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## Liquor laws go on trial in Costco's tangle with state

Some retailers fear deep discounts if wholesaler wins lawsuit

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Most beer and wine in Washington travels a long, complicated route from the producer to the consumer.

Defining that path are state laws promoting temperance, which were crafted in response to the repeal of Prohibition. By erecting barriers against the free flow of beer and wine, the state meant to ensure that prices would remain higher than in a free market.

Higher prices, the state claims, discourage abuse.

But Costco Wholesale Corp., in a lawsuit that goes to trial today before U.S. District Judge Marsha Pechman, is challenging the Washington State Liquor Control Board and its regulations. The Issaquah-based retail giant says the laws are an unfair restraint on trade, a claim that the court has supported in prior rulings.

The legal battle has already resulted in some changes: Out-of-state beer and wine producers may now ship directly to retailers, as their in-state counterparts do.

That now-defunct disparity was part of Costco's lawsuit -- until a Supreme Court decision on a similar case in New York and Michigan caused Pechman to find the prior prohibition unconstitutional and send it to the Legislature for resolution.

What remains to be decided is whether other price-boosting regulations are defensible under the 21st Amendment, which repealed Prohibition and gave states the right to control the distribution and sale of alcohol within their borders.

In Washington, Costco and other retailers can't negotiate for discounts on their large volume purchases. Whether the order is one bottle, or 10,000 cases, the price per bottle is the same.

Nor can Costco use its own warehouses to store the wine -- state laws say that distributors must bring the goods directly to each store for a state-mandated price markup of at least 10 percent. Producers must also charge at least 10 percent above cost to distributors.

The state says that helps small retailers stay in business, because they don't have to wrangle over prices with suppliers in competition with behemoths such as Costco. Costco says that was not the aim of the 21st Amendment.

Also ranking Costco is the fact that the Liquor Control Board can and does employ the business practices that it denies other retailers who compete with its wine sales.



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Joshua Trujillo / P-I

Linda Stoner browses the wine selection at a Costco Wholesale in Seattle.

Still, far more than retail prices is at stake, say industry observers.

"There are so many individual artisan wineries that in an environment where there is an unbelievable pressure to discount, I am not sure that it would not seriously hurt the small or midsize wineries," said Bill Nelson, the president of Wine America, a national association of American wineries. "If you whittle it down to just a few big suppliers, a low-cost producer may not be able to survive."

In the past decade, the number of state wineries has exploded from 80 to 400 -- but the share of in-state wine sales by Washington vintners has held steady, hovering at around 17.8 percent of the volume sold.

Gary Jackson owns St. Hilaire Cellars, which bottles wine produced by other wineries as private-label vintages for businesses and events. While he thinks his niche business won't be affected, he does not support Costco's position.

"I think this could be the end for many wineries in the state of Washington because virtually all are too small to compete with Gallo or Mondavi," Jackson said. "Their wines are probably every bit as good, but they do not have money and marketing muscle to go head-to-head with big ad campaigns and serious volume discounting."

The problem is not Costco, which Jackson said doesn't put that many wines on its shelf, but the combined force of other major retail chains such as Safeway, Kroger and Wal-Mart, which would respond to a Costco victory by putting downward pressure on the prices charged by their suppliers and producers.

Most Washington wineries are extremely small and could be beneath the radar of the grocery chains. But the industry has an estimated \$3 billion annual impact on the state, and it contributes 14,000 wine-related full-time jobs, according to the Washington Wine Institute.

"I would say that the wine industry is not afraid of competition," said Marty Clubb, whose L'Ecole No. 41 winery in the Walla Walla Valley produces 30,000 cases per year. "Most products are traded freely. Why shouldn't it be the case for wine? I certainly don't feel the government has to step in and make rules for my winery."

Clubb said he would expect some wineries to close, but "I think many of these changes would help the consumer."

That, says the Washington Beer & Wine Wholesaler Association, depends on how you look at it. The trade association represents distributors in Washington and is fighting the lawsuit alongside the Liquor Control Board.

The distribution industry employs 3,000 people in Washington but is already consolidating, following a national trend.

"Beer and wine ought not to be sold at loss-leader prices like potato chips," said Phil Wayt, the wholesaler association's executive director. "We'll have to see who survives and how the system works, but I think the important thing is that there may be less distributors, and ultimately consumers will see less choice than they have now."

Some retailers, such as Fred Andrews, who has owned Madison Park Cellars for 20 years, hope that isn't true.

Andrews hopes that his bevy of older and rarer vintages will buffer his shop from any increased competition that Costco's lawsuit may bring to the regulatory system.

But he believes that Costco's fight is unlikely to end with beer and wine: "They are looking for liquor as the next step."

## WHAT'S AT STAKE

The 21st Amendment repealed Prohibition and allowed states to govern the sale and distribution of alcohol within their borders. Costco is suing the Washington State Liquor Control Board to change the current state system. Regulations that the state will try to defend under the 21st Amendment include:

- A ban on high-volume discounts.
- A mandatory 10 percent markup from producer to distributor and distributor to retailer.
- A ban on central warehousing. \_\_\_\_\_ (Currently, deliveries must be made by distributors to each store, instead of to a retailer's central warehouse.)
- Prices that must be posted simultaneously and remain in place for 30 days.
- A ban on variations in prices to different retailers.
- A ban on credit sales: All deliveries are cash only.

### Wineries

Washington is the second-largest wine producing state in the United States. The state's wine industry has grown with many wineries opening every year; still, the vast majority of wineries in Washington produces less than 5,000 cases per year.

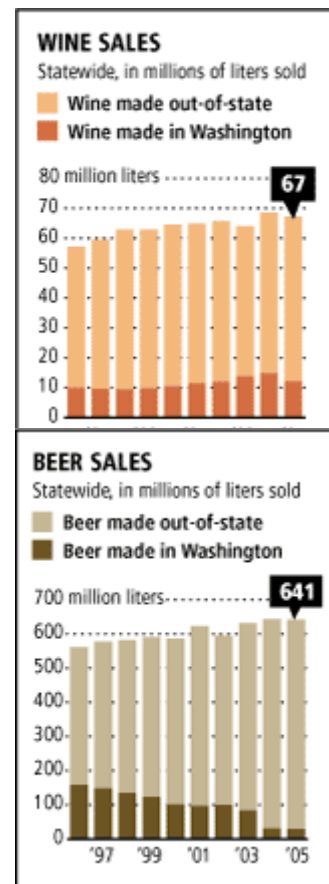
Producers say that the effect of regulatory changes would vary according to the size of the winery and quality of its product.

### Breweries

Beer sales are stagnant locally and nationally. In Washington, the state's breweries are losing market share to out-of-state producers. Most Washington breweries are small production microbreweries.

It's unclear what impact this case would have on them, though the chief executive of Redhook Ale Brewery has expressed support for the current system.

### Liquor Control Board



The state's Liquor Control Board says the three-tier distribution system keeps prices high enough to discourage alcohol abuse, so it's protected under the 21st Amendment. It also says that the system facilitates the collection of taxes and maintains an orderly marketplace.

The Liquor Control Board does not track the total dollar amount of beer and wine sales in Washington, but it pulled in \$49.2 million through its producer taxes alone last year.

## Costco

Costco Wholesale Corp., the largest U.S. wine merchant, says state beer and wine laws keep it from using large volume buys to get cheap prices and using its warehouses for distribution. It's also challenging a three-tier distribution system that requires producers and distributors to mark up prices.

If it prevails, some smaller retailers fear increased competition; others say they specialize enough to differentiate from Costco.

## Distributors

The Washington Beer & Wine Wholesalers Association, representing the majority of the state's estimated 75 distributors, is an intervenor defendant on the side of the Liquor Control Board. It says if the system is changed, smaller distributors will go under - giving consumers less choice. Most wineries and breweries say they will continue to use distributors whether or not their status is guaranteed by law.

**Note:** Military sales are excluded from accompanying charts.

**Sources:** Costco Wholesale Corp. and Washington State Liquor Control Board

