

CANADIAN DAIRY COMMISSION **ANNUAL REPORT** 2003–2004



Canadian Dairy
Commission

Commission
canadienne du lait



Canada

Mandate 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.

Mission statement

To enhance the vitality of the Canadian dairy industry for the benefit of all stakeholders.

Values

- Integrity
- Leadership
- Respect and dignity
- Professionalism

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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LETTER TO THE MINISTER

Mr. Minister,

We are pleased to submit the Canadian Dairy Commission's Annual Report for the 2003-2004 dairy year. In this 38th 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 2003-2004 required several adjustments on the part of the Canadian dairy industry. Two factors forced these adjustments: the limitation of the exports of Canadian dairy products at WTO commitment levels for subsidized exports, and the growth of the structural surplus. This growth was in turn fuelled by two factors: the growth in imports of various milk protein sources which replaced domestic milk protein in manufactured foods, and the use of feed strategies at the farm which increased the ratio of solids non fat to butterfat in raw milk. In reaction to this new situation, the industry took several measures. Milk production in excess of quota allocation has been curtailed, new markets have been explored for milk solids other than fat, the Canadian Dairy Commission (CDC) has made the most of the allowed exports, and the provinces have agreed to take measures to lower the solids non fat to butterfat ratio in raw milk.

Domestic market growth has been strong in the first part of this dairy year but softened later in the year. Since August 2003, the Market Sharing Quota (MSQ) for industrial milk was increased by only 0.1 percent to satisfy domestic demand for dairy products. MSQ as of July 31st 2004 stands at 49.2 million hectolitres.



Last December, the CDC announced an increase in the support prices of 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. Because of the impact of the mad cow (BSE) crisis on the revenues of dairy farmers, the Commission held consultations in July on a possible price increase for September 1st, 2004. However Commissioners decided that, given the available data, a price increase was not justified at that time. The Commissioners are nonetheless committed to a significant increase during the next dairy year.

Following a first workshop to initiate a constructive dialogue between dairy producers and processors, the CDC organized a second edition of such a workshop in order to move initiatives forward. We are pleased to report that participation was as good for this second workshop as for the first one, and that delegates zeroed in on specific initiatives which are currently being further developed.

The market for dairy ingredients in food products continues to be important. Under the Special Milk Class Permit Program, 5.4 million hectolitres of milk were used to make dairy ingredients for products such as frozen entrées, soups, baked goods and confectionery products. Despite higher prices for a large part of the year, the utilization of this program has increased.

In the meantime, the CDC is pursuing the activities that were planned in its Dairy Ingredient Marketing Program to promote increased utilization of Canadian dairy ingredients in manufactured products.

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 and further initiatives are being planned.

The Canadian Milk Supply Management Committee (CMSMC) continued its work to achieve greater harmonization of policies. The Committee held important discussions related to tighter control of production, disposal of the structural surplus, and the future of programs such as the Domestic Dairy Products Innovation Program and the Dairy Ingredient Marketing Program.

We would like to take this opportunity to recognize the hard work and dedication of CDC employees and their contribution 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

Carl Harrison
Vice-chairman


Jean Grégoire
Commissioner

THE CANADIAN DAIRY



INDUSTRY

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

Key Highlights of 2003-2004

The dairy industry in Canada has made some great strides over the last year and can be proud of the progress achieved during the 2003-2004 dairy year. Some of the key highlights include:

- a continued dialogue between dairy farmers and processors;
- a strategy to drastically reduce over-quota milk production;
- the implementation of measures to curtail the surplus of skim milk solids, the disposal of which is costly to dairy producers;
- growth in domestic demand for the seventh consecutive year.

Milk Production

Farm cash receipts

As a key contributor to the Canadian economy in the 2003 calendar year, the dairy industry ranked fourth behind grains, red meats, and horticulture generating \$4.5 billion in total farm cash receipts.

Number of farms and production per farm

In the 2003-2004 dairy year, Canada had 16,970 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 2003-2004 dairy year was 4,800 hectolitres (hl), a 9 percent increase from the previous year.

In the 2003-2004 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*

1999-2000 to 2003-2004

	Number of farms	Number of cows (million)	Total production (million hl)
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	17,931	1.07	78.6
2003-2004	16,970	1.08	81.5

* At 3.6 kg of butterfat per hectolitre.

In the 2003 calendar year, there were 1.08 million dairy cows in Canada producing an average of 9,519 kg of milk per cow.

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NUMBER OF MILK AND CREAM FARMS IN 2003-2004

	Cream	Milk	Total
Newfoundland and Labrador	0	41	41
Prince Edward Island	10	291	301
Nova Scotia	0	344	344
New Brunswick	0	285	285
Quebec	0	8,054	8,054
Ontario	92	5,549	5,641
Manitoba	5	550	555
Saskatchewan	0	294	294
Alberta	1	775	776
British Columbia	0	679	679
TOTAL	108	16,862	16,970

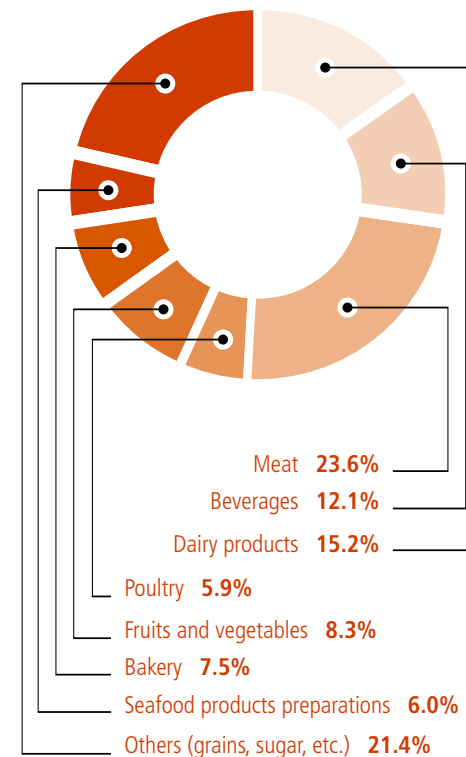
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Milk Processing

In the 2003 calendar year, the processing industry generated \$11.0 billion* worth of products shipped from approximately 288 processing plants accounting for 15.2 percent of all processing sales in the food and beverage industry. During the 2003-2004 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 (2003)



INDUSTRY

Milk Markets

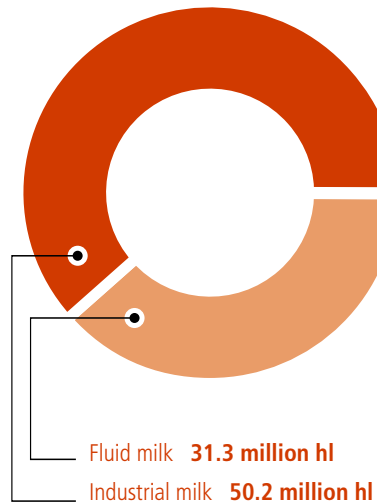
Canadian dairy producers supply two main markets:

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

In the 2003-2004 dairy year, the fluid market accounted for approximately 38 percent of total producer shipments of milk, or 31.3 million hectolitres*. The industrial market accounted for the remaining 62 percent or 50.2 million hectolitres* of total producer shipments.

* At 3.6 kg of butterfat per hectolitre.

INDUSTRIAL AND FLUID MILK PRODUCTION IN 2003-2004



Ingredients market

The use of dairy products as ingredients in finished food products continues to be an important sector in terms of real growth and innovation. The CDC has been working closely with further processors who have the potential to incorporate dairy ingredients in the place of substitutes. Particular effort is being devoted to those companies able to use skim milk powder and/or milk protein concentrate. The current strong interest in high protein/low carbohydrate value-added products is timely. Growth in the use of skim milk powder has been taking place thanks to pudding desserts, meal replacement beverages, prepared sauces and chocolate confectionery bases manufactured in Canada.

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 classified according to its end use based on the Harmonized Milk Classification System. The price paid for milk by the processors will vary according to the milk class.

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HARMONIZED MILK CLASSIFICATION SYSTEM

Class	Description	Milk used (2003-2004)	
		ooo kg butterfat	% of total milk
Class 1	a) fluid milks	83,041	28
	b) fluid creams		
	c) milk-based beverages		
	d) fluid milks and creams for the Yukon, Nunavut and Northwest Territories (these markets are supplied by British Columbia and Alberta)		
Class 2	yogurt, sour cream and ice cream	22,778	8
Class 3	a) specialty cheeses	46,165	16
	b) cheddar cheese	50,668	17
Class 4	a) butter, butteroil, powders and concentrated milk for ingredient purposes	64,329	22
	b) concentrated milk for retail	3,906 (b, c, d, m)	1
	c) new products for the domestic market		
	d) inventories and losses		
	m) marginal markets		
Class 5	a) cheese ingredients for further processing for the domestic and export markets	19,347 (a, b, c)	7
	b) all other dairy products for further processing for the domestic and export markets		
	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		
TOTAL		292,991	100

INDUSTRY



THE CANADIAN DAIRY



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.

The federal government funds about 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 October 7, 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

Carl Harrison

Appointed April 27, 2004 (second mandate)

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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Commissioner

Jean Grégoire

Appointed April 27, 2004

Mr. Grégoire is a former President of Dairy Farmers of Canada and of the Fédération des producteurs de lait du Québec. He has been involved in various dairy producer groups since 1975, when he became administrator of the Syndicat des producteurs de lait de transformation de Saint-Hyacinthe. He and his two sons operate a dairy and grain farm in St. Alexandre d'Iberville in Quebec. He has broad experience in the dairy industry and extensive knowledge of dairy policies.

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 backgrounds as former producers or processors 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 CDC's strategic directions, Corporate Plan and budgets with input from senior management;
- approve the financial statements and the Annual Report, which are audited by the Office of the Auditor General of Canada;
- ensure proper accountability through internal audits and evaluations of CDC's systems, practices and programs;
- report on CDC activities and services to the industry as they relate to the legislated mandate, and present the related financial statements to the Canadian Milk Supply Management Committee (CMSMC) at least four times a year; and
- receive and follow up on the Annual Audit and the Special Examination report of the Office of the Auditor General, carried out every 5 years.

Special initiatives in the past year include:

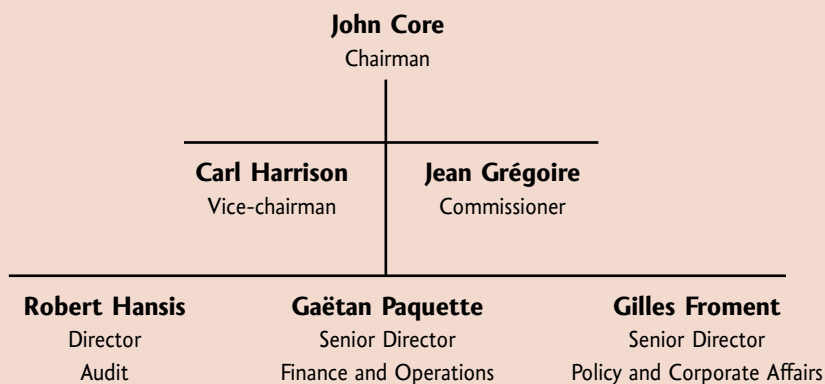
- Two Commissioners and one Senior Director attended Corporate Governance courses for Crown Corporations.
- The Domestic Dairy Product Innovation Program, the Dairy Ingredient Marketing Program, as well as the services that the CDC provides to industry committees were evaluated.
- An internal audit of the Financial Statement Reporting and Management Accounting Information was performed.

COMMISSION

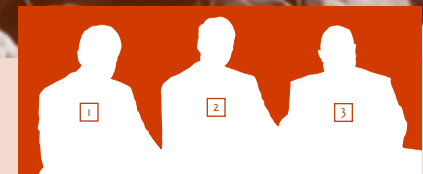
- Employees attended a presentation on the new Values and Ethics Code for the Public Service issued by Treasury Board and effective September 1, 2003.
- The Foreign Exchange Hedging Policy of the Commission was updated to reflect the latest requirements of the Canadian Institute of Chartered Accountants.
- An internal Security, Occupational Health and Safety Committee was formed to oversee the implementation of the recommendations from the Threat Risk Assessment study performed on Commission activities and to deal with health and safety issues.
- An updated Delegation of Financial Authority was completed and approved by Commissioners.

- The Human Rights Commission performed an Employment Equity audit at the Commission. The CDC's Employment Equity Plan was found to be in compliance with the requirements of the *Employment Equity Act*.

The Commissioners meet on a monthly basis to establish the strategic orientation of the CDC. They have established a senior 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.



1 Carl Harrison Vice-chairman 2 John Core Chairman 3 Jean Grégoire Commissioner



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AUDIT



- 1 Robert Hansis
Director, Audit
- 2 Indira Gangasingh
Manager, Assurance Services

- 3 Hossein Behzadi,
Manager, Program Audits

FINANCE AND OPERATIONS



- 1 Mark Lalonde
Chief, Marketing Programs
- 2 Gaby Da Silva
Manager, Special Milk Class
Permit Program
- 3 Marcel Claude
Chief, Finance and
Administration
- 4 Gaëtan Paquette
Senior Director,
Finance and Operations

- 5 Richard Rancourt
Chief, I.T.
- 6 Chantal Laframboise
Manager, Pooling
- 7 Laval Létourneau
Chief, Commercial Operations
Andre Berckmans
Manager, Financial Reporting,
Accounting, and Treasury
(Was absent when the picture was taken)

POLICY AND CORPORATE AFFAIRS



- 1 Erik Kramar
Chief, Economics
- 2 Paula Flood
Human Resources Advisor
- 3 Nelson Coyle
Chief, Policy and
Strategic Planning

- 4 Chantal Paul
Chief, Communications
- 5 Gilles Froment
Senior Director,
Policy and Corporate Affairs

COMMISSION

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 encourages and supports good individual and organizational performance. The Commission employs 62 people.

Activities and Programs

Main Activities

As a national facilitator and chief administrator for the dairy industry, 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 national and provincial stakeholders and 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, the Western Milk Pooling Agreement, 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 target national milk production 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 also manages the imports of tariff rate quota butter for the industry;
- 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 allowing further processors to have access to competitively-priced dairy ingredients, and allowing exporters to export dairy products within Canada's WTO commitment levels;
- It develops and implements programs and services aimed at encouraging further processors to maintain or increase their use of dairy ingredients in their various products. 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.

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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, such as the Canadian Milk Supply Management Committee (CMSMC), that are involved in dairy policy.

The CMSMC is a permanent body created by the 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, processor, and consumer representatives also participate on the committee as non-voting members.

PRODUCTION OF INDUSTRIAL MILK AND CREAM*

(thousands of kg of butterfat)

	2001-2002	2002-2003	2003-2004
Newfoundland and Labrador	57	81	115
Prince Edward Island	3,088	3,060	3,255
Nova Scotia	2,332	2,404	2,448
New Brunswick	2,158	2,129	2,632
Quebec	81,835	81,802	86,482
Ontario	50,420	50,251	53,533
Manitoba	6,394	6,438	6,811
Saskatchewan	5,516	5,224	5,279
Alberta	9,400	9,695	10,390
British Columbia	8,769	8,840	9,861
Total	169,969	169,924	180,806

* 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 the butterfat required to fulfill 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 2003-2004 dairy year, Canadian Requirements were 49.0 million hectolitres, representing a 0.4 percent increase over the previous dairy year. During the same period, industrial milk and

COMMISSION

cream production totalled 50.2 million hectolitres, up 6.4 percent from the previous dairy year.

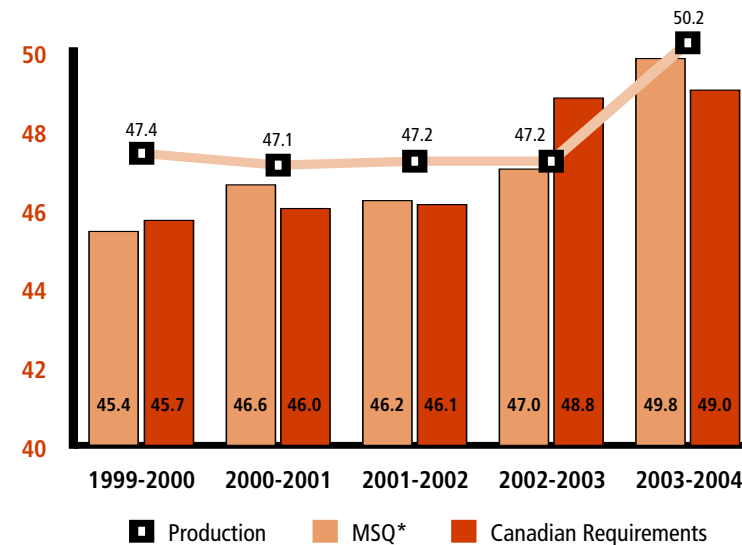
Milk production increased significantly more than demand over the last year. During the first part of the year, demand was strong and the industrial quota was adjusted accordingly. Producers responded with higher production. As a result, Canadian production was sufficient to meet demand, thereby avoiding the need for supplementary import permits. The dairy year ended with a production that is very close to quota and producers must be recognized for their discipline in bringing production in line with requirements.

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 one percent 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.

Market sharing quota as of July 31, 2004 was 49.2 million hectolitres. Industrial milk and cream production in 2003-2004 exceeded by about 1 percent the weighted average MSQ for the year, which was 49.8 million hectolitres.

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



*Weighted average MSQ, including Domestic Dairy Product Innovation Program

Note: In previous Annual Reports, MSQ was expressed as MSQ as of July 31st of each year.

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PROVINCIAL SHARES OF MSQ* – JULY 31, 2004

	Butterfat (thousand kg)	Milk (million hl)	%
Newfoundland and Labrador	216	0.060	0.1
Prince Edward Island	3,128	0.869	1.8
Nova Scotia	2,019	0.561	1.1
New Brunswick	2,330	0.647	1.3
Quebec	81,241	22.567	45.8
Ontario	55,877	15.521	31.5
Manitoba	6,321	1.756	3.6
Saskatchewan	4,362	1.212	2.5
Alberta	11,631	3.231	6.6
British Columbia	10,108	2.808	5.7
Total	177,233	49.231	100.0

* 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.

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 agreements on behalf of the dairy industry.

Comprehensive Agreement on Pooling of Milk Revenues

Under the Special Milk Class Permit Program implemented in August 1995, industrial milk is made available for use in dairy products and products containing dairy ingredients at competitive prices. 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.

All Milk Pooling Agreement

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. The province of Manitoba, with the agreement of the other members, withdrew from the pool as of February 1st, 2003.

During the fall of 2003, most of the pool's activities were focused on trying to reach an agreement on the fluid milk price increase for February 1st 2004. Unfortunately, provinces were not successful and implemented different price increases.

In November 2003, Newfoundland and Labrador made a formal proposal to join the All Milk Pooling Agreement. A negotiating committee, chaired by the CDC, was implemented in early 2004 and met on several occasions during the dairy year.

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In April 2004, stakeholders of the All Milk Pool attended a special workshop to deal with the fluid pricing issue and to reaffirm the participants' commitment to the Agreement. As recommended during this workshop, a Fluid Action Committee was created to explore new mechanisms for fluid milk pricing. This Committee made its recommendations to the Supervisory Body in July 2004.

In June 2003, Nova Scotia indicated its intention to initiate a Dispute Settlement Procedure over the lack of an Interprovincial Quota Exchange. During the dairy year 2003-2004, negotiations took place between Nova Scotia and some other provinces but without success. As a result, an Arbitration Panel was officially implemented in July 2004.

Western Milk Pooling Agreement

In March 1997, the four Western provinces (Manitoba, Saskatchewan, Alberta and British Columbia) also implemented an all milk pooling system. In 2003-2004, the Western Milk Pool (WMP) initiated two measures intended to grow the market. A one-year discount for new and innovative fluid and industrial milk products was approved. As well, the Coordinating Committee set up a research committee with the goal of stimulating innovation and growth.

The issues of cream availability, fluid milk pricing policy and WMP governance were also addressed. The Vice-chairman of the CDC was asked to chair the Coordinating Committee for a one-year period.

Two committees were established: a transportation committee with a mandate to establish a disaster plan, and a milk security committee with the responsibility of coordinating truck sealing programs across the four Western provinces effective August 1, 2005.

Finally the WMP initiated a request to the CDC and the CMSMC to review the way that population was used in quota allocation. This resulted in some increases in quota for the West.

POOLS IN NUMBERS 2003-2004

	Fluid milk produced (million hl)	Industrial milk produced (million hl)	Blend price to producer* (\$/hl)
All Milk Pool	21.9	41.2	60.78
Western Milk Pool	9.1	9.0	62.09

* In-quota milk at 3.6 kg butterfat /hl

Special Milk Class Permit Program

The Special Milk Class Permit Program was implemented on August 1, 1995 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.

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

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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 the 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 5.4 million hectolitres of milk in the 2003-2004 dairy year. A total of 1,055 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 836 in 2003-2004, up from 801 in the previous year.

SPECIAL MILK CLASS PERMIT PROGRAM

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

Class		1999-2000	2000-2001	2001-2002	2002-2003	2003-2004
5(a)	Volume	1.517	1.791	1.633	1.881	1.954
	Price	\$37.34	\$35.63	\$45.55	\$33.29	\$40.08
5(b)	Volume	1.452	1.221	0.728	1.042	1.872
	Price	\$38.95	\$42.94	\$42.67	\$35.19	\$32.85
5(c)	Volume	1.033	1.053	1.344	1.361	1.548
	Price	\$33.69	\$31.97	\$30.09	\$29.97	\$29.99
Total	Volume	4.002	4.065	3.705	4.283	5.374
	Price	\$36.74	\$36.16	\$39.42	\$32.71	\$35.17

*Volumes and prices are calculated at 3.6 kg of butterfat per hl.

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 the prices paid by 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 views of dairy industry stakeholders are also carefully examined before making this decision.

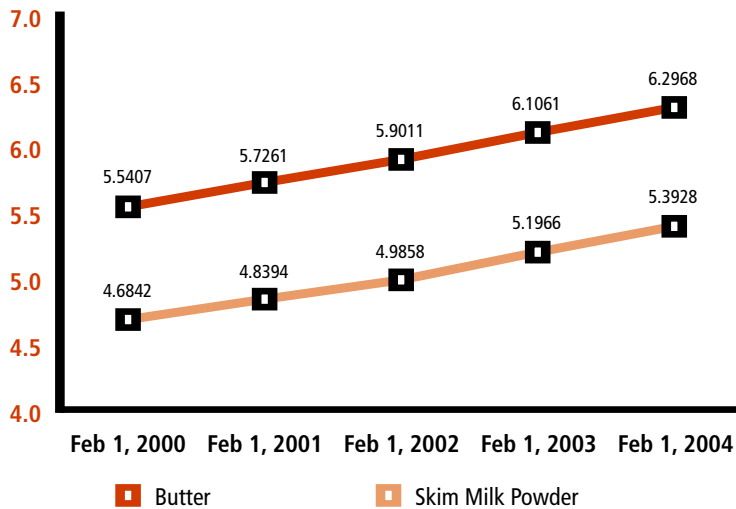
The pricing decision announced by the CDC in December 2003 was effective on February 1, 2004. The support price for skim milk powder rose from \$5.1966 to \$5.3928 per kg, and for butter from \$6.1061 to \$6.2968 per kg. In 2002, the CDC committed to cover the cost of production of 50 percent of dairy farmers by 2006. The December 2003 decision was an important step in fulfilling this commitment.

These higher support prices were expected to provide dairy farmers with an increase of \$2.20 per hectolitre on the price paid for industrial milk. This represents an increase of 3.5 percent.

In July 2004, the Commission held consultations to see if a support price increase was warranted for September 1st, 2004, to offset some of the impacts of the bovine spongiform encephalopathy (BSE) crisis on the revenues of dairy farms. Based on the data available, the Commission decided that a price increase was not justified at that time.

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SUPPORT PRICES FOR BUTTER AND SKIM MILK POWDER FROM 2000 TO 2004 (\$ PER KG)



Butter Imports

Under the terms of the 1994 WTO Agreement, Canada has established Tariff Rate Quotas (TRQ) for a number of dairy products. TRQs are quantities of products that can enter Canada with little or no tariff. 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.

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 allows 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.

During the 2003-2004 dairy year, Canadian firms in Quebec, Ontario, Alberta and British Columbia used 15.9 million litres of milk under the DDPIP. In 2002-2003, the total was 25.1 million. The maximum utilization limit was established at 1 percent of the MSQ, which is approximately 49 million litres.

This year, the Selection Committee has received 21 applications compared to 20 during the previous year. Following the trend, most applications involved new specialty cheeses. Of the 21 applications received, 9 applications met the program criteria and were accepted, 5 were rejected and 7 require additional information before a decision can be made.

A program evaluation was conducted on the DDPIP during the last year. Following this evaluation, the CMSMC extended the program for another five years and accepted that a technical advisor be added to the Selection Committee. The CMSMC also approved promotion activities for the DDPIP and the use of an innovation champion to collect and circulate information to small and medium-sized processors and further processors.

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Dairy Ingredient Marketing Program

The purpose of this Program is to contribute to increasing 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. Activities so far include a Web site, a support program and seminars.

Thanks to the continued support of our industry partners, the Web site MILKingredients.ca has received the Canadian Farm Writers Federation's Gold Award for the second year in a row. This on-line information centre remains a vital tool for communicating marketing services and up-to-date industry information directed at the dairy ingredient sector. The site now averages close to 20,000 visits per month.

The Milk Ingredient Technical Support Program was implemented in the fall of 2003 to provide assistance to further processors involved in re-formulating recipes to incorporate dairy ingredients. The CDC has so far approved 5 projects under this relatively new Program which is expected to grow as a result of the dairy industry's interest to explore new opportunities for the use of solids non fat.

The CDC continues to champion industry seminars that focus on the use of dairy ingredients in food processing. Three new seminar programs were finalized in June 2004 and will be held in the fall in partnership with the Guelph Food Technology Centre, the Alberta Food Processing Development Centre and the Governors Foundation (Quebec).

A program evaluation was conducted on the Dairy Ingredient Marketing Program. The evaluation committee concluded that the Program was providing valuable services to the dairy ingredient sector which faces growing competition from substitutes. The evaluation committee recommended that the Program be maintained and that efforts be increased to encourage further growth and innovation in the use of dairy ingredients in the further processing sector.

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 after the Holiday period. 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 \$4.2 million in 2003-2004. 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

COMMISSION

stocks. This amount was reduced from \$0.08 to \$0.07 per hectolitre of industrial milk during the 2003-2004 dairy year since low interest rates reduced storage costs.

Storage programs

Butter

The CDC holds butter in storage throughout the year. The Canadian Milk Supply Management Committee sets a target of 12 million kg of butter at the beginning of the 2003-2004 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. In addition to the normal butter inventories, the Commission purchases butter that is surplus in the industry to balance the system.

The total stocks of butter are 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 sometimes

insufficient to satisfy requirements. 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 2003-2004 dairy year with 9.32 million kg of butter and 2.28 million kg of skim milk powder in inventory. During the year, the CDC purchased 24.94 million kg of butter and 53.95 million kg of skim milk powder. Sales of 19.88 million kg of butter and 23.51 million kg of skim milk powder left respective closing inventories of 14.38 and 32.72 million kg as of July 31, 2004 (butter statistics include imports and butteroil).

Surplus Removal Program

The CDC administers a Surplus Removal Program (SRP) on the industry's behalf. The program ensures that milk that is surplus to the domestic market is removed in the appropriate region and in a timely fashion.

THE CANADIAN DAIRY

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 2003-2004, the majority of dairy product exports were performed by the private sector under permits from the CDC. The main role of the CDC was to dispose of the structural surplus in the form of skim milk powder. During the dairy year 2003-2004, the CDC exported 16.25 million kg of skim milk powder either as skim milk powder or as an ingredient in blend products. The CDC also authorized small quantities of whole milk powder, evaporated milk and ice cream, through the issuance of permits.

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 5(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 directors and chaired by the Vice-chairman of the Commission reviews audit priorities and approves the annual 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 2003-2004 dairy year, a major audit was carried out on the management of butter resale by the Commission. This included a review of the systems and practices related to the purchase, storage and resale of butter. The systems and practices were found to be well controlled. Only minor suggestions were made to improve current controls. One suggested enhancement was for performance measures to be developed by managers to facilitate annual reporting on the effectiveness of the management of butter resale.

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External audits

External audits are, in large part, performed on companies participating in the Special Milk Class Permit Program. Risk assessment is used to identify high risk companies among program participants. During the 2003-2004 dairy year, 40 companies were audited, resulting in claims of \$597,000 from companies who showed discrepancies in the use of their permit. This money was returned to Canadian dairy producers.

The CDC also establishes mandates and reviews the work contracted with professional audit firms as they review the milk plant revenues based on records maintained in each province. This provides assurance on the reliability of revenues reported to the Commission within the national pool, which are subject to revenue sharing among all provinces.

The CDC continues to work with provincial auditors to assist in the audit of Special Class transactions. The CDC also provides advice on practices related to plant utilization audits and on the interpretation of the National Audit Manual to further harmonize these audits across Canada.

The Commission performs the milk plant utilization audits in Prince Edward Island and Newfoundland and Labrador on a cost-recovery basis.

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GOALS

Achievements for 2003-2004

The goals set by the Canadian Dairy Commission (CDC) for 2003-2004, 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.

In order to continue the work undertaken last year under this goal, the CDC collaborated with Agriculture and Agri-Food Canada and Dairy Farmers of Canada to follow up on a first Visioning Workshop, which was held in March of 2003. Considerable background documentation and several options were developed to address the four issues identified at the first Workshop: 1. growth of the market through the replacement of imports by Canadian products; 2. growth of the market through the Special Milk Class Permit Program; 3. growth of the market through innovation and new products, with an increase in per capita consumption; and 4. balancing supply and demand.

This material was used as background information for a second Visioning Workshop in October 2003. The objectives of this meeting were to share information regarding the four issues listed above, and to identify concrete actions that producers and processors could undertake together in order to address these issues. Follow up on this second workshop is ongoing.

In addition, the CDC organized a visioning session for the Western Milk Pool (WMP) in Calgary in October 2003. The CDC is assisting the WMP in following up on this visioning session. In addition, the WMP decided that, beginning in March 2004 and for a one-year period, the CDC would chair the meetings of the WMP Coordinating Committee.

The CDC also organized a workshop for the eastern All Milk Pool. This activity was held in April 2004 in Montreal. Its objectives were to re-affirm participants' commitment to the Pooling Agreement, to improve understanding amongst the producers, processors and provincial governments, to articulate common principles for moving forward, and to develop an action plan for addressing specific key issues. Again, the CDC will be closely involved in the follow-up to this workshop. In addition, the CDC chairs the committee in charge of negotiating the entry of Newfoundland and Labrador in this pool.

The writing of the book on the history of the CDC is on track. The senior writer is working on location and has access to an advisory committee and CDC staff to help with research and writing. The manuscript should be finalized in August 2005.

During the course of the last year, major dairy processors in Canada joined together to create a new organization to represent their interests.

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The Dairy Processors Association of Canada was established at the end of 2003 and has increased its membership to more than a dozen companies from coast to coast. The CDC supports the creation of this organization since it allows the processors to have a common voice at the national level.

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.

In an effort to tighten the management of milk production in Canada, the CDC worked very closely with the industry in the last year to make the necessary changes to quota policies. Various scenarios were designed, analyzed and proposed to the Canadian Milk Supply Management Committee (CMSMC). It is this committee who decides which changes will be put in place. In March, the CMSMC adopted one of the scenarios developed by the CDC to bring changes to the quota system which will make the supply management of milk more sensitive to seasonal variations in demand as of August 1, 2004.

In response to the 2002 WTO Appellate Body ruling, the Comprehensive Agreement on Pooling of Milk Revenues was re-drafted to remove all provisions related to Commercial Export Milk. The CDC oversaw the re-drafting and approval process of the agreement. The CDC is collecting the endorsement signatures from each of the nine signatory provinces participating in this pool.

The CDC was responsible to oversee the audit work involved in the winding down of the Commercial Export Milk program, which allowed direct contracting, between producers and processors, for the sourcing of milk to manufacture dairy products for export. These audits are performed in collaboration with provinces.

In accordance with Ministerial Directions, the CDC conducted its export activities while respecting Canada's WTO limits on subsidized exports. This was done through the issuance of permits for individual export transactions (5(d) permits). A new computer system was developed to determine the value of the subsidy. Quarterly reports were submitted to Agriculture and Agri-Food Canada.

3. Encourage consumption of dairy products and the use of Canadian dairy ingredients through promotion, market research, and technical support.

Apart from continuing its regular activities, the Dairy Ingredient Marketing Program has been enriched with a new technical support fund. The Milk Ingredients Technical Support Program provides technical support to Canadian further processors involved in the reformulation of finished products to incorporate dairy ingredients. The Program is intended to provide financial support and assistance to Canadian further processors who lack the facilities, technical expertise, and/or resources to conduct controlled product trials and analysis. The Program was launched in 2003 with a budget of \$100,000 per year and has already received several applications and inquiries.

GOALS

Following the funding of a butter promotion program in the last two years, the CDC has offered to contribute financially to the further promotion of dairy products. This would be done through branded advertising programs in partnership with Dairy Farmers of Canada. This initiative would involve producers, processors, and possibly further processors.

4. Achieve administrative efficiencies through the continuous improvement of administration and management practices.

Following the Threat Risk Assessment conducted the year before, the CDC has formed a Security, Occupational Safety and Health Committee who will serve as an advisory body to senior management to develop policies and make recommendations on matters of security, safety and health.

Already, the CDC has prepared a second set of computers which are kept off the premises and are available to resume operations in case of a major disaster in the CDC building. This Business Resumption Hot Site is a key feature of the Business Resumption Plan of the CDC.

The CDC has also continued the evaluation of its programs. An evaluation of the Dairy Ingredient Marketing Program was carried out in the spring and summer of 2003 and a report was presented to the CMSMC in October which supported the expansion of these activities. Although the Special Milk Class Permit Program was next slated for an evaluation, this exercise was postponed because in July, the CMSMC requested an evaluation of the Domestic Dairy Product Innovation Program, which was up for review. The conclusions and

recommendations of this evaluation were presented to the CMSMC in January and several recommendations stemming from the evaluation were adopted by the CMSMC in July.

The CDC has evaluated the services it offers to the various forums of the industry, such as the CMSMC, the All Milk Pool, the Western Milk Pool and their technical committees. Services such as organization of meetings, preparation and distribution of background documents, technical analysis and minutes and reports were examined. Conclusions and recommendations from this evaluation were presented to the CMSMC in July 2004.

In the area of human resources, the CDC worked closely with the Human Rights Commission in the last year as it was being audited for compliance with the *Employment Equity Act*. CDC's Employment Equity Plan will be implemented over the coming three years. The CDC took a preliminary look at the demographics of its work force and a formal succession planning exercise will follow. As a number of people left the CDC in the last year, requiring several hiring actions, the competency requirement analysis has been postponed to the coming year.

Outlook

Over the years, the Canadian supply management system has adapted to new parameters in the environment. Freer trade has been a major factor in these changes. As the Doha round of negotiations progresses at the World Trade Organization (WTO), discussions on the possibility of reduced tariffs on imports and increased market access cause a

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great deal of concern for the dairy industry. Furthermore, any reduction in the level of subsidized exports allowed under the WTO would have serious repercussions.

A reduction in tariffs threatens the integrity of the domestic market by increasing the probability that foreign products such as butter could enter Canada to compete with domestic products. This would make it extremely difficult to manage supplies for the domestic market, not knowing exactly how much imported products will come in for a specific period. An increase in market access would automatically reduce the overall Canadian milk production required to supply the domestic market. Our current limitations on exports make it challenging to dispose of our structural surplus of skim milk solids and any further reduction in exports would worsen the situation.

The structural surplus of skim milk solids has grown beyond our export limits and the industry must find ways to deal with it. Policies at the farm level are being reviewed to remove incentives that lead to a larger structural surplus. As a first step, provinces have agreed to implement policies aimed at lowering the solids non fat/butterfat ratio of raw milk over the next two to three years. In addition, new domestic uses for skim milk solids must be found rapidly. In that respect, producers and processors are discussing the possibility of developing a new program for the production of milk protein concentrate and/or casein.

Pricing at the farm gate continues to be a contentious issue and the industry needs to examine alternatives beyond 2006 when the CDC

reaches its target of setting support prices to cover the cost of production of 50 percent of producers.

The internal environment of the Canadian Dairy Commission is also changing. Our workforce is aging and we need to prepare the next generation of specialists and managers. The Commission also wants to put a greater emphasis on governance and this requires that new systems be put in place.

As a result, the CDC has identified six issues to be addressed in the next five years:

The emphasis on improving the governance of public corporations

Public corporations are under more and more public scrutiny and governance is taking centre stage. The CDC subscribes to this trend and has already started to put measures in place to improve its accountability framework. The CDC intends to continue in this direction.

Renewing our workforce

In the next five years, up to 10 CDC staff members are expected to retire. This is 17 percent of our workforce. Most of these people are managers or specialists. They will take with them a lot of our corporate memory. The Commission has to prepare for this and plan the transfer of knowledge and corporate memory to other employees to ensure continuity.

GOALS

The need for better cohesion and more rapid decision-making within the Canadian dairy industry

Although the CDC has continued in the last year to encourage an open dialogue between dairy farmers and processors, our efforts cannot stop here. Integrated solutions to tomorrow's challenges will have to be negotiated and implemented and the CDC will continue to play a key role in facilitating a dialogue that will lead to actions. The decision-making process should become more responsive to rapid change.

The need for domestic markets for the non-fat milk components and the need to operate the supply management system more tightly

The reduction of exports forces the development of new markets for dairy products within Canada. Innovation and promotion will receive particular attention in the next year, as well as the exploration of new markets for non-fat milk components.

The uncertainty regarding the efficiency of tariff walls, depending on the results of the WTO negotiations

If, at the conclusion of the current WTO negotiations, there is an agreement to reduce tariffs applied to dairy products entering Canada, the milk supply management system will be greatly challenged. If more foreign products enter the country, there will be a reduction in the domestic demand for Canadian milk which will translate into a reduction in the overall quota, unless Canadian milk can compete with these cheaper imports. Given its central role and expertise, the CDC will work in close cooperation with stakeholders in order to alleviate any adverse effects on the dairy industry.

The need for a new strategy for pricing beyond 2006

Each year, the Canadian Dairy Commission sets the support prices for butter and skim milk powder. These prices are used as a reference across Canada to establish the prices that the producers will receive for their production of industrial milk. For the moment, the direction of the pricing decisions is quite clear. In 2002, the CDC made the commitment that, by February 1st, 2006, the cost of production of 50 percent of Canadian dairy farmers would be covered by support prices. However, it is time to start thinking about the direction for pricing beyond 2006. Any change in strategy will require consultations with the various sectors of the dairy industry and with consumers. The new strategy will also have to take into consideration the future economic environment. The interdependency of support prices and milk class prices needs to be examined.

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Goals for the period 2004-2005 to 2008-2009

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

COMPLIANCE GOAL

Goal 1 Enhance corporate governance, in line with Treasury Board's Modern Comptrollership guidelines.

Performance indicators for 2004-2005

The CDC will:

- review and update the CDC bylaws
- operationalize and embrace CDC's corporate policy for employment equity, as well as Treasury Board's Values and Ethics Code
- promote CDC values to all CDC employees
- ensure that all Commissioners complete the course on Crown Corporate Governance
- include "improving internal communications" in the objectives of management for 2004-2005
- encourage managers to hold regular staff meetings
- establish a Manager's forum for middle management
- harmonize the processing and the filing of information, both in electronic and printed format
- train staff on their obligations under the *Access to Information Act* and the *Privacy Act*

- run a second round of training for staff concerning our electronic records management system

OPERATIONS GOAL

Goal 2 Improve the planning of human resources.

Performance indicators for 2004-2005

The CDC will:

- prepare a succession plan
- offer all CDC employees the opportunity to prepare a personalized training plan
- prepare a corporate training plan

STRATEGIC GOALS

Goal 3 Provide leadership to the industry and particularly enhance stakeholder relationships.

Performance indicators for 2004-2005

The CDC will:

- complete the industry visioning initiatives and communicate the results to stakeholders
- provide transparent and impartial advice to stakeholders
- ensure stakeholders interests are heard
- participate in Agriculture and Agri-Food Canada's Dairy Round Table

GOALS

Goal 4 Further develop profitable markets for Canadian dairy products.

Performance indicators for 2004-2005

The CDC will:

- develop, recommend to the CMSMC and fund an expanded innovation program for dairy product development and marketing
- explore ways to replace substitutes with dairy ingredients and investigate new markets for solids non fat and provide proposals to the CMSMC
- stimulate growth through partnership initiatives
- maximize WTO-allowed subsidized exports
- develop policy alternatives to reduce structural surplus

Goal 5 Provide technical assistance to the Canadian negotiation team and evaluate the potential impact of the agriculture negotiations at the World Trade Organization on the Canadian dairy industry.

Performance indicators for 2004-2005

The CDC will:

- monitor negotiations and provide any technical assistance and advice required by the Canadian negotiating team
- evaluate, anticipate and communicate any potential impact on the Canadian dairy industry

Goal 6 Facilitate effective national milk quota management.

Performance indicators for 2004-2005

The CDC will:

- provide various quota management analyses and recommendations to the CMSMC
- assist in the implementation and the administration of the chosen system

Goal 7 Review farm gate pricing beyond 2006.

Performance indicators for 2004-2005

The CDC will:

- hold consultations on farm gate pricing beyond 2006 and its dependency on CDC support prices

FINANCIAL REPORT



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

Original signed by:

Gaëtan Paquette, Senior Director, Finance and Operations

Ottawa, Canada

September 29, 2004

FINANCIAL REPORT

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

for the year ending July 31, 2004

The following discussion and analysis of the operating results and financial position of the Canadian Dairy Commission (CDC) for the year ending July 31, 2004 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)

	Dairy year 2003-04		Dairy year 2002-03	
	Export	Domestic	Export	Domestic
Total sales	\$ 36,624	\$ 135,418	\$ 85,040	\$ 146,279
Total cost of sales	\$ 37,195	\$ 129,976	\$ 82,620	\$ 129,418
Margin (loss) on sales	\$ (571)	\$ 5,442	\$ 2,420	\$ 16,861
Surplus at year end	\$ 21,405		\$ 32,440	
Inventory on hand at year end	\$ 133,598		\$ 67,041	
Loans from the Government of Canada	\$ 98,337		\$ 28,702	

On export activities

Sales

Total export sales revenue is 57 percent lower than the previous year as a result of lower levels of allowed exports under WTO rules. Therefore, the CDC had to accumulate skim milk powder in inventory and will need to find domestic markets to dispose of surplus milk instead of the normal export channels.

The only product exported this year was skim milk powder and the quantity exported had to be reduced by 56 percent as compared to the last dairy year, when the CDC was able to export a small quantity of butter and whole milk powder in addition to skim milk powder.

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 these markets are 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, 2004, the cost of sales was also lower by 55 percent as a consequence of reduced exports. Lower than anticipated sales prices generated a small loss of \$0.57 million. In contrast, export operations in the dairy year ending July 31, 2003 resulted in a gain of \$2.4 million. That year, the CDC experienced unanticipated rising sales prices for dairy products on the world market in comparison to the purchase prices which had been established earlier, when stable export prices were anticipated.

Carrying charges

In comparison with the previous dairy year, the CDC's carrying charges for inventory decreased substantially due to reduction in exports under the WTO rules. Inventories of products destined for export were lower on average during the year. This resulted in a direct decrease of storage and handling costs compared to the same period the year before.

On domestic activities

Sales

In total, revenues from domestic sales declined by 7 percent in the 2003-2004 dairy year, mainly resulting from lower Plan A butter sales because the CDC had not been able to replenish these stocks from the industry earlier in the year. This decrease in revenue was partly offset by larger sales of skim milk powder to domestic users in animal feed. Sales of skim milk powder to the animal feed industry increased by 72 percent, from 8.2 million kg to 14.1 million kg. The CDC had to sell this product on the domestic market because the structural surplus could not all be exported.

The quantities of other products sold on the domestic market remained relatively similar to the previous year.

Cost of sales

In order to meet Canada's Tariff Rate Quota obligation under the WTO agreement, the CDC imported 3,261 tonnes of butter and butteroil at prevailing world prices. This product is directed through butter manufacturers to the further processing sector.

In 2003-2004, the CDC sold Plan A butter which was purchased at full domestic price, resulting in a lower margin on sales as compared to 2002-2003.

During the previous dairy year, demand increased significantly, leading to a shortage of domestic butter. The CDC used butter originally destined for the export market to address the domestic market shortage. While this butter was purchased at the world price, it was sold at the domestic price thereby generating a profit.

Carrying charges, inventories and loans from the Government of Canada

Carrying charges increased substantially due to higher inventories at year end.

Following a CMSMC decision, the CDC increased its level of butter stocks at year end from 12 million kg to 15 million kg in order to reduce the risk of future shortages.

Inventories increased substantially from a value of \$67.0 million to \$133.6 million this year, causing a corresponding increase in the loans from the Government of Canada.

FINANCIAL REPORT

Administrative expenses

Total administrative expenses increased by 1.3 percent only as compared to the previous year. This increase is attributable to higher salary costs.

Challenges for the future

The WTO decision in December 2002 on Canada's Commercial Export Milk will require tighter management of production in order to minimize surpluses in the domestic market. It also heightens the challenge of finding new markets domestically to deal with the structural surplus.

New initiatives have been taken to match supply with demand more tightly and reduce the potential amount of surplus milk. There remains the challenge, however, of finding ways to dispose of surplus skim

milk powder in domestic markets which currently use imported ingredients or finding novel ways of marketing solids non fat in products such as blends and high protein functional powder.

The Commission has to use, to its best advantage, various export product categories in order to maximize our export subsidy commitments. The Commission has enhanced its tracking system for export activities in order to fully control the quantities of subsidized exports made by the industry to ensure Canada respects its WTO commitments.

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, 2004 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, 2004 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:

Ronald C. Thompson, CA
Assistant Auditor General for the Auditor General of Canada
Ottawa, Canada
September 29, 2004

FINANCIAL STATEMENTS

Balance Sheet

as at July 31
(in thousands)

	2004	2003
Assets		
Cash	\$ 375	\$ 17
Accounts receivable		
Due from provincial milk marketing boards and agencies	33,221	20,091
Trade (Note 3)	432	12,500
Prepaid expenses - promotional activities	–	2,053
Inventories (Note 4)	133,598	67,041
	\$167,626	\$101,702
Liabilities		
Bank indebtedness - pooling account (Note 5)	\$ 1,422	\$ 734
Accounts payable and accrued liabilities		
Due to provincial milk marketing boards and agencies	30,484	18,166
Trade	14,039	18,593
Other liabilities	1,939	3,067
Loans from the Government of Canada (Note 6)	98,337	28,702
	146,221	69,262
Surplus (Note 8)	21,405	32,440
	\$167,626	\$101,702
Commitments (Note 12)		

Approved:

Original signed by:

John Core

Chairman

Carl Harrison

Vice-Chairman

Gaëtan Paquette

Senior Director of Finance and Operations

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

Statement of Operations and Surplus
for the year ended July 31
(in thousands)

	2004	2003
Sales and cost of sales		
Domestic sales	\$ 135,418	\$ 146,279
Cost of sales	129,976	129,418
Margin on domestic sales	5,442	16,861
Export sales (Note 9)	36,624	85,040
Cost of sales	37,195	82,620
Margin (loss) on export sales	(571)	2,420
Total margin on sales	4,871	19,281
Pooling of market returns activities		
Contributions from provincial marketing boards and agencies	133,313	105,359
Equalization payments to provincial marketing boards and agencies	126,128	98,329
Contributions withheld to fund operating expenses	7,185	7,030
Results before net operating expenses	12,056	26,311
Operating expenses (Schedule of Operations by Product)	13,955	10,355
less: funding of administrative expenses by the Government of Canada (Note 10)	3,172	3,599
Net operating expenses after funding by the Government of Canada	10,783	6,756
Results of operations after funding by the Government of Canada	1,273	19,555
Surplus at beginning of year	32,440	15,132
Refund of surplus to producers	(12,308)	(2,247)
Surplus at end of year	\$ 21,405	\$ 32,440

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

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Statement of Cash Flows

for the year ended July 31

(in thousands)

	2004	2003
Cash flows from operating activities		
Cash receipts from customers	\$ 184,110	\$ 227,284
Cash paid to suppliers and others	(251,127)	(182,271)
Cash receipts from provincial milk marketing boards and agencies	120,183	103,414
Cash paid to provincial milk marketing boards and agencies	(113,810)	(98,018)
Cash receipts from the Government of Canada	3,515	3,899
Interest paid on loans from the Government of Canada	(528)	(1,026)
Cash flows from (used in) operating activities	(57,657)	53,282
Cash flows from financing activities		
New loans from the Government of Canada	161,234	78,710
Loan repayments to the Government of Canada	(91,599)	(131,419)
Refund of surplus to producers	(12,308)	(2,247)
Cash flows from (used in) financing activities	57,327	(54,956)
Net decrease in cash	(330)	(1,674)
Cash (net bank indebtedness) at beginning of year	(717)	957
Net bank indebtedness at end of year	\$ (1,047)	\$ (717)
Components:		
Cash	\$ 375	\$ 17
Bank indebtedness - pooling account	(1,422)	(734)
	\$ (1,047)	\$ (717)

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

Notes to Financial Statements

July 31, 2004

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, in co-operation with the Canadian Milk Supply Management Committee (CMSMC), which it chairs, undertakes the management and administration of operations funded by producers.

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 manufacturers’ requirements and is sold domestically in certain marginal markets or exported. The Commission exports surpluses 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.

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

Most sales and purchases in foreign currencies are hedged by forward exchange contracts and are translated into Canadian dollars at the exchange rates provided therein. To be accounted for as a hedge a forward exchange contract must be designated and documented as

FINANCIAL STATEMENTS

a hedge, and must be effective at inception and on an ongoing basis. If the hedge criteria were not met, the forward exchange contracts would be accounted for on the balance sheet at fair value, with the initial fair value and subsequent changes in fair value recorded in earnings in the period of change. The Commission's forward exchange contracts are hedges and are therefore not recognized in the balance sheet but are only disclosed in note 12.

Sales and purchases 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 is the most significant item 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 the rate to be paid under forward exchange contracts for those being hedged, as further explained in Note 12, or at the rate of exchange at year end.

4. Inventories

	2004	2003
	(in thousands)	
Butter	\$ 88,872	\$ 56,021
Skim milk powder	44,726	11,008
Other dairy products	—	12
Total	\$ 133,598	\$ 67,041

The Commission's inventory includes 11,372 tonnes of butter and 1,947 tonnes of skim milk powder (2003 — 8,879 tonnes and 2,020 tonnes) with a total cost of \$71.03 million and \$10.50 million respectively (2003 — \$53.64 million and \$10.49 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.

The balance of the inventory is comprised of 3,003 tonnes of butter and 30,775 tonnes of skim milk powder (2003 — 442 tonnes and 264 tonnes) with a total cost of \$17.84 million and \$34.23 million respectively (2003 — \$2.38 million and \$0.52 million).

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 \$5 million (2003 — \$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, 2004 was 3.75 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 2.06 percent to 3.32 percent (2003 — 2.50 percent to 3.37 percent) during the year and totaled \$0.95 million (2003 — \$0.71 million).

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 the normal levels 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.

9. Export sales

Export sales include \$0.27 million representing net gains (2003 — net losses of \$0.18 million) arising from currency translation relating to transactions incurred in foreign currencies.

10. Costs funded by the Government of Canada

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 \$3.2 million (2003 — \$3.6 million) of the Commission's administrative expenses of \$6.3 million (2003 — \$6.2 million), as well as \$0.3 million (2003 — \$0.3 million) for professional services relating to costs of production data collection.

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11. Pension Plan

Operating expenses include the Commission's contributions to the Public Service Superannuation Plan during the year totaling \$450 thousand (2003 - \$447 thousand), which corresponds to about 2.6 times the employees' contributions to the Plan.

12. Commitments

Forward exchange contracts

As part of its foreign exchange risk management, the Commission enters into forward exchange contracts with regard to its export sales contracts and purchase contracts requiring settlement in foreign currencies. At the end of the year, the Commission's outstanding forward exchange contracts totaled \$12.8 million Canadian equivalent (2003 — \$5.0 million Canadian equivalent). These contracts will mature over the period ending December 2004. 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 and when settlement is due for purchases in foreign currencies. The Commission's forward exchange contracts as at July 31, 2004 are as follows:

		(in thousands)	
Currency sold	Currency purchased	In USD	In Canadian
U.S. dollars	Canadian dollars	4,113	5,460
Canadian dollars	U.S. dollars	5,535	7,342
Total		9,648	12,802

Purchase commitments

As at July 31, 2004, the Commission was committed to purchase certain quantities of butter and skim milk powder. These commitments amounted to approximately \$8.8 million (2003 — \$3.1 million). Most of these commitments are in foreign currencies and are covered by forward exchange contracts.

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. This lease may be automatically renewed at CDC's option for another period of 5 years with rates possibly revised in order to reflect the rental market value pursuant to Treasury Board's Policy on Real Property.

The remaining minimum lease payments totaled \$ 796,800 at year-end. For 2006-2007 the rent is for 8 months as the lease term ends March 31.

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

2004–2005	\$298,800
2005–2006	\$298,800
2006–2007	\$199,200

13. Representatives' fees

The Commission used the services of representatives for sale of dairy products on the export market. Total fees for the year were \$0.3 million (2003 — \$0.8 million) and are included in cost of sales.

14. 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 \$1.6 million during the year (2003 — \$1.3 million).

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Schedule of Operations by Product

for the year ended July 31

(in thousands)

	2004				2003			
	Butter	Skim Milk Powder	Other Products*	Total	Butter	Skim Milk Powder	Other Products*	Total
Sales and cost of sales:								
Domestic sales	\$113,736	\$21,682	\$ –	\$135,418	\$129,189	\$13,835	\$3,255	\$146,279
Cost of sales	108,003	21,973	–	129,976	114,456	12,508	2,454	129,418
Margin (loss) on domestic sales	5,733	(291)	–	5,442	14,733	1,327	801	16,861
Export sales	–	36,624	–	36,624	654	82,542	1,844	85,040
Cost of sales	–	37,195	–	37,195	236	80,748	1,636	82,620
Margin (loss) on export sales	–	(571)	–	(571)	418	1,794	208	2,420
Total margin (loss) on sales	\$ 5,733	\$ (862)	\$ –	\$ 4,871	\$ 15,151	\$ 3,121	\$ 1,009	\$ 19,281
Operating expenses:								
Carrying charges	\$ 2,877	\$ 1,355	\$ –	\$ 4,232	\$ 2,112	\$ 784	\$ 15	\$ 2,911
Projects and promotional activities	2,310	–	210	2,520	379	–	82	461
Domestic dairy product assistance	–	–	357	357	–	–	258	258
	<u>\$ 5,187</u>	<u>\$ 1,355</u>	<u>\$567</u>	<u>\$ 7,109</u>	<u>2,491</u>	<u>\$ 784</u>	<u>\$ 355</u>	<u>\$ 3,630</u>
Administrative expenses								
Salaries and employee benefits				4,651				4,435
Other expenses				1,627				1,762
				<u>6,278</u>				<u>6,197</u>
Cost of production, interest and bank charges related to the operation of the pooling of the market returns system				568				528
Total operating expenses				<u>\$ 13,955</u>				<u>\$ 10,355</u>

*Includes whole milk powder, concentrated milk and cheese.

