COMMISSION APPROVED

Comments of the Bureaus of
Competition, Consumer Protection and Economics
of the Federal Trade Commission

on

Council Bill 6-442

The Wine, Beer, and Spirits Franchise Act of 1986

Council of the District of Columbia
August 29, 1986

COMMENTS OF THE BUREAUS OF COMPETITION,
CONSUMER PROTECTION, AND ECONOMICS
OF THE FEDERAL TRADE COMMISSION
ON THE
DISTRICT OF COLUMBIA, BEER AND
SPIRITS FRANCHISE ACT [1]

We welcome the opportunity to present the views of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission on the proposed District of Columbia Wine, Beer and Spirits Franchise Act of 1986 (the "Act"). Our comments are offered in response to an invitation from Councilman H.R. Crawford to express our views on the competitive ramifications of this proposed legislation.

The Act grants all existing wholesalers of wine, beer, and spirits certain contractual rights (discussed below) that may not be provided by current franchise agreements between wholesalers and suppliers. The Act would restrict the ability of suppliers of alcoholic beverages to switch wholesalers or to increase the number of wholesalers handling suppliers' brands in response to changes in market conditions. It would also increase barriers to entry of new, more efficient wholesalers. The end result will be higher costs of distribution of alcoholic beverages and higher prices. We see no benefits to consumers from this legislation.

It is especially important to examine carefully any regulatory change in private contractual relationships in the alcoholic beverage industry because existing District of Columbia regulations already impose severe restrictions

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[1] These comments represent the views of the Bureaus of Competition, Consumer Protection, and Economics of the Federal Trade Commission and do not necessarily represent the views of the Commission or any individual Commissioner. The Commission, however, has authorized the submission of these comments.

on the distribution process. Under existing regulations, for example, all liquor retailers are required to purchase brands carried by local wholesalers from those wholesalers and can obtain permits to import directly only brands not carried by District of Columbia licensed wholesalers.[2]

It is also important to examine carefully any regulatory change because the distribution of alcoholic beverages in the District of Columbia is highly concentrated. Any change that restricts entry or entrenches incumbent wholesalers in such a market must be carefully considered, since it could have a significant anticompetitive effect. Thirteen companies are licensed in the District to distribute distilled spirits, wine and beer (Class A wholesalers), and an additional twelve companies are licensed to distribute light wine and beer (Class B wholesalers). Not all license holders are active distributors. The four leading distributors account for approximately 80 percent of the sales of distilled spirits and wine in the District.

Description of the Bill

The bill requires that suppliers designate one wholesaler as the exclusive distributor of each of the suppliers' brands in the district, gives the wholesaler an absolute right to transfer his exclusive distributorship rights to a member of his family, and mandates that "No supplier shall change wholesalers and/or amend, terminate, cancel or refuse to renew an exclusive distributorship without good cause." Grounds which constitute good cause include bankruptcy, revocation of the wholesaler's license, and failure of the wholesaler to maintain sales of a supplier's brand or brands

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[2] See Distilled Spirits Council of the United States, Inc. Summary of State Laws and Regulations Relating to Distilled Spirits, Twenty-fifth Edition, 1985, p. 18.

"comparable to that of other similarly situated wholesalers of that brand, in light of all the circumstances of the market for those brands in the District of Columbia." Under this provision, the transfer of ownership of brands from one supplier to another does not constitute good cause for a change in wholesalers.

Any supplier desiring to make any change in wholesalers must notify the District of Columbia Alcoholic Beverage Control Board 90 days in advance and provide a detailed explanation for the requested change. If the conditions leading to the request for a change can be rectified by the wholesaler within 60 days, the wholesaler is afforded that amount of time to improve conditions. In Board proceedings, the supplier has the burden of proving the existence of good cause.

If a supplier is found to have acted without good cause, the wholesaler can elect to have the exclusive distributorship remain in effect or be reinstated. Alternatively, the wholesaler can require the supplier pay the reasonable value of his distributorship (including good will) as determined by mutual agreement or by an appraiser.

<u>Likely Effects of the Act</u>

The impact of the bill is perhaps best assessed by considering the changes it would impose on the terms of existing wholesaler contracts. Existing contracts do not grant exclusive distributorships to wholesalers (although virtually all brands are distributed on an exclusive basis) nor do they require purchasers of a supplier's brands or business to use the same distributors. Moreover, current contracts provide for supplier approval of any change in wholesaler ownership, including transfer to other family members. Existing contracts thus enable suppliers to change methods of

distribution to meet the changing conditions of the marketplace in a manner which maximizes efficiency. Enactment of Council Bill 6-442, however, would change the terms of these contracts and could prevent suppliers from efficiently distributing their products in the District of Columbia, leading to higher prices to consumers.

The mandatory contract terms envisioned by the proposed legislation are for several reasons unnecessary to protect distributors from arbitrary or unfair treatment by suppliers. First, suppliers engaging in such conduct will be exposed to competitive disciplinary forces. Suppliers and wholesalers are mutually dependent on each other. Suppliers who systematically terminate distributors "without cause" will find that distributors will be more reluctant to handle their brands or to promote them actively. Such actions will also make it more difficult for those suppliers to attract distributors in new markets or to obtain distribution for new brands in existing markets.

Second, existing distribution agreements appear to reflect the legitimate expectations of suppliers and wholesalers, so that wholesalers are protected from unfair treatment by contract and antitrust remedies. The fact that there are dozens more suppliers than wholesalers in the District of Columbia does not suggest the existence of a gross disparity in bargaining power in favor of suppliers. Imposing contract terms different from those mutually agreed upon runs counter to the policies underlying the Uniform Commercial Code.

The Act could have several deleterious effects on competition in the industry. It could create a potentially serious barrier to entry at the wholesale level. New wholesalers would be able to enter the market only if they could convince suppliers to terminate or not renew existing distribution

agreements. However, given the statutory presumptions and allocation of the burden of proof, suppliers may be reluctant to risk civil actions by terminated dealers.

The Act will also interfere unnecessarily with market forces by increasing the supplier's costs of switching from one distributor to another. The stimulus to efficiency in distribution resulting from competition for the supplier's patronage among existing and potential distributors will be reduced as it becomes more costly for suppliers to change distributors. These higher costs will also reduce the incentives of existing suppliers to introduce new brands into the District and of new suppliers to enter the market.

Furthermore, the restrictions on termination and non-renewal of distribution agreements make it more costly for suppliers to replace wholesalers who collude. This reduces the penalties existing wholesalers would bear should they decide to collude and thereby makes collusion more likely.

In addition, even if an exclusive distributorship were, at one point in time, the most efficient type of distribution system, the need to have "good cause" for not renewing a particular arrangement with a wholesaler, as well as the ninety-day notification requirement, could prevent suppliers from reacting at minimum cost to changes in supply and demand conditions. Often, suppliers choose to discontinue particular distributional arrangements not in response to poor performance on the part of their individual wholesalers, but rather out of desire to restructure distribution networks that have become obsolete and inefficient. In these cases, for good business reasons, suppliers may not be able to satisfy the proposed requirement that wholesalers be given an opportunity to correct their conduct before an

agreement is discontinued. As a result, suppliers may find themselves with increasingly inefficient distributional arrangements. The higher costs caused by this inefficiency would undoubtedly be reflected in higher consumer prices.

Conclusion

Unregulated contracting between alcoholic beverage wholesalers and suppliers insures that suppliers maintain distributional arrangements that, in the judgment of the marketplace, are as efficient as possible. The Act replaces this free contracting solution with mandated contract terms that (1) make it difficult for suppliers to switch to more efficient wholesalers, (2) reduce the probability of entry by new, efficient wholesalers, and (3) require that suppliers designate exclusive distributors for each of their brands. By substituting regulation for the forces of the marketplace, the Act may raise the costs of distribution and thereby permit the survival of inefficient distributional arrangements that can result in restricted supply and increases in the prices that consumers must pay. For these reasons, the Commission staff opposes the enactment of this bill.