Alberta

Gaming and Liquor Commission

Liquor Warehousing and Distribution in Alberta – Operational and Financial Business Case

Findings and Conclusions

June 11, 2009

Prepared by:
PricewaterhouseCoopers LLP
Suite 1501, TD Tower
10088 – 102 Ave NW
Edmonton, Alberta T5J 3N5

PRICEWATERHOUSECOOPERS

Overview

When considering all of the operational and financial factors, the preferred solution for the distribution of beverage alcohol products in the Province of Alberta should continue to be a single warehouser carrying all products currently handled by Connect Logistics Services ("CLS").

The above conclusion is reached in the context that the contract for the operation of the single warehouse should be retendered competitively every five years under conditions which permit a timely and cost effective transfer of the contract to the successful bidder at each tendering should the incumbent not be re-appointed. For the sake of clarity this means that the new operator should be able to take full responsibility for the operation within 180 days of their appointment. A five year tendering process is long enough for the warehouser to have stability while at the same time ensuring that the warehouser maintains its competitive position in advance of the next retendering.

Prior to the first retendering, the Alberta Gaming and Liquor Commission ("AGLC") needs to consider amending the current arrangements to ensure that a 180 day transition period is feasible. The primary obstacle to this happening is the control and operation of the sophisticated data systems needed to ensure regulatory compliance, good service to suppliers, agents and licensees, and efficient operations.

Background

On March 1, 2007, the AGLC released the PricewaterhouseCoopers LLP ("PwC") report on the Supply Chain Analysis for Liquor Warehousing and Distribution in Alberta. The report identified a series of short, medium and long-term recommendations. The key medium-term recommendation was to develop an operational and financial business case that considered four options for the physical network. These four options were further refined into eight alternatives.

PwC was contracted by the AGLC to assess the potential implications of the defined range of supply chain alternatives.

One option, the "Excess Capacity" option, was excluded from further analysis. This decision was based on the positive outcomes resulting from the changes made in 2007 and the recognition that returning to the model that existed at privatization would add burdensome and unnecessary costs to the system which would not be in the best interest of stakeholders. The remaining seven alternatives were evaluated as part of the medium-term strategy. These alternatives were:

- A single warehouser carrying all products (excluding domestic beer) serving the entire province;
- A single warehouser carrying all products (including domestic beer) serving the entire province;
- Multiple warehousers – one carries all wines / spirits, one carries imported and domestic beer; both serve the entire province;
- Multiple warehousers carrying all products (excluding domestic beer) – each serves a defined part of the province;
- Multiple warehousers carrying all products (including domestic beer) – each serves a defined part of the province;

- Supplier-controlled liquor distribution – multiple warehousers carrying select products serving the entire province; and
- Licensee-controlled liquor distribution – multiple warehousers carrying select products serving select licensees.

Approach

The approach used to complete this analysis consisted of six key steps:

1. **Alternative Definition** – This step included working with the AGLC to describe the alternatives in more detail and preparing a Discussion Paper for circulation to stakeholders for input.
2. **Stakeholder Consultation** – This step included evaluating written submissions from interested stakeholders and meeting with the key stakeholder groups to get their input on the relative pros and cons of each of the alternatives.
3. **Environmental Scan** – This step required conducting a review of liquor distribution models in other jurisdictions to gain an understanding of the likely implications of changing the current liquor distribution model in Alberta.
4. **Preliminary Cost Analysis** – For this step, PwC conducted a preliminary review of inbound and outbound transportation costs to determine if, from a transportation perspective, any significant cost savings could be realized if all products were shipped into or out of one warehouse location outside Edmonton or if volumes were split between more than one warehouse location.
5. **Cost/Benefit Analysis** – In this step, the costs, benefits, risks and implications of a short-list of alternatives were analyzed. The short-list, determined by the AGLC, was based on the results of the Stakeholder Consultation process, the Environmental Scan and the Preliminary Cost Analysis.
6. **Reporting** – PwC prepared a presentation of the results of the analysis (including financial and non-financial implications) to the AGLC and completed writing this final report.

Findings

Stakeholder Consultation

- The majority of stakeholders expressed a strong desire to see the Principles of Privatization retained.
- Licensee-controlled liquor distribution was viewed as the least favourable alternative.
- Retaining the current model (i.e., single warehouser carrying all products (excluding domestic beer)) was viewed as the most favourable alternative.
    - ✔ Two downstream associations (the Alberta Hotel & Lodging Association and the Alberta Liquor Store Association) as well as two downstream licensees ranked this alternative as their first choice. Agents (e.g., Beverage Alcohol Importers Council of Alberta (“BAICA”) ranked it as their second choice.
- Larger beer suppliers (e.g., Canada’s National Brewers) and agents (e.g., BAICA) expressed a strong preference for the supplier controlled liquor distribution alternative; CLS rated this option as its least preferred.

Environmental Scan

- Alberta's liquor supply chain is similar to that of Wyoming, Mississippi and Iowa, where wholesaling for spirits is state-controlled but retailing is privately licensed.
- Using U.S. state and city-level data over several years, the environmental scan looked at the potential impact of opening up liquor wholesaling to competition in Alberta.
- The analysis found evidence that states with a mix of state-run wholesaling and licensed retailing, as in Alberta, have more retail stores, higher average retail prices and less price variation across cities compared to states with licensed wholesaling and retailing.
- Such states also have more liquor stores, although we found no significant impact on liquor store employment.

Preliminary Cost Analysis

A preliminary analysis of inbound and outbound transportation costs was performed to answer a number of broad based questions:

- What are the potential economically viable locations of alcohol warehouses in Alberta (based on inbound transportation costs)?
- What is the potential increase in inbound cost, if any, of splitting volumes between two warehouses?
- What is the potential increase or decrease in outbound transportation costs for a warehouse located outside of Edmonton as opposed to in Edmonton?
- What is the potential decrease in outbound cost, if any, of splitting volumes between two warehouses?

The findings from this preliminary cost analysis were:

- On average, inbound costs to a warehouse in the Calgary area are not significantly different than those to a warehouse in the Edmonton area; inbound costs to a warehouse outside the Edmonton area or the Calgary area will likely be significantly higher.
- The existence of more than one warehouse will likely increase total inbound costs due to Agents' need to break out shipments.
- In a single warehouse scenario, there is, on average, no significant difference between the cost of outbound transportation from Calgary or Edmonton.
- Two warehouses (one in Calgary and one in Edmonton) may reduce the cost of delivery due to relative geographical proximity to licensees. However, the reduction in outbound cost per case would likely be largely offset by the increase in inbound costs.

Cost / Benefit Analysis

Based on the findings from the stakeholder consultation, the environmental scan and the preliminary cost analysis, the AGLC eliminated a number of alternatives and the remaining alternatives were more clearly defined so that financial and non-financial implications could be evaluated against the current operating model. The alternatives that were reviewed in more detail were:

- A single warehouser carrying all products (excluding any beer not currently handled by CLS) serving the entire province.
- Multiple warehousers – one or more carries select products (excluding any beer not currently handled by CLS); all serve the entire province.
- Two warehousers carrying all products (excluding any beer not currently handled by CLS); each serves a defined part of the province.

Several factors were considered and analyzed in order to estimate the financial impact for each alternative. These included:

- Inbound costs;
- Outbound costs;
- Diseconomies of scale; and
- Competition.

The financial impact of each of the foregoing factors was estimated for each of the alternatives and then combined to arrive at an overall estimate of the change in the operation costs under each of the alternatives as compared to the base case.

The financial analysis included the following major steps:

- Completion of the inbound analysis conducted in the preliminary cost analysis;
- Interviews of outbound transportation companies;
- Detailed analysis of CLS financial data;
- Interviews with CLS representatives;
- Discussions with a warehouse cost expert firm;
- Survey of 10 warehouses in "open"[1] states including New Jersey, California, Illinois, Massachusetts and Maryland
- Labour cost research;
- Discussions with and review of results of a survey conducted by Spirits Canada regarding warehouse fees in open U.S. states; and
- Research of "typical" U.S. margins.

Non-financial impacts that were considered included:

- Ease of transition;
- Operational risk; and

[1] "Open" states refers to those states that have licensed liquor wholesaling and retailing to private business.

- Stakeholder impact.

In addition, the analysis included the possibility of introducing a regular tendering process as an alternative means to competition. The findings in this regard were compared to the conclusions reached from the analysis of the other alternatives.

Implications

Alternative 1 – Single warehouser subject to retendering

- Retendering is expected to result in a decrease in costs.
- Subject to making changes to the existing systems arrangements, this option is expected to be the least disruptive to implement.
- This option carries a higher operational risk if the single warehouser cannot operate (e.g., labour disruption, capacity constraints).
- This option also reinforces the perceived "monopoly" position of the single warehouse provider for the duration of the contract.
- A five year tendering process is long enough for the operator to have a financial incentive to maintain its competitive position compared to potential competitors, thus encouraging the operator to keep a low cost structure

Alternative 2 – Multiple warehousers, each carrying select products (i.e., warehouser competition)

- Warehousing and transportation costs are expected to increase if the model is changed to two warehousers.
- The effect of introducing competition is expected to be a decrease in costs.
- The net effect after introducing competition (even with the increase in warehousing and transportation costs) is expected to be a decrease in costs (though not as significant a decrease as Alternative 1).
- This option creates the potential for improved customer service, reduced delivery times and improved delivery reliability.
- This option provides some degree of contingency (i.e., back-up).
- Agents handling beer and wine or spirits would have to have distinct inbound streams to both facilities.
- Licensees would need to order products from multiple warehouses, thereby adding to their costs.
- Possibility exists of multiple shipments being made to licensees (over and above domestic beer shipments from BDL) again adding to the licensees' costs.

Alternative 3 – Two warehousers serving a defined geography, both carrying all products

- Warehousing and transportation costs are expected to increase if the model is changed to multiple warehousers.
- Our models show that the effect of geographically separate "monopolies" eliminates the benefits of competition.

- This option creates the potential for improved customer service, reduced delivery times and improved delivery reliability; however, the lack of true competition (i.e., competing in the same market for the same clients) suggests that this potential may not be fully realized.
- This option provides some degree of contingency (i.e., backup).
- Agents will have to have distinct inbound streams to both facilities thereby adding to agent costs.

Conclusions

- After giving consideration to the financial and non financial implications of each of the alternatives, Alternative 1, a single warehouser carrying all products (excluding beer not currently handled by CLS) subject to retendering, is the preferred alternative based on the assumptions identified.
- The AGLC should make the required systems changes prior to retendering the contract.