Economic Impact Analysis
Virginia Department of Planning and Budget

3 VAC 5-40 and 3 VAC 5-70 – Direct Shipment Rules

Department of Alcoholic Beverage Control

June 22, 2004

The Department of Planning and Budget (DPB) has analyzed the economic impact of this proposed regulation in accordance with Section 2.2-4007.G of the Administrative Process Act and Executive Order Number 21 (02). Section 2.2-4007.G requires that such economic impact analyses include, but need not be limited to, the projected number of businesses or other entities to whom the regulation would apply, the identity of any localities and types of businesses or other entities particularly affected, the projected number of persons and employment positions to be affected, the projected costs to affected businesses or entities to implement or comply with the regulation, and the impact on the use and value of private property. The analysis presented below represents DPB's best estimate of these economic impacts.

Summary of the Proposed Regulation

Section §4.1-103 of the Code of Virginia provides the Alcoholic Beverage Control Board with the authority to grant, suspend, and revoke licenses for the manufacture, bottling, distribution, importation, and sale of alcoholic beverages and to do all acts necessary or advisable to carry out the purposes of Title 4.1 (Alcoholic Beverages and Industrial Alcohol). Specifically, Chapter 1029 of the 2003 Acts of Assembly amended §4.1-112.1 of the Code of Virginia to allow for the direct shipment of up to two cases of wine and two cases of beer per consumer per month and authorized the Alcoholic Beverage Control Board to promulgate regulations necessary to implement the provisions of the Code.

The proposed regulation establishes procedures and requirements for licensure as a wine or beer shipper, including the application procedure, minimum recordkeeping requirements, and a monthly reporting process for the payment of wine and beer taxes. All shipments of wine and beer to consumers are to be by common carriers approved by the Alcoholic Beverage Control

Board. The regulation establishes approval procedures and requirements. Finally, the proposed regulation also requires manufacturers who apply for or consent to a shipper's license to notify all wholesalers authorized to distribute their brand of the application and to ensure that all wine and beer intended for direct shipment meet the label approval requirements specified in the regulation.

Estimated Economic Impact

Chapter 1029 of the 2003 Acts of Assembly amended the Code of Virginia to allow for the direct shipment up to two cases of wine and two cases of beer per month per consumer. Prior to this amendment, only in-state retailers were allowed to ship wine and beer directly to consumers. There was no limit on the number of cases of wine and beer in-state retailers could ship to consumers. The amendment to the Code followed a 2001 ruling by a U.S. Magistrate Judge and a 2002 ruling by a federal judge in Virginia that the state's direct shipment ban on out-of-state manufacturers and retailers was unconstitutional as it discriminated against out-of-state sellers. There has been similar litigation in other states, with mixed results. While the direct shipment ban has been ruled unconstitutional in states such as Virginia and North Carolina, it has been upheld in states such as Indiana and Florida. The battle is currently ongoing.

Description of the Regulation:

The proposed regulation establishes procedures and requirements for licensure as a wine or beer shipper. The application process requires the submission of an application form, a list of wines and beers sought to be shipped directly to consumers (the regulation allows shippers to add or delete brands from the list submitted at the time of application), a consent letter from the owners of brands sought to be shipped when the applicant for the shipper's license is not the owner (the regulation allows manufacturers to withdraw consent by submitting, to the shipper and to ABC, a letter to the effect), a copy of a current winery, farm winery, brewery, or alcoholic beverage retailer license, and evidence of the applicant's registration with the Virginia Department of Taxation for the purposes state wine and beer tax collection. All licensees are required to submit a monthly report detailing activity for the previous month and making a payment for the appropriate amount of wine or beer tax on or before the 15^{th} of each month. Licensees are also required to maintain records of all shipments for a minimum of two years, including the number of containers shipped, the volume and brand of each container shipped, the price charged, and the name and address of the recipient. The records are to be made available for inspection upon request of the Alcoholic Beverage Control Board. Finally, licensees are required to affix on all packages of wine and beer intended for direct shipment to consumers a notice indicating that the package contains alcoholic beverages. The regulation specifies the size, content, and location of the notice.

All shipments of wine and beer to consumers are to be by common carriers approved by the Alcoholic Beverage Control Board. The regulation establishes approval procedures and requirements. In order to apply for approval, common carriers are required to have the necessary licenses and permits for operating in Virginia. Approved common carriers are required to submit quarterly reports detailing activity for the previous quarter on or before the 15th of January, April, July, and October. Approved common carriers are also required to maintain records for all shipments for a minimum of two years, including the date of shipment and delivery, the number and weight of items shipped and delivered, the name and address of the shipper and the recipient, and an acknowledgement of receipt by the recipient. Finally, approved common carriers are required to ensure that all recipients are at least 21 years old by requiring proof of age at the time of delivery and a signed acknowledgement of the receipt of delivery. All packages of wine and beer intended for direct shipment are to have the required notice indicating that the package contains alcoholic beverages prior to be being accepted for shipment by the common carrier.

The proposed regulation also requires manufacturers who apply for or consent to a shipper’s license to notify all wholesalers authorized to distribute their brand of the application. Manufacturers are also required to ensure that all wine and beer intended for direct shipment meet the label approval requirements specified in the regulation. Labels are required to conform to federal label approval requirements. Unlike wine and beer sold at retail establishments around the state, labels on wine and beer intended for direct shipment are not required to meet any Virginia-specific label requirements. According to ABC, Virginia label requirements include a number of factors, such as the appearance of lewd or obscene matter on the label, that are not included in the federal requirements. However, in the case of alcohol that does not appear on store shelves and is shipped directly to consumers, factors such as label appearance are not essential to the public interest.

An emergency regulation to this effect has been in place since July 2003.

Estimated Economic Impact:

Fee Analysis: Apart from meeting the requirements of the regulation mentioned in the previous section, applicants for a wine or beer shipper's license will be required to pay an annual $50 license fee. The fee is intended to cover costs incurred by the Department of Alcoholic Beverage Control (ABC) in administering the program, including the processing of applications, the review of reports submitted by licensees and approved common carriers, and the monitoring required to ensure compliance with the regulation. The agency has issued 226 licenses to-date and the application processing, report review, and tax collection has been handled without any additional resources. ABC intends to use existing label approval and tax collection staff at the agency to administer the program.

Businesses and individuals involved in the direct shipment of alcohol to consumers have the potential to create public health and safety hazards as a result of conducting their activities in an improper or inappropriate manner. For example, improper and inappropriate business practices could result in alcohol being sold to minors. The aim of the proposed regulation is to enforce certain compulsory minimum standards for shipping licensees and approved common carriers such that the risk to public health and safety from their activities is reduced to a level deemed appropriate. The cost of obtaining a license can be viewed as part of the compliance cost incurred by a business or an individual to ensure that they do not jeopardize public health and safety.

Thus, while licensed shippers and approved common carriers will incur costs in meeting the requirements of the regulation, they will also reap the benefits of alcohol being shipped directly to consumers in Virginia. The costs incurred can be viewed as part of the compliance cost associated with operating in manner that is protective of public health and safety. Setting fees such that they cover the cost incurred by ABC in ensuring that wine and beer shippers operate in an appropriate manner will result in a more efficient allocation of resources, with licensees paying compliance costs commensurate with the risk posed to public health and safety from their activities. Only those businesses and individuals for whom the benefits outweigh the costs will chose to apply for a shipper's license or approval as a common carrier. Thus, setting the fees at a level that is reflective of the actual cost of administering the program will ensure that the number and type of businesses entering the industry are such that the risk to the public from their activities is kept low. Setting fees at a level lower than the actual cost of administering the program could result in more numerous and more unsuitable firms entering the industry, significantly increasing the risk to public health and safety, and setting the fees at a level higher than the actual cost of administering the program could deter some firms that would not have an adverse impact on public health and safety from entering the industry, resulting in a waste of resources.

Economic Impact: The proposed regulation is likely to produce economic benefits for the Commonwealth. By allowing out-of-state manufacturers and retailers to directly ship wine and beer to consumers in Virginia, the proposed regulation is likely to expand the range of choices available to consumers. Consumers will now be able to buy wines and beers that are not available through in-state retailers and manufacturers. Increased consumer choice is also likely to increase competition among wine and beer suppliers in Virginia, lowering the price of these products in Virginia. Specifically, the direct shipment of wine and beer will allow consumers to circumvent the three-tier wine and beer distribution system in place in Virginia and purchase a wider variety of wines and beers at lower prices than available under the three-tier system.

A significant part of the benefits of direct shipment of alcohol to consumers arise from the circumvention of the three-tier alcohol distribution system that prohibits the sale of alcohol directly from manufacturers to retailers. The three-tier system was put in place following Prohibition. It was done in order to prevent the vertical integration of ownership of bars and alcohol manufacturers, which was seen to be encouraging alcohol consumption. However, the need for the three-tier system in current times is unclear. Requiring manufacturers and retailers to buy and sell alcohol through wholesalers only serves to introduce economic inefficiencies while not providing any significant additional benefits. Requiring manufacturers and retailers to go through wholesalers results in higher prices being charged. Existing studies estimate that a typical wholesaler marks up a bottle of wine by between 18% and 25%. In addition, the three-tier system also serves to restrict consumer choice. For many small manufacturers, the cost of acquiring a wholesaler and selling their product through the three-tier system is prohibitive. Two recent federal court opinions found that the costs associated with the three-tier system do not make it cost-effective for smaller wineries to sell their product in states with the three-tier system. By allowing consumers to circumvent the three-tier system, the proposed regulation is likely to increase consumer choice and reduce prices, leading to a more efficient allocation and use of these resources.

However, the extent of the economic benefits to the state from allowing the direct shipment of alcohol is limited by the statutory requirement allowing only two cases of wine and two cases of beer to be shipped per month per consumer. According to ABC, the two-case limit is intended to prevent the purchase of wine for the purpose of resale. The statutory requirement effectively precludes retailers from purchasing wine and beer directly from manufacturers. Removing the two-case limit would allow both retailers and consumers to circumvent the three-tier system, increasing the efficiency gain and producing even larger economic benefits for the state.

Estimates of the share of online sales between 1994 and 1999 found that online wine sales accounted for approximately 3% of the market[1]. Other studies estimate that this percentage is likely to increase to between 5% and 10% in the next few years[2]. Between July 2003 and February 2004, direct shipment of wine accounted for less than 0.5% of the total volume of wine sold in Virginia. Over the same period, direct shipment of beer accounted for less than 0.002% of the total volume of beer sold in the state. While the percentages for both wine and beer are likely to increase as direct shipping becomes more common, wine shipments are likely to account for a lion's share of alcohol shipped directly to consumers. ABC estimates that the average cost of shipping a case of wine or beer is approximately $36.

A 2003 Federal Trade Commission (FTC) report[3] on the wine industry concludes that consumer welfare could be significantly enhanced through the direct shipment of wine to consumers. Specifically, FTC staff studied the wine market in McLean, Virginia and compared the prices and choices consumers could find in area stores to the prices and choices they could find online. The study analyzes the prices and labels available to McLean consumers for the 50 most popular wines identified in the 13th annual restaurant poll of the Wine and Spirits

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[1] Freedman, A. M. and J. R. Emshwiller, October 4, 1999. Vintage System: Big Liquor Wholesaler Finds Change Stalking Its Very Private World. *Wall Street Journal*.
[2] Swartzberg, M. and J.F. Solomon, March 17, 2000. Clicking on Wine: Will E-Commerce and Other Forces Increase U.S. Consumer Access to Wine? *Salomon and Smith Barney Equity Research Report*.
[3] Possible Anti-Competitive Barriers to E-Commerce: Wine. *A Report from the Staff of the Federal Trade Commission*, July 2003.

magazine[4]. It compares the prices and labels available through bricks-and-mortar wine retail outlets within a 10-mile radius of McLean and compares them to the prices and labels available through online retailers. The study finds that 12 out of 79 wines (or 18%) were not available at retail outlets in McLean but were available online[5]. The study also finds that depending on the price of the wine, the quantity purchased, and the method of delivery, online purchases of wine can be cheaper than purchases at bricks-and-mortar outlets. For bottles of wine priced at $20 or more, a McLean consumer could save between 5% and 13% per bottle by purchasing wine online (the savings were between 8% and 13% when the least expensive shipping method was used). For bottles priced at $40 or more, the savings are even greater, between 13% and 20% (the savings were between 20% and 21% when the least expensive shipping method was used). For all wines, purchase of more than six bottles of wine shipped via standard ground service is, on average, likely to result in savings for consumer compared to purchases made at bricks-and-mortar retailers. However, including shipment costs, the study found that lower-end wines are more expensive to purchase online than through a bricks-and-mortar retailer.

The findings of the study are likely to underestimate the impact of direct shipment on prices and consumer choice. The study only analyzes the label availability for 83 bottles of wine whereas there are countless other smaller and lesser-known labels that are only likely to be available to consumers online. The three-tier system, which requires manufacturers and retailers to sell or purchase wine and beer through wholesalers, is likely to restrict consumer choice even further. In order to sell their product in Virginia, wine and beer manufacturers are required to go through 150-odd wholesalers licensed in the state rather than sell directly to retailers. Finally, limited shelf space at bricks-and-mortar retailers is another factor limiting consumer choice. Including all these factors, the negative impact of direct shipment bans on consumer choices is likely to be even larger than that estimated by the FTC study. The impact of the direct shipment ban on prices is also likely to be larger than estimated by the FTC study. The FTC analysis of the difference in price between bricks-and-mortar retailers and online retailers does not include the long-term effect of increased competition from out-of-state retailers and manufacturers.

[4] The survey actually identifies 83 individual bottles of wine. It recognizes all relevant bottles that fall under a given winery's varietal when identifying the most popular Chardonnays, Merlots, and other wines.
[5] Four bottles were unavailable both at retail outlets and online.

Apart from expanding consumer choice and lowering prices, direct shipment of wine and beer is also likely to produce additional economic benefits. It will provide Virginia manufacturers with the opportunity to sell their wine in reciprocity states. States such as California only allow for direct shipment of wine and beer from manufacturers in states affording the same reciprocal privilege. Following the lifting of the direct shipment ban in Virginia, in-state manufacturers will be able to ship to consumers in reciprocal states whereas previously they could not. The increased sale of Virginia wine and beer in such states[6] is likely to produce economic benefits for Virginia's economy.

The proposed regulation is also likely to impose additional costs. Direct shipment of wine and beer to consumers could increase the risk of alcohol being sold to minors. Based on 2002 data from an in-school survey of eighth, tenth, and twelfth grade students[7], it was estimated that approximately 20% of eighth graders, 35% of tenth graders, and 49% of twelfth graders reported that they had consumed alcohol one or more times in the past 30 days. Moreover, approximately 68% of eighth graders, 85% of tenth graders, and 95% of twelfth graders reported that it was "fairly easy" or "very easy" to get alcohol. While it is difficult to quantify the costs of underage drinking, a study prepared for the U.S. Department of Justice[8] estimated the total cost of underage drinking in 1996 at $52.8 billion or $530 per U.S. household. The direct shipment of wine and beer to consumers could contribute to the problem of underage drinking by providing minors with another avenue by which to purchase alcohol. Moreover, state laws aimed at preventing the sale of alcohol to minors may be harder to enforce against shippers located outside the state.

There is little empirical evidence assessing the impact of direct shipment of wine and beer on alcohol consumption by minors. One of the few studies on the topic examines the impact of home delivery of alcohol on underage drinking, but does not indicate whether home delivery is a significant source of alcohol for minors[9]. It establishes that minors can obtain

[6] Currently, there are 13 reciprocity states

[7] Johnston, L. D., O'Malley, P. M., and J. G. Bachman, December 16, 2002. Ecstasy Use Among American Teens Drops For The First Time in Recent Years, and Overall Drug and Alcohol Use Also Decline in the Year After 9/11. *University of Michigan News and Information Service.*

[8] D.T. Levy et al., 1999. Costs of Underage Drinking. *A Report Prepared for the U.S. Department of Justice's Office of Juvenile Justice and Delinquency Prevention*.

[9] L. A. Fletcher et al., 2000. Alcohol Home Delivery Services: A Source of Alcohol for Underage Drinkers. *Journal of Studies on Alcohol* 61: pp 81-84.

alcohol through home delivery, just as they can through bricks-and-mortar retailers. Several states have conducted sting operations in which minors have been able to purchase alcohol online. However, based on these operations, it is not possible reach any conclusion about whether minors can buy alcohol easier online or at bricks-and-mortar retailers. Moreover, in most cases the sting involved providing the minor with a credit card, eliminating an important determining factor of underage drinking, price.

The 2003 FTC report conducted an informal survey of states allowing direct shipment on the issue of shipment of alcohol to minors. Based on the response, the FTC report concludes that most state officials "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". Several of the states surveyed had procedural safeguards and enforcement mechanisms similar to those being proposed for Virginia to prevent the sale of alcohol to minors and none of the states surveyed reported more than isolated instances of minors buying or attempting to buy wine online.

There is empirical evidence indicating that underage drinking is highly sensitive to price. For example, a study by Saffer and Dave (2003)[10] indicates that price of alcohol has a significant effect on alcohol participation and binge alcohol participation by adolescents. Direct shipment of wine and beer provides the greatest price savings for high-end and niche varieties of wine and beer. In fact, the 2003 FTC study of the wine market in McLean, Virginia finds that lower-end wines are more expensive to purchase online than through a bricks-and-mortar retailer. The FTC report goes on to state that, "an interstate shipping ban primarily deprives consumers of access to lower-cost sources of high-end, expensive wines".

The price of alcohol for minors includes two components, the direct cost of the alcohol and the indirect cost associated with purchasing the alcohol illegally. Bricks-and-mortar retailers are likely to continue to be the source of the lowest cost wines and beers. Direct shipment is only likely to impact the price and availability of more expensive varieties of wine and beer. Moreover, there is no evidence to indicate that, given the procedural safeguards and enforcement mechanism in place in Virginia, minors will find it easier to buy alcohol online compared to

[10] Saffer, H. and D. Dave, 2003. Alcohol Advertising and Alcohol Consumption by Adolescents. *National Bureau of Economic Research Working Paper: 9676.*

buying it at bricks-and-mortar retailers. Thus, it is likely that minors will continue to use bricks-and-mortar retailers as their primary source of alcohol and unlikely that the direct shipment of alcohol to consumers will lead to a significant increase in alcohol consumption by minors.

The direct shipment of alcohol could also lead to an overall increase in alcohol consumption in Virginia. Increased consumer choice and lower prices for wine and beer could lead to more individuals consuming alcohol and larger amounts of alcohol being consumed by each individual. Increased alcohol consumption imposes social and economic costs through rising health costs, falling productivity, and an increase in social problems such as domestic abuse. A 1998 study by the National Institutes of Health estimated that alcohol abuse and alcoholism generated costs of about $148 million (or approximately $580 per capita) in 1992.

However, the increase in alcohol consumption due to the lifting of the direct shipment ban is not likely to be significant. Alcohol purchased through direct shipment is likely to form only a small proportion of total alcohol purchased and consumed. Most of the benefits of direct shipment are related to the availability and consumption of more expensive bottles of wine and bottles produced by small manufacturers that cannot afford to sell their product through the three-tier system. Thus, direct shipment is likely to have the greatest effect on individuals with a taste for niche and high-end varieties of wine and beer. It is unlikely that any increase in consumption of niche and high-end varieties of alcohol by these individuals will significantly increase the overall level of alcohol consumption in the state. The 2003 FTC report concludes that, “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”.

The net economic impact will depend on whether the benefits of allowing the direct shipment of wine and beer to consumers are greater than or less than the costs of doing so. Based on available information, it appears that the benefits of allowing direct shipment of alcohol to consumers are significant. These benefits include greater consumer choice, lower prices, and the ability of Virginia manufacturers and retailers to sell their wine in reciprocity states. The costs, on the other hand, are not likely to be very significant. A combination of the safeguards built into the regulation and the types of wines and beers that benefit from the lifting of the direct shipment ban indicate that shipment of alcohol directly to consumers is unlikely to lead to a significant increase in underage drinking or to a significant overall increase in alcohol consumption in the state. Thus, the proposed change is likely to produce a net positive economic impact on the state's economy.

While the overall net economic impact of the proposed regulation is likely to be positive, the magnitude of the positive impact could be enhanced further. Section §4.1-112.1 of the Code of Virginia requires manufacturers that apply for or consent to a shipper's license to notify all wholesalers distributing their brand in Virginia of the application. The requirement does not appear to serve any purpose relating to public health or safety. To the extent that it has no connection to public health and safety, the proposed requirement is likely to impose unnecessary additional costs on manufacturers. The notification requirement could also impose indirect costs on manufacturers. The requirement may be used by wholesalers to discourage manufacturers from applying for or consenting to a shipper's license. For example, wholesalers may threaten to stop supplying brands from manufacturers that are shipping directly to consumers. By imposing unnecessary costs, both direct and indirect, the statutory notification requirement will result in efficiency losses and waste of resources. Removal of this requirement is likely to improve the efficiency of the direct shipment program and increase the magnitude of the net positive economic impact on the state from allowing the direct shipment of alcohol to consumers.

Businesses and Entities Affected

The proposed regulation is likely to affect wine and beer manufacturers, retailers, and wholesalers. Virginia manufacturers and retailers may see a decline in demand as lifting of the direct shipment ban leads some consumers to shift their purchases away from in-state manufacturers and retailers to out-of-state suppliers. Moreover, the increased competition from out-of-state manufacturers is also likely to put downward pressure on the price of wine and beer sold in Virginia. However, the in-state manufacturers and retailers are likely to receive additional benefits of being able to ship their product to reciprocity states. The net economic impact will depend on the magnitude of the decline in revenues from in-state sales compared to the magnitude of the increase in out-of-state sales. Direct shipment of wine and beer to consumers is likely to have a negative impact on Virginia wholesalers. Consumers will now be able to circumvent the three-tier system and purchase wine and beer directly from the manufacturers, reducing the amount of alcohol flowing through the three-tier system. The magnitude of the negative impact will depend on the number of consumers who now choose to purchase directly from manufacturers. Given that direct shipment largely affects the price and availability of high-end wines and beers and accounts for only a small proportion of total alcohol sales, the adverse impact on wholesalers is not likely to be very large.

As of June 2004, ABC has issued 226 shipper's licenses, 41 to in-state shippers and 185 to out-of-state shippers.

Localities Particularly Affected

The proposed regulation is applies to all localities in the Commonwealth.

Projected Impact on Employment

The proposed regulation is not likely to have a significant impact on employment in the Commonwealth.

Effects on the Use and Value of Private Property

The proposed regulation is likely to have a negative impact on wholesale businesses in Virginia. Consumers will now be able to circumvent the three-tier system and purchase wine and beer directly from the manufacturers, reducing the amount of alcohol flowing through the three-tier system. However, the magnitude of the negative impact is not likely to be very large as direct shipment is likely to account for only a small proportion of wine and beer sales in Virginia.

Direct shipment of alcohol to consumers is also likely to affect businesses manufacturing and retailing wine and beer in Virginia. These businesses could see increased competition and a decline in demand for their products in Virginia. However, these businesses will now have the opportunity to sell their product in reciprocity states, which they could not have done prior to the lifting of the direct shipment ban. The net economic impact of direct shipment on these businesses will depend of the magnitude of the decline in in-state sales compared to the increase in out-of-state sales.