Winemakers' Federation of Australia

WGGA Wine Grape Growers' Australia

Australian Government
Australian Wine and Brandy Corporation

Australian Government
Grape and Wine Research and Development Corporation

Wine industry must confront the reality of oversupply

A statement to the wine industry by the Winemakers' Federation of Australia, Wine Grape Growers' Australia, the Australian Wine and Brandy Corporation and the Grape and Wine Research and Development Corporation

Recognising the problem

It is widely acknowledged that the Australian wine industry is enduring its toughest period in two decades. All in the industry must recognise that this is our problem and we need to fix it.

Structural surpluses of grapes and wine are now so large that they are causing long-term damage to our industry by devaluing the Australian brand, entrenching discounting, undermining profitability, and hampering our ability to pursue the vision and activities set out in the *Directions to 2025* industry strategy.

Coupled with inefficient and/or inappropriate vineyard and wine operations, oversupply is amplifying and exacerbating fundamental problems in the industry, notably our decreasing cost competitiveness. As such it is compromising our ability to adopt new pricing structures and market solutions and adapt to changing market conditions.

Comprehensive analysis and consultation suggests at least 20% of bearing vines in Australia are surplus to requirements, with few long-term prospects. On cost of production alone, at least 17% of vineyard capacity is uneconomic.

The problems are national – although some regions are more adversely affected – and are not restricted to specific varieties or price points.

The industry must restructure both to reduce capacity and to change its product mix to focus on sales that earn viable margins. Bailouts are not an option and neither governments nor industry bodies should be expected to provide the answers; tough, informed decisions must be made by individual growers and wineries, from as early as the 2010 vintage.

The supply dimension

Australia is producing 20-40 million cases a year more than it is selling – roughly equivalent to total sales to our second largest export market, the UK. Our surplus already exceeds 100 million cases and at current rates of production and demand this will more than double in two years.

Drought, water shortages and climate change will continue to affect production but the impact is indiscriminate and largely insignificant given the scale of the problem. Estimates are that these factors combined can provide no more than 10% of the necessary reduction in supply.

The demand dimension

Australia's wine exports have fallen by 8 million cases and 21% in value since their peak in October 2007. The decline has been greatest for higher value exports, and where there has been growth at lower price points it frequently has been unprofitable and thus unsustainable. Over the same period domestic sales of Australian wine have fallen, while sales of imported wine have increased.

The global financial crisis has not helped, but it is far from the only factor; a strong dollar and our industry's cost competitiveness have been more significant. Better economic conditions will not automatically restore previous demand, and even if they do this would be insufficient to deal with our fundamental problem. Even an ambitious growth target of 4 million cases a year – equivalent to 6% annual value growth for the entire Australian category – would only eliminate 20% of oversupply.

New market opportunities do exist, but they will take time and significant, sustained investment to unlock.

Issues with competitiveness

Oversupply is unpicking our price structure, distorting perceptions about our product and exacerbating competitive pressures.

Globally we have been forced to trade in the low-value / low-margin market to sell excess wine, yet our costs are too high for us to be viable in that market in the long term – we cannot match the cost structures of some competitors (including a subsidised Europe) at very low price points. Just as damaging is the image being created that Australia is only a low-cost producer, making it difficult for our premium wines to gain recognition and market traction.

Domestically, excess supplies have allowed supermarkets to move from customers to competitors by launching their own low-price products, without the need to invest in capital infrastructure or the long-term health of the industry. This clutters the market place and eats into margins.

A range of factors suggests our long-term terms of trade will continue to weaken, putting the commodity market further out of reach. These include:

- real increases in the price of water
- the likelihood of exchange rates remaining unfavourable
- lack of international uniformity on carbon emissions trading, with the likelihood that Australia's costs will rise relative to some commodity wine competitors
- a reduction in winery throughputs – leading to increased fixed unit costs – as the industry rationalises to eliminate over capacity
- increased costs of accessing and servicing capital.

Research and innovation are essential but cannot provide the answer given the necessary timeframe and the scale of the problem. We need to restructure our industry to ensure we can compete as a premium wine producer.

Issues with viability

Australia has significant problems in terms of vineyard and winery viability. In particular, too many regions produce uneconomic fruit because of high-grade cost structures. High-grade cost structures have only one option and that is to produce high-grade fruit. This is highlighted in two studies of wine regions completed this year. Both have been independently corroborated by industry consultants.

One study graded fruit from A to E then assessed viability in terms of whether vineyards exceed cost benchmarks for the relevant quality level. Its findings suggest that:

- in more than 20 regions 50% or more of the production for C and D grade fruit (premium and popular premium) is uneconomic
- in total, 36% of C grade fruit is uneconomic
- three of our highest profile and most productive regions for A and B grade fruit (specialty and super premium) struggle to produce C and D fruit at a competitive cost, with 50-60% of that fruit considered uneconomic
- 10 regions have 70% or more of production considered uneconomic – most are small, but three have total production of around 20,000 tonnes or more.

The second study provides a regional breakdown which shows that significant quantities of grapes bring a realised price that is below the cost of production.

Viability is a complex issue, given the patterns and history of vineyard and winery development, but it needs to be addressed decisively and immediately. Where costs of production are high, vineyards must be achieving A and B quality grapes. Some regions do this reasonably well, some poorly.

Addressing the problem

The primary focus must be on helping businesses and regions to strategically and honestly assess their current and likely future position then make appropriate decisions. In particular we need to address the options for vineyards and wineries that are underperforming. Some may need to leave the industry; others may need to change what they produce and how they do it.

The Wine Restructuring Action Agenda includes the following initiatives as an immediate response.

- From 23 November 2009, detailed and confidential supply data summaries will be provided to regional associations. These will examine each region in isolation and in relation to the national picture, with a focus on levels and patterns of viability.

- From 30 January 2010, a package of tools will be available to help individual vineyard operators assess their performance and viability. This will include: a checklist; an upgraded *Deloitte Ready Reckoner* to assess winery profitability by market, channel and price point; and an upgraded *Vinebiz* program to assess vineyard profitability.

- From early next year, briefings will be held in 14 regional centres (covering all States) to discuss regional data and issues and offer business stress testing to assist with decision making. The Federal Government has been approached to help facilitate this initiative, and State input is being sought.

- WFA and WGGA will hold discussions with the Federal Government about improved exit packages for growers and small wineries seeking to leave the industry along the lines of drought and small block irrigator exit packages. Discussions also will be held with State Government agencies with regard to alternative land use options in wine regions.

Alongside these specific initiatives:

- The peak industry bodies will:
    - Work with the Federal Government to address aspects of the WET rebate that artificially allow uneconomic businesses to stay in business and thus contribute to overproduction.

    - Seek changes to regulations covering MIS schemes to ensure potential investors receive a fair picture of the wine industry's current position and cannot offset losses. The aim is to deter unwanted and unviable further vineyard expansion.

    - Work with regional associations on complementary issues related to demand and environmental sustainability.

- R&D priorities have been refocused to support the restructuring agenda, with an additional $750,000 committed so far by the GWRDC to support a range of initiatives, including:
    - Substantial funding for research to support the Wine Australia market development strategy
    - China market competitor analysis
    - Further analysis reconciling supply and demand
    - The upgraded *Deloitte Ready Reckoner* and *Vinebiz* program.

In addition, we will address our market development investment to:

- Refocus on the emerging markets of Asia, where growing affluence and a shift in preference towards wine provide promising opportunities (eg North and South-East Asia, where Australia has a competitive advantage through geographic proximity and strong existing trade ties).

- Provide additional support for educational, promotional and relationship activities in core growth channel opportunities, including China, the US (on and off-trade, >$10 a bottle), Quebec, Japan, UK (independent/specialist retail) and the Australian domestic market.

Conclusion

Oversupply is having a debilitating impact on Australian wine businesses and restructuring the supply base is both essential and inevitable.

Our objectives in releasing this statement and formulating an action agenda are to advance the adjustment process, to bring about more sustainable operating conditions as soon as possible, and to dispel any notion that the industry can trade its way out of its current problem or rely on the government to step in.

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