Winemakers' Federation of Australia

leadership strategy advocacy support

29 April 2016

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

(Submitted via Committee's website)

Dear Chair,

The Winemakers' Federation of Australia (WFA) welcomes the opportunity to contribute to the Senate Standing Committee on Economics inquiry into anti-competitive conduct in the retail sector of the Australian wine industry and the role the Australian Competition and Consumer Commission (ACCC) can play. We have structured our submission to reflect the stated focal points of the Committee's inquiry, being 1) to determine if there is anti-competitive behaviour in the retail sector of the Australian wine industry, 2) what the ACCC can do to promote competition and 3) any impediments that are preventing the regulator from performing its function effectively.

The wine sector is enthusiastic about its future and highly motivated to resolve issues that threaten enhanced productivity and profitability. The last ten years have been characterised by continuing low profitability, flat domestic demand and a marked decline in exports (albeit with some recent encouraging, early signs of recovery in traditional markets and new Asian markets). One of the factors contributing to low profitability has been the increasing market power of the major wine retailers. Our analysis indicates that the two major supermarket chains now control over 70 per cent of total domestic off-premise sales.

WFA has undertaken considerable work in these last few years to better understand the challenging market conditions for Australian wine. This work has been used to develop, and to action, proposals which address these challenges. One of the WFA's 'Actions' is to "Maximise Open and Fair Domestic Competition" by working with the national wine retailers and competition regulator on fairness, transparency and equity in the domestic wine market. The aim for this Action is for a more sustainable domestic marketplace for industry where companies can grow share through quality, innovation and investment.

In addressing this Action, the WFA has developed and signed a Code of Conduct (refer to Attachment .1.) with the largest wine retailer, titled "Good Wine Buyer and Supplier Principles: A Code for Fairness and Transparency" which outlines an acceptable level of market behaviour and a dispute resolution process. Negotiations on a similar agreement with other retailers are underway. But there is more that can be done – in terms of understanding the nature and prevalence of anti-competitive behaviour and of the practical steps that can be taken to address it. This inquiry represents an opportunity to investigate and progress these important matters.

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Anti-competitive behaviour in retail sector of the Australian wine industry

The wine industry continues to be concerned at the level of market power of the two dominant domestic wine retailers. The situation has been exacerbated by their ability (backed by Competition Law) to vertically integrate into wine production and vineyard ownership. For many winemakers, the retailers are now both their major customer and major competitor and this has subsequently introduced a higher level of insecurity in regards to brand management, discounting, contracting and certainty in future sales. This position has also enabled retailers to grow their own 'home brand' segment in a domestic market already in oversupply and to suppress retail and wholesale pricing growth and winemaker margins. Ultimately this translates into low wine grape prices. (Refer to Attachments .2. and .3. for more information.)

What the ACCC can do to promote competition

The WFA believe the ACCC has an opportunity to better support competition through greater vigilance in assessing two principle activities, being creeping acquisitions and predatory pricing. The recent decision by the Government, to amend Section 46 of the CCA with the removal of the 'misuse of market power test' in favour of an 'effects test' is very welcome and indeed should result in the ACCC having greater clarity in assessing these types of matters.

WFA supported the Recommendation 30 in the final report of the Harper Competition Policy Review to remove the 'take advantage test' and move from the current 'purpose test' to an 'effects test'. WFA believe that the current 'take advantage test' is particularly ineffective as unfair practices undertaken by companies with significant market power will have substantially more impact than the same activities undertaken by smaller businesses. An example from the wine industry would be one of the national chains charging the producer for the margin which they have had to give away to meet a competitor's price (who may be a small single owner-operator operating in a regional market) on a similar product sold to that competitor by the same producer.

Any impediments that are preventing the regulator from performing its function effectively

The Expert Review the WFA commissioned in 2013 provided good initial analysis of the domestic market and the impact of retail consolidation on margins and profitability. This works needs to be continued to help build a comprehensive fact base, to inform future policy discussions and to support the work of the ACCC. WFA believes the Productivity Commission has the appropriate resourcing and expertise to conduct such research. Ahead of the new effects test coming into force, a review of the Australian wine retail industry would be timely and would support the ACCC in its application of its newly framed assessment and enforcement powers.

We commend these views to you and welcome further dialogue. We would be happy to take questions on this submission or to appear at any hearings as part of the Committee's inquiry.

Yours sincerely,

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President

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Attachments:

1. “Good Wine Buyer and Supplier Principles: A Code for Fairness and Transparency”

   The Winemakers' Federation of Australia and Woolworths Liquor Group (WLG) have developed a set of Good Wine Buyer and Supplier Principles and a plain-English guide, for reference and consideration when negotiating a commercial agreement with WLG.

2. Excerpt taken from WFA’s submission to the Senate Inquiry into the Australian grape and wine industry. Excerpt addresses one of the terms of reference being, (g) ‘The power and influence of the retailers of Australian wine in domestic markets”. This excerpt provides additional background to the issues raised in this submission.

3. Wine Industry Report, Expert Report on the Profitability and Dynamics of the Australian Wine Industry, commissioned by the WFA and produced by Centaurus Partners, August 2013.

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Attachment 1

GOOD WINE BUYER AND SUPPLIER PRINCIPLES

A Code for Fairness and Transparency.

wfa Winemakers' Federation of Australia

WOOLWORTHS LIQUOR GROUP

CONTENTS

Good Wine Buyer and Supplier Principles

Plain English Guide to the Good Wine Buyer and Supplier Principles

PREAMBLE

The primary obligation of Woolworths Liquor Group (WLG), both in its own right and in the best interests of its wine suppliers, is to place retail customers at the centre of everything it does.

WLG also recognises that its role in delivering the highest quality products and the best available prices to its customers is only possible by entering commercial partnerships with wine suppliers that are mutually beneficial to WLG and wine suppliers and which promote a sustainable and diverse industry.

The Australian wine industry is highly fragmented. Large multinational entities market brands alongside small local producers, and sell through a diversity of outlets from retail chains, hospitality outlets, single stores, online and boutique cellar doors. This requires a flexible approach from WLG to the commercial relationship, particularly for small and medium sized enterprises.

WLG and the Winemakers' Federation of Australia (WFA), acting for the benefit of Australian wine producers and for customer choice, agree that WLG and wine suppliers will act honestly and deal fairly with each other and will be transparent in their processes and decision making, within the limitations of commercial confidentiality. WLG will reflect these good wine buyer and supplier principles set out in this document (the Principles) and WFA will encourage wine suppliers to do likewise in all agreements and dealings. Implicit and explicit in this approach is that neither party will in any way unfairly disadvantage the other for requesting adherence to these Principles.

WLG and wine suppliers agree to honour the spirit and intent of these Principles which will be supported through the dispute mechanism of this code that allows a review of any decision or action deemed unfair or contrary to these Principles by a third party agreed to by WLG and WFA.

A joint forum made up of WLG and WFA representatives will ensure the Principles are publicised and promoted; monitored for compliance; and regularly reviewed. Each organisation will also appoint a Compliance Manager as the first point of contact in understanding how the Principles work.

WLG and WFA will formally review the Principles every two years from 1 July 2014 to consider any changes in scope and content necessary to ensure their on-going relevance and effectiveness.

WFA and WLG have developed a plain-English guide to these Principles which should be referenced and considered when negotiating a commercial agreement.

PRINCIPLE 1: A FAIR AND CLEAR COMMERCIAL RELATIONSHIP

1.1 WLG will deal fairly and lawfully with wine suppliers without distinction between formal or informal arrangements. Parties will record all formal and informal agreements in writing as soon as possible after an agreement has been reached.

1.2 WLG recognises wine is an agricultural product that is subject to seasonal variation and long production lead times. This can vary production, delivery and payment risks and costs of trading for suppliers and this in turn may require reasonable price adjustments to be considered against prevailing market competition. To give certainty, WLG and wine suppliers will provide each other with as much notice as reasonably possible regarding any change to supply chain, ordering, invoicing, delivery or packaging requirements, and will minimise any detriment or disadvantage caused by those changes.

1.3 WLG will ensure that wine suppliers are fully informed throughout all aspects of the commercial relationship and, when negotiating an agreement, explain all trading terms, ranging and rebate expectations, methodologies and how these apply in invoicing and payment practices to enable wine suppliers certainty in business planning and to set in place appropriate accounting, accrual and audit systems. WLG recognises that smaller suppliers may take longer to adapt to changes in invoicing.

1.4 Trading Agreements with wine suppliers will not allow for unilateral changes by either party and will be drafted in clear, plain English and unambiguous terms, setting out the circumstances in which activities will be undertaken and how. Where requested or agreed, WLG will provide information or data to enable verification of all rebates, marketing and promotional claims.

1.5 At all times WLG will respect the rights of suppliers to work through distributors and distributors should respect the rights of wine suppliers that elect to utilise WLG national distribution and logistics infrastructure as a direct route to market.

1.6 Wine suppliers should remain aware of WLG expectation of receiving an offer of supply at a price commensurate with the commercial advantages WLG can provide, such as national distribution, disciplined execution, volume sales and certainty of payment.

PRINCIPLE 2: CLARITY IN MARKETING AND PROMOTIONAL ACTIVITY

2.1 Promotional activities where the wine supplier agrees to provide pricing support should be agreed in advance and be for a predetermined period that can only be extended by further agreement. WLG retains the right to select and rapidly respond to competitor activity, but should endeavour to give the wine supplier advice of any variation or change to promotional activity permitted in an agreement or promotional program with appropriate notice and details of the reasons for the change. In the event of any hardship or unreasonable disadvantage arising from the variation or change, either party may seek to negotiate a mutually acceptable outcome.

2.2 Wine suppliers may from time-to-time be offered the opportunity to participate in over-and-above promotional activity such as seasonal catalogues, buyers guides, receipt offers and sponsorship opportunities, etc. Participation in any of these activities is at the wine supplier's sole discretion and all negotiations on promotional activity will give due regard to the value of the participant's brand and a fair division of the costs of the promotion between WLG and wine suppliers.

2.3 WLG reserves the right to conduct promotional activity with a view to ensuring:

a) retail customers receive the best possible value;

b) the sustainability and continued vibrancy of Australian wine suppliers;

c) WLG meets its category objectives in sales and margins; and

d) the preservation and enhancement of brand equity for both WLG and its wine suppliers

And similarly WLG will respect the right of each wine supplier to set its wholesale price and promotional activity with WLG which seeks to meet the wine supplier's objective on sales and margins.

PRINCIPLE 3: OPEN, HONEST AND EARLY COMMUNICATION

3.1 WLG will use best endeavours to maintain ongoing open dialogue with wine suppliers on the performance of their brands within the WLG range and as part of a range review. Wine suppliers should constantly monitor the performance of their range and understand which lines may have the potential for delisting before a range review and make sufficient preparations should this eventuate.

3.2 Wine suppliers are encouraged to monitor www.wlgpartners.com.au for notice of any range review. The primary purpose of these reviews is to best reflect what retail customers are seeking while taking into consideration margin expectations, rate of sale, market trends and performance of a product versus its competitive set. The outcome of the review, including a decision to de-list a product, will also be communicated at the time the action is taken and will include advice on the benchmarks and indicators used to determine deletion. Range reviews generally take between ten to twelve weeks to finalise.

3.3 WLG and wine suppliers will keep confidential any information not already in the public domain regarding all aspects of each other's business and only use that information for the purpose for which it has been disclosed. Confidential information includes, but is not limited to: business plans, pricing, promotions, discounts offered, financial condition, results of operations, intellectual property, brand development, product development, marketing strategies or any development plan.

PRINCIPLE 4: PROTECTION OF INTELLECTUAL PROPERTY

4.1 WLG and wine suppliers will respect each other's intellectual property, branding, packaging and marketing strategies and will not take any action which could reasonably be seen to devalue, or unfairly capitalise upon, the intellectual property of the other.

4.2 Unless requested by WLG and agreed by the supplier, WLG will ensure that confidential supplier information (including the categories of information described in clause 3.3) is not shared with Pinnacle Drinks (WLG's wine making and contracting business).

PRINCIPLE 5: DISPUTE RESOLUTION

5.1 Suppliers should be encouraged to first seek resolution directly with the respective WLG buying team and are able to request a review by the respective banner Merchandise Manager. If still unresolved, the wine supplier can request a review by the WLG General Manager Merchandising.

5.2 Where matters cannot be resolved, the wine supplier can have the matter referred to WLG's and/or WFA's Compliance Manager to conduct a review.

5.3 Where matters are still unresolved to both parties satisfaction, an independent expert will be appointed from a list of experts agreed to by a panel of WLG and WFA representatives.

5.4 Wine suppliers are also encouraged to put in place a mechanism to allow for a review of any decision relating to its relationship with WLG that it deems to be unfair or contrary to these Principles.

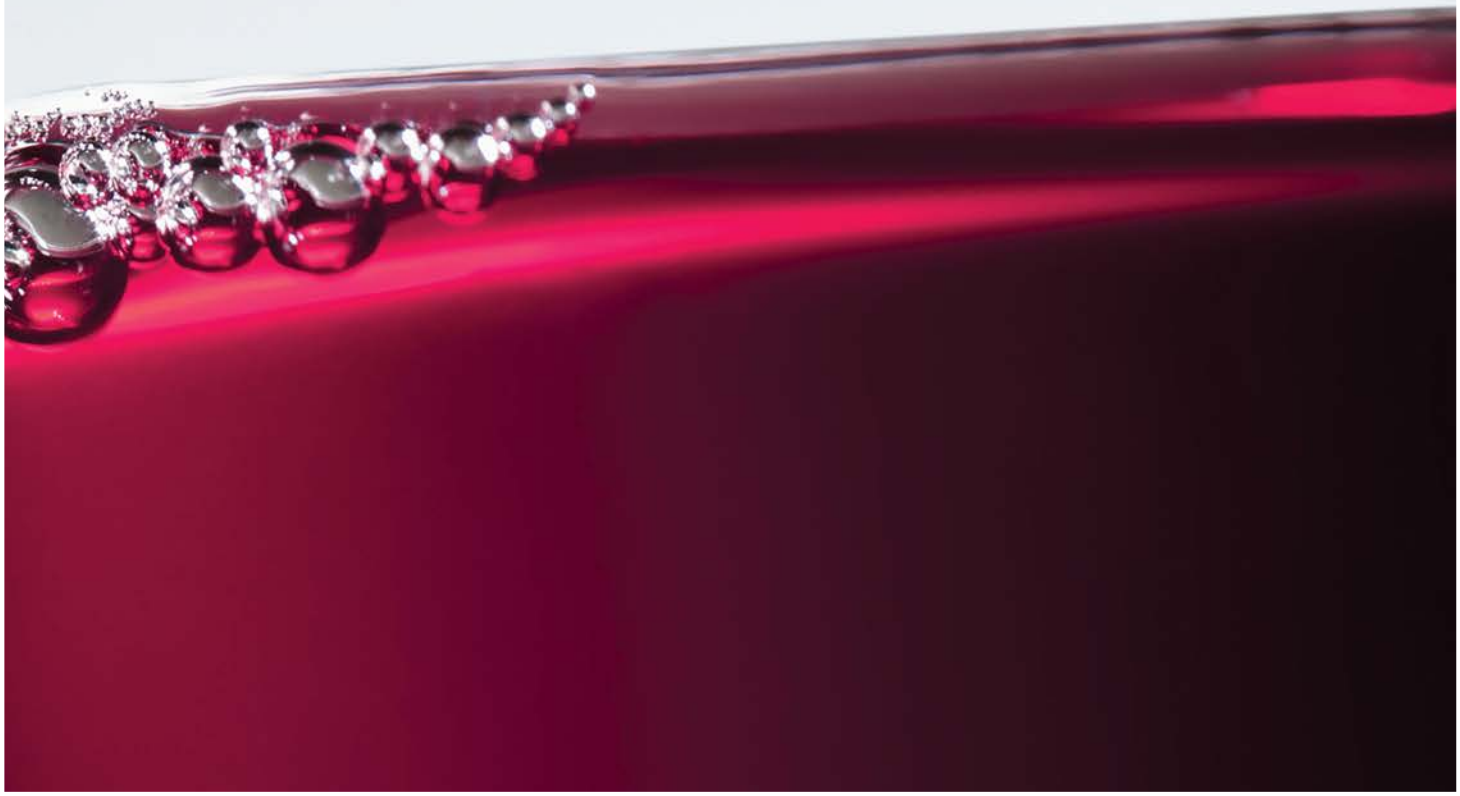
5.5 WLG and WFA will, based on cases which may be the subject of a dispute, issue guidelines or advice to wine suppliers to minimise the issue arising in the future with other wine suppliers and they together or separately issue other guidelines which they see as desirable to give effect to the spirit and intention of the Principles.

Attachment 1

PLAIN ENGLISH GUIDE TO THE GOOD WINE BUYER AND SUPPLIER PRINCIPLES

Winemakers' Federation of Australia

WOOLWORTHS LIQUOR GROUP



1. INTRODUCTION

1.1 What are the Good Wine Buyer and Supplier Principles?

The Good Wine Buyer and Supplier Principles (the Principles) have been agreed between the Winemakers' Federation of Australia (WFA) and Woolworths Liquor Group (WLG). They were created to provide guidance to wine suppliers and WLG employees in managing their commercial relationships. The Principles are to be used in creating and managing relationships between WLG and individual wine suppliers. The Principles manifest WLG's and wine suppliers intention to work collaboratively.

1.2 What are the Principles meant to achieve?

The Principles are intended to set a minimum standard of behaviour for both individual wine suppliers and WLG when:

(a) negotiating the commercial relationship ;

(b) working together;

(c) communicating about issues and concerns;

(d) dealing with each other's intellectual property; and

(e) dealing with disputes.

They basically require the parties to act honestly and deal fairly with each other and be transparent in their processes and decision making.

1.3 What are the Principles not designed or intended to do?

The Principles are not intended to resolve all issues relating to supply and demand imbalances and structure within the wine industry and should not provide any form of advantage for either WLG or wine suppliers. Instead, the Principles are intended to encourage fair and balanced behaviours in the commercial relationships between WLG and individual wine suppliers.

Importantly, the Principles are not designed to be used by groups of wine suppliers to extract concessions from WLG by working together. Wine suppliers who collude or coordinate their negotiations with WLG might breach competition laws. You should never coordinate your negotiations with other wine suppliers without first obtaining independent legal advice to make sure you won't breach any competition laws.

1.4 How the Principles apply?

The Principles are not legally binding on any party. Rather, parties will be bound by the terms of any commercial agreement they might enter into. The Principles give parties guidance on how they should act when negotiating and operating within the commercial relationship.

Importantly, it is not necessary for a wine supplier to be a WFA member to be able to use the Principles.

1.5 Who is responsible for the Good Wine Buyer Principles?

Both WLG and wine suppliers should follow the Principles. A joint forum, made up of representatives of both WLG and WFA, will be responsible for making sure they are promoted, monitored for compliance and reviewed every two years.

Both WFA and WLG have appointed Compliance Managers to act as the first point of contact in understanding how the Principles work. Compliance Managers also have a role to help parties work together to address any problems between them and are a step in the dispute resolution process.

1.6 What does this guide contain?

This guide provides a 'plain English' explanation of the Principles and how they are intended to work in practice. Whilst it is meant to help you in negotiations and dealings with WLG, it is not meant to replace the Principles and does not bind any party. You should always refer to the Principles directly when you have a concern about the other party's behaviour.

2. BEFORE YOU ENTER A COMMERCIAL RELATIONSHIP

2.1 Acting honestly and fairly

Both wine suppliers and WLG must act honestly and fairly at all times when dealing with each other, before and during a commercial relationship.

That does not mean that parties are required to act against their own interests or that they can't take a firm commercial position. Instead, it is intended to make sure that the parties:

(a) act honestly and fairly with each other;

(b) do not mislead or deceive each other;

(c) never intimidate the other party or force them to take any action or position beyond using reasonable commercial pressure;

(d) never make unrealistic threats or promises;

(e) never hide or fail to disclose important facts or issues;

(f) maintain lines of communication with appropriate levels of management;

(g) never unreasonably delay decisions or negotiations; and

(h) never assert that they have rights or powers beyond those that they do have.

Parties should strive to act commercially, honestly and fairly in all of their dealings.

2.2 Transparent communications

The Principles require parties to maintain an open dialogue in relation to brand performance and to be otherwise transparent in their processes and decision making (within the limits of commercial confidentiality). This is to ensure that neither WLG nor wine suppliers face unexpected issues in their business relationship. While recognising that WLG retains the right to rapidly respond to competitor activity, the parties should endeavour to clearly communicate with each other:

(a) their expectations of how the other party is to act;

(b) the reason for decisions ;

(c) any changes in quality, volume or availability of a given product;

(d) any changes to trading terms or supply chain or purchasing practices (to be communicated well in advance);

(e) planned promotions or changes to promotions; and

(f) any decision to delist, review the "ranging" of or modify an order for a particular product.

In regards to sales figures and other industry data, wine suppliers are encouraged to access their own data on sector and company performance as this information cannot always be seamlessly shared by the retailer due to confidentiality agreements between them and the data supplier. However, WLG will provide supporting data to verify any claims with suppliers.

WLG reserves the right to conduct promotional activity with a view to ensuring their retail customers receive the best possible value. Equally, wine suppliers have the right to negotiate and set a wholesale price that meets the supplier's sales and margin objectives.

By providing regular and honest communications, parties can avoid disputes and work together to address issues that arise.

2.3 What does 'plain English' drafting mean?

While commercial agreements are legal documents, every effort should be made to make them easy to understand. Technical terms, legal phrases, ambiguity and complicated language should be avoided, if possible, and short sentences should be used. If a technical term needs to be used, it should be explained clearly wherever possible.

2.4 Informal agreements vs formal agreements

WLG and WFA have recognised that, in the wine industry, commercial agreements are sometimes reached informally. This could be in person, over the phone or via email. Common law recognises that both formal and informal agreements have legal force. The Principles encourage equal respect be given by WLG and wine suppliers.

To make sure that this happens, all informal agreements should be confirmed in writing as soon as possible after they have been made. This does not have to be in a long-form legal document, but could be as simple as a letter or email which is agreed by both parties, setting out the agreement or variation in plain English terms.

3. NEGOTIATING A COMMERCIAL RELATIONSHIP

3.1 How should the Principles be used in negotiations?

The Principles are intended to be used as a tool by WLG and individual wine suppliers when negotiating a commercial relationship, promotional agreement or variation. Both parties are expected to ensure that agreements are consistent with the Principles.

The Principles can be used in two ways:

(a) to set the agenda for the negotiations; and

(b) as a reference point to make sure that the commercial relationship is fair and transparent.

We recommend that you read through this guide and the Principles before you begin negotiations, with a view to having a smooth negotiation and achieving a fair outcome.

If you consider that the other party is requesting a provision that is inconsistent with the Principles, you should feel free to point them to the relevant clause of the Principles and request their compliance. If they disagree with you, you could require the issue to be resolved by dispute resolution, as discussed in section 7 of this guide.

Once a commercial agreement has been drafted and negotiated, but before it has been signed, both WLG and the wine supplier should compare it to the Principles and consider whether or not it is consistent. Any issues should be raised and changes should be made to the agreement to ensure that it complies with the Principles.

Both parties are encouraged to obtain legal advice on the terms of all commercial agreements, promotional agreements and variations before they are signed.

3.2 What should your documents for the commercial relationship contain?

The Principles encourage the parties to consider a number of key issues when negotiating the commercial relationship. These include:

(a) production targets and indications of proposed purchase volumes;

(b) delivery requirements;

(c) trading and payment terms (including supply chain, ordering, invoicing and packaging requirements);

(d) who bears the costs of trading;

(e) ranging and rebate expectations;

(f) promotional activity;

(g) how variations and changes to commercial agreements are to be handled;

(h) the process for suggesting (and agreeing to) new promotions during the term of the commercial relationship ;

(i) processes for how a product can be delisted or discontinued and how the process will be managed; and

(j) processes for dealing with disputes and complaints and reviewing decisions.

The commercial relationship should make clear:

(a) the methodologies of how ranging decisions are made; and

(b) agreed promotional activities, including the timing and duration of those activities and anticipated sales to be provided by either party.

3.3 What should not be allowed in a commercial relationship?

Parties should not include in the commercial relationship :

(a) a right for one party to make changes to the agreement without the other party also agreeing to that change (a unilateral change);

(b) any penalty for or restriction against using a distributor

(c) a unilateral right to commence or extend an agreed promotion, except for WLG in response to competitor activity and where permitted in an agreement or promotional programme agreed by the parties;

(d) a prohibition against reviewing decisions or using dispute resolution mechanisms; or

(e) terms that are otherwise unfair.

3.4 Are there rules for how parties behave in negotiations?

In negotiations, each party is entitled to seek a commercially sound and competitive deal. WLG can expect a price that reflects the commercial advantages it can provide to the wine supplier. The parties must, however, ensure that the agreement is beneficial to both parties and sustainable for the wine supplier in the long term. WLG reserves the right to conduct promotional activity with a view to ensuring their retail customers receive the best possible value and that they meet their commercial objectives. Equally, wine suppliers have the right to negotiate and set a wholesale price that meets the wine supplier's sales and margin objectives.

Whilst WLG has committed to give regard to the sustainability and diversity of Australia's wine industry, wine suppliers should be careful to make sure they do not coordinate their negotiations with WLG to force it to change its pricing practices, or threaten to collectively refuse to deal with WLG if they don't grant particular concessions (a collective boycott against dealing with WLG). Doing this is likely to breach competition laws and could have serious consequences for wine suppliers.

3.5 What rules apply when negotiating promotions?

The obligations to act honestly and fairly with each other, and to follow the spirit and intent of the Principles, apply to parties during the negotiation of promotional activity. During negotiations each party should, whilst acting commercially and in their own best interests, be as open and transparent as is commercially possible in explaining their expectations of the other party and be honest at all times.

When negotiating promotions, parties should balance these important considerations:

(a) ensuring that retail customers receive the best possible value for money and that WLG meets its commercial objectives; and

(b) respect for the wine supplier's right to set a wholesale price that meets the supplier's sales and margin objectives.

Parties should set out the promotional activities they will implement. This should cover how the costs of a promotion will be allocated, the duration of the promotion and any limitations on the promotional activity. How the parties will report on, and review the success of, the promotional activity may be outlined, plus any rights to terminate the promotion.

Where possible, specific promotions should be described and provision should be made for the parties negotiating and agreeing to new promotions during the term of the agreement.

Neither party should be forced to take part in a promotion.

In order to rapidly respond to its competitors' activities, WLG will generally reserve the right under a promotional agreement to make changes to promotional activities. When it does this, it will provide wine suppliers with as much notice as reasonably possible, with reasons for the change. Where a change causes hardship or unreasonable disadvantage to either party, both parties should seek to negotiate a mutually acceptable outcome.

3.6 When can commercial agreements be varied unilaterally?

Commercial agreements should not allow one party to change any of their terms without the agreement of the other party (i.e. no unilateral changes are allowed).

3.7 Can I be penalised for using a distributor?

WLG respects the rights of wine suppliers to sell to WLG through distributors and distributors should respect the rights of wine suppliers to utilise WLG's distribution and logistics infrastructure.

WLG may inform wine suppliers of the advantages of using WLG's distribution and logistics infrastructure, but should not pressure wine suppliers into taking that route. On the other hand, wine suppliers should feel free to deal direct with WLG if they wish.

4. DURING THE TERM OF A COMMERCIAL RELATIONSHIP

4.1 What is the 'spirit and intent' of the Principles?

The Principles require both WLG and wine suppliers to honour the 'spirit and intent' of the Principles; in other words, to ensure and maintain honest, fair and transparent dealings between the parties. This means that parties should not try to use loopholes or over-legalistic interpretation of the wording of the Principles, or of a commercial agreement, to avoid acting honestly, transparently and fairly.

4.2 Variations

A commercial agreement may only be varied if:

(a) The commercial relationship allows for that type of variation;

(b) the party requesting the variation gives the other as much notice of the desired variation as possible; and

(c) both parties agree to the variation.

Unilateral variations should not be allowed.

4.3 What information and data can I get?

WLG has committed to maintaining an "open dialogue" with wine suppliers on the performance of their brands. Notice for a range review will be publicised by WLG on the www.wlgpartners.com.au website which wine suppliers are encouraged to monitor and the outcomes will be communicated to the wine supplier. The type of data a wine supplier could expect to be discussed includes:

(a) the performance of the wine supplier's products in WLG's retail operations;

(b) the reasons for decisions of WLG to stock or delist the wine supplier's products (including benchmarks and indicators); and

(c) discussion on market trends and performance of a product against its competitors.

Wine suppliers are entitled to information regarding the calculation of rebates, marketing and promotional claims. They are also entitled to the reasons for stocking, promotional and trading term changes. Any other information required by a wine supplier should be negotiated with WLG and included in the commercial agreement.

4.4 How do promotions work?

Promotional activity should proceed in accordance with the terms of the commercial relationship. Each promotion should be for a set period of time and should not change without agreement between the parties (except where WLG changes a promotion where it needs to rapidly respond to the activities of its competitors, as discussed in section 3.5 above).

4.5 When can new promotions be proposed and do I have to agree?

WLG may offer wine suppliers the opportunity to participate in so called 'over and above' promotional activities, being promotions additional to those in the commercial agreement (e.g. inclusion in seasonal catalogues and buyer's guides, receipt offers and sponsorship opportunities). Importantly, there is no obligation for wine suppliers (or WLG) to agree to participation in a promotion and the negotiation of any such promotion must be fair and pay due regard to the value of the wine supplier's and retailer's brand. Neither party should pressure the other to take part in a promotion that has not been agreed.

4.6 What happens if there is a change to trading terms?

The Principles recognise that, as wine is an agricultural product, during the term of a commercial agreement, certain terms (including supply chain, ordering, invoicing, delivery or packaging requirements) may change, which may lead to price adjustments (which must be reasonable). If a term changes, WLG and wine suppliers must give each other as much notice of the change as they reasonably can. Neither party is required to agree to any amendment of an agreement, as discussed in sections 3.6 and 4.2 of this guide.

If there is a dispute about price adjustment or any other decision, the dispute resolution mechanism discussed in section 7 of this guide may be utilised. In all cases, the parties should work together to minimise any disadvantage or detriment caused by the change.

5. COMMERCIAL RELATIONSHIPS

5.1 Confidentiality of trade information

WLG and wine suppliers are required to keep confidential any information that is not in the public domain regarding their respective businesses. This includes (but is not limited to) information about business plans, promotions, pricing, discounts, financial information, intellectual property, brand development, product development, marketing strategies and development plans. Wine suppliers should not share details of their negotiations with WLG if those details are confidential.

The Principles recognise that WLG is an integrated business, which includes a winemaking and contracting business (called Pinnacle Drinks Group (Pinnacle) that may compete with wine suppliers. Accordingly, the Principles prevent WLG from disclosing sensitive information about wine supplier's operations to Pinnacle.

To avoid disputes about which information wine suppliers consider to be confidential, the commercial agreement should specify clearly that WLG will ensure that confidential wine supplier information is not shared with Pinnacle.

5.2 What rights are there for the protection and use of intellectual property?

Each party is required to respect the other party's intellectual property. "Intellectual property," in this context, includes branding, packaging designs and marketing strategies.

Commercial agreements should provide details of what WLG and wine suppliers may and may not do with the other party's intellectual property. Parties should never take any action that would be likely to either reduce the value of the other party's intellectual property or unfairly profit from it.

5.3 Open and honest communication

Many disputes in commercial relationships arise because of a lack of open and honest communication. The Principles require parties to make reasonable efforts to communicate regularly, and honestly about the business relationship. This means that concerns about the performance of products and changes to the commercial agreement, and information regarding the reasons behind decision making, should be raised at the earliest opportunity.

Whilst the parties are expected to act in their own and their stakeholders' commercial interests, they should never intentionally mislead or deceive the other party or act dishonestly or unfairly.

6. DELISTING

6.1 When can a product be delisted?

Under the Principles, WLG should provide clear details of what circumstances will justify WLG delisting a product. This could include instances where:

(a) WLG has conducted a 'range review' and decided on reasonable grounds that it will no longer stock the product in question. Relevant factors might include sales performance, margins, market trends, changes in the retailer's strategy and performance against competitive products; or

(b) there are health or safety grounds for delisting a product.

6.2 What is the process for delisting a product?

Before a product is delisted, WLG will provide the wine supplier with:

(a) reasonable notice of the range review on the website www.wlgpartners.com.au

(b) a clear explanation of the outcome of the range review (including what indicators and benchmarks were used) and the decision to delist the product;

(c) range reviews generally take between ten to twelve weeks to finalise.

Wine suppliers should constantly monitor the performance of their range and understand which lines may have the potential for delisting before a range review and make sufficient preparations should this eventuate.

7. DISPUTE RESOLUTION

7.1 What happens if a party does not follow the Principles?

The Principles are non-binding and do not contain any penalties for non-compliance. WLG has, however, committed to the Principles and WFA strongly recommends that wine suppliers do also.

The Principles have been designed as a step towards greater fairness and transparency in commercial relationships between retailers and wine suppliers and are an indication of WLG's desire to work collaboratively with the wine industry to ensure its long term survival and success. We believe that it is in your interests as a wine supplier to follow the Principles.

If a party does not follow the Principles, it may not be in breach of its obligations under the commercial agreement (depending on the wording of the agreement). However, if you believe that WLG is non-compliant with the Principles at any stage during negotiation of the agreement, during its term or following its expiry, you are encouraged to:

(a) First seek resolution directly with the respective WLG buying team and are able to request a review by the banner Merchandise Manager.

(b) If still unresolved, the wine supplier can request a review by the WLG General Manager Merchandising.

(c) Where matters cannot be resolved, the wine supplier can have the matter referred to WLG's and/or WFA's Compliance Manager to conduct a review.

Where matters are still unresolved to both parties satisfaction, an independent expert will be appointed from a list of experts agreed to by a panel of WLG and WFA representatives. We also advise wine suppliers to follow the suggestion in the Principles to establish their own dispute resolution mechanism, to deal with concerns raised by WLG that wine suppliers may not be following the Principles. That might be as simple as the mechanism recommended in section 7.1 of this guide.

7.2 Which decisions can be reviewed?

In general, the Principles allow WLG or wine suppliers to review any decision they think is unfair or in breach of the Principles or their spirit or intent. The parties should include a dispute resolution mechanism as part of their commercial agreement. The dispute resolution mechanism should encourage the parties to discuss issues within the spirit of the Principles, but confidentially, and as soon as possible to resolve them before they escalate.

8. WHO CAN I CONTACT IF I HAVE A QUESTION ABOUT THE PRINCIPLES?

WLG and WFA have both nominated contacts within their organisations, who are responsible for administering the Principles and dealing with any concerns that arise, either from WLG's staff or from wine suppliers.

If you have any questions, in the first instance you should send them via e-mail to:

Shane Tremble, Head of Corporate Development at Woolworths Liquor Group:
shane.tremble@wowliquor.com.au
Paul Evans, Chief Executive, Winemakers' Federation of Australia: paulevans@wfa.org.au

Attachment 1

wfa Winemakers' Federation of Australia

WOOLWORTHS LIQUOR GROUP

(g) The power and influence of retailers of Australian wine in domestic markets

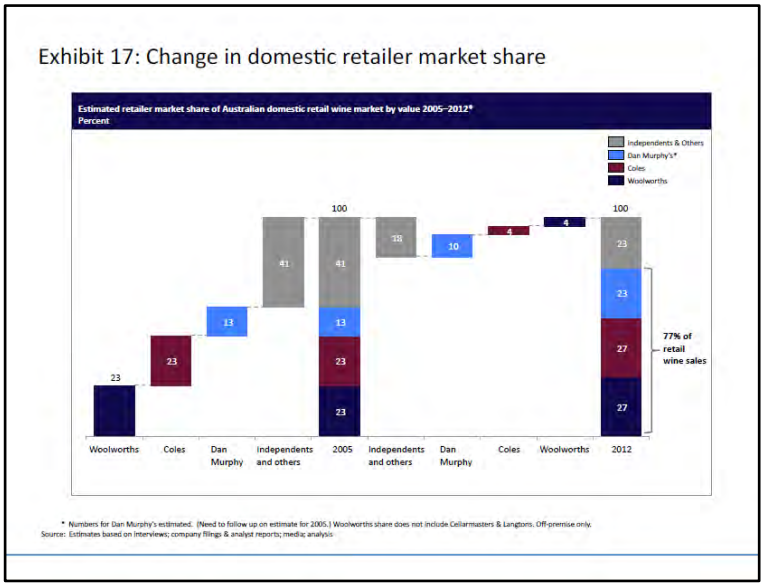
The wine industry continues to be concerned at the level of market power of the two dominant domestic wine retailers. The situation has been exacerbated by their ability (backed by existing Competition Law) to vertically integrate into wine production and vineyard ownership. For many winemakers, the retailers are now both their major customer and major competitor and this has subsequently introduced a higher level of insecurity in regards to brand management, discounting, contracting and certainty in future sales. This position has also enabled retailers to grow the 'home brand' segment in a domestic market already in oversupply and to suppress retail and wholesale pricing growth and winemaker margins. Ultimately this translates into low wine grape prices.

While some progress has been made, much more can be done by government to help alleviate the concerns of the industry as outlined below.

The Expert Review (Appendix A) commissioned by WFA and produced by Centaurus Partners analyzed the power and influence of retailers in the domestic wine market. We have provided a relevant extract below and then moved into discussion on the work we are doing and recommendations.

Retailer Consolidation and Power

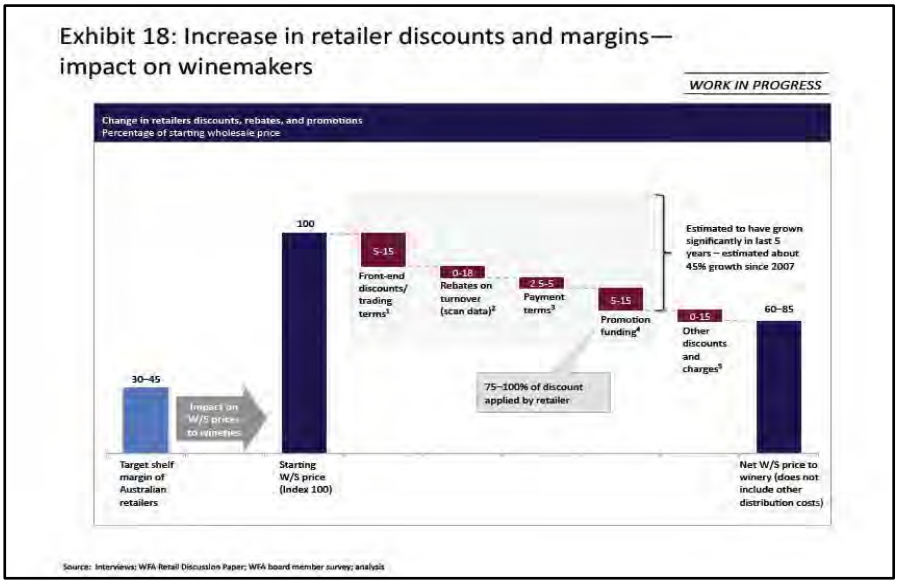
The combined groups of Coles and Woolworths distribute and sell circa 80% of all wine sold off premise (Exhibit 17 from Appendix A) up from circa 60% in 2007. This translates to about 70% of all domestic sales, on and off-premise. *We do not have access to the full Nielsen data or that of the retailers therefore these shares are estimates based on our interpretation and analysis of numerous sources.*



Woolworths is now a fully integrated wine player—owning and/or controlling all elements of the wine making process from vineyards, winemaking, bottling and packaging, and distribution to retail sales (on and off premise). The private labels of both retailers are estimated to account for at least 16% of domestic sales (off premise). In contrast to this retail and distribution consolidation, the Australian wine industry is highly fragmented (with circa 2,400 producers and 30,000 retail SKUs. Though the 38 largest producers account for 88% of total production (already a large number of alternate suppliers for retailers to leverage) the single biggest has less than 15%, most of which is exported.

The retailers have numerous sourcing options to leverage due to 1) this fragmentation, 2) the excess supply of grapes and wine, and 3) the ability to sell imported wine at attractive margins. As a result, there has been a massive increase in discounts and rebates (producer selling costs).

In addition, average discount levels being achieved by the major retailers are estimated to be about 30% and as high as 40% - up from 10–15% five years ago (Exhibit 18 from Appendix A).



Winemakers are affected directly and indirectly by the ability of retailers to significantly impact a company's volume/sales through their market share and related behaviours including: access to shelf space, promotional activity, volume for exclusivity, and de-listing. The risk of these behaviours to winemakers is extensive as they make production decisions far in advance of sale, have expensive inventories, and limited alternate distribution options. In addition, winemakers struggle to pass on genuine cost increases to retailers that are not then taken away by increased rebates and discounts.

The analysis shows that from 2007 to 2012 overall consumers did not benefit from the profit margins retailers have extracted across the portfolio of wines sold by the winemakers we analysed [on a confidential basis]. Though consumers of some of the lower priced wines in the portfolio benefited from lower prices, the profit margins to retailers grew due to falls in net wholesale prices (driven by rebates, discounts and promotions).

In addition, retailers generate most margins on wine sales than sales from beer and spirits. Wine sales provide two to three times more margin than beer. The ability of retailers to extract greater margins from wine can be a reflection of the highly fragmented industry structure and ease of transferring costs to wine producers.

WFA's work on codes of conduct with retailers

In line with WFA's 43 *Actions for Profitability*, specifically Action 4.2 which states: "WFA will work with the national chains to adopt an Industry Code of Conduct based on agreed Principles and Practice".

In August 2014, WFA launched the "*Good Wine Buyer and Supplier Principles: A Code for Fairness and Transparency"* with the Woolworths Liquor Group (WLG) (see Appendix H). In the Preamble of this document we state:

> *WLG and the Winemakers' Federation of Australia (WFA), acting for the benefit of Australian wine producers and for customer choice, agree that WLG and wine suppliers will act honestly and deal fairly with each other and will be transparent in their processes and decision making, within the limitations of commercial confidentiality. WLG will reflect these good wine buyer and supplier principles set out in the Good Wine Buyer and Supplier Principles (Principles) and WFA will encourage wine suppliers to do likewise in all agreements and dealings. Implicit and explicit in this approach is that neither party will in any way unfairly disadvantage the other for requesting adherence to these Principles.*
>
> *WLG and wine suppliers agree to honour the spirit and intent of these Principles which will be supported through the dispute mechanism of this code that allows a review of any decision or action deemed unfair or contrary to these Principles by a third party agreed to by WLG and WFA. A joint forum made up of WLG and WFA representatives will ensure the Principles are publicised and promoted; monitored for compliance; and regularly reviewed. Each organisation will also appoint a Compliance Manager as the first point of contact in understanding how the Principles work.*
>
> *WLG and WFA will formally review the Principles every two years from 1 July 2014 to consider any changes in scope and content necessary to ensure their on-going relevance and effectiveness.*

The Principles covered are as follows:

Principle 1: A fair and clear commercial relationship

Principle 2: Clarity in marketing and promotional activity

Principle 3: Open, honest and early communication

Principle 4: Protection of intellectual property

Principle 5: Dispute resolution

Discussions between WFA and other wine retailers on achieving a similar agreement to the Principles have also underway.

Australian Food and Grocery Code of Conduct

The Government tabled the Food and Grocery Code of Conduct in March of this year. In tone and detail, it is very similar to the WFA Principles document with WLG. The Code remains 'opt in' for retailers. The key difference with the WFA Principles document is that the ACCC has an enforcement role to ensure compliance with the Code from those who have chosen to be part of it.

At this stage, alcohol remains outside of the AFGC Code of Conduct. However, WFA notes that the Code is due for review in three years and would expect this to change. WFA is supportive of this.

The Harper Review of Competition Framework

In our submission to the Harper Review of Australia's Competition Framework, WFA called for the Government to analyse practices and agreements which enable retailers to demand retrospective pricing support from suppliers and determine whether they are a potential misuse of market power and even if they do not fall within the existing technical definition of "misuse of market power", and whether they should be explicitly dealt with through amendments to existing anti-competition laws. It is unclear to us whether the proposal in the Harper Review to review Section 46 of the *Competition and Consumer Act 2010* (CCA) to introduce an "effects test" will help to address the wine industry's concern around potential misuses of power in relation to retrospective pricing.

In relation to the Harper Review, WFA also called for specific review of how the competitive process embodied in our competition laws operates for small and medium businesses and more generally for effective competition. Related to this, WFA also called for rethinking and modification of the current legislative framework for protection of small and medium businesses.

The Productivity Commission and further market analysis

The Expert Review we commissioned has provided good initial analysis of the domestic market and the impact of retail consolidation on margins and profitability. This work needs to continue to help build a fact base, inform future policy discussions and assess the findings of the Review. WFA believes the Productivity Commission has the appropriate resourcing and expertise to conduct such research.

Appropriate labelling for homebrands

WFAs consultations with industry has highlighted strong support for the labels of brands owned by retailers to be clearly marked as such to ensure consumers are aware of the origin of the wine. WFA recommends the Government require that all brands owned by retailers be clearly labelled to inform consumer purchasing decisions. WFA contends that additional regulation would improve the competitive process and enable consumers to make informed choices.

WINE INDUSTRY REPORT

Expert Report on the Profitability & Dynamics of the Australian Wine Industry

PREPARED FOR WINEMAKERS FEDERATION OF AUSTRALIA BY CENTAURUS PARTNERS – AUGUST 2013

CENTAURUS PARTNERS

wfa Winemakers' Federation of Australia

INTRODUCTION AND REPORT CONTENTS

The Australian (and global) wine industry is highly fragmented with many different business models, and significant variations in performance. Players within the industry make decisions based on their individual position, strategy and view of economic fundamentals. The intention of this review is to provide facts and perspectives to help WFA determine where it should focus its industry efforts and how it can support individual participants in their decision-making processes.

The Report has four sections:

- Summary Findings of the Expert Review
- Recommendations for the WFA Board to Consider
- Executive Summary of the Fact Base Supporting the Findings and Recommendations
- Appendices
  - Recommended Next Steps for WFA
  - Overview of Approach, Analysis, and Sources
  - Additional Analyses and Exhibits—Available on the WFA Website www.wfa.org.au/review

Segment Definitions. To enable clear evaluation of the Australian wine industry quality segments for grapes and wine were developed and agreed with the WFA Board. There are five segments—A, B, C, D, E/F. The definitions are:

	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
Bulk wine is allocated to its quality segment. Under $1 per litre FOB to E/F, over $1 per litre FOB to D			

Data Sources and Limitations. Due to its fragmentation, predominately private ownership and modest investment in data gathering the Australian wine industry lacks publicly available quality information. This review has used an extensive combination of data sources to address this issue, including: confidential interviews and surveys of WFA board members and industry stakeholders, and detailed company financial and market data provided on a strictly confidential basis. Limitations of the data sources and the related analyses are noted through the report and in Section 2 in the Appendices.

SUMMARY FINDINGS OF THE EXPERT REVIEW

The Australian wine industry enjoyed considerable success from 1991 to 2007.

It more than tripled in size from less than 400 million litres to 1.2 billion litres and achieved total revenues of $5 billion in 2007. The value of exports grew from $212 million to $3,004 million. The industry and many of its participants built an enviable global reputation for producing quality wine and created strong export markets particularly in the UK, US and Canada. Analysis of available information suggests, on average, the industry enjoyed good profitability. From 2007 a number of factors resulted in tough times for the industry—the impacts of which and possible solutions are discussed in this Report.

Despite the recent difficulties facing the industry there are number of positives.

There has been a significant increase in domestic consumption of quality wines. 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. Unfortunately for the overall industry this only accounts for 16% of all wine produced in Australia by value and 3% by volume.

Another bright light has been China. From 2007 to 2012 exports to China rose 144% (26 million litres) by volume and 333% ($186 million) by value. Continued growth is predicted and will help the industry but it has limits:

- China is still just 6% of total export volume and 13% of value
- From 2007 to 2012 the value of wine exports fell by $1,336 million (excluding China). The increase in exports to China mitigated 14% of this fall
- Over half the increase in the value of exports to China came from A and B quality wines of which there is limited supply.

A good number of company success stories continue to emerge. In particular:

- Producers of high-quality fruit and/or wine
- Lowest cost producers of fruit and wine at each quality level—especially C, D, and E/F
- Players able to establish a niche—brand, market, and/or method of distribution.

Unfortunately, a number of players in the industry will find it difficult to transition to one or more of these models.

**The recent fall in the A$** will benefit Australian producers through higher A$ export prices (FOB) for existing volumes, and/or increased volumes.

The wine industry remains important and highly valuable to Australia and Australians. Its benefits extend well beyond the direct economics to elements of our global reputation, tourism, and the economics and vibrancy of our wine regions. As such it is critical that the industry works together (and with government) to rebuild its global/export franchise and address domestic profitability.

It is important to recognise and understand the issues facing the industry to ensure the correct next steps are taken by: the industry, groups of stakeholders working together, and individual players.

Industry profitability has fundamentally lowered over the last 5 years and will remain under pressure for the foreseeable future.

The key drivers of this change are:

- The collapse of export returns due to the appreciation of the Australian dollar (A$), falling demand, and issues in key markets
- The ability of retailers to extract margins from growers and winemakers
- Oversupply of grapes and winemaking capacity

(relative to domestic and export demand—at profitable prices) and the 'negative feedback loops' this has created.

In this environment the business models under the most profit pressure are:

- Higher cost growers of C, D, and E/F grade grapes
- Winemakers with significant portion of their portfolio in wines with retail prices around and below $10/bottle (and <$5/litre export FOB). Especially if highly exposed to exports
- Small to mid size (higher-cost) winemakers without significant volumes in more profitable distribution channels (mail order/online, unique market niches); and with less attractive portfolios (price points below $15 per bottle retail or $7.50/litre FOB).

The Australian wine industry is likely to remain in transformation for some years:

- The industry was built on expectations of continued strong export growth
- The majority of the growth and total volume is in lower priced/quality wines that are under profit pressure in domestic and export markets—in 2012 30% of the wine produced in Australia was sold domestically at retail prices less than $10 per bottle, another 52% was exported at FOB prices below $5 per litre
- Demand cannot solve this problem quickly. Domestic demand is relatively flat in volume terms. Export demand is experiencing both volume and price pressure. While the unprofitable supply of grapes and wine is significant
- The fragmented nature of the industry makes it difficult to respond in a coordinated way. And, individually 'capacity is slow to adjust' for numerous reasons including:
  - Winemakers buying uneconomic fruit and wine to maintain high production to make contribution to fixed costs—this can provide marginal growers with some income and hope. In the growth phase many winemakers invested in additional capacity and brands
  - Growers have significant sunk costs in their vines and vineyards with few attractive alternative uses for the land
  - Human and emotional factors
  - Some level of uneconomic production supported by the WET Rebate.
- As the supply of grapes tightens—and more growers make acceptable returns—winemakers will experience an increase in their cost of goods sold (COGS) from the cost of grapes. The likely inability to pass this cost on to domestic or export markets will then force further rationalisation of winemaking volume and companies.

Though needed it is likely the rationalisation of supply (grapes and winemaking) will not lead to an immediate fundamental improvement in industry profitability. A common view that reduced volumes will allow winemakers to increase margins and profits through: renegotiating margins with retailers, higher retail prices, and higher export prices is questioned by this Review. The majority of any benefit will likely flow to successful growers via higher prices. The benefits to winemakers will be limited by:

- Higher average COGS due to increased grape prices and lower volumes
- Retailers well placed to limit net wholesale price increases and/or extract, at least a significant share, of any improvement in margins from individual wine companies
- 62% of industry volume is exported—significant improvement in export returns requires: further depreciation of the A$, fundamental increase in demand relative to competitors in export markets, new/expanded export markets, and a reversal of the current trend in mix to lower value wines
- 94% of export volume (675 million litres) is C, D, and E/F wine (FOB below $7.50/litre). Export margins at each quality/price segment are significantly below domestic margins.
- The domestic market is higher margin but it is not large enough or growing fast enough to absorb significant quantities of wine currently being exported.

Though a major driver of the fall in industry profitability it is unlikely further significant depreciation of the Australian dollar will generate a proportionate rise in profitability. A lower A$ clearly benefits Australian producers. However, the following factors will likely prevent an immediate return to previous profit levels:

- There has been fundamental fall in demand for Australian wine in, at least, our two largest export markets (US and UK) in their currency—this is in addition to the impact of the higher A$
- Competition from wine exporting countries has increased, including—Italy, Spain, Chile, France, Argentina, and South Africa
- Many of those interviewed believed that foreign

retailers, importers and distributors have the market power and sophistication to extract some portion of improved returns from a lower exchange rate. The fragmentation of Australian producers means many will likely trade off margin for volume

- The analysis in this report for the period 2007 to 2012 used an average rate of 83.7 US cents for 2007 and 103.6 US cents for 2012. Since finalising the report the $A has fallen to circa 90 US cents. We believe this fall, while beneficial to the industry, has no material impact on the findings or recommendations of this report.

Opportunities exist for: the industry, groups of stakeholders, and individual companies to address these issues and in doing so build a stronger and more profitable wine industry for future generations.

RECOMMENDATIONS FOR THE WFA BOARD

This review recommends 6 actions to be taken by the WFA and its members to help re-build a more profitable and sustainable industry:

1. Urgent efforts to build export demand and improve market access.

Particular focus on US, UK and China; and possibly other large wine importing and 'niche' countries such as Canada, Sweden, Netherlands, and Switzerland, *WFA to:*

- Support development of fact base and insights as to issues and opportunities by market. For example, need to genuinely understand the causes of the massive deterioration in the performance of Australian wine in the US and UK markets, and what solutions exist for each wine segments—the issues and opportunities for A and B wine differ to those for C, and D, and E/F
- Identify and advocate actions for government. Advocate to link savings from reforms to the WET Rebate (discussed below) to funding for export market development
- Explore opportunities to 'match' our industry to the needs and purchasing decisions of these markets—such as: regionality/appellation, variety, understanding/recognition; and consumer trends especially varietal and high volume branding opportunities for commercial (C and D) wine in the US.

2. Seek improvements in retailer behaviour through a code of conduct.

Consider lobbying Government with a recommended set of reforms to address the impacts arising from retail consolidation. Including: restrictions on further vertical integration and acquisition growth in distribution/retail including on-line; and a mandatory code of conduct if an appropriate code cannot be negotiated voluntarily. *WFA to:*

- Provide fact base showing impact and need for action. Develop feasible changes
- Coordinate efforts and fact base with other industry bodies
- Manage advocacy/negotiations to protect individual companies from possible retaliation
- Possibly support the development of alternative distribution options for winemakers.

3. Provide proactive advice to Government on how to remove all significant inappropriate uses of the WET Rebate.

WFA to:

- Continue to build fact base, in planned consultation phase, on current impacts of WET Rebate and benefits of proposed changes to support advocacy. Seek ATO to improve the way it records tax payments, credits and rebates for the wine industry to allow proper understanding of who is using the Rebate
- Advocate Rebate reform. Including: limit Rebate eligibility to growers and/or manufacturers of Australian wine sold in packaged format under their own label. No controlling or collaborating entities to claim or benefit from more than one rebate. All grapes and wine must be sourced, manufactured and packaged in Australia.
  Wine must be fit for human consumption
- Lobby to have some portion of the savings from Rebate reform allocated to the industry to invest in export demand building and wine region development
- Upon reform of the Rebate allow the market to work, and reassess the Rebate (its purpose and effectiveness) in 3 years when better information is available.

4. Careful management of key downside demand and profit risks —

in particular the anti-alcohol lobby and tax changes. *WFA to:*

- Fund/call for more fact-based research and dialogue on health impacts of wine and issues of alcohol abuse
- Ensure any tax regime debate is well understood. Seek to maximise unity within the industry.

5. Support decision making of industry players—particularly marginal players—with quality information and opportunity for dialogue and support.

WFA to:

- Continue to build and engage industry participants on the fact base and independent perspectives on the industry—support decision making
- Seek government funding for rural support programs—decision-making assistance not subsidies
- Ensure key data sources are retained and where necessary enhanced.

6. Continue communication with government, regulatory bodies and media as to the true current state and potential futures for the Australian Wine Industry.

WFA to provide the 'back story' and fact base to build awareness, and support constructive dialogue and action. Messages to provide context for recommended actions include:

- The importance of the wine industry to Australia
- The industry is caught in a 'perfect storm' of a high $A, falling export demand, oversupply, and retailer power
- The industry is in the process of significant and difficult restructuring
- During this process the industry is fragile and risks permanent damage—including: massive reduction in size and scale; ongoing poor profitability preventing necessary reinvestment; and loss of key success factors including: talent, innovation, image and reputation (domestic and international)
- The WFA and key stakeholders have a plan to support the industry towards a more profitable and sustainable future.

EXECUTIVE SUMMARY OF SUPPORTING FACT BASE

The following summarises the reasoning and fact base used to develop the Summary Findings and Recommendations.

Contents of Executive Summary

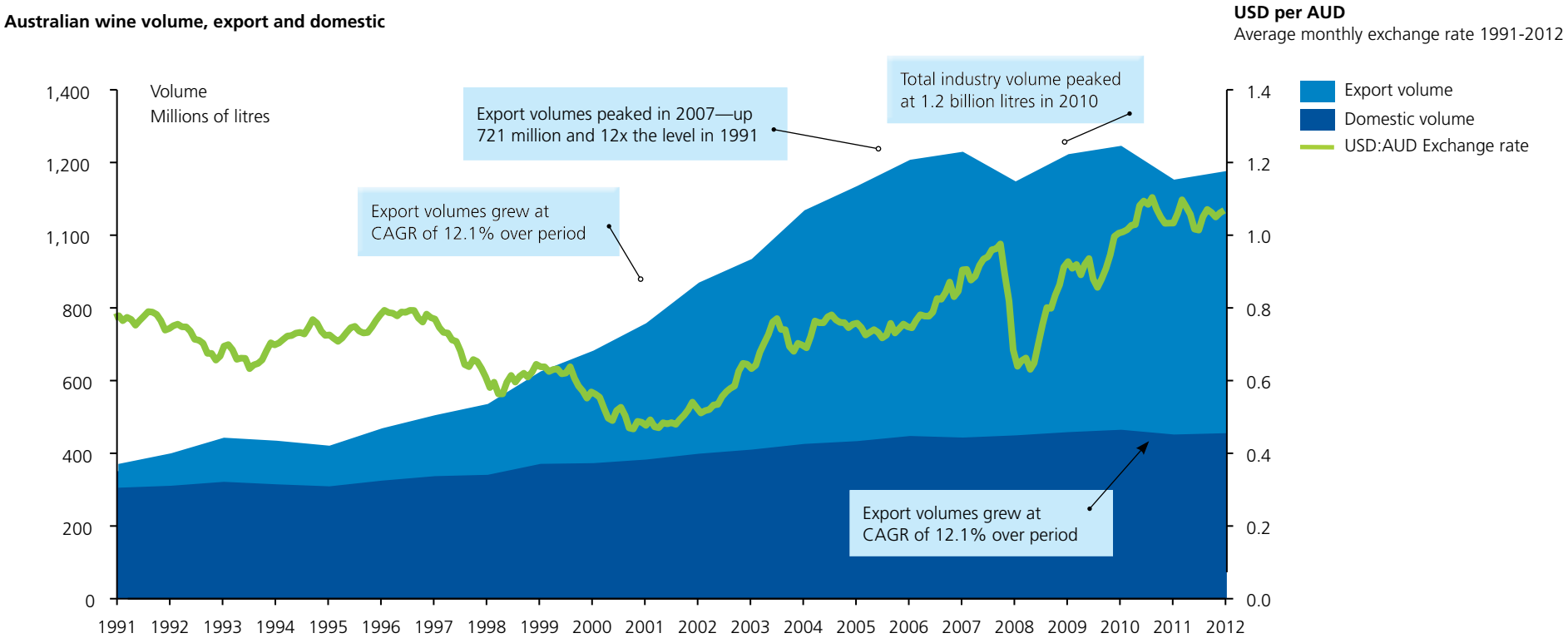
1. The Australian wine industry has tripled in size and been very successful at building export markets
2. Since 2007 the profitability of the Australian wine industry has declined significantly
3. This decline in profitability has been driven by a 'perfect storm' that has intensified
    - Export returns have declined sharply
    - Domestic margins have been squeezed by retailers, low-demand growth, and increased imports
    - The decline and shift in export demand has created an 'oversupply/under-demand' of grapes and wine in certain quality segments.
4. Efforts to improve profitability have, in many cases, only reduced the extent of the decline
5. There are foreseeable circumstances that would put further pressure on profitability
6. The other side of this 'perfect storm' is that no single lever will 'fix' the problem
7. The industry is not being impacted equally—some players/segments are more affected than others. There are a number of success models
8. Tax has been an issue for the industry. The solution in the current environment is relatively clear.

1. The Australian wine industry has tripled in size and been very successful at building export markets

From 1991 to 2007 the Australian wine industry tripled in size. Almost 100% of this growth was exported (Exhibit 1). In 2007 Australia exported 64% of its wine production by volume and 60% by value. In 2012 these figures were 62% and 43% respectively.

Exhibit 1: Growth of the Australian wine industry export and domestic market volume

Millions of litres, 1991–2012; USD per AUD



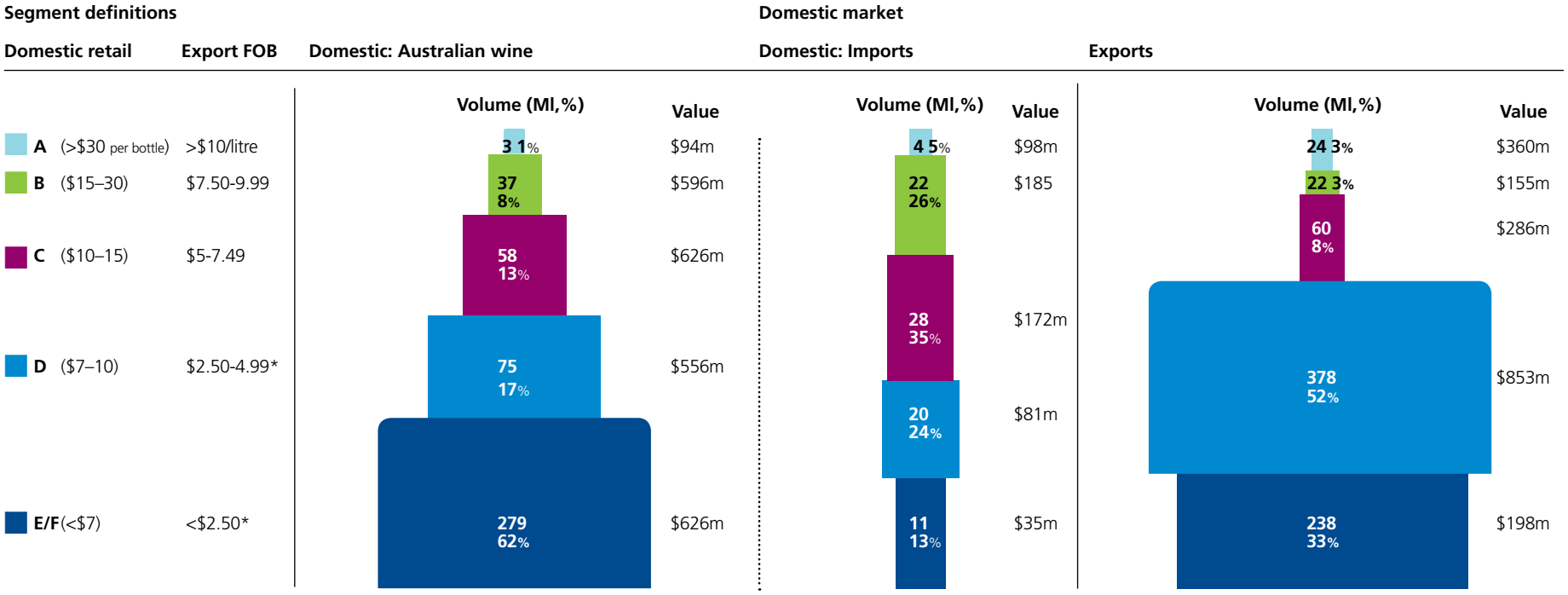
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
USD: AUD	0.78	0.74	0.68	0.73	0.74	0.78	0.74	0.63	0.65	0.58	0.52	0.54	0.65	0.74	0.76	0.75	0.84	0.85	0.79	0.92	1.03	1.04
GBP: AUD	0.44	0.42	0.45	0.48	0.47	0.50	0.45	0.38	0.40	0.38	0.36	0.36	0.40	0.40	0.42	0.41	0.42	0.46	0.50	0.59	0.64	0.65

Source: ABS; Wine Australia; xe.com; US Treasury

For the purpose of this review wine segment definitions—A, B, C, D, and E/F—have been agreed with the WFA Board (bulk wine is allocated to its quality segment). Exhibit 2 shows these definitions and the breakdown of volume and value by segment across domestic consumption of Australian wine, imports and exports.

Exhibit 2: Illustration of wine demand by quality/price segment

2012 volume, (Millions of litres) and value (AUD millions)



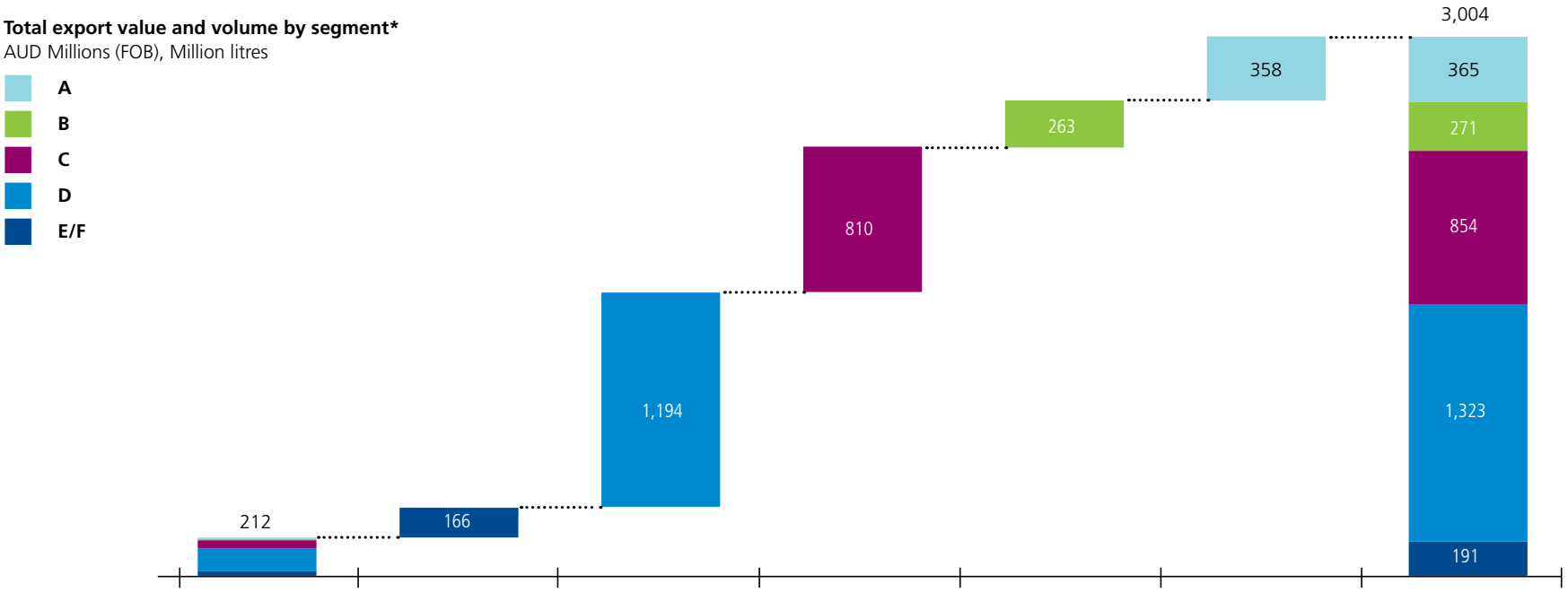
Total volume (Ml)	**452**	**84**	**721**
Total value ($m)	**$2,498**	**$571**	**$1,853**

* Bulk under $1.00 per litre is classified as E/F and above $1.00 per litre as D
Source: ABS; Wine Australia; Nielsen; analysis

Data back to 1991 shows that exports (and therefore Australian production) is dominated by lower end commercial (C) and commodity (D, E/F) wine (Exhibit 3).

Exhibit 3: Export value growth to 2007 was driven by D and C. A and B grew by the biggest multiples off a low base

Total export value and volume by segment*
AUD Millions (FOB), Million litres



	1991**	E/F	D	C	B	A	2007
Volume Millions of litres	**47**	147	405	136	30	21	**786**
2007 as multiple of 1991		8x value 19x volume	10x value 15x volume	20x value 19x volume	36x value 32x volume	58x value 44x volume	14x value 17x volume

* Segment definitions held constant in AUD terms
** Total export volume 2007 was 47 million litres
Source: Wine Australia; analysis

An overall picture of the Australian wine market by segment including domestic production, domestic consumption, exports and imports is shown in Exhibits 4, 5 and 6. Further detail for each individual segment can be found in the Appendices.

Exhibit 4: Value of Australian wine industry – domestic production and consumption, exports and imports. Changes from 2007 to 2012

$ Millions, 2007–2012[1, 2]

Segment and definition			Domestic production consumed domestically[3]				Export values[4]				% of total domestic production		Import values[5]			
Grade	Domestic retail price/bottle	Export FOB/litre	2007	2012	Change	%	2007	2012	Change	%	2007	2012	2007	2012	Change	%
A	>$30	>$10	64	94	30	46.9	365	360	(5)	(1.1)	8.5	10.4	73.8	97.9	24.1	32.6
B	$15–30	$7.50–$9.99	358	596	238	66.5	271	155	(116)	(42.8)	12.6	17.3	166.3	184.9	18.6	11.2
C	$10–15	$5.00–$7.49	667	626	(41)	(6.1)	854	286	(568)	(66.5)	30.4	21.0	82	171.7	89.7	109.5
D	$7–10	$2.50–$4.99	329	556	227	69.0	1,323	854	(470)	(35.5)	33.0	32.4	40	81	41	102.6
E/F	<$7	<$2.50	586	626	40	6.8	191	198	7.0	3.7	15.5	18.9	27.3	34.5	7.2	26.2
Totals			**2,004**	**2,498**	**494**	**24.7**	**3,004**	**1,853**	**(1,151)**	**(38.3)**	**100**	**100**	**389.3**	**569.9**	**180.6**	**46.4**
Total domestic production			**5,007**	**4,350**	**(657)**	**(13.1)**	**Market share of imports**						**16.3%**	**18.6%**		
Total domestic consumption (domestic and imports)			**2,224**	**2,975**	**751**	**33.8**										
Total domestic production and consumption			**5,227**	**4,827**	**(400)**	**(7.7)**										

1 All value are FOB or wholesale equivalent
2 Export figures include bulk; domestic figures include on- and off-premise
3 Total value and volume from ABS. Distribution by segment in glass based on Nielsen data on retail glass bottle sales. All cask and soft-pack assumed to be E/F
4 Based on export data by price point from Wine Australia. Segment definitions held constant in destination currency terms
5 Total value and volume from ABS. Distribution by segment based on Nielsen data on retail glass bottle sales
Source: ABS; Wine Australia; Nielsen; analysis

Exhibit 5: Volume of Australian wine industry—domestic production and consumption, exports and imports. Changes from 2007 to 2012

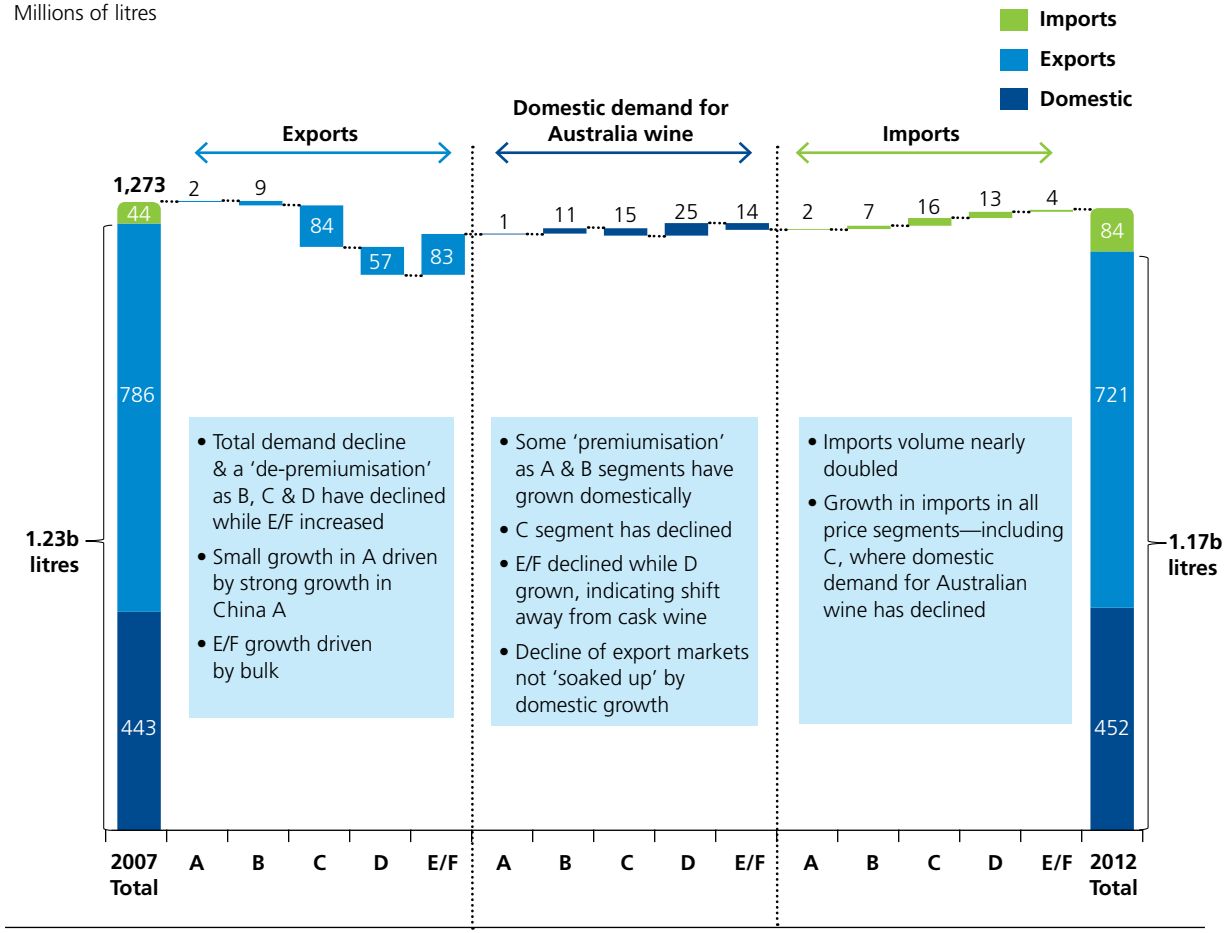
Millions of litres, 2007–2012[1]

Segment and definition			Domestic production consumed domestically[2]				Export volumes[3]				% of total domestic production		Import volumes[4]			
Grade	Domestic retail price/ bottle	Export FOB/litre	2007	2012	Change	%	2007	2012	Change	%	2007	2012	2007	2012	Change	%
A	>$30	>$10	1.7	2.5	0.8	47.1	21.8	23.9	2.1	9.6	1.9	2.3	1.9	3.5	1.7	89.8
B	$15–30	$7.50–9.99	26	36.8	10.8	41.5	31.4	22.3	(9.1)	(29.0)	4.7	5.0	15.1	21.8	6.6	43.9
C	$10–15	$5.00–7.49	73.1	58.2	(14.9)	(20.4)	143.6	59.6	(84.0)	(58.5)	17.6	10.0	12.3	28	15.7	128.3
D	$7–10	$2.50–4.99	49.8	75.1	25.3	50.8	434.0	377.5	(56.5)	(13.0)	39.4	38.6	7.3	19.8	12.5	170.1
E/F	<$7	<$2.50	292.7	279	(13.7)	(4.7)	155.4	238.1	82.7	53.2	36.4	44.1	7	10.9	3.9	57.2
Totals			**443.3**	**451.6**	**8.3**	**1.9**	**786.2**	**721.4**	**(64.8)**	**(8.2)**	**100**	**100**	**43.6**	**84**	**40.5**	**93.0**
Total domestic production			**1,229.5**	**1,173**	**(56.5)**	**(4.6)**	**Market share of imports**						**8.9%**	**15.7%**		
Total domestic consumption (domestic and imports)			**464**	**492.9**	**28.9**	**6.2**										
Total domestic production and consumption			**1,250.2**	**1,214.3**	**(35.9)**	**(2.9)**										

1 Export figures include bulk; domestic figures include on- and off-premise
2 Total value and volume from ABS. Distribution by segment in glass based on Nielsen data on retail glass bottle sales. All cask and soft-pack assumed to be E/F
3 Based on export data by price point from Wine Australia. Segment definitions held constant in destination currency terms
4 Total value and volume from ABS. Distribution by segment based on Nielsen data on retail glass bottle sales
Source: ABS; Wine Australia; Nielsen; analysis

Exhibit 6: Change in volume of Australian wine and imports to Australia from 2007 to 2012

Australian wine production and imports to Australia—Volume
Millions of litres



Value AUD Millions																
	$5,228	($4)	($116)	($568)	($470)	$7	$30	$238	($41)	$227	$40	$40	$61	$98	$45	$13	**$4,829**

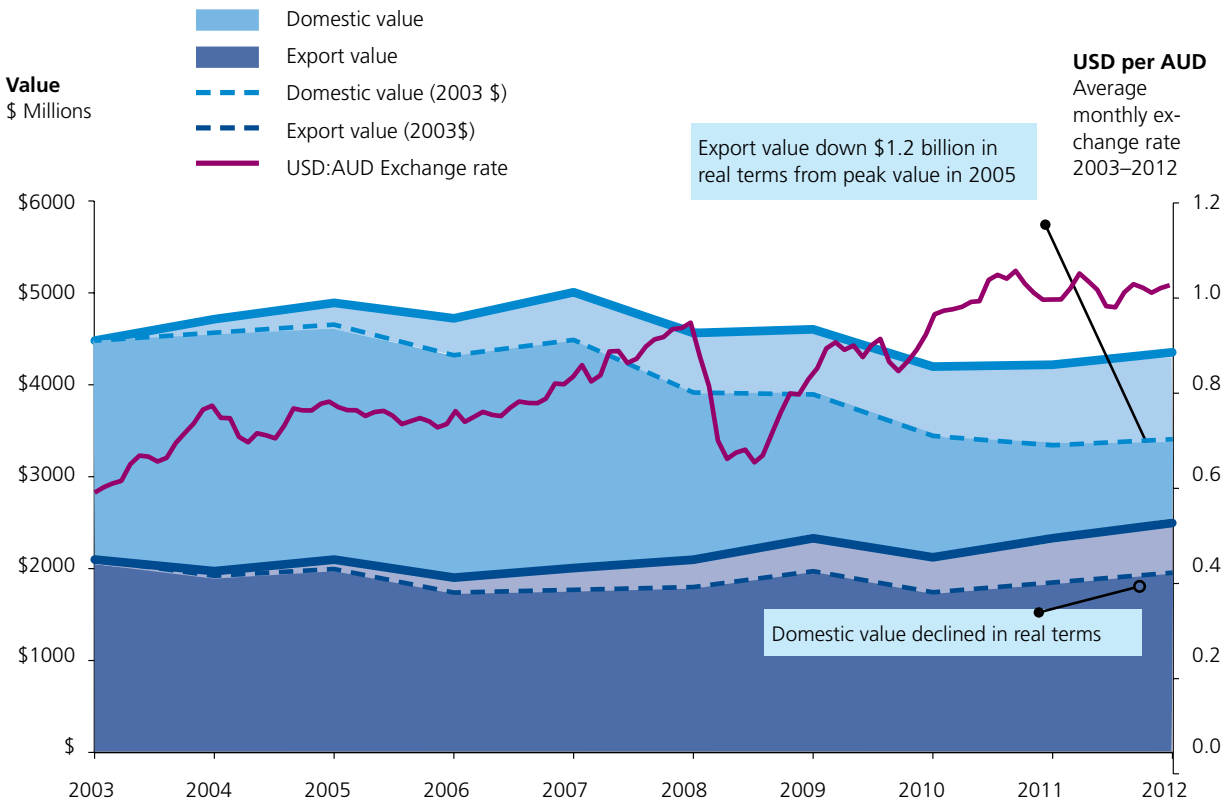
* Imports are glass bottle only
Source: Wine Australia; Nielsen; ABS; analysis

A few key points of context on the overall industry:

- The number of wine producers has grown dramatically—from 617 producers in 1991, to nearly 1,800 in 2004, and over 2,400 in 2012
- Australia is now the fourth largest exporting country with 8% of the global wine trade by volume. The other key exporters are: Italy (26%), Spain (24%), France (15%) and Chile (7%). Australia has significant shares in 4 of the top-10 wine importing countries (Exhibits in Appendices)
- By volume 75% of Australian wine exports goes to four countries—UK 35%, US 27%, Canada 7%, and China 6%. By value the top four countries total 69%—US 24%, UK 22%, China 13%, and Canada 10%
- From 1991 to 2012 to the export volumes of A and B wine grew by 36 times (52 million litres), C by 19 times (136 million litres), D by 15 times (405 million litres), E and F by 19 times (147 million litres). D is 56% of this growth in volume
- In 2012 30% of the wine produced in Australia was sold domestically at retail prices of less than $10/ bottle, and 53% was exported at less than $5/litre FOB. 83% of total wine produced in 2012 was D, E or F
- A and B wines account for just 7% of total domestic production—A is 2%, B is 5%, C is 10%, D is 39% and E and F are 44%
- A and B wines are higher in value—the 7% of total volume translates to 28% of Australian industry revenue. However, the majority (72%) of revenue comes from lower quality wines (21% from C, 32% from D, and 19% from E and F)
- The gross margins of wine differ significantly by

Exhibit 7: The value of the Australian wine industry has declined in real terms since 2003

Australian wine sales, export and domestic



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
USD:AUD	0.65	0.74	0.76	0.75	0.84	0.85	0.79	0.92	1.03	1.04
GBP: AUD	0.40	0.40	0.42	0.41	0.42	0.46	0.50	0.59	0.64	0.65

Source: ABS; Wine Australia; xe.com; US Treasury

segment and export versus domestic—much lower for lower quality segments and export.

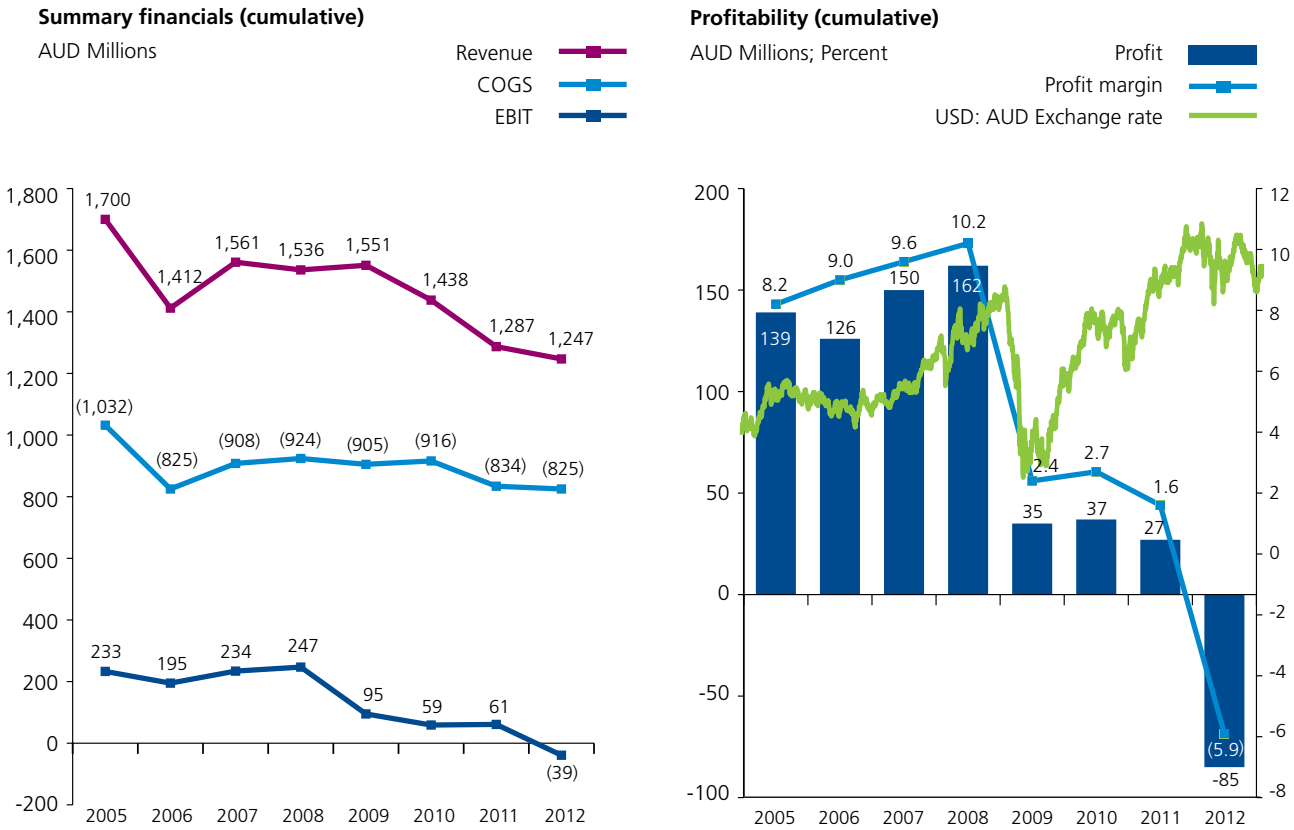
- In real terms the industry has declined since 2003, in both domestic and export sales, shown in Exhibit 7. The actual size of the industry has shrunk in real value terms almost 25% – from $4.5 billion to $3.4billion

2. Since 2007 the profitability of the Australian wine industry has declined significantly

Four separate analyses indicate a significant decline and structural shift in industry profitability over the last 5 years. The analyses are:

- ONE: Financial data for 9 wine companies from FY05 to FY12 summarised in Exhibit 9. These companies provide a representative cross section of the industry. In the 4 years from 2005 to 2008 their combined profitability and margins grew—peaking at $162 million and 10.2% in FY08. The aggregate profit of the 9 companies fell by 82% in FY09 and into loss in FY12. While much of these falls are due to asset write-downs and restructuring costs, it is clear that 8 of the 10 companies we have detailed data for (over a shorter time period FY07 to FY12) have experienced sustained reductions in margins and profit. In 2007 the average profit margin across these companies was 9.6%, in FY09 it averaged 2.4%; and in FY12 it was (5.9)%

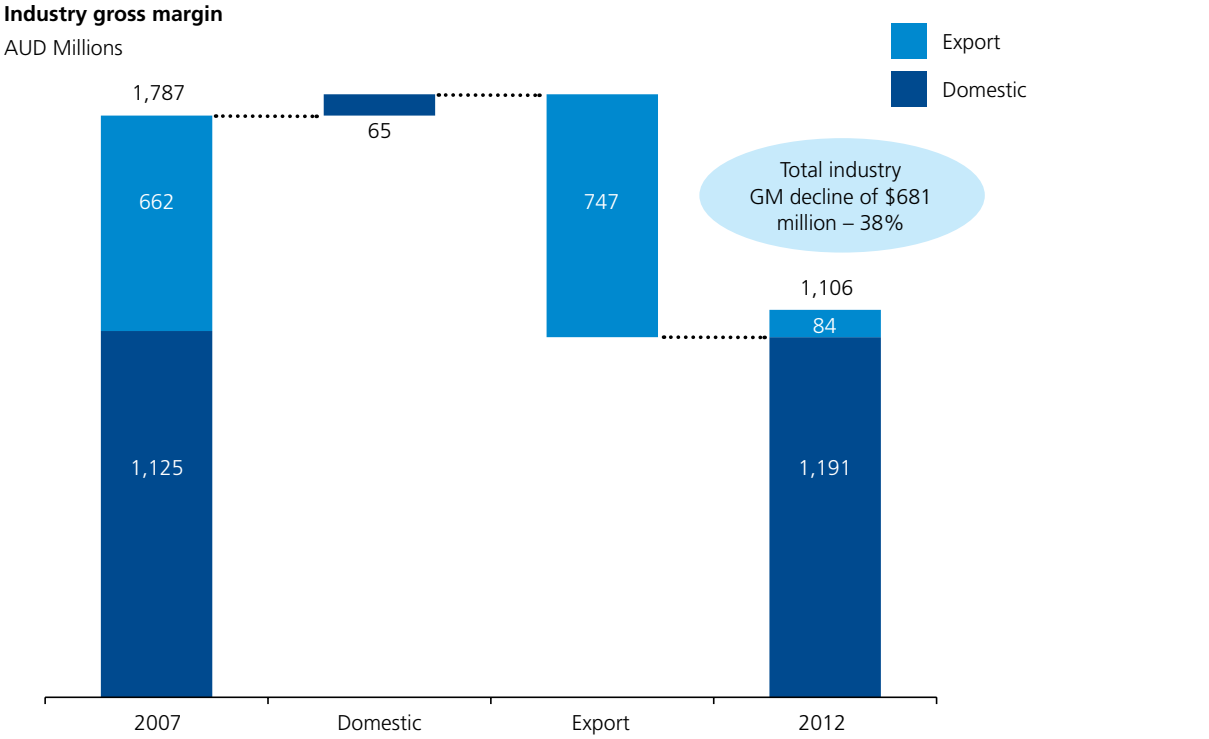
Exhibit 8: Profit performance of nine representative wine companies, 2005–2012



Source: Company information, US Treasury, analysis

- TWO: Modelling of industry profitability leveraging previous work by Deloitte and WFA, industry and ABS data, and using key assumptions developed via by confidential access to the detailed financials of a number of Australian wine companies, plus confidential interviews and surveys. The analysis estimated total industry gross margin declined by 38% to $1,107 million in 2012, from $1,787 million in 2007. This was driven by a $747 million decline in export gross margin. Whereas domestic gross margin rose by $66 million, just 6% over the 5 years—Exhibit 9.
- THREE: Confidential financial data provided by wine producers, and information on margins by product segment and market provided by 13 of the companies engaged in the Review process. Participants mostly indicated declines in gross margins. Several interviewees observed that the industry and individual companies (including themselves) "needed to re-set profit expectations..."
- FOUR: Numerous interviews, anecdotes and reports suggest a significant number of grape growers are currently unprofitable. The modelling of a representative selection of 13 growing regions comparing average costs of production to prices paid for grapes in 2012 suggests much of the volume across those regions was unprofitable in that year. This analysis is covered in detail in **Section 3.3** on 'oversupply'.

Exhibit 9: Estimated total change in industry gross margin, 2007–2012



Source: ABS; Wine Australia; Ready Reckoner; Deloitte Winemaker Survey; interviews; winemaker survey; Nielsen; team analysis

3.0 The decline in industry profitability is being driven by a 'perfect storm'

As the industry reached its peak in volume (and in recent history profitability) a 'perfect storm' began. From 2007 a number of forces combined to hit the Australian wine industry:

- The global financial crisis (GFC) hit world markets starting in August 2007 and accelerated through 2008—coinciding with a significant fall in Australian wine exports. Export volumes recovered through 2009, only to fall again in 2010 and 2011
- Fall in demand for Australian wine in key markets, especially the US, UK and Canada, from 2007 to 2012—further detail in Section 3.1
- From 2004 the A$ 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. Historical movements in the A$ are shown on Exhibits 1, 7, and 8
- Domestic retail consolidation, supplier management, and vertical integration into wine accelerated through the period. Woolworths (WLG) accelerated its growth of Dan Murphy, 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
- The situation has not been helped by the low domestic demand growth and increasing imports.

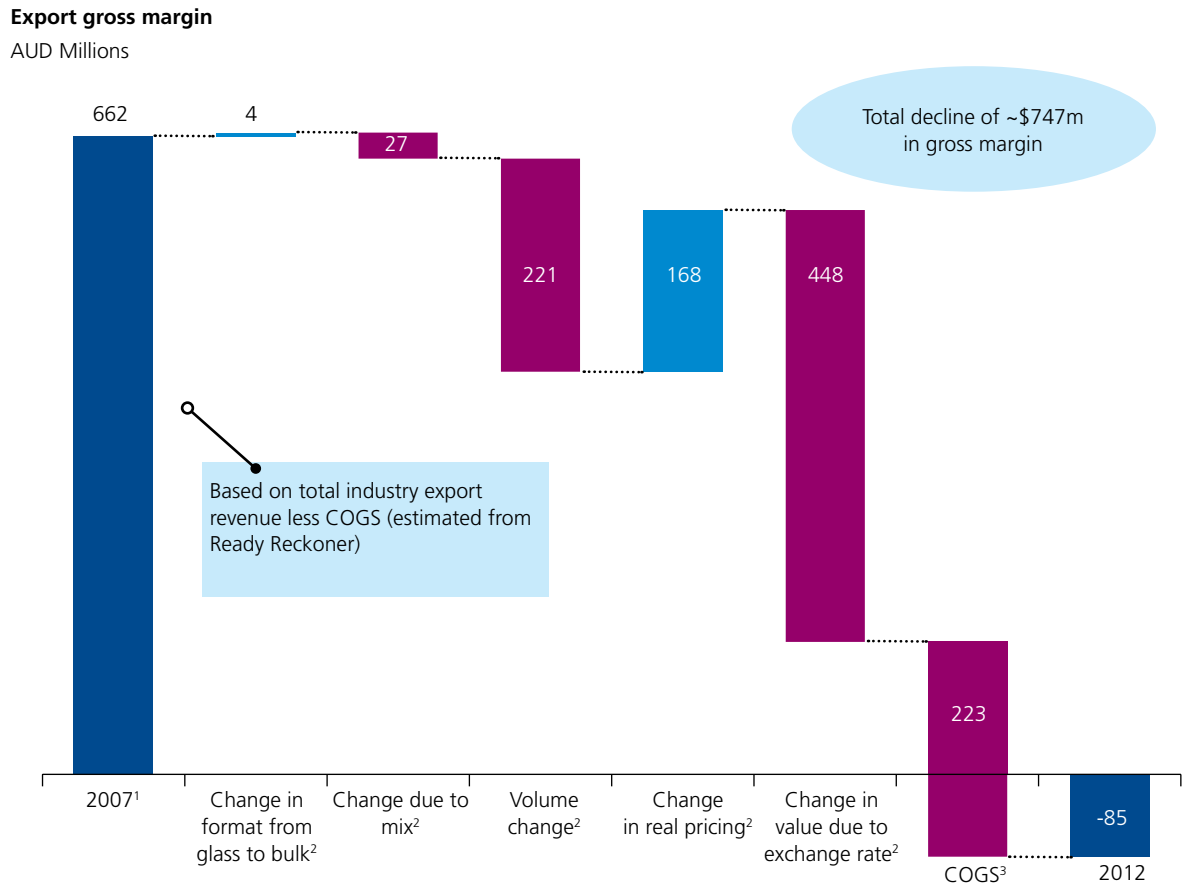
However, the 'storm' has intensified due to the oversupply of wine that resulted from excess planting and wine making capacity given the 'unexpected' fall in export demand and rise in the $A. This has created a series of responses with negative 'feedback loops' that: provide a market for uneconomic grapes and wine (ensuring supply is slow to respond to the fall in profitability), put further price and volume pressure on winemakers, educates the market to expect low price wine, and potentially further damages 'Brand Australia' and demand for exports. These responses include:

- Retailers are able to source cheap wine to support their private label and promotional strategies
- Flood of cheap Australian wine onto the export market (much of it in bulk or packaged without proper branding support)
- Winemakers accessing cheap fruit to maintain or increase wine production to amortise fixed costs—provides market for uneconomic grapes, and puts further price and volume pressure on winemakers
- Increased focus of some grape growers, winemakers, retailers, and opportunists on 'leveraging' the WET Rebate.

3.1 Export returns have declined sharply

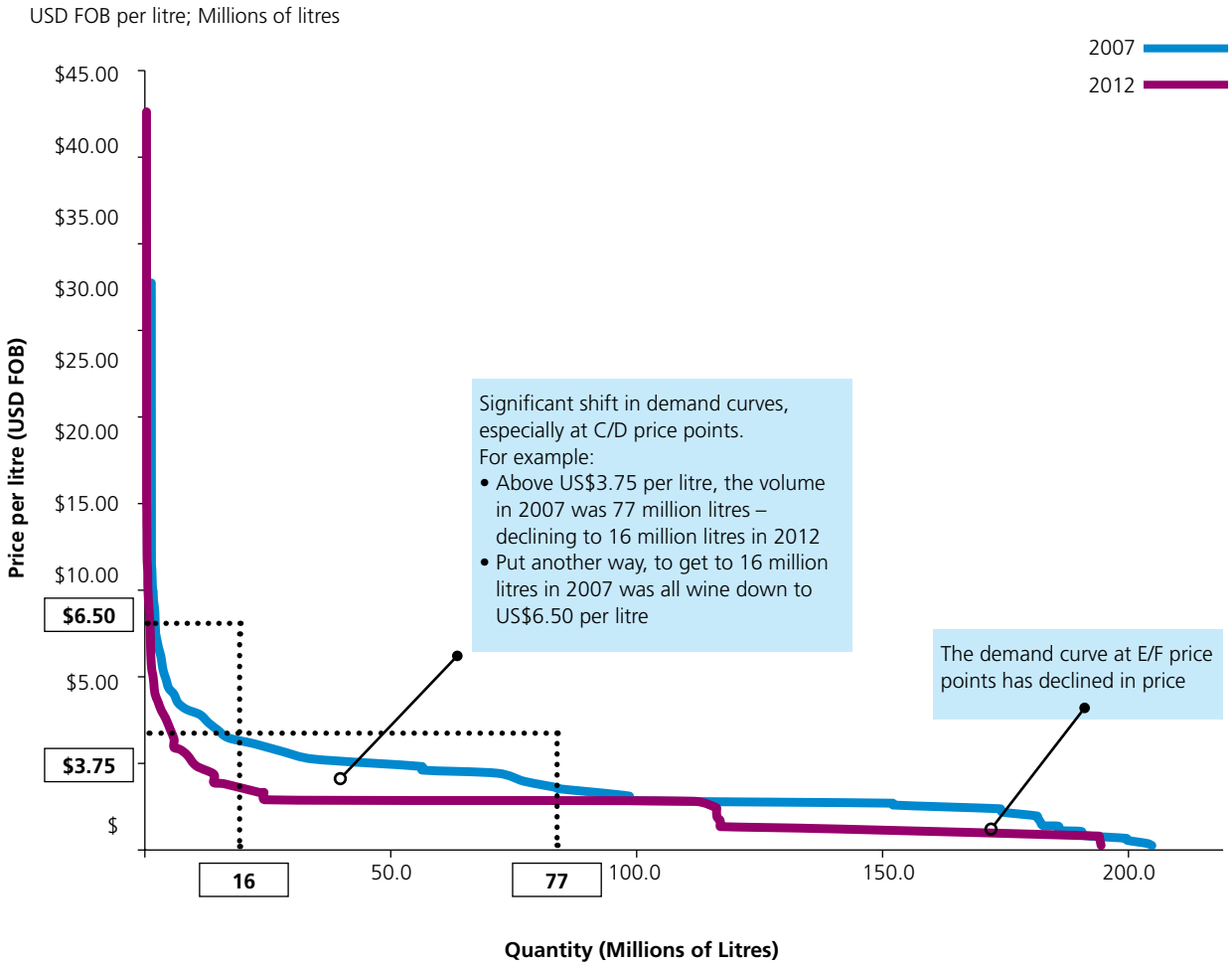
From 2007 to 2012 export volumes fell by 64 million litres (8%) and value by $1.15 billion (38%)—causing an estimated $750 million fall in total industry gross margin (Exhibit 10). The primary drivers of this are: a higher A$, falling demand, increased competition from other wine exporting countries, higher costs, and a deteriorating mix. The biggest factor is the exchange rate, estimated to have caused a $448 million fall in industry gross margin—though this was partially offset by efforts to increase prices that generated $168 million of gross margin.

Exhibit 10: Estimate of total gross margin change from exports, 2007–2012



1 Based on total export value from Wine Australia less COGS per litre estimated from Ready Reckoner
2 Based on detailed Wine Australia export data
3 Based on interviews, winemaker survey, and company financials
Source: ABS; Wine Australia; Ready Reckoner; Deloitte Winemaker Survey; interviews; winemaker survey; Nielsen; analysis

Exhibit 11: US demand for Australian wine has fallen in USD terms*



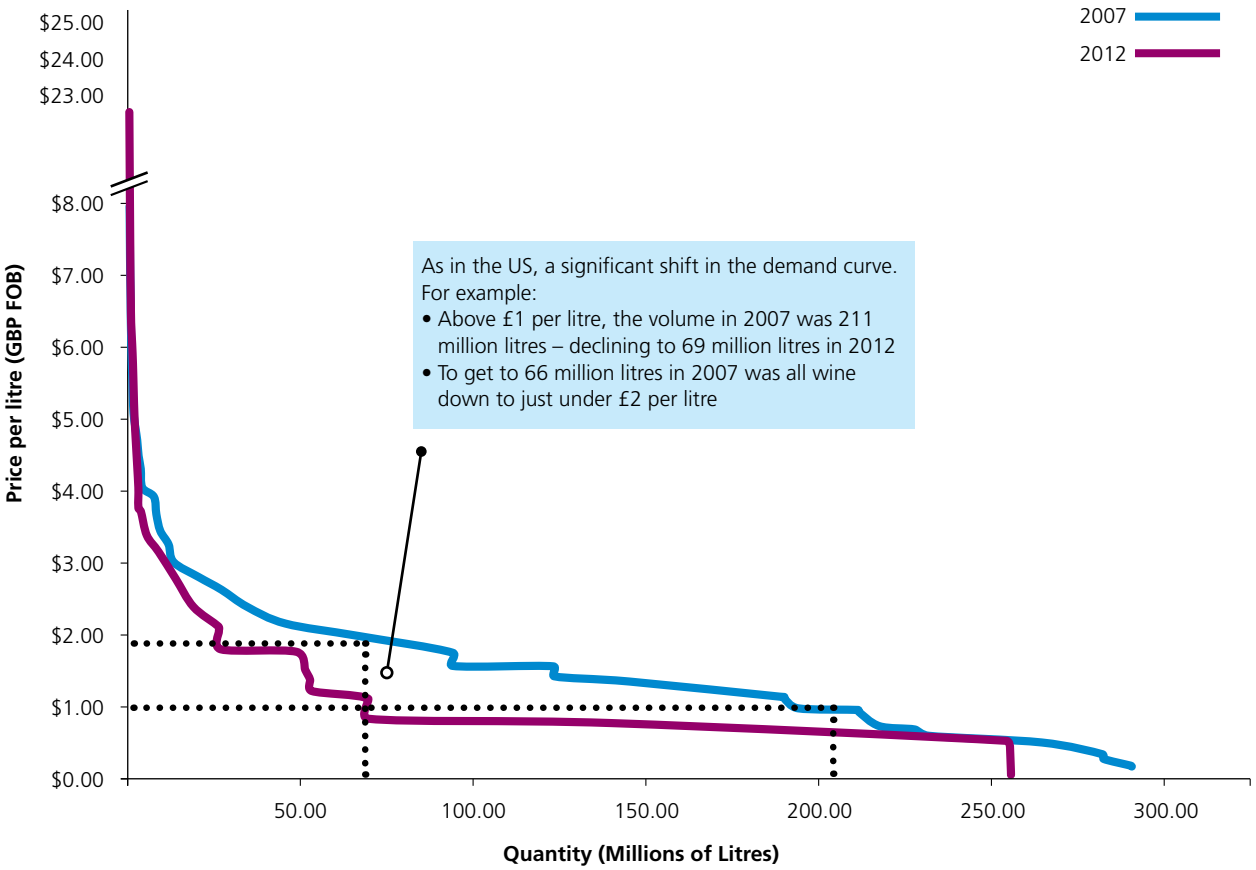
* All formats—glass, bulk, and others
Source: Wine Australia; xe.com for foreign exchange rates; analysis

Declining export demand has also reduced gross margins. In the US and UK markets demand has fallen at local currency price points (Exhibits 11 and 12). Defining the demand curves in the destination currency removes the impact of the appreciation of the A$. The US demand curves show that in 2007 US consumers purchased 77 million litres of Australian wine at USD prices of $3.75 and above—in 2012 they only purchased 16 million litres for the same price range; a decline of 61 million litres. While a number of interviewees commented on this fall in demand, separate to the impacts of the $A, we believe it is somewhat hidden and the reasons for it need to be better understood. The key drivers noted by the interviewees were:

- Increased competition and choice from other exporters including: France, Italy, Chile, Argentina, Spain and South Africa
- 'Damage to Brand Australia' by a number of factors including: exports of low quality wines, brand proliferation, loss of 'story and identity'

Exhibit 12: UK demand for Australian wine—in GBP terms*

GBP FOB per litre; Millions of litres

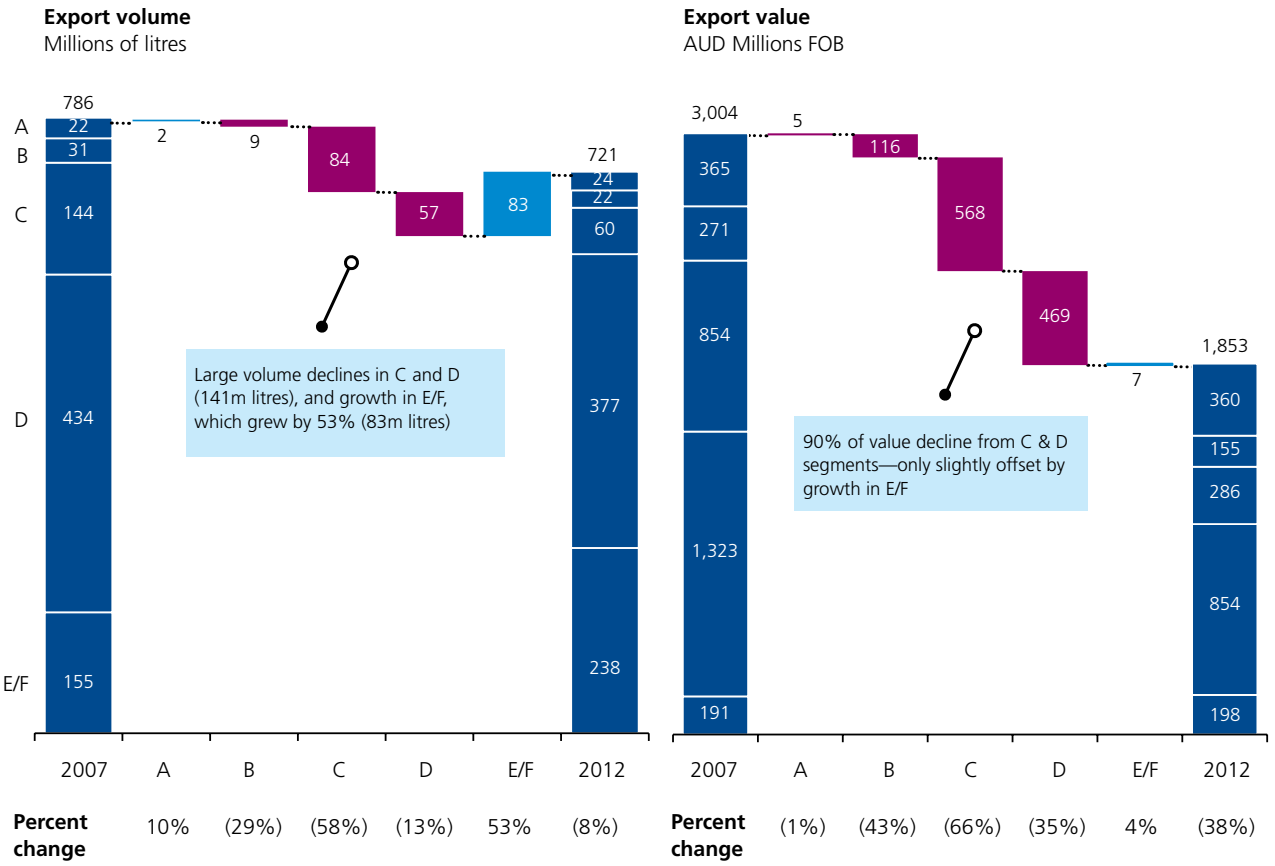


* All formats — glass, bulk and others
Source: Wine Australia; xe.com for foreign exchange rates; analysis

In the face of this declining demand the appreciation of the A$ has resulted in lower FOB prices (a 'double whammy'). While some Australian exporters have been able to increase prices in destination currencies on average this has not covered the increase in the A$, and fall in volumes. Further the sustained rise of the A$ has 'ended' hedging strategies that protected some exporters. This plus asset write-downs may be a primary driver of the accelerated fall in profit of a number of players in FY11 and/or FY12 (Exhibit 8 and analysis in Appendices).

Exhibit 13: Change in export volume and value by segment, 2007–2012

Segment definitions constant in destination currency terms*



Further detail on the overall situation for exports from 2007 to 2012 is shown on Exhibits 13, 14, and 15, including:

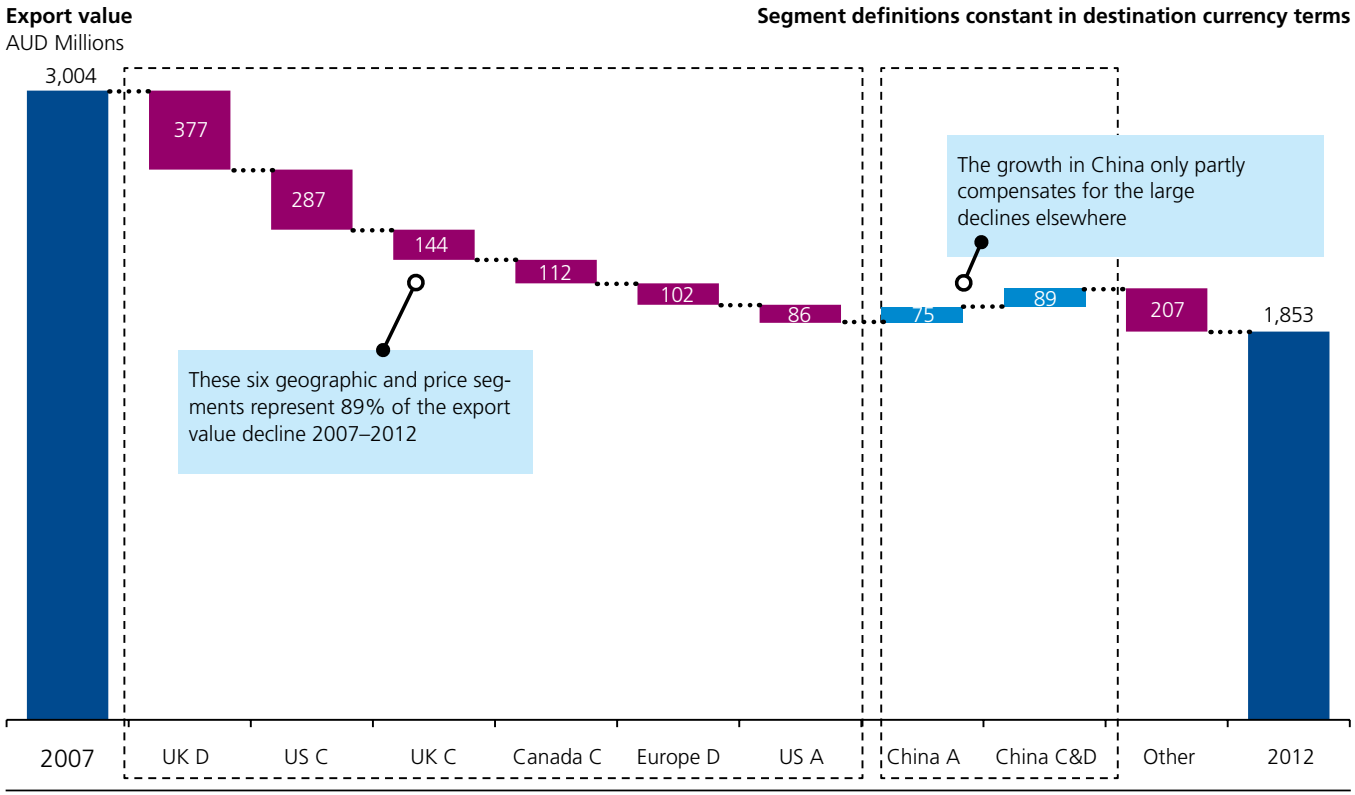
- 220% of the fall in export volume came from C and D wines. A 53% increase in the export of E/F wines kept the overall fall at just 8% (Exhibit 13)
- 90% of the fall in value comes from C and D wines. And, exports of B have fallen 29% by volume and 43% by value
- Switch to low quality/value wine—the volume of B is down 29%, C down 58%, and D down 13%, while E/F are up by 53%
- Significant issues in our major export markets—the US and UK account for 91% of the total fall in value. Canada previously our third largest single country market has maintained volumes but is down 35% in value (Exhibit 15)

* The analysis kept the segment definitions (price points) constant in the destination currency to prevent distortions to segment values due to the rising $A
For example: In 2007 wine exported to the US at A$10/litre FOB was classified 'A'. The value in USD was US$8.39/litre. In 2012 the US $8.39 equates to A$8.10 suggesting B analysis adjusts this so that 'A' is wine > A$8.10/litre FOB

Source: Wine Australia; analysis.

- Just six country and segment combinations represent 89% of the decline in value and almost 3 times the fall in total volume. The combinations are UK D & C, US C & A, Canada C, and Europe D

Exhibit 14: Decline in export value and volume by country and segment



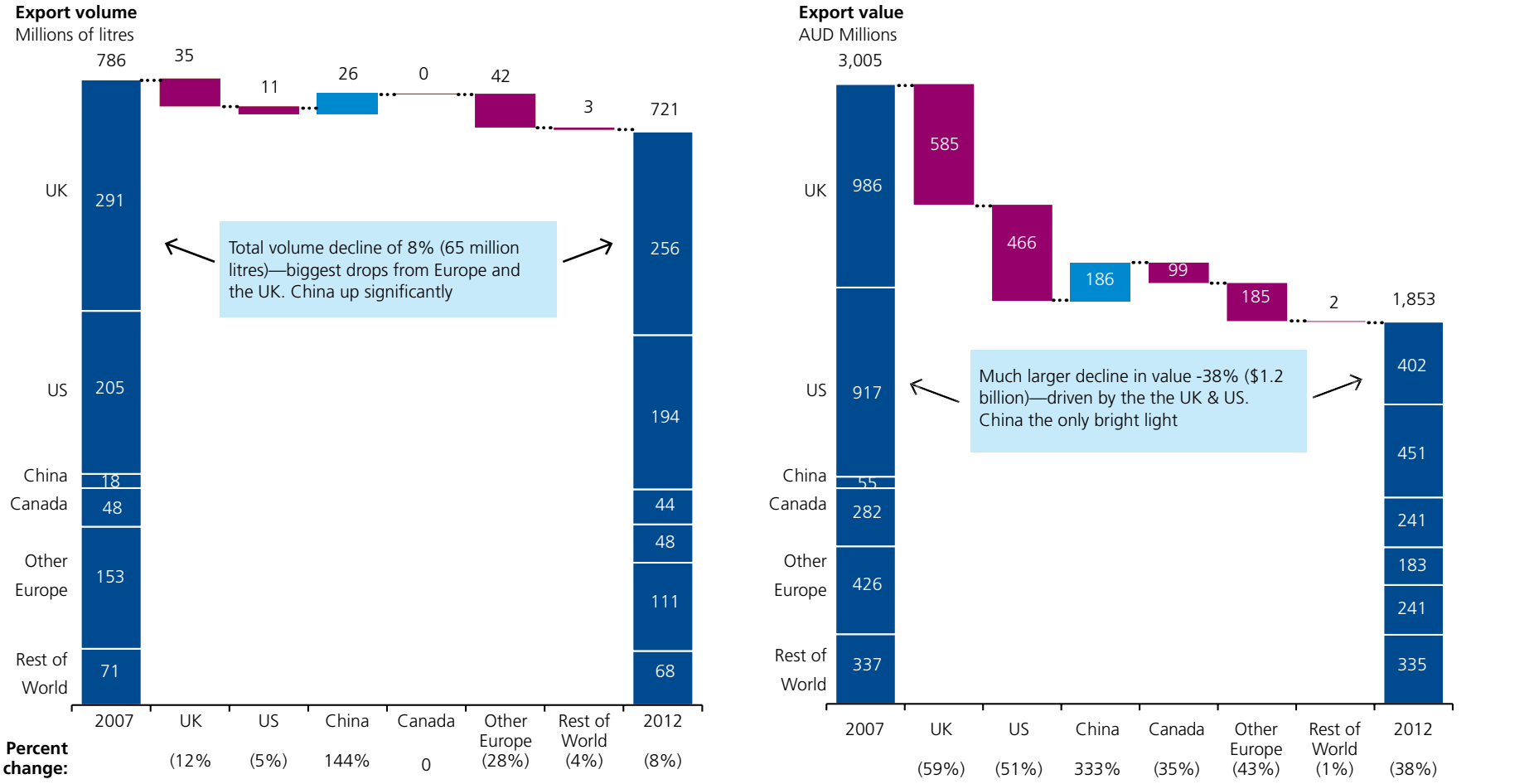
Volume Millions of litres

2007	UK D	US C	UK C	Canada C	Europe D	US A	China A	China C&D	Other	2012
786	(71)	(47)	(20)	(17)	(28)	(5)	4	24	95	721

Source: Wine Australia; analysis

- China is the bright light but unfortunately still small—volume is up 144% (26 million litres) but is still just 6% of total export volume. The value story is better, up 333% ($186 million) to $241 million and 13% of total export value. A continuation of this growth will help the industry but has limits:
  - Excluding China the value of wine exports fell by $1,336 million from 2007 to 2012. The increase in exports to China mitigated $186 million just 14% of this fall
  - Over half ($97 million) of the increase in exports to China came from A and B wines of which there is limited supply
  - Australia is the second largest exporter to China (almost 40% the size of France by value). In the last year imports of wines from Spain, Chile, Argentina, US, and South Africa grew at similar or higher rates.

Exhibit 15: Change in export volume and value by country, 2007–2012



Source: Wine Australia; analysis

3.2. Domestic margins have been squeezed by retailers, low demand growth, and increased imports

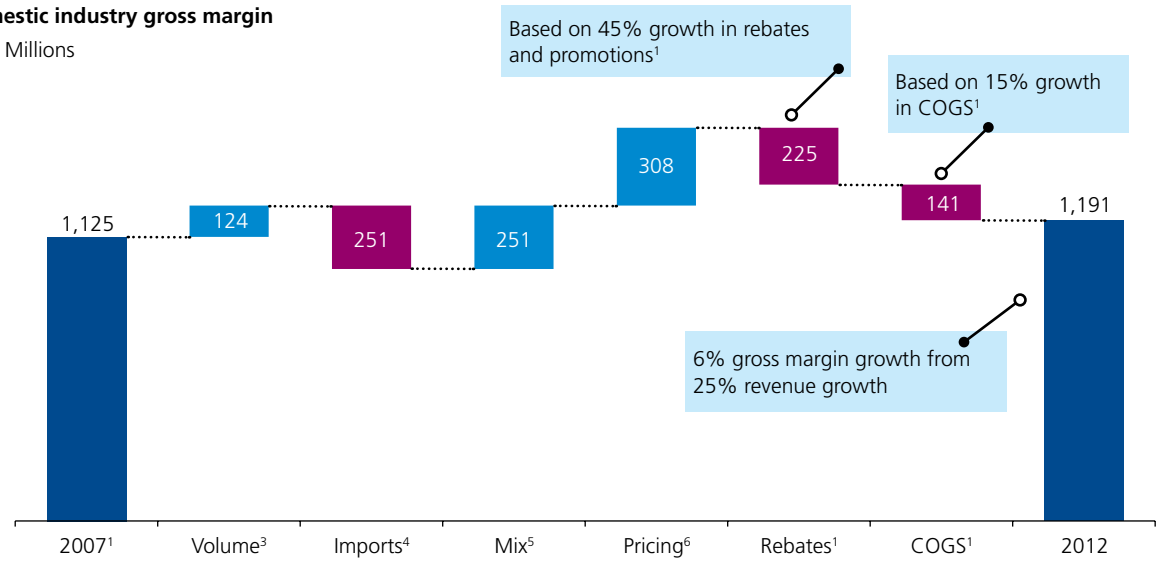
- Another possible opportunity is broadening and deepening the export base. Currently 80% of Australia's exports go to five countries. This concentration is significantly less for Australia's key competitors including: France (58%), Spain (57%), Chile (56%), South Africa (60%), Italy (64%), Germany (53%), US (70%), and Argentina (70%). Importing countries in the top 5 of competitors but not in Australia's top 5 include: Netherlands, Japan, Russia, Sweden, Hungary, France and Italy.

Previous Exhibits 8 and 9 show the marked fall in profitability of Australian wine makers. The analysis in Exhibit 16 shows that imported wine and increased rebates and discounts paid to retailers all but negated the gross margin benefits of premiumisation (increased sales of higher value wines—mix), increased prices, and volume growth. Domestic industry gross margin for the period grew just $66 million (6%) from revenue growth of 25% (refer Exhibit 4).

Retailer Consolidation and Power. It is estimated the combined groups of Coles and WLG distribute and sell up to 77% of all wine sold off premise (Exhibit 17) up from circa 60% in 2007. This translates to about 70% of all domestic sales, on and off-premise. The data required to accurately determine market shares is not available, therefore these shares are estimates based on our interpretation and analysis of numerous sources. WLG is now an integrated wine player—owning and/or controlling most elements of the wine making

Exhibit 16: Estimate of total gross margin change from the domestic market, 2007–2012

Domestic industry gross margin
AUD Millions



1 Based on interviews, winemaker surveys and company financials. Not the case for all companies with respect to COGS, a number of larger companies claim to have achieved better performance than this
2 Based on total industry value from ABS less COGS per litre estimated from Ready Reckoner
3 Volume change from ABS
4 Imports volume from Nielsen
5 Mix change from Nielsen
6 Pricing change from Nielsen and ABS
Source: ABS; Wine Australia; Ready Reckoner; Deloitte Winemaker Survey; interviews; winemaker survey; Nielsen; analysis

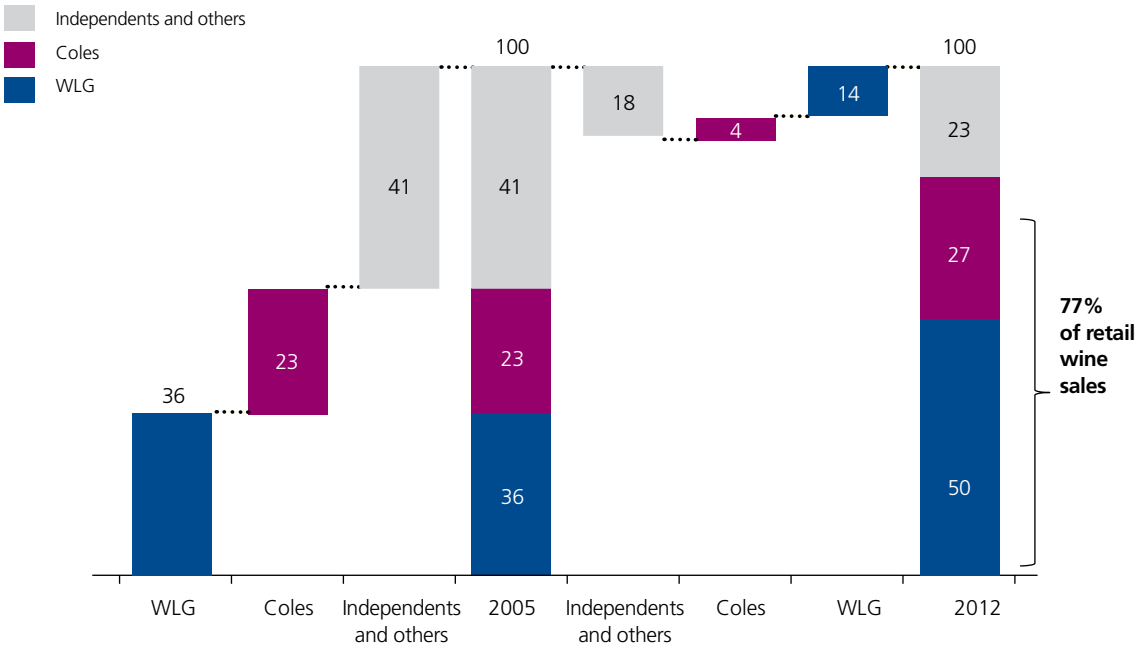
process from winemaking, bottling and packaging, and distribution to retail sales (on and off premise). It also has a significant number of contracted growers. The private, exclusive and controlled labels of both major retailers are estimated to account for at least 16% of domestic sales (off premise). A number of winemakers interviewed noted, 'the retailers' are both their biggest customer and competitor and this is a major issue affecting their profitability. In contrast to this retail and distribution consolidation, the Australian wine industry is highly fragmented—with circa 2,400 producers and 30,000 retail SKUs. Though the 38 largest producers account for 88% of total production (already a large number of alternate suppliers for retailers to leverage) the single biggest producer has less than 15%, much of which is exported. (refer Exhibit 29)

The retailers have numerous sourcing options to leverage due to: this fragmentation, the excess supply of grapes and wine, and the ability to sell imported wine at attractive margins. As a result:

- Many wine producers report a significant increase in discounts and rebates (producer selling costs). Average discount levels being achieved by the major retailers are estimated to be about 30% and as high as 40%—up from 10–15% five years ago (Exhibit 17). One of the retailers briefed on these findings stated that 25% was more representative and strongly disagreed with the 40% level. They also suggested that in cases where producers had switched to direct distribution to the retailer some of the increase in discounts reflects a sharing of the savings from not using a third party distributor
- Winemakers are affected directly and indirectly by the ability of retailers to significantly impact a

Exhibit 17: Estimated change in domestic retailer market shares

Estimated retailer market share of Australian domestic retail wine market by value 2005–2012*
Percent



* WLG share does not include Cellarmasters & Langtons. Off-premise only. MetCash is not include as a separate entity.
Source: Estimates based on interviews; company filings & analyst reports; media; analysis

company's volume/sales and brand strength by controlling: access to shelf space, promotional activity, pricing, volume for exclusivity, and de-listing. The risk of these behaviours to winemakers is extensive as they make production decisions far in advance of sale, have expensive inventories, and have extremely limited alternate distribution options

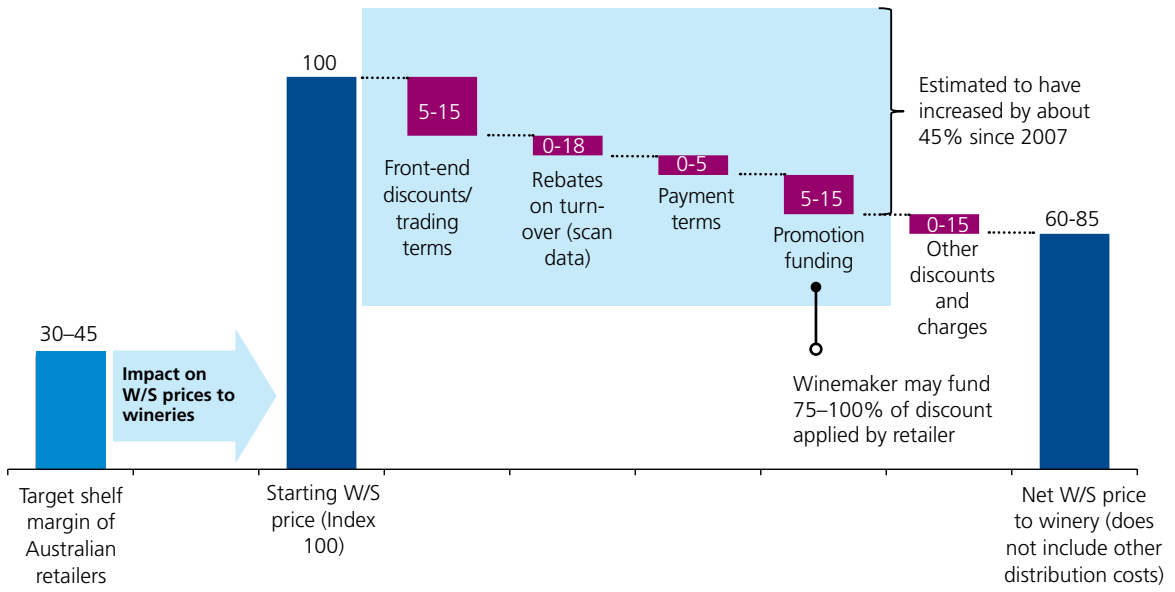
- The strong growth in market share of private label—including controlled and exclusive brands
- Many winemakers stated they struggle to pass on genuine cost increases to retailers that are not then taken away by increased rebates and discounts.

Our confidential analysis of a small number of producers shows that from 2007 to 2012 retailers captured a significant portion of these winemakers profit margin. The analysis also indicates the majority of this margin was not transferred to consumers.

- The change in consumer price varied across different product lines—with certain lines decreasing in price and some increasing. However, when adjusted for volume, the total amount paid by consumers on these products increased compared to what they would have paid in 2007. It should be noted that this is in nominal terms—prices (retail and net wholesale) have not been adjusted to reflect inflation over the period
- For the wines analysed, this total increase in consumer cost was combined with an increase in retailer profit margin, and a decrease in winemaker margin. This was due to falls in net wholesale prices (driven by rebates, discounts and promotions)
- Further work is required with a larger number of winemakers to enable this to be better proven and shared without putting individual companies at risk of recognition.

Exhibit 18: Indicative increase in retailer discounts and margins – impact on winemakers

Change in retailer discounts, rebates, and promotions
Percentage of starting wholesale price



Source: Interviews; WFA Retail Discussion Paper; WFA board member survey; analysis

The retailers briefed on these findings strongly believe their customers have benefited from overall lower wine prices. One of the retailers has shared summary data that indicates from August 2008 to August 2013 the average retail price paid for a domestically produced bottle of wine has fallen 4% from $10.55 to $10.13. Based on consumers buying the same quantities as in 2008 at 2013 prices (again these numbers are not adjusted for inflation). This is for the top 131 domestic wine SKUs (stock keeping units) by revenue. The data set excludes imported wines and domestic wine SKUs that were not sold in 2008. The total revenue of this basket is $1.06 billion, 61% of the total for the top 200 SKUs including imported wines (as per data

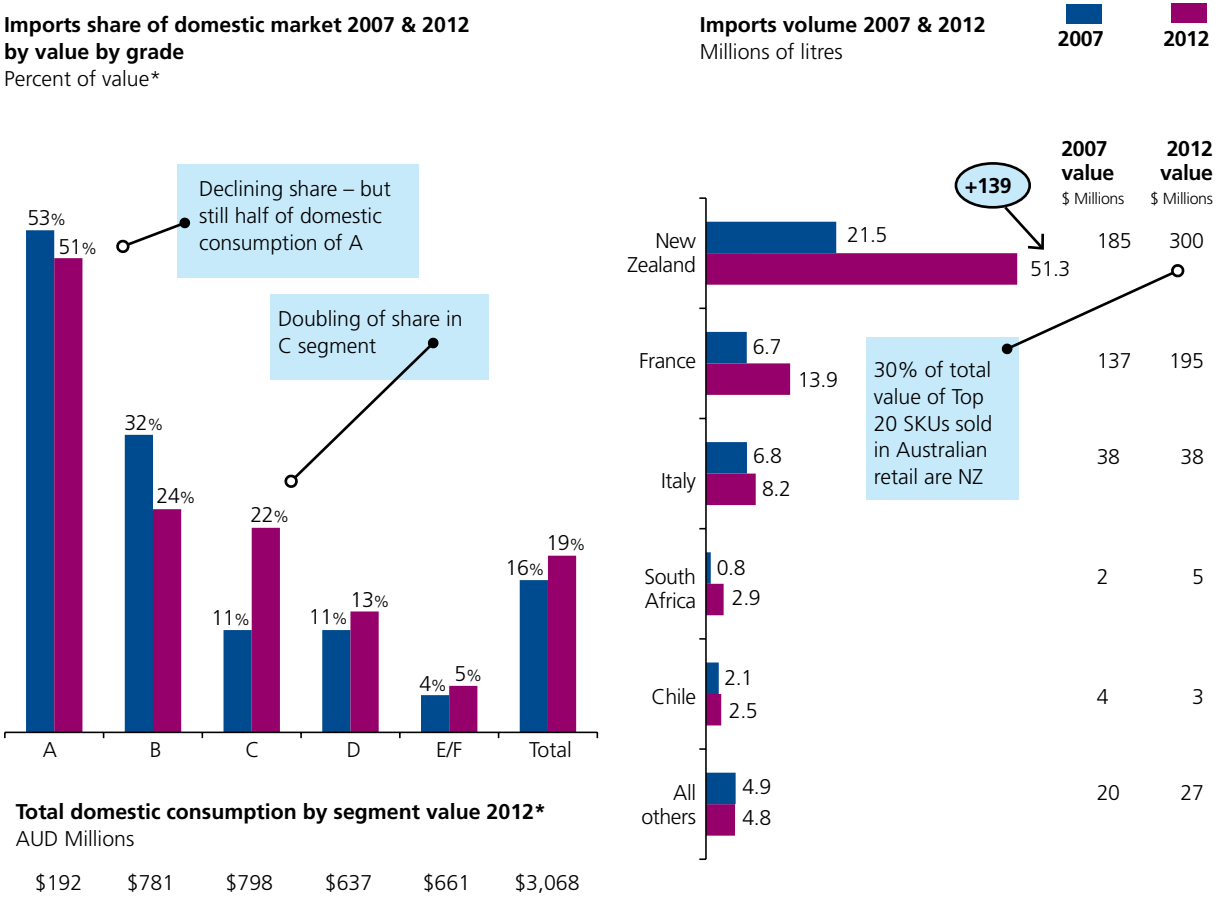
provided by the retailer), and approximately 42% of the value of all Australian wine consumed domestically in 2012 (as per data in Exhibit 4).

The differences in the results of the separate analyses illustrates a number of the challenges facing the industry:

- The retail sector, including independents, has been aggressive in discounting the most popular wine brands. In cases this has been supported or led by winemarkers seeking volume. This has contributed to a 'bargain mentality' and expectation of the consumer to buy quality wines at low prices
- Individual winemakers are affected differently by their relationships with the retailers. The major retailers are clear about targeting specific gross profit margins for SKUs and suppliers and manage to these targets. The dependence of most producers on the retailers to sell a major portion of their wine (many of those interviewed stated that 40 and up to 80% of their volume is sold by the 2 major retailers) means if they are not meeting the retailers gross profit targets they come under pressure to 'transfer more of their margin' to the retailer/s
- How/if winemakers and retailers can work together to refocus the consumer on quality at prices/margins that better support a strong and sustainable domestic wine industry. Any such solution requires continued focus on costs, efficiencies, and making wines consumers' want, in addition to a reduction in the use of low prices and discounting as the primary sale levers.

The major retailers are in the process of responding to a number of views and analyses in this report that may allow for revisions after its release. Any changes will be highlighted and made available on the WFA website.

Exhibit 19: Growth in imports' share of domestic market 2007–2012



* On & off premise
Source: Nielsen; ABS; Wine Australia; analysis

Slow growth in domestic demand combined with rapid growth in imports (2007 to 2012).

There are three key stories with respect to domestic demand:

- Strong trend to consumption of higher priced/quality wine (*good story*)
- Slow growth in overall wine consumption by volume, but solid growth by value (*bad and good story*)
- Significant growth in imports value and volume (*bad story*)

On the positive side, from 2007 to 2012:

- Domestic consumption increased in value terms by 34% ($751 million). Domestic consumption of domestic wine increased by 25% ($494 million)
- Sales of Australian wine sold above $15/bottle (A and B) increased by $268 million (64%) in value terms and 11.6 million litres (42%) by volume
- Total demand for A and B wines (domestic and imported) has grown by 62 and 43% by volume, and both by 66% in value terms.

On the negative side:

- By volume, total domestic demand has grown by just 6% in 5 years, and just 2% for wine produced in Australia (up 8.3 million litres (Ml)—comprising 11.6 Ml growth in A & B, 25.3 Ml growth in D, and a 28.6 Ml fall in C, E, & F)
- The volume of imported wine doubled from 2007 to 2012 and value rose by 116%. The domestic market share of imports has grown from 8.9% to 15.7% by volume and from 16.3 to 18.6% of value (Exhibit 19)
- Imports provided 71% of the growth in domestic volume consumed and 34% of value. A, B and C wines account for 80% of the value of total imports
- Unfortunately, the strong growth in demand for locally produced A and B wine only benefits a small portion of the industry—only 16% of all wine produced in Australia by value and 3% by volume.

With respect to imports, this growth is dominated by New Zealand, with France second in both volume and value (Exhibit 19). Other countries—Italy, South Africa, Chile and others—are just 22% of the volume and 13% of the value of all imports. NZ wines fill 6 of the top 20 domestic wine SKUs and represent 30% of the retail sales value of those 20 SKUs.

The overall growth in imports has been driven by:

- Purchasing strength of $A—increased competitiveness of imports
- Strategic sourcing by retailers—for increased margins, customer choice, differentiation, and supplier management
- Strong Australian consumer response to smart marketing and product development by NZ and possibly supported by the WET Rebate—205 NZ 'based' producers received a total of A$25 million in WET Rebate in FY12. (refer Exhibit 30)

However, the NZ Sauvignon Blanc phenomenon demonstrates both the opportunity to create new consumer demands, especially with a clear brand message, and the vulnerability of the Australian industry to 'imported trends'—particularly as the domestic consumer palate becomes more sophisticated and 'premiumised'. The industry should look to this as an opportunity.

3.3 The decline and shift in demand (primarily export) has created an 'oversupply/under-demand' of grapes and wine in certain quality segments

Falling export demand has created excess vineyard and winery capacity. This has particularly impacted growers of higher cost, lower quality fruit. It has also impacted the volumes and prices of many winemakers—as volumes in excess of demand search for a buyer. The oversupply has come from:

- Reduction in exports—portion of this volume is 'stuck' in domestic market
- Excessive and/or poorly planned planting (quantity, quality, variety). Too much commercial and commodity wine struggling to compete profitably in more competitive export markets and at higher $A levels
- Excessive wine making capacity/growth strategies of many wine industry players, creating 'pull through' of grapes to amortise high fixed costs.

The issue of 'oversupply' causes significant debate within the industry—how much is it, where and what is it, how much impact of what type does it have, is it 'oversupply' or 'under-demand', and why doesn't it leave? These are difficult questions, especially given the available fact base. Our analysis (quantitative and qualitative) provides the following perspectives:

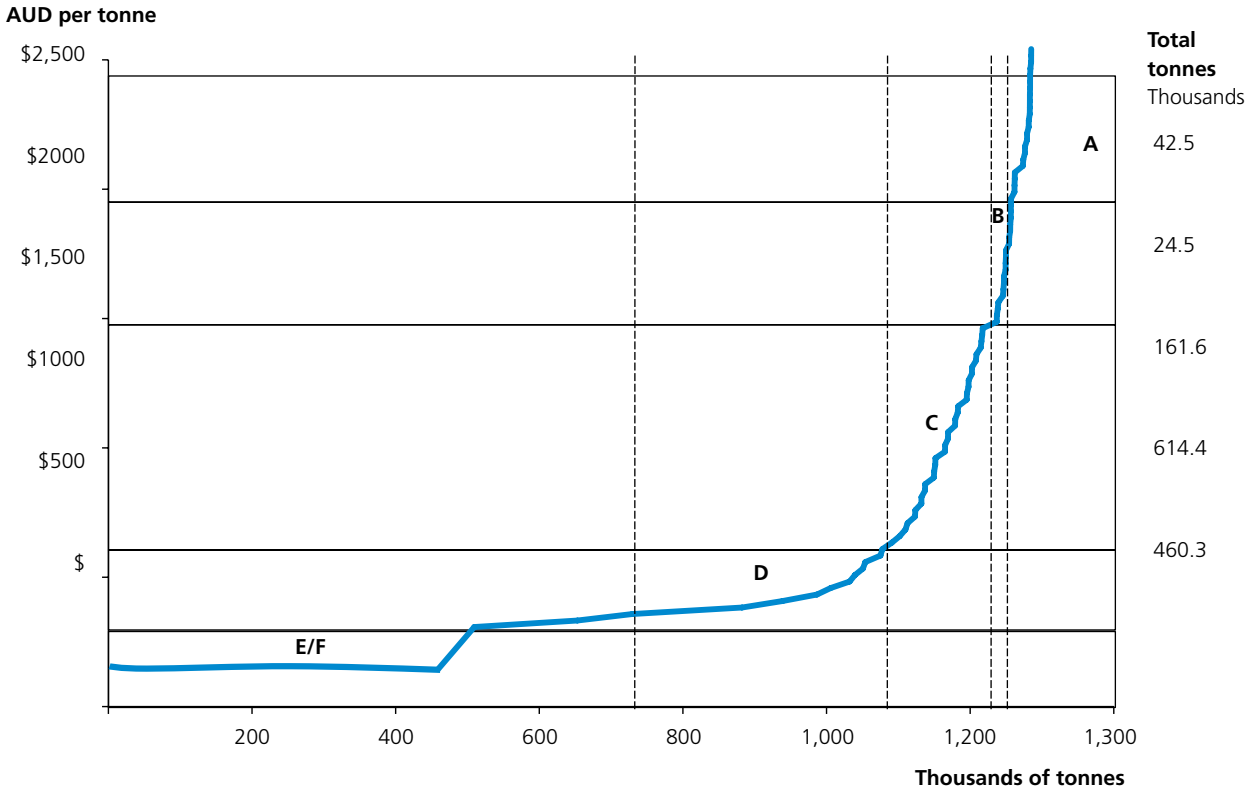
The analysis of 13 growing regions suggests the oversupply is significant.

The initial analysis of 13 growing regions suggests 70% of total volume in 2012 was likely unprofitable—summarised in Exhibit 21. The 13 regions were chosen by the WFA Board and WGGA as representative, combined they provided 78% of total Australian grape supply in 2012 (1.3 of 1.6 million tonnes crushed).

Exhibit 20: Grape supply profile by sale price—13 regions

AUD per tonne; Thousands of tonnes; 2012 vintage

Purchase price and quantities, 2012 vintage from: Barossa Valley, Langhorne Creek, Mudgee, Riverland, Yarra Valley, Coonawarra, Hunter Valley, Margaret River, McLaren Vale, Mornington Peninsula, Murray Darling—Swan Hill, Riverina, Tasmania



* Assumes price distribution of owned grapes matches that of those sold. These regions represent 78% of total tonnage in 2012.
Source: Wine Australia price dispersion data; ABS for total crush tonnage; analysis

Exhibit 21: Estimated portions of grape supply that is profitable by region and segment in 2012 vintage

AUD per tonne; Thousands of tonnes; 2012 vintage

Based on estimated growing costs by region and quality level* compared to actual prices paid in 2012, it appears significant volumes of C, D, and E/F do not cover growing costs

	A		B		C		D		E/F	
	Current total	Unprofitable	Current total	Unprofitable	Current total	Unprofitable	Current total	Unprofitable	Current total	Unprofitable
Barossa Valley	11,820	-	3,454	-	33,430	19,409	8,760	8,760	1,466	1,466
Langhorne Creek	4,088	-	275	-	27,148	17,109	17,176	17,176	47	47
Mudgee	-	-	-	-	1,929	1,929	4,363	4,363	-	-
Riverland	-	-	-	-	1,821	-	255,322	188,434	174,520	174,520
Yarra Valley	2,877	-	3,415	-	5,287	1,459	441	441	-	-
Coonawarra	4,927	-	4,307	-	19,590	8,874	1,288	1,288	-	-
Hunter Valley	-	-	311	-	7,433	7,399	2,691	2,691	-	-
Margaret River	2,121	-	8,906	-	24,644	13,650	9	9	134	134
McLaren Vale	9,220	-	2,772	-	22,476	5,206	5,564	5,564	14	14
Mornington Peninsula	2,131	-	717	-	430	257	-	-	-	-
Murray Darling – Swan Hill	-	-	-	-	14,713	-	226,744	198,310	138,931	-
Riverina	11	-	-	-	2,706	-	92,055	90,147	145,218	145,218
Tasmania	4,989	-	390	-	-	-	-	-	-	-
Total	**42,184**	**-**	**24,547**	**-**	**161,606**	**75,291**	**614,414**	**517,185**	**460,330**	**321,400**
Total if 'loss' grapes exited	**42,184**		**23,227**		**86,315**		**97,229**		**138,930**	

Individual companies with better cost performance than typical will reduce these numbers

Individual companies with higher costs – and who are not getting enough of a price premium – will increase these numbers

* Initial growing cost estimates from WGGA, refined with input from WFA Board Members. Estimated cost per hectare of $9000 for A grapes; $8000 for B; $7500 for C, D, E & F. Total cost by region based on these and the average yield by region, based on 2006, 2008, 2010, and 2012 vintages. 2007 excluded as it was a drought year and data not available for 2009 and 2011.

Source: Price dispersion for 2012 vintage; Wine Australia; ABS; WGGA; analysis; WFA Board Members.

Exhibit 20 illustrates the supply curve (volume by sale price) for the 13 regions combined. The WGGA and members of the WFA Board have provided further guidance on cost and yield assumptions for each region—however, it remains a work in progress that needs to be improved with further input from growers in the proposed consultation phase.

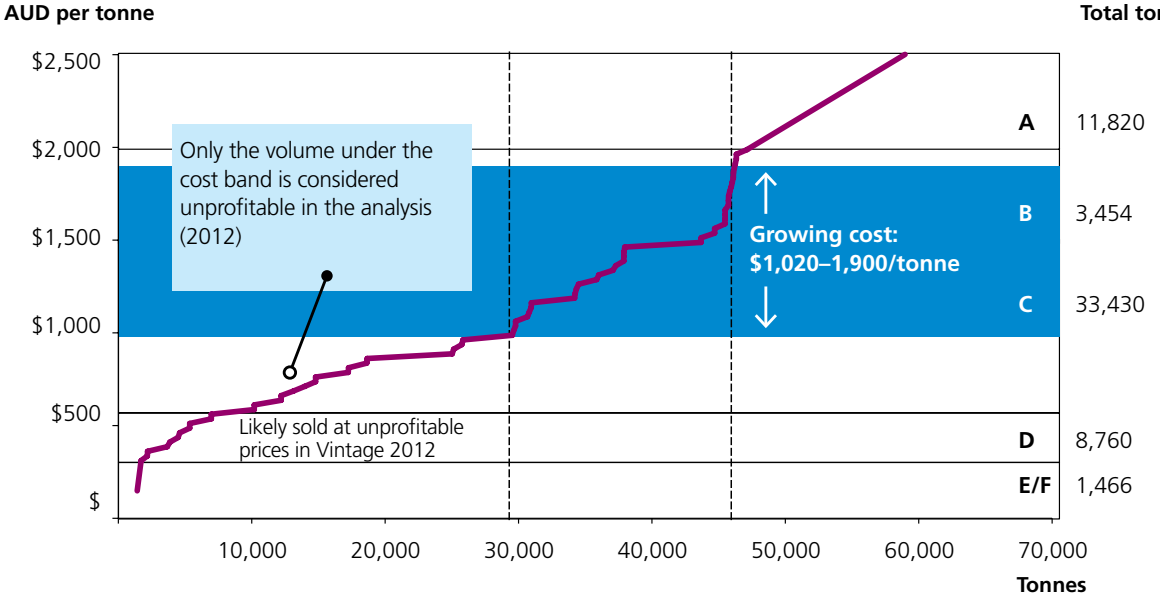
The situations in the Barossa, Riverland, Margaret River, and Hunter Valley are shown in Exhibits 22, 23, 24, and 25 (the other 9 regions are in the Appendices).

Overall the analysis suggests A and B grapes are profitable on average, but 47% of C, 84% of D, and 70% of E/F were unprofitable. However:

- Determining how much of this 'unprofitable production' is 'over-supply' depends on assumptions on: costs, future demand, 2012 vintage, and future economic conditions—including the value of the $A
- Some of the 'unprofitable supply' in D and E/F is likely being driven by artificially low prices due to winemakers taking advantage of C and D grade fruit at E/F prices.

Exhibit 22: Barossa grape supply and growing costs

Purchase price and quantities, 2012 vintage



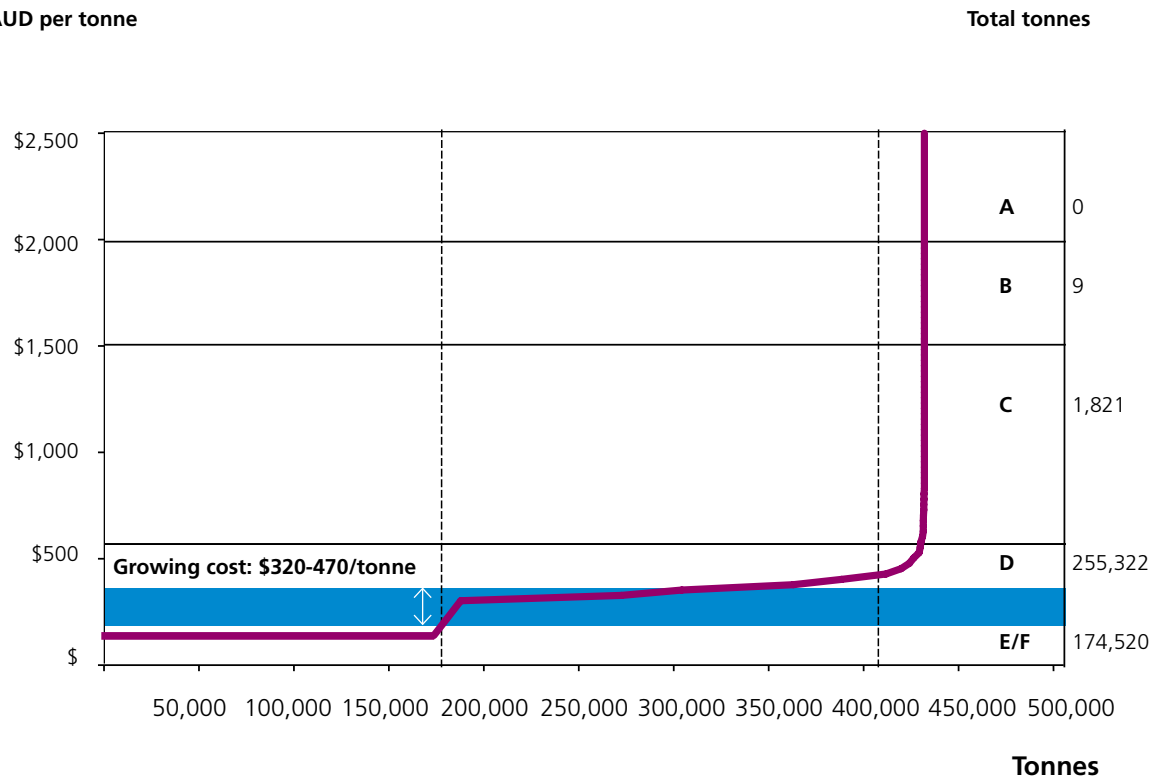
* Assumes price distribution of owned grapes matches that of those sold. Based on $7500 per ha for C/D/E/F; $8000 per ha for B; $9000 per ha for A & average yield from 2006–2012 (7.3 tonnes per ha)

Source: Wine Australia price dispersion data and yields; ABS for total crush tonnage; WGGA for growing costs per ha; WFA board input; analysis

- Very large volumes of E/F and D in warm inland regions are being sold 'just' below average growing costs. (refer Exhibit 23 for for Riverland) Whereas significant volumes are being sold from cooler and more temperate regions at hundreds of dollars below typical growing costs, likely depressing prices for the warm inland fruit
- However, based on the 13 regions analysed, just 13% or 117,246 of the 913,876 estimated 'unprofitable' tonnes comes from the cooler temperate regions (and over half this 13% comes from Barossa and Langhorne Creek)
- Improved data and further modelling is required to determine how much capacity in warm inland regions would be made economic by less supply of C and D from cooler areas such as the Barossa and Langhorne Creek.

Exhibit 23: Riverland grape supply and growing costs

Purchase price and quantities, 2012 vintage

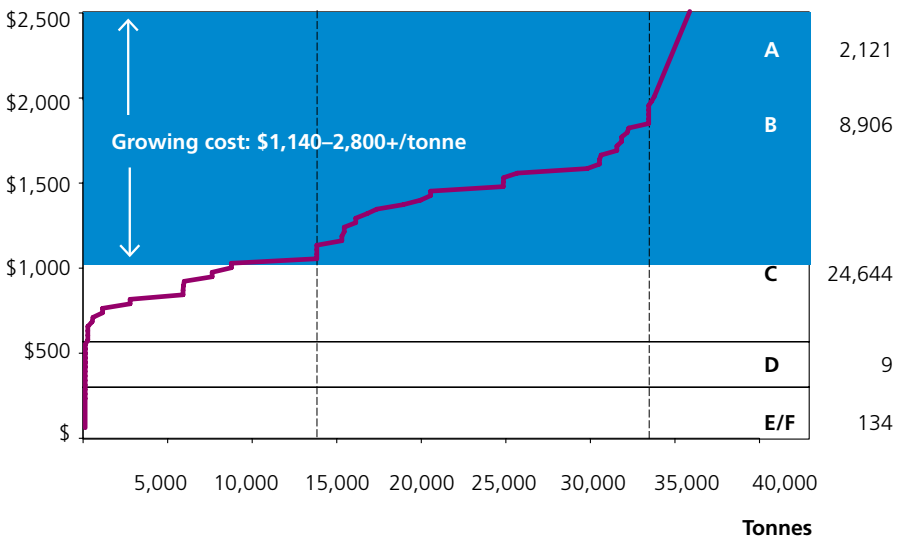


* Assumes price distribution of owned grapes matches that of those sold. Based on $7500 per ha for C/D/E/F; $8000 per ha for B; $9000 per ha for A & average yield from 2006–2012 (19.2 tonnes per ha)

Source: Wine Australia price dispersion data and yields; ABS for total crush tonnage; WGGA for growing costs per ha; WFA board input; analysis

Exhibit 24: Margaret River grape supply and growing costs

Purchase price and quantities, 2012 vintage

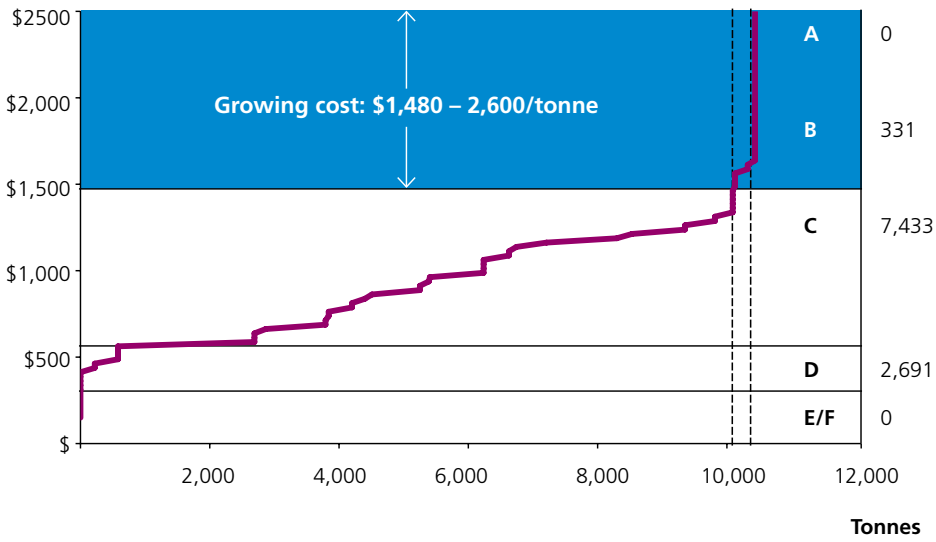


* Assumes price distribution of owned grapes matches that of those sold. Based on $7500 per ha for C/D/E/F; $8000 per ha for B; $9000 per ha for A & average yield from 2006–2012 (7.3 tonnes per ha)

Source: Wine Australia price dispersion data and yields; ABS for total crush tonnage; WGGA for growing costs per ha; WFA board input; analysis

Exhibit 25: Hunter Valley grape supply and growing costs

Purchase price and quantities, 2012 vintage



* Assumes price distribution of owned grapes matches that of those sold. Based on $7500 per ha for C/D/E/F; $8000 per ha for B; $9000 per ha for A & average yield from 2006–2012 (5.1 tonnes per ha). High end of range above due to premium fruit production & weather impact in 2012 vintage

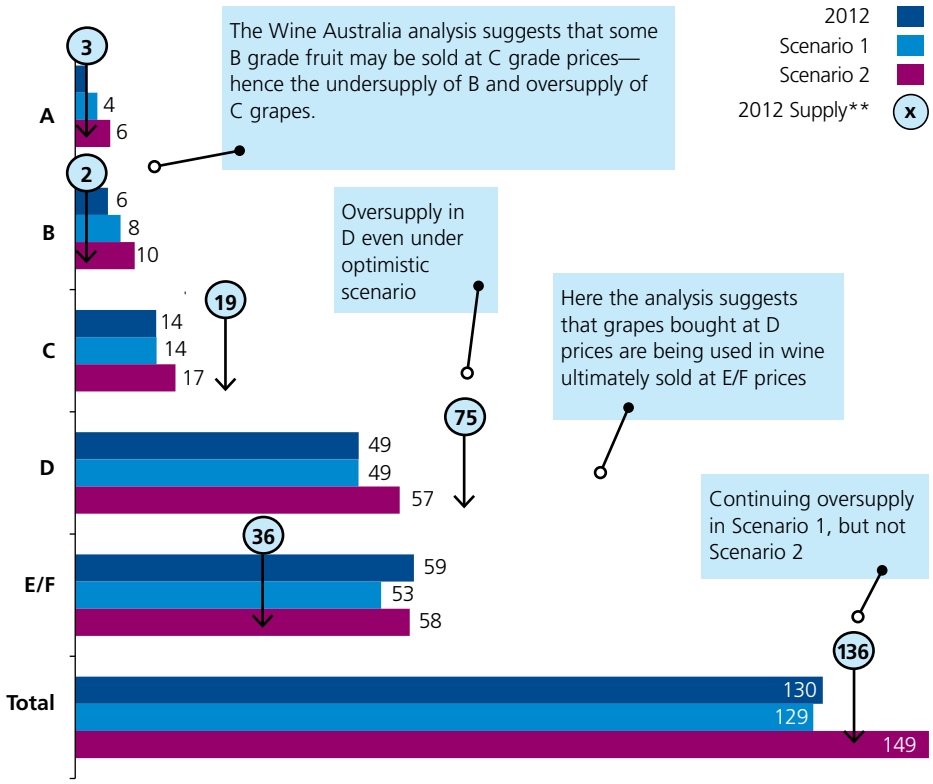
Source: Wine Australia price dispersion data and yields; ABS for total crush tonnage; WGGA for growing costs per ha; WFA board input; analysis

Exhibit 26: Wine Australia volume growth scenarios based on recent demand growth

Millions of 9 litre equivalent cases

Value
AUD Millions FOB

2007	2012	Sc 1*	Sc 2*
429	384	703	1,090
630	713	959	1,183
1,587	914	939	1,110
1,586	1,474	1,487	1,669
777	866	782	844
5,009	4,352	4,870	5,886



* WAC scenarios based on recent demand growth by segment by market. Domestic growth based on Euromonitor data. Scenario 2 assumes decline in AUD, significant marketing investment will bring growth to pre-GFC levels
** Based on grape price dispersion data and yields
Source: Wine Australia; Euromonitor; ABS; analysis

Scenarios generated by Wine Australia indicate demand will not solve this oversupply

Wine Australia's analysis of domestic production, domestic consumption and exports indicates some combination of significant over-supply and 'under demand' in C and D grapes/wine. Wine Australia data suggests that the oversupply of fruit in C (5 million cases equivalent) and D (26 million cases equivalent) is more than filling an undersupply of A and B (3 million cases equivalent) and E /F wine respectively (23 million cases equivalent), Exhibit 26. However, it is reasonable to assume much of this 'excess' demand for E/F is being created by the sale of wine at low and unprofitable prices.

Further, the scenarios of domestic and export demand provided by Wine Australia indicate that, if current trends continue, demand will not correct this over-supply in C or D by 2017—even in the optimistic scenario of growth returning to pre-GFC levels. However, their predictions indicate a likely growing undersupply of A and B.

Supply response (capacity leaving the industry) is likely to remain slow

Without significant changes in the perspectives of growers and winemakers further re-adjustment of supply is likely to remain slow. There are a numerous drivers of this:

- Winemakers are providing a market for uneconomic fruit and wine—providing marginal growers with some income and hope. Many winemakers have built their businesses on volume and need to maintain production to contribute to fixed costs
- Significant sunk costs with few attractive alternative uses for the land. It will take time for the assets to be written down and/or sold at values that enable economic returns from alternate uses

- Human and emotional factors such as: the existence of real success stories ("that could be us"); 'hope' in an environment of uncertainty ("it will all be ok when the exchange rate falls back to 80 US cents"); an unwillingness to 'let go' and/or realise the loss in value; and high perceived option value from 'hanging on' in a highly variable market
- Some level of uneconomic production supported by the WET Rebate
- A number of those interviewed believed that many loans in the industry are 'upside down', and the common banking strategy is to: limit further lending to the sector, extract as much loan repayment/interest as possible, and delay foreclosure until it is the best financial outcome for the bank.

4. Efforts to improve profitability have reduced the extent of the decline

Based on our interviews and analyses of company financials, many players in the industry have already pulled a number of the profit improvement levers available to them. The levers most commonly mentioned are:

- Leverage lower grape costs (at some grades)—benefit to wine makers not growers. Including renegotiation/ exit of onerous grape contracts
- Use of volume to lower average costs. Including purchase of distressed (cheap) grapes to maintain/ increase winery throughput; and 'toll' winemaking
- Boost grape yield (risk to quality); crop to more economic wine solution such as shift to sparkling (higher yield); to optimal fruit quality/cost (if 'always' going to be B then don't crop for and incur A costs)
- Improved product quality, mix and brand ('Premiumisation Strategy'). Stated by 10 of the producing companies interviewed as their strategy (numerous others on the public record). A number of companies have undertaken significant restructuring and incurred significant costs
- Cost cutting: overheads; vineyard and winery efficiencies and costs (including levers that may affect quality such as yield, chemical, vine & trellis management, use of oak, ageing); offshore bottling and packaging for export to reduce these costs and transport; and renegotiation of distribution margins, or going direct to retailers
- Pursued exclusive relationship with one of the retailers—to better secure volume and pricing. Usually includes direct distribution
- Product innovation and search/capture of niche markets (domestic and export)
- Increasing direct sales/alternative distribution channels
- Leveraging/increased reliance on the WET Rebate
- Other sources of income especially for grape growers and smaller wine makers.

5. Additional Profit Pressure is a possiblility

There are a number of factors that may lead to greater and/or more sustained profit pressure, including if:

- Long-term uneconomic supply (grapes and winemaking) remains slow to exit the industry. This could cause:
  - Sustained poor profitability and poor access to capital negatively impacting necessary investment and innovation in the industry. Industry needs to reconfigure (variety, style, quality, techniques) to support greater and more profitable demand
  - Operators that would be profitable in a more balanced market leave the industry, for example low-cost producers of E/F grapes
- Increasing global demand for wine does not increase the FOB prices for the majority of Australian wine exports (C, D, E, & F)
- Demand for Australian wine continues to fall in the US and the UK (two of the world's biggest wine markets)
- Wine's status as 'the cheapest form of alcohol' and its separate tax structure to beer and spirits exposes it to beer and spirits companies and the anti-alcohol lobby. The risk is this lobby is successful in reducing demand for wine in Australia—via changes to taxes, labeling, pricing and/or sale restrictions

- Imports continue to grow or the growth accelerates—across all segments
- Retail power and impact on producers increase. For example:
  - Further margin and volume pressure on producers (cost to access consumers—listing, shelf space and promotions)
  - Inability to create, develop or extend brands—space controlled by retailers
  - Industry fragmentation leads to less collaboration and more fierce competition for a 'smaller pie' potentially diluting the brand and quality message of Australian wine both domestically and overseas
  - Retailers support continued growth in imports across all segments
  - Further vertical integration and growth of private label including controlled and exclusive brands—including accelerated shift up into C, B, [and possibly A] wines
  - Increased control of distribution (including secondary) and on-line retailing making it even more difficult for producers to access consumers directly at a meaningful scale.
- Increased on-line wine selling creates further discounting pressure and 'bargain mentality' in the market.

6. The other side of the 'perfect storm' is that no single lever will 'fix' the problem

Popular commentary often points to a single major cause/savior—typically oversupply, exchange rate, or global demand. The consolidation and power of domestic retailers is another oft quoted cause. Unfortunately, the issue is more complex than that.

With respect to 'oversupply': without significant improvement in export returns and domestic profitability (retailer power) it is unlikely any feasible reduction in supply will return the industry to previous profit levels:

- Many winemakers have constructed their businesses on current or higher volumes—they will continue to buy the volume of grapes to support their cost structures for as long as low priced grapes are available
- Any significant decline in grape supply will likely increase grape prices for that grade/variety and further reduce winemaker profitability—this will be difficult to pass on to domestic retailers and 'impossible' to pass on to export for lower value wines. This will force further rationalisation and restructuring of winemakers before profit levels for those that remain can improve
- There may be some benefit from shifting export sales to domestic—higher margins—but limited 'room' domestically and retailers still have enough sources of supply to manage winemaker margins.

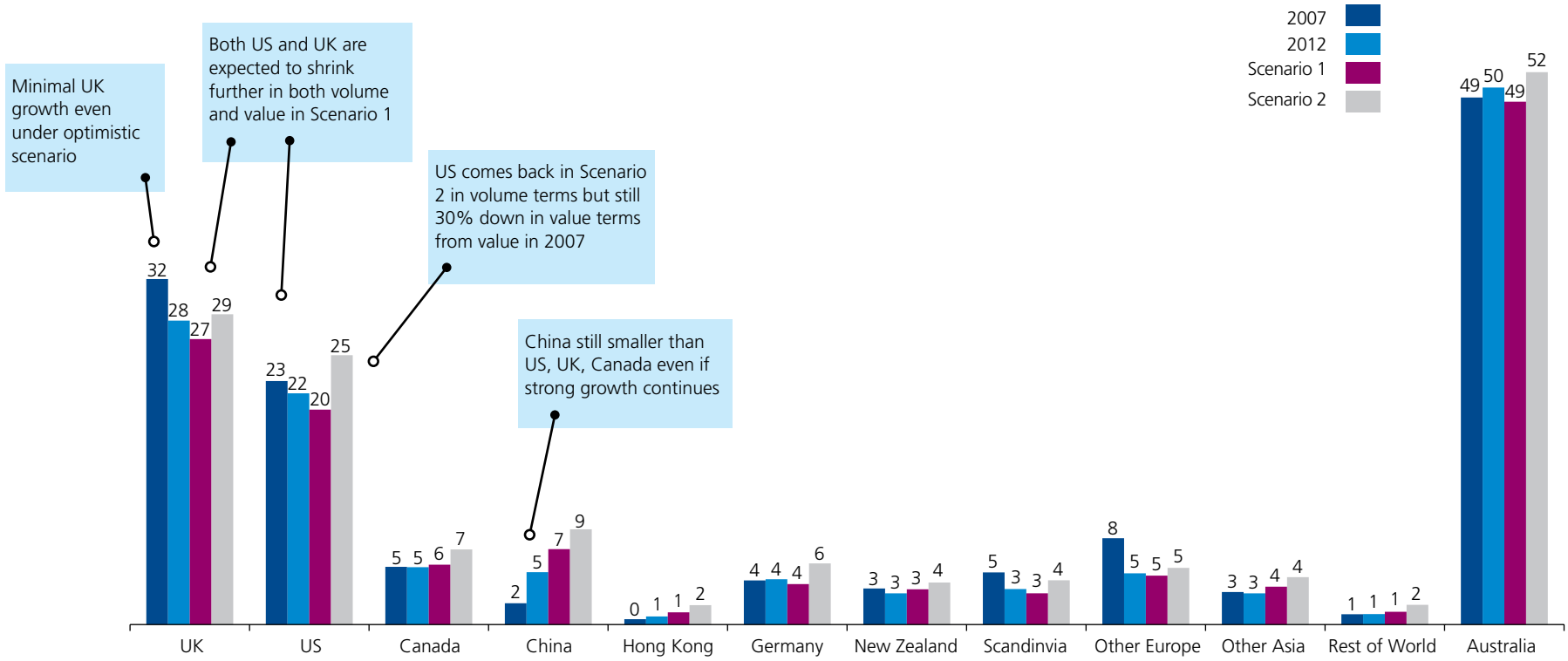
With respect to the exchange rate most economic forecasts suggest significant falls beyond the recent fall is unlikely in the foreseeable future. However, even if it was to occur it is unlikely there will be a proportionate increase in profitability:

- 85% of exports by volume are D, E and F wines that will still compete with low-cost commodity producers. To grow volumes and margins they must be even lower-cost and/or have successful innovative/niche marketing. It will take time to convince export markets (consumers) that Australian wines on average are higher quality at each price point (so they should pay/buy more). This is especially important for C wines (8% of current export volume) that appear to have suffered from a perceived fall in value with consumers in the US and UK in particular
- Access to consumers in export markets is a real issue especially given the fragmentation of Australian producers and the retail and/or distribution power that exists in key export markets. The two markets Australia is most dependent on are the UK and US—players in these markets will likely seek to capture price/margin gains from a lower exchange rate
- Export margins were low to marginal for many wine companies even at lower exchange rates. In many cases most of their profits came from domestic sales and exports of A, B [and C]. Clearly some winemakers will benefit far more than others
- Export volume has fallen by 65 million litres since 2007—exporters will need to balance increasing volume or increasing A$ FOB prices and margins.

With respect to global demand: The only 'silver bullet' solution for the whole industry is a massive and immediate increase in export demand for Australian

Exhibit 27: Wine Australia volume growth scenarios based on recent demand growth

Millions of 9 litre equivalent cases



Value (AUD Millions FOB)

2007	986	917	282	56	31	61	96	131	234	168	42	2005
2012	401	451	183	241	65	56	65	78	107	167	38	2499
Sc 1	393	417	204	477	146	63	77	72	110	200	53	2659
Sc 2	462	622	268	652	249	90	101	108	144	254	89	2845

* WAC scenarios based on recent demand growth by segment by market. Domestic growth based on Euromonitor data. Scenario 2 assumes decline in AUD, significant marketing investment will bring growth to pre-GFC levels
Source: Wine Australia; Euromonitor; ABS; analysis

wine—higher volumes at higher prices in destination currencies. Further falls in the A$ would also help. Though the industry can work toward this it is not an immediate solution.

Wine Australia's scenarios for global demand growth indicate that even under their optimistic scenario (in which growth returns to pre-GFC levels) the US and the UK will not return to their 2007 value by 2017, see Exhibit 27.

On the positive side, Wine Australia scenarios demonstrate continued strong growth in China and Hong Kong, which while remaining below the US & UK in volume, grow to be larger in value terms in both scenarios.

With respect to retailer power: it was the most cited of the key issues facing the industry in interviews with industry stakeholders—followed by exchange rate and grape oversupply, and then tax and imports. However, the negative impacts on winemaker profitability discussed in **Section 3.2** are difficult to address. And, even if successful it does not directly impact the poor profitability of exports—62% of the wine produced in Australia in 2012 was exported.

7. The industry is not being impacted equally—some players/segments are more affected than others. A number of success models exist

It is important to recognise that the 'tough' situation and outlook for the industry as a whole does not apply to all participants. It appears from our analysis of company profitability and interviews that in general, better performing companies have either:

- An 'in balance' portfolio of higher priced brands with strong domestic sales; and competitive costs or
- Globally competitive costs of production for bulk/commodity wine (without the significant costs associated with supporting consumer brands).

Whereas, companies with portfolios weighted more to commercial (C & D) and commodity wines (E & F) with branded cost structures and high export exposure are under more profit pressure.

A and B quality wines appear to remain more profitable on a stand-alone basis across domestic and export markets—indicated by the range of gross margin's provided by participants in the review and the tight demand and supply situation. While volume and margins have fallen in key export markets (US, UK & Canada) those in China have grown. The earlier Exhibit 22 on grape grower profitability suggests that growers of A & B grapes are on average profitable. However, growers and winemakers at the higher end of the supply cost curve for wines below $15/bottle (domestic retail) or $7.50/litre (Export FOB) are under significant pressure. These higher-volume wines started with lower margins and higher proportionate exposure to export markets.

Therefore:

- They experience more competition domestically and internationally—from other winemakers
- Retailers (domestic and internationally) have more supply options providing them more negotiating power
- Any increase in the A$ or retailer discounts has a proportionately greater negative impact on the profitability of lower margin wines.

Though there is no single success model for companies this review identified a number of existing and potential models, including:

- Growers of high-quality grapes needed by makers of A and B wines; or lowest cost grapes by quality
- Large high-quality wine companies with 'well purchased assets', globally competitive scale and costs, the correct size, quality and cost balance, and a portfolio of wines/brands that have sufficient market power to extract commercial returns from retailers domestically and internationally
- Mid-sized players with a combination of competitive costs and high-quality established and desired brands. Brands must enable preferred terms with retailers and access to export markets. The majority of their volume is in the desired brands
- Smaller high-quality wine company—circa 25 to 50,000 cases, selling mostly direct to loyal customers. Higher prices achieved allow for profit over higher

average costs (grapes, production, distribution, marketing). This model includes 'Iconic' wineries—where a wine has national and/or international acclaim and is sold at premium prices. This works when the wine accounts for a significant amount of total volume and/or the effect cascades to the rest of the range. Companies in this space should be careful of investing in expansion beyond their unique market demand—as this may expose them to lower return distribution channels such as retailers and actions that may undermine their portfolio (such as unsuccessful brand/range extensions)

- Absolute lowest cost and globally competitive in a given wine/grape quality. Given the fragmentation and often times uneconomic behaviour of some players in the industry the low cost should be supported by good access to markets
- Companies able to create and/or capture unique market and consumer branding opportunities. Casella's success with Yellow Tail is an example. Such companies still require a competitive operating model and cost structure to be profitable. And, an ability to lead or quickly respond to changes in consumer trends and sentiments.

Strategies/levers to pursue these success models include; but are not limited to:

- Premiumisation—stated by many as their strategy. There are two primary forms: convince consumes to pay more for your wines; and/or up-rate your wine portfolio. This strategy requires access to quality grapes, and the capital/cash flow needed to invest in: vines & grape quality, wine making, inventory, brand building and access to markets/distribution. Unfortunately this not a viable solution for the whole industry
- Consolidation to improve performance. Consolidation applies to both winemakers and growers. Given the general oversupply of capacity in the industry it is more likely to be achieved by acquisition, merger or some form of collaboration—rather than new investment. Participants need to be wary of repeating past examples that over spent and/or failed to capture synergies. Levers include:
  - Genuine cost savings in vineyards and/or winery. Including operating and capital efficiencies. Also efficiencies and benefits of scale through the value chain including: distribution, transport, bottling (including offshore/in market)
  - Accumulate sufficient brand power to improve: negotiations with retailers, market access, and demand
  - Economies of scale in: talent (winemaking, viticulture, innovation, commercial & management), market development (including export markets), and overheads
  - Opportunity to restructure the businesses—balance sheet, grower contracts, and possibly provide the assets, scale and funding to support a 'premiumisation' strategy.

8. Tax has been an issue for the industry

Our analysis on the two key tax issues—the WET Rebate, and WET versus Volumetric tax does not reveal a 'best answer' for the industry. There is no solution that suits a majority of industry stakeholders—as each tax regime affects individual companies differently. And, there remains insufficient facts to prove a best strategy and therefore tax system for the industry as a whole—separate to its individual participants.

On the impacts—focussing on 'extremes':

- Abolishing the WET Rebate completely removes all 'unintended uses' of the rebate.
  It also should accelerate the removal of uneconomic grape supply and unprofitable winemakers. It may enable faster consolidation and improved financial performance through scale and knowhow. It may support 'premiumisation' of the industry—if it only 'knocks out' producers of lower quality grapes/wine. However, it will negatively impact a large number of small to medium players that depend on the rebate to remain viable and/or invest in their operation. How many players of what type and size will be sufficiently affected to exit nor the resulting impact on the industry is known
- Switching to a volumetric tax regime—even set at the very low rate required for overall tax equalisation—will negatively impact players that

sell large amounts/proportions of lower priced wine domestically. Given current profitability levels it could force companies with significant volumes of D, E and F to exit the industry—especially if profits from their domestic sales support their export activities.

The fact base and analysis on the WET Rebate

The ATO advised the WFA that the data requested to evaluate the WET Rebate was not available and provided the following qualification for the data it was able to provide. *"The data for the WET rebate is reported on the Business Activity Statement along with at least 12 other refund circumstances for Wine Equalisation Tax including the producer's Rebate. The BAS is designed for processing liabilities and refunds and not as a data collection mechanism. As such the information requirements are kept at a minimum to reduce compliance costs for the taxpayers."* The ATO data does not distinguish between WET Rebate and other refunds. The BAS format also means an entity can legitimately claim a WET Rebate without designating themselves as a grape grower or wine manufacturer. Therefore, the data recorded does not allow a proper understanding of who gets the rebate and therefore how effective the investment in the industry is.

The information provided by the ATO and Senate Estimates, summarised in **Exhibit 29**, combined with our analysis suggests:

- Of the $308 million recorded as WET tax refunds and rebates for FY12: $25 million is paid to NZ producers, about $222 million may be paid as WET Rebate, and about $61 million is likely some combination of refunds of WET that did not need to be paid (one of the other 12 refund circumstances) and WET Rebate to entities not designated as grape growers or wine manufacturers. Our analysis uses only those that report as grape growers or wine manufacturers—1,912 of the 3,108 entities receiving some type of WET rebate/repayment.
- The ATO data shows 214 entities received 70 to 100% of the full rebate in FY12. The WFA estimates this accounts for $88 million (29% of total WET rebates paid in that year). It also shows there were 1,411 recipients of less than $100,000
- Since completing this analysis the ATO has advised that the 1,912 entities received $189.5 million in FY12 not the estimated $221.4 million based on our mid point calculation for each the percentage of Rebate & Refund bands provided by the ATO. Any further analysis and updates will be posted on the WFA website.

The analysis in Exhibit 29 attempts to link the WET Rebate and wine volumes in total and by estimated size of producer. It is based on our interpretations of the ATO data. Key points:

- The largest 21 winemakers produce about 84% of total domestic wine production volume, and the top 38 produce 88%
- Assuming each of these 38 producers only claim one full rebate—88% of total production only equates to $19 million of the possible range of $189.5 to 282.5 million WET Rebate paid to Australian entities in FY12
- If you assume the loss of the WET Rebate would not cause any of these players to exit then the absolute maximum impact of the Rebate on oversupply is 12% of total production
- Clearly this is not compelling logic. For example: it does not pick up the direct or indirect impact of the rebate on growers who supply to these large producers; or identify the other 176 entities that claim close to the full Rebate; or 'determine' if the loss of a small amount of Rebate will cause smaller participants to exit (the ATO data suggests hundreds of participants receive significantly less than $50,000 in Rebate)
- But, it does highlight the current inability to draw a quantitative link between the Rebate and oversupply with the information available (including from the ATO).

Finally, ATO provided data of total WET Rebate and Refunds show a continued increase in the total—from $211.6 million in FY08 to $269.3 million in FY11, to $307.5 million in FY12. And, the WET Rebate to NZ entities increased from $12 million in FY08 to $25 million in FY12. The ATO data also shows from FY08 to FY12 there was a 21% increase (365) in the number of claimants that designated themselves as grape growers or wine manufacturers. Given the industry is in downturn and is more likely consolidating than growing or fragmenting we believe this trend indicates increased use of structuring (legal and accounting) techniques to access the rebate and/or access it more than once. It clearly warrants close inspection by the ATO, and our interviews indicate many stakeholders in the wine industry want to be proactive on this issue.

Exhibit 28: The ATO has limited available information on the WET Rebate

The ATO does not know the exact amount of WET Rebate or the number of WET Rebate claimants that are winemakers or grape growers. The BAS Form (1D) covers those claiming WET rebate, repayment of WET that should not have been paid and the balance of both. Of the 3,108 reporters on (1D), 1,912 reported as a grape grower or wine manufacturer. Our understanding is it is not compulsory to designate therefore actual claimants of WET Rebate likely to be between 1,912 and 3,108.

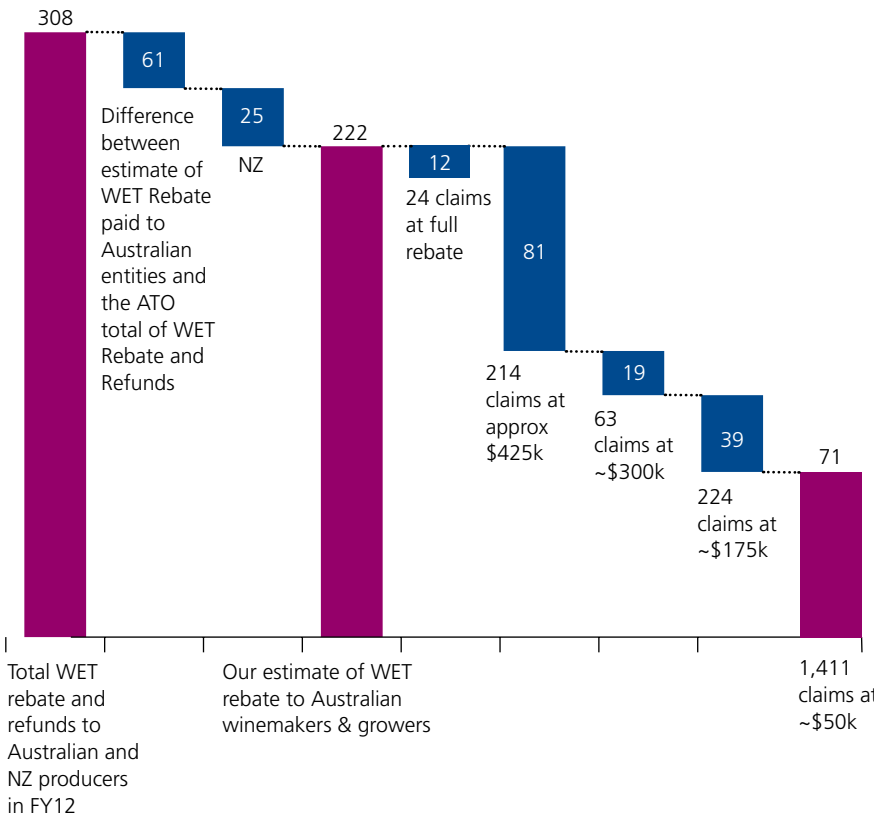
ATO breakdown of Australian WET rebate and refund recipients

	07/08		11/12	
% of Max rebate	#	$ Millions	#	$ Millions
0–20	1,258	—	1,411	70.6
20–50	169	—	224	39.2
50–70	46	—	63	18.9
70–100	142	—	190	80.8
>100	17	—	24	12
Total	**1,632**	**199.6**	**1,912**	**221.4****
			ATO (11/12)	**189.5**

ATO breakdown of New Zealand WET recipients

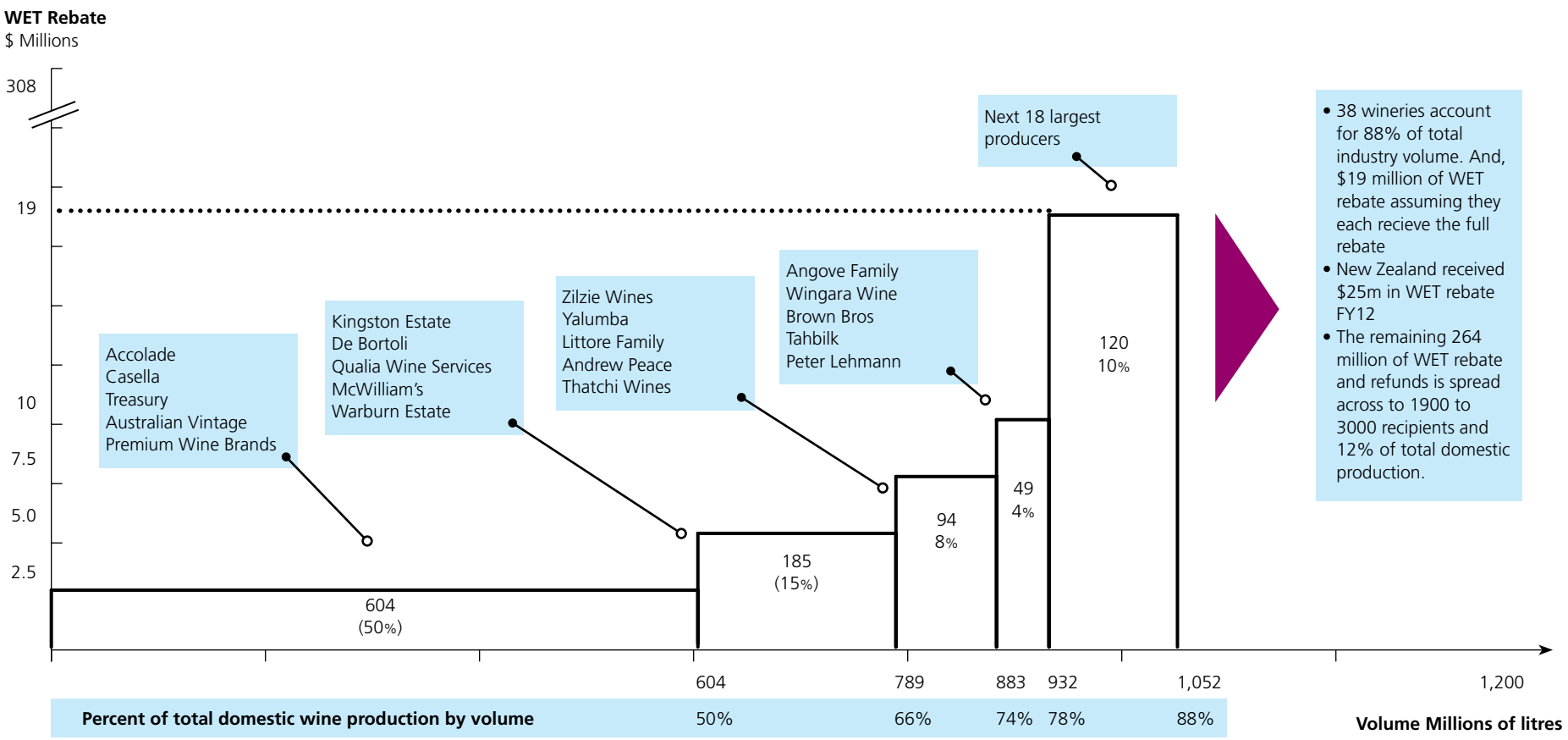
	07/08		11/12	
% of Max rebate	#	$ Millions	#	$ Millions
0–20	82	—	137	6.9
20–50	26	—	32	5.6
50–70	0	—	12	3.6
70–100	12	—	24	10.2
Total	**120**	**12**	**205**	**26.3****
			ATO (11/12)	**25.0**

Estimated breakdown of total WET rebate and refunds, 2011/12



* Estimated by WFA based on mid point levels of rebate by % group and assumed maximum of $500k for the > 100% category
** Different to ATO due to estimation approach
Source: ATO correspondence; Senate Estimates; analysis

Exhibit 29: Relationship between WET rebate and production volume, 2011/12



Source: Wine Titles; Wine Australia; team analysis

Report postscript:

The original version of this Report was prepared for and presented to the WFA Board on 19 June 2013. Since this time there has been a number of economic developments and views expressed by industry stakeholders and observers. In particular:

- The Australian/US dollar exchange rate fell from circa 102 US cents when the review started in February to 95 US cents on 19 June to circa 90 US cents today (9 August 2013). The rates used in our analysis comparing 2012 to 2007 are 104 and 84 US cents respectively
- Initial feedback from retailers (Coles and WLG) on a number of findings in the Report.

The Report has been modified in parts to address these changes and views. Further work is required to fully address them; in particular the differences of views with the major retailers. Any updates will be posted on the WFA website.

APPENDICES

1. RECOMMENDED NEXT STEPS FOR WFA

Continue to build the 'fact base' to support your actions. The wine industry suffers from significant fragmentation and differences in models and views. The lack of quality information to inform debate and allow united decisions on actions that serve the best interests of the overall industry is a major problem. The WFA should continue to build the fact base to support the above 6 actions and future issues the industry needs to address. In particular, we recommend:

- A combined team of WFA, Wine Australia and industry players to work on better understanding the issues in major export markets (US, UK) and what can be done by: the industry as a whole, C & D segments, individual players, and combinations of players. We believe the issues are far broader than the high A$ and marketing 'Brand Australia'
- Another combined team focus on identifying opportunity markets and how individual and collaborative groups of companies can find and capture market niches
- Continued work on retailer power—including building a robust (and confidential) fact base on: relative profitability, the transfer of profits over time, and how much of this profit transfer has been shared with consumers
- Extend and refine the analysis on grape supply curves and economics by growing region—beyond the current 13 regions. This can be part of the consultation process and should help individual growers to assess their businesses and future strategy.

W2. OVERVIEW OF APPROACH, ANALYSIS, AND SOURCES

The conduct of this review involved:

- 24 in-depth confidential interviews of all WFA Directors and key wine industry stakeholders and experts
- Review and analysis of detailed financial, market, and operational data supplied by or sourced from:
  - Interviews and survey results from 13 participating companies (all data provided in confidence on condition of anonymity)
  - Wine Australia Corporation and their detailed data on exports and wine prices by region
  - Previous reports commissioned by WFA, Wine Australia and Wine Grape Growers Association including: The Wine Restructuring Action Agenda (WRAA) statements, reports and inputs (2009—2011), Wine Australia: Directions to 2025—An Industry Strategy for Sustainable Success (2007), The Marketing Decade: Setting the Australian Wine Marketing Agenda 2000 – 2010 (2000)
  - Wine Grape Growers' Association (WGGA)
  - WRAA Toolkit including the Gross Margin Ready Reckoner for Wineries
  - Deloitte Financial Benchmarking study for the Australian wine industry
  - International Organisation of Vine and Wine (OIV)
  - Australian Tax Office (ATO) and Senate Estimates Committee
- Australian Bureau of Statistics (ABS)
- Nielsen analysis
- Analyst Reports including those from: RaboBank, Morgan Stanley, Goldman Sachs, JP Morgan, Merrill Lynch.
- Creation of a reference fact base on the volume and value across domestic, export, and imports based on the sources above
- In-depth analysis on the data available through a variety of lenses – value, volume, profit, market, region, and company – to understand industry developments and drivers of performance
- Collaboration and work with Wine Australia and WFA to gather data, prepare analysis, and review initial findings
- Two full-day workshops with the WFA Board to review and debate the analysis and findings. These workshops were also used to access necessary additional information and focus the efforts of the review
- A final presentation of the Draft Findings and Recommendations to the WFA Board
- Additional consultation with a number of individual stakeholders and participants in the review.

Notes on specific data sources and limitations

Wine Australia Demand Projections. Australian wine shipments are projected forward from 2012 through to 2017 under two broad scenarios:

- Scenario 1 - Base Case where exchange rates remain at current levels, global economic conditions improve only marginally and growth rates for the Australian category are similar to those achieved in recent years. Category marketing investment remains static
- Scenario 2 - High Case where the Australian dollar depreciates to US$0.85-0.90, £0.45, and 0.60, global economic conditions improve significantly and growth rates for the Australian category are similar to pre-GFC levels. Assumes a significant boost in category marketing investment.

The projections are based on examining past growth rates for the market and the Australian category as well as key macroeconomic indicators and market fundamentals. Limitations provided by Wine Australia and WFA:

- The results are not forecasts rather projections to assist in identifying the size of market opportunities at each price segment
- Projections are made independent of supply and thus any growth opportunities identified may be constrained by supply availability.

Grape Production Profitability by Region (Vintage 2012). Analysis on production profitability is based on a representative sample of 13 selected growing regions, average costs of production and prices paid for grapes in 2012. The analysis used the following data:

- Average cost per hectare as advised by industry participants including WGGA

- Average yield (tonnes/hectare) for 2006, 2009, 2010 and 2012. Data was unavailable for 2009 and 2011. 2007 was excluded as it was a drought year and yields were down significantly. Data on yields is sourced from Wine Australia
- 2012 price dispersion data from Wine Australia
- The price segment assumptions (A, B, C, D, E/F) are based on industry feedback. The matching of prices paid for fruit and the resulting market price of the wine is based on industry feedback

This data and analysis has a number of limitations:

- Average cost per hectare and yield vary significantly across individual growers
- Price dispersion data is based on wine grape purchases only and therefore does not account for winery-owned fruit
- Tonnages purchased and reported at the aggregate level are estimated to represent an estimated 80% of the total purchases.

3. ADDITIONAL ANALYSES AND EXHIBITS

Are available on the WFA website—www.wfa.org.au/review

Centaurus Partners

Centaurus Partners, founded in 2004, is a boutique management consulting firm based in Sydney.

Centaurus works with executives, directors, owners, and teams to help them quickly distil the opportunities and problems in their business, understand why they exist, and design and implement practical solutions that quickly generate lasting bottom-line impact and growth options.

Centaurus has worked closely with a broad range of clients (large, small, listed, private, family, and industry bodies) on strategy, performance transformation & business restructuring, and people performance. Our industry coverage includes: professional & industrial services, resources, agriculture, distribution/logistics, construction & building materials, and property.

Our people model allows Centaurus to provide highly experienced and insightful individuals and teams that match each client's business, people, and the opportunity/issue to be solved.

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Attachment 3