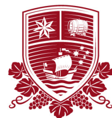

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Tax Forum
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Submission prepared by Treasury Wine Estates Ltd for the federal Tax Forum

Tax Reform for a Sustainable Australian Wine Industry

About Treasury Wine Estates

Treasury Wine Estates (TWE) is one of the world's leading premium wine businesses, headquartered in Melbourne and encompassing some of Australia's best loved and iconic wine brands including Penfolds, Lindemans, Wolf Blass, Rosemount, Wynns Coonawarra Estate, Seppelt, Coldstream Hills and Devil's Lair. With a global footprint of 11,000 hectares of vineyards, sales totalling over 33 million cases of wine annually and revenues of approximately $1.8 billion, TWE is also Australia's largest premium wine business. We employ over 4,000 winemakers, viticulturists, sales, distribution and support staff in Australia and eleven other countries.

With our leading presence in the Australian wine community comes a responsibility to contribute to its sustainability. This includes advocating product tax arrangements that are consistent with our vision for an industry that is economically and environmentally sustainable, with a reputation for quality and delighting wine consumers around the world.

TWE endorses the general principles reflected in Winemakers Federation of Australia's agreed position on alcohol taxation. We also submit the following in our own right, highlighting additional opportunities for wine tax reform. We would welcome the opportunity to provide more information on any aspect of our submission.

Executive Summary

This submission responds to Section 5 of the Tax Forum Discussion Paper (Environmental and Social Taxes), specifically the section on alcohol taxation.

Wine tax arrangements have a fundamental influence on the structure and sustainability of the Australian wine industry. Particularly in the context of the industry's current challenges, Treasury Wine Estates (TWE) believes ambitious reforms are required to wine tax arrangements, consistent with our vision for an Australian wine industry that is economically, socially and

environmentally sustainable, with a reputation for quality and a premium positioning around the world. In particular, TWE submits the following:

- The category-based approach to alcohol tax is fundamentally sound and should be maintained;
- Wine should be taxed on a volumetric, revenue neutral basis;
- Practically, a simple three-tiered tax structure, based on alcohol content bands by volume, would be most appropriate for wine. This would create a direct relationship between applicable tax and alcohol content without introducing undue complexity into tax arrangements;
- Should a tiered wine tax structure not be supported, the application of a flat, revenue neutral tax on wine per litre of alcohol would be the best alternative;
- The Wine Equalisation tax (WET) rebate is a damaging subsidy that has negatively impacted the profitability and productivity of the industry. It is preventing consolidation and sustaining uneconomic production, at a time when the industry urgently needs to retire excess supply and rebuild value in the Australian wine category;
- The WET rebate should be abolished or, at a minimum, fundamentally reoriented to become a cellar door style rebate available only to the retail sales of genuine wine producers;
- Consideration should be given to investing a percentage of the savings from WET reform to supporting one-off initiatives to assist industry restructuring and grow demand. This would reflect a balanced approach to industry sustainability and would help address the negative impact of the WET rebate;
- Current beer and spirits tax arrangements should be maintained, in order to reflect the different cost and benefit profiles attributed to alcohol products and categories. A flat volumetric tax across all alcohol categories would decimate the wine industry, and would be unprecedented internationally. Further, it would be ineffective in tackling alcohol abuse as problem drinkers would likely shift to the next-cheapest form of alcohol.

In making this submission, TWE is led by the overwhelming evidence that the current pace and extent of restructuring is manifestly inadequate to address the wine industry's challenges. Further, wine tax arrangements themselves, particularly the WET, are muting market signals that would otherwise drive restructuring more quickly and effectively.

Over several years, TWE has taken strategic decisions to move out of low value wine categories, invest in our premium branded portfolio and consolidate our production footprint – despite the tax disadvantages and short term cost penalties. As a result, our business is on a sustainable footing and would be likely to benefit from the wine tax reforms we are advocating. We are fully transparent about this. However, we are convinced that grasping the nettle of serious wine tax reform is also the right thing to do by the industry as a whole, to fundamentally address our challenges and protect the sustainability of Australia's wine sector over the long term.

We do not underestimate the potential impact on sections of the industry and the need for significant adjustment. We would support appropriate transition arrangements, and the provision of restructuring assistance, to help the industry adapt and respond to these changes.

Background

1. Category-based alcohol tax

TWE supports a volumetric approach to wine tax but emphatically rejects the introduction of a flat rate across all alcohol categories. The current category based system is the best available model and should be retained, albeit with some key reforms.

Taxation by beverage type provides policy makers far more flexibility than is possible under a flat-rate approach. This in turn ensures the tax system is able to take account of significant differences in costs and benefits attributed to various alcohol categories, and ultimately makes for more responsive, nuanced and better quality public policy in this critical area.

The central assumption of the flat volumetric argument that the total costs (and benefits) of alcohol beverages to the community wholly and simply reflect alcohol content is not credible. Costs and benefits vary widely across beverage types, and extend to a number of factors unrelated to alcohol content including:

- Cost of production. Typical wine production costs are far higher than, for example, beer and spirits[1] due to the inherently more complex and agricultural nature of grape growing and wine making;
- Economic contribution and value-adding. The wine industry generates around $2 billion per annum in export revenues, directly employs over 60,000 people and makes a significant contribution to regional communities and economies around Australia. Wine is also integral to 'brand Australia', and is leveraged extensively in support of broader national interests including trade promotion and tourism. On any objective analysis, the contribution made by the wine industry to the Australian community and economy is well ahead of other alcohol categories;
- Social / health costs. Under current arrangements, policy makers have the ability to apply higher taxes to specific beverage types where these are seen to be particularly associated with abuse and potential social harms. The debate around 'alcopops', which generally have the same alcohol content as full strength beer, demonstrates that assessing social harms is complex and involves a range of factors beyond alcohol content.

Further, a move to impose a flat volumetric tax on alcohol would simply result in low-cost full-strength spirits replacing cask wine as the cheapest alcoholic beverage by standard drink. This is more likely to shift dependent drinkers into a new alcohol category than it is to drive down harmful drinking and generate positive public health outcomes.

Category based tax systems are in place across most comparable economies around the world, underlining the point that such structures are acknowledged to deliver superior flexibility and better quality tax outcomes than flat-rate approaches. While Australia's tax arrangements are broadly in line with comparable overseas economies, there are some notable exceptions relating to wine, namely:

- Wine is taxed significantly more heavily in Australia than in any other wine-producing country globally. In fact, zero or low wine tax regimes are common in many competitor countries.[2]
- Of approximately $900 million collected as WET each year, some $200+ million is returned to producers as a rebate. It has become clear that the WET rebate is muting market signals and retarding vital industry restructuring – in particular, the removal of excess and unsustainable fruit supply. TWE believes that the rebate is failed policy and should be scrapped. Further detail on this is set out below;
- The WET is based on wholesale value, which is highly unusual. The result is that cheaper

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[1] TWE estimates the average cost of producing one standard drink of wine starts at $0.37, beer at $0.16 and spirits at $0.06.
[2] Kym Anderson, ***Reforming Taxes on Wine and Other Alcohol Beverage Consumption*** University of Adelaide, 2010

wine is taxed particularly lightly, while premium wine attracts a virtual "luxury" tax that is not applied to premium spirits or beers, or for that matter any other goods or services except luxury cars. Australia's premium wine consumers face an effective tax impost more than three times greater than the unweighted average for OECD countries.[3] At the same time, consumers of non-premium wine pay only half of the OECD average. These distortions and unintended consequences amplify the case for wine tax reform.

2. Volume based, revenue neutral Wine Tax

TWE supports a move to tax wine on a volumetric and revenue neutral basis, implying an average wine tax rate of approximately $12.50 per litre of alcohol (LAL), or around $1.60 per litre of finished wine. A simple three-tiered tax structure, based on alcohol content by volume, would be most appropriate way to implement this. This would create a direct relationship between tax and alcohol content in wine for the first time, delivering a desirable tax advantage to lower alcohol wine, without introducing undue complexity and cost into the wine tax system more generally.

The alcohol content of wine can vary widely across batches, vintages, varietals and styles. In terms of ABV, wine is a far more diverse category than either beer or spirits. A banded structure would obviate the need for testing of every batch and the application of potentially dozens of tax rates, and be relatively straightforward to implement at the winery level. Most other OECD countries have a tiered wine tax structure, including Canada, Denmark, Finland and Germany.

TWE has received advice that a volume-based tax could be implemented through minor amendments to the WET Act and without imposing onerous requirements (including bonded storage and weekly reports) that the industry is understandably keen to avoid.

Should a tiered wine tax structure not be supported, the application of a flat tax on wine of approximately $12.50 per litre of alcohol would be the best alternative.

The current ad-valorem wine tax system creates a number of anomalies and unintended consequences that must be addressed, namely:

- Cheaper wine is taxed particularly lightly, while premium wine attracts high 'luxury' tax as set out above. Low cost (particularly cask) wine is virtually tax-free, which can translate into an unjustifiably low cost per litre of alcohol at the retail level. TWE acknowledges community concern on this issue;
- The ad-valorem system creates a tax incentive to produce low value wine resulting in the cultivation of marginal land. This represents an artificial and inefficient allocation of resources, contributing to the industry's structural oversupply;
- the incentive to produce low value wine is also at odds with maintaining a credible premium for Australian wine, and a socially, environmentally and economically sustainable industry;
- finally, the ad-valorem system and the difficulty in defining wholesale prices creates opportunities for manipulating wine tax outcomes that would not be available under a volumetric approach.

Fundamentally, ad-valorem tax arrangements work against our vision for an Australian wine industry that is economically and environmentally sustainable, with a reputation for quality and delighting wine consumers around the world. TWE supports reforming this system, to tax wine on a volumetric and revenue neutral basis, preferably through the application of a simple three-tiered tax structure.

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[3] ibid.

3. Abolish WET rebate

While TWE is a recipient of the WET rebate and derives benefit from it, we strongly urge its abolition on the grounds that the short term advantages it delivers are wholly outweighed by its negative impact on the structure and sustainability of the industry more broadly. We believe the WET is a damaging subsidy that – in direct contrast with its stated objectives – is taking profitability out of the wine sector and transferring the benefit to retailers and opportunistic traders. The phenomenon of very cheap wines seen in Australia in recent years is a further unintended consequence of the WET rebate, and adds weight to calls to remove or fundamentally reform the scheme.

Currently, wine producers are eligible for up to $500,000 per annum in WET rebates. However, the definition of producer is so broad as to allow an individual wine to potentially attract the rebate multiple times, with many retailers legitimately structuring their sourcing arrangements to ensure they receive the rebate or a cost benefit equivalent to it. In addition, New Zealand wine producers, with whom Australian winemakers compete, are entitled to receive an equivalent rebate under bilateral trade rules. Industry estimates that $30 million of the $200+ million currently paid out in WET rebates each year is transferred to New Zealand producers and/or retailers selling New Zealand wine in Australia. The amount being paid to retailers and other non-genuine winemakers is impossible for TWE to determine, but is likely to be significantly larger again. While these examples fall within the rebate rules, they are clearly not consistent with the intention of the rebate and demonstrate that reform is required.

Further, to the extent that genuine Australian wine producers are receiving the rebate, a significant percentage of these businesses are marginal and in effect being artificially sustained by it. The most recent comprehensive financial benchmarking report on the wine industry found that wineries earning up to $1 million and between $5 - $20 million per year were on average producing negative to very low earnings before tax (EBT), with the majority of wineries in the 0 - $1 million and $10 - $20 million categories reporting a loss for the 2008 financial year.[4] Average EBT for small and medium sized wineries was found to be less than the sustainable benchmark of 15%, due to relatively high overheads and debt levels, and unsustainably low margins.

In addition, the fact that businesses can only claim the WET rebate once (up to the maximum of $500,000 pa) has become a major inhibitor to the development of scale, either through organic growth beyond the rebated level or through consolidation. In this way the WET rebate stymies the achievement of sustainable efficiencies in the wine sector, particularly at the smaller enterprise end, and is preventing many wine businesses from improving their financial performance and reaching their full potential.

By helping unsustainable businesses to continue to trade, and limiting options for consolidation, there is evidence to suggest that the net effect of the current wine glut and the WET rebate has simply been to churn the ownership of Australian wine production assets at low prices. Crucially, there has been no appreciable retirement of supply, with the 2011 vintage fractionally larger than the 2010 harvest despite wet growing conditions increasing the incidence of disease.

In November 2009, the four peak wine industry bodies released a watershed analysis that urged the industry to 'confront the reality of oversupply'.[5] The peak bodies found that "structural surpluses of grapes and wine are now so large that they are causing long-term damage to our industry by devaluing the Australian brand, entrenching discounting, undermining profitability, and hampering our ability to pursue the vision and activities set out in the *Directions to 2025* industry strategy." Specifically, 20% of bearing vines in Australia were found to be surplus to

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[4] ***Annual Financial Benchmarking Survey for the Australian Wine Industry – Vintage 2008*** Deloitte & WFA, 2009
[5] ***Wine Industry Restructuring Action Agenda*** WFA, Wine Grape Growers' Australia, the Australian Wine and Brandy Corporation and the Grape and Wine Research & Development Corporation, November 2009

requirements, with 17% of vineyard capacity uneconomic on the basis of costs of production alone. This equates to Australia producing around 20 – 40 million cases of wine more than it sells each year.

Almost two years on from the release of this analysis and less than 5% of supply is estimated to have been retired. At the same time, the trend towards bulk exports has accelerated, average prices per litre for Australian wine have generally fallen, the appreciation of the Australian dollar has further shrunk export opportunities and intensified unsustainable pricing overseas and at home. Major metrics from supply through to pricing and depletions paint a picture of an industry that is trapped in a negative cycle driven principally by a significant and static structural oversupply.

The wine industry does not expect to be sheltered from the need to compete aggressively for business, even in the face of significant headwinds that are beyond its control such as foreign exchange and export market contraction. However, the capacity of the industry to reform to meet these challenges ought not be undermined by domestic tax arrangements.

TWE believes that the WET rebate, while well intentioned, is a failed policy and must be abolished. We would however support a staged reduction over a number of years (ideally three) to allow the industry to adjust.

If this is not possible, TWE would support the fallback option of fundamentally recasting the WET rebate to become a cellar door style subsidy available only to wine producers with respect to direct to consumer sales.

4. Balanced approach to Industry Sustainability

TWE believes that consideration should be given to investing a percentage of the savings from any wine tax reform in supporting initiatives to assist industry restructuring and grow sustainable demand. This would represent a considered and balanced approach to the wine industry that is not simply about tax and costs but also seeks to build value, markets and opportunities.

Australia is the only major wine exporting country in the world that receives no financial investment from government in terms of market development and category promotion. Given that the industry is battling deepening structural problems and unprecedented headwinds in our main export markets, some government contribution would be welcome – if not necessary. In the context of broader tax reforms, the government has the opportunity to consider making such an investment.

5. *Beer and spirits taxation*

TWE does not see any structural problems with current beer and spirits tax arrangements, and is supportive of maintaining them.

Summary

While the government has established that alcohol tax will not be a focus of the 2011 Tax Forum, TWE appreciates the opportunity to flesh out key principles of effective wine tax reform and place these on the record.

In particular, we stress that the extent of restructuring underway in the wine industry is well short of what is required and will likely remain so unless and until key wine tax arrangements are reformed to facilitate meaningful change.

There is also a strong case for applying wine tax on a volumetric rather than ad-valorem basis, at a revenue neutral level and within the existing category-based tax system. This preserves the

positive attributes of the status quo, wherein tax arrangements can take account of significant differences in costs and benefits attributed to various alcohol products. It would also create a direct link between wine tax and alcohol content, incentivising the production of lower alcohol wines and increasing tax on unsustainably cheap wines. It also achieves this without imposing a catastrophic increase in the total tax burden borne by the wine industry, nor subjecting it to unnecessary administrative complexity and cost.

The $200+ million investment made in the WET rebate each year by Australian taxpayers is generating negative long term returns and must be abolished or, at a minimum, fundamentally reoriented to become a cellar door style rebate available only to the direct to consumer sales of genuine producers. Recognising the very significant impact that WET reform would have on many businesses in the short term, we would urge the government to put in place appropriate phase-in and restructuring support arrangements.

TWE does not underestimate the dimensions of the reform we advocate, nor the fact that many sections of the industry have alternative and passionately held views. We come to our position, after many years of supporting the status quo in the interests of industry unity, on the strength of the overwhelming evidence that restructuring is urgently required and that tax reform is critical to achieving it.

The current tax arrangements particularly the WET rebate and the ad valorem tax system, combine to artificially hold down the price of cheaper wine, disproportionately tax premium product and undermine the structural fundamentals of the industry. TWE will continue to advocate wine tax reform consistent with our vision for an Australian wine industry that is economically and environmentally sustainable, with a reputation for quality and a premium positioning around the world.