Rural and Regional Affairs and Transport References Committee

SUBMISSION COVER SHEET

Inquiry Title: Operation of the wine-making industry

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28 JUL 2005
Senate Rural and Regional Affairs and Transport Committee

SUBMISSION TO THE SENATE RURAL AND REGIONAL AFFAIRS AND TRANSPORT
INQUIRY INTO THE WINE INDUSTRY
July 2005.

Submission by

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A one time winegrape grower, executive winemaker, wine science teacher and researcher, foundation committeeman of ASVO, Board member of AWRI and currently consultant to the industry, I hereby submit the attached to the above enquiry.
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Summary

The wine industry does suffer problems from oversupply of grapes and wine and from the current industry structure and practices (especially with contractual arrangements), both of which warrant remedy in the industry's and the nation's interest.
These problems currently impact most severely on grape growers, and to a lesser extent, on smaller producers (wineries).

It is recommended that
- A mandatory code of conduct be established and enforced, addressing specifically
    * contractual arrangements between growers and producers and
    * quality parameters used to fix grape prices.
- An arbitrator be appointed to resolve disputes and to enforce the code of conduct.
- A national grower representative body and a peak industry body be established.
- The Australian Government review its level of taxation of, and contribution toward, the grape growing and wine producing industries to ensure a 'level playing field' commercial environment and to safeguard the industry's long term future.

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I. CURRENT SITUATION

a) SIZE AND NATURE OF THE WINEGRAPE GLUT.

Size of the glut:
Significant quantities of grapes were left on vines un-harvested in 2005: the exact quantity remains uncertain until final vintage statistics become available. Producers ('wineries') do attempt to accept all grapes grown, but this leads to excessive stocks held by producers.
Winemakers report a current stock to sale ratio of 2 compared with a required ratio of 1.5. This suggests excess wine stocks in the order of 500 ML of wine (equivalent to around 700,000 tonnes).

Nature of the glut.
I submit that the glut (or excess production) has arisen because of:

1. Grape-growers' and investors' over optimistic expectations.
Both owner-operators and investors (many tax driven) have assumed unrealistic future demand for winegrapes. This has been exacerbated by

1.1 Irresponsible (or at best, imprudent) developments by growers and investors without an assured market and without a supply contract to a producer. There are several large scale, new vineyard developments under way right now, even in the face of the winegrape 'glut'; promotion of such investment seems reckless.

1.2 Willingness of banks to lend money even in the absence of assured markets for grapes.

1.3 Poor advice from producers who have contributed, either by design or by neglect, to the surplus supply situation.
The current over-supply situation has benefited producers in the form of low grape prices paid to growers; producers may not want changes.

1.4 The attraction of viticulture as a relatively non-labour intensive enterprise, in the face of the high costs and risks of employing labour.

2. Producers' commercial ambition and short term opportunism.

2.1 Producers encouraged vine planting, recommended specific varieties and offered attractive contracts, then constrained acceptance of these grapes and terminated contracts when supply exceeded their needs and/or expectations.

2.2 Producers underestimated the quantity and quality of wine which has been produced from many new vineyards

2.3 Producers have bought grapes in excess of known requirements.
Some producers crushed record tonnages of grapes in 2005, despite the 'glut'. During the 2005 harvest one company simultaneously justified its very low prices for contracted grapes by claiming that the grapes were in excess of market requirements and the wine could not be sold, yet at the same time
- was promoting investment in large scale, new vineyard developments and
- did buy those 'unwanted grapes' albeit at 'give-away' prices.

3. Australian Government Taxation policies.

Tax concessions (e.g. accelerated depreciation allowance) to encourage vine planting helped the needed rapid development of the industry during the early 1990's. However, these concessions remained in force long after a looming winegrape surplus was obvious and have contributed to the present glut.
The Wine Equalization Tax is punitive and inhibits domestic demand. It was introduced when the industry was buoyant and it was perceived that the market could bear the imposition. Since then industry profitability has fallen and the industry can no longer bear this level of taxation.

4. World wine market.

4.1 Recent increases in production in other wine producing countries (especially 'new world' wine producers) has increased competition for Australian exported wine. This situation is worsened by low costs of production, weak currencies and Government subsidies for winemakers in some competitor countries.

4.2 The appreciation of the Australian dollar from around $US 0.50 to $US 0.75 has severely eroded returns to producers and inhibited volume growth.

Comment.

One might expect that the normal 'rules' of supply-demand would eventually solve this problem. However such adjustments are impeded by-
(i) Long lead times to change the national vineyard capacity; the pay-back time for vineyard investment is around five years. The supply/demand for winegrapes changed from shortage to excess in about two years. This inevitable time lag restricts the ability of the industry to adjust quickly.
(ii) Producers, being few and powerful, dominate contractual and bargaining negotiations with growers who are numerous and weak.
(iii) Winegrapes are highly perishable; thus growers cannot restrict supply by withholding produce from sale during negotiations.
(iv) The price elasticity of demand is considerably greater than unity; a 5% increase in supply/demand for winegrapes results in a price drop of 20 to 40%.
(v) Growers have made big investments in vineyards and are unwilling and/or unable to reinvest in an alternative crop.

Laissez faire economic management may be effective eventually but will result in considerable social dislocation and threaten the ongoing stability of the industry.

b) STRUCTURE OF THE INDUSTRY; GROWERS AND PRODUCERS

1. Structure

1.1 Grape-growers include
- Owner operators; most numerous group, mostly relatively 'small' scale individually but a large socio economic group.
- Investor owned vineyards (eg Timbercorp); few but increasing in number, larger scale.
- Producer owned, usually attached to a winery. Usually relatively large scale.

1.2 Producers, or wineries, include
- Large, mostly publicly listed, companies. The top four producers are responsible for around 80% of Australia's wine production.
- Medium size, some still family owned, companies.
- Cooperatives. Once dominant, now very minor with only or two one of significance left.
- Small specialist ('boutique'), private wineries; often also grape growers.

1.3 Retailers.
Consolidation of the retail sector, with fewer more powerful grocery chains and liquor groups is applying downward pressure on the final price of wine.

This hierarchy of bargaining power results in most of the cost pressures, most of the risk and most of the pain caused by the surplus, being born by growers. An analysis of costs indicates that the reduced margins and the WET tax have not increased retail prices nor significantly eroded producers' profits but are effectively paid for entirely by the growers.

2. Contractual agreements.

Following the demise (in South Australia) of the Government Fixed Price for grapes, the mid-80's vine pull scheme and then the grape price boom of the early 90's, grape supply contracts were introduced in an effort to stabilize supply-demand ratios and grape prices.
Alas, such contracts have failed to ensure the much wanted stability, as evidenced by
- the current over supply situation and
- grape prices now around half the price four years ago.

Observations on the possible causes of such failure include:

2.1 Producers dominate the setting of contracts (or supply agreements). Indeed, it is doubtful whether the contract satisfies the common law concept of a contract as being a true agreement by both parties. Growers have little if any input into setting conditions or grape prices each season; suggestions by growers to vary and improve their contracts are ignored by producers. Challenges are met with threats of non renewal of contracts.

2.2 Contracts currently list obligations of growers, with penalties, but admit few if any obligations of producers.
For example, downgrading of grape quality resulting from delayed intake, caused entirely by the producer, results in a lower price paid to the grower.

2.3 Some (few) growers have reneged on contracts when 'spot' prices exceeded contract prices, thus weakening producers stability of supply.

2.4 Producers (on one occasion at least) have reneged on pre-vintage set prices and downgraded grape prices retrospectively after harvest.

2.5 Producers prematurely terminated minimum price contracts and replaced them with contracts without a minimum price.

2.6 Producers have not renewed contracts in some cases, opting instead to buy un-contracted grapes at lower prices.

2.7 There is no realistic avenue for appeal or dispute resolution. Civil litigation, with its punitive costs, clearly is not a feasible option for growers though it is an option for, and has been used by, producers.

3. Quality benchmarks.

All stake holders agree that it is desirable to improve the quality of grapes and to reward those responsible accordingly. Systems currently in place largely fail to achieve these implied aims.

3.1 Since the introduction of 'grape price for quality', grape quality has improved but there has been a steady decline in prices paid by producers to growers.

3.2 Growers do not perceive that current quality bonus-penalty scales validly reflect the quality of grapes.
Some systems are quite subjective (quality rating based on taste) and arbitrary (if an arbitrary yield is exceeded grapes are assumed to be inferior).
Assessments cannot be verified and cannot be appealed.

3.3 The accuracy and precision of measurement of quality parameters is highly suspect and cannot be verified Data for some parameters indicate manifest errors which greatly distort the fairness of the prices paid to growers. One must question the legal validity of using such measurement for trade. Producers tend to defend such variation by claiming that across all grape samples and all growers, errors balance out. Even if this were true, it still allows the application and acceptance of gross injustices to an individual grower.

3.4 Growers have no reasonable avenue to challenge or appeal quality data which are manifestly suspect and are announced three months after harvest.

3.5 Quality criteria change from season to season ('goal posts keep shifting') which inhibits the ability and opportunity for growers to manage vines for optimum quality.

3.6 The method of calculating payments based on deviation from 'the district average' (as is used by at least one major producer) guarantees that as quality across the district improves there will be no reward for growers. This is quite contrary to the original aims of rewarding improved quality.

4. Industry-wide code of conduct.

The current situation with 'contracts' and with 'quality parameters', is clearly unsatisfactory. Rhetoric over the past decade about developing a voluntary code of 'best practice' has not achieved the desired result. A mandatory code of conduct to address supply arrangements and quality parameters is essential. Suggestions regarding such a code are included under "Conclusions and recommendations".

(c) ADEQUACY OF THE TRADE PRACTICES ACT

The current situation (e.g. with producers having unfettered control over grape prices, the paying of prices well below growers' costs of production and producers being unaccountable for their decisions) is prima facie evidence that the Act is not adequate to ensure fair trading and a balance in negotiations between producers and growers. Possible explanations are:

1. The provisions of the act are inadequate. An assessment of the Act is difficult when the Act has not really been tested.

2. Recourse to the Act is not a practical option for most growers; they lack the resources and money to pursue their case at law. The Act does not appear to be enforced by any law enforcement agency but appears to rely on civil litigation, which is, in practice, unavailable to most growers.

(d) NATIONAL GRAPEGROWERS' BODY

Following the demise in early 2004 of the Australian Winegrape Growers Council, which represented a large proportion of grapes but not all grape growers, the grape growing sector has been unrepresented at national level. Clearly, a national body representing grape growers is needed to provide information for planning, give growers some real bargaining power and to represent the commercial interests of growers.

2. CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

1. Reforms are needed because clearly the current situation is not in the national interest.

1.1 Winegrape growing in many vineyards is no longer viable. This jeopardizes the future of a major industry and threatens social dislocation and personal hardship for many growers, with dire results of unemployment and collapse of some regional centres.

1.2 Wine producers, in some cases, are at risk with low wine prices prompted by panic selling of excess stocks eroding profitability.

1.3 Australia nationally benefits from a viable, stable industry through export income, employment and contribution to government revenue.

2. Appropriate operating conditions and a fair trading climate are needed rather than excessive regulation of the industry through government fixed prices, subsidies and tariffs. A legal framework and business climate is needed to ensure a truly 'level playing field' both within Australia and internationally.
Reform cannot be achieved through voluntary adoption of a code - experience shows that self interest and greed over-ride ethics - so some form of compulsion, backed by legislation, is essential.

RECOMMENDATIONS.

1. Establish a code of practice, enforceable by law which addresses.

1.1. Contractual agreements are needed which;

1.1.1 Ensure that the 'purchase agreements' are in fact legally binding and enforceable contracts.

1.1.2 Define the minimum criteria which must be included in a grape supply contract, including obligations of both parties, fairly and equitably;
- rights to negotiate and to appeal with a fair and accessible dispute resolution procedure.
- conditions for renewal or rollover, which take into account the long lead times for vineyard and land use change.
- mutual obligation for the grower to provide grapes and for the producer to accept grapes at optimal maturity.

- mandatory ethical conduct, honoring the spirit of the contract (No retrospective price reduction and arbitrary penalty imposition, no unjustified termination of contracts, no duress or threats of contract termination, no buying on spot market in preference to buying contracted grapes.)

1.2 Quality parameters.

Parameters which may be used to vary grape prices (bonuses and penalties) need to be:

1.2.1 Valid, supported by technical evidence (not arbitrary or assumed).
1.2.2 Agreed by both winemaker producers and growers.
1.2.3 Objectively and reliably measurable by calibrated, reproducible and legally recognized methods (similar to the provisions of the Weights and Measures Act).
1.2.4 Applied consistently and not frequently varied between seasons or during a season.

2. Enforce the code

The law (including the Code and the Trade Practices Act) must be enforced by publicly authorized and funded enforcement officers or 'policemen'. Individual civil action is beyond the resources and abilities of many, especially growers, who need the protection of the law; such people are thus denied the protection of the law.
(If my household is robbed, I furnish notice of theft and then the police investigate and hopefully prosecute. If I am 'robbed' of grapes or grape payment I am denied natural justice.)

3. Establish an appeals commissioner (arbitrator or referee).

Application of a disputes resolution procedure and the enforcement of a mandatory code might be best be handled by a commissioner or referee rather than a full court.

4. Establish a national grower body.

The formation of a National Winegrape Growers' organization and the establishment of a peak body (Wine Industry Australia) as outlined in the Government funded 'CIE Business plan' should be pursued to its completion. One desirable outcome of information gathered by such bodies could be more transparency in commercial arrangements and a better information base leading to sounder planning and more prudent investment.

(How many newly recruited investors into vineyard schemes are aware of the present glut of winegrapes and that many grapes remained unpicked this season?).

5. Review and adjust Government taxation policies.

The Australian Government has a vested interest in a viable grape growing and wine producing industry and a responsibility to its citizens, both private and corporate, to foster enterprise and to protect those citizens.

5.1 Further investment into expanding vineyards must be discouraged now. At this time, any incentives (e.g. tax reduction or avoidance) which encourage further vineyard development are counter productive and should be withdrawn.
Indeed, there is a situation emerging where it may be necessary to assist some smaller, inefficient grape growers to exit the industry.

5.2 The Australian wine industry relies heavily on exports and competes with many wine producing countries which protect and/or subsidize their own producers - and have low or nil tax on domestic consumption. The Australian Government has a responsibility to ensure that Australian growers and producers can compete fairly, internationally. While protective tariffs or subsidies are contrary to our free trade philosophy, reduction or abolition of the WET is a real option. Current discount retail prices, a buoyant wine producer sector and depressed grape prices all indicate, as shown above, that the winegrape grower ultimately pays this tax. Thus the WET is now discriminatory and inequitable.

5.3 Over the last twenty years Governments have been called upon for, and have provided, funds for a vine pull scheme (in time of over-supply) and for concessions to encourage vineyard planting (in time of grape shortage). During prosperous times, Government revenue from the wine industry (company tax, income tax, WET and brandy excise) is enormous. This suggests that funding some of the initiatives suggested, including contributions to grower representative and to the peak wine industry bodies, could be a sound long term investment.

End of submission.