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

Office of Policy Planning
Bureau of Economics
Bureau of Competition

August 24, 2005

The Honorable Wesley Chesbro
California State Senate
State Capital, Room 5035
Sacramento, CA 90514

Re: Comment on Proposed Beer Franchise Act

Dear Senator Chesbro:

The staffs of the Federal Trade Commission's ("FTC" or "Commission") Office of Policy Planning, Bureau of Economics, and Bureau of Competition are pleased to respond to your invitation for comments on a proposal to put into place a beer franchise act in California.[1] The Proposed Franchise Act would govern the contractual relationships between beer manufacturers and beer wholesalers.[2] In your letter, you asked the FTC to analyze the "competitive impact" of the proposed franchise act.

The Proposed Franchise Act would reduce wholesalers' incentives to lower wholesale prices and to undertake efforts to increase the demand for brewers' brands, and therefore is likely to increase the costs of beer distribution and to reduce competition among wholesalers. Further, the Proposal may reduce competition among certain brands of beer. Consequently, we believe that, if enacted, the Proposed Franchise Act is likely to lead to higher beer prices for California consumers, and may reduce the variety of beers from which California consumers can choose.

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1 Hereinafter referred to as "the Proposed Franchise Act" or "the Proposal." We understand that this bill is likely to be offered as an amendment to California Assembly Bill 417.

2 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 (Commission) or of any individual Commissioner. The Commission has, however, voted to authorize us to submit these comments.

Interest and Experience of the FTC

Congress charged the FTC with enforcing laws prohibiting unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.[3] Pursuant to this statutory mandate, the Commission seeks to identify business practices and regulations that impede competition without offering countervailing benefits to consumers.[4] 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.[5] Further, in 2003, the Commission staff released a report on the competitive effects of bans on direct shipments of wine,[6] and in 2004, the FTC staff commented on a proposed New York bill involving direct shipment of wine.[7]

The Proposed Legislation

The Proposed Franchise Act would prohibit a brewer from terminating, refusing to renew, or refusing to enter into an agreement with a beer wholesaler "except for good cause and in good faith."[8] The Proposal defines "good cause" as "failure of a beer wholesaler to comply with the good faith requirements imposed upon [it] by an agreement between the beer manufacturer and the beer wholesaler."[9] Further, the Proposed Franchise Act expressly states that "good cause shall not include . . . a beer wholesaler's failure to meet a sales goal or quota that is not commercially reasonable under prevailing marketing conditions"[10] or a brewer's "national or regional policy of consolidation."[11] The Proposed Franchise Act defines "good faith" in the following terms:

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

4 Specific statutory authority for the competition advocacy program is found in sections 6(a) and (f) of the FTC Act, under which Congress authorized the FTC "to 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 "to 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).

5 *See, e.g.*, 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 Massachusetts Alcoholic Beverages Control Commission (Jun. 26, 1996), *at* http://www.ftc.gov/be/v960012.htm.

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

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

8 Proposed Franchise Act § 3(c)(1). The Proposed Franchise Act does allow for immediate termination of a wholesaler in certain circumstances: (1) insolvency; (2) felony conviction; (3) fraudulent conduct; (4) revocation or suspension of required permits or licenses; (5) selling outside of assigned territories; and (6) transfer of wholesaler ownership without brewer consent. *Id.* at § § 2(d)(1)-(6).

9 *Id.* at § 2(a)(3).

10 *Id.* at § 2(a)(3)(c).

11 *Id.* at § 2(a)(3)(E).

> honesty in fact and the observance and enforcement of, or conformity with, reasonable commercial standards of fair dealing in the trade. Good faith shall include the fair and equitable treatment, in a non-arbitrary manner, of beer wholesalers who, based on objective measures, are similarly situated.[12]

Further, under the Proposal a brewer cannot "[t]erminate, refuse to renew, or refuse to enter into an agreement" with a beer wholesaler "without first giving the beer wholesaler detailed written notice of any alleged deficiency" and "a reasonable opportunity of sixty to one hundred twenty days to cure the alleged deficiency."[13] The Proposed Franchise Act also expressly prohibits exclusive dealing[14] and requires that brewers award wholesalers exclusive territories.[15]

One of the Proposed Franchise Act's purported goals is to "foster vigorous and healthy inter-brand competition in the beer industry."[16] As explained below, however, the Proposal is likely to have the opposite effect.

Competitive Effects of the Proposed Legislation

Existing California law creates a so-called "three-tier" beer distribution system. California law prohibits brewers (the first tier) from selling their product directly to retailers (the third tier).[17] Instead, brewers must sell their beer to licensed wholesalers (the second tier), that in turn supply retailers. We understand that California law currently allows brewers to hold ownership interest in distributors, but as a practical matter, integration between brewers and wholesalers is not common.[18] Wholesalers are responsible for storing and delivering a brewer's beer in a manner that maintains the beer's quality. Additionally, wholesalers establish retail networks to sell the brands of beer that they carry. Although brewers typically are responsible for providing national and regional advertising, wholesalers often provide point-of-sale promotion like enhanced product placement, setting up displays, conducting in-store events, and supplying retailers with information on their brands.

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12 *Id.* at § 2(a)(4).

13 *Id* at § 3(c)(2).

14 *Id.* at § 3(c)(5).

15 *Id.* at § 3(c)(13).

16 *Id.* at § 1. It is also the intent of the Act to "prohibit improper business practices; . . . provide an orderly three-tier system for the distribution and sale of quality beer in the State; promote the public health, safety, and welfare of the people of California; provide a distribution system that will facilitate the collection of state and local taxes; and provide a distribution system that will remain accountable to state and local law enforcement in promoting the rules and regulations applicable to the beer industry." *Id.*

17 Retailers include all outlets that sell directly to consumers, including bars, restaurants, and grocery stores.

18 As discussed *infra*, the Proposed Franchise Act is likely to reduce wholesalers' incentives to provide demand-enhancing services called for in their contract with brewers. Consequently, the Proposed Franchise Act may cause some brewers to vertically integrate in an effort to exercise more control over the distribution of their product. To the extent that the Proposed Franchise Act were to cause firms that would prefer to turn to the market for distribution services to instead provide such services internally, it will induce inefficiency and may well increase the price that California consumers pay for beer.

The Proposed Franchise Act would make it more difficult for a brewer to enforce contractual arrangements designed to reduce wholesale prices and to increase wholesaler incentives to provide demand-enhancing services, and therefore is likely to raise brewers' costs of distribution and to injure competition among both wholesalers and brewers. Accordingly, if enacted, the Proposed Franchise Act would likely lead to higher beer prices for California consumers and may lead to less variety.

A. Reduction in Wholesaler Incentives to Take Actions that Increase Sales

The Proposed Franchise Act is likely to make it more difficult for brewers to ensure that wholesalers take actions to increase demand for their product, and therefore is likely to deprive California consumers of more intense competition among brewers.

1. Brewers' and Wholesalers' Incentives to Increase Sales are Likely to Differ

Suppliers (such as brewers) 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 price to allow them to compete more effectively against their rivals for consumers' business. Wholesalers, however, typically care less about stimulating sales than suppliers do.[19] Suppliers tend to benefit more than wholesalers when wholesalers increase demand for the supplier's product. A consumer who discovers a brewer'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 brewer 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 since they do not have to cover the costs of demand-enhancing efforts – and capture the increased demand.[20] Of course, 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

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

[20] *See* Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960). Suppliers also may have an incentive to act opportunistically when wholesalers have 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 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).

they actually receive, and are thus unlikely to purchase the supplier's product again.[21] For example, when a consumer does not enjoy a beer because it has not been stored at the correct temperature and consequently decides not to purchase that particular brand again, the brewer loses all of that customer's potential future purchases, regardless of where they are made. The wholesaler, on the other hand, 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 manufacturer would desire, meaning that undecided consumers are less likely to receive product information that they may find valuable in making purchase decisions.[22]

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 mark-up over the cost of distribution, which the supplier would not charge retailers if it distributed its own product.[23] When a supplier's product is marked-up twice, this ultimately leads to higher retail prices and concomitantly lower levels of output.[24]

2. Vertical Arrangements Can Mitigate Misaligned Incentives

To align their incentives better, manufacturers and wholesalers typically enter into agreements that require wholesalers to take certain actions. For example, contracts may include quality standards and maximum resale prices or sales quotas to limit wholesaler markups. They also may include exclusive territory provisions designed to provide wholesalers with additional

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21 For example, a brewer may insist that its beer be stored and transported in a certain way to preserve the beer's quality. Without proper storage, total demand for the beer (*i.e.*, not merely demand at the one retail location) would be lower because consumers would likely associate the poor quality not with the retailer's inadequate storage, but with the manufacturer's product. *See, e.g.*, *Adolph Coors Co. v. FTC*, 497 F.2d 1178 (10th Cir. 1974). Similarly, a fast food franchisee that uses inferior products at his restaurant does not internalize the full costs of his 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).

22 Margins in the apparel business may serve to illustrate the gap between wholesale and supplier margins in the beer industry. One study reports that apparel manufacturers' average gross profit margin is 46 percent compared with only 9 percent for "multiple apparel retailers." The authors note that this disparity in compensation for marginal sales "will limit the incentive of retailers to invest in developing and promoting their Web sites unless there is some form of co-op funding or restructured pricing." Robert H. Gertner & Robert S. Stillman, *Vertical Integration and Internet Strategies in the Apparel Industry*, 49 J. INDUS. ECON. 417, 427 (2001).

23 Wholesaler markups are likely to be greater than they otherwise would when they are given exclusive territories, as the Proposed Franchise Act would mandate. Of course, as discussed *infra*, exclusive territories also can be useful in aligning supplier and wholesaler incentives, thus leading to higher levels of output.

24 Not only are consumers better off (due to lower prices and higher output) when the distributors price at cost, but the joint profits earned by the supplier and the distributor are higher as well.

incentives to provide sales-generating effort[25] or exclusive dealing requirements to focus dealer efforts on the supplier's – rather than a rival's – product.[26] As many economic studies have found, such provisions tend to benefit consumers in the form of higher output, lower prices, and improved services.[27] Further, the U.S. Supreme Court has noted on numerous occasions how vertical contracts can intensify interbrand competition,[28] which benefits consumers with lower prices and improved quality.[29]

3. Increasing the Cost of Terminating a Wholesaler is Likely to Reduce Wholesalers' Incentives to Provide Demand-Enhancing Services

Typically, the threat of termination provides wholesalers an incentive to abide by their contractual commitments. By prohibiting a brewer from terminating (or failing to renew) a contract with a wholesaler except for "good cause,"[30] and by requiring a brewer to give a wholesaler 60 to 120 days to "cure any alleged deficiency," the Proposed Franchise Act would place severe limits on a brewer's ability to ensure that wholesalers take actions to increase the

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25 *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).

26 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 20.

27 *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 the 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*, INT'L J. OF INDUS. ORG. (forthcoming 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/faculty/slade/wp/soc/economics/staff/ecfeb2005.pdf.

28 *See Cont'l T.V. Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977); *Monsanto Co. v. Spray-Rite Service Co.*,465 U.S. 752 (1984); *Business Elec. Corp. v. Sharp Elec. Corp.*, 485 U.S. 717 (1988); *State Oil Co. v. Khan*, 522 U.S. 3 (1997). Vertical agreements challenged under Sherman § 1 are subject to rule of reason treatment and can violate the antitrust laws when they, on net, reduce interbrand competition.

29 *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.") (citation omitted).

30 Current California law does not impose a "good cause" requirement on a brewer's termination of a wholesaler. *See Bert G. Gianelli Dist. Co. v. Beck & Co.*, 172 Cal. App. 3d 1020, 1036 (1st Dist. 1985) (the implied covenant of good faith and fair dealing does not require cause for termination of a beer distributor by a brewer). The Proposed Franchise Act's prohibition against terminating a wholesaler "solely for . . . failure to meet a sales goal or quota that is not commercially reasonable under the prevailing market conditions," however, already exists under current California law. *See* CAL. BUS. & PROF. CODE § 25000.7.

demand for their products.[31] Indeed, even in circumstances where a wholesaler breached the terms of its contract, the Proposed Franchise Act would likely cause a brewer to incur substantial legal costs to switch wholesalers.[32] For example, a brewer that was displeased with a wholesaler's performance and wanted to terminate (or not renew) its contract would have to show that the wholesaler has violated some provision of their agreement and that this provision was "a good faith requirement." This, in turn, would require the brewer to show that the provision conformed with "reasonable commercial standards," and that by enforcing this provision the brewer was engaged in "the fair and equitable" and "non-arbitrary" treatment of beer wholesalers "who, based on objective measures, are similarly situated."

In this manner, the Proposed Franchise Act would increase the cost – and thus reduce the threat – of terminating (or not renewing) a wholesaler. Absent a credible threat of termination (or nonrenewal), wholesalers have less incentive to stimulate demand as their contracts require.[33] As discussed above, a reduction in the ability of brewers to control wholesalers' activities is likely to deprive California consumers of the lower prices, increased output, and better quality that result from more intense competition among beer brands.

4. Mandating Exclusive Territories and Prohibiting Exclusive Dealing is Likely to Increase Brewers' Distribution Costs

The Proposed Franchise Act's mandated exclusive territories coupled with its termination provisions also are likely to increase a brewer's cost of distribution. For the reasons discussed above, the Proposed Franchise Act will make it difficult to terminate a wholesaler that fails to exert sufficient effort to promote a brewer's brand. At the same time, the Proposed Franchise Act's exclusive territory requirement prevents a brewer from simply hiring another wholesaler in the same territory to distribute its brand in competition with the non-performing incumbent wholesaler. Further, exclusive territory requirements limit brewers' freedom to respond to changes in market conditions. For example, combining territories to achieve scale efficiencies would not qualify as "good cause" under the Proposal.[34] A brewer's effort to divide an existing territory where demand is growing between two wholesalers, moreover, may trigger a claim from an existing wholesaler that it is being terminated without cause. More generally, although exclusive territory provisions can have procompetitive effects by better aligning brewer and

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31 *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 nonrenewal); *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).

32 Further, by preventing a brewer from including contractual terms that require arbitration of claims or preclude a wholesaler from litigating a dispute in California state or federal courts, the Proposed Franchise Act is likely to raise the cost of settling contractual disputes. *See* Proposed Franchise Act § § 3(c)(8)-(9).

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

34 The Proposed Franchise Act states that a brewer cannot terminate (or refuse to renew) a distribution contract based on "a national or regional policy of consolidation." Proposed Franchise Act § 2(a)(2)(E). Similarly, the Proposed Franchise Act requires that compensation be paid to wholesalers that are terminated as a result of a merger between brewers. *Id.* at § 3(b). This also is likely to make it more difficult for merging brewers to realize efficiencies from consolidating distribution networks.

wholesaler incentives,[35] 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 brewers 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.

The Proposed Franchise Act also prohibits exclusive dealing arrangements, which, as discussed above, suppliers may use to promote wholesaler effort. This prohibition also is likely to reduce demand-enhancing activities to the detriment of consumers.

B. Reduction in Competition Among Wholesalers

The Proposed Franchise Act is likely to reduce competition among wholesalers for brewers' business. As discussed above, the Proposal would make it difficult – if not impossible – for a brewer to terminate its current wholesale contract in order to switch to a competing wholesaler offering more attractive terms. Knowing this, new and existing wholesalers have little incentive to compete to distribute a brewer's brands. Absent a threat of competition, incumbent wholesalers' incentives to improve performance or to lower costs are diminished, likely leading to higher wholesale beer prices, and ultimately higher retail beer prices in California.

C. Reduction in Competition Among Brewers

The Proposed Franchise Act also may lessen competition among brewers. Its provisions may affect smaller brewers to a greater extent than larger brewers, because larger brewers may be in a better position to incur the legal costs of 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 Franchise Act may lead to less variety as smaller brewers find it more difficult to market their product than larger brewers. Further, to the extent that larger brewers have brands that compete with small brewers' brands, if the Proposed Franchise Act raises small brewers' distribution costs relatively more than it raises large brewers' distribution costs, it may have the effect of reducing the aggressiveness of large brewers' pricing for those brands that compete with small brewers' brands, thus raising the price that California consumers pay for those brands of beer.

Conclusion

The Proposed Franchise Act is likely to reduce wholesalers' incentives to provide important demand-enhancing services and is likely to reduce competition among wholesalers to carry brewers' brands. Further, the Proposal may disproportionately increase the distribution costs of smaller brewers, potentially reducing competition among certain beer brands. Consequently, if the Proposed Franchise Act were enacted, California consumers would likely pay higher prices for beer and may enjoy less variety. We urge the California legislature to take into account these likely adverse effects on consumers when considering the Proposed Franchise Act.

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35 *See* notes 25 & 27, *supra*.

Respectfully submitted,

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