

10. Risks and Risk Management

10.1 Operating Risks and Risk Management

Each year, the Company performs an Enterprise Risk Assessment (“ERA”) which identifies the key risks facing the Company and evaluates the risk management effectiveness for each of these risks. The assessment is primarily carried out through interviews with senior management, who assess the potential impact of risks and the likelihood that a negative impact will occur. The results of the ERA are used to prioritize risk management activities, allocate resources effectively and inform overall business direction. The Audit Committee receives a report on the ERA.

A description of the risks and risk management strategies identified by the ERA is included in the operational risks discussed below, any of which has the potential to negatively affect financial performance. The Company has operating and risk management strategies and insurance programs which help to mitigate the potential financial impact of these operating risks.

Industry and Competitive Environment

The retail industry in Canada is a changing and competitive market. Consumer needs drive industry changes, which are impacted by changing demographic and economic trends such as changes in disposable income, ethnic diversity, nutritional awareness and time availability. Customer satisfaction is central to the Company’s business. Over the past several years, consumers have demanded more choice, value and convenience. If the Company is ineffective in responding to these demands or ineffective in executing its strategies, its financial performance could be negatively impacted.

The Company monitors its market share and the markets in which it operates, and will adjust its operating strategies, which include, but are not limited to, closing underperforming stores, relocating stores or reformatting them under a different banner, reviewing pricing and adjusting product offerings and marketing programs. The Company’s control label program represents a significant competitive advantage because it enhances customer loyalty by offering superior value and provides some protection against national brand pricing strategies.

The Company faces increasing competition from many types of non-traditional competitors, such as mass merchandisers, warehouse clubs, drugstores, limited assortment stores, discount stores, convenience stores and specialty stores, all of which continue to increase their offerings of products typically associated with traditional supermarkets. The Company is also subject to competitive pressures from new entrants into the marketplace and from the expansion of existing competitors, particularly those expanding into the grocery market. These competitors may have extensive resources which will allow them to compete effectively with the Company in the long term. Increased competition could adversely affect the Company’s ability to achieve its objectives. The Company’s inability to compete effectively with its current or any future competitors could result in, among other things, lessening of market share and lower pricing in response to its competitors’ pricing activities. Accordingly, the Company’s competitive position and financial performance could be negatively impacted. The Company may not always achieve the expected cost savings and other benefits of its initiatives, which could negatively impact the Company’s financial performance.

Change Management

2006 was a year of significant change for the Company. The change in senior management will be followed by changes to the Company’s structures and business processes. While these changes are expected to bring benefits to the Company in the form of a more agile and consumer-focused business, success is dependent on management effectively implementing these changes. Ineffective change management may result in disruptions to the operations of the business or affect the ability of the Company to implement and achieve its strategic objectives, due to a lack of clear accountabilities, or cause employees to act in a manner which is inconsistent with Company objectives. Any of these events could negatively impact the Company’s performance.

Food Safety and Public Health

The Company is subject to potential liabilities connected with its business operations, including potential exposures associated with product defects, food safety and product handling. Such liabilities may arise in relation to the storage, distribution and display of products and, with respect to the Company's control label products, in relation to the production, packaging and design of products.

A majority of the Company's sales are generated from food products and the Company could be vulnerable in the event of a significant outbreak of food-borne illness or increased public health concerns in connection with certain food products. Such an event could negatively affect the Company's financial performance. Procedures are in place to manage such events, should they occur. These procedures identify risks, provide clear communication to employees and consumers and are aimed at ensuring that potentially harmful products are expeditiously removed from inventory. The ability of these procedures to address such events is dependent on their successful execution. Food safety related liability exposures are insured by the Company's insurance program. In addition, the Company has food safety procedures and programs which address safe food handling and preparation standards. The Company endeavours to employ best practices for the storage and distribution of food products and also actively supports consumer awareness of safe food handling and consumption.

The Company strives to ensure its control label products have informative nutritional labelling so that today's health conscious consumer can make informed choices.

Information Technology

In order to support the current and future requirements of the business in an efficient, cost effective and well-controlled manner, the Company is reliant on information technology systems. These have been assessed by management to need significant upgrading in order to act as an enabler for the business to achieve its operating objectives. These systems are essential in providing management with the appropriate information for decision making, including its key performance indicators. Change management risk and other associated risks will arise from the various information technology projects which will be undertaken to upgrade existing systems and introduce new systems to effectively manage the business going forward. Failure by the Company to appropriately invest in information technology or failure to implement information technology infrastructure in a timely or effective manner may negatively impact the Company's financial performance.

Labour

A significant majority of the Company's store level and distribution centre workforce is unionized. Renegotiating collective agreements might result in work stoppages or slowdowns, which could negatively affect the Company's financial performance, depending on their nature and duration. The Company is willing to accept the short term costs of labour disruption in order to negotiate competitive labour costs and operating conditions for the longer term. Significant labour negotiations took place across the Company in 2006 as 87 collective agreements expired and 64 collective agreements were successfully negotiated which represented a combination of agreements expiring in 2006, those carried over from prior years, and those negotiated early. In 2007, 77 collective agreements affecting approximately 20,000 employees will expire, with the single largest agreement covering approximately 8,600 employees. The Company will also continue to negotiate the 57 collective agreements carried over from 2004, 2005 and 2006. The Company has good relations with its employees and unions and, although it is possible, does not anticipate any unusual difficulties in renegotiating these agreements.

Several of the Company's competitors operate in a non-union environment. These competitors may benefit from lower labour costs and more favourable operating efficiencies, making it more difficult for the Company to compete.

Employee Future Benefit Contributions

While the Company's registered funded defined benefit pension plans are currently adequately funded and returns on pension plan assets are in line with expectations, there is no assurance that this will continue. An extended period of depressed capital markets and low interest rates could require the Company to make contributions to its registered funded defined benefit pension plans in excess of those currently contemplated, which in turn could have a negative effect on its financial performance.

During 2006, the Company contributed \$88 million (2005 – \$59 million) to its registered funded defined benefit pension plans. During 2007, the Company expects to contribute approximately \$75 million to these plans. This estimate may vary subject to actuarial valuations being completed, market performance and regulatory requirements. The Company also expects to make contributions in 2007 to defined contribution pension plans and multi-employer pension plans, as well as benefit payments to the beneficiaries of the unfunded defined benefit pension and other benefit plans.

Multi-Employer Pension Plans

In addition to the Company-sponsored pension plans, the Company participates in various multi-employer pension plans, providing pension benefits in which approximately 41% (2005 – 40%) of employees of the Company and of its independent franchisees participate. The administration of these plans and the investment of their assets are legally controlled by a board of independent trustees generally consisting of an equal number of union and employer representatives. In some circumstances, Loblaw may have a representative on the board of trustees of these multi-employer pension plans. The Company's responsibility to make contributions to these plans is limited by the amounts established pursuant to its collective agreements. Pension cost for these plans is recognized as contributions are due.

Subsequent to year end, the Company was served with an action brought by certain beneficiaries of a multi-employer pension plan in the Superior Court of Ontario. In their claim against the employers and the trustees of the multi-employer pension plan, the plaintiffs claim that assets of the multi-employer pension plan have been mismanaged. The Company is one of the employers affected by the action. One billion dollars of damages are claimed in the action against a total of 17 defendants. In addition, the plaintiffs are seeking to have a representative defendant appointed for the employers of all the members of the multi-employer pension plan. The action is framed as a representative action on behalf of all of the beneficiaries of the multi-employer pension plan. The action is at a very early stage and the Company intends to vigorously defend it. Statements of Defence have not yet been filed.

During 2006, the trustees of a multi-employer pension plan (including an employee who was appointed by the Company) were charged under the Pension Benefits Act (Ontario) by the Superintendent of Financial Services with failure to administer various investments made by the trustees in a manner consistent with the legislation. It is not anticipated that the trial relating to these charges will be scheduled before February, 2008.

Third-Party Service Providers

Certain aspects of the Company's business are significantly affected by third parties. While appropriate contractual arrangements are put in place with these third parties, the Company has no direct influence over how such third parties are managed. It is possible that negative events affecting these third parties could in turn negatively impact the Company's operations and its financial performance.

A large portion of the Company's case-ready meat products are produced by a third party which operates facilities dedicated to Loblaw. The Company's control label products, which are among the most recognized brands in Canada, are manufactured under contract by third-party vendors. In order to preserve the brands' equity, these vendors are held to high standards of quality. The Company also uses third-party logistic services including those in connection with a dedicated warehouse and distribution centre in Pickering, Ontario and third-party common carriers. Any disruption in these services could interrupt the delivery of merchandise to the stores and therefore could negatively impact sales.

President's Choice Financial banking services are provided by a major Canadian chartered bank. *PC Bank* uses third-party service providers to process credit card transactions, operate call centres and monitor credit and fraud for the *President's Choice Financial MasterCard*®. In order to minimize operating risk, *PC Bank* and the Company actively manage and monitor their relationships with all third-party service providers. *PC Bank* has developed a vendor management policy, approved by its Board of Directors, and has established a vendor management team that provides its Board with regular reports on vendor management and risk assessment. *PC Financial* home and auto insurance products are provided by companies within the Aviva Canada group, the Canadian subsidiary of a major international property and casualty insurance provider.

Real Estate

The availability and conditions affecting the acquisition and development of real estate properties may impact the Company's ability to execute its planned real estate program on schedule and, therefore, its ability to achieve its sales targets. Real estate development plans may be contingent on successful negotiation of labour agreements with respect to same-site expansion or redevelopment. As the Company continues to offer general merchandise, on-time execution of the real estate program becomes increasingly important due to significantly longer lead times required for ordering this merchandise. Delays in execution could lead to inventory management issues. The Company maintains a significant portfolio of owned retail real estate and, whenever practical, pursues a strategy of purchasing sites for future store locations. This enhances the Company's operating flexibility by allowing the Company to introduce new departments and services that could be precluded under operating leases. At year end 2006, the Company owned 72% (2005 – 72%) of its corporate store square footage.

Seasonality

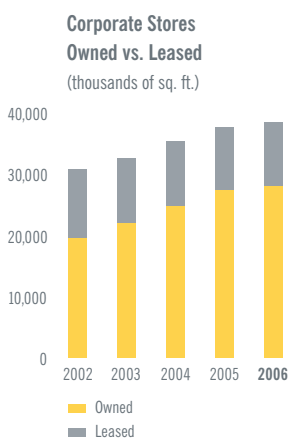
The Company's operations as they relate to food, specifically inventory levels, sales volume and product mix, are impacted to some degree by certain holiday periods in the year. Certain general merchandise items are subject to more seasonal fluctuations. As the Company expands and redefines its general merchandise offerings, its operating results may be subject to more seasonal fluctuations.

Excess Inventory

As the Company continues to offer general merchandise, it is possible that certain merchandising programs will result in excess inventory that cannot be sold profitably through the Company's stores. Excess inventory may result in mark downs, shrink or the need to liquidate the inventory, all of which may negatively impact the Company's financial performance. In addition, the Company's current inventory management infrastructure, including its information technology systems, is not efficient in its tracking of inventory through all stages of the supply chain. The Company has implemented procedures and information technology workarounds which provide management with the ability to adequately detect and quantify excess and obsolete inventory. The Company expects to implement new systems in this area to address this risk.

Employee Development and Retention

Effective employee development and succession planning are essential to sustaining the growth and success of the Company. The Company continues to focus on the development of employees at all levels and across all regions. The degree to which the Company is not effective



in developing its employees and establishing appropriate succession planning processes could lead to a lack of requisite knowledge, skills and experience which could, in turn, affect its ability to execute its strategies, efficiently run its operations and meet its goals for financial performance.

The tight labour market in Western Canada has created unique challenges to effectively operate stores and distribution centres, thereby affecting the Company's ability to meet its business objectives. The Company has implemented targeted programs to attract the appropriate calibre of employee in a very competitive environment.

The Company has announced a reorganization of some of its functions and an associated reduction of between 800 and 1,000 store support and regional office employees. These actions, if not properly executed, will impact the Company's ability to execute its strategies going forward. These actions will require the Company to address employee engagement in the process and ensure that key employees remain empowered to effectively execute the Company's strategies.

Utility and Fuel Prices

The Company is a significant consumer of electricity, other utilities and fuel. Unanticipated cost increases in these items could negatively affect the Company's financial performance. The Company has entered into contracts with suppliers to fix the price of a portion of its future variable costs associated with electricity and natural gas, and financial contracts to fix a portion of variable costs associated with heating oil requirements for 2007.

Insurance

The Company limits its exposure to risk through a combination of appropriate levels of self-insurance and the purchase of various insurance coverages, including an integrated insurance program. The Company's insurance program is based on various lines and limits of coverage which provides the appropriate level of retained and insured risks. Insurance is arranged on a multi-year basis with reliable, financially stable insurance companies as rated by A.M. Best Company, Inc. The Company combines comprehensive risk management programs and the active management of claims handling and litigation processes by using internal professionals and external technical expertise to manage the risk it retains.

Environmental, Health and Safety

The Company has environmental, health and workplace safety programs in place and has established policies and procedures aimed at ensuring compliance with applicable legislative requirements. To this end, the Company employs environmental risk assessments and audits using internal and external resources together with employee awareness programs throughout its operating locations. The Company endeavours to be socially and environmentally responsible, and recognizes that the competitive pressures for economic growth and cost efficiency must be integrated with sound environmental stewardship and ecological considerations. Environmental protection requirements do not and are not expected to have a material effect on the Company's financial performance.

The Environmental, Health and Safety Committee of the Board receives regular reporting from management, addressing current and potential future issues, identifying new regulatory concerns and related communication efforts. The Company's dedicated Environmental Affairs staff work closely with the operations to help ensure that corporate requirements are met.

Ethical Business Conduct

Any failure of the Company to adhere to its policies, the law or ethical business practices could significantly affect its reputation and brands and could, therefore, negatively impact the Company's financial performance. The Company has adopted a Code of Business Conduct which employees and directors of the Company are required to acknowledge and agree to on a regular basis. The Company has in place an Ethics and Business Conduct Committee which monitors compliance with the Code of Business Conduct and determines how the Company can best ensure it is conducting its business in an ethical manner. The Company has also adopted a Vendor Code of Conduct which outlines its ethical expectations to its vendor community in a number of areas, including social responsibility.

Legal, Taxation and Accounting

Changes to any of the laws, rules, regulations or policies related to the Company's business including the production, processing, preparation, distribution, packaging and labelling of its products could have an adverse impact on its financial and operational performance. In the course of complying with such changes, the Company may incur significant costs. Failure by the Company to fully comply with applicable laws, rules, regulations and policies may subject it to civil or regulatory actions or proceedings, including fines, assessments, injunctions, recalls or seizures, which may have an adverse effect on the Company's financial results.

During 2006, the Government of Ontario passed a new law which prohibits the receipt of rebates paid by manufacturers to pharmacies in respect of interchangeable products and products listed in Ontario's Formulary. Pharmacies are permitted to accept only limited defined professional allowances to be used in compliance with a new Code of Conduct. As a result of this recently enacted legislation, drugstore-related operating income could decrease although the Company is attempting to mitigate some of the impact of these changes. It is possible that similar legislation could be implemented in other provinces which could have a further negative impact.

There can be no assurance that the tax laws and regulations in the jurisdictions affecting the Company will not be changed in a manner which could adversely affect the Company. New accounting pronouncements introduced by appropriate authoritative bodies may also impact the Company's financial results.

Holding Company Structure

Loblaw Companies Limited is a holding company. As such, it does not carry on business directly but does so through its subsidiaries. It has no major source of income or assets of its own, other than the interests it has in its subsidiaries, which are all separate legal entities. Loblaw Companies Limited is therefore financially dependent on dividends and other distributions it receives from its subsidiaries.

10.2 Financial Risks and Risk Management

In the normal course of business, the Company is exposed to financial risks that have the potential to negatively affect its financial performance including financial risks related to changes in foreign currency exchange rates, interest rates and the market price of the Company's common shares. These risks and the actions taken to minimize them are discussed below. The Company is also exposed to credit risk on certain of its financial instruments.

Financial Derivative Instruments

The Company uses over-the-counter financial derivative instruments, specifically cross currency basis swaps, interest rate swaps and equity forwards, to minimize the risks and costs associated with its financing activities and its stock-based compensation plans. The Company maintains treasury centres that operate under policies and guidelines approved by the Board covering funding, investing, equity, foreign currency exchange and interest rate management. The Company's policies and guidelines prevent it from using any financial derivative instrument for trading or speculative purposes. See Notes 1 and 20 to the consolidated financial statements for additional information on the Company's financial derivative instruments.

Foreign Currency Exchange Rate

The Company enters into cross currency basis swaps to manage its current and anticipated exposure to fluctuations in foreign currency exchange rates. The Company's cross currency basis swaps are transactions in which floating interest payments and principal in United States dollars are exchanged against the receipt of floating interest payments and principal in Canadian dollars. These cross currency basis swaps limit the Company's exposure against foreign currency exchange rate fluctuations on a portion of its United States dollar denominated assets, principally cash, cash equivalents and short term investments.

Interest Rate

The Company enters into interest rate swaps to manage its current and anticipated exposure to fluctuations in interest rates and market liquidity. Interest rate swaps are transactions in which the Company exchanges interest flows with a counterparty on a specified notional amount for a predetermined period based on agreed upon fixed and floating interest rates. Notional amounts are not exchanged. The Company monitors market conditions and the impact of interest rate fluctuations on its fixed and floating interest rate exposure mix on an ongoing basis.

Common Share Market Price

The Company enters into equity forwards to manage its exposure to fluctuations in its stock-based compensation cost as a result of changes in the market price of its common shares. These equity forwards change in value as the market price of the underlying common shares changes, which results in a partial offset to fluctuations in the Company's stock-based compensation costs. The partial offset between the Company's stock-based compensation costs and the equity forwards exists as long as the market price of the Company's common shares exceeds the exercise price of employee stock options. As at year end 2006, 4,068,646 stock options had exercise prices which were greater than the market price of the Company's common shares at year end.

Counterparty

Over-the-counter financial derivative instruments are subject to counterparty risk. Counterparty risk arises from the possibility that market changes may affect a counterparty's position unfavourably and that the counterparty defaults on its obligations to the Company. The Company has sought to minimize potential counterparty risk and losses by conducting transactions for its derivative agreements with counterparties that have at minimum a long term "A" credit rating from a recognized credit rating agency and by placing risk adjusted limits on its exposure to any single counterparty for its financial derivative agreements. The Company has internal policies, controls and reporting processes, which require ongoing assessment and corrective action, if necessary, with respect to its derivative transactions. In addition, principal amounts on cross currency basis swaps and equity forwards are each netted by agreement and there is no exposure to loss of the original notional principal amounts on the interest rate swaps and equity forwards.

Credit

The Company's exposure to credit risk relates to the Company's cash equivalents and short term investments, *PC Bank's* credit card receivables and accounts receivable from independent franchisees, associates and independent accounts.

Credit risk associated with the Company's cash equivalents and short term investments results from the possibility that a counterparty may default on the repayment of a security. This risk is mitigated by the established policies and guidelines that require issuers of permissible investments to have at minimum a long term "A" credit rating from a recognized credit rating agency and that specify minimum and maximum exposures to specific issuers.

PC Bank manages the *President's Choice Financial MasterCard®*. *PC Bank* grants credit to its customers on *President's Choice Financial MasterCard®* with the intention of increasing the loyalty of those customers and the Company's profitability. Credit risk results from the potential for loss due to those customers defaulting on their payment obligations. In order to minimize the associated credit risk, *PC Bank* employs stringent credit scoring techniques, actively monitors the credit card portfolio and reviews techniques and technology that can improve the effectiveness of its collection process. In addition, these receivables are dispersed among a large, diversified group of credit card customers.

The Company also has accounts receivable from its independent franchisees, associates and independent accounts, mainly as a result of sales to these customers. The Company actively monitors the balances on an ongoing basis and collects funds from its independent franchisees on a frequent basis in accordance with terms specified in the applicable agreements.