000	$ 147,840,000	$ 188,160,000	$ 224,000,000
DeCA Gross Sales	$ 5,600,000,000	$5,429,760,000	$ 9,891,840,000	$ 5,075,840,000	$ 4,892,160,000	$ 4,704,000,000
4 X Price Elasticity***	Price decline 4 % for every 1 % decline in patron savings vs retail on a collective basis.					

There is mention of the impact of price elasticity in some recent studies but only to a potential range as it applies to the commissary system. There is a high probability that price elasticity within the commissary system is in the 3X or higher range. As shown in the previous charts, sales and profits diminish dramatically with a 3X or higher price elasticity. This analysis only takes into account the impact of rising prices due to application of margin. It does not take into account a reduction of supplier support resulting in increasing COG as DeCA becomes smaller.

Enclosures:

- Legal and regulatory implications associated with variable pricing of DeCA resale items
- Willard Bishop study on variable pricing
- DoD legislative proposal
- BCG report