



Peay Vineyards, located just 4 miles (6km) from the Pacific Ocean on the northwestern edge of Sonoma County, is quickly emerging as one of America's most highly regarded wineries. It is known for its Pinot Noir, Syrah, Chardonnay, and Rhône-style whites, and its most expensive bottle is \$52—a bargain in the world of fine wine. Consequently, many enophiles are on the winery's mailing list for a twice-yearly newsletter that allows consumers to purchase bottles directly from the winery.

Americans who live in Maryland and Utah, though, could face a felony conviction if they order from Peay—or any other winery, for that matter. Americans who reside in Alabama, Arkansas, Delaware, Kentucky, Mississippi, Montana, New Jersey, Oklahoma, Pennsylvania, or South Dakota shouldn't bother, either. These states also prohibit winery-to-consumer shipping.

The laws that keep US consumers away from booze date back to post-Prohibition America. When Prohibition was repealed in 1933 by the Twenty-First Amendment, states were given the power to regulate alcohol within their borders. Many decided to assume complete control over the sale and distribution of alcohol. Just about every other state created a "wholesale tier" to sit between producers and retailers.

This structure—in short, an artificial, state-mandated middleman—was the one advocated by temperance activists and retailers. Before Prohibition, many bars were owned by brewers or distillers. The Prohibitionists argued that these bars lured men in with free food, motivating them to drink. These "tied houses," as they were known, were blamed for all the ills associated with drunkenness. In Chicago, signs of tied houses owned by Schlitz, a famous American brewery, are still visible.

Liquor stores, restaurants, and bars, too, complained about alcohol producers. Because producers controlled the supply of booze, they could wield enormous power in the market. Many producers were empowered further by the credit they extended to retailers. Scores of bars were forced to offer only one manufacturer's product. By creating a middle tier, lawmakers hoped to weaken the influence of producers. Instead, they redirected that influence elsewhere. Today, wholesalers wield enormous power.

In the United States, wholesaling is big business. Southern Wine & Spirits, America's largest distributor of alcohol, had revenues exceeding \$8 billion in 2008. Hensley & Co, the family business controlled by Arizona senator John McCain's wife Cindy, is America's third-largest

Anheuser-Busch distributor. Booze has made her very rich—she's worth an estimated \$100 million.

The wholesaling industry is also especially friendly to politicians. In 2008, America's fifth-largest political action committee was the National Beer Wholesalers Association (NBWA), which donated nearly \$3 million to candidates for federal office. The Wine & Spirits Wholesalers of America (WSWA) is a bit smaller, but its lobbying apparatus is larger. While NBWA spent \$550,000 on lobbying in 2008, WSWA spent \$1 million. This April, the keynote speaker at WSWA's annual conference was former Alaska governor Sarah Palin.

In America's 50 states, wholesalers wield even more political influence. According to Specialty Wine Retailers Association—a group that seeks to liberalize alcohol distribution—wholesalers contributed nearly \$50 million to statewide political campaigns between 2000 and 2006. In Texas, where just two companies control over 95 percent of the market, wholesalers spent \$3.6 million on campaign contributions in 2006. That's more than every single labor union in the state donated to all political campaigns combined.

The focus on state politicians makes sense. They're the ones who keep wholesalers in business by protecting the state-mandated middle tier. But wholesaling laws are hurting producers, retailers, and consumers. Only the middlemen benefit from the current structure.

#### Accessing three-tier states

To see why, it's best to look at wine. In the United States today, there are more than 6,000 wineries. About half are in California; Washington, Oregon, and New York follow. Every state has at least one winery, and most produce more than one bottling.

Yet across America, there are only a few hundred wholesalers—WSWA has about 330 member companies—and the industry is dominated by its largest players: The six largest wholesalers control more than 50 percent of the market. This means that, to gain access to America's three-tier states—that is, the states that require a wholesaler to sit between the producer and the retailer—all the nation's wineries are fighting for the attention of just a handful of companies. Consumers and retailers just don't matter. As the former head of WSWA once explained, "[A winery's] only legal customer can be a licensed wholesaler, the wholesaler's only legal customer can be a licensed retailer, and the licensed retailer is the only one who has the privilege of selling alcohol to the consumer."

Thanks to economies of scale, large producers can make affordable, drinkable wine and spend millions annually on advertising. Think Kendall Jackson, Sutter Home, Beringer—the three bestselling wine brands in the United States. These are the sorts of wines that wholesalers tend to focus on.

This is understandable. It's a lot easier for wholesalers to work with the big producers than to seek out small, unknown wineries. Kendall Jackson, for instance, produces more than 40 different types of wine and sells nearly 6 million cases annually. That's 72 million bottles, most of which are low-priced varietals like Chardonnay and Cabernet Sauvignon. A wholesaler can satisfy just about all his customers with a company like Kendall Jackson.

It's no wonder, then, that the largest wine companies support the status quo. The parent companies of Kendall Jackson, Sutter Home, and Beringer Vineyards all declined interview requests for this article. A spokesperson for Constellation Brands—the world's largest wine producer, with a portfolio that includes Estancia and Ravenswood—only agreed to affirm that her company "fully supports the three-tier distribution system."

To access the volume and variety that these producers can supply from smaller wineries, a wholesaler would have to work with dozens of companies. And the wines would cost much more money. While most of Kendall Jackson's wines can be purchased at a retail shop for less than \$15, the cheapest bottle from Peay Vineyards costs \$40.

Andy Peay, who runs and owns Peay Vineyards, along with his brother Nick and their winemaker Vanessa Wong, helps explain. "Wine distribution is like an hourglass with a really tight belt. At the top, you have thousands of wineries. At the bottom you have all these customers—retailers and restaurants. In between, there are only a few distributors in each state. In some states, there's even less than that."

For small producers, only if a wine garners praise from an influential publication, such as *Wine Spectator*, *Wine Enthusiast*, or Robert Parker's *The Wine Advocate*, can it have any chance of gaining the attention of a wholesaler.

"The few distributors that are out there want to work with the wineries that are either going to give them a lot of wine that they can sell and make a lot of money on, or give them legitimacy and cache," explained Peay. "Small, well-known, high-end labels provide a foot in the door for wholesalers into many accounts. Wholesalers need them to gain entrée to sell those wines, as well as all the other wines that generate the bulk of their earnings."

But even if a winery is critically acclaimed, wholesalers often won't bother. If production is too low, or if prices are too high, wholesalers assume they won't be able to sell the wine. This leaves most consumers, retailers, and restaurants unable to access the majority of what's out there.

#### Tasting room as profit center

So, how do most small and midsize wineries make their money? Through tasting-room sales. According to a 2006 survey from winebusiness.com, American wineries producing fewer than 5,000 cases each year make nearly 70 percent of sales at their tasting rooms.

While wineries have long welcomed the public to come and check out their offerings, many wineries today have lavish, welcoming tasting rooms. Here, they charge tasting fees, sell wine and wine-club memberships, and host weddings, private parties, and corporate events. Many even sell wine-themed clothing and other paraphernalia.

In other words, for smaller wineries, the tasting room is the profit center. But this poses a problem for the small producers who are more interested in making and selling wine than in building an extravagant tasting room and hiring full-time staff to run it.

These facts make Peay Vineyards' success all the more impressive. The winery is closed to the public. It's two hours west of most other wineries in Sonoma. And its mailing list is rapidly filling up. Andy Peay is very aware of

how lucky he's been, but he's also aware of the impact of direct-shipping restrictions on other small wineries. "Thousands of wineries in California cannot get distribution. We're very fortunate. For the most part, we can pick and choose who we want to work with in the states we want to work in. But that is not the case for most wineries."

For those other small wineries, the wholesaling industry is standing in the way. Every time wine is purchased—whether at a liquor store, a bar, or a restaurant—a wholesaler profits. It's estimated that the existence of wholesalers adds about 18–25 percent to the price of every single alcoholic beverage sold in America. For the wholesalers, these profits are worth protecting. That's why the industry shovels so much cash into the political system. The wholesaling industry's very survival depends on lawmakers' willingness to keep the current regulatory structure in place.

Over the past several years, the wholesaling industry has fought tooth and nail against several efforts to open up the wine market. Most notably, it's battled small wineries and consumers over direct shipping. Historically, small winemakers were limited to on-site sales and the whims of

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wholesalers. About 20 years ago, as Americans developed a taste for high-end, small-production wines—and could find them, thanks to the Internet and Northern California's bustling tourism industry—consumers started purchasing wine directly from small outfits via mailing lists.

Many filled quickly. Most notable was the list at Screaming Eagle Winery and Vineyards in Napa. Its first vintage, harvested in 1992 and released in 1996, was awarded 99 points by Robert Parker. His tasting note described the wine as “one of the greatest young Cabernets I have ever tasted,” and he advised his readers to “get on the list.” Slots on Screaming Eagle's mailing list were highly coveted, as were spots on other Napa lists, like those at Harlan Estate, Bryant Family Vineyard, Grace Family Vineyards, and Colgin Cellars. Today, all those mailing lists are full. Screaming Eagle's waiting list is so long that it's no longer adding names.

Throughout the 1990s, the number of small wineries increased dramatically. Virtually all hoped to sell their wine directly to consumers. Such sales, though, cut the wholesaler out of the deal, so the wholesaling industry responded with a massive campaign to prohibit winery-to-consumer shipping.

The industry's arguments were silly. First came the warning that if wineries could ship directly to consumers, then minors would purchase alcohol. Kids are certainly creative when it comes to securing booze, but it's highly unlikely that teenagers would be willing to shell out several hundred dollars for a California cult wine.

Also came the contention that wholesalers help states “efficiently collect taxes on alcohol products.” The wholesaling industry still makes this claim, never mind the fact that state tax agencies manage to collect sales taxes on just about every other retail product without the help of wholesalers. And in an argument that would make any economics professor fall ill, the industry bragged about how many jobs it added to the American economy. The industry still makes this case; according to the National Beer Wholesalers Association, beer distributors employ nearly 100,000 Americans today.

This is a near-textbook example of Frédéric Bastiat's parable of the broken window. After all, if a government-created wholesale tier for the distribution of beer creates tens of thousands of jobs, why not create a wholesale tier for iPods, kitchen appliances, and every other consumer good?

Despite the obvious absurdity of these arguments, the wholesalers' efforts were quite successful in the early years. In 1998, just 17 states allowed direct shipping. Many states passed felony laws aimed at the small wineries that were willing to fulfill the demand for their wines. In Texas, WSWA pushed to punish those who illegally shipped wine with the same penalty as those who were found guilty of assault with a deadly weapon. The industry-supported measure actually passed the state legislature but was vetoed by then governor George W. Bush.

Wholesalers weren't just directing the distribution of wine; they were directing the laws that regulated the distribution of wine.

### Fighting the good fight

Groups started sprouting up, though, to tackle the influence of the wholesalers. Chief among them was Family Winemakers of California, an association of small wineries that split from the Wine Institute (California's largest association of wineries) to “give voice and presence to small, family wineries in the public policy arena” and to “protect individual freedom from government over-regulation.”

Shortly after its 1991 founding, Family Winemakers released a discussion paper, “Free Trade for Small Wineries in US Markets,” which laid the groundwork for the battle that it is still fighting. “The most important and in fact the only important reason for small wineries under 100 tons to join,” the paper stated, “would be to work for the right to market directly to end users thereby bypassing the three-tier system.”

At the turn of the century, their efforts started gaining steam. In July 1999, *USA Today*, America's largest newspaper at the time, came to the defense of wine drinkers in an editorial lambasting of the wholesalers' strategy: “The industry's tactics are a civics lesson in how scare stories, lobbying and political money can be used to limit consumer choice through special-interest protections.”

Four years later, the US Federal Trade Commission released a blistering report that debunked most of the wholesalers' arguments. That year, lawmakers in Virginia, North Carolina, and South Carolina opened up their markets.

Meanwhile, the legislative effort was amplified by a legal strategy spearheaded by the Coalition for Free Trade, a nonprofit legal foundation created by Family Winemakers to fight for the legalization of direct shipping, and the Institute for Justice, a nonprofit, libertarian, public-interest law firm. Both groups helped file suits around the country, arguing that restrictions on interstate wine sales violated the Commerce Clause of the Constitution.

In 2000, the Institute for Justice sued New York on behalf of two out-of-state wineries and three local consumers, challenging the state law that prohibited alcoholic beverages from being “shipped into the state unless the same shall be consigned to a person duly licensed hereunder to traffic in alcoholic beverages.”

As attorneys with the Institute for Justice wrote at the time, “the Commerce Clause of the US Constitution empowers only Congress—and not the states—to regulate the way business is conducted across state lines. The Commerce Clause was designed to prevent states from creating protectionist schemes, yet 24 states, acting at the behest of the politically and financially powerful wholesalers, have erected interstate trade barriers when it comes to the sale of wine.” The framers of the Constitution knew that if individual states could erect trade barriers to protect their own interests, they probably would.

In 2001, the Coalition for Free Trade hired Kenneth Starr (of Clinton impeachment fame) to help Michigan residents Ray and Eleanor Heald sue their state for allowing in-state wineries to ship directly to consumers but prohibiting out-

of-state wineries from sending wine to Michigan consumers. Their suit, too, focused on the Commerce Clause. The Institute for Justice won its case against New York in a federal district court, but the ruling was then overturned by the Second Circuit Court of Appeals. The Healds won their suit in Michigan, with the Sixth Circuit Court ruling that Michigan's law did indeed run afoul of the Constitution.

With the circuit courts' rulings at odds with one another, the Supreme Court consolidated the suits and slated the trial for December 2004. At question was how to reconcile the Commerce Clause with the Twenty-First Amendment, which gave states the power to regulate liquor within their borders. In May 2005, the court issued its ruling, deciding that states could, indeed, enforce direct shipping laws but only if such laws were applied consistently. In other words, states could only prohibit direct shipping from out-of-state wineries if lawmakers were willing to block in-state wineries from sending wine to consumers.

After the decision, state legislatures across the country started reforming their shipping laws. But what has followed could hardly be called a free market. Because the courts' decision was so narrow, wholesalers convinced state lawmakers that they could place a number of restrictions on wine shipments, so long as such rules were applied equally to in-state and out-of-state wineries.

Many states passed laws limiting the amount of wine consumers could have shipped. In Washington, DC, for example, citizens can only receive one case of wine per month; in Nevada, citizens can receive 12 cases per year. States also limited the amount of wine that consumers can have shipped from a single winery. In Minnesota, citizens can only receive two cases of wine per year per winery. Kansas is a bit more generous: Citizens are limited to 12 cases of wine per year per winery. In Delaware, consumers can only order from out-of-state wineries if the wine is ordered in person.

Other states enacted laws aimed squarely at larger wineries. In Massachusetts, lawmakers passed a bill prohibiting direct shipping from wineries producing more than 30,000 gallons annually. Conveniently, not a single winery in Massachusetts produced more than that amount. In November 2008, a district court ruled that the statute was unconstitutional. And on January 14, 2010, a federal appeals court agreed, ruling that the law “violates the Commerce Clause because the effect [...] is to change the competitive balance between in-state and out-of-state wineries in a way that benefits Massachusetts's wineries and significantly burdens out-of-state competitors.” Yet in Kentucky, a similar law remains on the books. Kentucky bans wineries that produce more than 50,000 gallons each year from shipping directly to consumers.

Keeping track of all these laws is a nightmare. Patricia Green Cellars, a small Pinot Noir producer in Oregon, puts it best. Its official shipping policy reads as follows: “Shipping laws have become so weird it is impossible to write down on a piece of paper what states are covered in what ways. Odds are we can ship to you. Some places we

cannot. Give it a shot and we will try to work something out.” Most wineries have little choice but to hire compliance consultants and purchase expensive software to manage the hotchpotch of state laws. And they're burdened with licensing and permit fees in virtually every state.

The wholesaling industry has also fought to prohibit Internet wine sales. In most states, ordering a gun online is perfectly legal, as is ordering ammunition, cigarettes, or pornography. A bottle of Merlot can land you in jail.

The Supreme Court's 2005 decision only addressed direct-to-consumer shipping from wineries. So, even though nearly 6,000 US wine shops are on the Web, just 13 states allow consumers to order wine online from out-of-state retailers. Even California, which advertises itself to tourists as the “land of wine and food,” prohibits its citizens from ordering wine from retailers outside of California.

Wine wholesalers push for these bans because they see interstate sales as a threat to the three-tier system that serves them so profitably. The ban on Internet sales, too, may eventually be decided by the Supreme Court. In January, the Fifth Circuit Court of Appeals ruled to uphold the Texas law prohibiting consumers from ordering wine from out-of-state retailers.

### Where's the choice?

One could, of course, envision a role for wholesalers even if America had never banned booze and subsequently given states the right to regulate alcohol within their borders. Small wineries, for instance, could very well determine that the most effective way to enter new markets and wind up on store shelves and on restaurant wine lists is to team up with a wholesaler.

When asked if Peay Vineyards would use distributors even if it didn't have to, Andy Peay said the winery probably would. “What one might do—which is the reason distributors don't want us to have this option—is cherry-pick off five or ten accounts that they know well and just send them wine directly and cut out the wholesaler. Even then, though, I most likely wouldn't, because I wouldn't want to upset my distributors. I want them to be happy with me and out there selling my wine.” Today, though, the three-tier system is mandated by law. If wineries want their products in restaurants and retail stores, they literally have no choice but to work with a wholesaler.

The wine world is populated by obsessives—enophiles are forever in pursuit of that perfect wine or that one last bottle to round out their cellar. But regular consumers, too, are constantly on the lookout for new wine and good deals. This is possible only because the wine market offers an abundance of choice. One would be hard pressed to name a single other consumer good with so many options.

Choice, though, is seriously hamstrung by the three-tier system. What consumers deserve is a true free market in wine, where any adult, anywhere, can purchase wine from wherever he or she wants. In the United States, at least, so long as the political influence of wholesalers remains so strong, such a market is unlikely to emerge. ■