Wine Grape Pricing in Ontario

Report of the Facilitator

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Table of Contents

1 Executive Summary

This paper reports the status and termination of facilitated discussions between Grape Growers of Ontario (GGO) and Wine Council of Ontario (WCO) concerning price determination mechanisms for wine grapes in Ontario.

After fourteen (14) months of discussion and work directed toward revising the wine grape pricing system in Ontario to allow individual grower to winery price negotiation and direct contracting within an amended regulatory framework, the parties have reached an impasse. The GGO is committed to collective price negotiation, and is unprepared to discuss changes which will involve direct price negotiation. The WCO is committed to achieving the ability for its members to enter into direct negotiations with growers, and is unprepared to discuss enhancements to the existing collective pricing system that do not include a move toward more open, direct, one on one relationships between growers and wineries.

The facilitator worked with the parties to assess the existing wine grape pricing system in Ontario, and to discuss how it might be transformed to a market responsive, direct contracting and negotiation system. The parties developed a constructive working relationship over the first twelve (12) months of the project. They examined the industry vision, market segmentation, market share, the products and the nature of quality, supply and demand trends, regulations, and different approaches to pricing. They developed a comprehensive framework for a pricing system that would allow direct contracting and price negotiation between growers and wineries, together with transitional safeguards and implementation considerations.

In May 2003, following the election of five (5) new directors to the GGO eight (8) member board, the GGO developed a new proposal. This proposal put forward improvements within the framework of the existing collective negotiation process and removed references or approaches involving direct negotiation. Upon receiving the proposal, the WCO took the position that it was a status quo proposal with enhanced regulatory restrictions and compliance requirements. The facilitator was asked to prepare a final report.

There are clearly different beliefs regarding the need for change, visions for the industry, market understanding and awareness, and philosophical approaches to business within and between the two parties. Growers are rooted in the culture of collective action supported by government regulation and programs to provide price and income supports to farmers while they accrue long term asset value through the appreciation in land values. Wineries are rooted in a culture of market responsiveness where government regulation either supports or constrains their competitive market behaviour as they seek to build their long term business value through brand and market penetration success.

The existing system is in need of change. The demographic and economic structure for both the grower and winery sectors has changed significantly over the years. The existing system is neither principle nor needs based, nor is it grounded in reliable information. The long term outcome of the existing system may be a decline in quality and an increase in integration. Moreover, the ability to achieve the industry vision may be constrained by the inability of the parties to form productive, long-term relationships unless they can overcome the institutionalized distrust that accompanies the philosophical gaps between their collective and competitive market approaches.

2 Introduction

This project was commissioned jointly by the Grape Growers of Ontario (GGO), the Wine Council of Ontario (WCO) and the Farm Products Marketing Commission (FPMC) in July 2002 to review the existing wine grape pricing system and develop options, an action plan and safeguards for introducing greater direct contracting and negotiation between individual growers and wineries. This project was the second (2^{nd}) formal, multi-party review of wine grape pricing in the past three (3) years. The first was work by PriceWaterhouseCoopers LLP which was terminated in the spring of 2001.

In this section we provide an overview of the problem, the parties and the terms of reference for the project.

2.1 Problem analysis

In April – May 2002, the FPMC sponsored a third party review of the problems associated with wine grape pricing in Ontario. The review brought together representatives of the GGO and the WCO to jointly examine and discuss wine grape pricing issues, and identified a willingness of the parties to jointly analyze the problems and to develop strategies for implementing a new pricing mechanism. The following quotes from the problem analysis provided the foundation for the pricing mechanism review project:[1]

> *The current pricing system no longer provides sufficient price discrimination for either growers or wineries to competitively reward delivery of the required wine grape products within individual winery production, quality, and marketing parameters, thereby suboptimizing the profitable pursuit of differentiating competitive market strategies.*
>
> *It was clear from the outset that the groups had well established and entrenched positions regarding how pricing should be undertaken, and that they were not particularly willing to compromise those positions.*
>
> - *The Board felt that the existing system was "OK", had served the industry reasonably well for years, and perhaps needed some minor "tweaking" to adapt it to current market conditions. The Board felt the problems were more in "other regulations."*
>
> - *The Council, on the other hand, felt that the collective approach had become so completely out of sync with market reality that discussion of any approach that involved a collective component on the part of growers was entirely unacceptable.*

The problem analysis served as the starting point for a facilitated process to review the existing pricing system with the intent to incorporate stronger direct individual grower-winery relationships.

[1] Taken from the problem analysis presented to FPMC in June 2002.

2.2 The Parties

In this section, the parties and their involvement in the pricing system are described. Unless otherwise indicated, when "the parties" are noted in the report it refers to the primary parties – Grape Growers of Ontario and Wine Council of Ontario.

2.2.1 *Grape Growers of Ontario*

Grape Growers of Ontario (GGO) is a marketing board constituted under authorities provided by the Farm Products Marketing Act (FPMA). The GGO has a mandate to ensure the orderly marketing of grapes in Ontario, including the authority to collectively negotiate minimum prices for wine grapes sold by all producers to all wineries in Ontario. All producers of grapes are required to belong to GGO, abide by its regulations, and pay fees. The full GGO board of directors took part in the price mechanism review process.

2.2.2 *Wine Council of Ontario*

Wine Council of Ontario (WCO) is an industry association constituted to pursue strategic development of the Ontario wine industry. Membership is voluntary, and the association comprises 95% +/- of the Ontario wine industry. The WCO has assumed responsibility on behalf of all wineries to negotiate minimum prices with the GGO. This responsibility is not provided by regulation. Six (6) members of WCO, representing a cross-section of small, medium and large wineries, served as a committee of the WCO to participate in the project.

2.2.3 *Farm Products Marketing Commission*

The Farm Products Marketing Commission is the supervisory body governing the application of the FPMA and Regulations thereto for 23 regulated marketing boards and associations in Ontario. The Commission delegates certain authorities to the GGO, and is responsible for monitoring and supervising the actions of GGO in establishing and enforcing regulations for the orderly marketing of wine grapes. Among the powers delegated to the GGO is the authority to collectively negotiate price on behalf of all growers. The Marketing Analyst responsible for the grape portfolio from FPMC attended most meetings, and monitored the process.

2.2.4 *Others*

Other parties, such as the Ministry of Consumer and Business Services (MCBS) and AgriCorp are tangentially impacted by the pricing process. Wineries and WCO have MCBS as an important point of access to government, particularly for licensing, wine content and labeling, and market access regulations. Wine grape pricing and pricing regulations are sometimes connected to wine content and labeling, market access regulations as part of the collective negotiation and political positioning of the parties. During the course of this work, the parties may have kept the MCBS apprised of discussions, but there was no direct involvement by the facilitator with MCBS.

AgriCorp is a Crown Agency charged with administering crop insurance plans in Ontario on behalf for the provincial and federal governments. The crop plan for grapes uses the negotiated price as a basis for adjusting claims for crop loss in wine grapes. Any change to the pricing mechanism would require changes to the crop plan for grapes. This was not addressed during the course of this work.

2.3 The Task – Terms of Reference

In July 2002, the GGO, WCO and FPMC jointly sponsored facilitation between the GGO and WCO to examine the price determination mechanism for wine grapes in Ontario. The purpose of the project was to:

> *"work with the parties to design a wine grape pricing system that is grounded in direct negotiation and contracting between individual growers and individual wineries. This system will, by necessity, be constrained by the several Acts and regulations under which the industry operates."*[2]

The project was envisioned and agreed upon as a collaborative process utilizing the services of a third party to facilitate discussion and document positions, analyses, and outcomes. Most of the technical components of the project were anticipated to be supplied by the parties, supplemented if necessary by research that would be sponsored and directed by the parties at the appropriate times.

The original objectives of the project were to:

- *Develop a new wine grape pricing system for the Ontario grape and wine industry that incorporates direct price negotiation and contracting such that individual growers contract with individual wineries;*
- *Examine appropriate safeguards to accompany the change from collective to individual price negotiation and contracting;*
- *Develop a plan for implementing the new pricing system for the 2003 crop year*.

The project required the willingness of both parties to work together in the spirit of needing progressive, mutually beneficial change in the way wine grapes have been priced in Ontario, while recognizing the need for adjustment and safeguards. This willingness had been lacking prior to the problem analysis, and appeared to have begun to develop through the problem analysis phase of this project.

2.4 Final Report

The purpose of this report is to outline the status of discussions between GGO and WCO at May 2003. It provides a review of the steps taken and the positions of the parties regarding wine grape pricing in Ontario. During the course of the work on this project, numerous papers were written and shared between the parties. A list of these reports is provided in Schedule 1.

The report is organized as follows. Section 3 summarizes the process or methodology. Section 4 summarizes considerations which impact the pricing of wine grapes in Ontario. In Section 5, the parties' positions and the gaps between these positions are analyzed. And finally, Section 6 provides a synopsis of the pricing dilemma together with suggested next steps.

[2] Taken from the services contract between the parties and the facilitator.

3 The Process

In this section the process followed over fourteen (14) months working with the parties to examine and develop options for the pricing of wine grapes in Ontario is summarized.

3.1 Problem Analysis

In February 2002, the FPMC determined that a third party review was required to develop an understanding of the problems in wine grape pricing that had apparently led to a breakdown in communication between GGO and WCO. Following the pricing negotiations in 2001, the WCO indicated an unwillingness to participate in future collective negotiations. The FPMC has the power to appoint individuals to negotiate should the WCO decline to participate. However, enacting this power would be a sensitive proposition since it would not be supported by WCO whose members represent >95% of the wine production in Ontario.

A review was undertaken in April and May 2002 by Mr. George Leroux, and a report was presented to the FPMC in June 2002. The report was supported by both GGO and WCO, and representatives of both parties attended at the FPMC for the presentation.

3.2 Direct Contracting Project

In July 2002, the GGO, WCO and FPMC agreed to jointly fund work directed to developing a pricing system that would include direct contracting between growers and wineries, including individual price negotiation, together with appropriate safeguards and transitional implementation mechanisms.

3.3 2002 Price Negotiations

In late July 2002, the WCO and GGO collectively negotiated minimum prices in much the same manner as previous years. Negotiated agreement was reached for all categories. In the two (2) previous years, final arbitration was required for some categories. GGO felt that the reduced prices compared to 2001 were a concession and recognition of increasing supply. WCO felt that the prices were still well out of the market and agreed to the final prices as a gesture of good faith for the price review process that the parties were jointly embarking upon.

3.4 Data Collection

During August 2002, a pricing mechanisms paper was developed examining a range of options for pricing and contracting agricultural products. Examples were developed from a number of commodities, including wine grapes in California. This work was research and literature based. It was intended to provide the parties with an understanding of the options available for their consideration as they moved forward.

Between September and January, market statistics were obtained, analyzed and discussed between the parties. Critical to this work was the analysis of market segmentation and growth rates of wine sales in Ontario, the projected wine grape production based on vine census information, and the demographics of producers and wineries.

3.5 Joint Discussions

The first joint discussion between the parties was held in September 2002 to fully review the industry vision and the problems associated with wine grape pricing. Following this meeting, the parties suspended discussion during the harvest and crush season, and then began developing their positions independently with the facilitator in November. In early December, joint meetings were once again established, and between December and early April there were many joint meetings to review positions and develop options.

3.6 Individual discussions

The facilitator worked with each party individually and in parallel to help them consider the issues and prepare their positions for presentation to one another. Numerous individual sessions were held between November 2002 and April 2002. In a number of cases, the facilitator would prepare each party's position paper, and then exchange these papers prior to a joint meeting to provide the basis for the joint discussions.

3.7 Development of a Draft Agreement

In late January 2003, the parties exchanged position papers on wine grape pricing. These papers examined perceptions and positions regarding purpose, mandate and authorities concerning pricing, the marketplace, contracting, negotiation, and pricing, the regulatory context, and safeguard and implementation considerations.

From these initial proposals, the parties each prepared more specific pricing proposals which were exchanged in February. These proposals led to joint work through March and early April to develop a mutually agreed upon framework[3] for developing a new pricing mechanism which incorporated direct contracting and pricing negotiations and transitional safeguards.

In mid-April 2003, following the election of five (5) new directors to the GGO board of directors, GGO worked with the facilitator until late May reviewing the work done to date, and preparing a counterproposal for presentation to WCO. This proposal was presented to WCO in late May 2003.

3.8 Communications

Between August 2002 and January 2003, the GGO declined to openly discuss the project or the process with its members. The WCO kept its board informed, which by virtue of the board being all the members, kept the membership informed of the project and the process.

In January 2003, the parties agreed to preparing and presenting an overview of the grape and wine market at the Ontario Fruit and Vegetable Growers' Association annual convention at Brock University in February. This was intended to provide information concerning the market. There was no presentation of wine grape pricing, past or future in the presentation.

The GGO began communicating with its members in the first quarter of 2003 concerning the fact that a pricing review process was underway. The GGO also sponsored a grower information

[3] This framework was referred to as a Memorandum of Understanding, which went beyond understanding and provided an overall framework for wine grape pricing.

session at Niagara College in mid-March to help ensure the information on the market place was provided to as many growers as possible.

3.9 Commitment

Both parties repeatedly expressed their support for the process and the progress being made between July 2002 and March 2003.

The election of five (5) new directors, including four (4) grower directors and one (1) winery-grower director, to the eight member board of GGO in early April 2003 brought new faces and thoughts to the process. The new Chair of the GGO expressed his support for the process to the Chair of FPMC, members of WCO, and the facilitator.

Wine Council of Ontario is committed to a contracting and pricing system that provides individual wineries the ability and right to develop stronger direct relationships with individual growers.

3.10 Final Report

Following the GGO's presentation of its revised proposal to WCO in late May 2003, the WCO requested that the facilitator prepare a final report for the parties.

4 Considerations

The pricing of wine grapes is impacted by the characteristics of the Ontario market, including competitiveness, market segmentation, production capabilities, industry structure and regulation. Underpinning these market economy considerations are the organizational capabilities of the parties.

4.1 Competitiveness

Competitiveness can be defined as the ability to profitably grow and sustain market share. Wineries compete with one another for supply, production capabilities, brand characteristics, and market access. Growers compete at the point they purchase land, and on the basis of their individual skills, but are less competitive with one another for market access, relying on the GGO to provide a "level and accessible playing field" in this regard.

If the premise that the consumer market drives the industry is accepted, then the primary competitive rivalry rests with the wineries competing for market share. This will be based on their success satisfying consumers in targeted market segments, and is materially impacted by the complex regulatory framework within which they must operate.

Some wineries target most or all market segments, while others target a narrow range of segments. If all wineries targeted all segments, then having a collective price would provide all wineries the same cost of goods. However, under the scenario of different marketing strategies, the collective price results in differential costs of goods to different wineries. In essence the "level playing field" argument is not supported from a winery perspective, and thereby the regulated pricing is differentially impacting the competitive opportunities and potentials of winery participants.

4.2 Market segmentation

The wine market is generally segmented by consumer market price point.

Segment	Price point 750 ml bottle	% of total LCBO sales[4]
Popular	< $8	55%
Premium	$8 - $10	19%
Super Premium	$10 - $12	11%
Super Premium	$12 - $15	8%
Ultra Premium	$15 - $20	5%
Specialty	> $20	2%
		100%

Wineries target products to the different price points. In Ontario, the general trend has been for flat sales growth in the large <$10 / bottle segments which represent 75% of the market, and increasing growth in the >$10 segments. Imports comprise ~56% of the Ontario market, leaving 44% market share enjoyed by domestic producers. For sales through the LCBO, imports hold a dominant position in all segments, with Ontario wines having 30-40% market share in the <$10 segments, declining to 5-10% in the >$15 segments.

[4] Based on LCBO sales data for sales through LCBO outlets for the 12 month period ending March 2002. Approximately 20% of Ontario wine sales are through winery retail stores and direct distribution, and while the LCBO data does not provide segmentation detail for these channels, the LCBO sales data provides a reasonable proxy for the Ontario market segmentation.

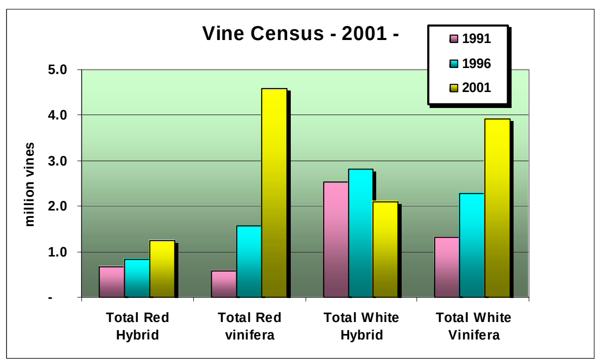
Consumers can buy products from around the world in all price point segments. There are no material restrictions on the importation of wine, and duties are marginal. Market access is controlled by regulation. The LCBO is the primary distribution channel, comprising ~80% of all wine sales in Ontario. The balance is distributed through winery retail stores and by direct distribution from wineries to the hotel, restaurant and institutional trade.

4.3 Production capabilities

Wine grapes are produced predominantly in the Niagara Peninsula, with smaller pockets of production in southwestern Ontario and eastern Ontario. Total Ontario wine grape purchases in 2002 were 43,700 tonnes, an increase from 41,300 in 2001 and 38,400 in 2000.

The conventional wisdom is that there are significant differences in the production capability of individual vineyards, even in the same producing region. These differences, coupled with the viticultural practices employed, result in a range of values and wine making qualities of grapes of the same variety produced in the same region and microclimate.

In the past five (5) years there has been a significant increase in the planting of many varieties of vinifera vines as illustrated in the chart below. Some of these new plantings may be well suited to the cool climate of Ontario, while others may be prone to damage and not produce to their anticipated potential. The production estimates based on the increased plantings suggest the potential for significant supply increases. However, weather and winter damage have acted to reduce the outputs to less than anticipated quantities.



Grapes are an expensive crop to establish and produce. Once established, a vineyard can produce for many years. Accordingly, shifts in consumer preference can have an impact on the varietal demands of wineries and, by extension, of growers.

The GGO has cooperated with OMAF to prepare a Cost of Production model for wine grapes. The model suggests that the returns from wine grape production are modest to zero at current prices. Yet planting of grapes continues. The WCO contends that the Cost of Production model is an aggregated average model that fails to represent actual results on individual vineyards.

The GGO and WCO agree that it is not possible to produce vinifera wine grapes profitably for the <$10 / bottle price point segments. Accordingly, Ontario vinifera production is best targeted to the 25% +/- of the market represented by the >$10 segments. The estimated vinifera crop is 30,000 +/- tonnes[5], which will produce ~21.0 million litres of wine produced. At current market levels, this would represent ~20% of the total Ontario wine sales, or 80% +/- of the >$10 segments. To utilize this level of production in the profitable segments will require time for market growth, considerable production and marketing investment, and superior product value.

[5] Estimated production based on projecting the vine census using historic production levels. Winter damage in 2002/03, changing genetics and viticultural practices will have material impacts on this estimate.

4.4 Industry Structure

The GGO is comprised of ~400 wine grape growers out of a total of 530 grape growers. The composition of wine grape growers follows that of many intensive agricultural products. Nineteen (19%) of the growers produced 81% of the volume in 2002. There are 50 growers with vineyards producing > 250 tonnes in 2002, and 128 growers with vineyards producing <25 tonnes in 2002. Fifty percent (50%) of growers produced ~9% of the crop in 2002. The electoral representation model of GGO is based on one member, one vote.

There are 86 registered buyers of wine grapes with the GGO. Wineries can be generally categorized as small, medium and large. Ten (10%) of the buyers purchase >75% of the crop, 30%, broadly representing mid-sized wineries, purchase 20% of the crop, and 60% purchase <5% of the crop. Large wineries produce a full product line for all price point segments, and have considerable market access power by virtue of their size and the number of retail store licenses held by them. Small wineries are primarily estate wineries targeting the higher price point segments, producing wines from grapes produced on their own vineyards, and marketing exclusively from their on-farm winery. Medium sized wineries pursue strategies that can range from a full product line to specifically targeted segments.

The industry has seen an increase in the integration of wine grape production and winemaking. Wineries are thought to comprise ~25% of wine grape production, up from 15% +/- three (3) years ago. It is projected that this level of integration may move to 35% +/- over the next three (3) years. While not all grapes produced by winery-growers go directly into their own wines due to grape production and wine making volume and variety imbalances, the trend to greater integration is clear. Integration is attractive to growers in pursuit of greater farm business returns, and to wineries that invest in vineyards to better manage and control their supply side. Overall, the trend leads to the proposition that grapes produced by independent growers may be used for opportunistic or marginal demand in the higher priced wines, and that they may be increasingly used to fill the demand in lower priced wines regardless of value characteristics.

4.5 Regulatory context

Grape and wine production and marketing is highly regulated. In some respects, the industry exists in its current state as a result of regulation, leading to the proposition that government and industry have a mutual interest and responsibility to address the problems associated with the pricing system. The supporting evidence is the fact that the parties worked with FPMC to undertake this review of wine grape pricing.

Grape production is regulated by the Farm Products Marketing Act and Regulations, and GGO Regulations authorized under the Act. This provides a framework for mandatory collective action and collective negotiation of minimum prices which must be paid by wineries to growers. Additionally, growers have access to subsidized insurance, income stabilization and disaster protection programs. The anticipated business risk management components of the APF will provide a new support program framework[6].

[6] Crop insurance is a government subsidized insurance program, income stabilization is provided through the Net Income Stabilization Account (NISA) coupled with the Self Directed Risk Management (SDRM) program, and disaster protection is provided through the Ontario Farm Income Disaster Protection plan (OFIDP). These programs are jointly funded by the federal and provincial governments. The APF, or

Wine production is regulated through licensing by both the GGO and the Alcohol and Gaming Commission, and through production regulations under the Vintners Quality Alliance (VQA) Act and the Wine Content Act (WCA). Market access is regulated through the Liquor Control Board and the retail licensing system.

Import and export trade in wine and grapes is relatively open. Import duties are minimal or non-existent. Canada is viewed as an attractive export market for foreign suppliers, as it represents <0.2% of world production, and 4% of global import trade.

The regulatory framework may have become the driver, rather than the facilitator. The range of government departments involved in the industry results in active lobbying by both GGO and WCO to present their issues and needs to government. In a broad sense, the lobbying intentions of the GGO could likely be characterized as seeking to sustain and enhance protection and support programs while those of the WCO are directed to lobbying for improvements to market access, wine production standards and overall market development.

4.6 Organizational Capability

Collective negotiation is based on the two parties, representing their respective constituencies, coming together to negotiate base prices, plus premium scales, for twenty-four (24) classes of wine grapes. The parties present their needs with differing levels of analysis and justification at the outset of the negotiation process. However, based on observation of the July-02 negotiations, as the collective negotiation advances it rather quickly degenerates to a somewhat unprincipled horse trading exercise aimed at distributing a total farm gate revenue target amongst 24 varieties with little connection to the needs presented.

Wineries are competitive with one another. Their ability to share certain information is constrained by competitive rivalry. They rest their arguments on trends in market sales statistics. Growers are less competitive with one another. They rest their arguments on a cost of production formula to demonstrate deterioration of grower welfare.

From an outsider's perspective, there is a significant gap in the respective abilities of the parties to understand and utilize data to develop informative, useful trends and directions of the industry. This results in a difficult negotiating environment wherein the parties resort to positional, political and regulatory tactics to advance their positions rather than promoting market, production and financial needs based on certain mutually agreed principles.

Agricultural Policy Framework, includes a intended comprehensive business risk management component. It is currently under development between the federal and provincial governments.

5 The Positions

In this section the positions of GGO and WCO regarding wine grape pricing, and the gaps between these positions, are reviewed.

5.1 The Positions

5.1.1 *GGO*

The GGO begins from the premise that it has the mandate from its members, and the authority by regulation, to collectively negotiate the minimum price that must be paid by all buyers to all sellers. It views any change to this collective power and action as a threat to the continued existence of the marketing board.

Accordingly, GGO proposals are oriented to activities that will refine and enhance the collective process. Among these proposals are standardized contracting to ensure reliable information collection, quality specification scales to standardize the payment incentives for readily measurable parameters such as brix (sugar content), and improved reporting of wine sales. Additionally, the GGO believes increases in the minimum domestic content regulations[7] for non-VQA wines are a lever to force wineries to purchase all grapes produced domestically.

To maintain orderly marketing in the event of a surplus, the GGO is prepared to consider developing a mechanism that will provide an approved, controlled sales outlet for grapes that are above a pre-determined agreed purchase quantity that would be adjusted annually based on changes in domestic wine sales.

5.1.2 *WCO*

The WCO begins from the premise that its members must be able to strike their own individual procurement agreements with growers, including the determination of price. Wineries seek to establish grower-winery specific supply contracts which provide for complete agreements linking varieties produced, viticultural practices, quality specifications, volumes and price. The underlying principle is that price is the payment for the specific goods and services provided, and these vary by grower and winery.

Wine Council of Ontario views the collective price process as being misaligned with the marketplace. It argues that the minimum price is not a minimum at all, but rather an average target price, above which growers attempt to negotiate individual premiums. The WCO argues that the requirement to pay an average, results in higher value grapes subsidizing lower value grapes, and thereby slows the development of higher value grapes in independent vineyards.

5.2 The Gaps

Among the gaps between the two parties are their conceptions of, and commitments to, the industry vision, skepticism and distrust which have become institutionalized, and differing pricing principles, underlying financial strategies, and perceptions of participant welfare, all resulting in a

[7] The Wine Content and Labeling Act regulations allow blending of imported wine juice in non-VQA wines. Current regulations require a minimum of 30% domestic grapes in non-VQA wines labeled bottled or cellared in Ontario.

different felt need for change. Moreover, the differential organizational capabilities and competencies together with the constituent demographics and electoral processes create a problematic situation wherein change might only be achieved by an industry crisis or government intervention to unilaterally amend regulation.

5.2.1 *Vision*

The parties have different visions for the industry.

Wine Council is committed to Ontario wineries being the leading contenders in the domestic market, growing overall Ontario market share from 40% to 50% over the next decade. This goal involves development of a premium, world class appellation, and growth in all market segments. Wine Council has worked with public and private sector stakeholders to develop an industry strategy, and has sought and received matching funds from government to assist in the implementation of this plan. Over time, WCO projects that the domestic grape growing industry may be hard-pressed to meet demand to supply grapes for VQA wines.

The GGO vision is to have Ontario-produced grape products in demand worldwide. GGO takes the position that it was not fully engaged and involved in the development of the industry strategy. It is not convinced the strategy is realistic, and suspects that achievement of the strategy will result in lower returns to growers. If the GGO is to achieve its vision, it appears to be based on the proposition that all grapes must target the top value segments.

From an outsider's perspective, there is a potential point of convergence of the two visions at some point in the future. The primary difficulties regarding vision are the institutionalized beliefs and biases, differing perceptions of time necessary to achieve convergence, and the collective versus competitive approaches to the market.

5.2.2 *Trust*

The individuals involved on behalf of both parties made a diligent effort to work together and build a positive working relationship through the course of the project. They were sincere, reasonable, willing individuals who generally got along well with the members from both organizations. This was necessary to overcome the high degree of institutionalized skepticism and distrust that had developed over the years.

Constituent demographics, cultural characteristics and historic behaviour within and between the two (2) groups incorporate significant levels of skepticism, cynicism and distrust. This has been routinely reinforced by unilateral political lobbying and the regulatory divide between producers and processors. It is clear that means need to be found to break down this organizational divide. As value chains and supply chains integrate, and as global competition intensifies, the need for a single, unifying organization may become increasingly apparent.

5.2.3 *Principles*

During the course of discussions, the parties agreed to certain principles to underpin the pricing system. Up to April 2003, the principles mutually agreed upon were:

- To be consumer market driven.
- To foster long-term, direct relationships between individual growers and wineries.
- To reward superior quality achievement.
- To provide for risk and reward sharing between growers and wineries.
- To involve timely and relevant supply and demand information.
- To minimize short term market volatility associated with implementation.
- To be simple to understand and apply.

In May 2003, the new GGO board put forward a revised list of principles, including that the system:

- Be in the best interests of the industry;
- Maintain orderly marketing of grapes in Ontario;
- Support the financial viability of growers and wineries; and,
- Recognize the Board's authority and responsibility to collectively negotiate price.

Clearly there are differences in the principles with which the parties are currently approaching wine grape pricing. These are discussed below in terms of market responsiveness, relationships, quality, information and financial viability.

Market responsiveness

Wineries wish to have a system that is consumer market driven, while growers seek to maintain the orderly marketing of grapes in Ontario. These principles can be mutually supportive, providing the parties both recognize and accept them. However, the absence of a consumer market principle in the GGO proposal is illustrative of the different views and positions of the parties concerning the value chain.

The market for wine in Ontario is globally exposed. Sellers to the Ontario consumer must compete with wines from around the world. If one accepts the premise that the price paid by the consumer determines the amount that can be paid for the production of the wine, and by extension the price that can be paid for grapes, then Ontario produced grapes must be price competitive with grapes from other parts of the world. The argument is put forward that there are subsidies and support programs in some regions of the world and that these are not matched in Ontario. This is a matter for government and industry to address jointly. It does not change the underlying proposition that, for consumers, domestic wines must be price and value competitive with imported wines, and that the competitive market prices paid by consumers determines the wineries' ability to pay for grapes.

Maintaining an orderly market for grapes is a different concept and can be achieved, in part, by better information and coordination on the supply side of the business. Interestingly, the existence of a mandatory, full participation collective system may result in the breakdown of orderly marketing in the event of an oversupply unless flexibility and responsiveness can be adopted. There were persistent suggestions that certain amounts of grapes were already being sold outside the regulated framework.

Relationships

WCO and GGO agree that long term relationships between growers and wineries are necessary and preferable. They diverge on the role of their respective associations in these relationships. WCO views its role as facilitator while GGO takes an active role by exercising its authority to collectively negotiate price.

Both grape and wine production are long term propositions. The market can move more quickly than vineyards can adjust. This can result in inventory that is in declining demand as new brands and varieties are demanded by consumers. Wineries and growers have a point of commonality when it comes to long term planning together. Wineries would suggest that long term planning is an individual firm activity that requires the ability to sustain and promote long term relationships. GGO might suggest that long term industry planning for varieties is part of the solution.

As an example of the need for long term relationships, consider viticultural practices. Wineries seek to work directly with growers to develop production plans to maximize the productive and quality capabilities of each vineyard, individually. This is done within the context of an individual winery’s procurement plans, which are in turn driven by its marketing plans. The agreement, formalized in a contract, includes a full description of individual agreement between the winery and grower, and the financial considerations that form part of the agreement. Each winery will experience different success in the market. The change in overall supply and demand may be very different from that experienced by an individual producer or processor. The contract, including pricing considerations, allows the parties to formalize and coordinate their production and marketing plans for the long term.

GGO takes the position that it must support and protect the individual grower in the direct contract relationship by establishing minimum prices on an industry wide basis. WCO takes the position that there is no relevance or realism to a collective component in a one to one comprehensive supply agreement for wine grapes.

Quality

The parties spent considerable time discussing the definition of quality. There is a common perception that the higher the price, the higher the quality. In technical terms, quality is defined as the standards and specification determined, in advance, by the buyer. Achieving quality is measured as conformance to these requirements. Accordingly, it is appropriate to consider high quality in all price segments. While the parties reached agreement on this definition, discussion regularly exhibited the conventional wisdom that high price is high quality rather than achievement of specific standards.

The WCO is committed to improving quality in all market segments. It takes the perspective that each vineyard has a certain potential in terms of the variety of grape and the value of the grapes that can be produced on it. It seeks to work with the grower to maximize the quality and thereby the grower returns on each individual vineyard.

The GGO is committed to improving quality, and sees this primarily as expanding the use of Ontario grapes in the higher priced market segments. This is based on the premise that all vineyards are capable of producing high quality grapes for the higher priced segments. As this goal is realized, growers will collectively be able to maximize returns from the vineyards.

The principal differences between the positions are centered first on time and market penetration, and secondly on production capability of individual vineyards. The current market penetration of Ontario wines in the higher priced segments is small, but growing. It will take time for the Ontario market share in these segments to demand the majority of grapes produced in Ontario.

The parties agree different vineyards have different productive capabilities. Some may be able to produce to quality specifications appropriate only for lower priced market segments, while others may be capable of producing for higher priced segments. If this is true, then there will be a range of wine grape price point potentials. All vineyards may be able to produce high quality grapes, and the products produced from these grapes will range from the low to high priced products based on the end-use capabilities of the grapes.

The parties are faced with a dilemma concerning quality. The largest market segments are in the lower price points, and the parties agree it is not profitable to produce vinifera grapes for these segments. Accordingly, to realize returns, the vineyards need to target grapes for the higher priced segments. However, as discussed previously, market demand for grapes for these segments lags the potential to supply. Moreover, the nature of branding and perhaps the collective process, from both the perspective of premium grape growers and wineries, have motivated a significant amount of integration. The grapes from integrated acres will most reasonably be targeted to the highest price points to maximize firm profitability. Accordingly, independently produced grapes capable of producing higher priced wines are likely being squeezed out of the top priced segments by integrated production.

Information

There are large amounts of data and information available concerning the industry, both locally and internationally. For collective negotiation to be effective there is a presumption that both parties will be equally informed and capable negotiators. This implies that each has the organization, information collection and analysis capabilities, and the negotiating experience and skills to develop, present, and assess options, and to reach agreement.

There are significant differences in the skills and understandings of the parties in terms of information and negotiating. Existing information systems have been able to capture some data, but the skills to compile and analyze the data have been less well developed. In the WCO, and certainly in the larger wineries, the skills and capabilities to analyze data and project trends is better developed than with GGO. This puts GGO at a disadvantage in the current negotiating model. This disadvantage is partially offset by the competitive nature of the relationship between wineries that constrains open and complete sharing of information.

Financial viability

The parties spent considerable time discussing the need for risk – reward sharing, minimizing short term volatility and the need for individual firms, grower and winery, to be financially viable. These objectives were considered in the context of the existing collective system, a direct negotiation system, and the implementation and safeguards that would accompany a transition from a collective to a direct pricing model.

Producers and wineries have different capital and cost structures, risk management tools, firm sizes, and market access leading to different perspectives on financial viability. Wineries seek financial reward by building the brand and achieving profitable market penetration for their products. Wineries have few price supports and subsidies. GGO argues, however, that the existing retail licensing system provides differential advantages to some wineries over others, and that this needs to be considered in collective pricing discussions, a point which WCO does not accept.

Growers seek to obtain a fair share of the return from the market, provided by wineries purchasing their grapes, supported by insurance and income stabilization programs to assure short term financial viability. These support programs were not examined by the parties during the pricing system review process. Growers do, however, put forward a Cost of Production study produced in cooperation with OMAF to support their contention that the existing prices are unprofitable to growers. WCO argues that the average cost of production, like the collectively negotiated average price, is not reflective of individual grower situations or the market. In the absence of an ability to negotiate directly with producers, therefore, an unprofitable average cost of production cannot be relied upon to provide evidence of the need for price increases.

In the short term, both parties agreed that growers and wineries must have sustainable cash flows to operate their businesses. They have material differences concerning how to achieve this goal.

5.2.4 *Financial Strategies*

In broad terms, WCO's belief is that achievement of industry vision will result from the sum of the individual actions of competitive firms seeking to grow and sustain themselves in a competitive environment, while GGO believes that collective action is necessary to protect and enhance the financial viability of all producers.

Grape Growers represents producers, defined as individuals or firms producing grapes for sale to wineries. Growers are motivated and influenced by their position on the value chain, being one step back from the ultimate consumer. There is a complex framework of regulations, price and income supports, and collective action in the farm community. Production cycles have a distinct annual character. Risk management is viewed as a shared activity between the farm community and government as public policy provides the support system for the farmers as an integral component of the rural social economy.

Wine Council represents wineries, defined as individuals or firms that purchase grapes from producers for processing into wine. Wineries are consumer focused, and seek to generate their wealth from the market without the necessity of price supports. Wineries' collective action is oriented to regulatory and general promotional matters associated with production standards, market development and market access. While production cycles have annual characteristics, long term business plans are oriented to efficiency of capacity utilization, brand development and market penetration. Risk management is a responsibility of individual firm management rather than a shared responsibility with associations and government.

To understand how these different financial approaches may impact the parties, consider the long term exit strategies for a grower compared to a winery. A winery's ultimate exit strategy is to sell the "brand" at greater than the asset liquidation value. A grower's ultimate exit strategy is to sell the land at its asset value which has appreciated, tax sheltered, over long periods of time.

Individual growers operate as independent businesses. The regulatory and income support system provides for the independent lifestyle and long term debt amortization and capital appreciation, tax sheltered, of the land asset upon which the farm business is based. Over time the value of the price and income supports has become capitalized in the land value, and it becomes increasingly necessary to sustain the support programs to maintain asset values. Growers realize their long term returns by selling the land asset at a point in time.

Individual wineries also operate as independent businesses within a complex regulatory system of production standards and market access. Within this framework, they seek to develop their brands to realize sustainable, attractive margins from the sale of wine to consumers. Wineries' long term returns are realized by selling their businesses, rather than their assets, at a multiple to earnings based on their attractiveness to strategic or financial buyers.

These differing financial goals and approaches may have resulted in market focus being overshadowed by support programs, licenses, quotas, grants, collective authorities, and other forms of government funding and protection.

5.3 Participant Welfare

Each party has the perception that the operations of the members of the other party are highly profitable, and that their own members are being damaged in some manner by the existing system. GGO believes wineries are highly profitable and use public company results and the establishment of new wineries, together with comparisons of Ontario wine grape prices to other regions, as evidence for this position. WCO observes increased planting, often uncontracted and not integrated or linked with a winery, as evidence that growers are profitable. GGO believes growers are unprofitable, and use the Cost of Production study as evidence. WCO believes some wineries are unprofitable, and use generally agreed costs of wine production as evidence. Both of these positions are simplistic, reflect the institutional skepticism and distrust between the parties, and do not likely reflect individual participant welfare in a reliable manner.

The parties agree that both growers and wineries must be profitable and healthy for the industry to prosper. The gap between them is both social philosophy and financial strategy. GGO takes responsibility for the welfare of all its members, and while it puts forward that it only seeks to create an environment in which producers have the opportunity to be profitable, it seeks to do this by treating all equally regarding price while recognizing that there are material differences in the value and quality produced by growers. WCO takes responsibility to work to improve market access, standardize production standards, and develop the market so that all its members can have the opportunity to pursue their individual competitive strategies in the marketplace. WCO does not seek any involvement in pricing as a means to promote winery welfare.

6 The Wine Grape Price Dilemma

There is a need for reliable, meaningful information and a balance of needs and principles in the negotiating relationships. These elements do not exist in wine grape pricing today. The information is incomplete, and the negotiations are based on power and regulation rather than principles and needs.

In this section we review basic principles, the existing pricing system which yields a notional weighted average price, the direct contracting framework developed by the parties prior to termination of the process, the need for change and some suggested next steps.

6.1 Basic principles

There are fundamental propositions that the parties discussed at length, including:

- The characteristics of a wine are closely linked to viticultural practices;
- The market for wine is competitive, segmented, and quality and value conscious;
- The industry must be market responsive;
- Returns to the industry come from the market; and
- Individual firms serve the market.

While they reached reasonable levels of consensus on these propositions, they were clearly divided on the industry vision and strategies for development of the local grape and wine industry. GGO seeks a collective approach, supported by regulation, to create an environment in which all growers may have the opportunity to be successful. WCO seeks a direct, individual approach, supported by regulation to enforce production standards and information collection. Both agreed that safeguards were an important and necessary component of a revised regulatory framework.

6.2 The Notional Weighted Average

The current collective negotiation process yields a notional weighted average which is called a minimum price. This price is supplemented by a brix (sugar) premium scale intended to reward higher sugar levels in the grapes. In reality, the negotiated minimum price is neither a weighted average nor a true minimum price.

The negotiated minimum price may not adequately promote or reward quality, since sugar is only one measure of quality that is used as a proxy for quality since it is measurable. Winemakers seek many other wine making characteristics from grapes, and these may or may not be correlated with sugar content. If they are not highly correlated, or perhaps even negatively correlated, with sugar levels, then the pursuit of sugar based on the price incentive provided may result in lower winemaking qualities and constraints on the pursuit of the industry goal of achieving higher market penetration in the higher priced market segments.

The GGO looks to the sales figures, and growth in the higher price point segments as evidence that wineries are succeeding in promoting the higher priced wines. Growers quite reasonably seek to obtain a fair share of this return. However, integration may be pushing the majority of independent production out of the high priced segments. This leads logically to a lower collective price since it most realistically represents the value placed on non-integrated grapes.

The notional weighted average, defined as the minimum price payable, becomes a winery's cost of goods sold. This regulated price results in some growers being paid more than the end-use utility value of their grapes, while others are paid less than value. Why? Because a winery's ability to pay is also being driven to the notional average, causing the winery to seek to recover the extra costs associated with purchasing lower value grapes by paying less for higher value grapes. This outcome is based on the proposition that there are different end use capabilities of grapes of the same variety.

Wineries forced to pay this weighted average cost of goods may be either advantaged or disadvantaged in the marketplace. If they produce for all price point segments, then the overall impact may be somewhat muted. If they produce only for the high price segments, they are likely underpaying, and if they are producing predominantly for the lower price segments, they will be overpaying.

Overlaying this cross-subsidization are the differential contractual commitments of the wineries. Wineries producing non-VQA wines are permitted to blend imported wine juice into the wines. If two competing wineries are both targeting these segments, and one is obligated by contract to purchase a greater percentage of its requirements domestically than the other, there is a clear competitive difference. This competitive dynamic also impacts the collective negotiation process.

6.3 <u>The Proposals</u>

The parties have broken off discussion with two (2) opposing proposals. On the one hand is the framework developed jointly over the winter to introduce direct pricing negotiation, and on the other is the GGO's May-03 proposal for improvements to the existing collective negotiation process.

During the winter of 2002/03, the parties developed a comprehensive framework that provided:

- For direct contracting, including individual price negotiation;
- Improved contracting protocols;
- Improved information systems;
- An auction for selling and buying grapes;
- Safeguards; and
- Phased implementation over several years.

The general framework of agreement clearly provided wineries the opportunity to demonstrate they would pay for higher value grapes at higher prices, and growers the right to return to collective approaches if wineries failed to demonstrate payment for value.

In May 2003, the GGO put forward a proposal to maintain and improve the existing collective price negotiation process by:

- establishing a longer timetable for collective negotiations;
- developing better information reporting and exchange;
- developing a standardized contract; and,
- establishing a market clearing mechanism for "surplus" grapes.

While the positions appear, at first glance, differ only in the collective versus direct price negotiation, there were other material differences. The Direct Contracting Framework (DCF) deferred to the actions of individuals and the market for evidence of outcome, while the Improved Collective Process (ICP) sought to control the outcome. The DCF provided for the establishment of monitoring and safeguard mechanisms, while the ICP used the existing regulations and support programs to achieve these safety nets. The DCF provided a transitional approach to purchasing existing contracted production, while the ICP sought to establish the 2002 production as the guaranteed purchase amount.

Clearly, the positions are both philosophically and economically very different.

6.4 The Need for Change

The successful pursuit of the industry vision may be challenged by the operation of the collective pricing system as currently implemented. If premium grape growers and wineries are integrating for the supplies to meet high priced market segments, and are restricted in their ability to form more complete long term relationships for independently produced grapes, they will increasingly limit the use of independent grapes to low price segments. This is not to say they will not seek to purchase higher value grapes, only that they will do so opportunistically. From an industry perspective, the viticultural requirements to produce for the lower priced segments are different than those for the higher priced segments, and the result may be an overall reduction in the value proposition of independent Ontario grapes.

The GGO is convinced that the collective price negotiation process is essential to balance the power between individual growers and wineries. It maintains that many growers depend on the GGO to establish the price for their product, and that many growers are unwilling and unable to undertake price discussions with their customers. The GGO does not, however, control the planting and supply of grapes. As planting has expanded over the past five (5) years, the potential for an oversupply has cast a shadow over the producer industry. This potential was likely the motivator that prompted GGO's participation in the pricing review discussions. Winter damage during the winter of 2002/2003 is projected to have severely reduced the potential crop for 2003 and possibly 2004. Accordingly, the perceived need for change to the pricing system by GGO has diminished as the potential crop size has declined.

The WCO is convinced that the existing collective negotiation process and outcomes are entirely inappropriate for the competitive, globally trading marketplace in wines. The WCO has developed a comprehensive marketing campaign and is building relationships with the LCBO to enhance the market share and penetration of Ontario produced wines in Ontario. To realize the benefits of this campaign, the industry needs to be competitive against aggressive import campaigns. Individual firms are developing strategies to differentiate themselves from one another and to build their brands. The industry is supporting this with generic marketing campaigns designed to promote the quality and image of Ontario produced wines. For wineries, the inability to manage the crucial element of pricing, and the risk – reward equation, with individual growers as part of their individual firm strategies, has created a pent up demand for change to the collective pricing system.

Accordingly, the impetus for change is different for GGO and WCO. GGO's felt need for change is closely tied to the projected annual supply of grapes above some pre-determined amount that growers feel wineries are obligated to purchase. For instance, if the projected supply exceeds last year's purchases plus some growth factor, GGO gets concerned about a "surplus" and feels a need to develop mechanisms to address this situation. However, if the supply projected shrinks, as happened following the winter of 2002/03, the need for change diminishes. WCO's felt need for change is based on the development of a long term vision that includes being able to fully manage the grower – winery relationship without the interference of a third party acting in a collective manner for a critical component of the relationship. Annual supply and demand shifts are viewed as short term constraints to manage while in pursuit of the vision.

6.5 <u>Next Steps</u>

The parties have reached an impasse.

It is too late in 2003 to implement material change to the collective negotiation process for the current crop year. In the proposals up to April 2003, the parties agreed, on a without prejudice basis, to certain actions that could be taken in 2003. Actions directed to improving information collection, analysis and dissemination may still be practical to consider for 2003. By and large these are relatively simple, mechanical activities that can be pursued either unilaterally or jointly by contracting or developing the skills and resources to establish and maintain the systems.

Beyond information system development, it is difficult to see what can be implemented in 2003 without agreement on the industry vision and principles of engagement between producers and wineries. The gap between commitment to collective action and competitive market strategies is significant.

The parties may wish to continue building understanding of the market by jointly or individually developing certain economic analyses. Among these are:

1. An economic and financial feasibility analysis of wine grape production in Ontario. This is not suggested as a sophisticated cost of production study. Rather it would analyze the market for wine, and then work back to the cost / price that could reasonably be afforded for wine grapes. It would then examine the economic viability of producing grapes at the cost / prices indicated for each price point segment. And finally, it would take the industry market share targets, project these forward, and estimate the economically viable quantities of wine grapes required in each year for the next 5 – 7 years. To undertake this study would require the confidential participation of several wineries. It might not require grower participation, since most major wineries producing for all price points have owned or controlled vineyards that could be used to provide reliable cost information.

2. An economic analysis of the market structure, regulation, and support programs compared and contrasted between Ontario and other wine grape producing regions of the world that export into the Ontario market. This would include a technical and economic policy analysis of the regulatory framework in Ontario to examine how regulation impacts the behaviour and competitive performance in the local market place.

The parties may also wish to continue dialogue with the intent to determine initiatives they can jointly pursue regarding to pricing. Given the time and effort directed to reviewing the price system over the past several years, including two (2) attempts using outside facilitators, this may not be welcome by one or both groups at this time.

7 Schedule 1. Reports Prepared during Process

Report	Date	Comments
Problem Analysis	Jun-02	Prepared for FPMC and agreed by GGO and WCO.
Wine Mark-up Study	Aug-02	Prepared on behalf of GGO using CanAdapt funding.
Price Mechanisms Backgrounder	Sept-02	Prepared to provide background information on pricing of agricultural products
Contracting Grapes	Sept-02	Papers reporting research on wine grape contracting in California circulated for information.
GGO Price Discussion Paper	Jan-03	Initial pricing system paper prepared for GGO.
WCO Price Discussion Paper	Jan-03	Initial pricing system paper prepared for WCO.
Gaps Memo	Jan-03	Overview of the gaps between the GGO and WCO Discussion papers.
Ontario Grapes and Wines Presentation	Feb-03	Slide presentation on market supply and demand presented at the OF&VGA convention in Feb. and at a GGO information session in Mar.
GGO Price Proposal	Feb-03	A price system proposal provided by GGO to WCO.
WCO Price Proposal	Feb-03	A price system proposal provided by WCO to GGO.
Draft Memoranda of Understanding	Feb-03 – Apr-03	Several drafts of a framework agreement between the parties.
GGO Pricing Proposal	May-03	A GGO proposal for pricing provided to WCO.
Wine Grape Pricing Memo	May-03	A compare and contrast review of the GGO May-03 proposal and the draft MoU.
Final Report	Jun-03	Facilitator's final report outlining the differences between the parties.

In addition, the various discussions and meetings were documented, and the notes to meetings were circulated to the parties throughout the process.