CT- 2001/003

THE COMPETITION TRIBUNAL

IN THE MATTER OF an application by the Commissioner of Competition for a Consent Order pursuant to sections 92 and 105 of the *Competition Act*, R.S.C. 1985, c. C-34 (as amended);

AND IN THE MATTER OF the acquisition of a majority share of Chapters Inc. by Trilogy Retail Enterprises L.P. and the proposed merger of Indigo Books & Music Inc. and Chapters Inc. and their respective affiliates, Indigo Online Inc. and Chapters Online Inc.;

BETWEEN:

THE COMMISSIONER OF COMPETITION

Applicant

- AND -

**TRILOGY RETAIL ENTERPRISES L.P.
CHAPTERS INC.
AND INDIGO BOOKS & MUSIC INC.**

Respondents

CONSENT ORDER IMPACT STATEMENT

I. INTRODUCTION

1. The Commissioner of Competition (the "Commissioner") files this statement pursuant to section 77 of the *Competition Tribunal Rules*. This statement describes the circumstances surrounding the Draft Consent Order ("DCO") and its anticipated effect on competition.

2. The DCO is submitted by the Commissioner with the consent of the respondents, Trilogy Retail Enterprises L.P. (“Trilogy”), Chapters Inc. (“Chapters”) and Indigo Books & Music Inc. (“Indigo”) (collectively, “the Respondents”). Though the Respondents do not agree with all the facts alleged and the Respondents do not admit the nature or degree of the substantial lessening or prevention of competition in this matter as alleged by the Commissioner, the Respondents do not contest this consent order impact statement for the purposes of this application or of any proceeding relating to the DCO, including an application to vary or rescind the order pursuant to section 106 of the *Competition Act,* R.S.C. 1985, c C-34 (the *“Act”*).

II. <u>NATURE AND PURPOSE OF PROCEEDING</u>

3. The Commissioner files this Consent Order Impact Statement, a Notice of Application, a Statement of Grounds and Material Facts and a DCO pursuant to sections 92 and 105 of the *Act*.

4. The DCO is designed to remove the substantial lessening or prevention of competition that, in the absence of the DCO, would be likely to arise in the market for the national distribution of English-language trade books from publishers to booksellers and the local distribution of English-language trade books from booksellers to consumers. The Commissioner respectfully requests that the Competition Tribunal approve the DCO pursuant to sections 92 and 105 of the *Act*, in order to require the Respondents to offer for sale 13 large-format stores (“superstores”) and 10 small-format stores located in shopping malls (“mall stores”), certain online assets, certain tradenames and a distribution facility, and to commit to certain minimum acceptable terms of trade with suppliers in order to avoid the substantial lessening or prevention of competition arising from the Merger.

III. CIRCUMSTANCES GIVING RISE TO THE LIKELY IMPACT ON COMPETITION

5. On February 1, 2001, Trilogy became Chapters' controlling shareholder. Trilogy proposes to merge Indigo and Chapters (collectively referred to as the "Merger").

6. Chapters and Indigo are, by far, the largest superstore chains in Canada and the only two book superstore chains which could be said to be operating in multiple regions. The Commissioner's concerns, as described more fully in the Statement of Grounds and Material Facts, are the effects of the Merger on the downstream supply to consumers of English-language trade books and the upstream exercise of market power in relation to publishers of English-language trade books.

7. Chapters operates a total of 77 superstores and 231 mall stores throughout Canada and is the majority owner of Chapters Online, one of two major Canadian online book distributors.

8. Indigo operates a total of 15 superstores: one in British Columbia, three in Alberta, ten in Ontario and one in Quebec. Indigo operates Indigo Online, the only other major Canadian online book distributor.

9. Based upon the factors listed in the Statement of Grounds and Material Facts, including the merged entity's high post-Merger market share, the high barriers to entry, the legislative barriers to foreign competition, and the removal of Indigo as a vigorous and effective competitor, the Commissioner has concluded that the Merger prevents or lessens, or is likely to prevent or lessen, competition substantially in the supply of English-language trade books in markets throughout Canada.

IV. DRAFT CONSENT ORDER

10. The DCO provides for a combination of structural and behavioural obligations to be assumed by the Respondents. The DCO provides for the divestiture of nine superstores and ten mall stores operated by Chapters and four superstores operated by Indigo. Specifically, the DCO provides for the divestiture of: two Chapters superstores in the Vancouver area; one Chapters superstore in Calgary; one Indigo superstore in Edmonton; three Chapters superstores in the Greater Toronto Area (the "GTA"); two Indigo superstores in the GTA; six Chapters mall stores in the GTA; one Chapters superstore in Oakville; one Chapters superstore in Belleville; one Indigo superstore in Kingston; one Chapters mall store in Ottawa; one Chapters superstore in the Montreal area; and three Chapters mall stores in the Montreal area.

11. The Respondents will offer for sale, to any *bona fide* prospective purchaser, all rights, title and interest of whatever character in Indigo Online, including any leasehold interest in equipment, software and portal agreements that the Respondents or any of their affiliates may own in respect of Indigo Online; provided, however, that Indigo Online's tradename, intellectual property rights, brand specific content and customer lists are not required to be offered for sale.

12. The Respondents will offer for sale, to any prospective purchaser, Indigo's distribution facility, located at 6160 Kenway Drive, Mississauga, as long as Indigo has possession of it.

13. The Respondents will offer, to any single purchaser of some or all of the assets, all rights, title and interest of whatever character in one of the following tradenames: "Classic Books", "Prospero" and "SmithBooks".

14. Pursuant to the DCO, during an initial sales period, the Respondents shall use their reasonable best efforts to complete the required divestitures for use as a going concern. Inventory may either be included in the divestiture, and sold at acquisition cost, or returned to the Respondents, at the discretion of the purchaser.

15. The divestitures shall be completed by sale, assignment of lease or sublease, assignment of contract, or other disposition which ensures that, on the completion of the divestiture, the Respondents do not retain directly or indirectly any right, title, control, interest, liability or obligations in respect of the divested assets, other than obligations in respect of any representation, warranties and covenants included in any agreement between any of the Respondents and any purchaser(s) of such assets.

16. The assets will be offered for sale to one or more arm's length purchaser(s) who will use the assets for the same purpose as such assets were used prior to the divestiture, unless the Commissioner consents otherwise.

17. If the Respondents do not complete the divestitures within the initial sales period, a trustee will be appointed to complete the divestitures. At this point, the trustee shall have the full power and authority to complete the divestitures and shall use all reasonable best efforts to do so. The Respondents shall use their reasonable best efforts to assist the trustee.

18. During the period in which the assets are offered for sale by the Respondents or the trustee, the Respondents shall maintain the assets to be sold and the management of the assets will be overseen by a Monitor appointed by the Commissioner.

19. For the five-year term of the DCO, the Respondents will not acquire (by ownership or operating arrangements) a retail bookstore outlet in any shopping centre or mall in which it already has an outlet. If, post-Merger, the Respondents have more than one such outlet, they will reduce, by closure or sale, to one outlet with reasonable expedition

(expected to approximate 30 months), subject to commercial feasibility including no cost of termination of the shorter of the two leases in question. Where the Respondents have an outlet in a shopping centre or mall but wish to open another outlet in the same shopping centre or mall, they shall be permitted to do so but only if they close the pre-existing outlet.

20. Where the Respondents have a retail book outlet in a shopping centre or a mall and are protected by a restrictive covenant precluding any further retail book outlets, the Respondents will not enforce or rely on the covenant insofar as it relates to outlets with less than 3,000 square feet of space. Further, during the term of the DCO, the Respondents shall not renew or enter into new such restrictive covenants in respect of any outlets with less than 8,000 square feet of space.

21. Except as otherwise permitted by the DCO or with the Commissioner's consent, the Parties will open no new retail book outlets in any location in Canada for a period of two years from the date of the Consent Order.

22. Pursuant to the DCO, the Respondents will forthwith adopt certain prescribed minimum acceptable terms of trade with its trade book suppliers. Any and all disputes arising out of or relating to these terms of trade shall be exclusively and finally settled by arbitration pursuant to the DCO.

23. Chapters has expressed its intention to exit the business of third-party wholesaling of books. Pursuant to the DCO, any proposal by the Respondents to re-enter the business of third party wholesaling or distribution of trade books to unrelated entities in Canada, will be subject to notice by the parties and review by the Commissioner.

V. <u>ANTICIPATED IMPACT OF THE PROPOSED REMEDY</u>

24. The divestiture of thirteen superstores and ten mall stores approximates Indigo's pre-Merger retail presence and overall size, in terms of trade book sales and store performance. In fiscal year 2001, the revenue from the sale of English-language trade books by the stores in the divestiture package was approximately 96% of that generated by Indigo's existing fifteen stores. The store contribution (EBITDA) of the stores in the divestiture package was approximately 156% of that of Indigo's chain. Consideration was given to the level of maturity of individual stores and of the store chain to determine the appropriate store contribution figure. Indigo's fifteen stores are, overall, less mature and, therefore, potentially offer more room for growth than the stores within the divestiture package; therefore, the higher store contribution figure for the divested stores is seen as appropriate. Consideration was also given to the fact that two stores in the Indigo chain were not open for the full fiscal year 2001. This meant that *pro forma* estimates were necessary for certain EBITDA calculations.

25. Individual stores were also chosen on the basis of Indigo's pre-Merger geographic representation and likely expansion. In Vancouver, Indigo had one superstore with plans to build another. The divestiture package includes two superstores in the Vancouver area. In Calgary, Indigo had two superstores. Calgary is considered, by the Respondents, to be a saturated market. The divestiture package includes one superstore in Calgary. The divestiture package includes Indigo's one superstore in Edmonton. In the GTA, Indigo had nine superstores. The GTA is considered, by the Respondents, to be a saturated market. The divestiture package includes six superstores and six mall stores in the GTA. The divestiture package includes Indigo's one superstore in Kingston. In the Montreal area, Indigo had one superstore. The divestiture package includes one superstore and three mall stores in the Montreal area.

26. The divestiture package also includes one superstore in Belleville and one mall store in Ottawa, where Indigo had no locations. Consideration was given to creating

economies of scale and scope associated with multi-store operations. A multi-store enterprise is better positioned to enter or make a credible threat to enter additional geographic markets. A prospective entrant can realize regional efficiencies, through cost-effective distribution and economies of scale and scope, with a multi-store chain operating within the GTA - Montreal corridor.

27. The divestiture of mall stores should help a prospective entrant achieve additional economies of scale and scope. The divestiture of mall stores also accommodates the flexibility of a new entrant with respect to mode of entry.

28. It is anticipated that the divested stores will encourage competition at the retail level with respect to price, discounts, selection, service, loyalty programs and price of loyalty cards.

29. The offer to sell certain online assets allows a purchaser, at its discretion, the opportunity to become an online retailer in support of their “bricks and mortar” presence. Online capabilities may position a purchaser to become a more viable and widespread new entrant.

30. The offer to sell a distribution facility may provide a potential purchaser, at its discretion, the opportunity to improve regional efficiencies and to support its retail presence. Ownership of a distribution facility may position a purchaser to become a more viable entrant. However, a distribution centre is not necessarily required for a retail bookseller of the scale of Indigo.

31. A purchaser will have the option of acquiring important brand equity through the divestiture of the tradenames, "Classic Books", "Prospero" or "SmithBooks". The brand equity associated with the above-noted tradenames will assist in overcoming certain reputational barriers to entry and will help position any purchaser to become a more viable new entrant.

32. Growth restrictions on the merged entity will lower the barriers to entry and expansion by the purchaser(s) and existing players. The merged entity will also be prohibited from opening new stores for a period of two years absent the Commissioner's consent. Thus, new entrants will be reassured that the merged entity will not open stores in close proximity during the first two years of their existence.

33. The removal of certain restrictive covenants will increase the likelihood of entry in malls by independent booksellers. Chapters already occupies a dominant position in the mall format.

34. As concerns the upstream market, the proposed divestiture package aims to restore an alternative for suppliers of English-language trade books. Accordingly, the divestitures will help constrain the merged entity's ability to exercise market power with respect to publishers.

35. In addition to the divestitures, the proposed trade terms will assist in addressing the merged entity's exercise of market power with respect to publishers. Prior to the Merger, publishers experienced delayed payments, pressure for increased supplier discounts and onerously high return rates.

36. The proposed trade terms between the Respondents and their suppliers are intended to set minimum acceptable parameters with respect to key terms of trade including payment periods, discounts and returns.

37. The trade terms have a self-enforcing arbitration mechanism to resolve any issues which may arise between the merged entity and its suppliers. An appeal lies from the decision of the arbitrator on questions of law alone to the Ontario Superior Court of Justice. An appeal lies from the decision of the Ontario Superior Court of Justice to the Court of Appeal for Ontario, with leave, and to the Supreme Court of Canada, with leave. In no circumstances shall the matters of terms of trade revert to the Competition Tribunal. All other provisions of the DCO are within the jurisdiction of the Tribunal.

38. Chapters' market power with respect to publishers was exacerbated by its ownership of Pegasus, a third-party wholesaling business. For this reason, the Commissioner will review any proposal, by the Respondents, to re-enter this business.

VI. ALTERNATIVE TO SETTLEMENT

39. The alternative to the settlement proposed through the DCO would be to proceed with a contested hearing of the Commissioner's challenge to the Merger as it relates to the supply of English-language trade books throughout Canada. The Commissioner has accepted the DCO for two reasons: first, the proposed remedies will, in the Commissioner's view, avoid the substantial prevention or lessening of competition arising from the Merger; and, second, the DCO provides a more timely and certain outcome than litigated proceedings. Rapid implementation will provide timely relief to the book industry and to consumers.

VII. CONCLUSION

40. For the reasons set forth above, the Commissioner recommends the settlement found in the DCO and respectfully requests that the Tribunal approve the DCO.