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COMMISSION APPROVED

Bureau of Competition
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

June 12, 1987

The Honorable Randolph J. Townsend
Nevada Legislature
Washoe No. 3
P.O. Box 20923
Reno, Nevada 89515

Dear Senator Townsend:

The Federal Trade Commission staff[1] is pleased to respond to your May 4, 1987, request for comments on Nevada Assembly Bill No. 569 ("A. B. 569"), a measure that would amend the statute governing franchise agreements between liquor suppliers and wholesalers.[2] The bill would significantly restrict a liquor supplier's ability to alter its distribution system in response to changes in market conditions. The likely results are a rigid and inefficient distribution system for alcoholic beverages and increased prices to Nevada consumers and visitors.

Congress has cha[illegible]d the [illegible]ission with enforcing the nation's antitrust a[illegible]ns[illegible] protection laws. Under this mandate, the Commiss[illegible]or [illegible]staff has frequently appeared before other governm[illegible]es to help assess the competitive and consumer welfar[illegible]a[illegible]ions of pending issues. The Commission is part[illegible] familiar with competition issues in the distribution of [illegible]everages. On numerous occasions in recent years, the FTC [illegible]f has presented its views on proposed

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1 These comments represent the views of the Bureaus of Competition, Consumer Protection, and Economics, and not necessarily those of the Commission itself. The Commission has, however, voted to authorize the staff to present these comments to you.

2 <u>See</u> Nevada Revised Statutes 598.290 <u>et seq</u>.

legislation governing the sale of these products.[3]

Likely Competitive Effects of A. B. 569

By protecting existing local liquor distributors from market forces, A. B. 569 can be expected to cause inefficiencies, injury to potential entrants, and higher prices to consumers. The bill effectively prohibits suppliers from terminating a wholesaler for reasons other than "good cause." Sections 1-2. "Good cause" is narrowly defined and generally will not exist unless the wholesaler loses a necessary governmental permit, is in serious financial difficulty, has been convicted of certain types of crime, has failed to act in good faith in performing under the franchise, or has failed to comply with a franchise requirement

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3 See, e.g., Comments of the Federal Trade Commission's Bureaus of Competition, Consumer Protection, and Economics on the Maryland Wine Cooler Fair Dealing Act (Mar. 11, 1987); Comments of the Federal Trade Commission's Bureaus of Competition, Consumer Protection, and Economics on the District of Columbia Wine, Beer, and Spirits Franchise Act (Aug. 29, 1986); Comments of the Federal Trade Commission's Bureaus of Competition, Consumer Protection, and Economics on the California Beer Distribution Bill, Senate Bill No. 1211 (July 2, 1985); Comments of the Federal Trade Commission's Bureaus of Competition, Consumer Protection, and Economics on the Rhode Island Distilled Spirits and Vinous Beverages Fair Dealing Law (Apr. 3, 1985); Comments of the Federal Trade Commission's Bureaus of Competition, Consumer Protection, and Economics on the Virginia Wine Franchise Act, House Bill No. 1301 (Feb. 8, 1985); Malt Beverage Interbrand Competition Act: Hearings on S. 1215 Before the Senate Comm. on the Judiciary, 97th Cong., 2d Sess. 266-90 (1982) (oral and written statements).

that is reasonable, lawful, and nondiscriminatory. Section 1.[4] In addition to defining the circumstances that constitute good cause,[5] the bill requires the supplier to show that it acted in good faith and to prove that good cause for termination exists. Sections 1, 3-4.

A. B. 569's restrictions would make it difficult for suppliers to distribute their products efficiently. By providing that distributors cannot usually be terminated except for fault or insolvency, the bill is likely to prevent suppliers from reacting quickly and efficiently to changes in supply and demand conditions. Thus, suppliers might be unable to restructure distribution networks that have become obsolete. The higher prices associated with such inefficiencies would presumably be passed on to consumers.

It is certainly possible that some distribution networks in Nevada will become outmoded within the next decade. Between 1970 and 1980 the total annual consumption of distilled spirits almost doubled in Nevada; however, between 1980 and 1985, Nevada consumption apparently dropped, reflecting a nationwide trend.[6] In markets where sales in a given decade may double or may

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4 In essence, the legislation sharply limits the grounds for ending a franchise. The bill would thus overturn a 1985 Nevada judicial decision upholding franchise termination for legitimate, prudent business reasons of the franchisor notwithstanding the absence of franchisee fault. See American Mart Corp. v. Joseph E. Seagram & Sons, Inc., 643 F. Supp. 44 (D. Nev. 1985). Under American Mart, liquor distribution systems can continuously evolve to remain rational and efficient, making possible the lowest possible price to the consumer. Under the bill, the necessary flexibility for efficient decision-making by the supplier is eliminated, with a likely result being higher prices to the consumer.

5 Even when the supplier can establish the requisite good cause, the distributor, in some situations, has sixty days to cure the claimed default. Section 1.

6 Jobson's Liquor Handbook 1986 52-53 (D. Hecht ed. 1986); Washington: First in Thirst, Washington Post, Aug. 3, 1986, at B6, col. 1. In 1984 and 1985 Nevada ranked first among the fifty states in liquor consumption on a per capita basis. Jobson's Liquor Handbook 1986 46, 56 (D. Hecht ed. 1986); Washington: First in Thirst, Washington Post, Aug. 3, 1986, at B6, col. 1.

decline, consumer demand patterns may be quite volatile. In order for distribution networks to remain economically efficient, supply patterns must be free to change with equal speed. A law that fails to allow for such changes could impose significant costs on consumers.

The constraining effects of A. B. 569 may be especially severe in areas where suppliers have established exclusive sales territories for their distributors. Since the bill prohibits the supplier from terminating or refusing to renew a franchise except under certain circumstances, a supplier that has assigned an exclusive sales territory may not be able to create new distributorships in that territory without triggering a claim from the existing distributor alleging that the territory is being terminated or reduced.

As a result of the proposed statute, suppliers may find it difficult to improve their distribution networks by introducing additional distributors, or by consolidating territories to achieve scale efficiencies. Even though a supplier may have a legitimate and procompetitive business reason for wanting to modify, reduce, or eliminate a distributor's territory, it could not act in the absence of franchisee fault or franchisee insolvency. Furthermore, even in some cases of franchisee misconduct, a supplier might be reluctant to undergo a court battle and the costs of proving the existence of "good cause."

A. B. 569 may also have the highly undesirable effect of making entry into the market more difficult. Under current law, distributors have an incentive to provide retailers with adequate liquor supplies at competitive prices. They know that if they attempt to charge more than the competitive price, their suppliers can give franchises to new distributors that are willing to charge lower wholesale prices. By limiting possible entry into the territory, however, A. B. 569 may eliminate this competitive pressure and may therefore increase the prices paid by consumers. In addition, by increasing the suppliers' costs of altering their distribution systems, the bill will reduce the incentives of existing suppliers to introduce new brands into Nevada and of new suppliers to enter the market.

In short, A. B. 569 would protect some existing distributors at the expense of other existing distributors, potential distributors, suppliers, consumers, and competition. Changes sought by suppliers to meet different market conditions are not abusive demands that require statutory remedies. Suppliers have no incentive to mistreat their distributors because good distributors are necessary for the efficient marketing of liquor. There is, therefore, no need for new legislation to skew contracts between suppliers and distributors in favor of the distributors.

Conclusion

A. B. 569 will interfere unnecessarily with market forces by increasing the supplier's costs of adding or eliminating distributors or switching from one distributor to another. The stimulus to efficiency resulting from competition for the supplier's patronage will be reduced if it is more costly for suppliers to make changes and easier for distributors to challenge any changes. In the absence of the bill's proposed restrictions, competition is likely to encourage alcoholic beverage suppliers to maintain more efficient distributional arrangements and to retain necessary flexibility to respond effectively to shifting consumer preferences and demand patterns. The FTC staff therefore concludes that enactment of A. B. 569 would not serve the public interest.

Sincerely yours,

Jeffrey I. Zuckerman
Director