Wine and Spirits Wholesalers of America, Inc.

Wine and Spirits Wholesalers of America Summary Position Paper[1]

Prepared for the Federal Trade Commission Workshop:
“Possible Anti-Competitive Efforts to Restrict Competition on the Internet”

Presented by C. Boyden Gray
WSWA Outside Counsel
Wilmer, Cutler & Pickering
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Good afternoon.

The maintenance of competition on the Internet is a topic that will greatly benefit from the FTC’s attention and is also one to which I am happy to make a contribution. But as I will describe in more detail in a minute, the distribution of beverage alcohol is subject to a truly unique set of rules that, first, have no applicability to any other industries, including those being examined at these hearings and that, second, were developed to secure important state interests which preceded the Internet and which supercede any interests put forward as a rationale for dismantling those rules. Let me go into these two points in a little more detail.

With respect to the first point, Section 2 of the 21st Amendment, ratified in 1933, is unambiguous in its enumeration of broad power to the states to regulate the importation and shipment of alcohol coming across its borders. It reads:

> **The transportation or importation into any state, territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.**

No Supreme Court or appellate court decision interpreting that amendment over the past 69 years has ever diminished that authority. As noted by respected jurist Frank Easterbrook in a recent 7th Circuit opinion upholding Indiana’s right to regulate the channels of distribution, alcohol is not cheese -- nor contact lenses nor caskets nor any of the other products at issue here. In fact, alcohol is the sole product that has its own constitutional provision -- a reflection of the unique history of alcohol in this country.

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[1] Given the time constraints placed on speakers testifying at the Workshop, this paper is simply a summary of the many compelling arguments that militate against any proposed dismantling of state alcohol regulatory control systems. A more comprehensive annotated position paper will be provided by WSWA within the time allotted by the FTC.

Given the 21st Amendment's mandate to the states to determine the appropriate regulatory structure for the distribution of alcohol, I do not believe the FTC should be inserting itself into this debate. Nevertheless, I will use my remaining time to address the policy issues raised by the FTC.

Let me emphasize at the outset that the three-tiered system is remarkably efficient and consumer oriented. The average retail store is packed with hundreds of quality brands of wine, many imported from overseas. Moreover, the price for beverage alcohol products has remained consistently affordable for the average consumer over the past 69 years -- and in many cases the pre-tax price has declined when adjusted for inflation. The majority of the consuming public is quite satisfied -- perhaps overwhelmed -- with the quality and selection of brands available to them just around the corner from their homes.

Part of the reason that the three-tiered system works so well is that the federal government, through the Federal Alcohol Administration Act, and the states through related laws, require that there be an intermediary between the supplier and retail tiers designed to ensure that large suppliers with market power do not dominate individual retailers to the exclusion of other suppliers who might try to break into the market. In other words, the wholesale tier actually serves to blunt monopolistic supplier tendencies that had prevailed prior to Prohibition.

The three-tiered system also functions as a partner with state regulatory and monitoring systems that are designed to promote the core concerns of the state -- ensuring orderly market conditions, promoting temperance, including keeping alcohol out of the hands of minors -- and collecting tax revenue.

In order to understand how the three-tiered system operates as a partner with the state and federal regulatory communities and serves the interests of consumer protection, I would ask you to follow a bottle as it flows through the three-tiered system. A supplier must obtain approval for the label from the BATF and state authorities to ensure that it contains truthful and non-misleading information and mandatory health warnings. That bottle must then be sold to a state and federally licensed wholesaler who is responsible for maintaining records and filing detailed reports tracking each bottle brought into the state, paying the excise taxes due on the alcohol, and delivering the alcohol to a state licensed retail establishment. The retailer is responsible for paying over to the state the sales taxes generated by each sale, and is directly responsible for ensuring that alcohol does not fall into the hands of minors or other prohibited individuals. Since both the wholesaler and the retailer must be licensed by the state, they are fully accountable for any dereliction of their duties. They are subject to on-site inspections, auditing and compliance checks, and any violation can result in the loss of license, fines and other potentially more several penalties.

In sum, the three-tiered system both protects important state interests in regulation and taxation and has created an economically efficient system of alcohol distribution. By channeling the physical distribution of beverage alcohol through licensed in-state wholesalers and retailers, the state can effectively enforce its sales and tax policies (including barring sales to minors, protecting dry areas, limiting strength, controlling labels and advertising and the like) because it can license, inspect, and hold responsible these local firms. At the same time, the in-state wholesalers required by the three-tier system enhance competition at both the supplier and retailer levels, making distribution more efficient and keeping the price to the consumer low.

The same cannot be said of a regime that permits direct interstate shipments.

First, because a state is unable to effectively monitor direct sales to consumers, there is no guarantee that the person ordering or receiving the alcohol is of age. Private carriers are unaccountable; they may leave the package at the front door or forget to check the I.D. of the recipient. And online systems that are supposedly "designed" to ensure the sale is not to a minor are not face-to-face, and most teenagers between the ages of 18 and 21 years of age (and many who are younger) possess credit cards allowing them to order online.

The failures of online direct sales systems to prevent sales to minors have been exposed through stings by scores of media outlets and several states over the past several years which showed that minors ordering alcohol online were able to have it dropped off at their door or delivered without I.D. checks. In fact, it was after learning that a minor working in his office was able to order wine online using a credit card, and have that wine delivered in an unmarked box to the state capitol mailroom without an I.D. check, that South Dakota Governor William Janklow decided to veto a bill that would have allowed for direct shipping in his state.

Proponents of direct shipping denigrate state and wholesaler warnings that direct sales will lead to increased illegal purchases by minors. But noted public health researcher Henry Wechsler, principal investigator for the Harvard School of Public Health College Alcohol Study, felt compelled to provide expert testimony for the first time in the New York direct shipping case because he recognized the increased threat to minors posed by direct sales. Dr. Wechsler reported to the court that allowing direct sales of alcohol through the Internet, telephone or mail was dangerous, bad public policy, and would invariably weaken controls over underage drinking – noting particularly the risk inherent in losing the ability to conduct face-to-face I.D. checks by trained personnel. Among the many studies he reviewed which supported his conclusions, he highlighted a recent one addressing home delivery of alcohol which found that minors, especially those who were binge or problem drinkers, used home delivery to avoid I.D. checks they would normally experience in face-to-face transactions.

I might add here that the FTC has taken great pains to warn the public about the ability of minors to gain access to online gambling sites, emphasizing the obvious point that gambling is illegal for kids. I would suggest that the threat to minors through online alcohol sales – also clearly illegal - should be no less of a concern to the FTC than that posed by online gambling.

Second, when a bottle of alcohol is shipped direct to a consumer, the tax revenue that would normally have been collected by the receiving state's wholesaler and retailer is lost. That revenue helps fund such regulatory efforts as checks for underage compliance and is sometimes earmarked for social responsibility and healthcare programs. Given the budget crises currently confronting state government, it would seem irresponsible to advocate the erosion of that critical state revenue so that online chardonnay purchases could be legalized.

Third, there is no effective way to ensure that direct shippers are held accountable. There is no way to conduct on-premises inspection of their books to determine the accuracy of their reports as there is with licensed in-state entities -- and there is no easy way to shut them down if violations occur. Direct shippers often claim when caught making illegal sales that they are not subject to the jurisdiction of the receiving state, and the cost of court actions against those out-of-state interests is prohibitive. It is simply more efficient for the state to channel the distribution of alcohol to its citizens through a limited number of in-state wholesalers than to try to license, monitor, regulate and police thousands of out-of-state suppliers.

Fourth, the alleged cost savings from direct shipment are non-existent -- and in fact the price is often cheaper for the same bottle purchased locally. Why? Because online suppliers often list their product at the retail price. Thus, while the supplier captures an additional profit that would have accrued to the state through taxation, the consumer -- whom the FTC is ostensibly looking out for -- sees no differential in the price.

Our critics have argued that wholesaler consolidation has contributed to the inability of some wineries to get into local markets. But those same critics fail to mention the dramatic increase in the number of wineries in this country from 800 in 1975, to 1,400 in 1995, to more than 2,700 today. Simply put, wholesaler consolidation is largely irrelevant to this debate since having 10,000 wholesalers in a given state would not correspondingly increase the amount of shelf space available in retail stores, which are already overflowing with hundreds of brands of wines.

Wholesalers are also accused of attempting to stifle competition, but that contention is unsupportable. Every supplier, new and old, foreign and domestic, is invited and encouraged to market its products at the wholesaler's annual convention - and no wholesaler worth his salt would fail to market any quality product for which a demand can be demonstrated. The fact that hundreds of imported wines have managed to compete quite successfully in the American marketplace at the same time that others claim they are unable to obtain wholesaler representation belies any claim that wholesalers are restricting access to the market.

Among the questions posed by the FTC is whether the states have enacted barriers to Internet commerce. But the three-tiered system of distribution equally limits all modes of interstate purchase, including through catalog and direct sales solicitations. The fact that delivery cannot ordinarily be made by direct shipment has nothing to do with the Internet itself, but rather reflects the history of alcohol in this country – a history that long predates the Internet age.

Prior to prohibition, states had difficulty regulating traffic in alcohol originating in other states. Although states were permitted considerable leeway in licensing and regulating suppliers within their borders, courts consistently ruled that the dormant commerce clause prevented them from regulating imports from unlicensed out-of-state suppliers as unlawful interference with interstate commerce.

In response to those cases, Congress in 1913, and again in 1935, passed the Webb-Kenyon Act -- entitled "An Act Divesting Intoxicating Liquors of Their Interstate Character in Certain Cases" -- passage of which was designed to cede federal commerce clause power to the states in an effort to provide them with the authority to effectively regulate the importation of alcohol. However, it wasn't until the end of prohibition that Congress passed, and the states ratified, the 21st Amendment, formalizing within our constitutional framework the delegation of commerce clause authority to the states in the area of alcohol importation and shipment.

The Webb-Kenyon Act and the 21st Amendment were designed to reverse discrimination that favored out-of-state suppliers -- as Judge Easterbrook noted in his opinion in the Bridenbaugh case. Prior to those enactments, it was in-state concerns which bore the burden of discriminatory regulation. Only they had to be licensed; only they had to pay taxes; only they were accountable to the state. It was only upon passage of the 21st Amendment that the states were free to require that all suppliers, in-state and out-of-state, be subject to their regulatory frameworks.

The proponents of direct shipping have applauded the decisions of trial courts in North Carolina, Virginia and Texas which have struck down as "discriminatory" certain state laws prohibiting interstate direct shipping. But the reasoning of these cases would nullify the 21st Amendment and recreate the conditions that existed in the Nineteenth Century when unlicensed, untaxed and unaccountable out-of-state suppliers competed on an uneven playing field with licensed, taxed and accountable in-state suppliers.

The argument that is being made today seems to be that because there is a demand for direct shipment of wine and a glut of suppliers who want to ship direct, the FTC should weigh in on the side of direct shippers. However, there is also apparently a great demand for the direct shipment of beer and spirits as well. A recent sting by the Michigan AG's office ensnared 70 different companies who shipped 1,020 bottles of wine, 318 bottles of beer and 20 bottles of spirits, many of those sales going to underage buyers. And since the constitution speaks only to alcohol – it makes no distinction between wine, beer and spirits – the FTC should consider whether a decision to weigh in on this matter in favor of the direct shipment of wine will inexorably lead to pressure in the future to ensure consistent state action with respect to all alcohol, by removing state barriers to the sale of spirits and beer on the Internet as well. I believe the FTC would be well advised to refrain from opening the Pandora's box that has been presented to them by the proponents of direct shipping.

The legislature of each state speaks to the concerns and choices of its citizenry regarding the distribution of alcohol, and the laws of the state are simply the reflection of the will of the consumers in each state. Some states are control states and alcohol must be shipped through a state wholesaler; some states are license states and alcohol is shipped through licensed private companies; some states have dry areas or prohibit Sunday sales. But whatever system of distribution is employed, they all have one thing in common. They were created pursuant to the power granted to the states under the 21^{st} Amendment, in keeping with the country's post-Prohibition view that these matters were best left in the hands of the states, not the federal government.

Until the 21^{st} Amendment is repealed, the FTC should respect that unambiguous, constitutionally enumerated state power, and the decisions made by the states pursuant to that power.

Thank you.