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Mark Katz & Erika Douglas[1]

I. INTRODUCTION

Perhaps more than ever, tensions between suppliers and retailers have become the defining feature of the grocery industry worldwide. These tensions have also frequently formed the basis for interventions (or proposed interventions) by competition enforcement authorities in this sector.

Canada is no exception to this global trend. The Canadian retail grocery industry is intensely competitive, with retailers surviving on razor-thin margins. Not surprisingly, margins and pricing pressure at the retail level have led Canadian retailers to seek relief from suppliers. This has generated considerable tension and also provided the backdrop—or source—for calls for competition law intervention.

In recent months, for example, the Canadian Competition Bureau (the "Bureau") has completed two lengthy merger investigations in the grocery sector where retailer/supplier relations became a key issue of focus. Retailer/supplier tensions have also given impetus to a debate in Canada over how far the Bureau should go in "regulating" pricing conduct in the industry (and more generally), with particular sensitivities raised about the "price gap" between Canada and the United States. Finally, this ongoing dispute has generated the suggestion in some quarters that Canada should follow the U.K.'s lead and adopt a form of "code of conduct" to govern retailer/supplier relationships in the grocery industry. We consider these developments below.

II. MERGER REVIEW: SOBEYS/SAFEWAY AND LOBLAWS/SHOPPERS DRUG MART

A. Sobeys/Safeway

On June 12, 2013, Sobeys Inc. ("Sobeys") announced the proposed acquisition of the following assets from Canada Safeway ("Safeway"):

- 213 grocery retail locations, which included 199 in-store pharmacies and 62 co-located fuel stations;
- 10 liquor stores;
- 4 primary distribution centers and the related wholesale businesses; and
- 12 food-manufacturing facilities.

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Both Sobeys and Safeway were full-line grocers that competed with one another in the retail sale of grocery products. Full-line grocery stores typically carry a wide variety of food items, such as bread and dairy products, refrigerated and frozen food and beverage products, fresh and prepared meats and poultry, produce (including fresh fruits and vegetables), shelf-stable food and beverage products (including canned and other types of packaged products), and staple foodstuffs. Full-line grocery stores typically also carry non-food items, such as household products. At the retail level, many full-line grocery stores also offer additional products or services, either in-store or in a location adjacent to the store. These may include pharmacies, gas bars, and liquor stores.

The Bureau's analysis (as reflected in its public statement regarding the transaction) focused on whether the proposed transaction would (a) provide Sobeys with enhanced market power in the retail sale of grocery products, and/or (b) provide Sobeys with enhanced market power in the wholesale supply of full-line grocery products to independent retailers. With regard to the latter, the Bureau concluded that existing and prospective competition would generally be sufficient to prevent the exercise of market power arising from the proposed transaction. With regard to the former, however, the Bureau concluded that the proposed transaction would lead to a substantial prevention or lessening of competition in the retail sale of a full-line of grocery products in several markets in Western Canada. Sobeys agreed to divest 23 retail stores to resolve the Bureau's concerns.

Although supplier issues do not appear to have been at the core of the Bureau's analysis of the Sobeys/Safeway transaction, these issues soon gained prominence in the transaction's aftermath. According to media reports, shortly after closing the Safeways deal, Sobeys dispatched letters to its suppliers with several demands, including a one percent retroactive price reduction and a freeze on price increases in 2014. Our understanding is that this step generated complaints to the Bureau, thereby adding to the growing contentious atmosphere surrounding retailer/supplier relations in the Canadian grocery industry.

B. Loblaws/Shoppers Drug Mart

While the Bureau was investigating the Sobeys/Safeway transaction, it was also examining another major merger affecting the grocery sector, the proposed acquisition of Shoppers Drug Mart Corporation ("Shoppers") by Loblaw Companies Limited ("Loblaws").

Loblaws is Canada's largest retail grocery chain. Shoppers was Canada's largest drugstore chain. Loblaws announced on July 14, 2013 (one month after the announcement of the proposed Sobeys/Safeways transaction) that it proposed to acquire all of the outstanding common shares of Shoppers for a total purchase price of CDN$12.4 billion. The merged entity would have approximately 2,738 stores and 1,824 pharmacies across Canada.

On March 24, 2014, the Bureau announced that it had entered into a Consent Agreement with Loblaws to remedy its concerns about this proposed acquisition. These concerns focused on two theories of competitive harm: (i) that Loblaws would be able to exercise market power in its retail operations which could lead to higher prices for consumers, and (ii) that Loblaws would become the largest purchaser of many of the overlapping products sold by both companies and could use its buying power to disadvantage suppliers.

To address the Bureau's concerns about horizontal market power, the Consent Agreement required Loblaws to divest 18 retail stores and 9 pharmacies within Loblaws stores to an independent operator. To address the Bureau's concerns about the exercise of buyer power, the Consent Agreement also imposed restrictions on Loblaws' agreements with suppliers insofar as they related to products affected by the transaction.

In the latter regard, the Bureau was particularly concerned with Loblaws' programs/agreements that require suppliers to compensate Loblaws on the basis of lower prices advertised by competing retailers for those suppliers' products. The Bureau determined that, given Loblaws' market position following the transaction with Shoppers, the continued operation of these programs/agreements would likely lead suppliers to charge competing retailers higher prices for specific products, thereby preventing/lessening competition for those products at the retail level and resulting in higher retail prices for consumers.

There were two specific types of Loblaws' programs/agreements that concerned the Bureau in this regard, one called the "Ad Collision Program" and the other known as the "Threshold Deal."

- The "Ad Collision Program" refers to Loblaws' programs or policies under which Loblaws requests financial compensation from a supplier "on the basis that Loblaws has identified a product in another retailer's flyer promotional materials that is advertised or promoted at a lower retail price than the same product is advertised or promoted in Loblaws' flyer promotional materials within the same or an overlapping time period."
- The "Threshold Deal" is similar in concept to the "Ad Collision Program" except that the compensation to be paid by the supplier to Loblaws is based on a pre-determined amount or formula that is designed to ensure that "Loblaws achieves a stated [i.e., minimum] margin for the volumes of its sales as affected as a result of Loblaws adjusting its price based on the flyer promotional price of another retailer."

The Bureau was concerned that, by effectively making suppliers financially responsible for the competitive pricing decisions of other retailers, these Loblaws' programs/agreements would increase the incentives of suppliers to influence upwards and impose restrictions on competing retailers' pricing decisions to the detriment of competition. For example, the Bureau believed that, in this context, these Loblaws' programs/agreements would: incentivize suppliers to penalize competing retailers for vigorous price competition, diminish supplier incentives to continue to offer promotions to competing retailers, and align supplier interests with Loblaws to increase wholesale prices to competing retailers.

The Bureau was also concerned with the impact on smaller suppliers of certain other compensation requirements imposed by Loblaws:

- **Fill Rate Penalties**: Financial charges levied by Loblaws on suppliers for "short deliveries" (i.e., when suppliers failed to achieve established "fill rate" standards by only delivering a percentage of the quantity ordered by Loblaws over a certain period of time).
- **Supply Chain Fees/Penalties**: Financial penalties levied by Loblaws on suppliers for failing to achieve defined supply chain logistics standards.

- **Other Financial Requirements**: Obligations on suppliers to reduce the current costs of products or to provide other types of non-promotional financial commitments.

The Consent Agreement imposed the following restrictions on the various Loblaws supply programs/agreements described above:

- Loblaws cannot, for a period of five years, enter into a Threshold Deal for specified categories of products sold at both its Loblaws and Shoppers stores.
- Loblaws cannot, for a period of five years, enter into any new Threshold Deal; amend or renew any pre-existing Threshold Deal; or require or induce any supplier to enter into, amend, or renew a Threshold Deal, for all other products to be sold in Shoppers stores. Loblaws is also prohibited for a period of five years from including the volume of products purchased from a supplier for sale in Shoppers stores when calculating any financial compensation it may be owed under Threshold Deals applying to other parts of its business.
- Loblaws cannot, for a period of five years, apply its Ad Collision Program in respect of purchases of products for its Shoppers stores.
- Loblaws cannot, for a period of two years, charge Fill Rate Penalties to any suppliers that, during Loblaws' previous fiscal year, supplied products to Loblaws at a total cost of less than CDN$4 million ("Exempt Suppliers").
- Loblaws cannot charge Supply Chain Fees/Penalties to any Exempt Supplier for a period of two years.
- Loblaws cannot require Exempt Suppliers, for a period of two years, to reduce the current cost of a product or to pay any other non-promotional financial commitment, unless this is related to a reduction in the Exempt Suppliers' cost of producing the product or is intended to ensure that Loblaws pays the same wholesale price for the product across its business.

Finally, the Consent Agreement obliged Loblaws to ensure that all of these programs/agreements are provided or made available to suppliers in writing, and to confirm with suppliers which programs/agreements apply to them.

The Bureau's approach to the Loblaws/Shoppers Drug Mart transaction is interesting for two reasons:

1. The Bureau's typical remedy for merger transactions is to require the divestiture of assets (as it did in this case). It is less common for the Bureau to impose "behavioral remedies" such as remedies governing the types or terms of supply programs/agreements. However, it is apparent that the Bureau's approach in this case was influenced by complaints it received from suppliers about the impact of the proposed Shoppers acquisition on their future dealings with Loblaws and Shoppers.
2. The Bureau's announcement also reflects the recent interest by other competition authorities in the competitive implications of "contracts that reference rivals" or "CRRs" (such as the Threshold Deals and Ad Collision Programs at issue in the

Loblaws/Shoppers case). Typically, the potential concern arises where a dominant party with market power uses a CRR either to disadvantage competitors or as a vehicle to collude with competitors. In the Loblaws/Shoppers case, the Bureau's concern was principally with the former, i.e., that the Threshold Deals and Ad Collision Programs would induce suppliers to charge more to Loblaws' competitors (or take other steps harmful to competition between these retailers and Loblaws) in order to avoid having to pay financial penalties to Loblaws.

What is even more intriguing is that the Bureau used the occasion of the Loblaws Consent Order to announce that it is also engaged in a more general investigation of Loblaws' "policies, agreements and conduct relating to pricing strategies and programs with suppliers that reference rivals' prices." Publicly announcing an inquiry is an unusual and surprising step for the Bureau. By doing so, however, the Bureau has signaled that its concerns about retailer/supplier relations in the grocery industry extend beyond the specific circumstances of this one transaction to practices employed more generally in the sector.

III. PRICING ISSUES

A. Price Maintenance

Since 2009, and the repeal of the *Competition Act*'s criminal pricing offenses (price maintenance, price discrimination, predatory pricing, geographic price discrimination, and promotional allowances), the only element of pricing conduct remaining subject to an express prohibition in Canadian law is the civil "reviewable practice" of price maintenance. This provision authorizes the Bureau to seek remedies in a variety of circumstances, including where a supplier "influences upward or discourages the reduction of" the price at which customers re-sell the supplier's products at retail. Significantly, however, the provision only applies if the conduct in question has had, is having, or is likely to have an "adverse effect on competition in a market." The establishment of a competitive effects standard is an important change from the pre-2009 situation, when price maintenance was a *per se* criminal offense.

The shift in Canadian law on price maintenance is consistent with current economic and legal thinking, which recognizes that price maintenance (and other types of previously prohibited pricing conduct) can be pro-competitive and thus should not be automatically prohibited. The switch from a *per se* criminal offense to effectively a rule-of-reason approach was designed to give suppliers more flexibility to impose resale pricing restrictions that previously would have been strictly prohibited, such as minimum advertised pricing ("MAP") policies and minimum retail pricing ("MRP") policies.

This light-handed approach is confirmed by the Bureau's draft enforcement guidelines on the civil price maintenance provision (the "Draft Guidelines"), which were issued for comment in March 2014. The Draft Guidelines identify several scenarios in which the Bureau is likely to take the view that there has been an adverse effect on competition. The common feature of all of these scenarios is that they involve conduct where price maintenance practices are being used to inhibit or exclude competition between competitors. None truly captures the classic unilateral price maintenance scenario in which a supplier is solely interested in controlling the price at which its products are sold at retail.

The liberalized price maintenance laws in Canada are providing another battleground for grocery retailers and suppliers. More and more suppliers (both in the grocery sector and otherwise) are trying to take advantage of the new regime in Canada by introducing programs that limit the freedom of retailers to set pricing as they see fit. Many retailers, in turn, are unhappy with this turn of events, arguing that MAP and MRP policies have constrained their ability to implement competitive pricing strategies and have inevitably resulted in higher prices for consumers. What will be interesting to see is whether these complaints about the negative impact on consumers of Canada's liberal pricing laws will influence the Bureau to “reset” its enforcement stance towards price maintenance in Canada.

B. Country Pricing

Another issue that has aggravated retailer/supplier relations is the so-called question of “country pricing,” i.e., the alleged practice by certain cross-border suppliers of charging more for products sold in Canada than in the United States.

Concerns about the gap between Canadian and U.S. pricing have grown in the last several years, spurred on by complaints from consumers and retailers alike. Most notably, the Canadian Senate conducted hearings on the matter that culminated in a report that was issued in February 2013. The Senate reached the tentative conclusion that the segmentation of the Canadian and U.S. markets "reduces competition and allows some manufacturers—even some Canadian ones—to practice country pricing between the Canadian and the American markets, which may contribute to the price discrepancies between the two countries.”

The Senate report offered the following recommendations to address the Canada-U.S. price gap: (1) a comprehensive review of Canada’s tariffs, (2) continuing efforts to harmonize product standards without compromising safety, (3) increasing the monetary threshold for low-value goods to be exempt from custom duties, and (4) examining a reduction of the permissible mark-up for Canadian exclusive book distributors of American books.

The cross-border pricing issue was next raised in the Canadian government's October 2013 “Speech from the Throne” which set out the government's agenda for the 2014 legislative year. Without getting into specifics, the government stated that Canadian consumers “should not be charged more in Canada for identical goods that sell for less in the United States” and committed to take “further action to end geographic price discrimination against Canadians.”

At the time, the scuttlebutt surrounding the Speech from the Throne was that the government was examining several legislative options, including possible amendments to the *Competition Act*. This was confirmed with the release of Canada's federal budget for 2014 in February of this year. In the 2014 budget, the government indicated that it was considering a new provision for the *Competition Act* that would allow the Bureau to seek remedies against companies with “market power” that cannot “justify” charging higher prices for products sold in Canada.

An assessment of the full scope and implications of the Canadian government's “country pricing” proposal will have to await release of the actual draft legislation. That said, all indications have been that the Canadian government intends to move forward with this proposal and to require at least certain multinational companies to justify cross-border differentials resulting in higher prices in Canada. If so, this would reverse direction from the 2009

amendments to the *Competition Act* referred to above, which repealed the then-extant price discrimination offenses.

Interestingly, if the "country pricing" proposal is adopted, one by-product may be to affect the relative flexibility now afforded suppliers under Canada's price maintenance provision.

For example, if a supplier mandates that its retail customers in Canada price at a level that is higher than in the United States, it could conceivably be investigated for engaging in unjustified cross-border price discrimination, even though its unilateral pricing program may not raise issues under the price maintenance provision. This could effectively tip the balance back in favor of retailers over supplier pricing flexibility.

IV. NEXT UP: A GROCERY CODE OF CONDUCT?

The various tensions and conflicts between retailers and suppliers in Canada's grocery industry have led some parties (both suppliers and smaller independent grocers) to suggest the adoption of a retailer/supplier "Code of Conduct" for the industry. Although details are sparse, presumably these parties are suggesting that Canada establish a code that is similar to the one issued by the U.K. competition authorities following a lengthy "market investigation" into alleged anticompetitive conduct by U.K. retailers targeted at suppliers. As an example, retailers governed by the U.K. code may not:

- vary supply terms retroactively unless permitted under a supply agreement,
- require suppliers to contribute to a retailer's marketing costs or to predominantly fund a promotion,
- charge listing or shelf allocation fees except in limited circumstances (e.g., for promotions),
- require suppliers to pay for shrinkage or wastage, and/or
- de-list suppliers except for "genuine commercial reasons" and only with reasonable notice and opportunity to discuss.

In contrast to the United Kingdom, the Bureau cannot unilaterally inquire into the state of competition in a market and issue an order imposing mandatory remedies, including a code of conduct. In a recent speech discussing the topic,[2] Canada's Commissioner of Competition, John Pecman, acknowledged the limitations on his authority with respect to a grocery code of conduct and did not express enthusiasm for the idea. However, in a tantalizing aside, he also made the following statement: "If the Government expresses a desire to move in the direction of a Code of Conduct, and if we are asked to participate, we would certainly implement it and include it as another tool in our enforcement kit."

Although we have no reason to believe that the Canadian government has any plans to introduce a grocery "code of conduct," it seems clear that the issue of retailer/supplier relations in Canada's grocery industry will continue to attract attention from enforcement authorities as the two sides struggle for position in a very intense competitive environment.

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[2] *Available at* http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03719.html.