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Prohibition Hangover Cure for Keystone State Brewers

Reform to Outdated Three-Tier Beer Distribution System
Will Help Small Businesses and Increase Consumer Choice

By Michelle Minton *

In Pennsylvania, the way beer gets from the brewery to your local bar or store may be about to fundamentally change, for the better. On August 29, 2013, Pennsylvania State Rep. Mike Tobash (R-125) introduced a bill that would end a longstanding system that locks brewers into contracts for life with their distributors—and sometimes longer, as explained below.¹ If approved, Rep. Tobash’s bill would finally give brewers the flexibility to choose distributors based on their business needs. This would increase competition, allow new distributors to enter the market, and result in lower prices and greater choice for consumers.

The Three-Tier System. The current beer distribution system in Pennsylvania, as in much of the nation, is structured into three tiers. The three-tier system has been in place since the end of Prohibition. Its main feature is the legal separation between the companies that make, ship, and sell alcohol. In the beer market, brewers, who make up the first tier, may only sell their products to distributors—wholesalers—who make up the second tier and then sell and ship the beer to bars, restaurants, and stores—the third tier—that sell the beer to consumers.

Prior to national Prohibition, beer was largely a local commodity, and brewers exerted considerable influence over bars to carry only that particular brewer’s products, by either owning the bar or providing financial incentives.² Prohibitionists viewed these “tied houses” as a means whereby brewers encouraged excessive consumption and drunkenness. Thus, they saw the three-tier system, which forcibly separates producers from retailers, as a way to minimize the influence of the brewers.³ After the enactment of the 21st Amendment, which repealed Prohibition and gave states the power to control alcohol sales, virtually every state, including Pennsylvania, adopted some form of the three-tier system for beer distribution, which remains in place today.

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State Franchise Laws. Most states also have franchise protection laws, another hangover from Prohibition. These are meant to protect wholesalers, who at the time of Prohibition's repeal consisted of a large number of small local operations, from the handful of big breweries that supplied the entire nation with beer at the time. These behemoth brewers could threaten to walk away from contracts—which would put many wholesalers out of business, since most only carried products from one brewery—to bully wholesalers into accepting unfair contractual terms.

These days, the roles are largely reversed, yet franchise protection laws remain. For the most part, brewers can only sell to wholesalers and bars and stores can only buy from wholesalers, so the system gives the middle tier considerable control over the market. Today, the majority of breweries are not large. In fact, more than 90 percent of U.S. breweries operating today produce fewer than 15,000 barrels a year.⁴ Meanwhile, the number of wholesalers has drastically decreased with consolidation leaving a smaller number of wholesalers.

Franchise laws place a significant burden on small brewers. They bind brewers to wholesaler contracts regardless of the wholesaler's performance. It is expensive, and sometimes impossible, for brewers to get out of contracts with their wholesalers, unless the wholesaler is willing to release the brewer. The contract and all its terms are essentially frozen in perpetuity. And if a wholesaler decides to sell the distribution rights for a brewer's brands to another wholesaler, the brewer has no say in the matter.

In fact, franchise laws make getting out of a distribution contract harder than getting out of a marriage. A marriage ends when "death do us part," but an alcohol distribution contract can be sold or passed down through a family business indefinitely. As Bill Covaleski, president of the Brewers of Pennsylvania and president and brewmaster at Victory Brewing put it, "[C]urrent regulations support an environment of perpetual servitude."⁵ Ironically, a system designed to protect wholesalers from the nation's largest brewers now helps those mega-breweries and wholesalers can suppress competition by smaller craft breweries.

Additionally, most state franchise laws prohibit brewers from contracting more than one wholesaler per geographic area, known as a wholesaler's exclusive territory. Combined with an inability for brewers to switch from one wholesaler to another, this creates regional monopolies. This gives wholesalers limited incentive to improve performance, increase efficiency, or reduce prices. With brewers locked into contracts, a wholesaler has little or no fear that it will lose any of its existing brands. And with all established beer brands firmly locked into contracts, new wholesalers cannot add those brands to their portfolios. That makes it exceedingly difficult for new brewers to enter the market.

The net effect is that wholesalers have become far more powerful than even the largest breweries, and the industry has seen continued concentration as big wholesalers buy out smaller ones. That may explain why the number of beer wholesalers has been declining dramatically over the last three decades. There were more than 4,000 beer wholesalers in America in 1988 while there are less than 2,000 today, according to the Beer Institute.⁶ On the other hand, the number of breweries has skyrocketed from less than 100 in 1980 to more than 2,500 today, with no sign of that growth slowing down.⁷ As a result, fewer beer distributors are handling an ever-increasing number of brands, making it likely that each brand will get less promotional attention

from its wholesaler over time. While in most other industries a dissatisfied client would be able to take his or her business to another provider, franchise laws do not recognize general dissatisfaction as reason enough to end a wholesaler-brewer contract, and make it nearly impossible for a brewer in this situation to take his or her brand to a different wholesaler who might offer improved service or sales.

Reform Means Greater Choice for Brewers. Currently in Pennsylvania, a distributor may sell a brewer's brands to another wholesaler without getting permission from, or even speaking to, the brewer. Rep. Tobash's bill would change that. It would do away with perpetual contracts by requiring brewers and wholesalers to renegotiate their contracts every five years. Brewers would be able to opt out of their wholesaler contracts for any reason they see fit, so long as they make up less than 20 percent of the wholesaler's total volume. For brewers whose brands make up more than 20 percent, they will have to show "good cause."

Currently, Pennsylvania law is vague about what constitutes "good cause." Tobash's bill provides a list of justifiable reasons for the termination of a brewer-wholesaler contract. Specifically, a brewer may terminate a distribution contract if the distributor:

- Fails to meet the provisions of the agreement without reasonable justification;
- Loses a permit or license for more than 30 days;
- Sells "a material quantity" of the brewer's brands outside of the agreed upon territory;
- Is sold or merges with another distributor; or
- Sells the distribution rights for the brewer's brands without receiving prior consent from the brewer.⁸

The prospect of a brewer leaving a wholesaler for a competitor will motivate wholesalers to offer better terms and improve performance. It will also create opportunities for new wholesalers to get into the game and pick up contracts with established breweries. But arguably the most important effect is that small, craft brewers will find it easier to contract with wholesalers on favorable terms, and those wholesalers would now face potent incentives to promote these new offerings to bars, restaurants, and consumers. And beer drinkers would likely see greater choice and lower prices.

Tobash's bill also allows brewers to buy out their wholesaler contracts at-will, without showing good cause, provided they give 30 days' notice, pay fair market value for the contract, and account for no more than 20 percent of that wholesaler's total distribution volume. The bill defines fair market value as "the amount a willing seller, under no compulsion to sell, would be willing to accept, and a willing buyer, under no compulsion to purchase, would be willing to pay."⁹

Rep. Tobash's bill does have shortcomings, however, including expanded restrictions on self-distribution, whereby brewers sell directly to stores and consumers. The bill would limit in-state brewers to self-distributing to no more than 75,000 barrels a year. Currently, in-state brewers may self-distribute an unlimited amount of beer in any region of the state where they have not already assigned distribution rights to a wholesaler. On the other hand, the bill would allow out-of-state brewers, which to date have been barred from self-distributing any amount of beer in Pennsylvania, to self-distribute up to 75,000 barrels a year.

Conclusion. Wholesalers oppose Tobash’s bill, claiming it could result in job losses in their industry. John Beljan, president of the distributor Stockertown Beverage, said “Self-distribution by breweries on the proposed scale represents the dismantling and potential eradication of the three-tier system . . . How many living wage jobs at wholesale distributors would be jeopardized by such a policy?”¹⁰ Matt Funchion of Penn Distributor claimed, “[I]f the Victory Brewing Company or Tröegs Brewing arbitrarily decide to self-distribute or terminate without cause, you will materially and significantly impact my ability to continue doing business as a going concern. You will take my business out of the craft beer segment.”¹¹ Of course, it could also lead to more jobs at wholesalers and breweries that are able to expand due to the law change.

Rep. Tobash’s bill is not perfect. It would keep franchise protection laws in place, though it would make them less onerous. Additionally, it would create a new cap on the amount of beer an in-state brewery is allowed to self-distribute, though it would allow non-resident brewers to self-distribute in Pennsylvania for the first time. And, while the mandatory negotiation of contracts every five years represents a new interference in the market, it represents a substantial liberalization from the status quo in which contracts must be made in perpetuity. Requiring wholesalers to renegotiate their contracts would therefore increase competition, giving breweries the right to negotiate for more equitable arrangements with their distributors.

While the ideal course of action would be to eliminate all franchise protection laws and get the government out of what should be a voluntary contractual relationship between brewers and wholesalers, Rep. Tobash’s bill addresses some of the negative consequences of past government intervention. It would help create a more flexible system where brewers can change the companies that distribute their beer, and result in lower prices and greater variety for consumers.

Notes

¹ H.B. 1666 Sess. of 2013 (Penn. 2013), <http://www.legis.state.pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=HTM&sessYr=2013&sessInd=0&billBody=H&billTyp=B&billNbr=1666&pn=2289>.

² Evan T. Lawson, “The Future of the Three-Tiered System as a Control of Marketing Alcoholic Beverages,” in Carole L. Jurkiewicz & Murphy J. Painter eds., *Social and Economic Control of Alcohol: The 21st Amendment in the 21st Century* (Boca Raton, Fla: CRC Press, 2008), pp. 31-32.

³ Ibid.

⁴ “Brewers and Beer Importers Advocate for Fair Taxes” The Beer Institute, press release, May 14, 2013 <http://www.beerinstitute.org/mobile/detail/press-release/brewers-and-beer-importers-advocate-for-fair-taxes/bi> accessed on November 12, 2013

⁵ Bill Covalleski, email interview with author, October 30, 2013.

⁶ Bartholomew Watson, Written testimony for the Pennsylvania House, of Representatives, Liquor Control Committee, Hearing: “The Effect of Market Changes on Breweries and Beer Wholesaling,” August 29, 2013, http://www.legis.state.pa.us/cfdocs/legis/tr/transcripts/2013_0158T.pdf.

⁷ “Number of Breweries,” The Brewers Association, accessed November 12, 2013,

<http://www.brewersassociation.org/pages/business-tools/craft-brewing-statistics/number-of-breweries>.

⁸ H.B. 1666.

⁹ Ibid.

¹⁰ John Beljan, Testimony for the Pennsylvania House of Representatives, Liquor Control Committee, Hearing, August 29, 2013.

¹¹ Matt Funchion, Testimony for the Pennsylvania House, of Representatives, Liquor Control Committee, Hearing, August 29, 2013.