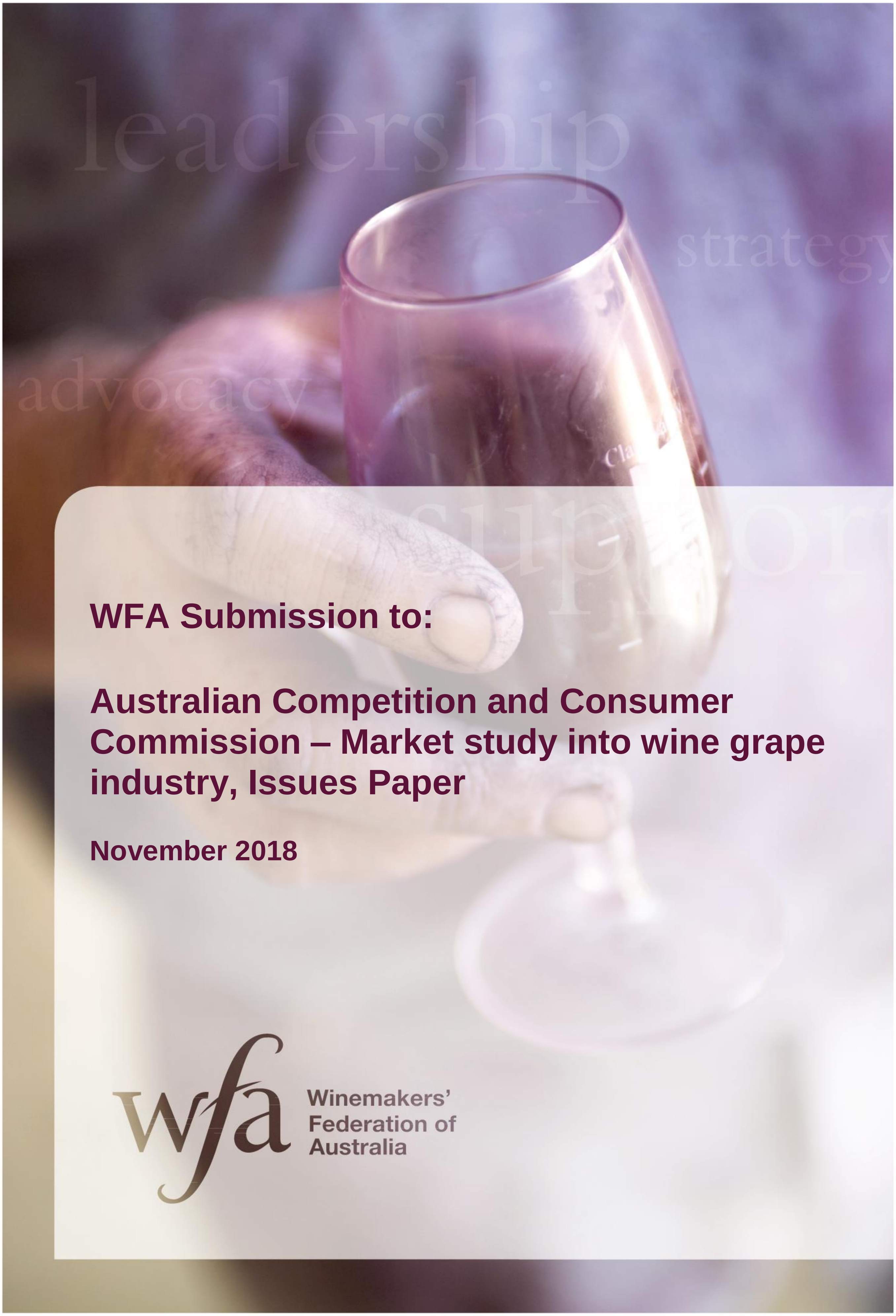

WFA Submission to:

Australian Competition and Consumer Commission – Market study into wine grape industry, Issues Paper

November 2018

Winemakers' Federation of Australia

Contents

Executive Summary

On 26 September 2018, the ACCC announced it would conduct a market study of the Australian wine grape industry. The purpose of the study is to complete an in-depth review of the industry and identify any market failures or trade practices issues that may be preventing the functioning of competitive markets or resulting in detriment to wine grape growers.

The Winemakers' Federation of Australia (WFA) welcomes the opportunity to provide a submission to the ACCC's market study of the Australian wine grape industry on behalf of the Australian wine sector. Winemakers and wine grape growers should not be considered separate industries. Together, they form the Australian wine sector, and WFA is committed to encouraging and, where possible, helping to facilitate positive and sustainable commercial relationships along the supply chain. We hope this submission contributes to an accurate and comprehensive market study that strengthens the evidence-base for future industry policy discussions to help achieve commercially successful outcomes in the years to come.

Key messages

In developing this submission, WFA has identified a number of key messages that should be thoroughly considered by the ACCC as it develops its market study report.

Firstly, WFA's submission will seek to clarify some of the misconceptions and factual errors presented in the Issues Paper circulated by the ACCC to help guide the consultation process for this market study.

WFA's key messages in relation to the Issues Paper include:

- Our concern that the ACCC is basing its assessment of industry dynamics on an unrepresentative survey of growers.
- That the assessment of market conditions from the mid-1990s to today is superficial, and fails to recognise some of the key drivers of these conditions.
- Our concern that the ACCC seems to consider wine as a homogenous agricultural commodity, and (associated with this) that the ACCC's understanding of what drives winemakers to source wine grapes from certain regions is based on flawed assumptions.
- The ACCC's emphasis on the divide between cool-climate regions and warm-climate regions; and also the perceived dichotomy of large winemakers and small winemakers, is inaccurate, and fails to recognise the diversity of business operations within the industry.
- Our concern that the ACCC's understanding of how risk is allocated across the supply chain (ie – between wine grape growers and winemakers) does not recognise the significant risk winemakers carry across the supply chain, including lack of ability to influence the price of wine and enter into longer term supply contracts.

Following this analysis, the paper seeks to respond directly to the questions raised in the Issues Paper. It is important to note that in these responses WFA will not seek to comment on a number of specific contractual issues, focusing instead on general trends across the sector. Individual companies with direct experience in

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managing relationships and contractual arrangements with wine grape growers may wish to respond to these specific issues in a more targeted manner in their own submissions.

Finally, this submission will present background on the Australian wine sector to help provide further context to the ACCC's considerations going forward.

Once again, WFA welcomes the opportunity to lodge this submission and we thank the ACCC for the work it has done to date in developing the Issues Paper and in consulting with the industry. WFA is committed to supporting the development of a comprehensive and accurate market study into the sector and is happy to elaborate upon the issues raised in the submission.

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Who we are

The Winemakers' Federation of Australia (WFA) is the national peak body for Australia's winemakers. Our activities are centred upon the objective of providing leadership, strategy, advocacy and support that serves the Australian wine industry now and into the future.

We do this by representing the interests of Australian wine industry on national and international issues. The Australian wine industry includes 65 regions nationally with over 2500 wine businesses and over 5000 wine grape growers, contributing to growth of regional economies, exports, tourism and jobs.

WFA voluntary membership represents around 80% of the national wine grape crush. WFA represents small, medium and large winemakers from across the country's winemaking regions, with each having a voice at the Board level. WFA Board decisions require 80% support, so no one category can dominate the decision-making process, and in practice, most decisions are determined by consensus. WFA works in partnership with the Australian Government and our sister organisation, Australian Vignerons (AV), to develop and implement policy that is in the wine industry's best interests.

The Australian government recognises WFA as a representative organisation under the *Wine Australia Act 2013,* and WFA is incorporated under the *SA Associations Incorporation Act 1985.*

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Analysis of the ACCC Issues Paper

WFA acknowledges the fact that the Australian wine sector is complex and dynamic, and recognises the ACCC's work to develop an Issues Paper which aims to guide the consultation process by assisting interested parties to make a submission to its wine grapes market study. In undertaking this work, it is critical that the ACCC gains a comprehensive and accurate picture of the sector to support its deliberations.

However, WFA is concerned that a number of factual errors and inaccuracies within the paper could lead to those making a submission working off incomplete and flawed information, potentially tainting the analysis that will underpin any future ACCC recommendations.

In this submission, WFA seeks to correct the errors in the issues paper and contribute to the ACCC gaining a more comprehensive and accurate understanding of our industry.

The ACCC's Wine Grape Growers Survey was unrepresentative

WFA notes the ACCC has used the results detailed in its *Wine Grape Grower Survey results report* of September 2018 as the primary basis for undertaking this market study. While we are happy to work with the ACCC to support the market study, WFA has identified a number of concerns about the survey.

Firstly, the response rate of around 5 per cent of Australia's 5,000 wine grape growers is low and given this, the views expressed in the survey report cannot be considered as truly representative.

Secondly, while the issues paper has a national focus, the results stated in the survey report are skewed heavily in favour of certain regions due to the variance in response rates from across Australia's 65 wine regions. This further undermines the representativeness of the survey results and by extension, the veracity of many of the issues raised in the issues paper.

While the ACCC does not elaborate on the causes of this variance, there may be a number of reasons for it, including:

- the capacity of local and regional associations to encourage grape growers to respond to the survey
- that the vast majority of wine grape growers are satisfied with their current business arrangements, including their commercial relationships
- that prices for wine grapes are increasing in the majority of Australia's regions, prompting a lower response rate
- that some growers place the majority of the blame for the drop in wine grape prices at the height of Australia's oversupply of wine grapes (as noted in Table 1 on page 10) on winemakers and felt compelled to air their grievances in the survey, despite the drop in price being a result of market forces, and the improved market conditions experienced in 2018.

Thirdly, the ACCC's Survey Results Report notes on page three that "Previous consultation indicates that industry concerns are most prevalent in the three warm climate wine grape growing regions of Australia: Riverina (NSW), Riverland (SA) and Murray Valley" (NSW and Victoria). It is unclear from the issues paper how previous consultations have led to this assessment, particularly given the six workshops held in 2016 (in

Shepparton, Toowoomba, Bunbury, Griffith, Murray Bridge and Devonport) seemed limited in scope and did not cover a comprehensive range of wine regions.

With regard to the Survey, it is important to note approximately 1% of growers in the Riverland responded to the survey, with a 10 per cent response rate in the Riverina and a 17% response rate in the Murray Valley, suggesting the views of warm inland regions are far from homogenous. Breaking these figures down further, the 89 responses from the Riverina and Murray Valley make up almost 34 per cent of total responses.

Given the Survey cannot be said to be representative, WFA considers that it is unreasonable to use it as the primary basis for consideration of the Australian wine sector. More robust research and analysis is required.

The issues paper paints an incomplete picture of the market conditions since the mid-1990s

The background section of the Issues Paper notes the fluctuating market conditions for Australia's wine sector over the last three decades. While the general themes of a boom in wine sales and plantings, followed by oversupply, and now a more balanced supply and demand equation are reasonable, the analysis around this series of events is superficial.

The Australian wine industry tripled in size between 1991 and 2007, with the value of exports growing from $212 million to $3,004 million during this period. Australia's wine businesses had developed a strong reputation in export markets for producing wines that consumers perceived as:

- representing good value for money
- innovative and fun
- technically sound (Australia's strength in wine science had given the industry a technical edge, particularly in comparison to other producer nations with reputations for high degrees of technical faults and bottle variation), and
- easy to understand (largely due to the widespread shift to using the grape variety name on the label).

The industry was profitable across the supply chain, and the seemingly insatiable appetite for Australian wine overseas sent market signals that encouraged significant levels of new vineyard plantings across Australia. Further to this, in the early to mid-2000s a number of vineyard Managed Investment Schemes (MIS) led to further vineyard plantings in Australia, often driven by an investor's interest in minimising their taxation liability, as opposed to achieving a commercial return on their investment. These additional plantings were not confined to any particular region and, unfortunately, at times led to vineyards being planted to the wrong varieties in the wrong vineyard sites.

A 'supply and demand imbalance' in the wine industry was acknowledged in 2005–06, with market response of lower wine grape prices. These market forces were the predictable outcome, in economic terms, reflecting changes in demand and competing sources of supply.

Unfortunately, the structural oversupply in Australia coincided with a number of other factors that exacerbated the problem. These included:

- the Global Financial Crisis of 2007-2008, which significantly dampened demand for wine, particularly in the US market.
- the high value of the Australian dollar against the US dollar between 2007 and 2014 eroded Australia's competitiveness in key markets like the US and Canada. From 2004 the AUS$ rose steadily from 80 US cents to almost parity in July 2008. A sharp fall to 62 cents in August 2008 preceded a steady climb to parity in November 2010.
- a structural oversupply in the European Union coinciding with Australia's situation.
- a loss of consumer interest in Australian wine in key export markets.
    - During the boom, consumers in key markets had fallen in love with Australia's consistent, clean wine offering, often accompanied by so-called "critter labels", identified by the pictures of Australian animals on the label. However, after years of success with this approach, consumers started to perceive the formerly admired qualities of consistency and technical excellence as boring, and the "critter labels" as immature, leading to further dampening of demand.
- Retailer consolidation in Australia and overseas, led to narrower channels through which wine could be sold, and led to smaller profit margins for many winemakers. Supplier management and vertical integration into wine accelerated also through the period. Woolworths (WLG) accelerated its growth of Dan Murphy's and BWS stores, acquired Langton's in 2009, and Cellarmasters in 2011. Wesfarmers acquired Coles in 2007 and began to transform its management, strategy and performance—including its liquor business, which now includes the First Choice Liquor, Liquorland, Vintage Cellars and Liquor Market retailer banners.
- Finally, after the Australian wine sector's excellence in research, development and innovation helped bring us to the forefront of the global wine industry in the 1990s, in the 2000s a number of other producers began to follow suit, reducing Australia's competitive edge for consistent, value for money wines in export markets, and increasing the market share of imports in the domestic market.

Further to this, while it did not contribute directly to the oversupply scenario, it is important to note that the oversupply period in 2008 coincided with a period of drought, in which many wine grape growers had to purchase water, placing further stress on their profitability. Water security remains a significant issue for many wine grape growers across Australia, and particularly in the warm-inland regions.

By 2009, Australia was producing 20–40 million cases a year more wine than it was selling, and by 2014 an estimated 84 per cent of producers were not covering their variable costs, up from 77 per cent in 2012, while in contrast, United States and New Zealand producers received positive returns. Of course, given the geographic dispersion of the market and continued demand for high quality wine, the oversupply experienced in many regions was the inverse for others (eg. Tasmania and Western Australia). Both of these states reported upward trends in grape prices during this period, largely due to trends in consumer preferences, successful investment in regional branding and a string of high quality vintages, particularly in Western Australia.

Recognising this, the Australian wine industry took a number of steps to directly address the oversupply situation and help encourage positive commercial relationships between winemakers and wine grape growers.

The Wine Industry Code of Conduct was established in December 2008 by WFA and the then Wine Grape Growers Australia (now known as Australian Vignerons) with the aims of:

- establishing a common Australian wine grape supply contract framework; and
- providing a dispute resolution system to manage disagreements which arise over price or quality assessments.

More information about the Code of Conduct is presented at page 18 of this submission.

Furthermore, in 2009 the Australian wine industry, led by WFA and Wine Grape Growers Australia (now Australian Vignerons), the Australian Wine and Brandy Corporation and the Grape and Wine Research Development Corporation (now a merged body known as Wine Australia) jointly launched the "Wine Restructuring Action Agenda", which aimed to bring forth a suite of measures to encourage structural adjustment within the sector. The focus of this agenda to provide clear and factual information about the nature of the oversupply situation to the Australian wine industry and encourage them to seriously consider the viability of their business in this environment.

This led to a number of winemakers and grape growers making the tough decision to exit the industry. WFA understands that in 2014-15 vine removals exceeded 1,400 hectares. However, a range of issues impact upon a member of the industry's willingness or capacity to leave the industry.

Fortunately, today , the wine sector is experiencing more positive market conditions. Wine grape prices are up 8% on average in 2018, compared to 2017 and export figures are strong, leading to improved returns for winemakers and wine grape growers. Growth in demand for Australian wine in China has played a significant role in this recovery, but not all Australian wine companies are enjoying the same level of success in the Chinese market. Despite the positive gains in recent months, the market – both domestic and international – remains extremely competitive.

As noted by Treasury Wine Estates in its 2018 Annual Report[1], the forecast five-year (2017-2021) compound annual growth rate (CAGR) in wine consumption in key growth areas and markets is positive. Drawing on IWSR data, TWE forecasts CAGRs of:

- 8.2% in China
- 1.4% in Canada
- 0.9% in Australia
- 0.9% in the USA
- 0.8% in New Zealand

[1] Treasury Wine Estates Annual Report, 2018, Page 13- https://www.tweglobal.com/-/media/Files/Global/Annual-Reports/2018-Annual-Report.ashx

Issues impacting adjustment

Investments in all three key components of the modern wine industry (vineyards, the winery, brand development) require large amounts of capital up front which, once invested, becomes a sunk cost. Given the uncertainty about future profitability in this (somewhat fashion-driven) industry, it is not surprising that when new opportunities arise, investments are made cautiously at first until prospective profit signals become clearer. It is equally unsurprising that when profits slump, disinvestments in the industry tend to be drawn out over many years as producers hang-on in the hope that the downturn is only temporary. Such slow downward adjustment is made even slower as the proportion of producers who are earning the majority of their income from other sources grows.

The last growth cycle (beginning in the 1980s and finishing in the mid-2000s) was underpinned by exports. To exploit the new market opportunity in the UK required large volumes of consistent, low-priced branded premium wine. Land- and capital-abundant Australia had the right factor endowments to supply precisely that. High labour costs were overcome for larger firms by adapting and adopting new techniques for mechanical pruning and harvesting, thereby generating large economies of size, especially in the hot areas along the Murrumbidgee and Murray rivers, where irrigation water was (as in most countries) greatly under-priced. That stimulated a number of mergers and acquisitions among Australia's wine firms, which resulted in several very large wine companies able to reap scale economies not only in grape growing and winemaking, but also in viticultural and oenological R&D, in accumulating market intelligence globally, in innovative brand promotion and related marketing investments, and in distribution. It also enhanced their capacity to bargain with emerging retail giants. The volumes of grapes grown and purchased from numerous regions by these large firms enabled them to provide massive shipments of consistent, popular wines, with little variation from year to year, for the British and American supermarkets.

Once profitability in the key markets of the United Kingdom and United States plummeted due to retail pressure, strong international competition, changes in fashion and the high dollar all impacted directly back on grape growers. A direct consequence of the wine and grape price collapse was that both vineyard and winery asset prices plummeted after 2007, with some vineyards selling for no more than unimproved land value, even though the average cost of planting a vineyard was in the vicinity of A$30,000 per hectare. The collapse in value was partly because banks lost interest in financing such purchases, and partly because listed corporations sought to shed their least productive vineyard and winery assets to boost the rates of reported return on their remaining capital. The slump was in sharp contrast to the growth in industry asset prices in the United States and Western Europe, which reached record levels in local currency terms at the start of the millennium's second decade, thanks to the weakening of the US dollar and Euro and the growth in demand for iconic wines and wineries by Chinese buyers.

What drives the price of wine grapes?

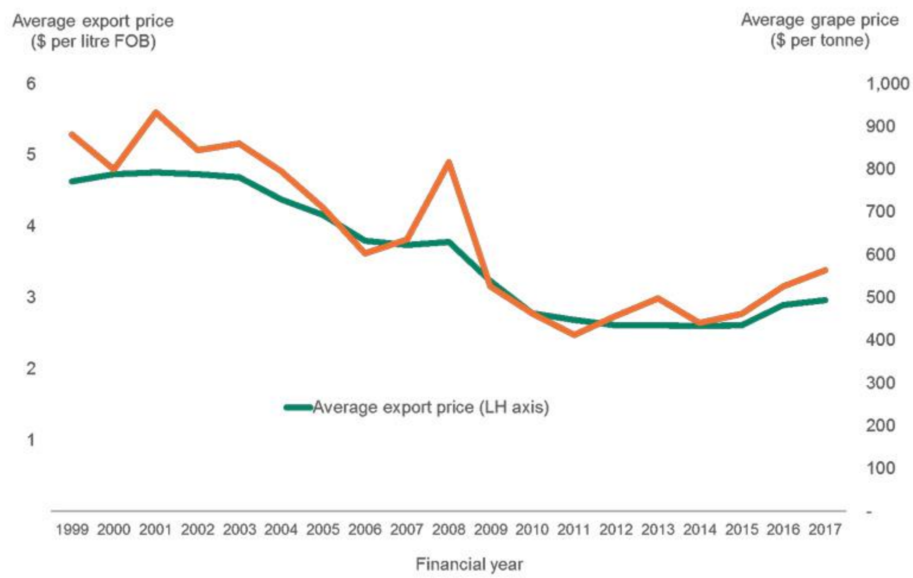
It is important to consider the key drivers of price for wine grapes, particularly those grown in warm inland regions, in the context of this market study.

In its market bulletin of December 2017[2] Wine Australia explored what is driving grape prices in Australia's warmer inland regions. The report notes the strong correlation between export prices and grape purchase prices, specifically stating that:

The global wine supply and demand situation is a major determinant of wine grape pricing in the warmer inland regions. At 790 million litres, Australia is a relatively small producer in comparison to the major producers of France, Italy, Spain, and, to a lesser degree, the United States. The supply situation in these countries has a significant impact on Australia's trade, particularly at the price-driven commodity end of the market.

The biggest influence on bulk wine prices over the last few years was the huge crop Spain produced in 2013. According to the OIV[3], Spanish wine production increased by 44 per cent to 4.6 billion litres in 2013. Such a large volume of wine had a deflationary effect on prices for commodity wine, not just for Spain but for other producers such as Australia. In 2015-16, Spain exported 1.3 billion litres of bulk wine at US$0.41 per litre – this is more than Australia's total wine production and it was exported at around half the average bulk wine price of Australian wine.

Table 1: Export prices v grape purchase prices over time



2 https://www.wineaustralia.com/news/market-bulletin/issue-88

3 The International Organisation of Vine and Wine – www.oiv.int

Wine is not a homogenous agricultural commodity

It is important to recognise that wine is not a homogenous agricultural commodity. Wine is subject to fashion and consumer trends in a way that other agricultural industries like grains and dairy are not. For example, wheat is a globally traded commodity with clear and objective measures of quality that is purchased and transformed into a range of value added products. If a flour mill in "country X" wants wheat with a particular set of qualities, it will not necessarily mind if that wheat is grown in Australia, the United States, Ukraine or elsewhere. Wine is different.

There are more than 10,000 varieties of wine grapes in the world today, making a variety of different styles of wine. On the whole, they are grown for the single purpose of making wine (ie, few can be marketed as table grapes, or dried grapes, for eating, or for other purposes like distilling for spirits like gin, vodka, grappa and other grape based spirits)[4].

Despite this variation in wine grape characteristics, in Figure 2 on page 7 of the Issues Paper, the ACCC presents a bar chart noting the average weighted price per tonne of wine grapes across a number of regions, which reinforces the perception that the ACCC sees wine grapes as a homogenous commodity, as opposed to a wide range of varieties for which values fluctuate according to the quality of the grape produced, and trends in the market.

At times the Issues Paper also makes assumptions about the link between wine grapes, region and quality that are in WFA's view, inaccurate and misleading. For example, on page 5 of the issues paper, the ACCC write that in warm climate regions "There tends to be less emphasis (or at least the perception of less emphasis) on the individual qualities of either grapes or wines produced in these regions". Further to this, the statement on page 6 that "In warm regions, commercial arrangements focus on producing higher volumes of generalised qualities of grapes" erroneously implies a causal relationship between commercial relationships and the production of so called "generalised qualities of grapes".

For winemakers, the primary driver for purchasing wine grapes in any region is the desire to source a particular variety, with a particular set of characteristics. There are over 65 distinct wine producing regions, also known as geographical indications or "GIs", across Australia. Three of the warm-inland regions—the Riverland in South Australia, the Riverina in New South Wales and the Murray Valley in Victoria—account for approximately 60 per cent of wine grape production. Temperatures across the remainder of Australia's wine regions vary significantly along a spectrum from warm to cool climate, with the majority considered as either "temperate" or "cool climate" regions. Most other wine regions are either considered as either "temperate" (sometimes referred to as Mediterranean), or "cool-climate" regions. Examples of temperate Australian regions, include Heathcote in Victoria and the Barossa Valley in South Australia, while the Canberra District, Orange and the Mornington Peninsula are examples of cool-climate regions.

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[4] Commercially, there is a significant distinction between – for example – wine grapes and table grapes. Table grapes have thinner skins, are usually larger in size and have a very different flavour profile. There are some examples where grapes are used for both winemaking and consumption, like the variety "sultana", but this is not a significant premium wine grape variety and such examples represent the exception, rather than the rule.

Production costs, grape characteristics, yield and demand for particular varieties all vary significantly between regions. These factors, taken individually or collectively, influence the price growers receive for their wine grapes from purchasers.

For example, warm inland regions usually have higher water, fertiliser and herbicide costs than other temperate and cool-climate regions, but lower labour and contract costs due to the use of mechanical harvesting systems. Furthermore, warm regions typically produce significantly more grapes per hectare which allows for spreading production costs. However, while warm inland regions can generally produce greater amounts of wine grapes at lower cost, these grapes tend to be used to produce wines of a lower quality, which are therefore sold at lower values in the commodity and bulk-wine markets.

The relationship between a region and the prices of wines derived from that region is complex and multifaceted, but in the case of warm inland regions it is predominately associated with quality characteristics. In general, winemakers producing high-value wines from most common grape varieties in Australia will tend not to look to warm inland regions to source grapes because these regions tend not to deliver the specific characteristics (eg. acid levels, sugars, phenolic ripeness, aromas and flavours) required to produce wines sold at high-value price points.

Taking chardonnay – Australia's most widely planted white wine grape – as an example, in 2018 the price varied significantly across cool, temperate and warm regions. In Tasmania, a cool climate region with a reputation for high-quality, high-value chardonnay, the average price per-tonne for chardonnay was $2,960 (an increase of 2% from 2017). In the more temperate region of the Barossa Valley, the average price per tonne in 2018 was $636 (an increase of 5% from 2017). While in the warm inland Riverland region, the price per tonne was $327 (an increase of 5% from 2017).

However, it is important to note that some emerging alternative grape varieties in Australia, such as Nero d'Avola, tend to thrive and produce high-quality wine grapes in warmer climates. While it is not yet commonplace, in this scenario a winemaker would likely choose to purchase wine grapes from warm-inland regions over cool and temperate regions on the basis that they possess the characteristics they desire. WFA notes there is a trend within the Australian wine industry to plant alternative grape varieties that are better suited to Australia's climate. For example, from 2017 2018, the price of Nero d'Avola increased by 220% in Australia.[5]

The issues paper misrepresents the structure of the industry

The ACCC's emphasis on the divide between cool climate regions and warm climate regions is at times overstated in the issues paper. For example, the commentary on page 5 of the issues paper suggesting Australia's largest wine processing facilities are concentrated in warm climate regions is somewhat misleading. Large facilities also exist in the Barossa Valley, Coonawarra and McLaren Vale, and it is important to note the business decision to open a processing facility is based on proximity to vineyards and logistical considerations like scale, warehousing, transport, and other factors like the availability of land.

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[5] Wine Australia, National Vintage Report 2018

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Further to this, it is important to note that the assessment of regions either being cool climate, or warm climate, is simplistic. As noted above, producers across Australia's wine regions operate across a broad spectrum of climates. It is a much more nuanced picture than simply warm climate vs cool climate.

The commentary relating the scale of operations to the degree of mechanisation in the vineyard is also incorrect. While it is true that in cool-climate regions there is a greater degree of hand-tending in the vineyard, this business decision is not necessarily driven by the scale of the vineyard. The decision to tend by hand is driven primarily by a desire to maintain a particular set of quality characteristics and investment is technology is driven by methods which can mechanise while maintaining quality. Further to this, it is important to note that even in cool climate regions, it is relatively unusual for a vineyard to be 100 per cent hand tended. There is usually some level of mechanisation involved in the production process.

The authors' also misunderstand the relationship between geographical indications (GIs), branding and price. On page 6 of the issues paper it states that "Some cool climate regions have prestige branding attached to the area, such as the Barossa Valley and Mornington Peninsula. Wine grapes and wines from these regions typically attract premium pricing". This is a simplistic portrayal of the relationship between region and price. Sourcing grapes from a particular GI does not dictate the price offered by a purchaser, either of wine grapes, or the wine produced therefrom. As noted above, quality remains the primary determinate of price, along with demand for particular varieties and styles, which are driven by market preferences and consumer trends, and reputation and prestige derived from a strong history of high-quality production. Investment in marketing also plays a significant role in driving higher prices for wines.

The Issues Paper's reference to Australia's largest winemakers on page 7 of the issues paper is incomplete, as it fails to mention the role of the Endeavour Drinks Group (EDG), a subsidiary of Woolworths, and Coles, as major purchasers of wine grapes and producers of wine. Furthermore, the paper seems to focus on large winemakers and small winemakers (defined as under 500 tonnes) as the only two models in the sector. In reality, there is a broad spectrum of business sizes among the 2,500 winemakers in Australia, many of which produce more than 500 tonnes, but may not be considered large businesses.

The paper also makes some value judgements about the role of bulk wine sales in the sector. For example, on page 8, the authors note that "The majority of exports are 'bulk wine' which is transported in containerised bladders and then bottled at destination". It is implied throughout the paper that bulk wine is low quality, but quality is not determined by its method of storage and transportation. Furthermore, for some large companies, shipping bulk wine to be bottled and labelled as Australian wine overseas is the most cost-effective method of getting their wines to market. The business decision to structure export arrangements like this is driven by the cost of transport, bottling, warehousing and logistics and not necessarily by the quality of the product being shipped.

Winemaker risk and shared risk

The issues paper implies in a number of sections that wine grape growers carry the majority of risk in commercial relationships and that there is not enough competition in the market for grapes, leaving growers with little bargaining power. WFA does not accept this argument for a number of reasons.

Firstly, it is important to recognise that some risk is shared across the supply chain, and that other risks are concentrated within a particular segment of the chain. While the ACCC correctly points out that wine grape growers carry a level of risk in the process of growing wine grapes, but this risk is shared with winemakers. For example, if an event such as a hail storm or the emergence of significant disease pressure severely damaged a crop of wine grapes in a particular vintage, growers would not have as much to sell to purchasers and winemakers would not be able to source the grapes they require to make their wine. In this instance, both winemakers and wine grape growers share the risk, and both would suffer financially. Further to this, many winemakers are also vineyard owners who grow their own grapes, in which case the agricultural risk would be concentrated within a vertically integrated supply-chain.

Secondly, winemakers carry a significant amount of risk in their businesses that is not shared with wine grape growers. For example, winemakers make large scale capital investments in equipment, branding, marketing and storage in the hope of successful returns over the long-term.

In terms of the process of making and selling wine, it is important note that winemakers assume the risk burden in its entirety at the moment a delivery of wine grapes is accepted at the weighbridge. It can be many years before the wine produced from these wine grapes is sold. For example, it is relatively common to produce a wine that is sold at five years of age, like Henschke "Hill of Grace Shiraz" or Peter Lehman "Wigan" Riesling, or even later, as is the case for Tahbilk's "1927 Vines" Marsanne, which is released at 10 years of age. This is one way to illustrate that between the point of accepting the grapes and selling the wine, the winemakers assumes risks including:

- technical risks during the winemaking process
- no security of demand an unknown price for the eventual product, as retailers often don't tell winemakers what they will be purchasing and the price of the purchase until a matter of days before it is expected to be delivered (payment for product is generally made a few weeks after delivery)
- the compliance costs relating to risks associated with traceability and consumer safety
- insurance costs, and
- storage costs and associated risks (eg a fire in a warehouse, or a temperature controlled facility failing to keep wine at the correct temperature)

In addition to this, the alcohol beverage industry is subject to a broad range of additional regulatory restrictions around sales, delivery and advertising, that other agricultural commodities are not subject to.

Furthermore, as noted above, winemakers face considerable issues relating to a very competitive retailer landscape, both in Australia and overseas, in which profit margins are thin, currencies fluctuate and consumer preferences can change quickly. In 2013, an industry report[6] estimated that the combined groups of Coles and WLG distributed and sold up to 77% of all wine sold off premise. Further to this, it noted the emergence of the major retailers as winemakers and wine grape growers in their own right, leading to a scenario in which many winemakers noted that Coles and Woolworths were both their largest customer, and a significant competitor.

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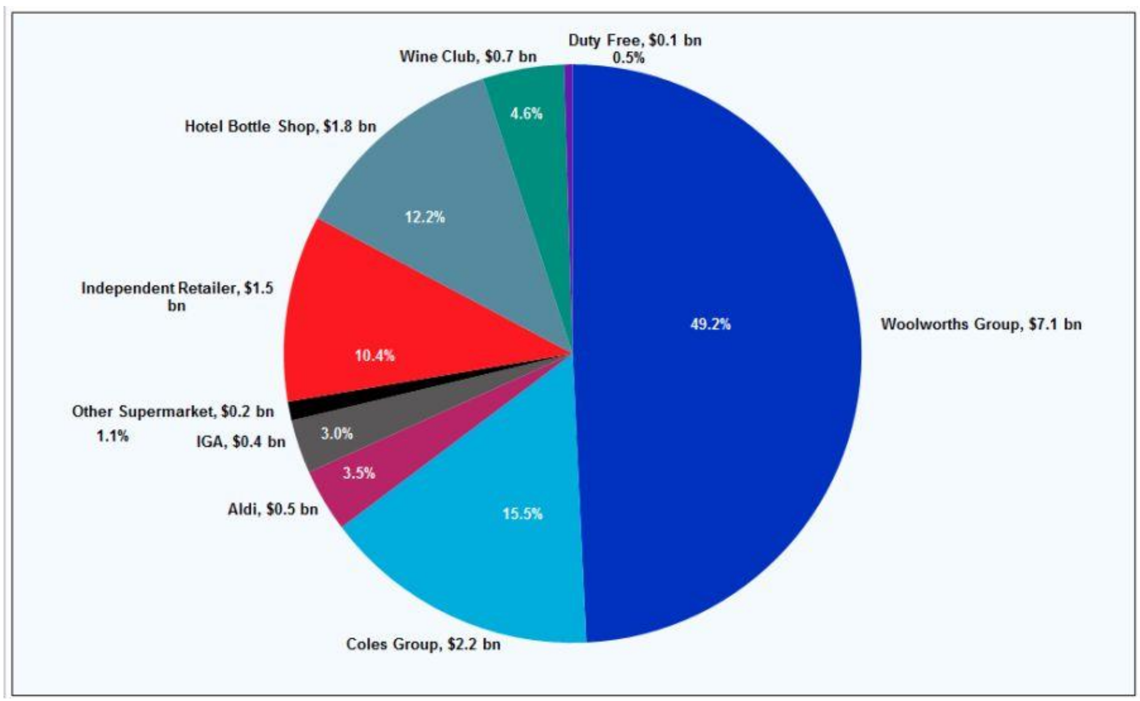
[6] http://www.wfa.org.au/assets/noticeboard/Expert-Review-Report.pdf

The concentration of the major two retailers (as illustrated in the pie chart below) has brought a high level of competition to the market place, resulting in lower prices for consumers, but has also left winemakers with fewer options in terms of sales channels, and also smaller profit margins. With the supply of wine grapes tightening in the recent vintage, there is increasing competition in the market for wine grapes and prices are increasing as a result. It is important to note that is very difficult for Australian winemakers who rely on the major retail outlets for the majority of their sales to pass the increased costs of purchasing wine grapes onto consumers. This is despite the fact WFA understands that, as a rule of thumb, the major retailers take a margin of 35% on wine sales, as opposed to 35% for spirits and 20% for beer.

It is also important to understand that wine companies do not have long-term supply contracts with retailers, and in most cases have little or no ability to influence price. Retailers have many different wine brands to choose from and there are very few brands that are “must-have” for their businesses. WFA understands that an average retail store carries around 2,000 SKUs from about 355 wine brands, while the largest stores can carry considerably higher numbers of individual wines. In the international market place, Australian retailers have the flexibility to quickly source product from a great variety of different countries, let alone suppliers, so there is a highly competitive market place in which retailers are in a position to place considerable price pressure on suppliers. Therefore, wine companies are required to estimate demand for different brands, based on previous market conditions, but without commitments from retailers or a clear future for that product.

Alcohol retail dollars by store type



Source: *Roy Morgan Single Source (Australia), January-December 2016, n=3,502.* Base*: Australians 18+ who purchased packaged alcohol last 7 days. **

NB: Woolworths Group = Woolworths Liquor, BWS and Dan Murphy’s; Coles Group = Liquorland, First Choice and Vintage Cellars.

Responses to the specific issues identified by the ACCC

Issue 1 – Markets for the sale and purchase of wine grapes

The Issues Paper states that "despite there being a significant number of winemakers in both south-eastern Australia and Western Australia, competition between winemakers for wine grapes appears limited". WFA argues this is a simplistic assessment of the market dynamics within the industry and that further analysis is required.

While the Issues Paper is correct in assessing that the export market for wine grapes is thin to non-existent, due to the high cost and technical difficulties in maintaining quality standards when shipping overseas, and also due to the global oversupply of wine grapes, the domestic market is very different.

Firstly, WFA argues that this simplistic assessment about competition within the market is another example of the ACCC treating wine grapes like a homogenous agricultural commodity. As stated above, the various wine grape varieties grown throughout Australia and the enormous breadth of wine styles produced from them means that wine grapes grown for the purpose of making a particular product are not readily substitutable for another. Furthermore, as stated above, wine is subject to competition in ways that other agricultural commodities are not, and as a result of this, purchaser demand for particular varieties shifts to meet consumer preferences.

Secondly, the prices offered to wine grape growers in the 2018 vintage were higher than previous vintages. These improved conditions are driven partially by the growth in demand for Australian wine in China, which has led to a significant tightening of supply for wine grapes. In 2018 the Australian wine grape crush was 1.79 million tonnes, which is just above the long-term average of 1.76 million tonnes. Despite the above-average level of supply, the average purchase price of wine grapes across all varieties increased by 8 per cent to $609 per tonne – the highest level since 2008.[7] Of course, as we note above, there is significant variance in demand and price movements between the different varieties being grown in Australia. Anecdotally, WFA members have informed us that there is significant tightening of the market for premium fruit in particular.

Thirdly, wine grape growers can choose how they sell their grapes to winemakers. While many growers prefer to enter into supply contracts with winemakers to ensure they have surety of supply, there are a proportion of growers who prefer to trade some, or all, of their grapes on the spot market to gives them greater flexibility and cash-flow. We have seen vineyards with ongoing supply contracts achieving higher sales prices than those vineyards that rely on the spot market.

Fourthly, the analysis of competition for wine grapes in the industry should not place undue weight upon the size and location of regional processing facilities as a measure of competition. As noted above, wine businesses base their decision to locate a winery primarily on proximity to vineyards and logistical considerations like warehousing and transport. However, there are also examples of businesses taking the decision to consolidate their fixed winery assets, due to the high capital investment required to set up and maintain facilities, and the relatively short period of time they are used for processing each year[8]. However, the decision to locate a

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[7] Wine Australia National Vintage Report 2018

[8] Unlike other agricultural processing facilities, breweries and distilleries, wine processing facilities are used essentially once per year, during vintage. Winemakers have one opportunity to get a vintage right during the year.

processing facility does not tie a winery to purchasing grapes from the region where the facility is located. Wineries regularly source grapes from hundreds of kilometres away to be processed, if there is a need for particular varietal characteristics, with many companies producing wines from a broad number of Australian wine regions. Individual companies would be best placed to advise about their particular arrangements for transporting wine grapes and/or juice.

The ability to transport wine grapes to a broad range of processing facilities underlines the fact that competition for fruit extends beyond any particular region. To reinforce an earlier point, the demand for fruit is not necessarily driven by geography – quality and the particular characteristics sought remain the primary driver of demand. However, it is important to note that this can present challenges for maintaining quality standards, particularly for white wine grapes, and impose costs. Further to this, there are some restrictions that apply to grape transport due to biosecurity regulatory arrangements, particularly around fruit-fly and phylloxera. These arrangements are established by State governments.

Fifthly, competition extends beyond the largest wine companies, across the spectrum of small, medium and large traditional producers in Australia. Wine grape growers have the option of having their fruit contract made into their own branded product, or they can sell their fruit to virtual wineries (defined as winemakers who invest in a brand - but do not own winery or vineyard assets – but use someone else's facilities to produce their wine).

Finally, wine grape growers also have the option of investing in their own processing facilities. However, as noted above, winemakers carry significant risk as a part of their business, which may be a deterrent to such investment.

Issue 2 – contracting practices between growers and winemakers

As mentioned above, demand from winemakers for wine grapes in Australia is strong, particularly at the premium end of the market. Given this, growers who can produce high-quality grapes according to agreed specifications, have stronger negotiating power to secure longer term supply contracts. In the highly competitive lower quality, lower margin wine category, contracts may be of shorter duration.

As in all business dealings, a strong contract is the best and most important way to provide assurances to contracting parties. However, many winemakers and wine grape growers around Australia have traditionally maintained excellent relationships over long periods, and have chosen to trade without written agreements (although the recent changes to accessing the Wine Equalisation Tax Rebate has started to change this approach). WFA's position has long been to encourage written contracts between winemakers and wine grape growers, even when relationships are good. A written contract provides clarity and protect the buyer, the grower and the relationship between the two if anything does goes wrong or circumstances change.

Winemakers and growers use a variety of contracts and arrangements for trading in wine grapes including long-term exclusive supply contracts, year on year agreements, standard form agreements and tailored contracts. WFA will let individual companies provide further detail on how these contracts work, either through their submissions, or via additional consultation over the coming months.

However, it is important to recognise the staggered payment terms that are now common industry practice. These terms, derived from South Australian State Legislation, have been widely adopted across within the industry. Under the South Australian Wine Grapes Industry Act, the purchaser is required to make three payments to the wine grape grower, with the final payment to be made by 30 September in the same year as the grapes were harvested. Under the Act, it is also illegal for a winery to accept wine grapes while still owing money for grapes supplied in previous years. Importantly, some growers prefer to have the third payment staggered until after 30 June, so that their income from a particular vintage can be spread across two financial years.

Issue 3 – voluntary industry Code and dispute resolution processes

The Australian Wine Industry Code of Conduct (‘the Code’) was signed by representatives of the Winemakers’ Federation of Australia (WFA) and Wine Grape Growers Australia (WGGA) on 19 December 2008. With the exception of Part 2 (Wine grape Purchase Agreements), the Code took effect on 1 January 2009. Part 2 took effect for all new agreements for the supply of wine grapes for the 2010 vintage onward.

The Code is voluntary; there are no joining fees or ongoing annual costs.

The purpose of the Code is two-fold:

- to establish a common framework for Australian wine grape supply contracts; and
- to provide a dispute resolution system to manage price or quality assessment disputes.

The minimum requirements set out in the Code have been agreed by the lead industry organisations of both wine grape growers and winemakers. Wine grape purchasers who are Signatories to the Code agree to be bound by the principles of the Code in their commercial dealings with wine grape growers. They also undertake to provide a grower with a copy of the Code whenever that grower signs a new Agreement.

The Code is overseen and administered by the Wine Industry Code Management Committee (CMC), comprised of members of WFA and AV, and jointly appointed by the Boards of these organisations. It consists of six members, an independent Chair, supported by a Secretariat of two, with the assistance of a minute taker.

The CMC’s responsibilities include acting as the custodian of the Code, monitoring and assessing the Code’s performance, improving the Code, facilitating resolution of disputes over wine grape prices and vineyard downgrades and rejections, and determining alleged breaches of the Code. It is required to produce an annual report to be published each year containing:

- a description of the nature and number of disputes received;
- any comments it wishes to make about conduct or trends in the industry;
- a report on the Code’s operations, including the names of any parties removed from the Code; and
- a list all current signatories to the code and new signatories since the previous annual report.

In monitoring the Code, the Committee may recommend amendments to assist the Code’s operation.

The CMC appoints a Secretariat to the Code (jointly funded by AV and WFA) to provide secretariat services to the Code’s administration and to which the CMC may delegate any of its powers or duties under the Code. The Accord Group was the appointed secretariat for the Code from October 2016.

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The Code is working, but we would like to see more Signatories

WFA acknowledges that signatories to the Code remain well below the target of half of the top 100 Australian wine producers (by tonnes processed) signing the code by the end of 2013. However, we continue to seek new members and believe the Code is having a positive impact.

The Code is clearly working. In 2017-18, there were 50 enquiries, which is significantly more than the 29 enquiries received in the 2016-17 period.

It should be noted that 36 enquiries related to the same pricing issue with a specific wine grape purchaser. A further 10 enquiries related to the same pricing issue with a different wine grape purchaser. There were also two enquiries relating to the same pricing issue with a further wine grape purchaser. This amounts to 48 enquiries relating to pricing issues with three wine grape purchasers.

One enquiry concerned a wine grape supplier who was financially penalised due to low colour readings. The grower had concerns that the test used was unfair due to inaccurate calibration.

A second enquiry related to the contractual timeframe for raising issues in response to chemical tests by the wine grape purchaser. In this case, the timeframe was significantly shortened due to postage delays in notification of test results.

As mentioned above, 48 enquiries related to disputes over wine grape price with three different wine grape purchasers. The growers disputed that the prices offered by the purchaser on the basis that they believed they were lower than the market price. As far as we are aware, most, if not all, disputes were resolved by direct negotiation between the parties.

During this period, we received an additional two applications to become a signatory to the Code – Feathertop Winery and Australia Food and Beverage Group Pty Ltd. As a result, our current signatories increased from 41 to 43 - around 46% of the annual crush.

It is encouraging that most enquirers were able to resolve their dispute through the early stages of the dispute resolution process outlined in the Code. It appears that the use of the Code is gaining significant traction through outreach by industry associations. The multiple applications to become signatories to the Code also support the ongoing utility of the Code. The challenge is to further increase awareness and uptake of the Code by growers and purchasers. One way to do this is promoting the Code through industry events and engaging with key stakeholders.

There are a variety of likely reasons why some winemakers have chosen not to sign up to the Code, including:

- many Australian wineries don't buy wine grapes under contract (they may be vertically integrated, producing wine from estate grown fruit), and
- that many others maintain good relationships with their growers, and already do what is required under the code.

Nevertheless, WFA and AV continue to publicise and promote the Code and its dispute resolution procedures, and to work to maximise its adoption within the industry. In addition to this, WFA and AV are working together to identify options to improve the Code in the future to ensure it remains as attractive as possible to those considering signing on.

Issue 4: Transparency and Timing of Pricing Information

A strong written contract should be the critical pillar of the relationship between a winemaker and a wine grape grower. A strong contract provides both parties with a clear understanding of their obligations, including in relation to pricing.

As noted above, the Wine Industry Code of Conduct provides a framework for grape supply contracts a mechanism for dispute resolution. While it is important to recognise that not all winemakers are signatories to the Code, and that different winemakers may have different practices whether they are signatories or not, the Code still provides a general overview of how many winemakers who purchase wine grapes operate in Australia.

A broad range of factors determine the price of wine grapes in any particular vintage, but the primary driver is the amount of supply and demand for grapes. As mentioned above, winemakers seek fruit of a particular variety, with a particular set of characteristics, or a particular quality, and will be willing to pay more for fruit that meets their exact requirements. These factors, however, can change from year to year.

Quality assessments of wine grapes are also a primary determinate of the final price paid. More detail about quality assessments is provided in response to Issue 5 in this submission.

Indicative pricing is commonly raised as a concern by both winemakers and wine grape growers. The Code requires:

- By 15 December: purchasers must provide growers in the Hunter Valley, Riverina, Murray Darling/Swan Hill and Riverland regions Indicative Regional Prices for each variety of wine grape.
- By 15 January: purchasers must use their “best reasonable endeavours to provide to its wine grape grower(s) in all other regions Indicative Regional Prices for each variety of wine grape”.

WFA is aware that these arrangements are, at present, relatively unpopular for winemakers and wine grape growers alike. The Issues Paper is correct in its assessment of the difficulties or winemakers in issuing indicative prices. For many winemakers, in December it is too early to understand the mix of wines that will be produced from the following vintage and given this, and furthermore, it is difficult for winemakers to gauge how much wine they will be able to sell and what prices retailers will be willing to pay for their product. Given this, while it is difficult to provide an accurate picture of the price that will be offered at harvest.

It is clear that the sector would benefit from the provision of publicly available data which contributes to pricing decisions. This could include bulk wine availability and prices, domestically and internationally; information on market demand in key markets; information on Australian juice and bulk wine prices, vintage conditions and outcomes in major competitors. Wine Australia could be well placed to provide this data on a regular basis to inform growers and winemakers of market and supply conditions.

The key thing wine grape growers can do to mitigate against the risk of price movement is to enter into strong written contracts with winemakers and ensure they grow fruit to the conditions specified in that contract.

Working to form positive ongoing relationships with winemakers is important in helping to achieve this mutually beneficial objective. Further to this, we understand many wine grape purchasers have an ongoing conversation with their growers throughout the year to provide feedback on fruit provided in the previous year and to discuss the requirements for the forthcoming vintage. This is a positive and tangible way in which winemakers and grape growers can work together to plan for the coming vintage.

Issue 5 – quality assessment

As noted earlier in this submission, the desire to obtain wine grapes of a particular variety, of a particular quality, as defined by the specific characteristics the grapes possess at harvest, and how closely these characteristics align with the winemaker's requirements for a wine.

Defining quality

Defining quality in wine grapes is challenging, but winemakers and wine grape growers frequently work together to build an understanding of the expectations for quality in the market.

While the International Standards Organization (ISO) defines quality as "the degree to which a set of inherent characteristics fulfils requirements", it is important to note that no one measure will be universally applicable in assessing a parcel of wine grapes. Different winemakers may be seeking very different characteristics in wine grapes of the same variety, but this difference does not mean the expectations around quality would be different. Taking the Semillon grape as an example:

- "Winemaker A" may wish to produce a wine fit for a long life in the cellar, high in acid with particular citrus characteristics
- "Winemaker B" may wish to produce a softer, earlier drinking style of Semillon, or to use it in a blend with another variety like Sauvignon Blanc
- "Winemaker C" may wish to produce a rich dessert wine, high in sugar, with a particular level of acid.

While these three producers would make three very different wines, all of them may seek wine grapes of the same level of quality. Having said this, consumer trends at a point in time could mean that the wine grapes with qualities sought after by, for example, "Winemaker B" may be in significantly greater demand than the other different parcels of wine grapes, regardless of their equal quality assessments.

Assessing quality

As noted above, winemakers will assess the quality of wine grapes before purchase. Winemakers have traditionally employed objective measures including basic compositional measurements such as Baume, pH and titratable acidity when assessing the quality of wine grapes. In more recent years, a large number of other measurements have been developed and examined as potential application as quality measures. Some of these include:

- Vineyard measures – quantitative assessments including yield, bunch size, bunch number, bunch weight, leaf area, sugar, anthocyanins (colour), acid, fungal contamination, physical damage; and qualitative assessments such as vigour, vine balance, and grape flavour.
- Weighbridge and winery measurements – quantitative determinations such as sugar, acid, anthocyanins, matter other than grapes (MOG), glycosyl-glucose, methoxypyrazines, tannin, yeast assimilable nitrogen; and qualitative assessments such as organoleptic characteristics (mouthfeel, flavour, balance).

Some of the measurements can be considered as imparting negative attributes (e.g. bunch rots, MOG) and some positive (e.g. flavour), although for many of these, there may well be an optimum level for a given product style with both very low or very high levels causing diminution of ‘quality’.

However, it is impossible for winemakers to assess the quality of a parcel of wine grapes using these measures alone. Some measures of quality are subjective in nature, and this is appropriate. For example, over the past 20 years, colour in red grapes has been deployed by some wine companies as a quality measure and at least one company attributes increased red wine quality over this time period to using this measure of quality. However, this is not a universal practice. Flavour is another critical quality parameter that is difficult to objectively assess. There are many chemical interactions between compounds that can affect the taste of a wine to varying degrees, and some of these compounds and reactions are not known or well understood. Furthermore, linking back to the example of Winemakers A, B and C listed above, each of these winemakers would require grapes with different degrees of physiological ripeness, which is difficult to measure objectively.

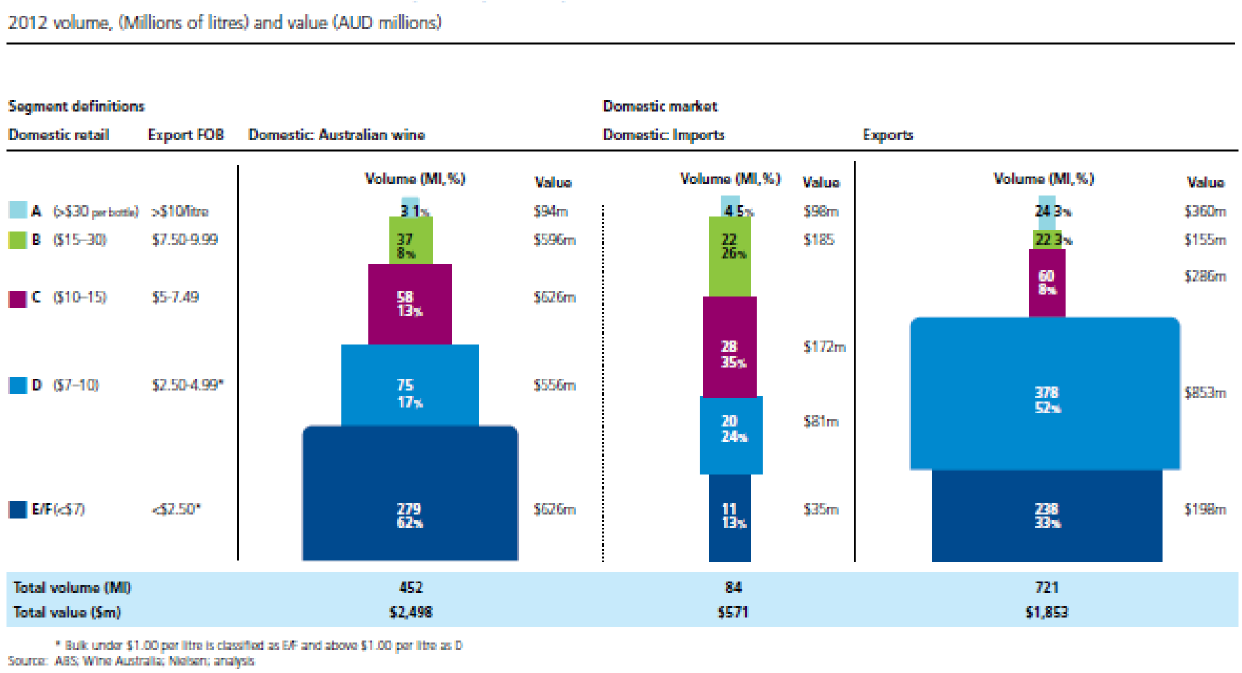
Returning to an earlier point, it is important for winemakers and wine grape growers to develop a clear understanding of the qualities and specifications winemakers are looking for, and to clearly set these parameters out in a strong written contract.

What are the quality grades for wine grapes in Australia?

Quality segments for grapes and wine and product specifications differ between companies and are not always directly comparable. Many companies use a five segment approach — A, B, C, D, E/F. This roughly correlates as outlined below:

	Grape Price	Domestic Retail Price	Export FOB Price
A	> A$2,000/tonne,	> A$30/bottle,	> A$10/litre
B	A$1,501 – 1,999/tonne,	A$15 - 30/bottle,	A$7.50 – 9.99/litre
C	A$601 – 1,500/tonne,	A$10 - 15/bottle,	A$5.00 – 7.49/litre
D	A$301 - 600/tonne,	A$7 - 10/bottle,	A$2.50 – 4.99/litre
E/F	< A$300/tonne,	< A$7/bottle,	< A$2.50/litre

<u>Illustration of wine demand by quality/price segment</u>



Expert Report on the profitability & Dynamics of the Australian Wine Industry, WFA, August, 2013

Case studies

Some other key challenges around adoption are explained below through examination of some specific objective measurables; these being the use of red grape colour, glycosyl-glucose and tannin.

Brown Brothers pioneered the use of *red grape colour* using a 'skin disc' method developed in-house during the early 1990s. Some slightly less complex methodologies were subsequently developed leading to considerable uptake by other larger wine companies in the early 2000's. However, in recent times, the measurement of red grape colour as an OMQ tool has become a less preferred method among some wine companies. There is a strong view that the use of red grape colour dramatically 'lifted the bar' of red wine quality in the warmer inland regions such as the Riverland, Murrumbidgee and Sunraysia, and notably also in the cooler King Valley region.

Unfortunately, some of the payment systems implemented by wineries used a linear curve to relate colour to payment, which became a financial problem in years of high overall colour, unless allowance was made for capping or normalisation (which was not often the case). Secondly, whilst the near infrared spectrophotometric technique offered the possibility of rapid measurement that could also help ameliorate variability caused by sampling, the calibrations proved to be technically challenging and complex to develop and maintain. These two aspects meant that adoption of red grape colour as an OMQ stalled and there remain some strong adherents and detractors in the industry today.

Glycosyl-glucose in grapes was touted in the late 1990s as a potential indicator of flavour intensity of red and potentially white wines, however the measurement techniques were too laborious for most practical winery laboratories, despite considerable efforts for simplified methods. Furthermore, the concept was difficult to understand and convey to winemakers and grape growers. Moreover, there was no clear link between the numbers and the taste, or how it might be affected by winemaking processes.

The measurement of **tannin** has been a major focus for many in the industry since the late 1990s when it was perceived that there were major gaps in knowledge. Recently, relatively simplified methodologies have been developed to quantify tannin, including the AWRI Tannin Portal, which aimed to help overcome the analytical complexity. While this may have been technically successful, the uptake within the sector is quite low. A common reason for this was that it was perceived that the numbers did not provide any meaningful insight into products and probably would not influence their processing. It is not clear if the reason for this is communication or the technique itself, but it may be worthy of further investigation.

These examples, illustrate some of the key points that are articulated by industry stakeholders about the characteristics required of OMQ for it to be of benefit to industry:

- Meaningful – the results of testing must covey "how does this number taste" and relate to wine value, together with a clear path of what processes can be changed to impact it
- Simple – the tests must be easy to do and user friendly
- Affordable – to conduct the tests and without high sampling costs
- Robust – the measurements must be precise, and reproducible
- Flexible – the measurements must be able to adapt to changes in market demands

It is still not clear how well grape quality attributes carry through to wine quality attributes. That said, for some regions and for red wine types, red grape colour is considered to be sufficient as a commercially relevant OMQ at present. For those particular products, it would appear that the characteristic that the buyer values is related to the measurable attribute – *viz.* colour.

Unfortunately, it appears that what the buyer values in a wine product can't always be measured. However, consumer group preference profiling can identify very broad aspects of composition that are important to a given market segment. For some large-scale commercial wines, some of these might include residual sugar, alcohol, acid, and tannin. All of these elements can be manipulated to varying degrees in the winery, meaning that there may possibly be no need to do so in the vineyard – hence specification at the grape level may be of minimal importance. Wine trade customers (i.e. wholesalers or retailers) may be quite demanding in terms of product specifications, but generally, this takes the form of a trading negotiation (usually heavily based on price) rather than a technical specification.

In the USA, several wine companies have systems in place that utilise a number of measurements to determine a quality grade. These systems use a mix of subjective and objective measurements with some specific weighting for each factor. Very often the relationship between the 'quality score' and price is specific to the region, variety, wine style, brand or any combination of these.

In Portugal, at least one wine company (approx. 35,000 tonnes) has adopted a similar quality grading approach).

As this submission shows, currently, grapes are graded based on a number of characteristics measured in the vineyard and at the weighbridge. These different product specifications mean that different purchasers give different waiting to different grape characteristics. However, grape growers with longer-term relationships with winemakers, in general, are more able to provide product according to specification, as both parties understand the requirements.

Background: The Australian wine industry

Introduction

Australia is the fifth largest wine producer in the world, and the largest in the Southern hemisphere.[9] Wine production occurs in all Australian states and territories apart from the Northern Territory.[10] The majority of winemakers are located in Victoria (773), followed by South Australia (720), New South Wales/Australian Capital Territory (484), Western Australia (379), Tasmania (117) and Queensland (100).

The history of Australia's wine industry spans more than 150 years. Australia was one of only two countries in the world whose vines were not destroyed by phylloxera in the nineteenth century, which means it has some of the oldest grapevines in the world. The first Australian vineyards were established in the early 1800s, but today these vineyards represent only 0.9 per cent of the industry. Today, the total vineyard area in Australia is around 135,000 hectares planted across 65 official wine regions.

Most Australian vineyards are new, with over 40 per cent of businesses having been established since 1990. There are approximately 5,000 wine grape growers in Australia producing a wide range of varieties with different characteristics and levels of quality. While the top five varieties making up three quarters of all plantings, there are more than 100 different varieties planted in Australia, with a growing trend towards planting more "alternative" varieties that are well suited to Australia's climate.

Contribution to the Australian economy

Australia's wine industry is a significant contributor to the Australian economy, particularly across rural and regional Australia. WFA estimated that the industry contributed $1.77 billion in 2013–14, and we note that wine is Australia's fifth largest agricultural export product. The industry employs more than 20,000 people across 2,500 wineries across Australia.

The industry contribution extends beyond production and sales. For example, wine tourism is critically important to a significant number of regions across Australia. It is an important destination for domestic tourism, and in 2016, one in seven international tourists to Australia visited a winery, and one in every five international tourist dollars are spent on food and wine in Australia. Of course, this tourism expenditure flows to rural and regional communities, to local hotels, restaurants and other members of the tourism sector.

A history of boom and bust periods

As noted above in this submission, the industry experienced a boom period between from the late 1980s to the mid-2000s, followed by a difficult period defined by structural oversupply, low demand and low prices. Professor Kim Anderson AC notes in his widely acclaimed work of 2013 *Growth and Cycles in Australia's Wine Industry: A Statistical Compendium*[11]*, 1843 to 2013* that this period is the fifth such identifiable boom period in

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[9] Note that Australia vies with Argentina for both positions from year to year.

[10] According to research released in 2013 by Professor Kym Anderson AC, the Northern Territory has not produced wine since 2007.

[11] https://www.adelaide.edu.au/wine-econ/databases/winehistory/

the Australian wine industry since the 1840s. WFA encourages the ACCC to read Professor Anderson's study to provide historical context to its market study.

The Australian market

The Australian domestic market accounts for approximately 500 million litres of Australian wine per year or 40 per cent of Australian wine production – making it our largest individual wine market. White wine is the largest category with 45 per cent of domestic sales, followed by red with 40 per cent and sparkling with 11 per cent. The share of red wine has been growing in recent years.

Australian wine dominates the local market, with imported wine from all sources having less than a 20 per cent share. Australia imports around 95 million litres of wine per year, of which two-thirds comes from New Zealand.

Overview of the 2018 wine grape crush

The 2018 wine grape crush is estimated to be 1.79 million tonnes, based on responses to the Wine Sector Survey 2018. This crush is 10 per cent lower than the 2017 final crush figure of 1.99 million tonnes and 2, and 3 per cent below the average over the past 3 years (2015–2017) of 1.85 million tonnes. However, it is 1.8 per cent above the long-term (10-year) average of 1.76 million tonnes (based on the Department of Agriculture and Water Resources levies unit figures) and reflects a return to more normal cropping levels after an exceptionally large crop last year. The 2018 crush saw red varieties decrease substantially more than white varieties, reversing last year's results. The 2018 red variety crush is estimated to be 932,334 tonnes – a decrease of 164,420 tonnes (15 per cent) compared with 2017. The white variety crush is estimated to be 861,848 tonnes, a decrease of 34,217 tonnes (4 per cent) compared with 2017. This meant that red varieties decreased their share of the crush to 52 per cent, compared with 55 per cent in 2017. The results indicate that the total harvest was closely in line with the three-year average (2015–2017).

The wine grape purchases collected in the Wine Sector Survey 2018 totalled 1.05 million tonnes, valued at $638 million. Over 32,000 transactions were collected and form the basis of this analysis. Dividing the total value by total tonnes purchased gives an average purchase price of $609 per tonne, up by 8 per cent on the price of $565 calculated in 2017. This figure is the highest since 2008 and above the average price across the past 10 years of $508 per tonne. It is the fourth consecutive vintage where the average purchase price for wine grapes has increased. Since hitting a low in 2011, this figure has increased by an average of 6 per cent per year over the past 7 years. However, it is still roughly two-thirds of its peak in 2001. The overall average purchase price of red grapes increased by 11 per cent from $692 per tonne to $768 per tonne, while the average price of white grapes increased by 5 per cent from $421 to $444 per tonne. The divergence between red and white average price has increased steadily since 2011, driven by strengthening relative demand for red wine

Wine Australia, 2018, **National Vintage Report**, https://www.wineaustralia.com/getmedia/fce5bf18-468b-4e1b-a478-d6ca231d40f6/VintageReport2018_full.pdf

The export market

Australia exports more than 60 per cent of the wine we produce and growth and profitability in the Australian wine sector is strongly correlated with export performance. Australian exports have shown a pleasing improvement in the past few years, with the past 12 months showing growth in both value and volume, with an increase of 11 per cent in value to $2.71 billion and 5 per cent in volume to 842 million litres (or 94 million 9-litre case equivalents) for the year ended 30 September 2018 (see Table 2).

Shipments of bottled wine increased by 8 per cent in value to $2.16 billion and 2 per cent in volume to 366 million litres (41 million 9-litre case equivalents). Shipments of unpackaged wine also grew strongly, with a 23 per cent increase in value to $525 million and a 9 per cent increase in volume to 468 million litres.

There were also increases in the average value of wine exported, with a 7 per cent increase for bottled wine to $5.90 per litre, a 13 per cent increase of unpackaged wine to $1.12 per litre and a 5 per cent increase of all wine exported to $3.21 per litre.

In the 12 months to 30 September, there was healthy growth across the price spectrum. Exports above $10 per litre increased by 20 per cent to $805 million, with the $20 to $29.99 segment in particular, showing considerable growth. Below $10 per litre, the $5 to $7.49 segment was the best performer, growing by $50 million.

Table 2: Exports by price segment (million AUD FOB)

Price segment (A$/litre)	MAT September 2018	Value change	Growth rate
$2.49 and under	$543	$38	8%
$2.50 to $4.99	$838	$33	4%
$5.00 to $7.49	$362	$50	16%
$7.50 to $9.99	$159	$11	8%
$10.00 to $14.99	$207	$16	8%
$15.00 to $19.99	$73	-$8.4	-10%
$20.00 to $29.99	$168	$60	55%
$30.00 to $49.99	$98	$14	16%
$50.00 to $99.99	$189	$43	30%
$100.00 to $199.99	$20	$5.1	35%
$200.00 +	$50	$4.2	9%
Total value	$2,706	$266	11%

Export values grew to all but one of the major destination regions. The standout growth of 24 per cent was experienced in Northeast Asia, where exports grew to $1.14 billion in value, while in North America, a $16 million increase in exports to Canada only partially offset a $38 million decline in exports to the United States of America (USA).

Regions in growth:

- Northeast Asia, by 24 per cent to $1.14 billion
- Europe, by 5 per cent to $604 million
- Southeast Asia, by 5 per cent to $170 million
- Oceania, by 21 per cent to $105 million, and
- the Middle East, by 41 per cent to $30 million.

Growing the China and the USA markets is the key focus of the Australian Government's Export and Regional Wine Support Package ($50m Package). We are seeing strong growth in China and we have redoubled our efforts in the USA to capture more of the premium end of the market as American consumers trade up to higher priced wines.

Australia remains very vulnerable to movements on the China market. The growth in China has been reflected in a return to a better supply-demand position, leading to price improvement. However, it must be remembered that much of the volume growth has been at the lower price points.

Only one in three Australian wine producers currently export.[12] However, adding to the complexity of the exporting ecosystem, a large proportion of exporters (41 per cent) are not wine producers but agents, distributors and other intermediaries.

Within these groupings of wineries and non-wineries are larger and smaller firms (levy payers) who export very different volumes and values. Using the WFA's classification of SMEs, Table 1 presents this breakdown by number of exporters and their average export volume and values. This indicates a high level of concentration of exports by volume and value by large and medium enterprises.

Table 1 Number of exporters by crush size, value and volume (2016)

Enterprise classification	Grape crush t	Number of exporters	Average volume (000's litres)	Average value ($ 000's)
Large	>50,000 t	7	65,000	$184,000
Medium	2,001-49,999 t	35	4,000	$7,000
Small	<2000 t	1,118	100	$400
Other non-levy paying exporters		1,494		
Average	-	-	400	$1,200
Enterprise classification	Grape crush t	Number of exporters	Average volume (000's litres)	Average value ($ 000's)
SOURCE: WINE AUSTRALIA, 2017				

Performance and Outlook

Despite the recent difficulties facing the industry, WFA is encouraged by recent positive indications of better returns for both winemakers and wine grape growers.

There are positive signs in the Australian domestic market after a long period of flat sales. Australian wine consumption increased to 29.6 litres per annum in 2016 after five years in decline, according to the International Wine and Spirit Record (IWSR), and the IWSR forecasts that wine sales will continue to grow slowly over the next five years. There is also a trend towards drinking higher priced wine, with sales above $10 per bottle (off-trade) increasing in 2017 while sales below $10 per bottle declined. From 2007 to 2012 the domestic consumption of Australian wine sold above $15/ bottle increased by $268 million (64%) in value terms and 11.6 million litres (42%) by volume.

Another bright light has been China. Wine Australia's export report for September 2018 notes the strength of Australia's position as an exporter of premium wines to China. It notes that "in the year ended September

[12] AGWA, 2017

2018, exports to China (including Hong Kong and Macau) increased by 24 per cent in value to $1.06 billion and 25 per cent in volume to 175 million litres". This growth is spread across almost every price point, and opportunities in China are plentiful. The forecast growth in the Chinese market should equate to a consumption level of more than 3 billion litres in 2022, which would see China surpass the USA as the world's largest wine market (Euromonitor).

Furthermore, the growth of China's middle class population is surging, with an additional 350 million people expected to be classified as middle class by 2022. This is expected to drive demand for goods and services significantly, with Australia well placed to cater to the well-publicised willingness of Chinese consumers to pay a premium for quality, safe and reliable products.

While the opportunity China presents is exciting, it is important to note that not all winemakers are experiencing the same levels of sales in this market. Furthermore, WFA anticipates that despite growth in the China market, industry profitability along the production chain will continue to be under pressure for the following reasons:

- the ability of retailers to extract margins from winemakers continues to place pressure on profitability
- winemakers will likely have higher levels of Costs of Goods Sold (COGS) due to increased grape prices and lower volume
- continued growth in competition from other wine producing nations, particularly at the lower value end of the market
    - more than 60% of industry volume is exported, and the majority of export volume is C,D and E/F grade wine (FOB below $7.50 per litre)
    - Export margins at these levels are significantly below domestic margins, however, the domestic market is not large enough or growing fast enough to absorb quantities of wine currently being exported.
- Currency fluctuations remain a threat to export demand and profitability
- The growth in demand for wine in China, combined with a better exchange rate has now managed to improve the supply-demand imbalance and provide significant growth opportunities in China. However, outside China, market conditions remain tough and the China growth has not been reflected elsewhere.

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