Prepared Statement of
the Federal Trade Commission

Before the

Subcommittee on Commerce, Trade, and Consumer Protection
Committee on Energy and Commerce
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I. Introduction

Mr. Chairman, I am Todd Zywicki, Director of the Federal Trade Commission's Office of Policy Planning.(1) I am pleased to appear before the Subcommittee today to testify on behalf of the Commission regarding "E-Commerce: The Case of Online Wine Sales and Direct Shipment." The wine issue is the subject of a recent staff report entitled "Possible Anticompetitive Barriers to E-commerce: Wine,"(2) and is representative of the types of policies that are impacting e-commerce in many different industries across the nation. The Commission would like to thank Chairman Stearns for his excellent leadership in this area and for his efforts to promote e-commerce and consumer welfare. The Commission would also like to thank the Subcommittee for its continued interest in studying potential anticompetitive barriers to e-commerce. Last September, this Subcommittee held a hearing entitled "State Impediments to E-Commerce: Consumer Protection or Veiled Protectionism?" that focused on the e-commerce issues in three industries: auctions, contact lenses, and wine.(3)

II. Overview of Possible Anticompetitive Barriers to E-Commerce

The Internet enables consumers to purchase an unprecedented array of goods and services from the convenience of their homes. Consumers can find and purchase thousands of goods, from thousands of suppliers around the country, and have those goods delivered to their doors. Moreover, perhaps for the first time, consumers can also conveniently purchase a wide array of services from distant sources. Consumers can obtain legal and medical advice, realtor services, and an education from out-of-state online suppliers. In many instances, these consumers may find lower prices and a greater variety of goods and services online than in bricks-and-mortar stores.

The Internet, however, also raises regulatory concerns about online fraud and other abuses. As a result, many states have adopted regulations that may limit consumers' ability to buy certain goods and services online. For example, some states require that online vendors maintain a physical office in the state, while other states prohibit online sales or shipments of certain products entirely. Many states also require that out-of-state suppliers obtain an in-state license before selling particular goods, like wine or caskets, or services, like medical or legal advice. Although many of these regulations may have legitimate consumer protection rationales, many of them also have the effect of insulating local businesses from out-of-state competitors.

In October 2002, the Federal Trade Commission held a workshop to study these issues. Over three days, Commission staff heard testimony on possible anticompetitive barriers to e-commerce in many different industries: auctions; automobiles; caskets; contact lenses; cyber-charter schools; online legal services; real estate, mortgages, and financial services; retailing; telemedicine and online pharmaceutical sales; and wine. For each industry, Commission staff gathered evidence from many different perspectives, including online companies, bricks-and-mortar businesses, consumer groups, academics, state officials, and others. The staff also invited and received comments from the public at large.(4)

As part of the process of examining possible barriers to e-commerce, the Commission has strongly encouraged policymakers to adopt rules that encourage e-commerce. For example, the Commission filed a joint comment with the Department of Justice before the North Carolina State Bar opposing two new opinions that would require the physical presence of an attorney for all real estate closings and refinancings, which would significantly increase the costs of Internet lenders that rely disproportionately on lay closers.(5) The Commission also filed joint FTC/DOJ comments before the Rhode Island legislature and Georgia State Bar on similar issues.(6) On the health care front, the Commission filed a staff comment before the Connecticut Board of Opticians, which was considering additional restrictions on out-of-state and Internet contact lens sellers.(7) The Commission has also filed *amicus* briefs to promote competition. For example, the FTC recently participated in a court challenge to a state law that banned anyone other than licensed funeral directors from selling caskets to members of the public over the Internet. While recognizing the state's intent to protect its consumers, the brief questioned whether the law did more harm than good.(8)

III. Wine

A. Background

Wine is a good example of how the Internet can permit fundamentally different business models to flourish. Through the Internet, many smaller vineyards, with limited distribution networks, can now market their wines to consumers around the country. Consumers also can potentially save money by buying online, avoiding markups by wholesalers and retailers. Online wine sales are a small but growing percentage of the wine market. From 1994-99, consumers doubled the amount of money they spent having wine shipped directly to them to around $500 million, or about 3% of the total spent on wine.(9) According to some private estimates, online wine sales could account for 5-10% of the market within a few years.(10)

On the other hand, many states limit or prohibit direct wine sales over the Internet. Under the common "three tier" distribution system, many states require that wine pass through a wholesaler or a retailer before reaching the consumer. These states, and many commentators, contend that the distribution system furthers the state's interest in taxation, advances the Twenty-First Amendment's important public policy goal of temperance, and helps prevent alcohol sales to minors. Lawsuits are pending in many states regarding the direct shipment of wine, although the FTC has taken no position on the constitutional issues raised in the lawsuits.

At the workshop, Commission staff heard testimony from all sides of the wine issue, including wineries, wholesalers, state regulators, and a Nobel laureate in economics. Commission staff also gathered evidence from a wide variety of published sources, such as studies and court decisions, and from other sources, such as package delivery companies and the Bureau of Alcohol, Tobacco, Firearms, and Explosives (now the Alcohol and Tobacco Tax and Trade Bureau). Finally, FTC staff studied the wine market in a state that until recently banned direct shipment of wine to consumers from out-of-state sources, and, as a result, banned most online wine sales. In particular, the study examined the wine market in McLean, Virginia, and compared the prices and choices that consumers could find in area stores to the prices and choices that consumers could find online.

B. FTC Staff Report

Commission staff wrote the report based on the study of the McLean market, testimony received at the workshop, and additional research. The Commission's staff report assesses the impact on consumers of barriers to e-commerce in wine. The report also surveys the alternative policies adopted by many of the states that permit their citizens to order and receive wine from out-of-state sources.

1. ***Benefits of E-Commerce***

The report concludes that states could significantly enhance consumer welfare by allowing the direct shipment of wine to consumers. Through direct shipping, consumers can purchase many wines online that are not available in nearby bricks-and-mortar stores. The McLean study found that 15% of a sample of wines available online were not available from retail wine stores within ten miles of McLean. Similarly, testimony unambiguously reveals that, by banning interstate direct shipments, states seriously limit consumers' access to thousands of labels from smaller wineries.(11)

Moreover, the report finds that, depending on the wine's price, the quantity purchased, and the method of delivery, consumers can save money by purchasing wine online. Because shipping costs do not vary with the wine's price, consumers can save more money on more expensive wines, while less expensive wines may be cheaper in bricks-and-mortar stores. The McLean study suggests that, if consumers use the least expensive shipping method, they could save an average of 8-13% on wines costing more than $20 per bottle and an average of 20-21% on wines costing more than $40 per bottle.(12)

2. *Barriers to E-Commerce*

In terms of the regulatory regime, the report finds that state bans on interstate direct shipping represent the single largest regulatory barrier to expanded e-commerce in wine. Approximately half the states prohibit or severely restrict out-of-state suppliers from shipping wine directly to consumers. In approximately seven states, interstate direct shipping can be prosecuted as a felony. Many of these same states, however, allow intrastate direct shipping, such as from in-state wineries and retailers.(13) Besides the direct shipping bans, many other regulations impede e-commerce in wine. These include prohibitions on online orders, very low ceilings on annual purchases, bans on advertising from out-of-state suppliers, requirements that individual consumers purchase "connoisseurs' permits," and requirements that delivery companies obtain a special individual license for every vehicle that might be used to deliver wine.(14)

3. *Underage Drinking*

The direct shipping debate involves other public policy goals. For example, citizens are concerned about the direct shipment of wine to minors. To gather information on the actual experiences of states that allow interstate direct shipping, FTC staff contacted officials from numerous reciprocity and limited importation states and asked them a variety of questions, including whether they had experienced problems with interstate direct shipping to minors. Most of the surveyed states provided written responses. Staff also reviewed testimony from a California alcohol regulator who had testified before California's legislature.

In general, these state officials report that they have experienced few, if any, problems with interstate direct shipment of wine to minors. Most of them do not believe that interstate direct shipment of wine to minors is currently a serious problem, although several of them believe that it is possible for minors to buy wine online. None of them report more than isolated instances of minors buying or even attempting to buy wine online. Some of them, such as California, have monitored the issue of alcohol delivery to minors for years or even decades.(15)

These state officials offer many possible explanations for their experiences. Several state officials opined that minors are more interested in beer and spirits than wine.(16) New Hampshire concluded that minors are less likely to purchase wine online because of the extra expense of ordering over the Internet.(17) These conclusions correspond with the McLean study, which found that when transportation costs are included, lower-end wines are more expensive when purchased over the Internet than through the three-tier system.(18) Minors would have to pay a hefty premium, from 33-83%, to purchase a bottle of wine costing less than $20 online and have it delivered to them via 2nd Day Air.

Several state officials commented that, based on their experience, minors were much more likely to buy alcohol through offline sources than over the Internet.(19) In a 2002 survey, large percentages of high school students, from 68-95%, said that it is "fairly easy" or "very easy" to get alcohol.(20) In examining offline and online stings, there are not enough data from which to conclude that minors can buy wine more easily or less easily online than offline (among other reasons, there is far more sting data about offline sales). In the absence of such information, it is difficult to ascertain whether online wine sellers are, or would be, a significant source of alcohol for minors.

Of course, the fact that states have received few complaints about direct shipments to minors does not establish that minors are not purchasing wine online. As noted by a Michigan Assistant Attorney General, minors who buy wine online are unlikely to report their purchases to the authorities, and neither the package delivery company nor the supplier may know or care that they are delivering wine to a minor.(21) The FTC cannot rule out the possibility that minors are buying wine online undetected by state officials.

The report, however, finds two clear results. First, several states that permit interstate direct shipping have adopted various procedural safeguards and enforcement mechanisms to prevent sales to minors. New Hampshire, for example, requires an adult signature at the time of delivery, permanently revokes the direct shipping permit of anyone who ships wine to minors, and declares him guilty of a class B felony.(22) Second, states that allow interstate direct shipping generally say that direct shipping to minors currently is not a serious problem, and that they have received few or no complaints about direct shipping to minors.

4. *Tax Collection*

The report finds that some states also have adopted less restrictive means of protecting tax revenues while permitting direct shipping, such as by requiring out-of-state suppliers to obtain permits and to collect and remit taxes.(23) Most of these states report few, if any, problems with tax collection. Nebraska, for example, reports that they "have also not, as yet, had any problems with the collection of excise tax[es]."(24) North Dakota reports that "Taxes are collected. No problems to date that we are aware of."(25) The staff report finds that, to the extent that states have problems with out-of-state suppliers, they have addressed the problem in less restrictive ways than banning all interstate direct shipping. Other states with reciprocity agreements forego taxing interstate direct shipments altogether.

5. *Less Restrictive Alternatives*

As mentioned previously, the report finds that some states have adopted less restrictive means to satisfy their regulatory objectives an alternative to banning interstate direct shipment of wine. For example, some states register out-of-state suppliers and impose various civil and criminal penalties against violators. Several states, including Nebraska, New Hampshire, and Wyoming, require out-of-state suppliers to register and obtain permits for a reasonable fee (a permit can be conditioned on the out-of-state supplier's consent to submit to the state's jurisdiction). None of these states reported any problems with interstate direct shipping to minors.(26)

In addition, some states have applied the same types of safeguards to online sales that already apply to bricks-and-mortar retailers, such as requirements that package delivery companies obtain an adult signature at the time of delivery. Unfortunately, there is no systematic empirical data revealing how often couriers obtain a valid adult signature. FTC staff contacted both FedEx and UPS, and neither company keeps such records. Both companies, however, have adopted policies that require their couriers to obtain adult signatures.

IV. Conclusion

For these reasons, the staff report concludes that consumers could reap significant benefits if they had the option of purchasing wine online from out-of-state sources and having it shipped directly to them. Consumers could save money, choose from a much greater variety of wines, and enjoy the convenience of home delivery. Indeed, in states that are litigating the constitutionality of direct shipping bans, several courts have found that the bans deprive the state's consumers of lower prices and greater variety. In addition, many states appear to have found means of satisfying their tax and other regulatory goals that are less restrictive than an outright ban. These states generally report few or no problems with shipments to minors or with tax collection.

The report has general implications for e-commerce. Anticompetitive state regulations can insulate local suppliers from online competition and deprive consumers of lower prices and greater selection. Although states have legitimate regulatory goals in protecting consumers, they may have less restrictive alternatives that would allow online competition and, ultimately, provide the greatest benefits to consumers.

The wine debate illustrates several key principles that policymakers should consider as they address the growth of e-commerce:

- **Legacy laws can unintentionally inhibit e-commerce.** In many cases, state bans on interstate direct shipment of wine exist not as a response to e-commerce, but because the three-tier distribution system developed before the Internet even existed. As e-commerce continues to expand, the potential cost to consumers of restrictions will rise. Consequently, legacy laws that inhibit e-commerce merit re-examination.

- **New laws restricting e-commerce deserve careful scrutiny.** Not all restrictions or penalties for direct shipping are of ancient vintage. Some states, for example, have recently converted interstate direct shipping from a misdemeanor to a felony. On numerous workshop panels, consumer representatives and scholars warned that new restrictions on e-commerce often are driven more by the desire to protect established businesses than to protect consumers. Given this risk, proposals for new restrictions on e-commerce, or harsher penalties for existing violations of the law, deserve careful scrutiny.

- **Not all licensing is created equal.** Some states that permit interstate direct shipping use licenses and permits to make suppliers identify themselves and agree to abide by the state's laws. Such licensing appears to have little negative impact on e-commerce. In other states, however, high license fees or cumbersome procedures impede e-commerce by imposing substantial costs on suppliers, delivery companies, and consumers. For states that favor licensing, the key challenge is to craft a licensing regime that is only as burdensome as necessary to satisfy the state's objectives. Reciprocal licensing agreements with other states may provide one means of accomplishing regulatory objectives at lower costs to consumers.

- **States may have alternatives to in-state office requirements.** A common argument for prohibiting interstate direct shipping is that states can only enforce the law against in-state suppliers. This argument also arises in other contexts where states require sellers of goods or services to maintain in-state offices and hire state residents. States may, however, have less burdensome means of regulating out-of-state suppliers. Through permits and cooperation with federal law enforcement agencies and other states' enforcement agencies, states may be able to permit e-commerce while still satisfying their regulatory objectives.

- **Not all "level playing fields" benefit consumers equally.** In the wine context, states could "level the playing field" either by prohibiting all direct shipping or by permitting interstate as well as intrastate direct shipping. The FTC staff study of McLean, Virginia suggests that Virginia consumers will benefit from the Commonwealth's recent decision to achieve policy neutrality by legalizing interstate direct shipping. Virginia's experience illustrates a general principle: although there are many ways to avoid discriminating against a group of suppliers, a pro-consumer approach would attempt to achieve policy neutrality by expanding consumer choice.

Thank you for this opportunity to share the Commission's views. The Commission looks forward to working with the public and with the Subcommittee to help give consumers the full benefits of online commerce.

Endnotes:

1. The views expressed in this statement represent the views of the Commission. My oral statement and responses to questions you may have are my own and do not necessarily reflect those of the Commission or any individual Commissioner.

2. FTC Staff Report, *Possible Anticompetitive Barriers to E-Commerce: Wine* (July 2003), *available at* <http://www.ftc.gov/os/2003/07/winereport2.pdf> (hereinafter "Wine Report").

3. *State Impediments to E-Commerce: Consumer Protection or Veiled Protectionism?: Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the House Comm. on Energy and Commerce*, 107th Cong. (2002), *available at* <http://energycommerce.house.gov/107/hearings/09262002Hearing732/hearing.htm>.

4. Public Workshop: Possible Anticompetitive Efforts to Restrict Competition on the Internet, 67 Fed. Reg. 48,472 (2002). More information is available at the workshop's homepage, at <http://www.ftc.gov/opp/ecommerce/anticompetitive/index.htm>.

5. FTC/DOJ Letter to the Ethics Committee of the North Carolina State Bar re: State Bar Opinions Restricting Involvement of Non-Attorneys in Real Estate Closings and Refinancing Transactions (Dec. 14. 2001), *available at* <http://www.ftc.gov/be/V020006.htm>.

6. FTC/DOJ Letter to the Rhode Island House of Representatives re: Bill Restricting Competition from Non-Attorneys in Real Estate Closing Activities (Mar. 29, 2002), *available at* <http://www.ftc.gov/be/v020013.pdf> FTC/DOJ Letter to the Georgia State Bar re: Comments On Potential Unlicensed Practice Of Law Opinion Regarding Real Estate Closing Activity (Mar. 20, 2003), *available at* <http://www.ftc.gov/be/v030007.htm>.

7. FTC Staff Comment Before the Connecticut Board of Examiners for Opticians (Mar. 27, 2002), *available at* <http://www.ftc.gov/be/v020007.htm>.

8. Memorandum of Law of *Amicus Curiae* Federal Trade Commission, Powers v. Harris, Case No. CIV-01-445-F (W.D. Okla. Sept. 5, 2002), *available at* <http://www.ftc.gov/os/2002/09/okamicus.pdf>.

9. Alix M. Freedman & John R. Emshwiller, *Vintage System: Big Liquor Wholesaler Finds Change Stalking Its Very Private World*, Wall St. J., Oct. 4, 1999, at A1. *See also* Vijay Shanker, Note, *Alcohol Direct Shipment Laws, the Commerce Clause, and the Twenty-First Amendment*, 85 Va. L. Rev. 353, 353 n.5 (Mar. 1999) (discussing other estimates).

10. Mark Swartzberg & Jennifer F. Solomon, Salomon Smith Barney, *Clicking on Wine: Will E-Commerce and Other Forces Increase U.S. Consumer Access to Wine?*, at 18 (Mar. 17, 2000) (equity research report).

11. Wine Report at 16-26.

12. *Id*.

13. One such state is Texas. In a recent case, a federal court in Texas found that Texas law does not promote temperance in banning direct shipment of out-of-state, but not in-state, wines:

The Court finds that there is no temperance goal served by the statute since Texas residents can become as drunk on local wines or on wines of large out-of-state suppliers able to pass into the state through its distribution system, and available in unrestricted quantities, as those that, because of their sellers' size or Texas wholesalers or retailers' constraints, are in practical effect kept out of state by the statute.

Dickerson v. Bailey, 212 F.Supp.2d 673 (S.D. Tex. 2002), *incorporating Dickerson v. Bailey*, 87 F.Supp.2d 691, 710 (S.D. Tex. 2000), *aff'd*, No. 02-21137, slip op. at 2 (5th Cir. June 26, 2003).

14. Wine Report at 14-16.

15. *See* Wine Report at 26-40.

16. Illinois letter; Washington letter (Wine Report, App. B).

17. New Hampshire letter (Wine Report, App. B).

18. Wiseman & Ellig (Wine Report, App. A).

19. *See* California testimony; letters from New Hampshire and Wisconsin (Wine Report, App. B).

20. *See* Wine Report, notes 47-50 and accompanying text.

21. Testimony of Irene Mead 196, *available at* <http://www.ftc.gov/opp/ecommerce/anticompetitive/021008antitrans.pdf>.

22. New Hampshire letter (Wine Report, App. B).

23. *See*, *e.g.*, La. Rev. Stat. Ann. § 26:359(B)(1); N.H. Rev. Stat. Ann. § 178:14-a(V); Nev. Rev. Stat. § 369.462.

24. Nebraska letter (Wine Report, App. B).

25. North Dakota letter (Wine Report, App. B).

26. *See* Letters from Nebraska, New Hampshire, and Wyoming (Wine Report, App. B).