

Toward Liquor Domination

How Alcohol Wholesalers, Time and Money Have Corrupted the American Alcohol Industry

—A Study of Political Money and the Alcohol industry from 2005 to 2010—

Specialty Wine Retailers Association July 2011

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KEY POINTS

- 1. In the three election cycles between 2005 and 2010, American alcohol wholesalers have spent \$82 million on contributions to federal and state political campaigns and federal lobbying efforts.
- 2. In the last three election cycles between 2005 and 2010, American alcohol wholesalers have spent more than \$15.4 million dollars on Contributions to federal election campaigns.
- 3. Wholesalers have spent nearly double the rest of the alcohol industry on federal campaign contributions over the past three federal election cycles.
- 4. The primary wholesaler trade associations, the National Beer Wholesalers Association and the Wine & Spirits Wholesalers Association, alone have spent more than \$8.8 million on federal lobbying over the past three election cycles between 2005 and 2010.
- 5. Nationwide, wholesalers have contributed more than \$58 million to state political campaigns in the past three election cycles between 2005 and 2010.
- 6. Wholesalers have spent roughly twice what all other sectors of the American alcohol beverage trade have spent on state political campaigns during the past three election cycles between 2005 and 2010.
- 7. Due to their tremendous influence and access purchased with profits guaranteed by a state mandated use of the wholesale tier, wholesalers have been successful in significantly gaming the alcohol regulatory system to their advantage with protectionist laws in nearly every state.
- 8. The success of the American alcohol wholesaler in buying protection from competition has put the other sectors of the alcohol industry under their control, reduced state tax revenues, and severely limited consumer access to new products.

PREFACE: TOWARD LIQUOR DOMINATION

In 1933, on the eve of Repeal of Prohibition "Toward Liquor Control" was published. Financed by John D. Rockefeller Jr., this little book would become the handbook that inspired the creation of the post-Prohibition alcohol regulatory system in the various states and the most influential book on the new science of alcohol regulatory systems in the United States.

The authors of "Toward Liquor Control," Raymond B. Fosdick and Albert L. Scott, had little confidence in a system of alcohol control that relied on issuing licenses to for-profit companies, the method by which most states chose to regulate alcohol post-Prohibition and that remains with us today. If the goal was to prevent the kind of corruption that existed prior to Prohibition in the form of the Tied House and paid-off liquor administrators and that existed during Prohibition in the way of the Speakeasy, it was the authors' contention that a licensing system would be ineffectual:

"Its primary weakness consists in the preservation of the private profit motive, which wold be threaded through the entire business from manufacture to ultimate local sale," wrote Fosdick and Scott.

Fosdick and Scott were prescient, particularly in their most dire conclusions.

"Even if the initial results were satisfactory under severely restrictive licensing arrangements, the test would come later as vendors learned the ropes. Then would appear the annual flood of bills in the legislature proposing amendments designed to relax the license system's stranglehold on licensees...

"For the establishment of a licensed liquor trade means the deep entrenchment of a far-flung proprietary interest. This interest would have a large capital investment to be protected at all costs. Buildings, leases, fixtures, inventories, stocks and bonds—representing millions of dollars—would require defense against those who in the public interest might threaten curb or reduction...

"Moreover, such a vested interest is bound to employ aggressive tactics in its own defense. Liquor trade associations, open and disguised, would continuously oppose every restriction of opportunities to sell....

"As proposals to dismember any part of the liquor selling business becomes more threatening, the entire trade combines more solidly to protect itself. In brief, a licensed liquor trade, once established, cannot be easily dislodged.

"The wholesale tier has a huge investment in people, trucks, warehouses, selling systems, information technology and inventory and there needs to be a fair return on that investment."

Bill Goldring, recipient of the Wine & Spirit Wholesalers of America's 2011 Lifetime Achievement Award. —April, 2011 This short
report explores
the tool used
by wholesalers
to game the alcohol beverage
regulatory laws
to their favor
and to the detriment of the
other tiers, state
revenue agencies and consumers: Money

The authors of "Toward Liquor Control" predicted the reasons why and the tools by which political and commercial influence would be sought by the members of the alcohol industry under a licensing system in the post-Prohibition era. However, what they failed to predict was that it would be one single segment of the alcohol industry that dominated all others through its successful pursuit of influence: Wholesalers.

In their best efforts to advise on how to create a licensed based alcohol control system, Fosdick and Scott never recommended the creation of a wholesale tier that retailers and producers would be required by law to traverse. The state-mandated use of the wholesaler was an innovation developed by others after the publishing of "Toward Liquor Control"

Nevertheless, the dangers that Fosdick and Scott warned us of in 1933 are with us today.

This short report explores the tool used by wholesalers to game the alcohol beverage regulatory laws to their favor and to the detriment of the other tiers, state revenue agencies and consumers: Money.

It was the most radical piece of alcohol legislation to be considered in Washington since the 18th Amendment that brought on Prohibiton.

HOW DID THEY DO THIS?

In early 2010, the American alcohol beverage industry woke up to discover, suddenly and without warning, that the U.S. Congress was considering a bill to strip producers and retailers of their right to be free of state-sponsored discrimination in interstate commerce. House Resolution 5034, sponsored by Representative William Delahunt (MA), quickly got the attention of producers and retailers of alcohol. And why wouldn't it? It was the most radical piece of alcohol legislation to be considered in Washington since the 18th Amendment that brought on Prohibition.

If passed, H.R. 5034 would permit states to pass laws that blatantly discriminate against out-of-state alcohol companies and for any reason they desire, including protecting in-state businesses from competition. How could such a bill get introduced, let alone receive a hearing in the House Judiciary Committee as it would later in the year?

No group of wineries, brewers or distillers asked that this bill be introduced. No retailers lobbied for such a bill to be considered. No state legislatures had demanded such a bill be written. And no state alcohol regulators ever advanced the idea that a bill such as H.R. 5034 be introduced into Congress.

Instead, H.R. 5034 was written by the National Beer Wholesalers Association, in consultation with the Wine & Spirit Wholesalers of America—two

\$82,461,849*

*Total Known Wholesaler
Expenditures Meant to influence
State and Federal Alcohol Regulations
(2006-2010 election cycles)

powerful trade associations representing the middle contingent of the Three-Tier system: wholesalers. How did they do this? And how did American wholesalers, only one part of the three tier system that is meant to balance industry and state interests, come to so dominate the political and legal environment surrounding alcohol regulation that a bill representing such a radical departure from American business and commercial traditions could find introduction into Congress?

The answer is simple: Money. Lots of Money.

Between the 2006 and 2010 election cycles, American beer, wine and spirit wholesalers have dropped more than \$82 million into state and federal election campaigns, into PACS, and on federal lobbying efforts.

Keep in mind, this staggering sum does not include the money used to lobby on a state-by-state level, a figure that is very difficult to obtain. Despite figures being difficult to obtain for state-by-state lobbying, it should be noted that it is in the state legislatures where wholesalers and their state associations are most active. Were the state-by-state lobbying figures included in the total, the amount wholesalers have spent nationwide on campaign and PAC contributions and on lobbying during the past three election cycles would far exceed \$100 million.

H.R. 5034 did not get out of committee in 2010. However, unsurprisingly, this year the bill reappeared with a new bill number (H.R. 1161) and with a new chief sponsor's name (Rep. Jason Chaffetz—UT).

SYSTEMIC ADVANTAGE

The \$82 million wholesalers donated over the course of five years dwarfs that spent by retailers and producers on influencing lawmakers across the country. It could be argued that retailers and alcohol producers simply don't have the same kind of ambitions as wholesalers and simply choose not to spend the money. But this explanation ignores the reality of the systemic advantage that wholesalers have over the rest of the industry.

In nearly every state all but a fraction of alcohol distribution is required to move from producer to wholesaler to retailer. If a producer wants to sell directly to a retailer (or restaurant) and can carry out the distribution without the aid of a wholesaler, they are prohibited from doing so. If a retailer wants to augment their selection by purchasing from a small distiller or brewer or winery in another state, they are prohibited from doing so. They must buy it from an in-state wholesaler, if they happen to carry the product. If the wholesaler does not carry the brand or won't carry the brand, the product won't get to the retailer, nor to the consumer. And wholesalers, despite being granted this state-mandated monopoly, are in no way required to carry any brand that desires introduction into their state market.

Combine this systemic commercial and regulatory advantage with the fact that the number of wholesalers across the country and in the various states has shrunk dramatically over the past 20 years at the same time that the number of producers and importers of wine, beer and spirits has exploded, and you begin to understand the enormous profits and control that are guaranteed to the shrinking wholesale tier.

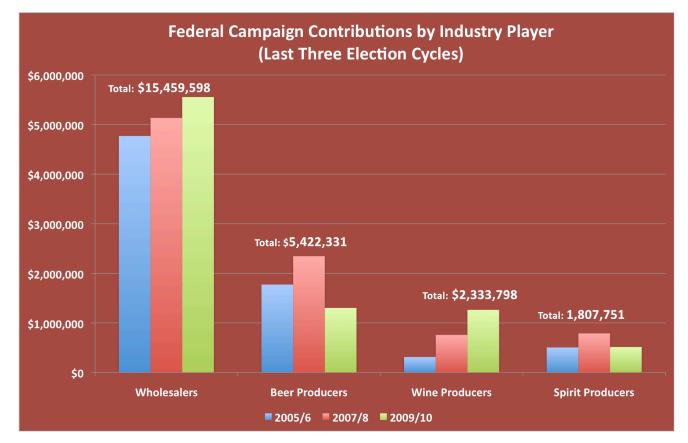
The \$82 million wholesaler money drop over the course of five years dwarfs that spent by retailers and producers.

In 2009 Forbes Magazine estimated that the top five wine and spirit wholesalers produced \$22.65 billion in revenue. M. Shanken's IMPACT Newsletter in 2010 estimated that the top six American wine and spirit wholesales control just over 50% of the entire national wholesaler marketplace. As the wholesale tier continues to see its power concentrated in fewer and fewer players, those wholesalers will gather far more power with their increased profits. But even now, clearly, a portion of wholesaler profits are being plowed back into the service of buying influence and protection for a smaller and smaller group of very large companies.

A portion of wholesaler profits are being plowed back into the service of buying influence and protection

FEDERAL INFLUENCE

The two influential wholesaler players at the Federal level are the National Beer Wholesalers Association (NBWA) and the Wine & Spirit Wholesalers Association (WSWA). During the past three election cycles (2005/6, 2007/8, 2009/10) these two trade associations alone have given more than \$15 million to federal election campaigns and Political Action Committees. The federal campaign contributions dwarf those of all other alcohol industry players combined for these years.



"At least 10 lawmakers were given contributions within a day of co-sponsoring the bill."

Politico.com December 21, 2010 The NBWA alone is responsible for more than \$9.5 million of the wholesalers federal campaign contributions during the past three election cycles. Remarkably, going back to 1989, the NBWA ranks #22 on the list of all time largest federal campaign contributors. As a comparison, the NBWA spent more on Federal campaign contributions during this period than either Goldman Sachs, the AFL-CIO, the National Rifle Association, Citigroup or General Electric

Even more important than the absolute dollars may be looking at how the wholesalers have used their contributions in strategic ways. The battle over H.R. 5034 in 2010 offers a perfect illustration.

Last year beer and wine wholesalers became very generous with their political contributions at exactly the same time they were shopping around H.R. 5034 on Capitol hill looking for sponsors. As Politico.com reported last December:

"As beer and wine wholesalers were looking for co-sponsors for their top legislative priority this Congress, they opened their checkbooks wide — giving at least \$1.3 million in campaign cash to House lawmakers who signed on to the bill. In all, at least 32 House members were given wholesaler contributions within a month of signing on to the legislation — including at least 10 lawmakers who were given contributions within a day of co-sponsoring the bill."

The close proximity of political donations and signing on to the wholesalers' bill is not illegal, nor does it prove corruption. However it raises important questions that the Politico article ferrets out:

"Craig Holman of the government watchdog group Public Citizen said the 'suspicious pattern' of the wholesalers' contributions has the 'appearance of corruption, and that's enough to have grounds to file a complaint' with the Federal Election Commission. "It is gift-giving for favors, and that appears to be what the PACs are doing — and making sure that everyone knows it by making it so closely tied with the favor,' Holman said."

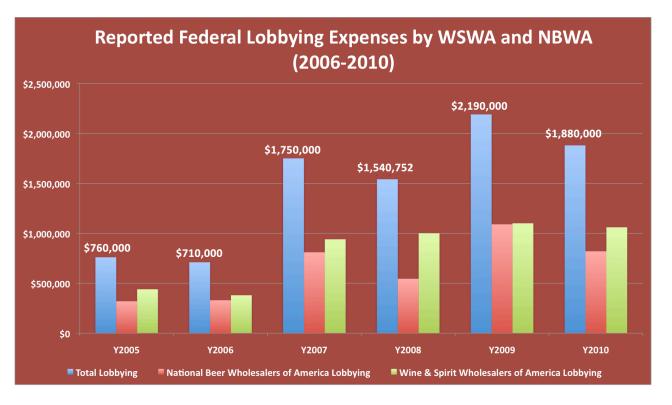
In the same Politico article someone much closer to the H.R. 5034 battle took an ever dimmer view of the wholesaler's contribution tactics. Frank Colman of the Distilled Spirits Council of the United States was very disturbed by the appearance of bill sponsorships being purchased with campaign contributions:

"POLITICO's research shows a lot of money that has resulted in co-sponsorships for a bill that is designed solely to help the wholesale tier of the beverage industry to the disadvantage of the consumers, small distillers, small breweries and small wineries in every congressional district of the country. It's really quite disturbing."

The largest recipient of wholesaler money in 2010 was Representative John Conyers of Michigan, receiving \$66,699 from WSWA and NBWA. Representative Conyers chaired the House Judiciary Committee where the wholesalers got their hearings on H.R. 5034.

But enormous campaign contributions do more than encourage lawmakers to sponsor special interest legislation. Perhaps more importantly it buys access to lawmakers. But that costs money too, and wholesalers have also spent enormous amounts on their lobbying efforts.

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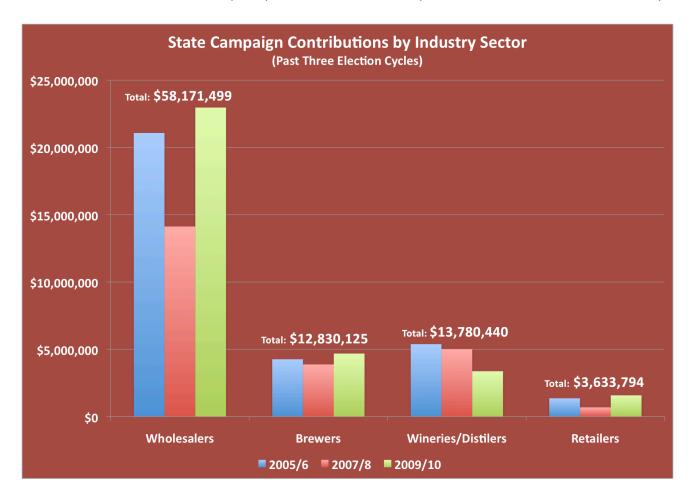
Again, WSWA and NBWA are the primary agents for lobbying on behalf of wholesalers. During the past three election cycles (2005-2010), these two trade associations alone have reported spending more than \$8.8 million on federal lobbying efforts.

It's worth noting again that while this figure appears to be a substantial amount of money, wholesalers do the vast majority of their work in state capitals, not in Washington, D.C. It is in the state capitals where laws are passed that play the key role in protecting their businesses from competition.

STATE INFLUENCE

During the past three election cycles, wine, beer and spirit wholesaler interests have donated more than \$58 million to state political campaigns. In most states, wholesalers are among the largest contributors to state political contests. What is remarkable, however, is the degree to which wholesaler contributions at the state level far outpace political contributions by other sectors of the alcohol industry.

The \$58 million contributed by wholesalers to state political campaigns nationwide is roughly double all the contributions given by brewers, distillers, wineries and retailers... combined.



The \$58 million contributed by wholesalers to state political campaigns nationwide is roughly double all the contributions given by brewers, distillers, wineries and retailers...combined. In most states, alcohol wholesalers rank among the most generous industries for campaign contributions.

The \$30 million contributed by the rest of the industry to state political campaigns represents nearly all other members of the three-tier system of alcohol distribution. And yet, they can muster no more than half of what a single tier of the trade, wholesalers, have contributed.

The fact is that wholesalers have a great deal more to lose and, with their state-mandated profit structure, they are in a position to gain a great deal more than the other tiers.

The overriding concern of wholesalers at the state level is preservation of the state-mandated use of wholesalers. Everything else pales in comparison to this objective. Without the states mandating that wineries, brewers and distillers sell to them and retailers buy from them, they risk having to operate on a level playing field and without a shield from competition—something they have not had to do in more than 70 years. It turns out that their political contributions have been very effective.

But beyond protecting the legal requirement that wholesalers be given a cut of nearly all alcohol sales regardless of whether their services are needed, this tier has been very effective in gaining political support for a number of other protectionist measures:

Bans on Central Warehousing: Wholesalers have been effective in many states defending bans on retailers driving the inventory they own from one store to another. A retail store that has, say, three outlets is banned from taking delivery of their store's inventory from a wholesaler in one location then moving it with their own trucks to their another outlet when needed. By law, wholesalers must make that delivery. It results in millions of dollars in additional revenue for the wholesalers, despite their services being unnecessary. And, it increases the price of the product to the consumer. And yet there is nothing about the practice of Central Warehousing that substantially addresses any of the concerns of for which any alcohol regulatory system was created.

Bans on Self Distribution: Wholesalers have been effective in limiting, prohibiting and in some cases rescinding the privilege of local producers to sell and deliver their own products to retailers and restaurants. In many states, a craft brewer may not deliver their beer to a retailer down the street. They must sell the beer at a discount to a wholesaler and the wholesaler takes their cut before delivering it to the store. These kinds of bans and restrictions surrounding Self Distribution play perhaps the greatest role in hampering the economic viability of small producers of beer wine and spirits. And yet, no harm is visited upon society, there is no chance of domination of one tier over another and no chance of shady marketing practices are tied to Self Distribution. Bans and limitations on Self Distribution merely line the pockets of wholesalers who have the political clout to demand protection from competition.

This tier has been very effective in gaining political support for a number of other protectionist measures It has been wholesalers who have used their local muscle to assure local consumers only have access to the wines they provide to retailers.

<u>Franchise Laws</u>: In many states alcohol producers are prohibited from moving from one wholesaler to another if they are displeased with the work of the wholesaler. Franchise laws have been put in place to protect wholesalers from having to meet the demands of their client, the producer. And under many of these Franchise laws a wholesaler must be compensated if the producer is able to take their business elsewhere. Justified as a way to protect their investment in a brand, it should be noted that in other industries where level playing fields are demanded, Franchise laws are nearly unheard of.

<u>Producer-to-Consumer Direct Shipping Bans:</u> Despite safeguards and no evidence that direct shipping increases minors' use of alcohol, Wholesalers have been able to stop or delay the change in laws that allow wine and beer and spirit lovers to purchase the products they want and having them shipped to directly to the consumer. Often the result is consumers in many states are left only with access to the collection of products wholesalers decide to bring into the state. The bans and limitations harm producers, state tax coffers, and consumers, while serving primarily to protect the wholesaler from competition.

Retailer to Consumer Direct Shipping Bans: Only 13 states currently allow consumers to have wine shipped to them from out-of-state wine stores. This is despite the fact that there is no difference between a winery shipping a bottle of wine across state lines and a retailer doing so. Nevertheless, it has been wholesalers who have used their local muscle to assure local consumers only have access to the wines they provide to retailers. The results is that consumers in most states may not have any imported wines, wine-of-the-month club wines or auction house wines shipped to them from out-of-state because only retailers sell these products. In addition, states lose significant amounts of tax revenue by protecting wholesalers from competition through these bans.

<u>Primary Source Laws:</u> Wholesalers have been very effective in getting state to ban the importation of Parallel Market wines, not imported by the authorized agent. Many wines that are not available from local wholesalers can be procured by retailers by having an agent buy them overseas and import them for the retailer. Those states that allow parallel market wines have the most vibrant market place for wines. Butt most states, at the request of wholesalers, ban this practice and demand that wines only be made available from their "primary source", the wholesaler, again hurting the consumer and the wine trade in general, but protecting the wholesaler from competition.

This is only a short list of the kind of laws that wholesalers have demanded and gotten for their own protection on the state level—laws that in no way help promote temperance, tax collection or work to stop the vertical integration of the alcohol market that the original creators of the alcohol control system urgently sought to do.

There is a means by which the domination of the wholesalers can be curtailed and the entire industry can find its way back to a more balanced environment

IN DESPERATE NEED OF REFORM

There appears little chance that the American political system will reform its campaign financing laws. Rather, due to recent Supreme Court decisions it appears that money will play an even bigger role in how government is managed and political decisions are made.

Yet, where the alcohol beverage trade is concerned, there is a means by which the domination of the wholesalers can be curtailed and the entire industry can find its way back to a more balanced environment where all three tiers, government and consumers are equally served.

Wholesalers have been able to dominate the American alcohol market due largely to their protected place in its middle. As long as states continue to endorse the idea of a state-mandated wholesaler, the middle tier will keep its boot on the necks of producers and retailers and consumers, continue to generate substantial and protected profits and, as the wholesale tier continues to consolidate into a smaller and smaller group, stay dominated by a tiny group of huge, private companies.

Any reform that comes to the alcohol beverage industry must recognize that nothing about the present day is remotely similar to the 1930s when the current regulatory regime was devised and put in place.

- There is no threat that the dreaded "Tavern" or "Speakeasy", the motivating dread of alcohol regulators and the public in the 1930s, will ever return to America.
- The idea of Tied-Houses, by which producers controlled retailers and restaurants prior to Prohibition and which led to unsavory marketing practices, are outlawed on a federal and state level, making their reappearance impossible even without mandating the use of wholesalers between the producers and retailers.
- The number of producers and importers of alcohol has exploded over the past 20 years, while the number of wholesalers has been reduced drastically, making it impossible for a mandated three-tier system to fully satisfy commercial or consumer demand.
- Historic changes in logistics, technology, communications and the attitude of American consumers toward diversity and experimentation in their imbibing habits has changed the way the American alcohol marketplace functions to a degree that could not be predicted in the 1930s.

Once lawmakers and regulators understand and accept these important changes, the groundwork will be laid for the substantial reforms needed in the American alcohol beverage industry.

Once lawmakers and regulators understand and accept these important changes, the groundwork will be laid for the substantial reforms needed in the American alcohol beverage industry. But there are very strong forces that will work both extraordinarily hard and overtime to counteract the power of these most basic conclusions and to assure nothing comes of their evidence. Currently, there are more than \$82,000,000 reasons why reforms are unlikely to come soon.

As this report is being written, lobbyists of the WSWA and NBWA are fanned out across Washington, D.C., seeking sponsors for H.R. 1161. We don't yet have numbers on the kinds of contributions that might be currently waved in lawmakers' faces and we are not in an election year. But rest assured, they are substantial. And you can be sure that if H.R. 1161 advances to the hearings in the House of Representatives, is taken up in the Senate and eventually comes to a vote in Congress, it will be due to the unfair commercial and regulatory advantages granted American wholesalers across the country, their liberal use of state-protected profits generated from their advantages, and the access to the halls of power they have purchased.

That's what \$82 million and counting buys.

To repeat the prescient words of Fosdick and Scott in "Towards Liquor Control" from 1933:

"As proposals to dismember any part of the liquor selling business becomes more threatening, the entire trade combines more solidly to protect itself. In brief, a licensed liquor trade, once established, cannot be easily dislodged."

CAMPAIGN AND LOBBYING SOURCES

All information and records concerning state and federal campaign contributions and lobbying expenditures from sourced from the two most authoritative online sources for this information:

1. The National Institute on Money and State Politics http://www.followthemoney.org/
The National Institute on Money and State Politics is the source for all facts and figures in this report concerning state-based campaign contributions.

2. The Center for Responsive Politics

http://www.opensecrets.org/

The Center for Responsive Politics is the source for all facts and figures in this report concerning federal campaign contributions and federal lobbying expenditures.

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Specialty Wine Retailers Association is a national coalition of wine retailers, wine professionals, wine related businesses and consumer supporters that advocate for free trade in wine, a well-regulated wine market, and an end to protectionist alcohol regulations and laws that stand between retailers and consumers. For information see: http://www.specialtywineretailers.org and http://www.stop1161.org. Or, call 707-266-1449.

