Three-Tier or Free Trade?

By Sara Schorske
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TRY TO imagine a world in which there is no three-tier system of alcoholic beverage distribution. Although in the past such speculation would be purely fanciful, now, for many reasons, it has become a timely and appropriate consideration. Because that is so, we dedicate this column to thinking realistically and open-mindedly about the past, present and future of the three-tier system.

The Evolution of the Three-tier System Until Now

Beginning at the end of Prohibition, alcoholic beverages have been sold in the US through a mandatory three-tier system. Our state and federal laws require that, in general, wine, beer and spirits made by licensed producers must first be sold to licensed distributors and then to licensed retailers before reaching the hands of the consumers. Moreover, in order to keep these levels of the industry entirely separate and independent, legislatures across the nation have strictly regulated the relationship between players of different tiers. Elaborate regulatory schemes, including complex pricing requirements and claustrophobic franchise protections, have evolved to support the system.

Today, seventy years after the end of Prohibition, a new confluence of forces that actually have enough combined power to seriously challenge the traditional alcohol distribution scheme is beginning to emerge. Although the three-tier system is not likely to disappear entirely, the free trade forces gathering on the horizon could significantly change the sales and distribution landscape for wine.

Allies in the Attack on the Three-Tier System

Part of the current pressure on the United States' three-tier system comes from the globalization of the alcoholic beverage industry and the consolidation of the international producer conglomerates. While the alcoholic beverage industry in this country may accept the three tier system as a given, the rest of the business world–including the international alcoholic beverage industry–operates in a competitive environment where markets are only lightly regulated and restraints on free trade are frowned upon.

International players simply cannot understand why restrictions that are not directly related to important social purposes–such as tax collection, temperance and restricting sales to minors–should be tolerated. From their objective perspective, many aspects of our three-tier system unacceptably hamper efficient distribution systems and unnecessarily inflate shelf prices. They see America's cumbersome distribution system as anti-competitive and unfairly favoring local interests–possibly in violation of international free trade treaties.

The perspective of these three-tier critics abroad is shared in this country by the reigning heavyweights of the marketplace, the big-box retailers. These enormously powerful firms have their own bone to pick with the system. They are taking the aggressive approach of arguing that many aspects of the three-tier system violate antitrust laws and the Constitution, and they are threatening to challenge the system in the courts.

Finally, industry members and consumers are gaining momentum in their efforts to eliminate the middle tiers when it comes to direct shipment of wine. Small wineries and wine lovers have won significant legal victories in their guerilla war on the three-tier system, and the Federal Trade Commission itself has taken a stand on the wineries' side of the battle. While most wineries think of these victories simply as successes in opening new markets for direct shipping, the implications go much farther.

The legal principles being developed in those cases show that the 21st Amendment did not cast the three-tier system in stone. In recent direct shipping cases, the courts have consistently overturned parts of the three-tier system that anti-competitively discriminate in favor of local economic interests.

Let's look now in detail at each of these allies to better understand the seriousness of the threat to the system of wine distribution as we know it.

Close Scrutiny from Afar

The globalization of the industry has highlighted the fact that the US alcoholic beverage market is one of the most regulated in the world. While our highly regulated marketplace is not new, what is different now is the unprecedented strength of our trading partners abroad and the existence of new international trade treaties, in addition to as well-established mechanisms for enforcing them.

In recent trade negotiations, the European Union (EU) has requested that the US liberalize its alcoholic beverage distribution system. It's no wonder that

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our European counterparts find our system confining. In Europe wine is distributed no differently than other products; European brand owners can freely choose among a variety of distribution models, often selling directly to large retail chains while using wholesalers to service smaller on- and off-premise outlets. EU negotiators say they are willing to recognize "the rights of the states to have their ABCs but not to control access to markets." The EU wants "improved market access to the US" and states, "Distribution needs increase competitive efficiency."

The opening or liberalization of markets is the very heart of the international free trade treaties—treaties which have been ratified by our own government. Now it appears that America's three-tier system is at odds with the objectives of the major trade treaties, including the General Agreement of Trade and Services (GATS).

Already the EU is requesting that the US bring our alcohol distribution systems into conformity with the requirements of GATS. It is clear that EU alcoholic beverage producers and exporters will continue to push for equal market access in the US, necessitating the removal of many of the barriers established as part of the three-tier system.

The EU's requests may not be possible to ignore for long. While we may think our alcoholic beverage three-tier system is protected because it's based on our domestic legal system, the World Trade Organization (WTO) has been granted the power to dictate what member governments may do, including legislation, regulations and procedures. Indeed, many people believe that our international obligations will ultimately prevail over the protectionistic aspects of the three-tier system.

Three-Tier System on Trial

The direct shipping cases in Texas, Michigan, New York and North Carolina have all shown that our own courts are unwilling to hold the three-tier system as absolutely sacrosanct simply because liquor is involved. Instead, when a three-tier regulation discriminates against interstate commerce, the courts have asked whether it actually supports one of the three "core principles" of temperance, ensuring orderly market conditions and raising revenue. The proponents of the three-tier system have found it hard to make any convincing arguments that these "core principles" must be applied in a manner that restricts free trade.

This new judicial scrutiny is not limited to the direct shipping cases. In two recent cases involving disputes between wineries and distributors in Illinois and Washington, the courts ruled that out-of-state suppliers should be allowed to terminate their agreements with distributors as easily as in-state wineries can. In Washington, the court decision essentially ended the "franchise" system for out-of-state wineries.

The Verdict of Public Opinion

Public opinion has supported the movement to rework the three-tier system. Surprisingly, the Seattle newspapers praised the courts for giving California wineries the same rights as Washington wineries and removing the protections the Washington wholesalers had enjoyed. Throughout the country, newspaper editorial pages have praised the free trade implications of the victories in the direct shipping cases and questioned why wine should be treated differently than other goods.

Distributors have argued that the media does not reflect the true public sentiment and, citing polls they've commissioned, claim the public is happy with the current system. But given the success of "Two Buck Chuck" and other bargain wines sold by large West Coast retailers, consumers are clearly voting for free trade with their wallets. The resellers can afford to offer rock-bottom prices, at least in California, Oregon and Washington, primarily because the laws of those states allow them to buy directly from large wineries, bypassing the middlemen.

Scathing FTC Critique

The Federal Trade Commission jumped on the bandwagon against the three-tier system recently. In a report released last year, the FTC concluded that the three-tier system limited consumer options and increased the price of alcoholic beverages. It noted that "wine and spirits have the most expensive distribution system of any packaged-goods industry by far, with margins more than twice those in the food business."

The FTC reviewed the core regulatory concerns of tax collection and temperance and found that those purposes could be met by other means that had less impact on free trade. It concluded that most of the system was an "abuse of the regulatory process to protect concentrated economic interests" which hurts consumers by limiting the choices of wine and driving up consumer prices.

Mega-Retailers Move in for a Killing

Now that the three-tier system is losing favor with the global industry, the buying public, the media, the courts, the FTC and two of America's mega-retailers, Costco and WalMart, are savvy enough to know a wounded caribou when they see one.

In November, Costco launched a broad attack on Washington State's three-tier system, claiming that many of the system's requirements violate federal antitrust laws, and threatened to file a lawsuit against the state. WalMart has not gone that far, but has complained publicly that "the three-tier system adds an entire level of costs" and that they would prefer to bypass the entire wholesale tier.

Many other chain retailers are also chafing under certain targeted requirements of the three-tier system which prevent them from purchasing directly from suppliers and self-distributing, and which subject them to higher costs due to price posting and minimum wholesale markups.

What Parts of the Three-Tier System Are Most Vulnerable?

As shown by the direct shipping and other cases, any part of the three-tier system which discriminates against interstate commerce is the most vulnerable. Many states allow their in-state wineries to sell directly to consumers, but prohibit out-of-state wineries from doing the same.

Another common privilege granted to in-state wineries is the ability to sell directly to retailers, while out-of-state wineries must use a distributor to reach the same resellers. In-state wineries are often exempt from the distributor franchise laws while out-of-state wineries must literally buy their way out of their distribution contracts in order to change distributors.

This type of discrimination is not likely to survive in the courts, but in each case the choice of remedy will be up to the state legislature. Whenever state laws give in-state wineries a benefit that it denies to out-of-state vintners, the state will be forced to choose between extending the privilege to out-of-state wineries as well or taking it away from their in-state wineries.

However, because the survival of small and medium-size wineries is often dependent on self-distribution, a likely remedy could be to extend privileges based on production levels. Such a solution would allow smaller wineries, both in- and out-of-state, to self-distribute, but require larger wineries to use the three-tier system.

According to antitrust lawyers, there are many other aspects of the three-tier system which are unlikely to survive legal challenges. These endangered requirements include price posting, prohibitions on quantity discounts and deliveries to retailers' central distribution warehouses, and mandatory markups by distributors. Costco has alleged that in Washington State, five such regulations are *per se* violations of antitrust laws.

The basis for Costco's challenges are not particularly new; price regulation of alcoholic beverages has been vulnerable since the 1980 US Supreme Court ruled California's minimum retail price regulations for wine were unconstitutional. And that was just the beginning. Subsequent verdicts have required the states to show a more compelling and rational purpose for limiting competition in other regulated industries, such as insurance or electric power, and to actively supervise the markets they are regulating. So far no ABC has been willing to commit to "actively supervise" the alcoholic beverage market in order to preserve price controls.

Exerting more control may not necessarily be an answer in any case because the more controls the states apply, the more susceptible the system is to free trade challenges under GATS in the WTO. In fact, many believe that the obvious first targets of these attacks will be the so-called "control states"–jurisdictions in which the state monopolizes one or both middle tier of wine and spirits distribution. But *any* controls which limit market access and a competitive playfield for imports are likely to be challenged.

Are We Ready for the Brave New World of Free Trade in Wine?

Ask any winery owner or executive if he thinks free trade in wine is a good thing and he is likely to agree. Wineries have tended to think of "free trade" as conveying them the right to ship their wine direct to consumers, free from burdensome compliance regulations, excise and sales taxes, and the distributors' piece of the action. But truly "free trade" will bring many more changes to an industry that has been protected from competitive forces by regulation. Are we ready to play in a truly free market for wine? Let's consider for a minute what some of the implications could be.

• The producers of other types of grocery products routinely pay "slotting allowances" to get shelf space in the chain supermarkets. Wineries have been shielded from this type of legalized bribery. If you think Gallo has a lot of shelf space now, just think how much more they'd have if all the shelves in the wine section were for rent to the deepest pocket!

• Large retailers are accustomed to using their massive purchasing power to get the best price possible. Most wineries are probably not ready to play let's-make-a-deal with the mega-retailers. But in a world in which the larger wineries play on that scale, and consumers get spoiled by "Two Buck Chuck" values, how well will the small and medium size wineries be able to compete?

• The fact that the market regulation has protected the wine industry from extreme price competition may actually mean that distributors have had more profits to dedicate to the smaller brands and labels that otherwise might not be able to compete. A case in point may be the Indiana beer price war of a few years ago. Indiana briefly allowed its beer distributors to sell anywhere in the state.

In response the major chain retailers went from distributor to distributor, negotiating the best price possible on large orders. In the end the retailers were able to force prices so low that a number of the distributors wound up out of business. As a result, craft brewers who had relied on some of those distributors lost their access to the retail market. To save the industry from further collapse, the Indiana ATC promptly instituted a territory system so that retailers could no longer play the distributors against each other, to the death.

Conclusion

The forces that are aligned to change the three-tier system were summarized best by a CEO of a US spirits producer, who said:

"Powerful forces—globalists, the Federal Trade Commission, the US courts, the World Trade Organization, a global industry, and the European Union—are at work. In concert these forces represent a powerful voice in changing the three-tier system."

Each of those forces alone is bigger than anything that ever took an interest in the American alcoholic beverage business before. And none of them can easily be deterred or detoured once it builds up momentum. So whether we like all the implications or not, it now seems inevitable that the three-tier system will be remodeled if not replaced.

With that in mind, the industry would do well to put some of its brightest thought and most cooperative action into coming up with solutions that will protect the health and diversity of our domestic wine industry while honoring our obligations as citizens in a world economy.

The task may seem daunting but other industries have faced even harder challenges—and solved them. Sure, the Internet has shaken up the wine business, but at least no one has figured out how to download bottles of wine for free! The music industry was not as fortunate.

The skyrocketing popularity of the Internet and its free trade ethic—the paradigm of sharing information *literally* for free—turned record companies' balance sheets upside down. Websites serving up free copies of music were all the rage. Suddenly copyright protections seemed worthless, and their huge investment in developing and promoting talent looked like a fast track to the poorhouse. The record companies successfully took legal action to protect their interests, but in the end no one was happy with the stalemate that resulted.

Then Steve Jobs, CEO of Apple Computers, had the bright idea of creating iTunes, a characteristically user-friendly service that sells high quality music tracks over the Internet—at the irresistible price of $0.99 each. iTunes was launched with the enthusiastic support of the artists and recording companies because it offered the consumer a higher quality product while maintaining some copy protection. And at iTunes' price, the consumers didn't mind the built-in piracy prevention.

In fact, in the first months, iTunes sold over four million songs even without a Windows version. Today, iTunes is doing a brisker business than Napster, and artists, music lovers and record companies are all getting plenty of what they want in this new and original way. *That* is the kind of win-win solution we should shoot for, and we can achieve if we are willing to be proactive, open-minded and embracing.