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Learning, Innovation And Cluster Growth
A Study Of Two Inherited Organizations In The Niagara Peninsula Wine Cluster

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LEARNING, INNOVATION AND CLUSTER GROWTH
A STUDY OF TWO INHERITED ORGANIZATIONS IN THE
NIAGARA PENINSULA WINE CLUSTER

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Abstract
This paper applies an innovation system framework to analyze the development of a natural
resource-based system of innovation within the wine cluster in the Niagara Peninsula in
Canada. A variety of policies shape the parameters (financial, fiscal, legal) within which
opportunities for innovation open or are constrained and choices are made. Two of these have
led to inherited organizations that have created contradictory incentives for innovation and
growth in the cluster. On the input side, it is often said that great wines are ‘grown in the
vineyard’ and the demand for innovation in the grape sector, thus depends upon the relationship
between clients, in this case, vintners and their suppliers of grapes. That relationship is a learned
one and the interactions within the Ontario Grape Growers Marketing Board (OGGMB), now
the Ontario Grape Growers (OGG) have had a powerful, and not always positive, impact on the
innovation process. With regard to outputs, policies affecting the sale and distribution of wine as
administered through the Liquor Control Board of Ontario have created a ‘glass ceiling’ that is a
disincentive for growth and innovation among small wineries.
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INTRODUCTION

Soil and climatic conditions have traditionally endowed specific regions with advantages in grape growing. As a result of the close linkage between grape growing and winemaking, wineries have tended to locate close to their suppliers. Over time ancillary supporting organizations and services co-locate in the region forming a geographical agglomeration or cluster. In its emergence and development through the 1980s, the Niagara peninsular wine cluster is typical of this model. Public policies contributed to shaping the cluster in this earlier period in two ways. On the input side, the Ontario Grape Growers Marketing Board established in 1947 under the Ontario Farm Products Act set minimum prices for and regulated the marketing of grapes grown in the province. On the output side, when Prohibition was repealed throughout Canada in 1927, a new organization, the Liquor Control Board of Ontario was created to control the production and distribution of wine. The former took place through the Liquor Licensing Board of Ontario that licensed new wineries; the latter through the monopsonistic purchasing and sale of wine and alcoholic beverages in the Province.

As the Niagara wine cluster began its transformation into a dynamic innovation system in the late 1980s and 1990s, these two inherited organizations were, inevitably, influential in shaping the contours of this process and have had a major impact on the evolution of the sector. This paper examines their role and impact over this period through the lens of an innovation systems approach.\(^1\)

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\(^1\) Future papers will deal with a number of other issues related to the growth and innovativeness of the Niagara Wine Cluster such as land use planning, Research-Industry Linkages and other interactive processes that form part of the dynamics of innovation in the cluster.
1. FROM CLUSTER TO INNOVATION SYSTEM

A system of innovation is defined as a network of economic agents, together with the institutions and policies that influence their innovative behaviour and performance (Nelson:1993; Nelson and Winter:1982, Lundvall, 1992). Underlying the system of innovation approach is an understanding of innovation as an interactive process in which enterprises, here, grape growers and vintners, in interaction with each other and supported by institutions and a wide range of organizations play a key role in bringing new products, new processes and new forms of organization into economic use (Figure One). Following Edquist, Storper and others, we understand institutions as “sets of common habits, routines, established practices, rules or laws that regulate the relations and interactions between individuals and groups” (Edquist:1997,7), as such they “…prescribe behavioral roles, constrain activity and shape expectations.” (Storper:1998,24).

At the heart of an innovation system are knowledge and information flows. Although these may, on occasion, move along a linear path from the ‘supply’ of research to products in the market, more often they are multidirectional and link a wider set of actors than those typically located along the value chain. Which actors other than, suppliers and clients, will be critical to a given innovation process cannot always be known a priori and they are likely to be sector specific. So, while it is important to have an overview of the ‘national’ system of innovation, sector specificity, in industrial structure and technological terms, but also with regard to the competencies and the particular habits and practices of actors in that sector will be major factors in shaping the nature and intensity of their interactions, learning processes and investment practices, three of the key elements that are important in turning a cluster of co-located actors into an innovation system (Mytelka:2000). These habits, practices and institutions are learned behaviour patterns, marked by the historical specificities of a particular system and moment in time. As such, their relevance may diminish as conditions change. Learning and unlearning on the part of firms and other actors within the system, are thus essential to the evolution of a system in response to new challenges.

The stimulus to innovation within a cluster might come from many sources. One is the market. Another is through non-market mediated collaborative relationships between individual users and producers of innovation (Lundvall: 1988,35) and where still broader systemic coordination
is required, the stimulus to innovation might be intermediated by policies. Policies may stimulate and support a process of innovation by agenda-setting that targets specific actions for immediate attention. In the evolution of the Niagara Wine Cluster, the Ontario Wine Assistance Programme (OWAP) of 1988, for example was a powerful force in reshaping the composition of grape varieties planted in the province in the period from 1988 to the early 1990s, by providing funds to pull up Labrusca and Hybrid vines and from 1988 to 2000 by providing ‘sugar bonuses’ to encourage the planting of vinifera grapes and the use of newer viticulture techniques that produce grapes of high quality for the wine sector.

Since these transitional programmes have ended, demand for continued innovation in the grape sector has depended upon the relationship between clients, in this case, vintners and their suppliers of grapes. That relationship, too, is a learned one and Section 3 of this paper analyzes the impact of interactions within the Ontario Grape Growers Marketing Board (OGGMB), now the Ontario Grape Growers (OGG) in this process.

A variety of less explicit policies also affect the innovation process by shaping the parameters (financial, fiscal, legal) within which opportunities are opened or constrained and choices are made. In Section 4 of this paper we analyze one of these, the policy affecting the sale and distribution of wine in the province as administered through the Liquor Control Board of Ontario (LCBO). As an actor within the emerging Innovation System in the Niagara peninsula, the LCBO has gained considerable prominence as one of the world’s largest purchasers of wines and spirits. There is a long history in other innovation systems of the use of state purchasing power to stimulate innovation and support the growth of local enterprise. Recent World Trade Organization (WTO) negotiations over subsidies, now constrain this role to a large extent, but do not eliminate it altogether. As the system’s core actors act within such parameters, of central concern in industrial and technological policy making is the impact that these implicit policies have on the innovation process overtime. Continuous monitoring of policy dynamics generated by the interaction between policies and the varied habits and practices of actors in the system will be of considerable importance in fine tuning policies for maximum impact. Adaptive policy making is part of what makes an innovation system, a learning system.

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2 The development literature provides numerous examples from Brazil and Korea, but similar practices have been used to stimulate the development of telecommunications equipment manufacture through the purchasing power of local telecom monopolies in a number of European countries.

3 For Metcalfe, at issue, then, “…is how well policymakers learn and adapt in the light of experience.” (Metcalfe:1997,275).
Within the above framework, it is now possible to map the main actors who constitute the Niagara wine cluster (Figure 1). Central to all innovation systems are supplier enterprises, here the grape growers and their clients, the vintners. Other organisations generally found to be critical actors in the process of innovation within these systems are industry associations, of which the Wine Council of Ontario (WCO) is probably the most important. Centres for Research and Development such as the Cold Climate Oenology and Viticulture Institute (CCOVI) at Brock University or the Vineland Research Station now part of Guelph University\(^4\), standard setting bodies, here the Vintners Quality Alliance (VQA) initially a voluntary industry association, transformed in 2001 into a regulatory body, universities and vocational training centres such as Niagara College, information gathering and analysis services, in the Niagara Wine Cluster, a number of organizations play these roles, including the WCO, VQA, some of the tourism oriented organizations and relatively new associations amongst actors in the cluster such as the Niagara-on-the-Lake marketing group “The Wineries of Niagara-on-the-Lake”\(^5\). Banks, Venture Capital and other sorts of Financial services have elsewhere proven critical, but are less important players in the Niagara Wine Cluster, though investment costs in terms of land prices, planting a vineyard and building a winery can amount to $1 million over five years.

In mapping the Niagara Peninsula Wine cluster two organizations do not find their counterparts in either sector –based or cluster-based systems of innovation studied elsewhere. These are the Ontario Grape Growers Marketing Board, created under the Ontario Farm Products Act in 1947 and the Liquor Control Board of Ontario. Established under the Liquor Control Act of 1927. Both of these organizations intermediate between clients and their suppliers, or in Lundvall’s terms between users and producers of innovation. Each of them, moreover, embodies historically rooted institutional attributes that are today, at variance with the evolution of the wine cluster. In the case of the OGGMB an adversarial relationship couched in somewhat biblical ‘David vs. Goliath’ terms underlay the role of this organization as a mediator. Its mandate was “to enable producers of a commodity to collectively market their product in an orderly manner and balance the power between many small individual sellers and relatively few larger buyers”\(^6\).

\(^4\) Curiously some of our respondents exclude Guelph University but include the Vineland Station as an actor within the cluster. The interaction of Guelph University –based researchers with actors in the cluster –both researchers and vintners-- has been a long and continuous one. From an innovation system perspective, they are thus considered to be part of the system.
\(^5\) This group includes 14 members: Chateau des Charmes, Hillebrand (Andres), Peller (Andres), Inniskillan (Vincor) Jackson –Triggs Niagara Estate Winery (Vincor), Joseph’s, Konzelman, Lailey, Marynissen, Pilliteri, Reif, Stonechurch, Strewn, and Sunnybrook.
\(^6\) See the Ontario Farm Products Act of 1947.OMAFRA at http://www.gov.on.ca/OMAFRA/english/
In the case of the LCBO, regulations governing the Ontario wine industry were shaped by immigrants from the British Isles and northern Europe who brought with them a “Puritan Ethic” in which the consumption of alcohol topped the list of socially-disintegrating evils. Under the Canadian Temperance Act of 1916, however, wine had remained the only alcohol to be sold legally and small wineries proliferated. When Prohibition was repealed, restricting the growth of winemaking activities and the sale of wine became fundamental precepts and were put into practice by the LCBO which maintained only 16 stores throughout the province and imposed a long term moratorium on the issuance of new winery licenses while they developed laws for the regulation of alcohol consumption. Over four decades, no new licenses to produce and sell wine were granted in the province and a process of consolidation ensued in which the number of Ontario wineries fell from 61 in 1927 to six by 1974. This would change in 1975 when the Liquor Licensing Board granted Don Ziraldo and Karl Kaiser the first winery license since Prohibition. Inniskillin was created that year.

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7 see, for example, http://www.canadianvintners.com/canadianwines/modernhistory.htm
9 These included Brights, Andres, Jordan, Cartier and London (check: Chateau Gai, Barnes)
2. GROWTH AND TRANSFORMATION IN THE NIAGARA WINE CLUSTER

The Niagara peninsula has been home to grape growing and wine making for more than a century but well into the 1970s this emerging cluster was based on Canadian Labrusca grapes, Concords, Niagaras and other local varieties that made a sweet desert wine which at the time, corresponded to Canadian and more broadly, North America tastes. In the midst of the great depression, one of Niagara’s pioneering winemakers, T.G. Bright and Company launched a long term research and development programme in both viticulture and viniculture. Convinced that European vinifera grapes could grow in the soil and under the climatic conditions of the Niagara Escarpment. Adhemar de Chaunac, Bright’s French-born winemaker and chemist, later joined by other winemakers, grape rowers and agricultural research stations at Vineland (Ontario) and Somerland (British Columbia), succeeded in developing a large variety of hardy Canadian hybrids over the next 50 years. Slowly grape acreage planted to hybrids in Niagara expanded and grape varieties such as De Chaunac, Foch, Baco Noir, Seyval Blanc and Vidal became the mainstays of a new sort of table wine.

The creation of Inniskillin in 1975 signaled the relaxation of winery licensing regulations and led to the establishment of more commercial estate wineries in the late 1970s and early 1980s. Many of the new estate wineries were founded by grape growers who had been experimenting with imported European vinifera grape varieties for some time. Others were established by immigrants from Europe with the training in viticulture and were committed to quality winemaking. Together these actors spearheaded a movement towards premium wines made from vinifera grapes. While Labruscas continued to account for over 50 percent of the 17,887 acres planted to grapes in the Niagara district in 1981, hybrids had risen to 21.5 percent in that year and would reach almost 29 percent in 1986 shortly before joining Labruscas in a steep and irrevocable decline as the Niagara peninsula wine cluster underwent a major transformation (Table 1).

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Table 1
Trends in the evolution of the Niagara Wine Cluster

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</thead>
<tbody>
<tr>
<td>Vinifera</td>
<td>460</td>
<td>447</td>
<td>1654</td>
<td>3403</td>
<td>7644</td>
</tr>
<tr>
<td>Hybrids</td>
<td>3851</td>
<td>5118</td>
<td>3689</td>
<td>2795</td>
<td>3818</td>
</tr>
<tr>
<td>Labrusca</td>
<td>10,071</td>
<td>9066</td>
<td>6656</td>
<td>5136</td>
<td>4360</td>
</tr>
<tr>
<td>Total</td>
<td>17,887</td>
<td>17,920</td>
<td>12,681</td>
<td>13,105</td>
<td>16,402</td>
</tr>
</tbody>
</table>

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</thead>
<tbody>
<tr>
<td>For wine</td>
<td>38,980</td>
<td>31,952</td>
<td>29,658</td>
<td>28,963</td>
<td>41,267</td>
</tr>
<tr>
<td>Total Crop</td>
<td>69,925</td>
<td>77,240</td>
<td>56,630</td>
<td>47,738</td>
<td>53,186</td>
</tr>
</tbody>
</table>

Source: OGGMB Annual Reports

The transformation of the Niagara Peninsula Wine Cluster was precipitated by changes in global consumption patterns for dryer wines made from European Vinifera varieties – initially whites, such as Chardonnay, Riesling and Sauvignon Blanc, more recently reds, Cabernet Sauvignon, Merlot and Syrah, by negotiations that would lead to a Free Trade Agreement between Canada and the United States in the wake of a 1987 GATT panel that upheld a European Union complaint against discriminatory practices of the LCBO\(^{11}\), and by the rapid growth in exports by still newer challengers such as Australia\(^{12}\). The transformation was given a major boost by government policies (OWAP) that underwrote the uprooting of older native and hybrid varieties an encouraged replanting with European viniferas. The impact of this policy has been dramatic. From less than 3 percent of total grape acreage planted to vinifera grapes in the period 1981-86,

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\(^{11}\) The LCBO marked up Foreign wines by 60 percent as compared to a mark-up of 1 percent for Ontario wines. We will return to this point in Section 4.

\(^{12}\) The technological foundation for increased output in the Australian wine industry was laid in the 1960s and 1970s and accompanied by rising output in this period. “But the real take-off year can be dated quite precisely – it was 1986, when a big unexpected depreciation of the Australian dollar led to a surge of exports to the UK...and the proportion of output exported rose from about 3% in 1986-7 to about 30% in 1993-4.” Email communication from Keith Smith, 3 April 2003.
vinifera plantings rose to 13% of total in 1991, 26% in 1996 and reached 47% in 2001 (Table 1).

A rapid overview illustrates the extent to which a dynamic wine cluster has emerged in the Niagara peninsula. That cluster today counts between 70 and 80 wineries of which 69 are members of the Vintner’s Quality Alliance (VQA), the label that signifies quality and for the most part wines made from vinifera grapes. The peninsula continues to attract new wineries. Following the granting of three winery licenses in the 1970s, 8 wineries were established in the 1980s, 23 in the 1990s and a further 8 in the years 2000-2003. Output of wine from the Niagara Wine Cluster, especially of quality wines bearing the VQA label has grown from 645,000 litres in 1991 to nearly 4 million litres in 2002 (Appendix I, Table 1). The value of VQA wine sales has increased from $5.6 million dollars to more than $50 million dollars during the same period (Appendix I, Table 2). Over the 1990s, protection offered to Ontario wines by the LCBO in the form of a mark-up of one percent, considerably lower than the 60% placed on imported wines, now has been eliminated. Today Ontario VQA wines are competitive in the domestic market and their sales account for nearly 30 percent of the domestic total.

Despite this credible record of growth and innovation a number of disquieting trends have begun to appear. First, although the total acreage planted to grapes has not yet regained its level of 20 years ago and less than half the acreage is planted to vinifera, by 2001 Ontario had a surplus of vinifera grapes. Second, although the number of wineries has increased, most of these are small and even those established in the 1980s and early 1990s have not notably expanded. New large firms, moreover, are the offspring of consolidations and changes in marketing strategies. A glass ceiling seems to have been put in place with respect to the growth of smaller wineries. Third, although VQA wines are doing well in Ontario, the share of Ontario wines in total wine sales in the province has been declining over the past decade. In what follows we examine some of the factors that have contributed to these paradoxical trends.

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13 An important class of VQA wines that are not exclusively vinifera based are icewines.
14 Globally, wine production in Canada is small. Of 267.6 hectolitres produced world-wide in 2001, Canada produced 0.15% as compared with 19.9% in France, 19% in Italy, 5.9% in Argentina, 3.8% in Australia, 2.4% in South Africa and 2.1% in Chile) (Leroux:2003,13)
15 All data on wine production and sale are drawn from LCBO annual reports.
3. THE ONTARIO GRAPE GROWER MARKETING BOARD

As defined by the Farm Products Marketing Commission, marketing boards “are producer elected, controlled, and financed. All producers of specified commodities are required to sell/market those commodities according to the marketing board’s marketing plan…” Accordingly, the OGGMB is structured through an annual electoral process. Producers are divided into four geographical districts within which each grower has one vote. All elected representatives must be grape growers. At their annual meeting, growers elect the Grape Growers Committee, with each committee member representing approximately 30 growers in their district. The Grape Growers Committee then elects seven directors who choose the officers for the Board of Directors, which approves the programs, policies and strategic direction of the Grape Growers of Ontario. The Board meets every month and conducts regular information and policy discussion meetings for growers throughout the year.

In its primary role as a marketing board, the OGGMB negotiates the floor price for all grapes sold to processors each year. Winemakers are represented by the Wine Council of Ontario and manufacturers of juice, jams and other grape products, by the Ontario Food Processors Association. If prices cannot be settled through the negotiating process, the dispute is referred to an arbitration board.

Grapes are divided and priced by class. Classes 1-3 consist of grapes for juice, while Classes 4 and upward are wine grapes. An estimated 80% of grape production goes into commercial winemaking and negotiations with the WCO are thus critical in setting the minimum prices for different grape varieties. Within these categories prices also vary in terms of grape quality, which is measured by the OGGMB solely in terms of sugar levels (Brix). While growers contract their grape sales directly with processors, prices may not fall below these floors.

Between 1947 and 1974 consolidation in the grape processing sector had posed a threat to the balance of market power between grape processors and growers and the prices negotiated within the OGGMB were important in maintaining the viability of grape growers vis-à-vis larger wineries. In 2003, the Ontario Grape Growers Marketing Board was officially renamed the Grape Growers of Ontario (OGG), as the Board felt that “there was a negative connotation

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16 OMAFRA http://www.gov.on.ca/OMAFRA/english/farmproducts/factsheets/role.htm#what
17 http://www.grapegrowersofontario.com/thegrowers/aboutus/organization.html
18 Farm Products Marketing Act, Grapes for Processing, O.Reg.274/92,s.5.
19 Ibid.
21 Interview with Smith, OGGMB, 2002.
connected to the term ‘marketing board’, that somehow we manipulated the price and the market and kept the prices artificially high.”\textsuperscript{22} The structure and functions of the renamed organization, however, would remain the same.

The operations of the OGGMB are financed by growers, each of whom pays fees to the Board for every metric tonne of grapes sold to processors.\textsuperscript{23} Fees are paid on an annual basis, and the Board has the authority to penalize growers who do not pay fees on time. Services provided by the Board beyond price negotiations include acting as “the voice of the OGGMB membership and an information resource to growers, the general public, media, and our winery partners on viticulture and the relevant grape and wine issues affecting our industry.”\textsuperscript{24} In addition, the Board supports some grape-related research through grants. In what follows we focus on the OGGMB’s three main function, pricing, representation and research funding, as a means to analyze the way in which this organization has shaped the behaviour of actors in the sector and the impact it has thus had on innovation and growth.

The 1980s and 1990s have ushered in a period of transition and change in Ontario’s grape and wine sector, which has altered the environment in which the OGGMB operated. As opposed to 6 large wineries, uniform in size and market power, dominant in the sector from the 1950s into the 80s, Ontario wineries now are highly differentiated by the regulations under which they fall, their market power, and the products they market. Alongside the large wineries that flourished under the old labrusca-based system, small estate wineries have proliferated in the 1990s. Consequently, the size of wineries is polarized, with a large number of small wineries and a few very large wineries (see Figure 2).

In contrast to the labrusca-based wine system from the 1940s to the 1980s, contemporary vintners in Ontario market wines differentiated according to non-VQA and VQA designations, with a range of price and quality differentiation within the VQA appellation. In particular, larger firms have opted to compete in all non-VQA and VQA market segments while small vintners predominantly focus on a range of VQA market segments. The segmented market within which large and small firms operate has led to conflicting demands for change in the grape market revolving around quality. In addition, estate wineries are increasingly engaged in grape growing as a result of changes in alcohol retailing regulations in 1993, requiring wineries with retail outlets to be located on at least 5 acres of vineyard.

\textsuperscript{22} OGG Newsletter, January 2003.  
\textsuperscript{23} http://www.grapegrowersofontario.com/thegrowers/aboutus/index.html  
\textsuperscript{24} http://www.grapegrowersofontario.com/thegrowers/aboutus/index.html
During the 70s and 80s, a slow but steady decline in the number of Ontario grape growers took place. Nonetheless, there remain about 530 grape growers in Ontario, with 397 growers engaged in wine grape production.

Table 2  
Grape Grower Demographics: Ontario Wine Grape Sellers 2002

<table>
<thead>
<tr>
<th>Grapes Produced (tonnes)</th>
<th>Number of Growers</th>
<th>Grape production (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;1000</td>
<td>4</td>
<td>14</td>
</tr>
<tr>
<td>500-1000</td>
<td>19</td>
<td>24</td>
</tr>
<tr>
<td>250-500</td>
<td>27</td>
<td>19</td>
</tr>
<tr>
<td>100-250</td>
<td>77</td>
<td>25</td>
</tr>
<tr>
<td>50-100</td>
<td>69</td>
<td>10</td>
</tr>
<tr>
<td>25-50</td>
<td>73</td>
<td>5</td>
</tr>
<tr>
<td>&lt;25</td>
<td>128</td>
<td>3</td>
</tr>
</tbody>
</table>

Source:
OGG Annual Report 2003

Towards the end of the 1980s and into the 1990s, a number of growers moved downstream in order to sell a higher value-added product, wine. Approximately 25% of all grape growers are currently vertically integrated. Consequently, the distinction between wineries and growers is beginning to blur, with many estate wineries now characterized as grower-vintners. The rising number of grower-vintners confounds the initial purpose of the OGG in negotiating prices between small growers and large wineries. As both buyers and sellers of grapes, grower-vintners are doubly represented at annual grape price negotiations-- by the OGG as grape growers and the Wine Council of Ontario as vintners. More importantly, being a grower-vintner also means that many estate wineries pay marketing fees to the OGG in order to buy their own grapes. The paradox of grower-vintners positioned on both sides of the price negotiation table appears to render the OGG redundant.

In essence, most grower-vintners growing their own grapes do not require the OGG to act as an marketing intermediary. In fact their costs would be lower if they did not have to pay marketing fees (called licensing fees). Tensions surfaced during the course of 2001 when an increase in OGG licensing fees almost doubled the cost of marketing viniferas for growers.25

Several grower-vintners refused to pay the increased fees and the OGG took action through the Farm Products Review Tribunal.26 Fees were reduced the following year and the animosity of grower-vintner members has led the OGG to form a distinct grower-vintner constituency, which

25 The licensing fees were subsequently reduced in 2002 to a more manageable level.
will entitle grower-vintners to vote for three committee members at the annual OGG elections.\textsuperscript{27} While this structural change gives grower-vintners distinct representation in the OGG, it does not address the efficacy or the necessity of the OGG’s functions in an innovative Ontario wine and grape sector. As such, expanded representation does not resolve the paradox of grower-vintners as buyer-sellers in the Ontario grape market.

Another source of tension lies in the differing grape demands generated by the interests of non-VQA and VQA producers coupled with recent vinifera surpluses. These have renewed old tensions between growers and large wineries in particular. In 2001, the OGG reported that for the first time, vinifera production outpaced that of labruscas and French hybrids to the point of surplus. With grape plantings taking at least four years to bear fruit, the surplus situation was repeated in 2002 as new grape plantings came into production, and is forecasted to get worse with each year.\textsuperscript{28} The OGG has even gone so far as to urge growers to stop planting viniferas, as increased plantings will only depress prices.\textsuperscript{29}

Serving as an axis of division in the cluster is the fact that the largest wineries buy 75\% of the grapes grown on the peninsula, despite the growing number of small estate wineries in the Niagara Peninsula. As such, many grape growers still see the OGG as an important buffer between them and the large players who dominate the grape market (Table 3)

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
Grape Tonnage Purchased & Number of wineries & Grape Purchases (\%) & Grape Production as \% of purchases \\
\hline
>1000 t & 8 & 75.5 & 9.7 \\
500-1000 t & 7 & 11.1 & 54.1 \\
100-500 t & 18 & 9.6 & 62.4 \\
25-100 t & 25 & 3 & 170.5 \\
<25 t & 28 & 0.7 & 72.8 \\
\hline
\end{tabular}
\caption{Winery Demographics: Ontario Grape Buyers 2002}
\end{table}

Besides the power differential within the grape market, grape growers regard the large wineries with derision due to the Wine Content Act of 1973 and its subsequent renegotiations\textsuperscript{30}. Grape growers find the Wine Content Act, which governs the content requirements of non-VQA wines, particularly offensive for three reasons. First, wines containing foreign content that are

\textsuperscript{27} OGG Newsletter, January 2003.
\textsuperscript{28} OGG, 2001 Crop Report.
\textsuperscript{29} OGG Newsletter, January 2003.
\textsuperscript{30} See page 15 for further information on the Wine Content Act.
labeled “Product of Canada” and “Cellared in Canada” prevent Canadian consumers from fully supporting the domestic grape and wine sector. Under the current Wine Content Act, non-VQA wines may contain foreign wine content, and added water and sugar. Wineries are compelled by the Wine Content Act to include a minimum of 75% Canadian grape content in wines in order to use the Product of Canada label and only 30% Canadian grape content for a Cellared in Canada label. To growers, the current Wine Content Act constitutes false advertising that prevents Canadian consumers from making informed choices about the wines they purchase. The largest Ontario wineries have prospered on non-VQA table wines, and continue to rely on these products to maintain their high domestic market share.

Given the world wine glut, the ability of large wineries to import cheap foreign blending material to add to Ontario wines will always create a downward pressure on Ontario grape and wine prices. Larger vintners such as Andres, Vincor and Magnotta import blending material for non-VQA products, as the cost of imported blending materials for non-VQA wines from prolific grape and wine producers such as Chile, South Africa and Australia is very low when compared to the cost of producing grapes in Canada. Blending material imports have increased steadily since Free Trade despite the new emphasis on VQA in Ontario, while no wineries licensed after 1993 can import blending material. The practice of blending imported wine is particularly problematic in the light of vinifera grape surpluses in Ontario in 2000 and 2001.

### Table 4
*Trends in Grape Purchasing by Ontario Wineries*

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</tr>
</thead>
<tbody>
<tr>
<td>Imported Blending Material</td>
<td>5,086</td>
<td>12,270</td>
<td>22,602</td>
<td>22,658</td>
<td>345%</td>
</tr>
<tr>
<td>Ontario Grapes</td>
<td>24,756</td>
<td>16,511</td>
<td>32,309</td>
<td>41,267</td>
<td>66%</td>
</tr>
<tr>
<td>Total Ontario Winery Purchases</td>
<td>29,842</td>
<td>28,781</td>
<td>54,911</td>
<td>63,925</td>
<td>114%</td>
</tr>
</tbody>
</table>

Source: OGGMB Annual Reports

Interacting with these factors are the listing practices of the LCBO, discussed later in this paper, which serve to disadvantage Ontario grape growers as well as small VQA wine producers.

Finally, while the growth of VQA output has been based on quality wine production on the Niagara Peninsula, grapes grown especially for VQA production still constitute a small portion of the grape supply. With the bifurcation of grape demand most basically along non-VQA and VQA product designations, grape growers are receiving mixed signals as to how to grow their grapes. In contrast to VQA production, the 30-75% domestic grape content for non-VQA
products does not induce the same quality requirements for the mainly large vintners engaged in non-VQA production. Non-VQA production, which accounts for well over half of Ontario’s grape demand, encourages a cheap price for grapes, which is countered by growers through higher yields.

VQA production, on the other hand, which accounts for a little over a quarter of the industry’s grape demand, requires premium grapes grown at low yields at prices that both estate wineries and grape growers can manage. These factors are complex and largely negative for Ontario growers, and help to explain why the OGG has strengthened its commitment to VQA production significantly in recent years, while continuing to cling to its function as a market intermediary despite the grower-vintner dilemma.

Though the OGG is trying to adjust to the changes in the grape and wine sector, it has only recently recognized the burgeoning problems with the current pricing system. The OGG’s 2003 Annual Report indicates that the OGG is undertaking efforts to change its functions to better serve the interests of the Ontario grape and wine sector. In 2002, the Farm Products Marketing Commission hired a consultant to facilitate a discussion about grape pricing between the OGG and the WCO. According to the OGG, the discussion revealed that the current pricing system “was not meeting the needs of both the growers or the wineries”, and that as a result, “the OGG must make changes in its pricing methodology”, while remaining committed to collective negotiations on behalf of growers.31 While the main function of the board is to negotiate minimum prices for grapes, the current structure and processes of grape pricing through the OGG act as economic and social disincentives to innovation in viticulture and oenology.

The price structure for Ontario grapes is based on brix (ie. sugar content), which is inadequate as a sole measure of quality. The minimum grape prices negotiated by the OGG are based on a sliding sugar scale that calculates the weighted average brix content of the past 5 years. The sugar scale was introduced in the early 1980s as a quality incentive at a time when brix levels were very low (approximately 17 brix) in Ontario grapes. Each tonne of grapes with a brix level above the weighted average received a higher price (referred to as a sugar bonus), which was meant to create incentives for grape growers to produce grapes with higher brix levels. Since the 1980s, the weighted average brix level of grapes has increased substantially, signaling the success of the original OGG incentives in disproving claims that Canada’s cool climate prevented the necessary sugar levels for good wine grapes.

Now that Ontario’s grapes have attained acceptable brix levels, the bar of quality has once again been raised. As a sole measure of quality, brix is insufficient because acids and other complex compounds which constitute the varietal character of grapes are critical to wine flavours. Two

grape growers may produce grapes with identical brix levels, but due to differing viticulture techniques the varietal character of one bunch of grapes will be more complex than the other. In creating disincentives for innovation, the sliding sugar average incorporates every individual grape grower’s innovations into the following year’s base brix level without compensating the grower for his efforts, while ensuring that he/she must incorporate the same efforts in subsequent years in order to meet the base brix level. Moreover, acids and other flavours eventually decrease as brix increases indefinitely.

More fundamentally, there seems to be some question as to whether grape quality can be empirically measured, or whether there is a substantial tacit component to ascertaining grape quality. For long standing grape growers who are content with the brix scale, the quality card appears to be another trick in a winery’s hand. Quality is now a thorny issue for grape growers, but the fact remains that a price scale that equates grape quality with brix is problematic for innovative growers and wineries.

Second, the grape price system is based on tonnage, which creates incentives for high volume output. Relationships between growers and vintners have changed as a result, as the top priority for vintners producing VQA wines has shifted beyond access to the right variety of grapes (i.e. viniferas) towards demand for higher quality viniferas. This has led to a focus on viticulture practices that produce low yields that allow for maximum flavour development within the grape bunches. In devising ways to ensure quality grapes through desired low yield viticulture practices, some vintners now attempt to compensate grape growers for losses incurred by low yield techniques by paying per acre prices. These prices constitute special contracts that are meant to offset the cost to growers of sacrificing grape yields to quality imperatives. These special contractual arrangements are rare, however, given that integrated grower-vintners will produce as much of their own premium grape content as possible in order to control vineyard practices for quality assurance.

To stabilize the risks to growers in producing low yield, quality viniferas, some vintners sign long-term contracts with preferred growers, which often create positive collaborative relationships in the vineyard between the contracted grower and the winery. Thus, while estate wineries are growing a portion of their own grapes, they maintain long-term contracts with trusted grape growers to ensure that their quality needs are met, purchasing a small quantity of grapes on the market for flexibility purposes.32 Essentially, however, efforts to ensure premium quality within the small VQA segment of the wine grape market have been undertaken by vintners and growers negotiating amongst themselves, around the OGG grape pricing system and the incentives it creates. These arrangements indicate that the OGG is a redundant

32 11 wineries interviewed indicated that this was the case.
intermediary for most innovative actors in the grape and wine sector. With respect to quality, the OGG’s current price system is currently creating more disincentives than synergies for innovation.

Besides the implications for relations between vintners and growers, long-term contracts are costly for the larger vintners that can continue to produce non-VQA wine because input costs make grape prices in Ontario higher than imported bulk wine from Chile, Australia and Italy. Consequently, one very recent trend among larger vintners is consolidation and backward integration, through vineyard acquisitions or land purchases and new vineyard plantings of their own as they look to expand their VQA production. This strategy suggests that the OGG pricing system does not allow for grape pricing flexibility along the quality spectrum, creating the incentives to acquire more vineyards in order use different viticulture techniques for specific products (i.e. high yields for non-VQA content, medium yields for low-end VQA products like Vincor’s Ancient Coast, and low yields for premium VQA wines.) As these strategies are too costly for small estate vintners mainly due to distribution problems at the LCBO, the only option remaining is to simply stay small and vertically integrated, and to compensate grape growers on the Niagara Peninsula for premium grape production.

In addition to its function as a price regulator, the OGG has traditionally been the principal lobby for grape growers within the policymaking process. The most significant portion of OGG expenditures is, in fact, on promotion (Table 5). With the emergence of the VQA, the OGG responded by contributing to VQA wine promotion in 1995, and in 2000 began contributing to VQA Ontario. The board also publishes a newsletter with issues pertaining to the industry and maintains data on Ontario grape and wine market.

<table>
<thead>
<tr>
<th>Table 5: OGG Promotion and Research Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promotion Expenditures</td>
</tr>
<tr>
<td>Research Expenditures</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>
Source: OGGMB Annual Reports

The OGG’s involvement in research and development and extension services has largely been limited to administrative and joint-funding capacities in an attempt to counter the downsizing of the Horticultural Research Institute of Ontario at Vineland. Two projects administered in the 90s included virus-free woodstock propagation and the establishment of twelve automated

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weather stations in the Niagara peninsula. In addition to these joint-funding initiatives, the OGG contributes small grants mainly towards grape pest and disease research initiatives. According to the OGG, however, the board has become “less focused on what needs to be done in the areas of primary viticulture research”, and as such has hired a consultant “to assist in creating a long-term research vision and implementing a process to achieve these goals”. 34

The OGG is an inherited organization that has been slow to adapt to differentiating needs and demands of the Ontario wine and grape cluster. The continued dominance of large wineries in the grape buying market suggest that its initial function may still be valid. However, the ability of wineries to compete, even in the domestic market, requires a continuous process of innovation in grape growing and not only in viniculture. Conflicts and tensions within the OGG do not facilitate the kind of trust-based interactions that are needed for innovativeness. Whether or not the OGG is successful in contributing to the ongoing dynamism of the wine sector will depend heavily on how it chooses to deal with its outdated grape pricing structure.

34 OGG Annual Report 2003:3.
4. THE LIQUOR CONTROL BOARD OF ONTARIO

In the late 1980s, a series of events culminated in the radical restructuring of not only the grape and wine industry, but of the policies and practices of the LCBO. The first two of these, the European Community’s launch of a formal complaint regarding provincial liquor board practices and the upholding of this complaint in a 1987 GATT Panel\(^{35}\) and the signing of a Canada-US Free Trade Agreement in 1988 led to the adoption of national treatment in the listing and distribution of wines through the LCBO\(^{36}\), the progressive equalization in the LCBO’s mark-up on imported and domestic wines and the elimination of import duties on wines\(^{37}\). Under the terms of these agreements, foreign wines would be treated no less favourably than Canadian wines in the Ontario market. The third, also a feature of the FTA, was a moratorium on multiple retail licenses. All wineries in operation at the time of the FTA were allowed to keep their established winery retail stores. As such, their retailing privileges were “grandfathered”. All new winery licensees, however, would be allowed only one retail store, located at the winery site. The structure was thus biased against smaller wineries that would have no other outlet for province-wide distribution than the LCBO.

In 1989 the Vintner’s Quality Alliance was put in place at the request of small estate wineries in order to establish quality standards for vinifera-based wines and thus build a more positive image for Canadian and Ontario wines amongst consumers.\(^{38}\) Products labeled with the VQA insignia would henceforth be made from 100% Ontario vinifera grapes grown in one of the three provincially Designated Viticultural Areas: Niagara Peninsula, Lake Erie North Shore, or Pelee Island.\(^{39}\) VQA rules also stipulated labeling and content requirements. It is important to note, however, that adherence to VQA was strictly voluntary for the first ten years after its creation. Legal enforcement was not possible until the adoption of the VQA Act in 1999 which in 2001 vested authority in a new regulatory body, VQA Ontario.\(^{40}\)

While the VQA controlled the content requirements and labeling of VQA wines, non-VQA wines were governed by the provisions of the Ontario Wine Content Act.\(^{41}\) Since 1983, the Wine Content Act allows the larger wineries who are not required to produce only VQA wines

\(^{35}\) Agriculture and Agri-Food Canada, Wine Sector Profile
\(^{36}\) Agriculture and Agri-Food Canada, Wine Sector Profile
\(^{37}\) AAC, Wine Sector Profile.
\(^{39}\) Vintners Quality Alliance Act, 1999.
\(^{40}\) VQA Ontario
\(^{41}\) The Ontario Wine Content Act of 1973 falls under the Ontario Ministry of Consumer and Business Services and not OMAFRA. It has been traditionally renegotiated every five years.
grown with Ontario vinifera grapes, to import up to 30% foreign material for blending in any bottle of wine. Although large domestic wineries were satisfied with the 30% blending rule and still enjoyed access to Ontario labruscas for certain established products, new actors had entered the sector and were pushing for change. The VQA was one of these and the transformation of the VQA into a regulatory body carried this still further. It was thus a disappointment to many that when the Wine Content Act was renegotiated in 2001 it would still allow older wineries that were legally permitted to manufacture non-VQA wines, to import 30% foreign content for wine production. Once again rules were put in place that discriminated unfavorably against the small and emerging medium-sized wineries in the Niagara Peninsula.

In the period between 1989 and 1993, one particular trend appeared which prompted a further change to liquor licensing. Operating within existing liquor licensing regulation and wine content rules, wineries such as Magnotta, Vinoteca and Cilento established themselves within the city of Toronto to sell wines with foreign content bottled onsite. Primary winemaking activities like fermentation were secondary to retailing and by operating outside of ‘wine country’, these stores were direct competitors of the LCBO. In 1993, the Liquor License Act was amended to require that for wineries to have a retail store, it must be located on 5 acres of vineyards. In addition, at least 25% by sales volume of the full primary fermentation process would now have to be carried out onsite, of the remaining 75% the manufacturer, the manufacturer was required to carry out in full at least one significant winemaking step. The licensing changes effectively made viticultural and winemaking activities a prerequisite to wine retailing from 1993 onwards.

As the number of wineries within the wine cluster rose, a glass ceiling seems to have emerged with respect to the growth of smaller wineries. Three factors related to the operation of the LCBO are contributing here: the ability of small and medium-size wineries to access the Ontario market through the LCBO (getting listed), the LCBOs new marketing strategy and its effect on the ability of smaller wineries to stay listed and the value added of a provincial monopoly for the sale of wine and spirits which largely flows from its substantial dividends to government, a large share of which comes from imports.

1. Access to market:

The LCBO is the main vehicle for wineries to access the Ontario Market. Only a few of Ontario’s wineries have their own retail stores apart from the one store permitted to all at the vineyard. These are the four largest wineries, Vincor, Andres, Magnotta and Chateau des Charmes and one medium-sized winery, Kittling Ridge. The top two have 270 private retail stores, the other three have 18 (Table 6).
Table 6
Access to Markets -2003

<table>
<thead>
<tr>
<th>Winery</th>
<th>Number of Private Retail Stores</th>
<th>Number &amp; Share LCBO Table Wine Listings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1998 (N=390)</td>
</tr>
<tr>
<td>Vincor</td>
<td>165 wine rack stores</td>
<td>100 (25.6%)</td>
</tr>
<tr>
<td>Andres</td>
<td>105</td>
<td>73 (19.7%)</td>
</tr>
<tr>
<td>Share of top two in total Table wines</td>
<td></td>
<td>44.3%</td>
</tr>
<tr>
<td>% Share of Top Two in VQA wines</td>
<td></td>
<td>25 listings (23%)</td>
</tr>
<tr>
<td>% Share of Top two in non-VQA wines</td>
<td></td>
<td>74% of 200 listings</td>
</tr>
<tr>
<td>Magnotta</td>
<td>7</td>
<td>No listings (a)</td>
</tr>
<tr>
<td>Kittling Ridge</td>
<td>7</td>
<td>17 (4.4%)</td>
</tr>
<tr>
<td>Chateau des Charmes</td>
<td></td>
<td>14 (3.6%)</td>
</tr>
<tr>
<td>Total these five wineries</td>
<td>288 stores</td>
<td>52.3% of total listings</td>
</tr>
</tbody>
</table>

Notes: (a) LCBO did not list Magnotta while its court case was underway.

These very same wineries have a large share of the LCBO’s listings and that share has increased from 52.3% in 1998 to 66.8% five years later (Table 6). This sharp increase resulted from an LCBO strategy to focus on volume sales thus leading to a reduction in the total number of listings from 390 to 295 and the competitive practice of larger firms the world over, to buy up or introduce new brands which enable the firm to occupy still larger amounts of shelf space. Vincor is a typical example. In addition to its older brands, the 2003 listings contained four new brands with a total of 12 new listings. Between 1998 and 2003, listings also rose for 2

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42 See also the Australian case.
middle-sized wineries but declined or remained the same for five and one was delisted along with four smaller wineries. In 2003 four other small wineries were listed but with fewer listings.

With tremendous growth in small estate wineries and low volume VQA wine production throughout the mid- to late 1990s in Ontario, the LCBO controls access to the main distribution network for Ontario wine. Yet there is a growing awareness that smaller wineries have not benefited from the existence of a state monopoly in this critical role. The LCBO has had mixed responses to the situation, on the one hand arguing that their retail system encourages competition between smaller wineries, while on the other hand pointing to specific programs and “exceptions” made for Ontario wines despite Canada’s trade obligations. A significant problem for smaller wineries lies in the LCBO’s retail policies, in which product listings are based primarily on volume sales and secondarily on the store manager’s discretion.

Getting listed at the LCBO is itself a complex process and requires the development of a long terms strategy and marketing plan by the winery. This is a serious problem for SMES which cannot spare personnel for strategic planning and marketing purposes and generally require assistance from business support services.\footnote{The United Nations Conference on Trade and Development (UNCTAD) maintains a small business support programme, known as EMPRETEC in more than a dozen Latin American and African countries for this purpose. Within the European Union, to enable small firms to participate in R&D Consortia, small business services and other intermediaries have similarly been used.}

The process of getting listed is thus a lengthy one and the risks are all born by the supplier if the product does not pass muster.

The LCBO retail system, has centralized merchandizing and distribution activities, the latter through six large warehouses that supply all 800 outlets with stock. Nevertheless, there is considerable discretionary power left to local store managers in managing inventory. The LCBO system pushes products with the highest levels of volume sales system-wide, but below a certain sales performance level, the store manager has discretion to tailor store inventory to local consumer tastes. A new listing, must achieve its annual provincial quota within 12 months from the announcement of its availability. As new products are reviewed quarterly, failure to achieve acceptable sales may lead to delisting before the 12 months are over. There are examples of early delisting, especially at local store manager discretion. All risks incurred in delisting are born by the supplier. When this happens, the supplier must reimburse the LCBO for 25% of the purchase price and the LCBO can then sell off the remaining stock at a discount or the supplier takes back the remaining stock at her own expense.

Store size is another factor that shapes the quantity but also the selection of products that are found on shelves. The number of wine Stock Keeping Units (SKUs) on the LCBO’s General
List amounts to about 2,000, with the largest stores offering about 1600 wines from the General List and 1500-2000 from the Vintages list, a list of premium wines (Interview:LCBO). Smaller stores, however, offer 250-300 wines from the General List and few, if any Vintage products. In agency stores operated by private retailers there may be as few as 50 wines for sale, all from the General List.

<table>
<thead>
<tr>
<th>Number of brands</th>
<th>Number of LCBO Outlets</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;2,500</td>
<td>78</td>
</tr>
<tr>
<td>1,500-2,500</td>
<td>196</td>
</tr>
<tr>
<td>1,000-1,500</td>
<td>165</td>
</tr>
<tr>
<td>500-1,000</td>
<td>333</td>
</tr>
<tr>
<td>&lt; 500</td>
<td>31</td>
</tr>
</tbody>
</table>

| Total LCBO Outlets | 803 |

But discretionary practices of the managers of small LCBO outlets, is not the only problem. Despite the fact that Ontario table wines make up about two thirds of domestic wine listings at the LCBO, and 29% of total wine products on the General List, most Ontario VQA table wines are available in as few as 56 LCBO stores. It will be remembered, that VQA wines are the stock in trade of the smaller Estate Wineries. This is particularly problematic in view of the vast array of wines from Australia, France, Italy, US, Chile, etc. that are prevalent in most LCBO stores, and is related to the product retail strategy employed in the majority of stores, a point to which we will return below.

In general, the products that sell best get the largest amount of shelf space and usually the most visible in LCBO stores (Interview: LCBO). According to the LCBO, the only exception is made for Ontario wines, which occupy desirable shelf space even when they are not always best sellers. The LCBO has just recently started to measure linear shelf footage, and points out that while Ontario wines account for 31% of sales by, they have just under 33% of linear footage in most stores. The LCBO is now committed to dedicating 35% of linear shelf space to Ontario wines by the end of fiscal year 2002-03. But as we have seen above most of the space is going to a small number of larger wineries and few of the smaller wineries are beneficiaries.

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Recognizing this, the LCBO set up a number of programmes designed to support smaller wineries. The LCBO has introduced some new programs specifically for estate or niche wineries such as the Hotline, Craft Winery, and Direct Delivery Programs. One criticism of these programs, however, is their availability in a limited number of stores located mainly in southern Ontario. The Hotline and Destination Store programs are intended to counter difficulties wineries face with the discretion of individual LCBO store managers. Through the Hotline program, wineries can ship directly to targeted LCBO stores with more direct and preferential access to particular store managers.\textsuperscript{45} In this way, wineries can target specific markets for their products (Interview: LCBO). The Destination Store is designed for unique low-volume premium products and unique varietals from both domestic and import suppliers. Intended for niche brands, selected wines are purchased in smaller quantities and are distributed to destination locations, approximately 20 LCBO stores and licensee depots through a forced distribution. Other LCBO stores are not permitted to stock these brands, enabling participating wineries to concentrate their promotional efforts exclusively on destination locations, enabling growing estate wineries to develop and hone their in-store promotional activities. Wineries are expected to conduct product tastings to support sales.

The VQA Direct Delivery Program was introduced in 1999 as a response to the decrease in independent winery stores sales after LCBO Sunday shopping was introduced. Before 1997, only winery retailers sold wine on Sundays. The decision to open on Sunday, made by the Minister of Consumer and Business Affairs, increased the LCBO’s level of competition with winery retail outlets, highlighting the LCBO’s commitment to more aggressive retailing. As a result, winery retail stores suffered significant declines in sales, while the LCBO gained small sales increases. The VQA Direct Delivery program allows wineries to deliver their wines directly to bars and restaurants with only a 2% markup, constituting a revenue loss of $7m to the LCBO (Interview: LCBO).

The Craft Winery Program began in March 2002, designed as a 3-year cycle to introduce products from “Growing Estate Wineries”.\textsuperscript{46} Selected products can progress from a forced distribution to up to 60 predefined stores in the first year, to full General List at the end of the third year. The aim of this program is to enable wineries to develop brands for the General List, not for niche brands produced in limited production. Basically, this program gives small wineries premium shelf space that usually exceeds their market share (Interview: LCBO). By February 2003, only 11 small wineries had 17 wines on offer through this programme. The craft winery programme is thus not an antidote to the lack of listings, the difficulties of staying listed and the limited shelf-space for small wineries.

\textsuperscript{45} Conducting Business with the LCBO
\textsuperscript{46} Conducting Business with the LCBO
Even for medium-sized wineries the LCBO’s product management policy is a challenging one. Shelf placement is predominantly dependent on short term sales performance; hence, if a product fails to meet the required sales quota it is moved to a less prominent shelf space where it is invariably less noticeable to consumers. This sets such products down the slippery slope to delisting as we saw above. New wineries and new products are slow in getting on to LCBO shelves (Interview: Strewn) and have little consumer recognition by virtue of being new. They are nonetheless expected to meet the LCBO’s provincial sales quotas within a matter of months. Combined with the LCBO’s commitment to promoting wines from other countries, the task of staying on the shelf for both small and medium-sized wineries appears daunting.

In contrast to the situation of smaller wineries, LCBO product management policies have not been a problem for larger wineries with diversified products for whom the LCBO is a significant distribution outlet for their more recognizable non-VQA products. As their non-VQA products came under pressure from cheaper imports, these firms made up for losses by expanding into VQA production (Table 7). In addition, sales from the retail stores of these five firms have increased by 47.1% over the period 1991 to 2002. This is in spite of a decrease in sales between 1998 and 1999, as a result of the LCBO decision to open stores on Sunday and compete head-on with independent winery retail stores.

2. The LCBO Marketing Strategy: Staying Listed

Over the period 1988-2003 the LCBO was transformed from a state instrument designed to control the production and distribution of wine, into Ontario’s leading large-scale marketer. In 1985, the LCBO launched its changing image with a campaign entitled “Innovate, Merchandise & Generate Enthusiasm Programme (IMAGE)” designed as much for marketing as to encourage learning and adaptation within the organization. By 1988 the new strategy to move ‘from a control-based distributor to a customer-focused retailer’ had been put in place. This included the creation, of a $1.7 million LCBO Quality assurance laboratory upon which many wineries depend for testing in 1989 and beginning in 1991 a major revamping of the top 140 stores and the launching of a new campaign to promote Ontario wines. By 1994 all counter-service stores had been converted to self-service and wineries were encouraged to promote products with purchased in-store displays. Wine sales were facilitated by the growing use of debit and credit card purchases and training programmes for employees were launched.

As part of this process, in 1991, “…the government funded a $5 million advertising campaign that involved a set of two television commercials incorporating the slogan: “We’re ready when you are” (Aspler,1993). The intent of these commercials was to make the local population aware of the quality wines now being produced in the region, and to help local wineries compete with
the influx of American and European wines entering the country due to free trade and GATT. As described by John Aspler, the result was an increase in VQA sales of 1.1 percent, while the import’s sales fell 3.8 percent in the same fiscal year.” (Steward:1997, 46). The early 1990s were the highpoint of a positive intersection between the new LCBO marketing strategy and the strategy for growing a cluster in which local vintners created a number of associations (VQA) and linkages to stimulate this process.

In 1993, the LCBO renamed its Today magazine, ‘Food & Drink”, and began its ‘shop the world’ marketing programmes. Capital expenditures on marketing rose from $1.6 million in 1996 to $2.6 million in 1999. For smaller wineries, producing 100% VQA wines, the LCBO marketing strategy is highly risky because of the costly marketing programmes and uncertain and low returns (Interviews with Strewn, Pillitteri, Lenko, Warren, Marynissen). The LCBO, for example, charges suppliers for tastings, shelf-talkers, and extra promotional display materials. Maintaining lists at the LCBO is an ongoing struggle that requires significant expenditures in terms of both time and capital. Promotional materials offered by the LCBO are sold to wineries which gives larger wineries an advantage. For example, in the 1997 Shop the World Campaign, suppliers had the option to purchase “performance packages” rated Gold, Silver and Bronze corresponding to their cost, which ranged in price from $22,350 for a Gold Package to between $1,250 and $5,215 for a Bronze package, the number of participating LCBO stores and the amount of ‘signage’ – such number of signs and promotions, shelf extenders and corner shelves.

These programmes were highly successful and by 1995 Financial Post Magazine ranked the LCBO “Canada’s most profitable company’. In 1997 and 1998 the Retail Council of Canada named the LCBO “large-store innovative retailer of the year’. The shift to high volume, rapid turnover marketing was completed with the building of mega-stores in Toronto (1999) and Ottawa (2000 and 2001).

Between 1990/91 and 1999/2000 shifts in Canadian consumer tastes for alcoholic beverages were notable. Sales of spirits fell from 30.7 to 25.9 percent, beer sales held steady at 51.7 percent, while those of wines rose from 17.5% to 22.5% (Statistics Canada: 2001). Within this, consumers also increased their purchases of red wine relative to white. Ontario, which accounts for 40% of domestic consumption, was the province with the strongest increase in red wine sales, up 17.3% over the period, and much of this was imported. Despite this pattern, in 2002, as part of its transformation, the LCBO launched a campaign to promote Australian wines. Normally with a weak dollar imports become more costly and fall, but this was not the case in wine sales. Imported wine sales in litres rose that year by 4.5% while domestic wine sales fell to just under 30 percent and what accounted for this was the dramatic increase of Australian sales in that year. These rose 22.3%, a growth rate that was three times that of Chilean wines and 15 times the rate of growth of US wines in the Ontario wine market that year. LCBO sales figures
also show, however, that sales of VQA wines have continued to grow and its share of Ontario wine sales are rising (Appendix 1). VQA wines have thus become strong competitors to imported wines. Their prices have fallen on average, they are able to increase their sales through the LCBO despite a nearly complete loss of mark-up protection and by value VQA shares are also growing and faster. We are getting premium prices for premium wines despite the fact that VQA wines are not widely available in LCBO stores. Instead of promoting Australian wines, from a state monopoly, one might have envisaged a quite different promotional campaign, something more along the lines of the 1991 promotion of Ontario wines, in which a two-for-one sale of matched Ontario and Australian wines was promoted as a vehicle for tasting and comparing to demonstrate just how far Ontario wines had come\

But another set of considerations might be leading to a quite different strategy. The LCBO can count among its successes, the substantial increases in the dividends paid to the provincial government which included profit remittances (based largely on the mark-up) of 72% and the liquor sales tax). These rose from $793 million per year in 1993 to $1.2 billion in 2002. The Federal government also received revenues from customs and excise taxes and the GST totaling $298 million in 1993 and rising to 370 million in 2002. A recent study places Ontario third in a field of 12 jurisdictions in wine levies per capital, just following Quebec at $8.40 and British Columbia at $7.17. This can be compared with Pennsylvania at $5.43, Washington State at $3.49, New Zealand at $2.29 and California at $1.13. (Girling et al:2003) Ontario is thus a major contributor to Provincial revenues and the key question in so far as wine in Ontario is concerned, is the proportion of that increase derived from imports. From a policy perspective, such considerations will need to be set against the relative employment, value-added and environmental impacts of Ontario wine production as compared to wine imports.

47 The LCBO might also consider a more pro-active role in promoting Ontario wines in other Canadian provinces.

48 The KPMG (2003) study has provided some indication of the relative employment and value added impacts per litre of Ontario Wine as compared to Foreign Wine sold on LCBO shelves. But more work is needed in this area.
5. CONCLUSIONS

This paper focused on learning in two organizations that have played an important role in promoting innovation and growth within the Niagara Peninsula Wine Cluster, the OGG and the LCBO. Both organizations trace their establishment to the pre-World War II period and a set of conditions in the cluster that were significantly different from those that prevail today. Nonetheless, the first of these organizations, the OGG, has evolved little in its structures. Its underlying institutional base, moreover, remains rooted in the notion that grape growers and vintners are distinct sets of actors whose interaction takes place mainly through a price setting process that must be mediated not by the market but by a marketing board, an institution reminiscent of collective bargaining between actors with different and contradictory interests. A year ago, the OGGMB was renamed the Grape Growers of Ontario to counter claims that the prices fixed by the marketing board were out of line with the market. But nothing in this change of name implied a change in the adversarial nature of the rules governing the relationship between those who remained grape growers and the legally mandated disappearance of the non-grape growing vintner and their replacement by vintners who grew their own grapes. These old habits and practices are now a disincentive to the longer term collaboration between suppliers and clients that elsewhere has been shown to be a positive factor in the growth of dynamic innovation systems (Mytelka & Farinelli:2003; Maskell & Malmberg:1999, Lundvall)

The second organization, the LCBO dates to a still earlier period. But, unlike the OGG, which has evolved little as conditions changed, the LCBO’s role and strategy have undergone a profound transformation. From a learning perspective we might be tempted to see this as a positive example of adaptive learning. Current LCBO practices, however, are reducing the incentives for innovation and growth in small wineries. This is because the economic rewards to innovation for these wineries are constrained by the limited opportunities to amortize the costs of innovation through wider sales. These practices thus reinforce the negative signals inherent in the legal structure of wine retailing in the province. If there was a special role for a state monopoly in this area in the past, that role has been replaced by the LCBO’s current retail policy and marketing strategy which, for all practical purposes, have turned the LCBO into a private retailer.

According to the Wine Council of Ontario, “(e)very $10 million in wine sales produces $16 million in economic activity in the province of Ontario”49. With atleast 25,000 acres of good grape growing land available for viniferas in the Niagara peninsula there is still room for growth
here. Although the Niagara Wine Cluster may be Canada’s largest, Canada as a whole will remain a relatively small producer on the global scale relative to countries like Australia with its 130,600 hectares of bearing vineyards in 2001 (Zhou:2002,14). But this should not discourage further expansion and growth of the cluster and its continued innovativeness. For this to take place, rethinking the roles of the OGG and LCBO will have to be placed on the policy agenda.

Figure One

Innovation Systems

International Trade Agreements

Increased international investment and knowledge flows

Traditional Habits and Practices of Actors

Suppliers (Grape growers)

LCBO

VQA

Financial Services

R&D & Training Centers (a)

OGG

WCO

Interaction

Clients (Vintner)

Geographical indications

New technologies in both viticulture and viniculture

Growing concentration

National Policies

Financial Services

(a) Brock University’s CCOVI, Guelph University, Niagara College,

Source:
Figure 2: SIZE OF WINERIES BY YEAR OF ESTABLISHMENT (A)

LARGE FIRMS
1970 - Inniskillin (Vincor)
- Chateau des Charmes (Independent)

Source: VQA Membership lists of 69 wineries in Ontario and interviews
Table 1. LCBO total wine sales by volume per year 1989-2002 (in 000s litres)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Domestic Wine (inc.VQA)</td>
<td>30,457*</td>
<td>26,002*</td>
<td>22,170</td>
<td>22,370</td>
<td>20,969</td>
<td>20,483</td>
<td></td>
</tr>
<tr>
<td>VQA wines</td>
<td>-</td>
<td>-</td>
<td>645</td>
<td>904</td>
<td>1,285</td>
<td>1,485</td>
<td>1,200</td>
</tr>
<tr>
<td>Domestic Wine Coolers</td>
<td>-</td>
<td>2,626</td>
<td>2,341</td>
<td>1,629</td>
<td>1,255</td>
<td>1,042</td>
<td></td>
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<tr>
<td>Imported Wine</td>
<td>44,922</td>
<td>45,476</td>
<td>45,814</td>
<td>44,017</td>
<td>43,966</td>
<td>44,951</td>
<td>46,375</td>
</tr>
<tr>
<td>Total Wine</td>
<td>75,379</td>
<td>71,478</td>
<td>70,610</td>
<td>68,728</td>
<td>67,618</td>
<td>67,175</td>
<td>67,900</td>
</tr>
<tr>
<td>%Domestic/Total</td>
<td>-</td>
<td>-</td>
<td>31.6</td>
<td>32.5</td>
<td>32.6</td>
<td>31.2</td>
<td>30.2</td>
</tr>
<tr>
<td>% VQA/Domestic (inc.VQA)</td>
<td>-</td>
<td>-</td>
<td>2.9</td>
<td>4.0</td>
<td>5.8</td>
<td>7.1</td>
<td>5.9</td>
</tr>
<tr>
<td>% VQA/Total</td>
<td>-</td>
<td>-</td>
<td>0.9</td>
<td>1.3</td>
<td>1.9</td>
<td>2.2</td>
<td>1.8</td>
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<tr>
<td>Domestic Wine (inc.VQA)</td>
<td>22,208</td>
<td>24,957</td>
<td>25,845</td>
<td>25,795</td>
<td>26,523</td>
<td>26,958</td>
<td>26,934</td>
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<tr>
<td>VQA wines</td>
<td>1,660</td>
<td>2,494</td>
<td>2,534</td>
<td>2,718</td>
<td>3,158</td>
<td>3,659</td>
<td>3,933</td>
</tr>
<tr>
<td>Domestic Wine Coolers</td>
<td>903</td>
<td>895</td>
<td>718</td>
<td>544</td>
<td>489</td>
<td>499</td>
<td>549</td>
</tr>
<tr>
<td>Imported Wine</td>
<td>47,671</td>
<td>48,328</td>
<td>49,617</td>
<td>52,952</td>
<td>57,010</td>
<td>60,626</td>
<td>63,339</td>
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<tr>
<td>Total Wine</td>
<td>70,782</td>
<td>74,180</td>
<td>76,180</td>
<td>79,291</td>
<td>84,022</td>
<td>88,083</td>
<td>90,822</td>
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<tr>
<td>%Domestic/Total</td>
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<td>33.9</td>
<td>32.5</td>
<td>31.6</td>
<td>30.6</td>
<td>29.7</td>
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<tr>
<td>% VQA/Domestic (inc.VQA)</td>
<td>7.4</td>
<td>9.9</td>
<td>9.8</td>
<td>10.5</td>
<td>11.9</td>
<td>13.6</td>
<td>14.6</td>
</tr>
<tr>
<td>% VQA/Total</td>
<td>2.3</td>
<td>3.4</td>
<td>3.3</td>
<td>3.4</td>
<td>3.8</td>
<td>4.2</td>
<td>4.3</td>
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</table>

* Canadian wines category includes both VQA and wine coolers in 1989 and 1990 figures.
Table 2. LCBO wine sales by net value 1989-2002 (in $000s)

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<tbody>
<tr>
<td>Domestic Wine(inc.VQA)</td>
<td>161,712*</td>
<td>150,080*</td>
<td>134,506136</td>
<td>619145,536143,270143,105</td>
<td>145,536</td>
<td>143,270</td>
<td>143,105</td>
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<tr>
<td>VQA wines</td>
<td>-</td>
<td>-</td>
<td>5,614</td>
<td>8,234</td>
<td>12,885</td>
<td>15,339</td>
<td>16,446</td>
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<tr>
<td>Domestic Wine Coolers</td>
<td>-</td>
<td>-</td>
<td>8,665</td>
<td>8,260</td>
<td>6,056</td>
<td>4,663</td>
<td>3,739</td>
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<tr>
<td>Imported Wine</td>
<td>367,652385,041396,053372,925379,358390,427410,573</td>
<td>529,364535,121539,224517,804530,950538,360557,417</td>
<td></td>
<td></td>
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<tr>
<td>Sales by ON winery stores</td>
<td>49,141</td>
<td>49,701</td>
<td>51,095</td>
<td>55,814</td>
<td>63,107</td>
<td>68,317</td>
<td>83,369</td>
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<tr>
<td>%Domestic/Total</td>
<td>30.5</td>
<td>28.0</td>
<td>24.9</td>
<td>26.4</td>
<td>27.4</td>
<td>26.6</td>
<td>25.7</td>
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<tr>
<td>% VQA/Domestic(inc.VQA)</td>
<td>-</td>
<td>-</td>
<td>4.2</td>
<td>6.0</td>
<td>8.9</td>
<td>10.7</td>
<td>11.5</td>
</tr>
<tr>
<td>% VQA/Total</td>
<td>-</td>
<td>-</td>
<td>1.0</td>
<td>1.6</td>
<td>2.4</td>
<td>2.8</td>
<td>3.0</td>
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</tr>
</thead>
<tbody>
<tr>
<td>Domestic Wine(inc.VQA)</td>
<td>158,888178,563190,809201,723211,595214,443217,234</td>
<td>20,075</td>
<td>27,671</td>
<td>31,146</td>
<td>34,827</td>
<td>41,259</td>
<td>47,770</td>
</tr>
<tr>
<td>VQA wines</td>
<td>3,209</td>
<td>2,612</td>
<td>1,976</td>
<td>1,797</td>
<td>1,954</td>
<td>2,154</td>
<td></td>
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<tr>
<td>Imported Wine</td>
<td>435,845469,803503,290559,624635,112680,993731,605</td>
<td>598,080651,575696,711763,323848,504897,390950,993</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales by ON winery stores</td>
<td>95,227</td>
<td>106,257114,805111,765118,219123,739136,587</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>%Domestic/Total</td>
<td>26.6</td>
<td>27.4</td>
<td>26.4</td>
<td>26.4</td>
<td>24.9</td>
<td>23.9</td>
<td>22.8</td>
</tr>
<tr>
<td>% VQA/Domestic(inc.VQA)</td>
<td>12.6</td>
<td>15.5</td>
<td>16.3</td>
<td>17.3</td>
<td>19.5</td>
<td>22.3</td>
<td>23.1</td>
</tr>
<tr>
<td>% VQA/Total</td>
<td>3.4</td>
<td>4.2</td>
<td>4.5</td>
<td>4.6</td>
<td>4.9</td>
<td>5.3</td>
<td>5.3</td>
</tr>
</tbody>
</table>

* Canadian wines category includes both VQA and wine coolers in 1989 and 1990 figures.
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