



Reconciling Distribution and Transport Licensing Under MCRSA and Proposition 64

Issue: The 2015 Medical Cannabis Regulation and Safety Act (MCRSA) establishes distribution (Type 11) and transporter (Type 12) licensing categories for medical cannabis in California. The purpose of the transport license is unclear, and the distribution licensing category is unnecessarily restrictive (in number of licenses and who may hold the licenses) and creates additional product costs, which will hamper the State’s ability to eliminate the illegal market and create monopolies and anti-competitive behavior. Meanwhile Proposition 64, which was approved by California voters on November 8, 2016 establishes a licensing category for distribution, but does not impose the same restrictions on ownership or the number of licensees.

Solution: We propose the following legislative policies to address the monopoly, illegal market and gaming issues with MCRSA’s distribution model outlined below:

- Regulations should allow cultivation (Types 1, 1A, 1B, 2, 2A, 2B, 3, 3A, 3B and 4), manufacturing (Type 6 and 7) and dispensary (Type 10 and 10A) licensees to hold distribution (Type 11) and transporter (Type 12) licenses in addition to independent holders of these licenses;
- Distribution and transportation licenses should be issued in sufficient quantity to ensure (i) marijuana businesses have a variety of geographically distributed options, and (ii) there is competition to provide better pricing, security and services;
- Rules should be established to prevent independent distributors from establishing pay-to-play or most-favored-nations policies that can create monopolies;
- Measures should be taken to ensure that cultivators and manufacturers have discretion over the use and disposal of products they provide to distributors to prevent diversion of spoiled product;
- Legislators and regulators working to reconcile MCRSA and Prop 64 should provide clarity on the purpose of the transporter licensing category and ensure it does not become a source of logistical friction or unnecessarily raise product costs for medical and recreational consumers.

Why the alcohol distribution model is not appropriate for the cannabis industry

Unlike the alcohol industry and its “tied-house” rules, which put in place a mandatory separate distribution layer, the cannabis industry does not currently utilize a separate entity for either the transportation or distribution of cannabis (and most other states legalizing have not required such a distinction). This includes moving cannabis products either from cultivation and manufacturing sites to testing labs, or from these same producers to dispensaries and delivery service providers. Cannabis cultivators, manufacturers and dispensary operators currently either (i) use their own employees or (ii) organize cooperative agreements to move their products from cultivation and manufacturing sites to testing labs, and as well as from cultivation and manufacturing sites to dispensaries and delivery service providers. However, MCRSA disrupts these existing arrangements by forbidding cultivation (Types 1, 1A, 1B, 2, 2A, 2B, 3, 3A, 3B and 4), manufacturing (Type 6 and 7) or dispensary (Type 10 and 10A) licensees from holding distribution (Type 11) or transporter (Type 12) licenses. Justification for this system is based on the regulatory structure established for the alcohol industry, but this analogy is not accurate, both due

to the nature of the product being sold as well as the underlying justifications for alcohol tied-house rules. The second justification is that independent distribution or transportation allows monitoring and taxation of the marijuana industry, but the use of seed-to-sale systems or audit and reporting at the individual business level provide superior and more cost effective solutions that don't harm the industry.

Rationale behind distribution model for the alcohol industry

The alcohol industry's tied-house rules were created as a response to markedly different market conditions than those which exist for the cannabis industry. The key differences between the two industries include:

- Following the end of alcohol prohibition, the ownership of points of sale (speakeasies and bars) and production (distilleries and breweries) was highly consolidated and there was a high risk that monopolies would form in geographic regions.
- Organized crime elements were highly integrated into the alcohol industry and new distributors were thought to break this hold.
- Alcohol producers had what was believed to be an unhealthy level of influence and control on state and local politics and independent distribution was viewed as a counter-balance to this.
- Prohibitionists had a fear of over-consumption and there was a misguided belief that independent distributors would ration out alcohol to prevent over-consumption (which never occurred).
- There was a high variance in quality such that control of quality supply could easily be leveraged to create monopolies or force competing bars out of business.

It was ironic that the largest justifications for the tied-house rules was to prevent monopolies or price fixing from occurring, when the end result of alcohol distribution has been:

- The formation of a few large dynastic alcohol distribution monopolies, and
- The continuing inability of independent brewers and distillers to access the market due to onerous (and possibly collusive) requirements by distributors.

It is for this reason that there has been an increasing sentiment towards abolishing tied-house rules that govern the alcohol industry. Subjecting the cannabis industry to this same misguided policy is not appropriate.

Uniqueness of cannabis market

The alcohol industry's tied-house model does not work for the cannabis industry for multiple reasons attributable to the differences in the product and the current market, which include:

- Product differences
 - Cannabis is not a homogenized product and cannabis grown in different locations (even if done in a uniform manner) generally will be of materially varying quality. This contrasts with alcohol where spirits and beer crafted in different locations can all be sold under a single unified label.
 - Cannabis is significantly more perishable than alcohol and more layers in the process drastically increase the risk of mishandling. For instance, in the case of cannabis concentrate, even a few minutes of high heat in a vehicle can cause the concentrate to "sugar" or separate, rendering it unsuitable for sale.

- Certain cannabis manufacturing (e.g. live resin extracts) can only be conducted with product that is close to harvest.
 - Almost all cannabis plant transactions require the purchaser to touch and smell the product to ascertain quality in a manner akin to agricultural product. Limited distributors, particularly those with no industry knowledge, make this difficult and impractical.
 - Certain forms of cannabis are effectively commodity goods that cannot be differentiated (e.g. clear THC extract, bulk pre-filled cartridges) and there is a risk that distributors could relabel them.
- Market differences
 - There is no consolidation in cultivation, manufacturing and dispensaries that requires a distribution layer to prevent monopolies. Most top cannabis producers and manufacturers in California prefer not to participate in dispensaries, and recently some top cannabis brands that held dispensary licenses have divested those licenses.
 - There is such a wide variety in cannabis products that it would be impossible to self-source even 50 percent of the products sold in a dispensary and still meet consumer demand.
 - A number of marquee California cannabis brands are sold by groups that control neither cultivation nor manufacturing – they simply provide the intellectual property and know-how. These are cornerstone brands to the California market and source cannabis biomass from independent growers and utilize contract manufacturers to produce products ranging from concentrate to vape cartridges to edibles. The mandatory distribution model leaves these brands without a future as they are effectively only acting as a distributor.
 - With the rise of seed-to-sale tracking systems and technological recording, independent distribution is an inefficient, costly and superfluous layer to drive compliance with testing requirements.

How independent distribution will preserve illegal cannabis markets

MCRSA's mandate that all cultivation and manufacturing licensees send all cannabis and cannabis products to a licensed distributor for quality assurance, inspection and testing will guarantee a large rise in the level of illegal cannabis activity in the California. Illegal cannabis markets rob state and local governments of tax dollars while continuing to drive up policing and incarceration costs, as unregulated market participants amass large volumes of unbanked revenue.

To help reduce legal market prices and assist California state and local governments in crowding out the illegal market, legislators and regulators working to reconcile MCRSA and Prop 64 should allow cultivation (Types 1, 1A, 1B, 2, 2A, 2B, 3, 3A, 3B and 4), manufacturing (Type 6 and 7) and dispensary (Type 10 and 10A) licensees to hold distribution (Type 11) and transporter (Type 12) licenses.

Price Increases

Inflated legal market prices dissuade medical and recreational consumers from purchasing products from legal market retailers when illegal market prices remain low. While little information is available detailing the total number of legal and illegal industry participants (cultivators, dispensaries, delivery services, testing labs, processors, manufacturers, etc.) operating in California, what is known is that the California cannabis market is the largest in the country. The Los Angeles market alone is larger than the entire state of Colorado's market. With licensing only beginning at the local level and no state licenses set to be issued

until 2018, nearly all of the State's cannabis industry participants are operating illegally until licenses are issued and have ample comfort in dealing in the "grey" market.

The high state tax rate on recreational cannabis, the state's cultivation taxes and the freedom provided to California's local governments by MCRSA and Prop 64 to impose tax rates however they see fit already present substantial challenges in the effort to keep legal market pricing reasonable and eliminate the illegal market. The independent distribution model included in MCRSA will only serve to make this exercise more challenging by inserting an unnecessary layer into the cannabis supply chain, which will increase already high legal market prices.

In addition to the added facilities and transportation costs that independent distribution imposes, groups vying for independent distribution under MCRSA have anecdotally said they believe that could achieve 20 percent profit margins on their operations. This is because under MCRSA cannabis cultivators and manufacturers would have to first pay a distributor to transport their products to a laboratory for testing, and then pay distributors again to purchase their products for secondary processing, the creation of vaporizer cartridges, etc., and then these products would need to loop through the distributor a second (and possibly third) time before finally arriving at a retail sales point.

Inability to Provide Desired Products

A number of products that are very popular with consumers would be difficult to provide with an independent distribution model that requires movement to a distributor for transactions between the other licensing categories. A key example of this is live resin extracts, which are marijuana concentrate products that are produced from freshly harvested marijuana that is processed from refrigerated plant matter immediately after cutting (without a cure period). Live resin is extremely popular because it provides a flavorful "terpene" forward smell and taste. The time-frame and handling requirements are so specific for live resin that top producers will have a courier immediately deliver fresh cut plant material in a dry-ice cooled storage container and process the material in less than 48 hours. A second example are "budder" or "batter" concentrate products that have an extremely short shelf life in terms of potency and the time until the product starts to visibly degrade (sugaring).

In both of the above cases, an independent distribution layer would introduce sufficient delays and logistical complexities that making these products would be difficult or impossible. In the absence of legal sources for products, cannabis consumers have shown they are amply willing to turn to the illegal markets to find products they cannot find on the legal market (e.g. concentrates in Oregon, flower in New York, BHO in Canada).

Separating Counterparties

In a manner similar to wine and other specialty agriculture goods, the cannabis market is largely based upon direct relationships between buyer and seller and the ability of dispensaries and other B2B buyers to be able to ask questions to growers and processors to ascertain product quality. Factors such as the medium in which the cannabis is grown, the genetic lineage of the product and the curing or processing method used are all important for a buyer to determine quality; and these are not items that can be determined from any testing label a distributor affixes. An independent distribution layer serves to sever this tie and conversely increases the appeal of illegal market relationships where a direct connection with the seller can exist. Additionally, when dispensaries are unable to fully vet the product, the consumer ultimately suffers when the dispensary is unable to fully diligence the products.

Independent Distributor Qualifications

There are no independent, non-cannabis industry distribution companies with the expertise required to transport, properly handle, certify quality, or identify and interact with high quality cannabis storefronts and delivery service providers. Cannabis cultivators, manufacturers and dispensary operators currently organize cooperative agreements to move their products from cultivation and manufacturing sites to testing labs, and as well as from cultivation and manufacturing sites to dispensaries and delivery service providers.

High Risk of Independent Distribution Creating Monopolies

The rise of large-scale distributors with access to bulk product and the channels of retail presents an unprecedented risk for the formation of monopolies in the California cannabis market. There is nothing in MCRSA that prevents distributors from morphing their role from providing distribution logistics services to one of creating their own brands that compete against the upstream cultivators, processors and manufacturers. Currently, there are numerous marijuana brands in California where the brand does not produce, manufacture or grow any marijuana, but rather they source marijuana and have it processed into a variety of end products such as vape cartridges, pre-roll joints or concentrate products using a third party processor. They are in essence simply a facilitator, marketer and owner of trademarks. This business model is already somewhat akin to distribution as envisioned under MCRSA. Without regulation, there is a high risk that distributors could:

- become their own brands by mirroring the same model described above for facilitation brands that simply source raw marijuana and have it processed into end products,
- choose cannabis industry winners and losers by favoring those products provided by large producers or those who pay the largest fees (in a manner akin to issues with craft beer), or
- mandate excessive pay-to-play fees to have products distributed or artificially limit the geographical range of distribution of disfavored products.

In each of the above cases, the end result can quickly become that either the distributor or its selected counter-parties rapidly gain control of dispensary shelf space and market share while small growers and new entrants are forced to the sidelines. The simplest solution to this is a series of regulations which ensure that there are sufficient distributors to ensure robust competition and rules to prevent consolidation above certain thresholds. The second key policy is to ensure that distributors have a fiduciary role to the cultivators and manufacturers who place product with distributors such that distributors are not empowered to divert products to become distributor “house brands” or sell product that is beyond its shelf life.

Clarifying MCRSA’s transport license

In addition to the above concerns on the distribution license type, the current transportation license type needs further clarity and rule-making to ensure that it does not pose the same risks. If the purpose of the ‘transport’ license is to enable cannabis cultivators, manufactures, processors and dispensaries to move product along various points in the supply chain this should be stated specifically, and cannabis cultivators, manufactures, processors and dispensaries should also be permitted to utilize this license to move their products to testing facilities. To the extent license types are co-located on the same or adjoining premises, there should be clarity that handling by a transport licensee is not required. Additionally, there should be consideration of how to lower logistical issues for transportation between cultivation and processing/manufacturing locations held by the same owner when such facilities are not co-located.

MCRSA Definitions

Distribution: means the procurement, sale and transport of medical cannabis or medical cannabis products between entities licensed pursuant to this chapter.

Distributor: means a person licensed under this chapter to engage in the business of purchasing medical cannabis from a licensed cultivator, or medical cannabis products from a licensed manufacturer, for sale to a licensed dispensary.

Transport: means the transfer of medical cannabis or medical cannabis products from the permitted business location of one licensee to the permitted business location of another licensee, for the purposes of conducting commercial cannabis activity authorized pursuant to this chapter.

Transporter: means a person issued a state license by the bureau to transport medical cannabis or medical cannabis products in an amount above a threshold determined by the bureau between facilities that have been issued a state license pursuant to this chapter.