WGGA

Wine Grape Growers' Australia

SUBMISSION

INQUIRY INTO FOOD PRODUCTION IN AUSTRALIA: IMPACT OF MANAGED INVESTMENT SCHEMES

Senate Select Committee on Agriculture and Related Industries

July 2009

Executive Summary

WGGA believes that the continuation of Vineyard Managed Investment Schemes (MIS) under the current tax structures and disclosure regulations would only serve to exacerbate the chronic oversupply of wine grapes and wine within the Australian wine industry, to which Vineyard MIS have been a significant contributor. Vineyard MIS now represents 10% or 16,000 hectares of the national vineyard estate – growing from a zero base little more than a decade ago.

WGGA maintains that the tax-driven nature of many Vineyard MIS has been at odds with the prevailing market conditions within the wine grape sector and Australian wine industry – meaning that despite general indications of the buoyancy of the sector within some Vineyard MIS prospectuses, beyond the initial tax deductions available to investors, there is limited likelihood of generation of profits from many of these vineyards over the longer term. Indeed the oversupply of wine grapes to which Vineyard MIS have been a significant contributor has exacerbated the lack of profitability in the Australian wine grape sector, with growers experiencing a sharp decline in prices of between 30% and 50% in the last year and projections of further declines of 20% to 30% in 2010 – driving wine grape prices well below cost of production. In the current environment of chronic over supply of wine grapes and the prospect of a consequent adjustment in vineyard area of as much as 20% of plantings to bring supply and demand back into balance, chronic water shortages in the Murray-Darling Basin, and grape prices that fall well short of growers' costs, WGGA opposes any Government endorsed scheme that has the potential to add to the oversupply problems confronting the Australian wine industry. Vineyard MIS that are primarily promoted as a means of reducing investors' tax liability are not supported by WGGA and should the Government choose to allow MIS into the future these schemes must be structured in such a way that they do not have the potential to skew the supply – demand balance of the Australian wine industry and other primary industries, as the evidence now clearly indicates they have.

Specific to other terms of reference of this Senate Select Committee Inquiry, WGGA also contends that Horticultural Sector MIS have bid up the price of suitable land, and the corralling of significant water resources for Horticultural MIS in the Murray Darling Basin in particular has pushed up the price of water to all irrigators in the Basin, in which 70% of Australia's wine grape production is located.

WGGA submits that the collapse of the major proponents of Agricultural MIS – Timbercorp and Great Southern Plantations – brings the system of MIS tax structures, the levels of tax deductibility available to investors, and the rules governing disclosure to investors on the prospects for industry sectors and the implication of future performance of their investments in MIS, into serious question.

Accordingly:

1: WGGA recommends that the Government applies an immediate moratorium on any further agricultural MIS product rulings by the Australian Taxation Office until a thorough investigation of the impact of the past MIS rules and system of regulation has been completed – with particular regard to the impact of the regulations governing tax deductions, disclosures of information in prospectuses, the impact of MIS on supply within industries, and the failure of the two major MIS proponents.

2: WGGA recommends that the Government withdraws preferential taxation arrangements for Vineyard MIS, and puts future taxation deduction arrangements for vineyards on the same basis for all producers.

3: WGGA recommends that the Government require all future Vineyard MIS prospectuses to include:
(a) a prominent recommendation to investors to seek independent information on the future industry prospects from accredited peak industry bodies and Government agencies.
(b) clear disclosure of the comparative commercial cost of developing a hectare of vineyard.
(c) full disclosure of the term and pricing of grape contracts and the grape price assumptions used.

4: WGGA recommends that competent supervision be instituted within the Australian Taxation Office to ensure product rulings issued to Vineyard MIS only approve tax deductions commensurate with the real commercial level of vineyard establishment and management costs generally applicable within the industry.

Wine Grape Growers Australia

Wine Grape Growers' Australia (WGGA) is the peak industry body representing Australia's 7500 independent (non winery) wine grape growers. The WGGA Executive Committee includes representatives of 8 Electoral Zones covering all of Australia's wine grape producing regions. Part of the role of the organization is to advocate policies and programs that will impact positively on the profitability and sustainability of the wine grape sector – including the impact of vineyard investment.

Wine Grape Sector Industry Environment

The Australian wine grape sector is now suffering significant adjustment pressures as a result of an overheating of vineyard plantings and wine grape and wine production, stemming from more than a decade of rapid growth in vineyard plantings that has seen Australia's vineyard area more than double since 1995 to over 160,000 hectares. This rapid expansion of the national vineyard estate has also been marked by the entrance of large scale investor funded vineyards into the wine grape sector – many of these as Managed Investment Schemes (MIS) developed by wine companies, new and existing vineyard operators, investment promoters and others.

The surge in vineyard investment reached its peak between 1998 and 2000 – prompted by shortages of grapes available to wineries to grow export markets which had shown strong and growing demand for Australian wines since the early 1990's. Consequently, the sector experienced unprecedented high prices for grapes through the mid to late 1990s and this led to the signing of long-term supply contracts between wineries and growers. This buoyant industry climate sent a strong investment signal for new investment in vineyards, and generated a new trend of investors from outside the traditional sphere of the Australian wine industry investing in vineyards via tax driven Vineyard MIS.

The unprecedented growth in wine grape plantings from the mid-1990s to 2002 has seen a rapid reversal of the supply shortages of the 1990s that prompted this rapid growth in the industry's vineyard base. By 2004 the Australian wine industry was beginning to move into oversupply, with an associated rapid decline in grape prices, culminating in a significant volume of grapes left on the vine or dumped following vintage 2006. The 2004, 2005 and 2006 vintages produced three consecutive record or near record harvests in Australia – with the a new record production of over 2 million tonnes in 2006 comprising 1.9 million tonnes crushed by wineries and a further 135,000 tonnes (ABS) either not harvested or dropped to the ground.

Beside this record production and an oversupply of wine grapes, WGGA estimated that up to 300,000 tonnes of the 1.9 million tonnes taken by wineries in that vintage was sold at prices below the cost of wine grape production. Despite a low drought affected 2007 vintage of 1.45 million tonnes, a much higher than expected 1.83 million tonne vintage in 2008and a much higher than required 1.7 million tonnes in 2009, together with the high $A and a significant decline in export volumes in calendar year 2008 (the first time in over 15 years) these factors have combined to drive the industry towards higher inventories of wine than wineries require. Wine grape oversupply is now considered by the peak industry bodies in Australia as chronic.

As a result, the major wineries are now cutting back on their contract wine grape purchases and shedding grower contracts. At the release of the *Australian Wine Grape Outlook 2008-2012* in June 2008 WGGA advised growers of the return of downward pressure on grape prices and a fall in required volumes in vintage 2009 by all the major wine producers. Grape prices fell by between 30% and 50% for vintage 2009, with as much as 100,000 tonnes of un-contracted grapes not picked or harvested to the ground. This decline in winery intakes and grape prices is predicted to deepen in 2010, with major wine companies continuing to shed supply contracts or in some cases even buying out the remaining period of existing contracts, and projecting a fall of a further 20% to 30% in wine grape prices for the next vintage.

The industry now faces a sharp structural adjustment with profound economic ramifications for a large proportion of the grower sector, the future shape of the Australian wine industry's production base, and for regional economies. It is now widely acknowledged by both WGGA, the Winemakers Federation of Australia (WFA), and the Australian Wine & Brandy Corporation (AWBC)that the industry's vineyard 'footprint' is too large for the industry's medium and longer term wine grape requirements and wine sales profiles - with estimates of up to 480,000 tonnes of excess wine grape production and between 20,000 and 40,000 hectares of vineyard over-planted against the longer term projected demand for wine grapes. This means that up to 25% of the national vineyard estate is considered to not be required into the future.

Impact of Vineyard MIS

Despite the rapid emergence of wine grape oversupply, a significant spike in wine inventories, and a sharp trend downwards in wine grape prices and grower returns, and in direct contradiction of repeated statements from WGGA, WFA and the AWBC that there was no market signal for new large-scale planting, the planting of significant new MIS vineyards by selected investment promoters and MIS operators continued unabated up until June 30 2008, when the taxation arrangements for Non-Forestry MIS were changed (although later overturned on appeal in the Federal Court in December 2008). However, it should be noted that a majority of MIS Vineyard operators have ceased investment in additional plantings due to the difficulties in securing new supply contracts with major wine producers, the uncertain outlook for future wine grape demand, and the sharp downward movement of prices to less viable levels. A number of these MIS operators have been openly critical of the continuing planting of new MIS vineyards by others. It is telling to note that despite the deepening economic difficulties of both the wine grape and wine production sectors, the consequent decline in demand for wine grapes, and the well publicized demise of the MIS market leaders Great Southern Plantations and Timbercorp – a prominent Vineyard MIS promoter in the Barossa region currently has a new prospectus lodged with ASIC for approval. This is occurring at a time of significant oversupply of wine grapes in the Barossa Valley, and the worst wine grape demand and price outlook for growers there in over 3 decades.

In 2006 ABARE estimated MIS vineyards represented 9.8% of the total area of vineyards or 15,000 hectares. WGGA now estimates MIS vineyard plantings at not less than 16,000 hectares or 10% of plantings – representing more than 200,000 tonnes of existing or potential wine grape production.

Not surprisingly, growers (particularly long-time growers experiencing market dislocation) are highly critical of MIS vineyard developments and their perceived role in overheating vineyard plantings. The impact on the future viability of long term wine grape growers is an issue of very serious concern amongst many wine grape grower communities, which perceive a pattern of large wineries actively encouraging large scale Vineyard MIS plantings by providing supply contracts, while reducing the levels of contracted fruit or eliminating contracts with smaller family-run vineyards. At the heart of these industry concerns are the preferential taxation arrangements available to Vineyard MIS investors which are encouraging growth in wine grape supply at odds with industry demand signals. In other words, investors are being encouraged to invest in Vineyard MIS to utilize available tax deductions – not through a realistic assessment of the medium and long term demand for and profitability of the wine grapes their Vineyard MIS investment will produce.

Of primary concern to the industry is the capacity of Vineyard MIS to skew the market for wine grapes and for wine. WGGA is concerned at the impact of the grapes generated by MIS plantings that may not have an identified end-market secured via long term supply contracts with established wine producers, or are purely speculative. Grapes may well be sold at unviable returns on the spot market to generate cash flows as investors' capital has already been sunk in the vineyard, the promoters and operators fees are assured, losses and establishment costs are tax deductible and profitable income from wine grape sales may therefore not be the primary driver. WGGA contends that the production of wine grapes by some Vineyard MIS on a speculative basis or for sale at marginal returns has been a significant contributor to the oversupply of low priced wine grapes that has perpetuated the imbalance in supply and demand in the wine grape sector over recent years. Wine grape growers have suffered a sharp decline in grape prices over the last 4 years, with falls of between 30% and 50% in 2009 alone, and with the prospect of a further fall of between 20% and 30% in 2010 – pushing returns to below the cost of production for a large proportion of the sector.

Financial organizations such as Rural Finance Victoria have identified that Agricultural MIS have bid up the price of land in many regions, and WGGA contends that the price of land suitable for horticulture has also been bid up via aggressive expansion of Horticultural MIS. In parallel, the price of water has also been driven up particularly in the Murray Darling Basin. MIS companies have aggressively corralled significant volumes of irrigation water to feed expanding plantings. Timbercorp, for example, is the largest single owner of water rights in Victoria – controlling 154,000 megalitres. While the increased cost of land suitable for horticulture may have become a barrier to entry for potential producers, the increase in the cost of water (particularly in the Murray Darling Basin) has had a negative economic impact on all irrigators.

WGGA's Position On Vineyard Investments and Vineyard MIS

PREVIOUS DIALOGUE WITH GOVERNMENT

WGGA has raised concerns with the Australian Government over some time regarding a number of negative aspects of Vineyard MIS plantings:

- WGGA presented a Submission to the Dutton Inquiry Into Forestry MIS in 2006 – using that Inquiry to call on the Howard Government to take action to circumvent the upfront taxation benefits available to investors in Non-Forestry Agricultural MIS and to change the ASIC rules governing statements in prospectuses to require independent industry outlook analysis to be prominently published in MIS prospectuses.

- WGGA applauded the 2007 decision of the Howard Government to remove the upfront taxation benefits to Non-Forestry Agricultural MIS from June 30, 2007 and expressed its disappointment that a 12 month extension was granted by the Government; predicting a rash of last minute Vineyard MIS plantings – which has subsequently occurred.

- WGGA wrote to Prime Minister Rudd in February 2008 – asking him to maintain the timetable for removing preferential taxation treatment of Non Forestry Agricultural MIS investments at June 30, 2008; despite pending legal action by some MIS proponents.

- WGGA supported the ATO ruling that Non-Forestry Agricultural MIS investments are capital in nature and supported its decision to cease issuing Product Rulings on new schemes after June 2008. WGGA subsequently expressed its disappointment that the decision of the Federal Court to overturn this ruling in December 2008 would lead to further planting of tax driven Vineyard MIS, at odds with the market signals on new plantings within the industry.

- WGGA lodged a Submission with the Treasury Inquiry into Non Forestry Agricultural MIS in September 2008 – calling on the Government to remove the preferential taxation treatment of Vineyard MIS and require more prominent independent information on the current status and future outlook for the industry in MIS prospectuses.

- WGGA presented a Submission (largely reflecting the content of this Submission) to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Agricultural MIS in June 2009.

CURRENT VIEWS ON VINEYARD MIS

WGGA is not anti-investment, nor anti-MIS per se. WGGA recognizes that the financial model presented by MIS could potentially be used by growers to harness new external investment in their vineyards or to allow vineyard syndication that could leverage the financial advantages of additional scale. Nevertheless **WGGA now believes that the continuation of Vineyard MIS under the current tax structures and disclosure regulations would only serve to exacerbate the chronic oversupply of wine grapes and wine within the Australian wine industry, to which Vineyard MIS have been a significant contributor.**

WGGA remains deeply concerned about two key aspects of Vineyard MIS:

- The taxation benefits available to MIS investors have been the predominant driver of investment in many Vineyard MIS, and as such have added to the overheating of wine grape plantings; distorted the wine grape market through oversupply of wine grapes; and in some cases led to the sale of wine grapes at prices significantly below economically sustainable levels.

- That the looseness of the ASIC provisions regarding information currently provided on some Vineyard MIS prospectuses and the lack of reference to official sources of industry information has in some cases allowed investors to be misled on the future outlook for the industry and the outlook for profitable revenues from their vineyard investment.

Taxation Driven Investments

WGGA maintains that the previously existing preferential taxation treatment of Vineyard MIS investment has had a negative impact on the wine grape sector because their key driver is the tax benefit for investors – not the generation of profits from the sale of wine grapes from the vineyards over the longer term. In support of this proposition WGGA makes the following points:

- MIS vineyard plantings have continued – despite the current downturn in vineyard revenues, chronic oversupply of wine grapes, and despite the widespread publicity regarding the sector's current and longer term economic difficulties.

- Many MIS vineyard plantings are speculative – without a secure supply contract or viable market for the grapes produced. This supports the proposition that the prime motivation for continued Vineyard MIS plantings is revenue for the scheme promoters, financial advisers and the vineyard managers through fee revenues, rather than profitable income generated by future wine grape sales.

- The structuring of the schemes has allowed unreasonably high levels of taxation deductions in the early years of the investment – through the grossing up of vineyard land purchase, establishment costs and management fees to levels that still allow significant short term tax benefits, despite the elimination of accelerated depreciation of vineyards. WGGA is aware of a number of Vineyard MIS that have charged investors double and sometimes treble the reasonable establishment costs for vineyards in that production zone, even after taking into account the legal and advisory costs of establishing and marketing the MIS. It is apparent that investors have been more attracted to the tax deductions available through payment of such large sums in the initial years of the investment than pursuing alternative direct investments in vineyard developments not structured as MIS at significantly lower establishment costs. WGGA maintains that this not only confirms the tax-driven nature of Vineyard MIS but promotes investment decisions that are less, or at best, not particularly concerned with future levels of vineyard income per se.

- The ATO has exacerbated the problem by issuing Tax Rulings with no scrutiny of, or restriction on the level of fees charged to investors and approving 100% tax deductibility of grossly inflated establishment costs.

Investment Based On Misinformation

WGGA maintains that despite the ASIC rules regarding statements on future earnings in prospectuses, some Vineyard MIS have used misinformation to convey a positive basis for investment in the wine industry.

- Many Vineyard MIS plantings are promoted in more general or generic terms by using selective and overly optimistic media articles regarding the historic buoyancy and rapid growth of the wine industry, implying strong future wine grape prices and investor revenues – completely at odds with current market realities.

- While Vineyard MIS require the statement of an independent expert on the viticultural aspects of the plantings, there is no requirement to publish independent sources of information on the wine grape sector such as current outlook statements by ABARE, AWBC or the annual Australian Wine Grape Outlook Paper.

Recommendations for Government Action

The WGGA submits that:

- The collapse of the leading Agricultural and Forestry MIS promoters, Timbercorp and Great Southern Plantations, has exposed the reliance of many MIS on the ongoing stream of fee and management income rather than the capacity of the investments to generate profits in their own right – with many of these schemes now shown to have significantly underperformed against the projected performance originally outlined or implied in their prospectuses. The failure of these primary proponents of Agricultural & Forestry MIS has exposed the fact that while investors have enjoyed significant tax deductions, the failure of these entities has also cost investors between $2 billion and $3 billion in invested capital. Together with the cost of the tax deductions for investors; the lost capital invested and the negative impact of tax driven MIS on the wine grape sector (and possibly on other sectors) through overheating of new plantings and the skewing of supply, it is appropriate that the Government take the opportunity to place a moratorium on any further MIS Product Rulings until such time as the cause of the causes of the collapse of Timbercorp and Great Southern Plantations are fully identified, and the findings of the Treasury Inquiry into Non-Forestry Agricultural MIS, the Parliamentary Joint Committee on Corporations & Fiancial Services Inquiry into Agricultural MIS, and this Inquiry are released and the Government has identified appropriate rules and system of regulation for future MIS investments.

1: WGGA RECOMMENDS THAT THE GOVERNMENT APPLIES AN IMMEDIATE MORATORIUM ON ANY FURTHER AGRICULTURAL MIS PRODUCT RULINGS BY THE AUSTRALIAN TAXATION OFFICE UNTIL A THOROUGH INVESTIGATION OF THE IMPACT OF THE PAST MIS RULES AND SYSTEM OF REGULATION HAS BEEN COMPLETED – WITH PARTICULAR REGARD TO THE IMPACT OF THE REGULATIONS GOVERNIING TAX DEDUCTIONS, DISCLOSURES OF INFORMATION IN PROSPECTUSES, THE IMPACT OF MIS ON SUPPLY WITHIN INDUSTRIES, AND THE FAILURE OF THE TWO MAJOR MIS PROPONENTS.

Beyond this WGGA submits that should the Government decide to continue to allow the ATO to issue Product Rulings on Agricultural MIS, it should take note of the following Recommendations:

- Vineyard MIS have contributed to the overheating of vineyard plantings, and the consequent distortion of the wine grape and wine markets. On that basis there is no public benefit in maintaining the preferential taxation treatment of Vineyard MIS investments. The industry's current efforts to move supply and demand back into balance as rapidly as possible will be frustrated by the continuation of the preferential tax treatment of Vineyard MIS plantings (many of which are speculative in nature) undertaken against the prevailing market conditions and investment sentiment and economic outlook for the wine industry. There is a need for Government to align the nature and level of tax deductions available to investors in Vineyard MIS with the common, reasonable establishment and management cost levels prevailing within the industry.

2: WGGA RECOMMENDS THAT THE GOVERNMENT WITHDRAWS PREFERENTIAL TAXATION ARRANGEMENTS FOR VINEYARD MIS, AND PUTS FUTURE TAXATION DEDUCTION ARRANGEMENTS FOR VINEYARDS ON THE SAME BASIS FOR ALL PRODUCERS.

- The current provisions governing Vineyard MIS prospectuses are not sufficient to protect against misinformation being provided to investors. Independent information provided by industry peak bodies or the Government economic and industry agencies on the industry's economic outlook and prospects for profitable investment in the wine industry is required in future prospectuses.

3: WGGA RECOMMENDS THAT THE GOVERNMENT REQUIRE ALL FUTURE VINEYARD MIS PROSPECTUSES TO INCLUDE:
(A) A PROMINENT RECOMMENDATION TO INVESTORS TO SEEK INDEPENDENT INFORMATION ON THE FUTURE INDUSTRY PROSPECTS FROM ACCREDITED PEAK INDUSTRY BODIES AND GOVERNMENT AGENCIES.
(B) CLEAR DISCLOSURE OF THE COMPARATIVE COMMERCIAL COST OF DEVELOPING A HECTARE OF VINEYARD.
(C) FULL DISCLOSURE OF THE TERM AND PRICING OF GRAPE CONTRACTS AND THE GRAPE PRICE ASSUMPTIONS USED.

- The Australian Taxation Office (ATO) has issued Product Rulings that have allowed Vineyard MIS with disproportionately high levels of establishment and management costs when compared with the costs of vineyard establishment and management in other non-MIS vineyard enterprises of comparative size and regional location. In some instances these costs have been up to three times the commercial costs incurred within the sector. While this enables a significant 'grossing up' of up-front tax deductible expenses related to the investment, it makes the achievement of future profits from the wine grapes produced from the vineyard investment extremely difficult. The answer is for the ATO to allow only reasonable levels of establishment and management costs to be deductible – benchmarked against the real commercial costs within the industry.

4: WGGA RECOMMENDS THATCOMPETENT SUPERVISION BE INSTITUTED WITHIN THE AUSTRALIAN TAXATION OFFICE TO ENSURE PRODUCT RULINGS ISSUED TO VINEYARD MIS ONLY APPROVE TAX DEDUCTIONS COMMENSURATE WITH THE REAL COMMERCIAL LEVEL OF VINEYARD ESTABLISHMENT AND MANAGEMENT COSTS GENERALLY APPLICABLE WITHIN THE INDUSTRY.

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July 23, 2009