

Beer Business Daily

October 10, 2008

Three-Tier Primer

Dear Client:

About three years ago I was at a party in San Antonio when I struck up a conversation with a Texas state legislator. After a respectable amount of small talk, he grabbed my sleeve and said, "*Listen, Harry, don't you work in the beer business? I'm getting pressure from a certain large retailer to take a look at the alcohol code's cash law. Tell me, what's the public policy benefit of having a cash law?*"

Now, I've been in the beer business all of my life, so I should have been able to explain it in my sleep. First I should have immediately corrected him, saying it wasn't a "cash law" but a "prohibition on credit." And I should have explained that the ban on credit was essential to ensuring that retailers are above-board, financially healthy, and not shady; and that distributors don't become bankers to the seedy underworld. And I should have emphasized that distributors' timely payment of state excise taxes depended on retailers paying for their beer up front.

And most of all, I should have explained that the ban on credit was just one spoke in the alcohol code wheelhouse that the state uses to prevent suppliers or distributors from having undo influence over retailers in what they sell and how much they sell ... like the big brewers did pre-Prohibition, putting taverns heavily in debt and inducing them to limit choice and debauch cowboys. I should have said this and a lot more. But I stood there with a bemused look on my face, brain completely blank. "*Uh, I believe it has something to do with keeping cowboys on the straight and arrow,*" I finally managed. He was unimpressed.

Yesterday in Branson, Missouri, I was reminded of this embarrassing moment by respected Missouri three-tier attorney Charles Smarr, who stressed in a speech to Missouri distributors that it wasn't enough for them to have a vague worldview of why the three-tier system has worked well for 75 years, but they need to have it memorized in detail front and back so that it's "*top of mind when regulators or legislators ask you about it.*"

He also said that more people need to understand that franchise laws aren't there "*to create wealth for distributors*", but serve a legitimate "*public policy purpose*" [PPP?] by holding back the powerful hand of big brewers and giving distributors a chance at independence, lest the system slowly revert back to the abuses of tied-house in pre-prohibition times. "*Regulators need to know this,*" he said. Charlie pointed to passages in the important Louisiana "mini-Costco" decision (see BBD) as a great primer on why the three-tier system was created in the first place, and why it's important that retailers and brewers don't usurp power. The MillerCoors allusion was hardly veiled when Charlie warned against "*vertical integration by contract*" which would create a de facto tied house. Once the slippery slope is descended on watering down three-tier, Charlie warned, "*the system could collapse, just like Wall Street collapsed. They thought they didn't need regulation.*"

With that in mind, I thought I would give a summary of why the 21st Amendment is important and why it gave the states the power to set up their three-tier systems, pulling heavily from that Louisiana decision. This way, you won't get caught deaf and dumb like I did, babbling about drunken cowboys. You have my permission for this particular issue to forward, print, copy, laminate and otherwise distribute this summary for people to learn.

THREE-TIER SYSTEM SUMMARY

The three-tier system mandates separation of the alcoholic beverage industry into three tiers: supplier, wholesaler, and retailer. Without the three-tier system, the natural tendency historically has been for the supplier, usually with an HQ out of state, or now out of country, to attempt to integrate vertically, taking control of distribution and retail. When so tied, the retailer takes its orders from the supplier, including the supplier's mandate to carry only its brands, and to maximize sales without regard to local policy concerns. This created two immediate problems: the loss of diversity in products available to consumers, and a large and powerful absentee supplier which would prove difficult to regulate by local authorities. With three-tier, you have three separate tiers with no one tier controlling the other. Companies don't become so large and powerful that they can out-muscle local regulators. And the distributor and retailer in particular are licensed by the state, thus giving each state leverage over how alcohol is sold within their borders.

Part of helping distributors maintain their independence from undo brewer influence is the existence of franchise laws in many states. These laws are constructed to prevent arbitrary terminations by suppliers, thereby promoting both the stability of the middle tier and, most importantly, its independence.

Central to three-tier is a comprehensive of controlled and continuously tracked and recorded transportation, distribution, storage, code-dates, taxes paid, and sales system. This system of total transparency allows states to not only accurately tax the alcohol sold in its borders, but also to know where the alcohol has been, where it is now, and where its going. Unlike other countries which do not have a regulated three-tier system, the U.S. is consequently virtually devoid of counterfeiting, bootlegging, and a black market in alcohol. This is also attributed to the lack of undo supplier market incentives, which inevitably constrain choice and create price differentials across territories, thereby almost certainly creating black markets.

All this is why the Granholm ruling characterized the three-tier system as "*unquestionably legitimate*." It's also why 95% of Americans have never heard of the 21st Amendment or the three-tier system: it works so well that it is taken for granted. And when something works well, naturally we are inclined to dismantle it -- just to see what happens. It's the same compulsion that drives everybody to put a moving rental car in reverse -- we know the outcome is bad, but we just want to see what happens.

BEER INDUSTRY "TRANSFORMATIONAL", SAYS PURSER

NBWA chief Craig Purser also spoke in Branson, and he characterized the current environment in the beer business as "astonishing" and "transformational," but, and this is key, he says that "*the beer glass is half full*." Why on earth would Craig say that? Because while all this is going on, the three-tier system remains resilient.

Craig focused on four goals for NBWA: 1. Execute on distributor-specific issues. 2. Equip distributors with the knowledge to describe what it is they do (and we hope we helped out with that today -- reread above). Craig said, "saying you deliver beer is no longer an acceptable answer." 3. Address the power shift to big retail. Of the Fortune 100, 20 are beer retailers. A-B is number 146 on the list. 4. Continue to have resources to promote our overall interest in the industry against a backdrop of consolidation. That means checking the formula, paying your fair share in dues and giving to the PAC, says Craig.

Craig added to his list of challenges to the industry a concern about the possibility of a "*new emboldened supplier strategy to exert control over independent distributors*." While recognizing the "improvements" in the proposed MC agreement, he said he continues to hear from distributors, state associations, regulators and other suppliers that have serious concerns about attempts to shift control as to how distributors manage, operate, grow and sell their businesses.

One distributor asked about any possible relief on the CDL issue. The difficulty in finding people with commercial driver's licenses who are willing to drive a route truck delivering beer in the heat when they can earn more listening to books on tape and pointing a long haul between the white lines in a desultory manner is a big issue. There was talk of federal legislation a few years back to loosen in-city route truck drivers from CDL requirements. But Craig earnestly said that, with a Democratic Congress and a focus on safety and regulation, don't count on it coming to fruition. *"The votes simply aren't there, but we will continue looking for solutions,"* he said.

And finally, in the Q & A, Craig made the interesting point that, ironic as it is, were it not for the independent three-tier system, it may have been less likely that the DOJ would have approved the MillerCoors J-V. In fact the DOJ was in contact with NBWA lawyers during the antitrust review process, and Craig says *"we didn't oppose the JV because, we believe that an independent distribution system helps preserve consumer choice and access to market."*

PEACOCK: AB AND INBEV CULTURES NOT THAT FAR APART

As reported yesterday, Dave Peacock has been appointed by InBev to be president of Anheuser-Busch, which will be the U.S. division of AB InBev. BBD spoke with Dave yesterday and asked him if he ever thought he would be running Anheuser-Busch. *"I was an assistant media planner 17 years ago,"* said Dave to BBD. *"My ultimate goal was to make \$35,000 a year by the age of 30."* Well, he recently turned 40 and I would assume he achieved that milestone. Dave also said that it's been a pleasure working with InBev, and he said that the two companies' cultures aren't that far apart, which was a surprise. *"The cultural similarities are far greater than anybody would have thought,"* he told me.

Does he still close to August IV. *"I talk to August almost every day, and he's been helpful to me as I transition into the new job. He has great instincts and he knows the company and the market. It makes it easier that he and I are so close."*

We asked Dave if he knew his new boss Luiz Fernando. *"We had met once before, and we talked a lot on the phone,. He's a very nice guy."*

And finally, I asked Dave if its bittersweet that A-B just posted the best quarter in ten years. *"Not at all. It's a great accomplishment, and it's a testament to our people. Despite all that's going on, our people put their heads down and got the job done."*

BEER BRIEFS:

CONGRATS TO MILLERCOORS' Shenandoah plant which achieved OSHA's "Star" status in the Virginia Voluntary Protection Program. The "Star" status is OSHA's highest honor. It is awarded to workplaces that have comprehensive safety and health management systems and cooperative relationships between plant management, labor employees and OSHA, according to a press release. OSHA representatives spent four days at the Shenandoah plant in January, conducting interviews and auditing the facility. On Tuesday, they presented senior MillerCoors executives with a flag, designating the facility as a VPP-approved site.

You know times have changed when MC is having strained relations with its distributors, but OSHA is heaping praise on a Coors brewery. And A-B just completed friendly negotiations with the Teamsters. Stop the insanity!

BEER GURU and BA chief Charlie Papazian emailed me from the GABF with an interesting question, which I pose to you. His question, which was driven purely by his personal curiosity (and he stressed he is neither encouraging or discouraging the concept) is this: *"Where there is consolidation, like the MillerCoors events that are going on, there are family distributors who love the beer business that don't want to get out. If they sell the*

large brands and are left with the assets, will they pick up smaller regional crafts and imports, stay in business and build those brands with the attention that they had given to the lost brands they once had? Rather a simplistic approach and phrasing of the question, but just wondering what is going to happen to all that distribution know how, trucks, warehousing, etc. Are any of these business going to stay in the business and reformulate themselves?"

That is an interesting question. I have heard of one distributor who is losing the MC brands in one of his territories, but is keeping his other brands and will continue to sell beer there. The obvious challenge is maintaining gross profits per stop. In most cases I would imagine that service levels and call ratios would have to drop. Have you heard of any examples of this happening or going to happen? Ping me at hs@beernet.com.

DON'T FORGET that the NBWA's Center for Alcohol Policy is putting on a three-tier legal symposium in Dallas on Oct. 19-21 to discuss legal issues and the 21st Amendment, including franchise law, antitrust, commerce clause, etc. I'll be there. Get more info at: <http://www.centerforalcoholpolicy.org>

MANY THANKS TO Mary Strate and the Missouri beer distributors who hosted me at their meeting in Branson.

Until tomorrow, Harry

"Tragedy is when I cut my finger. Comedy is when you fall into an open sewer and die."
-Mel Brooks

----- Sell Day Calendar -----

Today's Sell Day: 8
Sell days this month: 23
Sell days this month last year: 23
This month ends on a: Fri.
This month last year ended on a: Wed.
YTD sell days Over/Under: +1

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