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Risk Management

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2021 M&A Outlook



Catastrophic Risk Modeling: Consequences and Opportunities

Taking the proactive approach to wildfires, pandemics and unknown disruptions

Bill Pregler

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TURMOIL HAS RATTLED THE wine industry over the last year, from wildfires to a pandemic and total market disruption, making it understandable that grapegrowers and wineries now steel against the uncertainties of the future. And they are not alone. Two other industries are just as concerned and are made up of the people who usually must help pick up the pieces: the insurance agents and lawyers.

Risk is what these folks are trained to avoid, and providing safety nets is their job. While risk management has been in the wine industry for some time, catastrophic risk management is a relatively new concern. The difference is that the risk involves large numbers of people or businesses suddenly in peril. We tend to guard for some level of uncertainty, but no one expects everything to “hit the fan”—so to speak.

Today there are plenty of unknowns in the wind, so I decided to speak with some industry representatives about catastrophic risk management.

Future Risk Modeling

Over the years I was fortunate to know Ed Kempkey, a now retired, 48-year veteran insurance broker in the Napa/Sonoma wine industry. Years back, *Wine Business Monthly* had him chair roundtable discussions with other agents and lawyers to discuss risk. Back then, we navigated “current” issues, like vineyard heat stress, evolving OSHA regulation and ADA litigation, though the latter has now evolved to include websites and other digital assets.

However, a lot of today’s risk modeling has become as dated as traditional hazard avoidance. Seemingly, risk modeling has become a daily, standalone activity, often separated from the daily winery operation and with little ongoing training. According to Kempkey, it should be dynamic and used as a strategic advantage.

In brief, the proactive winery and grower must now learn to project further into the future. They must explore, in the words of Kempkey, “opportunities in the face of adversity,” and not simply focus on solving problems as they arise or being reactive after the event. Hoping to get a check from your insurance company is not forward-thinking. Nor is it innovative or progressive to simply return to your current business plan and what has been considered normal.

Instead, Kempkey wants us to focus on the effects of uncertainty and what can go right even after chaos. He wants you to think about how to become “objective-centric” so that you focus on the “consequences of an event,” rather than the probability. Being objective-centric directs a winery to target potential value, which can come about after an unexpected event.

With many wineries having quickly adjusted to tasting room closures, strengthened their wine clubs, adjusted grape contracts, and dealt with smoke taint testing, these efforts show that many are already reshaping our industry’s future in ways no one ever dreamed—all in about one year.



Wildfires and Catastrophic Risk in the Wine Industry

For now, many catastrophic wildfire claims are still in gray zones, ultimately to be determined in court. Finger pointing, from poor forest management to who provided the spark, will be ongoing. That said, a lot of insurance activity appears to still focus on more conventional risk modeling, with fire mitigation as a central theme.

Larry Chasin, CEO of PAK Programs Insurance, and his team travel the country to assess the physical characteristics of production facilities and identify potential loss due to catastrophic events, such as the wildfires in California. He told me that “boots on the ground,” with personalized coverage is still an overarching theme for his specialty company, but they continue to innovate in the market.

A large part of their program is iRAD™, or Insurance Risk Assessment Drone. I spoke with creative director Justin Guerra, who talked about developing an aerial mosaic with GIS (Geographic Information Systems) for each winery. He also described their Fire Triangle, a formula whereby they identify three components critical to fire protection: fuel, topography and weather.

As you might expect, being proactive with defensible space by eliminating surrounding trees and undergrowth is paramount. Studying the surrounding landscape, including canyons and slopes, may offer predictable avenues for fire to spread and should be the focus of prevention efforts. The location of buildings, pump houses and related structures is also important to include for any underwriting.

A major problem, however, is weather, which caught everyone off guard in Napa and Sonoma counties in 2020. While every state is as different as the landforms and winery locations therein, California has the Santa Ana and Diablo winds to consider.

Current science suggests that climate change is increasing the winds’ intensity and frequency, which will impact the wine industry everywhere. When all conditions are ripe—reoccurring droughts contribute to dry grass and plenty of fuel, which coincide with a blast of hot Santa Ana winds and a “spark”—your hillside vineyard might suddenly be in the wrong place at the wrong time. Moreover, scientists who utilize tree core samples and carbon dating have well established that wildfires are simply part of California’s history, dating back long before vineyards on hillsides.

I'm reminded of past *WBM* articles about frost protection and other problematic vineyard site locations. Growers should survey their properties and avoid planting vineyards on downslopes and at the base of hills. These and canyon outflows produce katabatic winds, resulting in disastrous frost conditions.

The consequences will instantly change the dynamics of your well-intentioned business model. And though adding sprinkler systems and felling trees is a good proactive action, much of the loss (especially with a pandemic stymying business worldwide) will still be beyond your control and, more importantly, outside of the language of your insurance contract. This is when we enter the legal arena.



INSURERS TRYING TO INNOVATE ESTIMATES

I honestly do not know how you wrap a future liability, with monetary compensation, around a complete unknown. Unfortunately for many, lost business due to a pandemic, constantly changing markets and consumer attitudes, or even Mother Nature are just estimates and trying to calculate the potential losses with so many of these types of unknowns is a challenge.

It was also interesting to hear that some insurance folks think a pandemic is uninsurable. None of these episodes sits well with an industry based on metrics.

While an analogy of the insurance industry to gaming casinos is not necessarily complimentary, it is reasonably accurate. The house does not plan on losing, and the odds are always in their favor. Insurance profits are contingent upon your annual premiums, which are then invested somewhere, and hopefully profits are not impacted by paying out on the insureds' claims.

In the world of insurance, there is also the growing, and controversial, InsurTech Business, said to be the industry's future and the possible end of the underwriter. Utilizing AI, it is best described as a revolutionary, digital transformation, automating the use of financial services to improve efficiency within the insurance industry. In theory, it will save consumers money and speed up the process.

Unfortunately, many feel integrated data management, while providing simple and efficient solutions, will replace the traditional face-to-face local agent interaction, further reducing the customer to an extended algorithm. Even more important, the insurance industry is traditional, with lots of complicated rules, regulations and legislative oversight, which all vary by state. The idea of sudden change is questionable.

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Lawyers and Uncertainty

One reason COVID-19 and the wildfires of last year were so hard on the industry is the far-reaching scope of the wine business itself. From growers with vineyards and grape contracts, to imperiled production facilities, shuttered tasting rooms and lost sales in restaurants, everything was affected.

I spoke with Cody Gregg and Todd Friedman with the national law firm of Stoel Rives LLP. Both are based out of Portland, Ore. and deal extensively with western wine industry issues, such as land use regulations, water availability, weather and systematic risks, like vineyard pests, molds and smoke taint.

Concepts and events, like climate change, wildfires and smoke taint, will require insurers to craft new language for risk modeling—but this time possibly without metrics, something insurance companies are wary of.

As an example, both Gregg and Friedman suggested we may never have a definitive “go-no-go” definition for smoke taint. Caught off guard, laboratories throughout California were overwhelmed with samples. “Tests were taking up to a month for results,” said longtime winery owner/grower Bill Kreck of Mill Creek Winery. “By then, it was too late to harvest much of the hanging fruit anyway.”

Unfortunately, according to Kreck, the resulting numbers from the tests were often meaningless. I foresee plenty of dissertations from UC Davis over the next few years that attempt to equate numerical results with personal palate. Friedman is also concerned about how, or even if, the definition of

MOG (material other than grape) and smoke will play out in the courts. How will a court make a determination on a series of unknowns?

To compound matters, we are discussing taste. A saying goes, “If you sit five winemakers in a room and ask them the color of the sky, you will get six answers.” How are we going to equate levels of taint with something as subjective as taste among winemakers?

Friedman and Gregg emphasized that much of the business between grower and winery is based on relationships. In general, lawyers attempt to avoid arguments and, as in the insurance business, are going to encourage personal interaction over confrontation. Rewriting future contracts in the face of unforeseen possibilities, after monumental uncertainty, will require a lot of legal rewrites.

This immediately brings to mind common law, which has been around for over a millennium. One basic concept is that laws that are not statutory (written or codified) are malleable, not necessarily bound by past precedent and can adjust to new trends. We see this in socially-driven rulings each year.

I have always heard that common law is also based on the idea of partnership, allowing individuals to cooperate by sharing common knowledge and traditions such that all parties can benefit.

Friedman observed that pointing fingers accomplishes nothing. And with the industry’s market dynamics, evolving consumer tastes, global climatic conditions and Mother Nature, the only constant, moving forward, will be change. For me, that translates into new definitions for risk management and exploring opportunities.

The Future

With today's catastrophic developments and risk assessment, the wine industry must learn to focus on the effects of uncertainty and what can go right. While many wineries have incurred considerable loss, there is also talk of unforeseen benefits.

Grape and bulk wine brokers are suggesting the effects of smoke taint have helped balance the marketplace. Ciatti Company recently addressed the rebound in bulk wine prices and relief from excessive grape tonnage from prior record harvests. According to many wineries, Mill Creek Winery among them, the effect of restaurant closures resulted in increased wine club activity. While warehouse inventory levels were not drastically impacted, the revenues were up.

Friedman and Gregg suggested the new market dynamics might also encourage changes within intrastate shipping. Nothing is guaranteed, but the thought is there.

Wineries will also certainly be adjusting their marketing business models, specifically with tasting room activity. I hear talk of more wineries that are moving toward leasing event space. Generational attitudes and consumer buying habits constantly change, and emphasis has moved increasingly toward the internet. People are learning the importance of developing impressive websites.

In the words of Kempkey, the proactive wineries will now "project further ahead and explore the opportunities in the face of adversity." **WBM**



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