8. LIQUIDITY AND CAPITAL RESOURCES

8.1 MAJOR CASH FLOW COMPONENTS

($ millions)	2007	2006	Change
Cash flows from operating activities of continuing operations	**$ 1,673**	$ 1,452	$ 221
Cash flows used in investing activities of continuing operations	**$ (832)**	$ (1,715)	$ 883
Cash flows used in financing activities of continuing operations	**$ (511)**	$ (70)	$ (441)

Cash Flows from Operating Activities of Continuing Operations

Cash flows from operating activities of continuing operations increased in 2007 to $1.7 billion from $1.5 billion in 2006. The change in cash flows from operating activities of continuing operations for the year was mainly due to the change in non-cash working capital due to the timing of income tax refunds relating to prior years, an increase in accounts payable and accrued liabilities and a reduction in pension funding.

Cash Flows used in Investing Activities of Continuing Operations

Cash flows used in investing activities of continuing operations in 2007 were $0.8 billion compared to $1.7 billion in 2006. The change was primarily due to a decline of $0.4 billion in capital expenditures, an increase in the proceeds from fixed asset sales, and the shorter term to maturity profile of the Company's short term investments portfolio, which resulted in less of a shift to short term investments from cash and cash equivalents, partially offset by an increase in credit card receivables, after securitization.

Capital investment amounted to $0.7 billion (2006 – $1.1 billion). Weston Foods capital investment in 2007 was $109 million (2006 – $184 million). The capital was directed toward the completion of one new plant in the United States, the Bay Shore restructuring, facility improvements and upgrades of production lines and distribution assets. Weston Foods capital investment benefited all of its operations to varying degrees and strengthened its processing and distribution capabilities.

Loblaw's capital investment amounted to $0.6 billion (2006 – $0.9 billion) for the year as Loblaw restrained capital spending in an over-spaced market. Approximately 31% (2006 – 38%) of the capital investment was for new store development, expansions and land, approximately 43% (2006 – 51%) for store conversions and remodels, and approximately 26% (2006 – 11%) for infrastructure investment. The continued capital investment activity benefited all regions to varying degrees and strengthened the existing store base. Some of the new, larger stores replaced older, smaller, less efficient stores that did not offer the broad range of products and services demanded by today's consumer.

Loblaw is investing in higher return expansions and renovations to its existing store base, with a focus on improving same-store sales. Loblaw expects to invest in 2008 an estimated $700 to $800 million in net capital expenditures. Approximately two-thirds of these funds are expected to be used in remodeling, expanding and maintaining existing stores and a small increase in square footage, with the remainder split two-thirds in upgrading information systems and one-third on supply chain infrastructure.

Loblaw's 2007 corporate and franchised store capital investment program, which includes the impact of store openings and closures, resulted in a decrease in net retail square footage of 0.2% compared to 2006. During 2007, 34 (2006 – 37) new corporate and franchised stores were opened and 73 (2006 – 147) underwent renovation or minor expansion. The 34 new stores, net of 79 (2006 – 33) store closures, including 46 stores that were closed as part of the store operations restructuring plan, and stores which underwent conversions and major expansion, decreased net retail square footage 0.1 million square feet (2006 – increased 1.2 million square feet). The 2007 average corporate store size increased 5.9% to 60,800 square feet (2006 – 57,400) and the average franchised store size increased 2.2% to 28,000 square feet (2006 – 27,400).

At year end 2007, Loblaw had committed approximately $113 million (2006 – $153 million) with respect to capital investment projects such as the construction, expansion and renovation of buildings and the purchase of real property.

During 2007, the Company also generated $244 million (2006 – $116 million) from fixed asset sales.

Cash Flows used in Financing Activities of Continuing Operations

Cash flows used in financing activities of continuing operations were $511 million in 2007 compared to $70 million in 2006.

During 2007, Weston and Loblaw completed the following financing activities:

- consolidated commercial paper outstanding was reduced by $229 million; and
- Weston issued $42 million of Series B Debentures.

During 2006, Weston and Loblaw completed the following financing activities:

- consolidated commercial paper outstanding increased by $340 million;
- Weston repaid $200 million of 5.25% Medium Term Notes ("MTN");
- Weston issued 8.0 million preferred shares, Series V for total proceeds of $194 million;
- Loblaw repaid $125 million of 8.70% Series 1996 Provigo Inc. Debenture; and
- Weston issued $40 million of Series B Debentures.

See notes 18 and 21 to the consolidated financial statements for the terms and details of the debt and share capital transactions.

In 2007, Weston renewed its Normal Course Issuer Bid ("NCIB") to purchase on the Toronto Stock Exchange or enter into equity derivatives to purchase up to 5% of its common shares outstanding. Weston did not purchase any shares under its NCIB during 2007 or 2006. The Company intends to file a NCIB in 2008 to purchase on the Toronto Stock Exchange or enter into equity derivatives to purchase up to 5% of each class of its common and preferred shares outstanding.

At the end of 2007, Weston had no preferred share or MTN prospectuses outstanding.

8.2 SOURCES OF LIQUIDITY

The Company obtains short term financing through a combination of cash generated from operating activities, cash, cash equivalents, short term investments, bank indebtedness and has limited access to commercial paper programs. Loblaw relies on cash, cash equivalents and short term investments of $977 million, a $500 million committed credit facility provided by several banks, as well as $845 million in uncommitted operating lines of credit, for its short term funding requirements. Weston relies on cash, cash equivalents and short term investments of $979 million, a $300 million committed credit facility provided by several banks, as well as $265 million in uncommitted operating lines of credit, for its short term funding requirements.

In the first quarter of 2007, Loblaw entered into the 364-day revolving committed credit facility of $500 million, provided by several banks for general corporate purposes, which matures in March 2008. At the end of the year, no amounts were drawn on the committed or uncommitted facilities. Weston's $300 million 364-day revolving committed credit facility provided by several banks will expire in May 2008. At the end of the year, $30 million was drawn on the committed facility and nil on its uncommitted facilities. Neither committed credit facility has financial covenants and borrowings are based on short term floating interest rates.

Subsequent to year end, Loblaw entered into discussions, which have not yet been finalized, with a syndicate of banks to replace its $500 million committed credit facility with a new, longer term committed credit facility of a higher amount. It is anticipated that any new credit facility will contain financial covenants and will be the primary source of Loblaw's short term funding requirements. Concurrent with these discussions, Loblaw obtained a 60-day extension of the existing facility, extending the maturity date to May 2008. The new facility is expected to close prior to the expiry of the existing facility.

Subsequent to year end, Weston also entered into discussions, which have not yet been finalized, with a syndicate of banks to replace its $300 million committed credit facility with a new, longer term committed credit facility. It is anticipated that any new credit facility will contain financial covenants and will be the primary source of Weston's short term funding requirements.

Securitization of credit card receivables provides *PC* Bank with an additional source of funds for the operation of its business. Under *PC* Bank's securitization program, a portion of the total interest in the credit card receivables is sold to independent trusts. *PC* Bank securitized an aggregate $225 million of credit card receivables during 2007 (2006 – $240 million). In the absence of securitization, Loblaw would be required to raise alternative financing by issuing additional debt or equity instruments. Further information about *PC* Bank's credit card receivables and securitization is provided in notes 1 and 12 to the consolidated financial statements and in the Off-Balance Sheet Arrangements section of this MD&A.

In 2006, *PC* Bank restructured its credit card securitization program and Eagle Credit Trust ("Eagle"), a previously established independent trust, issued $500 million of five year senior notes and subordinated notes due in 2011 at a weighted average rate of 4.5%. The restructuring of the portfolio yielded a nominal net loss.

In the normal course of business, the Company enters into certain arrangements, such as providing comfort letters to third-party lenders in connection with financing activities of certain franchisees, with no recourse liability to the Company. In addition, the Company establishes standby letters of credit used in connection with certain obligations related to the financing program for Loblaw's independent franchisees, securitization of *PC* Bank's credit card receivables, real estate transactions and benefit programs. At year end, the aggregate gross potential liability related to the Company's standby letters of credit was approximately $531 million (2006 – $552 million), a portion of which is recorded on the consolidated balance sheet, against which the Company had $628 million (2006 – $615 million) in credit facilities available to draw on.

Between the second quarter of 2007 and February 7, 2008, Loblaw's MTN, other notes and debentures ratings were downgraded twice and the commercial paper ratings once by each of Dominion Bond Rating Service ("DBRS") and Standard & Poor's ("S&P"). The following table sets out the current credit ratings of Loblaw.

	Dominion Bond Rating Service		Standard & Poor's	
Credit Ratings (Canadian Standards)	Credit Rating	Trend	Credit Rating	Outlook
Commercial paper	R-2 (high)	Stable	A-2	Negative
Medium term notes	BBB (high)	Negative	BBB	Negative
Other notes and debentures	BBB (high)	Negative	BBB	Negative

The rating organizations listed above base their credit ratings on quantitative and qualitative considerations. These credit ratings are forward-looking and intended to give an indication of the risk that Loblaw will not fulfill its obligations in a timely manner.

As a result of the DBRS downgrade of the short term credit rating, Loblaw has limited access to commercial paper. Loblaw expects it will be able to secure short term funding from other sources, primarily a new longer term committed credit facility of a higher amount.

Certain independent franchisees of Loblaw obtain financing through a structure involving independent trusts, which were created to provide loans to the independent franchisees to facilitate their purchase of inventory and fixed assets, consisting mainly of fixtures and equipment. The gross principal amount of loans issued to Loblaw's independent franchisees outstanding as of year end 2007 was $418 million (2006 – $419 million), including $153 million (2006 – $124 million) of loans payable by VIEs consolidated by Loblaw in 2007. Based on a formula, Loblaw has agreed to provide credit enhancement in the form of a standby letter of credit for the benefit of the independent funding trust equal to approximately 10% of the principal amount of the loans outstanding at any point in time, $44 million (2006 – $44 million) as of year end 2007. This credit enhancement allows the independent funding trust to provide favourable financing terms to Loblaw's independent franchisees. As well, each independent franchisee provides security to the independent funding trust for its obligations by way of a general security agreement. In the event that an independent franchisee defaults on its loan and Loblaw has not, within a specified time period, assumed the loan, or the default is not otherwise remedied, the independent funding trust shall assign the loan to Loblaw and draw upon this standby letter of credit. Loblaw has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit.

Automatic termination of the agreement can only occur if specific, predetermined events occur and are not remedied within the time periods required, including downgrades of Loblaw below a long term credit rating of "A (low)" or a short term credit rating of "R-1 (low)" as issued by DBRS. On February 7, 2008, DBRS downgraded Loblaw's long term credit rating to "BBB (high)" from "A (low)" and also lowered Loblaw's short term credit rating to "R-2 (high)" from "R-1 (low)". Subsequent to the DBRS downgrades, Loblaw was notified that an Event of Termination of the independent funding trust agreement for the Loblaw's franchisees had occurred as a result of the credit rating downgrades. The $44 million (2006 – $44 million) standby letter of credit provided to the independent funding trust by Loblaw has not been drawn upon.

To address this issue, Loblaw is currently in the process of securing alternative financing with a syndicate of banks, in the form of a 364-day committed credit facility for the benefit of its franchisees. This new financing is expected to be completed during the second quarter of 2008. Upon closing, this new alternative financing that might be arranged could result in higher financing costs to the franchisees, which in turn could adversely affect operating results. Although Loblaw anticipates that appropriate financing for the franchisees will continue to be secured in the future, any failure to do so could adversely affect Loblaw's franchise programs and may impact its operating results. In addition, any new financing structure which might be implemented would need to be reviewed to determine if there are any implications with respect to the consolidation of VIEs.

Between the second quarter of 2007 and February 12, 2008, Weston's MTN, Exchangeable Debentures, other notes and debentures and preferred share ratings were downgraded twice and the commercial paper ratings once by DBRS. Weston's MTN, other notes and debentures, preferred share and commercial paper ratings were downgraded once by S&P. The following table sets out the current credit ratings of Weston.

	Dominion Bond Rating Service		Standard & Poor's	
Credit Ratings (Canadian Standards)	Credit Rating	Trend	Credit Rating	Outlook
Commercial paper	R-2 (high)	Stable	A-2	Credit Watch with Negative Implications
Medium term notes	BBB	Stable	BBB	Credit Watch with Negative Implications
Exchangeable Debentures	BBB (low)	Stable		
Preferred shares	Pfd-3	Stable	P-3 (high)	Credit Watch with Negative Implications
Other notes and debentures	BBB	Stable	BBB	Credit Watch with Negative Implications

The rating organizations listed above base their credit ratings on quantitative and qualitative considerations. These credit ratings are forward-looking and intended to give an indication of the risk that Weston will not fulfill its obligations in a timely manner.

As a result of the DBRS downgrade of Weston's commercial paper credit rating, Weston has limited access to commercial paper. However, Weston expects to be able to secure short term funding through other sources including a new committed facility with a syndicate of banks, cash flow from operations, cash, cash equivalents and short term investments.

The Company has obtained its long term financing primarily through MTN and preferred share programs. The Company may also refinance maturing long term debt and preferred share programs with MTN if market conditions are appropriate following the refiling of a Base Shelf Prospectus or it may consider other alternatives. Weston does not have any MTN maturing in 2008.

Loblaw has obtained its long term financing primarily through a MTN program. Loblaw may also refinance maturing long term debt, including $390 million of 6.00% MTN maturing in 2008, with MTN if market conditions are appropriate following the refiling of a Base Shelf Prospectus or it may consider other alternatives.

The Company's ability to obtain funding from external sources may be restricted by further downgrades in the Company's credit ratings, should the Company's financial performance and condition deteriorate. In addition, credit and capital markets are subject to inherent global risks that may negatively affect the Company's access and ability to fund its short term and long term debt requirements. The Company mitigates these risks by actively maintaining appropriate levels of cash and cash equivalents, actively monitoring market conditions and diversifying its sources of funding and maturity profile.

8.3 CONTRACTUAL OBLIGATIONS

The following illustrates certain of the Company's significant contractual obligations and discusses other obligations as at December 31, 2007:

Summary of Contractual Obligations

	Payments due by year						
($ millions)	2008	2009	2010	2011	2012	Thereafter	Total
Long term debt[1]	$ 432	$ 399	$ 326	$ 676	$ 24	$ 3,912	$ 5,769
Operating leases[2]	222	194	168	144	121	718	1,567
Contracts for purchase of real property and capital investment projects[3]	110	4					114
Purchase obligations[4]	792	589	574	568	376	4	2,903
Total contractual obligations	$ 1,556	$ 1,186	$ 1,068	$ 1,388	$ 521	$ 4,634	$ 10,353

(1) Long term debt includes capital lease obligations and excludes Exchangeable Debentures.

(2) Represents the minimum or base rents payable. Amounts are not offset by any expected sub-lease income.

(3) These obligations include agreements for the purchase of real property and capital commitments for construction, expansion and renovation of buildings. These agreements may contain conditions that may or may not be satisfied. If the conditions are not satisfied, it is possible the Company will no longer have the obligation to proceed with the transaction.

(4) These include contractual obligations of a material amount to purchase goods or services where the contract prescribes fixed or minimum volumes to be purchased or payments to be made within a fixed period of time for a set or variable price. These are only estimates of anticipated financial commitments under these arrangements and the amount of actual payments will vary. The purchase obligations do not include purchase orders issued or agreements made in the ordinary course of business which are solely for goods which are meant for resale, nor do they include any contracts which may be terminated on relatively short notice or with insignificant cost or liability to the Company. Also excluded are purchase obligations related to commodities or commodity-like goods for which a market for resale exists.

At year end, the Company had other long term liabilities which included accrued benefit plan liability, future income tax liability, stock-based compensation liability, unrealized equity derivatives liability and accrued insurance liabilities. These long term liabilities have not been included in the table above for the following reasons:

- future payments of accrued benefit plan liability, principally post-retirement benefits, depend on when and if retirees submit claims;
- future payments of income taxes depend on the levels of taxable earnings and income tax rates;
- future payments of restricted share units depend on the market prices of Weston's and Loblaw's common shares;
- future payments related to equity derivatives depend on the market price of the Company's common shares; and
- future payments of insurance claims can extend over several years and depend on the timing of anticipated settlements and results of litigation.

8.4 OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of business, the Company enters into the following off-balance sheet arrangements:

- standby letters of credit used in connection with certain obligations mainly related to real estate transactions and benefit programs, the aggregate gross potential liability of which was approximately $221 million (2006 – $221 million) at year end;
- the securitization of a portion of *PC* Bank's credit card receivables through independent trusts; and
- guarantees.

Guarantees

The Company has entered into various guarantee agreements, including standby letters of credit in relation to the securitization of *PC* Bank's credit card receivables, third-party financing made available to the Company's independent franchisees and obligations to indemnify third parties in connection with leases, business dispositions and other transactions in the normal course of the Company's business. For a detailed description of the Company's guarantees, see note 25 to the consolidated financial statements.

Securitization of Credit Card Receivables

Loblaw, through *PC* Bank, securitizes credit card receivables through an independent trust administered by a major Canadian chartered bank and through Eagle, also an independent trust. In these securitizations, *PC* Bank sells a portion of its credit card receivables to the trusts in exchange for cash. The trusts fund these purchases by issuing debt securities in the form of asset-backed commercial paper ("ABCP") and asset-backed term notes respectively, to third-party investors. The securitizations are accounted for as asset sales only when *PC* Bank transfers control of the transferred assets and receives consideration other than beneficial interests in the transferred assets. All transactions between the trusts and *PC* Bank have been, and are expected to continue to be, accounted for as sales as contemplated by Canadian GAAP, specifically Accounting Guideline ("AcG") 12, "Transfers of Receivables". As *PC* Bank does not control or exercise any measure of influence over the trusts, the financial results of the trusts have not been included in the Company's consolidated financial statements.

When *PC* Bank sells credit card receivables to the trusts, it no longer has access to the receivables but continues to maintain credit card customer account relationships, and certain servicing and administrative responsibilities. *PC* Bank does not receive a servicing fee from the trusts for its servicing responsibilities and accordingly, a servicing obligation is recorded. When a sale occurs, *PC* Bank retains rights to future cash flows after obligations to the investors in the trusts have been met, which is considered to be a retained interest. The ABCP issuing trust's recourse to *PC* Bank's assets is limited to *PC* Bank's retained interests and is further supported through a standby letter of credit provided by a major Canadian chartered bank for 9% (2006 – 9%) on a portion of the securitized amount. This standby letter of credit could be drawn upon in the event of a major decline in the income flow from, or in the value of, the securitized credit card receivables. Loblaw has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. The subordinated notes issued by Eagle provide credit support to those notes which are more senior. Effective January 1, 2007, the retained interests are recorded at fair value.

As at year end 2007, the total amount of securitized credit card receivables outstanding which *PC* Bank continues to service was $1.5 billion (2006 – $1.3 billion) and the associated retained interests amounted to $8 million (2006 – $5 million). The standby letter of credit supporting a portion of these securitized receivables amounted to approximately $89 million (2006 – $68 million). During 2007, *PC* Bank received income of $141 million (2006 – $114 million) in securitization revenue from the independent trusts relating to the securitized credit card receivables. In the absence of securitization, Loblaw would be required to raise alternative financing by issuing debt or equity instruments. Further disclosure regarding this arrangement is provided in notes 12 and 25 to the consolidated financial statements.

Independent Funding Trust

Certain independent franchisees of Loblaw obtain financing through a structure involving independent trusts, which were created to provide loans to the independent franchisees to facilitate their purchase of inventory and fixed assets, consisting mainly of fixtures and equipment. These trusts are administered by a major Canadian chartered bank. The independent funding trust within the structure finances its activities through the issuance of short term ABCP to third-party investors. The independent funding trust has a global style liquidity agreement from a major Canadian chartered bank in the event that it is unable to issue short term ABCP. The gross principal amount of loans issued to Loblaw's independent franchisees outstanding as of year end 2007 was $418 million (2006 – $419 million) including $153 million (2006 – $124 million) of loans payable by VIEs consolidated by the Company in 2007. Based on a formula, Loblaw has agreed to provide credit enhancement in the form of a standby letter of credit for the benefit of the independent funding trust equal to approximately 10% of the principal amount of the loans outstanding at any point in time, $44 million (2006 – $44 million) as of year end 2007. This credit enhancement allows the independent funding trust to provide favourable financing terms to Loblaw's independent franchisees. As well, each independent franchisee provides security to the independent funding trust for its obligations by way of a general security agreement. In the event that an independent franchisee defaults on its loan and Loblaw has not, within a specified time period, assumed the loan, or the default is not otherwise remedied, the independent funding trust shall assign the loan to Loblaw and draw upon this standby letter of credit. Loblaw has agreed to reimburse the issuing bank for any amount drawn on the standby letter of credit. As a result of implementing Section 3855, "Financial Instruments – Recognition and Measurement" ("Section 3855") (see note 2 to the consolidated financial statements), a liability of $7 million related to the fair value of this standby letter of credit was recognized.

Neither the independent funding trust nor Loblaw can voluntarily terminate the agreement prior to December 2009, and following that date only upon six months' prior notice. Automatic termination of the agreement can only occur if specific, predetermined events occur and are not remedied within the time periods required including downgrades of Loblaw below a long term credit rating of "A (low)" or a short term credit rating of "R-1 (low)" as issued by DBRS. On February 7, 2008, DBRS downgraded Loblaw's long term credit rating to "BBB (high)" from "A (low)" and also lowered Loblaw's short term credit rating to "R-2 (high)" from "R-1 (low)".

Subsequent to the DBRS downgrades, Loblaw was notified that an Event of Termination of the independent funding trust agreement for the Loblaw's franchisees had occurred as a result of the credit rating downgrades. The $44 million standby letter of credit provided to the independent funding trust by Loblaw has not been drawn upon.

If such an event were to occur, long term debt in the amount of $126 million would need to be reclassified to short term liabilities. This amount relates to certain franchisees that are VIEs that Loblaw currently consolidates. Loblaw is currently in the process of securing alternative financing with a syndicate of banks, in the form of a 364-day committed credit facility for the benefit of its franchisees to address this issue. Any new alternative financing structure which may be implemented would need to be reviewed to determine if there are any implications with respect to the consolidation of VIEs.

8.5 DERIVATIVE INSTRUMENTS

Commencing January 1, 2007, the Company adopted accounting standards which impacted the recognition, measurement, disclosure and presentation of its derivative instruments. With the adoption of these standards, all financial derivative instruments are accounted for on the Company's balance sheet at fair value. In addition, non-financial derivative instruments are recorded at fair value on the consolidated balance sheet unless they are exempt from this treatment based upon expected purchase, sale or usage requirements. Prior to January 1, 2007, interest rate swaps which were designated within a hedging relationship were not recorded on the balance sheet. In addition, embedded derivative and certain non-financial derivative instruments were also not recorded. For a detailed description of the Company's derivative instruments and the related accounting policies, see notes 1, 2 and 24 to the consolidated financial statements.