

LCBO New Product Procurement

Follow-up to VFM Section 3.08, *2011 Annual Report*

Background

The mandate of the Liquor Control Board of Ontario (LCBO)—a Crown agency with the power to buy, import, distribute, and sell beverage alcohol products in Ontario—is to be a socially responsible, performance-driven, innovative and profitable retailer. For the 2012/13 fiscal year, the LCBO's sales and other income were approximately \$4.9 billion (\$4.6 billion in 2010/11), and its profit was \$1.7 billion (\$1.56 billion in 2010/11). The LCBO remitted virtually all of that profit to the province. LCBO sales have increased 57% from 10 years ago, and its profit and the dividends it pays to the province have gone up 74% in that time.

The LCBO offers consumers more than 23,200 products—approximately 4,100 items on its general list, 6,700 Vintages products and 12,400 products available by private order—available at more than 630 stores. About 13% of general-list products and 42% of Vintages products were newly acquired for the 2012/13 fiscal year. The LCBO uses three methods to select and buy new products. The principal one, both for general-list products and for the Vintages fine wine and premium spirits line, is to issue a call to suppliers, known as a “needs letter,” for a specific category of product. It can also buy prod-

ucts on an “ad hoc” basis or, in the case of Vintages, directly from suppliers.

Within the framework of the pricing policy established in consultation with the Ministry of Finance, the LCBO has the power to set the retail prices for the products it sells, guided by its mandate to promote social responsibility in the sale and consumption of alcohol while generating revenue for the province. Ontario's *Liquor Control Act* sets out minimum retail prices for alcohol to encourage social responsibility. This means that the LCBO, like other Canadian jurisdictions, does not sell its products at the lowest possible prices, so retail prices for alcohol products are generally higher than those in the United States.

Although some of the products that the LCBO sells are offered at lower prices in other Canadian jurisdictions, a January 2013 survey found that the LCBO had the lowest overall alcohol prices of all those jurisdictions (an April 2011 survey also found that the LCBO had the lowest overall alcohol prices), with the second-lowest prices for spirits and beer, and the lowest wine prices (the April 2011 survey found that the LCBO had the third-lowest prices for spirits and beer, and the lowest wine prices).

Our 2011 audit focused on whether the LCBO had adequate systems, policies and procedures in place for the purchase of new products, and

whether such purchases were acquired and managed effectively and in compliance with applicable legislation, government directives and LCBO procurement policies.

In our *2011 Annual Report*, we noted that the LCBO had many well-established purchasing practices consistent with those in other Canadian jurisdictions and other government monopolies. Nevertheless, our 2011 audit suggested certain changes that could be made to improve some of the LCBO's processes related to purchasing and the subsequent monitoring of product performance, to better demonstrate that these are carried out in a fair and transparent manner. Our findings included the following:

- In the private sector, large retailers use their buying power to negotiate lower costs with suppliers. However, the LCBO, despite being one of the largest purchasers of alcohol in the world, does not focus on getting the lowest cost it can for a product. Rather, the cost it pays is driven by the retail price it wants to charge for a product. The LCBO gives suppliers a price range within which it wants to sell a product. Suppliers' product submissions include, among other things, the retail price at which they want their product to sell in LCBO stores, and they then work backwards, applying the LCBO's fixed-pricing structure to determine their wholesale cost. We noted that in some instances suppliers submitted wholesale quotes that were significantly lower or higher than what the LCBO expected, in which cases the suppliers were asked to revise the amount of their quotes in order to match the agreed-upon retail price, which effectively either raises or lowers the price the LCBO pays the supplier for the product.
- The LCBO does not negotiate volume discounts. This is also true of other Canadian jurisdictions we looked at. The LCBO's fixed-pricing structure gives it no incentive to negotiate lower wholesale costs; doing so would result in lower retail prices, and, in turn,

lower profits, something that runs against the LCBO's mandate of generating profits for the province and encouraging responsible consumption.

- The LCBO does have many well-established purchasing practices. However, it could improve some of its processes relating to purchasing and monitoring of product performance to better demonstrate that these processes are carried out in a fair and transparent manner.

We made a number of recommendations for improvement and received commitments from the LCBO that it would take action to address our concerns in all but one area. This area is noted later in the section on recommendation 4 regarding the lack of documentation around the reasons for selection or elimination of products at the prequalification stage.

Status of Actions Taken on Recommendations

According to information the LCBO provided to us in spring 2013, it has fully implemented most of the recommendations we made in our *2011 Annual Report*. For example, the LCBO has updated its internal policies and procedures for each procurement method, including the evaluation criteria and processes to be used in assessing new-product submissions. However, a couple of the components of our recommendations that involve working with other organizations, such as the Ministry of Finance, will require more time to be fully addressed. The two particular areas that have yet to be substantially addressed are our recommendation to consider using, on a trial basis, a variable markup when purchasing new products, and our recommendation to determine the most appropriate organization to monitor compliance with the *Liquor Control Act's* minimum retail price

requirements. Progress on these is not expected until late 2013. The LCBO noted that in the meantime it continues to operate within the pricing and procurement parameters that have been set by the Ministry of Finance.

The status of actions taken on each of our recommendations at the time of our follow-up was as follows:

RETAIL PRICES OF BEVERAGE ALCOHOL PRODUCTS

Legislated Minimum Retail Prices

Recommendation 1

To better inform Ontarians about how beverage alcohol prices are set, the LCBO should provide more information to the public on its pricing policy, including how its mandate and provincial policy objectives affect pricing, and details about its pricing structure. As well, the LCBO, in conjunction with the Ministry of Finance, should establish a process for ensuring that all stores are complying with the Liquor Control Act's minimum retail price requirements and consider whether the LCBO is the most appropriate organization to monitor this compliance.

Status

The LCBO has expanded its website to include more information on its pricing policy, including how its mandate and provincial policy objectives affect pricing, and details about its pricing structure.

The *Liquor Control Act's* minimum price requirements apply to both LCBO retail stores and non-LCBO stores including The Beer Store and winery, brewery and distillery retailers. A working group made up of staff from the LCBO, the Ministry of Finance, the Ministry of the Attorney General, and the Alcohol and Gaming Commission of Ontario has been tasked with assessing where responsibility for regulating the *Liquor Control Act's* minimum price requirements should reside. The LCBO expected the working group to have completed its interim report by late 2013.

The Cost of Beverage Alcohol Products

Recommendation 2

In keeping with its mandate to generate sufficient profits and adhere to the government's policy direction of maintaining a retail pricing mechanism that encourages responsible consumption, the LCBO should consider, in consultation with the Ministry of Finance, the following strategy on a trial or pilot basis to take advantage of its being one of the largest purchasers of beverage alcohol products in the world:

- *once product categories and their related retail price ranges have been determined, allow suppliers to offer a product at whatever cost they are willing to accept to have it sold at the LCBO, and then use a variable markup to arrive at the desired fixed retail price; and*
- *calculate the gross profit margin for a particular product based on the supplier's cost quote, and take this into consideration in making decisions on which new products to purchase along with the other evaluation criteria currently used, such as the quality of the product.*

Status

The LCBO informed us that it has provided the Ministry of Finance with options on how to proceed with piloting a purchasing strategy as suggested in our recommendation. The Ministry requested that the LCBO first consult with stakeholders before deciding whether to proceed. The LCBO expected to report back to the Ministry with stakeholder feedback by late 2013. A pilot program could begin in the 2013/14 fiscal year.

The LCBO also informed us that it was no longer asking suppliers to raise quotes that, perhaps because of an error in calculation or changes in freight or exchange rates, were too low to produce the agreed-upon retail price. It would, however, continue to ask suppliers to lower any quote that was higher than expected.

IDENTIFYING PRODUCT NEEDS

Recommendation 3

To help ensure that purchases reflect corporate sales objectives and meet customer demand, the LCBO should develop detailed annual category plans for the major beverage alcohol categories.

Status

The LCBO has developed detailed annual category plans for the major beverage alcohol categories for fiscal years 2013 and 2014. The LCBO indicated that it would continue to develop annual category plans as part of the LCBO's annual business planning process in the future.

METHODS OF PURCHASING NEW BEVERAGE ALCOHOL PRODUCTS

Recommendation 4

To ensure that it can demonstrate to suppliers and other stakeholders that purchases are acquired through an open, fair and transparent process, the LCBO should:

- *develop written policies and procedures for each procurement method, including the evaluation criteria and process to be used in assessing submissions at the various stages of the procurement process;*
- *disclose its evaluation criteria to suppliers, including a clear articulation of all mandatory requirements, an indication of the relative weighting for rated requirements where applicable, and a description of the shortlisting process; and*
- *ensure that reasons for selection and required management approvals are appropriately documented.*

Status

The LCBO has developed written policies and procedures for each procurement method, including the evaluation criteria and process it uses in assessing submissions from suppliers. This information has been published both on the LCBO's main website and on its trade resources website that suppliers use.

As noted in the LCBO's response to our audit recommendations, the LCBO had concerns with documenting the reasons for selection or elimination of products at the prequalification stage. The LCBO said it believed this process would entail either limiting the number of submissions it would accept, or hiring additional staff because of the high volume of submissions it receives. As a result, the LCBO does not believe it is practical to document these decisions at the prequalification stage of the procurement process. According to the LCBO, as of spring 2011, management has commenced overseeing and approving prequalification selections.

The LCBO also advised us that it has also been documenting the reasons for the selection or elimination of products for the submission stage onward, as well as the required management approvals, since spring 2011.

ONGOING MONITORING OF PRODUCT PERFORMANCE

Recommendation 5

To help ensure that products not meeting acceptable sales targets are identified in a timely manner, the LCBO should:

- *regularly review and assess sales targets for each product category to ensure that they continue to be reasonable and appropriate for identifying underperforming products;*
- *establish clear guidelines for the nature and timing of action to be taken when a product is identified as underperforming; and*
- *establish policies for documenting decisions on delisting and requesting supplier rebates.*

Status

The LCBO indicated that it has been setting sales targets annually and reviewing them for appropriateness throughout the year. It has also developed guidelines for actions to be taken when a product is identified as underperforming, and policies for documenting decisions on delisting and requesting supplier rebates.