Chapter 3
Section
3.08

Liquor Control Board of Ontario

LCBO New Product Procurement

Background

The Liquor Control Board of Ontario (LCBO) is a Crown agency incorporated under the *Liquor Control Act* (Act) with the power to buy, import, distribute, and sell beverage alcohol products in Ontario. It reports to the Minister of Finance.

The LCBO's mission is to be a socially responsible, performance-driven, innovative, and profitable retailer. Overall, it offers consumers more than 21,000 products—approximately 3,400 items on its general list, 6,200 Vintages products, and 12,000 products available by private order. Vintages, the LCBO's fine wine and premium spirits line of business, contributes about 8% of total sales. About 10% of general-list products and about 50% of Vintages products were newly acquired for the 2009/10 fiscal year. The LCBO operates five warehouses that supply more than 600 stores across the province.

The LCBO uses three methods to select and buy new products. The principal one, for both the general list and Vintages, is to issue a call to suppliers, known as a "needs letter," for a specific category of product. It can also purchase products on an "ad hoc" basis or, in the case of Vintages products, buy directly from suppliers.

For the 2010/11 fiscal year, the LCBO's sales and other income were approximately $4.6 billion, and net income was $1.56 billion, with the LCBO remitting virtually all of that profit to the province. LCBO sales have increased by 67% compared to 10 years ago, and its net income and the dividends it pays to the province have gone up by about 80% over the same period. The breakdown of sales by product category for the 2010/11 fiscal year in dollars and by percentage of contribution to gross margin is illustrated in Figure 1.

Figure 1: Total Beverage Alcohol Sales and Contribution to Gross Margin by Category, 2010/11
Source of data: Liquor Control Board of Ontario

Product	Sales ($ billion)	Sales (%)	Gross Margin Contribution (%)
spirits	1.84	40	47
wines	1.57	35	35
beer	0.91	20	15
other	0.22	5	3
Total	**4.54**	**100**	**100**

Audit Objective and Scope

The objective of our audit was to assess whether the LCBO had adequate systems, policies, and procedures in place with respect to new product purchases, and whether such purchases were acquired and managed effectively and in compliance with applicable legislation, government directives, and LCBO procurement policies.

Before we began our audit fieldwork, we identified the audit criteria we would use to address our audit objective, then designed and conducted tests and procedures to address them. Our audit objective and criteria were reviewed and agreed to by LCBO senior management.

In conducting our audit, we reviewed relevant legislation and administrative policies and procedures, and we interviewed appropriate LCBO head-office staff and, where applicable, Ministry of Finance staff. We also reviewed and assessed pertinent summary information and statistics, as well as a sample of general-list and Vintages purchasing files. We held discussions with several key beverage alcohol stakeholder groups, including Spirits Canada, Drinks Ontario, the Wine Council of Ontario, and the Winery and Grower Alliance of Ontario. These groups represent both large and small beverage alcohol suppliers and agents. In addition, we met with a representative from the Canadian Association of Liquor Jurisdictions, whose members include the liquor jurisdictions of the 13 provinces and territories in Canada. We also contacted the liquor organizations in British Columbia, Alberta, and Quebec to get an understanding of their operations for comparison purposes, and the National Alcohol Beverage Control Association in the United States, which represents 18 states that directly control the distribution and sale of certain types of beverage alcohol in their jurisdictions.

Our audit included a review of related activities of the LCBO's Internal Audit Services. We reviewed its recent reports and considered its audit work and any relevant issues it had identified when planning our work.

Summary

Under Ontario's *Liquor Control Act* (Act), the Liquor Control Board of Ontario (LCBO) has the power to set the retail prices for the beverage alcohol products it sells. The mandate it follows in doing so is to promote social responsibility in the sale and consumption of alcohol while generating revenue for the province. In this regard, the Act sets out minimum retail prices for alcohol—certain other jurisdictions, such as Quebec and New York State, have no such minimums. This means that the LCBO does not sell its products at the lowest prices possible but rather at levels aimed at encouraging responsible consumption and generating profit for the government.

Most Canadian jurisdictions operate in a similar context. Canadian beverage alcohol products generally have higher markups and taxes as compared to alcohol sold in the United States, which means that many products are sold at lower prices in the U.S. Although some of the products that the LCBO sells are offered at lower prices in other Canadian jurisdictions, an April 2011 survey found that the LCBO had the lowest overall beverage alcohol retail prices of all Canadian liquor jurisdictions, with the third-lowest prices for spirits and beer, and the lowest wine prices. In a 2010 LCBO customer survey, about two-thirds of the respondents agreed that the LCBO's prices represented good value.

The LCBO's purchasing process differs from those used by private-sector retailers. In the private sector, retailers attempt to buy their products at the lowest possible cost. Although one might expect the LCBO—one of the largest purchasers of alcohol in the world—to follow a similar approach, the LCBO's purchasing process does not focus on cost. Instead, it focuses on the retail price it wants to charge for a product. Suppliers submit a retail price within an established retail price range set out in the LCBO's call for products and then work backwards, applying the LCBO's fixed-pricing structure to determine the wholesale cost they will charge the LCBO. If a supplier's cost quote results in an amount that does not match the agreed-upon retail price, the LCBO will ask it to raise or lower the wholesale cost of the product. We found examples both where the supplier's initial cost quote had been raised and where it had been lowered, usually by fairly small amounts. But we also found examples where suppliers submitted wholesale quotes that were significantly lower or higher than what the LCBO expected, so the LCBO requested that the supplier revise the quote, which effectively either raised or lowered the price it paid the supplier for the product. The LCBO informed us that such discrepancies between the submitted quote and the expected amount may have been due to changes in transportation costs, currency exchange rates, or a supplier's error in calculating its quote.

Most large retailers use their buying power to negotiate with suppliers to drive down costs. We found that the LCBO does not negotiate discounts for high-volume purchases to reduce its costs. This is also true of the 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, which the LCBO indicated would be contrary to its mandate of generating profits for the province and encouraging responsible consumption. The LCBO has been successful in consistently generating increased profits for the province year after year.

The LCBO has many well-established purchasing practices that are consistent with those in other Canadian jurisdictions and in other government monopolies, such as in Sweden and Norway. However, the LCBO could improve some of its processes relating to purchasing and subsequent monitoring of product performance to better demonstrate that these are carried out in a fair and transparent manner. For example:

- In a sample that we examined, the LCBO rejected more than 80% of shortlisted products under the needs-letter process but documented the reasons for very few of its decisions.
- The LCBO did not have written policies and procedures to help its staff determine under what circumstances it is appropriate to purchase products on an ad hoc or direct basis, and what evaluation criteria should be used, although 60% of all new products in the 2010/11 fiscal year were purchased using these two procurement methods.
- There was no documented rationale for the 60% of the products in our sample purchased using the ad hoc process. However, LCBO staff generally were able to recall the rationales behind their purchasing decisions when we discussed these with them.
- With respect to direct purchases of Vintages products, more than 45% of the direct purchases in our sample had not been previously purchased by the LCBO, and therefore never underwent the required taste, sight, and smell assessment. In addition, there was no documentation of the reasons for purchasing them. For those that were purchased directly because the LCBO had purchased them in the past, our review of historical sales noted that the amount of sales for most was less than the required sales threshold, and that many of these same products continued to sell poorly.
- The LCBO has a well-defined category management process and sets sales targets by product category to assess product performance and deal with products that are performing badly. It can delist products that fail to meet sales goals and request rebates. However, we found that some products that failed to meet sales goals for four or five years had not been delisted, and we also noted that the LCBO requested and received rebates for only 35% of delisted products.

OVERALL LCBO RESPONSE

The LCBO appreciates the Auditor General's observations that the LCBO's purchasing practices are well established and similar to the practices of other liquor boards in Canada and abroad. The Auditor General's recommendations for enhancing these practices will help the LCBO further improve current practices; many of the recommendations are already being implemented.

LCBO buyers make every effort to get the best products in every price band, whether for wines under $8 or those greater than $100. They review more than 50,000 submissions annually and work with suppliers to make the best of these available at good prices. The LCBO is an attractive customer for manufacturers, and there is fierce competition for listings. As a result, suppliers frequently submit products to the LCBO at prices lower than those at which they sell for in other Canadian jurisdictions. It is a mandatory condition of sales to the LCBO that suppliers do not sell the same product at a lower price to other Canadian liquor retailers. Regular price surveys show that the LCBO has the lowest overall alcohol prices in Canada.

The audit examined new product procurement, but suppliers of products already listed can unilaterally lower their retail price by selling to the LCBO at a reduced cost. Again, strong competition between listed products causes this to happen.

The LCBO must achieve a balance among the elements of its mandate: generating revenue, promoting social responsibility, and providing customers with selection and value at all price points. Although the audit report states that "the LCBO does not sell its products at the lowest prices possible," in fact many products in the LCBO do sell for the lowest price legally allowable. Under its mandate and the fixed-markup structure, the LCBO cannot currently negotiate for volume discounts. The National Alcohol Beverage Control Association confirms that although there is variation at the state level, wholesale discounts are not permitted in most U.S. states. Similarly, as the audit report notes, other Canadian liquor boards also do not negotiate volume discounts. In light of this, and in addition to obtaining the best products at very competitive prices, the LCBO also obtains more than $100 million annually from suppliers to support promotions and in-store merchandising.

Detailed Audit Observations

RETAIL PRICES OF BEVERAGE ALCOHOL PRODUCTS

Under the *Liquor Control Act* (Act), the LCBO has the power to set the retail prices for beverage alcohol in Ontario. It sets the prices for spirits, imported wines, and most Ontario wines, as well as for the beers that it sells exclusively. Beer manufacturers set the retail prices for other beers, in accordance with the Act.

In setting retail prices, the LCBO considers key aspects of its overall mandate and objectives to generate sufficient profits for the provincial government, promote social responsibility in the sale and consumption of beverage alcohol, support the province's wine industry, and offer customers good product selection and value at all price points.

A number of federal and provincial taxes, fees, and levies must be incorporated into LCBO prices, as illustrated in Figure 2. However, the two components that account for most of the retail price of alcohol are the wholesale price (described more fully in the later section titled "The Cost of Beverage Alcohol Products") and the LCBO's markup.

The markup structure was established by the LCBO and approved by its Board of Directors in consultation with the Ministry of Finance (Ministry). The LCBO advised us that successive governments

Figure 2: Components of Retail Prices for Alcohol Products
Source of data: Liquor Control Board of Ontario

Component	Explanation
supplier quote	price at which the supplier sells its product to the LCBO
+ federal excise tax	a variable tax based on volume and alcohol content
+ federal import duty	applied only to imported goods; similar in structure to excise tax
+ freight	rate based on existing LCBO freight contracts
= landed cost	
+ cost of service charge	applied to beer* products at a fixed rate per litre
+ LCBO markup	variable rate applied according to the type of product (see Figure 3)
+ wine levy	applied to most wine products at a fixed rate per litre
+ bottle levy	applied to all products at a fixed rate per litre
+ environmental charge	applied to all non-refillable products at a fixed rate per container
= base price	
+ harmonized sales tax (HST)	fixed rate of 13% applied to the basic price
+ container deposit	amount varies depending on volume of container (up to $0.20)
= final retail price	prices are rounded up to the next $0.05

* The LCBO sets the price of beer products that are exclusively sold by it. In accordance with the *Liquor Control Act*, retail prices for beer products that are also sold by The Beer Store are set by the manufacturer.

have endorsed the fixed-markup structure, and thus a fixed-pricing structure, as an appropriate means for a government agency such as the LCBO to show transparency in its purchasing and pricing practices. Markup rates vary by product category. However, within each category, the markup is the same for all products (examples are shown in Figure 3). Although the markup applies to all products, the LCBO can, at its discretion and with Board approval, change the markup on Vintages products. In addition, international trade agreements require government agencies such as the LCBO to treat domestic and imported products in the same way by applying the same markups to similar domestic and imported products. However, the LCBO can apply additional charges on imported products to cover any extra costs associated with such purchases.

The pricing structure and the related impact of LCBO's mandate and its objectives are well understood by suppliers and agents. Although some of this information is disclosed on the LCBO website under the "Contact Us" section, it would not be easy for the public to find this information or use it to fully understand how beverage alcohol prices are set.

Retail Price Comparisons

The LCBO conducts retail price comparisons across Canada on a quarterly basis on behalf of the Canadian Association of Liquor Jurisdictions (Association), whose members include all 13 liquor jurisdictions in Canada. Prices are compared for some 50 products from different categories (except Vintages) that generate high sales revenue across Canada and that are sold in all 13 jurisdictions. The most recent survey results at the time of our audit showed that the LCBO had the third-lowest retail prices for spirits and beer, and the lowest for wine. The LCBO also had the lowest overall beverage alcohol retail prices.

We selected a sample of popular LCBO products to compare their retail prices to those in British Columbia, Alberta, and Quebec, as well as New York, Michigan, and Pennsylvania. Prices varied across, and sometimes within, these jurisdictions, but we noted that:

Figure 3: Examples of Markup Rates for Spirits, Wines, and Beer
Source of data: Liquor Control Board of Ontario

		Markup Applied	
Class of Products	**Product Origin**	**%**	**($/litre)**
vodka, whisky, rum	domestic	141.0	–
	imported (U.S.)	148.1	–
	imported (other)	148.0	–
table wine	Ontario	65.5	–
	other domestic and imported	71.5	–
beer	domestic and imported	–	.7094
	microbrewers	–	.2095

- Two other Canadian provinces sold almost all of the products at higher prices. The third province sold many of its products at prices lower than the LCBO, but all of its prices were within 7% of the LCBO's prices. This result was generally consistent with the Association's survey findings discussed at the beginning of this section.
- The three states sold most of the products at prices 3% to 55% lower than the LCBO.

The LCBO does not sell products at the lowest price possible because doing so would be contrary to its social responsibility mandate and would reduce its profits. For example, Ontario has minimum retail prices set out by the Act, while Quebec, Alberta, New York, and Pennsylvania have no such minimum prices. According to the LCBO, Canadian jurisdictions have consistently higher markups and taxes than those in the U.S. to encourage socially responsible consumption while generating revenue for government. The LCBO also pointed out that its 2010 customer survey found that about two-thirds of respondents agreed that it charged prices that represented good value.

Legislated Minimum Retail Prices

The government has established minimum retail prices for alcohol products to moderate consumption. Public health research shows that higher alcohol prices lead to a reduction in drinking and the consequences of alcohol use and abuse. Ontario is one of six Canadian jurisdictions that have minimum retail prices.

With senior management approval, retail prices for discontinued products and products that will soon become unsellable because of age are allowed to fall below these minimum thresholds. However, such exceptions are not allowed for beer.

Minimum pricing applies to products sold in all Ontario stores, including LCBO retail stores and non-LCBO stores (such as agency stores in communities with populations too small to support a regular LCBO store, The Beer Store, and manufacturers' stores such as winery and distillery retailers). Minimum retail prices for beer and spirits are established by legislation. For wine, the legislation establishes minimum prices that the LCBO must pay its suppliers. According to the LCBO, the decision to set a minimum cost for wines was made in the 1980s to prevent the dumping of foreign wines into Ontario at subsidized prices. For the purpose of this report, we have converted the minimum acquisition cost for wine into a minimum retail price by applying the LCBO's fixed-pricing structure, as illustrated in Figure 4. Both the minimum retail price and the minimum acquisition cost are adjusted for inflation on March 1 of each year in accordance with the Act.

We were informed by staff at the Ministry that the LCBO is responsible for ensuring that all stores

Figure 4: Examples of Minimum Retail Prices as of March 1, 2011 ($)
Source of data: *Liquor Control Act*, Liquor Control Board of Ontario

Product Type	Minimum Retail Price (excluding bottle deposit)
spirits – 750 mL	23.20
table wine, Ontario – 750 mL	5.65
table wine, imported – 750 mL	5.80
beer*	26.40

* case of 24 341-mL bottles with alcohol content equal to or greater than 4.9% and less than 5.6%

selling alcohol in Ontario, including non-LCBO stores, comply with the minimum pricing requirements. However, LCBO staff said they were unclear about their role in enforcing minimum prices, especially considering that some non-LCBO stores could be viewed as competition. The LCBO also noted that the Act does not specify the mechanisms by which these requirements are to be enforced. This increases the potential for products to be sold below their minimum retail price in contravention of the LCBO's social responsibility mandate.

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.

LCBO RESPONSE

The LCBO agrees that Ontarians should have easy access to information about its mandate and operations, including pricing policy. That is why this information is currently available on the agency's website (**www.lcbo.com**). It is also routinely shared with the beverage alcohol trade and the media. The LCBO will examine ways to make it easier to locate this information and present it in the clearest way possible.

The LCBO will work with the Ministry of Finance to review how compliance with minimum prices is assured in all beverage alcohol retail locations across the province and which agency or part of government should fulfill this regulatory function.

The Cost of Beverage Alcohol Products

In the private sector, retailers attempt to buy their products at the lowest possible cost. One might also expect the LCBO, as one of the world's largest purchasers of beverage alcohol, to use its buying power to negotiate the lowest possible costs from its suppliers, but the LCBO's purchasing process does not focus on cost. Instead, the LCBO focuses on setting a specific retail price range, and suppliers must offer their products to the LCBO within this range. The wholesale price, or cost of the product to the LCBO, is determined by applying the LCBO's fixed-pricing structure and working backwards from the supplier's retail price to arrive at the cost the supplier will be paid for its product.

The LCBO's purchasing process is consistent with those in other Canadian jurisdictions we contacted and also resembles the ones used by other government monopolies, such as Sweden and Norway. The LCBO also informed us that, in keeping with its mandate to encourage responsible drinking, its retail pricing is geared toward "premiumization." This strategy aims to generate more revenue without increasing the amount of alcohol that is consumed by encouraging consumers to buy more premium-priced products and by increasing the number and variety of products offered at higher prices.

Once the LCBO determines the category of products it wishes to purchase, it issues a "needs letter," which is posted on its website and sent to various trade organizations. A needs letter outlines the required product category, the product specifications, and, in almost all cases, the retail price ranges. The retail price ranges that the LCBO asks for vary depending on the type of product requested and are based on what the LCBO establishes as prices that the market will bear. Most needs letters establish a price range, but some establish a firm price that suppliers must meet or exceed. For instance, the annual needs letter for general-list wines issued for the 2010/11 fiscal year requested 48 product categories. Of these, 41 required the retail price to exceed

$9.95, while another six had to exceed $8.95 (one did not stipulate a price range). The LCBO advised us that most of the requested wines were required to retail for more than $9.95 because it already had an adequate selection of wines under $10.

The retail price at which a supplier wants its product to sell in Ontario must be within the price range established in the LCBO's needs letter. As noted earlier, the wholesale cost to the LCBO is determined by applying the fixed-pricing structure and working backwards from the agreed-upon retail price. In essence, the LCBO sets the cost it will pay for a product by first establishing its retail price. We also found that the LCBO does not negotiate discounts for high-volume purchases to reduce its costs, but neither do the other Canadian jurisdictions we looked at. With its fixed-pricing structure, the LCBO has no incentive to reduce the supplier's wholesale cost, because doing so would result in lower retail prices and, in turn, lower profits—which would be contrary to the LCBO's mandate.

After the LCBO has selected a product it wants to purchase, the supplier sends a written confirmation or quote for the product. The LCBO inputs the supplier's quote into its system and applies the fixed-pricing formula. The result should equal the retail price in the supplier's submission. If the calculation results in an amount greater than the agreed-upon retail price, the LCBO will request that the supplier lower its wholesale quote to ensure that the LCBO is not overcharged. However, if the wholesale quote results in a lower retail price than what has been agreed to, the LCBO does not accept the quote, because the application of its fixed-pricing structure would result in a retail price that is too low. In such cases the LCBO asks the supplier to increase the quote, effectively raising the price it will pay for the product.

Although we found in a sample of products that some supplier quotes had been raised while others had been lowered, for the most part by minor amounts, we did note that while some suppliers submitted higher wholesale quotes, others submitted quotes that were significantly lower than what had been expected for some of the products in our sample. As a result, these suppliers were requested to revise their wholesale price. The LCBO informed us that differences in quotes may have been due to changes in transportation costs, currency exchange rates, or a supplier's error in calculating its quote in order to match the required retail price. However, the reasons for adjusting the quotes were not documented.

The process just described did not always apply to products acquired for Vintages. We found that suppliers of these products were generally not asked to adjust their quotes. Instead, the LCBO adjusted its markup to arrive at the agreed-upon retail price.

We also noted that, as a condition to its purchase agreement, the LCBO requires suppliers to agree that they will not sell their product to the LCBO at a higher wholesale price than the price at which it is sold to any other government liquor purchaser in Canada, in the same quantities. If this happens, the LCBO is entitled to a rebate for the difference. We found that, for general-list products, the LCBO did not regularly monitor and compare its supplier costs to those paid by other jurisdictions for the same products. LCBO management indicated that it was difficult to obtain supplier cost information from other jurisdictions. Reasons for this included concerns that other jurisdictions considered the terms of payment to their suppliers confidential information. The LCBO also noted that other Canadian jurisdictions may purchase products at a lower cost than the LCBO, but that it would be unable to purchase them at this wholesale price if the application of its fixed-pricing structure resulted in a retail price lower than that allowed by the Act.

For Vintages products, the LCBO informed us it occasionally scans the Internet and reviews trade papers to identify retail price differences. In one case, it identified a supplier that charged the LCBO more than another Canadian jurisdiction for three Vintages products from 2006 to 2009. The LCBO requested and received rebates from this supplier totalling approximately $600,000.

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.

LCBO RESPONSE

Previous independent reviews of the LCBO, commissioned by the province, have examined variable or flexible markups. The current fixed-markup structure, and the LCBO's use and management of it, has been endorsed by successive governments as appropriate for a government agency such as the LCBO. The current structure provides certainty and transparency for suppliers and more easily ensures that foreign products are treated as trade agreements require.

The LCBO looks forward to discussing the recommendation of a pilot of variable markups with the Ministry of Finance and will support the government's policy analysis of this proposed change.

As the Auditor General noted, the LCBO's fixed-markup structure results in product needs letters identifying retail price ranges for new products rather than a supplier quote or the payment the LCBO makes for the product to the supplier. LCBO buyers and suppliers or their agents focus on retail price, and once the price has been established, the supplier quote follows from the mechanical application of the fixed-pricing structure.

The LCBO is a single buyer for a major market. As a result, suppliers are keen to have their products listed for sale in LCBO stores. Competition for listings is fierce, and suppliers and their agents strive to submit the best products they have in response to LCBO product calls. By leveraging its size and buying power, the LCBO is able to obtain the best products the world has to offer at prices lower than those in comparable jurisdictions. When a product call asks for wines between $13 and $15, for example, suppliers often choose to offer wines that they would prefer to retail for $16 to $18 because of the attractiveness of large-volume orders from the LCBO. This is a central way that the LCBO meets one of the key objectives of its mandate: offering its customers good product selection and value at all price points.

IDENTIFYING PRODUCT NEEDS

The LCBO conducts a planning process to identify the types of products it will buy for the forthcoming year. The process includes establishing a budget that encompasses sales targets and the targeted amount of the dividend it will pay to the province. The LCBO provides this information to the Ministry and incorporates the Ministry's feedback before finalizing its targets.

An overall business plan sets out the LCBO's financial goals, such as total sales, litres to be sold, and average gross margin, and its non-financial objectives, such as development of a varied product assortment to meet customer needs. These are further divided into high-level business plans for Vintages, beer and spirits, and wines. These include sales and gross-margin targets for each category as well as some detail on where to focus the forthcoming year's purchases. The LCBO uses a well-defined category management system for product purchasing. Annual category reviews identify growing or declining categories and gaps in the product selection where there may not be products available at certain retail price ranges, and this information is included in detailed category plans. These plans are also based on research to identify key trends and customer preferences. Prior sales histories also help staff to determine which products to purchase. Most respondents to the LCBO's 2010 customer survey said it offered a wide product selection, and more than half said there were often new products available to purchase.

Once these business plans are developed, the LCBO posts the needs letters described in the previous section on its website and distributes them to various trade associations. Needs letters are generally issued once during the fiscal year for each general-list product category, and three to four times a year for Vintages products. Needs letters include a number of requests for purchases. For example, the 2011 general-list needs letters included requests for purchases of 68 different types of products.

We selected a sample of the LCBO's needs letters to determine whether the products requested were consistent with those identified in the applicable fiscal year's detailed business plans. We found that purchases of spirits and beer in the 2009/10 fiscal year and Vintages purchases for both 2009/10 and 2010/11 were consistent with the business plans for those years. However, we noted that no detailed category plans had been created for the entire general-list category in 2010/11 or for the wine category in 2009/10. High-level business plans had been developed in 2011 and draft versions were available for 2010, but these provided staff with only limited direction. The LCBO informed us that detailed plans had not been created for these years because of staff turnover and restructuring. According to the LCBO, an evaluation was conducted using information such as the historical sales performance of each product, trend analysis, price-band analysis, and an assessment of the inventory levels and overall performance of the portfolio. However, this evaluation was not documented and, as a result, it was not apparent what direction was provided to staff to guide their purchasing and whether the purchases they made were consistent with the direction they received.

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.

LCBO RESPONSE

The two LCBO business units and Vintages produce business plans every fiscal year. These business plans provide the context to produce detailed category management plans. The LCBO will ensure that these plans are produced for the major categories every year.

METHODS OF PURCHASING NEW BEVERAGE ALCOHOL PRODUCTS

The Management Board of Cabinet's Procurement Directive (Directive) establishes comprehensive policies for the procurement of all goods by ministries and government agencies. Although the procurement of alcohol products is subjective in nature, the principles in the Directive are still fundamental to procurement across the public sector. These principles include open access for qualified vendors; conducting the procurement process in a fair and transparent manner; procuring goods only after considering the business requirements; and the effective management of procurement through the appropriate policies and procedures. The Directive also sets out guiding principles that must be followed in the evaluation process. These include the evaluation of bid responses in a consistent manner and in accordance with the evaluation criteria, rating, and methodology set out in the procurement document. They also require the evaluation process to be fully disclosed, including a clear statement of all mandatory requirements, all weightings for rated requirements, and a description of any shortlisting process. Following the evaluation process, only the highest-ranked submissions that have met all mandatory requirements may be selected.

According to its memorandum of understanding with the Ministry, the LCBO must comply with the Directive. It may develop and use its own internal policies so long as these policies incorporate the principles set out in the Directive. Because the procurement of alcohol is a specialized area, the LCBO chose to develop its own policy. We found that its policy for general-list products, with the exception of a description of the prequalification or shortlisting process, was based on the principles established in the Directive. However, at the time of our audit the LCBO had no documented policies related to Vintages' purchasing, although Vintages was in the process of creating such documentation.

The LCBO purchases new products throughout the year using three different methods: requests for purchase through the needs-letter process, purchases on an ad hoc basis, or purchases direct from suppliers. The number and percentage of purchases by each purchasing method for the 2010/11 fiscal year are shown in Figure 5.

Purchases by Needs Letters

As noted previously, needs letters setting out details including the countries, regions, varietals, and retail price ranges of products that the LCBO wants to purchase are posted on the LCBO's website and sent to various trade organizations. As shown in Figure 5, most general-list purchases are made via needs letters. Suppliers send their product submissions electronically, including such information as supplier name, product name, product price, a one-page marketing plan, relevant product attributes, third-party accolades, and photos of the product and packaging.

Because supplier responses to needs letters can number in the hundreds or even thousands, the LCBO shortlists a more manageable number of qualified responses before proceeding to the next stage. For general-list products, the use of a prequalification or shortlist stage started in the summer of 2010; Vintages had already been using a prequalification stage for a number of years. The LCBO informed us that, because it does not have a specific policy for the prequalification stage, a number of informal factors are considered when assessing submissions, including whether the product received a high score from a third-party reviewer, the types of awards it has won, whether it is a high-demand product with limited availability, and the product's image and packaging.

We reviewed a sample of needs letters issued in the 2009/10 and 2010/11 fiscal years for both general-list and Vintages products. We noted that more than 80% of the submissions in our sample

Figure 5: Types of Purchases by Purchasing Method, 2010/11
Source of data: Liquor Control Board of Ontario

	Needs-letter Purchases		Direct Purchases		Ad Hoc Purchases		
Category	**#**	**%**	**#**	**%**	**#**	**%**	**Total #**
Vintages	1,450	32	2,659	59	422	9	4,531
spirits and ready-to-drink	319	85	–	–	58	15	377
wines	280	72	–	–	110	28	390
beer	217	72	–	–	83	28	300
Total	**2,266**	**40**	**2,659**	**48**	**673**	**12**	**5,598**

were declined during this prequalification stage, but there was documentation to support the decision to decline for only a few of them. There was documentation to support the decision to shortlist the product for only a few of the remaining 20% of accepted submissions.

We also noted that approximately 10% of the accepted submissions that were shortlisted for a more detailed assessment did not fall within the retail price range established in the LCBO's needs letter. For instance, one Vintages needs letter specified a range of $14 to $50, yet one of the accepted submissions had a retail price of $64. One needs letter for general-list wines requested a price range of $11.95 to $16.95, and five of the accepted submissions quoted a price of $9.95. The rationale for accepting these products was not documented.

We were informed that submissions outside of the needs specified are generally rejected, but exceptions may be made at the discretion of the LCBO if the product is deemed to be outstanding and to meet the LCBO's financial and product-variety objectives.

According to the LCBO, management oversees the product selection process. However, we did not note any documented approval for these shortlisted products, including those products selected even though they did not meet all the requirements set out in the needs letter. The LCBO's Internal Audit Services also noted in its July 2010 review of the selection process for new products that the LCBO should document its basis for selecting products that were not within the established needs-letter criteria.

The next stage in the assessment includes an organoleptic (taste, sight, and smell) evaluation, and a label and container assessment. Suppliers send a sample of the product for organoleptic assessment by a panel of LCBO employees, including those who work in the category's purchasing unit and specially trained store employees. For some Vintages products, an employee who holds a Master of Wines designation is also included in the panel. A chemical analysis is also performed on the product, generally in the LCBO's own laboratory, to ensure that it is safe to drink and contains its stated contents.

For general-list products, suppliers must submit a detailed plan, which includes information such as sales from previous purchases by the LCBO, sales generated in other provinces, and marketing information. Suppliers of general-list products are informed that their submissions will be evaluated on a scale of 100 points, assigned as follows: sales information (10); marketing information (45); organoleptic assessment (20); and sample package appeal (25). The cost of the product is not a factor in the selection process because the needs letter has already specified what the retail price (and hence what the cost to LCBO) will be. Suppliers of Vintages products are not required to submit a detailed plan; rather, we were informed that the tasting evaluation was the key determinant. Other factors taken into consideration include third-party reviews, price/quality ratio, and availability of inventory. The entire process, from the issuing of the needs letter to the selection of the product, takes approximately three and a half months.

We reviewed a sample of general-list and Vintages product submissions and noted considerable variations in the level of documentation to support the decisions made. For example:

- In some cases there was no documented rationale for a purchase, while in others the reasons for accepting or declining the product were clear.
- In many cases, the submission was not scored, and there was no evidence that the marketing and sales information was evaluated, even though these components accounted for 55% of the overall assessment. However, each panel member's organoleptic assessments and packaging and price/quality ratio assessments were documented for all general-list products. LCBO management indicated that the scoring structure was outdated and did not reflect the differing priorities of each product category, but there was no evidence that another scoring system had been formally established and used to assess these submissions.

- Although organoleptic evaluation is the key criterion for Vintages products, the LCBO was unable to locate the organoleptic scores for 143 of the Vintages products in our sample, although it ended up purchasing 60 of these. The organoleptic scores for the rest of the items in our Vintages sample were documented for each panel member. We were informed that other factors, such as third-party reviews or historical sales, are taken into consideration during the purchasing process, but that these factors are not formally scored.

Overall, because the LCBO does not rank or summarize its assessment for each product submission, it was not evident why certain products were selected for purchase. We also noted that when submissions were declined, the supplier was sent an email notifying it that “other products submitted performed better against selection criteria.” We were informed that suppliers may contact the LCBO to obtain more detailed information on why their product was declined. However, given the lack of documentation, it would be difficult in our view for LCBO staff to subsequently provide suppliers with more specific details.

In its July 2010 report, the LCBO’s Internal Audit Services noted similar concerns and recommended that staff be given guidelines to help support their decisions for purchasing new products. Such guidelines would include the establishment of product selection criteria and an evaluation that would be subject to annual management review and approval.

Ad Hoc Purchases

When warranted, the LCBO can purchase products on an ad hoc basis, outside of the needs-letter process. The situations in which this may be necessary include shifts in consumer purchasing behaviour for products not currently available at the LCBO, needs-letter calls that were not timely enough to address a shift in consumer purchasing behaviour, or the identification of new or innovative products with favourable accolades. Ad hoc purchases may be initiated by LCBO staff, or suppliers may inform the LCBO about a specific product they feel the LCBO might want to purchase. We were informed that very few products are purchased directly from supplier-initiated offers.

A product must be approved by LCBO management for ad hoc purchase before it is accepted, and then it is subject to taste-testing and the rest of the regular procurement process. In the 2010/11 fiscal year, 15% of spirits and 28% of both wine and beer purchases were made on an ad hoc basis, as shown in Figure 5.

At the time of our audit, the LCBO did not have written policies and procedures to guide its ad hoc purchasing process. Staff told us that they applied informal criteria, such as whether a product met a current gap in the product category, or the innovativeness of a product. We were informed that all decisions to accept an ad hoc submission were reviewed with management prior to finalizing the decision, but this review was not documented in most instances. The LCBO’s Internal Audit Services also noted a need for formalized ad hoc purchasing policies in its July 2010 review.

We reviewed a sample of general-list and Vintages ad hoc purchases and noted that for 60% of the products purchased there was no documentation explaining why the product had been purchased on this basis. However, when we asked about certain products, LCBO staff were generally able to provide a verbal rationale to support these purchase decisions.

Direct Vintages Purchases

Direct purchases are made either during the prequalification stage of the needs-letter purchasing process or from products submitted directly by the supplier with prior LCBO permission. Only Vintages products can be procured by direct purchase and, as noted in Figure 5, about 60% of all Vintages products purchased in the 2010/2011 fiscal year were acquired in this way. Products that the LCBO decides to purchase directly do not require organoleptic evaluation.

At the time of our audit, the LCBO did not have written policies and procedures in place to guide the direct purchasing process. Therefore, no formalized evaluation criteria existed to assess product submissions and there was no guidance on the level and type of documentation required and the type of management approval needed to support purchasing decisions. The LCBO informed us that the main considerations in the selection of products for direct purchase included high historical sales of previously purchased products, defined as sales of more than 75% of product inventory within 12 weeks; a compelling case showing that the product is in high demand in other markets and therefore likely will sell well in Ontario; or high third-party accolades. The LCBO also noted that it selects products for direct purchase when its capacity to perform additional organoleptic assessments is limited.

We reviewed a sample of supplier submissions in response to the LCBO's needs letters from the 2009/10 and 2010/11 fiscal years and found that there was often no documentation showing the rationale for making a direct purchase from them. Specifically:

- More than 45% of the direct purchases in our sample were for products that had not been previously purchased by the LCBO and therefore had never had an organoleptic assessment. No reasons for these direct purchases were documented.
- The remaining products selected for direct purchase had been bought in the past by the LCBO. About half of these purchases had no documentation of the buyer's review of the related historical sales of the product or other support for purchasing them. For those that did have documentation of the prior sales history, we found that more than 50% of these products had sales of less than the required 75% of product inventory within a 12-week period, yet were still selected for direct purchase. For instance, one product had previous sales of only 4%, and another just 37%. According to the LCBO, the previously purchased products may have been from a different vintage, and therefore were not exactly the same. Another possible explanation is that some new circumstance may have arisen to make the product more attractive than its past sales might suggest, such as a new review or a price change. However, we found no documentation showing the reasons these products were selected.
- To determine how well the products selected for direct purchase were selling, we reviewed sales data for those products that had performed poorly in the past and compared it to subsequent sales data. More than half of those products that had performed poorly in the past continued to perform poorly.

Although the LCBO has no formal policy requiring management approval of significant direct purchases, we were informed that such purchases may be presented to the category manager for validation or verbal approval. However, for the direct purchases in our sample, there was no documentation of management having approved the products selected.

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.

LCBO RESPONSE

The LCBO is in the process of updating its Product Management Policies and Procedures manual, which will include a description of the shortlisting process. The LCBO was in the process of documenting its Vintages policies during the audit and provided them to the Auditor General when the audit fieldwork was completed. The LCBO will continue to disclose its purchasing policies and procedures, and any changes or updates to them, to the beverage alcohol trade on its Trade Resources website at **www.lcbotrade.com**.

The LCBO agrees that the reasons for product acceptance and required management approvals should be documented. The LCBO will continue to record new product acceptance decisions in the New Item Submission System and has implemented a new process for documenting the rationale for these decisions from the submission stage onward, including management approvals. The LCBO has added further oversight to the shortlisting of product applications at the pre-submission stage, where the product manager reviews all applications with the category manager, whose documented approval is now required.

The LCBO has concerns regarding the idea of documenting the reasons for selection or elimination of products at the pre-submission stage. Currently, the LCBO receives more than 50,000 submissions annually and anticipates that this number will continue to grow. Documenting the reasons why products are accepted or declined at this stage would entail either limiting the number of submissions the LCBO would accept or hiring additional staff. Neither would result in a better product assortment.

Product submissions are assessed against general evaluation criteria, combined with the experience and judgment of the LCBO's buyers. This is a common retail-sector practice and one that the LCBO believes is appropriate for its purchases. LCBO product purchase risk is further mitigated by the use of sales targets or sales performance terms to ensure that the products perform well in the market. This allows the LCBO to responsibly discontinue any underperforming products and to continue to create opportunities for new products.

ONGOING MONITORING OF PRODUCT PERFORMANCE

Monitoring the sales performance of products is done to help identify, in a timely manner, products that are not selling well and that should be replaced with better-performing ones.

The LCBO sets various sales targets by product category and adjusts them annually. Sales targets for wines, spirits, and Vintages core products (called Essentials) are based on the sales in dollars achieved in the previous year, while beer targets are based on the number of litres sold in the previous year. Targets are set to retain 90% to 95% of the products.

The LCBO informed us that the targets did not consider factors such as limited store distribution of products and niche products, although, according to LCBO staff, these factors were considered in their reviews of product performance. LCBO management informed us that targets can be adjusted as necessary. However, we found that there was no policy or guidance on when it is appropriate to adjust the sales targets or by how much.

New products are not held to their targets in their first year of release. Monitoring of a product occurs on a monthly basis at the start of the second year for general-list products and at the start of the third year for Vintages Essentials products. The LCBO produces a monthly report that tracks, on a 13-month rolling average, product sales against targets. However, it does not track the length of time that a product has failed to meet its sales targets. We selected a sample of individual products from the general-list and Vintages Essentials categories that had not met their sales targets for approximately 16 consecutive months as of early 2011 and reviewed their performance for the previous four years. We found that often, timely action had not been taken to address poorly performing products, and that some of these products had not been meeting their sales targets over a period of four or five years.

In the event that a product fails to meet its performance targets, the LCBO may consider delisting or discontinuing it. LCBO management told us that they work with suppliers to try to increase sales—through, for example, additional marketing or promotional campaigns—before delisting a product. When a product underperforms and the LCBO decides to delist it, it may request a rebate in accordance with its purchasing conditions. It asks for 25% back on the cost of remaining inventory for general-list and Vintages Essentials products, and 20% back for Vintages Retail Release products (new products released every two weeks for a limited time). The LCBO's policy does not specify how long a product may continue to underperform before it is delisted and when it is appropriate to request a rebate from the supplier. The decision to request a rebate is left to the judgment of LCBO management. The LCBO informed us that Vintages Essentials products that do not meet sales targets may be periodically transferred out of the Essentials program and offered through other Vintages programs, and therefore rebates are generally not claimed for these products. However, for other types of products, we noted that the LCBO often did not ask suppliers to provide rebates when it delisted poorly performing products. In particular, we noted that 2,270 general-list and Vintages Retail Release products were delisted from April 2009 to around December 2010, and the LCBO had requested and received rebates for about 35% of them.

Products for which rebates have been requested and received are marked down at LCBO stores. However, prices remain the same for those where no rebates have been sought. The LCBO informed us that it uses its judgment on a case-by-case basis to determine when to request rebates. For instance, it may not ask for a rebate when sales are deemed close enough to the target, or if the product comes from an iconic supplier with which the LCBO does not want to jeopardize its relationship. But there is no requirement to document these decisions.

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.

LCBO RESPONSE

LCBO sales targets are reviewed and updated annually. In the future, Vintages Essentials sales targets will also be reviewed and updated annually.

The LCBO agrees to establish clear guidelines for the nature and timing of action to be taken when a product is identified as underperforming and for developing policies to document the decision to delist products and/or seek a supplier rebate.

With respect to the reference to the LCBO requesting and receiving rebates on only 35% of delisted products, it is important to note that rebates are requested only for products that are reduced in price to clear inventory. Rebates compensate for part of the reduced profit from these sales. The LCBO avoids rebates where possible in order to maximize revenue.