Submission to the Senate Inquiry into the Australian grape and wine industry

Rural and Regional Affairs and Transport References Committee

Submitted by

Wine Grape Growers Australia, June 2015

Addressed to –

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About Wine Grape Growers Australia and the Australian winegrape industry

Wine Grape Growers Australia (WGGA) welcomes the opportunity to provide input to the Senate Inquiry on behalf of all its members and the wider population of winegrape growers, their families and communities.

WGGA is the national voice for Australian winegrape growers. It is an incorporated association that is accountable to its members through a representative Executive Committee. In 2012, there were roughly 6,200 winegrape growers in Australia and WGGA could count around 3,700 of these as having a direct involvement in the organisation.

Winegrapes are a significant contributor to Australian agriculture and regional economies. The value of grapes in 2012 (for all uses) was approximately $1 billion – similar to sugarcane and about a third of all fruit other the winegrapes, combined. The estimated value of winegrapes specifically that year was $880 million. This places winegrapes in about tenth place on a list of Australian crops by value.

When converted to wine, the value of winegrapes translates to over $4 billion in wine sales revenue. Exports of wine were valued at $1.9 billion in 2012-13 – ranked fifth among food and beverage exports after grains, meat, oilseeds and all dairy products. The wine industry is estimated to employ between 16,000 and 20,000 Australians directly – with many more in associated supplier and extension industries such as agrichemicals and tourism respectively.

Submission scope

This submission focusses primarily on an analysis of market failure in the wine value chain – specifically as a result of deficiencies in the commercial practices between wine companies and winegrape growers. Brief points of importance for winegrape growers are made under other terms of reference.

Inquiry Terms of Reference (a): The extent and nature of any market failure in the Australian grape and wine industry supply chain

Required reform to traditional commercial practices in the industry

The wine sector has failed to adjust to supply and demand imbalance since it was widely acknowledged to exist in the industry by 2005-06 (and by some, as early as 2000).

Prima facie, this is evidence of market failure. Efficient markets ‘clear’ (that is, supply clears to balance with demand) through the mechanism of market signals exchanged between industry players, mediating the adjustment process – or – in common parlance, ‘the market sorts it’.

Despite supply-demand imbalances being acknowledged since 2005-06, the imbalance persists today, “Brand Australia” has been damaged, non-profitability is endemic and hope for redress still seems distant.

Currently, the popular view is that the industry needs a demand-led recovery. However, while action in this regard is essential, it is not sufficient. Sole reliance on demand growth is not only short-term, it is short-sighted.

The short-sightedness of demand-led recovery is that without the necessary market mechanics to ensure that the new demand is aligned with required supply, such an emphasis has the potential to create another up-cycle that will solicit lead to yet another cycle of overproduction such as that currently being experienced. It is a commitment to another round of maladjustment at a later date preceded again by wild volatility and swings in industry fortunes.

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The lesson of the past ten years of protracted maladjustment is surely that of the short-comings of single-dimension solutions.

Longer-term, substantial and transformative change can be brought about instead by ensuring that supply and demand 'talk to each other' where doing so means each tracks the other and although adjustments will still be required along the way, they will be smaller in amplitude and more aligned with the desired direction.

Fix demand, fix supply or fix the way they talk to each other?
Far better then, that the combined forces of demand expansion/contraction and supply expansion/contraction are synchronized to create smaller swings, smaller adjustments and less industry, investor and community disruption.

Market signals are embedded in the range of commercial practices that exist between buyers and sellers.

In any economy, supply and demand talk through market signals. Market signals enable markets to function by clearing supply which is the essence of what is meant by 'the market sorting it'.

There is a sense in which 'fixing demand' or 'fixing supply' by themselves, depending on the cycle the industry is in, is dealing with the symptoms of the problem but not the underlying cause. In the case of supply and demand imbalances, the underlying cause is deficiencies in the market mechanisms that provide the signals to keep supply in balance with demand.

Market signals are embedded in the range of commercial practices that exist between buyers and sellers.

WGGA has identified a range of commercial practices that are dysfunctional in the wine sector and which undermine the industry's ability to find alignment between supply and demand. Reports of these practices come from winegrape growers themselves.

Many of the poor commercial practices in the industry stem from an imbalance of negotiating power between winegrape growers and wine companies (in favour of the latter).

Good commercial practices and grower-winery relations and effective business operations are defined by:

- Fair and reasonable price determination mechanisms relying on measurable input that is transparent and accountable.
- Fair and reasonable terms of trade.
- Appropriate sharing of risk (ie growers bear production risk and wine companies bear market risk).
- Trust and respect in the business relationship.
- Accessible and non-retaliatory disputation mechanisms.
- The existence of professional business standards and practices.

Three elements of poor commercial practices will be further developed here.

a. The role of contracts in best-practice commercial arrangements.
b. Price determination mechanisms described in codes of conduct together with those that sit outside such codes due to competition law.
c. Sharing of agricultural and market risk.

a The role of contracts in dealing with best-practice commercial arrangements

Following the 5 May 2015 Roundtable on business behaviour in the industry, hosted by the office of the National Small Business Commissioner, the Commissioner expressed the view in his submission to this inquiry that there are significant benefits to the industry as a whole in improving how the business of wine is conducted. Among other things, the statement included improved contract terms and the development of standardized contracts (Australian Small Business Commissioner, May 2015).

An uneasy "collaboration without trust" has evolved in commercial relations between grape growers and wine companies, due in part to the financial pressures facing the industry leading to bad commercial behavior by some. More important however, are outdated, traditional commercial arrangements that are familiar and accepted in the industry. This describes a structural problem in the industry, not just exceptional instances of bad practice.

Symptomatic of the lack of trust in the wine sector is the failure, in the six and a half years of existence of the Australian Wine Industry Code of Conduct ('the Code')[1], to meet the industry-agreed targets for the number of wine company signatories to the Code.

Contracting standards in the wine sector needs to improve
Contracts describe the commercial relations that should streamline discussion, improve negotiations, aid dispute resolution, and reduce transaction costs between buyer and seller.

However, research by WGGA indicates that the prevailing contracts used in the industry do not provide the right incentives to improve performance and increase transaction costs.

In 2013, WGGA reviewed a sample of 20 wine industry contracts. A number of concerns with the contracts were identified.

- Complex clauses relating to the determination and notification of pricing.

[1] The Code is a voluntary industry code collaboratively developed by the Winemakers' Federation of Australia and Wine Grape Growers Australia.

- The one-sided nature of contract price-setting mechanisms.
- The absence of penalties for late payments.
- The non-explicit nature of quality standards used in the final determination of price.
- The ability of the purchaser to make decisions at their "sole discretion".
- The lack of dispute resolution clauses in up to 50% of contracts.
- Inconsistencies over the use of various termination clauses covering different scenarios.
- The presence of errors and poorly worded clauses.
- Complex and lengthy contracts that were hard to read and understand.
- A number of contracts that stated they were covered by the Code where the review found them to be non-compliant.

These issues with contracts work against the effectiveness of the most fundamental tool for establishing fair, transparent and accountable market signals in the industry.

<u>Potential solutions</u>

The next generation of winegrape contracts will require greater attention to the basic principles of transactional arrangements if the goals of lower contracting costs, greater value adding, and less disputation are to be achieved.

Contracting performance varies considerably across businesses involved in growing winegrapes and making wine. An increase in the general level of capability in negotiating and writing contracts is needed to improve trust, efficiencies and mutual gain. Through the Code Management Committee, the combined WGGA-WFA custodian of the Code, the industry is committed to make available contract templates to aid this process. The assistance of the Minister of Small Business and relevant agencies could also help.

b Price determination

Following the 5 May 2015 Roundtable hosted by the office of the National Small Business Commissioner, the Commissioner expressed the view in his submission to this inquiry that variability throughout the industry in price determination imposes risk and financial distress on winegrape growers (Australian Small Business Commissioner, May 2015).

Traditional, existing mechanisms in the industry:

- confuse quality and quantity incentives,
- are open to abuse,
- do not build working/trustful business relationships,
- do not encourage innovation,
- do not encourage quality improvement (rather, mitigate against it), and
- impose the greater burden of risk on the grower.

Most people are familiar with the role of supply/demand in determining price but the lack of delineation between this and quality determinants of price is problematical in the industry. The traditional classification of fruit by grades illustrates this.

In the wine sector, grades are defined by price ranges and this has become, by default, the frequent way of describing quality. In the current operating environment; A grade fruit is considered to be that which is >A$2,000/tonne; B grade fruit as A$1,501 – 1,999/tonne; and so on down to E/F grade fruit, <A$300/tonne. This practice says nothing about quality attributes other than referring to grades.

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If these categories do reflect quality, the industry is in trouble because the proportions of fruit in the lower 'grades' have increased in recent years. Nevertheless, quality is unlikely to have slipped to the extent reflected in the changes in mix. After all, Australia continues to punch above its weight in international wine competitions and the increased proportion of premium winegrape varieties in the national mix, particularly from cooler-temperate districts, is pronounced.

The answer is more likely to be that the downward shift in 'grades' reflects lower prices from a poorer supply/demand balance in the industry. Evidence again that pricing is more about supply and demand balances, and not about rewarding quality.

'Quality'[2] is widely recognized in the industry to be the single most likely element that will improve the competitiveness of Australian wine on overseas markets. Quality needs to be incentivized and standards for objective trade measures need to be developed and promoted for adoption within the industry.

The real issue, in an industry that places so much faith in quality, but rewards fruit based on supply and demand balances, is that quality objectives are un-signalled and are not incentivised. Moreover, the lack of distinction between price components based on supply and demand balances as opposed to quality attributes, means winegrape prices are open to manipulation by winegrape purchasers. This has the effect of not just severely blunting the incentives for quality but also undermining buyer/seller relationships.

Winegrape price-setting needs to be based on measurable attributes that separate quality from supply/demand influences on price and send clear signals about requirements for each

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Imperfect quality measurement exposes growers to excessive price risk. Deployment of more sophisticated quality measurement systems is needed.

In his submission to this inquiry, the Australian Small Business Commissioner states that the adoption by businesses of objective measures could have a positive impact on the overall

[2] The term 'quality' is an indiscriminant and sometimes subjective term and offers little to the debate about transparent and accountable market signals. For the purposes of this submission, 'quality' can be considered to be short-hand for winegrape and wine attributes that are desirable and sought-after by consumers.

business environment, as it would assist winegrape growers to better understand what best practice winegrapes are and contribute to a decrease in the number of winegrape price disputes (Australian Small Business Commissioner, May 2015).

The problem with objective measurement of quality is not the lack of availability of measures, rather it is their non-adoption by winegrape purchasers

Potential solutions

The Australian wine industry has developed highly serviceable quantitative technical measures of winegrape quality attributes that are acknowledged world-wide. Moreover, the 'datafication' of grape and wine production – sensors-in-field, mobile communications, cloud data storage and predictive modeling – means that quality now can be measured with greater accuracy and in real time.

The problem with objective measurement of quality is not the lack of availability of measures, rather it is their non-adoption by winegrape purchasers.

'Quality' exists at all price points

Measurement of quality attributes is applicable to the whole range of wine price points, not just the premium end. This rests on the concept of 'value' – that is, quality for the price.

In the design of contracts, it is possible to incorporate incentives based on objective measures of quality attributes that relate to either:

- viticulture management – the monitoring of inputs and practices/processes, or
- grape performance – the monitoring of outputs, such as grape sugar content and other product attributes.

In cool temperate regions, where winegrape attributes have greater expression and range and have monetary reward in the marketplace, contracts should rely on measurements of viticulture inputs and practices that affect subtle wine attributes sought by consumers.

Contracts in warm inland regions should specify price incentives that rely on measurements of outputs, and less on the monitoring of inputs.

The wine sector is a laggard in the area of quality incentivisation

Most other Australian agricultural commodities have objective measure element/s in price determination mechanisms.

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Notable commodities that incorporate objective measurement of quality attributes in price determination mechanisms include wheat, wool, sugar and sheep/beef meat.

The sheep and beef meat industry is a good example. Meat Standards Australia (MSA) was developed in 1996 and provides a number of useful elements that ensure the effective operation of an objective measurement system in a price determination mechanism, including - signals and rewards for meat attributes desired by consumers, guidance to producers on the production and delivery of these attributes, and a marketing tool for the meat.

The MSA system -

- was designed to deal with many of the same issues currently faced by the wine sector (low demand and consumer confusion about quality),
- sets standards that respond to critical quality attributes sought by consumers,
- permits tracing of quality outcomes which permits food safety and quality assurance,
- not only rewards innovation but provides the information to identify the innovation required,
- has an adjunct facility of a livestock identification system which provides biosecurity benefits,
- provides transparency in price setting and builds trust in the buyer/supplier relationship, and
- provides an accreditation mechanism that can be used for quality assurance and promotion.

Potential solutions

The development of price determination mechanisms requires industry-wide dialogue and problem-solving. However, wine company interests and 'voice' (political power at both industry and government levels) dominates the wine sector. It is not unusual to be told "We have been doing business this way for years and we are not going to change". In these circumstances, growers require the involvement of government to facilitate the necessary dialogue between growers and wine companies.

c Appropriate sharing of agricultural and market risk

Under prevailing contracting arrangements, growers bear a disproportionate share of the risk and they often bear market risk that is more appropriately borne by wine companies.

Growers are directly exposed to weather risks and pest/disease problems, which raise input costs and reduce output volume and quality. These are the natural risks for agricultural producers together with the inescapable effects of supply and demand balance for their product.

In addition to their agricultural risk, there are many examples of market risk growers are required to bear, which are more appropriately the business risks that the market-facing wine companies bear. However, traditional and accepted commercial practices in the industry means growers bear market risk as well as their own production risk.

Under prevailing contracting arrangements, growers bear a disproportionate share of the risk and they often bear market risk that is more appropriately borne by wine companies

- Growers are exposed to price risk due to the absence of systems for price determination systems based on quality attributes. A grower's grapes fruit may be downgraded, not because of quality problems, but because purchasing wine companies may have filled their quotas for grapes at matching price points.

- Growers are exposed to payment risk, due to the traditional practice of payment in three deferred payments over six months or more. For historical reasons, this practice is enshrined in legislation in South Australia and is included in Section 2.6 of the Australian Wine Industry Code of Conduct. Moreover, it is unlikely that final payments carry a compensating premium for the grower funds that are being 'borrowed' over this period to shore up wine company's cash flow while their wine matures.
- With delayed payments, grower payment risk is accentuated by them being unsecured creditors in the event the wine company fails. While the Personal Property Security Register (PPSR) facilitates their ability to become secured creditors, it is understood that banks generally discourage wine companies they deal with, from providing the relevant clauses in contracts that facilitate access to PPSR. From the bank's perspective, they do not wish to dilute their own security over the assets of a failed company.
- The requirement in the Code for price to be determined within two weeks of off-take, or worse, on a take-it-or-leave-it basis at the weighbridge[3], growers effectively take on wine company market risk by committing to the major part of their investment in the crop while wine companies have well over half a year to review and revise the market assessment they will have made by 30 June each financial year.
- Growers are "locked-in" to grape production for up to decades, once the vines are planted.
- Imposing yield caps without valid and verifiable cause or adequate compensation and in some cases, denying the ability of the grower to achieve per hectare cost of production.
- Unfettered discretion of wine companies over harvesting schedules that result in penalties to grower returns through sub-optimal ripeness and quality or increased capital and labour costs.

Despite grower absorption of market risk, wine companies are in fact, better positioned than growers to manage this risk.

- They are generally bigger businesses.
- Wine companies have more secure relationships with banks due to the wine company size.
- Perishability of product is less of a problem for wine companies.
- Wine company businesses are more diversified than grower businesses, for example, including both growing and processing operations or by being a part of larger companies or groups of companies.

[3] By virtue of sub-optimal adoption of the Code by wine companies and to add to the difficulty, with a product on-hand that spoils quickly.

- Wine companies are less susceptible to production risk due to weather and disease through the ability to source winegrapes across a wide range of geographical locations.

Wine companies must assume their fair share of commercial risk in purchasing arrangements, including for example, more timely payment for fruit and by providing grading information based on agreed indicators for quality attributes that come with sound technical verification. In districts with strong wine identities, and higher value-adding, innovation may be appropriate such as use of contracts in which winegrape growers are made (at least partially) residual claimants for the value of the wine output.

Traditional debt-based investment for vineyard establishment

Grape growing, with its large fixed investments combined with lagged and uncertain returns, is an example of an industry prone to boom-bust cycles. These circumstances create delayed entry and exit behaviour.

For the investor, there exists an 'option value' in waiting to invest or waiting to exit the industry because of heightened uncertainty in asset returns. This results in a very wide window of indecision about exit despite lack of profitability. This indecision is one of the drivers of the industry's lack of supply adjustment in the nine to ten years since oversupply was widely acknowledged in the industry, in 2005-06.

<u>Potential solutions</u>

Mechanisms to minimise the indecision in vineyard investment include the following.

- Provision of better and more timely information on industry supply and demand outlooks. This is largely an industry role although government can play a supporting role as explained in the following section of this submission (Information for effective grower decision-making).
- Creating investment tools and business models that make vineyard investments more responsive to changing economic circumstances (eg separating the investment in the land asset from the business operated on it). The financial community has expertise in this area and can be encouraged to deploy this expertise by government incentives.

Grape growing, with its large fixed investments combined with lagged and uncertain returns, is an example of an industry prone to boom-bust cycles. These circumstances create delayed entry and exit behaviour

Information for effective grower decision-making

From a position of having world-benchmark foundation datasets less than ten years ago, the Australian wine sector has fallen well behind is this facet of competitive advantage today. A national viticulture data collection has not existed since 2012 and since 30 June 2014, neither have collections of wine production, sales or inventory. The absence of such foundation data *leaves the industry blind to its direction and severely hampers grower's ability to plan for the future.*

In the current industry downturn, lack of effective information is a result of declining funds available to the industry, a lower priority put on such an investment in an earlier form of the industry RDC and reduced Commonwealth funding of the ABS, affecting capability.

Deficiencies in this area not only impede competitiveness through failure in decision-making at the individual business level but also stand in the way of effective biosecurity responses and the ability of growers to improve the operating environment for winegrape growing through collective action based on aggregate knowledge of the industry's status.

From a position of having world-benchmark foundation datasets less than ten years ago, the Australian wine sector has fallen well behind is this facet of competitive advantage today

Potential solutions

The wine industry view is that its information needs can be met through an industry-owned collection of data via the agency of the industry's statutory body, the Australian Grape and Wine Authority. The advantages of this arrangement include –

- capacity of the statutory body to cover-off on the privacy and confidentiality requirements,
- ability to produce information outputs in a timely fashion,
- direct access to feedback on, and incentive to respond to, industry views on emerging information needs,
- greater likelihood of providing services at least cost,
- greater engagement of industry in the data collections,
- ability to combine multiple purposes in the collecting activity (statistics, biosecurity responses, contact information),
- ability to encompass both grape and wine collections in one facility.

A single industry-held database with the functionality to produce all the required statistical information – including contact information, location and size, foundation data etc – would also reduce duplication in surveys and increase efficiency.

To achieve this, AGWA needs to be granted the legislative authority to make the provision of data by individual operators mandatory combined with the necessary assurances of comprehensive privacy and confidentiality.

Inquiry Terms of Reference (b): The role of federal and state legislative and regulatory regimes

There are two areas in particular where state and federal regulation and legislation have a negative impact on winegrape growers, in terms of increased costs, reduced competitiveness and increased agricultural risk. These are:

a. lack of harmonisation of state legislation, and
b. access to agrichemicals

a Harmonisation of state-based legislation

The existence of different legislation and regulations in different states gives some growers a potential advantage or disadvantage with respect to others and hence distorts the market for winegrapes.

For example, the existence of contract dispute legislation and terms of payment regulation in South Australia may advantage growers in terms of fairness, but may make wineries less inclined to do business with them compared to interstate suppliers.

In another instance, the lack of protective legislation, for example controlling spray drift damage and disease threat from abandoned vineyards, creates an additional risk for growers and ultimately is costly to the sector in terms of lost production and the potential spread of disease.

Finally, where inconsistent regulation between the states relating to cross-border transfer of winegrapes results in increased compliance costs and risk due to error.

<u>Potential solutions</u>

Commonwealth-led harmonisation of State regulations through COAG/ SCoPI – for example in:

- terms of payment regulation (illustrated by the Wine Grapes Act of SA),
- contract dispute legislation (illustrated by the South Australian Fair Trading [Farming Industry Dispute Resolution Code] Regulations 2013),
- legislation to intervene in abandoned vineyards that represent disease risk to surrounding vineyards,
- protocols governing the interstate transfer of winegrapes,
- initiatives to eliminate spray drift damage to vineyards from broad acre application,
- initiatives to prevent smoke damage to vineyards from bushfire prevention burn-offs in regional jurisdictions, and
- a consistent approach to the resourcing services for winegrape growers through collective funds – such as the Grape Growers Industry Fund in SA.

b Access to agrichemicals

As markets for agricultural products globalise, plant industries face increasing biosecurity threats at the same time as access to overseas agrichemicals, to combat diseases, which are available to overseas competitors, declines.

Australia is no longer on the global priority list for pesticide commercialisation as it was 20 years ago. Many agricultural industries in Australia are missing out on a large proportion of the new agrichemicals, which key competitors in Europe and the USA have access to. By way of illustration, the table below shows one small selection of viticulture chemicals that are available in parts of the US but not in Australia.

Many agricultural industries will experience significant productivity losses in 8-10 years through the combined impacts of evolving pesticide resistance and the limited access to new technology due to either the smaller size of the Australian market or high costs from red tape in Australia.

Commercial name	Active ingredient	Target pest or disease
Aliette	Fosetyl-Al	Downy Mildew
AuxiGro	Gamma aminobutyric acid + L-glutamin acid	Powdery Mildew, Botrytis
Blight ban	Pseudomonas fluroescens	Sour rot, bunch rot
Ferbam	Ferbam	Black rot
Fungastop	Citric acid, ascrobic acid, mint oil, fish oil	Reduced sour rot
Gavel	Zoxamide (+ mancozeb)	Downy Mildew, Bunch rot, dead arm
Inspire super	Difenconazole (+ cyprodinil)	Powdery Mildew, Botrytis, Black rot, anthracnose
Nutrol	Monopotassium phosphate	Powdery Mildew
Oidate	Hydrogen dioxide	Powdery Mildew
Presidio	Fluopicolide	Downy Mildew
Prev-am	Sodium tetrborohydrate decahydrate	Mealybugs, mites
Procure	Triflumizole - DMI	Powdery Mildew
Quadris top	Difenconazole (+ azoxystrobin)	Powdery Mildew, Downy Mildew, Black rot
Ranman	Cyazofamid	Downy Mildew
Reason	Fenamidone	Downy Mildew
Ridomil Gold	Mefenoxam	Downy Mildew
Sonata	Bacillus pumilis	Powdery Mildew
Sovram	Kresoxim-methyl	Powdery Mildew
Sulforix	Calcium polysulfide	Powdery Mildew
Tanos	Famoxadone + cymoxanil	Downy Mildew
Topspin	Thiophanate methyl	Botrytis
Trilogy	Clarified neem oil extract	Fungicide, miticide, insecticide

Some agrichemicals that yield productivity gains that *are* available in Australia, are constrained in their use due to the absence of negotiated maximum residues limits (MRLs) in key overseas markets. A prime example is Phosphorous Acid, an antifungal chemical with great efficacy in terms of effectiveness and cost, which cannot be used in the key market of China due to the absence of MRLs for Phosphorous Acid residues in wine imports. WGGA is involved in negotiating MRLs with the Chinese authorities but several factors point to a need for government assistance on similar issues.

- A more universal solution for Phosphorous Acid MRLs is to negotiate MRLs through Codex, which global standards rather than through one-on-one negotiations in individual markets like China.
- There are other agrichemicals for which MRLs need to be negotiated and again, Codex is the most expeditious agency through which to operate.
- While delivering greater benefits, Codex is nevertheless a more difficult and resource intensive agency for negotiations to be conducted.

With a lead-time of 7 to 10 years to deliver new agrichemicals that have demonstrated proof of concept, Australia must act on this issue promptly.

<u>The solution</u>

To address investment market failure in the longer term, there is need for transformational change to agrichemical regulation to support investment in Australia. Changes like consumer and government acceptance of international standards together with streamlining local protocols and standards would deliver:

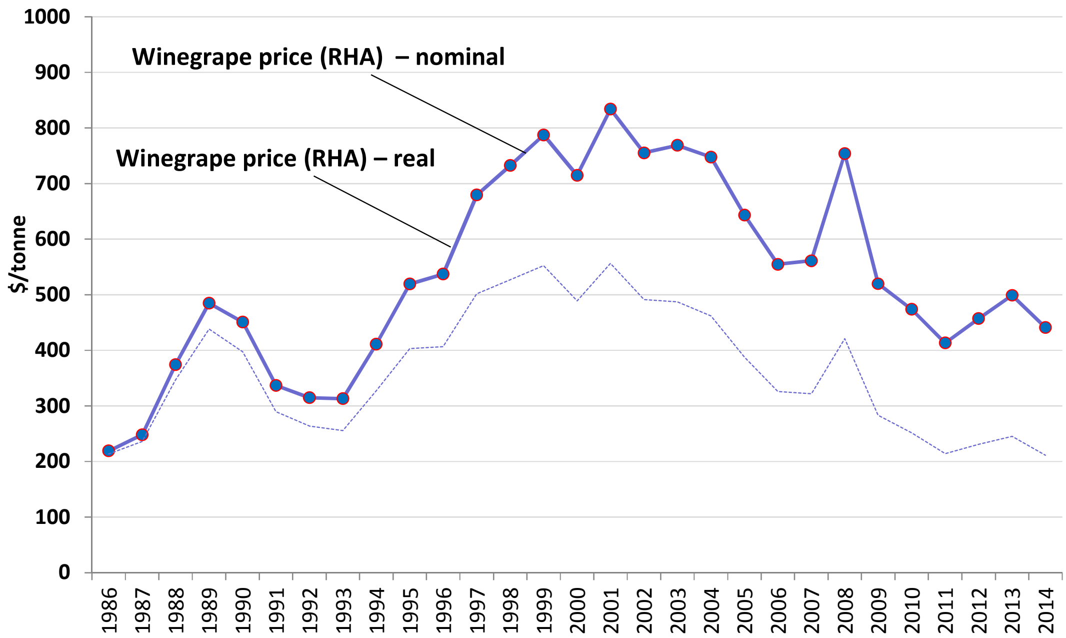
- cost savings to Australia,
- fastest possible technology access to overseas,
- Australia on the first priority commercialisation list, and
- greater competitiveness with overseas producers.

WGGA has been in discussion with other plant industries on these issues. We recommend that the government urgently address the following;

- funding assistance for industry members to provide input into the Agriculture Chemical Advisory Group advising the government on reforms to improve the access of Australian businesses to overseas-sourced agrichemicals,
- consider increased international partnership in co-regulation and look for efficiencies and incentives for agrichemical investment in Australia,
- consider regulatory reforms to reduce the red tape associated with the responsible use of agrichemicals in Australia,
- assist industry with international trade access negotiations and rapid resolution of MRL negotiations.

Inquiry Terms of Reference (c): The profitability of winegrape growers

Numerous assessments point to the lack of profitability in winegrape growing. For example, WFA estimated that over 75% of grape production did not cover the costs of production in vintage 2014 (Winemakers' Federation of Australia, October 2014). WGGA calculations based on national industry statistics, show that the average Australian winegrape grower has not met cost of production in the last 5 to 6 years (Wine Grape Growers Australia, September 2012). Finally, a winegrape price series maintained by WGGA (see illustration),



shows the national average winegrape price has declined steadily since a peak in 2001 and in 2014 was around half what it was at the peak. In real terms, meaning adjusted to the same buying power each year, the 2014 price was back to what it was nearly thirty years ago, at a time when the industry fortunes were so low that a vine pull was enacted (Wine Grape Growers Australia, June 2015).

Repeated efforts have been applied at individual, regional and national levels to reduce production costs, create efficiencies and improve quality and consistency – in an attempt to both cut costs and raise revenues. Much of the saving has been in increased mechanization and hence reduced labour costs. The latter nevertheless can have negative impacts in regional economies.

Cost savings are counter-productive in that they are likely to lead to a vicious cycle of poorer quality fruit, lower demand and hence lower prices. Moreover, they are likely to be absorbed in increased margins to the more powerful players in the value chain anyway

Cost savings in terms of reduced chemical use, slower replacement of equipment, cheaper (poorer quality) inputs, less expenditure on insurance and activities such as biosecurity as well as industry memberships are counter-productive and likely to lead to a vicious cycle of poorer quality fruit, lower demand and hence lower prices.

A more significant problem is that while wine companies and retailers have greater negotiating power than growers, any cost savings are not likely to be realised by the grower but are instead absorbed in increased margins to the more powerful players in the value chain – or lower costs to consumers.

Business skills can be improved

With limited opportunity for cost-cutting to assist profitability, it is important that growers are able to make good management decisions for their businesses and personal welfare.

In this respect, both the WFA and WGGA, as well as some regional associations, state and Commonwealth governments, have attempted to promulgate financial benchmarking and information tools for grower and wine company use. Typically, these have attracted interest but have failed due to lack of industry participation.

While, in a knowledge intensive sector, the desire for education in product specification and performance is strong, it does not necessarily extend to the acquisition of business skills

The Australian Small Business Commissioner noted that while improved financial management, basic budget and cash flow understanding as well as negotiation skills, would improve how business is conducted across the value chain - industry attempts to engage its members in educative efforts have nevertheless failed (Australian Small Business Commissioner, May 2015).

While, in a knowledge intensive sector, the desire for education in product specification and performance is strong, it does not necessarily extend to the acquisition of business skills.

Potential solutions

There is an important role for Government to assist industry attempts to upgrade business knowledge and acumen. An example of this could be through the Rural Financial Counselling Service, including collaboration with industry organisations to reach and assist growers.

Inquiry terms of Reference (d): The impact and application of the wine equalisation tax rebate

The following is taken from a submission made by WGGA to the Tax White Paper in May 2015. The WGGA Tax policy submission also deals with the important debate on the ad valorem versus volumetric basis to wine taxes.

The original justification for the WET rebate - to support small regionally based producers – is an important objective but is not sufficient, given industry conditions that have emerged since the rebate was established. For various reasons, the conditions that have emerged since the installation of the rebate, mean that the original policy objective for the rebate is no longer being achieved – with good outcomes and bad.

The rebate is now poorly targeted in that it captures more than the original target group of cellar-door outlets. That is - non-regionally based businesses, non-wine producing (virtual) wineries, large wineries and offshore producers (New Zealand for wine sales in Australia) - all now access the rebate.

Moreover, compared to when the WET rebate was originally introduced, wine oversupply and growing retail power mean that wine producers are willing to trade away the rebate to achieve sales, through lower on-sell prices, meaning retailers and consumers derive the benefit of the rebate through lower retail prices.

In a further flow-on effect, lower profitability for wine producers means fewer winegrapes are purchased from independent winegrape growers who might therefore choose to survive by converting their unsold grapes into wine under contract and then selling the wine directly to retailers for marketing as retailer-owned-brands. The WET rebate is an essential element of the business model for many of these arrangements. However, as discussed above, the ability of the more powerful players in the value chain to take margin from the weaker players means that much of the revenue from the rebate may be traded away in lower selling prices.

WGGA supports the removal of eligibility for the WET rebate from bulk and unbranded wine sales. Doing so would remove the incentive for direct sale of wine to major retailers for retailer-owned-brands. Hence, the measure curbs to some extent, the market power of retailers to operate in the market in a way that drives down prices, including for winegrapes.

In theory therefore, WGGA's policy to remove the eligibility of bulk and unbranded wine trade for the WET Rebate will mean higher winegrape prices for by far the larger number of independent winegrape growers. However, WGGA has a number of reservations about this reform.

- Some grower and wine businesses, legitimately using the Rebate to restructure their businesses in a changed operating environment, will undoubtedly be worse off through the reform. The potential number of independent grower businesses in this situation is estimated to be around 300 and to account for half of the independently produced winegrape tonnages.
- There is no evidence available to predict the impact of the proposed reform and there could be adverse unintended consequences from it.
- The operation of the rebate, even according to industry's own estimates, is not the major cause in the problems currently facing the industry.

In the light of these reservations, WGGA seeks the support of government in:

- ensuring that modelling be done as part of the preparation of the Treasury paper on the WET rebate to clarify the likely impact of the proposed reforms to the rebate, and
- directing a portion of the savings from reduced rebate payments to initiatives to support growers who are adversely affected by the changes.

The ability of major retailers to capture the value of the WET Rebate is a key part of the unintended consequences of WET rebates

The ability of major retailers to capture the value of the WET Rebate is a key part of the unintended consequences of WET rebates in the current operating environment. While major retailers are an emerging dynamic in food and beverage marketing, and this trend should not/cannot be denied, their growing market power through consolidation erodes competition. The erosion of competition needs monitoring and containment to ensure it is not excessive. This work is the role of government.

Inquiry Terms of Reference (e): Representation at regional, state and national level and the collection and distribution of levies

There are a number of issues with the collection and distribution of levies in the wine sector.

Available levy income is declining as crops decline in response to reduced demand. At the same time, there are a number of major initiatives in the industry requiring funding that will arguably be above and beyond the ability of current funding base to address. The most prominent of these initiatives are biosecurity, the grape and wine data base and marketing.

However, at a time of low profitability for the industry, industry support for higher levies is low. Therefore, in the short term, the best way to redress lower levy revenues is to reduce the cost of the collection process. These costs are high in the wine sector relative to other agriculturally-based industries.

Currently there are three major national industry levies collected:

- The Grape Research Levy (GRL) – paid by winegrape growers on winegrapes produced,
- The Wine Grape Levy (WGL) – paid by wine producers on winegrapes crushed, and
- The Export Levy – paid by wine exporters.

There are numerous other state and regional levies collected to fund industry organisations and activities – some of which overlap or duplicate.

A regular complaint in the industry is the complexity of industry representation and provision of services together with the multiple funding arrangements that support them.

The creation of AGWA represents the creation of a whole-of-value chain statutory service body (growing through to wine producer interests) and hence provides justification for rationalising the separate grower and wine producer levies (GRL and WGL) into something more representative of a whole-of-value chain levy.

While the GRL and the WGL are levied on a different basis (winegrape production vs winegrape crush), they are levied on a common entity (winegrapes) and are submitted by the same agent (wine producers) – hence there is an opportunity to rationalise these collections.

A regular complaint in the industry is the complexity of industry representation and provision of services together with the multiple funding arrangements that support them

A comprehensive review of wine sector levies would provide the opportunity to refine the industry levies in a manner that has been discussed in industry for some time. For example; a review of caps, different rates paid by growers vs wine producers, a grower contribution to marketing/GIs/knowledge development, and the levy rates.

A review and reform could build in funding provisions for currently unfunded initiatives that are considered necessary – thus negating the need to introduce specific levies to support them.

It may also be possible to consider incorporating other levies into such a review, for example, state-based and regional voluntary levies. A mechanism for including the Export Levy in a rationalization program could also be explored.

Key players in levy policy and concomitant reforms are governments and industry. Both have reason to undertake reforms. Government motivation will come from reducing regulatory impacts on industry. For industry itself, collection cost-savings that would result as well as cut-through in simplifying industry representation which will improve the engagement of individual businesses in industry planning issues.

Inquiry Terms of Reference (g): The power and influence of retailers

As alluded to in the statements under Terms of Reference (d), the primary task in relation to the power and influence of retailers is to ensure that their market presence is not anti-competitive and that the market power is not abused.

WGGA recognizes that the major retailers are an evolving part of the market dynamics of in food and beverage retailing. Competition between wine company brands and retailer-owned-brands is an inevitable part of this evolution. It is healthy for wine companies to compete.

To some extent, it could even be argued that that 'oversupply' in the current market, is oversupply relative to the demand reach of wine company brands. WGGA calculations show that retailer-owned brands can provide a viable route-to-market for fruit that may not find a home in wine company brands (Wine Grape Growers Australia, October 2014). As such, there is room to embrace the opportunity major retailers provide.

WGGA recognizes that the major retailers are an evolving part of the market dynamics of in food and beverage retailing. Competition between wine company brands and retailer-owned-brands is an inevitable part of this evolution

This proposition is not without qualifications however. Three of these follow.

1. Again, the involvement of major retailers should not erode competition or represent abuse of market power.
2. Wine labelling should clearly distinguish between wine company brands and those belonging to retailers – so that wine companies can derive the benefit of promoting their value propositions and consumers can choose.
3. If there are specific instances when retailer-owned brands gain an unfair advantage as a result of interference in open market transactions (such as the major retailer's ability to capture the value of the WET Rebate and to thereby unfairly position their own brands) then these are issues should be addressed by government, to restore a level playing field, through the agency of the ACCC and ASIC.

Inquiry Terms of Reference (h): The adequacy and effectiveness of market intelligence and pricing signals

For comments on this issue, please see Terms of Reference (a), under the heading "Information for effective grower decision-making".

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