Submission to

The Senate Rural and Regional Affairs
and
Transport References Committee

Inquiry into the Wine Industry

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Terms of reference:

Supply and purchase of grapes [in relation to the Australian wine glut] and the relationships between independent growers and wine makers in the current market.

Format of submission:

General overview

(a) Supply and purchase of grape [in relation to the Australian wine surplus]

(b) Relationships between independent growers and wine makers in the current market

Discussion

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General overview

(a) Supply and purchase of grape [in relation to the Australian wine glut]

The Australian wine industry continues to achieve phenomenal success having come into its own in the last 10 to 15 years. Developed in 1996, the industry's "Strategy 2025" has been instrumental in achieving that growth and has exceeded expectations, with targets expected to be reached in 30 years completed within a decade. This period of rapid growth has created its own challenges and has inevitably led to a change in momentum – a situation common to an industry cyclical in nature.

It is tempting to forget the past 217 years of the Australian wine industry, focus on the past two to three years and conclude that the industry is in trouble. Nonetheless, domestic consumption continues to rise by 2 to 3% by volume per annum and export sales by volume are also rising at around 12 to13% per annum, representing a total annual increase of around 14-16% by volume - a figure much higher than the vast majority of other Australian industries. Whilst volume sales increases do not always translate to profit increases, the demand curve for Australian wines cannot be ignored. Neither should the current short-term oversupply of some red varieties driven by overly optimistic expectations of red wine consumption trends in the late 1990's and resulting in over-planting of red varieties; a practice that will not be repeated. In future, most vineyard owners will balance white and red plantings accordingly. For an industry that is growing so rapidly, the demand and supply curves for grapes are not always going to be in perfect synchronization over longer periods. Both the time lag between planting and production and the difficulty of obtaining accurate vine national planting data are likely to hinder the industry's re-structuring efforts. The coordination of vineyard plantings, with expected but unknown consumer demand for different grape varieties in three or more years' time, will prove a challenge.

In the late 1990's, 22.5% of the vines planted were not bearing commercial quantities of grapes. The disproportionate planting of red varieties, resulting in the current oversupply of red variety grapes, has caused winemakers and grape growers to aim for the lower retail price points. Growers are forced to sell their grapes at bottom prices to survive in the current climate and wine producers are exporting wines that sell at the bottom end of the Popular Premium price points. This short term solution has resulted in Australia developing the rapidly growing reputation of producing the best low value wines in the world. This cyclical situation undermines efforts to sell wines at the more profitable and sustainable higher price points, causing even further grief to the cool climate grape growers whose grapes were necessarily produced at higher cost than warm climate areas. However, by 2003, the proportion of non-bearing vines of total vines planted had fallen to 9.5%. This clearly points to lower levels of new vine plantings in the past 3-4 years. With a strong overall demand curve for Australian wines and a declining or slowing supply curve for grapes, the demand and supply curves are bound to intersect in the next two to three years.

The ability of the Australian wine industry to behave collectively to achieve a sustainable and reasonable balance of the longer term demand and supply curves for grapes is paramount to moving forward as an industry. Cheap fruit not only destroys the growers' viability, it also clearly destroys markets and more sustainable and profitable price point sectors for wine producers. In an effort to counteract the 'cheap wine producing country' syndrome, the re-launch of "Wine Australia" is based on the need to enhance the opportunity for growing Brand Australia at higher price points and to showcase regionality. Australia's wine products repositioning must change the consumers' mental maps, both for the low involvement and the high involvement wine buyer. Exacerbating the challenge is the fact that, in both overseas and domestic markets, retail consolidation means the balance of power has shifted to giant retailers who are increasingly dictating the retail price points and ranges of products stocked. The range of products stocked on the retailers shelves have declined dramatically and the price winemakers are paying for grapes has been adversely affected.

Directly related to the grape demand and supply economics of the wine industry is the way in which shareholders and stakeholders capital will be used in the future growth of the wine industry. Because of retailer consolidation and the subsequent concentration of retail power, efficient use of capital in the wine industry will be driven by the top priorities of sales, marketing and branding at the expense of new vineyard developments and winery processing facilities. This will mean large economies of scale are required in new vineyard developments and winery processing facilities and it is likely that these two functions and their capital requirements will be outsourced to external players by wine brand owners. These overall trends will certainly affect the future structure of the Australian Wine Industry. "The big will become bigger and the big will only be able to deal with the biggest".

(b) Relationship between independent growers and wine makers in the current market

Winemakers source fruit from their own vineyards (approximately 30%) and from a number of independent grape growers that have or do not have grape sale contracts in place.

The current concerning problem is the low prices being offered by winemakers on the spot market for uncontracted grapes. This is a natural tendency for winemakers to reduce costs but, in the longer term, the viability of growers without grape sale contracts in place is destroyed. There are more grape growers than winemakers in Australia and this imbalance of power is currently firmly with winemakers and exacerbated by the current wine grape surplus. Winemakers are trying to survive in the cut throat low price point popular premium wine segment in global markets and wine grape costs are forced downwards.

Current low grape pricing is the product of a combination of related issues:

(i) Currency realignment and the rapid change in the global structure of wine production and wine retailing.

- Wine retailing at present is the most profitable segment of the wine industry and retail consolidation is placing pressure on wine producers, demanding among other things (i.e. more promotions, fast deliveries, better inventory management) lower prices resulting in thinner profit margins.
- Four wine companies own about three quarters of the Australian market with the largest 20 companies holding about 95%. This leaves the remaining 1,700 and more wineries to compete for the outstanding 5% of the Australian wine market.
- National centralized buying by the two largest retailers (i.e. Coles Myer and Woolworths) has an increasingly destructive effect on smaller regional wineries (i.e. the 1,700) as these wineries are unable to properly present their products in the retail market at a reasonable cost to their business.

(ii) Appropriate reaction to cost pressures on grape growers.

- Increasing economies of scale are emerging in winegrape production as evidence shows that large scale vineyards operate profitably even in this competitive climate. It is more efficient for a winery to do business with one big grower (or Syndicate) and the tendency would be to favour bigger and better performing grape growers than renegotiating grape contracts with many stretched smaller growers.
- The coordination of wine grapes supply and demand and ensuing grape price balance must not be under-estimated. The need for a national grape growers' representative body is strongly felt as it is becoming evident that there are some areas where the interests of wine producers and grape growers differ dramatically. The balance of power is firmly with the wineries who buy grapes with total disregard for the viability and long term profitability of their grape supplies. Effective lobbying to protect the interests of grape growers and facilitate communication between all relevant parties is now proving necessary at both regional and national levels. This means a new era of collaboration for the Australian wine sector under a somewhat segmented but unbiased umbrella.
- There is a role for the Australian Government in addressing issues related to the current low grape pricing but this must be viewed in the context of a joint Australian Wine Industry and government partnership.

Suggestions

The terms of reference of this Senate enquiry are commendable; however, the relationship between independent grape growers and winemakers in the current market cannot be evaluated on its own without including the market place, i.e. the end wine consumer and access to the consumer.

The wine industry is made up of grape growers, wine manufacturers and wine brand owners who must collectively work together to finally produce a retail product that is sold to consumers via licenced retail outlets. It is this final business relationship between brand owners and licenced retailers that is the absolute fundamental relationship in the wine industry because it determines the price, range, grape varieties and locations from which a wineries' wine is purchased by retailers and ultimately feeds backwards to the growers supplying those grapes. We know that retailers are squeezing the prices paid to wineries. We know the automatic reaction from wineries is to squeeze even harder their suppliers' grape prices. But we also know that retailers are not passing on those lower margins to consumers.

In these fundamental business relationships, there is one area where grape growers and wineries have absolutely no influence on their ability to sell their products. It is in the area of state legislation and legislative structure which has a domino effect right back to the grape grower. In simple terms, this lack of wine product selling influence is a legislative hurdle characterized as follows:

The wine market is global and it is also a very competitive business environment. To a great extent, the business environment for the sale of liquor (including wines) is controlled by State Government legislation with respect to types of licences, types of outlets, trading hours etc. This retail funnel to the consumer creates significant hurdles for wine sales and ultimately finds its way back to the grape grower.

The legislated environment has clearly created an opportunity for large retailers to buy specific types of licences (i.e. bottle shops) and strongly oppose, with their financial strength and legal know how, the creation of other liquor retail businesses. Such large retail chains (i.e. Coles Myer and Woolworths) have virtually been unhindered in their ability to purchase bottle shops and now, through those outlets, control approximately 60% of all wine sold. At the same time, these retail chains have used the legal system in each state to hinder and bully new liquor outlets being created and delay new licences being issued to independent operators. Even though these retailers were heavily fined, it does not change the fact that the current system creates a window of opportunity for large retailers to abuse their retail power and go to the extreme where they are not afraid of conducting their business illegally.

This is a crucial point. Our economy relies on free enterprise principles. However, as these giant retailers have acquired more liquor stores (not hotels, not restaurants and not clubs) and consequently more of the wine market share, they have abused this imbalance of power and have used it against winemakers by squeezing winemakers margins, increasing co-operative promotion and advertising dollars and increased their own retail margins in the process to 40-50% markup on cost. Added to that fact is the declining number of products being stocked and wine product buying being centralized away from the actual wine production areas. This is clearly unsustainable for winemakers' viability. This lopsided business relationship is transferred back to the grape grower and ultimately, to prices paid for grapes.

As if this situation is not bad enough, two of these retailers (Coles Myer & Woolworths) are now using the media to openly say that they are aiming for approximately 30% of their wine products to be their own brands. It is often quoted that they want to mirror the English retailers who have almost 45% of their bottle shop shelf space allocated to their own brands. Clearly English supermarket chains have not supported their own UK wine industry and if that same model is applied in Australia, Australians will probably not be drinking Australian wines in the next 10 to 15 years: they will be drinking wines coming from Bulgaria, Chile, China, India etc at inflated prices.

In a nutshell, we have the effects of very limited access to markets by the vast majority of winemakers and a legislative mentality that acts like a narrowing funnel that controls a market to the point where growers are the complete commercial losers.

The Government in each state and federally creates the business environment.

Consider the French and Italian landscape with respect to wine retailing. Virtually any retail outlet can sell wine; butchers, patisseries, delicatessens, bakeries etc. In a modern civilized country like Australia, do we have such a cultural cringe that we believe we need to control every single aspect of wine selling to the public to the point where this function has been handed over to two large retailers hence creating an opportunity for them to abuse their retail power? Consider the newly de-regulated Victorian framework for liquor licencing: this is the action of an enlightened modern society reacting to modern consumers.

There are enormous benefits in de-regulating liquor licencing laws:

1. Diversity and availability of wine products to consumers (and tourists) increase.
2. Wineries in Australian rural areas (where business is needed and communities need to be supported) have a chance of financial success on a more leveled playing field and better access to the wine drinking market.
3. Increased wineries income means tourism facilities will be improved in rural areas. More income will flow back to the rural wine business if their products can be sold in more retail outlets and not just confined to outlets controlled by one or two operators. Giant retailers do not contribute to tourism and rarely invest in rural tourism facilities. To my knowledge, I have never heard a tourist say they have gone to Margaret River in Western Australia to view a Liquorland outlet. The rebate of WET tax for cellar door sales up to $1 million is a brilliant initiative and this, over time, will improve tourism facilities in all rural wine growing regions of Australia, assuming it is maintained long term and expanded.

Conclusions

In summary, Australia is part of a free world trade environment with virtually no agricultural subsidies. This is admirable and, in the longer term, will create vibrant local industries. Unfortunately, the wine industry is weighted down by out-dated traditional state licencing regulations, hindering its ability to sell its products to wine consumers. These regulations have led to the abuse of this well intended legislation by powerful retail groups that have increasingly purchased the control channel of access of wine to the consumers and virtually act as the wine market's distribution funnel. Further, such retail groups not only want to be wine retailers but also wine manufacturers and suppliers by creating their own brands. This selfish commercial behaviour could be stopped and appropriately legislated by not allowing retailers to be manufacturers. Shop permits should not allow retailers to also be brand owners and/or manufacturers. Australia needs to follow the examples of France, Italy and Victoria and allow outlets to be more easily licenced in order to sell wines wherever a wine market exists. This act of creating a positive less regulated business environment means there will be more access to market by more wineries in many more retail outlets. This automatically spreads the retail control away from large operators.

The current imbalance of retail power is the primary reason that grape growers and wine makers are locked in commercial conflict regarding each others viability. It is a hopeless uncooperative business environment forced upon both these parties by overly powerful retailers taking advantage of their strength and their state's legislative regulations. Good legislation creates a good business environment that allows reasonable and fair access to retail outlets for all wine industry participants. Apart from Victoria, this is clearly not the case in Australia.