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April 23, 2014

To: Sharon Foster, Chair, Washington State Liquor Control Board
Ruthann Kurose, Board Member, Washington State Liquor Control Board
Chris Marr, Board Member, Washington State Liquor Control Board
Karen McCall, Rules Coordinator, Washington State Liquor Control Board

From: Washington Restaurant Association

Re: Proposed rules #13-21, regarding "Fair Trade Practices"

Dear Honorable Members of the Board and Staff;

The Washington Restaurant Association, with 5,400 members across the state, represents this state's restaurant industry, which consists of over 13,700 businesses. Although almost all of those businesses are small, together they employ more people than any other private industry in the state (over 200,000 employees).[1] The restaurant industry comprises over 8,000 businesses licensed by the board to serve wine and spirits; we are your largest licensed and regulated stakeholder. On behalf of our members, we submit the following comments in opposition to the proposed rules to regulate "fair trade practices" for spirits and wine.

We respectfully request the Board refrain from adopting the proposed fair trade rules, WAC 314-23-060 through 314-26-080, because, first and foremost, they contradict Washington state law. Additionally, the rules will not result in the Board's intended outcome; the proposed rules will result in irreversible financial harm to on premise licensees; and the Board has not fulfilled its obligation to evaluate the disproportionate negative impact on small businesses through a Small Business Economic Impact Statement. Due to the immediate, irreparable harm our members will suffer, should these rules be adopted, WRA will file a petition for review in the Superior Court for Thurston County, and we request the Board exercise its discretion to issue a stay of its rules or delay the effective date of the rules to allow a court to rule on the validity of these rules before they do irreparable harm to our members.

A. The Rules Are Unlawful

WRA has submitted numerous legal memos which join additional legal opinions offered by other stakeholders that the proposed rules violate RCW 66.28.170 and the language and intent of I-

[1] Eighty-five percent of the restaurants in our industry have annual sales of $1 million or less, making them predominantly small businesses.

1183. We are hereby resubmitting all three legal opinions, as we believe the Board must consider each one carefully and respond to its analysis before the rules go into effect. (Attached as Exhibits C to E).

WRA will not rehash the same legal arguments here. Many stakeholders have provided comments that the pricing practices the Board is contemplating prohibiting are normal and customary practices employed by suppliers for other products purchased by restaurants and bars. Prof. Shulman has submitted a professional opinion that supports the conclusion that the same pricing practices the Board wants to eliminate are (1) used for goods of other kinds, and (2) they are used for goods of other kinds because there are many legitimate business factors that influence a supplier in setting a price for a product. Further, these practices are used by alcohol distributors in states across the country where uniform pricing is not utilized. These practices cannot possibly violate RCW 66.28.170, or federal law, in each and every instance the price differential is used, and the Board thus has no authority to create per se rules that such pricing practices are not the result of bona fide business factors. The Board exhausted significant staff time investigating whether price differentials exist, but failed to investigate whether the recipients were similarly situated, and whether the differentials harm competition or what bona fide business factors cause their existence. There was no investigation into whether the price differentials are lawful under trade regulation laws applicable to goods of all kinds.

These blanket prohibitions are just as unwarranted under a theory that undue influence prohibitions somehow trump RCW 66.28.170's more recent and more specific grant of permission to engage in price differentials based on bona fide business reasons. As the Legislature made clear, undue influence is to be investigated on a case-by-case basis by the Board. RCW 66.28.300. In the two statutory provisions that actually contain a prohibition on undue influence (compared to the definition of the same), the Legislature imposed a "more likely than not standard" rather than the per se standard contained in chapter 66 RCW prior to the revision of the Tied House Laws in 2009. RCW 66.28.290; RCW 66.28.315. The Legislature has made clear that undue influence is a measure of degrees, and the Board cannot now impose heavy-handed general restrictions on practices based on its understanding of undue influence.

Based on our conversations with Board members and staff, the Board seems motivated less by a concerns that these practices are in fact unlawful—as indicated by its failure to request a formal or informal Attorney General opinion and its willingness to spend nearly two years on the rulemaking process—and more by a desire to help the former state and contract liquor stores, which may be struggling now that the State lost the authority to offer them preferential market status under I-1183. As discussed below, these rules will fail to help to such stores.

B. Desire to Protect Contract Liquor Stores

The petition for rulemaking was submitted by the Washington State Liquor Store Association, a group that represents approximately 200 former state contract stores and state store auction

winners, and this organization has requested the Board to determine that price differentials between off premise licensees and on premise licensees are illegal. They are of course predisposed to call all of these price differentials illegal and discriminatory because they believe their own business is harmed by them. Board Members have expressed sympathy with the former state contract stores and stated that a main reason for these rules is to help these stores be more competitive.

Although we find it highly improper for the Board to base rulemaking on a desire to provide financial help to one (small) set of stakeholders and insert itself into the private market for wholesale transactions of spirits and wine, we also want to point out that the proposed rules will fail to remedy these stores' concern.

We understand the former contract liquor stores are hoping these rule changes will help them recover the Class H accounts that many lost after I-1183 (largely due to the disputed interpretation of the 17% rule promulgated by the Board). However, their complaint lies with the fact that they are struggling to compete with the major distributors, not with on-premise retailers. The only way to allow these stores to compete with the distributors on price to on-premise retailers is for the Board to require the distributors to offer *lower* prices to off-premise than to on-premise retailers. A mere leveling of prices between on- and off-premise licensees will not help these contract and former state liquor stores. These stores are an additional link in the chain of commerce, imposing additional costs—and that extra link necessarily adds an additional markup, since current law prevents spirits and wine from being sold below the cost of acquisition.

To help illustrate the place former contract and state stores have in today's market, WRA used LCB's published sales data to compile sales summaries between on- and off-premise licensees from which the on-premise licenses primarily purchase their spirits and wine. *See* Ex. A. On-premise licensees make up approximately 12% of the business for contract and former state liquor stores. *See id.* at 1 (average of CLS Spirit Retailer and State Store Spirit Retailer). The total sales volume to on-premise licensees was $15.9 million between the second quarter of 2012 to the end of 2013. *Id.* In comparison, spirits retailers (e.g., grocery stores) sold half that volume. *Id.* Such numbers show that contract and former state stores compete effectively against the spirits retailers, many of whom can take advantage of larger inventory space to obtain better volume discounts—showing that the price at which the off-premise can get its spirits and wine is not the determinative factor. These numbers are supported by the purchasing decisions our members make. Our members patronize the former contract and state stores because they offer convenience, preferred locations, additional delivery services, and other services—not because the contract liquor stores can compete only on price.

Not only are equal prices between on- and off-premise retailers not sufficient to help the former contract stores compete with distributors for on-premise business, but the distributors are not going to "level down" to the prices now being charged on-premise retailers. The former contract stores do not provide the same services and cost and other advantages to the distributors, and so the prices to both categories will have to come up, as the distributors have made clear.

Consumers and our members will suffer, but the contract stores will not benefit.

C. There can be no price discrimination between purchasers that do not compete for customers

For a pricing differential to constitute unlawful discrimination, a number of factors must be analyzed. But perhaps most importantly, such discrimination is unlawful only to the extent it has a significant adverse effect on competition.[2] On-premise and off-premise licensees do not compete for the same business. Instead, restaurants patronize the off-premise stores for its inventory.

Channel pricing—recognizing the different functions, services, costs, and customers of different components of the distribution chain—is not discrimination and not illegal. First, we remind the Board that prior to I-1183, restaurants, by statute, were entitled to a 15% discount on spirits—which was in itself a channel pricing discount. Second, we commissioned Dr. Jeffrey Shulman, a professor at the University of Washington Foster School of Business, to provide an overview of the marketing factors that support such price differentials—without violating any laws or fair trade principles. We request that you look at his comments closely. We also echo the submissions made by other stakeholders, which detail the requirements under the law for "discriminatory" pricing, and highlight again for the Board that the fundamental prerequisite for such discrimination is that the two entities be similarly situated. That prerequisite is not met here.

On premise licenses and off premise licensees serve completely different roles in the marketplace, have different customers, and in most cases, do not even sell the same items. Off premise licensees are serving spirits by the bottle; while on premise licensees use those products as an ingredient in the final product. Since voters approved a private marketplace for spirits, it is not the Board's role to arbitrarily choose winners and losers in a private market. Favoring a segment of licensees will cause harm to the licensees who are disadvantaged by your decision.

In short, a price differential is not price discrimination unless a number of factors is analyzed and found satisfied. The Board now proposes to scuttle this framework and declare any number of business practices (approved and used for other goods) as per se discriminatory. Such an

[2] For specific legal references, WRA refers the Board to the detailed legal analysis set out by the Washington Wine Institute, submitted April 11, 2014. WRA adds only that RCW 66.28.285(j) (proposed rule WAC 314-23-075(10)), discussing undue influence, similarly identifies undue influence only in the context of "price discrimination."

approach is contrary to what the Legislature has intended, and thus exceeds the Board's authority.

D. Our Industry Will Be Seriously Harmed if the Rules Are Passed

The Board has stated that it believes that prices will not go up as a result of these rules. Such a conclusion is contrary to the statements of the Board staff, which have been clear in meetings with stakeholders that they understand prices will go up; all of the evidence in the record; violates basic notions of economics, as Prof. Shulman states in his letter; and has been contradicted by the distributors themselves. At the September 11, 2013 work session where the Board requested feedback on the four issues the proposed rules seek to prohibit numerous restaurateurs and bar operators presented oral and written comments of the harm the proposed rules would cause. Ex. F. Since the proposed rules have been drafted, we have heard no evidence to the contrary of what was provided at the work session. In fact, like you, our members have heard directly from their distributors that if the rules are adopted, they will see a price increase. This fact was also publicly reported in an Associated Press article dated February 24, 2015, entitled *Another possible booze price hike looms over Wash*ington: "the board will move forward with its rulemaking, and drinks in bars and restaurants could see a price hike come April — as much as 15 percent, according to distributors." (Attached as Ex. B).

Furthermore, the Board has expressed a belief that any such price increase causes a rather insignificant decrease in restaurant's profitability and as such is not a serious consideration in their rulemaking. As the representative organization for over 5,000 restaurants, WRA has researched and analyzed the business models for hundreds of restaurants. Based on this experience, we can tell the Board that such a conclusion is completely unwarranted. Adoption of these rules will disproportionately harm a business segment that statistically has a more difficult chance of survival and is responsible for a significant economic contribution to the state through sales and B&O tax and employing hundreds of thousands of people.

A 5-15% increase in the cost of a major item of inventory is not simply something businesses in our industry can easily absorb. In short, when prices go up, thousands of our members will suffer an immediate, negative impact on their businesses. The average restaurant in Washington has approximately $750,000 in total annual sales. Yet on average, our industry also runs on only a 4% profit margin – meaning an average restaurant makes just $30,000 in profit—before paying taxes. For every $1,000 in additional costs, a restaurant must increase sales by $20,000 to make up for that cost increase. Because wine and spirits inventory consists of a large part of the costs a restaurant has to incur, increases to these two categories could easily wipe out a restaurant's *entire* profit margin, and many restaurants will face a significant reduction in their profit margin.

In talking with our members throughout the rulemaking process, we have learned that to absorb the loss of the discounts our members can currently negotiate will have to mean cutting costs elsewhere. Some members may be forced to close their doors; almost all will reduce or

eliminate staff; offer less variety and choice in product offerings; charge higher prices on *all* items to off-set the increased costs; and take fewer risks on new products to reduce inventory and due to lack of cash to fund such purchases.

If the Board adopts the proposed rules, serious economic harm will be done to business across the state.

E. Small Businesses Will Be Disproportionally Affected

As the majority of our members are small businesses, it should be clear by our submission alone that the rules will have a disproportionate impact on small businesses in this state.[3] The costs imposed by the rule are more than minor; as discussed above, these rules have the potential to force businesses to close.

The Board appears to consider a small business economic impact statement to be unnecessary for these rules. We've heard conflicting reasons for the lack of any work done on this to date. The Board claims that no such analysis is required because the pricing practices are already illegal, and thus it would be akin to doing an impact study for a rule that prohibited underage drinking.

First, as the many legal opinions submitted to the Board have shown, these pricing practices are not "clearly" illegal, and the Board is exercising its discretion to make rules that "clarify" statute. *See* WSR 13-07 (CR 101 discussing need to "clarify fair trade practices"); *see also* WSR 13-21 (CR 102). As has been shown by this process, the Board believes it has tremendous discretion in how it shapes these rules and executes them—and it is the exercise of that discretion that needs to be guided by consideration of the rules' impact on small businesses. Thus, an argument that the rules are needed because the statute already outlaws the same behavior is a variation of the same argument that the Board offered to the Thurston County Superior Court in the *Washington Restaurant Association et al. v. Liquor Control Board* case—and was roundly rejected.

As Judge Price stated only a year ago: "Since all rules must be reasonably consistent with their related statutes, *all* imposition of costs on business by any given rule could be blamed on its underling statute." And arguably, any activities that fall outside such a rule would always be in some sense "unlawful" in that it would be by definition inconsistent with the statute. But as the Court made explicit, "Even when the bulk of the impact on industry is arguably caused by an underlying statute, rule drafting still involves a series of judgments by the agency; certainly, industry participants can be affected differently depending on those rulemaking judgments." Judge Price invalidated dozens of rules for the Board's failure to perform a small business economic impact statement. The Board cannot avoid its duties to *at least* study the impact the rules have on small business and attempt to alleviate those impacts by hiding behind their illegality argument.

[3] Although we cannot speak for other entities, it appears to us that small wineries and craft distilleries will also be impacted—and many of these are small businesses.

Because of this input offered at the September 11, 2013 work session, and throughout the public comment period, it is clear the proposed rules will have a disproportionate impact on small businesses, and we have requested the Board conduct a Small Business Economic Impact Statement, as required by statute. Unfortunately our request has not been considered, and we must urge the Board that further consideration of the proposed rules is not appropriate until the full impact of the proposal is understood.

The failure to do this analysis will by itself cause harm. Not only will our members have to pay to defend their right to have a state agency consider their unique position in the state's economy and request a small business economic impact statement be performed, our members do not have the luxury of waiting months to litigate the Board's failure to fully consider all of the evidence.

F. The Board May Stay the Rules and Should Do So to Protect Small Businesses

Should the Board choose to adopt the proposed rules despite the concerns we have raised, we request the Board exercise its discretion and authority to stay the effectiveness of the rules until a court's opinion can be rendered on the serious legal questions raised during the comment period, by WRA and others. We accept that the Board may decide, contrary to the evidence as we see it, that the proposed rules are legal and required. Should the Board do so, we will file a petition of review and request a court to rule on the validity of the Board's rules, as in our view, the weight of the legal analysis on this issue supports our position. (In fact, we have yet been shown any contrary legal analysis, and we refuse to accept the opinion of Board staff on such complicated legal issues—with all due respect to the capabilities of the staff, who are not attorneys.)

If we prevail, our members have no way to recoup the business opportunities they have lost or recover the increased costs they had to shoulder while their ability to negotiate wine and spirits prices was unlawfully restricted by the Board.

The Board has before it evidence not just of harm to thousands of restaurants in the state, but also of testimony of other stakeholders, such as wineries, that will be harmed by the rules. And we have discussed above, at most, 200 former contract and state liquor stores may see a modest positive gain—although this is highly unlikely, in our opinion, and a drop in the bucket comparatively given the small volume these stores account for. *See* Ex. A (sales data summary).

It seems illogical and cruel to gamble with the livelihoods of thousands of restaurateurs and their employees while we await judicial resolution of our genuine dispute about the state of Washington liquor laws after I-1183. The Board has communicated to us that "it's time" to enact the rules and that they have allowed stakeholders plenty of time to seek a legislative fix to the issue. (We note that in our own lobbying efforts, our proposals to address this issue were rejected because legislative representatives found there was no reason to "fix" RCW 66.28.170—it clearly allows price differentials based on bona fide business reasons.)

The Board clearly has discretion to stay the rules and to expedite preparation of the administrative record to support prompt judicial resolution, and the failure to do so would impose disproportionate extra litigation costs on us and our small business members in terms of

what is necessary to seek preliminary injunctive relief. Those costs alone require an SBEIS before denying the request to allow judicial review to proceed before the rules become effective.

As the Board has been considering these rules since November of 2012, we see no reason why the Board cannot now wait six months while a court resolves the serious legal questions that have been raised by stakeholders—especially when a failure to do so will result in immediate, irreparable harm to so many small businesses.

Should the Board refuse to stay the rules, we request (1) the Board explicitly explain its reasons for such a refusal in its Concise Explanatory Statement, and (2) the Board prepare the agency record within ten days of the petition being filed to allow WRA to bring the matter to an administrative hearing as soon as possible and thereby minimize the damages to its members.

G. Incorporation of Prior Comments

Attached to this letter as Exhibit G are previous comments submitted to by our members prior to the filing of the CR 102 that we believe apply with equal force to the proposed rules now in front of the Board and request they be considered again.

H. Conclusion

For the reasons stated, we have serious concerns over the legality of the proposed rules. As the proposed rules, if adopted, will cause irreversible economic harm to thousands of businesses across the state, we request that if the Board does indeed decide to adopt the proposed rules, they do so while staying the effect pending the outcome of a legal opinion. We feel this is an appropriate request, as there is no emergency in adopting rules that have been contemplated since November 21, 2012, and there have been no legitimate concerns regarding public safety raised.

Thank you for your consideration,

Julia Gorton

Government Affairs Manager

Washington Restaurant Association