



CANADIAN DAIRY COMMISSION **ANNUAL REPORT** 2002–2003



Canadian Dairy
Commission

Commission
canadienne du lait



Canada

Mission of the Canadian Dairy Commission

Under the *Canadian Dairy Commission Act*, the CDC's legislated objectives are:

- to provide efficient producers of milk and cream with the opportunity to obtain a fair return for their labour and investment; and
- to provide consumers of dairy products with a continuous and adequate supply of dairy products of high quality.

Commission staff is available to serve you, in either official language, from 8:00 a.m. to 4:30 p.m. eastern time, Monday to Friday (statutory holidays excluded).

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The CDC wishes to express its gratitude to Joel Verdurmen and family, Dutcan Farms, for their kindness in allowing us to take photographs of their farm.

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LETTER TO THE MINISTER

Mr. Minister,

We are pleased to submit the Canadian Dairy Commission's Annual Report for the 2002-2003 dairy year. In this 37th year of operation, we pursued our goals to strengthen the industry and achieve harmonized dairy policies to maintain a viable Canadian dairy sector.

The year 2002-2003 was a diverse year for our industry. In December 2002, the decision of the World Trade Organization Appellate Body concerning Canada's export system for its dairy products was a disappointment. It had major impacts for the Canadian Dairy Commission (CDC), as well as the industry. These include the need to re-regulate the production of all milk in the country; important reductions in the quantity of dairy products that Canada is allowed to export; and the need to operate an even tighter supply management system, coupled with the search for new outlets for the structural surplus of solids non fat created by this system. We anticipate the changes brought about by this World Trade Organization (WTO) ruling will be felt for some time into the new dairy year.

Conversely, domestic market growth has been strong in this dairy year. Since August 2002, the Market Sharing Quota (MSQ) for industrial milk was increased by 6.8 percent to satisfy domestic demand for dairy products. MSQ as of July 31st 2003 stands at 48.7 million hectolitres. Growth was especially noticeable in the case of yogurt, cheese, and ice cream.



Last December, the CDC announced a relatively large increase in support prices for butter and skim milk powder. This increase was a significant step in the CDC's commitment to gradually increase support prices with an objective of covering the cost of production of 50 percent of Canadian dairy farmers by 2006. The increase was not well received by the industry. Producers, in particular, held a demonstration in Ottawa to express the opinion that this increase was not large enough. Since then, discussions have been initiated with producers and other stakeholders in order to prepare the next review of support prices. In the coming months, the CDC will facilitate a dialogue between producers and processors on the timing and frequency of support price adjustments.

Following the consultation that we held last year with industry stakeholders, we organized a formal workshop to initiate a constructive dialogue between dairy producers and processors. We are happy to report that approximately 40 representatives from the industry participated in this workshop and agreed to work together to promote the growth of the industry. Another workshop will take place in October 2003.

The market for dairy ingredients in food products is important. Under the Special Milk Class Permit Program, 4.3 million hectolitres of milk were used to make dairy ingredients for products such as frozen entrées, soups, baked goods and confectionery products.

To promote increased utilization of Canadian dairy ingredients in manufactured products, the CDC is pursuing the activities that were planned in its Dairy Ingredient Marketing Program. This year, the CDC increased the existing array of services that are available to further processors who use, or wish to use, milk ingredients in manufactured food products.

The Canadian Milk Supply Management Committee (CMSMC) continued its work to achieve greater harmonization of policies. The Committee held important discussions related to the responsibility for surplus removal and alternative ways to dispose of the structural surplus.

We would like to recognize the hard work and dedication of our staff in contributing to the achievement of the CDC's objectives. We also want to express our appreciation for the co-operation we receive from industry stakeholders, provincial governments, and our colleagues at Agriculture and Agri-Food Canada.

Thank you for your ongoing support for the work of the Commission.

Original signed by:

John Core
Chairman

Louis Balcaen
Vice-chairman

Carl Harrison
Commissioner

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INDUSTRY

Key Highlights of 2002-2003

The Canadian dairy industry operates on a “dairy year” basis, which runs from August 1 to July 31.

The dairy industry in Canada has made some great strides over the last year and can be proud of the progress achieved during the 2002-2003 dairy year. Some of the key highlights include:

- the intensification of the dialogue between dairy farmers and processors;
- the adjustments made to the Canadian dairy export system in order to conform to the World Trade Organization decision taken in December 2002;
- a growth of the domestic demand for the sixth consecutive year.

Milk Production

Farm cash receipts

As a key contributor to the Canadian economy in the 2002 calendar year, the dairy industry ranked fourth behind meats, grains and oilseeds, and horticulture generating \$4.1 billion in total farm cash receipts.

Number of farms and production per farm

In the 2002-2003 dairy year, Canada had 17,890 dairy farms. Although there has been a decline in the number of dairy farms in Canada, the individual farming units have grown in size and have increased their efficiency. The average production per farm in the 2002-2003 dairy year was 4,390 hectolitres, an 11 percent increase from the previous year.

In the 2002-2003 dairy year, Quebec and Ontario had the greatest number of dairy farms at 81 percent, followed by 13 percent in the Western provinces and 6 percent in the Atlantic provinces.

NUMBER OF FARMS, COWS AND TOTAL PRODUCTION*

1998-1999 to 2002-2003

	Number of farms	Number of cows (millions)	Total production (million hl)
1998-1999	21,561	1.16	79.5
1999-2000	20,576	1.10	78.6
2000-2001	19,363	1.09	78.1
2001-2002	18,673	1.08	78.3
2002-2003	17,890	1.08	78.6

* At 3.6 kg of butterfat per hectolitre.

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In 2002, there were 1.08 million dairy cows in Canada producing an average of 9,511 kilograms of milk per cow.

NUMBER OF MILK AND CREAM FARMS IN 2002-2003

	Cream	Milk	Total
Newfoundland and Labrador	0	41	41
Prince Edward Island	12	304	316
Nova Scotia	0	345	345
New Brunswick	0	302	302
Quebec	0	8,502	8,502
Ontario	102	5,911	6,013
Manitoba	6	577	583
Saskatchewan	0	318	318
Alberta	1	819	820
British Columbia	0	691	691
TOTAL	121	17,769	17,890

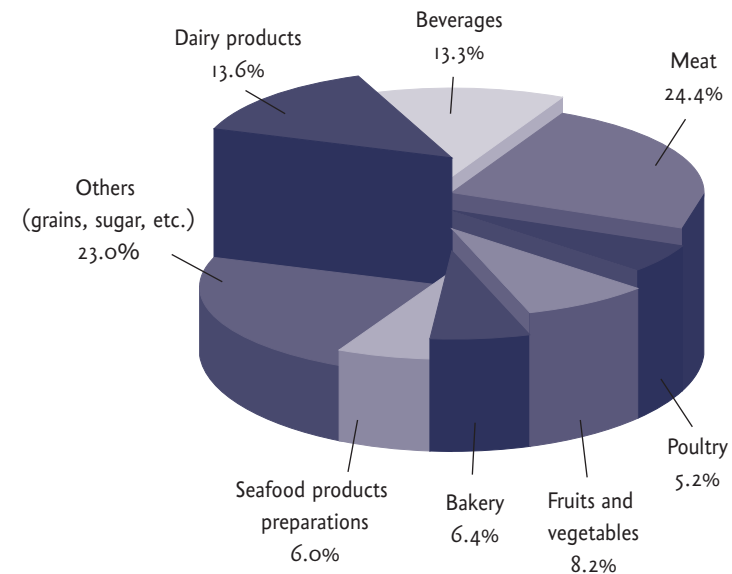
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Milk Processing

In the 2002 calendar year, the processing industry generated \$9.9 billion* worth of products shipped from approximately 292 processing plants accounting for 13.6 percent of all processing sales in the food and beverage industry. During the 2002-2003 dairy year, the dairy processing sector employed approximately 26,000 people.

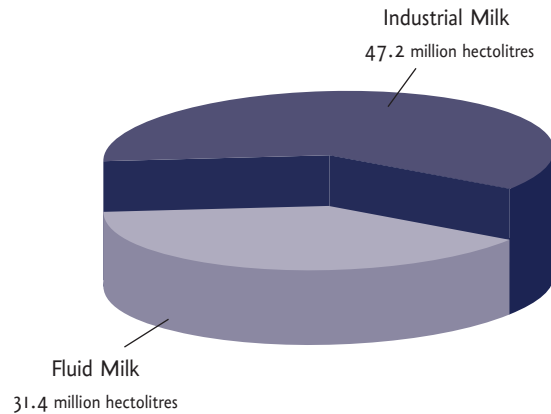
**Based on the North American Industry Classification System prepared by Statistics Canada.*

SHARE OF MANUFACTURED SHIPMENTS IN CANADA – VALUE BASIS (2002)



INDUSTRY

INDUSTRIAL AND FLUID MILK PRODUCTION 2002-2003



Milk Markets

Canadian dairy producers supply two main markets:

- fluid milk, including flavoured milks and creams; and,
- industrial milk used to make products such as butter, cheese, yogurt, ice cream and milk powders.

In the 2002-2003 dairy year, the fluid market accounted for approximately 40 percent of total producer shipments of milk, or 31.4 million hectolitres*. The industrial market accounted for the remaining 60 percent or 47.2 million hectolitres* of total producer shipments.

* At 3.6 kilograms of butterfat per hectolitre.

Ingredients Market

The use of dairy products as ingredients in finished food products and other goods continues to be an important sector in terms of real growth and innovation. The use of dairy products such as cheese, yogurt, cream and skim milk powder in frozen pizza or entrées, baked soups, and salad dressings are a few examples. The “food on the go” sector which includes meal replacement beverages or bars, portable soups, and snack foods also shows real promise in terms of the potential for increased use of milk fat and protein-rich dairy ingredients. The slow but steady emergence of Canadian-produced organic skim milk used in the manufacture of organic bakery and other products is a smaller niche market but a new outlet for solids non fat.

The CDC, in its marketing efforts, is placing particular emphasis on these food sectors which show the most potential in terms of increased utilization of dairy ingredients.

Harmonized Milk Classification System

Provincial marketing boards and agencies purchase milk from producers and sell it to processors for the manufacture of dairy products. The milk produced in Canada is sold to processors through a Harmonized Milk Classification System for the manufacture of products according to the five classes of milk listed on the following page:

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HARMONIZED MILK CLASSIFICATION SYSTEM

Classes	Products	Milk End Use (2002-2003)	
		ooo kg butterfat	% of total milk
Class 1	a) fluid milks	83,116	29
	b) fluid creams		
	c) milk-based beverages		
	d) fluid milks for the Yukon, Nunavut and Northwest Territories (these markets are supplied by British Columbia and Alberta)		
Class 2	yogurt, sour cream and ice cream	22,731	8
Class 3	a) specialty cheeses	44,173	16
	b) cheddar cheese	49,986	18
Class 4	a) butter, butteroil, powders and concentrated milk for ingredient purposes	56,310	20
	b) concentrated milk for retail	7,297	3
	c) new products for the domestic market	(b, c, d, m)	
	d) inventories and losses		
	m) marginal markets		
Class 5	a) cheese ingredients for further processing for the domestic and export markets	15,420	5
	b) all other dairy products for further processing for the domestic and export markets	(a, b, c)	
	c) domestic and export activities of the confectionery sector		
	d) planned exports and other exports, the total of which shall not exceed Canada's WTO commitments	3,156	1
TOTAL		282,189	100

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COMMISSION

Corporate Governance

The Canadian Dairy Commission (CDC) is a Crown corporation created in 1966 through the *Canadian Dairy Commission Act*. The Commission reports to Parliament through the Minister of Agriculture and Agri-Food to whom it serves as an important advisor on matters related to the dairy industry.

Presently, the federal government funds almost half of the CDC's administrative costs. The other costs, including the CDC's marketing activities, are funded by dairy producers and the marketplace. The CDC supports the interests of all dairy stakeholders — producers, processors, further processors, exporters, consumers and governments.

The Canadian Dairy Commission is comprised of three Commissioners appointed by Governor in Council for a renewable mandate of three years.

Chairman and C.E.O.

John Core *Appointed in October 2002*

Mr. Core holds a Masters degree from the University of Guelph. He was a lecturer at Ridgetown College in Ontario at the beginning of his career. He then owned and operated a dairy and cash crop farm in Lambton County, Ontario, with his brothers. During his dairy farming years, Mr. Core was a board member for Dairy Farmers of Ontario from 1981 to 2001. He chaired this organization from 1990 to 2001. He was also a member of the board of Dairy Farmers of Canada from 1986 to 2001, and was the organization's President between 1999 and 2001.

Vice Chairman

Louis Balcaen *Appointed in October 2000 (third mandate)*

Born in Manitoba, Mr. Balcaen has devoted a great deal of time and energy to the dairy industry over the past 30 years. Prior to joining the Commission, he was a member of the Manitoba Milk Producers since 1979 and served as its Chairman for seven years. He is also a past President of Dairy Farmers of Canada.

Over the years, Mr. Balcaen has served on the executives of numerous organizations and committees, such as the Task Force on National Dairy Policy, the Consultation Committee on the Future of the Dairy Industry, the Dairy Industry Strategic Planning Committee, and the federal government's Task Force on Orderly Marketing.



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After the departure of the previous Chairman, Mr. Louis Balcaen acted as the CDC's Chairman between June and October 2002, until a new Chairman was appointed, as specified in the *Canadian Dairy Commission Act*.

Commissioner

Carl Harrison *Appointed in December 2000*

Prior to being appointed to the Commission, Mr. Harrison was a Director of the Ontario Dairy Processors Council, a founding Director of the Ontario Dairy Council (ODC) and also served as ODC President. In addition, Mr. Harrison has many years of service with the National Dairy Council of Canada, serving as Director from 1973 until 1998, as a member of their Executive Committee from 1994 until 1997, and was the organization's Chairman in 1996-1997.

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The CDC Commissioners are authorized and governed by the *Canadian Dairy Commission Act* and the *Financial Administration Act*. The Commissioners provide leadership and supervision of the CDC's activities in the best interest of the Commission. They also ensure that a good accounting mechanism exists for the funds provided by the Government of Canada and the industry. The Commissioners have many years of experience in the dairy industry and their diverse backgrounds bring a balanced approach to satisfying the often conflicting objectives of the industry's stakeholders.

As part of their overall stewardship, the Commissioners:

- establish and approve the strategic direction, Corporate Plan, and budgets, with input from senior management;
- approve the financial statements and annual report audited by the Auditor General of Canada;
- ensure that proper accountability exists through the performance of internal audits and evaluations of CDC systems, practices and programs;
- report on CDC activities related to the legislated mandate (the *Canadian Dairy Commission Act*) and serving the industry, and present the related financial statements to the CMSMC at least four times a year; and
- receive and act upon the Special Examination report of the Auditor General, carried out every 5 years.

Special initiatives in the past year include:

- a forum to obtain input from producers and processors into future strategic directions of the Commission;
- the creation of a program evaluation framework;

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Canadian Dairy Commission Structure



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- a review of the funding from government and stakeholders compared to the related expenses to ensure appropriate allocation and accountability to each group;
- four internal Audit/Evaluation Advisory Committee meetings to review audit and evaluation plans and discuss results of the work performed as well as action plans to address the issues identified; and
- a Threat Risk Assessment of the security over information technology operations.

The Commissioners meet on a monthly basis to establish the strategic orientation of the CDC. They have established a management team composed of the Senior Director, Policy and Corporate Affairs, the Senior Director, Finance and Operations, and the Director of Audit to be responsible for the day-to-day operations in consultation with the Chairman.

The Commission's offices are located in Ottawa, Ontario. The Commission employs approximately 60 people.

The success of the Canadian Dairy Commission depends largely on its human resources as well as on the pursuit of excellence in the services offered. The CDC continually implements programs and internal initiatives that are aimed at encouraging and supporting good individual and organizational performances.

Activities and Programs

Main Activities

As a national facilitator and chief administrator, the CDC undertakes a number of activities and programs:

- Through its chairmanship and work for the Canadian Milk Supply Management Committee (CMSMC), the CDC provides ongoing support to the Canadian dairy industry while operating in close co-operation with provincial stakeholders and provincial governments;
- It acts as a facilitator and provides secretariat services to the revenue pooling and market sharing systems. Provisions for these functions are set out in the All Milk Pooling Agreement (P5), the Western Milk Pooling Agreement (WMP), and the Comprehensive Agreement on Pooling of Milk Revenues. The CDC also administers the financial mechanisms required by these agreements;
- It calculates and makes a recommendation to the CMSMC on the level of the national production target for industrial milk, or Market Sharing Quota;
- It has the authority to purchase, store, process, or sell dairy products on the domestic or export market, within Canada's World Trade Organization (WTO) commitments. The CDC manages also the imports of tariff rate quota butter for the industry;

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- The Commission establishes support prices at which it will purchase butter and skim milk powder. These support prices are used as references by provinces to establish prices for milk used to manufacture products such as butter, cheese, and ice cream;
- It administers the Special Milk Class Permit Program and issues permits to further processors for purposes of obtaining access to competitively-priced dairy ingredients, and to exporters for the export of dairy products within Canada's WTO commitment levels;
- It develops and implements marketing programs and services aimed at encouraging further processors to maintain or increase their use of dairy ingredients in their various operations. These activities are guided by the objectives set out in the Dairy Ingredient Marketing Program.
- The CDC carries out internal audits of its systems and practices as well as external audits, which are in large part performed on companies participating in the Special Milk Class Permit Program; and
- It acts as a facilitator in advancing the harmonization of plant audit procedures in the industry.

Programs in Detail

National Dairy Policy

Canada's supply management system for the dairy industry is the foundation of current policies in this sector. Supply management in dairy was adopted in the mid 1970s and is used to manage and administer the supply of milk used to make products like butter, cheese and yogurt.

In this context, the role of the Canadian Dairy Commission is to act as a facilitator within the various forums that are involved in dairy policy such as the Canadian Milk Supply Management Committee (CMSMC).

The CMSMC is a permanent body created by the provincial signatories to the National Milk Marketing Plan (NMMP). Its mandate is to determine policies and to supervise the provisions of the NMMP as well as the Comprehensive Agreement on Pooling of Milk Revenues. The National Milk Marketing Plan is a federal/provincial agreement that governs the supply management system for dairy in Canada. The CMSMC is chaired by the Commission and has representation from dairy producers, processors and governments from all provinces. National dairy producer and consumer representatives also participate on the committee as non-voting members.



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PRODUCTION OF INDUSTRIAL MILK AND CREAM*

(thousands of kg of butterfat)

	2000-2001	2001-2002	2002-2003
Newfoundland and Labrador	n/a	57	81
Prince Edward Island	3,041	3,088	3,060
Nova Scotia	2,099	2,332	2,404
New Brunswick	2,094	2,158	2,129
Quebec	83,117	81,835	81,802
Ontario	49,267	50,420	50,251
Manitoba	6,467	6,394	6,438
Saskatchewan	5,728	5,516	5,224
Alberta	9,285	9,400	9,695
British Columbia	8,440	8,769	8,840
TOTAL	169,538	169,969	169,924

* Before pooling

Production and Demand

The Commission monitors trends in Canadian Requirements (demand) and production (supply) on a monthly basis. Canadian Requirements are defined as total domestic consumer demand plus planned exports for industrial dairy products. Production includes all production of industrial milk and cream within supply management.

In the 2002-2003 dairy year, Canadian Requirements were 48.8 million hectolitres, a 5.6 percent increase over the previous dairy year. During the same period, industrial milk and cream production totalled 47.2 million hectolitres, which is the same level as the previous dairy year.

Production in the last year was lower than expected. This is due in part to a long heat wave that affected Québec and Ontario during the summer. These two provinces also adopted in the spring some restrictive quota policies that resulted in lower production. Exceptionally, this lower production was coupled with a strong demand throughout the year. The industry therefore had to draw on its stocks to meet consumer demand. Furthermore, a small quantity of cheese was imported using supplementary import permits to ensure adequate supplies in the domestic market.

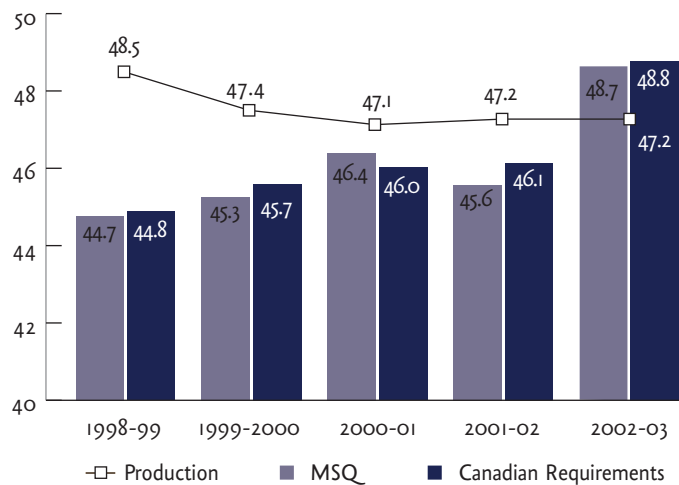
Market Sharing Quota

On a regular basis, the CMSMC reviews the national production target for industrial milk, called the Market Sharing Quota (MSQ). The MSQ is based on Canadian Requirements and includes a growth allowance to prevent shortages. This target is constantly monitored and, when necessary, adjusted to reflect changes in the domestic demand for industrial milk products, as well as changes in planned export activity. The objective is to minimize the possibility of shortages or surpluses on the domestic market.

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MSQ at July 31, 2003 was 48.7 million hectolitres. For the 2002-2003 dairy year, industrial milk and cream production was less than the Market Sharing Quota by 1.5 million hectolitres.

INDUSTRIAL MILK PRODUCTION, CANADIAN REQUIREMENTS AND MSQ (MILLION HL)



PROVINCIAL SHARES OF MSQ*

July 31, 2003

	Butterfat (thousand kg)	Milk (million hl)	%
Newfoundland and Labrador	180	0.05	0.1
Prince Edward Island	3,151	0.875	1.8
Nova Scotia	2,040	0.567	1.2
New Brunswick	2,159	0.600	1.2
Quebec	81,277	22.577	46.3
Ontario	55,760	15.489	31.8
Manitoba	6,260	1.739	3.6
Saskatchewan	4,306	1.196	2.5
Alberta	11,007	3.058	6.3
British Columbia	9,203	2.556	5.2
TOTAL	175,343	48.707	100.0

* Base MSQ before sharing of markets

Even if the supply of milk is carefully managed throughout the year, surpluses can occur due to fluctuations in milk production or demand. These are managed by adjusting the Market Sharing Quota, stocks, or by exporting surpluses, within Canada's trade commitments. Surpluses are managed through the Surplus Removal Program, with revenues from these activities being returned to producers through pooling.

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Pooling of Producer Returns

For dairy producers, pooling agreements are a good tool to manage the financial risks associated with the evolution of the domestic market. In its role as a national industry facilitator, the Canadian Dairy Commission administers these pooling arrangements on behalf of the dairy industry.

Comprehensive Agreement on Pooling of Milk Revenues

Under the Special Milk Class Pricing and Pooling Program implemented in August 1995, industrial milk is made available for use in dairy products and products containing dairy ingredients at competitive prices that vary according to end use. The Comprehensive Agreement on Pooling of Milk Revenues provides a means for the market returns from the sale of milk to processors for Special Class purposes to be shared among all dairy producers.

Agreement on All Milk Pooling (P5)

Since August 1996, the Agreement on All Milk Pooling has provided a means for revenues from all milk sales (fluid and industrial), transportation costs, along with responsibility for skim-off to be pooled among dairy producers in Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island.

Last year, the CDC assisted the province of Newfoundland and Labrador in the preparation of a proposal to become a member of this pool in its own right. The province of Manitoba, with the agreement of the other members, withdrew from the pool as of February 1st, 2003. During the same period, the P5 adopted a new Harmonized Transportation

Cost Model, which must now be implemented. Members of this pool, through a special committee, reached an agreement on a fluid milk price increase for February 2003. Discussions are now ongoing concerning the implementation of a pricing formula for fluid milk.

Western Milk Pooling Agreement (WMP)

In March 1997, the four Western provinces (Manitoba, Saskatchewan, Alberta and British Columbia) also implemented an all milk pooling system. In the last year, the Western Milk Pool members continued to refine their agreement for handling surplus milk with Saputo, one of the main dairy processors in Western Canada. Members of the pool are also developing a similar agreement with Parmalat in Manitoba. Biosecurity, promotion and quota management were discussed to try to harmonize policies and improve the industry. A visioning conference was held in Kananaskis, Alberta, last fall. For all those projects, the CDC provided information and advice to the pool and ensured that follow-up action was taken.

POOLS IN NUMBERS 2002-2003

	Fluid milk produced (million hl)	Industrial milk produced (million hl)	Blend price to producer at 3.6 kg/hl butterfat*
All Milk Pool (P5)**	22.0	38.8	\$59.84/hl
Western Milk Pool	9.1	8.4	\$63.89/hl

* In quota milk

** Newfoundland and Labrador is not a member

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Special Milk Class Permit Program

The Special Milk Class Permit Program was created and implemented on August 1, 1995 in order to allow processors, exporters and further processors to remain competitive on international and domestic markets. Through this system, milk components are made available for use in dairy products and products containing dairy ingredients at competitive prices that vary according to their end use.

Processors, exporters and further processors can access certain quantities of dairy components through permits issued by the Canadian Dairy Commission. There are three types of permits. The first type (permit 5(a), 5(b) or 5(c)) is a permit issued to further processors who use dairy products as ingredients.

The second type of permit (permit 5(d)) is issued to exporters for individual transactions. The exporters' permit specifies the maximum quantity of dairy products that may be exported according to the volume of milk identified as available for export. Permits are issued under Class 5(d) for the volume of milk covered under planned exports incorporated into MSQ, as well as other exports, the total of which falls within Canada's WTO commitment levels.

The third type of permit is issued under Class 4(m). Surplus milk under this class is sold for animal feed and other similar uses.

Further processors used the equivalent of 4.3 million hectolitres of milk in the 2002-2003 dairy year. A total of 998 permits were issued this year for Classes 5(a), (b) and (c), the majority of which were Class 5(b) permits. The number of businesses participating in the program rose to 801 in 2002-2003, up from 773 in the previous year.

SPECIAL MILK CLASS PERMIT PROGRAM

Volume (in million hl) of Milk Sold and Producers' Average Revenues*

Class		1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
5(a)	Volume	0.912	1.517	1.791	1.633	1.881
	Price	\$44.25	\$37.34	\$35.63	\$45.55	\$33.29
5(b)	Volume	0.875	1.452	1.221	0.728	1.042
	Price	\$43.30	\$38.95	\$42.94	\$42.67	\$35.19
5(c)	Volume	1.152	1.033	1.053	1.344	1.361
	Price	\$33.13	\$33.69	\$31.97	\$30.09	\$29.97
TOTAL	VOLUME	2.939	4.002	4.065	3.705	4.283
	PRICE	\$39.63	\$36.74	\$36.16	\$39.42	\$32.71

*Volumes and prices are calculated on a standard hectolitre basis at 3.6 kg of butterfat per hl.

Note: Some data have changed from the previous Annual Report because of changes in the compositional standards of milk.

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Pricing

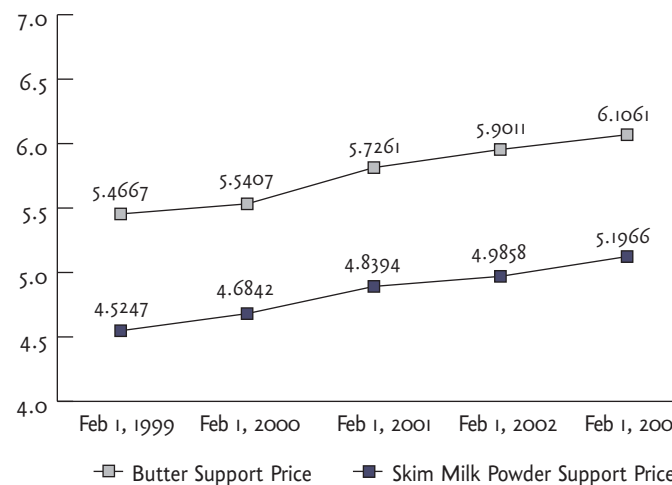
Each year, the CDC reviews and establishes support prices for butter and skim milk powder. These prices are used by the CDC when purchasing or selling dairy products. As well, the support prices serve as a reference for agencies and provincial milk marketing boards when they establish prices paid by the processors.

Two elements of the CDC's mission are taken into account in the pricing decision: providing efficient producers with an adequate return on their labour and investment; and providing Canadian consumers with an adequate supply of high quality dairy products.

The pricing decision announced by the CDC in December 2002 was effective on February 1, 2003. The support price for skim milk powder rose from \$4.9858 to \$5.1966 per kilogram, and for butter from \$5.9011 to \$6.1061 per kilogram. Last year, the CDC committed to cover the cost of production of 50 percent of dairy farmers by 2006. The December 2002 decision was an important step in fulfilling this commitment. The views of dairy industry stakeholders were also carefully examined before making this decision.

These higher support prices were expected to provide dairy farmers with an increase of \$2.36 per hectolitre on the price paid for industrial milk. This represents an increase of 3.9 percent.

SUPPORT PRICES FOR BUTTER AND SKIM MILK POWDER FROM 1999 TO 2003 (\$ PER KG)



Imports of Dairy Products

Under the terms of the 1995 WTO Agreement, Canada has established Tariff Rate Quotas (TRQ) for a number of dairy products. With the support of the industry, the CDC has acted as the first receiver of imports of butter under federal permit since 1995 and has directed this product through butter manufacturers to the further processing sector.

This year, the Tariff Rate Quota for butter remained at 3,274 tonnes. Of this, approximately two thirds is a country allocation to New Zealand, amounting to 2,000 tonnes.

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Domestic Dairy Product Innovation Program

The Domestic Dairy Product Innovation Program (DDPIP) encourages the manufacture of new and innovative products on the domestic market. It makes provision for the addition of specific volumes of milk to provincial quotas to ensure that the supply needed to produce an innovative product is available to a successful applicant. Accordingly, the DDPIP allows for a certain amount of flexibility within the national supply management system.

During the 2002-2003 dairy year, Canadian firms in Quebec, Ontario, Alberta and British Columbia used approximately 25.1 million litres of milk under the DDPIP. In 2001-2002, the total was 22.1 million. The maximum utilization limit was established at 1 percent of the MSQ, which is approximately 48 million litres.

This year, the Selection Committee has received 20 applications compared to four during the previous year. Following the trend, most applications concerned new specialty cheeses. Of the 20 applications received, two applications met the program criteria and were accepted, eight were rejected and 10 require additional information before a decision can be reached.

The Selection Committee also suggested to the CMSMC to request a program evaluation in order to identify the changes that could be necessary for the continuation of the program. The evaluation will be conducted by the CDC during the next year.

Dairy Ingredient Marketing Program

The purpose of this Program is to increase the visibility and utilization of dairy ingredients in the Canadian further processing sector, with an emphasis on finished products such as baked goods, confectionery and nutraceutical products. Once again this year, the CDC sponsored two seminars for the benefit of processors, further processors and distributors at the Guelph Food Technology Centre in Ontario and at Agriculture and Agri-Food Canada's Food Research and Development Centre in Saint-Hyacinthe, Quebec. The CDC also took part in three industry trade shows in Vancouver, Toronto and Halifax.



THE CANADIAN DAIRY

At the same time, the CDC continued to develop and update the content and services associated with the MILKingredients.ca Web site, which has now grown to over 14,000 visits a month. This site offers a wide range of technical and business information, for the benefit of current and potential dairy ingredient users. Also the CDC finalized the details of a new program aimed at providing financial assistance to companies seeking technical advice and support in the reformulation of their further processed products for the purpose of incorporating or significantly increasing the use of Canadian dairy ingredients. The Milk Ingredients Technical Support Program will be launched in August 2003.

Domestic Seasonality Programs

Milk production fluctuates on a seasonal basis. It is highest in the spring when cows tend to produce more milk, while in the fall and winter months, production may drop slightly. Conversely, demand for dairy products such as butter and cheese is highest in the fall and early winter months, decreasing slightly in January. In most years, this leads to demand being higher than supply for a brief period in the winter.

Domestic Seasonality Programs allow the industry to balance the seasonal demand and supply of dairy products. The industry has mandated the CDC to operate these programs, in cooperation with the private sector.

Carrying charges associated with the CDC's Domestic Seasonality Programs for butter and skim milk powder totalled \$2.90 million in 2002-2003. In order to defray the costs associated with storing the normal levels of butter stocks, an amount is collected from consumers by the Commission through pooling arrangements and is adjusted as required to correspond to the actual costs associated with these stocks. This amount remained at \$ 0.08 per hectolitre of industrial milk during the 2002-2003 dairy year.

Storage Programs

Butter

The CDC holds butter in storage throughout the year. The Canadian Milk Supply Management Committee set a target of 11 million kilograms of butter at the beginning of the 2002-2003 dairy year, referred to as the normal butter inventories. These stocks are considered necessary to ensure that the domestic market has a constant supply throughout the year.

COMMISSION

The total stock of butter is an indicator to the industry of possible surpluses or shortages of butterfat in the marketplace. This information is used to assess whether production quotas should be adjusted and indicates the need to manage surpluses. In the past few years, butter produced in the domestic market has, in large part, been consumed in Canada and exports have been infrequent.

Milk Powders

The CDC operates a program for the storage of specialty types of milk powders. It encourages manufacturers to make these products when the supply of milk is plentiful and minimizes the demand for fresh milk to make these products in the fall when milk production is usually low. Stocks held under this program act to balance the supply and demand of non-fat milk solids.

Concentrated Milk Assistance Program

The Concentrated Milk Assistance Program (CMAP) is used to encourage the production of evaporated and sweetened condensed milk during the period of the year when milk supply is abundant. Unlike the other Domestic Seasonality Programs where the CDC actually purchases and sells the products, the CMAP is a financial assistance program to compensate manufacturers for the carrying charges associated with additional product storage time.

Inventories

The Commission began the 2002-2003 dairy year with 15.71 million kilograms of butter and 9.15 million kilograms of skim milk powder in

inventory. During the year, the CDC purchased 17.38 million kilograms of butter and 36.17 million kilograms of skim milk powder. Sales of 23.77 million kilograms of butter and 43.04 million kilograms of skim milk powder left respective closing inventories of 9.32 and 2.28 million kilograms as of July 31, 2003 (butter statistics include imports and butteroil).

Surplus Removal Program

The CDC administers a Surplus Removal Program (SRP) on the industry's behalf. The program is designed to minimize the manufacture of products for exports when unfulfilled domestic opportunities exist. The program ensures that milk that is surplus to the domestic market is removed in the appropriate region and in a timely fashion.

The Milk Management Committee has the authority to direct the CDC in operating the SRP. This Committee is comprised of representatives from the production and processing sectors at the provincial and national levels. It assesses market conditions and the milk production situation for the purpose of determining when surplus removal activities are required and the quantity of milk that the CDC is authorized to remove from the marketplace.

Exports

During the dairy year 2002-2003, the majority of dairy products exports were performed by the private sector. The main role of the CDC was to dispose of the skim milk powder structural surplus.

THE CANADIAN DAIRY

During the dairy year 2002-2003, the CDC exported 40.0 million kg of skim milk powder. The CDC also exported a small quantity of butter (0.4 million kg) which was committed the previous year.

In regard to cheese exports, the CDC's major responsibility is to deliver certificates to Canadian exporters that give them access to the aged cheddar market in the European Union. In 1980, Canada negotiated a special access quota with the European Union. The current access level is 4,000 tonnes, which allows Canada to continue to market its finest aged cheddar to the United Kingdom. Consumers in the UK have been enjoying this famous Canadian product for over a century.

All this volume, as well as the exports associated with the S(d) permits issued by the CDC to trading companies are accounted for against Canada's export commitments to the WTO.

Audit

In terms of audit, the CDC has a dual accountability:

- to the Government of Canada, given that the CDC is a Crown corporation; and,
- to dairy industry stakeholders, in light of the programs administered by the CDC on their behalf.

Internal Audits

As mandated by the *Financial Administration Act*, internal audits must be carried out on the systems, practices and programs of the Commission. An internal audit committee, comprised of managers and chaired by a Commissioner, reviews audit priorities and develops an annual, as well as a five-year audit plan.

The CDC auditors work with management in order to ensure that operations are carried out economically, efficiently and effectively. They also co-operate with the Office of the Auditor General of Canada during its annual audit by providing relevant reports and information on CDC practices.

During the 2002-2003 dairy year, more emphasis was placed on the follow-up to recommendations contained in prior internal audit reports. This resulted in the development of new procedures for loan and banking operations as well as for foreign exchange hedging activity. A major audit on financial and management accounting reviewed the adequacy of reporting and suggested enhancements to the management accounting information available. These enhancements should result in better accountability and decision-making and ensure compliance with the Financial Information Strategy of the government.

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External Audits

External audits are, in large part, performed on companies participating in the Special Milk Class Permit Program. During the 2002-2003 dairy year, 41 companies were audited, resulting in claims of \$361,000, which were returned to Canadian dairy producers. Risk assessment is used to identify high risk companies among the close to eight hundred companies that generated \$212 million in revenue under the program during the year.

The CDC also establishes mandates and reviews the work contracted with professional audit firms in each province. This provides assurance on the reliability of revenues reported to the Commission within the national pools. In cooperation with provincial milk plant auditors,

the CDC developed a national Milk Utilization Plant Audit Manual, establishing a set of minimum audit standards to be followed in the performance of milk plant audits. This contributes to the application of uniform audit methods across the country.

In addition, the CDC performed milk plant utilization audits in Prince Edward Island and Newfoundland and Labrador on a cost-recovery basis. The CDC is also assisting the provinces in completing the audits of the commercial export milk (CEM) program, for which no exports were permitted beyond July 31, 2003. The CDC's role is critical in ensuring that similar audit procedures are consistently applied across various provinces. It is particularly important in this case as major processors operate in several provinces and their CEM projects generally impacted more than one province.



PERFORMANCE AND



GOALS

Achievements for 2002–2003

The goals set by the Canadian Dairy Commission (CDC) for the last period, along with a brief summary of the status of achievement of each goal, are described below.

1. In collaboration with producer and processor groups, coordinate and facilitate an open dialogue between the two sectors to foster a common vision, identify goals for the Canadian dairy industry, and establish a comprehensive means of communication.

As a first step, the CDC shared with all sectors of the dairy industry, the information gathered in a consultation tour undertaken by the Commissioners in the spring of 2002. These consultations have uncovered a desire on the part of producers and processors to work together to generate an integrated response to some of the challenges facing the industry. The CDC therefore organized a formal workshop in March 2003 to pursue these common interests. Close to 40 representatives from producer and processor organizations participated in the event. Participants agreed to work together on certain issues that affect the industry. A Steering Committee is ensuring the follow-up and the CDC will provide leadership and support during the course of the next steps.

2. Continue to co-ordinate and facilitate efforts to refine and harmonize Canada's milk marketing and pooling systems administered by the Canadian Dairy Commission.

At the national level, the East-West price difference and certain milk classification issues requiring harmonization were at the forefront.

The CDC was asked to act as a facilitator and key player in the discussions of committees set up to address these issues. Progress was made on reducing the price gap between the East and West for certain classes of milk and the classification of heavy cream is almost resolved.

In the past year, the CDC assisted the Province of Newfoundland and Labrador to initiate the preparation of a proposal to become a full member of the Eastern All Milk Pool. A new transportation cost model has also been agreed to by this pool, and must now be implemented. A meeting was held in July with the signatories of this milk pool to agree on the orientation of certain outstanding issues. The province of Manitoba, with the agreement of the other members, withdrew from the pool as of February 1st, 2003.

The CDC was instrumental in the organization of a visioning conference held by the members of the Western Milk Pool in November 2002.

PERFORMANCE AND

3. Continue to implement and co-ordinate an audit system that will ensure that Canada's obligations under international trade agreements are being respected, and that the integrity of the domestic market is protected.

This year, the CDC continued to carefully track the volume of subsidized exports and to provide the Department of Foreign Affairs and International Trade (DFAIT) with data to fulfill its international reporting requirements. The Commission continues to consult with DFAIT in order to ensure that policies and procedures are compatible with the World Trade Organization (WTO) and comply with Ministerial Directions.

In collaboration with provinces, minimum audit standards were set and ongoing monitoring of timeliness of audit work was established as part of this initiative. This helps to ensure the accountability over all milk, thereby contributing to the protection of the integrity of the domestic market.

The CDC agreed to perform audits on the plant use of milk in Newfoundland and Labrador as well as in Prince Edward Island, on a cost-recovery basis. This further advances the initiative of harmonization of audit procedures across the country.

4. Increase administrative efficiencies through better use of electronic information technology, the planning of employee training, and the implementation of an evaluation plan.

A Threat Risk Assessment, required to deal with security over information processed at the CDC, was performed and the final report was received in July 2003. It includes a review of information technology security. In addition, various procedures and measures were implemented to improve the security related to the CDC offices on the Central Experimental Farm in Ottawa.

Human Resources Services developed generic training programs to raise employee awareness about building a respectful workplace, access to information and document management. General training on the new electronic document management system was also organized. The CDC's Intranet site was entirely redesigned to allow better access to information services for all employees.

The CDC began a series of program evaluation studies in July 2002. The studies are being conducted on a priority basis, as laid out in the Evaluation Framework. An evaluation plan for the Special Milk Class Permit Program has been approved and the Dairy Ingredient Marketing Program evaluation is complete. As a result of this evaluation, the CDC plans to commit the resources necessary to strengthen its efforts in the following areas: industry seminars, support programs, technical services and program promotion. The Domestic Dairy Product Innovation Program will also be evaluated in the coming year at the request of the CMSMC.

GOALS

5. In cooperation with provinces, governments and industry, support the work to defend any challenges of the Canadian milk marketing system before a WTO Compliance Panel and ensure that Canada's system of dairy exports is in compliance with the international trade agreements.

Over the course of the summer and fall of 2002, the CDC was involved in defending the Canadian dairy export system before a WTO Appellate Body, following a complaint launched by the U.S. and New Zealand. Canada lost the appeal and this WTO decision will have major impacts on the Canadian dairy industry.

In addition, the CDC continued to rigorously track all subsidized exports to ensure that Canada's WTO budgetary outlay and quantity reduction commitment levels were met. The CDC, in cooperation with industry stakeholders and the provinces, monitored domestic supply and demand balances, as well as quota management policies, to tightly match supply with demand on the domestic market.

6. Continue the implementation of the initiatives called for in the Dairy Ingredient Marketing Program.

In its efforts to increase the visibility and utilization of dairy ingredients in further processing, the CDC continued to implement the initiatives contained in the Dairy Ingredient Marketing Program. The CDC sponsored two seminars on dairy ingredients used in further processing and participated in three industry trade shows.

In consultation with industry partners, the CDC developed a training and education fund in support of further processors and dairy ingredient

distributors seeking to improve their knowledge and expertise in the use of dairy products. The CDC also developed a technical assistance fund that will provide expertise and financial support to further processors seeking to incorporate dairy ingredients in food formulations and/or significantly increase their dairy content.

7. Facilitate a dialogue within the dairy industry to further the goals of the Agriculture Policy Framework (APF).

During 2002-2003, the CDC participated in several meetings aimed at fine-tuning and explaining the various facets of the APF. Most of these meetings were organized by the Agriculture and Agri-Food Portfolio Coordination Secretariat.

The CDC Chairman participated in two one-day retreats for Portfolio Heads. Discussions on how to ensure better collaboration between the various agencies of the Agriculture Portfolio were held during those days.

Outlook

Most of the trends and issues that the Canadian dairy industry is facing have not changed significantly in the last year. The disposal of the structural surplus, the replacement of Canadian dairy ingredients by foreign dairy ingredients or non-dairy ingredients in food products and the consolidation in the retail sector are still providing challenges to this industry. Furthermore, a national organization for processors has still not emerged.

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Some progress has been accomplished in the area of cooperation between producers and processors. However, much remains to be done. The industry has agreed that the CDC continue to facilitate upcoming discussions and provide leadership and technical expertise.

In December 2002, the WTO ruled against Canada in its dispute with New Zealand and the U.S. concerning the export of dairy products. The decision of the WTO Appellate Body was that Canada's domestic pricing system constituted an export subsidy and therefore, all Canadian exports of dairy products made from milk produced on farms holding domestic quota were considered subsidized and were submitted to the limits imposed by the WTO.

The decision of the WTO Appellate Body had a significant impact on the activities of the CDC and the industry as a whole. It requires policy adjustments that might be the largest since 1995.

In order to comply with previous WTO rulings, Canada had developed two parallel milk marketing systems: one for the domestic market and the planned export market, where production was controlled through quotas at the farm level, and another for private export markets, where quotas were not necessary (commercial export milk and cream). Under the private export system, farmers would contract with processors for milk supply through bulletin boards or directly, without going through their provincial marketing boards.

Following the latest WTO decision, the export contract system had to be dismantled. Provinces have re-regulated the production of all milk. This means that all the milk that is now produced in Canada must

be sold by the farmers to their respective provincial marketing board. The federal legislation is also in the process of being amended to ensure that all milk production is regulated.

Since Canada's exporting capacity is greatly reduced, the production of milk for the domestic market has to be monitored very closely. The disposal of milk in excess of domestic requirements will be more difficult. Producers will have to exercise more discipline in managing their quota. New measures will have to be put in place to reduce variations in production and better synchronize supply and demand. The Commission will support the CMSMC as these measures are proposed, evaluated, chosen and implemented.

Similarly, Canada's traditional opportunities for structural surplus exports of skim milk powder are greatly reduced. New ways will have to be found in order to dispose of this surplus on the domestic market.

WTO negotiations are continuing. In the past, the CDC has contributed to the support of the Canadian negotiating team and will continue to do so during the current Doha round of negotiations. The results of this round of negotiations might have further impacts on the dairy industry and on the activities of the CDC.

Given that Canada's potential to grow the market for its dairy product exports has been limited by the last WTO ruling, the dairy industry has to turn toward the domestic market for growth. According to the CDC Act, the CDC can "undertake and assist in the promotion of the use of dairy products, (...)". In recent years, the CDC's involvement

GOALS



in this area of activities has been increasing through the Dairy Ingredient Marketing Program. This evolution will continue.

CDC management and employees are regularly looking for ways to provide programs and services in the most efficient way. In order to provide improvements on the administrative front, program evaluations will continue and important planning will be done in the area of human resources.

Goals for the Period 2003-2004 to 2007-2008

The following goals are derived from the above outlook on the industry and its forecasted impact on the CDC.

1. In collaboration with producer and processor groups, coordinate and facilitate an open dialogue between the two sectors to foster a common vision, identify goals for the Canadian dairy industry, and establish a comprehensive means of communication.
2. Facilitate the changes required in the Canadian dairy industry as a result of the World Trade Organization (WTO) ruling concerning the exports of Canadian dairy products and provide support to the Canadian negotiating team in the current round of WTO negotiations.
3. Encourage consumption of dairy products and the use of Canadian dairy ingredients through promotion, market research, and technical support.
4. Achieve administrative efficiencies through the continuous improvement of administration and management practices.

FINANCIAL STATEMENTS



Management Responsibility for Financial Statements

The financial statements of the Canadian Dairy Commission and all information in this Annual Report are the responsibility of management. Those statements have been prepared in accordance with Canadian generally accepted accounting principles, using management's best estimates and judgements where appropriate. Financial information presented elsewhere in the Annual Report is consistent with the statements provided.

In discharging its responsibility for financial reporting, management maintains and relies on financial and management control systems and practices designed to provide reasonable assurance that transactions are authorized, assets are safeguarded, and proper records are maintained. These controls and practices ensure the orderly conduct of business, the accuracy of accounting records, the timely preparation of reliable financial information and the adherence to Commission policies and statutory requirements. The process includes management's annual communication to employees of Treasury Board's guidelines on conflict of interest and code of conduct.

The Audit Committee of the Canadian Dairy Commission, made up of the Commissioners, oversees management's responsibilities for maintaining adequate control systems and the quality of financial reporting. The Commission's internal and external auditors have free access to the Audit Committee to discuss the results of their work and to express their concerns and opinions.

The transactions and financial statements of the Commission have been audited by the Auditor General of Canada, the independent auditor for the Government of Canada.

Original signed by:

John Core, Chairman

Gaëtan Paquette, Senior Director, Finance and Operations

Ottawa, Canada

September 26, 2003

FINANCIAL STATEMENTS

Management's Discussion and Analysis of Financial Conditions and Results of Operation

for the year ending July 31, 2003

The following discussion and analysis of the operating results and financial position of the Canadian Dairy Commission (CDC) for the year ending July 31, 2003 should be read in conjunction with the financial statements of the Commission enclosed herein and the Annual Report.

SELECTED KEY RESULTS OF OPERATIONS

In thousands

	Fiscal 2003	Fiscal 2002
Total sales	\$231,319	\$262,051
Total cost of sales	\$212,038	\$265,929
Results of operations after funding by the Government of Canada	\$19,555	\$(9,508)
Surplus at year end	\$32,440	\$15,132
Inventory on hand at year end	\$67,041	\$102,237

On export activities

Sales

Total export sales revenue is 32 percent lower than the previous year as a result of several factors. Increased demand by the Canadian market combined with less over-quota milk production reduced the need for exporting products surplus to domestic requirements. In addition, lower pricing on the world market, particularly during the early part of the dairy year, contributed to lower overall sales revenues. During

the year, the strengthening Canadian dollar reduced the return on transactions denominated in US dollars which constitute a large portion of the Commission's export sales.

Cost of sales

The CDC purchases surplus dairy products destined for export at prices that reflect prevailing world market conditions at the time with the intent of breaking even over the course of a given dairy year. As this market is very difficult to predict, the CDC often finishes the dairy year with gains or losses that reflect this pricing uncertainty.

For the dairy year ending July 31, 2003, unanticipated rising sales prices on the world market combined with purchase prices set at breakeven levels for export operations prior to this rise, generated a gain of \$2.4 million. In contrast, export operations in the dairy year ending July 31, 2002 resulted in a loss of \$10.1 million. That year, the CDC experienced a rapid fall in world market prices for sales of dairy products in comparison to the purchase prices which had been established earlier, anticipating stable export prices.

Carrying charges

In comparison with the previous dairy year, the CDC's carrying charges for inventory decreased substantially. On average, inventory quantities were lower than last year. This resulted in a direct reduction of storage and handling costs over the same period the year before. The continued drop in interest rates combined with shorter holding periods have permitted the CDC to reduce its year over year loan balance and related interest expense compared to the previous year.

On domestic activities

Sales

Domestic sales quantities of Plan A butter doubled as compared to the previous year. Greater quantities of Plan A were necessary to supply the domestic market mainly during the fall period when milk production was significantly lower than the market requirements. The average sale prices as well as the quantity sold in the other domestic product categories remained relatively similar to the previous year.

Cost of sales

At year end July 31, 2002 the CDC had butter in its inventory which had been bought at world prices with the intention of being exported, as a result of surplus butterfat on the Canadian market during the previous dairy year. During the 2002-2003 dairy year, demand increased resulting in a revised forecast for domestic requirements predicting a shortage of domestic butter. The CDC, using its discretion, redirected the butter destined for export to the domestic market. This butter was sold at the domestic price while having been purchased at the world price. This operation generated a profit.

Carrying charges

As was the case with export activities, the products sold on the domestic market benefited from substantial reductions in carrying charges.

Administrative expenses

Total administrative expenses have decreased by 7 percent as compared to the previous year. This performance is attributable to lower salary costs and other administrative efficiencies.

Challenges for the Future

The WTO's decision in December 2002 on Canada's Commercial Export Milk (CEM) programs will require tighter management of production in order to minimize surpluses in the domestic market. New initiatives have been taken to more tightly match supply with demand and reduce the potential amount of surplus milk.

There remains the challenge, however, of finding ways to dispose of surplus skim milk powder in new domestic markets or in novel ways of incorporating solids non fat in products such as blends.

The Commission has to use, to the best of its advantage, various export product categories under WTO so that Canada uses its allowed subsidized export value in each category.

The Commission has enhanced its system for tracking export activities in order to fully control the quantities of subsidized exports made by the industry and will assist in ensuring, on an ongoing basis, that the WTO commitments are not exceeded.

FINANCIAL STATEMENTS

Auditor's Report

To the Minister of Agriculture and Agri-Food

I have audited the balance sheet of the Canadian Dairy Commission as at July 31, 2003 and the statement of costs funded by the Government of Canada, and the statements of operations and surplus and cash flows for the year then ended. These financial statements are the responsibility of the Commission's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Commission as at July 31, 2003 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles. As required by the *Financial Administration Act*, I report that, in my opinion, these principles have been applied on a basis consistent with that of the preceding year.

Further, in my opinion, the transactions of the Commission that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part X of the *Financial Administration Act* and regulations, the *Canadian Dairy Commission Act* and regulations, the *Directions to the Canadian Dairy Commission (Export Dairy Products)* and the by-laws of the Commission.

Original signed by:

Sheila Fraser, FCA
Auditor General of Canada

Ottawa, Canada
September 26, 2003

FINANCIAL STATEMENTS

Balance Sheet

as at July 31, 2003

(in thousands)

	2003	2002
Assets		
Cash	\$ 17	\$ 957
Accounts receivable		
Trade (Note 3)	12,500	8,465
Due from provincial milk marketing boards and agencies	20,091	18,090
Prepaid expenses - promotional activities	2,053	—
Inventories (Note 4)	67,041	102,237
	\$ 101,702	\$ 129,749
Liabilities		
Bank indebtedness - pooling account (Note 5)	\$ 734	\$ —
Accounts payable and accrued liabilities		
Trade	18,593	11,597
Other liabilities	3,067	3,810
Due to provincial milk marketing boards and agencies	18,166	17,799
Loans from the Government of Canada (Note 6)	28,702	81,411
	69,262	114,617
Surplus (Note 8)	32,440	15,132
	\$ 101,702	\$ 129,749

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Commitments (Note 11)

Approved:

Original signed

by: John Core

 Chairman

Louis Balcaen

Vice-Chairman

Gaëtan Paquette

Senior Director, Finance and Operations

The accompanying notes and schedule are an integral part of these financial statements.

Statement of Costs Funded by the Government of Canada

for the year ended July 31, 2003

(in thousands)

	2003	2002
Administrative expenses	\$ 3,599	\$ 2,873
Costs of production data collection	300	300
Subsidies to producers of industrial milk and cream	—	16,197
Total costs funded by the Government of Canada (Note 9)	\$ 3,899	\$ 19,370

The accompanying notes and schedule are an integral part of these financial statements.

FINANCIAL STATEMENTS

Statement of Operations and Surplus

for the year ended July 31, 2003

(in thousands)

	2003	2002
Export sales	\$ 85,040	\$ 125,503
Cost of sales	82,620	135,633
Margin (loss) on export sales	2,420	(10,130)
Domestic sales	146,279	136,548
Cost of sales	129,418	130,296
Margin on domestic sales	16,861	6,252
Total margin (loss) on sales	19,281	(3,878)
Pooling of market returns activities		
Contributions from provincial marketing boards and agencies	105,359	122,877
Equalization payments to provincial marketing boards and agencies	98,329	115,421
Contributions withheld to fund operating expenses	7,030	7,456
Results before net operating expenses	26,311	3,578
Operating expenses (Schedule of Operations by Product)	10,355	15,959
less: funding of operating expenses by the Government of Canada	3,599	2,873
Net operating expenses after funding by the Government of Canada	6,756	13,086
Results of operations after funding by the Government of Canada	19,555	(9,508)
Surplus at beginning of year	15,132	26,768
Refund of surplus to producers	2,247	2,128
Surplus at end of year	\$ 32,440	\$ 15,132

The accompanying notes and schedule are an integral part of these financial statements.

Statement of Cash Flows

for the year ended July 31, 2003

(in thousands)

	2003	2002
Cash flows from operating activities		
Cash receipts from customers	\$ 227,284	\$ 267,028
Cash paid to suppliers and others	(182,271)	(277,556)
Cash receipts from provincial milk marketing boards and agencies	103,414	127,063
Cash paid to provincial milk marketing boards and agencies	(98,018)	(118,612)
Cash receipts from the Government of Canada	3,899	27,895
Subsidies paid to producers of industrial milk and cream	—	(24,722)
Interest paid on loans from the Government of Canada	(1,026)	(1,923)
Cash flows from (used in) operating activities	53,282	(827)
Cash flows from financing activities		
New loans from the Government of Canada	78,710	196,812
Loan repayments to the Government of Canada	(131,419)	(193,924)
Cash paid to refund surplus to producers	(2,247)	(2,128)
Cash flows from (used in) financing activities	(54,956)	760
Net decrease in cash	(1,674)	(67)
Cash at beginning of year	957	1,024
Cash (net bank indebtedness) at end of year	\$ (717)	\$ 957
Components:		
Cash	\$ 17	\$ 957
Bank indebtedness - pooling account	(734)	—
	\$ (717)	\$ 957

The accompanying notes and schedule are an integral part of these financial statements.

Notes to Financial Statements

July 31, 2003

1. The Commission

The Canadian Dairy Commission (the “Commission”) is an agent Crown corporation named in Part I, Schedule III to the *Financial Administration Act* and is not subject to the provisions of the *Income Tax Act*. The objects of the Commission, as established by the *Canadian Dairy Commission Act*, are “to provide efficient producers of milk and cream with the opportunity of obtaining a fair return for their labour and investment and to provide consumers of dairy products with a continuous and adequate supply of dairy products of high quality”.

The Commission administered subsidy payments to producers (the program was terminated on January 31, 2002) and administers other costs funded by the Government of Canada. In co-operation with the Canadian Milk Supply Management Committee (CMSMC), which it chairs, the Commission undertakes the management and administration of operations funded by producers. The results of the Commission’s operations in each of these areas are presented in the Statement of Costs Funded by the Government of Canada, and in the Statement

of Operations and Surplus, respectively, in order to distinguish and reflect the accountability relationships for them. The Statement of Cash Flows reflects transactions of both areas of operations.

The Commission purchases all butter and skim milk powder tendered to it at either the Canadian support price or at prices established by the Commission, depending on the intended resale markets, except for a portion of butter imported by the Commission at international market price for domestic consumption in accordance with Canada’s commitments to the World Trade Organization (WTO). While a major portion of the butter purchased by the Commission is later resold in the domestic market, most of the skim milk powder is in excess of domestic needs and is exported. The Commission sells production surplus to domestic requirements in the form of whole milk products, skim milk powder and butter on international markets.

The Commission administers, on behalf of the industry, a pricing and pooling of market returns system which provides milk components to further processors and exporters through processors at competitive prices. Accordingly, this system is administered by the Commission in accordance with the Comprehensive Agreement on Pooling of Milk Revenues to allow dairy producers to share revenues nationally as well as the Western Milk Pooling Agreement and the Agreement on All Milk Pooling to allow dairy producers to share revenues regionally. The ten provincial milk marketing boards and agencies represent the country’s dairy producers and they provide the Commission with all the relevant data and funding for its administration of the pooling system.

FINANCIAL STATEMENTS

2. Significant accounting policies

Inventories

Inventories are valued at the lower of cost or estimated net realizable value.

Cost of sales

Goods purchased by the Commission for export sales are purchased at prices established by the Commission.

Foreign currency translation

A significant portion of sales in foreign currencies are hedged by forward exchange contracts and are translated into Canadian dollars at the exchange rates provided therein. Sales in foreign currencies that are not hedged are translated into Canadian dollars at the exchange rate in effect on the transaction date. Foreign currency gains and losses are included in the operating results of the year in which they occurred.

Contributions to Public Service Superannuation Plan

The Commission's eligible employees participate in the Public Service Superannuation Plan administered by the Government of Canada. Both the employees and the Commission contribute to the cost of the Plan. Contributions by the Commission are expensed in the year incurred.

The Commission is not required under present legislation to make contributions with respect to actuarial deficiencies of the Public Service Superannuation Plan.

Measurement uncertainty

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Valuation of inventories and other liabilities are the most significant items where estimates are used. Actual amounts could differ from the current estimates. These estimates are reviewed annually and as adjustments become necessary, they are recognized in the financial statements in the period in which they become known.

3. Accounts receivable — Trade

Most of the trade accounts receivable are in foreign currencies and their Canadian dollar value has been determined using either the rate to be paid under forward exchange contracts for those deemed being hedged, as further explained in Note 11, or at the rate of exchange at year end. These foreign accounts receivable are guaranteed by letters of credit, are payable on demand and are non-interest bearing.

4. Inventories

	2003	2002
	(in thousands)	
Butter	\$ 56,021	\$ 79,186
Skim milk powder	11,008	22,234
Other dairy products	12	1,458
	<u>\$ 67,041</u>	<u>\$ 102,878</u>
less: allowance for inventory write down	—	641
Net book value	<u>\$ 67,041</u>	<u>\$ 102,237</u>

The Commission's inventory includes 8,879 tonnes of butter and 2,020 tonnes of skim milk powder (2002 — 11,311 tonnes and 1,662 tonnes) with a total cost of \$53.64 million and \$10.49 million respectively (2002 — \$67.27 million and \$8.29 million) that must be repurchased by the manufacturers from the Commission within the course of the next dairy year at the then prevailing support prices.

5. Bank indebtedness - Pooling account

To provide bridge financing and ensure the efficient operation of the pricing and pooling of market returns system, the Commission established a \$10 million line of credit with a member of the Canadian Payments Association. The bank indebtedness incurred under this line of credit is due on demand and bears interest at prime which on July 31, 2003 was 4.75 percent per annum. The bank indebtedness is repaid monthly.

6. Loans from the Government of Canada

Loans from the Government of Canada, to a maximum of \$100 million, are available to finance operations. Individual loans are repayable within one year from the date the loan is advanced. Principal and accrued interest are repaid regularly during the year when funds are available. Interest on the loans are at the normal rates established for Crown corporations by the government and varied from 2.50 percent to 3.37 percent (2002 — 2.03 percent to 4.54 percent) during the year.

7. Fair value of financial instruments

The carrying amounts of the accounts receivable, bank indebtedness, accounts payable and accrued liabilities and loans from the Government of Canada approximate their fair values because of the short-term to maturity.

8. Surplus

The Commission indirectly collects amounts from consumers through a charge included in the retail sale price of butter. This charge is used to fund the carrying costs associated with normal level of butter inventory. This amount is included in contributions withheld to fund operating expenses presented in the Statement of Operations and Surplus. The surplus at the end of the year is made up of an accumulated surplus of this funding and surplus amounts relating to commercial sales.

The refund of surplus to producers relating to commercial sales is determined on an annual basis and recorded in the year in which it is authorized.

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9. Costs funded by the Government of Canada

Agriculture and Agri-Food Canada provided funding to the Commission for subsidy payments to producers of industrial milk and cream shipments produced to meet domestic requirements. This dairy support program ended January 31, 2002.

Funding of the Commission's administrative expenses is shared among the federal government, dairy producers and the market place. The Government of Canada has funded \$3.6 million (2002 — \$2.9 million) of the Commission's administrative expenses of \$6.2 million (2002 — \$6.7 million) as well as professional services relating to costs of production data collection.

10. Pension Plan

Operating expenses included the Commission's contributions to the Public Service Superannuation Plan during the year totaling \$447 thousand (2002 — \$496 thousand), which corresponds to about 2.6 times the employees' contributions to the Plan.

11. Commitments

Forward exchange contracts

As part of its foreign exchange risk management, the Commission enters into forward exchange contracts with regard to a portion of its export sales contracts. At the end of the year, the Commission's outstanding forward exchange contracts totaled \$5.0 million Canadian equivalent (2002 — \$19.5 million Canadian equivalent). These contracts matured during the month of August 2003. The maturity dates of the forward exchange contracts correspond to the estimated dates when the Commission expects to receive the foreign currency proceeds arising from export sales contracts.

During the year, transactions involving foreign currencies resulted in foreign currency exchange losses of \$0.18 million (2002 — \$0.31 million). These losses are included in the operating results of the year in which they occurred.

Purchase commitments

As at July 31, 2003, the Commission was committed to purchase butter, skim milk powder and other dairy products produced prior to that date. These commitments amounted to approximately \$3.1 million (2002 — \$2.0 million).

Long Term Lease

The Commission is committed under a long term lease with Agriculture and Agri-Food Canada for office accommodation ending in 2007. The lease contains escalation clauses regarding maintenance costs and taxes. The remaining minimum lease payments totaled \$1,095,600 at year-end.

The minimum lease payments for the next four years are as follows:

2003-04	\$298,800
2004-05	\$298,800
2005-06	\$298,800
2006-07	\$199,200

12. Representatives' fees

The Commission used the services of representatives for sale of dairy products on the export market. Total fees for the year were \$0.8 million (2002 — \$0.9 million) and are included in cost of sales.

13. Related party transactions

The Commission is related in terms of common ownership to all Government of Canada-created departments, agencies and Crown corporations. The Commission enters into transactions with these entities in the normal course of business. These transactions totaled about \$1.3 million during the year (2002 — \$1.4 million).

14. Financial Statement Presentation

Certain comparative amounts have been reclassified to conform with the presentation adopted in the current year.

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Schedule of Operations by Product

for the year ended July 31, 2003

(in thousands)

	2003				2002			
	Butter	Skim Milk Powder	Other Products*	Total	Butter	Skim Milk Powder	Other Products*	Total
Sales								
Export sales	\$ 654	\$ 82,542	\$ 1,844	\$ 85,040	\$ 1,769	\$ 111,409	\$ 12,325	\$ 125,503
Cost of sales	236	80,748	1,636	82,620	3,788	118,623	13,222	135,633
Margin (loss) on export sales	418	1,794	208	2,420	(2,019)	(7,214)	(897)	(10,130)
Domestic sales	129,189	13,835	3,255	146,279	128,776	7,772	—	136,548
Cost of sales	114,456	12,508	2,454	129,418	122,370	7,926	—	130,296
Margin (loss) on domestic sales	14,733	1,327	801	16,861	6,406	(154)	—	6,252
Total margin (loss) on sales	\$ 15,151	\$ 3,121	\$ 1,009	\$ 19,281	\$ 4,387	\$ (7,368)	\$ (897)	\$ (3,878)
Operating expenses								
Domestic dairy product assistance	\$ —	\$ —	\$ 258	\$ 258	\$ 29	\$ —	\$ 274	\$ 303
Carrying charges	2,112	784	15	2,911	3,740	1,512	90	5,342
Projects and promotional activities	379	—	82	461	2,493	—	—	2,493
Inventory writedown	—	—	—	0	441	78	122	641
	\$ 2,491	\$ 784	\$ 355	\$ 3,630	\$ 6,703	\$ 1,590	\$ 486	\$ 8,779
Administrative expenses								
Salaries and employee benefits				4,435				4,717
Other expenses				1,762				1,987
				6,197				6,704
Cost of production, interest and bank charges related to the operation of the pooling of the market returns system				528				476
Total operating expenses				\$ 10,355				\$ 15,959

* Includes whole milk powder, concentrated milk and cheese