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Federal Trade Commission Workshop
"Possible Anti-competitive Efforts to Restrict Competition on the Internet"
(Wine Panel)

Summary Statement

October 8, 2002

The American Vintners Association is a national trade association of 650 wineries in 48 states. Most AVA members are small family-owned and operated farm enterprises. The Commission is to be commended for holding this public workshop on barriers to e-commerce for a variety of consumer products and services, including wine.

The elimination of unnecessary state barriers to on-line wine sales is especially critical to America's small wineries, as the local wholesalers through which they are required to sell their products in most states are generally unwilling to facilitate their access to the marketplace.

American Wine Today

There are now more than 2,700 bonded wineries in the United States. Most are farm-based operations, providing significant economic benefits to the rural communities in which they are located. More than 80 percent of these wineries are truly cottage businesses, producing less than 25,000 cases per year – a quantity which could reasonably be marketed through on-site tasting rooms, and by direct shipment to consumers via the Internet and other remote means.

Tastes have changed dramatically over the past two decades as consumers have become more knowledgeable about wine. The popularity of formulaic, commodity-type wines has declined and the demand for individualistic, hand-crafted wines has grown. This is amply demonstrated by the fact that the most widely read consumer-oriented wine magazine – *The Wine Spectator* – carefully reviews over 10,000 wines per year!

Tourism is a driving force for smaller wineries, which almost universally have on-site retail operations for their visitors. Through these tasting rooms a wide and diverse population is exposed to the products of "craft" wineries. Many visitors seek to continue that relationship even though they may reside in other states. Similarly, when consumers relocate to other states, they may want to continue receiving wines from a favorite winery.

Mandatory Three-Tier Distribution System

After Prohibition, most states adopted a mandatory “three-tier” system of distribution, requiring producers to sell only through local wholesalers, who, in turn, supply retailers. This system is enforced by a series of laws which, among other things, require that all “product” physically come to rest in a wholesaler’s warehouse before proceeding to the retail level, and that only designated wholesalers can sell a given supplier’s products to the retail trade. This system has many and growing problems.

1. **No requirement to serve willing sellers and buyers.** Typically, when governments create oligopolies or monopolies – such as by granting licenses to broadcasters or operating certificates to public utilities – they also impose service requirements on such entities to protect the public interest and prevent profiteering. However, despite this extraordinary grant of state authority, wholesalers have no requirements to facilitate commerce between willing sellers and buyers; economic self-interest is the only consideration. Even with orders in hand, AVA members often cannot get wholesalers to sell their products.

2. **Big is better.** As a consequence, wholesalers focus their marketing efforts on those products in greatest demand and promising the greatest profits, which usually means representing only the 50 to 100 largest wineries. The other 2,600 wineries are effectively shut out of the commercial mainstream, with few alternatives for selling their products. The implications of this are dramatic and measurable. Today, there are more than 25,000 domestic wine labels – most of which are produced by small wineries. However, even in a robust market like Illinois, only slightly more than 500 of these labels are available through the three-tier system – less than 2 percent of all labels produced by domestic wineries. Mid-sized wineries are also hurt by this dynamic. When one of the oldest family-owned wineries in California – Louis Martini Winery – was recently sold, the reason given for the sale was an inability to attract enough wholesalers to sustain the business.

3. **Wholesaler consolidation.** As the number of wineries has increased, the number of wholesalers has declined. From a high of more than 5,000 in the mid-1950s, there are fewer than 400 wine wholesalers in the market today – and only about 170 with the resources to service entire state markets. Consolidation within the wholesale tier has greatly compounded the “market access” crisis for small wineries. As a consequence of continued consolidation, several major markets, including Chicago, are down to only two wholesalers.

4. **Monopolistic system of “economic rents”.** By exploiting legitimate state alcohol policy interests, wholesalers have used their considerable political power in state legislatures to transform the three-tier system into an increasingly monopolistic regime yielding economic rents. For example, state laws which set excessively high barriers to wholesaler entry, or provide franchise protection to distributors, reduce the pool of distributors available to suppliers and diminish competetition. In Florida, for example, to obtain and keep a wholesale license, a business must rent or own a warehouse; own outright an inventory with a minimum cost of $100,000; sell to at least 25 percent of the licensed vendors in the county; have a total volume of sales during any 12-month period within the state consisting of at least 50 percent of individual sales, which are in quantities of ten cases or less, etc. Under Georgia’s franchise law, the state demands that wholesalers be given exclusive territories, which can only be changed or terminated by a showing of cause, and with the approval of the state liquor commission. In states with such laws, even when the cause is non-performance

or failure to pay, it is generally quite costly for wineries to terminate relationships with distributors.

Barriers to E-Commerce

The direct interstate sale of wine to consumers was surely not contemplated in the 1930's when most states developed their post-Prohibition wine marketing laws. In the last twenty years, two separate and contradictory trends in the state treatment of direct shipment have emerged. Almost half of the states have passed laws allowing consumers some reasonable access to the vast diversity of American wines through direct shipment. In contrast, the remaining states – several of which are among the most populous in the country – have either fought the process of opening access, or have prohibited out-of-state wineries from shipping to consumers within their borders. As a result of well-funded wholesaler lobbying campaigns, seven states – Maryland, Florida, Georgia, Kentucky, Tennessee, Indiana and North Carolina – have made direct shipment a felony; another 18 have made it a misdemeanor.

Veiled as legitimate Twenty-First Amendment policies to prevent underage access and ensure payment of excise taxes, the real purpose of these state laws is the economic protection of local wholesalers. In fact, experience in the 23 states that permit interstate wine sales suggests that such laws pose no conflict with state alcohol control prerogatives. Moreover, we are not aware of any prosecutions resulting from attempts by minors to purchase wine over the Internet.

Direct Shipping Litigation

A few years ago, wineries and consumers took to the federal courts to challenge the constitutionality of several of these state laws. The most significant of these cases are in states which permit in-state wineries to ship to consumers, but deny that same access to out-of-state wineries. Notwithstanding state powers under the Twenty-First Amendment, we believe such disparate treatment constitutes impermissible discrimination under the Commerce Clause. Hopefully, this issue will soon be ripe for Supreme Court review.

While decisions thus far have given both sides some victories, it is worth noting that virtually every federal judge that has examined this conflict has concluded that less extensive and intrusive mechanisms than the mandatory three-tier system could accomplish legitimate state interests.

Potential Remedies

We thank the Commission for its willingness to use the "bully pulpit" to discourage states from adopting uneccessary barriers to e-commerce. Your efforts have already helped to prevent the enactment of ill-considered legislation in a number of states.

In addition, we also recommend that the Commission work with Congress to put in statute a test for determining when state interests are sufficiently compelling and appropriate to warrant interference with interstate commerce.

In Central Hudson Gas and Electric v. Public Service Commission, 447 U.S. 557 (1980), the Supreme Court developed an excellent balancing test that could form the basis for such

legislation. While this was a First Amendment case, the concept could be readily applied to state law conflicts with the Commerce Clause.

The Central Hudson test requires: 1) the demonstration of a substantial state interest; 2) a showing that the regulation or law in question directly advances that governmental interest; and, 3) that the regulation or law is not more extensive than necessary to serve that state interest. Such a law would help to mitigate the special interest political power of local businesses and ensure that parochial state interests are not permitted to supercede that national interest of free and unfettered commerce among the states. It would also provide important guidance to the courts and to the states.