E-COMMERCE: THE CASE OF ONLINE WINE SALES AND DIRECT SHIPMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

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THURSDAY, OCTOBER 30, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room 2123, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Whitfield, Shimkus, Shadegg, Radanovich, Bass, Issa, Schakowsky, Towns, and McCarthy.

Also present: Representative Thompson of California.

Staff present: Ramsen Betfarhad, policy coordinator; David Cavicke, majority counsel; Jill Latham, legislative clerk; Jon Tripp, deputy communications director; and Jonathan Cordone, minority counsel.

Mr. STEARNS. Good morning, everybody. Welcome to the subcommittee's hearing entitled E-Commerce: The Case of On-Line Wine Sales and Direct Shipment.

This hearing is one of a number of hearings that the subcommittee has held on electronic commerce in this and the 107th Congress. As I have said in the past, I think it is important that the subcommittee and the full committee, as congressional custodians of the commerce clause, be vigilant of and encourage interstate commerce in general and nascent forms of interstate commerce such as E-commerce in particular.

In particular, this hearing is a follow-up to a subcommittee hearing held in September of last year focused on State impediments to E-commerce. At that hearing we heard testimony on State legal and regulatory impediments that were undermining consumer choice in E-commerce with respect to three products and services: one, auctions; two, contact lenses; and, three, wine.

Just 4 weeks ago the committee approved H.R. 3140, removing a number of State regulatory barriers identified in the subcommittee September 2002, hearing that impeded on-line contact lens sales.

This past July the Federal Trade Commission issued a report entitled Possible Anticompetitive Barriers to E-Commerce Wine, and I ask for unanimous consent to enter into the record this FTC report. Without objection, so ordered.

[The FTC report is available at: http://www.ftc.gov/os/2003/07/winereport2.pdf]

Mr. STEARNS. This staff report grew out of the FTC's Internet Task Force convened in August of 2001 to evaluate government regulations of particular products and services that could stifle on-line commerce and competition. The objective of the report is to inform a raging debate between those who argue that direct shipment of wine to consumers, specifically on-line sales, should not be banned because it provides consumers with lower prices and greater variety of wines and States that ban such sales so that they can protect against sales to minors and collect excise taxes. I commend the Commission for undertaking this report with the purpose of informing about this debate.

Today we hope to examine the FTC report carefully and consider its broader public policy implications with respect to interstate and electronic commerce. The FTC's July staff report concludes that "States could significantly enhance consumer welfare by allowing the direct shipment of wine to consumers." The report states that through direct shipping, on-line wine sales offer consumer's lower prices and greater selection.

In looking at both the availability and pricing of some 83 wines, all of which appeared in Wine and Spirits magazine's top 50 wines list for 2002 within a 10-mile radius of McLean, Virginia, the Commission staff found that 15 percent of those 83 wines could not be found in McLean retail outlets, while they were being available on-line.

Moreover, the Commission staff report found that on-line prices for wines priced at above $20 were about 8 to 13 percent lower than prices at brick and mortar retailers. The savings accruing to customers from on-line sales increased to 20 to 21 percent for wines priced over $40. Yet they found that bricks and mortar stores, after factoring in shipment costs, offered better prices on less expensive wines. At the time of the survey, Virginia had a ban on direct shipments of wine.

In light of the consumer welfare gains demonstrated in the McLean survey, the report observes that public policy goals of excise tax collection and prevention of sales to minors can still be accomplished by States through less restrictive regulation, short of an outright ban of direct interstate wine sales. Many States, the report notes, permitting interstate direct shipment report few or no problems with shipments to minors or with tax collection.

My colleagues, I know this debate highlights attention between the commerce clause and the 21st Amendment to the Constitution. Under the dormant commerce clause doctrine, the Supreme Court has held States cannot impede or discriminate against interstate commerce. Meanwhile, the 21st amendment has been interpreted as giving the States broad powers in its regulation of the sale and distribution of liquor within and across its borders.

Is there a split in the circuits on how to resolve that tension? I think we believe that, ultimately, the Supreme Court will address this matter. But notwithstanding this ongoing legal battle, I think that the States' public policy objectives of precluding wine sales to underage drinkers and the collection of excise taxes, both of which are advanced under the color of the States' 21st amendment authority, are very important public policy objectives.

Still, if the FTC staff report's analysis holds true for markets other than just McLean, Virginia, I find it persuasive that States should pursue less restrictive forms of regulation of direct interstate wine sales than outright bans. For example, the report concludes that States can prevent sales to minors using restrictions other than bans on direct shipments by requiring wineries to label their packages as containing alcohol and requiring the package carrier to verify the age of the consumer by obtaining an adult's signature at the time of delivery and by requiring out-of-State companies to obtain shipping permits and setting up penalties and enforcement systems.

I thank the witnesses for appearing before the subcommittee this morning. I look forward to hearing their testimony.

With that, the distinguished ranking member is recognized for an opening statement.

Ms. SCHAKOWSKY. I want to thank you, Chairman Stearns, for convening the hearing on E-commerce and the on-line sale of wines and to discuss the recent FTC staff report on the subject.

The report explores the competitive impact of State regulations that restrict the on-line sale of wines. The FTC reached the conclusion that restrictive State laws and regulations limit consumer choice and they force consumers to pay artificially high prices for wine. The FTC also concluded that on-line wine sales do not add to the problem of underage drinking. The FTC's staff has concluded that restrictive State laws and regulations should be loosened.

While I am in agreement that open and fair competition benefits consumers, great competition means lower prices and greater variety, adult consumers should have a broad range of options when they are purchasing wine and unnecessary trade barriers should be removed. Having said that, though, before we hastily consider legislation that would deregulate the on-line sale of alcohol, we need to carefully its potential impact on minors, among other things.

Underage drinking continues to be a national public health problem. There are more than 10 million underage drinkers in our country. More than two out of five college students are binge drinkers. Sadly, excessive drinking accounts for 1,400 deaths and contributes to 70,000 sexual assaults on college campuses every year. Before considering legislation that might weaken State laws, we need to take every precaution necessary to ensure that we do not inadvertently make this serious problem even worse.

In its report, the FTC asks State regulators to discuss on-line wine sales, how they contribute to the underage drinking problem. State regulators reported that they did not believe that on-line wine sales create a problem. In their view, States have taken adequate measures to prevent the illegal shipping of wine to minors.

However, it should be noted that several State agencies, including my own, including the Illinois Liquor Control Commission, were not aware of any sting operations performed against out-of-State shippers. Therefore, they cannot adequately assess if the delivery of on-line wines adds to the problem of underage drinking. In my view, the FTC report does not satisfactorily answer this important question.

Proponents of on-line sale of wine point out that underage drinkers do not usually buy expensive wines. However, if the Congress passes legislation that preempts State law, what would stop a business or a State from claiming in court that beer and liquor companies should have to comply by the same rule as wineries? Is this, in fact, a slippery slope?

As the chairman outlined, the on-line sale of wine also raises important constitutional considerations for Congress. The commerce clause of the Constitution gave Congress the power to regulate interstate commerce. However, the 21st amendment of the Constitution ended prohibition and gave the States broad authority to regulate the sale, importation, and distribution of alcoholic beverages within and across their borders. So the question is, who has the power to regulate alcohol sales? Should it be left to the States or Federal Government?

According to the courts, this remains an open question. Federal circuit courts have reached contradictory conclusions. Many experts believe that this question will eventually be resolved by the Supreme Court. We need to carefully weigh this question before we consider legislating on the issue.

We will also need to carefully review on-line wine sales' impact on State revenues. As we all know, States are having a very difficult time meeting the most basic needs of their citizens. The FTC report does not provide conclusive evidence about its impact on revenues. This raises a larger question about collecting taxes from online sales that will need to be considered as part of the debate.

I look forward to hearing from the FTC and industry stakeholders. However, we don't have any witnesses from the public health community. We are also not hearing from unbiased constitutional experts or State government officials. Before proceeding forward on legislation we need to hear their views on this important topic.

Again, I thank the chairman and look forward to hearing from our witnesses.

Mr. STEARNS. I thank my colleague.

The gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman—and good morning—for holding this hearing to address on-line sale of wines and economic inhibitors that face this industry. Ironically, my home State of Illinois, which is largely known for its agricultural production of corn and soybeans, is slowly emerging as a wine-producing State. We now have over 39 wineries. The lower third of my State, which encompasses my district, has rich loamy soil and long sun-drenched summers which create an ideal grape- and fruit-growing region.

I will continue to support the wine growers and wineries in my district because of the benefits they provide to my region. These small businesses provide economic development. They promote tourism, encourage domestic purchases of wine, and help producers diversify their crops.

I see many benefits in allowing these local wineries to sell their product on the Internet. These are not huge production facilities. These are mom and pop organizations like GenKota Winery in Mount Vernon, Illinois, and Fox Creek Vineyards in Olney, Illinois. Olney is the home of the famous white squirrels, for those of you who want to know where Olney is. These businesses do not have the luxury of selling their product wholesale. They are just local wineries who sell roughly 15 different types of wine for about $10 to $20 a bottle.

I am discouraged by States that have prohibited this type of Internet retail. I am also disappointed that they have enacted these laws as economic protectionism in the guise of some greater public and social policy. For example, States that allow direct shipment within the State will prohibit out-of-State sales of the same product.

With that being said, I am concerned about the same problems associated with on-line sales of wine. I have sponsored legislation like Dot Kids that has provided a safe place for children on the Internet. Therefore, I am looking for some type of reasonable solution where we can promote wineries like those in my district without providing a tool for minors to obtain alcohol.

I look forward to the testimony from our witnesses; and, Mr. Chairman, I yield back the balance of my time.

Mr. STEARNS. I thank the gentleman.

The gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman, for holding this hearing today on an issue that is becoming timely as technology converges on traditional business models. It does not take a Fortune 500 CEO to tell you that if a business has no ability to get goods or services to the consumer they will not be operating too long.

I am proud of the many success stories spawned by E-commerce; and even this year my colleague, Mr. Burr from North Carolina, and I sponsored legislation that enables consumers to get contact lenses on-line with greater ease and oftentimes a more affordable price.

I do, however, have grave concerns about selling controlled substances such as pharmaceuticals, tobacco and alcohol over the Internet. They are not the same as contact lenses or golf clubs. Online sales seemingly have been a panacea for small- and medium-size business, including wineries, to increase their market share and revenues, but this profiteering must be tempered with the possible detriment to society at large, due to the pitfalls connected with underage drinking and alcohol abuse.

Wine is alcohol, and I have long held the notion that all alcohol should be taxed. So why should some types of alcohol be regulated and distributed differently?

There is a truth to the notion that a 15-year-old is not going to order a $500 bottle of Zinfandel. However, I do see safety issues with respect to children ordering alcohol without being checked for ID, as I have indicated above, and see no reason to deputize an overnight carrier or letter carrier, a mailman or mailwoman, to club bouncer status.

I would like to see the expansion of a system where out-of-State shipments of all alcohol passes through a third party so that not only are consumers able to have greater access to small- and medium-sized wine labels but one that is financially rewarding to all parties involved. Most importantly, it should be responsible to our children as well. That should be our No. 1 goal, and we should not forget it.

Mr. Chairman, I look forward to hearing the testimony; and on that note I yield back.

Mr. STEARNS. I thank the gentleman.

The gentleman from California, Mr. Radanovich.

Mr. RADANOVICH. Thank you, Mr. Chairman.

I want to again start off by thanking you for holding this hearing today. I appreciate your taking the time to do this.

I want to thank our witnesses, particularly David Sloane from WineAmerica and Juanita Duggan from Wine and Spirits Wholesalers. Welcome. Thank you for being here to testify.

As somebody who has been involved in the wine industry for several years, I know that on-line wine sales provide a path for significant economic growth in the wine industry. Also, on-line sales have opened a window of opportunity for many consumers to try a variety of wines, many of which are not available to them in local retail outlets. In order for this economic growth and consumer choice to continue, Congress must actively support E-commerce through the principles established in the commerce clause. The free flow of goods between States critical in the future of E-commerce and wine should not be excluded from this effort. Certainly when dealing with an alcoholic product such as wine, there must be mechanisms in place to ensure that children are protected.

The FTC report that we will hear today discusses the various methods some States and shipping companies use to protect children. Notably, the report states that there are no documented non-sting cases of juvenile access to wine shipments generated from on-line sales. The State of California has been allowing direct shipments of wine for about two decades, and they say it is not aware of any problems with minors buying wine on-line and shipping the products to themselves.

Given this and other favorable aspects of the FTC report, I believe that Congress has the responsibility to allow consumers the choice to purchase wine on-line and to give this venue a chance to grow and expand.

Again, Mr. Chairman, I appreciate your holding this hearing today; and I look forward to the testimony and the dialog afterwards.

Mr. STEARNS. I thank my colleague.

By unanimous consent I want to offer Mr. Thompson an opportunity to say some opening comments, and we welcome him as an interested observer to our committee.

Mr. THOMPSON. Thank you very much, Mr. Chairman. I want to thank you both for allowing me to participate today and for holding this hearing. I also want to thank my colleague George Radanovich for the influence that he exercised in making sure that this hearing did in fact take place.

I just want to put some meat on the bones. A number of folks have mentioned the importance that the wine industry is to the economy. I just want to let you know what that means. The wine industry is a vital part of our economy. It creates over a half a million jobs across the country. It accounts for over $12 billion in wages. The wine industry contributed almost $4 billion in State and local taxes, and the industry generates nearly $50 billion a year to our national economy.

In my district, I have a number of wineries, in California's first congressional district; and many of those wineries rely on their ability to send wine directly to consumers. The typical small winery, someone mentioned, is a mom-and-pop operation; and that is true. It is not uncommon to see the mom and the pop picking the grapes, crushing the grapes, bottling the wine and then out on the weekends trying to sell that wine; and there is a big problem in being able to get their wine to the consumers. It is not only an economic problem for the winery, but it is also an access problem for the consumers. We have a situation where consumers can't purchase and enjoy the wines that they want to purchase.

There has been a tremendous consolidation amongst distributors across this country, and that has greatly reduced the financial incentive to represent small wineries. So for these guys direct sales, direct shipment Internet sales are the only way that they can get their product to the consumers.

It is interesting, Mr. Chairman, your being from Florida, if you were to visit my district and buy a case of wine in my district at a winery, legally buy it and then leave that winery and try to mail it home to your house in Florida, not only is that illegal but it is a felony in your State; and this is not the sort of thing that I believe this Congress wants to promote.

There has been a lot said about children getting wine, and I think Mr. Towns had it somewhat correct, although I would like to find a bottle of that $500 Zinfandel. I might start growing——

Mr. TOWNS. You have to purchase it in New York.

Mr. THOMPSON. I have tasted some interesting wine from New York.

Kids don't buy wine over the Internet. Kids don't pay the amount that good wine or any wine sells for over the Internet or anyplace else. I think it is important, however, to be concerned about minors getting alcohol, and I believe that underage drinking is a problem, but there are ways that we should deal with that.

In regard to shipping of alcohol, it can be done the way other items are controlled in the mail system and in the shipping industry. Packages can be labeled. Alcohol delivery folks can verify the age of the recipient. You can get an adult-required signature at the time of the delivery. All these work.

They work in California. We have intrastate shipping in a number of States, California being one of those; and officials from California will tell you that there is not a problem with kids buying any type of alcoholic beverage and having it shipped to them. This is an issue of consumers being able to get the products that they want and people that produce these products being able to get those products to the consumers, and I hope that this hearing will help clarify that and move us closer to resolving this issue.

Mr. Chairman I have a statement I would like to ask——

Mr. STEARNS. By unanimous consent, so ordered. We will have your statement made a part of the record, and we thank you for your attention.

With that, there are no further opening statements.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. FRED UPTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you, Mr. Chairman. I am very interested in this issue. It might surprise you to know that Michigan has a good size wine industry. In my district alone, there are TEN small to midsize vineyards: Contessa, Domaine Berrien, Fenn Valley, Heart of the Vineyard, Karma Vista, Lemon Creek, St. Julian, Tabor Hill, Warner, and Wyncroft.

You may not have heard of these vineyards yet, but they are gaining in stature in the wine community. Over the course of four days in March, more than 3,000 wines from around the world were judged at the Tasters Guild International Wine Competition. Michigan wines were awarded 25 Gold Medals and two Double Gold. St. Julian Wine Co. of Paw Paw, MI—in my district—received the most awards for Michigan, with one Double Gold and 10 Gold Medals.

The internet is allowing these vineyards to get exposure and grow their businesses, and I think that is something to encourage not limit. Internet commerce allows small towns like Coloma, Michigan to reach the world with products grown and processed there. This is a GOOD thing!

Of course, there needs to be controls in place to ensure that underage drinkers are not able to get a hold of alcohol. But with all of the technology that is available, I find it hard to believe that we can't find a compromise that will allow connoisseurs to order wines that are not widely distributed.

Thank you, I look forward to hearing the testimony today.

PREPARED STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

Thank you, Mr. Chairman, for holding this hearing today. It provides us with a valuable opportunity for continued discussion pertaining to e-commerce.

The question before us today is the perfect demonstration of just how far commerce has come in our country. The Internet has opened doors for people in every community and access to goods is greater than ever before. With increased access comes the need to maintain a watchful eye and determine what, if any, regulation modifications or creation are needed to evolve in-step with the marketplace in order to remain effective.

While on the surface, the online sales of wine and direct shipment may seem a narrow slice to address. In reality, the debate before us is of monumental proportions. We are pitting the Commerce Clause from Article I, Section 8 and the 21st Amendment of the U.S. Constitution against one another and attempting to decide who wins. The question is certainly worth considering, but leads to the question, is this something we can legislate?

I am proud of the committee's steadfast work on similar issues pertaining to contact lenses, but the playing field is more complicated here. States, like my home state of Wyoming, have established state regulations pertaining to online wine sales that are working. I commend those in Wyoming with jurisdiction over this issue. Their examination, evaluation and implementation has been, and continues to be, sufficient for the citizens of Wyoming. As always, I am hesitant to throw federal regulations into the mix and wary of the impact it might have.

The discussion today will be valuable in bringing to light the interests involved here. If nothing else, the testimony and questions put forth today will reveal the need to continue examination of this marketplace, and where that examination should take place—the courts.

I thank the Chairman again and yield back the remainder of my time.

PREPARED STATEMENT OF HON. DARRELL ISSA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, thank you for holding this hearing today on this important subject. The three-tier system that the United States has used to regulate alcohol sales since the passage of the 21st Amendment to the Constitution is quickly becoming obsolete. The growth of e-commerce for goods and services has fundamentally changed the way business is done in this country. Small businesses now have more opportunities than ever to create and market products to consumers throughout the country. In most industries, entrepreneurs do not need to have a physical presence in a particular marketplace to be competitive. They simply need a quality product, a good website, and an efficient distribution system.

Unfortunately, there are artificial barriers that have prevented the wine industry from realizing the full benefits of e-commerce. Currently, 24 states prohibit direct sales of wine from producers to consumers across state boundaries. In Florida, for example, it is a felony for a consumer to visit a winery in California, return to Florida, and then order a case of that California wine to enjoy at home. Only a few licensed wholesalers are able to legally distribute out-of-state wines in Florida, often with a 30-40 percent markup. This practice is blatantly anti-competitive and unfair.

A recent Federal Trade Commission (FTC) study reported that even the most popular wines are difficult to find under the current three-tier wholesaler system. The FTC report surveyed the accessibility of the 83 most popular wines in the country. Of those 83 wines, 15 percent were not available in any local store in McLean, VA, a town that has strict direct distribution laws.

If the most popular wines are not even available to consumers, how much more difficult will it be for consumers to find more obscure vintages? These lesser-known wines are usually produced by small, family businesses that make ends meet only through direct sales to consumers. The number of these small businesses has grown considerably in recent years. The FTC reports that there are more than 2,000 wineries today, compared to 500-800 in 1975. These small wineries must be given a fair chance to compete against the large mega-brand producers who can more easily distribute their product to retail outlets around the country.

I am not convinced by the argument that opening up direct wine sales will increase the likelihood of sales to minors. Over 70 percent of alcohol sales to minors take place in face-to-face transactions in retail stores. Less than 10 percent of all sales to minors take place over the internet, and the majority of those sales are for either spirits or beer. I question the sobriety of those who suggest that we will see a surge in minors purchasing obscure wines as a result of changes to our direct distribution laws.

Small businesses are being excluded from the national marketplace by archaic laws that serve few practical purposes. Congress needs to act quickly to correct these unfair trade practices and allow entrepreneurs in the wine industry to compete at the national level.

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

I want to commend Chairman Stearns for holding this hearing and continuing the Committee's important work in the area of e-commerce. The Commerce, Trade and Consumer Protection subcommittee has held a number of hearings on barriers to e-commerce, and today will examine the unique issues involving direct shipment of wine.

Direct shipment is an important issue to most of the 30,000 wineries nationwide that are small family-run agricultural businesses. To them, direct shipment is the best way to access the market. It is of particular concern to communities on the Pacific Rim, and I want to acknowledge the presence of Mr. Radonovich [Mr. Walden] who has [have] a strong interest in these issues.

Direct shipment is an issue that raises important issues of Constitutional law, as sales of alcohol were the only good ever taken out of the interstate commerce clause of the Constitution.

Some states prohibit direct shipment of wine from out of state, but permit it on an instate basis. This may be good old fashion protectionism.

It also raises issues of prevent teenage drinking,

I look forward to the testimony, and yield back the balance of my time.

Mr. STEARNS. We will move to the witnesses.

We have Mr. Todd Zywicki, who is Director of Office and Policy Planning of the Federal Trade Commission. Welcome. Ms. Juanita Duggan, President of the Wine and Spirits Wholesalers of America, we welcome you; and Mr. David Sloane, President of WineAmerica.

Mr. Zywicki, we will have you start with your opening statement.

STATEMENTS OF TODD ZYWICKI, DIRECTOR, OFFICE OF PLANNING AND POLICY, FEDERAL TRADE COMMISSION; JUANITA D. DUGGAN, PRESIDENT, WINE AND SPIRITS WHOLESALERS OF AMERICA, INC.; AND DAVID P. SLOANE, PRESIDENT, WINEAMERICA

Mr. ZYWICKI. Thank you, Mr. Chairman.

I am Todd Zywicki, Director of the FTC's Office of Policy Planning. I am pleased to testify before the subcommittee today on behalf of the Commission regarding E-commerce: The Case of Online Wine Sales and Direct Shipment.

The Commission thanks the subcommittee and particularly Chairman Stearns for his excellent leadership in promoting E-commerce and consumer welfare. I am especially pleased to appear before Chairman Stearns today because my parents tell me that they are residents of Florida's sixth district in Ocala, and in fact last year for Christmas dinner they brought a bottle of Lakeridge southern red wine with them to dinner—by car, of course.

Free competition and consumer choice are the organizing principles of the American economic system. The Internet provides the potential to substantially advance these goals by enabling consumers to purchase an unprecedented array of goods and services from the convenience of their homes and by enabling entrepreneurs to create and market new products. The choices range from cars and caskets to contact lenses, and from medical and legal advice to an education.

The Internet, however, also raises unique regulatory concerns about on-line fraud and other abuses. Although the Internet raises new regulatory challenges, it does not change the baseline principles favoring freedom and competition. Artificial restraints on liberty and competition should not be lightly imposed but should be grounded in sound economic and empirical analysis.

In October, 2002, the FTC held a workshop to study the balance between the States' legitimate regulatory activities and concerns that regulation could have the unintended effect of choking off competition and consumer choice. Commission staff heard testimony on possible anti-competitive barriers to E-commerce in many different industries.

The purchasing of wine over the Internet illustrates the competition and consumer protection issues involving E-commerce. Through the Internet many smaller vineyards can now market their wines to consumers around the country. 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 and a retailer before reaching the consumer. Other States prohibit only interstate direct shipment of wine, while permitting intrastate direct shipment. 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 those lawsuits.

In July, the Commission issued a staff report on this issue. The report concludes that permitting direct shipment of wine to consumers could significantly enhance consumer welfare by increasing consumer choice and by reducing wine prices.

Using the Wine and Spirits list of the top 50 most popular wines in America, an FTC staff study found that 15 percent of the wines available on-line were not available from retail wine stores within 10 miles of McLean, Virginia. Given that the wines studied are among the most popular wines of many of America's largest wineries, it is likely that the wines of less popular or smaller wineries are even more difficult to locate in wine retailers.

Moreover, the same study suggests that, including the cost of shipping, consumers could save an average of 8 to 13 percent of wines costing more than $20 per bottle and an average of 20 to 21 percent on wines costing more than $40 per bottle. Less expensive wines, by contrast, may be cheaper in bricks and mortar stores.

Some have expressed concerns and offered anecdotes that permitting interstate direct shipping might have the unintended effect of increasing underage access to alcohol or undermining tax compliance. To determine whether these concerns were factually grounded, FTC staff officials contacted officials from 10 States that permit interstate wine shipping and received testimony and comments from several States that prohibit it.

In general, States that permit direct shipping report that, although it is possible for minors to buy wine on-line, most of them do not believe that shipment of wine to minors is currently a serious problem, especially when compared with the problem of underage access to alcohol through traditional distribution channels. Given the high cost of wine relative to beer and spirits as well as the cost and delay associated with shipping, most States that permit direct shipping have concluded that misuse by underage purchasers is unlikely to present a major problem.

The report also identifies several procedural safeguards and enforcement mechanisms that States have adopted to prevent sales to minors. These include such precautions as requiring labeling of packages containing wine and requiring an adult's signature at the time of delivery. States can also develop appropriate penalty and enforcement schemes such as by working with other States' enforcement agencies, as New Hampshire does.

The report also finds that some States also have adopted less restrictive means of collecting taxes while permitting direct shipping, such as by requiring out-of-State suppliers to obtain permits and to collect and remit taxes. Most of these States report few, if any, problems with tax collection.

Finally, the report found little evidence, based on the experience of State law enforcement authorities, to justify the distinction found in several States that allow intrastate direct shipment of wine but prohibit interstate direct shipment.

The wine industry has general implications for E-commerce. Anti-competitive State regulations can insulate local suppliers from on-line competition and deprive consumers of lower prices and greater selection. States have legitimate regulatory concerns, but they should be encouraged to carry out these goals by adopting less restrictive alternatives that recognize the value of competition and, ultimately, provide the greatest benefits to consumers. Whether the industry in question is cars, caskets, contact lenses or wines, the Commission has strongly encouraged policymakers to adopt rules that favor competition and consumer choice as baseline principles.

Thank you for the opportunity to share the Commission's views.
[The prepared statement of Todd Zywicki follows:]

PREPARED STATEMENT OF TODD ZYWICKI, DIRECTOR, OFFICE OF POLICY PLANNING, FEDERAL TRADE COMMISSION

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

[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>.

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.

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[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).

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

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[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 outofstate 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).

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 com-

[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).

pany 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.

Mr. STEARNS. Thank you.

Ms. Duggan.

STATEMENT OF JUANITA D. DUGGAN

Ms. DUGGAN. Thank you, Mr. Chairman; and thank you for the opportunity to appear today. I am Juanita Duggan, and I am representing the Wine and Spirits Wholesalers of America.

Today's subject in reality is not trade barriers or E-commerce but rather the deregulation of alcohol and the consequences of doing so, loosening restrictions including access to minors and local community control.

At a time when society is trying to restrict minors' access to alcohol through conventional means, we should not at the same time create a virtual vending machine for alcohol through the Internet. Nor is today's subject about wine but rather all forms of alcohol—beer, liquor and wine—a unique product with a long regulatory tradition and troubled history in our country. Alcohol is not like other products, and the FTC failed to recognize this fundamental point when it included alcohol with other products sold on-line such as contact lenses and caskets.

Through the 21st amendment to the Constitution and later congressional actions, this country made a decision that there should be a separation of the manufacturing, wholesaling and retailing tiers of the alcohol industry and that States have the jurisdiction to promote the goals of temperance, control and revenue collection. The American public understands that we need these safeguards. A new poll shows that 77 percent of all Americans support regulating alcohol through our current safeguards; 83 percent believe sales of alcohol over the Internet should be banned because it would increase the minors' access to alcohol. The American public understands that this is about kids, communities and common sense versus an uncontrolled environment where plain brown boxes crisscross the country in an anonymous fashion.

Unfortunately, this is happening as we speak. Because the FTC did not, WSWA conducted tests to demonstrate the reality of these uncontrolled direct shipments of alcohol over the Internet. Bottles of alcohol were ordered on-line. The alcohol providers made no attempt to verify a consumer's age or even notify the consumer that they need to be 21 years or older. The shippers understood they were breaking the laws of several States by putting their products in unmarked boxes with euphemistic return addresses. The results: bottles of liquor sent to consumers in several States where the shipments are prohibited by law regardless of the age.

In one case, a 15-year-old, using his own credit card, ordered bottles of tequila—very nice tequila, I might add—delivered to a State that prohibits those shipments regardless of consumer age. The package was left on his doorstep—two bottles, I might add, to be accurate. In most cases, the liquor boxes concealed their true content. They came in plain brown boxes, like this one, did not note their contents and had vague return addresses like Dave or John.

Dave, I hope this is not you.

This was sent from California to Franklin, Michigan; and the return address is Dave. It is not marked in any way, clearly attempting to hide the fact that it was shipped from alcohol purveyors.

In one instance a bottle of wine arrived in a box clearly marked wine and requesting an adult's signature. Yet an 11-year-old boy accepted the delivery, unchallenged by the carrier.

While advocates of deregulating alcohol will tell you that truck drivers are carding people when they deliver alcohol, that boxes are clearly marked and that alcohol is not left on doorsteps, these claims are pure fabrication. Unfortunately, the FTC ignored testimony about this from a number of sources in their official report, including the Michigan Attorney General's office.

These legitimate concerns do not seem to resonate with a handful of wealthy oenophiles and winery owners who have filed suits in several States to deregulate alcohol sales. Daniel McFadden, a Nobel-Prize-winning economist, grape grower and proponent of unregulated alcohol sales, admitted in his FTC testimony that the subject of direct sales is an elitist issue—his term, not mine—that caters to only a tiny percentage of the consuming public.

Unfortunately, that minority is endangering the very system of control that the rest of us in society are working to strengthen. Direct sales of wine result in the direct sales of beer and liquor and, ultimately, to the breakdown of our trusted system of safeguards. We must not deregulate the system to satisfy an elite group of people who don't want to play by the rules.

Just a few weeks ago, the National Academy of Sciences issued a report to Congress on underage drinking. The NAS says that 10 percent of kids who use alcohol get their alcohol through the Internet or through home delivery and that the number is likely to grow. The NAS said "an argument can be made for banning Internet and home delivery sales altogether in light of the likelihood that these methods will be used by underage purchasers."

Let us talk about the business of alcohol sales. There is no more competitive marketplace than the one for alcohol. This system was designed to foster such competition in spite of tight restrictions. Because of local distributors, consumers have an enormous selection of alcohol products. For instance, in New York a retailer has access to over 20,000 different brands and SKUs of wine alone. The average retail store in most States carries between 300 and 500 different wine brands at any given moment. Can you imagine selecting from that many toothpastes or contact lenses or cars?

And price, the FTC hearing itself established that wineries selling on-line do not pass the savings on to the consumers. They sell it at retail price and keep the additional profits for themselves. When you add the cost of shipping, consumers spend more for online purchases than at local retail establishments for the same product.

The wholesale tier is a partner with State regulatory systems that are designed to promote the 21st amendment core concerns. This license system assures that every bottle of alcohol is properly labeled, taxed and sold only to adults of drinking age. States created this system, and no court has ever challenged its logic or a State's right to establish such regulation.

Mr. Chairman, we as wholesalers of wine and spirits recognize that our product, alcohol, is not cheese and must be treated specially and differently. We support and defend the regulation and control of its distribution.

Thank you for the opportunity to appear today, and I look forward to answering any questions.

[The prepared statement of Juanita D. Duggan follows:]

PREPARED STATEMENT OF JUANITA D. DUGGAN, PRESIDENT AND CEO, WINE AND SPIRITS WHOLESALERS OF AMERICA, INC.

Mr. Chairman: Thank you for the opportunity to submit testimony to your Subcommittee for this important hearing. I represent the Wine and Spirits Wholesalers of America, Inc. (WSWA), a national trade organization and the voice of the wholesale tier of the wine and spirits industry. Founded in 1943, WSWA represents more than 370 privately held, family-owned and operated companies in 44 States, the District of Columbia and Puerto Rico that hold state-issued licenses to act as wine and/or spirits wholesalers. Our companies are licensed entities because they distribute alcohol—a product that our society has deemed a controlled substance and therefore subject to the highest possible regulations determined by each state.

ALCOHOL IS A UNIQUE PRODUCT WITH A LONG REGULATORY TRADITION.

First, let's all agree that wine is alcohol. And this issue isn't just about wine, it's about all forms of alcohol—beer, liquor and wine. And alcohol is not like other food products, books or compact discs. This issue is about kids, communities and common sense.

It's also about deregulating the alcohol industry and the consequences of doing so. Because that's what we're talking about—deregulating alcohol, which includes loosening our restrictions on the control of alcohol products, including access to minors. That should be a very real concern to all of us.

The FTC commissioned its staff report as part of an examination of products and industries across America. They looked a number of other industries, including auto dealerships, funeral home operations, and the contact lens market, among others. These businesses are all regulated primarily at the state level. The first flaw in the FTC study is the failure not to recognize that all forms of alcohol are not like cars, caskets or contact lenses. Alcohol is one of the few products that has its own constitutional amendment defining how it should be regulated and by whom. Simply put, wine is not like the other thousands of consumer products that sit on shelves in retail outlets across the country. To fail to recognize this uniqueness is to make a fundamental mistake when assessing the role the federal, state and local governments play in the alcohol industry.

AMERICA HAS COMPLICATED VIEWS ABOUT ALCOHOL.

The long history America has had with beer, wine and spirits is a contributing factor to the uniqueness of the alcohol industry and its system of distribution. Some of this historical background has resulted in significant tradition—Thomas Jefferson writing the Declaration of Independence with a mug of beer on the table. Wine and distilled spirits have had positive effects on the country as George Washington himself built a distillery at Mt. Vernon and created his own whiskey recipe.

Unfortunately, some of America's history with alcohol has not been positive. The use of federal troops in putting down the so-called "Whiskey Rebellion," the chronic abuse of alcohol by new immigrants and those living during America's industrial revolution when there was a so-called "unrestricted market" for all alcohol products. That turbulent time gave America some of our most familiar sayings—"lock, stock, and barrel" and "skid row." Then came a fifteen-year social experiment called Prohibition.

America thought the answer to alcohol abuse and a free market for alcohol products was to move in the absolute opposite direction and make alcohol illegal. Every serious academic and legal authority recognized, and continues to recognize, that Prohibition was a serious and disastrous mistake. It made average Americans criminals, encouraged and strengthened organized crime and did little to reduce abuse.

Out of the repeal of Prohibition came what might be called a middle position for America, resulting in the 21st Amendment to the U.S. Constitution; the separation of the manufacturing, wholesaling and retailing tier of the alcohol system; and aggressive state oversight to encourage the goals of temperance, control and revenue collection. This regulatory system has served this country well. And we need those safeguards perhaps even more today than we did before.

Why is that? A new National Academy of Sciences report confirms that kids are buying alcohol online and through the mail today. A new WirthlinWorldwide survey also confirms that the overwhelming majority of the public is against allowing alcohol sales via the Internet. The question I hope this Subcommittee will be asking is: If we know kids are getting alcohol online, and we know the public is opposed to online sales in general, why on earth should we deregulate alcohol sales to create a shadow trade that is both unchecked and unaccountable? Such a move defies common sense and is wholly irresponsible.

To demonstrate just how dangerous uncontrolled direct sales of alcohol are, WSWA recently conducted a series of tests. Bottles of alcohol were ordered online and the alcohol providers made no attempt to verify th consumer's age or even notify the consumer that he or she must be 21 years of age. The results:

- Bottles of liquor were sent to consumers in several states where such shipments are prohibited by law (regardless of age).
- In one case, a 15-year-old, using his own credit card, ordered bottles of tequila (delivered to a state that prohibits such shipments regardless of consumer age), and the package was left on his doorstep. The package was not marked as containing alcohol.
- In most cases, the liquor boxes concealed their true content: they came in plain brown paper boxes, did not note their contents and had vague return addresses like "Dave" or "John," clearly attempting to hide the fact they were shipped from alcohol purveyors.
- In one instance, a bottle of wine arrived in a box clearly marked "wine" and requesting an adult signature, yet an 11-year-old boy accepted the delivery unchallenged by the carrier.

We were not surprised by these results. In fact, we encourage Subcommittee members to conduct tests of your own. We have no doubt you will find similar results. While advocates of deregulating alcohol will tell you truck drivers are carding people when they deliver alcohol, that the boxes are clearly marked, and that the alcohol is not left on doorsteps—such claims are pure fabrication and easily debunked. We'd be happy to provide you a list of online providers, or you can search them out for yourselves.

Moreover, if you were to ask anyone in your local communities across this country—a parent, teacher, or police officer—whether it is a good idea to deregulate the sale of alcohol, the answer would be a resounding "No!" Overwhelmingly, people understand that alcohol is different from unregulated consumer products and that the rules governing its distribution must reflect that reality. Reasonable people understand that when you are dealing with the potentially deadly combination of teenagers and alcohol, it is unthinkable to support laws that allow kids to order intoxicating liquor from "virtual vending machines." Most people understand that when you already are dealing with the troubling and widespread problem of underage alcohol abuse, you don't make it worse by proposing that teens be given yet one more way to buy their buzz. As noted earlier, when it comes to beer, wine and liquor, our society recognizes its unique nature and the need for a unique system to control its distribution. After all, to reiterate, sales of beer, liquor and wine are not the same as those for cars, books or CDs.

But those legitimate concerns do not seem to resonate with the handful of wealthy oenophiles who are leading the battle to have limited edition chardonnay shipped directly to their homes. These self-proclaimed connoisseurs appear to have their blinders firmly in place and want to ignore the fact that their actions would also open the door for a 15-year-old to buy tequila or grain alcohol over the Internet and have it delivered without question to his door. As Nobel prize-winning economist, grape grower and proponent of unregulated alcohol sales Daniel McFadden admits in his testimony before the FTC, the subject of direct sales is an elitist issue that caters to only a tiny percentage of the consuming public. Unfortunately, that elitist minority is endangering the very system of control that we as an industry, in partnership with the government, parents and others, are working to strengthen in order to protect the public.

Thus, when the FTC announced in the fall of 2002 that it would be conducting a "Public Workshop" on the subject of "Possible Anti-Competitive Efforts to Restrict Commerce on the Internet,"—and included within its purview the subject of wine sales—WSWA and many in the regulatory community viewed it as a great opportunity to showcase the dangers of uncontrolled distribution of alcohol. We noted that the FTC was apparently so alarmed with the danger to kids of online gambling that it had set up an exclusive web page to warn parents about that problem. Surely, we thought, and the FTC felt it necessary, to warn parents about the dangers to kids of Internet gambling would need little prompting to come to the same conclusion about Internet sales of alcohol.

Voluminous evidence was produced through testimony at the Workshop and through information later submitted to the FTC during the comment period demonstrating the dangers of uncontrolled direct shipping and explaining the inability of the states to monitor and hold accountable companies that shipped directly. It was hoped that the FTC would fairly evaluate that information. That was not the case.

The final FTC report is a study in preordained conclusions. It is the triumph of rhetoric over reason. It is intellectually dishonest and scientifically specious. The report ignores evidence contrary to its suppositions, manufactures evidence out of whole cloth, and misapplies the findings of a geographically limited, inconclusive economic study. In other words, the final FTC report is a one-sided propaganda piece of little substance that this Subcommittee should not only ignore, but also wholly discredit.

THE TRUTH ABOUT SALES TO MINORS—

In the report, the FTC concludes that sales to minors are not a significant problem—despite the fact that in its press release it notes that it has no evidence concerning the effectiveness of adult signature requirements.

To support that conclusion, the FTC notes the results of a survey it sent to eleven different states to determine if there was a problem. The report contains a chart highlighting the results of that survey which they characterize as demonstrating that "[i]n 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."

From the survey information, most readers would be led to believe that the states have studied the matter and have determined based upon that study that there is no problem. However, if you actually look at the surveys (contained in the Appendix) you note that, without exception, not one of those states conducted any compliance checks or stings to determine the dangers of such uncontrolled shipments to minors. Not one went online to investigate the ease with which alcohol can be ordered and delivered without any age verification or control. There is no excuse for such an oversight.

And in fact, several states in the survey noted their belief that there was a problem with such sales and one even went so far as to identify direct sales as having the potential to become a major problem. One state reported that there was no system available to assure that minors did not obtain alcohol online since many had credit cards and they were not face-to-face transactions. Another reported that compliance checks on the far more secure face-to-face transactions even revealed sales to minors at a rate of 30%. Still another reported that 67% of high school seniors said they have purchased alcohol in face-to-face transactions alone. Even in states that reported having laws on the books requiring carriers to report alcohol shipments, some do not, and no actions have been taken against them. Absent such empirical evidence, any conclusion by the FTC to the effect that sales to minors are not occurring online is devoid of any real basis in fact. The survey merely records the opinions of various state control functionaries who apparently base their beliefs on the fact that no kids have self-reported their criminal misconduct, telling them they ordered and received a box of pure grain alcohol at their doorstep, for example.

What makes the FTC findings even more problematic is the additional evidence they omit beyond their skewing of the state survey.

For instance, you can look in vain for the testimony of Michigan Assistant Attorney General Irene Mead who recounted an enforcement action conducted by that state which ensnared scores of wineries and retailers shipping illegally to minors in that state, including shipments of such rare and hard to find vintages as "Eye of Newt" wine and blackberry wine. She also told a frightening story—omitted in the report—of a teen in a rehabilitation facility who actually succeeded in having a case of bourbon delivered to the facility—straight to him via the Internet. When he finished that case he contacted the Internet site and said all the bottles were broken on delivery. A free case was promptly shipped to him, again without detection.

Moreover, you don't see reference to the testimony of former White House counsel C. Boyden Gray reciting the experience of South Dakota Governor Bill Janklow, who vetoed pro-direct shipment legislation when an underage staff member in his office was able to order and have shipped to him—in the State House—a bottle of wine. And you certainly don't see reference to my comments submitted to the FTC in which I catalogued the sale and delivery of beer to a 17-year-old in Alabama from a company in Illinois, the shipment of beer to a minor in the Missouri Attorney General's Office, or the unsolicited report of recurring attempts by minors to buy online by the owner of the Internet company "877 Spirits."

THE NATIONAL ACADEMIES—

The conclusion of the FTC, with respect to sales to minors, is finally and completely discredited by the recent study by the National Academies of Sciences report studying the marketing of alcohol to minors.

In section two of the report entitled "The Strategy," the NAS focuses on the issue of underage access, in particular, Internet Sales and Home Delivery. The report states that underage purchase of alcohol over the Internet or through home delivery is a method of illegal access to alcohol used by 10% of underage drinkers. That figure, however, is based on data reported in the 2000 *Journal of Studies on Alcohol,* and the report correctly concludes that increasing utilization of the Internet likely has increased that percentage greatly over the last three years. Finally, the NAS report goes so far as to suggest that the significance of these illegal underage sales is so great that:

> *". . . an argument can be made for banning Internet and home delivery sales altogether in light of the likelihood that these methods will be used by underage purchasers . . ."*
>
> *(Page 176)*

CONTROLLED DELIVERY PROTECTS OUR KIDS, AND THAT'S WHAT THE PUBLIC WANTS—

As noted earlier, the overwhelming majority of Americans oppose allowing beer, liquor and wine to be sold directly to consumers over the Internet or through the mail, according to a new poll by WirthlinWorldwide conducted on behalf of the Wine and Spirits Wholesalers of America, Inc. and released just last week.

The poll expressed what everyone from parents of teenagers to alcohol consumers understand—that Internet and mail purchases of beer, liquor and wine will result in less control in local communities. The survey reveals that:

- 83% of respondents agree that sales over the Internet should not be allowed because they would give minors easier access to alcohol products.
- 80% of respondents believe that Internet commerce is generally a good thing for both businesses and consumers; however, alcohol is a socially sensitive product and should be treated differently from other products.
- 63% of respondents say that the sale of beer, liquor or wine over the Internet will result in less control over alcohol sales in their community.

These poll results are in line with similar findings from a WSWA poll conducted just prior to the FTC Workshop, which found that 75% of the respondents did not believe that online sales could be controlled to prevent sales to minors.

Once again, these results are not surprising given the nature of such sales.

Shadow sales made via telephone or through the Internet, since they are not face-to-face, cannot establish the age of the purchaser. There is no guarantee that the person ordering the alcohol is of age. Most young people between the ages of 18 and 21 years of age—and many who are even younger—possess credit cards allowing them to order online—still others have the use of their parents' cards and there is no way for the online seller to verify the age of the person ordering.

Moreover, there is no way to ensure that a minor does not ultimately receive a shipment of alcohol. The sellers wash their hands of the alcohol once it leaves their premises, and there is no guarantee that the delivery service will require an I.D. upon delivery—or that they will not simply drop the box off at the door unattended.

That is exactly what happened when scores of media outlets conducted stings over the past several years to determine the safety of direct sales. Those stings showed how easy it was for minors to order alcohol online—and how sloppy the carriers were who delivered the alcohol, often without checking I.D. or often just leaving the alcohol on the front doorstep. After all, it is not the job of truck drivers to card people—especially if boxes of liquor are being shipped in plain brown boxes with no indication alcohol is inside. That's why face-to-face transactions with licensees are so important. Anything less simply does not work.

JUNK SCIENCE: MCLEAN, VIRGINIA IS NOT REPRESENTATIVE OF ANYWHERE BUT MCLEAN, VIRGINIA—

A report that attempts to speak to the nature of the availability of certain wines nationwide is hardly authoritative when it tries to extrapolate the findings of a study from one small corner of a state across the entire country. It is self-evident that the ability to obtain different varieties of wines in Chicago, New York, New Orleans, Albuquerque or even the Washington, D.C. Metropolitan Area is not comparable to what can be obtained in the small suburb of McLean, Virginia.

For instance, in New York, a retailer has access to over 20,000 different brands or SKUs of wine alone. The selection is so great because of the wholesalers in that market. Our companies bring selection and competition to a highly competitive marketplace. If the FTC had conducted its economic study there, you can be sure that the findings with respect to variety and availability would be quite different than that represented in the final report.

The same holds true for price. Price differentials from market to market are not insubstantial. In many markets, the prices for high-end wines are much cheaper when purchased through the licensed system than if purchased online. It should be noted that testimony at the FTC hearing itself established that wineries selling online often do not pass the savings on to the consumers—they sell at retail price keeping the additional profits for themselves. If you add in the cost of shipping to that bill, consumers often end up spending more for online purchases than at local retail establishments for the same product.

THE FTC IS TREADING ON STATE TURF, AND ENCOURAGING DISRUPTION OF LOCAL CONTROL—

The 21st Amendment, ratified in 1933, is unambiguous in its enumeration of power to the states to regulate the importation and controlled distribution of alcohol within its borders. This is the specific language contained in the 21st Amendment:

> **21st Amendment Section 1:** *The eighteenth article of amendment to the Constitution of the United States is hereby repealed.*
>
> **21st Amendment Section 2:** *The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.*

No Supreme Court decision interpreting that amendment over the past 70 years has ever diminished that authority. The simple fact is, as noted by respected jurist Frank Easterbrook in a compelling 7th Circuit opinion upholding Indiana's right to determine and control the channels of distribution, alcohol is not cheese and its sale and distribution should be treated specially.

As prohibition ended, state lawmakers were determined to learn from the mistakes made prior to 1918. Principal among the reasons that the licensed system was established was consumer protection. It was determined that there should be an intermediary separating the supply and retail tiers to ensure that large suppliers with market power did not dominate individual retailers by establishing "tied-houses." These pre-prohibition tied-house retailers made their profits not by-the-glass, or by-the-bottle, but rather through winning incentives for moving large quantities of alcohol. In other words, the imposition of a mandatory wholesale tier served to end many unhealthy and unsafe practices that prevailed prior to Prohibition.

The wholesale tier functions as a partner with state regulatory systems that are designed to promote the core 21st Amendment concerns—ensuring orderly market conditions, promoting temperance, including keeping alcohol out of the hands of minors and collecting tax revenue. By requiring that every drop of alcohol passes through the licensed system, states are assured that every bottle of alcohol is properly labeled, taxed and sold only to adults of legal drinking age.

In order to understand how the licensed system operates as a partner with the state and federal regulatory communities and serves the interests of consumer protection, I would ask you to follow a bottle as it flows through that licensed and accountable system.

A supplier must obtain approval for the label from the Alcohol and Tobacco Tax and Trade Bureau (TTB) to ensure that it contains truthful and non-misleading information about the product's contents and that it contains mandatory health warnings. That bottle must then be sold to a state and federally licensed wholesaler who is responsible for maintaining and filing detailed records of each bottle brought into the state, pays the excise taxes due on the alcohol, and delivers the alcohol to a state licensed retail establishment. The retailer is responsible for paying over to the state the sales taxes generated by each sale, and is directly responsible for ensuring that alcohol does not fall into the hands of minors or other prohibited individuals. Since both the wholesaler and the retailer must be licensed by the state, they are fully accountable for any dereliction of their duties. They are subject to on-site inspections, auditing and compliance checks, and any violation can result in a loss of license, fines and other potentially more severe penalties.

Wholesalers believe that the licensed system is our nation's premier safeguard against underage access to alcohol. States created this system and no court has every challenged the logic of this system or a state's right to establish such regulations. As an industry, we are not only committed to this system, but also to its philosophy. We work diligently to uphold the letter and spirit of the stringent laws of each state in which we do business.

Congress has recently recognized the need for legislative action to support the safeguards and accountability mechanisms of the licensed system. "The 21st Amendment Enforcement Act," passed by the 106th Congress and signed into law in 2000, provides state Attorneys General with a powerful means by which to protect their citizens and prosecute illegal direct shippers.

IF YOU DESTROY THE SYSTEM, YOU DESTROY THE SAFEGUARDS—

However, the contributions of the wholesalers to the communities in which they live and work go far beyond protecting the licensed system of alcohol distribution. Our commitment as good corporate citizens is also unwavering.

Last year, WSWA conducted the first-ever survey of our members' broader contributions to their communities. We found that our members donate more than $55 million a year to charitable causes throughout this country. They include:

United Way, Boys and Girls Clubs of America, YMCA/YWCA, The Sober Ride Project, D.A.R.E. (Drug Abuse Resistance Education), Ronald McDonald House, MADD, Make a Wish Foundation, Project Graduation, Center for Women and Families, Crusade for Children, Sky Ranch, Big Brother Project, Camp Braveheart and many others.

Our members not only contribute to organizations that confront the problems some people face with alcohol abuse and other risky behaviors, but to other organizations that contribute to the greater good of us all—artistic endeavors, environment enrichments and developmental teachings that exemplify responsible behavior. These efforts promote social connectedness and help dissuade inappropriate behavior such as alcohol abuse and underage consumption. For example, the youth groups I listed help disadvantaged kids make the right choices about drugs, alcohol and risky behavior in general. You cannot overlook our commitment to these organizations.

CONCLUSION—

The proponents of direct shipping are posing a growing threat to a time-tested system best suited to prevent underage alcohol access. Led by a handful of oenophiles, powerful retailers and elite wineries—who by the way got into the business fully aware that they were producing a controlled product—advocates of unregulated alcohol sales—want to dismantle the licensed system of safeguards and instead sell alcohol with little or no real controls in place—creating a free-wheeling, anything goes environment. These groups are suing in several states to deregulate alcohol sales. And the issue is headed straight for the Supreme Court. The bottom line issue that must be addressed is simply this: Should leaders in local communities control how alcohol is marketed and sold within their state, or will wineries and large international alcohol conglomerates make that decision? We think local communities should have more control, not less—and most Americans agree. Besides, this issue is squarely addressed in the 21st Amendment, which gives states that authority.

In conclusion, Mr. Chairman, we as wholesalers of wine and spirits recognize—as did Judge Easterbrook—that our product is not cheese and must be treated specially. We recognize alcohol's unique consideration in our society and support—even defend—the regulation and control of its distribution. We also believe that we are good partners to the communities in which we live and work. As such, we are appreciative of the opportunity to provide testimony at this hearing and would hope that the Chairman will continue to consider Wine and Spirits Wholesalers of America a resource as you work to prevent underage consumption and access to alcohol.

Thank you again for this opportunity to provide testimony today for this important hearing.

Mr. STEARNS. Thank you.

Mr. Sloane, for your opening statement.

STATEMENT OF DAVID P. SLOANE

Mr. SLOANE. Thank you, Mr. Chairman, members of the subcommittee.

My name is David Sloane; and I am President of WineAmerica, a national trade association representing more than 700 wineries in 48 States. The vast majority of our members are small family owned and operated farms, producing less than 10,000 cases of wine per year.

Thank you for convening this important hearing on barriers to on-line wine sales. I very much appreciate the opportunity to discuss the market access problems of small wineries and the important contribution the FTC has made to the debate surrounding this issue. Before doing so, however, I would just like to clarify what this debate is really about.

Sometimes things are not quite as they appear, and folks in Washington usually have a finer appreciation for that than most. This debate is not really about tax evasion. This debate is not really about underage access. This debate is not really about elite wine geeks deregulating alcohol or dismantling the three-tier system, and this debate is most decidedly not about a public galvanized against direct shipment. This debate, as a very wise poet once said, is all about the money, honey.

The facts are simple. We have a mandatory three-tier system of distribution for alcohol that began with the repeal of prohibition. To ensure an orderly marketplace in the collection of applicable taxes, this system made wholesalers the funnel through which all beverage alcohol must go in order to reach the consumer. When the market had fewer brands and Americans had not yet developed a taste for wine, this market worked well. For the top 100 wineries with the powerhouse brands, the production capacity and the financial wherewithal, this system still works reasonably well today. However, it does not work well for the 2,900 other wineries in this country which do not have the brand clout or production capacity to be viable players in the three-tier system.

It is not that wholesalers have anything against small wineries. They are in this business to make money, and the volume brands are where the big money is to be made. What is more, given the plethora of successful brands in today's market, particularly with respect to wine, wholesalers are no longer in the business of building brands. Even the largest wineries have difficulty launching new brands.

When small wineries do end up working with large wholesalers, as does occasionally happen, these relationships are rarely satisfying or enduring. The typical refrain from the unhappy vintner is, they parked my wine in the warehouse and forgot about it and now that I want out, I can't get my wine or my money back. So without a willing wholesaler or a distribution system they can afford, the 2,900 other mostly smaller wineries are effectively locked out of the commercial mainstream, with few avenues for reaching consumers that lie much beyond the borders of their own States.

To solve this problem and since dozens of States have already permitted local wineries to ship wine to consumers on an intrastate business basis, wineries began in the 1980's to advocate interstate direct shipment legislation. As a result of this effort, a number of States enacted laws permitting wineries in one State to ship to consumers in another State, provided those rights were extended on a reciprocal basis.

Despite the fact that wholesalers had no interest in representing small wineries, they saw these laws as a threat to their control over the flow of alcohol and fought back by passing laws making the interstate shipment of wine a felony or the delivery of wine to a consumer by common carrier a misdemeanor.

Today, notwithstanding strong wholesaler opposition, 26 States in the District of Columbia governing roughly 52 percent of the population now permit the limited interstate shipment of wine to consumers. Forty States representing 87 percent of the population permit local wineries to ship to consumers on an intrastate basis, something wholesalers have never lost much sleep over despite their professed concern about the dangers posed to underage access by any form of direct shipment.

As you know, wineries and consumers have now turned to the courts to help settle the question of where the powers under the 21st amendment begin and end for States. The approach taken in this litigation is as follows: Out-of-State wineries and consumers bring suit against a State that bans interstate direct shipments but permits local wineries to ship within the State, arguing that such discrimination is a violation of the dormant commerce clause that cannot be saved by the 21st amendment.

Of the four appellate decisions handed down thus far, the courts have ruled in our favor with only one exception in the Seventh Circuit. Had an injured winery been a party to that case, as the court conceded in its opinion, the outcome would have been very different.

In addition, the Second Circuit in New York is expected to render a decision within the next few months, which we also hope to win. As such, at least for the moment, without any significant disagreement among the circuits, this issue is not yet ripe for Supreme Court review. Nonetheless, we are quite satisfied with the results of the litigation, which has also proven a useful lever in getting States to enact legislation extending direct shipment rights to out-of-State wineries.

Thus far in 2003, three States—Virginia, North Carolina and South Carolina—have adopted laws opening their borders to the direct shipment of wine. In addition, the Fifth Circuit Court of Appeals has declared unconstitutional the Texas ban on interstate shipments, thus opening that State to direct shipments from out-of State wineries.

Interestingly, these appellate court decisions read like the FTC report in many respects, which found that there are less restrictive means for meeting State regulatory obligations than outright bans on the interstate shipment of wine. For example, in handing down its ruling, the Michigan court said, “the proper inquiry is whether the three-tier system advances a legitimate local purpose that could not be adequately served by reasonable nondiscriminatory alternatives. We find no evidence on this record that it does.”

Turning specifically to the FTC report, I was pleased to be a participant in the agency’s workshop on wine and believe this report has done much to inform this debate, particularly for policymakers trying to sort through all the claims and counterclaims that have developed over the years. Importantly, the agency concludes that consumers will benefit from direct shipment by having more choices and lower prices and that the underage and tax concerns are not sufficient to warrant State prohibitions on interstate wine shipments. Indeed, in conducting interviews with State regulators, the agency found States reporting few, if any, significant problems with respect to either concern. They base this decision on the fact that a number of States have passed laws requiring out-of-State wineries to obtain permits, report sales activity and pay taxes, just like their in-State counterparts. WineAmerica strongly favors this type of legislation.

While there is much hard work ahead, I have every reason to be optimistic that more States will enact permanent laws in the near future and that the FTC report will factor prominently in those legislative debates. Moreover, these issues will in no way disturb but rather augment the current three-tier system by providing a more functional mechanism for smaller producers.

Notwithstanding the tensions surrounding this evolutionary process, wholesalers can rest assured that they will remain the primary conduit for the distribution of beverage alcohol in this country and that direct shipment will only be a very small piece of that pie.

In closing, I do not believe that Federal legislation to eliminate State barriers to on-line wine sales is necessary at this time. However, this committee should give consideration of legislation making clear to the courts and to the States that commerce, particularly E-commerce, should not be impeded absent compelling policy reasons and when there is no less disruptive alternative. Otherwise, States will continue to erect such barriers, disregarding the commerce clause and significantly diminishing the promise of the Internet.

Thank you very much.

[The prepared statement of David P. Sloane follows:]

PREPARED STATEMENT OF DAVID P. SLOANE, PRESIDENT, WINEAMERICA

Good morning, I am David Sloane, President of WineAmerica (formerly the American Vintners Association), the national association for America's wineries, with over 700 members in 48 states. The vast majority of our members are small family owned and operated farm enterprises, producing less than 10,000 cases of wine per year.

I wish to commend and thank the Subcommittee for holding this important hearing to examine state barriers to the interstate shipment of wine, and whether such barriers serve rational policy purposes, or amount to economic protectionism. My statement will provide the Subcommittee with the following information:

- Background on the burgeoning small craft winery movement;
- Marketing realities for small wineries;
- Thoughts on the Federal Trade Commission (FTC) Report on Wine
- Update on litigation and state legislative efforts;
- Recommendations for Congress.

THE BURGEONING U.S. WINERY MOVEMENT

The number of wineries in the U.S. has expanded dramatically in the last quarter century, rising from some 600 in 1975 to over 3,000 in 2002—an increase of more than 400 percent. Since 1990 alone, the industry has more than doubled from 1,400 wineries to its current number of over 3,000. In addition, local wineries now exist in all 50 states, a development that Thomas Jefferson, a visionary of America's wine producing potential, could not have predicted.

California is the premier winegrowing state comprising roughly half the nation's wineries and over 90 percent of the production. There are also high concentrations of wineries (in rank order), in Washington, Oregon, New York, Ohio, Virginia, Pennsylvania, Texas, Missouri, Colorado, New Mexico, Illinois and Michigan. All these states have at least 30 wineries, and the top three—Washington, Oregon and New York—have more than 150 each.

Wineries and vineyards comprise one of the fastest growing sectors of American agriculture, and have become a major force for economic development and rural stability. The vast majority of American wineries are small, family owned businesses, which invest heavily in vineyard and winery development. Indeed, behind every bottle of wine sold at a winery is an investment of almost $50 in land, development, equipment and working capital. In addition to bringing capital investment to rural communities, wineries are also an important source of stable, mostly year round employment, and are a magnet for tourism. Wineries also promote crop diversification and farmland protection—two additional elements that are critical to the stability of rural communities.

Virtually all wineries have on-site retail operations to receive visitors. Through their "tasting rooms," craft wineries expose a wide and diverse population to their products. Many visitors seek to continue that relationship even though they may reside in other states. Similarly, because America has a very mobile population, many customers who have discovered and developed relationships with particular wineries while living in one state want to continue purchasing those wines after moving to another state.

Most states have recognized the tourism-generating potential of wineries by featuring them in their tourism publications. Almost a dozen states now have wine regions that are major tourist attractions, welcoming between 50,000 and 700,000 visitors per year from almost all states. This tourism also helps other agricultural enterprises and rural communities to gain visitors and customers. Where wineries have become concentrated—in Eastern Washington, Oregon's Willamette Valley, the Finger Lakes in New York, Michigan's Leelanau Peninsula, Grand Junction in Colorado, and the Blue Ridge foothills in Virginia—economic prospects have greatly improved. This trend is now spreading to a much broader range of geographic regions, including the hill country of Texas, Iowa, Missouri, southeast Pennsylvania, and many other parts of the country.

Wineries have a unique capacity to generate sales through direct contact with customers. Out-of-state visitors, wine club members, preferred customer groups, national media exposures, and other opportunities create a pool of qualified customers who know the product they want and can initiate the purchase directly from the winery. Advantages of such marketing include a much more limited need for dispersed inventory, and much better alignment of product with actual sales.

However, because of restrictive laws in many states, it is impossible for wineries to fulfill orders from consumers who reside in states that do not allow the direct shipment of wine. In addition to the negative public relations implications of not being able to fulfill all customers orders, the lost sales opportunities isolate and limit the geographical marketing reach of wineries, diminish their revenues and undercut their potential for growth.

MARKETING REALITIES FOR SMALL WINERIES

While America's wineries are an exemplar of the country's entrepreneurial and craft spirit, they are also, unfortunately, "poster children" for the problem of state impediments to e-commerce. Under the guise of "protecting citizens against the evils of alcohol" more than half of the states—including big states like New York, Texas and Florida—have effectively shut all but the top 100 wineries out of their markets by prohibiting direct sales to consumers from out-of-state wineries, and by requiring out-of-state wineries to market their products exclusively through the so-called "mandatory three-tier system of distribution." Under the three-tier system—broadly adopted by the states following the repeal of Prohibition—out-of-state wineries are only permitted to sell their products to licensed in-state wholesalers, who in turn sell to licensed in-state retailers (both on and off-premise) who then sell to consumers.

Herein lies the conundrum for small wineries: the three-tier system is simply not a viable method for distributing their products. Indeed, with the exception of the highly branded products of the 100 largest wineries, most wine is "hand sold." Advertising, or mass brand identification, is unheard of in this market. Instead, such wine is sold through the knowledge and recommendation of members of the wine trade in direct, one-to-one contact with the person who is going to purchase and consume the wine. This fact illustrates, in a dramatic way, the limited influence of wholesalers on the marketing of wine. Their sales personnel never come directly in contact with the ultimate customer. At best, they help fulfill a sale made by a winery, retailer or restaurateur to a customer; at worst, they actually impede a sale by adding a layer of bureaucracy and unnecessary cost to the process.

As such, outside of their own immediate markets, small wineries simply do not have the volume, brand clout or financial wherewithal to secure wholesaler representation—and wholesalers are not inclined, as a rule, to work with small wineries. However, when small wineries do enter into relationships with wholesalers in other states, these arrangements rarely last long or end happily. Indeed, the most common complaint we hear is: "The wholesaler never expended any effort to sell my wine, and when I wanted out, I was unable to recover my inventory, or get paid by the wholesaler for my wine."

Like other small companies that specialize in marketing limited quantities of unique products with limited but more than adequate demand, small wineries must rely on remote sales to be profitable—either through catalogs, newsletters or increasingly the Internet. It is clearly impractical to convince retail stores with very limited shelf space to make that precious space available to the small winery, which might sell less than a case per year.

Yet if direct shipment were allowed on a nationwide basis, a winery could market 10,000 cases (70 percent of America's wineries produce less than 10,000 cases per year) without too much difficulty. Coupled with tasting room sales, which typically account for 50 percent or more of a winery's receipts, this could make the difference between mere survival and profitability for most small wineries. As such, opening up a national market for the remote sale of wine is of vital interest to our members.

THE FEDERAL TRADE COMMISSION REPORT

The FTC is to be commended for its report, "Possible Anti-Competitive Barriers to E-Commerce: Wine," issued this past July. This report explores the benefits to consumers of online wine sales, and the public policy issues surrounding the direct shipment issue. WineAmerica was pleased to be a participant in the workshop series convened last October by the FTC to examine state barriers to e-commerce for many different products.

The report also examines in considerable detail the most commonly cited reasons for prohibiting the direct shipment of wine to consumers from out-of-state wineries—underage access and tax evasion—and concludes that they are not sufficient to justify prohibitions on the interstate shipment of wine. Importantly, the FTC suggests that barriers to trade should only be acceptable when there are no less restrictive means for meeting public policy goals—a policy that this Subcommittee may find useful in developing any generic legislation to discourage unnecessary barriers to e-commerce. The report states, "Without a showing of likely harm, restraining competition in a way that is likely to hurt consumers by raising prices and eliminating their ability to choose among competing providers is unwarranted."

To quote from the report's summary: ". . . 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 . . . [M]any 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."

Underage Concerns

The FTC report examines whether allowing the direct shipment of wine would significantly exacerbate the problem of underage drinking. Their findings are instructive. Commission staff contacted officials from states that allow the interstate shipment of wine to their citizens. The agency concluded that there were "few, if any, problems with interstate shipment of wines to minors . . . [N]one of them report more than isolated instances of minors buying or even attempting to buy wine online."

The "laboratory of the states" has more than adequately demonstrated that direct shipment of wine can be accomplished without unacceptable risks. California, the nation's most populous state, has allowed the intrastate shipment of wine for 50 years and the interstate shipment of wine for more than 35 years. In 1999, Manuel Espinoza, then Chief Deputy Director for the Department of Alcoholic Beverage Control, wrote to Congressmen Mike Thompson and George Radanovich, stating that "California has permitted direct wine shipments [from sources outside of California] to consumers since 1963 . . . At no time was a complaint received indicating the wine was used for illegal purposes, i.e., re-sale by a retailer or purchase and consumption by an underage person." He also said, "we have . . . experienced no enforcement problems or impediments to our ability to enforce laws relating to sales to minors as a result of [remote sales of wine or other alcohol beverages]."

At this time, 40 states—covering approximately 87 percent of the nation's population—permit consumers to order and have shipped to their homes wine from in-state wineries. In addition, despite extraordinary pressure from wholesalers to erect or maintain protectionist barriers to out-of-state wines, 26 states and the District of Columbia—representing 52 percent of the population—permit the direct shipment of wine from out-of-state sources. This number is actually somewhat higher because a recent Federal statute [P.L. 107-273] permits wineries to ship to a purchaser's home that amount of wine the consumer could have lawfully carried back to his/her state so long as the consumer makes the purchase while visiting the winery.

All of this state action begs the question: "If direct shipment posed such an enormous risk of underage access, why have so many states enacted laws to permit it?"

Tax Concerns

The FTC also examined in some detail the question of tax collection and the potential for evasion. Here it reached the same conclusion it did with respect to underage access, indicating from its survey work that states permitting direct shipment report few if any tax collection problems. The Commission also suggested that, by choosing to license out-of-state wineries that are engaged in the direct shipment of wine to consumers and requiring the payment of taxes, states could reduce the potential for tax evasion.

At the state level, wine is subject both to an excise tax based on gallonage, and to sales/use taxes based on a percentage of the value of the product, as would be applicable to any other consumer product. Much has been made about potential revenue losses that might arise from the interstate shipment of wine to consumers. Careful analysis suggests that these arguments are grossly overstated.

The average state excise tax on table wine is about $0.65 per gallon, so each bottle is subject to an excise tax obligation of just over thirteen cents. WineAmerica estimates that the maximum potential for out-of-state direct shipment of wine is 0.5 percent of the total U.S. table wine market of about 500 million gallons. Even if states did not collect a single penny of excise taxes from these sales, the total revenue loss from excise taxes would be approximately $1.6 million!

Some perspective on potential revenue losses associated with sales/use taxes is also helpful. As this Committee is fully aware, remote commerce in general poses serious tax collection problems for the states. A national study estimates that states lost approximately $16.4 billion in uncollected sales and use taxes in 2001 on remote sales of all types of goods (Donald Bruce & William F. Fox: *State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates,* Center for Business and Economic Research, University of Tennessee, 2001).

Wine is a tiny portion of this potential loss. Using the WineAmerica estimate of interstate shipment potential at 0.5 percent of total wine market, and valuing the wine shipped at an average of $20 per bottle, the annual sales/use tax obligation engendered by interstate wine shipments ($250 million in sales) would amount to about $16 million (using an average sales tax of 6.5 percent), or 0.12 percent of the projected loss in sales/use taxes the states could incur.

However, as the FTC pointed out in its report, there is no need for states to lose any revenue because of the interstate direct shipment of wine. Several states—including Georgia, Louisiana, Nebraska, Nevada, New Hampshire, North Dakota, Wyoming and in 2003 Virginia, South Carolina and North Carolina—have chosen to establish a system for a wine shipper's permit where all taxes, including excise and sales taxes, are collected by the shipping winery, and are remitted to the states based upon those sales.

Another way to recapture virtually all of the potential lost revenue would be for Congress to solve the global problem of uncollected use taxes by requiring businesses to collect and remit those taxes as is currently recommended by the National Governors Association.

For the Subcommittee's information, WineAmerica endorses a model direct shipment bill which includes provisions for a shipper's permit, reporting requirements and collection of both excise and sales/use taxes. The bill also provides that all wine be shipped in packaging that is clearly marked: "CONTAINS ALCOHOL: SIGNATURE OF PERSON AGE 21 OR OLDER REQUIRED FOR DELIVERY."

So-called "shipper permit" bills provide a workable mechanism for the collection of both excise and use taxes from interstate wine shipments. This approach, now law in ten states, requires all shippers to be licensed by both the state where the shipment originates and the state where the consumer receives the wine, thus providing both nexus and enforceability.

LITIGATION AND STATE LEGISLATIVE ACTION

The appellate courts considering direct shipment litigation, like the FTC, have concluded that there are less restrictive mechanisms for states to meet their regulatory goals than outright bans on the interstate direct shipment of wine. The courts have pointed the way for proper analysis by indicating that the public policy concerns of the states can be met by less restrictive means than banning direct shipment, especially when in-state wineries are allowed to ship directly to their customers.

To date, the 4th (VA & NC), 5th (TX), 6th (MI), and 11th (FL, though still seeking more details on the tax issue) Circuits have ruled that this type of discrimination—permitting in-state wineries to ship wine to consumers while prohibiting out-of-state wineries from doing the same—in unconstitutional. The 2nd Circuit (NY) heard oral arguments in early September and a ruling is expected soon from that jurisdiction.

The 6th Circuit, ruling that Michigan's prohibition on interstate direct shipment was unconstitutional stated, "The proper inquiry . . . is whether (the three-tier system) 'advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.' We find no evidence on this record that it does."

Thus far in 2003, three states—Virginia, North Carolina and South Carolina—have adopted permit laws opening their borders to the direct shipment of wine. In addition, the 5th Circuit Court of Appeals has declared the Texas law restricting shipments from out-of-state wineries unconstitutional, and wineries may now ship to consumers in Texas.

RECOMMENDATIONS FOR CONGRESS

While we do not recommend that Congress take any specific legislative action at this time to reduce barriers to online wine sales, given the importance and potential of the Internet, we do, however, recommend that Congress consider developing legislation to provide more generalized guidance to the states and courts in this area.

Specifically, Congress could indicate that commerce—especially e-commerce—should be allowed in the absence of good, sufficient reasons to erect barriers, and when there is no alternative and less disruptive mechanism. The alternative—that of allowing states to erect barriers without regard to the Commerce Clause—will forever limit the potential of the Internet. The FTC found that reasonable and minimally restrictive means of protecting the public policy goals, such as requiring an adult signature at the point of delivery and requiring out-of-state suppliers to obtain a permit, are effective and states that have experience with these approaches report few, or no problems.

The U.S. Supreme Court captured the dilemma faced by America's wineries: "Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation . . . Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality." *H.P. Hood & Sons, Inc. v. Du Mond,* 336 U.S. 525, 539 (1949).

Our member wineries are both farmers and craftsmen!

Mr. STEARNS. I thank the gentleman.

I will start with my questions, and I think most members, when there is not a pressing issue in our congressional agenda, we come to this I think with really not a preconceived notion. If you are of one political persuasion, you are in favor of competition, lower prices, and choice. Perhaps if you are coming from another political persuasion, you are concerned about consumer safety and you are concerned about the children. So, hearing both sides, I think when I come down to try to understand it, I say, is there an actual situation where it is working; and, if so, would that be the norm? As I understand, Ms. Duggan there are 40 States that allow intrastate purchase of wine; is that true?

Ms. DUGGAN. There are—that is correct.

Mr. STEARNS. Just approximately.

Ms. DUGGAN. Approximately, yes.

Mr. STEARNS. So that means if I am in Ocala and I go on the interstate and I want to buy wine from Orlando, I could do that in the State of Florida.

Ms. DUGGAN. I believe so.

Mr. STEARNS. Okay. So the wine comes up from Orlando, and I have a teenager, and the system is all worked out. Yet in my State I could not buy this same wine from California. That seems to me a little illogical. If I can do it in Orlando, why can't I do it from Napa Valley?

So I just say that as an example where it seems to be working. So that is intrastate commerce.

Now let us move to interstate commerce. If I am in New Hampshire and I want to buy wine from California, Napa Valley, I can do it through the interstate. So somehow New Hampshire and, in fact, 26 States allow the interstate commerce; is that correct?

Ms. DUGGAN. Yes. There are some with reciprocity laws, and there are some with limited direct shipping.

Mr. STEARNS. The State of Washington? The State of Oregon?

Ms. DUGGAN. Some that have what we call a personal importation law, but they are all minor exceptions to what is the regulated license system. There isn't any State that has completely unregulated alcohol sales at this point.

Mr. STEARNS. But what I am trying to understand is, is this something that cannot work and yet it is working intrastate in 40 States and it is working in 26 States interstate? So my question is, if it is working, all these concerns that you have don't seem to be a problem, for example, in New Hampshire, which has been doing it for some time and they have got a system that seems to be working well. Even in your own opening statement you reported that almost 70 percent of high school seniors have purchased alcohol face to face.

So the predominant problem is not through the Internet, but it is through this distribution where we don't have the premium safeguard to protect our teenagers from underage drinking, and that is the teenager, my son and the teenager walking down the street and doing a fake ID. That is almost 70 percent of the problem. So this whole problem on the Internet is a very small part.

So I just submit that as a person who is trying to understand if this is possible, that this is a very serious problem, to stop it; and it appears that 40 States are doing it intrastate and 26 are doing it interstate, that it seems to be working with some safeguards. So your job is to convince me that it is not, that those 40 States are wrong and the 26 are wrong.

Ms. DUGGAN. I think I can answer for you what we consider to be the distinction there. In the intrastate situation that you just described, the person who is selling that and delivering that is licensed and authorized by the State to do so, and they are under local law enforcement control. So when and if they do something that violates Florida law, for instance, they are under local control and that law enforcement and those courts have jurisdiction over that individual. They can take his license away, they can put penalties. When it happens from California or Washington or from whatever other State into Florida, the State of Florida has no jurisdiction over that remote seller. So they have no way of enforcing their laws.

So there is a huge difference between buying and selling between people who are privileged by the State and have a license to do so and then interstate shipments that are coming in violation of that law by people who are not licensed. So from our perspective that is a very important point.

And you raised a very important point about the teenage access. Our point is that we have enough problems right now with face-to-face transactions. And face-to-face transactions, in our view, are really the only way to prevent teen-age access.

Mr. STEARNS. So if—you are saying if they have face-to-face problems, why should we contribute—even though it might be a small amount, we should not risk it further.

Ms. DUGGAN. It is a small amount, but it is growing. We know what the Internet usage is among those populations, and we know what the teen-age drinking incidence is among that population, and from our perspective there is absolutely no way to control that. The best way to do it is by people who are licensed by the State in that State and are under local law enforcement.

Mr. STEARNS. I am just going to close. Mr. Zywicki, you might want to comment on what she said or anything that I commented on.

Mr. ZYWICKI. With respect to those particular issues, we address this in some detail in the report. Again, one of the main reasons why we did this report is simply because there is such a vacuum of facts about how exactly these systems work and what we should be concerned about and that sort of thing; and we certainly agree and are concerned about access by minors to alcohol through traditional bricks and mortar liquor stores.

What we conclude in the report, though, is that it is unclear whether or not the problem would be better or worse as a result of Internet shipment. Face to face is one way of doing it, but there are a number of safeguards built into the Internet shipping system, including verification at the time of order, verification at the time of delivery, for instance, that raise particular issues on the other side of the equation. So we conclude that it is ambiguous how it would wash out.

Mr. SLOANE. Could I respond to that, by chance?

Mr. STEARNS. Sure.

Mr. SLOANE. I would like to say this. First of all, we are not talking about deregulating the system. The laws that are passing today are permanent laws that actually require the issuance of a permit from, to and out of State winery; and States do work cooperatively together to bring enforcement actions from time to time.

I would mention a few other things. The U.S. Congress just a few years ago passed something called the 21st Amendment Enforcement Act—how could I have forgotten—which provides new authorities to States to go into Federal court to get injunctions to stop out-of-State shippers who break laws on that. And, by the way, nobody has pulled the trigger on that so far, which I find kind of interesting.

Then, finally, the Department of Treasury itself, the ATF, has suggested in a circular that they are more than happy to cooperate with States in taking away a Federal basic permit of a winery that violates laws like that. So I think there are actually many, many safeguards in place.

Ms. DUGGAN. This is the evidence right here.

Mr. STEARNS. My time has expired.

Ms. Schakowsky.

Ms. SCHAKOWSKY. As I said in my opening remarks, I think that the panel, as important as the interests that are represented here, is incomplete because we don't have people who represent the public health sector or even State regulators. But listening to the various economic interests, Ms. Duggan, I would have thought at first you were from Moms Against Drunk Driving——

Ms. DUGGAN. I am a Mother Against Drunk Driving.

Ms. SCHAKOWSKY. I understand, but I thought you were representing that organization, and it took a while, in fact, never quite got to what is the economic interests. Surely you are representing the economic interest here today?

Ms. DUGGAN. Yes, ma'am.

Ms. SCHAKOWSKY. And, Mr. Sloane, it is all about the money, honey. In fact, there is a public policy goal. It is true that the money interest may end up being the decisive players in what we do here in Congress, but the fact is there are public policy goals here that involve underage drinkers and taxes and those kinds of things that do need to be considered. So it is not simply about Sloane versus Duggan or—you know, we do need to factor in these other things and——

Mr. SLOANE. I think the Federal Trade Commission did that.

Ms. SCHAKOWSKY. I understand that. But it is not just about the money, honey. We do have to consider these other things.

I do want to tell you, though, in Illinois we had a situation—because, Ms. Duggan, you talked about competition—where one of the most uncompetitive pieces of legislation was passed by distributors, by alcohol distributors, where they were given these territories where a retailer had to actually give notification. It was hard to even get out of the contract. And, Mr. Sloane, you talked about a markup that wholesalers take, how much money it costs. I am wondering if—from your points of view, what are the economics here?

Let me begin with you, Mr. Sloane, talking about where do, in your view, the wholesalers fit into this and the economic benefit. If you could again talk about that to the——

Mr. SLOANE. Wholesalers play a crucial role and are the ones who source probably, you know, 99.5 percent of the product in the United States today, and I—you know, we can make an argument about wholesaler consolidation, for example, but there is still a large number of wholesalers in the United States. I don't personally place a great deal of stake in that issue.

But what I would say to you is that the problem is if you are a small winery—and I realize that we can say it is alcohol and all of that, but if you are a small winery it is not unlike, other than the fact that it is alcohol, of being a small sort of artisanal food company, except they have got the burden of the 21st amendment. The problem is that when you want to be able to sell your product, typically if you want to be able to reach beyond your own State and to actually get into interstate commerce—and keep in mind that most of these wineries operate tasting rooms and they are a big source of tourism and that is really one of the main parts of this whole program for them—when people come in and establish relationships with them, they want to be able to continue selling to those customers who may or may not live in that State, unable to really get into the commercial three-tier system by not having enough volume, by not really having a recognized brand and all of those things. They are not able to participate in that market, and that is what this fight is really all about.

Ms. SCHAKOWSKY. Ms. Duggan, the example that Mr. Thompson raised, where if I go to one of these wineries I can't even have something shipped to me—but let us say I go home and I think that was the best wine I ever had and I want to go on-line and have it shipped to me. What is the harm of that?

Ms. DUGGAN. Well, it depends on what State you live in. There are some States that would allow that, and our point is that the 21st amendment gives a State the right to decide and to choose whether or not that is the right thing for that State. Some of them have adopted reciprocity laws that allow you to do that. Some have adopted some limited direct shipping laws. Some have personal importation laws. So it really depends on where you are.

Ms. SCHAKOWSKY. Can I ask you, does your association lobby against those laws in States or are you there supporting those laws?

Ms. DUGGAN. We have not lobbied—my organization does not lobby on State legislation, period. There are individual State associations that do that on behalf of the wholesaler, and they make those local decisions, but our viewpoint——

Ms. SCHAKOWSKY. Do you know of any situation where wholesalers have lobbied in favor of State laws that would allow——

Ms. DUGGAN. Yes. In fact, in Georgia and in Virginia recent direct shipping laws were promoted and written by the wholesalers and were supported and they are law now. They are, we think, very responsible kinds of direct shipping laws because they require licenses and taxes are paid and they go through a license system, but they are direct shipping laws.

Some of the issues that you asked Mr. Sloane about, the economics I would like to address. One of the problems you have in the wine industry right now is that there is a huge worldwide glut of wine on the market. All you have to do is look at any California newspaper at any given time and read the gloom and doom stories because there is—every year the California wine grape harvest is growing by something like 10 percent. Something like 100,000 additional acres have been planted in the last 4 to 5 years.

So there is just a huge amount of wine that keeps coming into the market and exports as well and as imports. There simply is too much wine.

I would like to quote the former head of the National Conference of State Liquor Administrators who said there is too much wine on the market and when there is too much wine on the market you can't sell all that wine and the easiest thing to do is to attack the system. So that is a very serious problem.

With regard to the establish a brand, the comments that Mr. Sloane made don't really coincide with what you have seen with some of the remarkable success stories of former wines.

Look at a brand like Yellow Tail, which was introduced 1 day, and the next day it was one of the hottest brands in America.

It is possible to establish a brand from a small remote place and it happens all the time, but there is too much wine on the market right now.

Mr. STEARNS. The gentlelady's time has expired.

The gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman.

I am kind of caught in the middle here with these microphones.

Let me just begin with—I really love the Constitution, and we do not get a chance to pull it out every now and then, deal with it, and I am not a constitutional scholar or a lawyer, but basically the 21st amendment repealed the 18th, which was prohibition, and then it put in a requirement for, in essence, State control of the sale of intoxicating liquors, so that the legal debate here is whether the interstate commerce clause trumps the 21st amendment, is that correct, as we see it?

Ms. DUGGAN. Generally speaking, yes, sir.

Mr. STEARNS. Mr. Zywicki?

Mr. ZYWICKI. Generally, yes.

The pivotal question has been whether it trumps the discrimination provision, which is to say that what has been tested is the distinction between intrastate and interstate, as opposed to sort of treating them equally.

Mr. SHIMKUS. And, Mr. Sloane, I think in your opening statement you mentioned lower Federal court rulings that, in essence, have upheld the fact that interstate commerce trumps the 21st amendment.

Mr. SLOANE. Certainly needs to be considered.

Mr. SHIMKUS. And of course it hasn't gone to the highest court yet, but boiling it down as far as a constitutional debate, that is kind of where we are at; is that correct?

Mr. SLOANE. That is correct.

Mr. SHIMKUS. Thanks.

Mr. Sloane, would WineAmerica object to the safeguards suggested in the FTC to protect against the dangers of teenagers buying wine online?

Mr. SLOANE. Absolutely not.

Mr. SHIMKUS. Okay, thank you.

Mr. Zywicki, in your view, is there a poster child-like State that has in place less restrictive but effective regulation of direct interstate shipment of wine in place?

Mr. ZYWICKI. A number of places have a number of good provisions, but studying New Hampshire, they were the ones that were mentioned in a number of different contexts as having a well-conceived system.

Mr. SHIMKUS. And, Ms. Duggan, has your organization expressed concern with States that permit direct intrastate wine shipments, as both interstate and intrastate direct deliveries pose the same courier delivery problems that you have testified?

Ms. DUGGAN. Yes, sir.

In a number of States, there were times when we were actually trying to repeal those intra state exemptions. We see no reason why there should be a distinction.

Our viewpoint is that there shouldn't be very much direct shipment at all because it departs from the face-to-face transaction. It is very difficult to control, very difficult to track. People do not report their illegal behavior. It is unfortunate.

Mr. SHIMKUS. Thank you, Mr. Chairman.

I yield back my time.

Mr. STEARNS. I thank the gentleman.

We have three votes on the floor, so I think what we will do is take a recess and come back after the three votes, and I urge all members to come back.

With that, the subcommittee will take a recess.

[Brief recess.]

Mr. STEARNS. The subcommittee will come to order again.

We will continue our questions for the witnesses and we thank them for their patience and forbearance here as we had our three votes, and with that, the gentleman from California, Mr. Radanovich.

Mr. RADANOVICH. Thank you very much, Mr. Chairman.

I want to thank, again, the panel and the committee for being here today.

There has been a lot of comment about what this is about and what it is not, and I am happy to contribute my opinion about what I think this is about and what it is not.

I would have to say I think it is about 5 percent for the kids and about 95 percent for the money, honey, because there is a legitimate issue regarding underage sales to children under the age of 18, but I think that what this report does today is does identify it as an issue and a manageable one, as proven by practices in interstate trade and also our shipments and where it is allowed to occur, I think, quite naturally.

This is about money, and it is about market share, and that is okay. You know, I think that that is just fine, and rather than—I think, hopefully, this hearing will help this clear out, the issue of underage drinking and the direct shipment issue and market protection, so that maybe someday we can have a real debate on the merits of the issue, and that is if direct shipment were allowed to occur or more encouraged, what effect would it have realistically on the wholesale, on the three-tier system and wholesalers or retailers or distributors throughout the United States?

I would like to see that debated here someday, rather than from front issues that may have some legitimacy but are minor and manageable and can be dealt with so that we someday can get to the real issue.

I would like to ask Mr. Zywicki; is it?

Mr. ZYWICKI. Yes.

Mr. RADANOVICH. Radanovich is a tough one, too, so if I don't get it right the first time, let me know. But did the report address the excise issue, the tax loss issue, and the controversy on that on interstate shipments?

Mr. ZYWICKI. Absolutely.

We discussed basically all the issues that were relevant to this, and again I think it should be remembered that there has been a real factual vacuum out there about all these things and a lot of anecdotes and theories about these things and one of the things we looked at was the tax issue, and again we contacted officials of 10 States that allowed direct shipping, and all of them reported that they have not had any problems with tax collection issues, that there are a variety of mechanisms that are set up through licensing and that sort of thing that allows them to allow shippers to remit taxes back to the State.

Mr. RADANOVICH. Right.

It has been mentioned that the FTC report was based on junk science. Would you care to respond to that?

Mr. ZYWICKI. Sure. I obviously disagree with that characterization. I think again this is without a doubt the most comprehensive and detailed report that has ever been done on this topic.

We are proud that the Bureau of Consumer Protection and the staff of the Bureau of Consumer Protection, who are second to none in their commitment on a number of the issues that we are talking about here today, signed on to the report, along with the rest of it. In addition I want to address the characterization of the National Academy of Sciences study, which to the best of my knowledge is the only thing that had been out there prior to this, and I have it here, and we discuss the National Academy of Sciences report in some detail in our report at pages 37 and 38.

It cites the one paper, which is a paper by Fletcher, which is this paper here, and it turns out this paper seems to have nothing to do with Internet direct shipment. This is a paper by academics that relates to local delivery of alcohol by grocery and liquor stores, primarily focusing on keg parties by teenage kids from a beer truck.

It is also interesting that the NAS report's conclusions and recommendations in the end line up with ours. We do not think that that study is very probative. In some sense I guess if wine is not cheese then a keg of beer is not a bottle of Merlot. We looked at that report, we considered it, and weighted it accordingly, and so I think that through our interviews with State officials, reading testimony, looking at the scientific literature and that sort of thing, our report is by far the most comprehensive study of this issue that has ever been done.

Mr. RADANOVICH. Does your agency have a history of producing, filing reports based on junk science?

Mr. ZYWICKI. We do not. We take our responsibilities very seriously through the Bureau of Economics and the high standards of the Federal Trade Commission.

Mr. RADANOVICH. In your view then is the issue of underage drinking, as it is connected with direct shipments, manageable in the areas where you observed that it is allowed by various techniques?

Mr. ZYWICKI. Based on the experience of State officials who we interviewed who allow direct shipping, our conclusion is that it is manageable. They certainly believe that it is manageable, and I think this is a very good example of where State experimentation has really taught us a lot of lessons about how to balance the goals of competition and consumer choice with these legitimate State goals, but in a way that is the least intrusive infringement on our competition.

Mr. RADANOVICH. Okay, thank you.

I would like to state for the record, too, that there isn't anybody on the panel represented by Mothers Against Drunk Driving or any anti-alcohol consumption for minors group here, right?

We have those representing wineries in America and those representing the wine wholesalers and distributors, and I would like to ask you, Mr. Sloane: Using common sense, are teenagers more likely to observe or obscure—are they more likely to buy an obscure

Oregon Pinot Noir online and wait a week to get it or will they focus their efforts on purchasing beer in a retail store immediately?

Mr. SLOANE. I think the latter.

Mr. RADANOVICH. Your mike.

Mr. SLOANE. I think the latter. I think it is clear from even the NAS study, for example, that beer seems to be the product of choice primarily for young people, and so I think their presence would be there.

I also think, you know, one of the things you also have to think about when you look at the question of regulation here, and I think the FTC said it, is you have to decide what is the threshold? How much effort are we going to put in to regulate something based upon the level that it poses to the system, and I think it was decided that it was manageable, State officials had indicated it was manageable, so I think it is important to note that just purely from a regulatory standpoint States can satisfy their 21st amendment responsibilities in ways short of banning the product, so—and the other thing to say, too, I think, finally, is alcohol is so abundantly available locally most kids are sort of more into instant gratification. Even if they wanted to order a bottle of Pinot Noir they would probably try to get it locally, I would think.

Mr. STEARNS. The gentleman's time has expired.

Mr. RADANOVICH. I am sorry.

Mr. STEARNS. That is okay.

The gentleman from New York.

Mr. TOWNS. Thank you, Mr. Chairman.

Mr. Sloane, do you believe that wine is alcohol?

Mr. SLOANE. Absolutely.

Mr. TOWNS. If you believe it is alcohol, please describe why small wineries are asking for special treatment under the law as opposed to larger beer distributors and of course spirit producers who are not allowed to ship alcohol directly to consumers.

Mr. SLOANE. Well, of course, the distributors are not seeking to ship alcohol directly to consumers. We have a unique situation, and, frankly—I mean, I understand the parallels that people draw between other forms of alcohol and I realize it is difficult to make distinctions, but if you look at the history of alcohol controlled law in the United States, they make all kinds of distinctions about different categories of products.

I for one believe that it doesn't really make a lot of sense to ship spirits and things like that via the Internet or beer. I just do not think it has the same degree of—I realize people are doing it, but I think you could easily create a policy that would say, you know, it doesn't make sense to do that and that there are other wines, for example, which the problem that we face—and let me give you an example in New York, in the State of New York.

If you look at the Finger Lakes, which New York is now one of the fifth or sixth largest producer of wine in the United States and just to give you an idea of what the distribution problems are like, many of those wines from the Finger Lakes, the only way you would really be able to get as a citizen in the State of New York is to ship them by intrastate shipment because they are not readily available in many retail establishments, because it is just not a viable system for small wineries to really participate, and I do not think it is a question of special treatment. I think it is a question of these folks cannot function.

In that system, people do. There is a market for these products. It may not be the tidal wave that it is for large mainstream commercial products, but I think there is a market and I think the FTC has concluded that that market can be served safely through direct shipment, so I do not think it is a question of special treatment.

The flip side would be is it fair to create a situation where a certain category of producers cannot really get access or play a meaningful role in the commercial mainstream marketplace?

I mean, I think it is kind of un-American almost.

Mr. TOWNS. Well, let me tell you what my real problem is. I have concerns about making letter carriers and overnight couriers responsible for checking IDs of people at their own homes. Maybe we need to have FedEx, UPS, and others here testifying as well.

What are your views on that, because I do not see them coming and asking for identification or looking at someone and saying that I do not think you are old enough to receive this or you are too young? I mean, how do you avoid that?

Mr. SLOANE. Well, let me say this to you: I mean, I think in any situation you can find instances where people do not do what they are supposed to do.

Mr. TOWNS. And also tell me who is liable in a case like that if something happens.

Mr. SLOANE. In a case where you would be shipping alcohol to somebody, it depends on the State's laws. In some States carriers have gotten into some trouble and they have had to sign notices of discontinuance where they are not selling alcohol because they didn't do it properly.

I think what you will find today, though, the market for this is gradually maturing. It has been very small, it is gradually maturing, and in dealing with companies, with UPS and FedEx, they have now made a pretty significant commitment to trying to carry out their responsibilities in this area, and, for example, I know FedEx does very, very intensive driver training to educate people about how to deliver various types of products, and it is not just, you know, alcohol. In many cases it can be firearms, it can be other things that have various types of State controls or other things on them. So they actually are fairly sophisticated at dealing with different types of products.

Ms. DUGGAN. Mr. Towns, could I comment?

Mr. TOWNS. Sure.

Ms. DUGGAN. You just asked who is liable in that situation?

The shippers will indicate that they are shipping under the law that they are shipping from and that the consumer is the one that is responsible and that they do not have to comply with the laws of the State they are shipping into and then vice versa.

The common carriers have no responsibility here for delivering alcohol. In our view they are not law enforcement, they are not equipped, they should not be requested to be the law enforcement arm for our alcohol laws, and I would strongly disagree with Mr. Sloane's viewpoint that FedEx, UPS, are doing a lot of training, because we have found so many instances where hopefully through no—without knowledge, they are delivering alcohol because they come in unmarked boxes and they have no idea what is in it.

This one came from Dave in California to someone in Michigan. So you know there is a situation in Michigan where a kid was in a rehab facility. Obviously, he had a problem with alcohol. He ordered a case of bourbon. It was delivered to him directly to the rehab facility. This was in the FTC's testimony from the Michigan Attorney General's Office. He drank the whole thing. It came to him in a rehab facility. He drank the whole thing, then called and told them it was broken and he got another case shipped to him and he drank that. That is going to happen.

There is no checking of ID's, nor should the common carriers be the people to do that.

Mr. TOWNS. Mr. Chairman, I know my time has expired.

I just think that this creates a problem because there is really no control here in terms of youngsters being able to order it, being able to receive it, and that is a real problem. So on that note I yield back, Mr. Chairman.

Mr. STEARNS. Thank the gentleman.

Gentleman from New Hampshire, Mr. Bass.

Mr. BASS. Thank you, Mr. Chairman.

I am sure the Chair of the subcommittee was good enough to mention New Hampshire's system which I suspect all three of you are familiar with, and I have three or four questions.

First, Ms. Duggan, taking a follow-up to a response you made to my friend from New York, you mentioned that there was some ambiguity about whether or not people who deliver packages by UPS or Federal Express being law enforcement.

Understanding, as you know, in New Hampshire there is a requirement that the package be clearly marked and that the delivery require ID and the signature, what is the difference between the qualifications of that individual making the delivery and the person who is at the checkout stand in the stop and shop where the exact same product is sold in terms of their qualifications for law enforcement?

Ms. DUGGAN. One is a licensed by the State to sell alcohol and one is not.

Mr. BASS. It is my understanding they are licensed. It is my understanding that at least in my State, the State requires a permit from the seller and so therefore the vendor is indeed licensed by the State and pays a fee, collects taxes and pays it and that the person who delivers the product is no different, in terms of qualifications, than the person who is 18, 19, or, rather, actually, in New Hampshire, there are people at the checkout counter who are under the age of 18, but they have to be accompanied by somebody else if beer or wine comes through. I just wonder what the difference is in terms of somebody who has a driver's license and has to collect a signature versus somebody in a store.

Ms. DUGGAN. Well, except the fact that we know it is not happening, and that is one of the biggest problems; I mean, look at this.

Mr. BASS. Are there any instances that you can cite where this has occurred in New Hampshire?

Ms. DUGGAN. I do not know of any in New Hampshire, but one of the things I would like to follow up on, our colleague from the FTC said in fact, what the State administrator has stated that is in the FTC report is that there is no enforcement, not that there was not a problem but there was no enforcement, and their own press release admitted they did not address the tax issue.

Mr. BASS. Reclaiming my time, please, the FTC in the State of New Hampshire wouldn't be the force mechanism. It would be the State Liquor Commission.

Ms. DUGGAN. I understand.

Mr. BASS. And my understanding is there is no evidence that there is any greater access to alcohol by minors as a result of the passage of New Hampshire's law.

If I could move to Mr. Sloane, no one has asked that the provisions of the 21st amendment be used yet; is that correct?

Mr. SLOANE. To the best of my knowledge, that is correct.

Mr. BASS. Are there any other—is there any other type of Federal support that could be provided that would ensure that violators be—violations be addressed?

Mr. SLOANE. ATF, now TTB, the Tax and Trade Bureau, issued a circular some time ago, indicating that they would be more than happy to cooperate with States in enforcement actions, even to go as far as yanking the license, the Federal basic permit of a winery that engaged in illegal direct shipment of any kind, which, if you lose your license, you are out of business. So it is a pretty significant deterrent, I think, actually.

Mr. BASS. Mr. Chairman, I have no further questions.

Mr. STEARNS. Thank the gentleman.

Ms. McCarthy.

Ms. MCCARTHY. Thank you, Mr. Chairman.

Mr. Zywicki, I want to commend you for the report that was done by the FTC staff. My State, Missouri, is not necessarily one of the frontier States in this matter, but our Attorney General has done some work in a sting operation to see about how it affects underage drinking, but overall, having been a State legislator and a chairman of the Ways and Means Committee, I am very involved in tax matters and how important those revenues are to States. I wonder if you would comment briefly, and if you have already done this, because I have been in and out because of votes and other matters and I do not want you to have to repeat yourself, but the report seems to show a disparity in what States actually do, although you didn't really have the breadth to look into it, how they do with that revenue issue, but in the course of the work on that that your staff did on this, did they come up with any thoughts that would be helpful to us on this revenue issue, because the Federal Government restricts the States in what tax tools they have, and sales tax on products is one of the areas that are important to States? And so I am wondering, as we review this whole issue and its many facets, if the revenue issue was something that was looked at and, if so, would you care to share your thoughts with us on that matter and what it does mean?

Mr. ZYWICKI. Absolutely. That was one of the things that, when we contacted the States and asked them about it, that was one of the particular things we tried to find out.

First, an obvious point is in States where direct shipping is illegal and it still occurs, such as situations that Ms. Duggan was describing, clearly no taxes are collected. We are basically talking Al Capone during Prohibition. In a number of States that she has described activity is illegal, which may account for why taxes are not collected. They are shipped in unmarked boxes and that sort of thing.

With respect to the States that allow direct shipping, though, our reports are that they had no problems collecting taxes, that they used a number of systems, including permits, and various different systems for remitting taxes. That was simply something that appears not to have been a problem in the States that have allowed direct shipping.

Ms. MCCARTHY. I thank you for that information.

I appreciate also the evidence in the report that bans on interstate direct shipping raised prices and that States not—you know, shall not engage in this activity if it is appropriate to the State and its vintners, can also be losing revenue at a time when States are really pressed for revenue.

So, Mr. Chairman, I am really grateful you held that hearing, and I think we should pursue that revenue where it is appropriate to our committee's work at a time when States are indeed looking for opportunities to make ends meet, and that is just because of my former Ways and Means role I am very sensitive to those matters.

Mr. STEARNS. Well, thank you for your insight.

Ms. MCCARTHY. Thank you.

Mr. STEARNS. Thank all of the panel for being here today.

Did any of the other panelists want to comment?

Mr. SLOANE. Well, one thing, I would like to comment on the tax issue. There are some States, Missouri is one of them, that have engaged in a reciprocal kind of arrangement with other States where they have made the decision from a public policy perspective to forgo the collection of the revenues if the other State, the receiving State, does the same when they ship wine to the other State, and in this day and age I think that is kind of a tough sell from a public policy perspective, given where the States are financially with the service structural deficit situation that they are looking at.

On the one hand, I would like to make one point, and I am not advocating not paying taxes by any stretch of the imagination; in fact, we support permanent legislation. We are even volunteering to pay Internet taxes, sales taxes and excise taxes as opposed to many other folks in the business community, but let me just point out one thing just to sort of give some perspective to the tax issue so the people can understand: Right now the basic estimate, no one really knows but the basic estimate is of the wine trade in the United States, about .5 percent, half of 1 percent, may be going via direct shipment, okay?

If you were to take the average State excise tax on wine, which is 65 cents per gallon, and you decided that you weren't going to collect that tax at all for that .5 percent around the United States, the entire revenue loss from that would be about $1.6 million. So when they made the decision in the reciprocal States, I think it was largely made over the notion that it would actually be more trouble and more costly to try to collect those taxes administratively than to just forgo them.

Ms. DUGGAN. Ms. McCarthy, I would like to speak to that. Again, I think what my colleague is referring to is .5 percent sales that are illegal. The problem is there has been no enforcement and so you have no idea what the true scope of the illegal trade is. So you have no way of having a tax revenue shortfall estimate for the States.

There have been some estimates that the States were losing over a billion dollars a year in lost excise taxes due to illegal directed shipments. So it is a very significant issue, and nobody reports their own illegal behavior.

Ms. MCCARTHY. Okay.

Mr. SLOANE. Well, can I also just respond to one thing?

Ms. MCCARTHY. Mr. Chairman, may I have an extension of time?

Mr. STEARNS. Yes.

Ms. MCCARTHY. Thank you.

Mr. SLOANE. Can I just respond to that briefly?

I think one of the questions you have to ask is: Yes, you can, under a variety of circumstances, orchestrate and it has been demonstrated that you can game the system and that somebody could buy alcohol, an underage person could buy alcohol, over the Internet.

The question is not whether they can or not. The question is whether they will and do. That is the real question that needs to be asked to determine how much of a regulatory kind of a framework you really want to establish for that. Is it really worth it, and to date, to the best of my knowledge, there are only maybe a handful of real cases in the United States where underage people have actually been apprehended, arrested, tried, or convicted, even if they had just been arrested.

To the best of my knowledge, almost all of the cases that you talk about are things that are basically orchestrated stings, and so I think you need to make a distinction. I do not think, given the wide availability of alcohol on the streets of America that you are going to find a great likelihood that kids are going to resort to something like the Internet. It is too easy locally. Why bother?

Mr. ZYWICKI. If I may, this is a letter signed by James Barbuti, who is the State of New Hampshire Liquor Commissioner. We asked the States about precisely this issue, do you try to collect sales or excise taxes; and I will just quote the response of New Hampshire's representative: "Yes, the State of New Hampshire Liquor Commission collects an 8 percent fee on all shipments into the State of New Hampshire. When the New Hampshire Liquor Commission discovers an improper shipment, we contact the company and inform them of the laws of New Hampshire. Once the company learns of New Hampshire laws, they normally get a permit or stop shipping into New Hampshire. The New Hampshire Liquor Commission is working with out-of-state suppliers and encouraging them to obtain a permit." And just to add, the question was asked earlier sort of about compliance. One other response we got from New Hampshire was in response to the question: Does your State conduct stings and with respect to whether there has been any compliance, New Hampshire—and again this is a quote: "the New

Hampshire Liquor Commission Bureau of Enforcement has in the past done compliance stings against out-of-state shippers who do not hold permits and against shippers who do hold permits."

So I think the States are well aware of these problems. The States that have allowed direct shipping are just as concerned as everybody in this room about the various problems about excise taxes and underage drinking, and their experience, I think, tells us a lot on both of these particular issues.

Mr. SLOANE. My associate advises me that actually the level of State excise tax collection today for wine in the United States totals around $300 million a year, so it would be hard to imagine a State would lose up to a half a billion or a billion dollars through illegal direct shipment.

Ms. DUGGAN. That was a public source.

Ms. MCCARTHY. Thank you, Mr. Chairman, for allowing the extension of time. I know I strayed into Ways and Means issues, but I think it was an important part of our understanding.

Mr. STEARNS. Well, you were chairing the committee in the State and your experience is very helpful.

Ms. MCCARTHY. Thank you.

Mr. STEARNS. We are going to conclude our subcommittee hearing. I think the last word is if the FTC staff report analysis holds true for markets other than McLean, Virginia and it can be extended to other communities across the United States then it is a persuasive argument, and I think the best poster child of that case is New Hampshire, that if they can do it properly, in which it appears they are doing, then it seems to be an argument for questioning an outright ban on other States, particularly when almost 50 percent of the States are doing it.

So I think we have at least aired that idea that you had, and anyone else?

Mr. Radanovich?

Mr. RADANOVICH. Mr. Chairman, please forgive me. I would like to ask one question.

Mr. STEARNS. Sure.

Mr. RADANOVICH. I would like to ask of Ms. Duggan, the excise tax number that was quoted of a billion dollars, it is easy to throw out numbers, and I would like to ask if there would be an opportunity for written response——

Mr. STEARNS. Sure.

Mr. RADANOVICH. [continuing] where you came up with that.

Ms. DUGGAN. Forbes Magazine.

Mr. RADANOVICH. If you would like to submit the article.

Ms. DUGGAN. Yes, I would be happy to, but it is actually an old figure, and it has probably grown since then.

Ms. RADANOVICH. That is fine, but I would like to see proof of that.

Mr. STEARNS. By unanimous consent, so ordered to be submitted, but also to allow other members if they wish to to submit other questions, perhaps some that are not here that would like to submit questions. They have up to 5 working days to do so?

Yes, okay. With unanimous consent, so ordered.

So I will thank you for your patience and forbearance, and with that and the subcommittee is adjourned.

[Whereupon, at 11:45 a.m., the subcommittee was adjourned.]
[Additional material submitted for the record follows:]

PREPARED STATEMENT OF HON. MAURICE D. HINCHEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Chairman Stearns, Ranking Member Schakowsky, and members of the Subcommittee, thank you for calling this hearing and for allowing me to submit testimony for the record. State laws that restrict on line sales and direct shipment of wine to consumers are relics of prohibition era policies that are long overdue for revision.

I represent a district in upstate New York that is home to a number of small, on-farm wineries. These wineries are bright lights in a region that has suffered much over the past decade. In addition to being a very high value agricultural crop, wine and grapes have done more for tourism, economic development, and job creation in rural New York than just about any other factor in recent memory.

New York is third behind California and Washington in wine and grape production. Our growers are projected to harvest a record 210,000 tons of grapes this year. Roughly two-thirds of this production will be made into juice and the remaining one-third will become wine. New York wineries employ nearly 3,000 people in the state, with a total payroll of nearly $35 million. Almost half of these jobs are full time, year-round positions.

The wine industry is fairly young in New York, but is growing rapidly. Just 25 years ago, the state had only 19 wineries, while today there are more than 160. Because many New York wineries are small, family-owned businesses with limited production, they have added tasting rooms and retail outlets on their farms to attract visitors, educate consumers, and sell directly to their customers.

Visitors to New York's four primary wine regions—Long Island, the Hudson Valley, the Finger Lakes, and Lake Erie—purchase a substantial portion of the wine produced in New York. My winemaking constituents tell me that many of their visitors come from other states and other countries, and that many make purchases on the spot. The most frequently asked question is whether they can buy more from the winery after they've returned home. To the great economic dismay of my constituents and their visitors, the answer to that question is no.

Despite the importance of the wine and grape industry to rural New York, my state is one of the largest that still prohibits direct shipment of wine to the state. That law was overturned last year by a Federal district court (*Swedenburg v. Kelly*); the injunction enforcing that decision was stayed while an appeal with the Second Circuit is pending. Because the states that allow direct shipment do so on a reciprocal basis, New York's prohibition effectively prevents New York wineries from shipping all but a very limited amount of their product out of state.

This is ultimately a state issue, and one for the New York legislature to resolve. A measure allowing direct shipment passed the legislature several years ago, only to be vetoed by Governor George Pataki because of concerns about underage drinking and a possible loss of sales tax revenue from mail order and Internet sales. Bills have been introduced in the Assembly and the Senate this year that address these problems, but are being held hostage to the competitive concerns of wine wholesalers who have monopoly on distribution in the state. These are the same wholesalers and distributors who will not handle sales and marketing for small wineries with limited production, but who call for strict enforcement and prosecution if even one bottle is shipped outside their system.

Because of the legislative impasse, New Yorkers are putting great faith in the courts to resolve this issue. Oral arguments in the *Swedenburg* case were held in early September and a decision is expected shortly. If the Second Circuit upholds the lower court's decision, we will have our hands full persuading the state not to appeal the case to the Supreme Court.

Congress addressed some of the issues surrounding direct shipment last year when we passed H.R. 2215, and allowed retail customers to ship home purchases of wine they made on the spot. This law should not be amended or repealed. In addition, the Federal Trade Commission issued a report this summer that studied the likelihood of increased underage drinking and sales tax evasion under direct shipment. By looking at the experience of states that have enacted direct shipment laws, the FTC concluded that direct shipment, properly constructed, could greatly benefit consumers and winemakers without increasing underage drinking or tax evasion. Furthermore, the Commission found that direct shipment complements, rather than supplants sales of wine through traditional distribution channels. http://www.ftc.gov/os/2003/07/winereport2.pdf

Mr. Chairman, I want to thank you again for holding this hearing and for allowing me to submit my statement for the record. Congress should not stand in the way of the state legislatures and courts that are removing barriers to direct interstate shipment of wine through e-commerce or mail order. The rural economy is hanging on by a thread and needs the boost that these sales will provide.

PREPARED STATEMENT OF THE WINE INSTITUTE

Restrictions on interstate direct-to-consumer wine sales limit competition and place constraints on consumer choice. This issue impacts the ability of consumers to have reasonable access to the wines of their choosing and has been a fundamental concern for Wine Institute's member wineries for decades. Wine Institute is the public policy advocacy group representing more than 660 California wineries and affiliated businesses responsible for more than 80 percent of U.S. wine production and 90 percent of the country's wine exports.

The Wine Institute believes that positive change will continue to be achieved within a regulated marketplace that will accommodate the requirements of state regulators and legislators. Several events, favorable to consumers, have occurred to allow for limited, regulated direct access in a manner that regulators, wineries and consumers all find satisfactory.

The Department of Justice Appropriations Authorization Act allows wine, purchased while visiting a winery, to be shipped to another state.

As a result of heightened airline security and restrictions on passengers to ensure safety, President George W. Bush signed this Act into law on November 4, 2002, which contained a limited direct shipping provision. Consumers, who could otherwise hand carry wine on aircraft into their state in accordance with their state law, can now have it direct shipped to their homes. The Act was a formal endorsement of limited direct shipment by the U.S. Congress.

S.577, the "21st Amendment Enforcement Act," signed into law in October 2000, recognizes that state authority for alcohol distribution laws are not absolute and must be balanced with other constitutional rights.

Congress recognized that the powers vested in the states by the 21st Amendment are not absolute. S.577 requires the courts to balance state authority with other constitutional rights, such as the commerce clause, the due process clause, and the First Amendment. State Attorneys General can now gain access to federal courts to pursue litigation for alleged violations of state law regulating alcohol shipping. However, they must demonstrate that state law is a valid exercise of power under the 21st Amendment and not inconsistent with any other provision of the Constitution.

Certain states maintain preferential treatment of local industry.

Despite U.S. Supreme Court decisions in the past that have ruled preferential taxes and treatments of local wine industries to be unconstitutional, a number of states continue to maintain such practices. As an example, Arkansas allows for local wineries to sell their products in grocery stores, while out-of-state wines are only available in package stores. Missouri and Washington both have imposed taxes on all wines (including out-of-state wines) that are used for the marketing and promotion exclusively of in-state wine industries. Eight states, Indiana, Maine, Michigan, New Jersey, New York, Florida, Rhode Island and Ohio, prohibit interstate direct wine sales, but allow intrastate wine sales and direct shipments.

Texas, Virginia, South Carolina and North Carolina have changed their laws this year to bring total limited direct shipping states to 26.

As an indication that momentum is on the side of the consumer, court cases, followed by legislative action, have resulted in new state laws allowing limited direct shipping. Several of the courts ruled that bans on interstate shipping were unconstitutional. The District of Columbia and 26 states now allow legal, limited direct shipments. This is the result of ongoing work by the wine industry, and provides various models for how the issue could be resolved in other states. In all cases, the amounts of wine that can be shipped are limited, and provisions exist to prevent delivery to minors.

Opponents of interstate direct shipping do not oppose in-state direct shipping and online sales, making their underage access argument invalid and the laws discriminatory to out-of-state wineries.

Direct shipping opponents have not targeted in-state online wine sales and delivery. The real reason for direct shipping bans is for protection of in-state businesses and the wholesaler system. In fact, opponents, such as the Wine & Spirits Wholesalers of America (WSWA) which claims that direct shipping provisions exacerbate underage access to alcohol, endorsed in 1999 the e-commerce web site, WineShopper.com. This now defunct website attempted to complete the sales transaction through the use of the three-tier distribution. WSWA is not opposed to the fulfillment method as long as the sale is completed through the wholesaler three-tier system.

A July 3, 2003 FTC Report concludes that direct shipping states with delivery safeguards have "few or no problems" with underage access.

The Federal Trade Commission (FTC) issued a July 3, 2003 report, entitled "Possible Anticompetitive Barriers to E-Commerce: Wine." Based on FTC survey responses, the report concludes that the states that allow direct shipping have procedural safeguards against shipments to minors and report "few or no problems" with these shipments.

The FTC report further concludes that many states hold the view that minors are more likely to buy alcohol from local retailers than the Internet because of the high cost of shipping and the fact that minors would have to wait days before learning if a delivery would be made. The FTC "found no evidence suggesting that direct shipping increases underage drinking beyond the levels attributable to sales by brick-and mortar stores . . . Unfortunately, the evidence shows that adolescents currently can obtain alcohol without going to the trouble and expense of ordering it over the Internet."

Several reports indicate that most youth obtain alcohol through friends, acquaintances, family members, and other adults who buy or provide alcohol to them. These conclusions are from reports from the Century Council, "Underage Alcohol Access," published May 2003; the NAS "Reducing Underage Drinking" and FTC "Alcohol Marketing and Advertising Report to Congress," both issued September 2003.

Procedural delivery safeguards are in place to prevent underage access.

All states where direct shipping is legal already have regulations that include the three National Academy of Science (NAS) recommendations: calling for alcohol packages to be clearly labeled as such; requiring the alcohol delivery person to verify the recipient's age; requiring that an adult signature be obtained from the recipient of the delivery. Wine Institute has consistently supported the use of these safeguards to help prevent underage access. In addition, common carriers, such as Federal Express and UPS, continuously conduct educational sessions for their delivery staff in those states with legal direct shipments to assure procedural safeguards that will prevent underage deliveries of alcohol packages.

Wineries can service their tasting room customers with direct shipments, especially if they do not have distribution in the customer's state.

Most of the 3,000 wineries in the country's 50 states begin their sales and marketing efforts primarily through their on-premise tasting rooms. In California alone, wineries are receiving nearly 11 million visitors annually. While most early visitors usually come from within the state where the winery is located, out-of-state visitors typically come to represent an expanding part of any winery's tasting room sales.

The challenge for wineries is finding a way to allow consumers to buy the wines that they tasted when visiting the winery. In a 2003 survey of Wine Institute members, 54 percent of the wineries indicated that they have been unable to gain access to another's state's market due to an inability to find a wholesaler who was willing to carry their brands. This is so because the number of wineries has dramatically grown, while the number of wholesalers has decreased. According to the October 15, 2002 issue of *Wine Spectator,* there were 2,188 wineries in the United States as of 2000, up from 579 in 1975. The vast majority of those wineries are small, producing multiple labels that the wholesalers are not able to carry. In contrast, WSWA had 450 members in 1975, down to only 170 today."

The wine media provides wide exposure to wine brands, leading consumers to contact wineries for a direct purchase.

Unlike most consumer goods, wine has generated an entire trade and consumer-based media. Wine-oriented consumers have access to a myriad of publications that discuss, critique, review and rate wines on a regular basis. Unlike most industries where product lines remain constant from year-to-year, wine is an agricultural product that can vary with every harvest. Consumers have come to rely upon the wine media to make recommendations and observations about the various wines that are available. Since most wine media is national in scope, it is inevitable that some consumers are going to find themselves searching for wines that are not readily available to them in their local markets. This exposure to new products often leads consumers to contact a winery directly to make a purchase.

Wine Institute supports the three-tier system, but advocates for augmenting distribution.

A number of state laws and regulations have developed since the repeal of Prohibition that serve to limit consumer choice. Wine Institute has worked carefully with its member wineries to develop solutions to this consumer problem which do not undermine the ongoing role of state regulators and local wholesalers and retailers. It has been Wine Institute's position that "we need to augment the three-tier system, not replace it."

CONCLUSIONS

Wine Institute believes that the right path for the future is working with states to craft legislation that is a compromise between consumer demand for choices and the regulatory requirements that create a safe and orderly market. Eighteen years ago no state had passed direct shipment legislation. Today, more than half of the states have some type of curative legislation on the books. Additional states will open up their markets for direct wine shipping. It is the consumer who will benefit. Wine Institute applauds the Congress for taking an interest in this consumer-driven issue.

RESPONSES BY DAVID P. SLOANE TO QUESTIONS FROM HON. EDOLPHUS TOWNS

Question 1. With respect to the Federal Trade Commission (FTC) staff report that included a study of market conditions in McLean, Virginia:

a. How does that study provide guidance for the rest of the United States with regard to the price and variety of wines available to consumers?

b. Doesn't the FTC testimony to the Committee contradict testimony received by the FTC at the FTC Workshop clearly demonstrating that wineries sell wine directly to consumers at retail prices, and when shipping costs are included, the cost to consumers is actually more expensive than purchasing the same products through the three-tier system?

Answer to Question 1

a) The FTC made a sound choice in selecting McLean, Virginia for its wine market analysis. This community, not being too urban or too rural, is reasonably reflective of the average wine market in the U.S. today in terms of price and availability. If anything, McLean, Virginia may offer consumers better pricing and selection than the average wine market, effectively skewing the results in favor of the three-tier system.

b) In general, since most wineries rely upon the three-tier system to sell at least some portion of their inventory in local markets, undercutting the established retail price would cause serious trade relations problems. The FTC study reveals that consumers do reap savings when they purchase more expensive wines over the Internet.

Question 2. The FTC press release regarding the FTC report claimed the report did not address the issue of lost taxes, yet at the Subcommittee hearing, the FTC claimed knowledge of the tax ramifications of direct shipping.

a. Has new information with regard to the tax collection ramifications of direct shipping been made available to WineAmerica?

b. How were you able to explain the tax collection ramifications of direct shipping to the Subcommittee if the FTC report did not address this issue?

Answer to Question 2

a) WineAmerica has developed a methodology for estimating revenue losses when direct shipment is permitted without taxation, which was discussed in my written statement to the Subcommittee. The average state excise tax on table wine is $0.65 per gallon, so each bottle is subject to an excise tax obligation of just over thirteen cents. Based upon all available literature, we estimate that the maximum potential for out-of-state direct shipment of wine is 0.5 percent of the total U.S. table wine market of about 500 million gallons. As such, even if states did not collect a single penny of excise taxes from these sales, the total revenue loss from excise taxes would be approximately $1.6 million. For example, New York, one of the largest states in terms of wine sales, would lose less than $40,000 per year in excise taxes if it permitted interstate direct shipping without collecting the tax. However, if New York enacts a "permit" direct shipment law similar to the ones enacted in Virginia, and the Carolinas in 2003, it will be able to collect those taxes.

b) These estimates are in an affidavit WineAmerica filed in the wine shipping case in New York district court. To our knowledge they are uncontested.

Question 3. The 21st Amendment to the Constitution of the United States gives individual states the right to regulate the distribution of alcohol.

a. Although admittedly not addressed in the FTC report, doesn't the 21st amendment give states the right to regulate the distribution of alcohol?

b. What constitutional or statutory authority gives the Federal Trade Commission the right to involve itself in alcohol importation or distribution?

c. What authority allows the Federal Trade Commission to supersede the authority of the Constitution of the United States and the 21st Amendment?

Answer to Question 3

a) Yes, but the courts have been gradually narrowing state authority under the 21st Amendment.

b) The Federal Trade Commission has general authority to examine issues of trade within the United States.

c) Clearly, the Federal Trade Commission does not have the authority to supercede the Constitution, nor has it made any attempt to do so with respect to its examination of barriers to e-commerce.

Question 4. What logical process has WineAmerica used to extrapolate from a report declaring that a state did not conduct any compliance checks or stings with regard to sales to minors, and conclude from that lack of information that there is not a problem with sales of alcohol to minors associated with direct shipping?

a. How do you reconcile the FTC's finding of "no problem" with respect to sales to minors in light of testimony given to the FTC by the Michigan Attorney General's office, media reports, and information provided by witnesses at the Subcommittee hearing?

b. What evidence does WineAmerica possess that the "safeguards" noted by proponents of direct shipping actually work? How do you reconcile that lack of evidence with the evidence given at the FTC Workshop and by witnesses at the Subcommittee hearing that shows the safeguards do not work?

c. In light of the information reported in media and other sting operations clearly demonstrating that common carriers often do not properly ascertain that the recipient of packages containing alcohol is of legal age; and that carriers sometimes leave packages containing alcohol at the doorstep of mailing addresses without any attempt to obtain proper identification, why does WineAmerica believe that common carriers can be relied upon to carry out the function of properly delivering alcohol by checking the identification of the package recipients?

d. In light of the fact that the Tax and Trade Bureau has never taken a single license away from a winery [in spite of voluminous evidence of violations from the Michigan Attorney General's office, for example], why does WineAmerica believe that the Tax and Trade Bureau can be relied upon as a caution to those shipping alcohol illegally?

Answer to Question 4

a) First, few of the state regulators responding to the Federal Trade Commission survey indicated any significant underage access problems related to direct shipment. Second, while tens of thousands of minors are prosecuted every year for illegally obtaining alcohol through the three-tier system, there are only a few known cases where minors have been prosecuted for trying to purchase alcohol illegally via direct shipment. Third, the appropriate question is not whether minors can obtain alcohol via the Internet, but whether they will given its general availability; states must target their enforcement resources to real problems, not hypothetical ones suggested by orchestrated stings.

b) The Federal Trade Commission examined the facts and drew conclusions. Irene Mead, then Michigan's Assistant Attorney General for Enforcement admitted during the FTC proceedings that her staff never determined whether any of the intercepted shipments were addressed to underage persons.

c) More than 50% of the nation's population may receive wine by interstate direct shipment and more than 80% by intrastate shipment. The laboratory of the states has demonstrated that direct shipment of wine does not constitute a significant risk of underage access. Moreover, there is no data to suggest that a clerk in a liquor or convenience store is any more reliable than a driver employed by a common carrier.

d) On February 11, 1997, ATF (now TTB) issued Industry Circular 96-3 clarifying its authority to assist states in enforcing their laws prohibiting the illegal importation of alcohol under the Federal Alcohol Administration Act. WineAmerica has no reason to doubt that TTB would respond to state requests for assistance. In 2000, Congress enacted the 21st Amendment Enforcement Act at the behest of state attorneys general to give states additional authority to pursue illegal out-of-state shippers in the federal courts. Since then, not one state has exercised that authority. That actions have not been taken by either TTB or the states suggests that illegal direct shipment is not of significant concern to warrant such action by state or federal regulators.

Question 5. What would be the response of WineAmerica to a mother of a teen who ordered wine over the Internet, who had the wine delivered to his door or didn't have his ID checked, and ended up getting hurt in a drunk driving accident? How would WineAmerica characterize the alleged safeguards in place in this circumstance?

Answer to Question 5

Drunk driving is a major problem in the United States, which is of deep concern to WineAmerica. Our members take very seriously their responsibilities to uphold the law, and to ensure best practices at their wineries. To our knowledge, however, the direct shipment of wine to teenagers has never resulted in any automobile accidents.

Question 6. How would the safeguards against minors' access to alcohol espoused by WineAmerica have prevented deliveries of alcohol from being made in the following cases:

a. The teen in the alcohol rehabilitation facility in Michigan who successfully ordered 2 separate cases of bourbon, and had them delivered to him in the rehabilitation facility?

b. The teen that successfully ordered a bottle of wine delivered to him in the South Dakota state capitol?

c. A 15-year-old who used his own credit card to successfully order bottles of tequila, and had the package left on his doorstep [no I.D. check] in a state that prohibits such shipments regardless of consumer age?

d. An 11-year-old boy who successfully accepted delivery from a common carrier of a bottle of wine in a box clearly marked "wine" and labeled to require an adult signature?

e. The sale and delivery of beer to a 17-year-old in Alabama from a company in Illinois?

f. The shipment of beer to a minor in the Missouri Attorney General's office?

Answer to Question 6

a) Clearly this involved a delivery in violation of Michigan law. The individuals responsible for that delivery should be prosecuted.

b) Illegal shippers should be prosecuted.

c) Illegal shippers should be prosecuted.

d) No system is perfect. However, since there is little hard evidence to indicate that teens are obtaining alcohol via the Internet, they must be obtaining it from other sources, such as the three-tier system.

e) Illegal shippers should be prosecuted.

f) Illegal shippers should be prosecuted.

Question 7. What system of safeguards is WineAmerica aware of that would prevent the foregoing incidents listed in Question 6 a-f from happening in the future?

Answer to Question 7

It is clear that direct shipment of wine does not pose a significant threat. Furthermore many of the instances cited in question 6 involve unrealistic "stings" where underage persons are being protected against the consequences of violation. There is no question that the difficulty, inconvenience and risk of being caught by attempting to obtain wine through direct shipment—with its high cost, delay in gratification, and paper trail—obviously serve as an enormous deterrent to abuse. There is no point in legislating more stringent safeguards where there is no evidence of abuse.

Question 8. What is the legal or regulatory difference between products such as "fortified wine" or "Eye of Newt wine" and so-called "fine wine" such that WineAmerica can be certain that only fine wine is shipped directly?

Answer to Question 8

Given the cost of shipping wine, most direct-to-consumer wine shipment involves more expensive wines that are not easily obtained through standard channels of distribution.

Question 9. If the lawsuits that allege discrimination, and which your members support, are successful, and wine is allowed to be shipped directly, won't your lawsuits result in further lawsuits seeking to ship beer and spirits directly on the same basis of discrimination against these other forms of alcohol?

Answer to Question 9

There is ample precedent for treating various kinds of alcoholic beverages differently, both at the state and federal level. Federal excise taxes are much higher for spirits than for beer or wine. Some states have chosen to limit their direct shipment laws to wine only. We cannot predict the future, but doubt such litigation will materialize, or be successful.

Question 10. Why do wineries sell wine via direct shipping at retail prices? If you are truly concerned about the price markup to consumers, why not pass any cost savings associated with direct shipping along to consumers? Isn't the "money, honey" issue you raised at the hearing all about more money accruing to the wineries you represent if direct shipping is allowed?

Answer to Question 10

The practical answer was already supplied in my response to question 1 b). As I testified during the hearing, the three-tier system works very well for the top 100 wineries in the U.S. However, most American wineries are small, and do not have the brand clout, production capacity or financial wherewithal to secure distributors outside of their own immediate markets. As such, in order to serve winery customers that reside in other states, an alternative market mechanism, such as direct shipment, is necessary.

Question 11. What is the average cost per acre of vineyard land for the members of WineAmerica? What is the average profit per bottle your members sell on their winery premises? What is the average profit per bottle your members sell by direct shipment?

Answer to Question 11

Cost per acre varies from a few hundred dollars to tens of thousands, depending upon state and region. We do not have any profit per bottle figures. However, one of our larger members, Robert Mondavi Winery, is a public company, so its financials are available. In 2002, the company sold slightly less than 10 million cases of wine with net income of approximately $40 million dollars, which translates to about $4/case, or 33 cents per bottle. The vast majority of our members are small family owned and operated farms, producing less than 10,000 cases per year. These are hard working farmers who depend upon direct sales because the three-tier system does not adequately serve their interests.

Question 12. If an average consumer consumes an entire bottle of Cabernet Sauvignon by himself, does that consumer become legally intoxicated? Is that level of intoxication less dangerous because wine is produced by an "ancient craft"?

Answer to Question 12

As any scientist will attest, it depends on factors such as whether the wine is consumed with food, as wine typically is, and the length of time over which that wine is consumed. However, such a quantity is probably excessive under any circumstance.

Question 13. Please provide the name of every member of and donor to the Coalition for Free Trade.

Answer to Question 13

We do not have membership or donor lists for the Coalition for Free Trade.

Question 14. Please provide the name of every member of and donor to Free the Grapes.

Answer to Question 14

We do not have membership or donor lists for Free the Grapes.

Question 15. Are any retailers or wine or spirits suppliers members of or donors to either the Coalition for Free Trade or Free the Grapes? Please provide the names of these entities.

Answer to Question 15

We do not have membership or donor lists for these organizations.

Question 16. Are any members of WineAmerica also members of either the Coalition for Free Trade or Free the Grapes? Please provide the names of those entities.

Answer to Question 16

We do not have membership or donor lists for these organizations.

Question 17. In a February 22, 2001, letter sent by you to the Progressive Policy Institute, while you were the chief lobbyist for the Wine and Spirits Wholesalers of America, you stated, "beverage alcohol does not fit 'cookie cutter' assumptions about e-commerce." How is it that you now, as the head of WineAmerica, can argue to the contrary that wine, which you do agree is beverage alcohol, should be a part of that "cookie cutter" deregulated system and be shipped freely over the Internet the same as books, CDs or other consumer products?

Answer to Question 17

I did not then, nor do I now, advocate the unregulated shipment of wine. WineAmerica supports the limited direct shipment of wine under state regulation. The legislation we support calls for payment of taxes, filing of reports, requirements for an adult signature and age verification with a government ID.

Question 18. In that same February 2001 letter, you stated, "The 21st Amendment to the Constitution cedes to the states the responsibility for regulating the importation and sale of alcohol across their borders. Alcohol is the only consumer product with a constitutional amendment affecting its regulation and distribution." You apparently now believe that the 21st Amendment should be ignored in favor of the dormant Commerce Clause. How did this change in your viewpoint come about?

Answer to Question 18

As the Supreme Court has stated, the 21st Amendment and the Commerce Clause are parts of the same constitution and must be considered in light of each other. This conflict deserves and needs a resolution, and I have always believed that.

Question 19. In addition, in that same February 2001 letter, you also stated, "Unlike other areas of e-commerce, the sale of wine over the Internet does not yield any savings to the consumer." Now, apparently, your story has changed and you state that direct shipments offers significant savings to the consumer. How did this change in your viewpoint regarding the alleged cost savings to consumers of direct shipping come about? Can you demonstrate that all of your member wineries are passing on the savings to consumers realized through bypassing the wholesale and retail tiers, and that your members are not taking advantage of direct shipment to enable them to pocket all three (producer, wholesaler and retailer) price margins?

Answer to Question 19

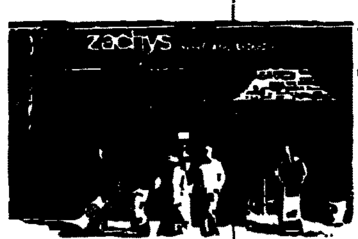
As I stated in my response to question 1 b), the FTC study reveals that consumers do obtain savings when they purchase more expensive wines over the Internet. However, by far, the more significant benefit is consumer choice. As I stated in response to one of your questions during the hearing, wineries in the Finger Lakes of New York State, which are making world-class wines, cannot find distributors to sell their products in New York City. Fortunately, New York permits in-state wineries to ship their products on an intrastate basis, so that consumers in Manhattan can still obtain these wonderful products. That authority has existed since the 1970s, without any incidence of underage access, and that experience is being repeated all over the country, as more states enact laws to regulate the interstate shipment of wine.

Mail-order wine is catching on. The distribution giants don't like that, and states are reacting.

Felonious shopping

By Tim W. Ferguson with James Samuelson

SHIP A BOTTLE of wine (or beer or spirits) into Kentucky outside the official channels and you'll get a warning. The second time it's a felony. That's the new law come this summer, the latest and loudest salvo from state regulators around the nation who are using powers dating back to the end of Prohibition to cork an alarming trend—the empowerment of retail customers.



The action at Zachys
"Mail me a case of Beaujolais."

Since the early 1980s, after the demise of "fair trade" statutes and the rise of boutique producers, direct marketing of premium wine has blossomed to approach, by one estimate, $1 billion. That compares with $6 billion in wholesale wine trade through the traditional distribution system. Leading the way have been discount wine shops that make their wares available across the country via catalogs and (soon) through the Internet. "Clubs" that send out selections to subscribers are also involved. Small wineries, too, rely on such sales when they cannot crack increasingly consolidated distribution lists.

At freight charges of $25 to $40 a 12-bottle case for out-of-state delivery, it's not necessarily cheaper to buy from a catalog as opposed to a standard wine retailer, but you may get more variety—especially from among small vintners—and convenience.

However, most states forbid wine to enter except via officially sanctioned channels, which can be either private distributors or a government liquor authority. The contraband's been getting in nevertheless, and the off-limits states are cracking down, with lawsuits, seizures or, in Kentucky's case, the threat of jail.

In Florida, the authorities are trying to make a federal case (literally, through a suit filed in U.S. district court) out of shipments by Zachys Wine & Liquor of Scarsdale, N.Y., and six other discounters or clubs. Prominent Miami attorney Hugh Culverhouse Jr. is among those who have fired off a letter to Governor Lawton Chiles demanding that Florida's regulators, not the shippers, cease and desist. Not only is his supply of rare vintages threatened, but Culverhouse's family is a large supplier of Florida juice oranges to Tropicana and fears some sort of retaliation from California's legislature. He wrote, "All that the California agriculture industry needs is an excuse, and the State Alcoholic Beverage Commission is giving them one."

When—as with Zachys and the others accused in Florida—interstate shipments of intoxicants bypass the three-tier system (producer-distributor-retailer) that is standard in the alcoholic-beverage industry, governments may miss out on sales and excise taxes (according to Chicago lawyer Morton Siegel, who works with liquor agencies, as much as $250 million a year is lost). The labyrinthing state laws are set up to snag both loot and underage libation; if they're breached, some politicians argue, kids may get their hands on the stuff.

But table wine is lightly taxed by liquor standards anyway, and you don't find too many teenagers binging on $30 bottles of cabernet sauvignon. Besides, the sellers say they'd gladly pay the levies and police ID at pickup. So the legal wave that's causing the stir would seem to have some ulterior motive. "The real purpose of this [Kentucky] bill," editorialized the *Lexington Herald Leader*, "was to ensure that every sip of alcoholic beverage consumed in this state put money in the bank for the monopolistic distributorships that control sales throughout Kentucky."

These entrenched distribution channels have political clout in both parties. Kentucky Governor Paul Patton, a Democrat, signed the law—he's the guy who proclaimed his narrow victory last November a repudiation of Newt Gingrich and the GOP's Contract With America. But seizures have taken place lately in New Jersey, Maryland and Massachusetts, a mixed bag. Republican Governor George Pataki of New York recently vetoed a bill that would have eased Empire State restrictions on direct wine shipments. But Governor George W. Bush of Texas nixed legislation to tighten limits there.

Most observers say direct selling of wine amounts to $350 million to $750 million a year, but Rich Cartiere, editor of *Wine Business Publications* in Sonoma, who covers the subject like nobody else, insists $1 billion is conservative. It can be so covert nobody knows. "Some of these shops are labeling the cases 'glassware' so Federal Express won't know [the airborne carriers are nervous about the laws], and putting their mother's house as a return address," Cartiere says.

Ronald Loutherback, owner of the three-store Wine Club chain in California, one of those sued by the State of Florida, is sending a letter to catalog retailers and wineries asking for contributions to fight the case to appellate courts if it comes to that. The pioneering Loutherback, who's built his ten-year-old business beyond $21 million (nearly all in-state) in yearly sales by charging only 8% to 12% above cost, says a stand needs to be taken, "or they'll do it again next year in some other state."

Who is "they"? "Everyone I talk to down there thinks this is the work of the major distributors," says Loutherback, and in Florida that fingers giant Southern Wine & Spirits.

Make no mistake: The liquor distributors exercise sway with their regulators. The state-by-state distribution industry, which includes beer and spirits as well, is a $47.5 billion franchise nationwide. Its most powerful players are survivors of a grueling consolidation process brought about

Wine lover Hugh Culverhouse Jr. of Florida fears for his cellar and his oranges.

by squeezed margins at the hands of discounters, large (as in Price/CostCo) and small. California, for example, had more than 20 distributors 15 years ago; today, only 2 major players remain: $2.1 billion (revenues) Southern and $1 billion Young's Market Co. of Orange County.

Big and small wineries alike need these middlemen to carry their brands and to navigate 52 different federal and state procedures for marketing their products. Some wineries would like alternative delivery channels. A few are embargoing Kentucky in protest of its new law, but most of them aren't inclined to antagonize their distributors on a core political issue. Looks like there's scope here for some pro-consumer deregulation.

In addition to providing minors easy access to alcohol, consumer-direct shipment of alcohol threatens state treasuries because, in most cases, it evades state excise and sales taxes.

This is crucial as states are increasingly dependent on revenues generated by alcohol, with revenues having jumped nearly 40 percent in the last decade, nearly 20 percent since 1990.

1995 Public Revenue from Alcohol Beverages Put At Risk By Illegal Direct Shipping

STATE	TOTAL STATE & LOCAL REVENUE	SOURCE
Alabama	$ 245,703,000	AL ABC Board
Alaska	$ 19,136,000	AK Dept. of Revenue
Arizona	$ 153,101,000	AZ Dept. of Liquor Licenses & Control, AZ Dept. of Revenue
Arkansas	$ 53,988,000	AR Dept. of Finance & Admin.
California	$ 692,683,000	Dept. of ABC
Colorado	$ 134,718,000	CO Dept. of Revenue
Connecticut	$ 108,002,000	CT Tax Dept., Dept. of Liquor Control
Delaware	$ 12,350,000	DE ABC Comm.
District of Columbia	$ 52,841,000	DC Dept. of Finance & Revenue
Florida	$ 1,118,944,000	FL Dept. of Business Reg., Div. of Alcoholic Beverages & Tobacco
Georgia	$ 374,842,000	GA Dept. of Revenue
Hawaii	$ 115,350,000	HI Dept. of Taxation
Idaho	$ 38,338,000	ID State Liquor Dispensary, ID State Tax Comm.
Illinois	$ 407,050,000	IL Dept. of Revenue, IL Liquor Control Comm.
Indiana	$ 117,179,000	IN Dept. of Revenue
Iowa	$ 92,708,000	IA Beer & Liquor Control Dept.
Kansas	$ 68,067,000	KS Dept. of Revenue, ABC Div., Div. of Taxation
Kentucky	$ 92,885,000	KY Dept. of ABC
Louisiana	$ 139,023,000	LA Dept. of Revenue & Taxation, Office of ABC
Maine	$ 70,009,000	ME Bureau of Alcoholic Beverages
Maryland	$ 94,746,000	MD Treasury Dept.
Massachusetts	$ 91,843,000	MA Dept. of Revenue, MA ABC Comm.
Michigan	$ 415,229,000	MI Liquor Control Comm.
Minnesota	$ 193,780,000	MN Dept. of Revenue
Mississippi	$ 117,979,000	MS State Tax Comm., Tobacco, Beer, Severance & Misc. Tax Div., ABC Div.
Missouri	$ 116,236,000	MO Dept. of Public Safety, Div. of Liquor Control
Montana	$ 21,927,000	MT Dept. of Revenue, Liquor Div.
Nebraska	$ 49,941,000	NE Liquor Control Comm.
Nevada	$ 125,978,000	NV Dept. of Taxation, Liquor Dept.
New Hampshire	$ 85,489,000	NH State Liquor Comm.
New Jersey	$ 336,948,000	NJ Dept. of Treasury, Div. of Taxation, NJ Dept. of Law & Public Safety
New Mexico	$ 70,523,000	NM Taxation & Revenue Dept., Tax Research & Statistics Office
New York	$ 720,834,000	NY Dept. of Taxation & Finance, Bureau of Tax Statistics, NY Div. of ABC
North Carolina	$ 304,065,000	NC Dept. of Revenue
North Dakota	$ 25,068,000	ND Alcoholic Beverage Tax Div., ND Licensing Dept.
Ohio	$ 370,604,000	OH Dept. of Taxation, Dept. of Liquor Control
Oklahoma	$ 99,088,000	OK Tax Comm., Beverage Div., OK ABC Board
Oregon	$ 83,946,000	OR Liquor Control Comm.
Pennsylvania	$ 367,134,000	PA Liquor Control Board
Rhode Island	$ 51,809,000	RI Dept. of Business Regulation, Liquor Control Div.
South Carolina	$ 198,821,000	SC ABC Comm., SC Tax Comm.
South Dakota	$ 34,283,000	SD Dept. of Revenue, Alcoholic Beverage Tax Section
Tennessee	$ 251,155,000	TN Dept. of Revenue, Misc. Tax Div.
Texas	$ 678,158,000	TX ABC, Comptroller of Public Accounts
Utah	$ 66,635,000	UT Liquor Control Comm., UT State Tax Comm.
Vermont	$ 27,339,000	VT Liquor Control Board
Virginia	$ 254,470,000	VA Dept. of ABC, VA Dept. of Taxation
Washington	$ 310,645,000	WA State Liquor Control Board
West Virginia	$ 46,818,000	WV ABC Comm., WV Beer Comm.
Wisconsin	$ 150,799,000	WI Dept. of Revenue, Beverage & Cigarette Tax Section
Wyoming	$ 15,927,000	WY State Liquor Comm.

Compiled by The Distilled Spirits Council of the United States, December 1996

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Office of Policy Planning

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Director

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The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515-6115

December 4, 2003

Dear Representative Dingell:

I very much appreciated the opportunity to present the Commission's testimony at the October 30, 2003 hearing before the Subcommittee on Commerce, Trade, and Consumer Protection regarding "E-Commerce: The Case of Online Wine Sales and Direct Shipment." Enclosed please find my written responses to the follow-up questions submitted by Representative Towns.

Please let me know if I can be of further assistance.

Sincerely,

Todd J. Zywicki
Director

Questions for Mr. Todd Zywicki
from the Honorable Edolphus Towns
Subcommittee on Commerce, Trade, and Consumer Protection
regarding the October 30, 2003, hearing entitled
"E-Commerce: The Case of Online Wine Sales and Direct Shipment"

1. With respect to the Federal Trade Commission (FTC) staff report that included a study of market conditions in McLean, Virginia:

a. How does that study provide guidance for the rest of the United States with regard to the price and variety of wines available to consumers?

Answer: Prior to the study of market conditions in McLean ("McLean study"), there was little empirical information on how access to out-of-state wine sellers through the Internet affected prices and varieties of wines available to consumers. To address this void, the study analyzed the prices and wine selections offered by stores that identified themselves as wine retailers in the greater McLean, Virginia area for a pre-identified bundle of wines. McLean was chosen as the relevant retail area for several reasons. First, at the time the study was conducted, Virginia banned direct sales from out-of-state suppliers. Second, given the socio-economic status of many residents in McLean (and northern Virginia, generally), it seemed likely that several bricks-and-mortar outlets could be found locally that catered to the needs of a sophisticated wine drinking population. As a result, an estimate of the effect on variety was likely to be conservative and could not be dismissed as driven by the choice of a location where few fine wines would likely be available. McLean is just one market; smaller or less affluent markets likely have somewhat less variety than McLean, and larger or more affluent markets likely have somewhat more variety.

The McLean study found that consumers can purchase many wines online that are not available in nearby bricks-and-mortar stores. The study found that 15% of a sample of popular wines available online were not available from retail wine stores within ten miles of McLean. The study also found 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. These results should be interpreted as an indicator of the potential for direct shipment to offer price and variety benefits to consumers, rather than a quantitative prediction of the size of these benefits if a direct shipment ban was lifted.

b. Doesn't the FTC testimony to the Committee contradict testimony received by the FTC at the FTC Workshop clearly demonstrating that wineries sell wine directly to consumers at retail prices, and when shipping costs are included, the cost to consumers is actually more expensive than purchasing the same products through the three-tier system?

Answer: The McLean study found that, including shipping costs, consumers can save more money on more expensive wines (as detailed in the previous answer), while less expensive wines may be cheaper in bricks-and-mortar stores. At the FTC Workshop, witnesses provided a variety of largely anecdotal views as to the prices available online. Systematic data analysis, however, generally provides more accurate and reliable evidence regarding prices than anecdotes. The McLean study was conducted by economists trained in methods of empirical analysis and reviewed by Ph.D. economists.

2. The FTC press release regarding the FTC report claimed the report did not address the issue of lost taxes, yet at the Subcommittee hearing, the FTC claimed knowledge of the tax ramifications of direct shipping.

a. **Has new information with regard to the tax collection ramifications of direct shipping been made available to the FTC?**

b. **How were you able to explain the tax collection ramifications of direct shipping to the Subcommittee if the FTC report did not address this issue?**

Answer: The Report focuses on the competition and consumer protection issues, although the Report does discuss the tax issue. The press release identifies the scope of the tax discussion: "The report also does not focus on the merits of the tax debate, other than to note that states attempting to collect taxes generally report few or no problems with collecting them." *See* Federal Trade Commission, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE (2003) ("Report"), at http://www.ftc.gov/os/2003/07/winereport2.pdf. Accordingly, while the Report does not "focus" on the tax issue, the Report does discuss information that state officials provided to FTC staff. For example, FTC staff asked officials from many different states the following questions: "Do you try to collect sales or excise taxes on shipments of wine into your state, and if so how effective have you been? Have you had any problems collecting taxes from out-of-state shippers?" The Report reprints the state officials' answers in an appendix, and also discusses their answers. In general, several states that allow interstate direct shipping also collect taxes from those shipments. By requiring out-of-state suppliers to obtain permits, states such as New Hampshire have sought to achieve voluntary compliance with their tax laws. Most of these states report few, if any, problems with tax collection.

3. The 21st Amendment to the Constitution of the United States gives individual states the right to regulate the distribution of alcohol.

a. **Although admittedly not addressed in the FTC report, doesn't the 21st amendment give states the right to regulate the distribution of alcohol?**

Answer: Yes. Section 2 of the Twenty-First Amendment states as follows: "The transportation or importation into any state, territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited."

b. **What constitutional or statutory authority gives the Federal Trade Commission the right to involve itself in alcohol importation or distribution?**

Answer: The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. Federal Trade Commission Act, 15 U.S.C. § 46. This statute gives the Commission the authority to "gather and compile information concerning, and to investigate from time to time the organization, business, conduct, practices, and management of any person, partnership, or corporation engaged in or whose business affects commerce." Under this statutory mandate, the Commission seeks to identify business practices that impede competition or increase costs without offering countervailing benefits to consumers. *See* 15 U.S.C. § 46(b). As outlined in the written testimony, Commission staff have often assessed the competitive impact of regulations and business practices affecting e-commerce in a variety of industries, including real estate, contact lenses, and funeral goods. Such assessments can inform the decisions of both state and federal policymakers.

c. What authority allows the Federal Trade Commission to supersede the authority of the Constitution of the United States and the 21st Amendment?

Answer: The Federal Trade Commission does not have the authority to supersede the authority of the Constitution of the United States or the 21st Amendment.

4. What logical process has the FTC used to extrapolate from a report declaring that a state did not conduct any compliance checks or stings with regard to sales to minors, and conclude from that lack of information that there is not a problem with sales of alcohol to minors associated with direct shipping?

Answer: 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.

Notably, New Hampshire has conducted stings against out-of-state shippers. In a letter to FTC staff, New Hampshire reported that, "The NH Liquor Commission Bureau of Enforcement has in the past done compliance stings against out-of-state shipper [sic] who do not hold permits and against shippers who do hold permits." New Hampshire then reported that, "We suspect there may be some instances where this is occurring but we have very little evidence in this area and do not believe this is a serious problem at this time."

As your question suggests, 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. The FTC cannot rule out the possibility that minors are buying wine online undetected by state officials. Nevertheless, 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. States can receive information in ways besides stings. For example, if online wine sales to minors were a serious problem, one would expect that at least some parents would complain to the relevant state officials, particularly because parents likely would see the wine orders charged to their credit cards. In other words, the fact that states have received few such complaints is itself important information about the scope of the problem.

a. How do you reconcile the FTC's finding of "no problem" with respect to sales to minors in light of testimony given to the FTC by the Michigan Attorney General's office, media reports, and information provided by witnesses at the Subcommittee hearing?

Answer: FTC staff carefully evaluated all of the information received at the workshop. FTC staff also gathered additional information from studies, media reports, and officials from many different states, including New Hampshire, Illinois, California, Michigan, and others. The Report did not find that there was "no problem" with respect to sales to minors. As discussed in the Report, in states that allow interstate direct shipping, the state officials generally report that they have experienced few, if any, problems with shipments to minors. As the Report also notes, there is evidence, largely anecdotal, that minors have been able to buy wine online in some instances. *See* Report, pp. 26-27. Nevertheless, FTC staff found or received no systematic studies assessing whether direct shipping causes an increase in alcohol consumption by minors. The principal sources of information – data from state compliance checks and one empirical study on home alcohol delivery – are inconclusive on this point. In regard to Michigan and other states that ban interstate direct shipping, it is not clear whether their experiences are comparable to the experiences of states that allow direct shipping, because those states may have different ordering and distribution practices, such as different levels of training for couriers in those states. In any event, the evidence from the McLean study suggests that an interstate shipping ban primarily deprives consumers of access to lower-cost sources of high-end, expensive wines. FTC staff has seen no evidence indicating whether higher prices for these types of fine wines would curtail consumption significantly either among the general populace, minors, or problem drinkers.

b. What evidence does the FTC possess that the "safeguards" noted by proponents of direct shipping actually work? How do you reconcile that lack of evidence, with the evidence given at the FTC Workshop and by WSWA at the Subcommittee hearing that shows the safeguards do not work?

Answer: Unfortunately, there is no systematic empirical data revealing how often couriers obtain a valid adult signature. Both UPS and FedEx, however, have adopted policies that require their couriers to obtain adult signatures. As several federal courts have discussed, states can develop penalty and enforcement systems to provide incentives for both out-of-state suppliers and package delivery companies to comply with the law.

If online wine sales to minors were occurring frequently, one would expect that parents would complain to the relevant state officials, particularly because parents likely would see the wine orders charged to their credit cards. FTC staff contacted officials from numerous reciprocity and limited importation states and asked them a variety of questions, but those state officials generally report that they have experienced few, if any, problems with interstate direct shipment of wine to minors. Most of those states require an adult signature at the point of delivery and similar safeguards discussed in the Report. In addition, FTC staff is aware of no evidence that states that allow *intrastate* direct shipping have experienced problems with direct shipments to minors. *See* Report, pp. 27-29. Finally, as noted earlier, it is not clear whether the experiences of states that ban interstate direct shipping are comparable to those of states that allow such shipping, because ordering and distribution practices, such as the extent of training for couriers, may differ.

c. Why does the FTC on its Internet site have information warning about Internet gambling and its negative effect on children?

Answer: The FTC Internet site contains two pages regarding Internet gambling. These sites are characteristic of the FTC's broad consumer education program, which provides consumers with information about issues of concern. The sites warn parents that many Internet game operators operate from servers outside the U.S. – beyond the jurisdiction of state or federal regulations. The sites warn that minors who gamble online can lose money, ruin a good credit rating, and become addicted. They further warn that gambling sites do not pay out to minors. *See* FTC website, http://www.ftc.gov/bcp/conline/pubs/alerts/olgamble.htm; http://www.ftc.gov/opa/2002/06/onlinegambling.htm.

d. In light of the fact that the FTC feels Internet gambling is dangerous for children, why does the FTC believe that Internet sales of alcohol to minors is not dangerous to children? Isn't alcohol a greater real danger to children than gambling?

Answer: The FTC has consistently reported that alcohol consumption poses significant dangers to minors. As discussed in the Report,

> Much of the public debate surrounding online sales focuses on the problem of underage drinking. In 2002, approximately 20% of eighth graders, 35% of tenth graders, and 49% of twelfth graders reported that they had used alcohol one or more times within the previous thirty days. . . . Alcohol use imposes significant costs, in both human and economic terms. Although the numbers are very difficult to quantify, one study estimated that, in 1996, the total cost of underage drinking – including traffic crashes, violent crime, burns, drowning, suicide attempts, fetal alcohol syndrome, alcohol poisoning, and treatment – was $52.8 billion.

See Report at 15. *See also* FTC, ALCOHOL MARKETING AND ADVERTISING (2003) at 1.

There are meaningful differences between online gambling and online wine sales. In the case of Internet gambling, the entire transaction occurs online, the injury is completed without the intervention of any gatekeeper, and the activity often falls outside the effective jurisdiction of state and federal operators. In contrast, online alcohol sales are not completed until the product is delivered to the home, and the delivery company thus plays a role analogous to the retail clerk, serving as a gatekeeper to ensure that an adult receives delivery. Moreover, operators of alcohol Internet sites are licensed entities subject to federal and state law enforcement penalties in the event of illegal conduct. There are, therefore, important protections and effective avenues of enforcement should violations occur.

Finally, the available evidence suggests that retail sales to minors of all alcohols pose a much greater problem than online sales of wine. Several state officials opined that minors are more interested in beer and spirits than wine. New Hampshire concluded that minors are less likely to purchase wine online because of the extra expense of ordering over the Internet. 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. 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.

Similarly, several state officials commented that, based on their experience, minors were much more likely to buy alcohol through offline sources than over the Internet. As discussed in the written testimony, 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. 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). Theoretically, either channel could be more accessible to minors. In the absence of empirical information, it is difficult to ascertain whether online wine sellers are, or would be, a significant source of alcohol for minors.

e. **In light of the information reported in media and other sting operations clearly demonstrating that common carriers often do not properly ascertain that the recipient of packages containing alcohol is of legal age; and that carriers sometimes leave packages containing alcohol at the doorstep of mailing addresses without any attempt to obtain proper identification, why does the FTC believe that common carriers can be relied upon to carry out the function of properly delivering alcohol by checking the identification of the package recipients?**

Answer: Although there is some anecdotal information, there is no systematic empirical data revealing how often couriers obtain a valid adult signature. Both UPS and FedEx, however, have adopted policies that require their couriers to obtain adult signatures. Courts have suggested that states could develop statutory systems that would impose similar requirements on package delivery companies as on retail stores. One court concluded that "[t]here is no practical difference from requiring such a procedure and that required of store clerks or bartenders who regularly check customers for valid identification to verify age before allowing the sale of alcoholic beverages." For instance, Michigan requires that retailers make a "diligent inquiry" to verify a customer's age, such as by examining a picture identification. States could impose similar requirements on delivery personnel, including training requirements, along with appropriate penalties. In Illinois, for example, package delivery companies "may face business or criminal offenses for failure to report [alcohol shipments] to the [Illinois Department of Revenue]." Many states go beyond verification and require that package delivery companies obtain an adult signature at the point of delivery. Moreover, in New Hampshire, the carrier "is required to forward to the NH Liquor Commission on a monthly basis signature information." For these reasons, package delivery companies have legal incentives to check the identification of package recipients. The Report recommends that states develop penalty and enforcement systems to provide incentives for both out-of-state suppliers and package delivery companies to comply with the law. Such systems would be less restrictive than an outright ban on interstate direct shipping. *See* Report, pp. 29, 40.

f. In light of the fact that the Tax and Trade Bureau has never taken a single license away from a winery [in the face of voluminous evidence of violations from the Michigan Attorney General's office, for example], why does the FTC believe that the Tax and Trade Bureau can be relied upon as a caution to those shipping alcohol illegally?

Answer: TTB, which has the authority to revoke a winery's basic permit, has stated that it will assist states in combating significant violations of state law:

> ATF [now TTB] could under appropriate circumstances take administrative action against a basic permit where a basic permittee ships alcohol beverage products into a state in violation of the laws of that state. . . . ATF will respond to an official state request for assistance only where a written determination has been made by the chief administrative officer of the state liquor enforcement agency or the State Attorney General that the conduct violates state law and ATF has independently determined that the state law violation has some pronounced impact on the regulatory and/or criminal enforcement scheme of the state in question. That is, ATF will evaluate the conduct in question in relation to the proper exercise of its Federal authority over matters that necessitate Federal intervention.

See Report, pp. 30-31. FTC staff is not aware of whether the circumstances for TTB's involvement, as outlined by TTB, have ever been met, *i.e.*, whether any state has ever made an "official state request for assistance," whether there has ever been a "written determination . . . by the chief administrative officer of the state liquor enforcement agency or the State Attorney General that the conduct violates state law," or whether TTB has ever "independently determined that the state law violation has some pronounced impact on the regulatory and/or criminal enforcement scheme of the state in question." Indeed, Michigan officials told FTC staff that they have never attempted to use the Twenty-First Amendment Enforcement Act against out-of-state shippers. *See* Report, p. 39 n.170. Some states may not turn to TTB; for example, New Hampshire works with out-of-state suppliers that may be violating the law:

> [T]he State of New Hampshire Liquor Commission collects an 8% fee on all shipments into the State of New Hampshire. When the NH Liquor Commission discovers an improper shipment we contact the company and inform them of the laws in NH. Once the company learns of NH laws they normally get a permit or stop shipping into NH. The NH Liquor Commission is working with out-of-state supplier[s] and encouraging them to obtain a permit.

See Report, p. 38.

5. What would be the response of the FTC to a mother of a teen who ordered wine over the Internet, who had the wine delivered to his door or didn't have his ID checked, and ended up getting hurt in a drunk driving accident? How would the FTC characterize the alleged safeguards in place in this circumstance?

Answer: The FTC has consistently reported that alcohol consumption poses significant dangers to minors. *See* Report at 15; FTC, ALCOHOL MARKETING AND ADVERTISING (2003) at 1. Unfortunately, safeguards sometimes fail for both online and offline sales. For example, bricks-and-mortar stings typically find that minors are able to buy alcohol between 15-30% of the time. In Michigan, minors were able to buy alcohol 55% of the time after showing a valid Michigan license that identified the customer as a minor. *See* Report, p. 35.

6. How would the safeguards against minors' access to alcohol espoused by the FTC have prevented deliveries of alcohol from being made in the following cases:

a. **The teen in the alcohol rehabilitation facility in Michigan who successfully ordered 2 separate cases of bourbon, and had them delivered to him in the rehabilitation facility?**

b. **The teen that successfully ordered a bottle of wine delivered to him in the South Dakota state capitol?**

c. **A 15-year-old who used his own credit card to successfully ordered bottles of tequila, and had the package left on his doorstep [no I.D. check] in a state that prohibits such shipments regardless of consumer age?**

d. **An 11-year-old boy who successfully accepted delivery from a common carrier of a bottle of wine in a box clearly marked "wine" and labeled to require an adult signature?**

e. **The sale and delivery of beer to a 17-year-old in Alabama from a company in Illinois?**

f. **The shipment of beer to minor in the Missouri Attorney General's office?**

Answer: 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. Some states also have developed penalty and enforcement systems to provide incentives for both out-of-state suppliers and package delivery companies to comply with the law. These states generally report few or no problems with shipments to minors, although no safeguards are foolproof.

7. What system of safeguards is the FTC aware of that would prevent the foregoing incidents listed in Question 6 a-f from happening in the future?

Answer: As an alternative to banning interstate direct shipment of wine, some states have adopted less restrictive means to satisfy their regulatory objectives. 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 (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 problems with interstate direct shipping to minors. In addition, many states require an adult signature at the point of delivery, and several federal courts have suggested that labeling requirements could be effective regulatory tools. *See* Report, pp. 27-31.

November 24, 2003

The Honorable George Radanovich
House of Representatives
438 Cannon Office Building
Washington, D.C. 20005

Dear Mr. Radanovich:

Thank you for the opportunity to respond to the written questions of the Subcommittee on Commerce, Trade & Consumer Protection following the October 30, 2003 hearing.

It was my pleasure to present testimony to the Members of the Subcommittee concerning direct shipment sales and the resulting threat to the controlled distribution of alcohol. I am also pleased to be able to articulate further the concerns of the Wine and Spirits Wholesalers of America, Inc. (WSWA) in the attached response to the Subcommittee's follow-up questions.

Thank you again for allowing me to address the Subcommittee on this important issue.

Sincerely,

Juanita D. Duggan

President and CEO

Attachment

JDD/mas

Response by
CEO Juanita D. Duggan
Wine and Spirits Wholesalers of America, Inc. (WSWA)

Subcommittee on Commerce, Trade, & Consumer Protection Committee on Energy & Commerce U.S. House of Representatives Follow-up Questions to October 30, 2003 Hearing

1. No. However, WSWA members are very concerned about the effects that direct shipment of wine—as well as beer and liquor—will ultimately have on the ability of a state to control the sale of alcohol within its borders as provided for in the 21st Amendment to the Constitution.

   Wine is unarguably intoxicating liquor, as are beer and distilled spirits. Once regulations are relaxed such that one type of intoxicating liquor can be direct shipped, what argument can the state make to the producers of other intoxicating liquors who want the same access to the market?

   As historical partners with the states in controlling the distribution of intoxicating liquor, wholesalers are concerned about the deregulation of alcohol and the loss of local control that will result if the direct shipment of alcohol is "freely allowed." Under deregulation: states may or may not know who is delivering alcohol into their state; states may nor may not know who is buying alcohol in their state; states may or may not be receiving sales and alcohol taxes on direct shipped alcohol; states may or may not be able to verify the product purity of alcohol being direct shipped into the state; and states may or may not be able to punish effectively those who violate state alcohol laws.

   Alcohol deregulation will turn a controlled situation into chaos.

2. First, there is absolutely no credible evidence that the issue of tax collection has been totally resolved in any jurisdiction. The Federal Trade Commission (FTC) reports that in New Hampshire the taxes due on legal direct alcohol sales are collected to the satisfaction of the state. However, this assumes that the state knows about all the shipments of alcohol crossing its borders. In reality, New Hampshire has no idea the volume of illegal alcohol being shipped into the state, as it has not conducted—to our knowledge—any enforcement actions/stings to investigate the problem.

   The state of Michigan, on the other hand, has conducted stings, and its findings should not be considered unique. In testimony before the FTC on October 8, 2002, the state reported that enforcement actions in mid-1999 netted 174 illegal shipments of alcohol to its residents. The shipments seized came from 89 different shippers (65% of whom were retailers, not wineries) in 16 states, South Africa and Australia. Not surprisingly, not one of these shippers contacted the state to report voluntarily their illegal activities or pay the sales and excise taxes due.

As former Michigan Assistant Attorney General Irene Mead testified to the Federal Trade Commission, those who direct ship alcohol illegally do not volunteer to pay taxes on the honor system, "...because these shipments are outside the ordinary stream of commerce, not going through licensed retailers, the shipments are not recorded or tracked by the state or its licensees. Little incentive or disincentive would exist for voluntary tax payment, and to expect that it would happen is naïvely optimistic."

It stands to reason that if enforcement actions in Michigan have uncovered illegal shipments and lost tax revenue, then enforcement actions in New Hampshire and other states are likely to net similar results.

It also should be noted that in a recent lawsuit challenging the state of New York's right to regulate alcohol, winery plaintiffs invoked their 5th Amendment rights when asked to provide documents related to any illegal shipments of alcohol they may have exported into the state. While within their right to avoid self-incrimination, it is unfortunate they were not forthcoming with information that could potentially put to rest the tax evasion concern.

As to minors' access to direct shipped alcohol, there is no way resolve the underage drinking issue to "everyone's satisfaction." As a key link in the licensed, accountable three-tier system for controlling the distribution of alcohol, wholesalers are committed to the position that that no level of underage access is satisfactory.

In fact, the wholesale tier stands firm that more, not less, should be done to combat underage access. Moreover, we condemn the "kids are getting alcohol anyway" approach being taken by advocates of direct shipping, as evidenced in the testimony of WineAmerica President David Sloane before the Subcommittee in its October 30, 2003 hearing.

We do not believe it is possible to stop underage access through direct shipment. Where authorities have made the effort to conduct enforcement actions, both clearly marked and permitted shipments of alcohol, as well as illegal shipments of alcohol in plain brown boxes, are left on doorsteps routinely and are even delivered to minors directly. My testimony to the Subcommittee in the same October 30, 2003 hearing highlights several such instances.

Most recently (airdate: November 12, 2003), WBIR-TV, the NBC affiliate in Knoxville, Tennessee, spotlighted a project by a group of concerned

University of Tennessee graduate students that confirms beyond a shadow of a doubt that minors can and do get alcohol illegally through direct shipment. In fact, the project was so compelling that the local sheriff is investigating. When asked if kids getting alcohol online is a problem, a sheriff's department spokesman told NBC, "It's an ongoing problem, it's a serious problem and we take it seriously."

3. The members of WSWA, as part of the licensed three-tier system for the controlled distribution of alcohol, believe that any underage access is too much. Sadly, it seems that direct shipping advocates are ignoring the safety of minors in favor of maximizing profit by adopting a "they're going to get it anyway" attitude on underage access to alcohol.

However, do not just take our word for it. The National Academy of Sciences (NAS), on page 176 of its recently published study "Reducing Underage Drinking – A Collective Responsibility," found that minors are obtaining alcohol through the Internet or home delivery currently and that the increasing use of the Internet will exacerbate the problem. In fact, "an argument can certainly be made for banning Internet and home delivery sales altogether in light of the likelihood that these methods will be used by underage purchasers," according to the NAS.

The point here is that if underage access to online alcohol is a problem today, it will be an even bigger problem tomorrow. While direct shipping certainly only represents one of many ways in which minors get alcohol, we agree with the NAS that it is our collective responsibility as an industry and a society to work toward reduce the ways by which kids can get alcohol – not expand them.

In an affidavit, opposing any change to the current system of alcohol distribution in New York, noted public health researcher Henry Wechsler, principal investigator for the Harvard School of Public Health Collect Alcohol Study, echoed this concern. He said, "In my expert opinion, changing the system of sales in New York by greatly increasing the number and type of suppliers who can sell alcohol products directly to New York consumers is likely to lead to a breakdown of controls over underage drinking."

This breakdown in control is occurring already, as documented by graduate students at the University of Tennessee who are now working with the local sheriff's office to investigate their findings of how easy it was for minors to get alcohol online (as referenced in more detail in question #2).

Another point to consider is that most states (unlike Michigan, as referenced in question #2), are not conducting investigations/stings of online alcohol sales. While states exercise such enforcement actions with traditional brick and mortar establishments, the same is not true for virtual vendors. In these instances, the state has no idea how much alcohol is being shipped illegally; they simply cannot know what they do not know. That is the problem with illegal direct shipments: they occur in the shadows, outside the view of the regulators.

4. As detailed in the response provided to your first question, the primary concern of wholesalers with respect to direct alcohol sales is the potential for the loss of state control over the sale of alcohol. As the state of Michigan made clear in its presentation to the FTC, "Invalidating state laws governing who may sell alcohol and the methods by which it is sold and delivered would eviscerate the state's alcohol licensing, sale and delivery systems. No effective control can be exercised over out-of-state sellers able to sell and ship alcohol to residents outside of the state's regulatory structure. This result requires a determination that the regulation of alcohol is no longer considered to be necessary."

   The state of Michigan goes on to say, "Alcohol is different from most other products because of the damage that results from its overuse and abuse. The costs to society from alcohol-related deaths and injuries have long been recognized, and as a result, alcohol trafficking has a lengthy history of extensive regulation and control."

   As partners with the states in the responsible and accountable three-tier system, we recognize the special nature of the product we sell and are concerned deeply about the creation of a climate in which the regulation of alcohol is no longer considered to be necessary.

5. It would be more appropriate for a carrier to respond to this question. However, according to Michigan's testimony to the FTC, the first actions in the illegal shipment and underage access stings in that state were taken against United Parcel Service. To settle the case, UPS became a partner of the state in identifying subsequent illegal alcohol shipments. In this case, it would seem that UPS was quite concerned about having completed illegal deliveries to underage recipients and sought to become part of the solution.

   As part of his affidavit in the New York case, Henry Wechsler (principal investigator for the Harvard School of Public Health Collect Alcohol Study) writes, "Allowing delivery services to check ages of persons obtaining alcohol will increase the number of persons and sites involved in the control system, and consequently increase the chance of unintentional or intentional errors. Removing the possibility of face to face ID checks by trained personnel is at best a risky practice."

6. The WineShopper.com model was a completely licensed system. All orders of alcohol were processed through the three-tier system of wholesalers and retailers licensed by the home state of the consumer. The model ensured the

quality and safety of the product, that all taxes due were collected and that a local retailer completed the transaction. Under that proposed system, any retailer breaking the law would have lost its alcohol license. Alcohol shipments from producer directly to a consumer occur outside the state's ability to control it, and fly in face of the 21st Amendment's intent to provide protective barrier between producers of alcohol and consumers.

7. WSWA members have offered representation repeatedly to small wineries, including an open letter from a large multi-state wholesaler that appeared in numerous trade publications, but not one winery has responded positively to date.

   Additionally, when I spoke at last year's VinExpo (one of the largest international gatherings of wine producers and others in the industry), I announced to the assembled wineries that if they cannot get representation, they should call me personally for assistance. I even gave out my office phone number from the dais. I received two phone calls but neither winery sent follow up information.

   Finally, WSWA regularly targets thousands of small, domestic wineries to attend WSWA's annual convention. This gathering of wholesalers from all 50 states affords wineries the opportunity to promote themselves and identify wholesalers to sell their products. If domestic wineries were interested in competing within the regulated marketplace, they would avail themselves of the opportunities our convention provides. Numerous foreign wineries and distilled spirit companies seek and find distributor representation at our convention each year.

8. According to *Impact Magazine*, the sales volume of the ten largest wine and spirits wholesalers represents approximately 52.4% of the U.S. market. Those ten wholesalers are part of a distribution tier that stocks a marketplace with an immense variety of wine and spirits. *Impact Magazine* further reports more than 6,500 brands representing over 39,000 distinct wine products are available through current distribution systems in the United States. In fact, in the New York metro area alone, consumers have access to 19,756 different kinds of wine and 3,036 types of spirits. No other consumer product—not cheese, nor televisions, nor even automobiles—can boast anywhere near such an immense variety.

   In actuality, the selection available to consumers is so great that a Wirthlin Worldwide survey found that fully 85% of Americans who consume alcohol are satisfied with the selection of products currently available in their locality.

   Therefore, it seems clear that the problem is not the concentration of wholesalers, but rather the proliferation of wineries in numbers that the marketplace will not support. The number of wineries increased 500% in the last 30 years, and as David Sloane pointed out in his recent testimony, there are now wineries in operation in all 50 states. According to direct alcohol sales proponents Free the Grapes, More than 10,000 new wines are produced by U.S. wineries alone each year. Add to that the abundance of reasonably priced foreign-produced wines in the American market, it becomes painfully clear that the number of wholesalers is not the problem—rather the glut of wine competing for finite consumer demand.

The bottom line is no other type of consumer goods manufacturer expects the extraordinary special treatment from the free market system that wine producers do. Nonetheless, the reality is that the American marketplace is driven by demand. Wineries who cannot or do not want to compete according to this simple rule have instead decided to try to undo state laws and the 21st Amendment, both of which are intended to protect consumers.

9. The FTC testimony is suspect at best and certainly does not reflect the reality of a broader sampling of prices available to consumers. The FTC based its conclusions on price data drawn from a sampling in McLean, Virginia. McLean is not reflective of even the broader Washington, D.C. metropolitan area, much less the county as a whole. The cost of living in McLean is about twice the national average and the median annual household income in Fairfax County (which includes McLean) is $85,310, as compared to $43,057 nationally.

To prove this point, WSWA undertook its own sampling of prices for the 11 wines listed by the FTC at three D.C.-area retailers (small, medium and large), and on each winery's website. We found that all but one of the 11, the Duckhorn Merlot Three Palms, which is actually sold only in limited allotments to high-end restaurants, were available at retailers within 10 miles of McLean, Virginia. In fact, two of the wines—the Cakebread Cabernet, Napa Valley and the La Crema (KJ) Pinot Noir that the FTC reported being unable to find at any local retailers—were found to be available at area retail stores despite the FTC findings to the contrary. Our sampling also found that nine of the remaining 10 wines are available at a price lower than that being charged online at least one of the three retail outlets—and this is before any shipping charges were factored in. On average, these 10 wines were $1.29 less expensive in area retail outlets, excluding shipping charges. When factoring in posted shipping charges, the 10 wines are an average of $16.43 more expensive when purchased online than McLean residents could purchase them within 10-miles of their home.

However, aside from the degree to which the FTC study was inaccurate, these findings are really no surprise. Even some of strongest proponents of direct alcohol sales have admitted that they themselves do not believe consumers save money by purchasing wine online. In a letter to the Progressive Policy Institute (Feb. 22, 2001), David Sloane (now president of WineAmerica though he then worked for WSWA), wrote "unlike other areas of e-commerce, the sale of wine over the Internet does not yield any savings to the consumer. As a general matter, whether sales occur in the tasting room or over the Internet, vintners charge the full retail price for their products, capturing both the wholesale and retail margin. On top of this, shipping and handling charges must be added." Rest assured, the facts presented then have not changed just because Mr. Sloane's employer has.

10. As stated previously, WSWA's members believe that any level of underage access is unacceptable and believe that we should be constantly in search of ways to make the system more effective in combating the ability of minors to access alcohol. We certainly do not believe that, as proponents of direct shipping have asserted before the committee, just because minors are finding ways to get alcohol now that it is okay to provide them with new opportunities to do so. We believe that the only responsible thing to do is explore aggressively ways to close traditional access points, not create newer, high tech ones. While the system is not perfect, to open the market to direct shipping from out-of-state sources will inevitably lead to increased underage consumption.

After the September 11th attacks, the federal government and the commercial aviation industry immediately began an intense effort to evaluate the effectiveness of the airport security system with an emphasis on making certain that such an attack could never happen again. Tough new restrictions were put on passengers and stringent new requirements on airlines. Recent news accounts have highlighted some glitches in the system. Items have been found aboard planes that should not have been there. However, no one has suggested that because the rules and regulations are not working perfectly that the FAA should relax the rules to make it easier for these prohibited items to find their way onto airplanes. We find it remarkable that the proponents of direct alcohol sales are suggesting just that when it comes to controlling underage access to alcohol.

11. No. We still believe that a WineShopper.com model of direct shipment through the three-tier system (including through a licensed retailer) is workable. It is important to point out that WineShopper.com failed to prosper not because of its fulfillment model, but rather a business plan which assumed there was a demand among consumers for hard to get, higher-priced select wines that were otherwise unavailable in their local area. That assumption proved to be faulty—yet it is the exact same claim direct alcohol sales proponents make today. While in operation, WineShopper.com found the reverse to be true. The vast majority of the orders it received were for readily available, lower price point wines that could not be delivered to the consumer cheaper than they were already available at local licensed retailers.

In fact, then-New Hampshire Liquor Administrator John Byrne confirmed this at the FTC workshop. Commissioner Orson Swindle asked Byrne to comment on the nature of wines ordered in the state of New Hampshire (a control state) pursuant to its direct shipping law. He noted that 95% of the wine ordered and shipped direct was available on the shelves of local retail establishments.

12. No, because in the case of intrastate direct shipment, the supplier shipper has been granted its primary license allowing it to do business by the same state in which it is engaged in shipping. There is a measure of accountability that simply does not exist with interstate direct shipment. If the intrastate shipper is found to have shipped product to a minor, then the state can take immediate action by revoking its basic license to do business and/or even physically closing its place of business.

    In the case of interstate direct shipments, one state cannot revoke the basic license of, or physically close, a business based in another state. Other than seek redress though the 21st Amendment Enforcement Act (likely to be expensive and lengthy), the best a state can do is revoke a permit to ship within its borders, if one has even been issued. Nevertheless, there is no way to verify that the illegal shipments have stopped. Thus, while a state may be able to stop shipments into its state, the violating company is free to continue their illegal and dangerous shipping practices into other states.

13. The 21st Amendment clearly gives them that right. We believe any alcohol shipments that move outside the established system of checks and balances – either interstate or intrastate, are a bad idea. However, beyond that we believe that it is each individual state's decision to make.

14. It is the position of WSWA that all licensees have a responsibility and a role to play in combating underage access. Wholesalers play important roles in educating retail staff in many states. We also partner with states to make certain that retailers whose licenses have been suspended or revoked do not receive alcohol products.

15. Once again, WSWA's concerns about direct shipping are related to the regulatory ramifications of taking steps to lessen local control and toward the deregulation of alcohol.

    We do find, however, the expressed views of one prominent direct shipping advocate interesting with respect to the finding of the FTC concerning market access. Ms. Juanita Swedenburg, owner of Swedenburg Estate Vineyard in Middleburg, Virginia and the plaintiff in a lawsuit challenging the state's right to regulate alcohol sales, on her website (http://www.swedenburgwines.com) seems to contradict the findings of the FTC. The opening page clearly states, "This is one Virginia Winery that easily sells out of each vintage it produces.

We no longer widely distribute our wines – 95% of sales are now at the Winery."

It seems that direct shipping may truly be a debate about economics, sales and profits, but for the "small" wineries—not the wholesalers.

16. Actually, even some of the strongest proponents of direct shipping concede this is an elitist issue. In refreshing candor, direct shipping advocate Daniel McFadden, a Nobel prize-winning economist and grape grower himself, admitted before the Federal Trade Commission that the subject of direct sales is an "elitist" issue that caters to only a tiny percentage of the consuming public.

This view of elitism is bolstered by a Wirthlin Worldwide survey that found that 85% of those who consume alcohol in this country are satisfied with the selection currently available to them locally; 82% are satisfied with current convenience; and 77% of all Americans oppose allowing the sale of alcohol directly to consumers over the Internet or through the mail.

In other words, a handful of alcohol producers and their powerful supporters want to deregulate alcohol despite widespread public opposition; they want to dictate to people in other states how and where alcohol is sold in their local communities; and they want to be able to ignore the laws of those other states in the process. It is no stretch to say such views are elitist and out of step with the mainstream.

17. Yes. However, as articulated in the answer to question 13, we believe that the 21st Amendment certainly gives states the right to make that decision for themselves. Moreover, as discussed in the response to question 12, in the case of intrastate direct shipping the state has sufficient contact with the shipper or, as presented in this question, the licensed courier to enforce its regulations and protect its system of alcohol controls. Should a minor receive an intrastate shipment of alcohol, the state may readily pursue remedy with either the shipper or the courier based upon a finding of liability.

18. No. Children in New Hampshire—as in other states—can easily get alcohol direct shipped to their door with no questions asked.

Just last week, in fact, an online merchant delivered through common carrier a bottle of whiskey and a bottle of tequila to Londonderry, New Hampshire. The shipper in question is not listed on the New Hampshire State Liquor Commission's website as being entitled to direct ship legally into the state. Moreover, the liquor came in a plain brown box (return address simply listed the shipping company as "Dave"). The delivery truck driver left it unattended in the garage, without obtaining an adult signature. Lack of proper labeling and lack of adult signature clearly violates New Hampshire's direct shipping laws. The liquor was left unattended, with no questions asked. Without a doubt, this order could just as easily been placed and received by a minor. And it is clear no taxes were collected by New Hampshire (as the state likely has no knowledge the sale happened). If New Hampshire is the "model" state for direct shipping, then the model is fatally flawed.

This national problem is not limited to a single state. For example, as detailed in my testimony before the Subcommittee on October 30, 2003, whether in a clearly marked container delivered by a lax courier or in an intentionally deceptive plain brown box—alcohol is being direct shipped into the hands of minors across the country.

America's family distributors of wine and spirits remain committed—regardless of the attitude on the part of pro-direct shipping advocates that if kids are getting it anyway, why worry about one more way that they can do so—to working with our partners in the states to tighten control over the distribution of alcohol in an effort to end underage consumption.

Federal Trade Commission Workshop,
October 8, 2002

Possible Anti-Competitive Efforts to Restrict Competition on the Internet

State of Michigan's Remarks
By Assistant Attorney General Irene M. Mead

Across the United States, 8 cases have been filed challenging state laws that do not permit direct shipping of alcohol as part of the state's alcohol regulatory structure. As in the case of the other states sued, the laws of the State of Michigan prohibit unlicensed and unregulated out-of-state alcohol producers and retailers from selling and delivering alcoholic beverages directly to the state's residents. All sales and deliveries of alcoholic beverages must be made in accordance with the statutorily prescribed regulatory structure.

In these cases, individual and winery plaintiffs have challenged the states' Twenty-first Amendment authority to regulate alcohol trafficking within their borders, suggesting that requirements of licensing and accountability violate the Commerce Clause. The District Court's decision in Michigan's favor is *on appeal to the Sixth Circuit*, waiting the scheduling of oral argument. *Heald, et al v. Engler, et al*, (6th Cir. No. 01-2720).

In challenging direct shipping laws, direct shipping advocates contend that enforcement and regulation of out-of-state entities can be accomplished as readily as with in-state entities. The direct shipping advocates suggest that direct shippers will voluntarily pay appropriate taxes. They assert that adequate protection against sales to minors can be accomplished by placing responsibility for verifying age on the delivery personnel for common carriers such as United Parcel Service. They contend that the direct shipping issue is limited to "fine" wineries that want to ship and wine "connoisseurs" who want such wines delivered to their doorsteps. They provide no support, however, for these contentions.

However, these contentions are not borne out by Michigan's actual direct enforcement experience.

Relevant law

First, a brief discussion of the law in this area, which unlike commerce in other products, is derived from the Constitution.

Section 2 of the Twenty-first Amendment provides for state control over alcohol trafficking within state borders:

> The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited. [U.S. Const. amend. XXI, § 2]

Pursuant to this authority, most states, including Michigan, enacted laws establishing a three-tier system of alcohol distribution within their borders, which require that purchases by consumers be from in-state licensed retailers. Licensed in-state wineries and breweries may make limited retail sales of their products only. Licensed retailers, wineries and microbreweries may also deliver the alcohol product they are authorized to sell to purchasers within the state.

The term "direct shipping" refers to the practice of an unlicensed and unauthorized out-of-state producer or retailer of wine, spirits, or beer, shipping alcoholic products directly to residents at their homes. Michigan's systems of licensure and regulation preclude the practice, as do most other states. NOT A SINGLE STATE permits unlimited, unregulated direct shipping of alcohol to its residents.[1]

Michigan and other states have created no impediment to sales of beverage alcohol products from other states. Rather, they have specified a regulatory structure for alcohol sales that ensures seller accountability for injuries resulting from such sales and violations of liquor laws, prohibits the sale of alcohol to minors or intoxicated persons, promotes an orderly market, and provides a verifiable method of tax collection.

Although certain producers of wine have chosen, for financial, marketing, or other reasons, to not sell their products in Michigan through the established regulatory framework, this private choice does not mean that the state has prohibited the sale of wines from that source.

The choice to not sell alcohol in a particular state within its regulatory system because it may be more costly to do so than to sell directly (and illegally) to individuals, does not render the regulatory system unconstitutional. No one has a constitutional right to compel a state to permit sales of alcohol in a manner that would maximize an alcohol producer's profits or provide self-appointed wine "connoisseurs" with access to any alcoholic product produced anywhere in the world.

Michigan's Experience

Because of concerns about the ability of minors to order and receive alcohol from Internet sites, in mid-1999, the Michigan Attorney General and Liquor Control Commission conducted a series of "stings", in which a minor with a valid credit card attempted to purchase various alcohol products for direct delivery. The results of these stings revealed that most alcohol sellers were far more concerned about the validity of the credit card number than the age of the purchaser. Virtually none of the sellers were concerned about Michigan laws precluding such shipments. The alcoholic beverage products available for sale ranged from fine wines to 194 proof grain alcohol, a substance so dangerous that in Michigan, it can only be used in industrial applications and must be shipped and transported as a hazardous, highly flammable material.

About one in three websites contacted during these stings agreed to sell alcohol to the minor purchaser with no more age verification than a "click" of the mouse. The United Parcel Service personnel who delivered the parcels containing alcohol purchased under these stings did not properly verify the age of the minor recipient.

Although these stings confirmed the problem, they were costly and time-consuming to conduct. Proceeding against all of the thousands of alcohol sellers and shippers through the use of stings was considered to be an impossible task.[2] Accordingly, the first action was taken against the common carrier used for the deliveries, United Parcel Service. The resulting settlement required that UPS cooperate with the state to identify illegal alcohol shipments.

Since that settlement, 174 out-of-state shipments of alcohol have been intercepted and seized on their way to Michigan residents. These contained beer, various kinds of spirits, and wine, both cheap and expensive. In some cases, packages deliberately were disguised or mis-identified to avoid detection of the alcoholic beverage contents.

These shipments of alcohol to Michigan residents included 318 bottles of beer, as well as 20 bottles of various "hard" spirits. Although some of the 1,062 bottles of wine that were intercepted could be classified as high-end, the shipments contained many cheap wines as well, including a number of wines made from fruits not normally used in "fine" winemaking - blackberries, cranberries, currants, elderberries, chokecherries, apricots, raspberries, and plums, as well as six bottles of a wine labeled "Eye of Newt", of unknown content .

The shipments came from 89 different shippers in 16 states, South Africa and Australia. Fewer than 10% of the shipments were from individuals to Michigan residents. Of the remaining commercially sent shipments, 65% were from out-of-state retailers. 25% of the shipments were from out-of-state wineries.

Thus, although wineries and "wine connoisseurs" are the loudest voices lamenting the inability to direct ship, the greatest impact will be shipments from alcohol retailers, who are primarily seeking to avoid state taxes and regulations for accountability.

Not a single shipper contacted the state to pay sales or alcohol excise taxes voluntarily prior to seizure of the product. All tax payments have resulted from threatened legal action and negotiated settlements.

Based on Michigan's real world experience, several conclusions may be drawn.

A. Access by minors to alcohol from out-of-state sources is a real issue.

Advocates of direct shipping contend that the states' concerns about access by minors to alcohol from out-of-state is pretense, insufficient to justify direct shipping prohibitions. In support of this, they assert that 1) no evidence exists that minors are buying from direct shippers, 2) minors are unlikely to buy costly, upscale wines, 3) minors want their alcohol purchase immediately, and will not purchase from a source for later delivery, and 4) training of common carrier delivery people can eliminate any access by minors.

1. *Access by Minors*

The results of the stings in Michigan showed that one in three Internet alcohol sites contacted sold to the decoy minor. Advocates for direct shipping of alcohol argue that only the minors who are participating in the stings are purchasing alcohol, that no evidence of such purchases exists outside of stings. This argument is virtually identical to the argument made by bricks and mortar retailers when in-state minor stings were intensified. The fundamental flaw in this argument is that neither retailers nor minors voluntarily turn themselves in for prosecution following a sale. Absent decoy stings, sales to minors are only identified when the minor is arrested for evidence of sales to minors outside of stings is very limited. The best evidence that minors have easy access to alcohol from remote sellers continues to be the results of decoy stings.

The Internet sellers who sold to the Michigan decoy did not know that the purchaser was a minor participating in a law enforcement sting. They simply sold to whomever could provide them with a valid credit card. That a greater percentage of remote sellers would sell to minors than the percentage of state retailers is to be expected, for two reasons.

First, a remote sale does not involve a face-to-face transaction. In-state retailers approached by a minor to purchase alcohol have an opportunity to observe the purchaser directly, to assess nervousness and other mannerisms that indicate the person may not be of legal age to purchase, and to closely scrutinize a government-issued picture identification. Michigan requires "diligent inquiry" to verify age, which is defined as, "at least an examination of an official Michigan's operator's or chauffeur's license, an official Michigan personal identification card, or any other bona fide picture identification." MCL 436.1701(7)(b). This requirement simply cannot be met by a "click" of the mouse or a faxed (and easily altered) copy of a license.

Second, in-state licensed retailers risk their state liquor license - their very livelihood - if they sell to minors. Out-of-state unlicensed retailers have nothing to lose, since, in the rare event that the sale is identified, they have no license at risk and out-of-state prosecutions are exceptionally difficult and costly to pursue.

2. *Type of Product Sold*

Advocates for direct shipping suggest that minors won't buy costly upscale wines. This premise presumes that minors have little discretionary money and limited knowledge of, or palate for, fine wines. However, no support is supplied for either presumption.

The discretionary income of minors is not perceived as minimal by those who market to this demographic. Studies by Teen Research Unlimited (TRU) , a market-research firm that focuses on the teen market, estimated that teens in the United States from ages 12 to 19 spent $155 billion in 2000, and $172 billion in 2001, despite slowdowns in the general economy.

The second presumption, that minors have no palate, knowledge, or interest in wines is not true. 35% of all wine coolers sold in the United States are consumed by junior high, middle school, and high school students . Moreover, current teen interest in expensive wines is irrelevant to this analysis. Although this issue continues to be characterized as limited to wine connoisseurs and enthusiasts seeking rare fine wines, however those are defined, in fact, the statutes sought to be invalidated apply much more broadly. The alcohol controlled by the states' three-tiered systems includes wine coolers, beer, rums, tequilas, flavored vodkas, and other similar products heavily marketed to young drinkers.

The alcohol industry may contend otherwise, but the marketing "intended" to reach those in the 21 - 25 age group has been, unfortunately, very effective at also selling to the under -21 crowd. One research study reported that 56% of students in grades 5 to 12 said that alcohol advertising encourages them to drink. One of the first studies to explore Internet marketing of alcohol and tobacco to minors was conducted by the Center for Media Education (CME):

> The study found that alcohol and tobacco companies are using the online media to advertise and promote their products, through a variety of marketing techniques that

young people.

In December 1998, the CME published an update to the original study. This study examined 77 beer, wine and spirits Internet sites, and concluded that 62% of the sites included elements appealing to youth. The study discussed the marketing techniques:

> The sites that appear to appeal to youth often strive to create a community of brand-loyal enthusiasts, a place where lonely teens can talk, find peers and support for risky activities like binge drinking. Known among marketers as relational advertising, this effort to build a relationship between the user and the product is the dominant trend in marketing on the Web and is already heavily exploited by the alcohol industry.

The wineries you will hear from today contend that they do not market to youthful drinkers. Again, this is not about wineries, exclusively. The statutes in question regulate beer and spirits sales as well. Moreover, even if the case were limited to wine, many wine sites either are directed at youth, or contain links to youth oriented wine sites. Sites such as Wine X Wired , with regular features "Wine Bitch" and "X-Rated Wines", and Winebrats" with its "Vino-versity" and "WineRave Tour", clearly are aimed toward youth.
And all types of alcohol are being offered by remote sellers.
The first purchase made by the minor in the Michigan stings from one Illinois retailer was a $6.85 bottle of blackberry wine. Even after the retailer was notified of the sale and charged with a misdemeanor sale to a minor, he sent a follow-up email to the minor, inquiring whether he wanted to purchase again. The minor then purchased a $6.66 bottle of wine, which again was delivered directly to *his* residence. This retailer, who pled guilty to misdemeanor sale of alcohol to a minor, claimed that his targeted customers were upscale wine connoisseurs. However, in addition to webpages devoted to beer, tequila, and vodka, at the time of the purchases, his website, www.internetwines.com, devoted an entire webpage to 192+ proof grain alcohol, being sold as a beverage alcohol. As of this writing, this website continues to sell grain alcohol.
3. *Immediate Possession of Purchase*
Another contention is that minors want immediate access to alcohol, and won't wait for shipment from a remote seller. The Wirthland Worldwide study of college students, conducted for Americans for Responsible Access for Alcohol , suggests otherwise, finding that 17,600 students in the survey reported having purchased beer, wine or liquor over the Internet, by toll-free phone order or by mail-order catalog. Obviously, the delay in receiving the alcohol did not stop these sales. The Wirthland Worldwide study also found that 80% of the students surveyed said their peers are likely to purchase alcohol online if no age verification is required.
Moreover, the delay between ordering and delivery of alcoholic products can be minimal. Most alcohol sale sites offer a variety of delivery options, ranging from UPS Ground to FedEx Preferred Overnight, the latter of which guarantees delivery by 10:30 a.m. the morning following the order.
Thus, a minor wishing to purchase a case of grain alcohol from Randall's Wines and Spirits (www.internetwines.com) for a Friday "party punch" could order it on the preceding Monday for regular delivery, or he could wait to order it until late Thursday, and still have it arrive on Friday morning by

adding only $20 more to the shipment cost.

4. *Common carrier delivery personnel training.*

Direct shipping advocates also contend that delivery personnel can be trained to properly validate age. The results of Michigan's stings showed that common carrier delivery personnel were not effective at verifying that the recipients of packages containing alcohol were at least 21 years old. This was true even where the contents were clearly identified on the box as alcoholic beverages, and a sticker stated that the package could only be delivered to an adult.

The failure to properly verify age is not surprising. Common carrier delivery personnel are trained to deliver packages - that is the business of and source of revenue for the delivery company. Delivery personnel, whose mission is to deliver as many packages in as short a time as possible, are only hampered in achieving their goal by requirements of age verification. Moreover, as a matter of policy, should delivery personnel be held to the strict diligent inquiry standard for verifying age? The common carrier and its personnel are not making money from selling alcohol. The responsibility and liability for deliveries to minors should not be placed on delivery personnel, with limited training in verifying age for alcohol purchases.

B. Enforcement efforts against out-of-state entities are prohibitively difficult and costly.

This should be self-evident.

But, it has been asserted that, if direct shipping is allowed, the states simply can subject out-of-state shippers to the same standards and enforce laws in the same way as the state does with its in-state retailers. To understand how simplistic and unreasonable this assertion is, one must have an understanding of the obligations placed on licensed in-state retailers and wineries and the extent of in-state enforcement efforts to ensure that these sellers are accountable.

In-state retailers and wineries are subject to rigorous investigation in order to become licensed, which requires, among other things, extensive disclosure of financial documents, on-site inspections of proposed license premises, and police background checks. Once licensed, they must comply with a multitude of statutory requirements and rules designed to protect the consuming public. Retailers bear the burden of ensuring that sales are not made to minors or intoxicated persons, that sales are made only during hours authorized by statute, that sales are not made in violation of local option laws, that only state approved products are sold, that spirit sales are made in accordance with state-mandated price controls, and that appropriate taxes are collected and remitted to the state. Retailers are held responsible for improper or illegal sales, with penalties ranging from fines to suspension or revocation of their liquor licenses. Dram-shop laws place liability on retailers for injuries and deaths resulting from sales to minors or intoxicated individuals.

These stringent requirements protect consumers from unlawful sales by requiring that alcoholic beverages be sold and distributed to consumers only by persons who are responsible and can be held accountable. In-state retail licensees are accountable to and reachable by the State, because non-compliance with the law may subject them to fines, suspension or revocation of their liquor licenses, and even criminal prosecution.

Attempting to impose and enforce all of these obligations on out-of-state wineries and retailers is virtually impossible, given the number of such sellers, their locations, and the overwhelming costs involved. It is estimated that approximately 2,200 wineries are operating in the United States. Because wineries selling and shipping their own products are acting as retailers for their wines, little distinction exists between these wineries and retailers who want to ship alcohol beverages produced by others . And literally hundreds of thousands of alcohol retailers in the United States are affected in the same way as the wineries by the direct shipping laws. Add to these the wineries, breweries distilleries, and retailers from around the world, and the numbers become mind-boggling.

In addition to several thousand investigations for in-state license applications, Michigan issued 3,453 complaints against in-state licensees in calendar year 2001, based on violations of the Liquor Code discovered by state investigators and local law enforcement agencies. The 2000+ hearings that resulted were held all over the state, and required, at a minimum, the attendance of a hearing commissioner, a court reporter, the investigator or police officer, the licensee, and counsel. Eight Michigan Assistant Attorneys General are dedicated nearly exclusively to this work.

The problems with attempting this level of oversight, investigation, and enforcement with a virtually unlimited number of out-of-state alcohol sellers are obvious. A decoy sting on an in-state retailer is simple: the minor attempts to make a purchase with cash furnished by law enforcement, and immediately is either sold to or turned away. A decoy team can make many stops in a single outing.

A decoy sting on an out-of-state retailer is more costly and time-consuming: the minor must have a credit card in his own name and must be present for delivery. Following such a sale and delivery, the actual seller must be identified for further enforcement effort.

Establishing the true identity of the seller from the Internet website name or assumed name is frequently difficult. The seller's website often provides few clues to the name of the seller or its location. Further, once located, out-of-state sellers typically dispute jurisdiction, refuse service, or ignore communications sent to them. There is no state-issued license to fine or revoke; the seller assumes little risk by selling in a manner that would never be permitted for in-state licensees.

Applying and enforcing the state's liquor laws "equally" on in-state and out-of-state wineries and retailers, so casually suggested as a panacea, is based on a superficial, simplistic, and flawed understanding of liquor control regulation and enforcement.

An understanding of the distinctions between licenses and why those distinctions exist is critical to this case. Out-of-state wineries and retailers are simply not equivalent to in-state wineries and retailers, because of the obligations imposed on them, the level of in-state enforcement efforts, the risks of financial penalties and suspensions or revocations of the licenses, and Dramshop liability where injuries or death result from improper sales. Any resemblance with out-of-state wineries and retailers is superficial and does not extend beyond the descriptive terms "winery" and "retailer".

There is not a state in the union that could afford to fund regulation of the hundreds of thousands of out-of-state retailers and wineries the same way it regulates its in-state retailers and wineries.

In-state retailers and wineries may make deliveries within the state of products they are authorized to sell, because they also are subject to intensive, ongoing scrutiny and regulation, and risk loss of their licenses and their businesses if they fail to comply with state liquor laws and rules. Out-of-state retailers and wineries are prohibited from making such deliveries because the necessary controls to ensure the same level of accountability, responsibility and liability cannot be imposed within the funds and resources available to the states.

C. Direct shipping of alcohol from out-of-state compromises control over product quality.

States also maintain controls over the type of product to be sold as beverage alcohol as a protection to their residents. Alcoholic products from unapproved sources, such as home breweries, wineries and stills, are not permitted to be sold. Some products from established commercial sources are not permitted because of the concern that the product is dangerous, such as grain alcohol and certain liqueurs that change alcohol proof in the bottle over time. Products with obscene or offensive labels, or which have labels targeting children, are prohibited, as are products in certain size packaging.

These types of restrictions cannot be enforced if direct shipping from out-of-state sellers is permitted. Grain alcohol, "Eye of Newt" wine, "Red Ass Ale", "Bad Frog Beer" (the frog on the label is giving the "finger"), and other such products will enter the states unrestricted. Although public safety requires product review and approval, this in no way precludes out-of-state sellers from bringing their legitimate products to market. To the contrary, the regulatory structure is designed to do just this.

Out-of-state producers of spirits, wine and beer may sell their products to Michigan consumers through other types of licensees, including wholesalers and out-state sellers of wine and beer. These licensees arrange for distribution of the product through licensed retailers in the state. The system permits approved products to be sold while ensuring accountability of the seller.

That the system works is apparent from the wide range and variety of alcoholic products lining the shelves of the in-state retailers, the vast majority of which is produced outside the state.

D. Unlicensed out-of-state sellers do not voluntarily pay sales or excise taxes on alcohol shipments.

It has been suggested that state sales and alcohol excise taxes would be paid voluntarily if only the direct shipping laws are struck down. The basis for this particular fantasy is unknown.

Not a single out-of-state seller who shipped alcohol into Michigan in violation of the direct shipping laws voluntarily paid Michigan's sales or alcohol excise taxes. Not one.

What possible incentive is there for a shipper to proactively offer to pay taxes on shipments that cannot be tracked, monitored, or taxed, if direct shipping is allowed?

Because these shipments are outside the ordinary stream of commerce, not going through licensed retailers, the shipments are not recorded or tracked by the state or its licensees. Little incentive or disincentive would exist for voluntary tax payment, and to expect that it would happen is naïvely optimistic.

In *Bridenbaugh v. Freeman-Wilson*, 227 F.3d 848 (7th Cir. 2000), *cert. denied, sub nom. Bridenbaugh v. Carter*, 121 S.Ct. 1672 (2001), the Court discussed the tax issue thus:

> Laws forbidding purchases from sellers that lack Indiana permits are devilishly difficult to enforce, however, for the same reason states have insuperable problems collecting their use taxes when people buy from out-of-state vendors that do not collect sales taxes. Noncompliance is almost impossible to detect, and rampant civil disobedience ensures that a handful of prosecutions would not be effective. Private gains from violating the laws vastly exceed the anticipated legal penalties. Sales and alcohol excise taxes are the lifeblood that funds state liquor control enforcement efforts. Without such taxes, a state loses its

ability to regulate the alcohol trade.

E. Alcohol regulation and control continues to be a necessary adjunct to alcohol sale and distribution.

Invalidating state laws governing who may sell alcohol and the methods by which it is sold and delivered would eviscerate the states' alcohol licensing, sale and delivery systems. No effective control can be exercised over out-of-state sellers able to sell and ship alcohol to residents outside of the state's regulatory structure. This result requires a determination that the regulation of alcohol is no longer considered to be necessary. Invalidating the states' importation laws would permit anyone with access to a credit card, including a minor, to have alcoholic beverages delivered to their doorstep, with the ease and anonymity of delivering products such as jeans or books. There is indeed a distinction to be drawn between the sale of other products that are generally not regulated, and the sale of alcohol, a substance that is always potentially dangerous and traditionally has been heavily regulated. Alcohol is different from most other products, because of the damage that results from its overuse and abuse. The costs to society from alcohol-related deaths and injuries have long been recognized, and as a result, alcohol trafficking has a lengthy history of extensive regulation and control.

In *Craig v. Boren,* 429 U.S. 190, 205, 206 (1976) *reh'g denied*, 429 U.S. 1124 (1977) the Supreme Court provided a brief illuminating history:

> The history of state regulation of alcoholic beverages dates from long before adoption of the Eighteenth Amendment. In the License Cases, 5 How. 504, 579, 12 L.Ed. 256 (1847), the Court recognized a broad authority in state governments to regulate the trade of alcoholic beverages within their borders free from implied restrictions under the Commerce Clause. Late in the century, however, Leisy v. Hardin, 135 U.S. 100, 10 S.Ct. 681, 34 L.Ed.128 (1890), undercut the theoretical underpinnings of License Cases. This led Congress, acting pursuant to its powers under the Commerce Clause, to reinvigorate the State's regulatory role through the passage of the Wilson and Webb-Kenyon Acts. . . . With passage of the Eighteenth Amendment, the uneasy tension between the Commerce Clause and the state police power temporarily subsided.
>
> The Twenty-first Amendment repealed the Eighteenth Amendment in 1933. The wording of § 2 of the Twenty-first Amendment closely follows the Webb-Kenyon and Wilson Acts, expressing the framers' clear intention of constitutionalizing the Commerce Clause framework established under those statutes. This Court's decisions since have confirmed that the Amendment primarily created an exception to the normal operation of the Commerce Clause. . . . (Omitting citations)
>
> Section 2 of the Twenty-first Amendment provides:
>
> The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws

> thereof, is hereby prohibited. [U.S. Const. amend. XXI, § 2]

The first purpose of the Twenty-first Amendment was to end Prohibition by repealing the Eighteenth Amendment. The "noble experiment" had failed. However, one of the reasons understood to have contributed to the failure was that national regulation had not taken into account local conditions. See, e.g., 76 Cong. Rec. 4146 (1933), statement of Senator Wagner ("The real cause of the failure of the Eighteenth Amendment was that it attempted to impose a single standard of conduct upon all the people of the United States without regard to local sentiment and local habits.") Another concern was that a state wishing to protect its residents from alcohol crossing the border from other states might lack the power to do so. 76 Cong. Rec. 4141 (1933), statement of Senator Blaine.

An additional concern was the loss of tax revenue during Prohibition because the trade in alcohol was illicit. *See, e.g., Ratification of the Twenty-first Amendment to the Constitution of the United States*, 142 (Everett Somerville Brown ed., 1938) ("It is both foolish and intolerable to go on submitting to a fallacious system under which an illicit, outlaw liquor traffic annually draws hundreds of millions of dollars of profits out of the nation's capital . . . .") (Indiana ratification convention.) The purpose of § 2 was summed up by Senator Blaine, "to restore to the States by constitutional amendment absolute control in effect over interstate commerce affecting intoxicating liquors which enter the confines of the States," 76 Cong. Rec. 4143 (1933).

It is worth noting that a proposed, but unadopted, § 3 of the Amendment would have given Congress concurrent power to regulate the sale of alcohol for consumption on the premises. This section was dropped on the basis that it was inconsistent with § 2 and "would take away from every State in the Union the right to determine how it would regulate the liquor traffic within its boundaries," statement of Senator Black, 76 Cong. Rec. 4177 (1933).

Finally, still another important, clearly stated purpose of the Twenty-first Amendment was to moderate consumption of alcohol by separating producers from consumers through a mandated distribution structure, typically a three-tier system of manufacturers, wholesalers, and retailers. Before Prohibition, "tied-houses," where alcohol producers controlled retailers, were considered to have contributed to irresponsible sales and increased consumption of alcohol. See, e.g., H.R. Rep. No. 1542, at 12 (1935) (Federal Alcohol Control Act). The regulatory statutes challenged provide that all alcohol sales to consumers be through accountable licensees. Like many other states, Michigan has established a three-tier system of manufacturers, wholesalers, and retailers, who deal in alcohol to be sold in the state.

Such three-tier systems have been upheld as legitimate under § 2. The 5th Circuit Court of Appeals stated, with respect to a similar Texas structure:

> To avoid the harmful effects of vertical integration in the intoxicants industry, the state has effectively restricted manufacturers, wholesalers, . . . and retailers to one level of activity . . . the state of Texas is surely acting within its discretion by placing reasonable restriction on the intoxicants industry in order to prevent these evils.

S. A. Discount Liquor, Inc. v. Texas Alcoholic Beverage Comm'n, 709 F. 2d 291, 293 (5th Cir. 1983) *See also, North Dakota v. United States*, 495 U.S.

423, 432 (1990). (Such three-tier systems are "unquestionably legitimate.") It would be wonderful to advise you that the historical problems of alcohol abuse and misuse that led to Prohibition, the Wilson and Webb-Kenyon Acts, the Federal Alcohol Administration Act, Sec. 2 of the Twenty-first Amendment, and all of the myriad state laws regulating alcohol have been eliminated. It would be pure joy to announce that sales to minors, alcoholism, drunk driving deaths and injuries, drunken assaults and rapes, and toxic alcohol poisoning deaths are all a thing of the past. Unfortunately, these ills continue.

The National Council on Alcoholism and Drug Dependence tells us that 75% of ninth graders have tried alcohol, and that alcohol related deaths are the leading cause of deaths among 15 to 20 year olds. A startling statistic from the Council is that at least 11% of all alcohol consumed nationally is purchased by underage drinkers. Students in junior highs, middle schools and high schools consume an estimated 1.1 billion cans of beer each year. The Wirthland Worldwide study found that 59% of college students under the age of 21 admitted drinking alcohol.

Researchers estimate that alcohol use is implicated in one to two thirds of sexual assault and acquaintance or "date" rape cases among teens and college students. In 1999, it was estimated that the total cost of alcohol use by youth - including traffic crashes, violent crime, burns, drowning, suicide attempts, fetal alcohol syndrome, alcohol poisoning and treatment - was more that $58 billion per year. Nine of Michigan's largest universities filed an amicus brief in the Michigan case challenging direct shipping, on the basis that eliminating the proscription against direct shipping would provide greater access to alcohol by underage college students, most of whom are quite tech-savvy. The Michigan Interfaith Council on Alcohol Problems also filed an amicus brief, asking that the court not overturn the laws because lack of regulation would lead to great public harm. It is sadly apparent that the need for strong alcohol regulation and control continues. The state's ability to regulate alcohol trafficking for the benefit of all of its citizens, should not be eviscerated solely because a number of self-proclaimed wine "connoisseurs" demand the right to have "exclusive" wines delivered to their doorsteps.

Endnotes:

1. Direct shipping is completely prohibited in Alabama, Arizona, Arkansas, Connecticut, Delaware, Kansas, Maine, Massachusetts, Michigan, Mississippi, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, and North Carolina, with the prohibition a felony offense in Florida, Indiana, Kentucky, Maryland, North Carolina, Oklahoma, and Tennessee. So-called "reciprocal" states permit shipments of wine only between each other, but on a limited basis: California [2 cases/mo.], Colorado [2 cases/mo.* on-site sales only], Hawaii [2 cases/year], Idaho [2 cases/mo.], Illinois [2 cases/year], Iowa [2 cases/mo.], Minnesota [2 cases/year], Missouri [2 cases/year], New Mexico [2 cases/mo.], Oregon [2 cases/mo.], Washington [2 cases/year], West North Carolina [2 cases/mo.], and Wisconsin [1 case/year]. A few states permit limited direct shipping without a reciprocal agreement: Alaska ["reasonable quantity"], District of Columbia [1 btl./mo.], Georgia, Louisiana [4 cases/year], Nebraska [1 case/mo.], Nevada [1 case/mo.], New Hampshire [5 cases/year], North Dakota [1 case/mo.], and Wyoming [2 cases/year]. See, Duncan Baird Douglass, Constitutional Crossroads: Reconciling the Twenty-first Amendment and the Commerce Clause to Evaluate State Regulation of Interstate Commerce in Alcoholic Beverages, 49 Duke L.J. 1619, nn. 134-136.
2. There are at least 2,200 wineries nationwide, with the numbers rapidly increasing: Washington State alone has added a new winery every 20 days since 1997. A *Very Good Year for Vintners*, Jerry Shriver, USA Today, June 28, 2002.
3. This should not be construed as a commentary on the merits of any particular alcoholic beverage, but rather, illustrative of the variety and extent of products shipped to Michigan.
4.A number of the shippers made multiple shipments into Michigan - this is why the number of shippers is much less than the number of shipments. BATF has indicated that a producer's violation of a state's importation laws may have a negative impact on the basic federal permit; however, this does not affect retailers.
5.www.teenresearch.com
6. Office of the Inspector General, United States Department of Health and Human Services, *Youth and Alcohol, Law and Enforcement: Is the 21-year-old drinking age a myth?*
7.Scholastic/CNN Newsroom Survey on Student Attitudes about Drug and Substance Abuse.

8. *Alcohol and Tobacco on the Web: New Threats to Youth*, March 1997.
9.*Alcohol Advertising Targeted at Youth on the Internet: An Update*, December 1998.
10. www.winexwired.com/toc.htm
11. www.winebrats.org
12.Randall's Wines & Spirits, a/k/a www/internetwines.com
13.www.wirthlin.com
14. ARAA's members and supporters include, inter alia, the North Carolina Attorney General, Students Against Destructive Decisions (SADD), the National Association of Governors' Highway Safety Representatives, the American Academy of Pediatrics, the North Carolina Alcohol Control Board, the American Council on Alcoholism, and the National Transportation Safety Board.
15. See fn 2.
16.That out-of-state retailers have the same goal of direct delivery is evidenced by the fact that 65% of illegal shipments seized in Michigan were from discount beverage shops, party stores, wine clubs, beer clubs, and other retailers.
17.As with many states, Michigan is in a budget crisis, and is reducing the staff available to handle liquor matters.
18.Oddly, the laws against direct shipping have been condemned as "economic protectionism" for wholesalers. The three-tier systems establishing wholesalers as a distinct tier were set up immediately following the repeal of prohibition. There was no wholesale tier to "protect". Certainly, licensed wholesalers have a long-standing financial investment in the three-tier system, which they would not want to see jeopardized. If the three-tier system has accomplished what was intended, the elimination of the harmful effects of vertical integration, why eliminate the value to the public from the system simply because a cost is associated with providing that value?
19. www.ncadd.org/facts/youthalc.html
20. Office of the Inspector General, United States Department of Health and Human Services, *Youth and Alcohol, Law and Enforcement: Is the 21-year-old drinking age a myth?*
21.www.wirthlin.com
22. Office of the Inspector General, United States Department of Health and Human Services, *Youth and Alcohol, Dangerous and Deadly Consequences.*
23. D. T. Levy, K. Stewart, et al, *Costs of Underage Drinking* (report prepared for the US Department of Justice, Office of Juvenile Delinq

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

JUANITA SWEDENBURG, in her own capacity and as proprietor of SWEDENBURG WINERY, a Virginia partnership; DAVID LUCAS, in his own capacity and as proprietor of THE LUCAS WINERY, a California sole proprietorship; PATRICK FITZGERALD; CORTES DeRUSSY; and ROBIN BROOKS,

Plaintiffs,

-against-

EDWARD F. KELLY, Chairman, and LAWRENCE J. GEDDA and JOSEPH ZARRIELLO, Commissioners, of the State Liquor Authority, Division of Alcoholic Beverage Control, State of New York, in their official capacities,

Defendants,

-and-

CHARMER INDUSTRIES, INC., PEERLESS IMPORTERS INC., EBER BROTHERS WINE & LIQUOR CORP., PREMIER BEVERAGE COMPANY LLC, METROPOLITAN PACKAGE STORE ASSOCIATION, INC., LOCAL 2D OF THE ALLIED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION, and DR. CALVIN BUTTS,

Intervenor-Defendants.

Case No. 00 CV 778 (RMB)

AFFIDAVIT OF HENRY WECHSLER IN SUPPORT OF DEFENDANTS' CROSS MOTION FOR SUMMARY JUDGMENT AND IN OPPOSITION TO PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

STATE OF MASSACHUSETTS)
) ss.:
COUNTY OF NORFOLK)

HENRY WECHSLER, being duly sworn, deposes and says:

1. I, Henry Wechsler of Quincy, Massachusetts, have been asked to provide expert testimony on behalf of the Attorney General of New York State in this case. I am testifying in opposition to changing the current system of alcohol distribution and sales in New York so as to allow direct sales from out-of-state suppliers to New York residents through mail, telephone, and Internet orders. I oppose this change because in my expert opinion it would increase the access of underage youth to alcohol, weaken the current system of controls over underage drinking, and increase underage drinking and the resulting harms. This is the first time I am providing expert testimony despite numerous requests to do so over the years. I am doing so because this is such an important issue.

2. I am a public health researcher specializing in studies of alcohol use and problems among young people. My experience and scholarly work in this field are reflected in my current curriculum vitae, which I have enclosed as exhibit A.

3. I received my Ph.D. degree in social psychology from Harvard University and have been on the faculty of the Harvard School of Public Health since 1966. I have regularly taught courses there on "Alcohol Abuse and Alcoholism from a Public Health Perspective" and "An Introduction to High Risk Behaviors: Epidemiology and Prevention and Public Policy." I have also held appointments as Adjunct Professor at the Boston University School of Public Health and the Simmons College School of Social Work. I was Research Director and Associate Executive Director of the Medical Foundation Inc. in Boston.

4. I have published 17 books and monographs and more than 150 articles in professional journals including the Journal of the American Medical Association, the New England Journal of Medicine, the Journal of Studies on Alcohol, the American Journal of

Preventive Medicine, the American Journal of Public Health, and the Journal of the American College Association. I am a member of the National Institute on Alcoholism and Alcohol Abuse Special Task Force on College Drinking, and I have consulted with a number of colleges and state agencies about student alcohol issues. In Massachusetts I was a consultant to the Governor's Alliance Against Drugs. I have been a keynote speaker at a number of national and state organizations including the American Society of Addictive Medicine, the New York State College Consortium in Alcohol and Other Drugs, the National Conference of State Liquor Administrators New Jersey Summit, the Mother's Against Drunk Driving College Commission, the Association for Medical Education and Research in Substance Abuse, the American Society of Addiction Medicine, the National Association of Student Personnel Administrators, the National Alcohol Beverage Control Association National Alcohol Education Symposium, and the Association of American Colleges and University Program for Health and Higher Education. I also lecture nationally to college administrators, college health personnel and students about binge drinking and other forms of high risk behavior. I am the recipient of the American College Health Association's Clifford B. Reifler Award for my research contributions.

5. I published my first study on the topic of alcohol use in 1969, and since then have published over 50 research articles in professional journals on alcohol and substance abuse. In the 1970s, when most attention was placed on marijuana and other illicit drug use, my research pointed to the greater prevalence and harms resulting from alcohol abuse.

WSWA Survey of Wine Price Data
A Review of Data From FTC Staff Report

Wine	Internet price	Internet price w/ shipping	retail price - small (Congressional)	retail price - medium (Ace)	retail price - large (Total Beverage - Landmark)	average difference in price (Internet price-retail price)	avg. difference in price - shipping included (Internet price-retail price)	notes
Cakebread Cabernet - Napa Valley	$49.00	$69.21	44.95 (4.05/24.26)	not available	not available	$4.05	$24.26	no taxes paid on internet purchase
Cakebread Chardonnay Napa	$45.00	$65.21	42.49 (2.51/22.72)	39..99 (5.01/25.22)	39..99 (5.01/25.22)	$4.18	$24.39	no taxes paid on internet purchase
Cuvaison Chardonnay Carneros	$21.95	$36.95	not available	20.99 (.96/15.96)	19.99 (1.96/16.96)	$1.46	$16.46	no taxes paid on internet purchase
Duckhorn Merlot - Three Palms	$75.00	$92.38	not available	not available	not available	n/a	n/a	4.5% tax included on Internet purchase; product done in limited alottments - typically to restaurants
Duckhorn Sauvingon Blanc	$22.00	$36.99	24.49 (-2.49/12.50)	26.99 (-4.99/10)	22.99 (-.99/14)	-$2.82	$12.17	4.5% tax included on Internet purchase
BV Rutherford Cabernet	$27.99	$36.47	22.99 (5/13.48)	20.99 (7/15.48)	18.99 (9/17.48)	$7.00	$15.48	via wine.com, no taxes paid on Internet purchase
Jordan Chardonnay	$26.00	$45.00	28.99 (-2.99/ 16.01)	29.99 (-3.99/ 15.01)	21.99 (4.01/23.01)	-$0.99	$18.01	no taxes paid on internet purchase
Kendall-Jackson Vinters Reserve Cabernet	$16.00	$29.50	14.99 (1.01/14.51)	17.99 (-1.99/ 11.51)	12.99 (3.01/16.51)	$0.67	$14.18	no taxes paid on internet purchase
La Crema Pinot Noir	$24.00	$37.50	24.99 (-.99/12.51)	14.99 (9.01/22.51)	12.99 (11.01/24.51)	$6.34	$19.84	no taxes paid on internet purchase
Murphy Goode Fume Blanc Reserve	$15.99	$24.47	not available	17.99 (-2.00/ 6.48)	14.99 (1.00/9.48)	-$1.00	$7.98	via wine.com, no taxes paid on Internet purchase
Stags Leap Cabernet - Napa	$40.00	$57.47	44.99 (-4.99/ 12.48)	47.99 (-7.99/ 9.48)	44.99 (-4.99/ 12.48)	-$5.99	$11.48	no taxes paid on internet purchase