UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Office of Policy Planning
Bureau of Competition
Bureau of Economics

December 12, 2005

The Honorable Bill Seitz
Ohio House of Representatives
Riffe Center
77 South High Street
Columbus, OH 43215

Re: Comment on Proposed Wine Franchise Legislation

Dear Representative Seitz:

The staffs of the Federal Trade Commission's ("FTC" or "Commission") Office of Policy Planning, Bureau of Competition, and Bureau of Economics[1] are pleased to respond to your invitation for comments on Ohio HB 306,[2] with which you propose to amend the operation of wine wholesale franchises in Ohio.

The Proposed Legislation likely would increase wholesalers' incentives to lower wholesale prices and to undertake efforts to increase the demand for wine suppliers'[3] brands, and therefore is likely to decrease the costs of wine distribution and to increase competition among wholesalers. Further, the Proposed Legislation is likely to increase competition among suppliers of wine. Consequently, we believe that, if enacted, the Proposed Legislation is likely to lead to lower wine prices for Ohio consumers, and may increase the variety of wines from which Ohio consumers can choose.

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1 This letter expresses the views of the Federal Trade Commission's Office of Policy Planning, Bureau of Competition, and Bureau of Economics. The letter does not necessarily represent the views of the Federal Trade Commission or of any individual Commissioner. The Commission has, however, voted to authorize us to submit these comments.

2 H.B. 306, 126th Gen. Assem., Reg. Sess. (Ohio 2005) (hereinafter referred to as "HB 306 " or "the Proposed Legislation").

3 As used herein, the term "supplier" refers to both vintners and importers of wine sold in Ohio.

Interest and Experience of the FTC

The FTC enforces laws prohibiting unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.[4] Pursuant to this statutory mandate, the Commission seeks to identify business practices and regulations that impede competition without offering countervailing benefits to consumers.[5] The Commission and its staff have considerable experience in analyzing the competitive impact of regulations affecting the alcoholic beverage industry. For example, the FTC staff has commented in the past on proposed restrictions on the vertical relationships between alcoholic beverage producers and wholesalers.[6] Further, in 2003, the Commission staff released a report on the competitive effects of bans on direct shipments of wine,[7] and in 2004, the FTC staff commented on a proposed New York bill involving direct shipment of wine.[8]

The Proposed Legislation

The Proposed Legislation would make several changes to the manner in which wholesale wine franchises operate in Ohio. First, HB 306 would eliminate the current minimum markup on wine at the wholesale level.[9] Ohio law currently requires wholesalers to mark up their wine prices by a minimum of 33.3 percent,[10] and further requires retailers to mark up their wine prices

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4 Federal Trade Commission Act, 15 U.S.C. § 45.

5 Specific statutory authority for the FTC's competition advocacy program is found in Sections 6(a) and (f) of the FTC Act, under which Congress authorized the FTC "[t]o gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce," and "[t]o make public from time to time such portions of the information obtained by it hereunder as are in the public interest." 15 U.S.C. § 46(a), (f).

6 *See, e.g.*, Letter from FTC Staff to Cal. State Sen. Wesley Chesbro (Aug. 24, 2005), *at* http://www.ftc.gov/os/2005/08/050826beerfranchiseact.pdf; Letter from Chicago Regional Office to Ill. State Sen. Dan Cronin (Mar. 31, 1999), *at* http://www.ftc.gov/be/v990005.htm; Letter from Atlanta Regional Office to North Carolina State Sen. Hamilton C. Horton, Jr. (Mar. 22, 1999), *at* http://www.ftc.gov/be/v990003.htm; Statement of Phoebe Morse, Dir., Boston Regional Office to the Mass. Alcoholic Beverages Control Comm'n (June 26, 1996), *at* http://www.ftc.gov/be/v960012.htm.

7 POSSIBLE ANTICOMPETITVE BARRIERS TO E-COMMERCE: WINE, FTC STAFF REPORT (2003), *at* http://www.ftc.gov/os/2003/07/winereport2.pdf.

8 Letter from FTC Staff to New York State Rep. William Magee *et al.* (Mar. 29, 2004), *at* http://www.ftc.gov/be/v040012.pdf.

9 HB 306 § 1, at 6. HB 306 also would prohibit the Ohio Liquor Control Commission from establishing minimum wholesale prices for wine. *Id.*

10 OHIO ADMIN. CODE 4301:1-1-03(C)(2)(b).

by a minimum of 50 percent.[11] Elimination of the minimum wholesale markup for wine would mirror current Ohio law regarding beer, which has no minimum wholesale markup.[12] You have indicated that, to the best of your knowledge, only Ohio and Washington currently require such a wholesale markup on wine.

HB 306 also would eliminate mandatory exclusive territories for the wholesale distribution of wine.[13] In addition, HB 306 would repeal current statutory requirements for terminating a wholesale wine franchise agreement.[14] Specifically, Ohio law currently requires "just cause" for such terminations.[15]

Further, under the Proposed Legislation, suppliers and wholesalers would be free to extend to wholesalers and retailers, respectively, up to thirty days of credit for wine purchases.[16] Current law requires that wholesalers and retailers pay by cash or check immediately upon receipt of any wine shipment.[17]

Finally, HB 306 would create a committee tasked with "study[ing] the best means of improving wholesale distribution of wine in Ohio" and reporting its findings to the Ohio Legislature within 210 days[18] of the effective date of HB 306.[19]

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11 *Id*. at (C)(2)(c). Although HB 306 does not address this minimum retail markup, such markup generally has the same negative effects on competition among retailers that the wholesale markup has on competition among wholesalers. *See infra* Section A.3. That is, it limits price competition and protects inefficient, high-cost retailers from competition from more efficient rivals, all to the detriment of wine consumers in Ohio.

12 *See* OHIO REV. CODE § 4301.041 (granting Ohio Liquor Control Commission authority to establish minimum retail markup on beer); *see also* OHIO ADMIN. CODE 4301:1-1-72(B)(1)-(3) (requiring 25% minimum retail markup on beer).

13 HB 306 § 1, at 1-2 (eliminating prohibition of "[a]ward[ing] an additional franchise for the sale of the same brand within the same sales area or territory").

14 *Id*. at 1-3.

15 OHIO REV. CODE § 1333.84(A).

16 HB 306 § 1, at 7-8.

17 OHIO REV. CODE § 4301.24.

18 All other provisions in HB 306 would become operative one year after the bill's effective date. HB 306 § 3, at 10.

19 *Id*. § 4, at 10-11. HB 306 also would expressly prohibit the use of volume or quantity discounts in connection with sales of wine (or any other alcoholic beverage) to wholesalers and retailers. *Id*. § 1, at 6. Such a prohibition would likely increase the price that Ohio consumers pay for wine. It is our understanding, however, that this amendment to the Revised Code would merely codify a rule already contained in the Administrative Code. *See* OHIO ADMIN. CODE 4301:1-1-43(A)(2) (prohibiting "discounts based on quantity of sales or any other reason"). If

Competitive Effects of the Proposed Legislation

Ohio law has created a "three-tier" wine distribution system. Ohio law prohibits suppliers (the first tier) from selling their product directly to retailers (the third tier).[20] Instead, suppliers must sell their wine to licensed wholesalers (the second tier), which in turn supply retailers. Ohio law currently prohibits suppliers from holding ownership interests in either wholesalers or retailers, just as it prohibits wholesalers from holding ownership interests in retailers.[21]

Within this three-tier system, wholesalers perform several key functions to create and maintain demand for the wine brands that they distribute. Wholesalers are responsible for storing and delivering a supplier's wine in a manner that maintains the wine's quality. Additionally, wholesalers establish retail networks to sell the brands of wine that they carry. Although suppliers typically are responsible for providing national and regional advertising, wholesalers often provide point-of-sale promotion, such as enhanced product placement, setting up displays, conducting in-store events, and supplying retailers (and ultimately consumers) with information on the brands that wholesalers distribute.

As discussed in more detail below, HB 306 would make it easier for a wine supplier to enforce contractual arrangements designed to reduce wholesale prices and to increase wholesaler incentives to provide demand-enhancing services, and therefore is likely to lower suppliers' costs of distribution and to enhance competition among both wholesalers and suppliers. HB 306 also would enhance competition among wholesalers by increasing their incentives to lower wholesale prices. Accordingly, if enacted, the Proposed Legislation would likely result in lower wine prices for Ohio consumers and may lead to more variety.

A. Increase in Competition Among Wine Wholesalers

There are several reasons why HB 306 is likely to increase competition among wine wholesalers for suppliers' business and thereby benefit consumers.

1. Elimination of Mandatory Exclusive Territories Is Likely to Enhance Competition Among Wholesalers

The currently mandated exclusive territories for wine sales in Ohio prevent a supplier from simply hiring another wholesaler in the same territory to distribute its brand in competition

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this is the case, this provision of HB 306 would have no impact.

20 Retailers include all outlets that sell directly to consumers, including bars and restaurants.

21 OHIO REV. CODE § 4301.24.

with a non-performing incumbent wholesaler. Further, the exclusive territory requirement limits suppliers' freedom to respond to changes in market conditions. For example, the requirement prevents a supplier from combining territories to achieve scale efficiencies, or from dividing between two wholesalers an existing territory in which demand is growing.

HB 306 would eliminate the exclusive territory requirement, thus permitting suppliers – if they so choose, based on their individual economic calculations – to contract with multiple wholesalers in any given geographic area. In the absence of the exclusive territory requirement, however, a supplier may nonetheless choose to utilize exclusive territories. Exclusive territories can have procompetitive effects by better aligning supplier and wholesaler incentives to engage in promotional and other activities designed to enhance demand for the supplier's brands.[22] Accordingly, it is better to let private parties determine whether it is in their interests to enter into contracts that contain exclusive territory provisions than to mandate such terms. Because suppliers have an incentive to minimize the cost and maximize the effectiveness of distribution, they are likely to grant wholesalers exclusive territories only if such contracts are likely to increase output. For these reasons, the elimination of mandatory exclusive territories is likely to enhance competition among wine wholesalers.

2. Easing the Requirements for Termination of a Wholesaler Is Likely to Enhance Competition Among Wholesalers

Typically, the ability of suppliers to terminate or not renew a franchise agreement provides wholesalers with an incentive to perform their distribution functions to the satisfaction of their suppliers. By prohibiting a supplier from terminating (or failing to renew) a contract with a wholesaler except for "just cause," and by requiring a supplier to give a wholesaler 60 days written notice of the reasons for such termination, current Ohio law limits a supplier's ability to ensure that a wholesaler is acting in the supplier's best interests. Overly restrictive termination requirements also prevent suppliers from reacting quickly and efficiently to changes in market conditions and consumer preferences. The end result is that suppliers are often locked into dealing with certain wholesalers, even if such distribution relationships are inefficient – not just for the suppliers, but from a consumer welfare perspective as well. For example, suppliers might be unable to restructure distribution networks that have become obsolete. The higher prices associated with such inefficiencies would presumably be passed on to consumers.

By eliminating the "just cause" requirement, HB 306 would make it less difficult for a supplier to terminate (or refuse to renew) its current wholesale contract in order to switch to a more reliable or less expensive wholesaler. With this new threat of competition – from both existing firms and new entrants – incumbent wholesalers' incentives to improve performance or to lower costs are increased, likely leading to lower wholesale wine prices, and ultimately lower retail wine prices in Ohio.

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22 *See infra* Sections B.1 and B.2.

3. Elimination of the Minimum Wholesale Markup Is Likely to Increase the Incentive for Wholesalers to Reduce Their Prices

Finally, elimination of the minimum wholesale markup will likely increase the incentive for wholesalers to lower their prices.[23] The currently mandated 33.3 percent minimum markup ensures that wholesalers achieve a minimum margin on their wine sales to retailers. The economic effect of this markup, however, is to limit price competition among wholesalers (to the extent that such competition exists under the current regime) and to protect inefficient, high-cost wholesalers from competition from lower-cost, more efficient rivals.[24]

Minimum wholesale markups have market-distorting effects similar to those caused by sales-below-cost statutes in effect in many states.[25] The FTC staff has commented on several such statutes, particularly those directed at gasoline prices.[26] As explained by the staff in such comments, the primary concern with sales-below-cost statutes is that they deter firms from lowering their prices, thus depriving consumers of the benefits of competition. The minimum wholesale markup on Ohio wines similarly deprives consumers of the benefits of unbridled competition among wine wholesalers: lower prices, increased output, higher quality products, and greater variety of brands.

Just as sales-below-cost statutes were originally concerned with "fair" treatment of (particularly, smaller) businesses, the minimum wholesale markup serves to protect inefficient wholesalers from competition from more efficient marketplace rivals. This type of economic protectionism, however, is anathema to the goals of competition law, which is focused on

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23 The local media has reported that Ohio consumers pay the highest prices in the United States for wine, in large part due to the state-mandated minimum wholesale and retail markups. *See* John S. Long, *Wine Costs in Ohio Are Highest in Nation*, CLEV. PLAIN DEALER, Mar. 3, 2002, at A1 (finding that "[c]onsumers can pay from one fourth to one half more for a bottle of wine in Ohio than in other states.").

24 Although HB 306 does not address the minimum retail markup for wine (or any other alcoholic beverage), that minimum markup similarly limits price competition among retailers and protects inefficient, high-cost retailers from competition from more efficient rivals, all to the detriment of wine consumers in Ohio.

25 In fact, some of these statutes are based on minimum markups above some definition of cost. *See, e.g.*, MD. CODE ANN., COM. LAW § 11-401(b) (cost to retailer defined as invoice and transportation costs plus 5-7% markup); CAL. BUS. & PROF. CODE § 17026 (cost of distribution is invoice or replacement cost plus 6% markup in absence of proof of "cost of doing business").

26 *See, e.g.*, Letter from FTC Staff to Mich. State Rep. Gene DeRossett (June 17, 2004), *at* http://www.ftc.gov/os/2004/06/040618staffcommentsmichiganpetrol.pdf; Letter from FTC Staff to Kan. State Sen. Les Donovan (Mar. 12, 2004), *at* http://www.ftc.gov/be/v040009.pdf; Letter from FTC Staff to Ala. State Rep. Demetrius Newton (Jan. 29, 2004), *at* http://www.ftc.gov/be/v040005.htm; Letter from FTC Staff to Wis. State Rep. Shirley Krug (Oct. 15, 2003), *at* http://www.ftc.gov/be/v030015.htm; Letter from FTC staff to New York Attorney Gen. Eliot Spitzer (July 24, 2003), *at* http://www.ftc.gov/be/nymfmpa.pdf.

protecting consumer welfare, rather than protecting competitors from "too much" competition.[27]

B. Increase in Competition Among Wine Suppliers

As explained below, the incentives of suppliers and wholesalers to engage in activities designed to enhance demand for the suppliers' products are likely to differ. For example, wholesalers are unlikely to promote a specific brand as vigorously as the supplier would wish. Suppliers therefore typically contract with wholesalers to require them to take certain demand-enhancing actions with respect to the suppliers' products. By decreasing the cost associated with terminating wholesalers, the Proposed Legislation is likely to increase wholesalers' incentives to take such demand-enhancing actions. Further, by eliminating mandatory exclusive territories, the Proposed Legislation is likely to reduce suppliers' distribution costs. The net result thus is likely to be more intense competition among suppliers, to the benefit of consumers.

1. Suppliers' and Wholesalers' Incentives to Increase Sales Are Likely to Differ

Suppliers (such as wine manufacturers) typically treat distribution as one of many inputs involved in getting a final product to consumers. And as is the case with other inputs, suppliers want to receive the best distribution services at the lowest possible prices to allow them to compete more effectively against their rivals for consumers' business. Wholesalers, however, typically care less about stimulating sales of a particular brand than suppliers do.[28] Suppliers tend to benefit more than wholesalers when wholesalers increase demand for the suppliers' product. A consumer who discovers a wine supplier's brand due to wholesaler effort (perhaps by providing point-of-sale information or negotiating better product placement), for example, will continue to purchase the brand regardless of which wholesaler supplies it; although the supplier has gained a new customer, that new customer has no allegiance to the wholesaler. Consequently, competing wholesalers that do not provide demand-enhancing services could benefit when another wholesaler creates demand for a particular brand: the so-called "free-rider" wholesaler could charge retailers lower wholesale prices for the brand because they do not have to cover the costs of demand-enhancing efforts – and capture the increased demand.[29] Of course,

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[27] *Cf. Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977) (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962)) (Congress designed the antitrust laws for "the protection of competition, not competitors").

[28] *See* Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988).

[29] *See* Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960). A supplier also may have an incentive to act opportunistically when a wholesaler has made large investments to increase the demand of a particular brand, for instance, by threatening to terminate its relationship with the incumbent wholesaler and turn over the business to a competing wholesaler (who could free-ride on the incumbent wholesaler's efforts) unless it receives price concessions. Of course, private contractual solutions often are employed by parties to

knowing that other wholesalers may free-ride on its effort, a distributor is not likely to engage in high levels of sales-generating activities in the first place. This is likely to reduce product information available to consumers in the marketplace and ultimately consumer purchases.

Additionally, because a wholesaler does not reap the full benefit of a supplier's reputation, it is likely to have less incentive than the supplier to maintain a level of quality associated with a particular brand. When this happens, consumers pay for more quality than they actually receive, and thus are unlikely to purchase the supplier's product again. For example, when a consumer does not enjoy a wine because it has not been handled properly and consequently decides not to purchase that particular brand again, the supplier loses all of that customer's potential future purchases, regardless of where they are made.[30] The wholesaler, by contrast, loses only the future sales to that customer that would have been made by retailers that the wholesaler supplies.

Further, when a supplier's profit margin for an additional sale is large in relation to the wholesaler's, the wholesaler rationally will not provide as much effort in securing an additional sale as the supplier would desire, meaning that undecided consumers are less likely to receive product information that they may find valuable in making purchase decisions.

Wholesale pricing also affects the demand for a supplier's product. As discussed above, from the supplier's point of view, the cost of the services that a wholesaler provides are but one part of the final price that consumers pay. As with other costs, suppliers would like the costs of distribution to be as low as possible to make their product more competitive. Typically, the price that wholesalers charge retailers – which includes both the price of the supplier's product plus the cost of distribution – will be higher than the price that a supplier would set if it distributed the product itself. This is because the wholesale price is likely to include a markup over the cost of distribution, which the supplier would not charge retailers if it distributed its own product.[31] When a supplier's product is marked up twice, this ultimately leads to higher retail prices and

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eliminate or mitigate such opportunistic behavior. *See, e.g.*, Benjamin Klein, *Exclusive Dealing as Competition for Distribution "on the Merits,"* 12 GEO. MASON L. REV. 119 (2003).

30 Without proper handling, total demand for the wine (*i.e.*, not merely demand at the one retail location) would be lower because consumers likely would associate the poor quality not with the retailer's inadequate handling, but with the manufacturer's product. Similarly, a fast food franchisee that uses inferior products at its restaurant does not internalize the full costs of its actions, because consumers will associate the bad experience with the franchisor's brand name, not a particular franchisee. *See* Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9 (1995); Paul H. Rubin, *The Theory of the Firm & the Structure of the Franchise Contract*, 21 J.L & ECON. 223 (1978).

31 Of course, as discussed *supra*, state-mandated minimum wholesale and retail markups lead to even higher retail prices.

concomitantly lower rates of output.[32]

2. Vertical Arrangements Can Mitigate Misaligned Incentives

Because wholesalers are unlikely to promote a specific brand as vigorously as the supplier would wish, suppliers and wholesalers typically enter into agreements that require wholesalers to take certain actions designed to enhance competition with competing brands. For example, contracts may include quality standards or sales quotas to limit wholesaler markups. They also may include exclusive territory provisions designed to provide wholesalers with additional incentives to provide sales-generating efforts[33] or exclusive dealing requirements to focus dealer efforts on the supplier's – rather than a rival's – product.[34] As many economic studies have found, such provisions tend to benefit consumers in the form of higher output, lower prices, and improved services.[35] Further, the U.S. Supreme Court has noted on numerous occasions how

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32 Not only are consumers worse off (due to higher prices and lower output) because of the double markup, but the joint profits earned by the supplier and the wholesaler are lower as well, because when one of these two firms raises its price, the gain from the increment in price is accrued entirely by the price-raising firm, while the loss from fewer consumers buying the product is distributed over both firms. That is, the final price ends up being higher than if a single, integrated firm had been exposed to all gains and losses.

33 *See* Tim R. Sass & David S. Saurman, *Mandated Exclusive Territories and Economic Efficiency: An Empirical Analysis of the Malt-Beverage Industry,* 36 J.L. & ECON. 153 (1993) (finding that in states where exclusive territories are mandated for beer wholesalers, prices tend to be higher and demand tends to be higher, consistent with exclusive territories leading beer wholesalers to provide more sales-generating effort).

34 Exclusive dealing agreements can be used to prevent distributors from using direct investments made by a supplier to promote rivals' products. *See* Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982). Additionally, exclusive dealing can be used to assure that suppliers receive the sales-generating effort that they have bargained for from distributors (*e.g.*, through direct payment or through increased revenue that comes with exclusive territories), rather than distributors focusing their efforts on competing brands. *See* Klein, *supra* note 28.

35 *See*, *e.g.*, Tasneem Chipty, *Vertical Integration, Market Foreclosure, and Consumer Welfare in the Cable Television Industry*, 91 AM. ECON. REV. 428 (2001); Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217 (2000); Margaret E. Slade, *Beer and the Tie: Did Divestiture of Brewer-Owned Public Houses Lead to Higher Beer Prices?*, 108 ECON. J. 565 (1998); Jan B. Heide, Shantanu Dutta & Mark Bergen, *Exclusive Dealing and Business Efficiency: Evidence from Industry Practice*, 41 J.L. & ECON. 387 (1998); Michael G. Vita, *Must Carry Regulations for Cable Television Systems: An Empirical Analysis*, 12 J. REG. ECON. 159 (1997). Two recent papers that have reviewed the empirical literature on vertical restraints find that most studies' results are consistent with vertical restraints being procompetitive. *See* James C. Cooper, Luke M. Froeb, Daniel P. O'Brien & Michael G. Vita., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639 (2005); Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in Paola Buccirossi ed. HANDBOOK OF ANTITRUST ECONOMICS (forthcoming 2005), *at* http://www2.warwick.ac.uk/fac/soc/economics/staff/faculty/slade/wp/ecsept2005.pdf.

vertical contracts can intensify competition among suppliers,[36] which benefits consumers with lower prices and improved quality.[37]

3. Decreasing the Cost of Terminating a Wholesaler Is Likely to Increase Wholesalers' Incentives to Provide Demand-Enhancing Services

As discussed above, by prohibiting a supplier from terminating (or failing to renew) a contract with a wholesaler except for "just cause," current Ohio law limits a supplier's ability to ensure that wholesalers take actions to increase the demand for the supplier's products.[38] By eliminating the just cause requirement, HB 306 would decrease the cost – and thus increase the feasibility – of terminating (or not renewing) a wholesaler. Absent a credible warning of termination (or non-renewal) by the supplier, wholesalers have less incentive to stimulate demand as their contracts require.[39] An increase in the ability of suppliers to control wholesalers' activities is likely to provide Ohio consumers with the lower prices, increased output, and better quality that result from more intense competition among wine brands.

4. Easing of Termination Restrictions May Increase Small Suppliers' Abilities to Compete with Large Suppliers

The current termination requirements in Ohio law may affect smaller suppliers to a greater extent than larger suppliers because larger suppliers may be in a better position to incur the legal costs typically associated with a wholesaler termination and thus have a greater ability to exercise control over wholesalers. Established brands that advertise heavily, moreover, may not rely as much on wholesaler effort. Consequently, the Proposed Legislation may lead to more variety as smaller suppliers find it less difficult to market their product than they currently do.[40]

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36 *See, e.g.*, *State Oil Co. v. Khan*, 522 U.S. 3 (1997); *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717 (1988); *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984); *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977).

37 *See Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 695 (1978) ("ultimately competition will produce not only lower prices, but also better goods and services").

38 *See* James A. Brickley *et al.*, *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101, 113 (1991) (analysis of case law supports the premise that termination laws increase the cost of termination and non-renewal); *see also* Tracey A. Nicastro, *How the Cookie Crumbles: The Good Cause Requirement for Terminating a Franchise Agreement*, 28 VAL. U. L. REV. 785, 796-98 (1994) (cataloging several courts' interpretations of "good cause" that limit a franchisor's ability to terminate franchisees).

39 In an extreme example of wholesaler non-performance, a wholesaler may refuse to supply retailers with the supplier's product at all (*i.e.*, "park" the brand). In these situations, consumers in the wholesaler's territory are deprived of the product altogether.

40 Yet another source of greater variety for Ohio wine consumers is direct shipment of out-of-state (and in-state) wines purchased online. In a 2003 report, the Commission staff found that, among other things, consumers can purchase many wines online that are not available in local retail stores, and that, depending on the circumstances,

Further, to the extent that larger suppliers have brands that compete with small suppliers' brands, if the Proposed Legislation lowers small suppliers' distribution costs relatively more than it lowers large suppliers' distribution costs, it may have the effect of increasing the aggressiveness of large suppliers' pricing for those brands that compete with small suppliers' brands, thus lowering the price that Ohio consumers pay for those brands of wine.

5. Elimination of Mandatory Exclusive Territories Is Likely to Decrease Suppliers' Distribution Costs

The currently mandated exclusive territories for wine sales in Ohio, coupled with the overly restrictive termination provisions, likely have served to increase a supplier's cost of distribution. For the reasons discussed above, the current termination requirements make it difficult to terminate a wholesaler that fails to exert sufficient effort to promote a supplier's brand. At the same time, the exclusive territory requirement prevents a supplier from simply hiring another wholesaler in the same territory to distribute the supplier's brand in competition with the non-performing incumbent wholesaler. Further, the exclusive territory requirement limits suppliers' freedom to respond to changes in market conditions. For example, the requirement prevents a supplier from combining territories to achieve scale efficiencies or dividing between two wholesalers an existing territory in which demand is growing.

As discussed above, although a supplier may choose to maintain exclusive territories upon enactment of HB 306 because it makes economic sense for that supplier to do so, it is better to let private parties determine whether it is in their interests to enter into contracts that contain exclusive territory provisions than to mandate such terms. Elimination of mandatory exclusive territories is likely to reduce the cost of distribution for suppliers as a group, and thus is likely to increase competition among that group.

C. Decrease in Transaction Costs for Wholesalers and Retailers

Ohio law currently requires that wholesalers and retailers pay by cash or check immediately upon receipt of any wine shipment.[41] HB 306 would permit wine suppliers and wholesalers to extend up to thirty days of trade credit to wholesalers and retailers, respectively. It is well established that the use of trade credit can decrease the costs associated with the exchange

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consumers can save money by purchasing wine online. *See* POSSIBLE ANTICOMPETITVE BARRIERS TO E-COMMERCE: WINE, FTC STAFF REPORT 18-22 (2003), *at* http://www.ftc.gov/os/2003/07/winereport2.pdf. As a result of the settlement reached in *Stahl v. Taft*, No. 2:03cv00597 (S.D. Ohio), Ohio consumers currently may purchase wines by direct shipment from outside Ohio. *See* Ohio Division of Liquor Control Web site, *at* http://www.liquorcontrol.ohio.gov/DirectShipping.htm (providing relevant information and tax form). Proposed legislation that would permanently allow such shipments has been introduced in the Ohio Senate. *See* S.B. 179, 126th Gen. Assem., Reg. Sess. (Ohio 2005).

[41] OHIO REV. CODE § 4301.24.

of goods.[42] HB 306 is thus likely to decrease the transaction costs for wholesalers and retailers of wine in Ohio. This reduction may be especially beneficial to smaller wholesalers and retailers, who may have more difficulty than their larger rivals in meeting the currently mandated cash requirement. Any reductions in transaction costs at the wholesale and retail levels, in turn, are likely to lead to reductions in the final prices paid by consumers.

Conclusion

HB 306 is likely to increase wholesalers' incentives to become more efficient, and to lower their prices and provide important demand-enhancing services for their suppliers' brands. HB 306 is therefore likely to decrease the costs of wine distribution and to increase competition among both wholesalers and suppliers. Further, HB 306 may disproportionately lower the distribution costs of smaller suppliers, potentially increasing competition among certain wine brands. Consequently, if the Proposed Legislation were enacted, Ohio consumers would likely pay lower prices for wine and may enjoy more variety. We urge the Ohio Legislature to take into account these likely effects on consumers when considering HB 306.

42 *See, e.g.*, Mitchell A. Petersen & Raghuram G. Rajan, *Trade Credit: Theories and Evidence*, 10 REV. FIN. STUDIES 661, 665 (1997) ("Trade credit may reduce the transaction costs of paying bills. Rather than paying bills every time goods are delivered, a buyer might want to cumulate obligations and pay them only monthly or quarterly. This will also enable an organization to separate the payment cycle from the delivery schedule.") (citation omitted); J. Stephen Ferris, *A Transactions Theory of Trade Credit Use*, 96 Q.J. ECON. 243, 244 (1981) ("[T]rade credit may arise as a way of lowering the exchange costs by separating the exchange of goods from the exchange of money.").

Respectfully submitted,

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