Testimony of Jessica Oski, Necrason Group, Lobbyists for Vermont Brewers Assoc.

I am going to speak briefly about why the Vermont Brewers Association is advocating for legislation to reform Vermont beer franchise laws. I am then going to briefly discuss some of the changes that were made in the House. Finally, I am going to discuss the changes that the VBA would like this committee to consider to H.710.

Included with my testimony is the Vermont Brewers Association mark-up of H.710. In the interest of time I am only going to discuss the major policy proposals we are advocating for and not the more technical changes in the mark-up. When you get into mark-up, I am happy to review our other proposed amendments as needed.

You might have heard a little bit about the franchise law from Leg Counsel so you may know that franchise laws were not an original feature of the post-prohibition three-tier system. Vermont's beer franchise law was adopted in 1975 when large brewers *(e.g. Anhueser-Busch, MillerCoors, PBR)* dominated their smaller distributers. This meant that typical contract laws that govern most all business relationships were not enough to protect distributors, who were at that time in a decided power disadvantage. Consequently, legislators rethought the beer market and adopted protections to level the playing field for our small distributors. **Beer franchise laws, which are a special privilege for beer distributors above and beyond general business laws, leveled the economic playing field and allowed smaller distributors to operate without fear of larger brewers abusing their more powerful market position.**

Today's beer market calls for a **similar rethink on how to address market power imbalances between large beer distributors and small brewers**. Although the vast majority of brewer-distributor relationships are positive, like marriages, there are exceptions. In limited cases distributors may sit on craft brewer brands, neglecting them while not allowing them to move to another distributor. In addition, the distribution needs or desires of a craft brewer may change as their business grows. In these cases, current law prohibits small brewers from fairly and adequately addressing their business's needs, offering extremely limited recourse, not even divorce.

Vermont's beer marketplace is very different today than it was in 1975, but our franchise laws are still in place and are enforced against not just the big breweries that were the intended target of the law, but they are enforced against, and they burden the small craft brewing industry.

The question or problem that this bill seeks to address is: Are Vermont's franchise laws still necessary? Do distributors need statutory protection from and advantages over small brewers? We believe the answer is No – distributors do not need statutory protections or advantages over small brewers.

As introduced, H.710 defined a small brewer as a brewer that produced 300,000 barrels or less per year. As introduced, H.710 exempted small brewers from all of the provisions of Vermont's beer franchise law as of January 1, 2022. After that date, contract law would apply. During the transition period, from July 1, 2018 to January 1, 2022, small brewers could terminate without

cause by giving notice and paying their distributor compensation equal to the average gross profits earned by the distributor from selling the brewers product over the last 3 years. (We borrowed that definition of compensation from Delaware law).

In the House, we agreed to a number of the distributors concerns. We agreed to reduce the amount of change (leaving in place a number of aspects of current franchise law, including Prohibited Acts and Exclusive Territories) and extended the effective dates.

We were not willing to compromise on the principal that we seek to achieve through franchise law reform. **Our goal remains - that small brewers and distributors should be free to negotiate enforceable contracts that govern the terms of their relationship, including and most importantly, termination of their relationship.**

So now to our proposed changes:

Definition of Small Brewer. When we discuss amending Vermont's franchise laws, it is important that throughout the discussion we keep in mind the purpose of the laws. **The purpose of Vermont's beer franchise laws was to correct the imbalance between the very large breweries and the small distributors by creating statutorily mandated protections for distributors.** There is no public policy reason to apply franchise laws to small brewers.

The question is what size brewer does a distributor not need protection from? What size brewer is so big that it can wield power and unfairly manipulate a distributor in the marketplace? The purpose of the law is to prevent that kind of market influence.

The VBA believes the answer to that question is, at a minimum, **a brewer that brews 300,000 barrels or less.** The House settled on 50,000 barrels or less and 3% or less of portfolio. The VBA urges this committee to return to the 300,000 barrels that was in the bill as introduced. **Why 300,000 barrels or less?**

U.S. Brewery Production by Size of Brewery 2017

Barrels (31 gallons)	Number of Breweries	Share by Size	Barrels of Beer	Share by Volume
6,000,001 Barrels and Over	15	0.3%	124,049,347	72.6%
2,000,000 to 6,000,000 Barrels	5	0.1%	16,092,811	9.4%
1,000,001 to 1,999,999 Barrels	4	0.1%	4,897,091	2.9%
500,001 to 1,000,000 Barrels	10	0.2%	5,720,118	3.3%
100,001 to 500,000 Barrels	40	0.7%	6,811,548	4.0%
60,001 to 100,000 Barrels	41	0.7%	2,714,929	1.6%
30,001 to 60,000 Barrels	53	0.9%	1,940,813	1.1%
15,001 to 30,000 Barrels	99	1.8%	2,239,986	1.3%
7,501 to 15,000 Barrels	152	2.7%	1,556,842	0.9%
1,001 to 7,500 Barrels	1,030	18.2%	3,626,288	2.1%
1 to 1,000 Barrels	3,646	64.6%	1,003,361	0.6%
Under 1 Barrel	553	9.8%	107,494	0.1%
Total	5,648	100.0%	170,760,628	100.0%

If you look at the data, an argument could be made that **a brewer producing 500,000 barrels or**

less is not large enough to unfairly wield influence in the marketplace. In 2017, 34 US breweries produced more than 500,000 barrels and accounted for **88.2 % of the marketplace by volume. These are the LARGE brewers. They were in 1975 and they are today.**

Brewers producing 500,000 barrels or less make up only **11.7%** of the US marketplace by volume. **These are the small brewers. These are the brewers that lack the ability to unfairly manipulate the marketplace.**

New York has a 300,000 barrel (and 3% of portfolio) volume limit, so the VBA decided that 300,000 barrels or less was a fair way to define a small brewer – one that distributors do not need protections or advantages over as they are not large enough to wield undue influence in the marketplace.

I want to flag here that the distributors may argue that a 300,000 barrel limit, which would more than cover all Vermont based brewers and many others in New England, could present a dormant Commerce Clause issue. We have studied that question and disagree. I won't bore you with those details now, but I will send notes on the subject to leg counsel.

% of portfolio. In the House, as part of defining what a small brewer is, the distributors also asked for a % of portfolio qualifier to be added to the barrelage amount to further qualify or limit the number of brewers that are considered small. As passed by the House, a small brewer is defined as a brewer that annually produces 50,000 barrels or less AND is 3% or less of the distributors portfolio. The VBA asks this committee to remove the percentage of portfolio qualifier for the following reasons:

1 There is no independent way for a brewer to know what % they are. In Vermont, this information is proprietary,
2 Distributors could manipulate their portfolio to reduce small brewers % of portfolio. Ex. They could spin off subsidiaries that handle only small craft brands, and
3 % could fluctuate regularly and possibly wildly.
4 % of portfolio favors largest distributors and will work to stifle competition from smaller distributors

Distributors will argue that the definition of small brewer should be based on the impact that a change in the law will have on their business model, which has relied for 40 years on their ability to lock all brewers in to life-long relationships and control those relationships, regardless of the benefits or needs of the brewers. Again, we urge the committee to evaluate size based on the purpose of franchise law.

If you do decide to include a % of portfolio, we would like to offer some amendments related to how a distributor's portfolio is measured and defined and some transparency of portfolio requirements so that a brewer will know at all times what percentage of portfolio they are.

COMPENSATION

As passed by the House, during the transition period during which small brewers and distributors will be moving toward enforceable written contracts, H.710 allows a small brewer to terminate their relationship with their distributor by providing notice and paying compensation related to losing the right to distribute the brewer's product. The House defined compensation to be 5 times the distributors annual gross profits from the sale of the brewer's product. The VBA believes that 5 times is excessive. We understand that there will be winners and losers under any defined compensation formula, but we think a more thoughtful and fair calculation should be closer to 2 times gross. Remember the distributor doesn't own the brewery, just the right to distribute their product.

Distributors will talk about their need to recover their investments. We need to dig into that statement a bit. When a brewer starts their business, they invest a lot of capital in equipment, supplies, marketing, staff – just like other manufacturing businesses. When they sell their product to a distributor, they mark it up from cost to (hopefully) generate a margin that contributes to the recovery of their investment and eventually returns a profit. When the distributor sells the beer to the retailer, they mark it up, usually between 25 – 35% in order to generate a margin that contributes to the recovery cost of their investments (marketing, trucks, warehousing, staff…) and returns a profit. And the retailer marks up the cost when they sell to the consumer. All the parties make investments in their business. The investments that distributors make are not any greater than the investments that the brewer or the retailer make.

If a brewer wants to leave a relationship with a distributor, 2 times annual gross is fair and reasonable. Five times gross is an unreasonably high bar.

TRANSITION PERIOD

The VBA would also like to see a change to the transition period. Under the House bill, franchises in existence as of January 1, 2019 will not be able to avail themselves of termination without cause until either**:** they negotiate a written contract with their distributor that includes a termination without cause provision**; or** until July 1, 2022 on which day their franchise will automatically terminate if there is no written agreement and the brewer will have to pay the distributor compensation. New distribution agreements entered into after January 1, 2019, that are not in writing or do not include termination provisions will be able to use the termination without cause provisions – but would still need to have their agreements set in writing by July 1, 2022.

The VBA believes that brewers in existing franchise relationships need the option of termination without cause as leverage as they negotiate written contracts with their distributor during the transition period. The VBA believes this is critical and that without this leverage, the effort to transition away from franchise law to enforceable contracts could be a disaster. The VBA is worried that a distributor could sit on or neglect a low performing brand for four years, take a payment and cut ties.

CONCLUSION

Many of you have already heard from distributors about this bill. And you are going to hear from distributors again today that they are very much opposed to this bill. They fear it will hurt their business.

The Vermont Brewers Association is not promoting this reform because we want to hurt distributors. Far from it. Of the 20 or so VBA members that do distribute their beer through a wholesaler, they each consider their distributor to be their partner. The distributor is their lifeline to the marketplace.

H.710 is not about hurting distributors. It is about a long overdue evolution of public policy. Growing pains are hard. Our goal is not to hurt anyone. This isn't about distributors doing a bad job.

This is about encouraging and stimulating innovation and competition in the marketplace.

We understand that the distributors have relied on the benefits and security of franchise law for a long time. It's now time for change.

And, this change should not come as a surprise. Vermont is not first in the nation to seek this change. It was just a matter of time before franchise reform would come to Vermont. Vermont is the craft brew capital of the world (I might be embellishing, but not much!). Our neighbors in Massachusetts have been considering franchise reform for a few years, and our neighbors in New York adopted franchise reform a few years ago. Arkansas, Colorado, Nevada, Rhode Island, Washington, Illinois, New Jersey, and North Carolina have all decided to unleash craft brewers from the stifling unfairness of franchise law.

I doubt the distributors in those states welcomed change there either. Businesses survived.

Franchise laws were enacted to protect wholesalers from the undue bargaining power of their largest suppliers.

Applying those laws to the relationship between a small brewer and the wholesaler is unfair and against free market principles.

The VBA believes that small brewers and wholesalers should be free to establish enforceable contracts that both parties agree are fair and equitable.

The VBA looks forward to working with the distributors and this committee to address their reasonable concerns as this legislation moves forward.

NOTES
Other States

To date, at least 10 states have adopted some form of relief from franchise laws for small brewers, with bills pending in a handful of other states. Another 6 states have NO franchise laws in place, or have a hybrid law that essentially acts to relieve craft brewers from franchise regulation. A number of states are actively debating these issues.

- **States with no franchise law or a hybrid/limited law:** Alaska, Hawaii, California, Montana, Oklahoma (franchise law only applies to "low-point" beers - less than 3.2%ABW), Delaware (allows no cause termination upon payment of reasonable compensation) and District of Columbia.
- **States with small brewer carve out from franchise law:** Arkansas (fewer than 30,000 barrels exempted from the law), Colorado (franchise protection do not apply to brewers producing less than 300,000 gallons), Nevada (less than 2,500 barrels), Rhode Island (all RI brewers), Washington (less than 200,000 barrels)
- **States with a small brewer carve out that allows termination upon FMV payment:** Illinois (10% or less of wholesaler's total volume for all beer), New Jersey (less than 20% of wholesaler's gross sales), New York (less than 300,000barrels produced or no more than 3% of wholesaler's total sales volume), North Carolina (fewer than 25,000 barrels).