HO-116

University of Kentucky
College of Agriculture, Food and Environment
Cooperative Extension Service

Wine Distribution for Small Farm Wineries in Kentucky

Ryan Baumgardner and Seth DeBolt, Horticulture

The following is an overview aimed to assist Kentucky small farm wineries in understanding the complexity of distributorships. A model for establishing a distributorship is evaluated.

Despite their importance to economic growth, tourism, agricultural awareness, and Kentucky Proud products, small farm wineries in the state of Kentucky face a major issue when they look to expand their brand(s) market opportunities through wholesale distribution into more retail outlets. Kentucky is a state, like many, that uses the 'three-tier system' of distribution. The three-tier system means manufacturers (wineries) must sell their product to a distributor, who then has the legal capacity to sell that product to retailers. In turn, retailers are the designated entity that can then sell the product to the end consumer. The major challenge with this system is that small to medium-sized wineries, defined as producing fewer than 100,000 gallons annually, fail to receive the benefits of working with large-scale distributors as the product volume is rarely sufficient to be attractive to major brand distributors and their clients, the retailers. The result is that small Kentucky-owned farm wineries have their products either not making it to the retail shelves at all or in suboptimal marketing positions for their target market. This missed opportunity leaves very little room for expansion and brand recognition. Here we provide a historical context underlying distribution, why laws exist that limit wineries from self-distribution—along with a framework for winery operations to start their own wholesale/distribution company—and what other states are doing to promote success of their endemic wine industries from the wholesale point-of-view.

Distribution: Historical Perspective

A central question to be addressed: Why develop the three-tier system as a legislative option? Based on available information, the three-tier system arose for alcohol sales in the wake of Prohibition and formed what amounted to be a ban on direct sales between producer and consumer. However, a three-tier system that includes 1) manufacturing or production, 2) wholesale distribution, and 3) product retailers is a broad structure applied to many industries. A main driver for the three-tier system in alcohol sales was to maintain freedom of the market. Before Prohibition, producers of spirits and beer served small geographic areas and frequently owned the retail outlets. Called "tied house" practices, suppliers, by virtue of having a partial or total ownership of retailers, coerced retailers to favor their brands. The worry was without a three-tier system, a large company could own the production, distribution, and retail aspects of the business and become too large and block out smaller competition. Knowing the three-tier system was created post-Prohibition to mitigate monopolization has some advantages. In the current state of the industry, wholesalers serve a wide variety of retailers, where they have the opportunity to capitalize on market trends and identify products for the retailers that they serve to maintain maximum sales. This is part of the challenge faced by small farm wineries that would benefit from greater exposure to their target markets via aggressive wholesale marketing along with the capacity for direct sales via delivery to the home after a winery visit. Direct-to-consumer shipping is a relatively new phenomenon and was only 2 percent of wine sales prior to *Granholm v. Heald* in 2005. *Granholm v. Heald* was a case where the U.S. Supreme Court ruled that the Commerce Clause prohibited states from regulating direct shipment in a manner that resulted in discrimination in favor of intrastate direct shipments and against interstate direct shipments. This case caused many states to revisit their views on the three-tier system and can allow the promotion in endemic products by blocking large out-of-state to support their stakeholders. However, since the Granholm case, the direct to consumer industry has been growing and prior to 2015 wholesalers who had been blocking a lot of legislation being proposed when it came to direct to consumer shipping, have been conceding to wineries, while they do still remain opposed to out-of-state retailer shipping.

Kentucky Wine Distribution

In Kentucky, some of the laws relating to Kentucky wineries capacity to influence their wholesale/distribution channels are as follows:

Kentucky statute 243.154 effective June 25, 2013: "(1) A small farm winery wholesaler's license shall authorize the licensee:

(a) To purchase, receive, store, or possess wine produced by small farm winery licensees;
(b) To sell the wine at wholesale from the licensed premises only; and
(c) To transport from the licensed premises for himself or herself only any wine produced by small farm winery licensees that the small farm winery wholesaler's license authorizes him or her to sell" (KRS 243.154).

In contrast to the utilization of traditional wholesale/distribution channels, a second way for Kentucky wineries to get their wine out to the market is to sell direct to consumers. This however, is still a state-by-state issue and some states restrict the passage of wine by direct sales. Some states have allowed wineries to ship directly to consumers regardless of their location at the domestic and international level. Wineries in Kentucky currently have the ability to ship direct to consumer within Kentucky and in 45 other states. This supportive legislative route aimed to increase in Internet users and online shopping, as long as proprietors remain within the provisions set out by each state (i.e. under 50,000-gallon annual production).

As we have now seen Kentucky wineries do have the ability to wholesale themselves, this just requires they start their own small farm winery wholesale/distribution company, per Kentucky statute 243.154. This is a significant opportunity and provides small-medium sized wineries the ability to self-distribute their wine, but does not eliminate all challenges associated with getting your wine to a retail store and in a position with optimal opportunity for success. First, when starting this new company, you must have at least three to five months of time to wait for the local, state, and federal government to approve your request to be a licensed wholesaler (Figure 1). The process starts by first getting federal approval, per the state's request (this is not a federal requirement). Once licensed federally, the process goes to local government, and then finally ends with state approval.

After going through these steps, which are notable logistical steps for a small to medium-sized winery to get through, you are licensed to distribute in Kentucky. All in all if you have successfully gotten a Small Farm Winery License, it is assumed herein that you have the legal framework to get your own Small Farm Winery Wholesale License. The time required to do so may be the only barrier to entry for a small farm winery. Once you are a licensed wholesaler and can legally distribute wine, you must become an approved vendor of the large retail stores where most customers purchase your product (Kroger and Liquor Barn are local examples of chain vendors). A process that has just as many steps and regulations as there are to get licensed. According to Harriet Allen, owner of Talon Winery, "The time and money that

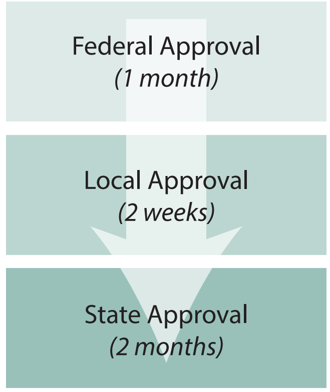

Figure 1. Legal process for Small Farm Winery License.

is required to get into these new retail outlets is a large and if you choose to start your own distribution company you have to be patient with seeing the returns."

Once through the legal and approval aspects of starting this new part of your business, many day-to-day business and financial questions arise. Jamie Cox of Midwest Wine Press, explained: "If you self-distribute, you will be doing the work of both supplier and wholesaler. You will have to market, promote and advertise your products. You will have to sell to retailers and develop and maintain relationships with them. You will have to do your own pricing, and you will have to deliver the product, which may include financial investments, as you will need a delivery system, including, trucks and more employees to serve as truck drivers." This is not to discourage new small to medium sized wineries from self-distribution, but just a practical look at what it looks like to take on such a big obligation for your business. There are many benefits of having control of your distribution, as can be seen with Purple Toad Winery, in Paducah, Ky. Purple Toad is in more than 400 stores in Kentucky and five surrounding states.

A small to medium-sized winery that takes on distribution responsibilities must have an exit strategy, or an understanding of how large they want to become and what they themselves can feasibly maintain. When thinking about self-distribution, it may be a vehicle to get noticed by a larger distribution company (if your goal is to grow) or for a small winery; the goal may be to get into the local market. A great strategy for growth in states that allow self-distribution would be to take a few years and establish yourself in the market with and get a good amount of retailers to carry your wine. When you finally get big enough that it does not become feasible for you to maintain and grow through self-distribution, working with a larger distribution company is an ideal mechanism to grow.

Alternative Wine Distribution Methods

If unable to use a large distributor/wholesaler and are averse to the risk or unable to set-up a separate small farm winery wholesale company, other alternatives still exist. One example of this is a winery wholesale co-op. The organization of a co-op for small farm wineries in a state would allow the wineries to spread the costs/risks that are present if you were to start your own wholesale company. The co-op would also give the wineries involved self-reliance to expand their market and bring awareness to their products as a collective. An example of this method of distribution in practice, is the co-op the wineries of Wisconsin set-up in response to a law that passed in 2008 that required all wineries to go through wholesalers to reach retail outlets. A group of 29 wineries formed the co-op in the same year, and the co-op was able to obtain a license to distribute their wines in Wisconsin. The only provisions to being a part of the Wisconsin winery co-op were you must produce under 25,000 gallons a year and be in the state of Wisconsin.

The second state to evaluate the winery cooperative model is Virginia. The Virginia wine co-op Vine to Wine started in 2011, and was created to allow vineyards and wineries to be in more control of time-consuming processes like purchasing and wholesale/distribution, saving the winery and vineyard owners both time and money. This co-op will hold an ABC license for Virginia, and have long term storage for supplies, pallets/cases of wine and transportation management to and from the warehouse. There is a lot of promise from the establishment of co-ops in areas like Virginia and Wisconsin that have many small wineries who could band together to split costs of operation and advertising.

The results are yet to be determined on the success of these co-ops, but it is a plausible path that small farm Kentucky wineries have not undertaken.

E-Commerce Distribution

This new Internet based distribution has the greatest ability to impact the industry as a whole in a large way. The idea of E-commerce distribution is moving everything online through an online wholesaler who will eventually be able to be in all 50 states and is expected to become a dominant sector of all markets moving forward. The first company to start experimenting with this is Liberation Distribution (LibDib). LibDib was created by Cheryl Durzy who has been working in the wine business for 20 years and became frustrated with opportunities to reach the market while managing her family's brand. With LibDib producers can input whatever product they choose to onto the website and choose where they want to distribute. With the products available on the website retailers/restaurants are able to then pick and choose which products they want from the producer. This prevents the closed market that had been established where the smaller producers cannot get their product into the market, because retailers are being pushed to purchase only from the largest producers who the distributors are carrying. This new technology is still very much in its infancy and is only just about to go live in California on April 5, 2017, but there is a lot to be gained in the coming years from internet based e-commerce distribution. This technology likely still has a few years before it reaches Kentucky and will still have some growing pains to go through along the way.

Conclusion

Whatever medium you choose to go through for distribution—be it self-distribution, direct to consumer shipping, co-op formation, or in the future e-commerce distribution—there is reason that established and large distribution companies are a desirable and valid option for many. There are, however, opportunities to allow small farm wineries to control their product distribution channels, whatever your end goal—if it is to maintain your local market and stay steady or to grow your business so you are shipping your wine across the state or regionally. The ability to self-distribute is a promising aspect to business success in either route you choose successfully maintain market share.

References

"Alcoholic Beverage Industry: Three-Tier System." *Park Street.* Accessed March 6, 2017, at: http://www.park-street.com/wine-spirits-industry-background/.

Berger, Judith, "MN-WI Distribution Differences Wider Than The Mississippi." *Midwest Wine Press.* January 15, 2012. Accessed April 3, 2017, at: http://midwestwinepress.com/2012/01/15/mn-wi-wine-distribution-differences-wider-than-the-mississippi/.

Business authorized by small farm winery wholesaler's license—Licensed premises on small farm winery KRS: 243.154 (2013). Accessed March 6, 2017, at: http://www.lrc.ky.gov/statutes/statute.aspx?id=42496.

Cox, Jamie, "Solving the distribution dilemma at Smaller Wineries." *Midwest Wine Press.* January 30, 2014. Accessed March 6, 2017, at: http://midwestwinepress.com/2014/01/30/winery-self-distribution/.

"Three Cheers for Three Tiers: Why the Three-Tier System Maintains and Social Benefits After *Granholm*." *Center for Alcohol Policy.* Acccessed March 25, 2017, at: http://www.centerforalcoholpolicy.org/wp-content/uploads/2016/02/Roni-Elias-Essay.pdf.

"Vine to Wine Co-op." 2014. Accessed April 1, 2017, at: http://www.vawine.org/wp-content/uploads/2014/11/3vinetowine.pdf.

Whitaker, Joel, "Now There's a Distributor Who Welcomes Truly Small Brands." *Kane's Beverage News Daily.* March 22, 2017. Accessed April 4, 2017, at: http://www.bevnewsonline.com/now-theres-a-distributor-who-welcomes-truly-small-brands/.