

Intelligence MEMOS



From: Ian Irvine
To: Provincial Marijuana Regulators
Date: July 22, 2017
Re: Legal Marijuana: Beware Supply-Side Market Power

The efficient sourcing of marijuana at the wholesale level will be critical to the success of provinces in generating tax revenue and competing with the illegal market. Limiting the power of suppliers to set uncompetitive prices for their product will be a starting point.

All provinces will institute a provincial cannabis authority for purposes of securing a supply. Some provinces (Ontario and Quebec for example) will insist that the same provincial authority also be solely responsible for retailing. This will make the cannabis subsidiaries of their liquor boards, the LCBO and SAQ, respectively, de facto monopolists in retail. Others (Manitoba and Alberta for example) will permit the private sector to enter retail.

A competitive market in the supply of marijuana products is essential; and this requires that Ottawa license numerous producers to ensure competition in the supply of product. At present about 80 suppliers have been licensed to produce or retail medical marijuana, although Health Canada said this week that another 208 applications are in the final stages. These producers will likely be permitted to supply recreational marijuana by mid-2018. We do not know the ultimate production capacity of these suppliers; we know that they are building inventory that currently amounts to several weeks of the total estimated supply of recreational and medical marijuana (legal and illegal).

Two conditions – efficient and transparent auctions as well as opportunities for open cross-provincial trade – will be necessary if markets are to function efficiently.

First, provincial authorities should eschew ‘private purchase deals’ involving undisclosed conditions and prices with individual suppliers. Standard practice in procurement involves a bidding process, a.k.a. an involving undisclosed conditions and prices with individual suppliers.

Whatever their form, auctions are designed to serve an objective – whether it be to sell a piece of art to the individual who values it most highly, or to secure a supply at minimum cost. The recent sale of Leonardo’s *Salvator Mundi* for \$450 million was through an English auction at Christie’s. The vendor was handsomely remunerated. Imagine if the seller, instead of going through auction, had decided to enter into a private agreement with some buyer on the advice of an agent who explained: “the government will negotiate a deal with a single buyer that will be in your best interest.”

When it comes to governments, the same logic that requires competitive tendering for a new highway should apply to how provincial authorities buy marijuana.

Second, provincial authorities must permit interprovincial trade. They should post their needs openly and invite bids from all licenced producers across Canada. They should not restrict themselves to ‘local’ suppliers. The current practice in alcohol does not permit open trade within Canada, although the Supreme Court is currently hearing a case that, if won, could strike down interprovincial barriers. If the new cannabis authorities insist upon within-province supply the effect will be to reduce competition and limit the benefits of scale economies. At present, some large provinces are home to just a couple of supply licenses – Quebec has just two.

Bricks-and-mortar retailing is expensive, particularly in unionized environments such as will prevail in Quebec and Ontario. Grey-market dispensaries are cheaper to run, and the street market does not incur bricks-and-mortar costs at all.

The logical development of such a sourcing process would be the evolution of a virtual market similar to stock exchanges or the Chicago Mercantile Exchange where prices and spreads would be open knowledge.

A competitive market may not require the number of suppliers currently operating in Colorado and Washington (I counted more than 400 on the Washington State government’s web site). Many of these suppliers will amalgamate or be taken over or will fail. But if individual producers wish to develop an artisanal product that will sell at a slightly higher price, there is little reason not to permit bona fide entrepreneurs to enter the market, even if they ultimately fail.

Regardless of the marketing and retailing roles played by government in our provinces, let’s keep the process transparent, and eliminate supply-side market power.

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