Submission to Re:Think

A better, simpler, fairer wine tax system for a stronger Australian wine industry

Pernod Ricard Winemakers

Submission on Indirect taxes – Alcohol tax

Changing the Wine Equalisation Tax to help restructure and restore profitability to the Australian wine industry.

June 2015

Executive Summary

- The Australian wine industry has enjoyed global success and has the potential to recapture and accelerate this success; however, to do so, it will need to overcome the challenges that it faces, supported by the right regulatory and fiscal settings.
- The **single biggest challenge facing the Australian wine industry is the ongoing, unsustainable oversupply** of lower-quality grapes and wines, which harms both its image and financial performance.
- The **current structure of the Wine Equalisation Tax (WET) and its rebate encourages oversupply**, contributes to this structural imbalance and **distorts both the domestic market and Australia's wine export markets**.
- The WET and its rebate motivate production of lower-priced, lower-quality wine, with the excess dumped onto the global market at low values.
- Most Australian wine exported to mature markets, particularly the UK and US, is now at the low-priced end of the spectrum.
- In addition, competition with cheap, bulk wine has resulted in a destructive discounting cycle.
- This has created a perception in these markets that all Australian wine is of lower quality, harming Brand Australia, damaging the promotion of our agricultural exports as high-quality premium products and undermining future wine marketing campaigns.
- Australia cannot compete profitably against other low-priced wine exporters, such as Chile, Argentina, South Africa, and soon China.
- The current WET structure is unfair because premium wine producers, including small and medium-sized winemakers, pay a higher amount of tax than producers of low-priced wine for the same volume of goods.
- The **industry's only path to a sustainable future is in producing premium wine**, with viable margins and improved image, restoring profitability and value growth potential to the industry.
- For these reasons, we support a shift to a **category-based volumetric WET, at a tax rate around $2.20 per litre of wine**, which would:
    - create a more equitable tax take between producers of premium, and those of low-priced wine;
    - **not substantially affect the price of wines sold between $6 and $15 a bottle**;
    - stimulate production of premium wines retailing for $15 a bottle or more;
    - improve the image of Australian wines in markets where Brand Australia has been damaged by an influx of cheap wine;

    - **be revenue neutral for the government**.
- Adopting this change within the existing WET system avoids the need for costly and burdensome administration and the logistical restrictions associated with an excise tax system.
- Similarly, **adopting a fixed tax rate per litre of wine** (rather than a rate associated with the alcohol content of each individual wine) **avoids unnecessary complexity**.
- The diversity of business models within the wine industry means that there is no single wine tax system which benefits all players; existing industry participants who have built a business model based on distortions in the market created by the current WET and its rebate would need assistance to adjust their business model or leave the industry.

Recommendations

Noting that due to the different business models of its members, the Winemakers' Federation of Australia has no preference on the structure of the Wine Equalisation Tax, Pernod Ricard Winemakers makes the following recommendations:

1. Change the method of calculating the Wine Equalisation Tax from an ad valorem approach, to one of **category-based volumetric, with a single rate for all wine** (irrespective of alcohol content) **at around $2.20 per litre of wine**. At this rate, the proposal would be revenue neutral for the Government (assuming no change to the WET rebate).

2. Maintain administration of wine taxation through the *Wine Equalisation Tax Act*, **leaving wine as a non-excisable good** due to the nature of its transportation during production and the high administration costs and complexity of the bonded warehouse excise requirements.

3. **Keep the WET at a preferential rate to other alcohol beverages**, due to the higher capital intensity and lower profit margins of the wine industry and its vital role in supporting jobs, high-value regional tourism and exports.

4. **Significantly reform or abolish the Wine Equalisation Tax rebate**, which distorts the market and contributes to structural oversupply.

5. Use savings from the abolition or reform of the WET rebate to **provide transitional assistance to winemakers and growers who wish to restructure or leave the industry**.

Pernod Ricard Winemakers supports the submission and recommendations of Treasury Wine Estates, with whom we have partnered in this proposal.

About Pernod Ricard Winemakers

Pernod Ricard Winemakers is the premium wine division of Pernod Ricard, the world's co-leader in wine and spirits. Our global wine business is headquartered in Australia, with wine production businesses location in Australia, New Zealand, Spain, Argentina, the United States and China.

In Australia, we are the owner of many historic wine brands, including Jacob's Creek, Wyndham Estate, Morris Wines, Richmond Grove Wines and Gramps. Pernod Ricard acquired the Barossa Valley's Orlando Wines, producer of Jacob's Creek, in 1989, and a year later, purchased Wyndham Estate in the Hunter Valley to create the Orlando Wyndham Group.

In 2013, the business was re-named Pernod Ricard Winemakers, with the vision of "Leading Wine Innovation", and with the aim to become the world leader in premium wine. In 2014, Jacob's Creek was the world's most awarded winery, and since the label was launched in 1976, has won more than 7,000 international wine awards. Jacob's Creek is the number one premium Australian wine brand in 17 countries, selling 6.2 million cases annually, and it is exported to 65 countries.

Introduction

The Australian wine industry is one of our country's great agricultural global success stories. Australia's diverse wine regions produce more than 100 grape varieties, and today is one of the most prolific producers of quality wines. Over the last 50 years, wine as a share of domestic alcohol consumption has risen from 12 to 38 per cent, marginally below beer.

Australia also has some of the oldest grapevines in the world. Many of Europe's established vineyards were destroyed by disease in the 1800s, with the only survivors being the vines brought to Australia. Today, the wine industry is a significant contributor to the national economy, directly employing more than 16,000 people, earning $1.8 billion in export revenue and contributing more than $8 billion to the tourism industry. The industry enjoyed rapid growth from 1997 to 2007, reaching $5 billion in annual sales at its peak.

After 2007 – when export volumes stalled – sales value plunged for Australian wine with a collapse of prices in key export markets, particularly the United States and United Kingdom. A strategy of volume growth and rapid vineyard expansion, in part driven by the prevailing tax structure, saw enormous increases in domestic wine production (which more than tripled between 1993 and 2007).

However, the push to achieve market volume came at the expense of market value, with the overproduction of lower quality wines flooding the export market and pushing down the average price. The strategy was production-driven rather than market-driven, and meant Australian winemakers had to use price to move volumes of wine through distribution channels to recover fixed costs.

(Source: Wine Australia)

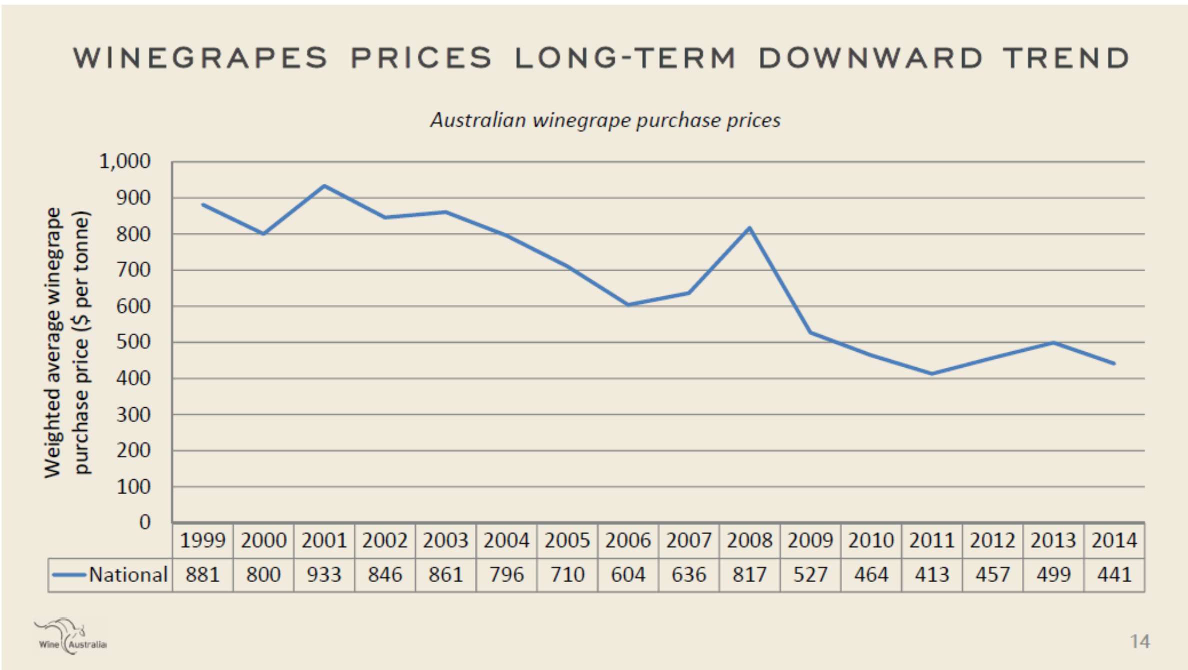
Using price to gain share created a consumer perception that price was the key factor in the purchase decision, damaging the perception of Australian wine in key export markets. By contrast, the French and Italian wine industries were willing to sacrifice volume to maintain (or increase) prices to maximise value for premium wines, which embedded a perception of quality by consumers.

For Australian wine in the United Kingdom, Western Europe and the United States, the push by producers to move increasing volumes at falling prices to meet fixed costs has created a "commoditisation loop" and damaged Brand Australia.

At the same time, a number of lower-cost new world wine competitors – particularly Chile, Argentina and South Africa – have exported greater quantities of commercial wine to these markets, and consumer preferences have shifted.

The result has been a damaging imbalance between supply and demand for Australian grapes, particularly at lower grades.

Wine grape prices have halved over the last 15 years. The size of the industry has shrunk in real value almost 25 per cent between 2003 and 2012. And in 2014, 84 per cent of Australian wine grapes were produced at a loss, up from 77 per cent in 2012.



(Source: Wine Australia)

The market has not self-corrected: the nature of sunk costs in agricultural production increase switching costs to other products.

Most industry participants agree that restructuring and reform are vital, but have not acted to address key structural issues. Too many players pin their hopes on currency exchange improvements, and seek more money for generic marketing. These are important, but the structure of the WET and its rebate has kept otherwise unprofitable players from exiting the industry, which in turn has distorted the market and impacted all of the industry.

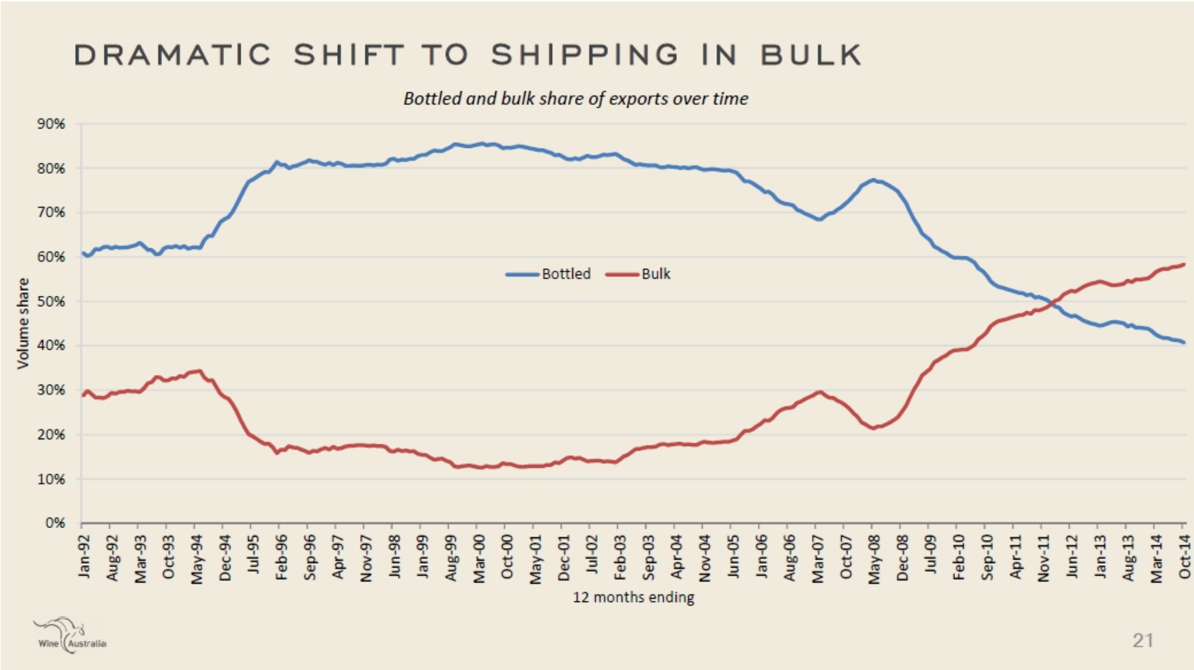
<u>The Australian wine industry needs reform to secure its future</u>

Pernod Ricard Winemakers has invested, and continues to invest, in the Australian wine industry; we believe it can recapture its position as a world leading producer of premium wines. The industry has the necessary elements for success: premium grape growing regions, passionate industry ambassadors, skilled winemakers, diverse grape varieties and wine styles and brands with provenance. However, to achieve success, the industry needs to overcome the challenges it currently faces, supported by the right regulatory and fiscal settings.

Pernod Ricard Winemakers regards the continuing oversupply of unprofitable Australian wine as the most significant challenge facing the industry. Government and industry have long recognised this as a structural problem, with all key stakeholders agreeing in 2009 that:

> *"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… industry strategy."*
>
> (Statement by Winemakers' Federation of Australia, Wine Grape Growers Association, the Australian Wine and Brandy Corporation and the Grape and Wine Research and Development Corporation, November 2009.)

In 2012, 62 per cent of Australia's volume was exported. Of this, 94 per cent of the volume was either bulk wine, or priced at less than $10 a bottle. The domestic market is neither large enough, nor growing fast enough, to absorb the over-production of grapes/wine at these quality levels.



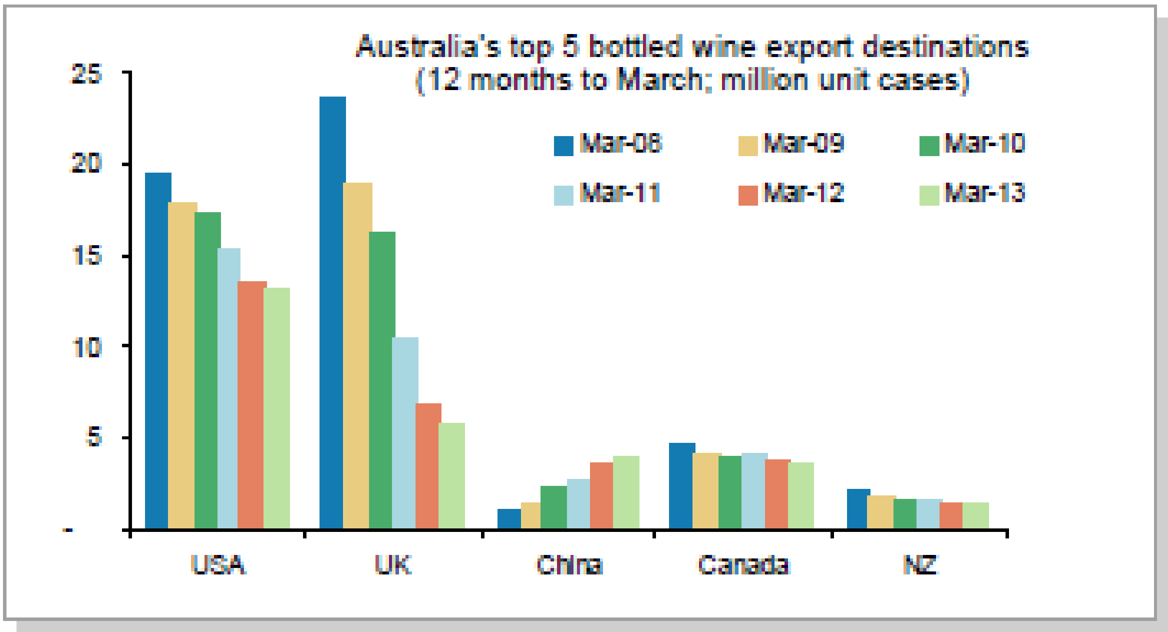
(Source: Wine Australia)

From 2007 to 2012:

- exports of Australian wine retailing between $7 and $15 a bottle fell more than 24 per cent in volume, while wine exports under $7 a bottle rose 53 per cent in volume;
- total export volumes fell by 8 per cent, while export value fell by 38 per cent;
- 91 per cent of the fall in value occurred in the United Kingdom and United States alone.

The rise in the export of unprofitable or marginally profitable bulk wine has hidden the collapse in Australian exports of bottled wine to the United Kingdom and United States.

In 2013, Australian wine in the United Kingdom was earning only £1.16 per litre, compared with £6.12 for French wine, £3.67 for New Zealand wine, and £1.64 for Chilean wine. In the same year in the United States, Australian wine was earning just US$2.72 a litre, compared with French wine earning US$12.36 a litre, Spanish wine US$4.89 a litre and Argentinian wine US$3.05 a litre.



(Source: Centaurus Partners for WFA)

The industry recognised the dilemma in 2009:

> *"Globally we have been forced to trade in the low-value/low-margin market to see 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 of our competitors… 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."*
>
> (Statement by Winemakers' Federation of Australia, Wine Grape Growers Association, the Australian Wine and Brandy Corporation and the Grape and Wine Research and Development Corporation, November 2009.)

The future of global competition and the pricing of commodity wine is also challenging for the Australian industry.

While wines from Chile, Argentina and South Africa have developed inroads in market share in Western Europe and the United States, global demand of commodity wine is stagnant or falling in most markets. But supply is likely to rise in the next ten years as China's domestic industry increases its yield and supply outstrips local demand.

China already has the second largest vineyard coverage in the world, although its lower yields mean that it is only the world's fourth largest producer. This wine is currently consumed almost exclusively within China, with local demand exceeding supply, particularly at the premium plus level.

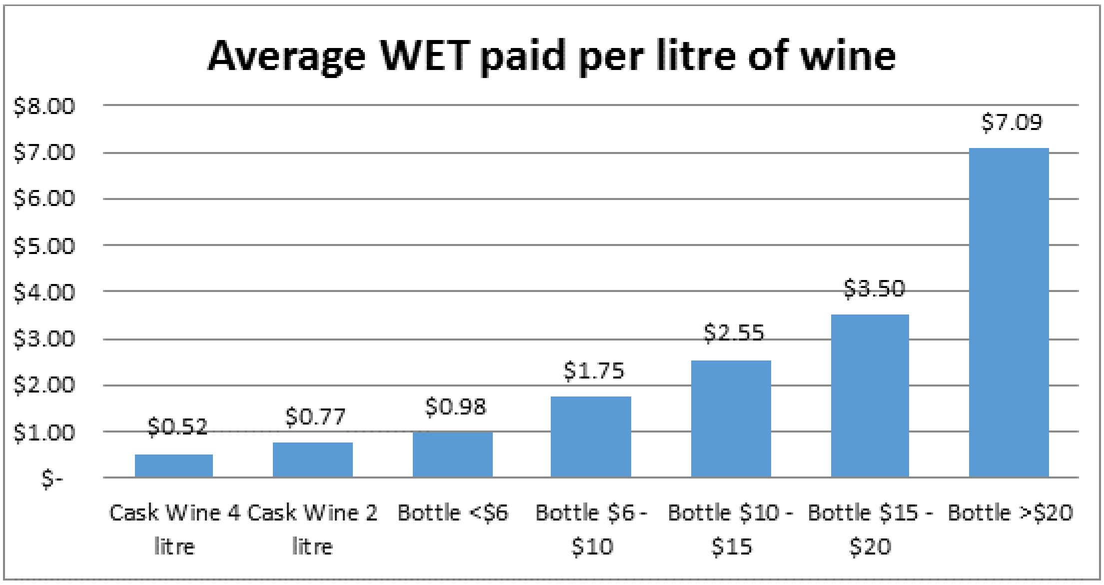
However, we expect China to be a net exporter of commodity and bulk wine within five to ten years, putting further pressure on the global price of bulk wine. As a result, it is clear that a sustainable future for Australian wine cannot be based on competing with low-cost commercial producers in the global market, where price remains the pre-eminent factor for purchase.

In our view, the sustainable future of the Australian industry is in the premium and fine wine categories, supported by reforms to the WET and its rebate.

> *"Some of the strongest growth is seen in the premium price segments and we'll be continuing to champion Australia's finest wines in our global marketing activities. While the above A$7.50 price segment accounts for just 5 per cent of total export volume, the value share is considerably higher at 27 per cent."*
>
> (Andreas Clark, CEO, AGWA, 28 April 2015)

<u>The existing wine tax structure is aggravating the problems faced by the wine industry</u>

Australia's wine production capacity far exceeds domestic consumption, and a profitable industry must rely on a successful export strategy. The Australian wine industry has two broad business models: one servicing the commercial or commodity sector and the other producing premium wine. These business models are directly affected by wine tax arrangements. The wine tax system cannot benefit all players, and choices need to be made if Australia's wine industry is to achieve its full potential.



(Source: BCG modelling for Pernod Ricard Winemakers and Treasury Wine Estates; excludes GST)

The current WET structure taxes low-priced wine significantly more favourably than premium wine.

Pernod Ricard Winemakers and Treasury Wine Estates commissioned the Boston Consulting Group to undertake modelling of ad valorem and category-based volumetric tax at different wine price points. Our model shows that in 2014, the average WET paid per litre of (four-litre) cask wine was $0.47, while wine of the same alcoholic strength which sold at $15 to $20 (exc. GST) paid around $3.52 per litre in WET.

The WET structure has driven the consumption and production of low-priced, lower quality wines. In contrast, the production of premium, high-margin and higher quality fine wine is penalised by an unfair tax system.

Despite the tax disincentive, Australian consumers want to trade up – consuming less low-priced cask and bottled wine and moving gradually towards more premium wine. Combined with falling export demand, this has resulted in a large surplus of wine at the lower end of the price/quality spectrum, which producers are then forced to dump on the domestic and global market, usually at a loss. Many winemakers have built their businesses on volume and need to maintain production to assist in the recovery of fixed costs.

Recent value growth in Australian wine exports has been at the premium price point, with Asia the key driver of growth. In 2014, the average value of wine exports to China was A$5.61 a litre, Hong Kong was A$14.57 a litre and Singapore was A$10.30 a litre, compared with the global average of Australian wine exports of A$2.60 a litre.

China is the number one destination for premium Australian wine, where there is a perception of Australian wine as superior. Australian producers have not flooded the Chinese market with bulk and low priced wine, given there is no demand (at present) for imported wine at this price point.

If the domestic industry is motivated to produce lower-priced wine by an unfair tax system, this will undermine the perception of Asian consumers that Australia is a premium wine producer and handicap Australia's efforts to increase export income and create jobs by promoting premium food and beverage exports.

The BCG modelling determined the level at which a category-based volumetric tax for wine could be set to be revenue neutral and to minimise the impact on the industry.

Assumptions were made based on industry data about the price and demand elasticity of wine at different price points, and about other alcohol beverages and the substitution effect. Assumptions were also made about the effect of tax on wine exports and imports, based on observed past data.

The BCG model determined that (assuming the WET rebate remained unchanged) the appropriate tax rate would be around $16.70 a litre of pure alcohol, or around $2.20 per litre of wine ($1.65 a bottle). If the Government chose to reform or abolish the WET rebate, this rate could be further reduced. With the rebate abolished, a revenue neutral volumetric rate would be around $10.65 a litre of alcohol, or $1.40 per litre of wine.

The price of cheap cask wine will rise under this proposal. At the proposed volumetric rate of $2.20 per litre of wine, the price of cask wine would rise on average $1.70 a litre.

Under the Australian Government guidelines for responsible drinking an individual would be consuming a maximum of 2 standard drinks per day, so for a responsible drinker of cask wine the added cost is approximately $2.60 per week.

Pernod Ricard Winemakers recognises that a change to the structure of the WET will not by itself solve the issue of oversupply. But it will have a real impact on forcing uneconomic producers to change their business model or leave the industry, and help resolve other causes of structural imbalance. We note that despite this being the highest priority for the industry for more than five years, nothing has made an impact on restructuring; we believe that the current tax settings are a significant factor preventing reform from being achieved.

It is essential that targeted transitional assistance be provided, in a similar manner to other Australian industries that have positioned themselves for a more sustainable future, to help those adversely affected to adjust their business model or leave the industry.

Our proposed tax structure is aligned with government policy

The Australian premium wine industry has the expertise, quality and natural advantages to be poised for success in exporting, particularly to Asia.

Since the start of 2015, the Federal Government has been showcasing Australian premium food and beverage, with trade delegations going to Japan, China, India and Korea. The recently completed Free Trade Agreements with Japan, Korea and China – and the possibility of a similar agreement with India – will improve access by Australian wines to the expanding markets in these countries, and enable us to build on early success.

Moving to a fairer wine tax system would reinforce the government's commitment to the premium sector of the wine industry where our industry has genuine future growth potential. Promoting premium wine tourism to domestic and international travellers also supports the government's commitment to regional Australia as a tourist destination.

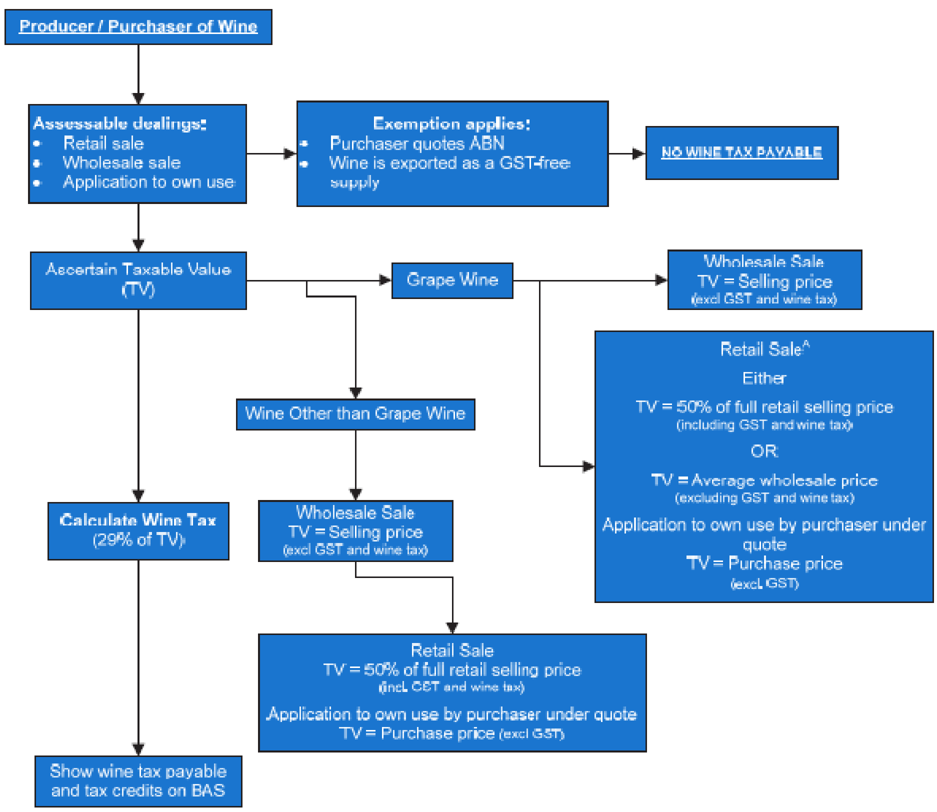
Pernod Ricard Winemakers notes that the export profile and profitability of Australian wines in Asia today resembles the early export profile of our wines to the United Kingdom and Western Europe. Without urgent tax reform, it is likely that the future profile of Australian exports to Asia will follow the European path where large volumes of lower-priced wine exploited the early reputation of Australia's quality wines and flooded the market.

The current administration of wine tax in Australia is overly complex. The December 2010 Australian National Audit Office report *Administration of the Wine Equalisation Tax* stated:

> *"There is considerable complexity in calculating the wine tax. To calculate wine tax payable, the Wine Tax Act covers a range of situations involving factors such as the type of wine product, the point of sale (for example, wholesale or directly by producers), whether an exemption applies, and the appropriate taxable value (see Figure 1.2)."*

Figure 1.2

Process for determining wine tax liability



(Source: Australian National Audit Office)

A move to a single tax rate for all wine would reduce much of this administrative complexity for both industry and government agencies.

The current WET rebate is unsustainable and needs urgent reform

The current WET rebate is another major factor inhibiting industry restructure, as it subsidises producers who would otherwise not be able to compete in a free market, artificially alters business models to maximise qualification of the rebate, and restricts consolidation of the industry.

In previous submissions to government, Pernod Ricard Winemakers has called for the abolition of the WET rebate. This remains our preference, as it is simpler and does not encourage wine businesses to artificially manipulate their business model to maximise their rebate.

Government support for regional development and cellar door wine tourism can be provided directly to intended recipients, avoiding the present situation which sees foreign winemakers qualifying for rebates.

However, as a first step, we support the proposed model for WET rebate reform as outlined by the Winemakers' Federation of Australia.

We agree that by extending the rebate to foreign winemakers and for the use in bulk and unbranded wine, the purpose of the rebate has been distorted and is open to abuse. We note that any rebate model should allow for industry consolidation and structural reform, and minimise distortions to the free market.

Why wine should have a single tax rate

Winemakers are unable to control the final alcohol content in their product, due to seasonal variations in each vintage (including grape characteristics, winemaking effect, and other external influences). The same wine of different vintages can have different alcohol percentage contents because of these factors. Therefore, we believe it would be simpler and more predictable for industry to have a single tax rate across the broad spectrum of table wines.

Why wine tax should not be equal to beer or spirits

Pernod Ricard Winemakers supports the submission of the Winemakers' Federation of Australia that wine should continue to receive a preferential tax rate to other alcohol categories.

Increasing the tax paid by wine relative to other categories would damage the wine industry's ability to create jobs and support regional communities.

Research shows that:

- the wine industry directly employs more than 16,000 Australians
- wine is a net export product, which plays a critical role in supporting and sustaining regional communities
- wine tourism contributes $4.9 billion to international visitor expenditure and $3.3 billion in domestic visitor expenditure
- the industry pays a number of compulsory levies that are not in other alcohol categories.

Winemakers also face unique structural and capital challenges compared with other sectors, including:

- only having one harvest a year to create a production opportunity for that vintage
- wine has the highest level of revenue volatility in the alcohol sector, with variability of grapes subject to climate, soil quality and disease
- long periods of fermentation, maturation and storage, particularly in comparison with beer
- wine having a much higher average ratio of invested capital to revenue, profit and income than other sectors.

Further details in support of these points are to be found in the submission of the Winemakers' Federation of Australia.

Why overall wine tax revenue should not increase

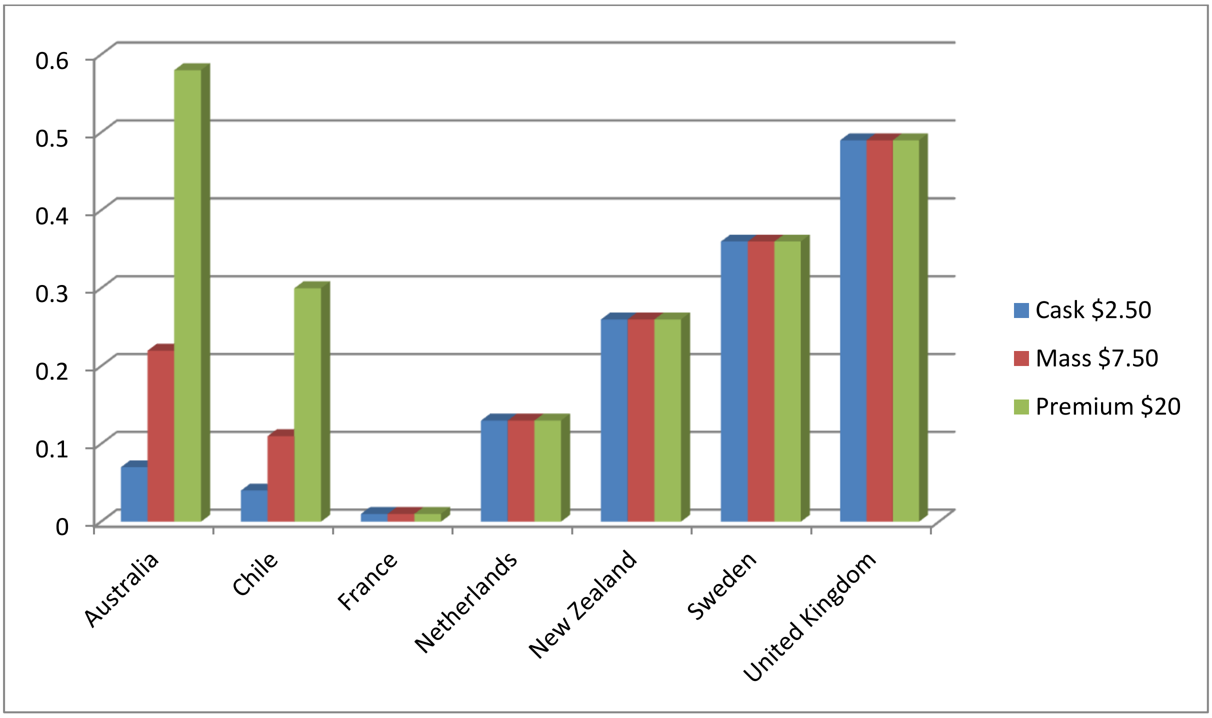
Although Pernod Ricard Winemakers supports a move to category-based volumetric tax for wine, we do not support the concept of using spill over costs as the basis for calculating alcohol tax.

Public health policy aimed at harm minimisation should be targeted towards those in society who abuse alcohol, rather than penalising responsible drinkers through inefficient and ineffective approaches which attempt to change the behaviour of those most at risk.

As outlined by the Winemakers' Federation of Australia, those most at risk of harmful consumption are the least sensitive to price changes, so increasing the tax revenue on all wine would affect consumption patterns of responsible drinkers but have less effect on those most needing intervention.

We also note that for premium wines retailing at $12, Australia has the highest wine tax rate for wine producing companies, with a rate more than 40 times higher than France, more than 7 times higher than South Africa and nearly 5 times higher than the United States. Italy and Germany do not impose a wine tax at all. Further information on Australia's high tax rate for wine can be found in the Winemakers' Federation of Australia submission.

Selected international tax rates ($A per standard drink) at different price points:



(Source: Professor K Anderson, University of Adelaide)

Why wine should not be an excisable good

Wine tax can and should be reformed without increasing the burden of complex and costly administration. The simplest means of achieving a better, simpler, fairer wine tax system would be to amend the existing WET legislation.

This would result in wine continuing to be treated as a non-excisable good, and therefore not subject to the costly imposts of bonded warehouse storage, inspections, weekly settlements and permissions to move product around the country. This is particularly important for winemakers who may move bulk wine parcels from different wine regions to blend together to create their final product.

Industry assistance through transition

Changes to Australia's wine tax structure will have an impact on some industry participants. It is essential that targeted assistance be provided, on a transitional basis, to help those adversely impacted to adjust their business model, or to exit the industry.

Pernod Ricard Winemakers looks forward to working with government and other stakeholders on models that move the sector from a complex and unfair system to a better, simpler, fairer wine tax model.