Competitive Effects of the Proposed Legislation

Ohio law has created a "three-tier" wine distribution system. Ohio law prohibits suppliers (the first tier) from selling their product directly to retailers (the third tier).[20] Instead,

with a non-performing incumbent wholesaler. Further, the exclusive territory requirement limits suppliers' freedom to respond to changes in market conditions. For example, the requirement prevents a supplier from combining territories to achie

protecting consumer welfare, rather than protecting competitors from "too much" competition.[27]

B. Increase in Competition Among Wine Suppliers

As explained below, the incentives of suppliers and wholesalers to engage in activities designed to enhance demand for the suppliers' products are likely to differ. For example, wholesalers are unlikely to promote a specific brand as vigorously as the supplier would wish. Suppliers therefore typically contract with wholesalers to require them to take certain demand-enhancing actions with respect to the suppliers' products. By decreasing the cost associated with terminating wholesalers, the Proposed Legislation is likely to increase wholesalers' incentives to take such demand-enhancing actions. Further, by eliminating mandatory exclusive territories, the Proposed Legislation is likely to reduce suppliers' distribution costs. The net result thus is likely to be more intense competition among suppliers, to the benefit of consumers.

1. Suppliers' and Wholesalers' Incentives to Increase Sales Are Likely to Differ

Suppliers (such as wine manufacturers) typically treat distribution as one of many inputs involved in getting a final product to consumers. And as is the case with other inputs, suppliers want to receive the best distribution services at the lowest possible prices to allow them to compete more effectively against their rivals for consumers' business. Wholesalers, however, typically care less about stimulating sales of a particular brand than suppliers do.[28] Suppliers tend to benefit more than wholesalers when wholesalers increase demand for the suppliers' product. A consumer who discovers a wine supplier's brand due to wholesaler effort (perhaps by providing point-of-sale information or negotiating better product placement), for example, will continue to purchase the brand regardless of which wholesaler supplies it; although the supplier has gained a new customer, that new customer has no allegiance to the wholesaler. Consequently, competing wholesalers that do not provide demand-enhancing services could benefit when another wholesaler creates demand for a particular brand: the so-called "free-rider" wholesaler could charge retailers lower wholesale prices for the brand because they do not have to cover the costs of demand-enhancing efforts – and capture the increased demand.[29] Of course,

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[27] *Cf. Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977) (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962)) (Congress designed the antitrust laws for "the protection of competition, not competitors").

[28] *See* Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement (See)Tj/TT0eec((Se)Tj2.16 .87(ti)T*

knowing that other wholesalers may free-ride on its effort, a distributor is not likely to engage in high levels of sales-generating activities in the first place. This is likely to reduce product information available to consumers in the marketplace and ultimately consumer purchases.

Additionally, because a wholesaler does not reap the full benefit of a supplier's reputation, it is likely to have less incentive than the supplier to maintain a level of quality associated with a particular brand. When this happens, consumers pay for more quality than they actually receive, and thus are unlikely to purchase the supplier's product again. For example, when a consumer does not enjoy a wine because it has not been handled properly and consequently decides not to purchase that particular brand again, the supplier loses all of that customer's potential future purchases, regardless of where they are made.[30] The wholesaler, by contrast, loses only the future sales to that customer that would have been made by retailers that the wholesaler supplies.

Further, when a supplier's profit margin for an additional sale is large in relation to the wholesaler's, the wholesaler rationally will not provide as much effort in securing an additional sale as the supplier would desire, meaning that undecided consumers are less likely to receive product information that they may find valuable in making purchase decisions.

Wholesale pricing also affects the demand for a supplier's product. As discussed above, from the supplier's point of view, the cost of the services that a wholesaler provides are but one part of the final price that consumers pay. As with other costs, suppliers would like the costs of distribution to be as low as possible to make their product more competitive. Typically, the price that wholesalers charge retailers – which includes both the price of the supplier's product plus the cost of distribution – will be higher than the price that a supplier would set if it distributed the product itself. This is because the wholesale price is likely to include a markup over the cost of distribution, which the supplier would not charge retailers if it distributed its own product.[31]
When a supplier's product is marked up twice, this ultimately leads to higher retail prices and

eliminate or mitigate such opportunistic behavior. *See*, *e.g.*, Benjamin Klein, *Exclusive Dealing as Competition for Distribution "on the Merits*," 12 G2 would lik,i5nQ prices and

concomitantly lower rates of output.[32]

2. Vertical Arrangements Can Mitigate Misaligned Incentives

Because wholesalers are unlikely to promote a specific brand as vigorously as the supplier would wish, suppliers and wholesalers typically enter into agreements that require wholesalers to take certain actions designed to enhance competition with competing brands. For example, contracts may include quality standards or sales quotas to limit wholesaler markups. They also may include exclusive territory provisions designed to provide wholesalers with additional incentives to provide sales-generating efforts[33] or exclusive dealing requirements to focus dealer efforts on the supplier's – rather than a rival's – product.[34] As many economic studies ha.830 Tc 10cl.Tf0 d

vertical contracts can intensify competition among suppliers,[36] which benefits consumers with lower prices and improved quality.[37]

3. Decreasing the Cost of Terminating a Wholesaler Is Likely to Increase Wholesalers' Incentives to Provide Demand-Enhancing Services

As discussed above, by prohibiting a supplier from terminating (or failing to renew) a contract with a wholesaler except for "just cause," current Ohio law limits a supplier's ability to ensure that wholesalers take actions to increase the demand for the supplier's products.[38] By eliminating the just cause requirement, HB 306 would decrease the cost – and thus increase the feasibility – of terminating (or not renewing) a wholesaler. Absent a credible warning of termination (or non-renewal) by the supplier, wholesalers have less incentive to stimulate demand as their contracts require.[39] An increase in the ability of suppliers to control wholesalers' activities is likely to provide Ohio consumers with the lower prices, increased output, and better quality that result from more intense competition among wine brands.

4. Easing of Termination Restrictions May Increase Small Suppliers' Abilities to Compete with Large Suppliers

The current termination requirements in Ohio law may affect smaller suppliers to a greater extent than larger suppliers because larger suppliers may be in a better position to incur the legal costs typically associated with a wholesaler termination and thus have a greater ability to exercise control over wholesalers. Established brands that advertise heavily, moreover, may not rely as much on wholesaler effort. Consequently, the Proposed Legislation may lead to more variety as smaller suppliers find it less difficult to market their product than they currently do.[40]

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[36] *See, e.g.*, *State Oil Co. v. Khan*, 522 U.S. 3 (1997); *Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717 (1988); *Monsanto Co. v. Spray-Rite Serv. Corp.,* 465 U.S. 752 (1984); *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977).

[37] *See Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 695 (1978) ("ultimately competition will produce not only lower prices, but also better goods and services").

[38] *See* James A. Brickley *et al.*, *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101, 113 (1991) (analysis of case law supports the premise that termination laws increase the cost of termination and non-renewal); *see also* Tracey A. Nicastro, *How the Cookie Crumbles: The Good Cause Requirement for Terminating a Franchise Agreement*, 28 VAL. U. L. REV. 785, 796-98 (1994) (cataloging several courts' interpretations of "good cause" that limit a franchisor's ability to terminate franchisees).

[39] In an extreme example of wholesaler non-performance, a wholesaler may refuse to supply retailers with the supplier's product at all (*i.e.*, "park" the brand). In these situations, consumers in the wholesaler's territory are deprived of the product altogether.

[40] Yet another source of greater variety for Ohio wine consumers is direct shipment of out-of-state (and in-state) wines purchased online. In a 2003 report, the Commission staff found that, among other things, consumers can purchase many wines online that are not available in local retail stores, and that, depending on the circumstances,

Further, to the extent that larger suppliers have brands that compete with small suppliers' brands, if the Proposed Legislation lowers small suppliers' distribution costs relatively more than it lowers large suppliers' distribution costs, it may have the effect of increasing the aggressiveness of large suppliers' pricing f

of goods.[42] HB 306 is thus likely to decrease the transaction costs for wholesalers and retailers of wine in Ohio. This reduction may be especially beneficial to smaller wholesalers and retailers, who may have more difficulty than their larger rivals in meeting the currently mandated cash requirement. Any reductions in transaction costs at the wholesale and retail levels, in turn, are likely to lead to reductions in the final prices paid by consumers.

Conclusion

HB 306 is likely to increase wholesalers' incentives to become more efficient, and to lower their prices and provide important demand-enhancing services for their suppliers' brands. HB 306 is therefore likely to decrease the costs of wine distribution and to increase competition among both wholesalers and suppliers. Further, HB 306 may disproportionately lower the distribution costs of smaller suppliers, potentially increasing competition among certain wine brands. Consequently, if the Proposed Legislation were enacted, Ohio consumers would likely pay lower prices for wine and may enjoy more variety. We urge the Ohio Legislature to take into account these likely effects on consumers when considering HB 306.

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[42] *See, e.g.*, Mitchell A. Petersen & Raghuram G. Rajan, *Trade Credit: Theories and Evidence*, 10 REV. FIN. STUDIES 661, 665 (1997) ("Trade credit may reduce the transaction costs of paying bills. Rather than paying bills every time goods are delivered, a buyer might want to cumulate obligations and pay them only monthly or quarterly. This will also enable an organization to separate the payment cycle from the delivery schedule.") (citation omitted); J. Stephen Ferris, *A Transactions Theory of Trade Credit Use*, 96 Q.J. ECON. 243, 244 (1981) ("[T]rade credit may arise as a way of lowering the exchange costs by separating the exchange of goods from the exchange of money.").

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