

CANADIAN DAIRY COMMISSION ANNUAL REPORT 2005–2006



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 a.m. to 4:30 p.m. eastern time, Monday to Friday (statutory holidays excluded).

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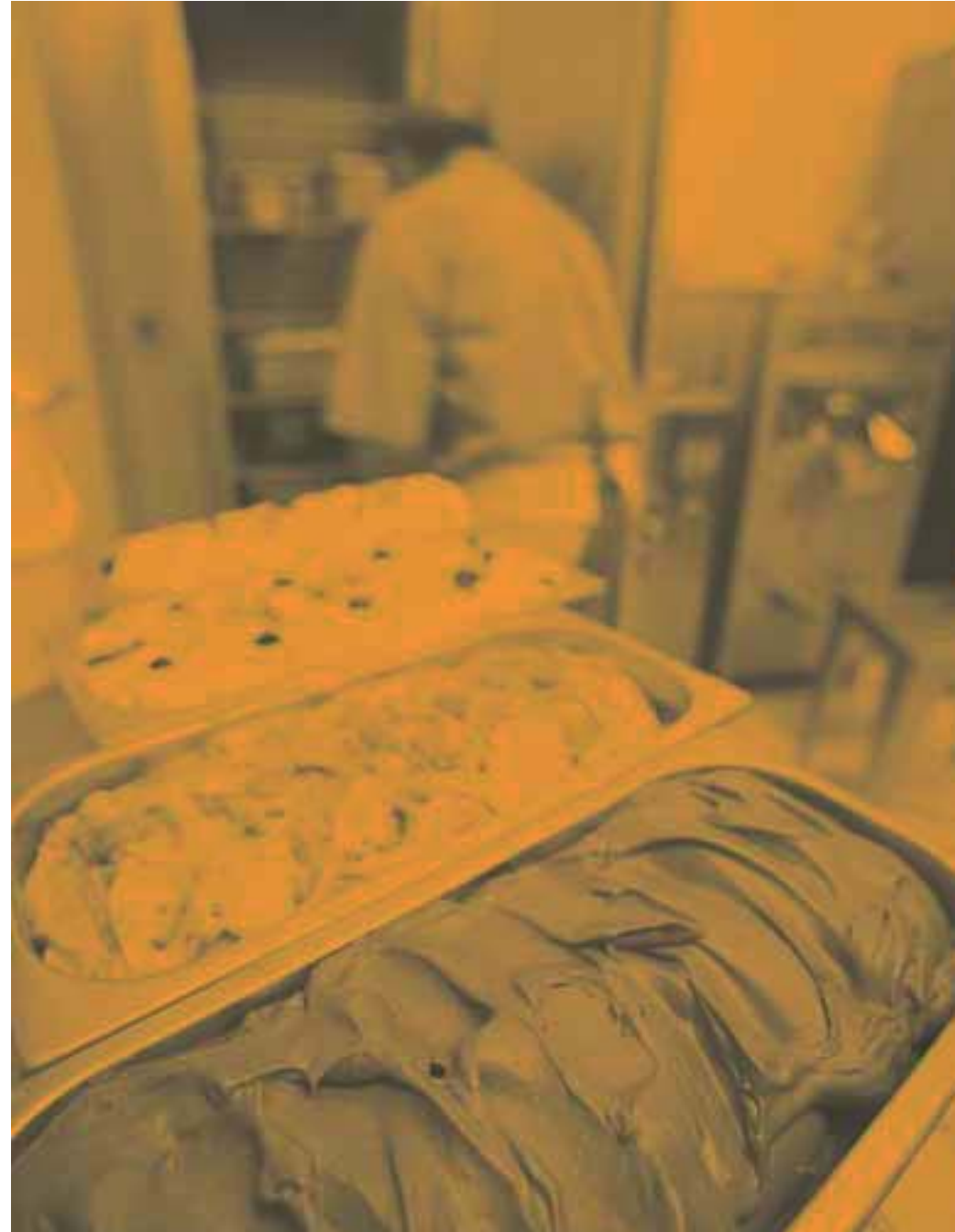
LETTER TO THE MINISTER

Mr. Minister,

We are pleased to submit the Canadian Dairy Commission's Annual Report for the 2005-2006 dairy year. In this 40th year of operation, we pursued our goals to strengthen the industry and achieve harmonized dairy policies to maintain a viable Canadian dairy sector.

Despite the uncertainty of world trade negotiations, the CDC and the Canadian dairy industry continue to manage change. The quantity of milk available for the Domestic Dairy Products Innovation Program doubled on August 1st, 2005 to reach 2% of the Canadian industrial milk quota, or about 1 million hectolitres. This program provides dairy product manufacturers with access to additional milk volumes to help introduce innovative dairy products into the marketplace. With the help of two new Innovation Champions, the Dairy Marketing Program reached out to close to 300 companies and sponsored three successful industry seminar events across Canada to promote the manufacture and use of Canadian dairy products.

Despite our marketing efforts and those of the dairy industry, 2005-2006 has been a year of declining demand. As a result, industrial milk production in Canada was reduced by 1.2 million hectolitres, but the industry has implemented ways to better manage production and to adjust milk composition to minimize surplus production.



Although all provinces are not willing to pursue the establishment of a national milk pool at this time, several partnerships came to fruition during the 2005-2006 dairy year. The CDC joined forces with provincial agencies to increase the promotion of fluid milk products. The Commission also signed five-year agreements with Canadian universities to provide scholarships to graduate students in the fields of agricultural economics and policy, food/dairy science or animal science in relation to the dairy industry.

Last December, the CDC announced an increase in the support price of skim milk powder while the support price of butter remained unchanged. This 2.59% increase, equivalent to 1.79 cents per litre of milk leaving the farm, allowed the CDC to fulfill its commitment to gradually increase support prices to cover the cost of production of 50 percent of Canadian dairy farmers by 2006.

In an effort to streamline its operations, the Commission has adopted various policies and procedures such as an Information Management Policy and a Policy on hedging of operations in foreign currency. The documentation of key operational and administrative procedures has also been undertaken.

We would like to take this opportunity to express our appreciation for the co-operation we receive from industry stakeholders, provincial governments, and our colleagues at Agriculture and Agri-Food Canada and the other Agriculture and Agri-Food Portfolio agencies. We are also indebted to the CDC employees who run our operations with efficiency and fairness.

In closing, we would like to thank you, Mr. Minister, for your 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 1st to July 31st. Most dairy policy decisions are made by a federal-provincial committee called the Canadian Milk Supply Management Committee (CMSMC). The Canadian dairy industry operates under a supply management system where raw milk production is kept in line with demand using production quotas. The quota for industrial milk, used to manufacture dairy products, is called Market Sharing Quota, or MSQ. Other key elements of supply management include regulated prices and protection of the domestic market.

Key Highlights of 2005-2006

Key highlights for the dairy industry of Canada in the 2005-2006 dairy year include:

- the adoption by the CMSMC of the CDC recommendation on MSQ adjustment. The calculation of the Canadian requirements is now based on butter stocks of both the CDC and the processors. In addition, the MSQ is now adjusted automatically every two months based on any change in the requirements;
- the elimination of the 1.0% growth allowance was completed by October 1st 2005. The allowance was removed to reduce the level of surplus butterfat production in a declining market and to reflect a more restrictive export environment;
- the signature by all provinces of the amended versions of the Comprehensive Agreement on Pooling of Milk Revenues and of the Agreement for the Entry of the Province of Newfoundland and Labrador into the National Milk Marketing Plan and the Comprehensive Agreement on Pooling of Milk Revenues; these agreements have been in force since 2003 and 2001, respectively;

- the replacement of the Class 5c) Committee by the Markets Committee whose mandate is to recommend measures which would find outlets for 1,600 tons of surplus butter and increase the utilization of SMP on the Canadian market;
- the in-depth revision of the National Audit Manual which advocates the use of national standards during the audits of processing plants.

Milk Production

Farm cash receipts

As a key contributor to the Canadian economy in the 2005 calendar year, the dairy industry ranked fourth behind grains, red meats and horticulture generating \$4.84 billion in total farm cash receipts.

Number of farms and production per farm

In the 2005-2006 dairy year, Canada had 15,522 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 2005-2006 dairy year was 5,195 hectolitres (hl), a 3.4% increase from the previous year.

THE CANADIAN DAIRY

In the 2005-2006 dairy year, Quebec and Ontario had the greatest percentage of dairy farms at 81%, followed by 14% in the Western provinces and 5% in the Atlantic provinces.

NUMBER OF FARMS, COWS AND TOTAL PRODUCTION*

2001-2002 to 2005-2006

	Number of farms	Number of cows (million)	Total production (million hl)
2001-2002	18,673	1.08	78.3
2002-2003	17,931	1.06	78.6
2003-2004	16,970	1.06	81.6
2004-2005	16,224	1.06	81.5
2005-2006	15,522	1.05	80.6

* At 3.6 kg of butterfat per hl

Based on Canadian Dairy Herd Improvement records, the average annual production of a dairy cow in Canada is 9,422 kilograms of milk.

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NUMBER OF MILK AND CREAM FARMS IN 2005-2006

	Cream	Milk	Total
Newfoundland and Labrador	0	41	41
Prince Edward Island	8	238	246
Nova Scotia	0	297	297
New Brunswick	0	258	258
Quebec	0	7,508	7,508
Ontario	0	5,057	5,057
Manitoba	3	492	495
Saskatchewan	0	259	259
Alberta	0	720	720
British Columbia	0	641	641
TOTAL	11	15,511	15,522

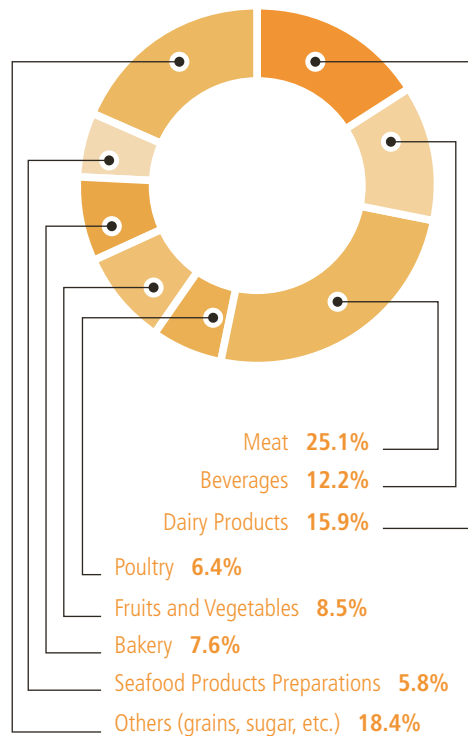
Milk Processing

In the 2005 calendar year, the processing industry generated \$11.5 billion* worth of products shipped from approximately 463 processing plants (295 of which are registered with the Canadian Food Inspection Agency) accounting for 15.9% of all processing sales in the food and beverage industry. During the 2005-2006 dairy year, the dairy processing sector employed approximately 26,800 people.

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

INDUSTRY

SHARE OF MANUFACTURED SHIPMENTS IN CANADA – VALUE BASIS (2005)



Milk Markets

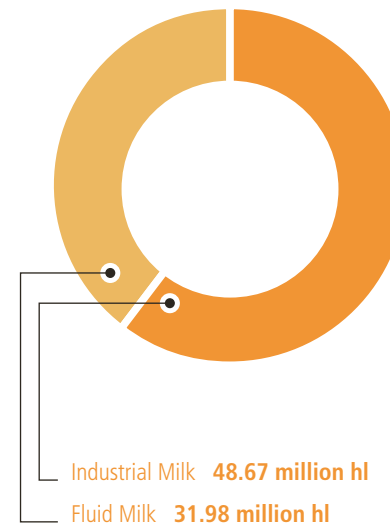
Canadian dairy producers supply two main markets:

- 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 2005-2006 dairy year, the fluid market accounted for approximately 40% of total producer shipments of milk, or 31.98 million hl*. The industrial market accounted for the remaining 60% or 48.67 million hl* of total producer shipments.

* At 3.6 kg of butterfat per hl.

INDUSTRIAL AND FLUID MILK PRODUCTION IN 2005-2006



THE CANADIAN DAIRY

Ingredients market

Dairy and prepared food products are gaining in popularity among a growing number of ethnic Canadians. Examples are Kefir, a fermented milk drink originating in the Caucasus, Paneer, the most common form of Indian cheese, and Ras Malai, an Indian sweet consisting of sugary balls of dough in a creamy sweet liquid. This translates into significant opportunities for Canadian dairy and prepared food product manufacturers. The same holds true for the organic foods sector where the current supply of organic dairy products is not keeping up with the growing demand. The CDC's industry support funds and Special Milk Class Permit Program offer important benefits to Canadian companies working to develop new products in response to consumer demand for ethnic and organic dairy and prepared foods.

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Milk Utilization by Class

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 (see Appendix 1). The price paid for milk by the processors varies according to the milk class. The following table shows how the Canadian milk production was used in the last dairy year.

Class	Million hl	% of total milk
1	23.5	29.14 %
2	5.8	7.21 %
3(a), 3(b)	27.3	33.91 %
4(a), 4(a)1	15.3	19.08 %
4(b), 4(c), 4(d), 4(m)	1.0	1.23 %
5(a), 5(b), 5(c)	5.7	7.07 %
5(d)	1.9	2.36 %
TOTAL	80.5	100 %

INDUSTRY



THE CANADIAN DAIRY



COMMISSION

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 CDC is part of the Agriculture and Agri-Food portfolio along with Agriculture and Agri-Food Canada, the Canadian Grain Commission, the Canadian Food Inspection Agency, Farm Credit Canada and the National Farm Products Council.

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 Commission employs 65 people who work in its offices which are located in Ottawa, Ontario. The success of the Canadian Dairy Commission depends largely on these employees and their pursuit of excellence in the services that they offer. The CDC encourages and supports good individual and organizational performance.

Commissioners

The Canadian Dairy Commission is comprised of three Commissioners appointed by the Governor in Council for a renewable mandate which is usually of three years but the term of which is decided by the Governor in Council. All three commissioners are part-time appointments

Chairman and C.E.O.

John Core

Appointed in October 2005 (second mandate)

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 in April 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 in May 2004

A former President of Dairy Farmers of Canada and of the Fédération des producteurs de lait du Québec, Mr. Grégoire 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.

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 good accountability 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.

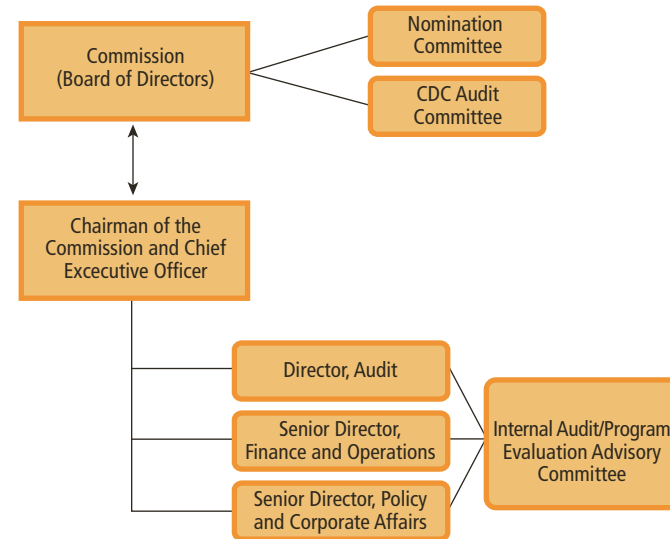
As part of their overall stewardship, the Commissioners:

- 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.

COMMISSION

The Commissioners meet on a monthly basis to establish the strategic orientation and monitor the operational activities of the CDC. They have created 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.

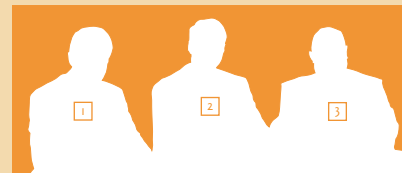
Committees



1 Carl Harrison
Vice-chairman

2 John Core
Chairman
and CEO

3 Jean Grégoire
Commissioner



THE CANADIAN DAIRY

CDC AUDIT COMMITTEE

Members

- Chairman and CEO
- Vice-Chairman
- Commissioner

Activities

The Committee met quarterly to review the financial statements and receive internal audit and program evaluation reports. Annual work plans and progress are reported to the Committee.

NOMINATIONS COMMITTEE

Members

- Chairman and CEO of the CDC*
- Senior Director, Policy and Corporate Affairs, CDC
- Executive Director, Dairy Farmers of Canada
- President and CEO, Dairy Processors Association of Canada
- representative from the Consumers Association of Canada at the CMSMC

Activities

The Committee did not meet this year because no nominations were necessary for the positions of Commissioners.

INTERNAL AUDIT/PROGRAM EVALUATION ADVISORY COMMITTEE

Members

- Vice-Chairman, CDC
- Senior Director, Finance and Operations
- Senior Director, Policy and Corporate Affairs
- Director, Audit
- Chief, Policy and Strategic Planning
- Manager, Financial Reporting, Accounting and Treasury

Activities

The Committee met periodically to review internal audit and program evaluation reports. Annual work plans were determined and progress was reported to the CDC Audit Committee.

**Replaced by the Vice-Chairman of the CDC when the current incumbent of the Chairman/CEO position is being considered for reappointment.*

COMMISSION

Corporate Governance

Main initiatives in 2005-2006 in the area of corporate governance include:

- the adoption of terms of reference for the CDC Audit Committee, as requested by the Office of the Auditor General (OAG) in its Special Examination;
- quarterly meetings of the CDC Audit Committee to review the financial statements and a report on foreign exchange hedging;
- the adoption or update of various internal policies (Policy on the Procurement of Goods and Services, Rules of Procedure, Information Management Policy, Security Policy);
- the adoption of the CDC's Strategic Plan for 2006-2007 and its presentation to CDC staff;
- an evaluation of the Domestic Seasonality Programs and of the Surplus Removal Program;
- an internal audit of the project to publish a book on the history of the CDC;
- the development of an Integrated Risk Management Framework consistent with Treasury Board guidelines;
- the implementation of a procedure to analyze the accounts receivable monthly and establish year-end allowances for doubtful accounts;
- the evaluation of the impact of the 31 measures contained in the Governance Framework for Canada's Crown Corporations;
- various training sessions for management on subjects such as performance management and integrated risk management;
- a test of the CDC's Business Resumption Plan and a review of the personnel's security clearances;
- the initiation of a project to document all practices and procedures of the CDC to establish and maintain corporate knowledge;
- improved access to the building to increase the safety of employees and visitors.

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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 Chantal Laframboise
Manager, Pooling
- 3 Marcel Claude
Chief, Finance and Administration
- 4 Richard Rancourt
Chief, I.T.
- 5 Gaëtan Paquette
Senior Director,
Finance and Operations
- 6 Josée Pigeon-Laplante
Acting Manager,
Special Milk Class Permit Program
- 7 Andre Berckmans
Manager, Financial Reporting,
Accounting, and Treasury
- 8 Laval Létourneau
Chief, Commercial Operations
(absent in photo)

POLICY AND CORPORATE AFFAIRS



- 1 Roger Heard
Acting Chief Economist
- 2 Julie Côté
Human Resources Advisor
- 3 Nelson Coyle
Chief, Policy and
Strategic Planning
- 4 Gilles Froment
Senior Director, Policy and
Corporate Affairs
- 5 Danie Doré
Secretary to the Commission
- 6 Chantal Paul
Chief, Communications

COMMISSION

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 leadership, advice and analysis 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 and advice 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 recommends to the CMSMC 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 imports and redistributes tariff rate quota butter on behalf of 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 through which 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 marketing programs and services aimed at encouraging food manufacturers 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 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 audit procedures for dairy plants and dairy policies in general.

THE CANADIAN DAIRY

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 early 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 CDC acts as chair, advisor, and secretariat to the CMSMC. It provides many economic and policy analyses to help the Committee make dairy policy decisions.

The CMSMC is a permanent body created by the National Milk Marketing Plan (NMMP). Its mandate is to determine policies and to supervise the provisions of the NMMP and of 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 has representation from dairy producers, processors and governments from all provinces. Representatives of dairy producer, processor, and consumer national organizations also participate on the committee as non-voting members.

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PRODUCTION OF MILK AND CREAM*

(millions of hectolitres)

Province	2004-2005			2005-2006		
	Fluid	Industrial	Total	Fluid	Industrial	Total**
Newfoundland and Labrador	0.3	0.1	0.4	0.4	0.1	0.5
Prince Edward Island	0.2	0.9	1.1	0.2	0.9	1.1
Nova Scotia	1.1	0.7	1.8	1.1	0.6	1.7
New Brunswick	0.7	0.7	1.4	0.7	0.7	1.4
Quebec	7.5	23.8	31.3	7.4	23.6	31.0
Ontario	12.3	14.6	26.9	12.6	13.8	26.4
Manitoba	1.3	1.9	3.2	1.3	1.9	3.2
Saskatchewan	0.8	1.5	2.3	0.7	1.6	2.3
Alberta	3.6	2.9	6.5	3.8	2.6	6.4
British Columbia	3.7	2.9	6.6	3.8	2.8	6.6
Total	31.5	50.0	81.5	32.0	48.6	80.6

* Before pooling. Data provided in kilograms of butterfat was converted to hectolitres for this table at the ratio of 3.6 kg of b.f. per hectolitre

** This total does not take into account skim-off and therefore cannot be compared to the data presented on page 8.

COMMISSION

Determining and Adjusting Quotas

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

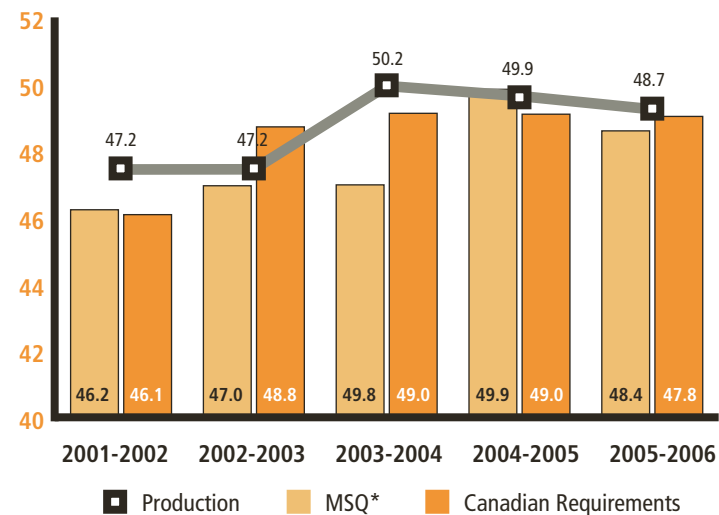
At the end of the 2005-2006 dairy year, Canadian Requirements were 47.8 million hl, down 1.2 million hectolitres or 2.5% from the previous dairy year. During the same period, industrial milk and cream production experienced a similar decrease, finishing the year at 48.7 million hl compared to 49.9 million hl a year earlier.

Growth in the consumption of specialty cheese and yogurt continued to slow over the course of the year, while butter, cheddar and ice cream experienced consumption decreases. In addition to the weakness in demand for dairy products, a large amount of skim-off from the fluid market and an increase in dairy ingredient imports contributed to the decline of Canadian requirements and MSQ.

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. Demand is constantly monitored and, when necessary, the MSQ is adjusted to reflect changes in the domestic demand for industrial milk products, as well as changes in planned export activity. Because it is expressed on a butterfat basis, MSQ also takes into account the fact that a portion of the butterfat from the fluid milk market will be used in the industrial milk market (skim-off). The objective of determining MSQ is to minimize the

possibility of shortages or surpluses on the domestic market. Since April 1st, 2006, a new method is used to calculate demand and adjust MSQ.

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



*Weighted average MSQ, including Domestic Dairy Product Innovation Program

As demand for dairy products decreased throughout the year, the CDC recommended quota cuts and the elimination of the 1% growth allowance to the CMSMC. As a result, the national market sharing quota (MSQ) was cut five times in the 2005-2006 dairy year, starting the year at 49.71 million hectolitres and standing at 47.70 on July 31, 2006, a reduction of 4%.

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PROVINCIAL SHARES OF MSQ* – JULY 31, 2006

	Butterfat (million kg)	Milk (million hl)	%
Newfoundland and Labrador	0.55	0.15	0.3
Prince Edward Island	3.08	0.86	1.8
Nova Scotia	1.81	0.50	1.0
New Brunswick	2.11	0.59	1.2
Quebec	79.79	22.16	46.5
Ontario	53.55	14.87	31.2
Manitoba	6.14	1.71	3.6
Saskatchewan	4.48	1.24	2.6
Alberta	10.75	2.99	6.3
British Columbia	9.46	2.63	5.5
Total	171.72	47.70	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 or the 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.

Agreement on All Milk Pooling

Since 1996, the Agreement on All Milk Pooling has provided a means for revenues from all milk sales (fluid and industrial) and transportation costs, along with markets and the responsibility for skim-off to be pooled among dairy producers in Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island. The CDC chairs the Supervisory Body of the pool, administers the pooling agreement, does the pooling calculations and provides technical expertise and secretariat services to the pool.

COMMISSION

The Supervisory Body set up a new program for the Development of New Dairy Market Opportunities (Class 1(c) 4(c) program). This program offers financial incentives to any processor located within the P5 provinces seeking to develop new market opportunities. The P5 Supervisory Body also investigated the possibility of harmonizing provincial policies regarding the allocation of milk to processing plant. A P5 Milk Allocation Committee was created and met on several occasions.

During the year, P5 provinces also continued to negotiate with Newfoundland and Labrador to establish the conditions under which the province could join the pool. However these negotiations were not successful, and were suspended before the end of the year.

P5 signatories have also undertaken a major redrafting of the P5 Agreement in order to make it better reflect today's reality. The review is currently in its final stage.

Western Milk Pooling Agreement

In 1997, the four Western provinces (Manitoba, Saskatchewan, Alberta and British Columbia) implemented an all milk pooling system where revenues and markets for all milk classes are shared. The CDC chairs the Western Milk Pool (WMP) Coordinating Committee, administers the pooling agreement, does the pooling calculations and provides technical expertise and secretariat services to the pool.

During the 2005-2006 dairy year, the WMP worked on the harmonization of several issues, such as fluid milk pricing and reporting from processors to the milk boards. The WMP also worked on data collection required to evaluate promotion programs, looked for ways to intensify research and development in the dairy industry in the Western provinces, and began the process to update and test its disaster plan. The WMP also started to organize a planning session for market growth and to look at a common approach to organic milk.

POOLS IN NUMBERS 2005-2006

	Fluid milk produced (million hl)	Industrial milk produced (million hl)	Blend price to producer* (\$/hl)
All Milk Pool	22.0	39.7	\$67.22
Western Milk Pool	9.6	8.9	\$66.53

**In-quota milk at 3.6 kg butterfat per hl*

THE CANADIAN DAIRY

Special Milk Class Permit Program

The Special Milk Class Permit Program was implemented in 1995 to allow processors, exporters and food manufacturers to remain competitive on international and domestic markets. Through this system, milk components are available to manufacture dairy products for use in 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 food manufacturers 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 the MSQ, as well as other exports, the total of which must fall within Canada's WTO commitment levels.

The third type of permit is issued under Class 4(m). This class is mainly used to sell surplus solids non fat for animal feed.

Further processors used the equivalent of 5.7 million hl of milk in the 2005-2006 dairy year. A total of 1,288 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 1,011 in 2005-2006, up from 920 in the previous year.

VOLUME OF MILK SOLD (IN MILLION HL) AND PRODUCERS' AVERAGE REVENUES (\$/HL)*

Class		2001-2002	2002-2003	2003-2004	2004-2005	2005-2006
5(a)	Volume	1.633	1.881	1.954	1.955	1.979
	Price	\$45.40	\$33.15	\$39.90	\$41.85	\$34.29
5(b)	Volume	0.728	1.042	1.872	2.088	2.274
	Price	\$42.75	\$35.26	\$32.91	\$36.80	\$32.54
5(c)	Volume	1.344	1.361	1.548	1.566	1.436
	Price	\$30.17	\$30.04	\$30.05	\$29.84	\$30.06
Total	Volume	3.705	4.284	5.374	5.609	5.689
	Price	\$39.35	\$32.68	\$35.12	\$37.06	\$32.68

*Volumes and prices are calculated at 3.6 kg of butterfat per hl, using the latest standard tests for all dairy years.

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 these 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 for milk.

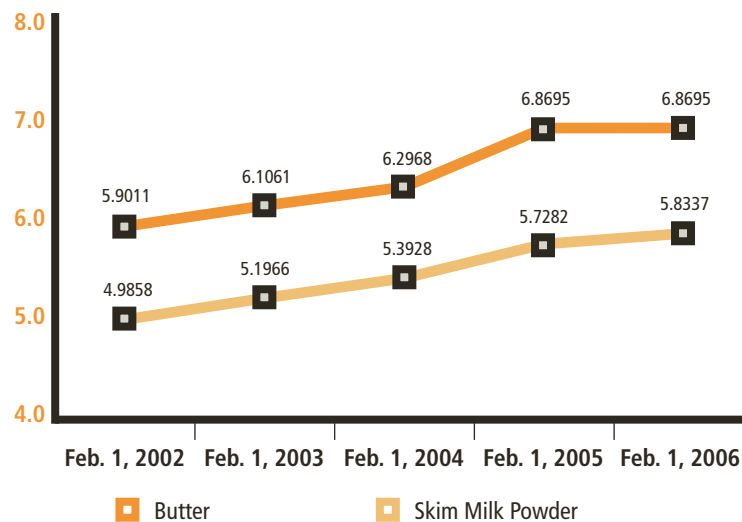
Two elements of the CDC's mission are taken into account in the pricing decision: providing efficient producers with an adequate return on their labour and investment; and providing Canadian consumers with an adequate supply of high quality dairy products. Each year, the CDC holds pricing consultations and the views of dairy industry stakeholders are carefully examined before making this decision.

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The pricing decision announced by the CDC in December 2005 was effective on February 1, 2006. The support price for skim milk powder rose from \$5.7282 to \$5.8337 per kg, and the support price of butter remained unchanged at \$6.8695 per kg. In 2002, the CDC committed to covering the cost of production of 50% of dairy farmers by 2006. The most recent increase was equivalent to 1.79 cent per litre and fulfilled this commitment.

Following advice from the industry, the Commission decided to apply the increase to the support price of skim milk powder only in order not to affect the declining butter market. Commissioners recognized the need to adjust the assumed processor margin following a study on yields and costs of production. This margin was reduced by \$0.85/hl. Carrying charges for butter remained at \$0.07/hl.

SUPPORT PRICES FOR BUTTER AND SKIM MILK POWDER FROM 2002 TO 2006 (\$ 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 receiver of imports of butter under federal permit since 1995 and has directed this product through butter manufacturers to the food sector.

This year, the Tariff Rate Quota for butter remained at 3,274 tonnes. Of this, approximately two thirds (2,000 tonnes) is specifically allocated to New Zealand.

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 2005-2006 dairy year, Canadian firms in Quebec, Ontario, Alberta and British Columbia used 12.4 million litres of milk under the DDPIP. In 2004-2005, the total was 17.7 million. The maximum utilization limit was established at 2% of the MSQ, which is approximately 100 million litres.

This year, the Selection Committee has received 34 applications compared to 33 during the previous year. Following the trend, most applications involved new specialty cheeses. Of the 34 applications received, 13 applications met the program criteria and were accepted, 16 were rejected and 5 require additional information before a decision can be made.

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Dairy Marketing Program

The Dairy Marketing Program continues to promote innovation in the manufacture and use of dairy products and components by offering Canadian companies direct access to dairy and food science expertise. Its Direct Access Fund and Innovation Support Fund provided \$21,000 and \$104,500 respectively to eligible projects in 2005-2006.

Dairy marketing staff conducted nearly 200 on-site company visits and participated in several food industry trade shows and conferences, targeting the nutraceutical, cosmetics and pet food sectors in particular. In collaboration with the Alberta Food Processing Development Centre and Alberta Milk, the Guelph Food Technology Centre, and the P.E.I. Food Technology Centre, they organized and sponsored three well-attended industry seminars which brought together dairy and food processors and other industry partners. MILKingredients.ca, the bilingual on-line information centre for dairy processors and distributors, underwent more improvements and continues to attract an average of 7,000 visitors per month.

In the coming dairy year, the Dairy Marketing Program will focus on the potential use of milk proteins in the pet food sector and on the development of a collaborative on-line resource centre to promote scientific research and discoveries in the dairy sector for the benefit of Canadian dairy and food processors.

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 supply not being aligned with demand.

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. Generally, the CDC buys and stores products when production is high and sells these inventories to processors when production slows down. These transactions take place at support prices.

Carrying charges associated with the CDC's Domestic Seasonality Programs for butter and skim milk powder totalled \$8.2 million in 2005-2006. 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 \$0.07 per hl of industrial milk during the 2005-2006 dairy year. Costs associated with butter stocks above normal inventories or with any other stocks under the Domestic Seasonality Programs are covered by Canadian dairy producers.

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Butter

The CDC holds butter in storage throughout the year. The Canadian Milk Supply Management Committee (CMSMC) kept 12 million kg of butter as target stocks for the 2005-2006 dairy year. This is 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 two years, due to decreasing domestic requirements, the Commission has had to purchase surplus butter and sell it on the export market.

Milk Powders

The CDC operates a program for the storage of specialty types of milk powders such as low-heat skim milk powder and whole milk powder. 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 storage time.

Inventories

The Commission began the 2005-2006 dairy year with 18.3 million kg of butter and 23.9 million kg of skim milk powder in inventory. During the year, the CDC purchased 32.6 million kg of butter and 34.0 million kg of skim milk powder. Sales of 31.9 million kg of butter and 39.0 million kg of skim milk powder left respective closing inventories of 19.1 and 18.9 million kg as of July 31, 2006 (butter statistics include imports and butteroil).

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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 CMSMC directs the CDC in operating the SRP. The seasonality and surplus removal programs were reviewed in 2005-2006 as part of the Evaluation Framework at the CDC. Management is now studying the recommendations contained in the evaluation report.

Exports

During the 2005-2006 dairy year, 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 of solids non fat mainly in the form of skim milk powder. During the dairy year 2005-2006, the CDC exported 10.0 million kg of skim milk powder and 2.3 million kg of butter. Excess butter production has been unusually high in 2005-2006 because quotas could not be reduced quickly enough to keep up with declining demand.

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 amounted to 6,041 tonnes of cheese and is 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 advisory audit committee, comprised of managers and directors and chaired by the Vice-chairman of the Commission, reviews audit priorities, approves the annual audit plan and monitors progress of audit activities.

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.

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During the 2005-2006 dairy year, an audit was carried out on the expenditures incurred in preparing a book on the history of the CDC. The audit concluded that proper accountability was exercised and that, considering the expenses incurred to date and the forecasts to complete certain elements, the total cost should not exceed the budget. The book is expected to be completed within the allocated time frame.

The audit team also provided input on the \$12 million fluid milk promotion fund being made available to the provinces over the next three years. CDC Audit reviewed the agreements to ensure that appropriate accountability over the funds has been defined. In cooperation with Policy and Corporate Affairs, program descriptions were reviewed and meetings were held with marketing personnel to discuss performance measures to be applied to review program effectiveness on an on-going basis.

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 2005 -2006 dairy year, 44 companies were audited, resulting in claims of \$452,773 from companies whose usage of dairy products in the manufacture of eligible products could not substantiate the total purchases made under 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 pooling agreement, which shares these revenues among producers of 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. A national meeting of plant utilization auditors was held during the year and the National Audit Manual was updated.

The Commission also 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 2005-2006

The goals set by the Canadian Dairy Commission (CDC) for 2005-2006, along with a brief summary of the status of achievement of each goal, are described below.

STRATEGIC GOALS

Goal 1. Provide leadership to the Canadian dairy industry

OBJECTIVES	PERFORMANCE INDICATORS FOR 2005-2006	RESULTS	PERCENTAGE COMPLETE
Adopt a methodology for industrial milk pricing beyond 2006	<ul style="list-style-type: none"> ■ Creation of a pricing review process ■ Receipt of recommendations from review process ■ Commission approval ■ Implementation of recommendations 	<ul style="list-style-type: none"> ■ The CDC proposed a temporary pricing method until results of World Trade Organization (WTO) negotiations are known and industry members have been consulted. 	70
Increase the level of harmonization among all provinces	<ul style="list-style-type: none"> ■ Completion of the All Milk Pooling Agreement review by March 2006 ■ Start active discussion on an All Milk National Pooling Agreement ■ Coordination of a national auditors meeting by March 2006 ■ Revision of the National Milk Utilization Audit Manual by March 2006 ■ Effective monitoring of the national milk quota management ■ Completion of the review of the Comprehensive Agreement on Pooling of Milk Revenues for presentation to CMSMC in January 2006 	<ul style="list-style-type: none"> ■ On going. Provinces have not yet agreed on the text of the new agreement. ■ The CDC proposed several options to the CMSMC in February 2006 and discussions have started at the provincial level. At this time, certain provinces have shown little interest. ■ Meeting held in September 2005. ■ The Manual has been revised and must now be approved by the CMSMC. ■ Monitoring and adjustments performed. ■ Completed. The provinces do not wish to negotiate a new agreement and will continue to use the existing agreement. 	60
Implement a new price agreement for Class 5(c)	<ul style="list-style-type: none"> ■ Creation of a 5(c) Price Committee ■ Receipt of Committee's report by the CMSMC ■ Committee's final report and recommendation(s) ■ CMSMC approval 	<ul style="list-style-type: none"> ■ Committee recommendations approved by CMSMC in October 2005. 	100

PERFORMANCE AND

Goal 2. Encourage the development of markets for Canadian dairy products

OBJECTIVES	PERFORMANCE INDICATORS FOR 2005-2006	RESULTS	PERCENTAGE COMPLETE
Develop additional solids non fat (SNF) markets with higher utilization and return	<ul style="list-style-type: none"> ■ New markets for SNF ■ Lower purchases and stocks of SMP under Class 4(m) ■ Increase level of activity under the Dairy Marketing Program ■ Increase level of activity under Class 4(a)1 ■ Increase in revenue per unit of SNF 	<ul style="list-style-type: none"> ■ SNF in hot beverage mixes. ■ Although 4(m) purchases increased by 33%, higher sales reduced stocks by 30%.¹ ■ 14 projects approved and 220 companies visited. ■ Activity under 4(a)1 was 954.025 kg/month², up from 871.938 kg/month the previous year ■ The average price for classes 4(m), 4(a)1 and 5(d) was \$1.27/kg as compared to \$ 1.22/kg the previous year.³ 	75
Review the elements necessary for the growth of Special Classes	<ul style="list-style-type: none"> ■ Report to CMSMC the results of the Special Class program evaluation ■ Act according to the CMSMC direction 	<ul style="list-style-type: none"> ■ Report presented in May and July 2005. ■ Some recommendations were approved by CMSMC in July 2005; further analysis referred to the Market Committee. 	80
Establish partnerships to increase promotion of dairy products	<ul style="list-style-type: none"> ■ Approval of partnerships by Commission 	<ul style="list-style-type: none"> ■ 4 agreements signed which include all provinces. ■ 4 promotion plans approved. 	100
Increase utilization of Canadian dairy ingredients	<ul style="list-style-type: none"> ■ Full implementation of Dairy Marketing Program ■ Reduced skim milk powder stocks 	<ul style="list-style-type: none"> ■ Program fully implemented. ■ Stocks reduced from 23.9 Mkg to 18.9 Mkg.⁴ 	100
Maximize WTO allowed exports	<ul style="list-style-type: none"> ■ Fulfill close to 100% of WTO export commitments without exceeding them 	<ul style="list-style-type: none"> ■ Almost all commitments have been met but not exceeded for all product categories. 	Over 99

1. August 1, 2005 vs July 31, 2006

2. March to July 2005 monthly average vs August 2005 to July 2006 monthly average.

3. 12-month rolling average as of July 31, 2006. May be attributable to market conditions.

4. Between August 1, 2005 and July 31, 2006. All skim milk powder, including Plan B SMP.

GOALS

Goal 3. Increase CDC's involvement and expertise in trade issues

OBJECTIVES	PERFORMANCE INDICATORS FOR 2005-2006	RESULTS	PERCENTAGE COMPLETE
Improve working relationship with agriculture negotiating team	<ul style="list-style-type: none"> ■ Train the new trade analyst to increase CDC's expertise in trade issues ■ Provide expertise and advice to WTO negotiation team 	<ul style="list-style-type: none"> ■ A trade policy analyst was hired in June 2005 and left the position in May 2006. Recruitment a new trade policy analyst is under way. ■ Monthly meetings with Agriculture and Agri-Food Canada (AAFC) negotiation team. 	65
Provide information and expertise to various stakeholders regarding trade	<ul style="list-style-type: none"> ■ Evaluate impact of WTO decisions on Canadian dairy industry ■ Report to Commission and stakeholder/government committees 	<ul style="list-style-type: none"> ■ Monthly reports to the Commission. ■ Presentation to Farm Credit Canada. ■ CDC acted as bridge between the dairy industry and AAFC to ensure WTO-compliant programs 	100

OPERATIONS GOALS

Goal 4. Enhance the governance and operations of the CDC

OBJECTIVES	PERFORMANCE INDICATORS FOR 2005-2006	RESULTS	PERCENTAGE COMPLETE
Create and implement a comprehensive HR Plan	<ul style="list-style-type: none"> ■ Key positions identified by March 2006 ■ Competency profiles of key positions developed by March 2006 ■ Development and implementation of a self-identification methodology by March 2006 ■ Number of people with personal learning plans 	<ul style="list-style-type: none"> ■ A summary of the positions which will need to be staffed as employees retire over the next 10 years has been completed. Further work on this objective was delayed due to staff turnover in HR Services. ■ About half of the employees have a training plan. 	50
Finalize CDC Rules	<ul style="list-style-type: none"> ■ Commission approval 	<ul style="list-style-type: none"> ■ Rules approved by the Commission in March 2006. 	100

PERFORMANCE AND

OBJECTIVES	PERFORMANCE INDICATORS FOR 2005-2006	RESULTS	PERCENTAGE COMPLETE
Implement the Public Service Modernization Act (PSMA)	<ul style="list-style-type: none"> Implementation of the PSMA elements as per Treasury Board timelines 	<ul style="list-style-type: none"> Discussions have taken place with AAFC regarding an MOU on conflict management services. During 2005-2006, about 57 employees have received training on conflict resolution. 	75
Improve employees' knowledge of CDC's activities	<ul style="list-style-type: none"> Implementation of two initiatives 	<ul style="list-style-type: none"> Each team will present its activities to other teams over 2 years. CMSMC decisions are posted on the Intranet as they become available. The Chairman holds regular information meetings with all staff. 	100
Increase emphasis on team management	<ul style="list-style-type: none"> Increased number of team meetings 	<ul style="list-style-type: none"> Several teams have adopted a regular meeting schedule. 	100
Monitor the review of Governance Framework for Crown Corporations	<ul style="list-style-type: none"> Implementation of directives as required 	<ul style="list-style-type: none"> An impact analysis has been prepared for the Commissioners. Directives regarding Audit and Nominations Committee have been implemented. Follow up by government is being monitored. 	100
Develop and implement an Information Management Policy and Guidelines	<ul style="list-style-type: none"> Commission approval Completion of training on the Guidelines for all employees Implement the policy and guidelines in daily operations of all employees 	<ul style="list-style-type: none"> The Policy has been approved and its implementation is ongoing. Employees have received training on the guidelines which relate to this policy and on the automated information management system. Work is ongoing on a filing system for hard copies. 	75
Improve efficiency of service delivery	<ul style="list-style-type: none"> Reach Expenditure Review goal through operational efficiency Review and recommend changes to improve services to clients (avoid duplication) Implementation of recommendations of CDC's Special Examination by OAG 	<ul style="list-style-type: none"> The CDC was not subject to Expenditure Review. Some processes have been streamlined. Toll free number has been promoted. Member's side of milkingredients Web site has been improved. Ongoing. Some recommendations have already been implemented. 	90

GOALS

Outlook

World Trade Organization Negotiations

Talks went on after the ministerial meeting which took place in Hong Kong in December 2005 but agriculture was a major stumbling block. For a while, experts believed that the Doha round of negotiations would lead to tariff reductions and greater market access but the scope of possible changes and how they would apply to dairy products remained unknown. Talks were suspended in July 2006 and the world trade environment is expected to remain relatively stable in the next year.

Leadership of the CDC

In the 2006-2007 dairy year, the CDC will continue to share its expertise and provide leadership in order to help the Canadian dairy industry move forward. Already, it has proposed an interim pricing method for skim milk powder and butter for the next two years and has facilitated discussions which led to the establishment of a new price for Class 5(c). It also proposed several scenarios for the establishment of a national milk pool but for the time being, provinces have set this project aside.

The Canadian Dairy Commission will pursue its efforts to harmonize provincial policies by examining provincial milk utilization reports, the supply model and transportation costs in the East and the gathering of data in the Western pool. It has prepared a harmonized Audit Manual which will be presented at the CMSMC meeting in October 2006.

The CDC will also continue its efforts to improve relations between producers and processors. To that effect, it will closely monitor discussions of the Dairy Industry Working Group, a body established by the Minister of Agriculture and Agri-Food Canada to assist producers and processors in resolving certain issues.

Finally, in collaboration with Agriculture and Agri-food Canada and the Canadian Food Inspection Agency, the CDC will maintain its participation in projects related to food traceability and emergency preparedness plans while supporting similar initiatives within the milk pools.

Declining Domestic Demand for Dairy Products

The Canadian Milk Supply Management Committee (CMSMC) reduced the market sharing quota (MSQ) five times during 2005-2006 and it wasn't before June 2006 that demand grew slightly. At the retail level, a decrease in the quantity of butter (-2.5%), ice cream (-1.1%) and cheddar (-1.7%) sold through grocery stores contributed to the overall decline in demand for dairy products domestically. The sales of specialty cheeses (2.7%) and yogurt (2.1%) did increase but at rates far inferior to those reported in the previous year.

A ruling handed down in January 2006 by the Federal Court supported the decision of the Canadian International Trade Tribunal which ruled that European dairy protein concentrates are not subject to import tariffs. Much like the butteroil/sugar blend imports which are used to make ice cream, these concentrates are displacing Canadian dairy products in processed foods.

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The CDC must therefore pursue its efforts to develop new domestic markets for Canadian dairy products. To do so, it will continue the activities of the Dairy Marketing Program. The Market Committee is looking at ways to make special milk classes more competitive and the CDC supports its efforts.

Knowledge of the Industry

The complexity of the dairy industry and of its stakes is such that the CDC feels that it is time to develop and offer training and orientation sessions to industry stakeholders. A survey was sent to industry members enquiring about topics of interest and preferred learning formats. The CDC will act on the results of the survey during 2006-2007.

Internal Management

To better achieve its mandate, the CDC must ensure the efficiency of its internal operations and the quality of its human resources. It has therefore undertaken the preparation of a succession plan and started to document its procedures. To simplify the production of reports, the CDC has drafted a list of tasks which could be automated. It also prepared an Integrated Risk Management Plan.

The Federal Accountability Act will have an impact on the structure of the Commission if it is adopted by Parliament in its current form. The CDC will monitor the evolution of this bill and comply with its definitive version.

Risk Management

In May 2006, the CDC commissioners, directors and managers gathered to identify the factors that could potentially prevent the CDC from achieving its core mandate as well as its specific objectives. Following that, a small committee identified the various measures that the CDC could adopt to reduce the impact of those factors and the resulting Risk Management Plan was adopted by the Commission at its August 2006 meeting.

Many of the risks identified are external to the CDC (for example, WTO negotiations and the lack of a common vision in the dairy industry) and the organization has no direct control over them. It proved easier to mitigate other risks, such as the aging of our workforce and a potential natural disaster.

Goals for the period 2006-2007 to 2010-2011

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

GOALS

STRATEGIC GOALS

Goal 1 – Provide leadership to the Canadian dairy industry

OBJECTIVES	PERFORMANCE INDICATORS FOR 2006-2007
Facilitate the creation of a national all milk pool	<ul style="list-style-type: none"> ■ Timely pooling scenarios were provided. ■ Process was established by the regional pools for further action. ■ One pooling model was accepted by the CMSMC.
Encourage the harmonization of provincial dairy policies	<ul style="list-style-type: none"> ■ The Milk Utilization Audit Manual was revised, issued and approved by the CMSMC. ■ An automated system for milk utilization reporting was implemented in Ontario and/or other provinces. ■ A pooled allocation model was approved by the Eastern Pool. ■ Pooling models for transport were provided when required. ■ A harmonized approach to the collection of pooling data was adopted in the Western Pool.
After consultation with the industry, adopt and implement an interim pricing methodology for the next 2 years	<ul style="list-style-type: none"> ■ A consultation document was prepared and circulated to stakeholders. ■ Consultations were held involving all dairy industry stakeholders. ■ The CDC communicated its decision to stakeholders. ■ The interim pricing methodology was implemented.
Improve the working relationship between producers and processors	<ul style="list-style-type: none"> ■ Discussions were held with producers and processors on the need for a forum. ■ If agreeable, regular meetings have been scheduled.
Investigate the need for a strategy on traceability and emergency planning	<ul style="list-style-type: none"> ■ Agriculture and Agri-Food Canada (AAFC) made a presentation to the Commission on traceability and emergency planning. ■ The Commission provided direction to staff to develop a strategy on traceability and emergency planning in cooperation with AAFC and CFIA. ■ The Western Pool revised its Disaster Plan and the Eastern Pool initiated discussions on a similar plan.
Facilitate the creation of a 5 to 10 year plan for the Canadian dairy industry, based on the results of the WTO Doha round of negotiations	<ul style="list-style-type: none"> ■ Monthly trade reports were provided to commissioners. ■ A report assessing the impacts for the Canadian dairy industry was provided to the Commission. ■ A policy discussion on planning for the future with producer and processor input was sponsored by the CDC.

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Goal 2 – Increase the utilization of Canadian milk components

OBJECTIVES	PERFORMANCE INDICATORS FOR 2006-2007
Improve the effectiveness of the Special Milk Class Permit Program (SMCPP)	<ul style="list-style-type: none"> ■ The Market Committee's current mandate was completed and recommendations were presented to the CMSMC. ■ The Market Committee's recommendations were approved by the CMSMC and implemented as required. ■ Appropriate administrative changes to the SMCPP were implemented.
Develop further strategies for the marketing of dairy ingredients and components	<ul style="list-style-type: none"> ■ An internal technical group was created to develop and recommend options and strategies. ■ A decision was made whether or not to reconvene a meeting of the Ingredients Committee and that decision was acted on.

Goal 3 – Contribute to an increased knowledge of the Canadian dairy industry

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OBJECTIVES	PERFORMANCE INDICATORS FOR 2006-2007
Improve the understanding of the Canadian dairy system	<ul style="list-style-type: none"> ■ Two workshops were given.
Communicate information about the Canadian dairy industry to the public	<ul style="list-style-type: none"> ■ Information about the relative importance of the dairy industry and some comparisons were added to the CDC Web site and the information kits. ■ The Chairman was listed on a speakers' bureau. ■ MILKingredients.ca Web site was updated.
Develop technical expertise in agricultural economics and policy, food science and animal science in Canada	<ul style="list-style-type: none"> ■ Funding agreements between the CDC and university scholarship administrators were signed.

GOALS

OPERATIONS GOALS

Goal 4 – Effectively manage human resources

OBJECTIVES	PERFORMANCE INDICATORS FOR 2006-2007
Develop and implement a succession plan	<ul style="list-style-type: none"> ■ Competency profiles of key positions were developed. ■ A succession plan was developed. ■ Adequate career training was reviewed and recommended by HR Services.
Ensure HR services to CDC employees are current and effective	<ul style="list-style-type: none"> ■ Relevant TBS policies and guidelines were communicated to staff. ■ The CDC-PSMA committee made recommendations to the Directors. ■ An action plan on classification was developed and implemented. ■ A 3-year MOU for compensation and job classification was signed with AAFC.
Promote a learning culture	<ul style="list-style-type: none"> ■ Agreed training plans were included in performance evaluations for all employees. ■ 9 team presentations were made. ■ 5 dairy industry updates were given by the Chairman to staff.

Goal 5 – Maximize efficiency in CDC operations and services

OBJECTIVES	PERFORMANCE INDICATORS FOR 2006-2007
Document practices and procedures	<ul style="list-style-type: none"> ■ Responsible coordinators in each section were identified. ■ Key functions and activities were identified. ■ Assessment of current state was completed. ■ An execution plan which included timelines was developed. ■ Practices and procedures were documented and centralized.
Implement an integrated risk management framework	<ul style="list-style-type: none"> ■ A training session on risk management was offered to Managers, Directors and Commissioners. ■ A facilitated workshop was held to identify risks within each section. ■ A draft document on integrated risk management framework was circulated to Senior Management.
Automate and streamline internal and external reports	<ul style="list-style-type: none"> ■ A review of activities was completed. ■ A list of tasks to be automated was established and prioritized. ■ 5 reporting tasks were automated.

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. This process includes the communication and ongoing practice of the Commission's Code of Ethics and Professional 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 22, 2006

FINANCIAL REPORT

Management's Discussion and Analysis

for the year ending July 31, 2006

The following discussion and analysis of the operating results and financial position of the Canadian Dairy Commission (CDC) for the year ending July 31, 2006 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)

EXPORT ACTIVITIES

Dairy year	2005 -2006	2004 -2005	2003 -2004	2002 -2003	2001 -2002
Total sales	\$ 34,003	\$ 32,999	\$ 36,624	\$ 85,040	\$ 125,503
Total cost of sales	\$ 34,065	\$ 32,071	\$ 37,195	\$ 82,620	\$ 135,633
Margin (loss) on sales	\$ (62)	\$ 928	\$ (571)	\$ 2,420	\$ (10,130)

DOMESTIC ACTIVITIES

Dairy year	2005 -2006	2004 -2005	2003 -2004	2002 -2003	2001 -2002
Total sales	\$ 239,933	\$ 205,576	\$ 135,418	\$ 146,279	\$ 136,548
Total cost of sales	\$ 224,788	\$ 195,195	\$ 129,976	\$ 129,418	\$ 130,296
Margin (loss) on sales	\$ 15,145	\$ 10,381	\$ 5,442	\$ 16,861	\$ 6,252

OTHER KEY ACTIVITIES

Dairy year	2005 -2006	2004 -2005	2003 -2004	2002 -2003	2001 -2002
Carrying charges	\$ 8,197	\$ 5,779	\$ 4,232	\$ 2,911	\$ 5,342
Surplus at year end	\$ 25,963	\$ 25,614	\$ 22,460	\$ 32,440	\$ 15,132
Inventory on hand at year end	\$ 159,942	\$ 147,849	\$ 133,598	\$ 67,041	\$ 102,237
Loans from the Government of Canada	\$ 116,739	\$ 106,126	\$ 98,337	\$ 28,702	\$ 81,411

On export activities

Sales

Total export sales revenue increased by 3% or \$1.0 million compared to the previous year. Butter sales were much higher at \$8.8 million for 4,093 tonnes as compared to sales of \$2.2 million for 871 tonnes last year. The CDC exported more butter due to the larger surpluses that it had to purchase from the industry during the year.

Skim milk powder sales were lower at \$25.2 million for 10,041 tonnes as compared to sales of \$30.8 million for 12,240 tonnes last year. The main reason for the reduction in revenues from the sale of skim milk powder was the substantial appreciation of the Canadian dollar vis-à-vis the US dollar in the last year.

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 small gains or losses that reflect this price uncertainty.

For the dairy year ending July 31, 2006, cost of export sales increased by 6% compared to the previous year. This is explained by a 3% increase in sales, by the higher cost of goods sold and by increased transport costs. These activities have generated a small loss of \$62 thousand as compared to a profit of \$928 thousand for the previous year.

On domestic activities

Sales

In total, revenue from domestic sales increased by 17% during dairy year 2005-2006. This is explained mainly by higher sales of Plan B butter and Plan B SMP, as well as by higher sales of skim milk powder to domestic animal feed manufacturers.

The profit on butter was partly due to the fact that Plan A and Plan B butter is sold at the prevailing domestic prices and that these prices increased on February 1, 2006.

The volume of skim milk powder sold to the animal feed industry increased by 13% from 22.3 million kg to 25.1 million kg. The CDC had to sell this product on the domestic market because part of the

previous year's structural surplus could not be exported in that year and therefore had to be exported this year. This product contributed to most of the profit on skim milk powder sales since it was purchased in the previous year at a price lower than this year's selling price. At the time of purchase, a low purchase price was set because of the uncertainty of the market.

Cost of sales

Since 1995, Canada has always fulfilled its obligation under the WTO agreement to import 3,274 tonnes of butter each dairy year. The Commission essentially imports all of this butter, with a small quantity reserved for the Department of Foreign Affairs and International Trade. The CDC imports butter at prevailing world prices. This product is directed to the further processing sector through butter manufacturers.

Cost of sales increased by 15% mainly because of increased sales. Product costs and other related costs have remained at approximately the same level as last year.

Carrying charges, inventories and loans from the Government of Canada

Carrying charges increased substantially due to higher inventories during the dairy year as compared to the previous dairy year. The average of CDC's butter stocks were approximately 16.5 million kg for 2005-2006 compared to 10.8 million kg for 2004-2005. The CDC's butter stocks at year end were 19.0 million kg compared to 18.3 million kg in the previous year.

FINANCIAL REPORT

Inventory value increased by 8% from \$147.8 million to \$159.9 million this year due to higher production in the latter part of the dairy year and less demand for butter from the industry. Higher inventories have a direct impact on the loans from the Government of Canada since these stocks are financed by the Government of Canada until the product is sold.

Administrative expenses

Total administrative expenses were \$6.6 million, or approximately the same level as last year.

Challenges for the Future

For the next year, the main factors that could affect the financial results of the Canadian Dairy Commission are the world prices for dairy products such as skim milk powder and butter, and the strength of the Canadian dollar. These two factors have an influence on the results of the export activities. However, since any loss is covered by Canadian dairy farmers, there is no risk for the Government of Canada.

In the longer term, trade talks could have an influence on the financial performance of the CDC. New international trade deals could further limit the ability of the CDC to export surplus dairy products and could

also allow a greater quantity of foreign dairy products into Canada. Although these outcomes would have a serious impact on the dairy industry, their effect on the CDC's financial results would likely be minor. Furthermore, at this time (September 2006) WTO talks are suspended and show no sign of resuming. If a new trade agreement was to be signed, it would likely include an implementation period that would allow the CDC to prepare for the new trade rules.

In spite of all the efforts of the dairy industry to keep surpluses in line, disposing of these surpluses will continue to be one of the CDC's key roles. In the 2005-2006 dairy year, sales of milk components (for use in processed cheese) generated better returns for producers than sales in the animal feed market. However, the CDC still has to find new ways to dispose of surplus skim milk powder in niche markets that will increase the average revenue to producers, such as blends and high protein functional powders.

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, 2006 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, 2006 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:

-
Dale Shier, CA
Principal
for the Auditor General of Canada

Ottawa, Canada
September 22, 2006

FINANCIAL STATEMENTS

Balance Sheet

as at July 31 (in thousands)

	2006	2005 <small>Restated (Note 3)</small>
Assets		
Cash	\$ 53	\$ 130
Accounts receivable		
Due from provincial milk boards and agencies (pooling)	20,045	24,637
Trade	1,491	2,386
Inventories (Note 4)	159,942	147,849
	\$181,531	\$175,002
Liabilities		
Bank indebtedness – pooling account (Note 5)	\$ 1,549	\$ 1,290
Accounts payable and accrued liabilities		
Due to provincial milk boards and agencies (pooling)	17,077	21,799
Trade	9,186	14,425
Provision for margin payable to provincial milk boards and agencies (operational surplus)	8,506	3,568
Other liabilities	2,511	2,180
Loans from the Government of Canada (Note 6)	116,739	106,126
	155,568	149,388
Surplus (Note 7)	25,963	25,614
	\$181,531	\$175,002

Commitments (Note 12)

Approved:

Original signed by:

John Core

Chairman

Randy Williamson

Vice-Chairman

Gaëtan Paquette

Senior Director, 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)

	2006	2005 Restated (Note 3)
Sales and cost of sales		
Domestic sales	\$ 239,933	\$ 205,576
Cost of sales	224,788	195,195
Margin on domestic sales	15,145	10,381
Export sales (Note 8)	34,003	32,999
Cost of sales	34,065	32,071
Margin (loss) on export sales	(62)	928
Total margin on sales	15,083	11,309
Pooling of market returns activities		
Contributions from provincial milk boards and agencies	115,046	115,287
Equalization payments to provincial milk boards and agencies	107,182	107,931
Contributions withheld to fund operating expenses	7,864	7,356
Provision for margin payable to provincial milk boards and agencies (operational surplus)	8,506	4,623
Results before net operating expenses	14,441	14,042
Operating expenses (Schedule of Operations by Product)	17,664	14,560
less: funding of administrative expenses by the Government of Canada (Note 9)	3,572	3,672
Net operating expenses after funding by the Government of Canada	14,092	10,888
Results of operations after funding by the Government of Canada	349	3,154
Surplus at beginning of year, previously stated	25,614	21,405
Adjustment (Note 3)	–	1,055
Surplus at beginning of year, restated	25,614	22,460
Surplus at end of year	\$ 25,963	\$ 25,614

FINANCIAL STATEMENTS

Statement of Cash Flows

for the year ended July 31 (in thousands)

	2006	2005
Cash flows from operating activities		
Cash receipts from customers	\$ 274,715	\$ 236,621
Cash paid to suppliers and others	(291,293)	(254,044)
Cash receipts from provincial milk boards and agencies (pooling)	119,638	123,871
Cash paid to provincial milk boards and agencies (pooling)	(111,904)	(116,616)
Cash paid to provincial milk boards and agencies (operational surplus)	(3,568)	–
Cash receipts from the Government of Canada	3,672	3,597
Interest paid on loans	(2,209)	(1,331)
Cash flows (used in) operating activities	(10,949)	(7,902)
Cash flows from financing activities		
New loans from the Government of Canada	161,547	146,430
Loan repayments to the Government of Canada	(150,934)	(138,641)
Cash flows from financing activities	10,613	7,789
Net decrease in cash	(336)	(113)
Net bank indebtedness at beginning of year	(1,160)	(1,047)
Net bank indebtedness at end of year	\$ (1,496)	\$ (1,160)
Components:		
Cash	\$ 53	\$ 130
Bank indebtedness – pooling account	(1,549)	(1,290)
	\$ (1,496)	\$ (1,160)

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

Notes to Financial Statements

July 31, 2006

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 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, being actual purchase cost, or estimated net realizable value.

Revenues

Revenues from sales of product are recognized upon shipment.

Cost of sales

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

Pooling of market returns activities

Contributions from provincial milk boards and agencies and equalization payments to provincial milk boards and agencies represent a redistribution of milk revenues among provinces. A portion is withheld from the distributions to fund operating expenses.

FINANCIAL STATEMENTS

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 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 11.

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 11, or at the rate of exchange at year end.

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.

Derivative financial instruments

The Commission uses derivative financial instruments such as forward contracts to hedge the adverse movements in foreign exchange related to purchases and sales denominated in foreign currencies, including anticipated transactions, as well as to manage its cash balances and requirements. The Commission's policy is not to utilize freestanding derivative financial instruments for trading or speculative purposes.

All designated hedges are formally documented as to the Commission's risk objective and strategy, the specific item being hedged, and the method in which effectiveness is measured. The settlement method of accounting is used by the Commission to account for its hedges.

Under the settlement method, gains and losses on hedges are deferred and recognized in the period of settlement as a component of the related transaction. In order to determine the effectiveness at off-setting changes in cash flow of the hedged item, the Commission assesses both at inception and over the term of the hedging relationship, whether the critical terms of the hedge and hedged item match or the cumulative change in fair value of the hedge and hedged item remain within an acceptable range. If a hedge ceases to be effective or is terminated, hedge accounting is discontinued.

Employee future benefits

Pension benefits

All eligible employees participate in the Public Service Pension Plan administered by the Government of Canada. The Commission's contributions reflect the full cost as employer. This amount is currently based on a multiple of an employee's required contributions and may change over time depending on the experience of the Plan. The Commission's contributions are expensed during the year in which the services are rendered and represent the total pension obligation of the Commission. 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 Pension Plan.

Severance benefits

Eligible employees are entitled to severance benefits as provided for under labour contracts and conditions of employment. The cost of these benefits is accrued as employees render the services necessary to earn them. Management determined the accrued benefit obligation using a method based upon assumptions and its best estimates.

Other future benefit plans

The Commission has no liability for any future benefits provided to employees after employment or on retirement.

Capital assets

All acquisitions less than \$10 thousand are expensed in the year incurred.

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.

Future accounting changes

In January 2005 the Canadian Institute of Chartered Accountants (CICA) issued the following three accounting standards that will impact the Commission:

Section 3855 – Financial Instruments – Recognition and Measurement – This standard establishes criteria for the recognition, derecognition, measurement and classification of financial instruments. The Commission will be required to categorize its financial assets as held for trading, held to maturity, available for sale, or as loans and receivables. The related accounting treatment will be dependent on the classification. Financial assets categorized as held for trading or available for sale are to be measured at fair value while financial assets held to maturity, and loans and receivables are to be measured at amortized cost.

Section 1530 – Comprehensive Income – This standard requires certain gains and losses such as those arising from the valuation of financial instruments, that would otherwise be recorded as part of net income, be presented in other comprehensive income until such time as it is considered appropriate for them to be recognized in net income. A new financial statement entitled Comprehensive Income may be required in order to record such amounts until they are realized.

Section 3865 – Hedges – Derivatives will be classified as held for trading unless designated as hedging instruments. All derivatives will be measured at fair value. For derivatives that hedge the changes in the fair value of an asset or liability, changes in the derivatives' fair value will be reported in the net income and offset by changes in the fair value of the hedged asset or liability. For derivatives that hedge variability in cash flows, the effective portion of changes in the derivatives' fair value will be initially recognized in other comprehensive income, and will subsequently be reclassified to net income in the periods affected by the variability in the cash flows of the hedged item.

These new standards will come into effect for the Commission's 2008 fiscal year, however early adoption provisions exist. The Commission

FINANCIAL STATEMENTS

is in the process of determining the impact that these standards will have on its financial reporting.

3. Change in recognition of margin paid to provincial milk boards and agencies

A portion of the Commission's margin on sales is payable to provincial milk boards and agencies. Previously, the Commission accounted for this margin as a reduction of surplus in the year that the actual payment to provincial milk boards and agencies was approved. Now, the Commission records the margin payable to provincial milk boards and agencies as an expense in the year that the margin is earned.

The Commission has accounted for this retroactively, and the effect on the financial statements for the year ended July 31, 2005 is as follows:

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	Previously Stated	Adjustment (in thousands)	Restated
Balance sheet			
Provision for margin payable to provincial milk boards and agencies (operational surplus)	\$ —	\$ 3,568	\$ 3,568
Surplus	29,182	(3,568)	25,614
Statement of Operations and Surplus			
Provision for margin payable to provincial milk boards and agencies (operational surplus)	—	4,623	4,623
Results of operations after funding by the Government of Canada	7,777	(4,623)	3,154
Surplus at beginning of year	21,405	1,055	22,460
Surplus at end of year	29,182	(3,568)	25,614

4. Inventories

	2006 (in thousands)	2005
Butter	\$ 111,613	\$ 109,132
Skim milk powder	48,329	38,717
Total	\$ 159,942	\$ 147,849

The Commission's inventory includes 12,983 tonnes of butter and 4,668 tonnes of skim milk powder (2005 — 12,290 tonnes and 2,426 tonnes) with a total cost of \$89.40 million and \$27.20 million respectively (2005 — \$83.87 million and \$13.89 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 6,075 tonnes of butter and 14,274 tonnes of skim milk powder (2005 — 6,024 tonnes and 21,502 tonnes) with a total cost of \$22.21 million and \$21.13 million respectively (2005 — \$25.26 million and \$24.83 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 (2005 — \$5 million) line of credit with a member of the Canadian Payments Association. The Commission has been granted the authority to establish this line of credit by the Minister of Finance up to a maximum of \$50 million. The bank indebtedness incurred under this line of credit is due on demand and bears interest at prime which on July 31, 2006 was 6.00% per annum.

6. Loans from the Government of Canada

Loans from the Government of Canada, to a maximum of \$120 million (2005 — \$120 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 is at the normal rates established for Crown corporations by the government and varied from 2.59% to 3.77% (2005 — 2.10% to 2.96%) during the year and totaled \$2.90 million (2005 — \$1.48 million).

7. 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 and not directly payable to provincial milk boards and agencies.

8. Export sales

Export sales include \$30 thousand representing net gains (2005 — net losses of \$130 thousand) arising from currency translation relating to transactions incurred in foreign currencies.

9. 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 \$3.52 million (2005 —

\$3.37 million) of the Commission's administrative expenses of \$6.63 million (2005 — \$6.66 million), as well as \$50 thousand (2005 — \$300 thousand) for professional services relating to costs of production data collection.

10. Employee future benefits

Pension Plan

Operating expenses include the Commission's contributions to the Public Service Pension Plan during the year totaling \$540 thousand (2005 — \$480 thousand), which corresponds to about 2.6 times (2005 — 2.6 times) the employees' contributions to the Plan.

Severance benefits

The Commission provides severance benefits to its employees based on years of service and final salary. This benefit plan is not pre-funded and thus has no assets, resulting in a plan deficit equal to the accrued benefit obligation. Benefits will be paid from future appropriations and other sources of revenue. Information about the plan, measured as at the balance sheet date, is as follows:

	2006 (in thousands)	2005
Accrued benefit obligation, beginning of year	\$ 820	\$ 789
Cost for the year	105	70
Benefits paid during the year	(123)	(39)
Accrued benefit obligation, end of year	\$ 802	\$ 820

The severance benefit liability is included on the Balance Sheet in Other liabilities.

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11. Financial instruments

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. The primary risk to the Commission when entering into foreign exchange contracts is represented by credit risk, wherein the counterparty fails to perform an obligation as agreed upon causing a financial loss. The Commission manages its exposure to credit risk by contracting only with creditworthy counterparties. All of the Commission's foreign exchange contracts are with major Canadian financial institutions.

At the end of the year, the notional value of the Commission's outstanding forward exchange contracts totaled \$3.55 million Canadian equivalent (2005 — \$9.17 million Canadian equivalent). These contracts will mature over the period ending October 2006. 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, 2006 are as follows:

Currency sold	Currency purchased	(in thousands)	
		In USD	In Canadian
U.S. dollars	Canadian dollars	3,198	3,551
Total		3,198	3,551

Due to the proximity of the settlement dates of the forward exchange contracts to July 31, 2006, fair value approximations are immaterial.

Other 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.

12. Commitments

Purchase commitments

As at July 31, 2006, the Commission was committed to purchase certain quantities of butter and skim milk powder. These commitments amounted to approximately \$5.27 million (2005 — \$8.06 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 the Commission'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 \$200 thousand 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 year are as follows:

2006–2007	\$200 thousand
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The Commission has exercised its option to renew the lease for another five years ending March 31, 2012 at a yet undetermined rate.

Promotional Funding

The Commission has entered into agreements to promote the sale of fluid milk. Under the terms of the agreement the Commission will contribute up to \$4 million per calendar year for the years 2006, 2007 and 2008. As at July 31, 2006 a total of \$720 thousand has been contributed.

Canadian Dairy Commission Scholarships Program

The Commission has entered into agreements with institutions whereby it will fund graduate studies at the Master and Doctoral levels to students in Canada in agricultural economics and policy, food/dairy science or animal science in relation to the dairy industry. The Commission has committed \$3 million towards the program. As of July 31, 2006, a \$1 million agreement had been signed and transfer of funds is pending until submission by the institute of an implementation plan which is a requirement of the program.

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 \$180 thousand (2005 — \$250 thousand) 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 and at normal trade terms. These transactions such as Employee Benefit Plans, accommodations and professional services, totaled about \$1.51 million during the year (2005 — \$1.65 million).

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Schedule of Operations by Product

for the year ended July 31

(in thousands)

	2006				2005			
	Butter	Skim Milk Powder	Other Products*	Total	Butter	Skim Milk Powder	Other Products*	Total
Sales and cost of sales:								
Domestic sales	\$180,248	\$ 59,685	\$ –	\$239,933	\$156,488	\$ 49,088	\$ –	\$205,576
Cost of sales	174,329	50,459	–	224,788	150,730	44,465	–	195,195
Margin on domestic sales	5,919	9,226	–	15,145	5,758	4,623	–	10,381
Export sales	8,848	25,155	–	34,003	2,167	30,832	–	32,999
Cost of sales	8,547	25,518	–	34,065	1,682	30,389	–	32,071
Margin (loss) on export sales	301	(363)	–	(62)	485	443	–	928
Total margin (loss) on sales	\$ 6,220	\$ 8,863	\$ –	\$ 15,083	\$ 6,243	\$ 5,066	\$ –	\$ 11,309
Operating expenses:								
Storage costs	\$ 3,256	\$ 1,204	\$ –	\$ 4,460	\$ 2,014	\$ 1,615	\$ –	\$ 3,629
Interest expense	2,694	204	–	2,898	1,367	124	–	1,491
Other carrying charges	634	205	–	839	483	176	–	659
Projects and promotional activities	1,376	–	140	1,516	587	–	174	761
Domestic dairy product assistance	–	–	306	306	–	–	417	417
	<u>\$ 7,960</u>	<u>\$ 1,613</u>	<u>\$446</u>	10,019	<u>\$ 4,451</u>	<u>\$ 1,915</u>	<u>\$591</u>	6,957
Administrative expenses								
Salaries and employee benefits				5,144				4,905
Other expenses				1,491				1,752
				6,635				6,657
Cost of production, interest and bank charges related to the operation of the pooling of the market returns system				988				916
Donation				22				30
Total operating expenses				\$ 17,664				\$ 14,560

*Includes whole milk powder, concentrated milk and cheese.



APPENDICES

Appendix 1

HARMONIZED MILK CLASSIFICATION SYSTEM

CLASS	PRODUCTS
1(a)	Milk and milk beverages, partly skimmed or skimmed, whether or not treated for lactose intolerance, whether flavoured or not, with or without vitamins or minerals added, for retail and food service (egg nog, cordials, cultured milk, concentrated milk to be reconstituted as fluid milk)
1(b)	All types of cream with a butterfat content not less than 5% for retail food service
1(b)ii	Fresh cream with a butterfat content of 32% and higher used to make fresh baked goods which are not eligible for a Class 5 permit. Any utilization of this class would require a Class 1(b)ii permit.
1(c)	New 1(a) and 1(b) fluid products for retail and food service as approved by the provincial authorities during an introductory period.
1(d)	1(a) and 1(b) fluid products marketed outside the ten signatory provinces but within Canadian boundaries (e.g. Yukon, NWT, Nunavut and cruise ships).
2	All types of ice cream, ice cream mix, yogurt, kefir, whether frozen or not, all types of sour cream, all types of milk shake mixes ¹ , other frozen dairy products and the following products: fudge, puddings, meal replacements, soup mixes, infant formula, caffeinate and Indian sweets
3(a)	All cheeses other than those identified in class 3(b), all types of cheese curds other than stirred
3(b)	All types of cheddar cheese, stirred curd, cream cheese, creamy cheese bases (cheese mixes), cheddar and cheddar-type cheeses sold fresh (see definition ²)

1. Milk shakes for retail sales are currently classified as a Class 1 product in the WMP and classified as Class 2 in the Ps.

2. Definition of cheddar-type cheese : a cheese of descriptive nomenclature will be recognized as a cheddar-type cheese for the purposes of classification if it is a firm or semi-soft, unripened, unwashed curd cheese, with a minimum milk fat content of 25% and a maximum moisture content of 45%.

CLASS	PRODUCTS
4(a)	All types of butter and butteroil, all types of powder, concentrated milk as an ingredient in the food industry ³ , all other products not elsewhere stated
4(a) ¹⁴	Milk components for the manufacture of rennet casein (dry or curd) or milk protein concentrate (MPC) to be used in the manufacture of non-standardized final products in the processed cheese category.
4(b)	Concentrated milk for retail sale whether sweetened or not
4(c)	New industrial products as approved by provincial authorities for an introductory period.
4(d)	Inventories and losses ⁵
4(m)	Milk components for marginal markets as established from time to time by the CMSMC
5(a) ⁶	Cheese used as ingredients for further processing for the domestic and export markets.
5(b) ⁶	All other dairy products used as ingredients for further processing for the domestic and export markets
5(c) ⁶	Dairy products used as ingredients for the confectionery sector destined for domestic and export markets
5(d)	Planned exports and other exports approved by the CMSMC, the total of which shall not exceed Canada's WTO commitments

3. In the Western Milk Pool, concentrated milk is used to make other dairy products. In the P5, such usage is classified on end-use.

4. Pricing and Administration

- i. Provincial boards or agencies will set the butterfat price for class 4(a)₁ at the 4(a) price and will set the price for protein and other solids for class 4(a)₁ at the price established by the CMSMC on a semi-annual basis (August 1 and February 1).
 - ii. CDC will receive the milk utilisation declaration from the provincial boards and agencies on a monthly basis for pooling or revenue purposes. Provinces agree that the revenues from class 4(a) will be pooled at the P10 level.
 - iii. Audit of Class 4(a)₁ will be performed by the usual organizations responsible for performing that task in the provinces. In the case of interprovincial movement of product, the CDC will coordinate the audit and supporting information with provincial auditors. The processor receiving the raw milk used to make rennet casein (dry or curd) or MPC under Class 4(a)₁ will be responsible for providing documentation which supports the claim that the components were utilized in the manufacture of non-standardized final products in the processed cheese category. Participating provinces will undertake to implement the proper audit procedures to ensure compliance within this class.
 - iv. Class 4(a)₁ will be renewed upon successful review and approval of the CMSMC by February 1, 2008.
5. Losses: Explained losses (dumps, fluid returns, dead vats, etc.) Unexplained losses: Up to 2% for processing (West only).
6. Under class 5(a), (b) and (c) (Special Milk Class Permit Program), industrial milk is classified and made available for use in dairy products and products containing dairy ingredients at prices which vary according to end use. The volume of dairy components accessed under this class is monitored through permits issued by the Canadian Dairy Commission.

APPENDICES

Appendix 2

GLOSSARY

Canadian Milk Supply Management Committee (CMSMC)

The CMSMC is the key national body for policy development and discussions respecting the sectors of dairy production and processing. It oversees the application of the National Milk Marketing Plan. The Canadian Dairy Commission (CDC) chairs and supports the CMSMC and its Secretariat, a technical committee which provides economic analysis and advice to the members of the CMSMC. The CMSMC has representation from producers and governments of all provinces. Representatives of national consumer, processor and producer organizations also participate as non-voting members. The CMSMC meets five times per year to review and consider the major economic and marketing factors affecting the dairy sector. It also reviews and monitors the CDC's marketing operations and promotional activities; the pooling systems established for market returns from certain milk sales; and provincial quota allocations and utilization. The CMSMC determines the national production target or Market Sharing Quota (MSQ).

Canadian Requirements

Total domestic consumer demand plus planned exports for all industrial milk processed into dairy products.

Dairy Producers

Dairy producers are farm owners and operators who keep a herd of cows and ship milk.

Dairy Year

The major elements of the supply management system for the Canadian dairy sector operate on a dairy rather than a calendar or fiscal year basis. Established to co-ordinate the natural patterns of milk production with market requirements, the dairy year goes from August 1 to July 31.

Domestic Requirements

Total domestic consumer demand for all industrial milk processed into dairy products.

Further Processors

Further processors use milk or other dairy products such as cheese to manufacture other food products that are sold at the retail level.

Industrial Milk

Milk sold for processing into such dairy products as butter, cheese, ice cream or yogurt.

Market Sharing Quota (MSQ)

The MSQ is the national production target for industrial milk. This target is constantly monitored and adjusted when necessary to reflect changes in the domestic demand for industrial milk products, as measured in terms of butterfat, as well as changes in planned export activity. The CMSMC applies the terms of the National Milk Marketing Plan to establish the provincial shares of the MSQ. Each province allocates its share of the MSQ to its producers according to its own policies.

Milk Class

All milk in Canada is classified according to its use (for example, fluid, cheese, butter, etc.). The price paid to the producer for the milk depends on the class. This classification system is not related to milk quality.

National Milk Marketing Plan

The National Milk Marketing Plan is the federal/provincial agreement that provides the framework for the operation of the milk supply management system and is administered by the CMSMC. All Canadian provinces are signatories to the national Plan.

Processors

Processors are companies or co-operatives that buy raw milk and manufacture fluid milk and cream, or other dairy products.

Supply Management

Supply management is a system by which the production of milk is controlled by production quotas at the farm level. The size of the quota depends on the demand for milk and other dairy products.

Structural Surplus

Since milk production quotas are measured in terms of kg of butterfat, and because the demand in Canada is greater for butterfat than for the non fat portion of milk, there is a surplus of non fat milk components, mainly in the form of skim milk powder.

Support Prices

Support prices are the prices at which the CDC offers to purchase domestically produced butter and skim milk powder under its Domestic Seasonality Programs. Support prices act as reference prices in the wholesale dairy trade and indirectly affect the wholesale prices of all industrial dairy products. They are established at levels designed to generate a fair return for producers.

