FEDERAL TRADE COMMISSION
Washington, DC 20580

DEPARTMENT OF JUSTICE
Washington, DC 20530

March 20, 2020

The Hon. Jim Wood
California State Assembly
State Capitol
P.O. Box 942849
Sacramento, CA 94249-0002

Dear Assembly Member Wood:

The staff of the Federal Trade Commission's ("FTC" or "Commission") Office of Policy Planning, Bureau of Economics, and Bureau of Competition,[1] and of the Antitrust Division of the U.S. Department of Justice (the "Division"), (together, the "Agencies") are pleased to respond to your invitation for comments on the likely competitive effects of California Assembly Bill 1541 ("A.B. 1541" or "the Bill"), a proposal to further restrict contracting between beer manufacturers and beer wholesalers.[2] In particular, the Bill would make it more difficult for a beer manufacturer to terminate a distribution relationship with a wholesaler, which can harm competition in several ways that will be discussed below. Among other things, you have asked "to receive input specifically regarding the potential competitive impact on members of California's craft brewing industry."[3]

A.B. 1541 is likely to diminish competition between California beer wholesalers and increase manufacturers' costs of obtaining distribution services from wholesalers; these effects, in turn, are likely to raise the costs of beer distribution. For these reasons, if enacted, the Bill would likely lead to higher beer prices for California consumers; and it may reduce the variety of beers available to California consumers and impede innovation in the beer industry overall.

[1] This letter expresses the views of the Federal Trade Commission's Office of Policy Planning, Bureau of Competition, and Bureau of Economics, and of the Antitrust Division of the U.S. Department of Justice. 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.

[2] Letter from the Hon. Jim Wood, California Assembly, to Bilal Sayyed, Director, Fed. Trade Comm'n Off. Pol'y Plan. (Dec. 12, 2019).

[3] *Id.*

In 2005, the California legislature considered, and rejected, similar restrictions.[4] Recent changes in the industry provide all the more reason for the legislature to reject them again. The Bill's restrictions are likely to burden members of California's large, and growing, craft brewing industry especially, as smaller, developing brewers might find it hard to bear the costs of the proposed restrictions, and might be ill-equipped to enforce, alter, or decline to renew distribution agreements, especially in dealing with large distributors, or with distributors owned by large manufacturers.[5] Moreover, we see no evidence that the costs of these proposed restrictions would yield any countervailing consumer protection benefits. We therefore recommend that California reject the proposed restrictions, just as it has in the past.

I. Background

a. Interest and Experience of the Federal Antitrust Agencies

Competition is the core organizing principle of America's economy,[6] and vigorous competition among sellers in an open marketplace gives consumers the benefits of lower prices, higher quality, and greater access to goods and services, and innovation. The Agencies work to promote competition through enforcement of the antitrust laws, which prohibit conduct that harms competition and consumers, and through competition advocacy (e.g., comments on legislation, discussions with regulators, and court filings.)

Both the FTC and the Division have extensive knowledge about the competitive dynamics of the alcoholic beverage industry. The Commission has investigated proposed

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[4] FTC staff comments at that time raised competition concerns regarding potential amendments to California A.B. 417. FTC Staff Comment to the Hon. Wesley Chesbro, California Senate, Concerning the Proposed California Franchise Act to Govern Contractual Relationships Between Beer Manufacturers and Wholesalers (2005), https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-honorable-wesley-chesbro-concerning-proposed-california-franchise-act-govern/050826beerfranchiseact.pdf (regarding proposed amendments to California Assembly Bill 417). The Assembly ultimately adopted a far more limited A.B. 417, which simply modified "the definition of beer to include any alcoholic beverage that qualifies as a malt beverage under a specified federal law." California Assembly Bill 417 (2005-06) (enrolled Sept. 14, 2005), http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=200520060AB417; *see also* Cal. Bus. & Prof. Code § 23006 (2020).

[5] *See, e.g.*, California Craft Brewers Ass'n, Number of Breweries in California Reaches New Record (2018), https://www.californiacraftbeer.com/number-breweries-california-reaches-new-record/ (number of California craft breweries tripling from 2012 to 2017); *see also* California Craft Brewers Ass'n, Craft Beer Statistics (2019), https://www.californiacraftbeer.com/ca-craft-beer/craft-beer-statistics/ (noting "1,039 craft breweries in operation across the state"). As explained below, the actual number may be higher if one considers both the holders of the 1,036 California "small beer manufacturer" licenses and some significant number – greater than 3 – of the 85 California "beer manufacturer" licenses to be "craft brewers." See text accompanying notes 19 - 20, *infra*. Tripling from 2012-2017, https://www.californiacraftbeer.com/number-breweries-california-reaches-new-record/

[6] *See, e.g.*, N.C. State Bd. Of Dental Exam'rs v. FTC, 135 S. Ct. 1101, 1109 (2014) ("Federal antitrust law is a central safeguard for the Nation's free market structures."); Standard Oil Co. v. Fed. Trade Comm'n, 340 U.S. 231, 248 (1951) ("The heart of our national economic policy long has been faith in the value of competition.").

mergers between distributors[7] and manufacturers[8] of alcoholic beverages; and the Commission and its staff have considerable experience in analyzing, in particular, the competitive impact of regulations affecting the industry. For example, in 2003, FTC staff released a report on the competitive effects of bans on direct shipments of wine;[9] and in 2010 the FTC's Bureau of Economics published a working paper on the effects of "post-and-hold" laws.[10] On several occasions, FTC staff, at the request of state lawmakers, have commented on bills involving direct shipment of wine to consumers.[11] FTC staff have also commented on proposed restrictions on the vertical relationships in the beer industry, including restrictions on contracting between producers and wholesalers.[12]

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[7] Fed. Trade Comm'n, Press Release, Statement of the FTC's Bureau of Competition Regarding Announcement that Republic National Distributing Company and Breakthru Beverage Group have Terminated Their Acquisition Agreement (Apr. 8, 2019), https://www.ftc.gov/news-events/press-releases/2019/04/statement-ftcs-bureau-competition-regarding-announcement-republic.

[8] Fed. Trade Comm'n, In the Matter of Pernod Ricard, S.A., Docket No. C-4224 (Decision & Order) (Oct. 17, 2008).

[9] FED. TRADE COMM'N, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE, FTC STAFF REPORT (2003), https://www.ftc.gov/sites/default/files/documents/reports/possible-anticompetitive-barriers-e-commerce-wine/winereport2_0.pdf; *cf.* Granholm v. Heald, 544 U.S. 460 (2005) (citing the FTC staff report extensively at 544 U.S. 466-68, 489-92).

[10] James C. Cooper & Joshua D. Wright, State Regulation of Alcohol Distribution: The Effects of Post & Hold Laws on Alcohol Consumption and Social Harms, Fed. Trade Comm'n Bureau of Economics Working Paper No. 304 (2010), https://www.ftc.gov/sites/default/files/documents/reports/state-regulation-alcohol-distribution-effects-post-amp-hold-laws-consumption-and-social-harms/wp304_0.pdf (a revised version of the paper was published as James C. Cooper & Joshua D. Wright, *Alcohol, Antitrust, and the 21st Amendment: An Empirical Examination of Post and Hold Laws*, 32 INT. J. LAW & ECON. 379 (2012).

[11] FTC Staff Comment to the Hon. Paula Dockery Concerning Florida Senate Bill 282, a Bill to Allow Direct Shipment of Wine to Florida Consumers (2006), https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-honorable-paula-dockery-concerning-florida-senate-bill-282-bill-allow-direct/v060013ftcstaffcommentrefloridasenatebill282.pdf; FTC Staff Comment to the Hon. Eric D. Fingerhut Concerning Ohio S.B. 179, to Allow Direct Shipment of Wine to Ohio Consumers (2006), https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-honorable-eric-d.fingerhut-concerning-ohio-s.b.179-allow-direct-shipment-wine-ohio-consumers/v060010commentreohiosb179directshipmentofwine.pdf; FTC Staff Comment to the Hon. William Magee et al., Concerning N.Y. A.B. 9560-A, S.B. 606-A, and S.B. 1192, to Allow Out-of-State Vendors to Ship Wine Directly to New York Consumers (2004), https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-honorable-william-magee-et-al.concerning-new-york.b.9560-s.b.606-and-s.b.1192-allow-out-state-vendors-ship-wine-directly-new-york-consumers/v040012.pdf.

[12] *See* FTC Staff Comment to the Hon. Wesley Chesbro, *supra* note 4; FTC Staff Comment to the Hon. Bill Seitz Concerning Ohio H.B. 306, to Amend the Operation of Wine Wholesale Franchises (2005), https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-honorable-bill-seitz-concerning-ohio-h.b.306-amend-operation-wine-wholesale-franchises/051212cmntohiolegiswinefranchis.pdf; FTC Staff Comment to the Honorable Dan Cronin Concerning Illinois S.B. 15, the Illinois Wine and Spirits Industry Fair Dealing Act of 1999 (1999), https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-honorable-dan-cronin-concerning-illinois-s.b.15-illinois-wine-and-spirits-industry-fair-dealing-act-1999/v990005.pdf; FTC Staff Comment to the Honorable Hamilton C. Horton and George W. Miller Concerning An Act to Amend the Wine Franchise Law to Provide for Exclusive Territories in North Carolina (1999), https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-comment-honorable-hamilton-c.horton-and-george-w.miller-concerning-act-amend-wine-franchise-law-provide-exclusive-territories-north-carolina/v990003.pdf.

The Division has extensive experience analyzing competition in the beer industry through its investigations of important industry mergers. In the course of those investigations, the Division analyzed the crucial competitive role of distribution. For example, in 2016 the Division required a number of remedies before allowing a merger between two of the largest brewers worldwide—Anheuser-Busch Inbev (ABI) and SAB Miller. In addition to requiring the divestiture of SABMiller's ownership interest in MillerCoors, the settlement prohibits ABI from engaging in certain practices that limit the ability and incentives of independent beer distributors to sell and promote the beer of ABI's rivals.[13] The Division has reviewed all of ABI's major acquisitions, requiring significant divestitures as a condition of allowing each of those major transactions to proceed.[14]

b. The Chain of Beer Distribution

California beer distribution typically follows a so-called "three-tier" system: brewers or "manufacturers"[15] (the first tier) sell to licensed wholesalers[16] (the second tier) who, in turn, sell to retailers[17] (the third tier). California consumers typically purchase beer for off-site consumption from retailers. This Bill primarily addresses the interaction between the first two tiers.

In addition to the large brewers that are familiar from national advertising campaigns, the past twenty years have also seen substantial growth in the craft brewing industry in California. The California Craft Brewers Association reports that there are 1,039 craft brewers in California today, up from 200 in 2000.[18] Although craft beer manufacturers are not a distinct category of licensed beer manufacturer under California law and regulations, it appears that large numbers of craft breweries are holders of the 1,036 California "Type 23 – small beer manufacturer" licenses, while others are among the 85

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[13] United States v. Anheuser Busch InBev, Case 1:16-cv-01483, Competitive Impact Statement, 3 (2016).

[14] *E.g.*, United States v. Anheuser-Busch InBev, Case 1:13-cv-00127, Competitive Impact Statement (2013); United States v. InBev NV/SA, Case 1:08-cv-1965, Competitive Impact Statement (2008).

[15] Beer manufacturers, licensed under Cal. Bus. and Prof. Code § 23357, include both larger holders of "Type 01 – Beer Manufacturers" licenses, producing over 60,000 barrels of beer per year, and holders of "Type 23 – Small Beer Manufacturer" licenses, which produce less than 60,000 barrels per year. California Dep't of Alcoholic Beverage Control, License Types, https://www.abc.ca.gov/licensing/license-types/ (last checked 02/10/20). Holders of Type 75 – Brewpub-restaurant" licenses also have limited brewing privileges, but are not considered true "manufacturers." *Id.* (citing Cal. Bus. & Prof. Code § 23396.3)

[16] Distributors or wholesalers are holders of "Type 17 – Beer and Wine Wholesaler" licenses, California Dep't of Alcoholic Beverage Control, License Types, https://www.abc.ca.gov/licensing/license-types/, under Cal. Bus. & Prof. Code § 23378 et seq.

[17] Retailers ("retail package off-sale beer and wine license" holders) are licensed under Cal. Bus. & Prof. Code § 23393, and may sell "to consumers only and not for resale . . . in quantities of 52 galls or less per sale, for consumption off the premises where sold."

[18] CCBA, Craft Beer Statistics (2018), https://www.californiacraftbeer.com/ca-craft-beer/craft-beer-statistics/ (reporting 1,039 craft brewers and more than 61,000 full-time employees) (last checked 02/19/20); CCBA History of Craft Beer in California (2017), https://www.californiacraftbeer.com/ca-craft-beer/history-craft-beer-ca/ (reporting fewer than 70 craft breweries in 1990, and 200 in 2000).

holders of California "Type 01 – beer manufacturer" licenses, as reported by the California Department of Alcoholic Beverage Control.[19] Holders of such "Type 01" and "Type 23" licenses do *not* include either brewpubs or home brewers.[20]

A 2016 Department of Justice investigation observed that craft brands "are increasingly gaining market share," and that "[t]his market trend is increasing the competition faced by ABI," and affecting the choices available to consumers."[21] We note, too, that Anheuser Busch owns and continues to acquire diverse manufacturers, including craft breweries.[22]

Wholesalers are responsible for storing and delivering a brewer's beer in a manner that maintains the beer's quality.[23] 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 the brands they represent.

Recent years have seen substantial changes in the chain of beer distribution, both nationally and in California. For example, the "second-tier" wholesalers now include both large vertically integrated firms, such as distributors owned by Anheuser Busch,[24] and large horizontally integrated firms, such as the six California wholesale firms that are part of the Reyes Beer Division of Reyes Holdings, Inc. ("Reyes"), which claims to be the largest distributor of beer in the United States.[25] With recent California acquisitions, Reyes is estimated to distribute nearly 100 million cases of beer per year in California—approximately one third of all the beer sold in California.[26]

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[19] California Dep't of Alcoholic Beverage Control, License Summary Count – State Totals, https://www.abc.ca.gov/licensing/licensing-reports/license-summary-counts-for-fy-2018-19/license-summary-count-state-totals/ (last checked 02/10/20).

[20] *See* note 15, *supra*.

[21] United States v. Anheuser Busch InBev, Case 1:16-cv-01483, Competitive Impact Statement, 7 (2016).

[22] *Id.* at 4-5 (reporting that Anheuser Busch owned 19 US breweries and over 40 brands of beer sold in the US, representing approximately 47% of beer sold nationally); *see also, e.g.*, Kimberly Chin, *Anheuser-Busch InBev to Buy Out Craft-Brewing Company*, Wall St. J., updated Nov. 12, 2019 (reporting on AB InBev's acquisition of Craft Brew Alliance); Ashlee Kieler, *Here Are The 8 U.S. Craft Brewers Bought By Anheuser-Busch Since 2011*, Consumerist, Consumer Rep., Apr. 13, 2016, https://www.consumerreports.org/consumerist/here-are-the-8-u-s-craft-brewers-bought-by-anheuser-busch-since-2011/ (reporting on acquisition of California's Golden Road Brewing, among others) (last checked 02/19/20).

[23] For an overview of wholesaler services under the "three-tier" system, see FTC staff comments, *supra* note 4, at 3.

[24] *See, e.g.*, United States v. Anheuser Busch InBEV, *supra* note 21, at 9-10.

[25] "Reyes Beer Division is the largest beer distributor in the United States." Reyes, https://reyesbeerdivision.com/ (last checked 02/19/20).

[26] Bryan Roth, So Shiny RN – America's Largest Distributor Makes Its Own Gold in Latest California Acquisition, Jul. 9, 2019, https://www.goodbeerhunting.com/sightlines/2019/7/9/so-shiny-rn-americas-largest-distributor-makes-its-own-gold-in-latest-california-acquisition (last checked 02/19/20) (estimating 98 million cases per annum in California). Reyes's own website suggests similar scale across its six California distributors: Harbor Distributing, LLC, Gate City Beverage, Crest Beverage, Allied Beverages, Golden Brands, and High Desert Distributing. Links to each distributor's web site can be found at https://reyesbeerdivision.com/our-distributors (last checked 02/19/20).

These tiers are not wholly isolated under California law. For example, while wholesalers may sell "only to persons holding licenses . . . authorizing the sale of alcoholic beverages,"[27] under certain conditions, consumers may purchase beer, for consumption on the premises, at a brewery.[28] California law expressly provides that beer manufacturers "may [also] hold retail . . . licenses,"[29] and we understand that California law also permits manufacturers to hold ownership interests in distributors. For example, Anheuser Busch, the largest beer manufacturer in the United States, also owns and holds ownership interests in beer wholesalers, including in California.[30]

c. Assembly Bill 1541

A.B. 1541 would substantially limit the ability of a beer manufacturer to "cancel, terminate, reduce, not renew, or cause any of the same, an agreement with a beer wholesaler for the distribution of beer and malt beverage products."[31] No similar restrictions would be placed on beer wholesalers.

According to the Bill:

- Except under special circumstances,[32] a beer manufacturer cannot cancel or alter an agreement—or even decline to renew an agreement—unless the beer manufacturer acts

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According to a 2018 report by the National Institute on Alcohol Abuse and Alcoholism, California beer consumption totaled 687,240,000 gallons in 2016; that is, roughly 305,000,000 cases. Nat'l Inst. on Alcohol Abuse and Alcoholism, Div. of Epidemiology and Prevention Res. Alcohol Epidemiologic Data System, APPARENT PER CAPITA ALCOHOL CONSUMPTION: NATIONAL, STATE, AND REGIONAL TRENDS, 1977–2016, Table 2 (2018). Hence, Reyes wholesalers alone appear to distribute approximately one third of all the beer sold in California.

[27] Cal. Bus. & Prof. Code § 23378.

[28] At the "licensed premises of production," manufacturers may sell beer directly to either a holder of a "license authorizing the sale of beer" or to consumers, "for consumption on the manufacturer's licensed premises or on premises owned by the manufacturer that are contiguous to the licensed premises and which are operated by and for the manufacturer." Cal. Bus. & Prof. Code §23357(a)(1) – (2).

[29] Cal. Bus. & Prof. Code § 23357(b).

[30] *See, e.g.*, United States v. Anheuser Busch InBev, Case 1:16-cv-01483, Competitive Impact Statement, 4, 9 (2016); *see also* Chris Furnari, Consolidation Continues as A-B Invests in 2 California Wholesalers, Brewbound (Sept. 2, 2015), https://www.brewbound.com/news/consolidation-continues-as-a-b-invests-in-california-wholesalers (last checked 02/19/20).

[31] Proposed Cal. Bus. and Professions Code § 25000.3(b).

[32] Some, but not all, of the notice requirements would not apply if, for example, a beer wholesaler's insolvency or "a petition by or against the beer wholesaler under any bankruptcy or receivership law," fraud by the wholesaler, or "[r]evocation of the beer wholesaler's license by the department or of the beer wholesaler's basic permit by the Alcohol and Tobacco Tax and Trade Bureau of the United States Department of the Treasury." [Proposed 25000.3(f)(1)-(7)]. In addition, the manufacturer would still bear the burden of showing its compliance with remaining notice requirements, and of showing "good faith" and "good cause." 25000.3(g).

"in good faith" and "with good cause" and has satisfied numerous "notice and opportunity to cure" and "notice of termination requirements."[33]

- The burden falls on the *beer manufacturer* to show that "it has acted in good faith, that it has or had good cause . . . and that it complied with the notice requirements [of the Bill]."[34]

- To meet the "good cause" requirement, the beer manufacturer would be required to demonstrate that:

  (1) There is a failure by the beer wholesaler, without reasonable excuse or justification, to comply substantially with essential and commercially reasonable requirements of the agreement. . . .

  (2) The beer wholesaler was given written notice by the beer manufacturer of failure to comply with the agreement, including reasonable supporting documentation.

  (3) The beer manufacturer first acquired knowledge of the failure described in paragraph (1) not more than ____ months before the date notification was given to the beer wholesaler.

  (4) The beer wholesaler has been afforded ____ days in which to submit a plan of corrective action to substantially comply with the agreement, and an additional ____ days to cure such alleged noncompliance in accordance with the plan of corrective action or, at the beer wholesaler's election, to sell its distribution business or the affected part of its distribution business.[35]

A manufacturer, including a craft brewer, could not even decline to renew a contract with a distributor whose performance it found unsatisfactory, without satisfying all of the Bill's "good cause" requirements. As noted above, except under special circumstances, a manufacturer would bear the burden of demonstrating its compliance with all of these notice requirements.[36] A beer manufacturer that fails any of these requirements would—for either a "violation or threatened violation"—be subject to "a temporary restraining order, and preliminary and permanent injunctions" from a California court.[37] Moreover, a beer manufacturer would be required "to compensate the injured beer wholesaler for all reasonable damages sustained," in addition to "any other statutory, legal, or equitable remedy available to the beer wholesaler."[38]

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[33] Proposed Cal. Bus. and Professions Code § 25000.3(b)(1)-(3).

[34] Proposed Cal. Bus. and Professions Code § 25000.3(g).

[35] Proposed Cal. Bus. and Professions Code § 25000.3(d)(1)-(4). The proposed notice requirements do not yet specify the number of days or months that would be required.

[36] Proposed Cal. Bus. and Professions Code § 25000.3(g).

[37] Proposed Cal. Bus. and Professions Code § 25000.3(h).

[38] *Id.*

To issue an order or injunction against a brewer, the court would be required to "consider the disruption to the wholesaler's business operations and its employees that may result" from the "violation or threatened violation."[39] But the Bill does not stipulate that the court should similarly consider impact on the beer manufacturer's operations or its employees; neither does the Bill stipulate that the court should consider the impact on competition or California consumers.

II. The Likely Competitive Effects of A.B. 1541

The Bill proposes to add significant regulatory burdens to contracting between beer manufacturers (breweries) and beer wholesalers. These would add to the substantial provisions of California's Business and Professions Code, and would in many respects supplant requirements under California's generally established body of contract law.[40] The Bill would make it more difficult—and more costly—for a brewer to enforce contractual arrangements designed to reduce wholesale prices or increase wholesaler incentives to provide demand-enhancing services. It would also make it more difficult—and more costly—for a brewer to alter a contract, or simply decline to renew one, with an under-performing wholesaler. Its economic burdens are asymmetric: it places no such costs on wholesalers. The Bill therefore is likely to raise brewers' costs of distribution and to damage competition among both wholesalers and brewers. Accordingly, if enacted, A.B. 1541 would likely lead to higher beer prices for California consumers and may lead to less variety, and less innovation.

When similar restrictions were proposed in 2005, they were purported to "foster vigorous and healthy inter-brand competition in the beer industry."[41] As FTC staff explained at that time, the proposed restrictions were likely to have the opposite effect.[42] Changes in the industry render these restrictions even more likely to cause harm today. As explained below, many of California's craft beer manufacturers may be ill-equipped to enforce, alter, or decline to renew distribution agreements, especially in dealing with large distributors, or with distributors owned by large manufacturers. Adding numerous and costly regulatory impediments, and increased exposure to liability, would put such craft brewers at a further disadvantage. Moreover, when forming distribution agreements, new and developing brewers may be less well positioned than established ones to anticipate their future distribution needs.

A. The Bill Would Reduce Competition Among Wholesalers

The Bill likely would reduce competition among wholesalers for brewers' business. As discussed above, A.B. 1541 would make it difficult—if not impossible—for a brewer to

[39] *Id.*

[40] *See generally, e.g.*, Cal. Civ. Code § 1549 et seq.

[41] FTC Staff Comment, *supra* note 4, at 3 (citing Proposed Cal. Bus. and Professions Code § 25000.3(c)(13)).

[42] *Id.*

terminate a wholesale contract in order to switch to a competing wholesaler offering more attractive terms. Even declining to renew a contract with a poorly performing wholesaler would require a brewer to undertake numerous, time-consuming, and costly steps, and would expose the brewer to additional liability.[43] Such costs and risks may be especially onerous for small craft brewers and entrants into the market. Knowing this, new and existing wholesalers would 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.

B. The Bill Would Likely Reduce Competition Among Brewers

The Bill also may lessen competition among brewers. As noted above, 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 and regulatory costs of termination, and may thus have a greater ability to exercise control over wholesalers. Established brands that advertise heavily, moreover, may not rely as much on wholesaler effort; and established brands that own or hold interests in wholesalers will be able to exercise such control directly, without the same administrative and legal burdens and exposure. Against the backdrop of reduced competition among wholesalers, small brewers—who face relatively high impediments to contract enforcement, and depend more heavily on wholesalers' marketing efforts—may find it relatively difficult to market new products. California consumers, as a result, may find the variety available to them diminished. In addition, other dimensions of competition, such as innovation, would also likely be dampened, as both established brewers and would-be entrants may be less willing to invest in developments that their wholesalers might not promote.

Further, as noted above, craft brands "are increasingly gaining market share," and "[t]his market trend is increasing the competition faced by [Anheuser Busch]."[44] To the extent that larger brewers have large or small brands that compete with small brewers' brands, and to the extent the Bill raises small brewers' distribution costs more than it raises large brewers' distribution costs, A.B. 1541 may reduce 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.

C. The Bill Would Reduce Wholesaler Incentives to Increase Sales

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

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

[43] *See* text accompanying notes 32 - 38, *supra*.

[44] *See* text accompanying note 21, *supra*.

A consumer who discovers a brewer's brand due to wholesaler effort (for example, the provision of point-of-sale information, or negotiation of better product placement), will continue to purchase the brand no matter which wholesaler supplies it to his or her retailer. The brewer has gained a new customer, but that customer has no particular allegiance to the wholesaler. Because the wholesaler might not capture all the returns on its efforts, its incentives to undertake those efforts in the first place are diminished.[45] That is, brewers and wholesalers both care about sales, but wholesalers typically care less about stimulating sales of particular products than the individual brewers with whom they contract.[46] Because some of the returns from a wholesaler's efforts accrue to individual brewers, not the wholesaler, the wholesaler's incentives may be to supply fewer of the demand-enhancing services than a brewer would seek.

In addition, because a wholesaler does not reap the full benefit of a brewer's reputation, it has less incentive than the manufacturer to maintain a level of quality associated with a particular brand. When this happens, consumers can receive less quality than they pay for, and might thus be less likely to purchase the brand's product again.[47] For example, when a consumer does not enjoy a beer that has not been stored at the correct temperature, and decides not to purchase that brand again, the brewer loses all of that customer's potential future purchases, wherever they would have been made. The wholesaler, on the other hand, loses only those future sales through retailers that the wholesaler supplies, and even then, only those that are not offset by sales of other brands through the same wholesaler.

Competition helps align brewer and wholesaler incentives: in a competitive market, beer wholesalers must vie with each other to secure and maintain brewers' business, competing on price, the range of services they offer, and the quality and consistency of their services. If a wholesaler's bid or performance seems unsatisfactory, a brewer can choose a competing offer. But the Bill would diminish this type of competition, making it far more difficult for brewers to switch to alternative wholesalers.

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[45] *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).

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

[47] 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).

These various differential incentive effects for manufacturers and wholesalers might be muted or skewed when the two tiers are vertically integrated.[48]

2. Contracts Can Mitigate Misaligned Incentives

Contracts also help to align brewer and wholesaler incentives, as manufacturers and wholesalers can enter into formal agreements that require wholesalers to take certain actions on behalf of the brewers with which they contract. 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 incentives to provide sales-generating effort.[49] As many economic studies have found, such provisions tend to benefit consumers in the form of higher output, lower prices, and improved services,[50] although they can, under particular circumstances, raise competition concerns.[51] As the U.S. Supreme Court has noted on numerous occasions, vertical contracts can intensify interbrand competition,[52] which benefits consumers with lower prices and improved quality.[53]

Typically, the threat of termination—or non-renewal—provides wholesalers an incentive to abide by their contractual commitments. But, as explained above, the Bill

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[48] Vertical integration – like vertical restraints – can, depending on the facts and circumstances, be competitively beneficial, benign, indeterminate, or harmful (anticompetitive). *See generally*, James C. Cooper et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 J. INDUS. ORG. 639 (2005). For a more recent review of empirical work on vertical restrictions, transaction costs, and inter-firm contracts, see Francine Lafontaine & Margaret E. Slade, *Transaction Cost Economics and Vertical Market Restrictions*, 55 ANTITRUST BULLETIN 587 (2010). Supplemental remedies imposed on Anheuser Busch acquisitions of, and dealings with, distributors are, presumably, designed to guard against anticompetitive arrangements that might be entered into by a particular manufacturer.

[49] *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).

[50] Papers reviewing the empirical literature on vertical restraints find that most studies' results are consistent with vertical restraints commonly (not always) being procompetitive. *See* Lafontaine & Slade, *supra* note 48; Cooper et al., *supra* note 48; *see also, 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).

[51] *See supra* note 48.

[52] *See* Continental 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.

[53] *See* Nat'l Soc'y of Prof. 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).

would diminish, and sometimes practically eliminate, this threat of termination: the Bill would impose numerous, time-consuming, and costly requirements on the termination, or even non-renewal, of such contracts,[54] impeding a brewer's ability to ensure that wholesalers take actions to increase the demand for their products, and decreasing the wholesaler's incentive to do so.[55] Even in circumstances where a wholesaler breaches the terms of its contract, or loses its license, the Bill would likely cause a brewer to incur substantial legal costs to switch wholesalers. The burden of proof (or "demonstration") would still fall with the brewer, and the brewer would still be exposed to a restraining order or a temporary or permanent injunction, as well as a risk of money damages, for a "violation or threatened violation" of its various regulatory burdens.[56]

As noted above, the Bill's burdens fall asymmetrically on brewers, as A.B. 1541 imposes no such costs, or heightened liability, on wholesalers. Hence, the Bill is likely to exacerbate, rather than resolve, misaligned incentives in the chain of distribution. Moreover, for the same reasons described above, smaller brewers could suffer greater harm than larger ones. On both counts, consumers are likely to suffer the consequences.

III. Conclusion

A.B. 1541 is likely to reduce wholesalers' incentives to provide important demand-enhancing services; and it is likely to reduce competition among wholesalers to carry brewers' brands. Further, the Bill may disproportionately increase the distribution costs of smaller brewers, potentially reducing competition among certain beer brands. Consequently, if the Bill is enacted, California consumers would likely pay higher prices for beer and may enjoy less variety.

Nothing in the Bill directly addresses the interests of California consumers. Moreover, the differential burdens the Bill would impose upon brewers do not seem calibrated to address any particular bargaining asymmetries between brewers and wholesalers, and we are pessimistic that they could. Indeed, as discussed above, the notion of a systematic bargaining imbalance between brewers and distributors has become more problematic than ever. California beer manufacturers are many and diverse, as are California wholesalers. While there are small distributors and large brewers doing business in California, there are also some very large distributors, distributors owned by very large manufacturers, and a large number of licensed craft breweries holding "small manufacturer" licenses.

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[54] *See supra* notes 33 - 38, and accompanying text.

[55] *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).

[56] *See* notes 36 - 38, *supra*.

We believe that the Bill is likely to impede competition in California beer distribution, to the detriment of California consumers. We see no countervailing consumer protection benefits in evidence. Hence, we urge the California legislature to reject A.B. 1541, just as it has rejected similar proposals in the past.

Sincerely,

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