Premium Wine Brands' Submission to Federal Government Tax Forum

October 2011

Executive Summary

Premium Wine Brands (PWB) welcomes the opportunity to contribute to the Federal Government's forum, *Tax Reform: Next Steps for Australia*.

PWB is a truly global business with winemaking operations in Australia, New Zealand, Spain, South Africa, Argentina and China. Australia is the global headquarters of our wine business and, as one of the largest winemakers in Australia and the owner of several major Australian global wine brands including Jacob's Creek and Wyndham Estate, PWB is passionate about the Australian wine industry and committed to its sustainable growth and development.

The structural oversupply of Australian wine and the dumping of excess wine into both our domestic and export markets is causing immeasurable damage to the Australian wine industry and threatens its long term sustainability. We recognise that efforts have been made by the industry, led by the peak bodies, to reduce production, but these efforts have not resulted in any significant restructuring. This is evidenced by the fact that, despite adverse weather conditions, latest figures show an increase in wine production in the 2011 harvest[1] where we would have expected to see a significant drop off from 2010 figures.

The Government has previously stated that it will not "change alcohol tax in the middle of a wine glut and where there is an industry restructure underway".[2] However, PWB believes that existing wine tax arrangements are distorting market forces by sustaining the 20 per cent of vineyards which the industry Wine Restructuring Action Agenda found to be surplus to market requirements and incentivising the production and sale of cheaper wines, contrary to the industry endorsed strategy of value building through premium, branded products. We believe that tax reform would end these distortions and allow normal market forces to address the structural oversupply issues.

Accordingly, we submit the following:

- The WET rebate system should be abolished, or if this is not supported, significantly restructured so that it only applies to sales of packaged wine by producers direct to consumers – this will remove or significantly reduce a subsidy which is inhibiting the industry reform agenda;

- To support sustainable value growth of the industry and to incentivise the production of premium products, the existing wine tax system should be reformed so that wine is taxed on a volumetric basis, with the rate set to reflect a revenue neutral approach;

- The rate of volumetric tax should be set in a practical manner which takes into account the fact that, unlike other alcohol beverage categories, winemakers are unable to precisely control the final alcohol content of their product and having a different amount of tax applying to each individual product and wine blend is unnecessarily complex;

- The volumetric wine tax should be administered through the existing wine tax system, avoiding the need for excessive administrative burdens and complexity for the industry, in particular small winemakers;

[1] WFA 2011 Vintage Report, 9 June 2011,
[2] Federal Government Initial Response to the Henry Review, 2 May 2010

- The industry reform agenda requires support and consideration should be given to investing a portion of the savings generated through the proposed tax reform in demand and supply side industry initiatives on a short term, transitional basis.

We understand that these are complex issues, with a wide variety of stakeholders, and would therefore ask that the Government undertake a review of wine taxation in the run up to the next Budget with a view to securing agreement on reforms that will deliver urgently required assistance to the industry.

Introduction

As one of the largest winemakers in Australia, PWB welcomes the opportunity to contribute to the Federal Government's forum, *Tax Reform: Next Steps for Australia*.

We believe that this consultation and subsequent forum process offers the opportunity for the Government to address the critically important issue of oversupply of Australian wine and remove some of unintended and damaging consequences of the existing tax arrangements for wine.

Our long history of winemaking in this country places us in a good position to respond to the Government's consultation in the area of alcohol (and specifically wine) taxation and it is in this area that we would like to focus our submission.

Premium Wine Brands

PWB is the wine division of Pernod Ricard, the world's co-leader in wine and spirits brands. In addition to global Australian wine brands such as Jacob's Creek and Wyndham Estate, PWB also distributes Pernod Ricard brands such as Chivas, Absolut and Malibu in a number of domestic markets, including Australia.

Pernod Ricard purchased the Barossa based wine company Orlando Wines in 1989. A year later it also purchased the Wyndham Estate wines in the Hunter Valley and merged the two to create the Orlando Wyndham Group.

In 2010 Pernod Ricard launched its new global wine division, Premium Wine Brands, based in Australia. PWB now has a complementary portfolio of premium wine brands from Australia, New Zealand, Argentina and Spain led by our key brands, Jacob's Creek, Brancott Estate, Graffigna and Campo Viejo.

PWB has a long and proud history of winemaking in Australia. We are passionate about the sustainable growth and development of wine from this country. Our strategy is to build value through strong brands supported by premium wine, and we continue to invest behind this vision.

The Australian Wine Industry

Australian wine has been a great success story over the past twenty years. The Australian wine industry has managed to establish a strong reputation at home and abroad as a supplier of consistent, quality wines which offer the consumer true value for money.

Through this growth the wine industry has given a lot back to Australia – wine is now the third largest agricultural export with export sales of approximately $2 billion and around 60,000 people directly and indirectly employed by the industry.[3]

PWB has been at the forefront of building successful wine brands for both the Australian and export markets. Our Jacob's Creek brand, for example, is truly a global brand with a strong presence in markets across Europe, North America and Asia. PWB believes it is crucial to maintain this focus on strong brands, quality and value growth as we continue to expand into rapidly growing markets such as China and India.

The Australian wine industry has matured and can no longer be seen as an homogenous industry – different business models have evolved (in some cases, as a result of the wine glut), some focussing on lower value, high volume products and others focussing on premium, branded products, which are positioned to deliver long term value growth. These business models are all impacted by wine tax arrangements. It is impossible to have a wine tax system which benefits all industry players and choices need to be made.

[3] Figures from WFA

Oversupply - The Urgent Challenge Facing Australian Wine

At PWB we see the continuing oversupply of Australian wine as the most significant challenge facing the industry and one which requires urgent intervention.

The damaging results of the wine glut have included:

- Unsustainably low grape prices in Australia threatening continued grape supply from all growers and not just those who have uneconomic business structures;
- Damage to the Australian wine brand as a result of:
    - the poor quality products finding their way to market with a focus on volume sales and not value building;
    - cheap “cleanskin” and retailer brands (utilising cheap excess wine) which now dominate sectors of the wine market;

  forcing entrenched discounting in both the Australian and export markets for all industry players;
- A threat to critical overseas markets stemming from bulk wine being ‘dumped’ into these markets.

The outcome of this is clear. Market share for Australian wine in the domestic off-trade market by value has dropped from around 86 per cent in 2008 to under 80 per cent currently, and continues to decline. Over roughly the same period the value of exports for Australian bottled wine has dropped from just under $2.5 billion to $1.6 billion.[4]

The industry faces many significant challenges, including an appreciating Australian dollar and global economic pressures, and we recognise that oversupply is not the only factor contributing to these trends. However, we believe that the damage being caused by oversupply is a key cause and is one of the few factors that can be changed.

Recognising the serious damage associated with oversupply, the peak industry bodies, including the Winemakers’ Federation of Australia, launched a Wine Restructuring Action Agenda in November 2009. [5]

This initiative aimed to combat what was seen at the time as temporary oversupply in the market with measures such as improved exit packages for growers and small wineries leaving the industry; toolkits to assist with assessments of winery profitability and viability; and, a general education campaign about the need for the industry to restructure for long term sustainability.

Shortly after this, in May 2010, the Government, in its response to its Australia’s Future Tax System review, stated that it would not “change alcohol tax in the middle of a wine glut and where there is an industry restructure underway.” [6]

The WFA released an update on progress of the WRAA in December 2010.[7] Despite some small progress with vineyard removals the conclusion of this update was that the necessary reform was not progressing as expected. In this update the WFA concluded that the damaging trend of dumping cheap wine on overseas markets had “become more entrenched” and that, despite market signals, “adjustment was not proceeding at a sufficient pace”.

Recent survey figures released by the WFA on the 2011 vintage[8] are further evidence that the industry attempt to ‘restructure’ is failing. The figures for 2011 show a harvest of just over 1.6 million tonnes. This represents a one per cent increase on the 2010 figure despite the adverse weather conditions for winemaking experienced in 2011.

PWB’s production of wine in the 2011 vintage dropped by roughly 30 per cent as a result of adverse weather and disease conditions and PWB maintaining its quality standards for the fruit picked. We were expecting to see a similar drop off in production across the sector. The fact that this did not occur demonstrates that the current industry restructuring strategy is not sufficient, in itself, to achieve the necessary outcomes.

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[4] Wine Australia Figures
[5] WFA Statement, ‘*Wine must confront the reality of oversupply*’, 10 November 2009
[6] Federal Government Initial Response to the Henry Review, 2 May 2010
[7] WFA Statement, ‘*Wine sector must continue to focus on transition*’, 6 December 2010
[8] WFA 2011 Vintage Report, 9 June 2011,

PWB is a strong supporter of the Wine Restructuring Action Agenda being run by the WFA. It was our expectation that market forces would operate to exit unsustainable sources of supply from the market. It is now clear that there are factors which are distorting the expected market response and we see both the WET rebate and the existing wine tax arrangements as key contributors to these distortions. The structural supply imbalance within the Australian wine industry is no longer temporary and needs to be urgently addressed to allow the industry to return to a value building growth model.

Addressing Wine Oversupply – WET Rebate Reform

Under the WET rebate system all wine producers are currently eligible for a rebate of up to $500,000 on the wine tax they pay.

Currently, of the $900 million WET collected every year by the Government, in excess of $200 million is returned to the industry through the WET rebate system. As the definition of producer used for the purposes of the rebate is very broad, many retailers and others have been able to legitimately structure their sourcing arrangements so that they either qualify for the rebate or can effectively use it to subsidise their wine purchases. Due to the current WET rebate blending rules, the rebate can also be claimed multiple times through the supply chain with respect to a single wine.

Overseas producers are also claiming the rebate, which they are entitled to under bilateral trade rules – industry estimates that up to $30 million is being claimed by NZ producers as a WET rebate each year.

It is PWB's view that the WET rebate is inhibiting industry restructuring as it subsidises producers who would otherwise not be able to compete in the market and restricts consolidation in the industry (as a result of how the rebate is structured).

Despite the fact that PWB currently benefits from the WET rebate we believe that its abolition would be in the best interests of the wine industry.

We recognise, however, the Government's desire to protect small vineyards offering a broader benefit, particularly in terms of tourism and employment, and should our proposal to abolish the WET rebate not be supported, we would propose reform of the rebate to limit its operation to the sale of packaged wine by producers direct to consumers. This would enable policy objectives to be pursued without the existing unintended consequences.

Addressing Wine Oversupply – Wine Tax Reform

Tax is currently levied on wine in Australia through the Wine Equalisation Tax (WET) system at a rate of 29 per cent on the wholesale price of the product. WET is administered through the BAS system in the same way as other business taxes.

Taxing wine on the basis of value rather than alcohol content means that low cost wine products attract a significantly lower tax burden than premium products. This, in turn, creates a price incentive for people to buy (and therefore for the industry to produce) low cost wines, fuelling the oversupply and inhibiting industry restructuring.

PWB supports the reform of the wine tax system in Australia so that wine is taxed by alcohol content (i.e. a volumetric tax), with the tax rate set to reflect a revenue neutral approach. We support the retention of the existing category based approach to alcohol taxes as we believe that this reflects the differing economic contributions made by the various alcohol sectors and is in line with global practice. A practical approach would need to be taken in relation to administering such a tax as:

- winemakers are unable to control the final alcohol content of their products (unlike other alcohol sectors) and having a different amount of tax apply to every product/blend is overly complex; and
- many participants within the wine industry are small wineries who lack the resources to administer a complex bonded system.

We believe that a volumetric wine tax could be implemented and administered through changes to the existing WET legislation with a flat rate(s) of tax applied per litre of wine.

We expect that such a reform would achieve the following for the Australian wine industry:

- Remove incentives in the tax system for the production of low value wine
- Greatly assist the Australian wine industry in delivering on its stated strategy of focusing on premium products (as set out in the wine industry strategy document, *Wine Australia: Strategy to 2025*).
- Assist in ending the glut of wine that undermines the competitiveness of Australian wine and devalues our brand in both the domestic and export markets.

The Henry Review and Wine Taxation

We note that the recommendations in relation to alcohol tax contained in the Australian Future Tax System were based on the premise that tax revenue from alcohol should meet the supposed "spillover" costs of alcohol related harm to society.

It is important to note that whilst PWB agrees with the review's call to shift wine to a volumetric system we do not agree with the concept of using spillover costs as a basis for alcohol taxation. We do not believe there is any conceptual or practical justification for setting the rate of tax on alcohol according to a calculation of the spillover costs of alcohol.

The objective of policy on alcohol and public health should be to reduce, and ideally eliminate, abuse of alcohol products that leads to harm. This is best achieved through interventions targeted at the small minority of people who abuse alcohol by drinking at harmful levels.

In addition, there are material practical difficulties associated with estimating the spillover costs. In the past, these costs have been significantly overstated[9] and more recent research has demonstrated that correct figure, based on standard economic processes, is approximately $3.8 billion, significantly less than the current revenue from alcohol taxes.[10]

Conclusion

Oversupply of Australian wine is the most significant issue facing the Australian wine industry at this time.

Without urgent policy action to reform wine taxation, it is a problem that will only get worse. We believe that reputational damage to Australian wine is already occurring as a result of the quality of some of the wine that is being produced due to structural oversupply.

It is also not inconceivable that some of our key export markets may start putting in place restrictions on the import of Australian wine as a result of dumping of wine in their markets. Such action would only serve to further damage the business interests of exporters who are investing behind strong Australian wine brands.

Australia is well placed to compete in the global wine market on the basis of quality, branded products. It is not able to sustainably compete on the basis of wine as a high volume, low cost commodity.

We understand that there is naturally a high level of concern within the industry regarding the possible effects of wine tax reform. We also understand the Government's stated position not to attempt reform whilst the industry is restructuring.

Given the crisis that the industry faces and the failure of its own attempts to address this, we would ask the Government to revisit its policy position and to consider our view that proper, well thought through tax reform is actually essential to allow this restructuring process to achieve its objectives. This is critical to building a sustainable wine industry which is capable of value growth into the future.

[9] David Collins/Helen Lapsley, '*The avoidable costs of alcohol abuse in Australia and the potential benefits of effective policies to reduce the social cost of alcohol*', 2008
[10] Eric Crampton/Matt Burgess/Brad Taylor, '*The Cost of Cost Studies'*, 2011