The California Wine Industry: Entering a New Era?

by

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The California wine industry is fragmenting into larger and smaller units to reflect the evolving consumer market in which sales of relatively expensive and relatively cheap wine are growing fastest. The future may be one of large wineries with many labels and small wineries that sell most of their wine to retail consumers.

In September 2002, California grape growers picketed a Gallo grape-receiving facility in Fresno, protesting the $65 a ton offered for their grapes– just enough to cover picking costs. Meanwhile, swank restaurants served wines made from Napa cabernet grapes worth $3,700 a ton. The wine industry in California and the world is entering a new era, as many people drink less but better wine. Will producers of lower-priced grapes raise their quality enough to attract more upscale wine drinkers, putting downward pressure on all grape and wine prices, or will the wine grape industry continue to fragment into distinct quality and price segments, allowing one segment to prosper while another languishes?

These changes have their origin in 1976 when a blind tasting pitted several California wines against top French vintages. To the eternal chagrin of the (French) judges the California wines—Stag's Leap Cabernet and Chateau Montelena Chardonnay—were voted superior. American consumers in the 1980s and 1990s took a new interest in wine and the lifestyle associated with fine wine and food. This new interest increased consumer appreciation of the fact that the taste of wine reflects where the grapes are grown and how the wine is made. Changing consumption patterns, the consolidation of production, and the globalization of sales and tastes are causing the reconfiguration of the California, and world, wine economy.

Consumption: Less but Better

U.S. wine drinkers have upgraded their tastes over the past quarter century, as baby boomers with leisure time and money began to explore wine. Consumption of cheaper table wines, those costing $3 a bottle or less, was stable during the 1980's. In November 1991, the CBS television program *60 Minutes* aired a segment on the French Paradox, the fact that moderate consumers of red wine have less coronary heart disease. Better quality table wine consumption rose sharply in the 1990s (Table 1). Wines carrying labels like Chablis or Burgundy and classified as jug wine fell from 65 percent of consumption in 1991 to 36 percent in 2001, while wines costing $7 a bottle or more were nine percent of sales in 1991 and 28 percent of sales in 2001. The average price of a bottle in inflation-adjusted prices rose from $3.50 in 1991 to $4.60 in 2001, an increase of 2.5 percent annually, which led to the mantra that consumers were drinking "less but better." There are about as many cases of popular-premium or fighting varietal wines sold as jug wines sold.

Higher grape and wine prices have led to increased plantings, especially in coastal areas associated with higher-priced wine grapes. At the beginning of the wine boom in the late 1970s, producer prices for wine grapes rose in all areas, but increased production in the 1980s led to lower prices and reduced acreage— acreage fell

Table 1. U.S. Wine Consumption by Retail Price (750 ml bottle),1991-2001

	Retail Price	1991	1995	1998	1999	2000	2001
Cases Sold (millions)							
Ultra-Premium	Over $14	2.4	3	5.5	10.1	14.4	14.8
Super-Premium	$7 to $14	7.1	10.1	21.4	24.5	24.5	26.4
Popular-Premium	$3 to $7	28.1	34.5	48.1	49.5	52.6	51.3
Jug Wine	Below $3	69.2	69.4	67.8	65.7	55	52.6
Total Table Wine	Mil cases	106.8	117	142.8	149.8	146.5	145.1
Average Price	Table wine	$3.44	$3.88	$4.60	$5.21	$5.88	$5.96
Percent of Total Volume							
Ultra-Premium	Over $14	2%	3%	4%	7%	10%	10%
Super-Premium	$7 to $14	7%	9%	15%	16%	17%	18%
Popular-Premium	$3 to $7	26%	30%	34%	33%	36%	36%
Jug Wine	Below $3	65%	59%	47%	44%	37%	36%

Source: Selected Gomberg-Fredrickson Reports

** Weighted average price is based on midpoint prices for each category times the share of total cases in each category. Retail price categories and weighted average prices are not adjusted for inflation.*

Table 2. California Winegrape Varieties, 1972 and 2001

Percent of acreage	1972		2001
Carignane	12%	Chardonnay	21%
French Colombard	10%	Cabernet Sauvignon	15%
Zinfandel	9%	Merlot	11%
Grenache	7%	Zinfandel	10%
Barbera	6%	French Colombard	8%
Top 5	44%		63%

Source: Grape Acreage Report, California Agricultural Statistics Service, http://www.nass.usda.gov/ca/

ten percent between 1982 and 1991. As the dollar rose in value in the 1980s, wine imports surged, achieving a 27 percent market share in 1984. During the late 1980s, the California wine industry again began to expand, but this time growers planted varietal grapes such as Chardonnay, Zinfandel, Cabernet Sauvignon and Merlot. The top five wine grape varieties accounted for 44 percent of the acreage in 1972 and 63 percent in 1997, but only French Colombard and Zinfandel were among the top five in both years (Table 2).

Winegrape production methods also changed. In the early 1970s, most growers planted vines in rows that were 10 to 12 feet apart, which reduced disease risks by increasing air circulation but also limited yields on what was becoming more expensive land. The most common trellis system had three wires: one for the irrigation hose; one for the cordon or vine; and a "catch wire" to support the vine's foliage. During the 1990s, trellises became more complex, often having wires to guide the shoots upward and thereby foster growth and facilitate exposure to sunlight. Grape clusters that are slow to ripen are removed, intensifying the flavor of the wine produced from the remaining clusters.

Grape growers have become more sensitive to terroir or local conditions. Rootstocks have been developed for particular areas, so that the vines have more disease resistance or drought tolerance, suggesting that parts of California may develop a French-style system that associates specific grape varieties with particular areas, such as Cabernet in the Napa Valley, Chardonnay in the Carneros area of Napa and Sonoma counties, and Zinfandel in the foothill counties.

During the 1990s, the demand for wine increased, and some wineries offered growers multi-year "planting contracts" with guaranteed prices. Plantings increased 48 percent between 1991 and 2001, with the fastest growth in the North and Central Coast areas (Table 3). Non-bearing acreage increased even faster, although the exact amount of non-bearing acreage remains uncertain because some growers have not fully reported their acreage.

In 2001-02, the increased supply of grapes and recession led to declining prices for winegrapes in all areas except the North Coast. In the southern San Joaquin Valley, the result was extremely low prices, which prompted the protests at Gallo. Thompson Seedless, which make-up over 60 percent of the grape acreage in the southern San Joaquin Valley (Madera, Fresno and Tulare counties), can be marketed as table grapes, dried into raisins, or crushed to make wine or grape juice concentrate, a natural sweetener added to soft drinks and confectionery products. Many southern San Joaquin Valley growers do not have contracts with wineries, which explains why they were protesting low spot market prices in 2002.

Consolidation

The farm and food industries are consolidating so that fewer and larger firms account for an increased share of the total sales. The same squeeze on mid-sized players is occurring in the wine industry. The top three wineries, Gallo, Canadaigua and The Wine Group, account for over 60 percent of U.S. wine shipments. In the current consolidation, larger wineries are buying smaller ones, in part to improve their bargaining position with retailers such as Costco. For example, Constellation Brands owns Canandaigua Wine Co, the second largest wine producer after E & J Gallo, as well as Franciscian Estates, giving it a total of 51 brands in 14 market categories, including Almaden, Cribari, Inglenook, Paul Masson, Taylor California Cellers, Nathanson Creek, Dunnewood, Talus, Manischewitz, Cook's and Taylor Sparkling wine, and Wild Irish Rose. Diageo owns BV, Domain Chandon and Dom Perignon, while The Wine Group owns Glen Ellen, Franzia and Mogen David. Consolidation enables one producer to market many labels, thus gaining shelf space in retail stores and facilitating exports and joint ventures.

Mid-size wineries are at a competitive disadvantage vis-à-vis both larger and smaller ones. Small wineries in areas frequented by tourists can sell wine directly to consumers through their tasting rooms, thereby eliminating middlemen and retailer markups. For example, the Napa Valley has 300 wineries, a third of the wineries in California, and most sell much of their wine to visitors. Mid-sized wineries, by contrast, must often sell their wine via middlemen who can have considerable market power under state laws regulating alcohol sales. In the traditional three-tiered marketing system for wine, wineries sell to distributors who sell to supermarkets and liquor stores. The markup from winery to consumer is often 100 percent or more, with much of the profit going to distributors. There is an ongoing effort to eliminate the middleman in wine marketing via internet sales, but that effort has been slowed by the constitutional right of states to regulate alcohol sales. Several lawsuits opposing the ban on internet sales of wine are presently in court.

Large wineries aim to achieve economies of scale and produce uniform wines with vertical integration, growing grapes in their own vineyards or having grapes grown for them according to winery-set specifications. Many of the largest vineyards are in the Central Coast region, which lends itself to large-scale production of varietal winegrapes. There are also economies of scale in wine making, with more fermentation and storage capacity smoothing production and reducing wine crush and fermentation costs. Technological changes in fermentation and quality control have made it easier to produce wine with a consistent taste, and research continues on understanding the chemical composition of wine to improve consistency in wine production.

Globalization

Even though wine is one of the world's oldest drinks, production and consumption remain concentrated in Europe, which produces 74 percent of the world's six billion gallons of wine, equivalent to one gallon for each of the world's six billion residents. The big three wine producers are France, 22 percent; Italy, 21 percent; Spain, 12 percent; the other major European wine producers account for 19 percent of global wine production.

The U.S. is the fourth-largest producer of wine, accounting for about eight percent of world production. Other major New World wine producers are Argentina, five percent; South Africa, three percent; Australia, two percent; and Chile, two percent. They are New World countries in the sense that they share a common wine style (fresh and fruity) and were largely settled by immigrants from Europe. The dynamic trio are Australia, Chile and South Africa, which collectively produce ten percent of the world's wine, but have just one percent of the world's population, which means that most of the wine they produce is exported. For example, Australia exports 90 percent of the wine it produces. The import share of U.S. wines has a V-shape: imports were 25 percent of the volume of U.S. wine consumed in the early 1980s, reached a low of 12 percent in 1990, and are now about 22 percent. Imports in the mid-1980s mostly affected U.S. producers of jug wines, as Italian imports such as Riunite and Bolla increased their U.S. sales. Today's import surge is led by two Australian labels, Lindemans and Rosemount Estate, that compete with wines produced in the Central Coast and Lodi/Woodbridge areas. In 2001 the U.S. imported 127 million gallons of wine and exported 80 million gallons; about 70 percent of U.S. wine exports go to Great Britain, Canada, Netherlands and Japan.

A battle is fermenting between Old World European producers and New World producers. In Old World Europe, there are thousands of grape growers, many

Table 3. California Grape Acreage, Production and Price

	1982	1991	2001
North Coast: Napa, Sonoma, Lake, Mendocino counties			
Winegrape Acreage	71,349	84,086	122,444
Winegrape Crush (tons)	251,600	347,400	383,000
Share of Total Crush	12%	17%	13%
Price/ton ($)	621	1,046	2,219
Grower receipts ($1,000)	156,244	363,380	849,877
Central Coast: Monterey to Santa Barbara counties			
Winegrape Acreage	54,152	49,854	86,501
Winegrape Crush (tons)	165,200	195,200	407,400
Share of Total Crush	8%	10%	14%
Price/ton ($)	460	749	1,240
Total Receipts ($1,000)	75,992	146,205	505,176
Central San Joaquin: Lodi-Woodbridge area			
Winegrape Acreage	80,791	73,111	114,765
Winegrape Crush (tons)	493,400	519,600	797,700
Share of Total Crush	24%	25%	28%
Price/ton ($)	150	240	390
Total Receipts ($1,000)	74,010	124,704	311,103
Southern San Joaquin			
Winegrape Acreage	140,474	108,076	142,463
Winegrape Crush (tons)	1,109,000	989,300	1,290,000
Share of Total Crush	55%	48%	45%
Price/ton ($)	143	157	185
Total Receipts ($1,000)	158,587	155,320	238,650

Source: Grape Crush Report, CASS
http://www.nass.usda.gov/ca/

Table 4. Top Four Wine Imports in U.S., 2001

Country of Origin	Gallons (1,000)	Major Brands
Italy	47,061	Riunite, Bolla, Casarsa, Ecco Domani
France	27,348	Georges Duboeuf
Australia	19,142	Lindemans, Rosemount Estate
Chile	13,669	Concha y Toro, Walnut Crest

Source: Gomberg Fredrickson Report, vol. 21, no. 12, page 21.

with fewer than five acres of grapes, and most send their grapes to co-op wineries—the famous Chateaux that grow grapes and bottle wines with their own labels are exceptions. Most European wines are a blend of several varieties of grapes, and the wine is labeled to reflect the region in which the grapes were grown, such as Bordeaux or Burgundy. The quality and quantity of wine varies from year to year, which means that vintage charts are needed to determine the best wines.

In the New World, grape growing and wine making are often integrated operations in which the winemaker aims for consistency so the first and last bottle taste the same. New World wines, often produced with more technology, tend to be preferred by consumers in countries that do not produce much wine, such as the UK.

Whither California Wine?

Parts of the California wine industry have transformed themselves from producers of jug or generic wine to producers of high quality wine, from producers of wines labeled "Chablis" or "Burgundy," which are wine growing areas of France, to producers of world-class Chardonnay and Cabernet Sauvignon wines. The ground work for the 1976 Paris surprise was laid by UC research and individuals in the Napa Valley. The wine boom they launched made parts of the wine industry among the most successful in the state.

The question facing the industry is how fast producers can respond to changing consumer tastes, as wine drinkers shift from jug wine to fighting varietals, fighting varietals to premium, and premium to ultra premium wines. Analysts who do not distinguish between these different categories predict a "wine glut of historic proportions," as the financial paper *Barron's* asserted on August 3, 1998 and again on August 27, 2001. *Barron's* emphasized that, with wine production rising four to five percent a year, and consumption rising zero to one percent per year, "the basic laws of supply and demand guarantee that the coming glut will have a depressing effect on retail wine prices." However, this prediction of a glut ignores the possibility of a segmented wine industry, as well as alternative outlets for lower quality grapes. In a segmented wine industry, some parts may be booming while others go bankrupt. Displaced growers have alternatives in the grape concentrate (sweetener), raisin and table grape markets. Thompson Seedless grapes, which are one-third of California grape acreage, can be marketed in any one of the four markets. However, profitability in these alternatives, especially raisins and wine, is presently very limited.

A related question is how long will the trend toward more expensive wines last? Today's senior cohort is the wealthiest in history. Many marketers feel this is the source of the shift to more expensive wines and they note that the size of the babyboom generation is unique in U.S. history. At some point the shift to wine and to higher-priced wines may cease. Current levels of consumption, even the upper end, have been stagnate over the 2000-2002 period. This may be due to current economic forces and perhaps 9/11, or it may foretell a plateau in wine consumption as experienced in the 1980s.

In addition to this change in tastes, considerable concern exists regarding the level and direction of imported wines both bottled and bulk—which are used for blending. California vintners in partnership with foreign wineries, or California wineries with vineyards abroad, may prosper, but the fate of growers is less clear. Other concerns arise over the impact of consolidation, especially on medium-sized wineries. The outcome could well be a few large wineries and many small wineries marketing to the agro-tourist and internet trade.

The wine industry has been among the most successful of California's farming sectors. Optimists emphasize that the growing number of educated wine drinkers means that the demand for premium wines can continue to expand. If the demand for jug or generic wines continues to fall, the 21st century wine industry may operate at very different speeds, with one segment enjoying record profits while another pulls out unprofitable grapes.

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