THE ECONOMIC AND FISCAL EFFECTS OF A PRIMARY SOURCE LAW FOR CALIFORNIA WINE IMPORTS

MAY 1986

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86-9

PREFACE

This report is being submitted to the Legislature in response to Senate Rules Committee Resolution No. 681, which requires that the Legislative Analyst prepare a specified "citizen cost" impact study of Senate Bill 589. This bill would have established a "primary source" law covering all wines imported into California. Under this proposal, no importer could bring a wine product into the state unless the product's brand owner or agent had specifically authorized that importer to do so.

In conducting the "citizen cost" impact study, we were required to identify the types of products that would be affected by SB 589's provisions, as well as the probable impacts of the measure on the prices charged for imported wines, the number and sales volumes of existing wine importers, and the prices and sales volumes of domestic wines. In addition to addressing these issues, the report evaluates the potential fiscal effects of SB 589's provisions on state government.

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EXECUTIVE SUMMARY

Senate Bill 589 (Dills) would have made all wines imported into California subject to a "primary source" requirement. Under this measure, no wine importer would have been able to bring a wine product into the state unless the product's brand owner or agent had specifically authorized the importer to do so. In other words, the measure would have prohibited the so-called "gray marketing" of imported wines.

Senate Bill 589 was enacted by the California Legislature in 1985, but subsequently it was vetoed by the Governor.

The general purpose of this report is to identify the various economic and fiscal effects which a measure such as SB 589 would have on consumers, industry and government.

THE CALIFORNIA "GRAY MARKET" FOR IMPORTED WINES

The "gray market" for imported wines encompasses wines which are being imported legally into California by nonauthorized importers, in direct competition with authorized importers. The latter have been officially designated by brand owners or their agents to import these wines. Nonauthorized importers, however, are able to acquire the products in the open market--usually overseas--and bring them into the state for sale to consumers.

For a variety of reasons, gray-market importers tend to charge Californians lower prices for these wines than do the authorized importers. For example, there was a period during 1985 when Dom Perignon, the "king" of French champagnes, was being acquired through the gray market and sold by some retailers for around $35 per bottle, or 40 percent less than the normal price.

Our review of the data available on California's "gray market" indicates that no one can say for sure precisely what the size and scope of this market are. This is because these data are limited, and the characteristics of the gray market themselves are in constant flux in response to such factors as movements in foreign-exchange rates in international money markets. However, what data are available, along with the results of our own surveys of California wine importers, distributors, retailers and producers, indicates the following.

SIZE AND SCOPE OF THE GRAY MARKET

- Gray marketing involves not only the well-publicized importing of certain famous French champagnes, but also the importing of certain premium and even moderately priced table wines. However, the vast majority of imported nonchampagne wines are not, nor will they probably ever be, gray marketed. Thus, gray marketing applies to only a small portion of the total wine market.
- At the end of 1985, our survey data suggest that gray market imports accounted for about 30 percent of imported champagne sales in California and 5 percent of all imported nonchampagne wine sales in the state. This means that gray market imports represented about 5 percent of total statewide champagne consumption and 1 percent of total nonchampagne wine consumption. (Since the time our data was collected, the U.S. dollar has declined in value relative to the currencies of European

wine-exporting nations. This may have reduced the volume of gray market importing compared to its level as of late 1985.)

GRAY MARKET IMPORTERS AND THEIR ACTIVITIES

- A conservative estimate of the number of licensed wine importers who have handled gray market wines at one time or another appears to be between 20 and 50, with the actual number probably exceeding 50. In comparison, there are about 700 licensed individuals and firms who actually import wine products into California.
- Gray market imports do not account for a significant share of the business of most gray market importers. Rather, most of these importers are involved in a variety of other importing activities as well.
- In order for gray marketing to be economically attractive to them, gray market importers require that the prices charged by producer-authorized importers be, on the average, about 20 percent ($5 per bottle) more than what gray market importers can charge and still cover their costs. We have found cases, however, where the reported differential was as low as 5 percent ($1 per bottle).

EFFECTS OF THE GRAY MARKET

- The quality of gray market wine imports does not appear to differ markedly from the quality of other wine imports.
- Gray marketing has brought about some reductions in the prices charged by "authorized" wine importers and domestic wine producers.

- Gray marketing has increased total wine sales by California retailers. For example, the retailers we surveyed reported that their champagne sales had risen by an average of 20 percent.
- The gray market has caused some reduction in the sales of California-produced wines, especially in cases where these wines have characteristics that place them in direct competition with gray market wines. Nevertheless, there are other much more important obstacles to the successful domestic and foreign marketing of California wines than the gray market. Moreover, the overall magnitude by which total California wine sales have been reduced by the gray market is not very much. For example, the retailers we surveyed estimated that their sales of domestic wines had fallen due to gray market competition by only about 1 percent.

FUTURE OF THE GRAY MARKET

- The possibility exists that gray marketing could expand somewhat in the future, both to more nonchampagne wines, and downward through the "price ladder" to more moderately priced wine products. This could occur for certain wines that offer a gray-market profit potential to importers.
- The actual future extent of gray marketing will depend, in part, on certain economic conditions. For example, gray marketing appears to pick-up when the value of the dollar rises relative to the currencies of European wine-exporting nations, and tapers-off when the dollar weakens.

PRINCIPAL FINDINGS REGARDING THE ECONOMIC EFFECTS OF A PRIMARY SOURCE LAW

The available evidence appears to suggest that a California primary source law for imported wines eventually would result in:

- Higher prices to consumers for certain imported and domestic wine products.
- A redistribution of wine sales away from certain smaller wine importers and distributors to other (generally larger) suppliers.
- Some increase in the sales of certain domestic wines.
- Increased concentration of both wine-related importing and distribution activities in the hands of fewer and larger firms. In other words, the number of wine importing and distribution firms within California could go down. (This is because a primary source requirement would encourage the development of more producer-controlled distribution arrangements.)
- Little, if any, improvement in the overall quality of imported wine products purchased by Californians.

THE FISCAL EFFECTS OF A PRIMARY SOURCE LAW

The likely fiscal effects of a primary source law would be:

- Higher costs and lower revenues to state government, amounting to a net negative impact on the state's General Fund of up to $200,000 annually. The higher costs result from the expenses involved in administering and enforcing a primary source requirement. The revenue losses would show up in the form of reduced wine-related excise tax and sales and use tax collections.

CONCLUSION

Given the above, we conclude that the net impact of a primary source requirement would be to leave California wine consumers and the state government worse off than they would be without such a requirement. While certain individual firms would benefit from the requirement, these benefits, to some degree, would be achieved at the expense of other firms who would be hurt by the requirement.

We also conclude that although a primary source requirement could enable the producers of certain California wine brands to increase their sales, such a requirement would not effectively address the underlying problems currently faced by the California wine and grape producing industries.

CHAPTER I

INTRODUCTION

A. LEGISLATIVE BACKGROUND OF THE "PRIMARY SOURCE" ISSUE

During 1985, the California Legislature considered Senate Bill 589 (Dills)--a bill to impose a so-called "primary source" requirement on all wines imported into California. Specifically, SB 589 would have:

- Prohibited any California-licensed wine importer from purchasing or accepting delivery of a particular brand of wine, unless he had been explicitly designated to do so by the brand owner (or his authorized agent).
- Required the Governor, beginning on January 1, 1987, and annually thereafter, to determine whether there have been significant changes in the barriers to the sale of California wines or champagnes within the European Economic Community (EEC) which would enable California wine producers to compete fairly within the EEC. In the event the Governor determined that trade barriers to the EEC had been reduced, the primary source requirement of SB 589 would no longer apply. Otherwise, the requirement would terminate on January 1, 1990.

According to proponents of SB 589, the bill was intended to put an end to the importing of wines into California through the "gray market." This term, "gray market," while not precisely defined, generally refers to a legal importing network which bypasses the network set-up by a foreign product's own producer.

During legislative hearings on SB 589, there was considerable disagreement regarding what the probable economic effects of both the gray market and the proposed primary source requirement for imported wines would be on consumers, importers, retailers, wholesalers, and the state's wine and grape-growing industries. These disagreements were never fully resolved.

Senate Bill 589 eventually was enacted by the Legislature. However, it was subsequently vetoed by the Governor, and consequently it never became law.

B. THE PURPOSE OF THIS REPORT

In June 1985, prior to when the Legislature passed SB 589, the Senate Rules Committee directed the Legislative Analyst to prepare a "citizen cost" impact study of the bill. The purpose of this study was to resolve the disagreements that arose during the Legislature's consideration of SB 589 regarding the bill's likely economic effects. Specifically, Senate Rules Committee Resolution 681 requires that, pursuant to Joint Rule 37.1, the Legislative Analyst shall prepare a study of SB 589 which does the following:

- Verifies what types of products would be affected by SB 589;
- Ascertains the possible impact of SB 589 on the prices charged for these products;
- Estimates the possible impact of SB 589 on the number and sales volumes of existing importers; and
- Determines the possible impacts of SB 589 on the prices and sales of domestic products which compete with the affected imported products.

This report contains the citizen cost impact study called for by the Senate Rules Committee.

C. ORGANIZATION OF THE REPORT

This report is divided into six chapters.

Chapter II presents general background information on California's wine industry that is relevant to understanding the economic effects of both the gray market and a primary source requirement for wine imports. Specifically, the chapter discusses how wine is defined and classified, key features of California's wine market, current problems facing the state's wine industry, and how the wine importing process works in California.

Chapter III discusses what is meant by the term "gray market," why the gray market for wines exists in California, and the scope and structure of this market.

Chapter IV discusses the nature and prevalence of primary source requirements, including what a "primary source" law is, and the extent to which primary source laws are in effect for alcoholic beverages at the national level, in other states, and in California.

Chapter V discusses the potential economic effects of a primary source law covering imported wines, such as that proposed by SB 589, including the way that a primary source requirement for California imported wines would affect California consumers, retailers, wholesalers, importers, and the state's wine and grape-growing industries. This chapter also discusses SB 589's requirement that the Governor evaluate whether there are barriers to the sale of California wines within the EEC, in order to determine whether a California primary source requirement for imported wines would actually stay in effect.

Chapter VI discusses the potential fiscal effects of SB 589, including its effects on alcoholic beverage tax revenues, general sales and use tax revenues, and the administrative, regulatory and tax-collection costs that would be incurred by state agencies such as the Board of Equalization and the Department of Alcoholic Beverage Control.

Lastly, Chapter VII summarizes the report's principal findings and conclusions.

CHAPTER II

THE CALIFORNIA WINE MARKET

In order to determine the potential effects of a California primary source requirement covering imported wines, it is necessary to have some knowledge of the California wine market and the products which SB 589's provisions would cover. This chapter provides information on the wine market and the products sold in it, including (A) how "wine" is defined and classified, (B) the key characteristics of California's wine market, (C) the major problems currently facing the state's wine industry, and (D) how wine is imported to California.

A. HOW "WINE" IS DEFINED AND CLASSIFIED

The term "wine" refers to an extremely broad collection of moderately-alcoholic beverages made from fermented fruit juices. Wines most commonly are made from fermented grape juices. However, juices from other fruits and even plants can be used to make wines, including apples, cherries and dandelions.

Although the exact number of different wines produced is unknown, it is in the thousands. These wines can vary greatly from one another in terms of their alcoholic content, the particular ethers and esters used to produce their distinctive bouquets (fragrance) and flavors, the fermentation process employed (including the types of storage containers used), and the type and location of the grapes used to produce them. (In the United States, for example, over 150 different varieties of wine-producing grapes are grown.) In addition, many wines actually are blends produced by mixing two or more types of grapes during the crushing stage, or mixing two or more types of wine during or following the fermentation process.

Classifications of Wine

Wines may be classified in several different ways. One way is to classify them according to their country of origin, which usually is either France, Germany, Italy, the United States, Portugal or Spain. Another way is to classify them according to their generic name, which refers to the region in Europe where the wines first were produced (for example, the Burgundy and Chablis regions in France). A third means of classification is by varietal name, which refers to the name of the principal grape used to produce the wine (for example, Cabernet Sauvignon, Chardonnay, Chenin Blanc or Pinot Noir).

Probably the single most common classification method divides wines into six different categories, based on when the wines tend to be served. These six categories are:

- Appetizer wines. These wines normally are served prior to the main meal course and generally have an alcoholic content of between 15 percent and 20 percent. They vary in taste from sweet to dry (unsweet), and include sherry and vermouth.
- Red table wines. These wines are used to complement main dishes such as red meats and highly seasoned foods, generally are served unchilled and, like all table wines, have an alcoholic content of between 8 percent and 15 percent. They include such varietals as Cabernet Sauvignon, Pinot Noir and Zinfandel, and such generics as Burgundy, Claret and Chianti.

- White table wines. These wines generally are served chilled with delicately flavored foods, such as chicken and fish. They vary in color from pale to deep gold, and in taste from sweet to extremely dry. They include such generics as Chablis, Rhine wine and Sauterne, and such varietals as Chardonnay, Chenin Blanc, Delaware and Semillon.
- Rose table wines. These are all-purpose wines that share characteristics of both red and white table wines, are best served chilled, and can be used with most foods.
- Dessert wines. These are sweet, rich wines which usually are served unchilled, either alone or with desserts. Their alcoholic content ranges from 15 percent to 20 percent. They include such favorites as madeira, muscatel, port and sweet sherry.
- Sparkling wines. These wines have a "bubbly" characteristic because they contain carbon dioxide gas. They are best served chilled, either alone or with any food, and can be either sweet or dry. Sparkling wines, which are especially popular for festive celebrations, have an alcoholic content normally ranging from 10 percent to 14 percent. The most famous of these wines is champagne, named after the Champagne region in northern France; other popular sparkling wines include sparkling burgundy and sparkling rose.

In the case of champagnes, the sparkling effervescence of the best-quality champagnes comes from a natural secondary-fermentation process called la methode champenoise, which occurs within the champagne bottle itself after the initial out-of-bottle fermentation process has already been completed.[1] In contrast, less expensive champagnes are made to sparkle by adding carbon dioxide to them.

B. DESCRIPTIVE CHARACTERISTICS OF THE CALIFORNIA WINE MARKET

A profile of the California wine market can be obtained by looking at data on California wine shipments, production, exports and imports, both by type of wine and over time.

California Wine Shipments, by Volume and Type

Table II-1 shows California wine shipments from 1976 through 1984 (the latest year for which published data were available at the time our report was prepared), by type, both in gallons and as a percent of total California shipments. It indicates that in 1984, California shipped 373 million gallons of wine to domestic and foreign markets, combined. Of the total, 74 percent were table wines, 7.5 percent were sparkling champagnes, 4.7 percent were dessert wines, 1 percent were vermouth, and the remaining 12.8 percent represented "all other" wines, including wine coolers. (Of California's total sparkling wine production, it appears that around 5 percent (or well under 1 percent of all produced wines) represent champagnes made using la methode champenoise, the same method used to produce the most exclusive French champagnes.)

Table II-1 also shows that:

- Between 1976 and 1984, the percentage distribution of California wine shipments, by wine type, shifted significantly toward table wines and champagnes and away from dessert wines and special natural-flavored wines. This reflects the fact that since 1976,

Table II-1

California Wine Shipments, By Wine Type
1976-1984[a]

Year	Table	Dessert	Sparkling	Vermouth	Other, With Alcoholic Content: not over 14%[b]	Other, With Alcoholic Content: over 14%	Totals, All Wines
	Shipments by Wine Type (millions of gallons)						
1976	161.1	40.2	15.9	3.8	39.7	11.3	272.0
1977	184.6	37.9	17.9	3.8	31.5	11.9	287.8
1978	205.5	34.7	18.8	3.7	25.0	10.9	298.6
1979	227.7	29.7	19.8	4.0	23.3	9.8	314.3
1980	255.4	25.5	21.9	4.6	21.5	9.8	338.7
1981	278.0	22.7	24.0	4.2	19.3	9.9	358.2
1982	280.7	21.3	25.5	4.3	16.6	10.1	358.5
1983	281.4	19.4	28.1	4.2	19.6[c]	11.0	363.6
1984	276.1	17.5	28.1	3.7	36.8[c]	10.8	373.0

Year	Table	Dessert	Sparkling	Vermouth	Other, With Alcoholic Content: not over 14%[b]	Other, With Alcoholic Content: over 14%	Totals, All Wines
	Shipments by Wine Type (percent of total)						
1976	59.2%	14.8%	5.8%	1.4%	14.6%	4.2%	100.0%
1977	64.2	13.2	6.2	1.3	11.0	4.1	100.0
1978	68.8	11.6	6.3	1.2	8.4	3.6	100.0
1979	72.5	9.4	6.3	1.3	7.4	3.1	100.0
1980	75.4	7.5	6.4	1.4	6.4	2.9	100.0
1981	77.6	6.3	6.7	1.2	5.4	2.8	100.0
1982	78.3	5.9	7.1	1.2	4.6	2.8	100.0
1983	77.4	5.3	7.7	1.2	5.4[c]	3.0	100.0
1984	74.0	4.7	7.5	1.0	9.9[c]	2.9	100.0

a. Based on data published in Wines and Vines, 42nd Statistical Issue, July 1985. These data were developed from information collected by the Wine Institute, the California State Board of Equalization, and the U.S. Bureau of Alcohol, Tobacco and Firearms. Detail may not add to totals due to rounding.
b. Includes minor quantities of special natural sparkling wines.
c. Includes "wine coolers."

the quantity of table wines and champagnes shipped has risen, while shipments of all other categories have declined.

- During the past several years, California wine shipments have not grown much. For example, between 1981 and 1984, total California wine shipments increased by only 4.2 percent, and shipments of table wines actually declined. What growth did occur in total shipments is primarily attributable to the introduction of new "wine-cooler" products after 1982. Thus, the California wine industry, as a whole, has not exhibited strong growth in recent years.

Destination of California Wine Shipments

Table II-2 shows where California-produced wines are shipped. Of the 373 million gallons of California wines shipped in 1984, about 28 percent was shipped to locations within California itself, and nearly 70 percent went to other states. Only 2.3 percent of total shipments went to foreign nations. Thus, although California itself consumes only a bit more than a quarter of the wine it produces, only a very small portion of the remainder goes to other countries.

There have been no significant shifts in the destination of California wine shipments during the past 10 years, although exports to foreign countries appear to have peaked in 1981.

Table II-3 shows the percentage of California wines that are exported, by wine type. It shows that in 1984, exports were well below 3 percent for all wine categories, and have rarely exceeded this level during the past decade. Thus, California producers have an extremely limited market for their wines abroad.

Table II-2
Destination of California Wine Shipments
1975 through 1984[a]

Year	California Wine Shipments by Destination (percent distribution) Shipped Within California	Exported To Other States	Exported To Foreign Nations	Totals, All Shipments
1975	27.2%	72.0%	0.8%	100.0%
1976	27.8	71.2	1.0	100.0
1977	28.4	70.5	1.1	100.0
1978	28.4	70.5	1.1	100.0
1979	28.2	69.9	1.9	100.0
1980	28.2	69.3	2.5	100.0
1981	27.4	69.5	3.1	100.0
1982	27.8	69.7	2.5	100.0
1983	28.5	68.8	2.7	100.0
1984	28.1	69.6	2.3	100.0

a. Based on data published in Wines and Vines, 42nd Statistical Issue, July 1985. These data were developed from information collected by the Wine Institute, the California State Board of Equalization, and the U.S. Bureau of Alcohol, Tobacco, and Firearms. Detail may not add to totals due to rounding.

Table II-3

California Wine Exports to Foreign Countries
As a Percent of Total Wine Shipments,
By Wine Type
1976 through 1984[a]

	California Wine Exports to Foreign Nations as a Percent of Total California Wine Shipments, by Wine Type					
Year	Table	Dessert	Sparkling	Vermouth	All Other[b]	Totals, All Wines
1976	0.8%	1.0%	2.8%	0.4%	0.8%	1.0%
1977	1.0	0.9	2.9	0.9	1.0	1.1
1978	1.1	0.6	2.8	0.8	1.2	1.1
1979	1.9	0.7	4.1	0.7	1.6	1.9
1980	2.6	1.1	3.2	1.1	2.1	2.5
1981	3.3	1.5	3.3	1.5	2.7	3.1
1982	2.6	1.1	2.5	1.1	2.0	2.5
1983	3.0	2.0	2.4	2.0	0.8[c]	2.7
1984	2.6	1.8	2.0	1.8	1.1[c]	2.3

a. Based on data published in Wines and Vines, 42nd Statistical Issue, July 1985. These data were developed from information collected by the Wine Institute, the California State Board of Equalization, and the U.S. Bureau of Alcohol, Tobacco and Firearms. Detail may not add to totals due to rounding.
b. Includes wine coolers and other special natural wines.
c. Includes wine coolers which must be manufactured on the premises of a bonded winery or bonded wine cellar in accordance with Bureau of Alcohol, Tobacco, and Firearms regulations.

California Wine Imports

Table II-4 provides data on the volume of wine imported into California between 1980 and 1984. The table indicates that:

- California imported about 12.4 million gallons of wine in 1984, the vast majority of it from foreign countries. This amount represented 10.6 percent of all wine distributed within California--up significantly from 8.5 percent in 1980.[2]
- In 1984, California imported 3.7 million gallons more from foreign nations than it exported to them. In other words, California had a negative foreign "trade balance" in terms of wine. Table II-4 also shows that this trade balance has worsened in recent years, reflecting a general tendency for imports to rise and exports to fall throughout the economy.

Thus, even though California is a major wine-producing region, the state imports over one-tenth of the wine it consumes, and does not compensate for this by exporting a comparable volume to foreign countries.

California's Role in the National Wine Market

Table II-5 shows California's share of the U.S. wine market during the 1975-1984 period, by wine type. The table indicates that:

- California-produced wines accounted for 66 percent of all shipments to the nation's domestic markets in 1984. Of the remaining 34 percent, about 9 percent came from other states (primarily New York), while 26 percent represented imports from foreign nations.

Table II-4

California's Foreign-Wine Imports and Foreign-Wine "Trade Balance"
1980 through 1984[a]

	Wine Gallons, in millions				
	1980	1981	1982	1983	1984
A. Total Wine Distributed Within California	104.5	108.8	109.9	116.5	117.2
B. Minus: California-Produced Wine Distributed in California	95.6	98.2	99.6	103.7	104.8
C. Equals: Foreign-Produced California Wine Imports[b]	8.9	10.6	10.3	12.8	12.4
D. Minus: California Wine Exports to Foreign Nations	8.4	11.1	8.8	9.9	8.7
E. Equals: Excess of California's Foreign Imports over California's Foreign Exports	0.5	-0.5	1.5	2.9	3.7

a. Based on data published in Wines and Vines, 42nd Statistical Issue, July 1985. These data were developed from information collected by the Wine Institute, the California State Board of Equalization, and the U.S. Bureau of Alcohol, Tobacco, and Firearms. Detail may not add to totals due to rounding.
b. Assumes wine imports into California from other states are negligible. In 1984, California accounted for over 90 percent of all U.S. produced wines entering U.S. distribution channels.

Table II-5

Sources of Wine Distributed in the United States,
By Wine Type
1975 through 1984[a]

Wine Type and Year	Wine Distributions in the United States: Millions of Wine Gallons, By Source: California	Other States	Foreign Nations	Totals	Percent of Total Gallonage, By Source: California	Other States	Foreign Nations	Totals
Table Wines								
1975	152.0	21.6	35.2	208.7	78.2%	10.3%	16.9%	100.0%
1976	159.8	22.3	45.6	227.6	70.2	9.8	20.0	100.0
1977	182.7	22.5	56.0	261.3	69.9	8.6	21.4	100.0
1978	203.3	19.1	78.2	300.7	67.6	6.4	26.0	100.0
1979	223.3	22.5	78.3	324.2	68.9	7.0	24.2	100.0
1980	248.6	22.9	88.2	359.6	69.1	6.4	24.5	100.0
1981	268.9	19.3	98.6	386.7	69.5	5.0	25.5	100.0
1982	273.3	18.9	105.1	397.3	68.8	4.8	26.5	100.0
1983	272.8	18.7	111.4	402.9	67.7	4.6	27.6	100.0
1984	268.8	17.6	118.7	405.1	66.3	4.4	29.3	100.0
Dessert Wines								
1975	45.3	19.3	2.4	67.1	67.6%	28.8%	3.7%	100.0%
1976	39.8	18.2	3.0	61.0	65.2	29.9	4.9	100.0
1977	37.6	16.9	3.0	57.5	65.3	29.4	5.3	100.0
1978	34.5	15.8	3.8	54.2	63.7	29.2	7.1	100.0
1979	29.5	14.6	3.3	47.3	62.2	30.9	6.9	100.0
1980	25.2	16.4	3.2	44.8	56.3	36.6	7.1	100.0
1981	22.4	16.5	3.4	42.3	53.0	39.1	8.0	100.0
1982	21.0	16.0	3.2	40.2	52.3	39.8	7.9	100.0
1983	19.0	15.7	3.4	38.1	49.9	41.2	8.9	100.0
1984	17.2	16.8	3.6	37.6	45.8	44.7	9.6	100.0

Table II-5--contd

Wine Type and Year	Wine Distributions in the United States: Millions of Wine Gallons, By Source: California	Other States	Foreign Nations	Totals	Percent of Total Gallonage, By Source: California	Other States	Foreign Nations	Totals
Vermouth								
1975	3.6	1.7	4.3	9.6	37.4%	17.9%	44.8%	100.0%
1976	3.8	1.4	4.0	9.2	41.4	15.1	43.5	100.0
1977	3.8	1.4	3.7	8.9	42.5	16.1	41.4	100.0
1978	3.7	1.6	4.2	9.5	38.6	17.2	44.2	100.0
1979	4.0	1.4	3.2	8.6	46.2	16.4	37.4	100.0
1980	4.6	1.1	2.9	8.6	53.3	13.2	33.5	100.0
1981	4.2	1.0	2.9	8.0	52.0	12.2	35.8	100.0
1982	4.3	0.7	2.6	7.7	56.1	9.3	34.5	100.0
1983	4.1	0.6	2.8	7.5	55.0	8.0	37.0	100.0
1984	3.6	0.6	2.9	7.1	50.6	8.5	40.9	100.0
Champagnes								
1975	15.0	3.4	1.9	20.4	73.8%	16.7%	9.5%	100.0%
1976	15.5	3.8	2.6	21.8	71.0	17.2	11.8	100.0
1977	17.4	3.9	2.9	24.3	71.8	16.1	12.1	100.0
1978	18.3	3.1	4.3	25.7	71.1	12.1	16.8	100.0
1979	19.0	3.4	4.5	27.0	70.5	12.6	16.8	100.0
1980	21.2	4.0	4.8	30.0	70.5	13.4	16.1	100.0
1981	23.2	4.1	7.1	34.3	67.5	11.9	20.6	100.0
1982	24.9	4.2	8.4	37.5	66.4	11.3	22.3	100.0
1983	27.4	5.0	11.1	43.5	63.0	11.4	25.6	100.0
1984	27.5	4.5	14.9	47.0	58.7	9.6	31.7	100.0

Table II-5--contd

Wine Type and Year	Wine Distributions in the United States: Millions of Wine Gallons, By Source: California	Other States	Foreign Nations	Totals	Percent of Total Gallonage, By Source: California	Other States	Foreign Nations	Totals
Other Special Natural Wines and Wine Coolers[b]								
1975	54.3	2.5	5.5	62.3	87.2%	4.0%	8.8%	100.0%
1976	50.6	2.4	3.8	56.8	89.1	4.2	6.7	100.0
1977	43.0	2.4	3.5	49.0	87.9	5.0	7.2	100.0
1978	35.4	2.1	3.5	41.0	86.3	5.1	8.6	100.0
1979	32.5	2.0	2.8	37.4	87.1	5.3	7.6	100.0
1980	30.7	2.5	3.5	36.6	83.8	6.7	9.4	100.0
1981	28.5	3.1	2.8	34.4	82.9	8.9	8.2	100.0
1982	26.2	2.4	2.8	31.4	83.4	7.7	8.9	100.0
1983[c]	30.4	3.4	2.3	36.1	84.2	9.4	6.5	100.0
1984[d]	47.1	8.2	2.3	57.5	81.9	14.2	3.9	100.0
All Wines								
1975	270.2	48.5	49.3	368.0	73.4%	13.2%	13.4%	100.0%
1976	269.4	48.0	58.9	376.4	71.6	12.8	15.7	100.0
1977	284.6	47.2	69.2	401.0	71.0	11.8	17.3	100.0
1978	295.2	41.8	94.1	431.1	68.5	9.7	21.8	100.0
1979	308.3	43.9	92.2	444.4	69.4	9.9	20.7	100.0
1980	330.2	46.9	102.5	479.6	68.9	9.8	21.4	100.0
1981	347.1	43.9	114.7	505.7	68.6	8.7	22.7	100.0
1982	349.7	42.3	122.1	514.0	68.0	8.2	23.8	100.0
1983	353.7	43.4	131.0	528.1	67.0	8.2	24.8	100.0
1984	364.2	47.7	142.4	554.4	65.7	8.6	25.7	100.0

a. Based on data published in Wines and Vines, 42nd Statistical Issue, July 1985. These data were developed from information collected by the Wine Institute, the California State Board of Equalization, and the U.S. Bureau of Alcohol, Tobacco, and Firearms. Detail may not add to totals due to rounding.
b. Includes wines with alcoholic content both over 14 percent and not over 14 percent.
c. Includes wine cooler shipments (not recorded prior to 1983) equal to 5.4 million gallons for California and 1.4 million gallons for other states.
d. Includes wine cooler shipments (not recorded prior to 1983) equal to 23.6 million gallons for California and 6.6 million gallons for other states.

- During the past 10 years, California's share of domestic wine production has risen moderately, from about 85 percent in 1975 to 89 percent in 1984. At the same time, however, California's share of the national market (including imports) has fallen steadily, from over 73 percent in 1975 to under 66 percent in 1984. Likewise, the other states' share has fallen, from over 13 percent in 1975 to under 9 percent in 1984.
- In contrast, foreign imports' share of the U.S. wine market has doubled during the past decade, going from about 13 percent in 1975 to nearly 26 percent in 1984. Table II-5 shows that this trend is evident in nearly all individual wine categories. It has been especially pronounced, however, in the case of sparkling wines and champagne, where imports' share rose from under 10 percent in 1975 to nearly 32 percent by 1984.

The strong upward trend in wine imports has resulted in a growing wine-related "foreign trade deficit" for the nation as a whole, as it has for California. For example, the ratio of foreign-produced wine imports to U.S.-produced wine exports in 1984 was 23.5 in terms of gallons and 37.6 in terms of dollars. In 1984 alone, the value of U.S. wine exports fell from $32.1 million to $25.4 million, while the value of U.S. imports of foreign wines rose from $853.7 million to $954.3 million. Thus, the gap between imports and exports rose by over $107 million in 1984, to almost $930 million.

Table II-6 provides additional detail on the characteristics of 1984 foreign wine imports into the U.S., by wine type and country of origin.

Table II-6

Characteristics of Foreign-Produced Wine Shipments into the United States in 1984[a]

Country of Origin	Percent Distribution of U.S. Imports By Country of Origin and Wine Type						
	Table	Dessert	Sparkling	Vermouth	Other Special Natural-Flavored	Totals, All Wines: Percent of All Imports	Totals, All Wines: Millions of Gallons
Italy	53.0%	6.7%	50.1%	86.3%	1.2%	51.4%	73.2
France	23.5	2.3	24.5	13.1	0.2	21.1	30.0
West Germany	13.5	--[b]	2.0	--	1.4	11.5	16.4
Spain	1.5	61.1	21.9	0.2	82.0	6.4	9.1
Portugal	4.1	6.9	0.1	--[b]	0.2	3.6	5.1
All Others	4.4	23.0[c]	1.4	0.4	15.0[d]	6.0	8.6
Totals	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	142.4
Millions of Gallons	118.7	3.6	14.9	2.9	2.3	--	142.4
Percent of All Imports	83.3%	2.5%	10.5%	2.0%	1.6%	100.0%	--

a. Based on data published in Wines and Vines, 42nd Statistical Issue, July 1985. These data were developed from information collected by the Wine Institute, the California State Board of Equalization, and the U.S. Bureau of Alcohol, Tobacco and Firearms. Detail may not add to totals due to rounding.
b. Less than 0.05 percent.
c. Includes 18.8 percent for Japan.
d. Includes 6.9 percent for Denmark and 3.6 percent for Mexico.

Table wines accounted for about 83 percent of imports, with sparkling wines and all other wine types accounting for 11 percent and 6 percent, respectively. Over 51 percent of the imported gallonage came from Italy, 21 percent came from France, and an additional 22 percent came from West Germany, Spain and Portugal.

C. CURRENT PROBLEMS FACING THE CALIFORNIA WINE INDUSTRY

During the Legislature's 1985 hearings on SB 589, some proponents of the bill cited a number of significant problems currently facing the California wine industry. They argued that failure to enact a "primary source" requirement for imported wines would only serve to aggravate these problems. In contrast, some of the bill's opponents suggested that a primary source law could end up hurting the state's wine industry.

An in-depth discussion of the wine industry's problems is well beyond both the purpose and scope of this report. However, given the role that these problems played in the legislative debate over SB 589, it is appropriate to identify them. These problems fall into three general categories: (1) increased competition from foreign wine imports, (2) limited foreign export markets for California wines, and (3) excessive California wine inventories accompanied by depressed wine grape prices.

1. Increased Competition From Foreign Imports

As discussed above, foreign-produced wine imports have steadily increased their share of both the nation's and California's wine markets in recent years. This has occurred at the expense of California-produced wines. Some of this growth in imports is attributable to the strength of the American dollar relative to foreign currencies in international monetary markets, which tends to make foreign-produced goods, including wines, relatively less expensive (and thus more attractive) to American consumers. (For example, between early 1980 and early 1985, the value of the dollar rose by around 50 percent, both on a composite international basis and with respect to the major European wine-exporting nations. During the past year, the dollar has "turned around" and lost some strength relative to these currencies. However, it still remains worth much more than during the late 1970s and early 1980s.) In addition, some foreign-produced wines enjoy a price advantage over California wines, because wine-related labor, land and production costs sometimes are lower overseas than in the U.S.

The wine industry also argues that foreign nations, through the "dumping" and subsidization of their wine exports, have been able to sell their wines in the U.S. at less than "fair market value." The U.S. Department of Commerce and U.S. International Trade Commission (ITC) recently investigated these claims and charges, in order to determine whether a countervailing U.S. import duty on foreign-produced wines should be levied. In October 1985, the ITC reported that it found no basis for levying any such special duty. Nevertheless, some evidence does exist that at least certain wines are being sold in the U.S. at prices that are below costs.[3]

2. Limited Foreign Export Markets for California Wines

Wine exports from the U.S. to foreign nations decreased in 1984 for the third straight year, and totaled only 57 percent of their 1981 level. Likewise, California's exports to foreign nations as a percent of its total wine shipments dropped from 3.1 percent in 1981 to only 2.3 percent in 1984. Here again, the drop in exports during this period reflects the strength of the U.S. dollar relative to foreign currencies. The strong dollar, however, tells only part of the story. For some time, California has had a relatively limited market for its wine exports. This is especially true if exports to Canada, which constitute over 47 percent of the total, are excluded.

This limited market for California wines abroad appears to be due to several factors:

- First, many Europeans appear to have a strong "provincial" preference toward the wines they consume, making it difficult for California wines to gain a strong foothold in European markets.[4]
- Second, many wine industry observers believe that California has not done an adequate job of advertising and marketing its wines to overseas markets.
- Third, there is some evidence that European nations discriminate against the importation of American wines, relative to how foreign wines are treated by the U.S. As one example, the U.S. currently levies a tariff of 37 cents per gallon on all EEC foreign wine imports, whereas the tariff per gallon on American wines is 62 cents in Italy, 69 cents in France, and 77 cents in West Germany.
- Fourth, the various foreign-government subsidy programs provided for certain European-produced wines often make it difficult for California wines to compete price-wise once they arrive in foreign nations.[5]

Given these factors, it is doubtful that mere declines in the value of the dollar relative to foreign currencies will, by themselves, solve the problem of limited foreign export markets for California wines, at least in the immediate future.

3. Surplus Wine Stocks and Depressed Wine-Grape Prices

According to industry sources, inventories of unsold California wines were somewhat excessive at the end of 1984. For example, the ratio of inventories to shipments (excluding wine-cooler products containing beverages other than wines) was about 1.68 in 1984. While this ratio was down sharply from the record 1982 level of 1.84, it still was at the high end of the normal range: 1.6 to 1.7. This relatively large inventory as of 1984 reflects a number of factors, including competition from imports, limited markets for exports, and growth in domestic U.S. wine demand that has not been sufficient to fully absorb new production and previously accumulated stocks.

In addition to these factors, there has been a significant decline in the prices paid to growers for wine grapes. For example, the price per ton paid for California wine grapes fell from an average of $188 in 1983 to only $155 in 1984, an 18 percent drop. This, too, reflects the inability of wine-grape demand to keep up with supply. In 1984, for instance, the volume of wine grapes crushed rose by nearly 11 percent, while grape-bearing acreage was up by 4 percent for the second straight year. The depressed grape prices have reduced both land values and profits for growers, since production costs have continued to rise.

D. THE WINE IMPORTING PROCESS IN CALIFORNIA

As discussed above, wine imports account for a significant share of California's wine market--more than 10 percent of the wines distributed and over 15 percent of the wines consumed in the state in 1984.

Altogether, hundreds upon hundreds of different wine products are imported into the state, ranging from high-priced exclusive champagnes and premium nonchampagne wines, to low-priced ordinary table wines. These imported wines make their way into the state in a variety of ways, depending on their physical characteristics, how they are marketed, and where they are produced. For example:

- Many imported wines are initially sold to wine brokers in the open commodity markets of Europe and are then resold, first to importers, then to U.S. wholesalers, and eventually to U.S. retailers. This is particularly true for nonpremium table wines.
- Certain other wines never even appear on the open commodity markets of Europe, and instead are sold directly by their producers (or the producers' representatives) to brokers and importers. This frequently is the case for the most exclusive premium wines and champagnes--those having producer-designated distribution systems.
- Various other wines are acquired from European wine wholesalers and even retailers into whose hands they have passed. This is the case, for instance, with gray market wines.

California's Importing Requirements

All imported non-California wines, regardless of their particular physical characteristics or the exact means by which they find their way from producers to California consumers, are subject to specified importing rules and regulations. These provisions are contained in the California Alcoholic Beverage Control Act and related statutes and nonstatutory regulations, all of which are administered and enforced by the California Department of Alcoholic Beverage Control (ABC). Specifically, California law provides that:

- Alcoholic beverages, including wines, may be brought into California only when they are consigned to a licensed importer, and only when consigned to the premises of the licensed importer or to a customs broker at the premises of a licensed public warehouse.
- In order to become a licensed importer, an individual or firm must obtain what is known as a beer and wine importer's general license. This license authorizes the person to whom it is issued to import both beer and wine into California, and to sell state-tax-paid beer and wine to licensed beer manufacturers, beer and wine wholesalers, wine rectifiers, and beer and wine importers. This import license cannot be issued to any person who holds an interest, directly or indirectly, in any retail wine license, and a retail wine license cannot be issued to anyone who is licensed to import wine or beer.
- Imported wines must be brought into the state by a common carrier, which is required to obtain from the licensed importer or customs broker a receipt on a form prescribed by and to be submitted to the ABC.

According to the ABC, there are over 1,200 individuals and firms who hold licenses to import wines into California. However, only a bit over half of these licensees--about 700--actually engage in wine importing, and only a portion of these do so to any significant degree in a commercial sense. Furthermore, even within this group, the majority of wine importing is done by a relatively small number of firms. For example, according to industry sources, 12 importers accounted for nearly 70 percent of all champagne and sparkling wine imports in 1984, and only 13 companies accounted for 52 percent of all table wine imports.[6] Thus, while a great many firms are engaged in wine importing, the majority of importing activity itself is quite concentrated in the hands of relatively few companies.

Footnotes to Chapter II

1. This process is associated with a Benedictine monk named Dom Perignon, who made wine for l'Abbaye d'Havtuillers in the late 1600s, and invented bottles and stoppers suitable for containing the bubbles caused by the fermentating activity.
2. In terms of actual 1984 consumption of wines in California, the market share attributable to foreign imports was even greater -- 15.2 percent, including 15.7 percent for table wines and 16.8 percent for sparkling wines.
3. The findings of this ITC investigation are discussed in greater detail in Chapter V.
4. Wine experts have also noted that European consumers are still being educated to the fact that the quality of California-produced wines has improved greatly in past years, to the point where they now are comparable, quality-wise, with most European brands. See, for example, discussions in Webster's Wine Price Guide: Consumer and Professional Handbook, 1985 Edition, London.
5. These subsidies include those provided by both national governments, regional governments, and the EEC itself. The major subsidies provided by the EEC are done so under the European Agricultural Guidance and Guarantee Fund and include (a) payments for distillation of surplus wine and wine by-products, (b) payments for wine storage, and (c) export refunds. Other types of foreign-wine subsidies include grants for export promotion, preferential financing arrangements, research grants, and grants for capital structures.
6. See discussions and various tabular data in Jobson's Wine Marketing Handbook, 1985 edition, Jobson Publishing Company, New York.

CHAPTER III

CALIFORNIA'S GRAY MARKET FOR IMPORTED WINES

The main purpose of primary source laws is to eliminate the "gray markets" for the covered items. This chapter discusses (A) what is meant by the term "gray market," (B) the reasons why gray markets exist for foreign-produced imports, including wines, and (C) the structure and scope of California's gray market for foreign-produced wine.

A. WHAT DOES THE TERM "GRAY MARKET" MEAN?

The term "gray market" refers to a market for imported goods which are brought into the country through channels other than "authorized" importing networks.

Most foreign-produced goods imported into the United States are handled by many different importing firms, domestic distributors and wholesalers, who openly compete with one another for business. Sometimes, however, a good's foreign producer specifically designates and authorizes one or more firms to import and distribute its product. This firm or firms constitute what is known as an "authorized" importing network. A "gray market" is said to exist when "nonauthorized" importers and distributors bring the product into the country without using the authorized network established for it. Because gray markets operate side-by-side with authorized networks, gray market importing frequently is referred to as "parallel" importing.

Most gray markets are perfectly legal, despite the somewhat shady connotation of the expression. Naturally, however, they tend to be extremely unpopular with designated agents since they draw business away from these agents.

B. WHY DOES THE GRAY MARKET FOR WINE EXIST?

Gray markets usually develop whenever individuals or firms who are not part of a commodity's normal established import distribution network, discover that they can import the commodity at a lower price than what the established network charges, and still earn an acceptable profit. In order for this to be the case, two conditions must be met:

- First, the gray marketer must have access to the commodity. That is, it must be legal for him to acquire and import the item, and he must be able to physically obtain it, either from the producer directly, or indirectly through a broker, foreign wholesaler, or even foreign retailer.
- Second, the gray marketer must be able to find a way to undercut the import prices charged by the established network. This might be done through bypassing certain "middlemen" involved in the importing business, limiting or avoiding altogether certain expenses that importers who are members of the established network incur, and accepting profit margins that are below the established network's norm.

These conditions are most likely to be met in the case of:

- Exclusive high-priced, trademarked items, whose supply frequently is somewhat limited from year-to-year.
- Goods which have abnormally high import price markups, made possible by the producer-controlled noncompetitive distribution systems.

- Goods with producer-controlled distribution systems that are not absolutely "airtight," thereby giving gray marketers some access to them.

Among the many goods that are said to have been gray-marketed in the past are Nikon cameras, Seiko watches, Christian Dior perfumes, and Michelin tires. Although the precise value of gray market imports into the United States is not known, some sources have estimated it to exceed $7 billion annually.

The Case of Wine

Prior to 1981, it appears that there was not much of a gray market for importing foreign wines into the U.S. To be sure, there were wines whose exclusiveness, physical attributes and high import-price markups made them attractive to gray marketers. However, these wines generally were distributed through noncompetitive producer-controlled networks which were relatively airtight, making it difficult for gray marketers to obtain supplies of these products in significant volumes. The main technique that the foreign wine producers used to keep their distribution networks airtight was to include "not for re-export" clauses in their contracts with foreign wholesalers and distributors. In effect, these clauses prevented the wines from being shipped to the U.S. except by the producers' designated importing agents.

The Moet-Hennessy Case. In November 1981, the Commission of European Communities handed down a trade ruling that such non-re-export clauses were illegal. The Commission fined the large French-champagne producer Moet-Hennessy $1.2 million for breaking European Economic

Community (EEC) free trade rules. The company was fined after it was discovered that its British subsidiary, Moet et Chandon Limited, restricted its wholesale customers from reselling its product outside of Britain. Moet et Chandon had been doing this so that it could export its premium products, including Dom Perignon (the "king" of French champagnes), through its self-designated American distributor Schieffelin & Co., which is 95-percent-owned by Moet et Chandon.

Similar practices traditionally have been followed by certain other major European wine producers. For example, Seagram distributes its well-known French champagne Mumms Cordon Rouge to its English, German, Dutch and Belgium subsidiaries, which in turn import it into the U.S. through another Seagram's company located in New York.

In both of these cases, the producer-controlled importers tended to apply as much as a 100 percent price markup before turning their champagnes over to U.S. wholesalers for subsequent distribution to retailers. The producer-controlled importers were able to impose such large markups because of their monopolistic position, and because the champagne producers had found that customers in the U.S. would pay a higher retail price for their products than would EEC consumers. As a result, a "two-tiered" pricing system had been developed for these wines, with the higher price tier applying to the U.S. market and the lower tier applying to the rest of the world.

<u>Gray Market Implications of the Hennessy Case</u>. The EEC's 1981 ruling against Moet and its non-re-export clauses allowed a gray market for European wines to develop, thereby disrupting the existing two-tiered

imported-wine pricing system. In effect, the ruling left gray marketers free to deal directly with European wine wholesalers, thereby enabling them to legally acquire wines for import into the U.S. without having to pay the high price markups applied by producer-controlled distributors such as Schieffelin.

Illustrative Gray Wine Market Examples. The economic forces that drive the gray market for wine can be illustrated by comparing the prices charged in September 1985 for the two premium champagnes mentioned above:

- Dom Perignon was being sold by Moet et Chandon to its subsidiary distributor Schieffelin for about $18 per bottle. Schieffelin then was selling it for about $36 per bottle to its designated U.S. wholesalers, who in turn were selling it for around $45 per bottle to U.S. retailers. Retailers then were selling it to consumers for between $50 and $60 per bottle. At the same time, gray marketers were selling Dom Perignon to U.S. wholesalers for around $24 per bottle, allowing them to sell it to retailers for between $30 and $35 per bottle. As a result, some retailers were selling the product to California consumers for around $35 per bottle--more than 40 percent below the price charged for "authorized" imports.
- Mumms Cordon Rouge was being sold by Seagram to its subsidiary New York importer for about $5 per bottle, and to authorized U.S. wholesalers for around $10 per bottle. In turn, retailers were paying these wholesalers around $12.50 per bottle, and then charging consumers up to $18 per bottle. At the same time,

California retailers were obtaining gray-marketed Mumms from wholesalers for about 40 percent to 50 percent less than the $12.50 "established" price, for a savings of $4 to $6 per bottle.

Thus, by circumventing established authorized import distribution systems, the retailer purchasing through the gray market was able to charge consumers dramatically lower prices for these two premium French-produced champagnes.

C. SIZE AND SCOPE OF THE GRAY MARKET FOR WINE

No one can say precisely how large California's gray market for wine imports is at this time. This is because a comprehensive data base containing the information needed to make a reliable estimate simply does not exist. This is due primarily to the large number of foreign-produced wines that are imported into California, the diverse channels through which these wines can make their way into the state, the relatively recent emergence of gray marketing activity on any significant scale, and differences of opinion, even within the wine industry itself, as to what the "gray market" encompasses. In addition, the volume of gray-market importing can fluctuate over time in response to such factors as the strength of the American dollar relative to the currencies of foreign wine-exporting nations, and the degree to which foreign wine producers attempt to tightly control the distribution of their products.[1]

It is generally agreed that the primary product sold in the gray market has been French-produced champagne. This product frequently has some type of producer-designated importing and distribution system, and it is not uncommon for the system to result in markups that make the U.S.

price considerably higher than the European price, even after adjusting for normal importing costs. Consequently, these products are very attractive to gray market importers. What is less clear, however, is the extent to which these champagnes actually are being imported through the gray market. Nor is it clear to what extent foreign-produced nonchampagne wines also are being gray marketed.

1. Are Nonchampagne Wines Being Gray Marketed?

The vast majority of foreign-produced nonchampagne wines are not, nor will they ever become, part of the gray market. This is because most of these wines are traded in openly competitive European wine markets, and therefore can be acquired for importation into the U.S. without being subject to the high import price markups that frequently characterize products with controlled distribution systems.

Certain nonchampagne wines, however, do not fit this exact description, and for some of these gray marketing is a possibility. This is especially true for those wines that have designated importers and somewhat liberal import-price markups.

a. Designated Importing and Distribution Systems

Producer-designated importing and distribution systems exist for quite a few nonchampagne wines. In fact, the 1985 edition of Jobson's Wine Marketing Handbook--one of the industry's leading trade publications--generally shows only a single importing company as handling over 70 of the top imported table wines and the 10 top imported nonchampagne sparkling wines. These brands account for about 70 percent and 85 percent, respectively, of imported sparkling wines and table wines sold in the U.S.

For instance, Reunite is imported by Banfi, Blue Nun is imported by Schieffelin, and Lancers is imported by Heublein. A listing of these brands and their importers is shown in Table III-1 for sparkling wines and Table III-2 for table wines.

Of course, the mere existence of a producer-designated importing and distribution system will not, by itself, lead to gray marketing unless the system also results in liberal price markups that can be exploited by gray market importers. Thus, the next question to ask is: To what extent do liberal price markups in fact exist for those nonchampagne wines that have producer-designated importing and distribution systems?

b. Do Liberal Price Markups Exist for Any Imported Nonchampagne Wines?

It is difficult to generalize about the price markups for imported nonchampagne wine products, given the large number of brands involved. Nevertheless, we can get a general idea of whether or not liberal markups exist for these wines by comparing the actual U.S. prices charged by designated U.S. distributors for individual wines, with an estimate of what U.S. prices for these wines would be if the wines were purchased directly on the open market from European wholesalers and then shipped into the U.S. where they are subject to normal price markups by importers, wholesalers and retailers.

Table III-3 shows the results of such a comparison for a small illustrative sample of different well-known champagne and nonchampagne wine products, using specified assumptions and price data for 1985. The table indicates that:

Table III-1

Estimated 1984 Case Sales of
Leading Imported Champagne and Sparkling Wine Brands
in the United States

Wine Brand	Wine Type	Country of Origin	Number of Cases Sold (in thousands)	Wine Importer
Freixenet	Sparkling	Spain	618	Freixenet
Tosti Asti Spumante	Sparkling	Italy	610	Tyfield
M&R Asti Spumante	Sparkling	Italy	587	Renfield
Codorniu	Sparkling	Spain	375	Jos. Victori
Moet & Chandon	Champagne	France	271	Schieffelin
Cella Asti Spumante	Sparkling	Italy	200	Jos. Garneau
Zonin Asti Spumante	Sparkling	Italy	197	Wine World
Gancia Asti Spumante	Sparkling	Italy	170	Paterno
Mumm	Champagne	France	170	Seagram
Cinzano	Sparkling	Italy	132	Julius Wile
Paul Cheneau	Sparkling	Spain	112	Mosswood
Chantaine	Sparkling	France	100	Jacquin

Source: Jobson's Wine Marketing Handbook 1985, p. 80, as reported by Abby Harman, Liquor Store Magazine.

Table III-2

Estimated 1984 Case Sales of
Leading Imported Table Wines in the United States
(thousands of cases)

Wine Brand	Country of Origin	Number of Cases Sold	Wine Importer	Wine Brand	Country of Origin	Number of Cases Sold	Wine Importer
Riunite	Italy	10,696	Banfi	La Sommelier	France	185	Star
Cella	Italy	2,513	Jos. Garneau	Weber	Germany	178	Mons. Henri
Canei	Italy	2,025	Star	Canteval	France	178	Premier/Chevalier
Bolla	Italy	1,760	Jos. Garneau	House of Franz	Germany	175	F. Bonanno
Folonari	Italy	1,750	"21" Brands	Premiat	Romania	175	Mons. Henri
Blue Nun	Germany	1,300	Schieffelin	Kreusch	Germany	175	L. Kreusch
Kreusch	Germany	990	L. Kreusch	Rhine Bear	Germany	165	Jacquin
Lancers	Portugal	954	Heublein	Louis Jadot	France	164	Kobrand
Mateus	Portugal	900	Sogrape U.S.A.	Concha Y Toro	Chile	160	Excelsior
Yago	Spain	850	Mons. Henri	Moreau Blanc	France	159	F. Wildman
Giacobazzi	Italy	750	Renfield	Bonifato	Italy	154	Victori
Principato	Italy	620	Palm Bay	Le Papillon	France	150	Bacardi
Partger	France	595	Seagram Wine	Piat D'or	France	149	Carillon
Barbella	Italy	594	Wellington/Bell	Madrigal	Germany	145	Kobrand
Bell'Agio	Italy	580	Banfi	Ruffino	Italy	135	Schieffelin
Zonin	Italy	550	Wine World	Mirebeau	France	130	Chateau & Estates
Keller Geister	Germany	505	Munson Shaw	Gambellara	Italy	129	Wine World
V.B. House	Italy	500	Banfi	Prima Vera	Italy	120	Banfi
Black Tower	Germany	495	Seagram Wine	Mazzoni	Italy	120	Paterno
Avia	Yugoslavia	430	Laureate	Le Jardinet	France	120	Alimar
Mouton Cadet	France	415	Buckingham	Pere Patriarche	France	120	Finest
Corvo	Italy	360	Paterno	B&G St. Louis	France	115	Seagram Wine
Fontana Candida	Italy	344	Crosse & Blackwell	Bolla Trebbiano	Italy	115	Jos. Garneau
Cruz Garcia Real	Spain	300	Schenley	Musette	France	115	Cellier Des Dauphin
Kreusch	Germany	275	L. Kreusch	Yvecourt	France	110	Yvon Mau
Dourthe	France	270	Barton Brands	Remy Pannier	France	110	Austin, Nichols
Rosegarden	Germany	250	"21" Brands	Fontana De Papa	Italy	110	I.V.W./Heublein
Medici	Italy	250	Vento	Demestica	Greece	100	Carillon
Chantefleur	France	240	Parliament	Kronenwein	Germany	100	Wine Imports
Della Scalla	Italy	225	"21" Brands	E'Epayrie	France	100	Bercut-Vandervoort
Trakia	Bulgaria	210	Mons. Henri	Fazi Battaglia	Italy	100	I.V.W./Heublein
French Rabbit	France	202	Crosse & Blackwell	Alexis Lichine	France	100	Shaw Ross
Boucheron	France	200	Wellington/Bell	Langenbach	Germany	100	Almaden
Valbon	France	200	I.V.W./Heublein	Santa Margherita	Italy	100	Paterno
Rene Junot	France	195	"21" Brands	Certo	Italy	100	Victori
Opici	Italy	190	American B.D.	Caraffa D'Oro	France	100	Mons. Henri
				Cusano	Italy	100	Monarch

Source: Jobson's Wine Marketing Handbook 1985, pp. 32-33, as reported by Abby Harman, Liquor Store Magazine.

Table III-3

Differentials Between Traditional Quoted Prices
and Estimated Cost-Based Prices
for Different Wine Imports and Selected Assumptions

Selected Wine Type	U.S. Retail Price Per Bottle, Based On: Traditional Wholesaler Quoted Prices[a]	Estimated Cost-Based Prices[b]	Price Differential, Per Bottle (Traditional price minus estimated cost-based price) Amount	Percent[c]
A. French Champagnes				
Dom Perignon	$56.25	$41.24	$15.01	36.4%
Bollinger Traditional RD	45.82	35.43	10.39	29.3
Bollinger Special NV	21.88	16.06	5.81	36.2
Moet Brut NV	23.06	18.00	5.07	28.1
Heidsieck '76 Rose	20.63	16.45	4.78	25.4
Laurent Perrier NV	18.68	16.45	2.23	13.5
Heidsieck Brut NV	16.41	14.90	1.51	10.2
Pol Roger '76	20.31	19.55	0.77	3.9
Perrier Jouet GB NV	16.41	16.45	-0.04	-0.2
Pol Roger Special '75	30.10	30.40	-0.30	-1.0
Duetz Brut NV	13.88	16.45	-2.57	-15.6
B. French Bordeaux Wines				
La Mission Haut Brion '79	$41.56	$29.47	$12.10	41.1%
Chateau Montrose '74	25.00	14.20	10.80	76.1
Chateau Montrose '75	35.31	25.75	9.57	37.2
Latour-a-Pomerol '79	23.13	18.31	4.82	26.3
Chateau Fonroque '78	15.28	13.27	2.00	15.1
Gruaud-Larose '78	20.31	18.77	1.54	8.2
Chateau Magdelaine '81	21.76	20.32	1.44	7.1
Chateau Belair '81	16.94	16.31	0.63	3.9
Gruaud-Larose '81	18.44	18.73	-0.29	-1.5
Grand Puy Lacoste '81	14.58	15.98	-1.41	-8.8
Chateau Magdelaine '80	11.66	13.55	-1.89	-13.9
Phelan Segur '76	14.06	16.68	-2.62	-15.7
Chateau Petrus '76	114.58	118.73	-4.16	-3.5
C. Low-Priced Table Wines				
Soave Clas. Lamberti (Italian)	$4.26	$5.99	-$1.72	-28.8%
Blue Nun (German)	4.68	7.15	-2.47	-34.6
Mateus (Portuguese)	3.75	8.31	-4.56	-54.9

a. Computed by applying a 25 percent retailer price markup to listed California wholesale wine prices, as published in BIN Merchandiser, September 1985. This publication is the wine industry's official wholesale price book for 50 Northern California counties.

b. These estimates assume that foreign-produced wines are purchased from wholesalers in London and other major trade centers in the United Kingdom, and then are imported into the U.S. Computations assume that retailer price markups in both the U.S. and United Kingdom equal 25 percent, that a combined 33 percent markup is levied by U.S. importers and wholesalers, and that shipping costs and taxes paid by importers and wholesalers average $2 per bottle. An exchange rate of 1.34 dollars-to-the- pound was used to convert pounds to dollars. This was the average rate in effect during the third week in August 1985, when most of the California wholesale price data published in the September 1985 edition of BIN Merchandiser were reported. Wholesale wine price data for the United Kingdom were estimated by deleting an assumed 25 percent retailer markup from reported retail prices, as published in Webster's Wine Price Guide: Consumer and Professional Handbook, 1985 edition. This publication provides the prices of over 10,000 different wines sold by merchants in the United Kingdom.

c. Price differential computed as a percent of the estimated cost-based price.

- One can, indeed, find nonchampagne wines in this small sample for which price differentials would seem to be large enough to attract gray market importers.
- These nonchampagne wines tend to be premium wines in the higher price ranges, such as exclusive-type Bordeaux wines; they generally do not include lower-priced table wines.
- For many of the premium wines, and even some champagnes, price differentials are negligible, or even negative. These wines would not be attractive to gray market importers.

c. Conclusions

Given the above, it seems reasonable to conclude that while most nonchampagne wines are not candidates for the gray market, at least some premium nonchampagne wines probably are being gray marketed into California.[2] This conclusion is supported by merchandising bulletins which identify certain nonchampagne wines that individual stores may acquire through gray market importers and wholesalers as well as through "normal" wholesalers. The actual extent to which nonchampagne wines are being gray marketed, however, is an empirical question to which we now turn.

2. Surveys of California Gray Market Activities

In order to get an idea of the size and scope of the gray market in California, we distributed survey questionnaires to the state's wine importers, wholesalers, distributors, retailers and producers. These questionnaires include the Retailer Survey (Appendix A), the Wholesaler and Distributor Survey (Appendix B), the Importer Survey (Appendix C), and the Producer Survey (Appendix D).

a. Scope of the Surveys

Altogether, these surveys were distributed to approximately 115 wine importers, 85 wine producers, 65 wine wholesalers and distributors, and 30 retail organizations. Our survey mailing lists were compiled with the assistance of various industry representatives, to ensure that they included the majority of those individuals and organizations participating in or affected by the gray market. More specifically:

- In the case of wine importers, wholesalers and distributors, we attempted to survey everyone in the state.
- In the case of California wine producers, our survey list included all of the state's major wineries and a sample of its smaller wineries. Together, these producers account for over 80 percent of the state's wine-producing capacity. Included on the list were all of the California wineries that we identified as producing champagnes using the la methode champenoise secondary-fermentation process. These champagnes are closest in nature to those exclusive French champagnes, such as Dom Perignon, that reportedly have been gray marketed heavily.[3]
- Our retail survey list included companies which represented about 2,400 individual stores, ranging from independent liquor stores very active in selling gray-market products, to the outlets of large chain store operations.

As shown in the appendices, each of these four surveys contained a fairly extensive list of questions relating to the California gray market for foreign wine imports, including the number and types of products involved, the availability and stability of gray market supplies, the price ranges of gray market imports, and growth trends in the gray market.

b. Survey Findings

Between approximately 20 percent and 40 percent of the four surveys which we mailed out to wine importers, distributors, retailers and producers were completed and returned.[4] The findings of these surveys are summarized below.[5] Because these results are based upon voluntary survey responses, it must be stressed that they do not represent statistically precise or comprehensive data on the gray market or its participants. Rather, they serve to provide only a general indication of gray market activities, and their reliability depends entirely on the extent to which these survey responses do in fact accurately portray the entire market.

i. General Characteristics of Respondents

The respondents to our surveys ranged all the way from very small establishments to extremely large firms, and represented a diverse spectrum of characteristics as regards to the number, volume and types of wine products they handle. The specific characteristics of these survey respondents are summarized in Appendix E.

ii. Information Regarding Gray Market Activities

Our survey respondents provided us with the following information regarding the size, scope and other characteristics of the gray market for imported foreign-produced wines.

Participation by Survey Respondents in Gray Market Activities

The extent to which the respondents themselves participated in the gray market varied considerably. For example:

- Regarding wine importers, 16 percent reported having participated in the gray market. Of these, the average number of brands they gray-marketed was seven for champagnes and four for nonchampagne wines. Gray market items accounted for an average of 60 percent of these importers' total champagne sales and 7 percent of their total nonchampagne wine sales. These participants also indicated that the products which they acquired in the gray market have been directly passed on to over 600 retailers and more than 25 wine wholesalers.
- Regarding wine distributors and wholesalers, 11 percent reported handling gray market wines, while an additional 11 percent stated that they were "unsure" whether any of their products had been passed through gray market channels. The gray market participants estimated that an average of about 3 percent of their total sales volume was attributable to gray market wines.
- Regarding wine retailers, 75 percent reported having obtained gray market wines, with the earliest date of such acquisition being 1982. The average number of gray market importers with which these retailers dealt was four. One-third of the respondents stated that their gray market purchases were confined to champagnes; the remaining two-thirds said that they purchased premium and other table wines as well. On the average, retailers reported that they had gray marketed about one-in-ten of the foreign wine brands they carried, with the maximum number of brands reported as having been gray marketed being 200 in the

case of a speciality liquor store. In the case of retailers carrying gray market wines, these wines accounted for 11 percent of their sales, on average. The highest percentages were reported by smaller retailers specializing in wine and other liquor products, one of which reported that his gray market sales were 35 percent of his business. In contrast, much lower percentages were reported by large grocery chain-store operations. (Not all of the respondents were willing to provide us with data on the volume of wine they sell. However, because the large chains tend to represent a high percentage of total wine sales, the gray market's "sales-weighted" share of the respondents' total wine business was less than 11 percent.)

The Number of Gray Market Importers

No one can say how many firms are involved in importing of wines through the gray market. Although about 84 percent of the wine importers responding to our surveys claimed never to have done any gray market importing themselves, all of the respondents offered an estimate of how many importing firms have been involved in gray market activities in California. These estimates ranged from under 10 firms all the way to between 50 and 100 firms, with the average being 15-to-20 firms.

We believe the average estimate offered by the importers probably understates the actual number of gray market importers, for the following reasons:

- Some respondents do not conduct operations on a statewide basis; therefore, they may not be aware of the amount of gray market importing taking place outside their own marketing area.

- Many gray market importers are not large enough to be all that visible to others. In fact, 50 percent of the respondents to our survey described gray market importers as primarily small-sized firms.
- Some importers engage in gray market activities on a relatively limited basis, and consequently their activities may not come to the attention of their competitors.

Based on our review, we believe that the number of California importing firms involved in gray market wine importing activities as of late 1985 was well in excess of 20 and probably exceeded 50. This includes both firms who are significantly involved in gray-marketing and those whose involvement is relatively limited.

Gray Market Share of Total California Wine Imports

The importers responding to our survey estimated that as of late 1985, champagne imports sold through the gray market accounted for anywhere from 5 percent to 80 percent of all import sales in California, with the average estimate being about 31 percent. For nonchampagne wines, the estimates of the gray market's importance ranged from 1 percent to 10 percent of imports and averaged about 5 percent. Using the average gray market share cited by the respondents, we estimate that as of late 1985 gray market imports accounted for around 5 percent of California's total consumption of sparkling wines and champagnes, and around 1 percent of California's total consumption of nonchampagne wines.[6]

When asked where gray market imports originate, 94 percent of the respondents cited France, 44 percent cited Italy, 27 percent cited Portugal, 22 percent cited Spain, and 17 percent cited Germany.

Price Characteristics of Gray Market Wines

Champagnes. Responding importers reported having seen gray market imports in wholesale price ranges all the way down to $5-to-$10 per bottle. Generally, however, gray market champagne imports were reported most frequently in the higher price ranges. For example, while 29 percent of the importers reported seeing gray market champagnes in the $5-to-$10 price range, the figure for the $10-to-$15 range was 88 percent, and 94 percent for the $20-to-$25 range. All respondents reported seeing gray market sales in the $15-to-$20, and over-$25 ranges. The minimum retail price at which wine retailers reported selling gray market champagnes averaged about $10.50, although some reported sales beginning at prices as low as $3 and as high as $15.

Nonchampagne wines. Responding importers reported having seen, and wine producers reported having been affected by, gray market activity in virtually all wholesale and retail price classes. Generally, more gray market activity was reported in the lower price ranges than was reported for champagnes. For example, the portion of respondents who reported having seen gray market activity for nonchampagne wines in the under-$5 range was 28 percent. It was 33 percent for the $5-to-$10 range, and 44 percent for price ranges above $10. The minimum retail price at which wine retailers reported selling gray market nonchampagne wines averaged about $4.30.

Price Spreads Needed to Make Gray Marketing Economically Attractive

When asked how large the potential spread between prices charged by producer-designated importers and gray market importers needs to be in order to make gray marketing economically attractive, wine importers reported:

- An average dollar price spread per bottle of $5.20. However, there was tremendous variation in the individual estimates of the minimum spread, ranging from a low of about $1 per bottle to a high of $35 per bottle.
- An average price spread per bottle in percentage terms of about 20 percent. Again, however, there was considerable variation in the individual estimates, which ranged from 5 percent to 35 percent.

The wide variation in the estimates of the minimum price spreads suggests that some wine importers require a much larger incentive to become active in the gray market than do other importers. This helps explain the survey's finding that gray market sales are not limited to high-priced champagnes with abnormally large price spreads, but rather involve certain more moderately priced wines as well.

Availability of Gray Market Wines

The availability of gray market wines to wine importers was described as "extremely reliable" by 11 percent of the respondents. In contrast, the supply was characterized as "somewhat reliable" by 42 percent, "very mixed" by 32 percent, and "unpredictable" by 16 percent. Thus, the majority of respondents indicated that importers face considerable uncertainty in obtaining wines through the gray market. This may be one reason why some importers require large spreads between the designated and gray market prices before they will bother to participate in the market.

Supply uncertainties also were cited by one-half of the wine wholesaler respondents when asked about the reliability of the gray market as a source of supply for foreign wines. In addition, about half of the importers indicated that it has become more difficult to obtain gray market wines during the past year, primarily due to such factors as the decline in the value of the dollar relative to the currencies of European wine-exporting countries, and efforts by foreign producers to restrict or more closely control the disposition of their supplies.

Effects of the Gray Market

Effect on wine prices. Respondents reported that the gray market has caused prices for both imported wines and California-produced wines to be lower than they otherwise would be. For example:

- Eighty percent of the importers said that the gray market had caused wine prices charged by producer-designated "authorized" importers to be lower than otherwise in at least some cases.
- Twenty-seven percent of the domestic wine producers said that the gray market has caused them to reduce the prices of at least some of their champagnes, and 12 percent said that it had caused them to reduce at least some nonchampagne wine prices.

Effect on sales volumes. Wine retailers reported increased sales, while wine distributors and producers reported lower sales, as a result of the gray market. Specifically:

- Wine retailers reported an average increase in sales volume of 20 percent for champagnes due to the gray market. They also reported that the increased sales of gray market wines had reduced their sales of domestic wines by an average of 1 percent.

- Fourteen percent of the wine wholesalers reported that the gray market had reduced their sales volume, by an average of 5 percent. Of the remaining 86 percent, 29 percent were unsure whether gray market imports had affected their sales, and 57 percent felt that there had been no effect. None of the responding wholesalers reported increased sales.
- Sixty percent of the wine producers reported reduced sales on account of the gray market. Forty percent reported reduced sales of certain champagnes and 36 percent reported reduced sales of certain nonchampagne wines.
- Wine producers ranked the gray market fifth out of eight factors identified as having caused marketing problems for domestic wines. Those factors mentioned more frequently were the high value of the dollar, foreign "dumping" of surplus wine stocks in the United States at below-cost prices, foreign subsidization of wine production abroad, and the increasing concentration of domestic wine wholesaling in the hands of fewer and larger firms.

Effect on product quality. Twenty percent of the responding wine wholesalers reported that they were less likely to encounter quality problems with wines imported through the gray-market than they were when dealing with "authorized" importers. The remaining 80 percent reported that product quality did not differ between these two markets.

Trends in the Gray Market

Two-thirds of the importers we surveyed expect that gray marketing will spread to nonchampagne wines in the future. Forty percent expect it to spread down the "price ladder" to the more moderately priced wines. In both cases, the reason cited most frequently for the expected increase in gray marketing was the profit which gray market importers can realize from their activities.

Even some state agencies are turning to the gray market for alcoholic beverages, including wines. For example, the Washington State Liquor Control Board, which acts as both wholesaler and retailer of distilled liquor products in Washington, announced in December 1985 that it would begin to take advantage of parallel marketing opportunities by acting as its own gray market importer for certain distilled spirits products. The reason given by the board for its decision is what the board considers to be excessive price markups being charged by authorized importers. In fact, the board's research found that the prices charged by traditional importers were 25 percent higher, on the average, than gray market prices. The board reported that it could save $15 per case of liquor by buying through the gray market, thereby, in the board's words, "eliminating the unnecessary and nonproductive expenses which a sole United States importer is able to include in its prices simply because of its sole appointment (i.e., monopoly) status."[7]

3. Summary

No one can say with certainty exactly what the size and scope of the gray market for imported wines is at the present time. This is because comprehensive data covering sales volumes simply is not available, either from government or nongovernmental sources. In addition, the gray market itself is fairly loosely structured and perpetually in a state of flux, with its size and scope at any particular time depending on such factors as foreign currency exchange rates and the adequacy of wine supplies. For example, the recent decline in the dollar's value on foreign-exchange markets may have reduced, at least for the time being, the volume of gray marketing importing from what it was before the dollar fell.

Our own efforts to collect information on the gray market by surveying California wine importers, wholesalers/distributors, producers and retailers, met with mixed success. A large portion of the firms we surveyed were unwilling to respond to our questionnaires. In particular, we received relatively little information regarding the magnitude and effects of gray marketing from organizations that were proponents of SB 589. In addition, there is always uncertainty regarding the factual grounds for certain survey responses, particularly when the respondents themselves have an economic stake in the issue being researched.

Nevertheless, we believe that the survey responses did provide a considerable amount of useful data on the general nature and extent of gray market activities. These data indicate that:

- Gray marketing involves not only the well-publicized parallel importing of certain famous French champagnes, but <u>also</u> the parallel importing of certain premium, and even moderately priced, table wines.
- As of late 1985, gray market imports accounted for about 30 percent of all imported champagnes and about 5 percent of all imported nonchampagne wines. This suggests that about 5 percent of total California champagne consumption and about 1 percent of

nonchampagne wine consumption involved the gray market at that time.

- The number of licensed wine importers who have handled gray market wines at one time or another is at least 20, and probably exceeds 50.
- Gray-marketing has caused some reduction in the prices charged by "authorized" wine importers and domestic wine producers, and has increased total wine sales by retailers.
- The gray market has caused some reduction in sales of California-produced wines. However, factors other than the gray market currently represent more significant obstacles to the successful marketing of California wines.
- The near-term incentives for gray marketing may have recently weakened somewhat, due to declines in the value of the dollar and efforts by foreign producers of gray-marketed wines to more-tightly control their distribution. However, favorable economic conditions permitting, the potential exists for gray marketing of imported wines to expand at some point in the future, both to additional nonchampagne wines and to more-moderately priced wine products.

We now turn to the subject of primary source requirements, including their nature and prevalence (Chapter IV), their economic impact (Chapter V), and their fiscal effects (Chapter VI).

Footnotes to Chapter III

1. There is some evidence, for example, that the prices charged by gray market importers tend to adjust more quickly to exchange-rate fluctuations than do the prices charged by authorized importers. To the extent that this occurs, a rise in the dollar's value (such as occurred from 1980 through early 1985) tends to increase the opportunity for profitable gray-marketing, whereas a decline in the dollar's value (such as has occurred over the past year) reduces the profit potential.
2. Of course, the extent to which estimated price differentials such as those in Table III-3 indicate whether or not a given wine actually is being gray marketed, depends partly on how closely the estimated differential reflects the true gray market importer's acquisition cost and the ultimate California gray market retail price of the item. For example, the estimated differential understates the potential for gray marketing to the extent that (a) gray market importers are able to maximize the gray market price differential (and thus their profits) by acquiring products such as premium Bordeaux wines early-on in their distribution process (the calculations in Table III-3 assume that these wines are not acquired until they reach wholesalers located in major trading centers in the United Kingdom and/or (b) California retailers choose to apply restricted markups to such wines in order to attract customers, as some retailers we have talked to have done in selling their gray-market champagnes. Alternatively, the estimated price differential overstates the potential for gray marketing to the extent that gray market importers are unable, due to limited supplies, to provide U.S. wholesalers and retailers with quantity price discounts equivalent to those offered by traditional importers.
3. These wineries include Domaine Chandon, Hanns Kornell, Schramsberg, Piper Sonoma, Korbel and Mirassou (see Guide to California Wine Country, Lane Publishing Company, 1983, page 83 and transcripts of SB 589 hearing testimonies). According to information presented during the legislative hearings on SB 589, Domaine Chandon and Piper Sonoma are owned by the French companies Moet Hennessy and Piper Heidsiek, respectively, both of which produce expensive champagnes, while Schramsberg is a joint-venture with Remy, another French firm. In 1983, the amount of California champagne produced using la methode champenoise appears to have been well under 1 percent of total California wine production and perhaps 5 percent of all sparkling wine production.
4. Response rates at the time this report went to press stood at 38 percent for wine retailers, 25 percent for wine producers, 21 percent for wine importers, and 18 percent for wine distributors and wholesalers.
5. The survey results discussed below have been calculated, unless otherwise noted, so as to reflect survey responses for the subgroup of respondents answering the specific question identified. This procedure was followed because some respondents did not answer every question on their survey form.

6. According to data published in Jobson's Wine Marketing Handbook (1985 edition), imports accounted for 17 percent of California's 1984 sparkling wine and champagne consumption, and 15 percent of all other wine consumption.
7. See "Liquor Board Joins Parallel Market," Washington State Liquor Control Board press release of December 9, 1985, and affidavit to the board of Robert H. Harvey, Liquor Purchasing Agent for the Washington State Liquor Control Board, January 7, 1986.

CHAPTER IV

THE NATURE AND PREVALENCE OF PRIMARY SOURCE REQUIREMENTS

Senate Bill 589 would have established a "primary source" requirement covering all wines imported into California. As noted earlier, this requirement was designed to eliminate the gray market for imported wine. This chapter describes exactly what a "primary source" requirement is, and discusses the extent to which primary source requirements exist today. The potential economic and fiscal effects of a primary source requirement covering wines brought into California are discussed in Chapter V and Chapter VI, respectively.

A. WHAT IS "PRIMARY SOURCE" REQUIREMENT?

A "primary source" requirement prohibits an importer from bringing a product into a particular jurisdiction, unless the importer has been given explicit permission to do so by the product's brand owner (or the owner's authorized agent). An importer who receives this permission becomes what is known as a "designated" (or "authorized") importer of the commodity.

Senate Bill 589 would have established a primary source requirement covering all wine products imported into the state, regardless of whether the wine was produced elsewhere in the United States or abroad. Specifically, SB 589 would have prohibited a licensed California importer from purchasing or accepting delivery of a particular brand of wine unless he had been explicitly designated to do so by the brand owner or its agent. The bill would not have imposed a limit on the number of importers that could handle a given brand, so long as each importer was properly designated as an authorized importer by the brand owner or its agent.

Senate Bill 589 provided for the termination of the primary source requirement on January 1, 1990. However, it also gave the Governor the authority to terminate the requirement prior to this date, if he found that the ability of California-produced wines to compete in Europe was enhanced by a lessening of European trade barriers. Specifically, SB 589 required the Governor to determine annually whether there had been reductions or modifications of any trade barriers to California wines or champagnes within the European Economic Community (EEC) which would enable California producers to compete fairly within the EEC. In the event that the Governor found a relaxation of these barriers, the primary source requirement would no longer apply.

B. THE PREVALENCE OF PRIMARY SOURCE REQUIREMENTS FOR ALCOHOLIC BEVERAGES

In this section, we discuss the extent to which primary source requirements exist in the United States today.

1. Primary Source Requirements at the National Level

At the present time, there is no general federal prohibition per se against the parallel importation of foreign-produced wines and other goods into the U.S. through the gray market. Nevertheless, gray-market importing of foreign-produced goods is prohibited under certain conditions. These conditions stem from U.S. trademark laws, which, in the case of imported products, are enforced by the U.S. Customs Service of the Department of the Treasury, and are most commonly adjudicated in the U.S. Court of International Trade.

The evolution and interpretation of U.S. import-related trademark law is lengthy and complex. Prior to the mid-1920s, the U.S. purchaser of an exclusive sales right for a foreign-produced good who also obtained a U.S. trademark right for the good, generally could not prevent a competitor from importing and selling identical merchandise bearing the same trademark in the U.S. so long as the competitor had legitimately acquired the trademarked merchandise abroad. Subsequent case law softened this interpretation, so that parallel importation was not always permissible. Even so, parallel importation may be excluded today only when an American distributor owns the right of trademark in his own name and is independent from the foreign trademark owner.[1] Even when this is the case, however, individual court cases also must take into account such factors as antitrust considerations and the exact nature of parent-subsidiary relationships between U.S. and foreign firms involved in producing and distributing the products in question.[2] Consequently, it is not surprising that parallel importation of trademarked goods through the gray market is fairly widespread today.[3]

It also should be remembered that if an imported good does not have a U.S. trademark, as is normally true of most foreign-produced wines, whatever U.S. trademark law-related restrictions that do exist against parallel importing are themselves not applicable.

2. Primary Source Requirements in States Other Than California

In order to determine the prevalence, characteristics and effects of primary source requirements outside California, we surveyed the alcoholic beverage control agencies in each of the other 49 states. The survey questionnaire which we used appears in Appendix F. Table IV-1 indicates that:

- About three-fourths of the states excluding California (36, to be exact) reported having a formal primary source requirement covering at least one of the three major categories of alcoholic beverages (distilled spirits, beer and wine).
- Thirty states reported having a formal primary source requirement for imported wines, while 28 states maintained such requirements for imported distilled spirits and 25 states had them for imported beers. In 17 states, primary source requirements existed for all three types of beverages.

We find that Table IV-1 understates the actual number of states in which the equivalent of primary source requirements are in effect, however. This is because many of the nation's 18 alcoholic beverage "control" states (where the state is the purchasing agent for some or all liquor and often operates liquor stores) have a general policy of dealing only with authorized importers, even though they do not have formal primary source requirements in effect.[4]

About 60 percent of the states with primary source requirements reported that these requirements were specifically imposed to limit gray market importing. In contrast, about 25 percent of the states said their primary source requirements were imposed to facilitate accurately collecting excise taxes and other such levies on imported beverages, while 15 percent cited other reasons such as better overall regulatory control over beverage-importing activities.

Table IV-1

Alcoholic Beverage Primary Source Requirements in Different States[a]

State	Existence of Primary Source Requirements, By Type of Beverage		
	Beer and Other Malt Beverages	Distilled Spirits	Wine
Alabama[b]	No	No	No
Alaska	No	No	No
Arizona	Yes	Yes	Yes
Arkansas	No	Yes	Yes
California	No	Yes	No
Colorado	Yes	Yes	Yes
Connecticut	Yes	Yes	Yes
Delaware	Yes	Yes	Yes
District of Columbia	Yes	Yes	Yes
Florida	No	Yes	Yes
Georgia	Yes	Yes	Yes
Hawaii	Yes	Yes	Yes
Idaho[b]	No	No	No
Illinois	Yes	Yes	Yes
Indiana	Yes	Yes	Yes
Iowa[b]	No	No	No
Kansas	No	Yes	Yes
Kentucky	Yes	No	No
Louisiana	No	No	No
Maine[b]	Yes	No	Yes
Maryland	Yes	Yes	Yes
Massachusetts	No	No	No
Michigan[b]	No	No	No
Minnesota	Yes	Yes	Yes
Mississippi[b]	No	Yes	Yes
Missouri	Yes	Yes	Yes
Montana[b]	Yes	No	No
Nebraska	Yes	Yes	Yes
Nevada	Yes	Yes	Yes
New Hampshire[b]	No	No	No
New Jersey	Yes	Yes	Yes
New Mexico	No	Yes	No
New York	No	Yes	Yes
North Carolina[b]	Yes	No	Yes
North Dakota	No	No	No
Ohio[b]	Yes	No	Yes
Oklahoma	No	No	No
Oregon[b]	No	No	No
Pennsylvania[b]	Yes	Yes	Yes
Rhode Island	No	Yes	Yes
South Carolina	No	Yes	Yes
South Dakota	Yes	Yes	Yes
Tennessee	No	Yes	Yes
Texas	No	Yes	Yes
Utah[b]	Yes	No	No
Vermont[b]	No	No	No
Virginia[b]	Yes	No	No
Washington[b]	No	No	No
West Virgina[b]	No	No	No
Wisconsin	No	Yes	Yes
Wyoming[b]	Yes	No	No
Total Number of States With Primary Source Provisions[c]	25	29	30

a. Data in table are based upon survey-questionnaire responses from individual state alcoholic beverage control agencies as of approximately year-end 1985. Reported primary source requirements include statutory requirements, regulatory requirements and rules and, in the case of certain alcoholic beverage "control" states, well-established state policies of acquiring alcoholic beverage products from traditional authorized importers.

b. Denotes an alcoholic beverage "control" state, where one or more designated state agencies are involved in various alcoholic beverage purchasing, distribution and retailing activities.

c. Survey responses also were received from Puerto Rico, American Samoa and Guam, none of which has alcoholic beverage primary source requirements.

In sum, primary source requirements are relatively widespread in the United States today. Although some of these provision date back as far as the 1930s, most are relatively new. Well over one-half of the provisions have become effective since 1980. This is not surprising since the widespread development of gray-market importing is a relatively recent phenomenon.

3. Primary Source Requirements in California

Currently, California has no primary source requirement covering either beer or wine imports. However, it does have such a requirement for distilled spirits imports. Specifically, Section 23672 of Division 9 of the California Business and Professions Code--a part of the California Alcoholic Beverage Control Act--states that:

> "A licensed importer shall not purchase or accept delivery of any brand of distilled spirits unless he is designated as an authorized importer of such brand by the brand owner or his authorized agent. Such distilled spirits imported into California shall come to rest at the warehouse of the licensed importer or an authorized warehouse for the account of such licensed importer, before sale and delivery to a retail licensee."

This requirement was enacted in 1979 (Chapter 280) and became effective January 1, 1980, following court decisions in 1978 and 1979 which overturned the state's "fair trade" laws pertaining to alcoholic beverages.[5,6] It was accompanied by a second requirement that distilled spirits must be sold to California wholesalers at prices that are no higher than those charged by the brand owner elsewhere in the nation.

Specifically, Section 23673 of the Business and Professions Code, as established by Ch 407/79, specifies in part that:

> "No brand owner of distilled spirits or his agent shall sell any brand of distilled spirits to a wholesaler or rectifier in the state at a price higher than the lowest price at which such brand of distilled spirits is sold by the brand owner or his agent to any wholesaler or rectifier during any calendar month anywhere in any other state or in the District of Columbia or to any state or state agency which owns or operates retail distilled spirits stores... providing that nothing...shall prevent differentials in price which make only due allowarce for differences in state excise taxes and fees and to actual cost of delivery."

This requirement, which is known as the "price affirmation" provision, was enacted to prevent discrimination by distilled spirits producers toward California consumers, once the primary source provision was in effect. Such discrimination can easily arise when primary source requirements are in effect because the prohibition against gray market importing can make it easier for monopolistic distribution channels for an imported good to arise. This, in turn, can result in higher prices for alcoholic beverage imports compared to prices in states which do not have primary source laws for such imports.[7]

As discussed in Chapter V, however, price-affirmation clauses do not necessarily prevent alcoholic beverage prices from rising when a primary source requirement is put into effect. This is because such clauses can be difficult to enforce and, in addition, there are several potential ways for beverage manufacturers to effectively circumvent them.

We now consider the potential economic (Chapter V) and fiscal (Chapter VI) effects that a primary source law, such as that proposed by SB 589, would have in California.

Footnotes to Chapter IV

1. During 1985, however, a coalition of foreign manufacturers requested the U.S. Department of the Treasury to consider a regulation which would make it illegal to import merchandise carrying a U.S. trademark through channels designed to bypass U.S. sales subsidiaries maintained by product manufacturers. This coalition, named the Coalition to Preserve the Integrity of the American Trademark (COPIAT), has argued that foreign manufacturers with brand-name merchandise trademarked in the U.S. and sold through U.S. distributors, should have the right to keep such merchandise from being brought into the U.S. through the gray market. The opposition against this proposed regulation has been led by the Associated General Merchandise Chains (AGMC), which represents major retail discount chains and argues that the regulation would be an "end run" around per se antitrust proscriptions against retail price fixing. For a discussion of some of these issues, see The Economics of Gray-Market Imports (May 1985), prepared for COPIAT by Lexecon, Inc.
2. This position evolved from a 1957 lower-court decision in the State of New York (United States v. Guerlain, Inc.), which held that U.S. trademark law as applied under Section 526 of the Tariff Act of 1922 should not be enforced in cases where the company seeking protection is simply the American component of a worldwide enterprise based elsewhere. The court's reasoning was that such enforcement would violate the Sherman Act's antitrust provisions, which made it illegal to monopolize, or attempt to monopolize, any aspect of trade or commerce between states or with foreign nations. The defendant appealed this decision but, before a ruling was made, the Justice Department made a motion for, and the district court granted, a dismissal. In 1972, however, the government adopted new Customs Regulations which prohibited enjoining parallel importation if the foreign and U.S. trademark owners are the same entity, or are in a parent-subsidiary relationship, or are subject to common ownership or control. Thus, the lower-court finding in the Guerlain case was effectively implemented through regulatory law. More recently, the International Trade Commission ruled to enjoin the parallel importation of batteries made by Duracell's (a U.S.-based corporation) Belgian subsidiary, deeming such importation to be a violation of Section 337 of the Tariff Act of 1930. However, the President overruled the ITC's decision in early 1985.

   Gray-market opponents contend that regulations reflecting the dismissed Guerlain case should never have been adopted in the first case, and that the Customs Service also has incorrectly interpreted existing trademark laws. These issues are currently being examined by the courts. It also should be noted that the view of many legal scholars is that the original intent of Section 526 of the Tariff Act was only to protect the American purchasers of foreign goods from fraud and, in this context, parallel importing of all trademarked goods (regardless of whether the U.S. trademark owner is independent from the foreign trademark owner) should be allowed unless the public is being confused or deceived about the origin or quality of the goods. For a discussion of these issues see, among others, Washington Law Review, Volume 57:433, 1982 (especially "Parallel Importation," pages 435-459) and various issues of the Customs Bulletin and Decisions, U.S. Customs Service of U.S. Department of Treasury (especially Volume 18:38, pages 25-43).

3. Many of these goods are fairly expensive items for which product warranties are important to consumers, such as watches, cameras, tires, and even automobiles. Given this, one of the key controversies regarding parallel importing involves the status of manufactures' normal product warranties when gray marketing occurs. Gray market opponents argue that parallel-imported merchandise does not carry valid manufacturers' warranties, yet these manufacturers face pressures to "make good" on consumer problems if they are to avoid the risk of breeding consumer animosity. It is argued that this, in turn, enables parallel importers and distributors of gray-market goods to get a "free ride" at the expense of product manufacturers and designated distributors, who together must provide the financing and services associated with the normal product warranties.
4. The nation's 18 alcoholic beverage "control" states include Alabama, Idaho, Iowa, Maine, Michigan, Mississippi, Montana, New Hampshire, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, Virginia, Washington, West Virginia, and Wyoming. In 1984, these states accounted for about 22 percent of all wines consumed in the U.S., including slightly over 17 percent of the nation's consumption of sparkling wines and champagnes.
5. The validity of California's primary source law for distilled spirits was upheld in 1982 by the U.S. Supreme Court in the case of Rice v. Norman Williams Company.
6. California's "fair trade" laws involved what is known as "retail price maintenance" (RPM) provisions. These laws basically facilitated vertical price fixing between product manufacturers and retailers. More specifically, RPM provisions permit a manufacturer to specify prices below which retailers may not sell his products. Traditional arguments offered in favor of RPM provisions are that they protect retailers' profit margins, prevent products from being sold at below-cost prices as "loss leaders," and protect small, locally owned retail establishments from competition from large chain stores and discount houses who, because of their high sales volumes, can apply very low price markups and still be profitable. Federal fair trade laws were declared invalid as a violation of Sherman Act antitrust provisions in 1975, when the 1937 Miller-Tydings Act and the 1952 McGuire Act were repealed. Similarly, California's resale price maintenance provisions for distilled spirits and beer were declared invalid by the state's Supreme Court in 1978 (Rice v. ABC Appeals Board and Corsetti), and by the State Court of Appeal in 1979 (Capiscean Corporation v. ABC, etc. Appeals Board).
7. Because primary source requirements permit the manufacturers of imported products to maintain direct control of these products until after they leave the hands of importers or importer-distributors, they obviously offer some of the same potential for manufacturer-controlled vertical price fixing that fair trade laws did. However, because California alcoholic beverage retailers are not permitted to import

alcoholic beverages (or vice versa), such vertical controls under a primary source law do not extend all the way to the retail level, and therefore are less "airtight" than they were under fair trade laws.

CHAPTER V

THE ECONOMIC EFFECTS OF A PRIMARY SOURCE LAW FOR CALIFORNIA WINE IMPORTS

This chapter discusses the potential economic effects of a primary source law covering California wine imports, such as SB 589 would have enacted. Specifically, this chapter:

- Identifies the various types of economic effects which, at least in theory, a primary source law could be expected to produce, and
- Discusses the empirical evidence regarding the actual economic effects of such a law.

A. TYPES OF POTENTIAL ECONOMIC EFFECTS OF A PRIMARY SOURCE LAW

In theory, a primary source law covering imported wines could affect imported and domestic wine prices, sales volumes, market shares, and distribution channels. These effects, in turn, could be expected to have an impact on wine consumers, importers, wholesalers, retailers and producers.

Generally speaking, primary source laws can be expected to affect the same variables as does gray-market parallel importing. The effects themselves, however, are very different. In particular, economic theory suggests that:

- The economic effects of a primary source law will be <u>opposite</u> to the effects of gray market activities. For example, while gray market importing can be expected to reduce certain wine prices, a primary source law can be expected to increase them.

- The "reverse" economic effects of a primary source law would more than offset the observed economic effects of gray market activities themselves. For example, the increase in certain wine prices under a primary source law probably would exceed the observed reduction in these prices resulting from gray market importing. Put another way, wine prices could be higher under a primary source law than they were prior to the emergence of gray marketing.

The second of these two points deserves elaboration before we explore more fully the potential economic effects of a primary source law.

1. The "Hidden" Potential Effects of a Primary Source Law

There are two basic reasons why the potential economic effects of a primary source law are likely to be underestimated if one merely looks at the effects of gray market importing.

First, many imported wines with designated distribution systems are not being gray marketed at the present time because the prices charged under the designated distribution system are not high enough to make gray marketing attractive. It may be that the mere threat of gray marketing has helped keep these prices lower than they otherwise would be. To the extent this is true, removal of the threat, through enactment of a primary source law, would tend to result in increased prices for the affected brands.

Second, many imported wines are not subject to tightly controlled importing and distribution systems. This may be because the brand owners find it either too difficult or too much trouble to enforce tight control over their wines, as is likely to be the case if the wines are produced in sufficient volume to be widely available on open markets. Obviously, passage of a primary source law changes all this, by giving wine producers an effective "tool" for enforcing authorized distribution systems. Consequently, one would expect a primary source law to increase the number of wine brands being imported and distributed through producer-designated networks. This, in turn, could lead to a reduction in the number of firms that import and distribute foreign-produced wines if large importing and distribution firms are able to sign exclusive contracts with large numbers of brand owners. Likewise, certain wine prices could rise as a result of both the increased concentration within the wine importing and distribution industries, and the ability of sellers to enforce monopolistic pricing policies.[1]

With these "hidden" effects of a primary source law in mind, we now discuss the types of effects that economic theory indicates such a law could be expected to have.

2. Types of Economic Effects

Economic theory suggests that a primary source law covering wines imported into California would have the following effects.

a. The Prices of Imported Wines Will Increase

Under a primary source law, imported wine prices are likely to be higher because the law would:

- Reduce competition in the wine importing business,
- Eliminate gray market importing where it now occurs, and
- Remove the threat of gray market importing where it does not now occur.

As a result, the number of authorized importing and distribution systems, and the ability of the operators of such systems to follow monopolistic pricing policies, will increase.[2] Of course, the extent to which an imported wine's prices will rise under a primary source law depends on pricing decisions made by the producer, the importer(s), and the distributor(s). These decisions, in turn, will reflect such factors as the extent to which the wine faces competition from other imported and domestic wines, the number of importers that are designated to handle it, and the strategy required to maximize sales volume, profits, or some other goal.

We believe significant price increases are most likely to occur under a primary source law in the case of high-priced exclusive champagnes. These products can be sold in the United States for considerably higher prices than what consumers in Europe are willing to pay, and their high per-bottle profit margins have made them popular targets for gray-marketing. Conversely, price increases are least likely to occur in the case of wines viewed by consumers as being totally interchangeable with one another, and for which numerous "authorized" importers are designated. In no case, however, would a primary source law tend to reduce imported wine prices.[3]

b. The Prices of Some Domestic Wines Could Rise

Many California wines compete directly with imported wines for the consumer's dollar, even though they may not be viewed as perfectly interchangeable with foreign-produced wines. To the extent that a primary source law results in higher prices for certain wine imports, economic theory suggests that the prices charged for competing domestic wines will also go up. This is because higher prices for imported wines will enable producers and distributors of competing California wines to raise prices without losing sales to imports.

Here again, prices will rise only to the extent that brand owners and retailers actually decide to take advantage of the opportunities offered by primary source laws. It is possible, of course, that domestic brand owners could choose to forego price increases in order to increase their sales volumes and market shares. In no event, however, would a primary source law tend to reduce domestic wine prices.[4]

c. Consumption of Some Imported Wines Will Decline

To the extent that a primary source law causes the prices of imported wines to go up, one would expect that the amount of these wines consumed by Californians would go down. The size of the reduction would depend on both the amount of the price increase and the strength of consumer preferences for the product itself.

It is possible, however, that sales of wine imports in dollar terms could rise, rather than fall. This would occur where, because of strong consumer attachment to these products, the reduction in their sales volumes is small in proportion to the price increase.[5,6]

d. Sales of Some California-Produced Wines Could Increase

Economic theory suggests that the sales of some California-produced wines probably would rise following enactment of a primary source law. The California-produced wines most likely to benefit in this manner are those that compete directly with imported wines whose prices go up. The increase in sales, of course, will be less--or even nonexistent--if California producers match the increase in imported wine prices.

e. <u>The Number of Wine Importers Probably Will Drop</u>

A primary source law would tend to shift business <u>away</u> from importers and distributors who handle gray-market wines, and <u>toward</u> "authorized" importers and distributors. In addition, a primary source law would tend to concentrate wine importing and distribution in the hands of <u>fewer</u> firms, by encouraging more producer-controlled distribution arrangements than now exist. To the extent this occurs, the number of wine importing and distribution firms within California could go down.

f. <u>Changes in Product Quality Are Likely To Be Minor</u>

Senate Bill 589's proponents claim that the <u>quality</u> of imported wines would be <u>better</u> under a primary source law, because gray-market importers do not have a long-term interest in product quality.

While there may be some truth to this allegation, the reverse could be true as well. For example, since gray market importers tend to handle relatively smaller volumes of wines, the wines tend to "turn over" more quickly and spend less time in warehouses where temperature variation and other factors can damage product quality. Moreover, any distributor who intends to remain in business must maintain a reputation for delivering good-quality merchandise. Consequently, there is little a priori basis for expecting that a primary source law would lead to significant changes in "product quality."

B. EMPIRICAL EVIDENCE ON THE ECONOMIC EFFECTS OF A PRIMARY SOURCE LAW

Because California has never had a primary source law for wine imports, the <u>actual</u> (as opposed to the theoretical) effects of such a law on Californians is a matter of speculation. Nevertheless, there are three sources of information which can shed some light on the probable economic effects of such a law:

- The experience of other states that have primary source requirements for alcoholic beverages, including wines;
- California's experience with its own primary source law for distilled spirits; and
- The views of California wine importers, distributors, retailers and producers regarding the possible effects of a California primary source law for wine, based upon their own knowledge of the California wine market and primary source requirements in other states.

1. The Economic Effects of Primary Source Laws in Other States

In order to determine what economic effects, if any, primary source laws have had in other states, we asked the alcoholic beverage control agency in each state having a primary source requirement the following three questions:

- First, is there any information indicating that primary source requirements have increased the prices of imported alcoholic beverages and, if so, have these increases been widespread or confined to only certain imported alcoholic beverages, such as expensive champagnes?
- Second, is there information indicating that primary source requirements have affected the volume of alcoholic beverage imports and/or the number of alcoholic beverage importers, wholesalers, and/or retailers?

- Third, how common is it for out-of-state alcoholic beverage producers to designate only one or a small number of importers for their product?

We can summarize the responses to our survey as follows:

- None of the alcoholic beverage control agencies have undertaken, or know of, a thorough study of the economic effects resulting from primary source requirements.
- Twenty-nine of the 36 non-California primary-source states either reported that there was no data available on the price effects of the requirement, or chose not to respond to our question regarding these effects. Of the remaining seven states, five stated that there was no evidence to indicate that alcoholic beverage prices were higher or lower, while two said they believed the requirement caused prices to be higher than they would have been otherwise.
- Thirty of the 36 non-California primary-source states either reported that there was no data available on how primary source requirements affect the volume and number of firms involved with alcoholic beverage imports, or simply did not respond to our question regarding these effects. Of the remaining six states, three stated there was no evidence that number of firms or import volume was affected in one way or another, while another three said there had been a reduction in the number of alcoholic beverage wholesalers as a result of the primary source requirement.

- Eight of the 36 non-California primary-source states either reported there was no data available regarding the number of "authorized" importers generally designated by brand owners, or simply did not respond to our questions pertaining to this potential effect. Of the remaining 28 states, 18 reported that it was either common or very common for only one or a few importers to be designated, five said this was uncommon, and five reported a mixed experience. Finally, of the 23 states which indicated that it was not uncommon for only one or a small number of importers to be designated per brand, 18 reported that these exclusive-type designations extended over all price ranges, while two said they were confined to expensive items such as prestigious champagnes and premium table wines.

The only substantive finding to emerge from this survey of state alcoholic control agencies is that the tendency for producers to designate only one or a small number of "authorized" importers for their brands is relatively widespread. As discussed earlier, it is precisely such exclusive-type designations which are most likely to result in higher prices and fewer importers and distributors of imported products when primary source requirements are in place. While only a couple of states actually reported higher prices and reduced numbers of wine importers and distributors, this is hardly surprising since none of the states had collected any empirical data on the economic effects of their primary source provisions.

Here, the experience of the State of Washington is revealing. As discussed in Chapter IV, Washington's beverage-control agency announced in December 1985 that it was departing from its policy of dealing solely with traditional importers, and would henceforth take advantage of the price savings which its research showed could be achieved in the parallel market. In making this announcement, the agency noted that were the parallel market to be curtailed, Washington consumers "would again be forced to pay artificially higher prices to the monopolistic benefit of private corporations."[7] This suggests that primary source requirements do cause prices to be higher than they otherwise would be.

2. The Economic Effects of California's Primary Source Law for Distilled Spirits

Wine imports differ from imported distilled spirits in a number of important respects, including their physical characteristics, the number of brands available, and the number of importers and distributors who handle them. Consequently, we would not expect the economic effects of a primary source law covering wine to be identical to the effect of the state's law covering distilled spirits. Nevertheless, the economic effects of this law would be suggestive of the effects that would result from a similar law covering wine.

Unfortunately, we were unable to identify any thorough, systematic analyses of California's distilled-spirits primary source law. This is not entirely surprising since the law was enacted at approximately the same time that California's fair trade requirements for alcoholic beverages were struck down. Thus, researchers never had an opportunity to observe the workings of the distilled spirits market in a neutral nonregulatory environment.

Nevertheless, the responses to our survey questionnaires may be somewhat enlightening regarding this issue. Specifically:

- Over 80 percent of the responding alcoholic beverage retailers reported that since California's primary source law was enacted in 1979, the number of wholesalers or importer/wholesalers from which they can acquire imported distilled spirits has declined. In fact, these retailers reported that the actual number of suppliers for six leading imported distilled spirits products declined, on average, by more than 50 percent between 1979 and 1985. This is shown in Table V-1. Many of these retailers reported that they currently have access to only one supplier per brand.
- The majority of alcoholic beverage retailers felt that the prices of imported distilled spirits were, indeed, higher as a result of California's primary source requirement. For example, Liquor Barn, one of the state's largest retailers of alcoholic beverages, has estimated that the primary source requirement has driven up the prices of such brands as Chivas Regal and Jack Daniels by more than $2 per bottle.[8] This is consistent with the price differential which the State of Washington found when it compared the prices charged by "authorized" distilled liquor importers to those available through gray market (25 percent).[9]

In sum, what limited evidence there is supports the views that California's primary source law for distilled spirits has tended to raise the prices of imported distilled products and reduce the number of suppliers.

Table V-1

Average Number of Distilled Liquor Suppliers
Reported by Retailers for 1979 and 1985

	Average Number of Suppliers Available[a]			
			Decline Between 1979 and 1985	
Distilled Product	1979	1985	Average Decline	Maximum Reported Decline
Canadian Club	5.0	2.1	2.9	7
Gilbey's Vodka	4.5	2.3	2.2	7
Jack Daniel's No. 7	4.3	1.7	2.6	7
Chivas Regal	5.0	2.0	3.0	8
Kessler Whiskey	4.5	2.2	2.3	7
Tanqueray Gin	4.3	1.8	2.5	7

a. Average number of importer-wholesalers and wholesalers from which imported distilled products could be obtained, as reported by retail store survey respondents.

We also asked the California Department of Alcoholic Beverage Control for its own assessment of the economic effects resulting from the distilled-spirits primary source law. The department stated that it had no definitive opinion or research data regarding the effects of this provision on prices or numbers of wholesalers, but added that "logic, together with a basic understanding of marketing principles, would suggest that fewer importers correlates to higher prices...."[10,11]

3. Survey Responses Regarding the Potential Economic Effects of a Primary Source Law for Wine Imports

In our surveys of California wine importers, wholesalers, distributors and producers, we asked a number of questions regarding the likely economic effects of a primary source law for wines. The responses to our survey are summarized below.

a. Potential Effect on the Number of Wine Importers and Distributors

About 65 percent of the wine importers responding to our survey felt that a primary source law would reduce the number of importers in business by anywhere from five to 40 firms (average: 12 firms). Similarly, about 45 percent of the wine wholesaler/distributor respondents said a primary source law would reduce the number of distributors in business (average: 11 firms). (By comparison, the Department of Alcoholic Beverage Control reports that there are about 700 active wine-import licensees, and about 1,060 wholesaler licensees who may handle wine and beer.[12])

b. Effects on Market Concentration

Approximately 80 percent of the responding importers and wholesalers felt that a primary source law would tend to concentrate sales in fewer and larger firms. In addition, 70 percent of the importers anticipate that a primary source law eventually would cause large import firms to dominate the market for wines that are not currently subject to producer-designated, or "authorized," import channels. Consistent with these expectations about increased market concentration, one-third of the responding wine producers felt that a primary source law would make it harder for them to find small-to-moderate-sized wholesalers and distributors who would take a special interest in promoting and marketing their own wines. Finally, about 20 percent of the wholesalers felt that eventually they would not be permitted to distribute certain wine brands.

c. Other Effects

Consistent with the effects anticipated by economic theory, about one-half of those domestic wine producers responding to our survey expect that a primary source requirement eventually would lead to some increase in their quantity of domestic wines sold, while 12 percent said the prices they charged for certain wines would tend to rise. Regarding product quality, the majority of wine distributors who responded to our survey felt that product quality was unaffected by whether or not a wine passed through the gray market, while some even felt that quality problems actually were encountered less frequently with gray market imports than with imports passing through designated channels.

4. Summary of Empirical Findings

The empirical evidence regarding the economic effects of a primary source requirement for imported wine is admittedly somewhat sketchy. Nevertheless, based on the evidence that is available, we conclude that a California primary source law covering imported wines probably would lead to:

- Increased prices for imported wines--certainly for those wines that currently are being gray marketed, and quite possibly for other imported wines as well;
- A reduction in the quantities of certain imported wines sold within the state;

- Increased prices for and sales of some California-produced wine products;
- Some reduction in the number of wine importers and distributors in California, and a redistribution of business from smaller firms to larger firms; and
- No change in the overall quality of imported wine products.

These effects are also consistent with what economic theory suggests would result from the implementation of a primary source law. Were a primary source requirement enacted today, its near-term economic effects probably would be limited by the fact that according to our surveys, California's gray market imports as of late 1985 only accounted for about 30 percent and 5 percent of its imported champagne and wine sales, respectively, and only about 5 percent and 1 percent of its total champagne and wine sales, respectively. (The volume of gray market importing could be even less than this at the moment, due to recent declines in the value of the dollar.) The longer-term economic effects of such a requirement, however, could be considerably greater, to the extent that more-tightly controlled importing channels give rise to increasingly monopolistic pricing and importing distribution policies for wine imports.

Clearly, a primary source requirement covering wine would tend to:

- Harm consumers by increasing the likelihood of increased prices;
- Benefit foreign wine producers having designated import channels, by allowing them and/or their agents to charge higher prices for their products;
- Benefit some importers and wholesalers, while harming others;

- Benefit certain California wine producers by allowing them to raise prices and/or increase their market shares.

C. EEC TRADE BARRIERS AGAINST CALIFORNIA WINE EXPORTS

In addition to establishing a primary source requirement covering wine imported into California, SB 589 would have required the Governor to determine annually whether trade barriers to California wine exports maintained by the European Economic Community (EEC) had been reduced or eliminated sufficiently to enable California wines to compete fairly within the EEC. In the event the Governor found an improvement in the trade situation, the primary source requirement for wine established by SB 589 would have been eliminated. In effect, this provision says to the EEC, "California will not allow reduced-price gray market wine imports into the state unless you give California wines a fairer chance to compete in European markets."

Assessing the relative merits and likely economic effects of this particular provision involves analyzing such complex issues as the overall international trade environment within which wines are marketed, the effect of foreign-exchange-rate movements on wine import and export prices, and the net effects of different nations' numerous trade provisions and policies on international trade flows. Clearly, a comprehensive analysis of the trade barriers confronting California wines is well-beyond the scope of this report. Nevertheless, we offer the following comments on three aspects of the trade barrier issue.

1. The Existence of EEC Trade Barriers for California Wines

As pointed out in Chapter II, California exports to foreign countries very little of the wine it produces--well-under 3 percent. In part, this probably reflects the need for California to improve its marketing activities overseas. Nevertheless, trade barriers undoubtedly play a role in holding down California's market penetration abroad. For example, the U.S. tariff on EEC-produced wines--37 cents per gallon--is less than that imposed by Italy (62 cents), France (69 cents), and Germany (73 cents).[13,14]

The extent to which trade-related barriers other than tariffs are detrimental to California wine producers is open to debate.[15] In fact, the United States International Trade Commission (ITC) reported in October 1985 that it could find no reasonable indication that governmentally subsidized table wine imports from Germany, France or Italy had materially injured, retarded, or even threatened to injure, the U.S. table wine industry or its grape growers. It also found no indications of significant price suppression or below-cost selling of table wines being imported into the U.S. from these nations.[16]

In sum, while there do appear to be some tariff-related trade barriers to the marketing of California wines abroad, these barriers, by themselves, cannot explain the state's lack of success in European markets. For example, these tariff differentials are equivalent to only about 6 cents to 8 cents per bottle of wine--hardly enough to have a dramatic impact on imports.

2. Could the Governor Determine Changes in Trade Barriers To California Wines?

To determine if EEC trade barriers had been sufficiently eliminated or reduced to enable California wines to "fairly" compete with the EEC, one would need a set of standards for evaluating the "fairness" of the European marketplace. Such standards were absent from SB 589. Consequently, we cannot predict what effects this provision of the bill would have had. If the Legislature chooses to impose a similar requirement on the Governor in the future, it should specify how the requirement is to be interpreted and applied.

3. Benefits And Costs to the California Economy

In order to justify a primary source law on the basis of "fair trade," one must find that the benefits to the California wine industry would exceed the costs of such a law. These costs include higher wine prices and less competitive conditions in certain segments of the wine importing and distribution industries.

It is not obvious that the benefit-to-cost ratio in this case is favorable, particularly given the ITC's recent finding that the U.S. table wine industry has not been materially harmed by unfair competition from Europe. We believe that more substantive evidence is needed before a primary source requirement can be justified as a means of aiding California's wine industry.

Footnotes to Chapter V

1. The potential significance of these "hidden" effects was stressed by a number of wine importers, distributors and retailers who we contacted. They pointed out, for example, that within the Bordeaux region of France alone, there are over 2,000 Chateaus producing wine, about 200 of which are extremely well-known and famous vineyards such as Chateau Lafite or Chateau Lynch-Bages. Most of these wines presently are available from a number of different importers who compete with one another on the basis of price and other factors. Some people believe that under a primary source law, a flurry of importers would descend upon hundreds of relatively small wineries in Bordeaux and elsewhere, seeking exclusive designations, with the advantage going to the large national importers who wield considerable market power. Clearly, this could hurt small importers and increase the likelihood of monopolistic import-pricing policies, which in turn would hurt consumers.
2. Numerous studies by economists have indicated that, in general, prices tend to be higher when markets are heavily concentrated. For example, see F.M. Scherer, Industrial Market Structure and Economic Performance, Second Edition, 1980 (see especially Chapter 9, "The Price and Profit Consequences of Market Structures," pages 267-295). These studies also have often found that profits are higher in more-concentrated markets. The higher profits reflect not only the effects of market concentration and pricing policies; they also reflect the fact that firms with large market shares often are able to reduce their average production and operating costs per unit of output.
3. A primary source law might indirectly result in reduced prices for certain wine imports if foreign wine producers and/or importers use excess economic profits from one group of wine products to subsidize the importation of other wine products. During legislative hearings on SB 589, it was suggested that a primary source law could result in higher profits on the importation of exclusive French champagnes, which could then be used to subsidize the importation of more-moderately priced wines which face stiffer competition from domestic wines. Although some California consumers would benefit in this event, they would do so at the expense of other California consumers, and the state as a whole would be worse off.
4. As discussed in footnote 3, if excess profits earned on one group of imported wine products were used to subsidize the importation of other wine products, a primary source law could indirectly put downward price pressures on those domestic wines that compete with the subsidized imported wines.
5. The effect of a price increase for any commodity (including wine) on its consumption will depend upon its "price elasticity of demand," which is defined as the percentage change in its consumption that will result from a 1 percentage point change in its price. For example, if an imported wine's price elasticity of demand is -0.9, a 10 percent increase in its price would cause a 9 percent decrease in the amount of it that is consumed. A product is said to be "price elastic" if the absolute value of its price elasticity of demand exceeds unity, and "price inelastic" if such value is less than unity. Given this, the

dollar amount spent on a wine when its price rises will decrease if it is price elastic, and increase if it is price inelastic.

6. Most of the empirical research on wines indicates that the demand for wine is relatively price inelastic. (For a review of this research see, for example, Gary L. Marshall, "Developing a State Alcohol Beverage Revenue Simulation Model," paper presented at the National Tax Association--Tax Institute of America Annual Conference on Taxation, October 1985, 19 pages.) This implies that an across-the-board percentage increase in wine prices would increase total wine expenditures. Whether a primary source law would cause a net increase in Californian's expenditures for imported wines is not clear, however. This is because to the extent that wines are partially substitutable for one another (for example, imported versus domestic wines, different Bordeaux wines, etc.), their individual price elasticities are greater than that for all wines collectively. Consequently, a primary source law would most likely see a rise in California expenditures on imported wines only to the extent that the demand for the individual imported wines carrying higher prices was relatively price inelastic.
7. See press release of December 9, 1985 entitled "Liquor Board Joins Parallel Market," issued by the Washington State Liquor Control Board, and affidavit to the board of Robert H. Harvey, Liquor Purchasing Agent for the Washington State Liquor Control Board, January 7, 1986.
8. See, for example, letter from Steven C. Boone, Operations Manager of Liquor Barn, in Wines and Vines, July 1985, page 56.
9. See footnote 7 above for source citation. Some of the specific per-bottle price differentials found by Washington included (for a 750 ml.-sized bottle) $2.55 for Johnnie Walker Black, $2.10 for Cutty Sark, $2.10 for Dewars, $1.75 for Johnnie Walker Red, $1.44 for Baileys, and $1.30 for Tanqueray Gin.
10. The full text of the department's response to us appears in Appendix G.
11. As discussed in Chapter IV, California's price affirmation provision provides that a brand owner cannot sell a distilled product to a wholesaler in California at a price higher than the lowest price at which he sells it in any other state, as specified. One difficulty in tightly enforcing such a provision involves the maintenance and collection of accurate data for all brands in all states. In addition, there have been cases in some states where distilleries have circumvented price affirmation provisions by invoicing wholesalers at affirmation prices, having wholesalers then reselling to retailers at the affirmation price plus a nominal markup, and then rebating to retailers (either in cash or some noncash form) an amount which brings the effective price to the retailer below the wholesaler's invoiced price (see, for example, An Inquiry Into Prices and Pricing Policies of Distilled Spirits and Malt Beverages in Georgia, Georgia Department of Revenue, 1975). Yet another possibility is that a brand owner may be able to pass its products into a state through a corporate subsidiary or "dummy" corporation, which in turn can charge a different price than the brand owner charges in other states.
12. California issues individual importing and wholesaling licenses that apply jointly to wine and beer. According to the department, there

are over 1,200 licensees in California who may import both wine and beer, of which 700 do in fact import wine and 500 exclusively import beer. Regarding wholesaling, there are about 1,060 licensees who may handle both beer and wine; however, the department has no specific breakdown on the portion of these licensees who handle wine as opposed to, or in addition to, beer.

13. The U.S. tariff was equivalent to a 6.8 percent ad valorem levy in 1984, and has been in effect since June 6, 1951 under the provisions of the General Agreement on Tariffs and Trade (GATT). Tariff levels in certain non-EEC nations tend to be even higher than in the EEC. For example, the current tariff imposed on U.S. wines by Japan--the second-largest foreign buyer of California wines today--is 38 percent of value. In Taiwan, the tariff is 50 percent of value. Even so, these tariffs are lower than they were in 1984, having fallen from 55 percent in Japan and 60 percent in Taiwan. The U.S. wine industry currently is very actively pursuing marketing opportunities in these Pacific Rim regions.
14. Wine imports also are subject to the federal excise tax on wine, with the rate being based on alcoholic content. Prior to 1979, the "effective" U.S. tax on many imported wines was artificially high because the U.S. assessed the tax using the "wine gallon" method. Under this method, spirits in bottles holding less than one gallon were taxed as though they were 100 proof. Thus, an imported liter of wine was taxed at a higher rate than its alcoholic content would warrant. Domestic producers, however, were able to avoid the excessive tax rate by paying the excise tax prior to bottling, so that it was based on actual alcoholic content. This method of calculating the tax, known as "proof gallon," replaced the "wine gallon" method in 1979, in exchange for certain EEC concessions regarding customs duties.
15. Economists specializing in international trade have identified some 800 specific different potential trade-distorting barriers. See, for example, Leslie Alan Glick, Multilateral Trade Negotiations: World Trade After the Tokyo Round, 1984, 421 pages.
16. See United States International Trade Commission, Certain Table Wine From the Federal Republic of Germany, France and Italy, Investigation Number 701-TA-258-260 and 731-TA-283-285, Publication 1771, October 1985. The ITC did find that the U.S. wine industry is experiencing "material injury"; however, it attributed this to factors other than unfair import competition.

CHAPTER VI

THE POTENTIAL FISCAL EFFECTS OF A PRIMARY SOURCE LAW FOR CALIFORNIA WINE IMPORTS

The potential fiscal effects on state government of a primary source law for imported wines can be divided into two categories:

- The effects on the administrative and regulatory costs of implementing and enforcing a primary source law, and collecting alcoholic beverage excise and sales taxes on imported wines; and
- The effects on state government revenues from alcoholic beverage excise and sales taxes, due to changes in wine consumption and wine prices in California.

A. EFFECTS ON STATE GOVERNMENT COSTS

In order to assess the potential effects of a primary source law for wines on state costs, we used two approaches. First, we asked the alcoholic beverage control agency in each state which currently has a primary source provision (or its equivalent) what costs, if any, could be attributed to the provision. Second, we asked the state agencies in California that would be affected by a primary source provision to estimate what their own costs would be.

1. The Experience of Other States

In our survey of other states (Appendix F), we asked whether primary source laws tend to impose any special administrative or regularly burdens on state government, particularly burdens associated with the verification and enforcement of wine producers' designations as to who can import their products (question number 6 on the survey questionnaire).

Of the 36 non-California states with some form of primary source requirement, six were not able to provide us with a response to our inquiry. Of the remaining 30 states, 21 stated that primary source provisions did not impose any measurable administrative or regulatory costs. Generally, this was because such states undertook a very passive enforcement role or simply relied on the self-enforcement efforts of the affected firms in the industry. The remaining nine states reported that some special costs could be attributed to their primary source requirements. These costs stemmed from the need to verify import-authorization forms, license designated importers, and conduct hearings involving importing authorizations. Most of these states, however, said that the increased costs were fairly minimal.

Thus, primary source requirements have not resulted in significant state administrative and regulatory costs in those states having them.

2. Cost Estimates by California State Agencies

We requested that the two California state agencies which would be directly affected by a primary source requirement for wines--the Department of Alcoholic Beverage Control (ABC) and the State Board of Equalization (BOE)--develop estimates of what the administration and enforcement of such a requirement would cost.

a. Department of Alcoholic Beverage Control (ABC)

The ABC's response to our question regarding the costs that would be imposed by a primary source law appears in Appendix G.

The department indicates that these costs would depend on whether it took a passive or active role in enforcing the provision.

- Under a passive enforcement program, the department would not maintain its own data bank of importer designations, and would limit its enforcement activities to investigating complaints that a violation of a primary source designation had occurred. In conducting these investigations, it would obtain the data it needed through correspondence with the product's brand owner and, if necessary, would hold an administrative hearing on the matter. The average investigation would require approximately 20 person hours, and the average administrative hearing would take about five to seven hours. The department believes that one full-time investigator could handle this workload, at a cost of approximately $40,000 annually.[1]
- Under an active enforcement program, the department would promulgate a regulation requiring that all brand owners register the identity of their authorized importers, and keep these data current. In addition to investigating complaints, the ABC also would conduct its own unsolicited periodic inspections to ensure that importer designations were being observed. The department estimates that this type of enforcement program would require two full-time investigators and a one-half-time clerical position, at a cost of approximately $95,000 annually.[2]

In addition to the cost of these activities, the department would incur some expense in connection with the trade-barrier-certification provision of SB 589. However, the department could not say what these costs would be. The department indicates that it might be able to perform the certification activities with <u>no</u> increase in staff <u>if</u> the federal government already maintains sufficient information on the subject. On the other hand, if the department needed to collect, maintain and analyze data on trade barriers itself, additional staff <u>would</u> be needed, although the department is unsure what its staffing needs would be.

b. <u>State Board of Equalization</u>

The BOE's response to our question regarding the costs imposed by a primary source law appears in Appendix H.

The BOE indicates that a primary source law for imported wine would have <u>no</u> effect on its basic operations, including staffing, workload, or costs. It maintains that a primary source law would <u>not</u> make it easier to trace beverage transactions, and would <u>not</u> otherwise affect its administration of the sales and excise taxes which are levied upon alcoholic beverages.

The basis for the board's conclusions is as follows:

- First, the BOE collects the alcoholic beverage tax on imported wine at the time the wine is brought into California. The tax returns filed by wine importers are then compared with information returns filed by common carriers (for example, trains and trucks) regarding the merchandise they carry, to ensure that the required taxes are being paid. These same returns would be filed and compared, and all related tax compliance, auditing and collection activities would be continued in the same manner, under a "primary source" requirement. No new tax-related documents would be required.

- Second, the BOE believes that although a "primary source" requirement might have some effect on the number and business volumes of wine importers, it doubts that the aggregate number of importers required to file tax returns would change significantly. It also points out that administration of the tax on imported wine products is a relatively small program; thus, any cost effects would be minor.

The board's conclusion differs somewhat from the responses of other "primary source" states. Specifically, 15 of these 36 states reported that primary source requirements made it easier to collect alcoholic-beverage-related taxes.[3] This could reflect the fact that state alcoholic beverage control agencies responding to our survey may not always have been the state agencies which actually administer tax-collection activities.

3. Summary

Given the above, we conclude that a California primary source law for wine imports would impose moderate administrative and regulatory costs on state government. Depending upon the degree to which such a law was enforced, these costs probably would fall somewhere in the range of $50,000 to $100,000 annually.

B. EFFECTS ON STATE GOVERNMENT REVENUES

The direct effects of a primary source law on state revenues involve the two state taxes which are levied on domestic and imported wines--the alcoholic beverage excise tax, and the sales and use tax.

1. California's Alcoholic Beverage Tax and Sales and Use Tax

The alcoholic beverage tax is an excise tax which is levied on a per-gallon basis. The tax rate depends on the type of wine being sold, and is 1 cent per gallon for dry wine, 2 cents per gallon for sweet wine and 30 cents per gallon for sparkling wine.[4]

The Governor's Budget for 1986-87 estimates that these taxes will raise about $4.6 million in 1986-87, consisting of $1.1 million for dry wines, $151,000 for sweet wines and $3.3 million for sparkling wines. By comparison, the state is expected to collect about $25 million from its 4-cent-per-gallon excise tax on beer and $104 million from its $2-per-gallon excise tax on distilled spirits.[5] Thus, while excise tax revenues collected for wine in 1986-87 are large in dollar terms, they are fairly small relative to total alcoholic beverage tax receipts (less than 4 percent of the nearly $134 million amount projected) and, of course, total state General Fund revenues (less than two one-hundredths of 1 percent of the $31 billion amount projected).

The state's sales and use tax is levied on all nonexempt taxable goods, including wines and other alcoholic beverages.[6] The basic sales and use tax rate is 6 percent, of which 4.75 percent represents the state tax rate, 1 percent is the tax rate for cities and counties, combined, and 0.25 percent is the rate for county transit systems. An additional 0.5 percent rate is levied by various transit districts for the support of local public transportation systems.[7]

The BOE does not have a precise figure on the amount of sales and use tax revenues attributable to wine sales.[8] However, it appears that in

1986-87, the state's 4.75 percent tax on wine-related sales will yield revenues in the vicinity of $100 million to $135 million, consisting of $75 million to $100 million from dry wine sales, $5 million to $8 million from sweet wine sales, and $20 million to $26 million from sparkling wine sales.[9] This represents about 1.1 percent of total state sales and use tax collections, and a bit under four-tenths of 1 percent of total General Fund revenues. Thus, the sales and use tax on wine raises about 25 times more revenues than the excise tax raises.

2. <u>The Revenue Effects of a Primary Source Law</u>

The overall direct revenue effect of a primary source law will depend primarily on two factors:[10]

- What changes occur in the <u>quantity</u> of domestic and imported wine shipments in California. (These changes will directly affect excise tax revenues.)
- What changes occur in total <u>expenditures</u> on wines by individuals, businesses and other types of consumers in California. (These changes will directly affect sales and use tax revenues.)

Unfortunately, it is extremely difficult to predict what these changes would be if a primary source law went into effect. As discussed in Chapter V, the number of gallons sold would decline for some imported brands, rise for other imported brands and certain domestic brands, and remain unchanged for yet other domestic and imported brands. Likewise, although prices generally would tend to go up, the amount of the increase could differ greatly from brand-to-brand.

For these and other reasons, it is <u>not</u> possible to calculate the revenue effect of a primary source law with any precision. The best we can do is to develop reasonable alternative <u>assumptions</u> about the key revenue-determining variables, and then use these assumptions to illustrate the types of revenue effects that the Legislature could realistically expect to result from a primary source law.

The relevant assumptions to consider include the portion of imported wines that are subject to gray marketing, the general price ranges of these gray-marketed wines, the way in which a primary source requirement could change these prices, the way that the amount of wine purchased would change as a result of wine price changes, and the extent to which changes in consumer expenditures on wine would change consumer expenditures on nonwine products.

A wide range of different revenue outcomes can be generated using different values for the above assumptions. As indicated earlier, our survey respondents felt that as of late 1985, about 30 percent of imported champagne and about 5 percent of other imported wines were subject to gray marketing, and therefore would have been affected by a primary source law had it been law. If prices of this amount of imported champagnes and nonchampagne wines were to rise under such a provision by somewhere between 15 percent and 25 percent, <u>without any reduction in their sales volumes and without causing any change in expenditures on nonwine products</u>, annual state revenues would increase by approximately $800,000 to $1.3 million. However, sales of most imported wine products are not insensitive to changes in their prices, and therefore it is unrealistic to assume there would be no change in their sales volumes. In fact, it is likely that increases in prices would result in an equal if not more-than-proportionate drop in volume for many of these wines. In addition, it is reasonable to assume that changes in wine expenditures would cause some change in expenditures on nonwine products. These factors, in turn, could cause a net loss in state revenues.

Appendix I describes in detail the different revenue outcomes that alternative assumptions produce, and discusses which are most likely to occur. Our "bottom line" is that the likelihood is greatest that revenues would decline, by up to about $100,000 annually. This conclusion assumes, among other things, that consumers will proportionally reduce their consumption of gray-market wines in response to increases in their prices, and will partially offset any changes in their expenditures on gray-market wines by adjusting their spending on other goods and services.

C. SUMMARY

In sum, we conclude that a primary source law for wines could increase state costs by between $50,000 and $100,000 annually and reduce state revenues by up to $100,000 annually. Thus, the likely net effect of a primary source requirement on the state's General Fund would be to reduce the amount of funds available for other purposes by up to $200,000 annually.

Footnotes to Chapter VI

1. This estimate reflects the pay level ($2,203 per month), plus benefits (34 percent of pay) and related operating expenses (12 percent of pay), for an ABC Investigator in 1986-87.
2. This estimate reflects about $77,000 in costs related to two ABC Investigators (see footnote 1), plus about $18,000 for a half-time clerical position.
3. Of the remaining 21 primary source states, nine said that a primary source law will have no effect on the ease of collecting taxes, while 12 either had not analyzed the effect, had insufficient data to measure the effect, or simply did not respond to the question.
4. These tax rates have remained unchanged for decades, having been set in 1935 (sweet wine), 1937 (dry wine), and 1955 (sparkling wine). (Dry wine is defined as still wine with not over 14 percent alcohol.) California's excise tax rates for wines tend to be relatively low compared to those in other states (see The Taxation of Cigarettes, Alcoholic Beverages and Parimutual Wagering, Legislative Analyst's Office, October 1981, 42 pages).
5. These estimates assume annual per capita consumption levels in California of 23.7 gallons for beer and 1.95 gallons for distilled spirits. The $2-per-gallon distilled spirits tax rate is for liquor of 100 proof or less; a rate of $4 per gallon is levied for over-100-proof liquor.
6. In the case of alcoholic beverages, the sales and use tax is levied after the alcoholic beverage tax has been applied. Thus, the excise tax itself is taxed.
7. Counties that currently levy this transit tax are San Francisco, San Mateo, Alameda, Contra Costa, Santa Cruz, Los Angeles, and Santa Clara. The Santa Clara County Traffic Authority also levies a separate 0.5 percent rate in addition to the county transit district tax.
8. The reason the BOE does not have this data is that its sales tax collections are classified by type of retail establishment, not type of product. Thus, for example, there is no separate breakdown of wine sales in stores that primarily sell other merchandise, such as grocery stores.
9. These estimates are based on the per capita consumption data referred to in footnote 5. They also assume that per-bottle retail beverage prices average between $3 to $5 for dry and sweet wines, and $8 to $10 for sparkling wines (assuming a 750-ml.-capacity bottle).
10. A third factor--tax compliance and the effectiveness of tax administration--also can affect revenues. We have excluded this factor from our discussion, given the BOE's belief that its operations would not be significantly affected by a primary source requirement for wine.

CHAPTER VII

CONCLUSION

The purpose of this report has been to identify the size, characteristics and effects of the California gray market for imported wines, and the economic and fiscal impacts that a primary source law effectively prohibiting gray market wine importing would have in the future.

The available evidence leads us to conclude that a California primary source law covering imported wines eventually would tend to result in:

- Higher prices for certain wine products;
- A shift of business away from certain smaller wine importers and distributors, and an increased concentration of wine importing and distributing activity in the hands of fewer and larger firms;
- Little, if any, improvement in the overall quality of imported wine products purchased by Californians; and
- A modest loss of resources to state government.

Given this, we conclude that a primary source requirement generally would leave California wine consumers and the state government worse off. And, while certain individual firms would benefit from such a requirement, they would do so at the expense of other firms who would be hurt. In addition, although a primary source requirement could enable the producers of certain California wine brands to increase their sales, such a requirement would not fundamentally address the problems currently faced by the California wine and grape producing industries.

APPENDIX A

SURVEY OF CALIFORNIA WINE RETAILERS

SURVEY OF RETAILERS REGARDING SB589

NAME OF RETAILER: ______________________________.
NAME AND PHONE OF CONTACT PERSON: ____________________.

1. Have you been obtaining any imported wines, including champagnes, through the "gray market" (that is, from import channels which bypass the established producer-designated, or "authorized", channels in cases where these exist) ____________________ ?

2. When did you first begin using the "gray market"__________?

3. With how many different "gray market" importers have you dealt _____, and what are their names (optional) ____?

4. How many different brands of imported wines do you sell _____ and, of these, how many have you obtained at one time or another through the "gray market" _____?

5. Are your "gray market" imports restricted to champagnes, or do they also include premium and table wines as well __________?

6. How far down the wholesale "price ladder" have you found that wines and champagnes are available to you at reduced costs through the "gray market" for:

   (a) Champagnes $ _____.
   (b) Nonchampagne wines $ _____.

7. Of your total annual volume of wine sales, what percentage is (a) champagnes only _____% (b) imported wines and champagnes _____%, and (c) "gray market" imports of wines and champagnes _____?

8. By roughly what percentage has your ability to obtain imported wines through the "gray market" at reduced costs (a) increased your total wine sales volume, both in terms of case movements (_____%) and dollar value (_____%), and (b) reduced your sales of domestically-produced wine products (_____%)?

9. Has the number of wholesalers or importer/wholesalers from which you can acquire each of the distilled products listed below changed since 1979, when California enacted "primary source" legislation for distilled spirits ____________________? Please indicate below the approximate number of wholesalers or importer/wholesalers available to you in both 1979 and 1985:

Distilled Product	Wholesalers Available 1979	1985
Canadian Club	____	____
Gilbey's Vodka	____	____
Jack Daniel's No. 7	____	____
Chivas Regal	____	____
Kessler Whiskey	____	____
Tanqueray Gin	____	____

10. The attached form has been designed for reporting data on case movements and prices of different imported and domestic wine products, focusing on products most likely to be affected by the "gray market". We would appreciate whatever data you are willing to provide, including partial responses.

11. COMMENTS. PLEASE PROVIDE ANY ADDITIONAL COMMENTS YOU WISH TO SHARE REGARDING SB589 IN THE SPACE PROVIDED BELOW.

____
____
____
____
____
____

IF YOU WISH TO RECEIVE COPIES OF OUR FINAL REPORT ON SB589, PLEASE PROVIDE THE MAILING ADDRESS BELOW TO WHICH THEY SHOULD BE SENT:

____
____
____

*** THANK YOU VERY MUCH FOR YOUR COOPERATION ***

Brand Name	Cases Sold, By Year				Wholesale Cost, Per Bottle				Retail Price, Per Bottle				Source of Supply		If "Gray Market" Suppliers Are Used:		
	1982	1983	1984	1985 January through September	July 1982	July 1983	July 1984	July 1985	July 1982	July 1983	July 1984	July 1985	Traditional Supplier(s)	"Gray Market" Supplier(s)	Date Began	Percentage of Cases Supplied 1984	Percentage of Cases Supplied 1985
A. Imported Champagnes																	
Moet White Star																	
Dom Perignon																	
Mumms																	
Taittinger																	
Roederer																	
Bollinger																	
Perrier Jouet																	
Jacques Trouillard																	
Krug																	
Veuve Clicquot																	
Piper Heidsieck																	
Laurent Perrier																	
Freixenet																	
Codorniu																	
Paul Cheneau																	
Rene Barbier																	
Other (specify)[a]																	

Brand Name	Cases Sold, By Year 1982	1983	1984	1985 January through September	Wholesale Cost, Per Bottle July 1982	July 1983	July 1984	July 1985	Retail Price, Per Bottle July 1982	July 1983	July 1984	July 1985	Source of Supply Traditional Supplier(s)	"Gray Market" Supplier(s)	If "Gray Market" Suppliers Are Used: Date Began	Percentage of Cases Supplied 1984	1985
B. Domestic Champagnes																	
Korbel													N/A	N/A	N/A	N/A	N/A
Domaine Chandon																	
Hans Kornell																	
Piper Sonoma																	
Schramsberg																	
Sebastiani																	
Chateau St. Jean																	
Mirassou																	
Le Domaine																	
Franzia																	
Cooks																	
Paul Masson																	
Lejon																	
Jacques Bonet																	
Andre																	
Other (specify)[a]																	
C. Imported Wines Supplied through Nontraditional "Gray Market" Channels																	
Specify:[a]																	

a. Please list any brand which represented a significant portion of your sales in this category.

APPENDIX B

SURVEY OF CALIFORNIA WINE WHOLESALERS AND DISTRIBUTORS

SURVEY OF CALIFORNIA WINE WHOLESALERS AND DISTRIBUTORS

NAME OF COMPANY: ____.
CONTACT PERSON: ______________________________. PHONE: ___________.

1. Approximately how many different wine brands do you handle _____ and, of these, how many are produced in California _____, in other states _____, and imported from foreign nations _____?

2. Do you also distribute domestic-produced beers _____, foreign-produced beers _____, domestic-produced distilled spirits _____, or foreign-produced distilled spirits _____?

3. a. Have you been designated, either by the producer or its agent, as an exclusive wholesaler or distributor of any brand(s) of wine or beer _____?
   b. If so, please indicate:

      (i) What percent of your total volume such items account for _____%
      (ii) What the names of these items are ______________________________
      ____.
      (iii) For which of these items your authorized area includes the entire state ______________________________.

4. What is your approximate total annual dollar sales volume __________ and, of this, what is the approximate percentage breakdown according to the categories listed below:

Type of Beverage	Percentage Share of Total Volume
California champagnes	_____%
Imported champagnes	_____
California nonchampagne wines	_____
Imported nonchampagne wines	_____
Domestic beers	_____%
Imported beers	_____
Domestic distilled spirits	_____%
Imported distilled spirits	_____
All other sales	_____%
TOTAL, ALL ITEMS	100 %

5. Do you ever handle any wine products that are imported into California through the "gray market" (that is, imported at reduced prices through channels other than producer-controlled or producer-designated "authorized" importing networks where these exist) _____?

6. If you do or have handled "gray marketed" imports, then:

a. What is the approximate number of these products _____, and of these, how many are champagnes _____?
b. What is the approximate percentage share of your total dollar volume that is accounted for by (i) all "gray market" wines _____, (ii) champagnes only _____ and (iii) nonchampagne wines only _____?
c. When did you first begin handling "gray market" wines _____?
d. From which countries have these wines been produced:

(i) France
(ii) Italy
(iii) Germany
(iv) Spain
(v) Portugal
(vi) Other (please specify): ____________.

7. Please indicate below (a) the approximate percentage of your total wine volume that falls into each price category shown, and (b) put a check mark for any category in which either you or other wine wholesalers/distributors you know of handle "gray market" imports:

	Wholesale wine price per bottle ($)				
	Under 3	3-6	6-10	10-15	>15
a. Percent share of your volume					
b. Price tiers where there have been "gray market" imports for:					
(i) Champagnes					
(ii) Premium and table wines					

8. What has been the effect of "gray market" wine imports on your own volume of business:

a. No effect
b. Has increased business
c. Has hurt business
d. Don't know

9. If the "gray market" has affected your business, approximately by what percent has the dollar volume of your wine sales been increased or reduced for (i) champagnes _____, (ii) nonchampagne wines _____, and (iii) total wine sales _____?

10. What group of wholesalers/distributors do you believe the "gray market" has helped the most:

a. small firms   b. large firms   c. all-sized firms   d. no one

11. How would you best characterize the supply availability of "gray market" wines from importers who make them available to you:

a. Extremely reliable
b. Somewhat reliable
c. Unpredictable
d. Very mixed, depending upon the brand

12. Suppose that California imposed a "primary source" requirement for wine imports. Do you believe that this would:

   a. Cause any wine wholesalers/distributors to go out of business ____? If so, do you have any guess as to how many firms might be so affected _____ and whether these would tend to be larger or smaller firms ___________?
   b. Tend to eventually concentrate wine distributing/wholesaling into the hands of fewer _____ and larger _____ firms?
   c. Shut you off from distributing certain champagne brands _____ and/or nonchampagne wine brands _____? If so, how many brands_____, and roughly what percent of your total business volume would this represent _____?
   d. Seriously jeopordize your own ability to stay in business and profitably operate _____, or conversely, improve your sales volume _____ and/or profit margins _____?

13. Do wines imported through "gray market" channels appear to have more _____, less _____, or about the same _____ quality problems as do other imported wines? If they differ, how ________________________________?

14. COMMENTS. Please include any additional comments below which you would like to share with us regarding the "gray market" and a "primary source" requirement for wines, as proposed by SB589.

____
____
____
____
____

IF YOU WISH TO RECEIVE A COPY OF OUR FINAL REPORT ON SB589, PLEASE PROVIDE THE MAILING ADDRESS TO WHICH IT SHOULD BE SENT:

____
____
____

*** THANK YOU VERY MUCH FOR YOUR COOPERATION ***

APPENDIX C

SURVEY OF CALIFORNIA WINE IMPORTERS

SURVEY OF CALIFORNIA WINE IMPORTERS

NAME OF COMPANY: ______________________________________.
CONTACT PERSON: ________________________ PHONE: _____________.

1. Approximately what percentage of your total dollar import volume is represented by imported champagnes (_____%), imported nonchampagne wines (_____%), imported beers (_____%), and imported distilled spirits (_____%)?

2. Do you ever import any wine into California for which there also exists some alternate producer-designated, or "authorized", import distribution system (that is, do you ever participate in what is sometimes referred to as the "gray market") ____________________?

3. How many different California wine importers would you guess do participate, at one time or another and to one degree or another, in the "gray market" (that is, import wines for which producer-designated, or "authorized", import networks also exist)?

   a. under 10
   b. 10-15
   c. 15-20
   d. 20-50
   e. 50-100
   f. over 100
   g. other (please specify): ____________________.

4. Regarding the types of import firms who do participate in the "gray market", would you tend to describe them primarily as relatively:

   a. smaller-sized import firms
   b. medium or average-sized import firms
   c. larger-sized import firms
   d. all sizes of import firms

5. What percent of California wine imports would you guess the "gray market" accounts for in the case of:

   a. champagnes only _____%.
   b. nonchampagne wines _____%.
   c. all types of wines (champagnes plus nonchampagnes) _____%.

6. Regarding your own operations:

   a. How many champagne brands do you import _____, and how many brands have you at one time or another "gray marketed" _____?
   b. How many nonchampagne wine brands do you import _____, and how many brands have you at one time or another "gray marketed" _____?
   c. What is the total dollar volume of your "gray market" imports as a percent of your total imports of (i) champagnes (_____%), (ii) nonchampagne wines (_____%), and (iii) all wine types (_____%)?
   d. Roughly how many retailers _____ and wholesalers _____ have directly acquired "gray market" wine imports from you at one time or another?

7. How many, if any, foreign wine producers have named you as a designated, "authorized" importer of their champagnes _____ or nonchampagne wines _____? If any have, what percentage of your dollar import volume do these items account for _____, and what are the names of these items ________ ____?

8. What percentage of the dollar volume of California champagne imports _____ and nonchampagne wine imports _____ would you guess are products that foreign manufacturers have specified designated, or "authorized", importers for?

9. Please indicate below those countries where the wines and champagnes are produced that are or have previously been imported (either by yourself or other firms you know of) through the "gray market", as opposed to through some producer-designated or "authorized" importing network that currently exists for them:

a. France
b. Italy
c. Germany
d. Spain
e. Portugal
f. Other (please specify): ____________________.

10. In each box below, please put a check if you are aware of any "gray market" importing that occurs for the price range shown, either by yourself or other importers you know of:

	Wholesale Price Per Bottle					
Wine Type	Under $5	$5-$10	$10-$15	$15-$20	$20-$25	over $25
a. Champagnes						
b. Other wines						

11. Do you think that "gray marketing" will increasingly spread in the future to:

a. nonchampagne wines _____ why? ____________________.
b. more moderately priced wines _____? why? ____________________.

12. Are "quantity discounts" offered to wine retailers and wholesalers on wines imported through the "gray market", either by:

a. yourself ____? or
b. other importers you know of ______________________________?

13. In order for "gray market" importing to be economically attractive, how large a spread to you believe needs to exist between (a) the price charged by an "authorized" or producer-designated importer and (b) the price that a "gray market" importer can afford to offer?

a. Necessary dollar price spread, per bottle: $ ____________.
b. Necessary price spread in percentage terms: ____________%.

14. How would you best characterize the supply availability of "gray market" wines to importers who wish to acquire them?

   a. Extremely reliable
   b. Somewhat reliable
   c. Unpredictable
   d. Very mixed, depending upon the brand

15. During the past year, has it become more or less difficult for U.S. wine importers to locate and obtain wines to import through the "gray market" _______________? Why _________________________?

16. What do you believe has been the effect of wine's "gray market" on the wine prices charged by producer-designated or "authorized" importers:

   a. No noticeable effect
   b. Prices generally are lower than they would be otherwise
   c. Prices have been lower than otherwise in some, but not all, cases
   d. Other (please specify): ___________________________________.

17. If a "primary source" law for imported wines was enacted in California, by what percent would you guess your own dollar import volume would change (increase or decrease) for:

   a. Champagnes ______________%.
   b. Nonchampagne wines _______%.
   c. Total wines (champagnes plus nonchampagne wines _______%.

18. Would a "primary source" law seriously jeopordize your own ability to stay in business and profitably operate _________________?

19. Do you believe that a "primary source" requirement would:

   a. Cause any wine importers to go out of business ____________?
      If so, do you have any guess as to how many firms might be affected ______________________________________?
   b. Tend to eventually concentrate wine importing into the hands of fewer _______________ and larger _______________ firms?
   c. Concentrate the importing of wines for which producer-designated, or "authorized", import channels do not currently exist (such as nonchampagne wines), into the hands of a limited number of large import firms _____?

20. COMMENTS. Please provide any additional comments below which you would like to share with us regarding the "gray market" and the potential effects of a "primary source" requirement, as proposed by SB 589: ___________________________________

____

____

____

DO YO WISH TO RECEIVE A COPY OF OUR FINAL REPORT ON SB 589 ________?
IF SO, PLEASE PROVIDE YOUR MAILING ADDRESS _______________________

____

*** THANK YOU VERY MUCH FOR YOUR COOPERATION ***

APPENDIX D

SURVEY OF CALIFORNIA WINE PRODUCERS

SURVEY OF CALIFORNIA WINE PRODUCERS

NAME OF COMPANY: ____.
CONTACT PERSON: __________________________. PHONE: ________.

1. What is your approximate total annual dollar wine sales _______ and, of this, what percentage constitutes champagnes (____%) as opposed to nonchampagne wines (____%)?

2. Please indicate approximately how your wines are distributed:

	Champagnes	Nonchampagne Wines
a. Method of distribution		
- Directly to retailers	____%	____%
- Through wholesalers and distributors	____%	____%
- Other: __________	____%	____%
b. Destination		
- Within California	____%	____%
- To other states	____%	____%
- To other countries	____%	____%

3. How many different wholesalers/distributors handle your wines for you (____) and, of these, how many:

   a. Handle only your products ____?
   b. Handle other California-produced wines ____?
   c. Handle other domestic-produced wines ____?
   d. Handle imported wines and champagnes ____?
   e. Handle domestic beers ____ and/or imported beers ____?
   f. Handle distilled spirits ____?

4. Has the number of wholesalers available to distribute your wines decreased significantly during the last several years ____ and, if so, has this changed the percentage of your wines that you sell directly to consumers and retailers ____? By how much ____________________?

5. a. Do you believe that your sales have been hurt this past year by foreign wine imports ____? If so, has this occured primarily for champagnes ____, nonchampagne wines ____, or both ____?
   b. Do you believe that your sales this past year have been hurt specifically by the "gray market" importing of foreign wine products (that is, importing which circumvents "authorized" producer-controlled or producer-designated importing networks where these exist) ____, or do you think that other factors are primarily responsible ____?

6. Please circle any of the factors below which have created significant marketing problems for you this past year:

   a. High value of the dollar
   b. Foreign trade barriers
   c. Difficulty in finding distributors to handle your products
   d. Growing concentration of wine wholesaling into the hands of fewer and larger firms, who do not aggressively promote your own wines
   e. Foreign "dumping" of surplus wine stocks at below-cost prices
   f. Foreign subsidization of wine production abroad
   g. Excessive California wine production
   h. "Gray market" importing of foreign wines
   i. Other (please specify): ________________________________.

7. a. If you believe that "gray marketing" has hurt your own sales, has this occurred for champagnes _____, for nonchampagne wines _____, or both categories _____?
   b. Has "gray marketing" affected the prices you charge for champagnes _____ or nonchampagne wines _____? If so, how ____________________ ____?

8. Please indicate below the approximate percentage of your total wine sales that fall into each price category, and indicate for which price categories, if any, "gray market" wine imports or other wine imports have hurt your sales:

	Retail price per bottle ($)				
	Under 4	4-7	7-10	10-15	Over 15
a. Percent share of your sales					
(i) Sparkling wines					
(ii) Still wines					
b. Price tiers affected by "gray market" imports					
(i) Sparkling wines					
(ii) Still wines					
c. Price tiers affected by all other imports					
(i) Sparkling wines					
(ii) Still wines					

9. If California imposed a "primary source" law for wine imports, requiring California importers to be designated by a foreign wine's manufacturer before importing its product into California, do you think this would affect:

   a. Your sales volume _____? If so, how ______________________________?
   b. The prices you charge for your wines _____? If so, how __________ ____?
   c. Your ability to find wholesalers/distributors who will effectively promote, distribute and market your own wines _____? If so, how and why ____?

10. COMMENTS. Please include any additional comments below which you would like to share with us regarding the "gray market" and a "primary source" requirement for wines, as proposed by SB589.

IF YOU WISH TO RECEIVE A COPY OF OUR FINAL REPORT ON SB589, PLEASE PROVIDE THE MAILING ADDRESS TO WHICH IT SHOULD BE SENT:

*** THANK YOU VERY MUCH FOR YOUR COOPERATION ***

APPENDIX E

SUMMARY CHARACTERISTICS OF SURVEY RESPONDENTS

APPENDIX E

SUMMARY CHARACTERISTICS OF SURVEY RESPONDENTS

This appendix presents summary information regarding the respondents to our surveys.

1. Wine Importers

The number of reported brands imported per firm averaged about 3 and ranged as high as 14 for champagnes, and averaged over 65 and ranged as high as 300 for nonchampagne wines. In terms of how the dollar import volume of these firms was distributed between different types of imported beverages, the average distribution was 21 percent imported champagnes, 53 percent imported nonchampagne wines, 12 percent imported beers, and 14 percent imported distilled spirits. Altogether, imported alcoholic beverages accounted for nearly 90 percent of the total import volume of these firms. Although the majority of firms imported a variety of product types and relied heavily on imported nonchampagne wines, some were much more specialized. For instance, one respondent's imported champagne volume accounted for nearly 85 percent of its entire import business.

About half of the importers specifically indicated that they have been designated as an "authorized" importer of a foreign-produced wine by its producer or the producer's agent. The number of such designated brands per respondent averaged about one for champagnes and about 24 for nonchampagne wines, although some firms reported that they were the designated importers for as many as 200 brands. Altogether, these "authorized" importers estimated that two-thirds of their dollar import volume involved producer-designated items, with the estimates ranging from 5 percent to 100 percent. The importers also estimated that foreign manufacturers have designated "authorized" importers for about 80 percent of California's imported foreign champagnes and nonchampagne wines.

2. Wine Wholesalers and Distributors

These respondents had an annual dollar sales volume that averaged $9.5 million and ranged from $1 million to $22 million. Most tended to handle a fairly wide variety of alcoholic beverage products, including both domestic and foreign champagnes, nonchampagne wines, beers and distilled spirits.[1] The number of wine brands that they distributed ranged from a low of 4 to a high of 60 and averaged about 26 per firm (12 of which were California brands). Ninety percent of the respondents indicated that they have been specifically designated by at least one domestic or foreign beer or wine producer as an "authorized" distributor of its product. On the average, these firms reported that designated products accounted for nearly 45 percent of their total sales.

3. Wine Producers

These respondents had annual sales volumes that averaged $6 million, and ranged from under $1 million to over $25 million.[2] Of the total sales volume reported by these firms, 18 percent represented sparkling wines and champagnes, while 82 percent represented other nonchampagne wines.

The respondents distributed this wine to consumers in several different ways. In the case of champagnes, an average of about 17 percent went directly to retailers, 81 percent went through conventional wine wholesalers, and 2 percent went through other channels such as tasting rooms. In the case of nonchampagne wines, about 22 percent went directly to retailers, 63 percent went through conventional wholesalers, and 5 percent went through other channels. Only about 2 percent of the wine produced by the respondents was exported to foreign nations. The remaining 98 percent was shipped either to other states (54 percent for champagnes and 41 percent for other wines) or within California (44 percent for champagnes and 57 percent for other wines).

The number of wine wholesalers and distributors who handled the wines of the producer/respondents averaged about 78 per firm, although the number reached as high as 300 for some producers. About three-quarters of these distributors and wholesalers also handled other California wines and wines imported from other states and nations, while one-quarter to one-third also handled beers and/or distilled spirits.

Sixty percent of the respondents reported that the number of wholesalers available to distribute their products has significantly fallen in recent years, and 30 percent indicated that this has led them to try to increase their direct sales to retailers. In addition, 95 percent of the respondents stated that their sales have been hurt recently by increased foreign wine imports. Approximately 37 percent said their sparkling wine and champagne sales have been hurt, and nearly 80 percent said their nonchampagne wine sales have been hurt.

4. Wine Retailers

These respondents ranged from small single-store firms to large multi-site chain store operations. The number of imported wine brands they reported carrying averaged about 280 per respondent, and ranged from 25 to 1,000. The share of their total wine sales volume attributable to imported wines and champagnes averaged about 34 percent and ranged from 15 percent to 60 percent, while their champagne sales as a percent of their total wine sales averaged 22 percent and ranged from 7 percent to 45 percent.

Footnotes to Appendix E

1. The average percent distribution of product types reported by these respondents was 3 percent for California champagnes, 4 percent for non-California champagnes, 20 percent for California nonchampagne wines, 6 percent for non-California nonchampagne wines, 15 percent for domestic beers, 12 percent for imported foreign beers, 25 percent for domestic distilled spirits, 10 percent for imported foreign distilled spirits, and 6 percent for all other items. The reported distributions for individual firms, however, often varied considerably from these averages. For example, firms reported as much as 35 percent of their volume in imported nonchampagne wines, 12 percent in imported champagnes, 55 percent in imported beers, and 40 percent in imported distilled spirits.
2. Although all of the state's larger wineries were asked to participate in our survey, the actual respondents turned out to be primarily smaller wineries.

APPENDIX F

SURVEY OF STATES REGARDING PRIMARY SOURCE LAWS

STATE SURVEY REGARDING PRIMARY SOURCE LAWS FOR
ALCOHOLIC BEVERAGE IMPORTS

NAME OF STATE: ______________________________.
CONTACT PERSON: ______________________________. Phone: ____________.

1. Does your state have "primary source" laws, which require that licensed importers of alcoholic beverages from outside your state be specifically designated by a beverage's domestic or foreign producer to handle that product?

   (a) If yes, when were the laws passed and to what alcoholic beverages do they apply?
   (b) If no, have there been unsuccessful attempts to enact such laws?

2. Were your "primary source" laws enacted in order to halt the activities of "grey market" importers who were bypassing established importing and wholesaling channels, or were there other factors involved?

3. Is there information which indicates that your "primary source" laws have increased the prices of imported alcoholic beverages and, if so, whether these increases have been for all imported alcoholic beverage items generally or confined to certain types of products, such as expensive champagnes?

4. Is there information indicating that your "primary source" laws have affected the volume of alcoholic beverage imports, or the number of alcoholic beverage importers, wholesalers, and/or retailers? Please explain.

5. Have your "primary source" laws made it more or less difficult to collect your state's alcoholic beverage excise taxes? Please explain.

6. Have "primary source" laws imposed any special state government administrative burdens, such as verification and enforcement of importers' designations? Please explain.

7. How common is it that out-of-state producers designate only one or a small number of importers for their product? If this occurs, does it tend to be primarily for expensive wines and champagnes, or for more moderately priced items too?

APPENDIX G

ESTIMATES OF FISCAL EFFECTS MADE BY THE CALIFORNIA DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL

STATE SURVEY REGARDING PRIMARY SOURCE LAWS FOR
ALCOHOLIC BEVERAGE IMPORTS

NAME OF STATE: ____________________________.
CONTACT PERSON: ____________________________. Phone: ____________.

1. Does your state have "primary source" laws, which require that licensed importers of alcoholic beverages from outside your state be specifically designated by a beverage's domestic or foreign producer to handle that product?

   (a) If yes, when were the laws passed and to what alcoholic beverages do they apply?
   (b) If no, have there been unsuccessful attempts to enact such laws?

2. Were your "primary source" laws enacted in order to halt the activities of "grey market" importers who were bypassing established importing and wholesaling channels, or were there other factors involved?

3. Is there information which indicates that your "primary source" laws have increased the prices of imported alcoholic beverages and, if so, whether these increases have been for all imported alcoholic beverage items generally or confined to certain types of products, such as expensive champagnes?

4. Is there information indicating that your "primary source" laws have affected the volume of alcoholic beverage imports, or the number of alcoholic beverage importers, wholesalers, and/or retailers? Please explain.

5. Have your "primary source" laws made it more or less difficult to collect your state's alcoholic beverage excise taxes? Please explain.

6. Have "primary source" laws imposed any special state government administrative burdens, such as verification and enforcement of importers' designations? Please explain.

7. How common is it that out-of-state producers designate only one or a small number of importers for their product? If this occurs, does it tend to be primarily for expensive wines and champagnes, or for more moderately priced items too?

B. SB 1211 - Since the provisions of the new statutes that would be created by this bill appears to be enforceable only by civil remedy by the aggrieved party, it would appear no regulatory responsibility would be fixed with the Department. Since the Department now processes and administers territorial agreements under existing law, no new responsibilities would be incurred in this regard. No new forms or filings would be necessary. We would, however, face the task of attempting to explain and interpret the provisions of the statutes in response to questions from the industry.

2. Anticipated Costs

A. SB 589 - There are over 1,200 licensees in California who have the privilege of importing wine. We estimate that approximately 700 do in fact import wine and that the remaining 500 import beer exclusively.

Based on past complaints and inquiries from the industry, we estimate that no less than twenty investigations per year would take place in connection with the "authorized importer" provisionsof the statute. Since the amount of evidence necessary to prove a violation is relatively small and fairly easily obtainable we estimate that the average investigation would require approximately 20 person hours plus another 5-7 hours if an administrative hearing is necessary. All considered, one investigator position could handle the increased workload assuming complaints are minimal and the Department's enforcement approach is a passive one.

A more aggressive enforcement policy where a regulation is promulgated, notices sent, brand owner files maintained and kept current, and a periodic inspection program implemented, would require a ½ clerical position and approximately two investigator positions.

With regard to the costs involved in administering the trade barrier certification, they would be proportional to the existence of information available to make the determination - i.e. if the federal government now maintains such information it is likely the additional workload could be assumed without an increase in staff. On the otherhand if it must be retrieved, correlated, analyzed, etc., it would be difficult now to determine the number of positions required to compile the information.

Our opinion of the direct effects on the approximately 50,000 retailers that sell wine in California is that

STATE OF CALIFORNIA

GEORGE DEUKMEJIAN, *Governor*

DEPARTMENT OF ALCOHOLIC BEVERAGE CONTROL
1901 BROADWAY, SACRAMENTO 95818
(916) 445-3221

RECEIVED
JAN 27 1986
Legislative Budget
Committee

January 24, 1986

Mr. William G. Hamm
Legislative Analyst
California Legislature
925 L Street, Suite 650
Sacramento, California 95814

Dear Mr. Hamm:

This is in reply to your letter of October 16, 1985, requesting our response to certain questions pertaining to Senate Bills 589 and 1211.

1. Administrative and Regulatory Responsibilities

   A. SB 589 - In order to enforce the prohibition on importations by non designated, non authorized importers, the Department would be required to determine the identity of the actual brand owner. Under a passive enforcement program where investigations are initiated only on the basis of complaints, the required information could be obtained by correspondence with the brand owner after his identity had been established.

      Under an active enforcement program, the promulgation of a regulation that requires all brand owners of wine to register the identity of all authorized importers with the Department would be done. Brand owners would also be required to keep this information current.

      As to the trade barrier certification provision, assuming the Department is assigned the responsibility of determining the existence and extent of trade barriers in the European Economic Community, the establishment of an information gathering and monitoring system would be necessary. It is not known at this time whether such trade barrier information in a form sufficient to allow certification by the Governor is available through the Federal Government. Gathering such information would at best require close liaison with other state and federal governmental agencies if the information is already being published. If it is not, a direct line system would be necessary in order to obtain the base data information from available sources.

However, we know of no studies or research data that would validate many of the arguments heard from both sides of this issue.

I trust this has been responsive to your letter. If we can be of further assistance, please feel free to call on us.

Sincerely,

Jay R. Stroh

Jay R. Stroh
Director

JRS:tnl

cc: Howard Gould
Business, Transportation and Housing Agency

STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 1799, SACRAMENTO, CALIFORNIA 95808)
Telephone (916) 445-3956

December 6, 1985

RECEIVED
DEC 9 1985
Joint Legislative Budget Committee

Mr. William G. Hamm
Legislative Analyst
925 L Street, Suite 650
Sacramento, CA 95814

Dear Mr. Hamm:

This is in response to your letter of October 16, 1985, regarding Senate Bill 589 and Senate Bill 1211 which were considered by the Legislature this past year but did not become law. Our comments are numbered to correspond to the questions in your letter:

1. The alcoholic beverage tax on beer is collected from manufacturers in this state when the beer is withdrawn from bond, and from importers when the beer is imported into California. Since beer is already tax-paid when it is sold by a manufacturer, importer, or broker to a beer wholesaler the provisions of SB 1211 regulating agreements between beer suppliers and beer wholesalers would have no effect on the administration of the alcoholic beverage tax.

   The alcoholic beverage tax on wine is collected from vintners in this state when the wine is withdrawn from Bond, and from importers when the wine is imported into California. Tax returns filed by wine importers are matched to information returns filed by common carriers. These same returns would be filed and matched, and our other compliance, auditing, and collection activities would be continued in the same manner regardless of any "primary source" restrictions placed on California wine importers. No new tax-related documents would be required. Consequently, the provisions of SB 589 would have no impact on Board operations.

2. The provisions of SB 589 and SB 1211 would have no significant effect on the Board's staffing, workload, or costs. Although the provisions of SB 589 might have some

APPENDIX H

ESTIMATES OF FISCAL EFFECTS MADE BY THE CALIFORNIA STATE BOARD OF EQUALIZATION

It will be very minimal. Retailers who would most likely oppose the bill are those that sell higher premium imports (specialty stores) and large volume warehouse outlets. For different reasons, both types of retailers do not want to lose the ability to negotiate directly with foreign market sources, bypass the exclusive or authorized U.S. importer, and arrange with a California importer/wholesaler to clear through U.S. Customs, wines already purchased on the open European Market.

The same relative effect would hold true at the wholesale level. If the bill is passed, small, independent importer/wholesalers would lose the potential for supplementing regular income by clearing periodic shipments for large chain buyers and specialty customers. The larger established, "authorized" importer/wholesalers would no longer continue to lose an unknown percentage of total wine sales to the smaller wholesalers.

B. SB 1211 - We do not envision any additional or significant costs to the Department that would result form the passage of this bill. Violations of the new chapter are remediable only by civil recourse and we see no requirement on the Department to investigate violations or impose penalties.

3. Effects on Prices

Since the California alcoholic beverage market is distinctly unique from other marketing areas of the nation, and because there exists no historical basis upon which to draw comparisons, we have no definitive opinion of how distilled spirits affirmation has effected prices. The same holds true for the effect on the number of total available wholesalers. Logic together with a basic understanding of marketing principles would suggest that fewer importers correlates to higher prices because the authorized importers must share advertising and merchandising costs with their brand owners and establish distribution networks satisfactory to those brand owners. This necessarily results in overhead expenses which are passed on.

Importers/wholesalers who are able to obtain fast moving brands are able to sell the product for less money because they do not have the shared responsibility with the brand owner for merchandising and promoting the product that the importers must abide by.

effect on the composition of wine importers, we doubt that the aggregate number of importers would change significantly. It should be noted that the administration of the tax on imported wine is a very small program. There were only 1521 beer and wine taxpayer licenses in effect on June 30, 1985, and most of these were in-state beer manufacturers, in-state vintners, and beer importers. The total annual revenue from the tax on wine is less than $5 million and relatively little of this is from imported wine.

3. We do not believe that the provisions of SB 589 and SB 1211 would affect sales and use tax or excise tax revenues from alcoholic beverages. Such revenue is a function of alcoholic beverage consumption and the effectiveness of tax administration. The provisions of these bills would not make it easier to trace beverage transactions and would not otherwise affect the administration of the taxes involved.

4. We do not believe that the "primary source" requirement for distilled spirits has made it easier to collect the full amounts of excise tax and sales and use taxes owed on distilled spirits. The sales tax is collected on retail sales and the distilled spirits tax is collected on sales by wholesalers to retailers. Distilled spirits are tracked from the time they are manufactured in this state, or imported into this state, until they are sold to a retailer. Consequently, regulation of the source of distilled spirits is irrelevant to the administration of the tax.

I hope that this information is helpful to you. If you have any further questions, please let us know.

Sincerely,

Douglas D. Bell

Douglas D. Bell
Executive Secretary

DDB:kw
cc: Mrs. Margaret Boatwright

APPENDIX I

COMPUTATIONS OF POTENTIAL FISCAL EFFECTS

APPENDIX I

COMPUTATIONS OF POTENTIAL FISCAL EFFECTS

In order to provide an illustration--not an estimate--of a primary source law's potential effects on state revenues, assumptions are necessary regarding:

- The level of prices of gray marketed wines and other wines whose prices would be affected by a primary source law (that is, the "average price" factor), and the extent to which these prices would rise under a primary source law (that is, the "price increase" factor).
- The extent to which the physical sales volume would decline for wines whose prices rise due to a primary source law (that is, the "price elasticity" factor).

Based on the survey data which we collected, together with other research findings and basic economic theory, we believe it is reasonable to assume that:

- The portion of total imported wines that either are being gray marketed now or could go up in price if a primary source requirement was imposed, falls in the range of 20 percent to 40 percent for champagnes, and 3 percent to 10 percent for nonchampagne wines;
- The price of wines affected directly or indirectly by a primary source law would increase anywhere from 5 percent to 25 percent;
- The "average price" of wines affected by a primary source law would range from $15 to $25 per bottle in the case of champagnes, and from $8 to $18 per bottle in the case of nonchampagne wines;

- The price elasticity of demand for affected wines would range from 0.5 to 1.5 (that is, for each 1 percentage point increase in their prices, demand for these wines would decline by between 0.5 and 1.5 percentage points); and
- The extent to which reduced (increased) expenditures for those wines directly affected by a primary source law are offset by increased (reduced) expenditures on other wines and/or nonwine items, would range from zero to 80 percent. (Thus, for example, if an average consumer's spending on affected wines rose by $200, his response would range anywhere from making no change in his expenditures on other items to reducing them by $160.)

Results

Table I-1 shows what the direct effects of a primary source law for wines would be on state revenues, given the assumptions listed above. It indicates that the revenue effects would range from a loss of nearly $850,000 per year to a gain of around $700,000 per year, depending upon the particular scenario.[1] The table also shows that:

- In the majority of scenarios, the direction revenue effect is negative. In fact, positive revenue effects occur only when the "price elasticity" factor is low, and even in these cases the negative effects disappear when the "expenditure offset" rate is high.[2]
- The sheer magnitude of the revenue effect becomes smaller as the "expenditure-offset" rate becomes higher. For example, Table I-1 shows that the annual revenue loss associated with a "price

Table I-1

Effect of a Primary Source Law on State Revenues Under Alternative Assumptions

Assumptions Regarding Share of Imports and Average Prices of Affected Imported Wine Brands			Average Increase in Prices of Affected Imported Wine Brands	Direct Annual State Revenue Effect (dollars in thousands)[a]											
				Expenditure-Offset Rate[b]											
				0%			20%			50%			80%		
	Affected Share[c]	Average Price[d]		Price Elasticity[e] 0.5	1.0	1.5	Price Elasticity[e] 0.5	1.0	1.5	Price Elasticity[e] 0.5	1.0	1.5	Price Elasticity[e] 0.5	1.0	1.5
A. Low Share															
Champagnes	20%	$25	25%	544	-31	-607	340	-31	-402	117	-31	-180	-6	-31	-57
Other wines	3	18	15	327	-19	-364	204	-19	-241	70	-19	-107	-4	-19	-34
			5	109	-6	-121	68	-6	-80	23	-6	-36	-1	-6	-11
B. Survey-Based Share[f]															
Champagnes	30	20	25	625	-47	-720	387	-47	-481	127	-47	-221	-16	-47	-78
Other wines	5	12	15	375	-28	-432	232	-28	-289	76	-28	-132	-10	-28	-46
			5	125	-9	-144	77	-9	-96	25	-9	-44	-4	-9	-15
C. High Share															
Champagnes	40	15	25	713	-64	-842	439	-64	-567	138	-64	-267	-28	-64	-101
Other wines	10	8	15	428	-39	-505	263	-39	-340	83	-39	-160	-17	-39	-60
			5	143	-13	-168	88	-13	-113	27	-13	-53	-6	-13	-20

a. Includes direct state revenues from California's alcoholic beverage excise tax on wine and general sales and use tax. Excludes direct local sales and use tax revenues, and indirect state revenue effects such as from the personal income tax and bank and corporation tax.

b. Represents (i) the percent of the decrease (increase) in expenditures on primary-source-affected imported wines that results in a partially offsetting increase (decrease) in expenditures on other imported and domestic wines, and (ii) the percent of the remaining difference that results in a partially offsetting increase (decrease) in expenditures on nonalcoholic-beverage products subject to the sales and use tax.

c. Share of import volume for each category of wine that experiences price increases directly attributable to a primary source requirement. The total import volumes to which these percentages are applied in the revenue-effect computations are 717,100 cases for sparkling wines and champagnes, and 5,753,000 cases for other wines (these figures are estimates of 1984 consumption as published in Jobson's Wine Marketing Handbook, 1985 edition, page 39). One case of wine equals on the average about 2.8 wine gallons, while a gallon is equivalent to about five 750-milliliter bottles.

d. Average price per 750 milliliter bottle.

e. Defined as the percentage decline (increase) in the quantity of wine demanded in response to a 1 percent increase (decline) in the price of wine. Total expenditures on a product will, in response to a price increase, rise if price elasticity is less than unity, remain unchanged if elasticity equals unity, and fall if elasticity exceeds unity.

f. Based upon survey responses from California wine importers, wholesalers, retailers, and producers, as discussed in Chapter III.

increase" factor of 15 percent, a high "affected share" factor, and a "price elasticity" of 1.5, declines from $505,000 to $60,000 as the "expenditure offset" factor rises from zero to 80 percent.

No one can say with absolute certainty exactly what the correct assumptions are regarding affected shares, average prices, price increases, elasticities, and expenditure offsets. However, based on our survey data, other research information and economic theory, we believe that it is most realistic to assume that the expenditure-offset rate will be at least 50 percent, and the price-elasticity factor will be at least equal to unity.[3] Given this, the data in Table I-1 lead us to conclude that:

- The revenue effects will be negative, and
- The annual magnitude of these revenue losses would range from a relatively negligible amount up to a couple hundred thousand dollars, depending on the specific assumptions used.

Our own belief is that the expenditure-offset rate could easily be closer to 80 percent than 50 percent, given that wine collectively has a somewhat inelastic demand (discussed in Chapter V).[4] In this case, Table I-1 indicates that a maximum revenue loss of about $100,000 annually would occur.

Footnotes to Appendix I

1. The revenue effects shown in Table I-1 do not include the effects on local sales tax revenues. On a statewide basis, these local sales tax revenue effects amount to about 32 percent of the state sales tax revenue effect.
2. Positive revenue effects only occur when increased sales tax revenues are sufficiently large to offset reduced excise tax revenues. In order for sales tax revenues to rise, wine-related expenditures would have to rise in response to wine price increases. This would occur if the affected wines are "price inelastic."
3. It was not possible for us to estimate the price elasticity of demand for gray market wine imports because industry representatives did not provide us with their estimates of total wine imports by brand, or how their individual prices and sales volumes have responded to gray marketing. Some imported wines undoubtedly are price inelastic. However, many of the importers, retailers and other wine-industry participants indicated to us during the course of our research that they had observed many cases of "price elastic" wine products, for which substantial sales volume increases had occurred due to gray market price reductions.
4. A relatively high expenditure-offset rate is especially likely to the extent that individual wine brands are fairly price elastic while total wine demand is fairly price inelastic, since this implies a high degree of interbrand substitutability. A high expenditure-offset rate is also likely when consumers view wine expenditures as only one part of some fairly fixed portion of their budget that they are willing to regularly allocate for various eating and entertainment-type purposes.