



INTERIM REPORT

to the 87th Texas Legislature



HOUSE COMMITTEE ON
LICENSING AND ADMINISTRATIVE PROCEDURES



JANUARY 2021

CHARGE 3: Control Labels

Examine "control label" products and their impact on the three-tier system and alcoholic beverage industry in the state. Make recommendations to regulate control label products in a way that promotes economic growth, benefits the consumer, and stabilizes the three-tier system.

Control Labels

The Alcoholic Beverage Code is built on the three-tier system of regulation, which mandates the separation of the industry into three tiers: Manufacturers (e.g., breweries), retailers (e.g., liquor stores), and the distribution tier that buys product from manufacturers and sells it to retailers. Without the three-tier system, the industry would vertically integrate so that one tier would absorb the other two. The result would be monopolization of the industry, boxing out independent operators. Historically, vertical integration enabled the large manufacturer to control the retail tier, leading to permanent indebtedness that fostered overconsumption and its consequences. The three-tier concept was designed to prevent this, and it became the most common form of regulation following the repeal of Prohibition. However, the landscape has shifted since then. Due to their enormous purchasing power, modern retail chains exert control over manufacturers and wholesalers.

A control label is a product made by a manufacturer exclusively for a (typically large) retailer. Because of its purchasing power, the retailer can force the wholesaler to sell the product exclusively to that retailer at a low cost. The retailer can then sell its store brands at a low cost to the detriment of other manufacturers' products.

The Code prohibits these arrangements. Chapter 102 of the Code is titled "Intra-Industry Relationships" and governs the interactions between the three tiers. While no provision explicitly addresses control labels, several provisions nonetheless prohibit these arrangements. Exclusivity arrangements are considered unlawful. In addition, the discounted price that the retailer can demand for the control labels are prohibited.

The challenge is that thousands of these products are already in the Texas marketplace. The Code forces TABC to approve a label application for any wine or hard liquor product that has already received federal approval. In contrast, beer label applications undergo TABC scrutiny. Hence, while we have successfully kept beer control labels out of Texas, thousands of wine and liquor products remain. We do not believe that TABC has the discretion to interpret the current Code in a way to authorize control labels.

The Committee heard from numerous groups all in favor of reforming control label regulations. The Texas Distilled Spirits Association, a trade group representing Texas craft distillers, considers control labels a "major concern." They see control label products as having a significant market advantage over other products. TDSA contends that because control label products have a much higher profit margin, a retailer will give them preferential shelf space, offer special promotions, and have staff push the products over others in the form of recommendations. They have reportedly seen such preferential treatment exacerbated during the

Covid-19 pandemic as shopping has shifted from the aisle to an app. As the digital shopping experience is a heavily curated environment, TDSA claims their member's products are becoming even harder to find.

Similarly, Wine Institute, a trade organization representing California wineries and businesses, responded that certain promotions run by retailers with control products actually have the effect of devaluing brands. They contend that those retailers use products with recognizable brand names as loss leaders to attract business and then promote their own control labels. Wine Institute argues that a below profit-margin price cheapens and disparages a brand, as price can be an indicator of worth, reputation, and quality.

There are other control label products that are bottled and packaged to look very similar to well known name brands.

While statute and spirit of the three-tier system might, in fact, prohibit control labels, their ubiquity may make such enforcement impractical. So rather than outright prohibition, the Committee recommends implementing statutory regulations and equipping TABC with the necessary rulemaking authority to ensure transparency, fair play, and basic compliance with the three-tier system. Collaboration within the industry will be key to meeting this goal.

CHARGE 4: Texas Wine Appellation Standards

Evaluate the Texas wine industry and the current labeling requirements associated with the use of “Texas” as an appellation. Determine if current regulations and permitting rules are adequate to support the industry’s development.

Texas Wine Appellation standards

Anyone familiar with wine knows that when picking out a bottle, appellation of origin is an important aspect of that decision. Wine is nuanced, and its terroir—the natural environment in which a wine is produced giving it its characteristic taste and flavor—is responsible for that uniqueness. Arguably the most important aspect of the label, without an appellation of origin, consumers would not know what they are drinking.

An appellation of origin generally designates the geographic area in which fruit was grown. Using an appellation of origin indicates not only that a wine has certain qualities or characteristics due to its environment, but that it also meets certain federal or state production requirements. Texas uses the minimum federal standards set by the U.S. Department of the Treasury Alcohol and Tobacco Tax and Trade Bureau (TTB) (27 CFR 4.25 and 4.34). In general the TTB requires labels to include an appellation of origin if the wine is labeled with:

- A vintage date;
- A varietal designation;
- A type designation of varietal significance;
- A semi-generic designation;
- An “estate bottled” claim; or
- A product name qualified with the word “brand” under the requirements of 27 CFR 4.39(j)

The TTB further sets type size and legibility requirements to prevent the appellation from being obscured.

In order to use a State appellation of origin the TTB requires:

- Not less than 75% of the wine must be derived from fruit or agricultural products (as applicable) grown in the named State; AND
- The wine must be fully finished (except for cellar treatment pursuant to §4.22(c), and blending that does not result in an alteration of class or type under §4.22(b)) in the named State or an adjacent State; AND
- The wine must conform to the laws and regulations of the named appellation area governing the composition, method of manufacture, and designation of wines made in such State.

With no signs of slowing down, the Texas wine industry has grown at an impressively rapid pace over the last decade. At more than 500 wineries, Texas is the 5th largest wine producing state

behind California, Washington, New York, and Oregon, all of which have laws protecting their appellations that surpass the minimum federal percentages.

As the industry has matured over the years, there has been a debate among producers and enthusiasts if Texas should embrace being a serious wine state and tighten its appellation of origin requirement. There are essentially two camps: one that wants to keep the federal minimum status quo and another that wants to require up to 100% percent Texas grown fruit to use the Texas appellation.

The status quo camp contends that the industry is thriving under the current system and the relaxed appellation requirement is at least partially responsible. They argue it would be detrimental to “burden Texas wineries with more government regulation” and that adding “state regulations on top of and inconsistent with federal law will put Texas wineries at a disadvantage.” Additionally, they believe there are not enough Texas grapes to sustain the production output of the state if wineries are required to use 100% native fruit. The two camps can coexist, they believe. Producers wishing to use 100% Texas grapes are free to do so and their label can reflect that. For everyone else, the Texas appellation can remain as is.

For the other camp, calling a wine a Texas wine while using only 75% native fruit is disingenuous and deceptive. Because wine is so particular to the environment in which it is grown and produced, this camp believes watering down Texas made wine with bulk juice from other states obfuscates its true origin. This, they contend, has at least two detrimental outcomes: first, consumers do not actually know what they are buying and drinking, and would likely be surprised to learn the true percentage of native fruit in wine labeled Texas; and second, blending significant amounts of foreign juice with Texas juice clouds the native characteristics of Texas wine damaging its profile and worldwide reputation. As a result, they contend that within the trade Texas wine isn’t taken seriously and its reach is stunted as national wine distributors are hesitant to carry it and top wine critics won’t score it.

Furthermore, they refute the claim that Texas does not produce enough fruit to sustain its wine production and that why producers use out of state bulk wine has more to do with economics than availability. Texas, they estimate, has hundreds of thousands of gallons of unsold bulk wine every year. Nevertheless, with over 600,000 acres of grapes in production, California, for example, will always be a lead exporter of inexpensive bulk wine. So while there may be plenty of native wine available, using the maximum amount of foreign wine allowed will produce the largest profit margins. The argument follows that appellation should highlight wine characteristics, not economic convenience.

Accordingly, this group has pushed for “truth in labeling” legislation for the past couple sessions. H.B. 4233 by Representative Kuempel (86R) would have required wine to use 100% Texas grapes to use the Texas appellation. It, however, gave the Agriculture Commissioner the authority to alter the percentage if the quantity of grapes was projected to be less than estimated production. A committee substitute version of the bill incorporated a graduated phase in percentage requirement stepping up 5% a year until 100%. This was done in hopes of reaching a compromise that never quite materialized.

It is the committee's view that, at its most basic, this argument is about how to use "Texas" as a wine signifier, as both sides clearly see economic value in the term. Should it be a marketing tool allowed to be placed on as many bottles as permissible under federal regulation? Or should the term be used in a more discerning manner, one that is transparent and telling of the product it is on? Critics of the current state might ask is "Texas" a legitimate appellation or is it just an advertisement?

The Committee has found that it would not be contrary to federal regulation to pass a state law regarding appellation standards. In fact, the federal percentage requirement is set up as the baseline with clear language authorizing states to implement stricter standards. Worldwide, wine is strictly regulated and organized. There is harmony across the globe in regards to origin and appellation labeling despite differences in percentage requirements. If Texas were to remain using the federal standard or create its own, it would be consistent with that worldwide practice. Encouraging winemakers to label their bottles with anything but an actual appellation, "100% Texas" for example, would not.

The Committee recognizes that this is a serious issue in the Texas wine industry. It is one of philosophical nuance but also of serious economic realities, both of which are of great importance to the Committee. For this reason, the Committee looks forward to continuing its education on this subject so it can make a decision that ultimately serves the best interest of the entire Texas wine community.