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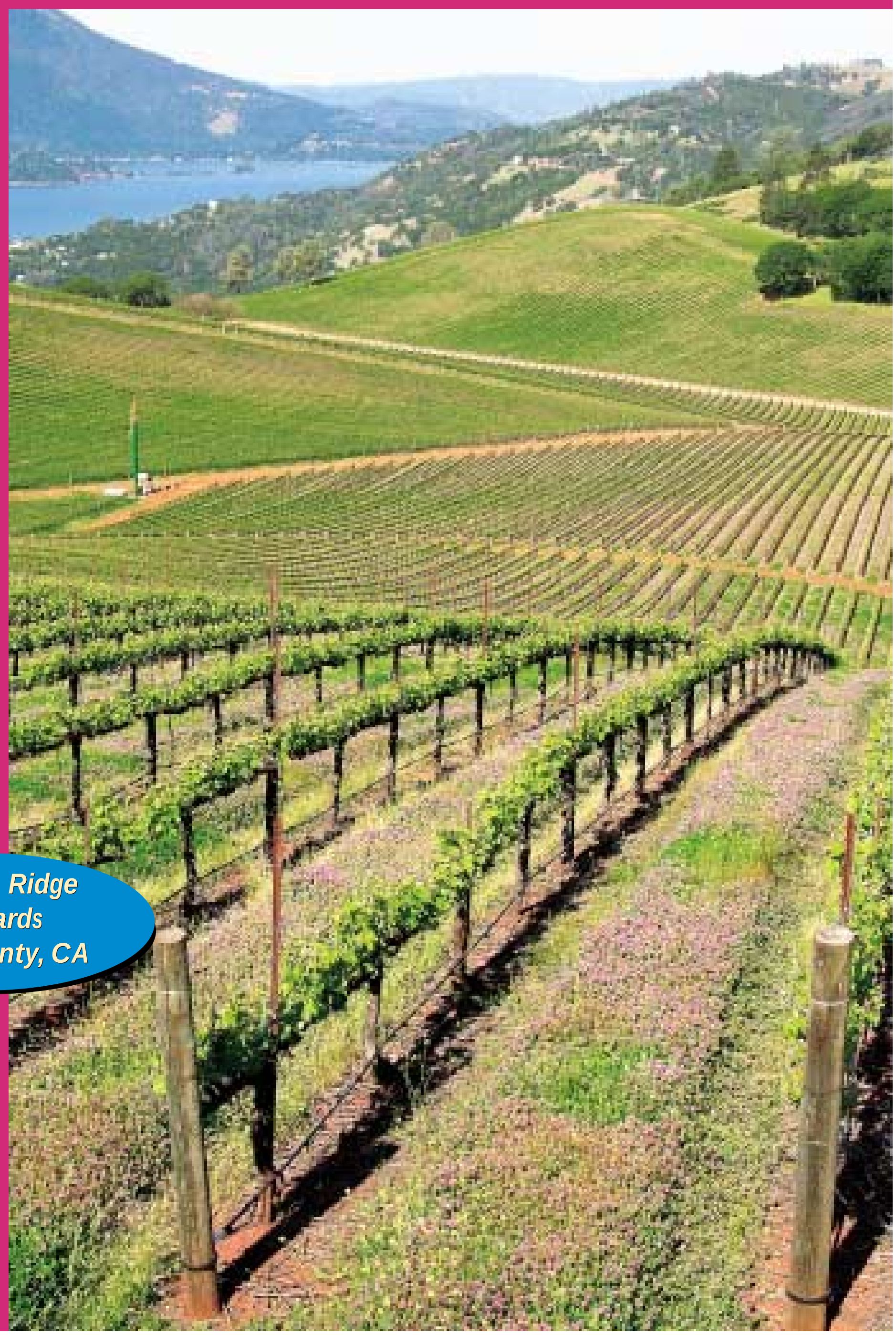

U.S. wine market liberalization by 2015
Perfect storm forming

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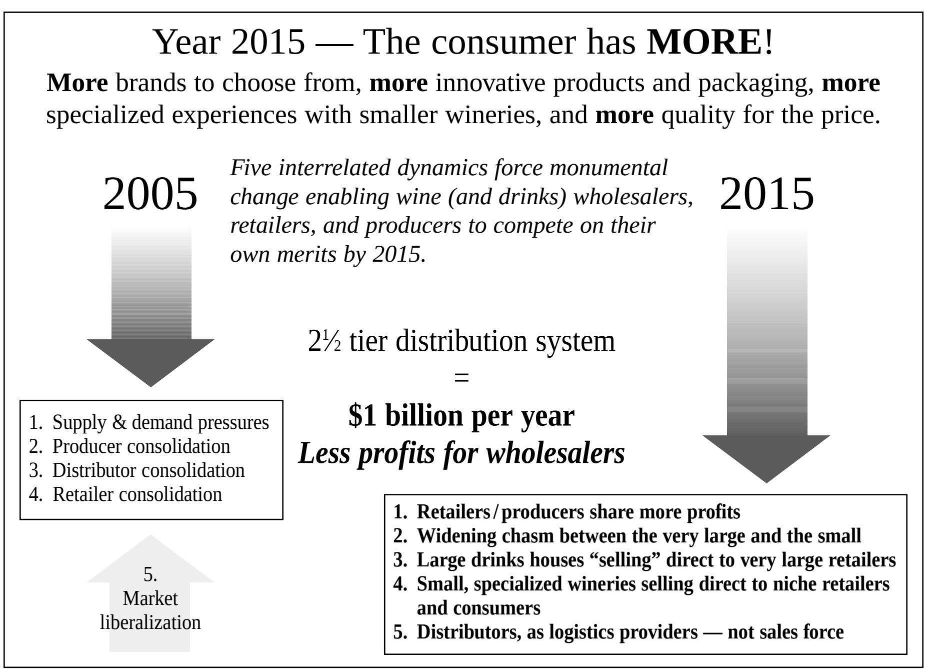
Today's wine industry in the U.S. is at a juncture in history unlike any it has ever experienced, facing complex challenges that are regional, national and global in scope. They include legal, political, and cultural developments. The speed of change is accelerated by economic drivers, technological innovation, and forces of globalization. One thing is sure — by year 2015, the wine and alcoholic beverage distribution system will be more efficient, and more unforgiving of failure, than it is today.

Each tier of the entire "drinks" industry will be impacted, including wine, beer, spirits, ready-to-drink (RTD), carbonated soft drinks (CSD), energy drinks, premium water, and juice. Tomorrow's successful industry participants will be proactive. New business models will emerge in response to market challenges, and successful operators will effectively leverage new opportunities.

Five interrelated dynamics are having a cataclysmic impact on all industry participants — a perfect storm is gathering and generating monumental change in all tiers of the industry as the players position themselves for growth and profitability. Industry participants will need to develop essential, focused, and disciplined strategies to weather this storm and prosper. Ultimately, consumers will benefit — from the innovation created by the forces of competition, from better access to higher quality wines for the price, and from increased retail resources available to incentivize customer purchase behavior.



What are these five interrelated dynamics?

1. Supply and Demand Pressures — The sheer volume of global wine supply is massive and provisioning a constantly expanding multibillion-dollar consumer market. The net results of industry growth are supply-chain pressures, which force producers to continually improve wine quality and production efficiencies, and demand-chain pressures, which drive producers and retailers to apply innovative practices and produce more customer-focused and differentiated products.

2. Producer Consolidation — Large producers are getting larger and are primarily publicly held companies, a status that provides better access to capital sources for funding growth. With two notable exceptions (E&J Gallo and Kendall-Jackson, which are privately held and only in the wine industry), the largest "drinks" producers are dominant merchandisers in all three major alcoholic beverage product markets — spirits, wine, and beer.

The inherent motivation behind producer consolidation is to achieve economies of scale in production and distribution, which equate to profit opportunities, market power, lower per unit administrative and delivery costs, and more sales and marketing clout. These billion-dollar, mass merchandisers are forcing mid-size ($60 million to $500 million) and small (less than $60 million) producers to become more focused and specialized and better differentiated. The outcome is a widening chasm in how wine is sold — separating the billion-dollar, mass drinks merchandisers from all other segments.

3. Distributor Consolidation — The strong are getting stronger. In the U.S., the alcoholic beverage distributor, or wholesaler, has benefited from a protected business environment, as a result of the legal and regulatory system created by the repeal of Prohibition.

The mandatory three-tier system, which still exists in most states, is a complicated weave of restrictive regulations (cash laws, credit restrictions, primary source laws, at-rest laws, franchise laws, product registration, price-posting, and prohibitions on direct retail sourcing from out-of-state). These regulations were designed to prevent brand movement between distributors and assure comfortable dis-

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tributor margins regardless of the economic climate.

Over the last 10 years, wholesale consolidation has been accelerated by wholesale margins being squeezed with new overhead costs in technology, retailer-required merchandising, and advertising. Consolidation is not abating. However, margin squeeze is causing wholesalers of alcoholic beverages to increasingly focus on doing what they do best — transporting and delivering product — and requiring producers to market, sell, and merchandise themselves if they want their products to move.

Modernization of the alcoholic beverage distribution system is being driven more by economic factors than by legal action. This is apparent in the reduction in the number of wine and spirits wholesalers. This tier has shrunk, from approximately 2,400 wholesalers in the mid-1980s, to approximately 250 today. This reduction occurred even without the spur of current legal decisions adverse to the distribution tier.

The expansion in size of distributor networks is another sign of the strengthening storm. Southern Wine and Spirits spans the U.S. from California to Massachusetts. National Distributing Company (NDC) is expanding its base in the south and southeast. Glazier's is growing by aggressively acquiring distributors in the midwest. Young's Market Company is a force in the west and Hawaii, and the Charmer group (Charmer, Sunbelt and Premier, among other companies) is powerful in the northeast, south, and the west.

4. Retail Consolidation — When wholesale margins are squeezed, the opportunity exists for large retailers to capture a significant portion of wholesale profits, sharing these with producers and using them to compete for consumer attention. This is happening today.

The retail wine industry is segmenting into two broad categories — on one side are wines sold in restaurant chains and broad market off-premise retailers with good price-to-value ratios (including private and controlled labels). On the other side high-end and scarce wines from high-profile producers are positioned as "luxury goods." These wines are sold to customers on allocated lists, and they are located on wine lists in high-end restaurant accounts and available at specialty alcoholic beverage retailers and in secondary markets, often at prices above $15 per bottle MSRP.

Implications of this "divide" are important. Positioning within one category or the other has a huge impact on the ultimate potential value of a brand.

Development of on-premise and off-premise, multi-outlet and multi-state retailers has driven much of the producer and wholesaler consolidation of the last 20 years. This retail model exists to service a highly identifiable, targeted, mass customer base and relies on controlled margins. Participating vendors must play a volume game.

Wine is an attractive product for these retailers, because it both exerts a pull on customers and provides more profit per unit of cost than general merchandise or food. These types of retailers will continue to expand globally and are likely to become even more focused on targeted customer segments. Some examples include: Chevy's and other Mexican restaurant chains, specialized pasta chains, or groups of white-tablecloth restaurants that share a common management and administrative structure. Competition in this arena continues to intensify, following today's mantra of "driving costs out of the system."

5. U.S. Market Liberalization — However it comes to pass, whether by opening or restricting the flow of goods, in the wake of the *Granholm* decision in the Supreme Court, the states (slowly and one-by-one) will have to repeal illegal laws that discriminate in favor of local interests to the detriment of competitors in other states.

It is our view that, by 2015, wholesalers, retailers, and wineries increasingly will be operating in an environment where they will have to compete on the merits of their wines, their prices in relation to the entire market, and customer service.

The May 16, 2005, Supreme Court *Granholm* decision is the most important development in the industry in the last 40 years. This decision is the culmination of a decade-long legal battle over the right of wine producers to ship out-of-state directly to consumers in states that permit their wine producers to ship to consumers within their state.[a] The *Granholm* decision supports the more general conclusion that no state law can benefit a private in-state interest against an out-of-state interest in the same line of commerce, absent a compelling state interest (or when the state itself is the actor, such as in control states).

The *Granholm* decision will create a domino effect in the long term, accelerating the purging of state-level discriminatory laws that currently prevent direct shipment of wine. First affected will be laws as they pertain to wineries, and then as they pertain to other industry members.

The immediate state-level direct shipping disputes will be legislative and political in nature. They will include attacks against the right of in-state wineries to ship directly to in-state retailers as a defensive mechanism on the part of wholesalers concerned about losing business. These attacks will ostensibly further the goal of equality on the anti-alcohol theory that everyone should be prohibited from shipping in order to protect minors and entrenched state interests. This has already happened in New Jersey, been threatened in Michigan and Indiana, and has been ordered as a remedy by a Federal District Court in Virginia in a follow-up case there.

21st Amendment jurisprudence has evolved from the late-1930s cases that allowed a state to regulate alcohol any way it wanted, without regard to the rest of the Constitution. A subsequent series of cases moderated that position: a state cannot affect another state's commerce;[1,2] a state cannot violate anti-trust laws,[3] a state cannot impose discriminatory taxes;[4] and a state cannot violate the First Amendment.[5,6] This continues to evolve right up to today's *Granholm* decision: a state cannot discriminate against out-of-state interests.

a. The Supreme Court in *Granholm v. Heald*, 544 125 S. Ct. 1885, May 16, 2005 found that the 21st Amendment did not authorize discrimination between in-state products and products from out-of state. Justice Kennedy held for the Court, "The Amendment did not give States the authority to pass nonuniform laws in order to discriminate against out-of-state goods, a privilege they had not enjoyed at any earlier time." This is the key holding in the opinion and represents the beginning of a clear line of authority (Authors).

The five essential dynamics described above are catalysts for change, consequently producing new global opportunities and challenges.

Supply and Demand Pressures

OPPORTUNITIES

New customer segments are evolving both in the U.S. and globally. More than 70 million consumers from the millennial generation will be the single most significant factor affecting U.S. market demand in 2015. This generation appears to be wine-savvy at a much earlier age than their parents were, and early studies predict they are likely to appreciate quality products and brands.

This phenomenon is equivalent to the post-WWII boomer explosion and is double the number of the millennial's older Gen-X brethren. Early adopters in this generation also appear to be large consumers of high-end spirits products, energy drinks, and premium water.

As developing countries are industrializing and acquiring expendable income, new, untapped regional wine markets are emerging in China, India, and eastern Europe. Although U.S. wine producers face global competition in these markets, well-positioned luxury goods and mass-marketed wines that leverage local cultural differences and values will encounter growth opportunities as these new wine consumers expand exponentially in volume.

One country's mass-produced wine and beer are often another country's luxury products, and many multi-national producers are currently capitalizing on that phenomenon.

Improvements in bulk transportation technology are now supporting growth in international bulk wine shipments. Bulk wine increasingly is shipped between eastern Europe and South Africa, between California and the United Kingdom, between South America and California, and between Australia and China. This is a trend that will persist and will play an important role by year 2015, enabling significant growth in negociant trade and private labeling, and smoothing out price differentials between regional markets. Most important, large global wine companies will be able to optimize their cost of goods in every market they choose to enter.

CHALLENGES

Global wine supply is perhaps too abundant? Wine is produced in almost every developed country in the world. India, China, and several eastern European countries are becoming wine producers. Countries with excess wine supply, such as Chile, Argentina, Australia, New Zealand, South Africa, Georgia, Moldavia, and the traditional European producers (France, Italy, Spain, Germany), are hitting the world market. In order to compete more successfully, many are replanting to take advantage of new production technology and soon will present more competition for California winemakers.

Driven by forces of good and bad, consistent growth in demand may still be tentative. Population growth, increasing worldwide income held by the middle and upper classes in developed and developing countries, higher-quality wine at reasonable prices, and improved marketing and advertising are fueling growth in consumption. However, gross demand is slowed by unfriendly legal climates (Russia and much of eastern Europe), counterfeiting and other illegal trade practices, decreased consumption by historically high-consuming nations (Italy and France particularly), the anti-alcohol movement, and religious and cultural practices in many parts of the world.

Global consumer perception of United States' wine quality is varied, inconsistent, and complicated by politics and currency fluctuations. Aside from E&J Gallo, very few U.S.-based wine companies have shown the staying power and commitment to profitably develop global wine products and markets. Untapped global markets may be price-constrained and become the domain of globalized mass merchandisers, such as Diageo, Fortune Brands, and Constellation, since these large-scale, multi-national business models are largely impervious to currency fluctuations and have the budgets to establish and maintain market share. Smaller players export when the value of the dollar is weak and retire from global markets when the currency pendulum shifts.

Producer Consolidation

OPPORTUNITIES

Large wineries can become more profitable through vertical integration of their distribution systems and aggressively segmenting their products and services to take advantage of market opportunities. From a distribution perspective, drinks are all liquid (also heavy, usually fragile, and must be protected from temperature variations) and need to be properly stored, delivered on time, and managed in accounts.

More and more beer distributors today are multiple-line houses handling many products, and many are also moving into wine distribution because it's simply another box on the truck. This is a trend that is inevitable and impacts every drinks market because it makes economic sense to consolidate as many products as possible on the same truck for delivery to the same accounts. For this reason, the major consolidated marketing companies are increasingly focused on producing premium products in almost every beverage segment. For example, Constellation has Corona and Diageo has Guinness. These same companies are also active in the RTD categories.

Examples of well-managed, large entities include E&J Gallo — with over 70 million cases shipped in 2004, the industry leader in wine depletions — and Anheuser Busch (AB) — the industry leader in beer with more than a 50% market share. E&J Gallo and AB are category leaders, function as "category managers" for many major off-premise chains, and are expanding product offerings to capitalize on the "premium is better" marketing climate.

E&J Gallo has segmented its products more than any other company in the wine industry and is capitalizing on the current popularity of low-priced brands from other countries (such as Yellow-Tail from Australia) with its launch of Red Bicyclette from France. E&J Gallo owns its distributors wherever possible, for example, G-3 in California, and is an assertive partner in other U.S. markets. AB owns distributors wherever it is permitted to own them, rewards loyal managers with franchises, and has adopted a distribution agreement that provides an additional margin on sales to compensate distributors that focus on AB products to the exclusion of competitive products.

A "two-and-a-half" tier system could eliminate between $1 and $5 billion per year in distribution inefficiencies by year 2015.[7] Large producers and large retailers increasingly work directly with each other on pricing, market positioning, advertising, and merchandising. They do not rely on distributors for these functions. Rather, they inform the distributor what the terms are and then pay for services they actually receive (transportation, storage, billing, timely delivery of product, and local market information).

If distributors provide extra services, such as merchandising support, they are paid for those services. This leaves more money in the hands of retailers and producers, to apply to developing consumer awareness and loyalty and fewer profits in the hands of wholesalers. The Diageo distribution agreement institutionalized these practices more than two years ago, and it is now being emulated by other very large producers through special promotional programming to encourage product movement at the retail level.

At the same time, large retailers are increasingly embarking on selling their own private, proprietary, and controlled-label brands, which afford them larger margins. Sales of the Charles Shaw brand at Trader Joe's is a perfect example. This new dynamic provides distributors no effectual role other than to deliver product.

Beer industry analysts have coined the phrase "two-and-a-half" tiers to describe this trend and ascribe a billion dollars per year to the expected annual efficiencies extracted from the distribution tier. These cost savings are split between producers and retailers as additional margins.

We believe that similar cost savings exist within the wine industry because individual unit values in wine are much higher than in the beer industry. Therefore, higher cost savings per unit are more likely to occur when the real value of services provided is substituted for a distributor margin. Our preliminary calculations leads us to believe the wine industry stands to earn $1 billion to $5 billion per year in cost savings once the wine market becomes fully liberalized. In response to market dynamics, the modern distributor is certain to provide more cost-effective local services, such as merchandising and product servicing, in an attempt to recoup lost profits.

Smaller and mid-size wineries that survive consolidation will grow in value and observable brand equity by becoming specialists. Concentrating on what they do best, these producers are investing in transforming their businesses through more professional and disciplined product portfolio and customer-based management practices. Many wine consumers are looking for unique experiences or luxury goods that do not fit the mass merchandisers' business models; they get that unique experience from feeling that they are part of a winery "family," and that only comes from personal relationships built-up over time and maintained.

By 2015, most successful small wineries will be 100% customer-focused — with consumers and retailers being the customers. To the extent that traditional distributors are relied upon, it will be for the purpose of servicing high-profile or important accounts in regions or areas where there is a large base of existing customers. High-profile account relationships provide a venue for obtaining and tasting wine, and thereby drive winery direct sales and build small winery brands in the marketplace.

The next 10 years will be marked by a trend toward large wine producers collecting smaller, more specialized brands. The market is rewarding significant mergers of specialized mid-size wineries, such as RH Phillips and Hogue Cellars, under the management of Vincor from Canada; the Icon Estates portfolio of brands, under the management of Constellation; and significant internal growth through the development of multiple stand-alone brands, such as the brands produced by E&J Gallo (both in Healdsburg and Modesto, CA).

The business models that will win are those that allow each specialized brand to maintain its separate, but strong and consistent relationship with its consumers. Kendall-Jackson's Artisans & Estates are a good illustration of this strategy.

CHALLENGES

Except for the few top (A) brands, most smaller and mid-size wineries are being locked out of the current three-tier distribution system. The cost of marketing and sales has escalated for most wineries to upwards of 25% to 30% of sales; consequently, many brands are not realizing their goals.

Many expect that relief is on the horizon from the three-tier system itself, because the *Granholm* Supreme Court decision is expected to liberalize state shipping laws and potentially open new consumer-direct channels. This is false hope for many, because it will take a long time for changes to be fully processed through each state legislature, and it will still be necessary to penetrate local markets to create demand-pull.

Timing is important because the winners will be the first to market — with the right wine, story, communications structure, and customer service. The window of opportunity is now, because successful brand building takes years, requiring a serious commitment of time and focused resources.

In order to survive and grow, small- and mid-size wineries must already be building the infrastructure capable of capitalizing on these opportunities. Brand building over the long term will become more and more difficult, as large producers segment their brands to fill available niches and well-positioned small wineries use their agility to capture the consumer's share of mind.

Distributor Consolidation

OPPORTUNITIES

In most of the world, the middle tier of the drinks industry exists as a service provider or as an adjunct of large producers. The distribution tier has always performed a valuable function in assuring proper product storage, delivery, and merchandising where and when required by producers and customers. An essential component of these relationships is the mid-tier investment in vehicles, warehouses, and transportation technology — offset by a concomitant return on the investment. This is understood by beer, RTD, CSD, juice, and energy drink segments of the U.S. market. Participants in these segments, seeking improved efficiencies in their distribution systems, are consolidating products for storage, shipment, and delivery on a common base of trucks, warehouses, and personnel.

As the wine industry follows in these footsteps and our laws continue to change, the large U.S. distribution houses should evolve from sales management to fleet management, leaving more money in the hands of the wine retailer and producer to build brands with consumers and less profit in the hands of wholesalers. In doing so, the industry becomes a two and one-half tier system, and the projected elimination of in excess of $1 to $5 billion per year in inefficiencies becomes more likely.

Investment in more efficient delivery technology is supported by large suppliers and retailers. Examples of functional, vertical integration are commonplace in the non-alcoholic beverage drinks segment, primarily achieved through shared investment, brand equity, and regional distribution networks. Driven by technology and economics as much as by legal challenges, the development of large producer networks and large retailer networks inevitably will spur the development of large, coordinated delivery networks.

CHALLENGES

U.S. distributors are being forced to invest in new technology and systems necessary to serve today's customers, especially large multi-state retail chains. Without the scale necessary to efficiently compete, many old-line distributors are selling to larger competitors rather than invest in the requisite technology and systems. Regardless of these economic developments, as long as the current wholesale tier is able to profit from the protectionist legal system it created, change will be slower and more incremental than it would be in a non-regulated product market.

With considerably more wine being sold through fewer distributors, only mass merchandisers and a few top (A) brands are getting properly serviced in exchange for a large share of their profits. New, specialized distributors and brokers are emerging to support smaller brands. As laws continue to change, new specialized shipping companies will emerge to fill the gap and facilitate direct shipping from producers to their retail customers and their consumers in return for a market-based service fee rather than a margin.

Retail Consolidation

OPPORTUNITIES

Large consolidated producers and wholesalers are becoming category managers for certain large retailers. The large national retailers share a common growth strategy. Examples of these include: grocery store chains (Safeway, Albertson's), the super-premium grocers (Andronico's, Whole Foods), the specialty food and beverage chains (Trader Joe's, Cost Plus World Market), the super retailers and warehouse stores (Costco, Wal-Mart, Target, K-Mart,), the chain restaurants (Olive Garden, Red Lobster, Chevy's), and the convenience store operators (7-11).

These retailers are centrally managed and are committed to vigorous competition (which means low-margins) and good pricing to consumers, efficient and cost-effective customer service, and limited SKUs (Stock Keeping Units or brands), which are easier to manage and have a high turn-ratio — usually better than 10 times to 12 times per year. They are also expanding into every geographic market that they can reach.

As they expand into these markets, the natural inclination is to implement centralized, regional product fulfillment at the lowest cost for every product they carry, including beverage products. This model emulates a "two-and-a-half" tier system, because the retailer hires the distributor to provide a delivery service for a fee rather than to be paid a margin for product.

Retailers are already favoring selected (large) wine producers that demonstrate the ability to analyze profit opportunities and assist the retailer in making difficult decisions among an ample supply of products competing for scarce shelf and wine list space. These (large) mass merchandisers also have the scale to provide advertising support, another critical component to category management.

A growing number of luxury wine producers are tapping into other large, more specialized, retailers. Specialty alcoholic beverage retailers service a more specialized domestic retail wine market. Examples include multi-outlet retail chains, such as Beverages & More in California and ABC Liquors in Florida, and smaller but high-volume specialty retailers, such as Zachy's in New York, Sam's in Chicago, Wally's in Los Angeles, and K&L Wines and the Wine Club in California. These retailers are heavily invested in inventory at higher price points and multiple SKUs and are increasingly managing a multi-market customer base with state of the art customer-relationship management systems. The hallmark of these retailers is customer-handholding, education, and service, particularly in the above $15 wine categories.

Wine.com may be most technologically sophisticated of these retailers, serving 35 states through a legally compliant combination of owned licenses and marketing partnerships with other retailers. These retailers use the three-tier system where possible but do not wholly depend on it for product relationships. Rather, they build relationships with high-end producers and importers and sophisticated customers.

Subsets of these retailers are also investing in "collector," luxury wines, purchased on the secondary market and sold through to high-end users. This would include the auction houses (WineBid.com, Christies, Acker Merrill and Condit, Butterfield's and Bonham's, etc.) and a host of smaller internet-based retailers. These channels are becoming increasingly important for the luxury wine segment, because they provide both a source of mature, investment-quality wines and an outlet for selling those same wines.

CHALLENGES

Wine — two markets: The widening chasm between large mass merchandisers and small to mid-size producers is most obvious at the retail level. Mid-size producers are either merging or being acquired and getting larger or specializing and getting smaller. More than ever before, small- and mid-size producers are carefully developing key retail relationships based on the value they are able to provide to these relationships, in terms of merchandising support and profit dollars.

Small producers are becoming even more specialized, selling to specialized wine shops and restaurants. Specialization requires improved communications; more effectively differentiated brands — through packag-

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ing, quality distinctions, and more focused product portfolios; and a commitment to working more closely with a smaller number of important retail relationships.

The reality is that all wine producers are seeking to become stronger at positioning their brands and are learning from each other in the process. Jug and the emerging "box" wine segments are now using varietal identifiers and upscale packaging. Through specialization and niche marketing, many winery — and retail — operated, proprietary wine clubs are growing in the U.S. and elsewhere in the world.

Larger retailers are not only looking to manage fewer SKUs, they are also launching their own, more profitable private labels in all price tiers. Retailers are attempting to build value by creating their own brands, to help build their reputation and generate stronger return on brand equity. Private, proprietary, and controlled-label brands are each strategies for achieving higher retail profits where the margin is essentially spilt, after transportation and delivery expenses, between producer and retailer.

Typically focused on wines in the low- to mid-range price tiers, this fast growing, global market is now moving into the luxury tier. Costco carries a $60/bottle Kirkland (private label) brand. In the last two years, multi-state wine distribution projects have been initiated — out of California to service the western states, out of Illinois to service the midwest, and out of Florida to service southern states.

These projects involve private and controlled labels or mid- to low-price national brands that are centrally priced and managed. Many wineries are actively specializing in supplying wine under these special labels, and they are an important outlet for excess production. Others, selling their own brands, compete with retail private labels directly for floor space.

U.S. market liberalization

OPPORTUNITIES

Wholesalers will most likely NOT be successful in maintaining the status quo. The depth of the wholesalers' anxiety is demonstrated by Wine and Spirits Wholesalers of America joining forces with the conservative, religious right (Ralph Reed and his Christian Coalition filed an Amicus brief in support of the wholesalers in the *Granholm* case) and the traditional anti-alcohol forces.

At least four dynamics are preventing wholesalers from holding back the storm: 1) wholesaler consolidation reduced the number of wholesalers — diluting their historic power. They will become even weaker over the next decade as they join consolidated systems.; 2) winery trade associations are more effective than in previous eras; 3) the *Granholm* decision truly exposes the vulnerability of traditional special-interest legislation; and 4) special-interest legislation is an enormous political risk that benefits one tier at the expense of putting another tier out of business. Wineries can generate votes, the real currency of politics.

A victory by Costco will reverberate through other states and lead to direct shipment from producers to retailers. The Costco case is the 800-pound gorilla behind the door of the direct shipping lawsuit, and Wal-Mart is right behind Costco. Costco filed suit in federal district court in Seattle, WA, in September 2003, seeking to invalidate the following Washington state laws: 1) distributor price posting; 2) minimum wholesale markups; 3) credit law (Washington is a cash state, requiring retailers to pay cash on delivery for alcoholic beverages); 4) prohibition on quantity discounts and cumulative quantity discounts; 5) prohibition on direct delivery from out-of-state wineries to Costco warehouses.[b]

Given that Costco is fighting so shipments can be sent directly from out-of-state producers to its Washington warehouse,[c] the interests of both wineries and Costco should be aligned. The wholesaler's legislative response to a Costco victory is certain to be an attempted repeal of in-state privileges held by local wineries. The Washington wine industry is also certain to resist encroachments upon the privileges for which it has battled so long. We predict that Costco will prevail in the courts and the Washington wine industry will prevail in the legislature.

If Costco establishes that it legally possesses the privilege of receiving direct shipments from out-of-state producers, then ***any*** retailer in ***any*** state where in-state wineries have a right to ship directly to retail accounts in their own states should possess the same right.

California has the same restrictions as Washington state and the same privileges for its domestic wineries. If challenged, California restrictions on out-of-state shipments to California retailers will also fall. This is certain to be a contentious and heavily litigated issue that will be battled first in the large coastal consumer market states, such as California, Florida, Texas, and New York. State by state, legal action will eventually move to smaller markets as consumer and business pressures rise over unjustifiable price disparities that become transparent because of better consumer and retailer access to market information.

CHALLENGES (OR OPPORTUNITY?)

The most significant court cases will come from the retail tier. Change will be slow, since regulators are disinclined to enforce laws that they believe may be discriminatory and subject to challenge. However, it is highly likely that the retail tier will build its case and win it — dramatically accelerating liberalization of the national wine market.

If an in-state retailer can ship through commercial delivery services to a cus-

b. The Costco action survived 2004 cross-motions for summary judgment and was stayed pending the U.S. Supreme Court decision in *Granholm.* The case is now going back for trial in March, 2006. Of note is the fact that in 2003, the Washington Supreme Court itself expressed hostility to the state regulatory scheme when it invalidated the Washington franchise laws on the basis that they were discriminatory because Washington wineries were excluded. *Mt. Hood Beverage Co. v Constellation Brands, Inc.,* (Supreme Court of the State of Washington, No. 72882-8, Feb. 20, 2003).

c. Equal treatment with in-state wineries that can ship direct to retail accounts, or with consumers in Washington who are also defined as "people" for legal purposes and who can receive goods directly from out-of-state.

tomer, we believe that there is no valid basis for denying that right to an out-of-state retailer. Many states permit their own retailers to ship directly within the state, clearly discriminating against retailers out-of-state.

Judging from the momentum of the last several years and driven by retail legal action, major legal hurdles will be overcome by 2015. While the economic and technological factors are the most predictable drivers of change, definite wild cards exist , including the potential impact of the anti-alcohol movement (which is currently focused on “youth” advertising and reduction in the availability of product through retail outlet control), positive or negative developments in health research, and the consequences of religious-based legislation prohibiting alcohol consumption in many parts of the U.S. and the world.

The “Perfect Storm” is already brewing with a two-and-a-half tier system operating with controlled-label or private brands that are delivered through distributors at rates that are essentially transportation and administration costs. As technological and regulatory breakthroughs occur, this two-and-a-half tier system will expand to broadly sold national brands over the next 10 years.

On the global scene, major super-retailers have been expanding worldwide for several years. These include Target, Costco, and Wal-Mart. It is likely that the major super-retailers from Europe — Tesco for example — may expand into the U.S. or may acquire (or be acquired by) their U.S. counterparts.

Because of globalization, we believe that the world in 2015 will comprise a dozen super-retailers operating throughout the developed world, who will be working primarily with their world-wide producer counterparts and less so with smaller, national producers. In 2015, the average retail wine buyer program will most likely consist of a limited number of well-segmented SKUs purchased from the top 20 wine producers.

The big will get bigger. However, highly specialized retailers and producers will continue to grow through niche marketing, because of the adventurous nature of the high-end wine consumer, who constantly seeks new experiences and education; many consumers will persist in their quest for undiscovered, still higher-quality wines.

New wineries will continue to emerge; but the strong that survive will go about marketing and selling their wines in a more focused, segmented, and disciplined manner over the next decade than they have over the last. The consumer will get **more**: **more** brands to chose from, **more** innovative products and packaging, **more** specialized experiences with smaller wineries, and **more** quality for the price. ■

Deborah Steinthal *is the founding partner in* ***Scion Advisors****, a professional advisory firm focused on finding creative solutions to the toughest problems of family wine businesses. Scion helps wine family leaders transform their companies into more profitable organizations with obvious brand equity. Seasoned executives, Scion’s three partners combine a unique perspective of the wine business with general management know-how from across several industries.*

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John Hinman*’s experience spans the modern history of the wine industry and includes regulatory defense before state and federal government agencies, distribution litigation throughout the U.S., arbitration and mediation of relations between grapegrowers and wineries, and deep involvement in the direct shipping battles from the very beginning.* ***Hinman & Carmichael LLP*** *provides expert corporate, administrative, and regulatory legal services exclusively to the alcoholic beverage and hospitality industries and assists other law firms and in-house counsel as special counsel on alcoholic beverage issues.*

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