Three-Tier Cheers!

States are calling the shots when it comes to regulating alcohol producers, distributors and retailers.

BY HEATHER MORTON

Last year was a busy one for U.S. alcohol makers. Wineries bottled 719 million gallons. Breweries produced 192 million barrels of beer. And distilleries bottled 405 million gallons of whisky, vodka, rum and other alcohol, according to the U.S. Treasury's Alcohol and Tobacco Tax and Trade Bureau.

And as the alcohol production business expands, so does the related tourism industry. At breweries, wineries and distilleries across the country, millions of visitors are comparing flowery bouquets, discovering hints of smoky aromas and spending money on locally produced spirits like never before.

As a result of all that brewing, aging, distilling and selling, the federal government collected $10.4 billion in alcohol excise taxes in 2014, while states collected $6.2 billion.

More and more small or craft producers open shop every year, while consumers' purchasing expectations continue to change. Now, 82 years after the end of Prohibition, state regulation of alcohol is evolving with these market changes.

States have largely maintained a three-tier system in which producers, distributors and retailers are regulated separately, although the lines differentiating the groups have blurred a bit, raising concerns that the familiar system may disappear.

States have updated the three-tier system in two important ways: by allowing smaller producers to sell directly to consumers and by strengthening laws that keep distributors independent from producers.

Consumers Direct

All 50 states, the District of Columbia and Guam now have statutes that authorize tasting samples, either for a fee or for free, through manufacturers, retail package stores or at festivals and farmers markets. Allowing adults to taste and sample alcoholic beverages enhances the tour experience and is an effective way for producers to share with and teach consumers about their products.

More than 35 states, the District of Columbia and Guam also allow breweries, small brewers or brewpubs to sell directly to consumers who take the products elsewhere for consumption. At least 40 states and the District of Columbia allow wineries to sell on-site to consumers, and at least 25 states and the District of Columbia allow distilleries of various sizes to do so as well. Proponents argue that the sales increase the manufacturers' visibility and in the long run can help all three tiers of the regulatory system.

For example, Alaska lawmakers enacted legislation last year allowing small distillers to sell up to 1 gallon a day to a person for consumption off the premises. The legislation puts small distilleries on par

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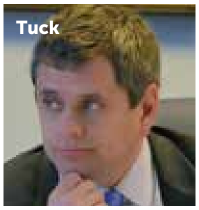

with microbreweries in the state. "Outdated, Prohibition-era rules prevented similar treatment of reasonably priced, hand-crafted Alaska spirits, and the market continued to be dominated by large-scale, out-of-state manufacturers," House Minority Leader Chris Tuck (D) says. "I'm pleased to remove a competitive disadvantage from our local Alaska businesses so they may cater to visitors and better promote Alaska-made products."

In November 2014, New York lawmakers enacted the Craft New York Act that reduced costs and increased the annual production cap for farm breweries, farm distilleries and wineries, while the governor launched several craft beverage grant programs to raise the profile of New York producers.

Supporters of the changes felt that cutting some regulations would give craft beverage producers more opportunities to succeed and grow. They argued that the industry plays such a vital role in many communities—by boosting tourism, generating economic activity and creating new jobs—that it is well worth any support the state can give. "This legislation relieves burdensome obstacles that prevent manufacturers from getting their products to consumers and will help continue growth in the marketplace for our state's beverage manufacturers," says New York Senator Carl L. Marcellino (R).

In a recent report on the economic impact of craft beer on New York's econony, Stonebridge Research found that the number of craft brewers has more than doubled from 95 in 2012 to 207 in January 2015.

California allows direct-to-consumer sales of beer, wine and brandy, but not of other distilled spirits. California Assemblyman Marc Levine (D) wants to change that. He is sponsoring legislation to allow up to three bottles of distilled spirits per person per day to be sold at distilleries. "States that have overturned Prohibition-era laws have seen a booming craft distilling industry. Direct-to-consumer sales have been particularly beneficial for small distilleries," he says. "California distillers are currently unable to truly market themselves, build brand recognition and remain competitive due to the regulatory hurdles dating back to Prohibition."

Caution When Mixing

Others involved in the three-tier system urge caution in changing state alcohol laws, fearing that too many changes could weaken the American regulatory system and alcohol marketplace.

"Each state needs to proceed carefully when considering laws that would allow brewers, distributors or retailers privileges outside of their tier," says Craig Purser, president and CEO of the National Beer Wholesalers Association. "What may appear to be a small exemption or carve-out aimed at economic growth for one segment of the industry can often negatively impact other industry participants, the public and the system as a whole."

The states created the three-tier system to prevent the excesses—manufacturers not only making the alcohol but also owning the bottling companies and many of the saloons where the alcohol was sold—that led to Prohibition.

But over the years, approximately 11 states have allowed breweries to own and operate distributorships, either through the lack of language in existing state laws or through legislative changes.

Since 2010, however, nine states have repealed their exemptions and closed some loopholes—preventing large brewers from owning distributorships—to protect the three-tier system. Kentucky is a case in point.

Until this year, Kentucky statutes and case law allowed out-of-state brewers to own distributorships. But recent events raised concern that big breweries like Anheuser-Busch were taking over too many distributorships, weakening the state's three-tier system. In 2014, Anheuser-Busch sought to purchase its second distributorship in Kentucky.

Kentucky House Speaker Greg Stumbo (D) introduced legislation to prevent this vertical integration into the state's alcohol indus-

Alcohol Sales By the Numbers

2.2%
Increase in spirits sales by volume

0.9%
Growth in beer and cider sales

11%
Craft brewers share of U.S. beer sales

19%
Increase in the number of operating breweries

3,464
Number of total breweries operating in the U.S.

3,418
Number of craft breweries operating in the U.S.

3.5 million cases
Production by small distillers

Note: All statistics reflect data from 2014 or the one-year change from 2013 to 2014.

Sources: The Distilled Spirits Council, the National Beer Wholesalers Association, the Brewers Association, 2014

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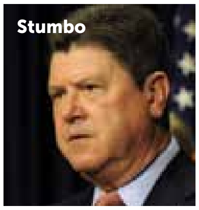


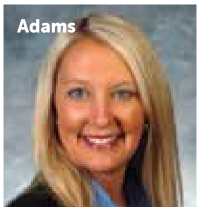
try. "All this bill does, when boiled down to its simplest terms," he says, "is bring the distribution of beer into compliance with current law that exists for wine and distilled spirits."

But he and the bill's supporters also argued that allowing brewers to act as distributors put independent distributors—and their employees—at risk. Big brewers, they argued, would naturally attempt to reduce competition by distributing only their own products, making it more difficult for new brands to enter the market.

Opponents countered that jobs at the brewer-owned distributors were safe, evidenced by the number of new brands breaking into the thriving craft beer market.

"Given the significant investment Anheuser-Busch has made in our brands, we should have a say in how our products are delivered to customers. In that regard, we share the same commitment to ensuring brand quality throughout the distribution chain as any other manufacturer or distributor would. Our experience in Louisville bears that out," says Bob Kelley, Anheuser-Busch region vice president for sales.

Stumbo's legislation, passed in March, however, and Anheuser-Busch will have to sell its two distributorships in the state. "This bill is the ultimate assault on private property rights," argued Representative Julie Raque Adams (R). "It retroactively takes from Anheuser-Busch what they lawfully obtained. It will require divestiture of its assets."



In April, Tennessee enacted similar legislation prohibiting beer manufacturers from owning or having financial interests in businesses with a wholesale or retail beer license.

The beer distribution industry employs more than 130,000 people in the U.S. and contributes nearly $10.3 billion in federal, state and local taxes in addition to nearly $11 billion in excise and consumption taxes. Wine and spirits wholesalers account for more than 63,000 jobs and contribute about $34 billion in taxes to state and local governments.

Two Types of Regulators

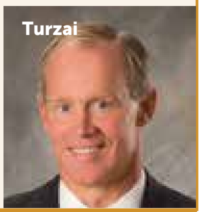
The way states regulate alcohol puts them into one of two categories. They are either control states or license states. Seventeen states—Alabama, Idaho, Iowa, Maine, Michigan, Mississippi, Montana, New Hampshire, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, Virginia, West Virginia and Wyoming—along with Montgomery County, Md., are classified as control states because they operate the distribution tier and also may participate in the retail tier through state-run liquor stores.

The other 33 states do not participate in the distribution or sales of alcohol, including Washington, the most recent state to switch from the control state group. It privatized all liquor sales in 2012, as a result of a 2011 voter-approved initiative.

Legislators in Alabama and Pennsylvania have recently introduced legislation to remove their states from the retail liquor business as well. Speaker of the House Mike Turzai (R), sponsor of the legislation in Pennsylvania, believes the state's current system is antiquated, unnecessary and burdensome. "Only a business can act like a business and be successful," he says. "Government has many responsibilities, such as providing an education, safe communities and clean air and water, but selling wine and liquor is not one of them. We need to get the state out of the business of buying and selling alcohol."

Looking for ways to save the state money, Alabama Senator Arthur Orr (R) proposed legislation to require the Alabama Alcoholic Beverage Control Board to phase out retail sales operations before Oct. 1, 2016.

Both bills are pending in this year's legislative sessions.



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>
> *—Pennsylvania Speaker of the House Mike Turzai*

Bills Brewing in Congress

State legislatures aren't alone in tackling alcohol issues. Congress has a few bills to consider involving excise taxes. Currently, the federal excise tax rate on beer is $18 a barrel (or 31 gallons) with a reduced rate—established in 1976—of $7 on the first 60,000 barrels for breweries that annually produce less than 2 million barrels.

The Small Brewer Reinvestment and Expanding Workforce Act (aka, the Small Brew Act) is supported by The Brewers Association, which represents craft brewers. It would cut the excise tax rate in half on the first 60,000 barrels for brewers who produce 6 million barrels or less and set a new rate of $16 per barrel on beer production between 60,000 and 2 million barrels.

The Fair Brewers Excise and Economic Relief Act of 2015 (aka, the Fair Beer Act) is supported by the Beer Institute. It would create a more tiered tax structure. The per barrel excise tax would be eliminated on the first 7,143 barrels, $3.50 would apply on barrels 7,144 to 60,000, $16 on barrels 60,001 to 2 million and $18 on barrels over 2 million.

For small producers of distilled spirits, there currently is not a similarly reduced excise tax rate, but the Distillery Excise Tax Reform Act of 2015 seeks to change that. It would establish a $2.70 per proof tax on the first 100,000 gallons with a top rate of $9 on all spirits above the 100,000 gallon limit. Currently, the federal excise tax rate is $13.50 per proof gallon. The Distilled Spirits Council and the American Craft Spirits Association support this legislation.

What's Ahead?

Times are good for alcohol producers of all varieties—from wine to beer to distilled spirits, from microbrewers to giant companies.

"The legacy of the 21st Amendment," says Craig Wolf, president and CEO of Wine & Spirits Wholesalers of America, "is an eight-decade record of constantly evolving and expanding a variety of products from suppliers across the country and around the world delivered to neighborhood markets, bars and restaurants in every corner of the nation. Nowhere else in the world is so much diversity of product distributed to so many locations offering consumers such an array of choices with guaranteed product integrity."

For many, that calls for a toast.