THE IMPACTS OF SB 1211 ON CALIFORNIA CONSUMERS, THE BEER INDUSTRY, AND STATE GOVERNMENT

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PREFACE

This report was prepared 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 1211. This bill contains various provisions relating to the distribution of beer in California. Specifically, these provisions relate to the required granting of exclusive beer distribution territories for wholesalers, and the regulation of beer distribution contractual requirements between suppliers, wholesalers and retailers.

The required objective of the "citizen cost" impact study is to ascertain how the bill's provisions would affect beer suppliers, wholesalers, retailers and consumers, including any changes in beer sales and beer prices that would result from the measure.

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

Senate Bill 1211 (Dills) contains a number of provisions which would affect the way that beer is distributed in California, as well as the contractual relationships that beer suppliers have with beer wholesalers. Specifically, the bill contains requirements regarding the granting of exclusive beer distribution territories to individual beer wholesalers for the brands they carry, prohibits wholesalers from selling beer to retailers who subsequently "transship" beer into neighboring wholesaling territories, requires that wholesalers provide retailers with specified services, and provides wholesalers with certain contractual safeguards.

The purpose of this study is to identify the effects that these provisions would have on consumers, industry and government.

THE CALIFORNIA BEER MARKET

In 1984, Californians purchased and consumed nearly 640 million gallons of beer, or an average of about 24 gallons per person. This consumption generated over $4 billion in retail sales, and about $300 million in direct revenues to California's state and local governments. In the beer wholesaling industry alone, there were over 5,700 employees. Thus, the beer industry clearly is a significant source of economic activity in California.

About 93 percent of the beer sold in California is produced by the six major-domestic brewers, with Anheuser-Busch accounting for over 50 percent of the total. The remaining 7 percent involves minor-domestic and foreign brands. This beer is sold at some 57,000 licensed retail establishments throughout California, including chain retail stores

(40 percent of total beer sales), non-chain retail outlets that sell for off-site consumption (40 percent of sales), as well as bars, restaurants and the like that sell for on-site consumption (20 percent of sales).

HOW BEER IS DISTRIBUTED FROM SUPPLIERS TO RETAILERS

Beer is distributed in California from suppliers to retailers in one of three different ways:

- By "traditional" wholesalers, who deliver beer directly to their retail customers and perform such services for them as shelf maintenance and removal of outdated beer;
- By large-volume wholesalers, who deliver to the central warehouses of large retail-chain organizations which in turn use their <u>own</u> internal distribution systems to place the beer into their stores; and
- By brewers, who choose to sell beer <u>directly</u> to retailers and thus circumvent the wholesaler network entirely.

The vast majority (over 95 percent) of all beer sold in California is distributed through the first approach--by "traditional" wholesalers who make direct deliveries to individual retail accounts. This system is commonly referred to in the industry as the "three-tier" distribution system, and is widely used in most other states as well.

One of the key aspects of this three-tier system is that beer producers or their agents assign individual wholesalers their <u>own</u> geographic territories in which to operate. Depending on the brand involved, these territories can range anywhere in size from the entire state to a subregion of a county, and can have as many wholesalers operating within them as a brewer desires. However, over 90 percent of California beer is sold on an exclusive-territory basis, under which a brewer gives each of his wholesalers his own exclusive geographic distribution area. Although this practice is not currently followed by most minor-domestic brewers and foreign brewers, it is used by all of the largest beer producers whose products are sold in California.

OTHER FEATURES OF THE BEER DISTRIBUTION SYSTEM

Regardless of the exact type of distribution system or territorial assignments used for beer, state law requires that all beer wholesalers regularly "post" the prices they charge with the California Department of Alcoholic Beverage Control, and prohibits quantity-based wholesale price discounts to retailers. In addition, pooled-buying of beer by retailers is effectively prohibited. (None of these provisions apply to the sale of other types of alcoholic beverages in California, such as wines and distilled spirits.) California does not require, however, that wholesalers sell beer to some minimum percentage of the retail establishments in their assigned territories, or provide specific services to the retailers they do serve, such as shelf maintenance and removal of outdated beer.

WHAT SB 1211 WOULD DO

Senate Bill 1211 would establish a number of statutory requirements regarding the way that beer is distributed and the contractual relationships between beer suppliers, wholesalers and retailers. Specifically, Senate Bill 1211 would, among other things:

- Require each beer supplier (that is, a brewer or its agent) to grant each wholesaler an exclusive sales territory for specific brands of beer. (Currently, 26 other states require such exclusive territories, while 1 state prohibits them.) However, nonexclusive territories that existed on January 1, 1985, would not have to become exclusive until only one of the territory's current wholesalers remains in business.

- Prohibit a wholesaler from selling beer to a retailer if the wholesaler knows, or reasonably believes, that the retailer intends to resell the beer to consumers from outlets located outside the wholesaler's exclusive sales territory.
- Require beer wholesalers and suppliers to offer their products generally to all retailers within their territorial areas, and specifically prohibit wholesalers and suppliers from refusing to sell beer to a retailer because the purchase request is not large enough.
- Limit the circumstances under which a beer supplier may terminate, cancel, or modify a distribution agreement with a wholesaler.
- Specify certain services (including stock rotation, cleaning of tap equipment, and so forth) which a beer wholesaler or beer supplier must provide to a retailer who has purchased beer directly from that wholesaler or supplier.

By and large, most of SB 1211's provisions are consistent with the beer distribution practices that the major-domestic brands (over 90 percent of the market) already presently follow. SB 1211's provisions, however, differ in a number of important respects from the beer distribution practices of the minor-domestic and foreign brands. Consequently, not all firms and consumers would be equally affected by the bill.

THE POTENTIAL ECONOMIC EFFECTS OF SB 1211

We used a variety of approaches in trying to develop a reasonable picture of what the economic impacts of SB 1211's provisions might be. Specifically, we:

- Reviewed the findings of previous research studies that have sought to assess the effects of exclusive territories and beer-servicing requirements.
- Surveyed other states in order to determine if they have provisions similar to SB 1211's and, if so, what economic and fiscal impacts these provisions have produced.
- Conducted our own broad-scale surveys of firms involved in the California beer industry, in order to develop an accurate picture of exactly how the industry operates and would be affected by SB 1211.

Admittedly, these approaches did not provide us with crystal-clear evidence about the effects of SB 1211. However, based on the weight of the evidence from these efforts and the basic principles of economic theory, our analysis indicates that eventually SB 1211 would probably tend to do the following:

- Place upward pressures on the prices paid by consumers for beer, at least for some of the minor-domestic beer brands and foreign beer brands and, very possibly (though to a lesser degree), for major brands as well. These upward price pressures will arise for a variety of reasons, including the effects SB 1211 would have on increasing beer wholesaling costs and reducing price competition in certain circumstances.

- Limit the ability of chain-store retailers to use central warehousing and their own internal distribution systems for beers, thereby raising their costs and reducing the efficiency of their operations.
- Limit, and possibly reduce somewhat, the number of beer wholesalers operating in the state.
- Adversely affect certain beer wholesalers that currently deliver only to large-volume accounts, by forcing them to deliver to certain smaller accounts as well, thereby raising their costs and making them less competitive.
- Cause some consumers to indirectly subsidize other consumers, and shift business from some wholesalers to others.
- Provide increased security for existing beer wholesalers, especially those who handle most minor-domestic and foreign brands. These benefits, however, would in many cases tend to come at the expense of other firms in the beer industry, such as new beer wholesalers attempting to compete in the marketplace.

In addition, we find no reason to believe that the bill would significantly improve the overall quality of beer products, such as their freshness. Nor do we believe that it would yield significant benefits to consumers in the form of improved beer selection and availability.

The above-identified likely impacts of SB 1211 might not occur immediately; however, at some point in time, it is likely that they would eventually begin to materialize.

THE POTENTIAL FISCAL EFFECTS OF SB 1211

The likely fiscal effects of SB 1211 would be:

- Lower revenues to state government. These revenue losses would show up in the form of reduced beer-related excise taxes and sales, and use tax collections. It is impossible to accurately predict the exact amount of these losses. However, calculations using a set of reasonable assumptions suggest that there could be a net negative impact on the state's General Fund of between $160,000 and $450,000 annually.

CONCLUSION

Given the above, we conclude that the likely net impact of SB 1211 would be to leave California beer consumers as a whole, and the state government, worse off than they would be without such a bill. While certain individuals and firms would benefit from the bill, these benefits would, to some degree, be achieved at the expense of other individuals and firms that would be negatively affected by the bill's requirements.

Thus, in summary, we conclude that the net effect of SB 1211 on the state's consumers would be negative. The bill also would probably result in a modest loss in governmental revenues.

CHAPTER I

INTRODUCTION

During 1985, a bill was introduced in the California Legislature to impose certain regulations on the distribution of beer in California. This bill--SB 1211 (Dills)--would do three things:

- First, it would require each beer supplier (that is, the manufacturer or brand owner) to grant each of his wholesalers an exclusive geographic sales territory, subject to the constraint that any existing nonexclusive territories would be allowed to remain so until all but one of its current wholesalers are no longer in business.
- Second, it would prohibit a wholesaler from selling beer to a retailer if the wholesaler knows (or reasonably believes) that the retailer intends to resell the beer to consumers located outside the wholesaler's exclusive sales territory.
- Third, it would impose certain contractual and service requirements on beer suppliers and wholesalers. For example, the bill would (a) require wholesalers to offer their brands to retailers "generally", regardless of the size of their order, (b) limit the circumstances under which a beer supplier could terminate a wholesaler, and (c) require that the seller provide certain services to the retailer, such as removing outdated beer from stores.

The stated purpose of SB 1211 is to "promote fair, efficient, and competitive distribution of beer." During the legislative hearings on SB 1211, however, there was considerable disagreement over the probable economic effects of the bill. According to the bill's proponents, the measure is needed to protect beer wholesalers, who often have invested large sums of money in their distribution trucks and warehouses, from the unfair termination of their contracts with brewers. In addition, the proponents argue that the measure is needed to protect the "quality" of the beer that consumers buy in stores, by ensuring that there will be regular cleaning of beer taps and removal of outdated beer that has become stale.

In contrast, opponents of SB 1211 argue that the bill would simply grant wholesalers monopoly distribution rights, and thereby raise prices to the consumer without yielding any offsetting benefits to the public.

Senate Bill 1211 was introduced in May 1985. At the time this report was prepared, the measure had been approved by the Senate and was pending in the Assembly.

THE PURPOSE OF THIS REPORT

In June 1985, the Senate Rules Committee directed the Legislative Analyst to prepare a "citizen cost" impact study of SB 1211. The purpose of this study is to resolve the disagreements regarding the potential economic effects of SB 1211 that arose during the hearings. Specifically, Senate Rules Committee Resolution No. 681 requires that, pursuant to Joint Rule 37.1, the Legislative Analyst shall prepare a study of SB 1211 which does the following:

- Ascertains the impact of SB 1211's supplier-wholesaler provisions on both major suppliers and smaller ones.
- Ascertains the impact of these provisions on both the domestic and imported beer markets.
- Ascertains how the bill might change both the prices which beer consumers in California are charged, and the number of beer wholesalers operating in California.

This report constitutes our response to the citizen cost impact study requirement.

ORGANIZATION OF THE REPORT

The remainder of this report is divided into six chapters.

Chapter II presents general background information on the California beer market which is relevant in analyzing the potential effects of SB 1211. Specifically, the chapter discusses the size of the California beer market, the number and market shares of individual brands available in this market, the alternative ways in which beer is distributed from the producer to the consumer, and the general characteristics of the beer distribution arrangements between suppliers and wholesalers. In addition, this chapter summarizes existing California laws and regulations that govern beer distribution activities in the state.

Chapter III discusses the specific provisions of SB 1211, including the requirement that wholesalers be given exclusive distribution territories, and the various contractual provisions which would be mandated for beer suppliers, wholesalers and retailers. This chapter also identifies the extent to which provisions similar to those in SB 1211 have been adopted elsewhere.

Chapter IV identifies the basic economic issues raised by SB 1211, including what economic theory suggests would be the economic effects of the measure on beer suppliers, wholesalers, retailers, and consumers.

Chapter V then discusses what empirical evidence exists regarding the effects of provisions similar to those in SB 1211, including the experience of other states that have adopted these provisions.

Chapter VI discusses the potential fiscal effects of SB 1211 on state government, including its effects on alcoholic beverage tax revenues, general sales and use tax revenues, and administrative, regulatory and tax-collection costs 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 conclusions.

CHAPTER II

THE CALIFORNIA BEER MARKET

This chapter provides background information on the beer market in California. Specifically, it discusses (A) what products are sold in the "beer" market, (B) the size and scope of the beer industry in California, including the market shares of different beer-making companies, (C) the different ways that beer is distributed from brewers to consumers, (D) the types of distribution agreements entered into by brewers and beer wholesalers, and (E) the laws and regulations that govern beer-distribution activities in California.

A. WHAT IS "BEER"?

The term "beer" is the generic name for alcoholic beverages made by fermentation of extracts derived from cereal grains or other starchy materials, in combination with hops, water and yeast. Beer is one of the oldest alcoholic beverages known to man. It dates back over 6,000 years and has been made by, among others, the ancient Assyrians, Babylonians, Chinese, Egyptians, Greeks, Romans, and Teutons.

In order to make most beers, brewers first mix barley malt with water and grains such as corn and rice.[1] This mixture is then heated so as to convert the starches found in the grains into sugar. Next, the excess grain is removed from the mixture and the liquid is boiled with hops to provide additional flavor. Following this, yeast is added to the mixture, which causes fermentation (the conversion of sugar into alcohol) to begin.

After fermentation, the beer is aged in tanks for several weeks or months to improve its taste, and then is filtered and packaged into barrels, bottles and cans.

The most popular beers in the United States are "lager" beers, which are of German origin. Lagers are light in color (generally golden), highly carbonated, and normally have an alcohol content of about 3 percent to 3.8 percent. They are made using a bottom-fermenting yeast strain, which falls to the bottom of the container when fermentation is complete. These beers include Pilsener, Dortmund, Munich, California steam beer, malt liquor and light beer. In addition, there are top-fermenting nonlager beers, which have a much stronger flavor than lagers and an alcoholic content in the 4 percent to 6.5 percent range. These beers, which include ale, porter, stout, and bock beer, release carbon dioxide during fermentation, which rises to the surface and forms a "head." Most lager and nonlager beers produced in the United States are pasteurized to ensure their preservation.

B. SCOPE AND SIZE OF THE CALIFORNIA BEER MARKET

In 1984, Californians purchased and consumed nearly 640 million gallons of beer, or an average of about 24 gallons per person. Although the state's per capita beer consumption has been dropping slightly in recent years, it is on a par with the national average. Beer sales in California totaled over $4 billion in 1984. About 40 percent of these sales occur in chain stores, another 40 percent occur in independent off-sale establishments (that is, for consumption <u>off</u> the retail premises), and the remaining 20 percent occur in on-sale locations (that is, where beer is consumed <u>on</u> the premises).[2] Clearly, the beer industry is a not-insignificant source of economic stimulus for the state.

Beer sales also directly generate revenues for California's state and local governments, including some $275 million in sales and use tax revenues, $25 million in alcoholic beverage excise tax revenues, and various other collections related to the state's personal income tax, corporate profits tax, and motor-vehicle-related levies.

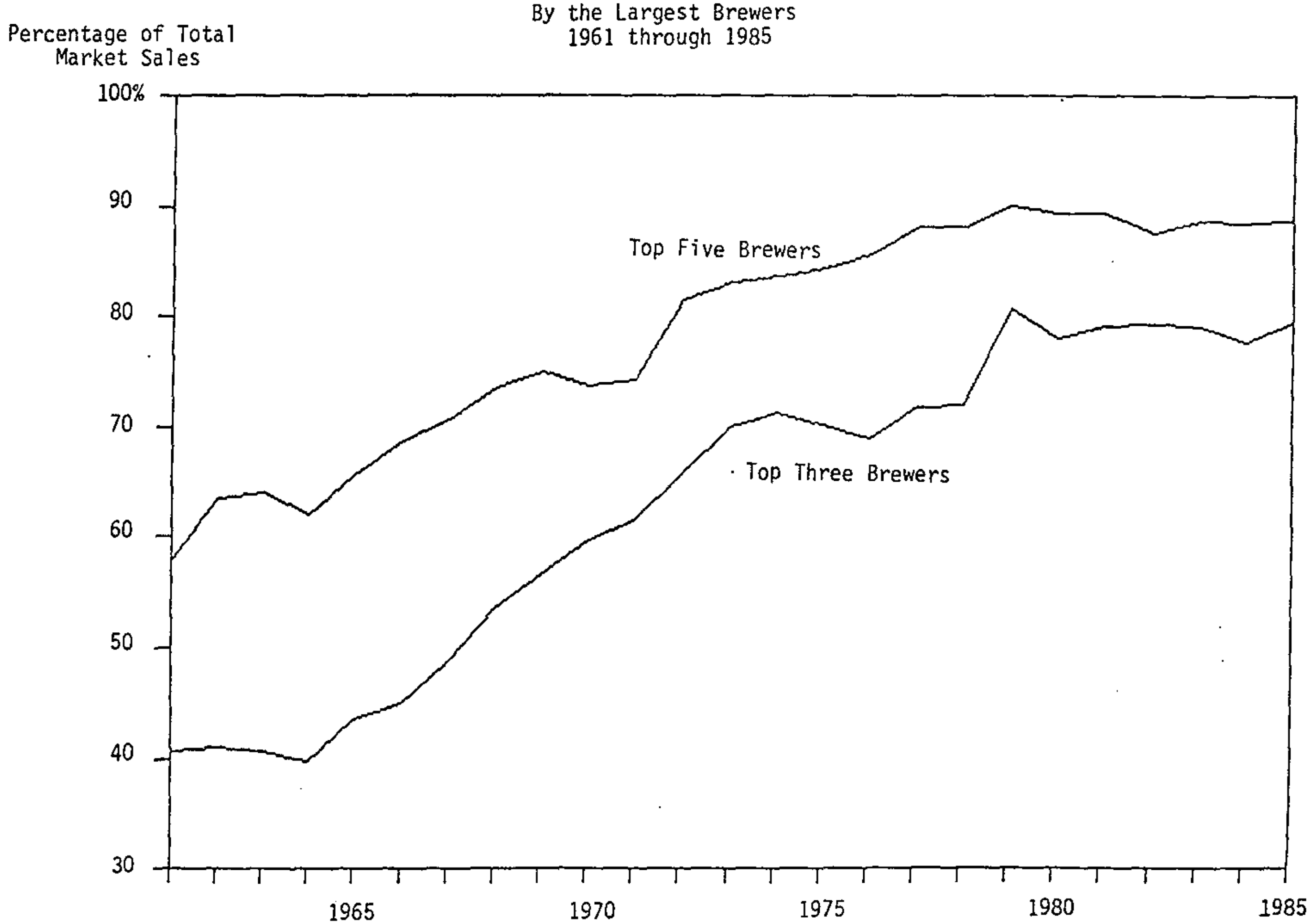
Market Concentration Amongst Beer Producers

Although there are dozens and dozens of individual beer brands sold in California, a few brewers account for most of these sales. As shown in Table II-1:

- Just one firm--Anheuser-Busch--accounts for over 50 percent of California beer sales.
- The top three firms--Anheuser-Busch, Adolph Coors, and Miller--account for 80 percent of California beer sales.
- The top six firms account for over 93 percent of sales.

Figure II-1

Total California Beer Sales
By the Largest Brewers
1961 through 1985



Source: California Brewers Association and United States Brewers Association Statistical reports.

Table II-1

Shares of California Beer Sales, By Brewer 1981 through 1985[a]

Brewer	1981	1982	1983	1984	1985[b]
Anheuser-Busch	46.6%	48.9%	50.6%	50.4%	51.3%
Adolph Coors	19.7	17.8	16.1	13.9	14.4
Miller	12.9	12.6	12.4	13.5	13.8
Stroh/Schlitz	4.8	4.1	4.4	6.0	5.7
General Brewing/Pabst/Olympia	6.5	6.6	6.7	5.8	4.5
G. Heileman/Blitz-Weinhard	4.6	4.8	4.1	4.0	3.5
Other Domestic Brands	1.2	0.7	0.6	0.4	0.6
Imported Brands	3.7	4.5	5.1	6.0	6.2
Totals	100.0%	100.0%	100.0%	100.0%	100.0%

a. Source: U.S. Brewers Association, Statistical Report, published monthly.
b. Based on partial-year data from January 1985 through August 1985.

Thus, market concentration in the California brewing industry is quite high. The same is true nationally, given that the combined market share of the four leading beer suppliers exceeds 80 percent in most states.[3] As shown in Figure II-1, the degree of market concentration in California has remained relatively stable since about 1980, after rising dramatically during the preceding 20 years.[4] Even so, the state's single largest supplier--Anheuser-Busch--has continued to expand its own market share since 1980.

Table II-1 also indicates that:

- Imported beers have captured a growing market share in recent years. In 1960, imported beers accounted for less than 1 percent of California sales, whereas their share now exceeds 6 percent.[5]

As we shall see later, the imports' growing market share is of special significance within the context of SB 1211. This is because the distribution methods used for imported brands often differ from those used for the major domestic brands. It is these brands that would be relatively more affected by SB 1211's provisions.

C. HOW BEER IS DISTRIBUTED FROM BREWERS TO RETAILERS

Beer is delivered from producers to California retailers in three different ways:

(1) By "traditional" wholesalers who deliver directly to the stores in which the beer is sold to consumers.

(2) By wholesalers who deliver to the central warehouses of large multi-outlet retail chains which, in turn, use their own internal distribution systems to put the beer into their stores.

(3) By brewers who choose to sell their beer directly to retailers (generally to those retailers' central warehouses), and thus bypass the wholesaling network entirely.

Each of these distribution methods is briefly described below.

1. "Traditional" Wholesalers

Nearly all of the beer sold in California is distributed using "traditional" wholesalers who service individual store locations and act as intermediaries between beer producers and retailers. This setup, commonly known as the "three-tier" system, dates back several decades and is widely used throughout the United States. In some states, it is even legislatively mandated. Altogether, traditional wholesalers accounted for about

95 percent of the $2.5 billion in wholesale beer sales recorded in California during 1984.

These wholesale distributorships come in all sizes. Most are smaller businesses with under 20 employees; some, however, are quite large. The total number of California beer wholesalers is a bit over 200, and has not changed much in the past five years. These firms employ about 5,700 people.

Normally, wholesalers enter into contracts with brewers that detail the services which the wholesaler will provide for the brewer and the geographic territory which it will serve. In return, the brewer promises to supply the wholesaler with beer. As discussed below, wholesaler-brewer contracts also contain provisions regarding the conditions under which the contract may be terminated.

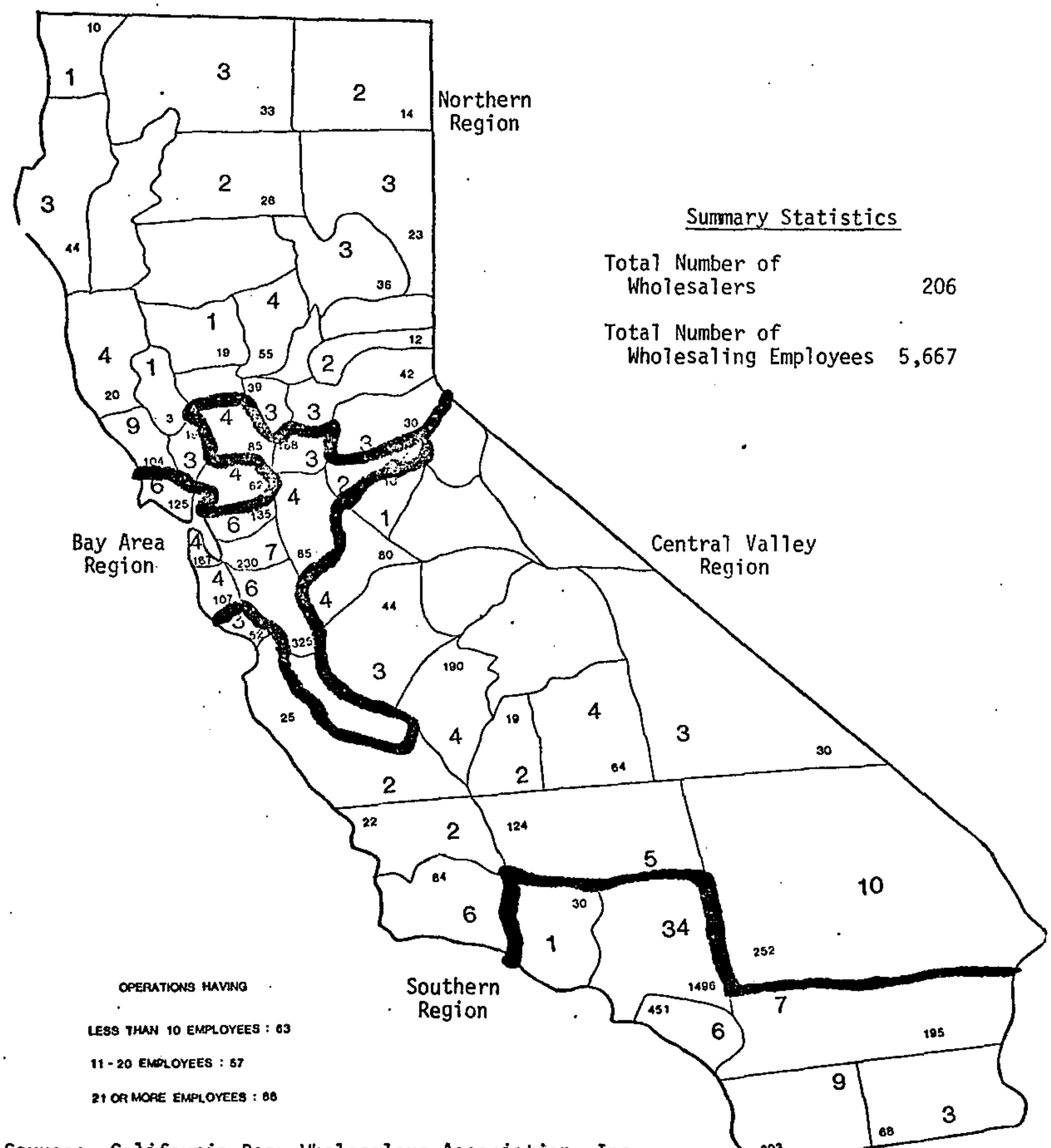
Most "traditional" wholesalers carry the brands of two or three domestic brewers. The major-domestic suppliers (including Anheuser-Busch, Coors, Miller, and Stroh) all grant their individual wholesalers exclusive geographic distribution territories, which generally encompass parts of one or two counties, depending on whether the area is urban or rural. About 90 percent of the beer sold in California is distributed in this fashion, meaning that a particular brand is available to a retailer from only one wholesaler. In contrast, the brewers of minor-domestic and foreign brands often assign their wholesalers to nonexclusive territories, thereby allowing competition between wholesalers over sales of the same brand. (Competition involving sellers of the same brand is called "intrabrand" competition; in contrast, competition between different brands is called "interbrand" competition.)

The number of beer wholesalers operating in different areas of California is shown in Figure II-2. It indicates that although there are over 200 beer wholesalers operating in California, the number of wholesalers operating in many of the geographic subregions of the state is very small. This naturally raises the question of how vigorous price competition is within the beer industry.

We discuss this issue of price competition in detail later on. At this point, we simply note that there are very limited price differentials among the major brands in California, while the prices charged for a particular minor-domestic or foreign brand can vary. This is illustrated in Table II-2, which covers a sample of brands. These data do not necessarily indicate that price competition is lacking among major brands handled by traditional exclusive-territory wholesalers. Before reaching this conclusion, one would have to adjust for factors such as differential transportation costs, average delivery size, and other factors that would affect costs in a competitive market. Nevertheless, it seems clear that, at the very least, different pricing mechanisms appear to exist in these two beer submarkets.

Figure II-2

Approximate Number of Beer Wholesalers Operating
In Different Parts of California
(As of 1980)



Summary Statistics

Total Number of Wholesalers	206
Total Number of Wholesaling Employees	5,667

Source: California Beer Wholesalers Association, Inc.
Data are as of 1980; however, the association indicates that the number of California wholesalers has been relatively unchanged since that date. "Large" numbers on the map represent the number of wholesalers in each delineated area, while the "small" numbers represent the number of employees for wholesalers in the specified area.

Table II-2

Selected Survey Data for Beer Prices, by Brand [a]

County	Major-Domestic Brands			Minor-Domestic and Foreign Brands			
	Budweiser	Miller	Coors	Henry Weinhards	Pabst	Becks	Kirin
Alameda	$9.25	$9.25	$9.25	NA	$8.02-8.79	$14.03-15.95	$12.50
Contra Costa	9.25	9.25	9.25-9.30	$10.25	8.02	14.03-15.95	14.50
Fresno	9.27	9.30	9.30	10.20	8.02-8.65	14.03-15.95	16.50
Humboldt	9.25	9.30	9.30	NA	8.02-8.02	14.03-15.95	16.25
Kern	9.15	9.15	9.15	10.00	8.05	14.03-15.95	NA
Lassen	9.30	9.35	9.35	10.20	7.45-8.02	14.03-15.95	NA
Los Angeles	9.05-9.15	9.05	9.10-9.15	9.80-10.00	8.05-8.85	14.03-14.25	12.50
Sacramento	9.25	9.25	9.30	10.20	8.02	14.03-15.95	14.50
San Diego	NA	9.15	9.20	NA	8.05-8.95	14.03	14.50
San Francisco	9.15	9.15	9.50	10.20	8.02	14.03-15.95	12.50
Santa Barbara	9.08-9.15	9.08	9.15	10.00	8.05	14.03	NA
Santa Clara	9.15	9.15	9.20	9.60-10.30	8.02	14.03-15.95	NA
Shasta	9.25	9.25-9.58	9.30	10.25-10.48	8.02-9.15	14.03-16.10	16.25-17.85
Sonoma	9.25	9.25	9.30	NA	8.02	14.03-15.95	13.25
Tehama	9.25	9.25	9.30-9.35	10.25	8.02-9.15	14.03-15.95	16.25-17.85
Ventura	9.08	9.08	9.15	8.85	8.05-8.40	14.03-14.25	NA
Price Range, By Brand	$9.05-9.30	$9.08-9.58	$9.10-9.35	$8.85-10.48	$8.02-9.15	$14.03-15.95	$12.50-17.85
Size of Price Range in Percentage Terms [b]	2.8%	5.5% [c]	2.7%	18.4%	14.1%	13.7%	42.8%
Average Percentage Variance:		3.7%				22.3%	

a. Prices shown were derived from price posting sheets filed by beer wholesalers with the Department of Alcoholic Beverage Control. Prices are for a delivered case (4 "sixpacks") of nonreturnable 12-ounce bottles as of approximately January 1, 1986: Counties shown were selected to provide a representative sample of rural and urban locations throughout California.

b. Equal to the dollar price difference between the high and low price posted for a brand, computed as a percent of the low price listed for the brand.

c. If the wholesaler charging $9.58 per case in Shasta County is excluded, the price range for Miller becomes 3.0 percent and the average price range for major-domestic brands becomes 2.8 percent.

2. Central-Warehouse Wholesalers

At least a dozen or so wholesalers make periodic deliveries to the central warehouses of large retail chain stores. This constitutes the second method used to distribute beer in California.[6] All but one of these firms, however, are wholesalers whose primary activity involves traditional retail store deliveries--not central-warehouse deliveries. The one exception is a firm called Beverage Distributors Inc. (BDI), most of whose business involves central-warehouse deliveries. Beverage Distributors Inc. has roughly 1 percent of the California wholesale beer market, and carries only the brands of minor-domestic and foreign brewers. Virtually none of the brewers supplying BDI use a wholesale distribution system based upon exclusive territories. Although BDI's distribution territory is statewide, in many cases the firm doesn't deliver even as far as the central warehouses of retailers. Rather, most of its sales are made directly from its loading dock to the delivery trucks of its retailer customers. However, the firm does maintain a sales staff which visits individual stores to provide point-of-sale service for the brands it handles, such as shelf maintenance.

The operators of chain-store central warehouses often deliver the beer they receive to stores located beyond the boundaries of wholesalers in whose territories the warehouses themselves are located. Accordingly, wholesalers with exclusive distribution territories generally will not deliver the beer they handle to central warehouses. In fact, suppliers of "exclusive" brands often specifically prohibit wholesalers from delivering to central warehouses.

3. Distribution Systems That Do Not Involve Wholesalers

A small percentage of beer sold in California currently is distributed to retailers directly by the brewer. The only company that appears to do this on a regular basis is General Brewing. Its direct sales usually are made only to central warehouse facilities, not to individual store outlets. Other brewers do not favor direct sales to retailers because it restricts their ability to control such point-of-sale merchandising activities as preferential cold box positioning, which they rely on wholesalers to carry out. Certain retailers, on the other hand, have expressed an interest in direct distribution, since they believe it would permit them to sell beer more cheaply if the traditional wholesaling network could be circumvented. Whether direct distribution will become more attractive to brewers and retailers in the future will depend, in part, on their ability to work out a mutually agreeable means of providing point-of-sale services.

D. THE CHARACTERISTICS OF BEER DISTRIBUTION AGREEMENTS

In order to get a picture of the contractual agreements entered into by beer suppliers and wholesalers, we either contacted or reviewed material prepared by the United States Brewers Association, individual beer producers, and the majority of beer wholesalers active in California. We found that these contractual agreements generally include some or all of the following:

- An agreement by the distributor to use his best efforts to promote, develop and sell the brewer's product (or to meet certain performance criteria), including satisfactory warehousing;

- Provisions governing the terms of payment for the brewer's product;
- Provisions assigning a distribution territory and setting requirements regarding the number of retail accounts in that geographic area that must be offered beer deliveries by the wholesaler;
- Provisions setting forth the advertising responsibilities of the wholesaler;
- A requirement that the brewer's written approval must be obtained before a distributorship can be sold or transferred;
- Provisions requiring the wholesaler to abide by the policies, sales and marketing practices, and methods of the brewer; and
- Provisions establishing how the contractual agreement may be terminated.

The exact nature of these contracts differs from brewer to brewer, although as discussed below, the contracts involving the major-domestic brewers tend to be fundamentally different from those involving the minor-domestic and foreign brewers.

1. Contracts Involving Major-Domestic Brewers

Exclusive distribution territories exist for all of the major-domestic brands, which account for some 90 percent of the beer distributed in the state. The use of exclusive territories, or "areas of primary responsibility" as the brewing industry usually terms them, has been the standard practice of many major-domestic brewers for over 20 years.

The major brewers usually require that the wholesaler, in exchange for being granted an exclusive territory right, offer to serve all of the retail accounts in its territory.

Generally, a wholesaler may terminate a distribution agreement simply by giving 30-days written notice to the brewer. When a brewer wishes to terminate a contract, perhaps because he views the wholesaler's performance as unsatisfactory, the process is more complicated. Generally, the brewer will send written notice of the pending termination to the wholesaler, give him time to correct the deficiency, and then even allow for a follow-up appeal process. (Other provisions of the contract usually allow for immediate termination by the brewer if the wholesaler goes into receivership or becomes insolvent, files for bankruptcy, has its state or local permit revoked or suspended, violates federal or state law, or acts fraudulently.) The contract also may call for payments to the wholesaler to cover his liquidation costs. These payments often equal the annual net-before-tax earnings of the wholesaler. In addition, the brewer may be required to buy back the wholesaler's inventory, and/or certain tangible assets such as delivery vehicles.

As discussed later in this report, most of the contract provisions required by SB 1211 already appear in the standard contracts used by the major-domestic brewers.

2. Contracts Involving Minor-Domestic and Foreign Brewers

Generally speaking, the distribution agreements between wholesalers on the one hand, and minor-domestic and/or foreign brewers on the other, tend to be simpler in nature, particularly with respect to distribution territories and termination procedures. Minor-domestic and foreign brands often are not distributed on an exclusive-territory basis. In addition, termination provisions for these brands generally are not as favorable to wholesalers as those offered by the major brewers. Frequently, a 30-day written notice is all that is required for a brewer to terminate a wholesaler, and there generally are no compensation requirements available to a canceled wholesaler. In addition, the servicing requirements imposed on wholesalers are less specific; for instance, the brewers of minor-domestic brands and foreign brands typically do not mandate that a wholesaler offer service to all of the accounts in a geographic area.

E. LAWS AND REGULATIONS GOVERNING BEER DISTRIBUTION ACTIVITIES

California law requires all beer wholesalers to be licensed by the state. In addition, it requires that brewer-wholesaler distribution agreements specify the geographic area (whether exclusive or nonexclusive in nature) where a wholesaler may sell a brewer's brands, and that these territorial agreements be posted with the Department of Alcoholic Beverage Control (ABC). The law also states that all wholesalers have "the right of choice of customers," subject of course to other legal restrictions that limit discriminatory behavior. Thus, the provisions of most beer distribution agreements between California suppliers and wholesalers go well beyond the requirements of law.

Finally, California law and regulations:

- Prohibit beer wholesalers from offering quantity-based price discounts to retailers;
- Prohibit cost-based pricing by beer wholesalers;

- Effectively prohibit retailers from pooling their beer orders together in order to save money; and
- Require beer wholesalers to post their beer prices with the ABC.

These four provisions are particularly significant from an economic standpoint, and for this reason warrant further discussion.

1. Prohibitions Against Quantity-Based and Cost-Based Price Discounts

Rule 105(a) of the ABC prohibits beer suppliers and wholesalers from offering any quantity-based price discounts to retailers. This rule also prohibits--except under very restricted conditions--price variations within a county.

These restrictions mean large, centrally located retailers pay more (and thus charge customers more) for their beer than would be true in an unregulated market. In turn, however, these increased costs for large, central retailers result in wholesalers charging small and rural retailers less for beer than they would without Rule 105(a). In effect, these cost savings to small and rural retailers are "paid for" by larger and more centrally-located retailers and their customers.

Proponents of Rule 105(a) maintain that the rule makes beer available to the consumer at reasonable prices, regardless of the size or location of the store where it is purchased, and that it helps small firms stay in business.

Opponents of the rule contend that it raises prices to the majority of consumers by preventing the cost savings that result from distributing beer through larger, more centrally-located retail stores from being passed through to the consumer.

A similar rule does not apply to either wine or distilled spirits in California.

2. Prohibitions Against Strict Cost-Based Pricing

Current law provides that wholesalers can quote prices for their products on an F.O.B. ("free on board") basis, but they cannot add to this price a separate charge for transportation costs or other services. Thus, a wholesaler is not permitted to charge individual retailers a price that reflects the true cost of its beer deliveries. This policy, in effect, requires one group of beer consumers (those who shop at centrally-located outlets) to subsidize another (those who shop at more-remote, hard-to-reach outlets).

It is not clear why the beer industry should be prohibited from pricing its product the way most other industries do--that is, by varying the price to reflect differences in the cost of production or distribution. If, for example, fresh vegetable prices had to be uniform and could not reflect the higher cost of moving perishables from California to the east coast, California consumers would pay much higher prices for produce than they do now.

3. Prohibition Against Pooling Orders

Retailers of beer are effectively prohibited from forming buying groups to purchase beer in large enough quantities to qualify for the equivalent of volume discounts. This prohibition has no effect on retailers purchasing the major beer brands, since they are delivered to individual stores by "traditional" wholesalers who are prohibited from offering volume discounts. The prohibition against pooling, however, does prevent small firms from acquiring other brands at more-favorable prices. It is possible for large-volume retail outlets to purchase from some suppliers who only accept large orders, such as BDI. If buying groups comprised of small firms were authorized to purchase in bulk from these large-volume wholesalers, they could reduce their costs and consequently would be able to sell the affected brands at lower prices.

Pooled-buying groups exist for many other products, and are permitted for wine and distilled spirits. It is not apparent why beer retailers should be prevented from forming these groups, as well.

4. Price Posting

California law requires that "each manufacturer, importer and wholesaler of beer shall file . . . a written schedule of selling prices." Amendments to these posted prices are not effective until 10 days after the filing date, unless the changes are made to "meet lower posted and filed competing prices," in which case the prices are effective "immediately if the competing prices are already effective, or at the same time as the competing prices become effective."

Price posting helps the ABC to enforce territorial assignments for wholesalers, and aids beer suppliers and wholesalers in developing and carrying out pricing policies. This can have both positive and negative effects. On the one hand, making price data available can enhance competition to the extent that wholesalers have access to competitors' pricing practices, and thus it becomes harder for any one firm to charge excessive prices. On the other hand, price posting also can reduce competition, by helping firms "coordinate" their prices in such a way as to maximize profits without hurting their individual market shares.

We believe that the Legislature may wish to consider the appropriateness of continuing to require price posting. It may also wish to reevaluate the current prohibitions against quantity-based pricing, cost-based pricing, and pooled buying.

We now turn to a discussion of the specific provisions that SB 1211 would impose on beer distribution activities in California.

FOOTNOTES TO CHAPTER II

1. Beers also are made from raw materials other than barley. Beers in this category include the African bousa and Kaffir beers (made from millet), Russian Kuass (made from fermented rye bread), and Chinese samshu, Korean suk, and Japanese sake (all brewed from rice).
2. See Productive Competition in California's Beer Industry, prepared for the California Beer Wholesalers Association by Moorehead and Associates, 1981.
3. See Testimony of the United States Brewers Association on the Malt Beverage Interbrand Competition Act, 97th Congress, June 23, 1982, p. 124. This testimony reported that in 28 of 37 states examined, the four-firm concentration ratio exceeded 80 percent. In 1984, the nation's 10 largest brewers and their production levels (figures in parentheses, measured in millions of 31-gallon barrels) were Anheuser-Busch, Inc. (64), Miller-Brewing Company (37.5), The Stroh Brewery Company (23.9), G. Heileman Brewing Company (17.5), Adolph Coors Company (13.2), Pabst Brewing Company (11.6), Genesee Brewing Company (3), Christian Schmidt (2.5), Falstaff Brewing Company (2.3), and Pittsburgh Brewing Company (1). See Jobson's Liquor Handbook, 1985 edition, p. 305.
4. A dramatic decline in the number of brewing plants began after 1940. In 1950, there were 407 brewing plants nationally; in 1960 the number had declined to 229; by 1970 the number fell to 142; and by the late 1970s had declined further to just over 40. In addition, the number of brewers declined. Several factors caused these trends, including the expansion of some firms into multiplant operations, and the adoption of technological innovations and efficiencies by the larger national brewers. In addition, industry profitability was not strong in the 1950s and 1960s, causing many small firms to fail. See William Downard, Dictionary of the History of the American Brewing and Distilling Industries, Greenwood Press, 1980, and U.S. Federal Trade Commission, The Brewing Industry, December 1978.
5. The nation's leading imported beer brands in 1984 (with market shares in parentheses) were Heineken (34.1%), Molson (13.6%), Becks (11.1%), Moosehead (7.4%), Labatt (4.6%), St. Pauli Girl (3.5%), Dos Equis (3.2%), Carling O'Keefe (2.3%), Amstel Light (1.8%), Corona Extra (1.8%), and all others (15.1%).
6. Estimate of the numbers of firms are based upon Legislative Analyst's survey of beer wholesalers. This survey and its general findings are discussed in Chapter V.

CHAPTER III

THE PROVISIONS OF SB 1211

This chapter discusses the provisions of SB 1211, how the bill would change the current statutory and regulatory requirements governing beer distribution in California, and the prevalence of similar provisions elsewhere in the United States. Specifically, the chapter:

- Explains what the provisions of SB 1211 are regarding beer distribution arrangements and activities, including mandated distribution territories for wholesalers, wholesaler services to retailers, and supplier-wholesaler contractual relationships.
- Discusses the prevalence of beer distribution provisions similar or identical to those in SB 1211 in <u>other states</u>.
- Discusses past and current attempts to adopt such provisions at the <u>national</u> level.

A. THE SPECIFIC PROVISIONS OF SB 1211

The provisions of SB 1211 can be divided into two general categories:

- Provisions regarding <u>mandated exclusive territories</u>, and
- Provisions affecting the contractual and business <u>relationships</u> between beer suppliers, wholesalers and retailers.

1. <u>Exclusive Territory Provisions</u>

The bill contains two basic provisions dealing with exclusive distribution territories for beer wholesalers:

- First, SB 1211 would require each beer supplier doing business in California to grant an exclusive sales territory to each of its wholesalers for a particular brand of beer. However, the bill would "grandfather" the nonexclusive territories that now exist. These territories would not have to become exclusive until only one of the territory's current wholesalers remains in business. SB 1211 does not require these territories to be of any particular size. Thus, a territory could range anywhere from statewide to part of a county or city. In addition to requiring exclusive territories, SB 1211 would prohibit a beer supplier from selling beer directly to any retailer located within a wholesaler's assigned territory without the wholesaler's written approval.
- Second, SB 1211 would prohibit a wholesaler from selling beer to a retailer when the wholesaler "knows or should reasonably believe" that the retailer intends to resell the beer to consumers outside the wholesaler's assigned exclusive sales territory. In other words, the bill aims at keeping retailers from buying beer at one location and then distributing it themselves to their retail sales outlets in other locations, such as a large retail supermarket chain might wish to do. (SB 1211, however, does not actually prohibit retailers themselves from engaging in such behavior.)

As noted in Chapter II, the major-domestic brands, which already are distributed by wholesalers with exclusive territories, account for about 90 percent of the beer sold in California. Thus, the main effects of SB 1211's exclusive territory requirements would be to (1) facilitate the enforcement of exclusive territories, and (2) increase the likelihood that, ultimately, the minor-domestic and foreign beer brands also will be distributed by exclusive-territory wholesalers.

2. Provisions Involving Contractual and Business Relationships

The provisions involving contractual and business relationships fall into three general categories.

a. Provisions Governing the Termination or Revision of a Wholesaler's Contract

SB 1211 would:

- Limit the circumstances under which a beer supplier may terminate, cancel or modify a distribution agreement with a wholesaler. These circumstances would be restricted to cases of bankruptcy and other credit-related problems, license revocation, material misrepresentations, sale of beer outside the wholesaler's authorized territory, and failure to "comply substantially with any lawful requirement imposed by the supplier" in the distribution agreement.
- Require the supplier to give the wholesaler at least 90 days written notification before a distribution agreement can be terminated for good cause, as specified.
- Require a supplier to make specified compensation to a wholesaler when a distribution agreement is terminated due to insolvency or beer sales outside the wholesaler's territory. This compensation would primarily involve buying-back the wholesaler's unsold inventory of beer.

b. Provisions Regulating Changes in Ownership of a Wholesaler Organization

SB 1211 would:

- Specify the allowable limitations which a supplier may place upon (a) the assignment of a wholesaler's rights under a distribution agreement, and (b) any change in the controlling ownership of a wholesaler's business.
- Require a supplier to make specified compensation to a wholesaler if the supplier acted improperly when prohibiting a proposed assignment or change in ownership by a wholesaler. For example, if a wholesaler's attempts to "sell out" to a new owner were thwarted by a supplier who overstepped his allowable authority, the supplier would be required to compensate the wholesaler for any loss he incurred if his eventual sales price turned out to be less than the original offer that the supplier improperly thwarted.

c. Provisions Specifying the Servicing Requirements that Wholesalers Must Meet

SB 1211 would:

- Require that beer wholesalers or beer suppliers provide certain services to a retailer who has purchased beer from that wholesaler or supplier. These services would include rotating shelf stocks so that beer would not become outdated before being purchased by consumers, and "tapping" beer kegs.
- Require each beer supplier who sells directly to retailers, and all beer wholesalers, to sell their brands within their relevant

territory to retailers "generally, rather than to a few selected retailers." (Because the term "generally" is not specifically defined in the bill, it would be subject to legal interpretation. A strict interpretation could be that all retailers within a distribution area would have to be offered service.)

- Prohibit wholesalers and direct-selling suppliers from refusing to sell beer to a retailer because the purchase request is not large enough.

The bill also specifies that individuals who are harmed by a violation of any of its provisions may bring civil court actions against the offending party. However, the bill provides for neither criminal prohibitions nor criminal punishments for such violations.

B. THE PREVALENCE OF SB 1211-TYPE PROVISIONS IN OTHER STATES

During the course of our research, we contacted each of the other states to ascertain whether it had adopted provisions similar to those in SB 1211 and, if so, what the economic and fiscal effects of these provisions have been. (The questionnaire which we distributed appears in Appendix A.) Table III-1 summarizes the states' responses to our survey.

Regarding exclusive distribution territories, we found that:

- 26 states either require exclusive distribution territories directly, or do so indirectly by prohibiting brewers from designating more than one distributor per territory.
- 13 states, including California, require that territories be assigned to wholesalers, but do not require that these territories be exclusive.

Table III-1

State Requirements Related to Beer Distribution[a]

State	Requirements That Beer Be Distributed Through Exclusive Territories	Prohibitions Against Wholesalers Selling Beer To Retailers Who "Transship"	Requirements That Specific Services Be Provided To Retailers	Requirements That Suppliers Service a Minimum Percentage of Accounts in their Geographic Area
Alabama	Yes	--[b]	No	No
Alaska	No	No	No	No
Arizona	No	No	No	No
Arkansas	Yes	Yes	No[c]	No
California	No	No	No	No
Colorado	No	No	No	No
Connecticut	Yes	No	No	Yes
Delaware	No	No	No	Yes - 100%
Florida	No	No	No	No[d]
Georgia	Yes	Yes	No	Yes - 100%
Hawaii	No	No	No[e]	No
Idaho	Yes	No	No	No
Illinois	Yes	Yes	No	Yes
Indiana	No[f]	No	No	No
Iowa	No	No	No	No
Kansas	Yes	Yes	No	No[d]
Kentucky	No	No	No	No[d]
Louisiana	No	No	No[e]	Yes - 20%
Maine	Yes	Yes	No	Yes - 100%
Maryland	Yes	Yes	No[e]	No
Massachusetts	No	No	No	No[f]
Michigan	Yes	Yes	No[e]	No
Minnesota	No	No	No	No
Mississippi	No	Yes	No	No
Missouri	Yes	No	Yes	Yes
Montana	Yes	Yes	No	No
Nebraska	Yes	Yes	No	No
Nevada	No	No	No	No
New Hampshire	Yes	Yes	No[e]	No
New Jersey	No	No	No	No
New Mexico	Yes	No	No	No
New York	No	No[g]	No	No
North Carolina	Yes	Yes	No	No[d]
North Dakota	Yes	Yes	No	No
Ohio	Yes	Yes	No[e]	Yes
Oklahoma	No	No	No	No
Oregon	Yes	No	No	Yes - 100%
Pennsylvania	Yes	Yes	No[e]	No
Rhode Island	No	No	No	No
South Carolina	Yes	No	No[e]	Yes - 100%
South Dakota	No	No	No	No
Tennessee	Yes	Yes	No	No
Texas	No	No	No	No[d]
Utah	Yes	Yes	No	No
Vermont	Yes	Yes	No	No
Virginia	No	No	No	No
Washington	No	Yes	No[e]	No[d]
West Virginia	Yes	Yes	No	No
Wisconsin	No	No	No	No
Wyoming	Yes	No	No	Yes - 100%

a. Data based on state responses to the questionnaire appearing in Appendix A.
b. Issue is currently pending in courts.
c. Required to offer equal service treatment to all accounts.
d. No minimum percentage is required; however, wholesalers are not allowed to discriminate between accounts when offering service.
e. Certain services are expressly prohibited.
f. Specifically prohibits the use of exclusive distribution territories.
g. Sales between different retailers are prohibited.

- 10 states have <u>no</u> requirements regarding beer distribution territories.
- 1 state (Indiana) specifically <u>prohibits</u> the use of exclusive territories.
- 20 states specifically prohibit wholesalers from selling beer to a retailer who, in turn, ships the beer outside of the wholesaler's own territory for sale elsewhere. (This practice generally is referred to as "transshipping.")

Regarding beer-distribution <u>services</u> and wholesaler-brewer <u>contractual relationships</u>, we found that:

- About one-third of all states require that wholesalers offer to <u>deliver</u> beer either to <u>all</u> or some <u>minimum</u> percentage of the retailers in their service areas, or prohibit them from discriminating between different retailers when offering service. The remaining two-thirds of the states do <u>not</u> impose any requirement upon wholesalers to service a minimum percentage of the retail accounts in their service area.
- Only one state (Missouri) reported that it actually <u>requires</u> wholesalers to provide specific on-site <u>customer services</u> to retailers, as SB 1211 would do. All of the other states either allow wholesalers the <u>option</u> of providing whatever customer services they desire (39 states), or have imposed <u>restrictions</u> on what services wholesalers can choose to provide (10 states).

Thus, as Table III-1 indicates, the service-related provisions of

SB 1211 generally go well beyond the scope of what other states mandate, while the bill's exclusive territory requirements prevail in a bit over half of the other states.

C. FEDERAL PROVISIONS REGARDING BEER WHOLESALING

At the present time, there are no provisions of federal law that specifically address beer distribution territories, transshipping by retailers, servicing requirements for wholesalers, or wholesaler-brewer contractual relationships. There is, however, a law pending before the Congress which deserves brief mention.

The Malt Beverage Interbrand Competition Act

The Malt Beverage Interbrand Competition Act (MBICA) would effectively grant a special exemption from federal antitrust laws to exclusive-territory arrangements between beer wholesalers and brewers. Specifically, the act would exempt such arrangements from "any antitrust law," provided that "substantial and effective competition with other malt beverage products" exists within the exclusive geographic territories that such arrangements establish. The bill, which also was introduced in each of the two preceding Congresses, is sponsored by the United States Beer Wholesalers Association.

Proponents of the MBICA maintain that the bill will clarify the legal status of exclusive territory agreements and thus minimize litigation associated with their enforcement. (Although challenges to the enforceability of these agreements have occurred in the past, our research indicates that these challenges have been minimal in the past five to eight years.)[1] The proponents also point out that similar legislation has been enacted for the soft drink industry.

In contrast, the bill's opponents maintain that past court cases generally have held that exclusive territorial arrangements are neither automatically legal <u>nor</u> automatically illegal, and that the purpose of the MBICA simply is to encourage states without exclusive territory provisions to adopt them.[2]

Since California <u>already</u> permits exclusive territorial arrangements, enactment of the MBICA by Congress would not directly affect beer distribution activities within the state.

FOOTNOTES TO CHAPTER III

1. Generally, court cases have upheld the rights of states to enact, and firms to employ, exclusive-territory provisions. For a discussion of some of these cases and the legal issues involved see, among others, L.A. Sullivan, Antitrust, 1977, pp. 376-500, and A.D. Veale, The Antitrust Laws of the U.S.A., second edition, 1970, pp. 203-224; United States v. Arnold Schwinn & Co., 388 U.S. 365, 379, 1967; Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 1977; Rice v. Norman Williams Co., 102 S. Ct. 3294 (1982) and California Retail Liquor Dealers Association v. Midcal Aluminum, Inc., 445 U.S. 97, (1980); and Michael H. Orbison, "Vertical Restraints in the Brewing Industry: Is the Malt Beverage Interbrand Competition Act the Answer?" Brooklyn Law Review, Fall 1983, pp. 143-189.
2. For a discussion of these issues, see The Beer Bill: An Assessment of the "Malt Beverage Interbrand Competition Act," The Food Marketing Institute, April 1985. In response to proponents' arguments that the beer industry deserves to be treated like the soft drink industry, opponents note that these two industries have some important differences. For example, they argue that (a) soft drink distributors also serve as bottlers, and therefore are similar to a processor or manufacturer, with significant capital expenditure requirements, (b) in most states, there is no regulation of soft drink distributors, and (c) in most states, there are not requirements that soft drink wholesalers operate between the manufacturing and retailing levels. By comparison, they argue, the capital requirements of beer wholesalers tend to be less than for soft drink wholesalers, state laws generally already regulate beer wholesaling activities, and the three-tier beer distribution system is firmly entrenched.

CHAPTER IV

THE POTENTIAL ECONOMIC EFFECTS OF SB 1211

This chapter discusses the potential economic effects which SB 1211's beer distribution provisions would have. Specifically, the chapter:

- Reviews the basic economic issues raised by SB 1211, and
- Discusses the various types of economic effects that the bill's provisions could have on California's beer industry and beer consumers.

Following this, Chapter V discusses the evidence available on the economic effects of provisions similar to those in SB 1211.

A. ECONOMIC ISSUES RAISED BY SB 1211's PROVISIONS

The economic issues raised by SB 1211 are best discussed by dividing them into two categories--those dealing with exclusive distribution territories and service requirements, and those dealing with contract requirements between beer suppliers and wholesalers.

1. Exclusive Territories and Beer-Servicing Requirements

Granting an exclusive distribution territory to a wholesaler of a commodity can, in theory, have both positive and negative economic effects.

Positive Effects

On the positive side, exclusive territories sometimes can help provide a necessary degree of stability to a product's distribution network. This, in turn, can encourage wholesalers to take certain steps that will improve the product's marketing, and thus the product's overall sales and profit potential.

For example, a beer distributor may be more likely to invest in and properly maintain top-quality delivery vehicles and refrigerated warehouse facilities if he knows that his market area will be secure until he has recouped his investment. Similarly, the distributor probably would be more likely to perform services such as removing outdated beer from store shelves, conducting local product-promotion campaigns, and setting-up and maintaining shelf displays, if he can keep other wholesalers from selling in his market area and thus benefitting from his efforts without helping to pay for them (this is known in the industry as "free-riding").

Negative Effects

On the negative side, exclusive territories inherently restrict intrabrand price and service competition. This is because, by definition, an individual wholesaler of a particular brand need not worry about competition from other wholesalers within his designated area. This, in turn, can work to the consumer's disadvantage if it enables the distributor, using his monopoly position, to maintain excessive prices. In addition, it can discourage changes in the distribution system that a competitive market would require, such as those that reduce costs by taking advantage of the economies of scale to be gained by encouraging high-volume centralized purchases.

Summary

Given the potential positive and negative effects of SB 1211's exclusive territory provisions, we believe the main economic issues raised by the bill are as follows:

- To what extent will wholesalers increase beer prices and reduce product service because of reduced intrabrand competition between wholesalers (that is, competition involving sellers of the same brand)?
- To what extent will the bill harm the business of wholesalers who specialize in large-volume deliveries?
- Will the provisions of SB 1211 improve the quality and selection of beer products that consumers buy in retail stores, by encouraging better management of outdated beer and improved beer-distribution facilities and equipment?
- To what extent will the sales of certain beers be hurt which are presently, by choice of these suppliers, distributed through a nonexclusive-territory system?

2. Economic Issues Related to Wholesaler-Supplier Contract Requirements

As discussed in Chapter III, SB 1211 would require that contracts between beer suppliers and wholesalers contain specified provisions covering such matters as termination conditions.

These provisions also could have both positive and negative economic effects. Specifically:

- The effects would be positive if existing contractual arrangements fail to adequately protect the public's access to beer by guaranteeing a stable distribution network--one in which beer wholesalers do not repeatedly go out of business because their contracts with suppliers are terminated without just cause.

- The effects would be negative if SB 1211's provisions impose unnecessary costs on suppliers and wholesalers, such as requiring excessive wholesaling services.

Given this, we believe the major economic issues associated with SB 1211's contractual requirements are as follows:

- To what extent will these requirements impose additional costs on beer wholesalers or suppliers, and therefore increased prices on consumers?
- To what extent will any such costs be offset by direct or indirect benefits to consumers?
- Will these provisions restrict the ability of beer suppliers to make economically efficient changes in their beer-distribution practices in the future, including replacing one wholesaler with another when the supplier feels it to be in his own best economic interests to do so?

B. THE LIKELY TYPES OF ECONOMIC EFFECTS OF SB 1211

In this section, we take a closer look at the economic issues raised above, using the principles of economic theory to help us predict what the consequences of SB 1211 might be.

It is important to recognize at the onset that the economic effects of SB 1211 will not be the same for all brands of beer. This is because the major-domestic brands already are distributed through exclusive territories and their supplier-wholesaler contracts already contain many of the provisions required by SB 1211, whereas this generally is not the case for minor-domestic and foreign brands. Consequently, the enactment of

SB 1211 will have, by far, the greatest effect on these latter brands, and relatively little direct effect on the major-domestic brands.

Price Effects

Economic theory suggests that SB 1211 would tend to increase beer prices. This is because the bill would:

- Strengthen the territorial monopoly power of existing wholesalers with exclusive-territory assignments by making these assignments statutorily enforceable. These wholesalers would have less reason to fear that other wholesalers would "invade" their territory, and therefore would be more inclined to raise prices.
- Eventually eliminate nonexclusive territories, thereby eliminating the intrabrand price competition between sellers of the same brand that now occurs within such territories.
- Reduce the likelihood that large retail chain stores with central warehouse facilities can take advantage of the cost-savings to be gained by using their own inter-store beer distribution systems.
- Require "extended" wholesalers--those dealing only with large-volume accounts--to offer service to small-volume accounts as well. This would raise these firms' average delivery costs, thereby putting upward pressure on the prices they charge all retailers (since the state does not permit wholesalers to offer quantity-based price discounts).
- Require that wholesalers provide certain product services which some of them do not provide now. This would raise their costs and, therefore, make them more inclined to increase the prices they charge.

- Possibly constrain the beer-distribution industry from evolving over time in whatever manner economic conditions normally would say is most efficient. For example, it could restrict the future ability of brewers to make selective direct shipments to retailers in those cases where this might significantly decrease costs, and therefore be in the best interest of consumers.

It seems most likely that the prices charged for certain minor-domestic and foreign brands would be most likely to increase under SB 1211, since the bill would require significant changes in the methods used to distribute these brands. It is possible that this in turn could induce some upward movement in prices of major-domestic brands, as well, since they must remain competitive with the foreign and minor-domestic brands, and may now be constrained by price competition from them.

Effects on the Number of Beer Wholesalers

In theory, the number of beer wholesalers doing business in California could either increase or decrease as a result of SB 1211.

- The number would decrease to the extent that suppliers of minor-domestic brands and foreign brands eventually would reduce the number of wholesalers carrying their brands, due to SB 1211's requirement that territories ultimately become exclusive.
- On the other hand, the number of beer wholesalers would tend to increase, or at least remain stable, if SB 1211 halts the trend toward central warehousing and internal distribution by the increasingly dominant retail chain-store operations.

Economic theory cannot tell us how these opposing effects will net out. In the short term, there probably would not be much effect. However, in the long run, the number of wholesalers might change as a result of the bill and, if this change occurs, we suspect that it is more likely that there would be some slight decrease in wholesalers as opposed to an increase.

Effects on Beer Quality

Unlike certain other alcoholic beverages, beer has a relatively brief "shelf life." A beer's taste tends to be best when it first leaves the brewery, and thereafter it slowly deteriorates and eventually becomes "stale." For this reason, most beer suppliers prefer that their product be consumed within 75 to 120 days of leaving the brewery. The deterioration in a beer's taste can be slowed if the beer is properly refrigerated, but will accelerate if the beer is exposed to heat and/or, in some cases, sunlight. Because consumption of stale beer can significantly damage a brand's reputation, it is very important to brewers that proper quality-control measures be followed by the wholesalers and retailers who handle their products, such as the removing of "old" beer from store shelves. Normally, the costs of replacing, removing and destroying "old" beer are borne by the wholesaler.[1]

The importance of product quality to brewers, wholesalers, and retailers alike explains why stale beer generally tends to be a "nonproblem." Even when wholesalers deliver beer into territories which are not their own, the beer often is rotated either by the designated wholesaler or the retailer itself, since neither wants to face the costs and customer problems that stale beer can cause. And, as noted earlier, nearly all suppliers already require their wholesalers to regularly rotate beer stocks.

Consequently, there would seem to be little opportunity for SB 1211 to noticeably improve product quality.

Effect on Product Selection and Availability

Economic theory provides relatively little basis for expecting that SB 1211 would significantly improve either beer selection (that is, the number of brands distributed in California) or availability (that is, the ability to actually purchase a particular brand in a particular geographic locality of the state).

It is possible that SB 1211 would increase the likelihood of being able to find certain minor-domestic and foreign beers on the shelves of some small and/or rural retail stores where they are not presently stocked. This is because the bill would require wholesalers to offer these brands to retailers "generally"--something that they may not do now, given prohibitions against cost-based pricing and the fact that suppliers of these brands often do not require their wholesalers to offer service to all retail accounts.

On the other hand, SB 1211 could reduce the availability of certain brands in certain locations if, by reducing intrabrand competition and requiring additional services at the wholesale level, the price of minor-domestics and imports rose to the point where they could no longer compete with the majors.

In any event, with the multitude of beer brands now offered statewide to California consumers, it is not clear that any significant "selection" or "availability" problem exists.

Effect on the Volume of Beer Sales

Because it is likely that SB 1211 would eventually put some upward pressure on the prices charged for at least some brands, the bill probably would cause beer sales to fall below what they otherwise would be. The exact magnitude of this decline would depend on:

- The magnitude of the increase in beer prices, and
- The sensitivity of beer consumption to prices (that is, what economists refer to as the "price elasticity of demand" for beer).[2]

Other Effects

Economic theory suggests that SB 1211 could have other effects as well, such as the following:

- Beer consumers who shop at stores where delivery costs are low could end up implicitly subsidizing the purchases made by consumers who shop at stores where such costs are higher. This is because SB 1211 could cause some wholesalers to make deliveries to certain stores that they presently do not serve, because such deliveries are not sufficiently profitable.
- Sales volumes may shift for certain beer brands, away from high-volume "extended" wholesalers to exclusive wholesalers.
- Sales may be shifted from the minor-domestic and foreign brands to the major brands, because the prices charged for the former are much more likely to increase under the bill.

We now turn to a discussion of the <u>empirical evidence</u> that exists regarding the effects that SB 1211-type provisions have had.

FOOTNOTES TO CHAPTER IV

1. Even though wholesalers generally provide financial credit to retailers to cover the costs arising from stale beer, there are several reasons why outdated beer still is "costly" to retailers as well as to wholesalers. For example, beer deliveries usually must be paid for prior to their shelf expiration date, and beer tends to occupy a significant portion of a store's limited refrigeration space. In addition, retailers face carrying costs for excessive beer inventories, and consumer-relations problems when stale beer is accidentally sold. All of these factors are incentives for minimizing excessive beer inventories.
2. Economists generally use the term "price elasticity of demand" when referring to the sensitivity of a good's consumption to changes in its price. This concept is discussed more fully in Chapters V and VI, including the results of empirical studies that have attempted to estimate the price elasticity of demand for beer.

CHAPTER V

EMPIRICAL EVIDENCE ON THE POTENTIAL ECONOMIC EFFECTS OF SB 1211

In attempting to compile empirical evidence on the economic effects of provisions such as those in SB 1211, we followed a three-step approach:

- First, we asked the alcoholic beverage control agencies in those states with similar provisions what the economic effects of these provisions have been.
- Second, we examined various research studies conducted by economists seeking to measure the economic effects of SB 1211-type provisions.
- Third, we conducted a broad-scale survey of California beer wholesalers, brewers and retailers, in order to develop data on the frequency with which exclusive-territory agreements are violated, wholesalers are "unfairly" terminated, central-warehouse beer deliveries currently are made, and so forth.

This chapter reports our findings from these efforts.

A. STATE SURVEY DATA ON THE EFFECTS OF SB 1211-TYPE PROVISIONS

In our survey of state beer-distribution laws and activities (see Appendix A), we asked the alcoholic beverage control agencies for information regarding how exclusive wholesaling territories or wholesaler-servicing requirements have affected consumer beer prices, numbers of beer wholesalers, and the availability and quality of distribution services provided to retailers (especially small and/or rural retailers). The responses to our survey may be summarized as follows:

- Two states indicated that they had reason to believe these provisions have had no effect.
- All of the remaining states either indicated that there was no data available on these matters, or refrained from answering our questions. In other words, none of the states with SB 1211-type provisions claimed to be aware of any economic effects resulting from these provisions. This, of course, does not mean that the provisions have not produced economic effects. It merely reflects the fact that states simply have not formally analyzed the economic effects of these provisions.

B. RESEARCH STUDIES ON THE EFFECTS OF SB 1211-TYPE PROVISIONS

Despite the prevalence of exclusive-territory assignments in the beer industry, we found relatively few analytical studies of the effects that these assignments have had. The same is true with respect to beer wholesaler-servicing requirements. There are, however, a few studies which deserve mention.

1. The Alexander Grant Study[1]

The Alexander Grant study attempted to demonstrate that beer prices do not go up as a result of exclusive distribution territories. The study focused on the State of Indiana, which enacted a law prohibiting the use of exclusive territories in 1979. Proponents of the law have claimed that it has reduced retail beer prices substantially. Alexander Grant's study attempted to refute these claims by comparing retail beer prices in different states, as well as by analyzing the movement of beer prices over time within Indiana.

The authors claim that their study shows the following:

(1) The abolition of exclusive territories had no significant effect on retail price trends over the time period studied;

(2) Retail beer prices in Indiana are not significantly lower than they are in neighboring states;

(3) The use of exclusive territories does not lead to higher wholesaler concentration; and

(4) Retail prices are not higher in states where market-share concentration for wholesalers is high and exclusive territories are required.[2]

Our analysis indicates that there are several problems with this study and its conclusions. First, the data which the study relies on covers a period of time that is too short to capture the effect of the ban on exclusive territories. The study uses data from 1977 through 1980, on the basis that the statute actually banning exclusive territories was adopted in March 1979. This, however, does not allow the author to draw "before" and "after" comparisons. This is because the 1979 statute merely codified the policy which already existed in Indiana. Earlier rulings by the state's Alcoholic Beverage Commission, together with local wholesaler practices, had already undermined exclusive territories. In fact, wholesalers began "transshipping" beer in Indiana as early as 1973.[3] Consequently, by looking just at the 1977 through 1980 time period, one cannot assess the impact of exclusive distribution territories.

A second problem involves Alexander Grant's comparisons of prices in Indiana and other states. While the author makes adjustments for differences in state taxes, he makes no adjustments for differences in such factors as local taxes or transportation costs. The study also assumes that only those states which mandate exclusive territories operate under exclusive-territory distribution systems. This assumption clearly is inappropriate, given that the nation's four largest domestic beer brands (77 percent of the national market in 1984)[4] have used exclusive distribution territories throughout the country for a number of years. In fact, the vast majority of beer shipments in all states (excepting Indiana) are done through a wholesaler network of *de facto* exclusive territories. Given this, the study's conclusions are suspect.

The third problem area is that Alexander Grant's purported comparison of wholesaler concentration in exclusive-territory and nonexclusive-territory states also fails to recognize that states without mandated exclusive territories nevertheless tend to have *de facto* exclusive territories for many beer brands. Again, this raises doubts about the validity of the study's findings.

We note that in the only comparison of average statewide prices for different major beer brands appearing in the study, Indiana is shown to have lower average beer prices than the neighboring states of Kentucky and Illinois, both of which have exclusive territories.

2. The Barsby Study[5]

The Barsby study attempts to assess both the consumer-price and retail-service implications of an exclusive distribution network for beer. The study has four principal conclusions:

- Without exclusive territories, wholesalers would have no incentive to service small retail accounts.
- Without exclusive territories, wholesalers will have less incentive to provide point-of-sale product services to retailers, and this in turn will inhibit the ability of beer suppliers to introduce new brands.
- The relatively high level of interbrand competition in the beer market minimizes the possibility that beer wholesalers with exclusive territories are able to manipulate retailers, charge excessive prices, or earn monopolistic profits on their deliveries.
- Beer wholesaling, despite the established industry practice of exclusive territories, demonstrates the basic characteristics of a competitive industry.

The conclusions contained in this study are extremely difficult to verify, since virtually no empirical data are presented to support them. However, several aspects of the study deserve mention.

First, the likelihood that small retailers will not be served in the absence of exclusive territories would seem to exist only when volume discounts and cost-based pricing are prohibited (as they are in California). Clearly, where all retailers must be charged the <u>same</u> price, small retail accounts do offer lower profit margins to wholesalers. However, where wholesalers are free to offer volume discounts, or to use cost-based pricing and thereby recognize the higher per-case costs of serving smaller accounts, a wholesaler <u>would</u> have an incentive to service such accounts.

Second, in arriving at the conclusion that exclusive territories do not affect prices, Barsby fails to analyze the effects of market concentration in the beer industry, the relative inelasticity of demand for beer (which makes it easier to raise prices without hurting sales), and the inability of individual retailers to obtain a given brand from more than one wholesaler. Since the study does not give more than cursory attention to these factors, the conclusions cannot be taken at face value.

Finally, we note that Barsby's conclusion regarding the competitiveness of beer wholesaling is based on statistics which show that the return-on-equity ratios for beer wholesaling are only "average."

Return rates often are an important indicator of whether an industry is fairly competitive in terms of its pricing and profit behavior. Thus, they can shed light on whether the use of exclusive territories gives some type of anti-competitive bias to the beer wholesaling system, resulting in higher prices to consumers. The data available on return rates, however, is more ambiguous than Barsby indicates. Table V-1 provides additional data on rates of return that we have compiled. It indicates that although alcoholic beverage wholesaling has "average" returns by some measures, it also has "above average" returns by other measures.[6]

Table V-1

Rates of Return on Investment For Different Components of the Wholesale Trade Sector

Wholesaling Subsector	Alternative Measurements of Rates of Return on Investment[a]							
	Dun and Bradstreet (Industry Norms and Key Business Ratios)[b]			Robert Morris Associates (Annual Statement Studies)[c]			Prentice-Hall, Inc. (Almanac of Business and Industrial Financial Ratios)[d]	
	Upper Quartile	Median	Lower Quartile	Upper Quartile	Median	Lower Quartile	Profitable Firms Only	All Firms
Alcoholic Beverages	24.1 (6)	13.0 (5)	6.4 (2)	39.1 (1)	21.0 (1)	7.7 (4)	15.5 (1)	7.4 (1)
Groceries	19.4 (8)	10.7 (7)	3.8 (7)	30.9 (7)	14.6 (7)	4.5 (6)	10.9 (2)	6.5 (2)
Farm Products							5.1 (5)	NA
Dairy	26.3 (5)	14.2 (3)	5.9 (3)	36.9 (3)	18.7 (2)	7.9 (2)	--	--
Poultry	28.7 (3)	9.4 (8)	0.8 (9)	28.9 (8)	13.3 (8)	2.9 (8)	--	--
Meats	36.0 (2)	17.0 (1)	4.5 (6)	32.3 (6)	17.6 (6)	5.2 (5)	--	--
Fruits and Vegetables	28.2 (4)	13.7 (4)	5.4 (4)	38.8 (2)	18.5 (3)	3.5 (7)	--	--
Grains	13.7 (9)	7.7 (9)	2.5 (8)	22.5 (9)	10.6 (9)	2.7 (9)	--	--
Drugs and Allied Products	22.5 (7)	12.7 (6)	5.1 (5)	35.4 (4)	18.3 (5)	7.8 (3)	7.5 (4)	4.3 (3)
Other Nondurable Goods	40.4 (1)	16.5 (2)	6.5 (1)	34.5 (5)	18.5 (3)	8.6 (1)	9.3 (3)	1.6 (4)

a. Figures in table without parentheses represent rates of return; figures within parentheses indicate relative top-to-bottom ranking of wholesaling subsectors, by rate of return.
b. Dun and Bradstreet's ratings are based upon its own data base of 1984 financial statements for private and publicly owned corporations, partnerships and proprietorships. These return-on-investment figures are obtained by dividing net after-tax profits by net worth for the firms in their sample.
c. Robert Morris Associates is a national association of bank loan and credit offices. Their data are based upon financial statements submitted to the association by its members. The financial statements used cover fiscal periods in both 1983 and 1984. The return on investment figures are calculated using a before-tax net-income figure divided by net worth.
d. Prentice-Hall's ratings are based upon tax return data for the fiscal year ending June 1982. Its return-on-investment figures are based upon taxable income divided by net worth.

We are the first to admit that the inter-and-intra-industry rate-of-return comparisons made by <u>any</u> source are subject to many important qualifications.[7] Nevertheless, Table V-1's results lead us to believe that one cannot rule out the possibility that beer wholesaling does, in fact, earn above-average returns, and that this could be due to the reduced price competition amongst beer wholesalers that results from the prevalence of exclusive territory designations.

3. <u>The Jordan Study</u>[8]

This study attempted to determine the effects of exclusive territories on beer prices. Specifically, the study compares the wholesale prices of Anheuser-Busch and Miller brands charged by "traditional" wholesalers and "transshippers" in New Jersey. Under New Jersey law, transshippers, like the designated Miller and Anheuser-Busch distributors, are required to post their prices with the New Jersey Division of Alcoholic Beverage Control. The Jordan study simply compared the posted prices of the transshipper with the prices posted by each of the designated distributors. The results show that the transshipper prices are lower in <u>all</u> cases, with the difference ranging from 1 percent to 14 percent and averaging 3.2 percent for Anheuser-Busch and 9.9 percent for Miller. The price data also show a significant difference (2 percent to 10 percent) in the prices charged by wholesalers of the same brand in adjacent distribution areas, suggesting a possible impairment of intrabrand price competition.

The Jordan Study assumes a minimum quantity purchase of 100 cases, which is larger than most of the deliveries that a local wholesaler would be likely to make. However, in New Jersey, unlike California, retailers may form buying cooperatives and therefore take advantage of these favorable quantity-based prices.[9]

Although the Jordan study's results are consistent with the theory that mandating exclusive territories and discouraging transshipping would tend to raise beer prices, this study, like those discussed above, has some important shortcomings. Most significant is the fact that it does not control for certain factors that affect the prices wholesalers charge. For example, the transshippers could have achieved their cost advantages over traditional wholesalers by only serving selected large accounts, by not advertising, and so forth. Without controlling for these factors, Jordon's findings could be biased. (We note, however, that because the transshippers were operating out of New York State, they should have been at a disadvantage in terms of transportation costs and certain other related expenses.)

4. The Jaffee Study[10]

The Jaffee study also focused on the effect that exclusive territories have on beer prices. Like the Alexander Grant study, it examined intrastate wholesale beer prices in Indiana. Specifically, it contrasted the prices charged by Indiana local wholesalers with the prices charged by transshippers, after controlling for differences in transportation costs. Jaffee's results indicate that the prices charged by transshippers were 8 percent to 10 percent lower than the prices charged by local wholesalers for the same brands. The study also notes that one effect of this price differential was that local wholesalers improved the quality of the retail services they provided, in an attempt to be competitive with the transshippers.

This study also has its shortcomings. For example, it does not adequately control for differences between wholesalers in the quality and types of services they provide to retailers. Nevertheless, it probably represents the most exhaustive work on the price effects of exclusive territories done to date, and is consistent the results of the Jordan study in concluding that exclusive territories can cause upward price pressures.

5. Other Studies

There are two other studies which often are referred to in debates about how exclusive territories affect beer prices. Unfortunately, both studies also have important limitations.

The first study was conducted by the New York City Department of Consumer Affairs, which performs ongoing pricing surveys of consumer "market baskets" in New York City. Included in that market basket is a beer price component. During 1983, when exclusive distribution areas were first introduced in New York City, the department found that the beer price component increased by approximately 20 percent. This result is consistent with the conclusion of economic theory that exclusive territories can lead to upward price pressures. The department's survey data, however, made no allowance for the fact that New York State instituted a bottle deposit law during this same time period. Consequently, any conclusions drawn from the department's data must be qualified accordingly.[11]

The second study was referenced in testimony presented to a special committee of the Indiana State Legislature regarding beer wholesaling.

This testimony cites a 20 percent reduction in beer prices resulting from the ban on exclusive territories in Indiana. This finding apparently is based on a very limited amount of surveyed price data for five brands in Indianapolis (where transshipping was occurring) and Terre Haute (where transshipping was not occurring). However, the study makes no allowance for such factors as differences in transportation costs and the nature of services provided by wholesalers to retailers. These shortcomings, plus the small amount of price data used, significantly limit the research's usefulness.

6. Summary Regarding Research Studies

None of these studies provides crystal-clear evidence regarding how beer wholesaling restrictions, such as those in SB 1211, would affect beer prices. However, none of these studies provides any firm basis for concluding that SB 1211 would not produce the economic effects discussed in Chapter IV. In fact, if anything, these studies "lean" toward the conclusion that exclusive territory arrangements result in upward pressures on beer prices.

C. SURVEY RESULTS OF BEER WHOLESALERS, BREWERS AND RETAILERS

In order to collect additional information that might shed light on the probable economic effects of SB 1211, we surveyed the various firms participating in the California beer market. These firms include (1) over 200 beer wholesalers, (2) the state's major chain-store retailers and various other retail establishments, and (3) most domestic brewers, including all of the top firms that account for over 90 percent of California beer sales.

The responses to our survey are discussed below.[12]

1. Overview of the Survey

Our survey posed an extensive series of questions regarding the general characteristics of a firm's sales activities, the way that beer is distributed, the services that wholesalers provide to retailers, the contractual relationships that wholesalers have with brewers, the product-advertising expenditures that wholesalers are required to make, the prevalence of "transshipping" by wholesalers and retailers, the degree of price competition between brands, the way in which exclusive territory assignments are enforced, and opinions regarding the potential effects of SB 1211 on beer prices, sales, distribution and numbers of wholesalers in business.

We sent a questionnaire to all of the beer wholesalers operating in California that we could locate. This questionnaire is reproduced in Appendix B along with a summary of selected responses to key questions. Our basic mailing list was provided by the California Beer Wholesalers Association (CBWA), and included each of their member wholesalers. We also contacted Beverage Distributors Inc. (BDI), one of the largest wholesalers in the state, which is not a member of CBWA. All told, we distributed a total of 203 survey questionnaires to wholesalers throughout the state. Of these firms, 65 percent provided us with completed survey-questionnaire responses. These firms account for nearly 70 percent of total wholesale beer shipments in California, and handle an average of 10 domestic and 14 foreign brands of beer.[13] Because of the high response rate, we believe the survey data we obtained probably are very representative of the beer-wholesaling industry generally.

We distributed a second questionnaire to all major retail chains in the state, as well as to a selected number of smaller retailers. This questionnaire is reproduced in Appendix C. In all, 30 surveys were sent to organizations which are responsible for approximately 2,500 individual retail stores throughout California. We directed this survey primarily towards larger retailers, both because of the logistical problems involved in surveying a significant number of smaller individual stores, and because of our interest in how SB 1211 might affect multi-store retailers who use central warehousing and engage in interstore transshipping. Approximately one-third of the retailers we contacted provided written responses to our survey. (We also discussed the survey's questions with several retailers.) Most of the large retail chains answered our questionnaire, and our average respondent dealt with six-to-eight different wholesalers and carried over 50 individual brands of beer. (Individual responses varied greatly regarding the number of brands carried. Some specialty liquor stores carried hundreds of brands, whereas the large retail chain stores, which account for a near-majority of the total beer market, typically carried only several dozen brands.)

Finally, we contacted 28 domestic brewers, including all of the larger ones. The questionnaire we used to obtain information from these firms is reproduced as Appendix D. Foreign brewers, however, are not represented in the survey results due to the lack of any industry association or any active involvement on their part in the SB 1211 hearing process. Altogether, about one-third of the brewers we contacted responded to our survey, including the three largest brewers. These respondents account for about 80 percent of California beer sales, and on average produce six different beer brands apiece.

2. Survey Responses

Because the number of questions asked on the surveys was fairly extensive, the discussion that follows focuses on the responses to only those questions that shed the most light on the potential economic effects of SB 1211. (In reviewing these results, it must be stressed that because these survey responses were voluntary, they do not necessarily represent statistically precise or comprehensive data regarding California's beer market activities. Rather, they serve to provide only a general indication of this market's activities, and their reliability depends entirely on the extent to which these survey responses do in fact accurately portray the entire market.)

a. How much beer is distributed through exclusive territories?

Wholesalers reported that over 91 percent of their beer sales are distributed via exclusive territories, meaning that about 9 percent is distributed on a nonexclusive territorial basis. Retailers reported a similar breakdown, and indicated that exclusive territories are the rule for the major-domestic brands and the exception for other brands. The large chains indicated that non-major brands tend to be distributed using retailer-operated interstore distribution systems.

Despite the fact that a relatively small volume of beer is distributed on a nonexclusive-territory basis, nearly one-half of the wholesalers--46 percent--reported that there are competing wholesalers for at least one of the non-major brands they handle.

This suggests that the distribution system for about 10 percent of the beer market could be affected by SB 1211's exclusive territory and service requirements.

b. How important are central warehouse deliveries and direct brewer-to-retailer deliveries?

Less than 2 percent of the wholesaler respondents reported making deliveries to central warehouses maintained by retail stores. In contrast, responding retailers indicated that 20 percent of their deliveries were made to their central warehouses. About 60 percent of these deliveries were handled by "extended" large-volume delivery wholesalers, such as BDI. The other 40 percent was split evenly between local territorial wholesalers and territory-violating wholesalers.

This indicates that some wholesalers and retailers would be adversely affected if SB 1211's wholesaler-servicing requirements worked to reduce reliance on, or growth in, central-warehouse deliveries.

The respondents generally agreed that direct brewer-to-retailer deliveries are rare, except in the case of certain smaller brewers. Thus, SB 1211 would have little immediate impact in this area, although it might serve to forestall the emergence of increased direct deliveries in the future.

c. How much "transshipping" occurs?

Only 3 percent of the wholesaler respondents admitted that they themselves ship beer outside of their own territories and into the assigned territories of other wholesalers. However, 54 percent of the respondents said that they knew of other wholesalers who did this. The average number of such transshippers reported by wholesalers was three, although one reported that at least one dozen firms transshipped beer. And, as noted above, retailers reported that 20 percent of their central warehouse deliveries came from transshipping wholesalers.

In the case of retailers, the chain-store respondents reported that they themselves transhipped between 5 percent and 10 percent of their beer volume between their own stores, presumably to take advantage of such factors as pricing differentials between wholesalers and their own internal distribution efficiencies.

To the extent that transshipping does occur, it may be providing some intrabrand price competitiveness and therefore some downward pressures on prices in certain wholesaling regions.

d. What happens to wholesalers who are caught transhipping beer in violation of their exclusive territorial assignments?

In order for exclusive territorial assignments to "work," they must be enforced so that transshipping will not occur.

In fact, the majority of wholesaler respondents reported that they risk a number of adverse consequences when they transship. For example, 48 percent said brewers warn them that their contracts will be canceled if they continue to transship. Another 9 percent reported that automatic cancelation occurs, while 8 percent reported that compensation payments must be made by the transshipper to the invaded wholesaler. Thirty percent, however, reported that nothing happens when they transship.

While the typical response of brewers to our questionnaire was that they warn and reprimand territory-violating wholesalers, none of these brewers reported punishments as dramatic as immediate terminations or financial penalties, and several said they would take no action. Thus, it is easy to see why a certain amount of transshipping occurs.

e. Is "stale" or outdated beer a significant problem?

Sixty-two percent of the respondents reported that they regularly or periodically remove outdated beer from retail establishments, and about 20 percent stated that they go so far as to pick up outdated beer delivered by competing wholesalers. On the average, however, both wholesalers and retailers estimated that pickups of outdated beer represented only one-half of one percent of their beer volume. This suggests that outdated or stale beer is not an excessive problem.[14]

f. How strong is price competition between wholesalers?

Only 8 percent of the wholesaler respondents stated that they focused primarily on price competition when vying for business with other wholesalers, while over 40 percent said they competed primarily in terms of the number and quality of the services they provided to retailers.[15] In cases where price competition was reported, over 70 percent of the respondents said that beer-related price competition was strongest on an interbrand, as opposed to intrabrand, basis. These responses lead us to question exactly how much price competition between beer wholesalers really takes place.

g. How common is it that wholesalers are required to provide specified services?

Eighty-nine percent of the wholesaler respondents stated that they are required by the brewers to offer beer deliveries to all of the retailers in their assigned territory. In addition, 92 percent of the wholesalers said they were required to participate in brewer-designated advertising programs, at an average expense of 17 cents per case. Once again, this confirms that about 10 percent of the beer market would most likely be affected by SB 1211's servicing requirements.

h. How frequently do brewers terminate wholesalers' contracts?

Nearly 45 percent of the wholesalers reported having been terminated by at least one brewer. Of these terminations, 62 percent involved foreign brands and 29 percent involved minor-domestic brands. In contrast, only 9 percent of these wholesalers were terminated by major-domestic brewers. In about 20 percent of the termination cases, the wholesalers said that they themselves had failed to meet contractual requirements.

We also asked the wholesalers whether they believe that their contracts with brewers offer them adequate protection against unwarranted termination. Fifty-three percent said "yes" in the case of major-domestic brewers. In contrast, only 30 percent responded affirmatively in the case of minor-domestic brewers and only 16 percent thought so in the case of foreign brewers.[16]

Most of the domestic brewers responding to our questionnaire do not believe that statutory contract requirements similar to those contained in SB 1211 are needed. These brewers stated that in nearly all cases their contracts already contain provisions similar to SB 1211's. Roughly one-third of these brewers indicated that they have the discretion to terminate agreements. They also stated, however, that terminations are not common occurrences. For example, these respondents averaged only seven terminations during the past five years, with approximately half of them initiated by the wholesalers themselves. Less than 10 percent of these terminations resulted in litigation against the brewers.

i. What are the anticipated effects of SB 1211?

About 9 percent of the wholesaler respondents were of the opinion that SB 1211 would put certain, primarily small, wholesalers out of business. Four percent felt that their own business could be jeopardized by the bill. On the other hand, 54 percent felt that the bill would improve their sales volumes and 36 percent felt it would increase the number of brands they handle. These responses are consistent with the theory that SB 1211 would shift business from some wholesalers to others by encouraging minor-domestic and foreign brewers to utilize wholesalers who already are set up to meet the bill's requirement that retailers be offered service "generally". A small number of the wholesaler respondents (3 percent) predicted that SB 1211 would lead to beer price increases, while none predicted price decreases. (The remainder said they thought prices would be unaffected.)

The domestic brewers responding to our survey said SB 1211 would, among other things, improve the servicing and quality-maintenance of their beer, and strengthen their distribution networks. However, their opinion varied as to the bill's likely effects on the ability of new firms to enter the wholesaling industry, on intrabrand price competition, and on the price levels of minor-domestic and foreign beer brands. (One cannot help but assume that foreign brewers would have offered negative views on SB 1211 had they been surveyed, since the bill would require them to take actions which they have not voluntarily chosen to take in the past.)

D. SUMMARY

The results of our survey, together with the results of other research discussed earlier, do not provide a crystal-clear picture of the economic effects that SB 1211 could be expected to produce. On the other hand, the empirical data provides little or no reason to reject the conclusions drawn from economic theory regarding the probable effects of provisions such as those contained in SB 1211, while some of the evidence itself is supportive of those conclusions.

Taking both the theoretical and empirical findings into account, we conclude that SB 1211 would:

- Tend to put upward pressure on the prices charged for some beers;
- Have little, if any, measurable effect on beer quality. (Likewise, we believe that any benefits to consumers due to improved beer selection and availability would be limited.);
- Limit, and possibly reduce somewhat, the number of beer wholesalers operating in the state;
- Redistribute business from some wholesalers to others; and
- Cause some beer consumers to indirectly subsidize other beer consumers.

These effects might not occur immediately; however, the odds are that they would eventually begin to materialize. In addition, these effects will be felt unevenly within the beer market. Specifically:

- The bill is most likely to affect minor-domestic and foreign brands, whose distribution systems and wholesaler-brewer contractual arrangements do not correspond to what SB 1211 requires (these brands account for 10 percent of California beer sales);

- Those firms (such as Beverage Distributors Inc.) that specialize in large-volume warehouse deliveries could be adversely affected by SB 1211's requirement that they deliver to retailers "generally" (including smaller accounts), thereby raising their costs. Similarly, small brewers that currently make direct deliveries to retailers could be adversely affected by the bill's provisions;
- Small and/or rural retailers would gain at the expense of retailers that are large and/or located near wholesaling centers. Large retailers, for example, would be prevented from achieving savings made possible by central warehousing and internal distribution systems;
- Existing wholesalers would enjoy increased job security and market power, while new firms would find it more difficult to enter the wholesaling industry;
- The major brewers' market position would be further strengthened, due to the additional requirements that would be imposed on minor-domestic and foreign brands.

We next discuss the potential fiscal effects which SB 1211-type provisions could have on state government costs and revenues.

FOOTNOTES TO CHAPTER V

1. See "The Malt Beverage Interbrand Competition Act," testimony before the House Judiciary Subcommittee on Monopolies and Commercial Law regarding H.R. 2262, July 27, 1983.
2. This study was done in conjunction with testimony for the MBICA. The study also attempts to show that beer wholesalers have comparable investments to soft drink wholesalers, and thus need comparable protection to that which Congress provided to the soft drink industry with the Soft Drink Interbrand Competition Act of 1980. The study concludes, however, that beer wholesalers, on average, have roughly one-half the investment of their soft drink counterparts. One reason for this is that soft drink wholesalers often do their own bottling.
3. Testimony of Bruce L. Jaffee, Associate Professor of Business Economics, Indiana University, on the Malt Beverage Interbrand Competition Act, 98th Congress, November 3, 1983.
4. Testimony of the United States Department of Justice by Charles Rule on the Malt Beverage Interbrand Competition Act, 99th Congress, May 14, 1985, p. 10.
5. Testimony of Steve L. Barsby on the Malt Beverage Interbrand Competition Act, 98th Congress, November 7, 1983, pp. 57-74.
6. Obviously, the data shown in Table V-1 for "alcoholic beverages" includes certain activities related to non-beer products.
7. Some of the typical problems encountered in working with such data include (a) <u>sample selection</u> (for example, financial statements are not available from all wholesalers, and there probably is a selection bias towards publicly-held and/or larger firms), (b) <u>inconsistent accounting treatment</u> (for example, it is difficult to control the data for inconsistencies in financial statement presentations, such as the use of LIFO versus FIFO accounting standards, and tax-return data versus other types of balance-sheet information. Likewise, firms often define such terms as "net worth" and "profit" differently.), (c) <u>general lack of comparability between firms</u> (for example, a firm may or may not devote its entire business to wholesaling beer; yet, if it does not, it still will be compared with "beer only" wholesalers), and (d) straightforward comparisons of rates of return across industries should ideally be adjusted for differences in business <u>risks</u> between industries (for example, the <u>less</u> risky a particular industry is, the <u>higher</u> any particular rate of return shown for it really is. Thus, to the extent that the three-tier exclusive-territory system reduces risks for beer wholesalers, one might expect their risk-unadjusted rate of return to appear to be "below average," even though their "true" (risk-adjusted) rate of return might be normal.)
8. Testimony of W. John Jordan, Associate Professor of Economics, Seton Hall University on the Malt Beverage Interbrand Competition Act, 98th Congress, November 7, 1983.
9. New Jersey law also permits volume discounts which are not permitted in California. It is not clear from the Jordan study whether or not transshippers required a minimum order amount from the retailers they were selling to.

10. See source citation in footnote 3 above.
11. The effect of beverage deposits on beverage prices depend on several factors, including the amount of the deposit itself, and the extent to which the deposit is incorporated into a beverage's price. This degree of "price incorporation" will be greatest when consumers either do not bother to return empty bottles (thereby forfeiting their deposits) or incur large costs in doing so (such as inconvenience, transportation costs, storage problems, and so forth). In contrast, the degree of "price incorporation" will be small if such costs are perceived as minimal.
12. The survey results discussed in the chapter 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.
13. The average breakdown of these firms' sales volumes was 81 percent for domestic beers, 9 percent for imported beers, 5.4 percent for domestic and imported wines, and 4.6 percent for other products.
14. Although a loss of only one-half of one percent due to spoilage is small in relative terms, it does represent a not-inconsequential financial burden relative to the profit margin that beer wholesalers typically earn on their sales volume. However, losses due to spoilage, and other factors such as theft, are not unique to the beer industry, and the costs they impose are normally factored into the prices charged for products. In other words, economists generally believe that consumers eventually pay for these costs one way or another.
15. The remaining 52 percent of the respondents said they engaged in both price and service competition.
16. The term "major-domestic" brewers as used here includes Anheuser-Busch, Coors, Miller, Strohs, and G. Heileman.

CHAPTER VI

THE POTENTIAL FISCAL EFFECTS OF SB 1211 ON STATE GOVERNMENT

In this chapter, we consider the potential effects of SB 1211 on California's state government budget. For purposes of discussion, we divide these effects into two categories:

- The effects on state administrative and regulatory costs of implementing and enforcing the bill's provisions, and of collecting alcoholic beverage excise and sales taxes on beer sold in California; and
- The effects on state revenues of changes in beer consumption and beer prices induced by the bill.

A. EFFECTS ON STATE GOVERNMENT COSTS

In order to assess the potential state costs which SB 1211's provisions could give rise to, we followed two approaches. First, we asked the alcoholic beverage control agency in those other states which currently have equivalent provisions what costs, if any, the provisions have imposed. Second, we asked those state agencies in California that would be affected by SB 1211 for their estimates of how SB 1211 would affect agency costs.

1. The Experience of Other States

In our survey of state Alcoholic Beverage Control agencies (Appendix A), we asked whether beer distribution provisions like those in SB 1211 tend to impose any special administrative or regulatory burdens on state government, such as those associated with verifying and enforcing exclusive wholesaling territory designations made by beer producers. The response to this question generally was "no." For example, of the 27 states which either directly or indirectly require exclusive territories (see Chapter III), 21 stated that this requirement did not impose any measurable administrative or regulatory costs. Generally, this was because the states either undertook a very passive enforcement role, or simply relied on self-policing enforcement efforts by the affected firms in the industry. Of the remaining six states, five stated that the exclusive territory requirement imposed only minor costs, such as those resulting from regulatory-related hearings involving exclusive territory violations. Only one state indicated that it had experienced some cost savings.[1]

Thus, given the way other states have chosen to administer and enforce exclusive territory requirements, these requirements have not resulted in significant state administrative and/or regulatory costs.

2. Cost Estimates by California State Agencies

While the experiences of other states is relevant to the Legislature's consideration of SB 1211, the bill's impact on California might be different. For this reason, we asked the two California agencies that would be directly affected by the bill--the Department of Alcoholic Beverage Control (ABC) and the State Board of Equalization (BOE)--to develop their own cost estimates.

a. Department of Alcoholic Beverage Control

The ABC is the state entity responsible for administering and enforcing all laws and regulations pertaining to alcoholic beverages. The department's response to our question regarding the potential cost impact of SB 1211 appears in Appendix E.

The department maintains that SB 1211 would impose no new regulatory responsibilities on it, since SB 1211's provisions "appear to be enforceable only by civil remedy by the aggrieved party." In addition, the department indicates that, since it already processes and administers territorial agreements under existing law, it would incur no new responsibilities in this regard, and no new forms or types of findings would be necessary. Thus, about all SB 1211 would require of the department is that it explain and interpret the provisions of SB 1211 in response to inquiries from the industry.

Given this, the impact of the bill on the ABC's cost would be negligible.[2]

b. State Board of Equalization

The State Board of Equalization (BOE) is responsible for administering and enforcing the state's taxes on beer, which include the alcoholic beverage excise tax, and the sales and use tax. The BOE's response to our question regarding the costs imposed by SB 1211 appears in Appendix F.

The BOE indicates that the bill would have no effect on its basic operations, including staffing, workload, or costs. More specifically, it indicates that the bill will have no effect on what is involved in tracing beer transactions, and would not otherwise affect its administration of the taxes which are levied upon alcoholic beverages.

3. Summary Regarding Costs

Given the above, it appears that SB 1211 would not impose significant costs on state government.

B. EFFECTS ON STATE GOVERNMENT REVENUES

The direct revenue effect of a primary source law would show up in the revenue collections from the two state taxes which are levied on beer--the alcoholic beverage excise tax, and the sales and use tax.[3]

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

The alcoholic beverage excise tax is levied on a per-gallon basis. For beer, the rate is 4 cents per gallon. (By comparison, the tax rates on other types of alcoholic beverages are 1 cent per gallon for dry wine, 2 cents per gallon for sweet wine and sparkling hard cider, 30 cents per gallon for sparkling wine, and $2 per gallon for distilled spirits.[4]

The Governor's Budget for 1986-87 estimates that the excise tax on beer will raise about $25 million in the budget year. (By comparison, the state expects to collect about $4.6 million from its excise taxes on wines and $104 million from its excise tax on distilled spirits.[5]) Thus, while excise tax revenues collected for beer in 1986-87 are large in absolute dollar terms, they are fairly small relative to total state General Fund revenues (about eight one-hundredths of 1 percent of the $31 billion amount projected).

The state's sales and use tax is levied on an ad valorem basis. The basic sales and use tax rate currently is equal to 6 percent of the dollar volume of nonexempt goods, including beer and other alcoholic beverages.[6] Of the total tax rate, 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 tax 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 sales and use tax revenues attributable to beer sales.[8] However, it appears that in 1986-87, beer-related sales and use tax revenues in California will be about $275 million, including around $210 million in state revenues and $65 million in local revenues.[9] The state's share represents about 1.9 percent of total state sales and use tax collections, and a bit under seven-tenths of 1 percent of total General Fund revenues. Thus, the sales and use tax on beer raises about 11 times more in total revenues, and over eight times more in state government revenues, than does the excise tax on beer.

2. The Potential Revenue Effects of SB 1211

The revenue effects of SB 1211 would depend primarily on two factors:[10]

- The change in the quantity of beer sales in California. (These changes will directly affect excise tax revenues.)
- The change in total expenditures on beer and other commodities by individuals, businesses and other types of consumers in California. (This effect, which reflects changes in both the price and quantity purchased of beer, will directly affect sales and use tax revenues.)

Unfortunately, it is extremely difficult to predict what these changes would be if SB 1211 went into effect. As discussed in Chapters IV and V, we would expect some upward pressure on retail beer prices, particularly in the case of minor-domestic and foreign brands. At the same time, these changes in absolute and relative prices for given brands likely would lead to decreased consumption for some brands while increasing sales for others.

For these and other reasons, it is not possible to calculate the revenue effect of SB 1211 with any precision. The best we can do is to develop reasonable alternative assumptions about the key revenue-determining variables, and then use these assumptions to illustrate the types of revenue effects the Legislature realistically could expect to result from enacting provisions similar to SB 1211.

The relevant assumptions to consider include the portion of the beer market which would be affected, the extent to which beer prices would change, the way in which the quantity of beer consumed would respond to these price changes, and the extent to which changes in consumer expenditures on beer would change consumer expenditures on non-beer products.

A wide range of revenue outcomes can be generated using different values for the above assumptions. As noted earlier, our research indicates that minor-domestic and foreign brands (roughly 10 percent of the total beer market) would be affected most significantly by SB 1211-type provisions. From the information we have been able to gather, a reasonable assumption is that SB 1211 might eventually (not necessarily immediately) lead to a modest (say, 5-to-10 percent) average price increase for minor-domestic and foreign brands, and a more-marginal (say, zero-to-5 percent) price increase for the remainder of the market. If beer prices were to rise according to the midpoint of these ranges (7.5 percent for minor-domestic and foreign brands, and 2.5 percent for other brands) without any accompanying reduction in sales volumes, annual state revenues would increase by approximately $1 million to $3 million.[11]

However, sales of most beer brands are at least somewhat sensitive to changes in prices, and therefore it is unrealistic to assume there would be no change whatsoever in the volume of beer sales. In fact, the empirical research conducted by economists on beer demand suggests that it is likely that increases in prices would result in an equal, or even slightly more-than-proportionate, drop in volume for many brands. Calculations using this set of assumptions tend to indicate that SB 1211 would likely cause a net loss in state revenues.

Appendix G describes in detail the different revenue outcomes produced by alternative assumptions about the above-cited revenue-determining variables, and discusses which are most likely to occur. Our "bottom line" is that the likelihood is greatest that revenues would decline, with the annual revenue loss falling between $160,000 and $450,000.

C. SUMMARY

In sum, it appears that SB 1211's effects on state costs would be negligible, and that the bill's effects on state revenues is most likely to be a loss, probably in the general range of $160,000 to $450,000 annually.

FOOTNOTES TO CHAPTER VI

1. One reason why exclusive territories might produce some cost savings for alcoholic beverage regulatory agencies is that, by making violations of exclusive territory designations a "law-breaking" (as opposed to a "contract-breaking") action, fewer violations might occur. This, in turn, might reduce the time spent by regulatory agencies in responding to complaints about such violations. In California, for example, the ABC currently has to follow-up on complaints about territory violations because such a violation would indicate that a wholesaler is not posting his prices. As discussed in Chapter II, the ABC is required to enforce the state's price-posting requirement.
2. Certain minor one-time form-processing-and-filing costs might arise if SB 1211 led some brewers to change their wholesalers or make revisions in their territories, so as to cope with the bill's various servicing requirements.
3. In addition to the direct revenue effects of a bill such as SB 1211, there also would be a variety of indirect revenue effects associated with collections from other state taxes, including the personal income tax and bank and corporation tax. The direction and magnitude of these indirect revenue effects would depend on such factors as how SB 1211 affected the number and wages of beer industry employees, and the profits of beer producers, wholesalers, and retailers.
4. All of California's alcoholic beverage tax rates have remained unchanged for many years, having been set in 1935 for sweet wine, 1937 for dry wine, 1955 for sparkling wine, 1959 for beer, and 1967 for distilled spirits. California's excise tax rates for alcoholic beverages tend to be relatively low compared to those in other states. For example, only a handful of states have a cents-per-gallon excise tax on beer which is below California's (see <u>The Taxation of Cigarettes, Alcoholic Beverages and Parimutuel Wagering</u>, Legislative Analyst's Office, October 1981, 42 pages.)
5. These estimates assume annual per capita consumption levels of 23.7 gallons for beer and 1.95 gallons for distilled spirits. The $2-per-gallon distilled spirits tax rate applies to liquor of 100 proof or less; a rate of $4 per gallon is levied on over-100-proof liquor.
6. In the case of alcoholic beverages, the sales and use tax is levied <u>after</u> 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. When these transit taxes are included, the average combined state-local sales and use tax rate in California is approximately 6.27 percent.
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 not a separate breakdown of beer sales in stores that primarily sell other merchandise, such as grocery stores.

9. These estimates utilize the per capita estimate of beer consumption referred to in footnote 5 above. They also assume that (a) 80 percent of the beer is purchased for off-site consumption, at an average price of $2.92 per six-pack, and (b) 20 percent of the beer is purchased for on-site consumption, at an average price of $1.25 per 12-ounce serving.
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 compliance would not be significantly affected by SB 1211.
11. This assumes that the expenditure-offset factor (discussed in Appendix G) lies between 50 percent and 80 percent. If this factor is zero, the annual state revenue gain would be over $6 million.

CHAPTER VII

CONCLUSIONS

The purpose of this report has been to assess the potential effects of SB 1211 on beer suppliers, wholesalers, retailers and consumers, including the bill's potential effects on beer prices and on foreign and domestic beer sales.

In conducting our research, we found that many of the objectives sought by the bill have already been largely achieved for most of the beer market. For example, more than 90 percent of the beer sold in California is distributed through the exclusive territories that SB 1211 would require, and a comparable percentage appears to be distributed by wholesalers that already enjoy many of the contractual safeguards proposed in the bill. Thus, SB 1211's impacts would be uneven, falling most heavily on the remaining portion of the beer market (about 10 percent of the total) that involves minor-domestic and foreign brands.

Regarding the specific effects of SB 1211, our research suggests that it is likely that its provisions eventually would tend to:

- Increase the prices paid by consumers for beer--certainly for some of the minor-domestic and foreign brands and, very possibly (though to a lesser degree), for the major brands as well.
- Limit the ability of chain-store retailers to use central warehousing and their own internal distribution systems for beers, thereby raising their costs.

- Adversely affect beer wholesalers which currently deliver only to large-volume accounts, by requiring them to deliver to retailers "generally" (including smaller accounts), thereby raising their costs.
- Tend to increase concentration in the beer wholesaling industry.
- Provide increased security for some beer wholesalers, especially those handling most minor-domestic beer brands and foreign beer brands. However, this gain would be at least partly at the expense of other firms in the beer industry (including both some currently-operating firms and potential new entrants).

In addition, we find no reason to believe that the bill would significantly improve either the overall quality of beer products, or their selection and availability. There also would likely be a modest loss in state government revenues, probably in the general range of $160,000 to $450,000 annually.

On this basis, we conclude that the net effect of SB 1211 on the state's consumers would be negative. Specifically, we could find no significant benefits to the consumer that would offset the possible costs resulting from the bill, including the eventual likelihood of somewhat higher beer prices.

APPENDIX A

SURVEY OF STATES REGARDING BEER DISTRIBUTION REQUIREMENTS

STATE SURVEY REGARDING BEER WHOLESALING PRACTICES
AND EXCLUSIVE WHOLESALING TERRITORY DESIGNATIONS

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

1. Does your state require exclusive territories for beer wholesalers, by brand?

2. If yes, is there any prohibition against a wholesaler selling beer to a retailer who then ships that beer into another wholesaler's territory?

3. Does your state require that beer wholesalers (or beer manufacturers who sell directly to retailers) provide specific services to retailers (such as rotating stocks, cleaning taps, etc.), or that they must sell to a certain minimum percentage of accounts in their territory?

4. Is there any information regarding how exclusive wholesaling territories or wholesaling-servicing requirements have affected consumer beer prices, numbers of beer wholesalers, and the availability and quality of distribution services provided to retailers (especially small and/or rural retailers)? If so, what does it indicate?

5. To what extent do exclusive-territory and/or wholesaler-servicing requirements impose special state administrative costs, such as for enforcement and auditing?

APPENDIX B

SURVEY OF CALIFORNIA BEER WHOLESALERS

SURVEY OF CALIFORNIA BEER WHOLESALERS AND DISTRIBUTORS

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

1. Approximately what is your total annual dollar volume of sales ________ and, of this, what is its approximate percentage breakdown according to the following categories?

Type of Beverage	Percentage Share of Total Volume
Domestic beers	_____%
Imported beers	_____
Domestic and imported wines	_____
Other items	_____
TOTAL, ALL ITEMS	100 %

2. How many different brands of domestic beer _____ and foreign beer _____ do you handle _____? Of these, for how many has the brand's manufacturer assigned a geographic distribution area to you _____, and what are the names of these brands ____?

3. Of the brands for which you have been assigned a particular geographic distribution area by the producer or its agent, for how many brands is your designated area an exclusive territory in the case of domestic brands _____ and foreign brands _____, and what are the names of these brands ____?

4. Approximately what percentage of your beer sales is accounted for by brands for which you have exclusive territories _____?

5. Do you make deliveries to any "central warehouses" of chain retail stores _____? If so:

   a. What percent of your beer sales do these deliveries comprise _____?
   b. Do any of these central warehouses subsequently ship any of this beer to sites located outside of the geographic territories that have been assigned to you _____? If so:

      (i) What percent of your total beer sales would you guess such "cross-territory" shipments tend to average _____?
      (ii) What percent of these "cross-territory" shipments are for brands that you have an exclusive distribution territory for _____?

6. a. Do you ever ship beer brands outside of geographic territories that brand manufacturers have assigned to you _____? If so, how often:

   (i) Rarely (ii) Periodically (iii) Frequently

   b. Do you know of other wholesalers/distributors who ship beer brands outside of their brewer-assigned geographic territories _____? If so, about how many wholesalers appear to do so _____ and how often:

   (i) Rarely (ii) Periodically (iii) Frequently

c. What actions do beer brewers generally take against a wholesaler/distributor who is found to be shipping beer outside of the boundaries of its designated exclusive territory:

(i) Immediate cancellation of distribution rights
(ii) Reduction in brands available to the wholesaler/distributor
(iii) Reduction in the size of its exclusive territory
(iv) Warning that cancellation will occur if practice continues
(v) Requirement that compensation payments be made to the distributor whose territory was invaded
(vi) Nothing
(vii) Other (please specify): ______________________________.

7. Do you typically provide any services to retail stores to which you make deliveries ____? If so, what are these services:

a. Stock rotation
b. Setting up displays
c. Shelf maintenance
d. Cleaning taps
e. Other (please specify): ______________________________.

8. How often do you typically find it necessary to pick up outdated beer from the retailers you service:

a. Never
b. Very infrequently
c. Periodically
d. Regularly

9. If you do pick up outdated beer from retailers you service:

a. What is done with this beer ______________________________?
b. What percentage of your total beer sales volume does the outdated beer you pick up typically represent ____?

10. Do you ever pick up outdated beer from retailers you service, which is not originally delivered by yourself but rather by another wholesaler/distributor who will not provide this service ____? If so, what would you estimate the typical annual value of this beer is as a percent of your own annual sales volume ____?

11. Have you ever had your rights to distribute a given brand of beer terminated by its producer ____? If so:

a. What brand(s) ______________________________?
b. Was the cause for termination that you had you failed to meet your specific contractual requirements with the producer (such as failure to reach sales goals, late payments, etc.) ____?

(i) If so, please specify the cause: ____________________.
(ii) If not, please indicate the reason(s) why you believe you were terminated ______________________________.

c. Do you believe that your existing contracts with beer manufacturers provide you with adequate protection against unwarranted cancellations of your distribution rights in the case of major domestic brands _____, other domestic brands _____, and foreign brands _____? If not, please explain: ______________________________
____.

12. Regarding any beer brands for which you have an assigned distribution territory:

    a. Are you required by the producer to service all of the retail establishments located within the assigned territory _____?
    b. If you are not required to do so, have you choosen to service all of the retail establishments located within your territory _____? If not, why not:

        a. Not all establishments want to carry my brand(s).
        b. Some establishments are too costly to service, due to their locations or low sales volumes.
        c. Other (please specify): ______________________________.

13. Do you maintain a refrigerated warehouse (that is, is the beer you eventually distribute refrigerated prior to when you ship it to retailers) _____? Are any of your delivery trucks refrigerated _____ and if so, what percent _____?

14. Have you ever had a beer manufacturer appoint another authorized distributor in your own distribution area who competed directly with you _____?

    a. If so, for what beer brand(s) did this occur ______________________?
    b. If not, have you heard of this happening to any other wholesalers or distributors _____ and, if so, how many _____ and for what brands of beer ____?

15. a. Do beer manufacturers who appoint competing distributors within the same geographic territory tend to be producers of major domestic brands _____, other domestic brands _____, or foreign brands _____?
    b. In your opinion, is the problem of beer manufacturers unfairly terminating distributors a serious one, in the case of either major domestic brands _____, other domestic brands _____, or foreign brands _____?

16. Are you required to financially participate in the advertising and/or marketing programs of any brewers whose brands you handle _____? If so, which brewers are these ______________________________________, and what would you estimate the dollar-per-case cost of this participation is _________?

17. When you compete with other beer wholesalers for business, do you focus primarily on (a) price competition or (b) the number and quality of the services you provide ________________?

18. Would you say that price competition tends to be strongest on an interbrand or intrabrand basis in California ______________________?

19. Do you think that the exclusive-territory provisions of SB1211 would eventually:

    a. Put certain wholesalers and distributors out of business _____? If so, about how many _____ and would these tend to be larger or smaller firms ______________________________?
    b. Seriously jeopordize your own ability to stay in business and profitably operate in the future ____________________?
    c. Concentrate beer wholesaling into the hands of fewer and larger firms, either immediately _____ or in the future _____?
    d. Eventually make it more difficult for small domestic brewers _____ and/or foreign brewers _____ to effectively distribute their brands?
    d. Shut you off from distributing certain beer brands that you currently handle _____? If so, how many _____, and roughly what percent of your current sales volume would this represent _____?
    e. Improve your sales volume _____ and the number of brands you handle _____?
    f. Cause beer prices to tend to rise _____, fall _____, or remain unchanged _____?

20. If California permitted you to offer quantity price discounts for your beer, what percentage of your beer do you think would:

    a. Be shipped directly by you to the central warehouses of large retailers _____?
    b. Eventually be shipped outside of your own distribution territory by retailers _____?

21. COMMENTS. Please provide any additional comments below that you would like to share regarding the impacts of SB1211.

____
____
____
____

IF YOU WISH TO RECEIVE A COPY OF OUR FINAL REPORT ON SB1211, PLEASE PROVIDE THE MAILING ADDRESS TO WHICH IT SHOULD BE SENT BELOW:

____
____

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

SUMMARY OF RESPONSES TO SELECTED QUESTIONS ON THE BEER WHOLESALER SURVEY[a]

		Response[b]
A.	Questions Regarding Beer Distribution	
	% of sales distributed via exclusive territories (4)	91.4%
	% of wholesalers who make deliveries to central warehouses (5)	1.7%
	% of wholesalers who ship outside their brewer-assigned distribution territories (6a)	3.4%
	% of wholesalers who know of other wholesalers who distribute outside of their assigned territories (6b)	53.6%
	Average number of known wholesalers distributing outside their distribution territories (6b)	2.9
B.	Questions Regarding Beer-Related Services	
	% of total sales that pickups of outdated beer represent (9b)	0.5%
	% of wholesalers who pick up outdated beer they didn't deliver themselves (10)	21.4%
	% of total sales that pickups of outdated beer delivered by another wholesaler represent (10)	0.5%
C.	Questions Regarding Contractual Agreements	
	% of wholesalers required to offer service to all accounts (12a)	89.0%
	% of wholesalers who have had their distribution rights terminated by a brewer (11)	44.5%
	% of these terminations which were by: (11a)	
	Major-domestic brewers[c]	9.1%
	Other domestic brewers	29.1%
	Foreign brewers	61.8%
	% of wholesalers who have had competing wholesalers assigned to their distribution territory (14)	46.0%
	% of these assignments made by: (14a)	
	Major-domestic brewers	3.3%
	Other domestic brewers	21.7%
	Foreign brewers	75.0%
	% of wholesalers who felt their contracts provide adequate protection against unwarranted terminations by: (11c)	

	Response[b]
C. Questions Regarding Contractual Agreements (cont'd)	
Major-domestic brewers	53.0%
Other domestic brewers	30.0%
Foreign brewers	16.0%
% of wholesalers required to participate in brewer advertising programs (16)	91.5%
Average cost per case of beer for these advertising expenses	$ .17
D. Questions Regarding Competition Amongst Beer Wholesalers	
% of wholesalers who focus their competitive efforts on: (17)	
Price competition	7.8%
Service competition	40.5%
Both price and service	51.7%
% of wholesalers who indicated that price competition was strongest on an: (18)	
Interbrand basis	71.4%
Intrabrand basis	21.4%
Both interbrand and intrabrand basis	7.2%
E. Questions Regarding the Anticipated Effects of SB 1211	
% of wholesalers who thought SB 1211 would:	
Put certain wholesalers out of business (19a)	8.5%
Jeopardize their own business (19b)	3.8%
Improve their sales volume (19e)	54.0%
Improve the number of brands they handle (19e)	35.8%
% of wholesalers who thought SB 1211 would cause beer prices to: (19f)	
Rise	2.9%
Fall	0.0%
Remain unchanged	97.1%

a. Figures in parentheses correspond to the question number on the beer wholesaler survey form.
b. Survey results have been calculated so as to reflect survey responses for the subgroup of respondents answering the specified questions. This procedure was followed because not all respondents answered every question on their survey form.
c. Major-domestic brewers are defined as Anheuser-Busch, Miller, Coors, Strohs and G. Heileman.

APPENDIX C

SURVEY OF CALIFORNIA BEER RETAILERS

SURVEY OF RETAILERS REGARDING SB 1211

NAME OF RETAILER: ________________________________.
NAME AND PHONE OF CONTACT PERSON: ________________________.

1. (a) How many different beer manufacturers _____ and beer brands _____ do you stock at a typical metropolitan location?
   (b) How many different beer wholesalers do you deal with in obtaining these beers at a typical metropolitan location ___________?
   (c) How many of these wholesalers supply you with:

      (i) Only one manufacturer's brands of beer ___________?
      (ii) Two manufacturers' brands of beer _______________?
      (iii) Three or more manufacturers' brands of beer _______?

2. Is beer distributed to your individual stores from:

   (a) Your own warehouses _____? If so, how many brands _____?
   (b) Beer wholesalers using their own delivery trucks _____? If so, how many brands _____?
   (c) Some other source (explain) _____________________________? If so, how many brands _____?

3. Approximately what percentage of beer deliveries that are made directly to your stores (that is, that are not delivered from your own warehouse(s)) come from:

   (a) Local beer wholesalers _____?
   (b) "Extended" wholesalers such as BDI _____?
   (c) Wholesalers who ship across the boundaries of "exclusive" wholesaling territories _____?

4. If you use central warehousing only for certain brands of beer:

   (a) Which brands are these ______________________________________?
   (b) Which brands are delivered directly to your stores by beer wholesalers ____?
   (c) What percent of your total beer sales are delivered directly to your stores by beer wholesalers (_____%) as opposed to from your central warehouse(s) (_____%)?

5. Approximately what percentage of beer deliveries to your central warehouse(s) come from:

   (a) Local beer wholesalers _____?
   (b) "Extended" wholesalers such as BDI _____?
   (c) Wholesalers who ship across the boundaries of "exclusive" wholesaling territories _____?

6. Do you ever ship a beer brand, either from your warehouse(s) or individual stores to which it originally has been delivered, to stores located outside of the brand's local beer wholesaling territory in which the warehouse or store is located ____? If so, what percentage of your total beer sales do these "cross-territory" shipments typically represent ____?

7. (a) What services do beer wholesalers typically provide at your stores (for example, stock rotation, floor displays, etc.) ____________?
   (b) If you rely on central warehousing for certain beer brands, what services do the warehousing personnel typically provide your stores with ____________?

8. (a) Which beer brands are available to you in a typical metropolitan area only through a single wholesaler who has an "exclusive territory" for that brand ____________?
   (b) Which brands normally are available in a typical metropolitan area from more than one wholesaler ____________?

9. (a) What percentage of your beer stock typically has its "shelf life" expire before you sell it ____?
   (b) What is done with this beer ____________?
   (c) What is the approximate cost to you in a normal year of this "spoiled" beer supply ____________?
   (d) Are you aware of cases where wholesalers have attempted "rolling" outdated beer into one of your stores ______? If so, how frequently has this occurred ____________?

10. Do beer wholesalers who distribute the same brand compete with one another for your business primarily through (a) price competition, (b) the services they provide you with, or (c) both ____________?

11. (a) Are "minor" domestic beer brands (i.e., brands not produced by Miller, Anheuser-Busch, Coors or Strohs) and imported beer brands typically available to you in metropolitan locations through more than one wholesaler ____________?
    (b) To what extent are the wholesalers for "minor" domestic beers and imported beers generally different wholesalers than those who provide the major domestic beer brands to you ____________?

12. PLEASE PROVIDE ANY ADDITIONAL COMMENTS YOU MIGHT HAVE REGARDING SB1211 IN THE SPACE PROVIDED BELOW.

____

____

____

____

____

APPENDIX D

SURVEY OF CALIFORNIA BEER PRODUCERS

SURVEY OF BEER MANUFACTURERS AND SUPPLIERS

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

1. How many different beer brands do you manufacture _____ and, of these, how many are currently being marketed in California _____ and what are their names ____?

2. What is the approximate annual dollar volume of your total beer sales __________ and, of this, about what percent is sold in California _____?

3. Approximately what percent of California's total beer market do sales of your brands represent _____?

4. Regarding how your beer is distributed:

   a. What percent of your beer sales do you make directly to retailers _____ as opposed to wholesalers and distributors _____, and how many different wholesalers and distributors handle your beers in California _____?
   b. About what percent of your beer is shipped directly by you to the central warehouses of retailers _____, or shipped by beer wholesalers to retailers' central warehouses _____?

5. a. Do you own or maintain a controlling interest in any of the distributorships that handle your beer brands _____? If so, how many such distributorships are located in California _____, and what percentage of your annual beer sales in California are made to these distributorships _____?
   b. Do you plan to move toward owning more of your own distributorships in the future _____? If so, do you think that SB1211 will restrict your ability to do this _____?

6. Has the percent of your sales that you make directly to retailers been rising in recent years _____, and/or do you expect it to do so in the future _____?

7. Do you assign geographic territories to the wholesalers who distribute your brands _____? If so:

   a. About how many different geographic distribution territories within California have you designated _____?
   b. Are these territories generally "exclusive" (that is, is only one wholesaler per territory permitted to handle your beer) _____?

8. Senate Bill 1211 requires that a beer producer who sells directly to retailers must provide the same services (stock rotation, etc.) to these retail accounts, that the producer requires its own wholesalers to provide to retail accounts. Do you think that this requirement would:

   a. Decrease the sales that you make directly to retailers _____ and, if so, by what percentage _____?
   b. Alter your long term plans for increasing your direct sales to retailers ____?

9. Do your designated wholesaling territories generally tend to have geographic boundaries that are similar to or different from those of competing beer manufacturers ______________________________?

10. When did you first begin the practice of assigning geographic territories __________ and "exclusive" geographic territories __________ to beer wholesalers/distributors?

11. How frequently do your wholesalers make sales outside of their assigned geographic territories?

    a. Frequently   c. Infrequently   e. Have no idea
    b. Periodically   d. Never

12. If and when wholesalers make sales outside of the territories you have assigned to them, which action(s) do you normally take:

    a. Terminate them immediately
    b. Warn them, and then terminate them if they don't stop this practice
    c. Require them to make financial restitution to the wholesaler(s) whose territory has been invaded
    d. Reduce the number of brands or volume of beer the wholesaler can obtain from you
    e. Reduce the size of the wholesaler's territory
    f. Permit one or more additional wholesaler(s) to directly compete in the violator's territory
    g. Do nothing, because it is not your responsibility to enforce territorial rights
    h. Other (please specify): ______________________________.

13. Regarding instances in the past where your distribution agreements with wholesalers have been terminated:

    a. How many times has this occurred during the past 5 years _____ and, of these, how many terminations have you initiated _____?
    b. What have been the usual causes for these terminations __________ ______________________________?
    c. Have these terminations ever resulted in any court litigation against you _____ and, if so, in how many cases _____?
    d. Do concerns over possible court litigation tend to limit your ability to strictly enforce the geographic distribution areas that you assign to individual wholesalers _____?

14. a. California currently prohibits "quantity price discounts" for beer sold to retailers. If this prohibition were removed, would you attempt to sell more of your beer directly to large retail establishments such as chain stores (including shipments to central warehouses) _____ and, if so, about what percent of your beer volume might you eventually distribute in this fashion _____?
    b. Do you sell beer in other states which permit "quantity price discounts" _____? If so, is the percentage of your beer that you sell directly to retailers (including their central warehouses) in these states significantly greater than in California _____? By how much ______________________________?

15. Please indicate the type of effect(s) you believe that exclusive beer distribution territories for wholesalers would have on the following:

	Positive	Negative	None
a. The distribution network for your products	___	___	___
b. Interbrand price competition	___	___	___
c. Product quality for your beers	___	___	___
d. Price competition for a given brand	___	___	___
e. Business opportunities for "extended" distributors (such as BDI in Calif.)	___	___	___
e. Wholesalers' incentives to aggressively market products	___	___	___
f. Entry of new firms into the beer distribution industry	___	___	___
e. Other: ______________________________.	___	___	___

16. Is there any difference in how well the quality of your beer generally is maintained (such as timely removal of outdated beer), depending on whether you distribute it through wholesalers or sell it directly to retailers _____? If so, please explain ______________________________
____.

17. Please indicate below what percent of local marketing expenses (and its approximate cost per case) you require your distributors to contribute in each of the following categories:

	Distributor Share of Marketing Expenses (%)	Distributor Cost Per Case ($)
a. Radio and Television	_____	_____
b. Print Media	_____	_____
c. Point-of-sale materials	_____	_____
d. Other _______________.	_____	_____

18. Senate Bill 1211 contains various provisions mandating that certain clauses appear in the distribution contracts between wholesalers and brewers. These standard clauses would basically require that a distribution agreement could not be terminated without "due cause and notice", as specified.

   a. Do your present contracts with distributors already contain such clauses _____, or are you allowed to terminate a contract at your discretion ____?
   b. Are you aware of any beer suppliers who tend to terminate wholesalers without "due cause" _____? If so, about how many suppliers that you know of do this in the case of major domestic beers _____, other domestic beers _____ and foreign beers _____?
   c. Do you believe that such statutory contract requirements are needed in your industry _____ , or instead that the private legal contracts which you presently rely on are fully capable of serving the needs of both brewers and wholesalers _____? If you believe that statutory requirements should be enacted, please explain why: _______________
   ____.

d. Are your present contracts with wholesalers for specified periods of time (subject to potential renewal) _____, or are they "open-ended" as regards their time frame _________? Do these contracts contain "performance clauses", such as sales quotas _____? If so, what criteria are normally involved ________________________________?

19. Do you think that SB1211's provisions would tend to raise, reduce, or leave unchanged the prices of:

a. Your beer ____________________________________.
b. Imported beers generally ____________________________________.
c. Major domestic brands generally ____________________.
d. Other domestic brands generally ____________________.

20. Do you think that SB1211 would eventually:

a. Hurt _____ or help _____ your profitability and sales in California?
b. Tend to either increase _____ or decrease _____ the number of beer wholesalers/distributors operating in California. If so, how many firms do you think might be affected _______________?
c. Improve _____ or hinder _____ the effective distribution and marketing of your own brands? If so, please expain why ____________ ____.
d. Place non-major domestic brands _____ and foreign brands _____ at a disadvantage in terms of their chance to be effectively distributed and marketed? If so, please explain why ___________________________ ____.

21. COMMENTS: PLEASE PROVIDE ANY ADDITIONAL COMMENTS BELOW THAT YOU WOULD LIKE TO SHARE WITH US REGARDING THE EFFECTS OF SB1211'S EXCLUSIVE-TERRITORY AND SUPPLIER/WHOLESALER PROVISIONS.

____
____
____
____

IF YOU WOULD LIKE TO RECEIVE A COPY OF OUR FINAL REPORT ON SB1211, PLEASE PROVIDE THE MAILING ADDRESS TO WHICH IT SHOULD BE SENT:

____
____
____

*** THANK YOU FOR YOUR COOPERATION ***

APPENDIX E

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

STATE OF CALIFORNIA

GEORGE DEUKMEJIAN, Govern

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.

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" provisions of 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

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. <u>Effects on Prices</u>

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.

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

APPENDIX F

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

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
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

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 G

COMPUTATIONS OF POTENTIAL FISCAL EFFECTS

APPENDIX G

COMPUTATIONS OF POTENTIAL FISCAL EFFECTS

In order to provide an illustration--not an estimate--of SB 1211's potential effects on state revenues, assumptions are necessary regarding:

- The extent to which beer prices would change as a result of SB 1211 (that is, the "price change" assumption).
- The way in which the quantity of beer consumed would respond to these price changes (that is, the quantity response, or "price elasticity," assumption).
- The extent to which expenditure changes for beer due to SB 1211's effects on beer prices and sales are offset by changes in expenditures on other types of taxable goods and services (that is, the "expenditure offset" factor).

Given the data collected in our survey, other research findings and the principles of economic theory, we believe it is reasonable, for illustrative purposes, to assume the following:

- Changes in Prices. We assume that the prices of beer eventually could rise by between 5 percent and 10 percent in the case of the minor-domestic brands and foreign brands, and by anywhere from zero-to-five percent in the case of major-domestic brands (90 percent of the market).
- Change in Quantity. We assume that for each percentage point increase in beer prices, there would be a decline in the quantity of beer sold equal to from 0.5 percent to 1 percent for the major

brands, and from 0.5 percent to 1.5 percent for the minor-domestic brands and foreign brands. (These quantity responses to price changes represent what economists call the "price elasticity of demand" for beer.)[1]

- Expenditure Offset Assumptions. We assume that between 50 percent and 80 percent of any change in beer expenditures due to SB 1211 would be "rechanneled" by consumers into expenditures on other taxable goods.

Results

Table G-1 summarizes what the direct state and local revenue effects of SB 1211 would be, given the range of assumptions discussed above. The table indicates that the revenue effects are very sensitive to the particular assumptions used, and range from a loss of over \$2.6 million per year to a gain of over \$2.7 million per year.[2] Likewise, there is a broad range of direct state government revenue effects, from a loss of nearly \$2.4 million per year to a gain of nearly \$1.9 million per year. However, Table G-1 also shows that:

- The direction of the revenue effects is positive when the "price elasticity" factors are low, but negative when they are medium or high.[3]
- The sheer absolute magnitude of the revenue effects becomes larger when the assumed increase in beer prices become greater, whereas this magnitude becomes smaller as the "expenditure-offset" rate becomes higher.

Given the above, in order to predict whether SB 1211 will increase or decrease revenues, it is necessary to venture an educated guess about which of the assumptions in Table G-1 are "most likely" to hold.

Table G-1

Direct Revenue Effects of SB 1211 Under Alternative Assumptions

Assumptions Regarding the Response of Beer Sales to Beer Price Increases[b]	Direct Annual Revenue Effect (dollars in thousands)[a]: Small Increase in Beer Prices and an Expenditure Offset of: 50%	80%	Medium Increase in Beer Prices and an Expenditure Offset of: 50%	80%	Large Increase in Beer Prices and an Expenditure Offset of: 50%	80%
A. Small Response (low "elasticity")						
State revenue effect	171	23	1,048	147	1,865	250
Local revenue effect	78	31	474	190	850	340
Total effect	249	54	1,522	336	2,715	590
B. Medium Response (medium "elasticity")						
State revenue effect	-152	-137	-162	-452	-267	-801
Local revenue effect	-8	-3	152	61	281	112
Total effect	-160	-140	-10	-391	15	-688
C. Strong Response (high "elasticity")						
State revenue effect	-476	-296	-1,372	-1,050	-2,398	-1,852
Local revenue effect	-94	-38	-169	-68	-287	-115
Total effect	-570	-334	-1,541	-1,117	-2,685	-1,967

a. Computations represent direct revenue effects from alcoholic beverage excise taxes and sales and use taxes on beer, and exclude indirect state revenue effects such as from the personal income tax and bank and corporation tax. Price-increase assumptions are defined as follows: "Small" increase equals zero for major-domestic brands and 5 percent for all other brands; "medium" increase equals 2.5 percent for major-domestic brands and 7.5 percent for all other brands; "large" increase equals 5 percent for major-domestic brands and 10 percent for all other brands. Computations assume that California beer sales total 640 million gallons with a retail value of $4,366 million, of which 90 percent is major-domestic brands and 10 percent is minor-domestic and foreign brands.

b. Price-elasticity assumptions are defined as follows: "Low" elasticity equals 0.5 for all brands; "medium" elasticity equals 0.75 for major-domestic brands and 1.0 for all other brands; "high" elasticity equals 1.0 for major-domestic brands and 1.5 for all other brands.

No one can say with absolute certainty exactly what the correct assumptions are regarding beer price increases, elasticities, and expenditure offsets. However, we believe that it is most realistic to assume that the price, quantity, and offset effects will fall in the middle of the ranges shown in the table.[4] If this proved to be valid:

- There would be a net loss of revenue as a result of SB 1211, and
- The magnitude of the revenue loss would range from a relatively negligible amount up to several hundred thousand dollars annually.

For example, if beer prices eventually rose by 7.5 percent for the minor-domestic and foreign brands and by 2.5 percent for the major-domestic brands, and if beer price elasticities were slightly less than unity (as empirical research suggests) the annual revenue loss would fall between \$160,000 and \$450,000 for the state, and up to \$400,000 for the state and local governments combined.

FOOTNOTES TO APPENDIX G

1. A number of economists have attempted to estimate beer's price elasticity. These studies have uniformly concluded that beer is price inelastic (that is, its elasticity is less than unity). Most of these studies have reported elasticity values in the range of 0.4. However, recent research suggests that a figure of 0.75 may be more accurate (see Gary L. Marshall, "Developing a State Alcohol Beverage Revenue Simulation Model," paper presented to the National Tax Association--Tax Institute of America Annual Conference on Taxation, October 1985, 16 pages). We have located no studies which estimate the elasticity for separate submarkets of the overall beer market, such as for major-domestic brands, minor-domestic brands, and foreign brands. Normally, however, elasticities for submarkets tend to be greater than for the total market, because of intramarket product substitutions, such as between different beer brands.
2. The revenue effects shown in Table G-1 reflect local alcoholic beverage sales tax revenues. On a statewide basis, local sales tax revenues amount to about 32 percent of the state's sales tax revenues.
3. For example, positive revenue effects occur when increased sales tax revenues are sufficiently large to offset reduced excise tax revenues. In order for sales tax revenues to rise, it is necessary that beer-related expenditures rise in response to any increase in beer prices. This, in turn, implies that the affected beers are "price inelastic."
4. For example, the "medium" elasticity assumption--0.75 for major-domestic brands (90 percent of the market) and unity for minor-domestic and foreign brands (10 percent of the market)--is equivalent to weighted elasticity for the entire beer market of 0.85. This roughly corresponds to the most recent empirical estimates of beer demand elasticity (see footnote 1 above).