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NOVA SCOTIA LIQUOR COMMISSION - GOVERNMENT REVIEW OF ALTERNATIVE SERVICE OPTIONS

BACKGROUND

12.1 The Nova Scotia Liquor Commission controls the possession, sale, transportation and delivery of all alcoholic beverages in the Province. It operates 100 outlets and employs approximately 750 people. The Commission had net sales of $371 million for the year ended March 31, 2000. Net income, which is returned to the Province of Nova Scotia each year, amounted to $135 million.

12.2 Our Office conducted an audit of the Commission in 2000. It focused on issues of governance, compliance with legislation and regulations, and attention to economy and efficiency. Audit fieldwork was completed in the spring of 2000 and the report on our audit was discussed with Commission management and finalized over the months leading up to the publishing of this Annual Report. Our report on the audit is in Chapter 11, beginning on page 186.

12.3 On April 11, 2000, as part of the tabling of its 2000-2001 Budget in the House of Assembly, the government announced that *"the provincial government will get out of the retail and wholesale liquor business, provided such a move makes good sense for taxpayers."* The commitment was described as being part of the government's pledge to focus on core government priorities while achieving fiscal objectives. Shortly thereafter, government initiated a process to determine its options.

12.4 The government's review of its role in the sale and regulation of alcoholic beverages was performed in the period between when we completed audit fieldwork and when we finalized the 2000 Report of the Auditor General. This Chapter provides a description of the goals, nature and outcomes of the review.

REVIEW OF ALTERNATIVES

12.5 The current government identified the Nova Scotia Liquor Commission as a candidate for privatization, in whole or in part. It undertook to conduct a comprehensive review of alternatives to the current system, one in which a Crown agency controls all aspects of alcohol distribution and sale. In announcing the review, government set Nova Scotia apart as being the only province in Canada that does not permit any private involvement in liquor distribution, wholesale or retail.

12.6 The review was given one overriding condition. The recommendations from the study must ensure government revenues are protected or improved. A further pledge was made that government would maintain its responsibility to ensure policies and regulations are in place to control alcohol sales and distribution, and to minimize the negative societal effects of alcohol.

12.7 A working committee of eight senior government and Commission officials was tasked with the responsibility of identifying and analyzing potential business models for warehousing, selling and distributing alcohol. The committee was asked to assess the impact of each of the models on Commission employees, government finances, service, and control over the sale and distribution of alcohol.

12.8 The working committee requested government to issue a call for proposals for assistance in the evaluation of various options. The call for proposals was announced April 26 and was open for bidding until May 12. The successful firm was expected to deliver a report by the end of June.

12.9 On May 30, it was announced that PricewaterhouseCoopers, an international management consulting firm, had been selected to help examine the options for liquor sale and distribution within Nova Scotia. It was estimated that the consultants would complete their work by July 7, at a total cost of $153,000.

12.10 As further input to the work of the committee, Nova Scotians were asked for their views on possible changes to the way beer, wine and spirits are sold in Nova Scotia. A website was set up to provide information and to act as one means of collecting responses from the public. In addition, consultation was held with various stakeholder groups.

CONSULTANTS' REPORT

12.11 Upon completion of their analysis of alternative business options, PricewaterhouseCoopers issued a report entitled *Evaluation of Business Options with Respect to the Nova Scotia Liquor Commission*, dated September 12, 2000. In their report, the consultants indicated that they were *"expected to identify and research alternative models of service delivery and to carry out an appropriate assessment of each model considered*." They were "*not expected to recommend to the Committee or Government the preferred model."*

12.12 The executive summary and conclusion of the report are reproduced below.

EVALUATION OF BUSINESS OPTIONS WITH RESPECT TO THE NOVA SCOTIA LIQUOR COMMISSION

PRICEWATERHOUSECOOPERS
SEPTEMBER 12, 2000

EXECUTIVE SUMMARY AND CONCLUSION

1.0 Executive Summary

The following document examines the various business options and potential proceeds to the Province of Nova Scotia of alternatives to the current provincial system of alcohol distribution and sales. PricewaterhouseCoopers LLP was retained by the Province to provide support to a government Review Committee with their broad-based analysis of the likely financial and other impacts of various business options using a variety of assumptions. Because of the broad nature of this request, we examined existing and recent privatization efforts in the alcohol wholesale and retail industries in Canada and the U.S. to help us understand both the approach and associated operating characteristics used in this analysis. These various business models have been conducted through a variety of approaches, ranging from full privatization to licensing systems. As we proceeded through this process, however, the specific scenarios considered in our analysis were tailored, to the extent possible, to more closely correspond to conditions within Nova Scotia. Please note that our review of options for the beverage alcohol industry incorporates the financial implications of continued enforcement and education efforts, but does not include a more detailed analysis of these areas.

1.1 Background

The NSLC is mandated to control the possession, sale, transportation and delivery of liquor — including beer, wine and spirits — in Nova Scotia. As part of this mandate the general control, management and supervision of all government liquor stores and shops is vested with the Province.

The NSLC is currently operating in a favourable position as a result of a number of years of "cost containment" and "right sizing mode" with projected increases in volume (.88%), sales dollars (2.59%), gross margin (3.21%) and net income (3.75%) for 2000-2001 over last year.

The current government process review with objectives of focusing operations on core government policies is understood. One such direction, as indicated in the 2000-2001 budget is the Government to "get out of the retail and wholesale liquor business provided that such a move made good sense for taxpayers". This statement has prompted the formation of the Committee charged with undertaking a comprehensive review of alternatives to the current system of alcohol distribution and sales.

It is understood that regardless of the approach, the Government will maintain policy over alcohol distribution and sales, thereby minimizing the negative social impacts of alcohol consumption.

It is against this backdrop of provincial and national trends that the Province of Nova Scotia is evaluating the feasibility of alternative business models for the beverage alcohol industry.

1.2 Alternative Business Model Analysis

The analysis contained in this document assesses the impact of various business models on the cash flows to the Province under the following alternatives:

- ***Nova Scotia Liquor Commission (NSLC) Operated** - This option represents the current NSLC model, where the wholesale and retail business of beer, wine, and spirits is owned and operated by the government.*

- ***NSLC Plus Agency Stores** - This option results in the closure of stores that are below the average profitability of NSLC retail stores. These retail outlets will be replaced by agency stores (i.e., corner stores, convenience stores). In addition, agency stores will be opened in the more rural/remote areas of Nova Scotia.*

- ***"Quebec" Model** - The "Quebec" model under review would envision that spirits would continue to be sold through NSLC run retail outlets only. The opportunity to sell beer and wine will be licensed to owners of grocery stores and corner stores. This will be operated in a more open market fashion. The supplier of beer and wine will decide which distribution network (i.e., NSLC outlets or grocery/corner stores) they will sell their product through. The same product/brand cannot be sold in both NSLC and private stores.*

- ***Franchise** - The franchise model option under review would see the elimination of all 100 NSLC retail outlets and have them replaced by franchise outlets. There will be a franchise agreement that defines all aspects of the operation including duration and parameters in* *which the franchisee must operate. All products, spirits, wine and beer will be sold through these outlets.*

- ***Alberta (Adapted to N.S.)** - The "Alberta Model" proposes that all aspects of the retail liquor operations be privatized. The privatized retail outlets are not required to be a stand-alone operation and may be operated within a grocery store, convenience store or other retail outlet. NSLC will retain its role as sole wholesaler and importer of liquor in Nova Scotia. The procurement, consolidation, shipment and ownership of all inventory will be the responsibility of the suppliers and/or agents representing the suppliers. NSLC may contract out the management and operation of the warehouse.*

- ***Monopoly** - The Monopoly option is one which assumes the Government will sell off ownership of the "Liquor Corporation" through an initial public offering of stock. This sale would generate initial cash flows to the Province equal to the value of the "exclusivity-right" to investors. The new owner could then grant licenses or franchise rights to retailers.*

- ***Private** - The Private Sector Model is envisioned as an option with both wholesale and retail fully privatized. The NSLC/Government would issue licenses to both wholesalers and retailers on an annual basis. The number of licenses would be driven by market forces.*

This analysis should only be used as a general "road map" for policy makers within the Province of Nova Scotia to determine likely financial effects of various options under different scenarios, and not to determine the "optimal" approach to changing the business model. As noted in the document, once a particular model is determined (based on public policy as well as financial considerations), the model can be optimized to determine the most likely financial results under that scenario using a variety of assumptions that may differ significantly from those used in this document. For just this reason, we have evaluated a wide range of options for consideration.

Given the need for ongoing discussion and development of options based on policy considerations, the results of this analysis form the basis of a work in progress. Additional analysis will need to be performed to develop specific operating characteristics and models that are tailored to the particulars of the Nova Scotia market. Where possible, we have adjusted the assumptions derived from the business model experiences of other provinces and states to reflect conditions in Nova Scotia. However, we have only used "broad-based" assumptions in many areas. Once a preferred approach to the business model is selected by the Province, additional analysis will need to be performed to adjust the assumptions to more closely represent Nova Scotia's demographics and commercial environment.

Conclusion

As can be seen in the attached financial summary spreadsheet, on a straight cash flow basis, the NSLC plus Agency Stores ranks as the highest return to the Government of Nova Scotia. However, it is important to note that it is both misleading and inappropriate to compare these options based solely on the cash flow results. Each of the options is based on a different set of assumptions, modelled largely on the recent experiences of other provinces and states.

After evaluating the initial wide range of business options and working with us to develop additional scenarios (all of which are presented in this document), it is our understanding that the Review

Committee will present the various alternatives to Government. Independent of whichever option is eventually selected, there are a number of system changes which can be made to respond to stakeholder concerns and improve the level of service to the citizens of Nova Scotia.

12.13 The 'financial summary spreadsheet' referred to above indicates that the option *NSLC plus Agency Stores* would yield, on a net present value basis, a ten-year cash flow of $1,053.8 million. This option involves closing 32 Commission-owned stores which are below the average profitability of Commission stores, and allowing 60 Agency Stores (e.g., convenience stores) to sell liquor products. The second highest yielding option was the current NSLC model (i.e., status quo), with a ten-year net present value of $1,035.3 million. However, as with any analysis involving future events, these projections are dependent on a number of assumptions. Factors such as anticipated discount rates, inflation, and sales growth — to name just a few — played a key role in determining the net present values noted above, and any difference between anticipated and actual rates will cause the actual financial outcomes to differ from the amounts projected, perhaps significantly.

12.14 The consultants' billings for this assignment totaled $153,000, the same amount that they bid in their proposal.

GOVERNMENT'S DECISION

12.15 On October 27, 2000 government announced a series of decisions made as a result of "*six months of extensive review, consultation and financial analysis of seven operating models*." It announced that: "*the Nova Scotia Liquor Commission would not be sold outright, but increased private-sector involvement in the liquor business will be permitted, and the liquor commission itself will become a more service-oriented operation*."

12.16 The following specific decisions were declared:

- Privately operated agency liquor stores will open, initially in eight communities identified as being underserved.
- Other private stores offering rare wines and more specialty products will be permitted to operate.
- New liquor stores could be operated privately or by the Liquor Commission, depending on individual business case analyses.
- The Liquor Commission will become a crown corporation, accountable to a board of directors "*drawn from a cross-section of Nova Scotians*."
- The changes stemming from the review will not result in the closure of any existing liquor outlets at this time.
- The Commission will extend credit card use to licensees.
- The 9.3% surcharge on the sale of liquor to licensees will be cut in half.

12.17 At the time of the announcement, government released a summary report on its consultation process. Stakeholders consulted included employees, suppliers, licensees, retailers, consumer groups, business communities, police, communities and municipalities. They received 161 submissions from the public, mostly through the website set up to gather public input.

12.18 Shortly after announcing these decisions, government tabled Bill 80 in the House of Assembly entitled *Justice and Administration Reform (2000) Act*. Sections 69 to 84 change certain responsibilities under the Liquor Control Act. The Act provides the legislation needed to effect the transfer of the regulatory responsibilities of the Nova Scotia Alcohol and Gaming Authority, partly to the Minister of Environment and Labour, and partly to the Nova Scotia Utility and Review Board.

12.19 On December 8, 2000 Executive Council approved a reduction in liquor licensing fees from 9.3% to 4.1% of the gross value of liquor purchased. This represents a 56% reduction, in contrast to the 50% announced on October 27, 2000.

CONCLUDING REMARKS

12.20 Because the results of our audit of the Nova Scotia Liquor Commission are being formally reported in this Annual Report (Chapter 11), we do not expect that a significant number of our recommendations would be implemented yet. Nonetheless, the decisions made by government and the tabling of Bill 80 do address some of the issues raised in our audit of the Nova Scotia Liquor Commission. We highlight these items below.

12.21 We examined the Commission's governance structure and concluded that it could benefit from an increase in the number of governors overseeing its operations. The Liquor Control Act provides for a maximum of three Commissioners. We state in our report: "*The current size hinders the Board from accessing a broader range of knowledge and experience which additional members would bring to the Board*" (paragraph 11.19, page 188). The government's plan to make the Commission a crown corporation will likely increase the number of people on its Board.

12.22 Paragraph 11.36 of Chapter 11 describes four examples of "over-sight requirements" of the Liquor Control Act which are generally not complied with. Bill 80 repeals Section 31(1) which required the approval of all liquor purchases by the Chief Commissioner or a person authorized by the Minister.

12.23 We also report: "*The Liquor Control Act permits only stores operated by the Commission to sell liquor. This provides the Commission with the authority and power needed to control the sale and consumption of liquor in Nova Scotia. However, the conditions of the Act in this area are so stringent that it prevents the Commission from engaging in some alternative means of serving the public. Most other provinces in Canada have privately-owned 'agency stores' which purchase their liquor from a provincial liquor authority and are closely monitored and regulated by the authority*" (paragraph 11.39, page 191). The announcement of government addresses this situation. However, Bill 80 does not provide the revisions necessary to effect such changes, and we expect that there are intentions to further amend legislation in the near future to make agency stores possible.

12.24 Further, in our 2000 audit of government user fees (Chapter 3), we noted that the Nova Scotia Liquor Commission collects a levy of 9.3% on the sale of liquor to approximately 2000 licensees (e.g., beverage rooms, restaurants). The funds are remitted in full to the Nova Scotia Alcohol and Gaming Authority to help fund its responsibility for enforcing various requirements of the Liquor Control Act pertaining to the sale and use of alcoholic beverages. In that chapter we state:

> "*The liquor licence fee is set by regulation and, until recently, had not been significantly changed for a number of years. Due to the Eurig Estate court decision, the Authority obtained a legal opinion on its licence fees and prepared an analysis relating the fee revenues to operating costs. Revenues exceed program costs, but it was indicated that there may be costs incurred by other Provincial entities that can be allocated to the licensing*

program. We recommend that consideration be given to completing the analysis by tabulating any other related costs not accounted for by the Authority" (paragraph 3.108, page 48).

12.25 We also indicate in Chapter 3 that liquor licensing fees amounted to $6.9 million for the year ended March 31, 2000. If a similar amount is forecasted for future years, government's decision to reduce the charge by 56% will lower government revenues by $3.9 million.

12.26 In discussions held with Nova Scotia Liquor Commission officials, we were informed that the directive that the Commission allow the use of credit cards by licensees will cost the Commission approximately $800,000 per year in credit card fees.