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Niagara Community Observatory

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CANNABIS LEGALIZATION:
Government choices interact with business realities to help or hinder policy goals

The Niagara Community Observatory (NCO) has partnered with Michael J. Armstrong, an associate professor in the Goodman School of Business at Brock University, to explore the business realities of the emerging cannabis industry. Notwithstanding its business focus, this policy brief raises serious questions for municipalities across the country. For the Niagara region, which has seen a wave of interest in cannabis growing, one central consideration is land-use. Municipalities are generally expected and required by law to regulate and strategically manage land-use to advance the economic, environmental, social, and aesthetic welfare of the local community. Not only do these objectives often conflict, but each dimension has multiple interests and stakeholders that contend with each other. With the cannabis industry's emergence in Niagara, new battle lines may appear over growing and processing site locations, greenhouse conversions, and repurposing of farmlands.

While this brief's discussion centres on the operational business issues of cannabis product quality, consumer satisfaction, and black-market competition, municipalities simultaneously are making strategic decisions about economic, ecological, social, and aesthetic land-use planning. They are also contending with this emerging industry's implications for tourism, agribusiness, and bio-life sciences. Similarly, post-secondary institutions need to be part of deliberations about workforce development, entrepreneurship training, and industry-related research and innovation.

- Charles Conteh, Director, Niagara Community Observatory

Canada's legalization of recreational cannabis is underway. The Senate is reviewing the federal legalization framework within bill C-45. Ontario passed its own legislation last December. Both governments are developing detailed regulations to support these laws. Municipal governments will end up dealing with many implementation issues. All three government levels must balance competing, sometimes conflicting, policy objectives in making their regulatory choices.

This policy brief examines how those government choices will interact with business realities to help or hinder achievement of certain policy objectives, focusing on cannabis product quality, consumer satisfaction, and black-market competition. It begins by discussing cannabis production and distribution, before concentrating on retailing.

Production

Like other provinces, Ontario will leave cannabis production to federally licensed businesses. It will also allow individual households to grow their own plants. That home-growing option may reduce government cannabis revenues but help decrease black-market activity.

Cannabis production is rapidly increasing. Existing medical-use growers are expanding while new recreational-use growers get started. Some greenhouses are replacing vegetables or flowers with cannabis. Alcohol and tobacco companies are investing in cannabis firms. Hydroponics and lighting suppliers are also benefiting.

Some cannabis growers use conventional greenhouses, like Canopy Growth's facility in Niagara-on-the-Lake. Others repurpose existing buildings, such as what Canopy Growth is doing with the old Hershey chocolate factory in Smith Falls. The latter especially are heavy consumers of electricity. All grow-ops require more security (fences, intrusion alarms, etc.) than traditional crops need.

It is unclear how closely cannabis supply will match demand. There may be product shortages initially, followed

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by surpluses later as more growers begin harvesting and raw cannabis becomes a commodity. Wholesale prices therefore may briefly rise before falling. Inefficient growers may go bankrupt before the industry stabilizes.

Product quality needs improvement. Canadian medical cannabis has experienced several recalls for pesticide contamination (Chiu 2017). In one U.S. sample, 70 per cent of medical cannabis products had significantly different cannabidiol (CBD) levels than their labels claimed (Rapaport 2017). Contrary to medicinal needs, some contained substantial tetrahydrocannabinol (THC) content.[1]

Value-added processing also needs development. Current producers basically sell raw material, dried plants, that consumers smoke while hoping for the desired effect. The federal government will legalize edible cannabis products in 2019. In anticipation, some growers are creating product development departments. Refined liquids and pills with controlled CBD and TBD levels should gradually become available.

Cannabis legalization poses many questions for Niagara and its agricultural economy. Vineyards have partly replaced orchards as the region's best-known agrarian activity.[2] Will cannabis similarly replace greenhouse food and flower crops? Cannabis growing facilities already exist in Niagara and further expansion is underway. Should local governments differentiate cannabis from other crops for zoning or property taxes?

Wholesaling

The provincial government will control wholesaling and distribution through its Ontario Cannabis Retail Corp. (OCRC). This centralized approach gives it direct control of product flow. That could help exclude black-market products and aid in tax collection.

Centralization also facilitates large-scale cannabis product testing, just as it does with alcohol. The Liquor Control Board of Ontario (LCBO) Quality Assurance Lab tested 28,000 beverages last year. OCRC should follow that example. This could encourage growers to improve quality and give legal cannabis a competitive advantage over black-market products.

Ontario's proposed regulations allow local growers to export cannabis into other provinces. Will cannabis enjoy interprovincial free trade? That could help Canadian growers gain enough scale to compete abroad.

Retailing

Ontario, like Quebec and the Maritimes, will only have public-sector retailing. (This may change if the Progressive Conservatives win the June election.) OCRC will handle storefront and online sales under the "Ontario Cannabis Store" name. By contrast, the western provinces will allow businesses to handle some or all retail sales.

A key goal of cannabis legalization is to squeeze out black markets that fund organized crime. To understand this competitive challenge, consider the "four P" categories that marketers use: the product characteristics, prices charged, places where sold, and promotional activity.

Pricing Choices

Price is the most mentioned competitive dimension. In Colorado, cheap legal cannabis means black markets control only 20 per cent of sales. In Washington state, however, higher prices allow black markets to capture 50 per cent.

Canadian governments agree cannabis prices must be competitive, often suggesting around $10 per gram including taxes. However, Statistics Canada estimates black-market prices fell below $7.50 last year. Vancouver street prices reportedly hit $5 in January (Zeidler 2018).

Ontario currently lacks confirmed suppliers, so product shortages could occur initially. Growers might prefer exporting their limited stocks to Europe's higher-priced medical market. OCRC therefore could face an awkward choice. If it prices high to cover costs, it may be uncompetitive. If it prices low to compete, taxpayers may subsidize drug use. Longer term, increasing supplies will enable lower prices.

OCRC has indicated that pricing will be "uniform" across Ontario. That predictability may help against the black market, but how will it work? Will OCRC fix a single retail price per gram for all products, regardless of wholesale cost or customer demand? Will it apply a fixed markup, allowing producers to compete for customers on price? Will it charge higher markups on "premium" brands than on "value" brands, as other industries do?

Retail Places

The places legal cannabis is sold also affect its competitiveness against black markets. Ontario's retailers will lack convenience. In 2018, OCRC expects to open 40 stores, only one per 355,000 people. Store count will grow to 150 by 2020, one per 95,000 people. Even then, OCRC outlets will only be as common as Walmart. That may be enough for

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[1] THC creates the "high". CBD is thought to have medical benefits.
[2] Hay and field crops use the most amount of land. Greenhouse production and poultry production both produce higher gross farm receipts than vineyards (Niagara Region Economic Development, personal communication, March 2018).

planned shopping trips, but not for consumers seeking convenience.

Other provinces will have a better ratio. Quebec eventually expects 150 government-owned outlets, or one per 56,000 people. New Brunswick plans 20, one per 38,000. Those numbers pale beside private-sector retailing. Alberta expects 250 store openings in the first year alone, one per 17,000 people. Colorado has more than 800 stores, almost one per 6,000.

Alcohol provides another contrast. Ontario has 2,067 locations selling alcoholic beverages, about one per 7,000 people. Those include LCBO outlets, beer stores, and wineries.

The Association of Municipalities of Ontario has suggested allowing businesses to enter the retail market in 2020. Similarly, Canopy Growth wants an outlet store at its Smith Falls site. If vineyards can sell their wares on site, why not grow-ops?

Ontario will not initially permit "cannabis lounges". Much like licensed bars and restaurants serve alcohol drinkers, licensed lounges would allow cannabis smoking on-site. Renters in non-smoking buildings and visiting tourists would particularly value such lounges. Otherwise, those groups are stuck with illicit facilities.

Individual store locations could provoke debate. For example, OCRC is putting an outlet in Niagara Falls. Should it be located near the Falls and casinos to target tourists, or in a shopping district serving residents? Could its placement revitalize a languishing area like Queen Street?

Product Characteristics

With current recreational cannabis products, consumers cannot easily evaluate CBD or THC content, nor detect contamination. Quality assurance efforts by growers and OCRC therefore could give legal cannabis a competitive edge over illegal products. Consistently performing brands also could develop favourable consumer reputations. Some may offer a mild buzz, others a powerful high. Consumers could learn to rely on them instead of unpredictable street weed.

However, it will be difficult to establish reputations if producers cannot develop memorable brand images. The federal government's law allows brand names but disallows many package design options like images of people, animals, or "lifestyles". Its draft regulations go further, requiring plain packages with only tiny brand logos.

These restrictions make reputation development harder for growers, neutralizing their key advantage over illicit products. They also reduce growers' incentive to boost quality, especially if prices are fixed. As near-generics, they may instead try to lower production costs, or boost THC numbers to stand out. That could inadvertently encourage cheaper, stronger cannabis.

The lack of edible products, like brownies and beverages, is a glaring gap in the legal product line. Until Ottawa legalizes those, unlawful suppliers will keep market control.

Promotion Limits

Federal rules also limit promotional activities. Advertising can be "informational" but cannot evoke emotions or depict lifestyles that suggest excitement, recreation, etc. That seems counterproductive. Good ads often evoke emotions and lifestyle images help explain complex products. These limits further undermine legal cannabis' competitiveness.

Because federal law prohibits self-service, sales staff will play key roles. Store ownership may matter here. Ontario's public-sector staff might be better at consumer education and harm reduction. Private-sector sellers elsewhere might respond better to customer preferences and market trends.

Ontario customers will not see or touch products before purchase, only viewing product information on computer screens. By contrast, New Brunswick's outlets will display products under glass, so consumers can read labels and compare packaging. Ontario's rules make it tougher for consumers to develop preferences and for growers to build reputations. That again weakens the competitiveness of legal products.

Niagara municipalities also have promotional issues to consider. For example, should cannabis tourism be actively discouraged, discretely ignored, or openly promoted ("Take the 420 Highway to your 420 high")?

Conclusion

In Ontario, legal cannabis will likely have little immediate impact on black markets. Retailing lacks convenience, edible products are absent, and smoking facilities are missing. Longer term, legal products should become increasingly competitive, if growers earn reputations for reliable quality. That will be easier if governments allow more promotional flexibility for growers and consumption options for consumers.

Niagara municipalities face their own challenges. They need to consider trade-offs surrounding issues like land use for growers, retail store locations, and cannabis tourism. Overall, cannabis legalization is a complex work in progress that will take several years to sort out. It will be an interesting journey.

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The Niagara Community Observatory is a local public policy think-tank at Brock University in St. Catharines, ON.

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