



Testimony of Brewers of Pennsylvania by  
Bill Covaleski, President Brewmaster and President of Victory Brewing Company  
August 29, 2013

Dear Honorable Members of the Pennsylvania House Liquor Committee:

Good morning, Chairman Taylor, Chairman Costa and Members of the Committee. We, the Brewers of Pennsylvania, appreciate the opportunity to speak about this most important issue before the Honorable Members of the House Liquor Committee. This matter involves the Pennsylvania beer franchise laws which have not been updated for over 30 years.

My name is Bill Covaleski, and I am President of the Brewers of Pennsylvania and co-founder of Victory Brewing Company.

Released January 22 of this year, the Study of the Economic Impact of the Brewery Industry in the Commonwealth underscored the positive impact of Pennsylvania's breweries. Pennsylvania Senate Resolution 2012-216 directed the Legislative Budget and Finance Committee to conduct this study which included legislative recommendations to promote the growth of Pennsylvania's brewing industry. According to this Study, Pennsylvania breweries had an estimated direct impact of \$1.1 billion in 2011. Capital investment in plant and equipment totaled \$782 million over the five year period since 2006, growing an impressive 318% in that time period. Pennsylvania breweries employ almost 2,000 residents full time and an additional 750 part time. An estimated 2 million tourists, contributing total expenditures of \$306 million, visited Pennsylvania breweries in 2010. Of important note are the recommendations of the Legislative Budget and Finance Committee; namely, to amend the Pennsylvania beer franchise laws to allow for changes in the industry, including allowing breweries to self-distribute and allowing breweries to pay a fair market value to wholesalers to be released from exclusive, perpetual relationships created by current beer franchise laws that hamper a brewery's ability to grow to its full potential and employ as many workers as possible.

As you may know, the three-tier system of beer distribution in Pennsylvania, *i.e.*, the beer franchise law, creates a state-mandated middleman monopoly. But for few exceptions, this monopoly is unique only to the beer industry. Manufacturers, like the members of our organization, are required to sell their beer to the one wholesaler they designate in a geographic region; then that wholesaler has the exclusive rights, in perpetuity, to sell to all retailers in that area. Those retailers, in turn, sell to the end consumers. In Pennsylvania, manufacturers cannot

terminate wholesalers unless there is a "good cause," which lacks definition in the Liquor Code. Termination for good cause typically translates into expensive litigation. Sometimes wholesalers aggressively pursue new brand rights only to add to their portfolios and keep the brand away from a competing wholesaler in the market. Wholesalers have acted unilaterally to sell their rights to a brewery's products to another wholesaler without the manufacturer's consent in Pennsylvania. One of our members just concluded litigation over this very issue which cost them hundreds of thousands of dollars in court costs.

The franchise laws dictating these situations have both their faults and historical benefits. The Brewers of Pennsylvania believe in the value and effects of this three tier system and fully support its existence, while recognizing the system's current flaws that need to be corrected. From a manufacturer's perspective, franchise laws prohibit free trade by creating a monopoly of the manufacturer's product and intellectual property in one wholesaler. The last time Pennsylvania amended these franchise laws was in 1980 and the current laws have failed to address mass industry beer consolidation and changes. Mass industry beer consolidations started at the top, *i.e.*, manufacturers, and have carried through to the wholesale tier. Lastly, the three-tier system increases the cost of beer to the general public.

The historical benefits of the three-tier system are recognized for prohibiting direct sales by a manufacturer to the consumer. At the close of Prohibition, when the three tier system was conceived of, it was feared that manufacturers would act in an anti-competitive manner and that would lead to the increased promotion of alcohol consumption. To avoid this concern, franchise laws required a manufacturer to go through a local wholesaler who was more knowledgeable of responsible alcohol distribution to retail outlets. Further, the local wholesalers are directly subject to state law enforcement.

Now, the landscape of our national and regional brewing industry has changed radically over the last 30 years as evidenced by the massive consolidation of Belgian owned InBev and Anheuser-Busch and the merger of Miller/Coors under the direction of South African owned SAB. National consolidation among brewers has reached a point at which a large majority of America's beer is produced by two companies, none of them with a single brewery in Pennsylvania. Growth of these larger, national breweries has led to the closures of many regional breweries which simply could not compete with pricing and the distribution power achieved by the mega-breweries. Compared to these mega-breweries, even the Brewers of Pennsylvania's largest members, D.G. Yuengling & Son, Inc. and Sam Adams, are considered, at best, mid-size breweries on a national scale. Beer maker Budweiser sells more beer in a week than Yuengling brews in a year. It takes the Miller/Coors merger two weeks to top Sam Adams' annual production. These two mega-breweries produce more than 75% of the beer consumed in this great industry. They dominate the market and aggressively attempt to consolidate and regulate the wholesale market by putting pressure on wholesalers to consolidate. These consolidations at the wholesale level ultimately have caused a loss of jobs and loss of competition in Pennsylvania. Since 1990, wholesaler numbers have decreased by over one-third with markets around the United States becoming a duopoly (two wholesaler market); one wholesaler controlled by the Anheuser-Bush and InBev merger and the other by Miller/Coors, both foreignly-owned.

The market power of the mega-breweries is astounding and transcends to their wholesalers. Through its trials and tribulations, Yuengling has taken over 180 years to achieve its current market share. Recently, one of the mega-breweries introduced a brand of beer flavored like a margarita that took only six weeks to obtain a market share larger than Yuengling. Such market power cannot be exerted without the unconditional support of the wholesale tier. Pennsylvania breweries do not enjoy such support at the wholesale level and many brands become lost in the shuffle of the wholesalers' proliferating brand portfolio. Franchise laws make it impossible for breweries to move to another wholesaler unless it has the resources to fund extensive litigation.

Consolidation at the wholesale level has reversed the bargaining power between breweries and wholesalers. While Sam Adams is one of the largest domestically-owned breweries in the United States, they are smaller than two Pennsylvania wholesalers. Nearly all the wholesalers in Pennsylvania are larger than the Pennsylvania breweries they represent. Back in 1980 when they were enacted, franchise laws were developed to protect wholesalers from developing national brewers. That shield has become the sword utilized by wholesalers to maintain the brand portfolio without regard to their performance. Wholesalers are immune from the market preference of consumers with all the brands they have collected. If a wholesaler does not adequately represent a brewery, only the brewery's business is at stake.

We, as the Brewers of Pennsylvania, are your mid-size brewer by Pennsylvania standards, like Straub in St. Mary's and Troeg's in Hershey, packing beer for sale across the Commonwealth and a number of states. We are also your neighborhood brew pub. As small, independent Pennsylvania brewers, we are gaining ground after significant setbacks. The closures of Schmidt's in Philadelphia, Stroh's in Lehigh and Kohler in Erie within the last 30 years took jobs from our State. Schmidt's, once the nation's tenth largest brewer, employed 1,400 while producing three million barrels of beer. Need we remind this Committee about Rolling Rock, severed from its home Latrobe by a foreign-owned entity? All of these breweries fell prey to national powers. Despite these challenges, we are proud to have America's largest independently-owned breweries call Pennsylvania home. Yes, both Yuengling and Sam Adams are the largest independently-owned breweries, but they are responsible for less than one percent of the beer sales nationwide. This is tiny in comparison to the big brewers who are more than 100 times their size. As a result, our products do not command the same focus and energy from our wholesalers as products from the mega-brewers.

More and more states have started to address this changing industry and amend their franchise laws. Even the surrounding states of Delaware, New Jersey, Ohio, and New York have laws in place which address the results of industry consolidation. The Brewers of Pennsylvania propose changes which have been embraced by other states and recommended by the Legislative Budget and Finance Committee. Many of the changes proposed by other states were to remedy constitutional issues created by the United States Supreme Court decision in Granholm v. Heald, 544 U.S. 460 (2005). Likewise, the Brewers of Pennsylvania propose to sanitize any Granholm issues created by our current Liquor Code and to preserve distribution of malt beverages through our Pennsylvania partners, the wholesalers, and through a three-tier system.

Presently, Pennsylvania manufacturers have the benefit of secondary agreements which should be eradicated in order to prevent any constitutional challenge under Granholm. Secondary agreements are a manner in which Pennsylvania manufacturers can self-distribute or exit a wholesaler relationship without enduring expensive litigation because of terminations for cause. In place of secondary agreements, the Brewers of Pennsylvania propose language that allows a brewery to terminate wholesalers without cause as long as the brewery is less than 20% of the volume of the wholesaler's house. Any wholesaler which is terminated under the 20% exit rule would receive "fair market value" for that brand which would be settled by arbitration if the parties could not agree. In addition, any manufacturer would be allowed to self-distribute up to 75,000 barrels with no distinction from in state or out of state manufacturers. The 75,000 barrel mark is consistent with differing malt beverage tax obligations given to brewers of varying scale under the Federal Tax Code as applied to the Pennsylvania population compared to the total U.S. population.<sup>1</sup>

Some of our proposals have their origins in previous attempts to fix franchise laws. In 2009 and 2010, the Pennsylvania Legislature, including this Committee, addressed HB291 whose legislation was advocated by the Pennsylvania Beer Alliance (formerly the Pennsylvania Beer Wholesalers Association). As Pennsylvania brewers detailed several years ago, that legislation would have had adverse affects on Pennsylvania brewers and their ability to redress distribution issues. At that time, Pennsylvania breweries were told by their wholesale partners that any performance issues should be freely addressed and bargained for in exchange for contracts between the parties. Unfortunately, current Pennsylvania beer franchise laws allow these contracts to be perpetual permitting some wholesalers to refuse to negotiate modified terms which would update these contracts and address the changing landscape of the brewing industry. As a result, we Brewers of Pennsylvania now propose that these distribution agreements be renegotiated every five years to allow those relationships to adapt as the industry changes. Our proposal suggests that any failure of the parties to agree would be sent to binding mediation and would not be a reason to terminate the wholesaler.

Around the United States and Pennsylvania, wholesaler consolidations will continue to occur and limit competition and a brewer's choice for a wholesale partner. The Brewers of Pennsylvania also propose clear statutory language to consent to any wholesaler-to-wholesaler transaction. The brewers' failure to consent would not create a private cause of action for wholesalers to sue a brewer. In consideration of consenting to such a transaction, the brewers propose that they would receive 10% of the brand rights' value exchanged between the wholesalers in such a transaction. Surely, the brewers should be compensated for the exchange of their own goodwill at the wholesaler level which will help them invest in marketing brands and neutralize the risks associated with the logistical change from one wholesaler to another wholesaler.

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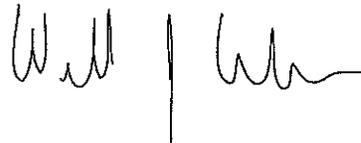
<sup>1</sup> Pursuant to 26 U.S.C. § 5051(a)(2) and 27 C.F.R. § 25.152, breweries which produce less than two million barrels of beer incur less tax per barrel and, as a result, smaller brewers are given a tax break. The United States Census Bureau reported the estimated population in Pennsylvania for 2012 of 12,763,536 and a total U.S. population of 313,914,040 people. When you divide the Pennsylvania population by the U.S. population and multiply that by 2 million barrels, arguably you arrive at the amount of barrels distributed in Pennsylvania for a smaller brewer assuming that smaller brewer has even distribution throughout the entire United States. The numbers in this equation equals approximately 81,000 barrels which we conservatively reduced to the 75,000 barrel mark.

The time is critical to address these important issues facing our industry. Soon consolidation experienced at the manufacturer level will permeate the middle tier of wholesalers of beer. Such a duopoly does not favor innovation, consumer choice, or local brewers. Brewers of Pennsylvania stand here as independent brewers employing residents of this Commonwealth and risking their own capital to expand its own facilities. Recently, my company concluded that investing in Pennsylvania was a sound strategy. Since beginning as the dream of two former Montgomery County residents in 1995, Victory now ranks as the United States' 26th largest brewery, with each barrel brewed and packaged in Downingtown, Pennsylvania. We will be opening a second facility in West Sadsbury Twp. this October at a cost of over \$30 million, in anticipation of an expanding consumer thirst for distinctive Pennsylvania products. On behalf of my employees and my brewing partners across the Commonwealth, I hope this strategy is sound as it relies on a stable, yet progressive business environment. Such an environment of success can be fostered by this Committee and the Pennsylvania General Assembly at large. Please amend the Pennsylvania beer franchise laws so the regulatory framework under which we must operate does not threaten to undermine our businesses and our employees' futures. Thank you for your time.

Respectfully submitted,

BREWERS OF PENNSYLVANIA

BY:

A handwritten signature in black ink, appearing to read 'William Covaleski', with a vertical line separating the first and last names.

William Covaleski, President  
Brewers Of Pennsylvania