



CANADIAN DAIRY COMMISSION ANNUAL REPORT 2004–2005



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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We wish to thank all the children who took the time to illustrate for us what dairy meant to them.

Morgane Basillais, 8 years old; Alexandre Brunet, 12; Dominique Brunet, 9; Jessica Geigel, 6; Justin Geigel, 8; Inès Cyr Gonzalez, 9; Renée Laframboise, 8; Olivia Manzoli, 6; Laurence Mercier, 7; Vincent Mercier, 7; Émie Vigneault-Desjardins, 7.

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LETTER TO THE MINISTER

Mr. Minister,

We are pleased to submit the Canadian Dairy Commission's Annual Report for the 2004-2005 dairy year. In this 39th year of operation, we pursued our goals to strengthen the industry and achieve harmonized dairy policies to maintain a viable Canadian dairy sector.

We are proud to say that many of the 2004-2005 initiatives were aimed at encouraging and supporting innovation in the creation and the use of dairy products. The amount of milk available for the Domestic Dairy Product Innovation Program will double on August 1st, 2005 to reach 2% of the Canadian industrial milk quota, or about 1 million hectolitres. This program allows dairy product manufacturers to have access to extra quantities of milk to develop and bring new dairy products to market.

The Canadian Dairy Commission (CDC) also revamped its Dairy Ingredient Marketing Program and it is now called the Dairy Marketing Program. It still includes a complete on-line library of information on milk ingredients, their suppliers, characteristics, and uses, as well as participation in major Canadian trade shows. Two Innovation Champions have been added to our marketing team. Their role is to visit food manufacturers and dairy processors who plan to use dairy ingredients in new products and offer them financial and technical assistance. The Program also features two new funds: the Direct Access Fund makes it easier for food companies to have access to the technical expertise required to develop new products; and the Innovation Fund provides financial help for product development. Both are more specifically targeted to small and medium-size companies. Changes in the national milk classification system will also help in the development of new dairy products.



Last December, the CDC announced an increase in the support prices of butter and skim milk powder. This 7.8% increase, equivalent to 5 cents per litre of milk leaving the farm, was significantly higher than increases in the last few years. It included a BSE add-on of 1.66 cent per litre to partially compensate for the financial impact that the BSE crisis has had on Canadian dairy farms. The existence and magnitude of this add-on will be re-evaluated at the next price review in December 2005. With this increase, the CDC is very close to fulfilling its commitment to gradually increase support prices with an objective of covering the cost of production of 50 percent of Canadian dairy farmers by 2006.

The Canadian dairy industry is still adjusting to the international trade rules under the World Trade Organization (WTO) Agreement on Agriculture (1994) and as they have been interpreted by subsequent panels. For example, the CDC is establishing partnerships with provincial agencies to increase the promotion effort for fluid milk products. The industry is looking at ways to better manage production and to adjust milk composition to minimize surplus production. Talks are underway to examine the possibility of a national all milk pool that should increase the flexibility of the sector.

To help the industry prepare and adapt to the changes dictated by the WTO, the CDC has hired a trade policy analyst whose role is to monitor trade negotiations and analyze their potential impact on the Canadian dairy industry.

In the last year, the Commission received the Special Examination Report from the Office of the Auditor General. The Report found

that “there is reasonable assurance that there were no significant deficiencies in the systems and practices examined”.

In an effort to streamline its operations, in the last year, the Commission has adopted various policies and procedures such as a delegation of financial and human resources authority and an Employee Recognition Policy. In addition, to comply with the new requirements from the Government of Canada, the CDC has established a Nominations Committee responsible for selecting candidates for the functions of Chair, Vice-chair and Commissioner.

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. 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 ongoing support for the work of the Commission.



John Core
Chairman



Carl Harrison
Vice-chairman



Jean Grégoire
Commissioner

THE CANADIAN DAIRY



INDUSTRY

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

Key Highlights of 2004-2005

Key highlights for the dairy industry of Canada in the 2004-2005 dairy year include:

- a revised national milk classification system, which should increase harmonization among provinces;
- a concerted effort to expand domestic consumption of dairy products; and
- the continued implementation of measures to better match supply and demand of milk in order to avoid surpluses.

Milk Production

Farm cash receipts

As a key contributor to the Canadian economy in the 2004 calendar year, the dairy industry ranked fourth behind grains, red meats, and horticulture generating \$4.6 billion in total farm cash receipts.

Number of farms and production per farm

In the 2004-2005 dairy year, Canada had 16,224 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 2004-2005 dairy year was 5,022 hectolitres (hl), a 4.6% increase from the previous year.

In the 2004-2005 dairy year, Quebec and Ontario had the greatest number of dairy farms at 81%, followed by 13% in the Western provinces and 6% in the Atlantic provinces.

NUMBER OF FARMS, COWS AND TOTAL PRODUCTION*

2000-2001 to 2004-2005

| | Number of farms | Number of cows (million) | Total production (million hl) |
|-----------|-----------------|--------------------------|-------------------------------|
| 2000-2001 | 19,363 | 1.09 | 78.1 |
| 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 |

* At 3.6 kg of butterfat per hl

In 2004, there were about 1.06 million dairy cows in Canada producing an average of 9,458 kilograms (kg) of milk per cow.

THE CANADIAN DAIRY

NUMBER OF MILK AND CREAM FARMS IN 2004-2005

| | Cream | Milk | Total |
|---------------------------|-----------|---------------|---------------|
| Newfoundland and Labrador | 0 | 41 | 41 |
| Prince Edward Island | 9 | 256 | 265 |
| Nova Scotia | 0 | 314 | 314 |
| New Brunswick | 0 | 277 | 277 |
| Quebec | 0 | 7,757 | 7,757 |
| Ontario | 0 | 5,346 | 5,346 |
| Manitoba | 4 | 526 | 530 |
| Saskatchewan | 0 | 278 | 278 |
| Alberta | 0 | 749 | 749 |
| British Columbia | 0 | 667 | 667 |
| TOTAL | 13 | 16,211 | 16,224 |

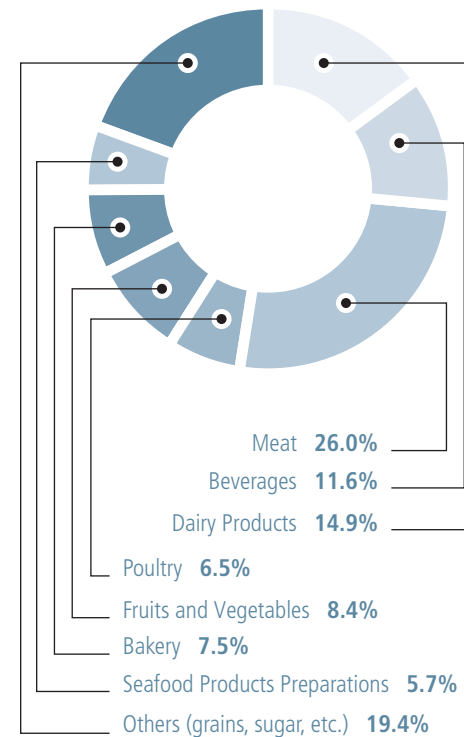
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Milk Processing

In the 2004 calendar year, the processing industry generated \$11.5 billion* of products shipped from approximately 445 processing plants (300 of which are federally inspected) accounting for 14.9% of all processing sales in the food and beverage industry. During the 2004-2005 dairy year, the dairy processing sector employed approximately 26,000 people.

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

SHARE OF MANUFACTURED SHIPMENTS IN CANADA – VALUE BASIS (2004)



INDUSTRY

Milk Markets

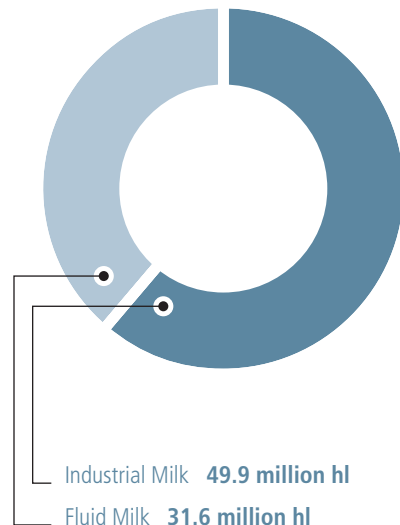
Canadian dairy producers supply two main markets:

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

In the 2004-2005 dairy year, the fluid market accounted for approximately 39 percent of total producer shipments of milk, or 31.6 million hl*. The industrial market accounted for the remaining 61 percent or 49.9 million hl* of total producer shipments.

* At 3.6 kg of butterfat per hl.

INDUSTRIAL AND FLUID MILK PRODUCTION IN 2004-2005



Ingredients market

Innovation in the manufacture and use of dairy products and components is vital to Canadian companies. These businesses continue to adapt their product lines to a more health conscious, active and culturally diverse clientele in search of convenient, nutritious and good tasting foods and beverages.

Health professionals and consumers are now more concerned with the presence of trans fatty acids, which can be found in many manufactured food products, than with carbohydrates. By their composition, dairy products and components find themselves ideally positioned to respond to these legitimate health concerns.

The two new Innovation Funds sponsored by the Canadian Dairy Commission assist dairy and food processors in responding to these and other challenges by bringing new and reformulated products to market. These help grow the market for milk.

Harmonized Milk Classification System

Provincial marketing boards and agencies purchase milk from producers and sell it to processors for the manufacture of dairy products. The milk produced in Canada is classified according to its end use based on the Harmonized Milk Classification System. The price paid for milk by the processors will vary according to the milk class.

In February 2005, the dairy industry adopted a new Classification System for Canada. As a next step each province needs to approve and implement the system. The following table shows how the Canadian milk production was used in the last dairy year.

THE CANADIAN DAIRY

HARMONIZED MILK CLASSIFICATION SYSTEM

| Class | Products | Milk used (2004-2005) | | | |
|----------------------|--|-----------------------|-----------------|--------------------|---|
| | | ooo kg butterfat | % of total milk | | |
| Class 1 | (a) fluid milks and beverages | 83,052 | 28 | | |
| | (b) fluid creams | | | | |
| | (b)(ii) fresh cream for fresh baked goods not eligible for a class 5 permit | | | | |
| | (c) new fluid products, as approved by provincial authorities | | | | |
| | (d) fluid products for the Yukon, Nunavut, Northwest Territories, and cruise ships | | | | |
| Class 2 | yogurt, sour cream, ice cream and frozen dairy products, meal replacements, some mixes, Indian sweets and others | 21,091 | 7 | | |
| Class 3 | (a) cheeses and curds other than 3(b) | 46,797 | 16 | | |
| | (b) cheddar cheese, stirred curds, cream cheese | 51,288 | 18 | | |
| Class 4 | (a) butter, butteroil, powders and concentrated milk for ingredient purposes | 59,048 ¹ | 20 | | |
| | (a)(1) components for rennet casein or milk protein concentrate for non-standardized final products in the processed cheese category | | | | |
| | (b) concentrated milk for retail | | | 6,078 ² | 2 |
| | (c) new industrial products, as approved by provincial authorities | | | | |
| | (d) inventories and losses | | | | |
| (m) marginal markets | | | | | |
| Class 5 | (a) cheese used as ingredient for further processing for the domestic and export markets | 20,191 ³ | 7 | | |
| | (b) all other dairy products for further processing for the domestic and export markets | | | | |
| | (c) domestic and export activities of the confectionery sector | | | | |
| | (d) planned exports and other exports, the total of which shall not exceed Canada's WTO commitments | | | 5,247 | 2 |
| TOTAL | | 292,792 | 100 | | |

¹ Classes 4(a) and 4(a)

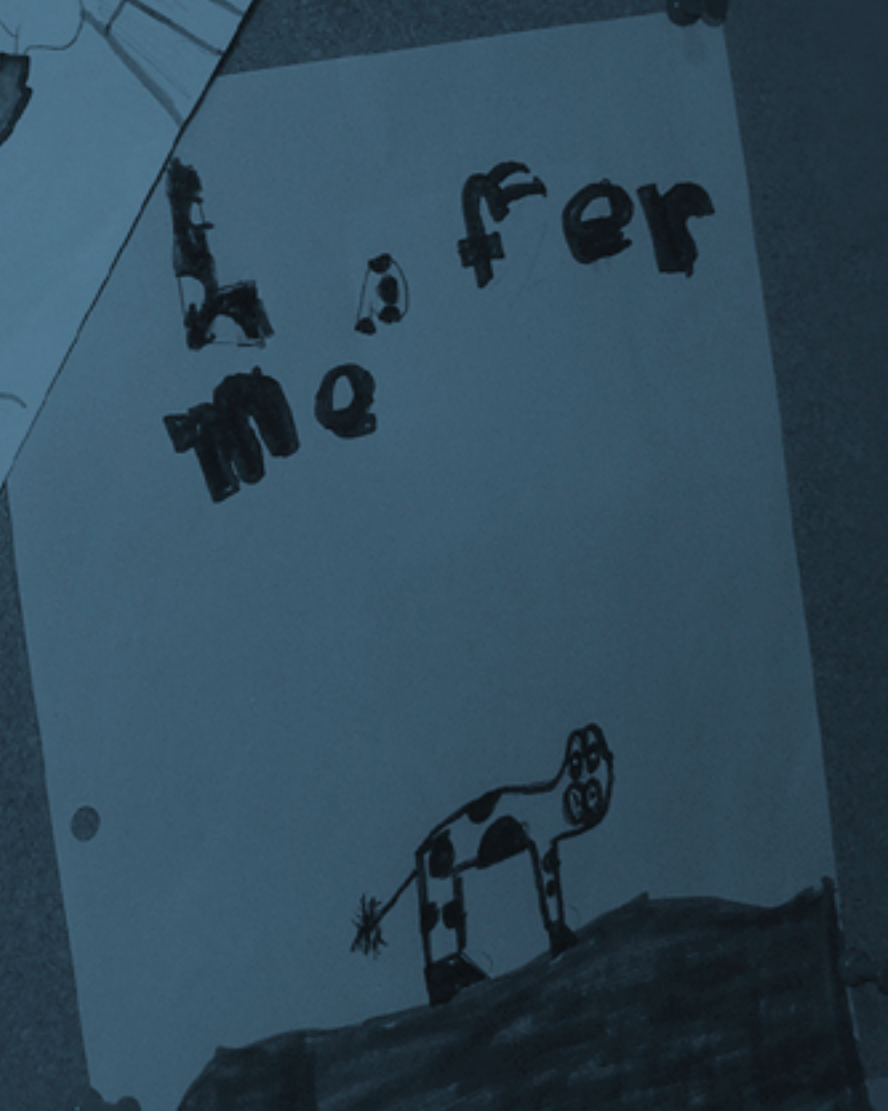
² Classes 4(b), 4(c), 4(d) and 4(m)

³ Classes 5(a), 5(b) and 5(c)

INDUSTRY



THE CANADIAN DAIRY



COMMISSION

Corporate Governance

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

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

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

Chairman and CEO

John Core

Appointed in October 2002

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

Vice-chairman

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.

THE CANADIAN DAIRY

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.

Special initiatives in 2004-2005 in the area of corporate governance include:

- The Office of the Auditor General performed the required Special Examination of the activities of the CDC and issued its report in June 2005. The Examination identified no significant deficiencies. The report is posted on the CDC Web site.
- The Public Service Human Resources Management Agency of Canada performed an employee classification monitoring exercise at the Commission. The recommendations from this audit will be reviewed and appropriate actions will be implemented in the coming months.

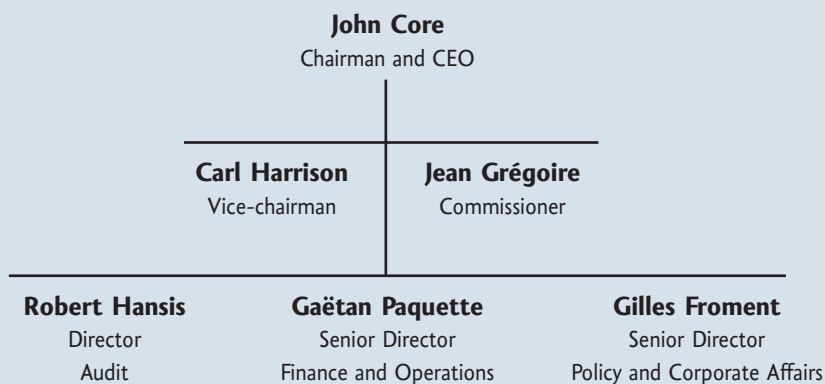
COMMISSION

- Various internal policies were adopted or updated (Hospitality/Catering Directive; Career Transition Policy; Delegation of Human Resources Authority; Grievance Procedure; Employee Recognition Policy; Translation Policy; Code of Ethics and Professional Conduct).
- The CDC conducted an evaluation of the Special Milk Class Permit Program. Recommendations were presented to the CMSMC in July 2005.
- Internal audits were performed on the Concentrated Milk Assistance Program and on the export subsidy monitoring system.
- In the area of Security and Health and Safety, the Commission approved several policies in the last year such as the Security Policy and the Password Policy. The CDC also installed first aid stations

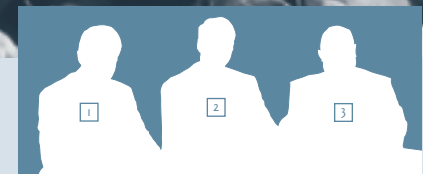
in its offices, conducted a fire drill and adopted an Emergency Preparedness Plan and a Business Continuity Plan. Inspections of the workplace are carried out on a regular basis.

- The CDC's Business Continuity Plan was tested and the results of the test were considered satisfactory by Commissioners.

The Commissioners meet on a monthly basis to establish the strategic orientation and monitor the operational results 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.



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



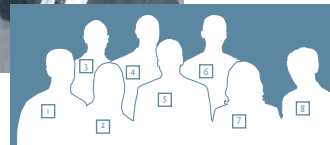
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AUDIT



- 1 Robert Hansis
Director, Audit
- 2 Indira Gangasingh
Manager, Assurance Services
- 3 Hossein Behzadi
Manager, Program Audits

FINANCE AND OPERATIONS



- 1 Andre Berckmans
Manager, Financial Reporting,
Accounting, and Treasury
- 2 Chantal Laframboise
Manager, Pooling
- 3 Mark Lalonde
Chief, Marketing Programs
- 4 Richard Rancourt
Chief, I.T.
- 5 Gaëtan Paquette
Senior Director,
Finance and Operations
- 6 Marcel Claude
Chief, Finance and Administration
- 7 Gaby Da Silva
Manager, Special Milk Class Permit Program
- 8 Laval Létourneau
Chief, Commercial Operations

POLICY AND CORPORATE AFFAIRS



- 1 Erik Kramar
Chief Economist
- 2 Paula Flood
Human Resources Advisor
- 3 Nelson Coyle
Chief, Policy and
Strategic Planning
- 4 Chantal Paul
Chief, Communications
- 5 Gilles Froment
Senior Director,
Policy and Corporate Affairs

COMMISSION

The Commission's offices are located in Ottawa, Ontario. The Commission employs 63 people.

The success of the Canadian Dairy Commission depends largely on its employees and on the quality of the services they offer. The CDC encourages and supports good individual and organizational performance.

Activities and Programs

Main Activities

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

- Through its chairmanship and work for the Canadian Milk Supply Management Committee (CMSMC), the CDC provides ongoing support to the Canadian dairy industry while operating in close co-operation with national and provincial stakeholders and governments;
- It acts as a facilitator and provides secretariat services to the revenue pooling and market sharing systems. Provisions for these functions are set out in the All Milk Pooling Agreement, the Western Milk Pooling Agreement, and the Comprehensive Agreement on Pooling of Milk Revenues. The CDC also administers the financial mechanisms required by these agreements;
- It calculates and 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 and issues permits allowing further processors to have access to competitively-priced dairy ingredients, and allowing exporters to export dairy products within Canada's WTO commitment levels;
- It develops and implements 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.

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.

PRODUCTION OF MILK AND CREAM*

(thousands of kg of butterfat)

| Province | 2003-2004 | | | 2004-2005 | | |
|---------------------------|----------------|----------------|----------------|----------------|----------------|------------------|
| | Fluid | Industrial | Total | Fluid | Industrial | Total |
| Newfoundland and Labrador | 1,245 | 115 | 1,360 | 1,248 | 267 | 1,515 |
| Prince Edward Island | 583 | 3,255 | 3,838 | 574 | 3,266 | 3,840 |
| Nova Scotia | 4,132 | 2,448 | 6,580 | 4,099 | 2,433 | 6,532 |
| New Brunswick | 2,523 | 2,632 | 5,155 | 2,621 | 2,493 | 5,114 |
| Quebec | 27,222 | 86,482 | 113,704 | 27,108 | 85,696 | 112,803 |
| Ontario | 44,336 | 53,533 | 97,869 | 44,244 | 52,517 | 96,761 |
| Manitoba | 4,421 | 6,811 | 11,232 | 4,561 | 6,812 | 11,373 |
| Saskatchewan | 2,684 | 5,279 | 7,963 | 2,749 | 5,416 | 8,165 |
| Alberta | 12,632 | 10,390 | 23,022 | 13,125 | 10,473 | 23,598 |
| British Columbia | 13,009 | 9,861 | 22,870 | 13,355 | 10,278 | 23,634 |
| Total | 112,787 | 180,806 | 293,593 | 113,684 | 179,651 | 293,335** |

* Before pooling

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

COMMISSION

The CMSMC is a permanent body created by the signatories to the National Milk Marketing Plan (NMMP). Its mandate is to determine policies and to supervise the provisions of the NMMP 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 is chaired by the Commission and 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.

Supply and Demand

The Commission monitors trends in Canadian Requirements (demand) and production (supply) on a monthly basis. Canadian Requirements are defined as the butterfat required to fulfill 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 2004-2005 dairy year, Canadian Requirements were 49.0 million hl, which is approximately the same level as the previous dairy year. During the same period, industrial milk and cream production totalled 49.9 million hl, down 0.64% from the previous dairy year. This reduction was mainly due to unusually high temperatures during the summer of 2005. Ironically, this was somewhat helpful since the growth in consumption of milk products such as cheddar, specialty and processed cheeses was slowing down rather abruptly. Consumption of butter actually decreased by 3% compared to the previous dairy year.

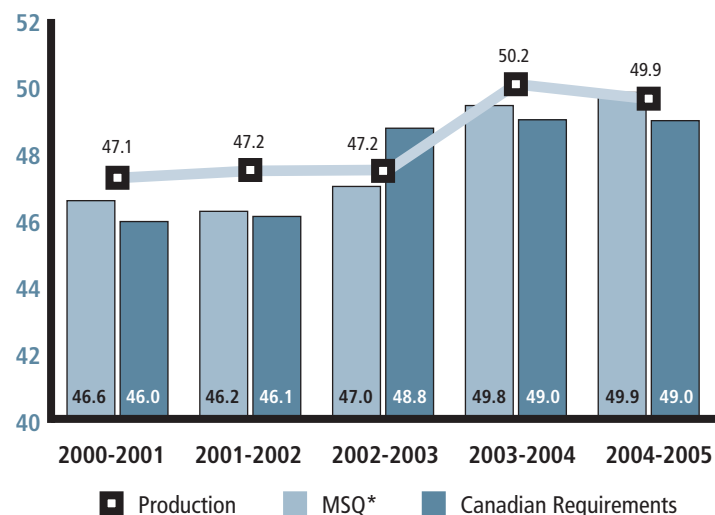
Determining Quota

On a regular basis, the CMSMC reviews the national production target for industrial milk, called the Market Sharing Quota (MSQ). The MSQ is based on Canadian Requirements and includes a 1% growth allowance to prevent shortages. 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.

Market sharing quota as of July 31, 2005 was 49.9 million hl. Production of industrial milk and cream in 2004-2005 totalled 49.9 million hl, which is equivalent to the weighted average MSQ for the year, which was also 49.9 million hectolitres.

THE CANADIAN DAIRY

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



*Weighted average MSQ, including the Domestic Dairy Product Innovation Program

PROVINCIAL SHARES OF MSQ* – JULY 31, 2005*

| | Butterfat (thousand kg) | Milk (million hl) | % |
|---------------------------|----------------------------|----------------------|--------------|
| Newfoundland and Labrador | 252 | 0.070 | 0.1 |
| Prince Edward Island | 3,117 | 0.866 | 1.7 |
| Nova Scotia | 2,080 | 0.578 | 1.2 |
| New Brunswick | 2,422 | 0.673 | 1.3 |
| Quebec | 81,780 | 22.717 | 45.5 |
| Ontario | 56,967 | 15.824 | 31.7 |
| Manitoba | 6,335 | 1.760 | 3.5 |
| Saskatchewan | 4,536 | 1.260 | 2.5 |
| Alberta | 11,777 | 3.270 | 6.6 |
| British Columbia | 10,540 | 2.928 | 5.9 |
| Total | 179 806 | 49.946 | 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.

COMMISSION

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 August 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 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.

The main accomplishment of the All Milk Pool for the 2004-2005 dairy year was to reach an agreement on the pricing and on the sharing of revenues from fluid milk. According to this five-year agreement,

fluid milk prices will be adjusted according to the CDC's support price announcements for the first two years. For the following three years, prices will be determined by a formula that takes into account the consumer price index, cash costs of producing milk, and personal disposable income. This agreement became effective February 1st, 2005. At the same time, provinces agreed to increase the contributions for the promotion of fluid milk and to implement a tank sealing program.

The panel requested by Nova Scotia to rule on the creation of a quota exchange mechanism between provinces handed down its ruling in September 2004. The panel indicated that the pool's Supervisory Body needed to establish a quota exchange mechanism as well as its rules. Negotiations have since taken place between provinces but the quota exchange is still not in place.

The committee in charge of negotiating Newfoundland and Labrador's entry into the All Milk Pool presented a draft agreement to the Supervisory Body in July 2005. Discussions will continue during the next dairy year.

During the year, provinces undertook a major review of the All Milk Pooling Agreement, which dates back to 1996. They asked Mr. Gilles Prigent, lawyer and former Chairman of the CDC, to draft a document that would accurately reflect the current operations of the pool. This mandate will continue in the next year.

Since January 2005, the members of the All Milk Pool are trying to iron out the problems associated with the implementation of the Harmonized Milk Transportation Cost Model. These discussions will carry on during the next year.

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Western Milk Pooling Agreement

In March 1997, the four Western provinces (Manitoba, Saskatchewan, Alberta and British Columbia) implemented an all milk pooling system. 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 year, the WMP provinces worked on the implementation of a milk tank sealing program. Work also continued on the promotion of dairy products, particularly cream. The provinces established new milk classes to encourage innovation in the area of fluid milk products and processed dairy products. The WMP also set up a sub-committee to discuss fluid milk pricing issues.

Finally, the WMP Research Committee played an important role in the development of the CDC's Dairy Marketing Program. Ideas discussed at this committee resulted in the CDC hiring two Innovation Champions who now cover Canada from sea to sea.

POOLS IN NUMBERS 2004-2005

| | Fluid milk produced (million hl) | Industrial milk produced (million hl) | Blend price to producer* (\$/hl) |
|-------------------|----------------------------------|---------------------------------------|----------------------------------|
| All Milk Pool | 21.8 | 40.7 | 64.08 |
| Western Milk Pool | 9.4 | 9.2 | 63.69 |

* In-quota milk at 3.6 kg butterfat per hl

Special Milk Class Permit Program

The Special Milk Class Permit Program was implemented on August 1, 1995 to allow processors, exporters and food manufacturers to remain competitive on international and domestic markets. Through this system, milk components can be made available for use in dairy products and products containing dairy ingredients at competitive prices.

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

Further processors used the equivalent of 5.6 million hl of milk in the 2004-2005 dairy year. A total of 1,161 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 920 in 2004-2005, up from 836 in the previous year.

COMMISSION

SPECIAL MILK CLASS PERMIT PROGRAM

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

| Class | | 2000-2001 | 2001-2002 | 2002-2003 | 2003-2004 | 2004-2005 |
|--------------|---------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| 5(a) | Volume | 1.791 | 1.633 | 1.881 | 1.954 | 1.955 |
| | Price | \$ 35.52 | \$ 45.41 | \$ 33.16 | \$ 39.92 | \$ 41.86 |
| 5(b) | Volume | 1.221 | 0.728 | 1.042 | 1.872 | 2.088 |
| | Price | \$ 42.92 | \$ 42.65 | \$ 35.18 | \$ 32.84 | \$ 36.73 |
| 5(c) | Volume | 1.053 | 1.344 | 1.361 | 1.548 | 1.566 |
| | Price | \$ 31.95 | \$ 30.08 | \$ 29.96 | \$ 29.98 | \$ 29.77 |
| Total | Volume | 4.065 | 3.705 | 4.284 | 5.374 | 5.609 |
| | Price | \$ 36.10 | \$ 39.35 | \$ 32.64 | \$ 35.10 | \$ 37.10 |

*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.

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,

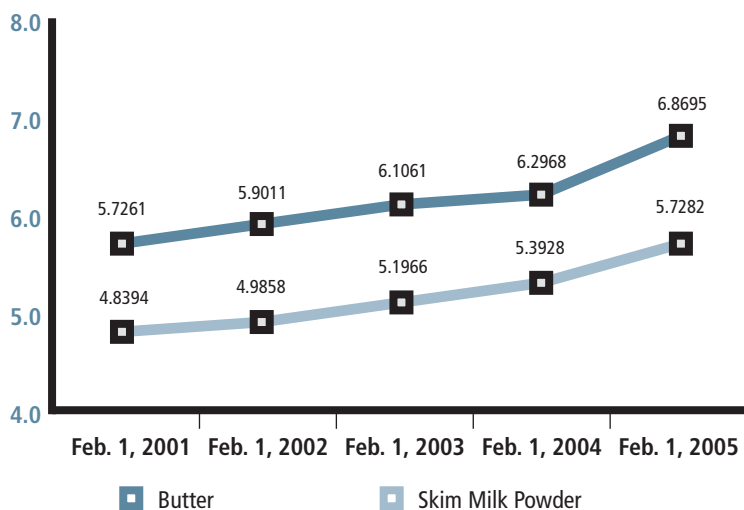
the CDC holds pricing consultations and the views of dairy industry stakeholders are carefully examined before making this decision.

The pricing decision announced by the CDC in December 2004 was effective on February 1, 2005. The support price for skim milk powder rose from \$5.3928 to \$5.7282 per kg, and for butter from \$6.2968 to \$6.8695 per kg. In 2002, the CDC committed to cover the cost of production of 50% of dairy farmers by 2006. The December 2004 decision brings the CDC very close to fulfilling this commitment.

These higher support prices were expected to provide dairy farmers with an increase of \$5.00 per hl on the price paid for industrial milk. This represents an increase of 7.8%. Included in this increase is an add-on of \$1.66 per hl to help Canadian dairy farmers deal with the financial consequences brought about by the bovine spongiform encephalopathy (BSE). The discovery of two cases of BSE in Canada in 2003 caused the United States to close their border to Canadian dairy cull cows. The market price for these animals plummeted as a result, causing losses of revenue to dairy farmers. This add-on will be re-evaluated at the next pricing review in December 2005 and, depending on the trade situation and the various government programs available, it could be increased, reduced, or removed entirely.

THE CANADIAN DAIRY

SUPPORT PRICES FOR BUTTER AND SKIM MILK POWDER FROM 2001 TO 2005 (\$ PER KG)



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Butter Imports

Under the terms of the 1994 World Trade Organization (WTO) Agreement, Canada has established tariff rate quotas (TRQ) for a number of dairy products. TRQs are quantities of products that can enter Canada with little or no tariff. With the support of the industry, the CDC has acted as the first receiver of imports of butter under federal permit since 1995 and has directed this product through butter manufacturers to the 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 2004-2005 dairy year, Canadian firms in Quebec, Ontario, Alberta and British Columbia used 17.7 million litres of milk under the DDPIP. In 2003-2004, the total was 15.9 million. The maximum utilization limit was established at 1% of the MSQ, which is approximately 49 million litres. As of August 1, 2005, the limit will increase to 2% of MSQ.

This year, the Selection Committee has received 33 applications compared to 21 during the previous year. Following the trend, most applications involved new specialty cheeses. Of the 33 applications received, 14 applications met the program criteria and were accepted, 12 were rejected and 7 require additional information before a decision can be made.

Dairy Marketing Program

The Dairy Ingredient Marketing Program was expanded in 2004-2005 to extend the services offered by the CDC in the area of innovation to dairy product manufacturers. The Program was therefore renamed the Dairy Marketing Program. Promoting awareness and increased utilization of dairy products and components are the Program's main objectives. Innovation in the manufacture of functional dairy and food products using solids non fat such as skim milk powder and milk protein concentrate are of particular interest.

COMMISSION

Two Innovation Champions have been added to the marketing team. MILKingredients.ca – an on-line information centre, CDC-sponsored industry seminars, and continued involvement in industry trade shows remain the focus of our marketing efforts.

The recent creation of two new industry support programs, the Direct Access Fund and the Innovation Support Fund, has been well received by the food science community and the dairy and food manufacturers targeted by those initiatives. Issues involving the use of milk components in alcohol beverages, substitution of whey with skim milk powder in hot drink formulations and the design of high-end soups with a high percentage of dairy ingredients are just a few examples of the projects that have been supported by these two new funds.

The successful industry seminar series continues with events in 2005-2006 being planned in collaboration with the Alberta Food Processing Development Centre, the P.E.I. Food Development Centre and the Guelph Food Technology Centre.

Domestic Seasonality Programs

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

Domestic Seasonality Programs allow the industry to balance the seasonal demand and supply of dairy products. The industry has mandated the CDC to operate these programs, in cooperation with the private sector. 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 \$5.8 million in 2004-2005. 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 2004-2005 dairy year. Costs associated with butter stocks above normal inventories or with any other stocks under the Domestic Seasonality Programs are covered by Canadian milk producers.

Storage Programs

Butter

The CDC holds butter in storage throughout the year. The Canadian Milk Supply Management Committee kept 12 million kg of butter as target stocks for the 2004-2005 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 few years, butter produced in the domestic market has, in large part, been consumed in Canada and exports have been infrequent.

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Milk Powders

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

Concentrated Milk Assistance Program

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

Inventories

The Commission began the 2004-2005 dairy year with 14.4 million kg of butter and 32.7 million kg of skim milk powder in inventory. During the year, the CDC purchased 30.2 million kg of butter and 29.3 million kg of skim milk powder. Sales of 26.2 million kg of butter and 38.1 million kg of skim milk powder left respective closing inventories of 18.3 and 23.9 million kg as of July 31, 2005 (butter statistics include imports and butteroil).

Surplus Removal Program

The CDC administers a Surplus Removal Program 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 this program.

Exports

During the dairy year 2004-2005, 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 2004-2005, the CDC exported 12.2 million kg of skim milk powder either as skim milk powder or as an ingredient in blend products. The CDC also exported 0.9 million kg of butter.

In regard to cheese exports, the CDC's major responsibility is to deliver certificates to Canadian exporters that give them access to the aged cheddar market in the European Union. In 1980, Canada negotiated a special access quota with the European Union. The current access level is 4,000 tonnes, which allows Canada to continue to market its finest aged cheddar to the United Kingdom. Consumers in the UK have been enjoying this famous Canadian product for over a century. All this volume, as well as the exports associated with the 5(d) permits issued by the CDC to trading companies, are accounted for against Canada's export commitments to the WTO.

Audit

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

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

COMMISSION

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 and approves the annual audit plan.

During the 2004 -2005 dairy year, an audit was carried out on the management of the Concentrated Milk Assistance Program. This included a review of the systems and practices related to the administration of the storage of concentrated milk. The systems and practices were found to be well controlled. As a result of this audit, the invoicing by companies will be followed up more closely and the program agreement will be updated to reflect current operations of the program.

The export subsidy monitoring system was also reviewed. The audit found that the system was functioning as intended and would ensure Canada's export commitments for dairy products were respected. Following the audit, the monitoring procedures will be documented to ensure consistency and continuity.

Additional audit work included some aspects of the CDC's history book initiative. This included input into the contract conditions and determination of appropriate deliverables.

The CDC audit group served as coordinator of CDC's work and documentation to respond to the requirements of the Office of the Auditor General (OAG) for the Special Examination. In performing the Special Examination, the OAG relied on the CDC audits of the Special Milk Permit Program to provide additional assurance as to the effective administration of the program.

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 2004-2005 dairy year, 43 companies were audited, resulting in claims of about \$471,500 from companies who could not fully justify all purchases made under their permit. This money was returned to Canadian dairy producers.

The CDC also establishes mandates for 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 is planned in the next dairy year.

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

PERFORMANCE AND



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GOALS

Achievements for 2004-2005

The goals set by the Canadian Dairy Commission (CDC) for 2004-2005, along with a brief summary of the status of achievement of each goal, are described below.

COMPLIANCE GOAL

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

| PERFORMANCE INDICATORS FOR 2004-2005 | ACHIEVEMENTS |
|---|---|
| Review and update the CDC rules | This objective has been set aside in light of Treasury Board’s Review of the Governance Framework for Canada’s Crown Corporation. The Rules will include applicable changes brought on by this review. |
| Operationalize and embrace CDC’s corporate policy for employment equity, as well as Treasury Board’s Values and Ethics Code | The CDC keeps monitoring the presence of protected groups in certain categories where a balance is required. An EE Advisory body was created and started its work. The Commission approved a Code of Ethics and Professional Conduct. It has been presented to employees and is now posted on CDC’s Intranet site. |
| Promote CDC values to all CDC employees | In a first promotion campaign, posters were displayed in the main entrance and in the meeting rooms of the CDC building. The new Employee Recognition Policy puts a lot of emphasis on the values of the CDC. |
| Ensure that all Commissioners complete the course on Crown Corporate Governance | So far, this course has not been offered in French therefore our Commissioner was not able to take it. |
| Include “improving internal communications” in the objectives of managers for 2004-2005 | This objective led to more frequent meetings of managers throughout the year. The Chairman held two meetings to inform staff of the current issues faced by the CDC. |
| Encourage managers to hold regular staff meetings | Some teams have started regular meetings while smaller teams have chosen a less formal method. |
| Establish a Manager’s forum for middle management | The managers’ forum met about six times during the year. |
| Harmonize the processing and the filing of information, both in electronic and printed formats | A policy on information management has been drafted. Consultations will be held before the final version is approved by the Commission. |
| Train staff on their obligations under the <i>Access to Information Act</i> and the <i>Privacy Act</i> | This will be done once the policy on information management is adopted and implemented. |
| Run a second round of training for staff concerning our electronic records management system | This will be done once the policy on information management is adopted and implemented. |

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OPERATIONS GOAL

Goal 2 – Improve the planning of human resources.

| PERFORMANCE INDICATORS FOR 2004-2005 | ACHIEVEMENTS |
|---|---|
| Prepare a succession plan | This task has been included in a broader goal for 2005-2006. |
| Offer all CDC employees the opportunity to prepare a personalized training plan | All employees have the opportunity to prepare a personalized training plan. |
| Prepare a corporate training plan | The corporate training plan in 2004-2005 included Performance Management (for managers), Media Training (for spokespeople) and First Aid/CPR for a group of 11 employees. |

STRATEGIC GOALS

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

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| PERFORMANCE INDICATORS FOR 2004-2005 | ACHIEVEMENTS |
|---|--|
| Complete the industry visioning initiatives and communicate the results to stakeholders | The industry visioning initiatives that started in 2003 were completed and the results communicated to stakeholders. Further sessions could be held in the future if the emergence of new challenges justifies it. |
| Provide transparent and impartial advice to stakeholders | Transparent and impartial advice was provided to stakeholders throughout the year thanks to economic and policy analyses performed by CDC staff and communicated by staff and Commissioners. |
| Ensure stakeholders interests are heard | Numerous meetings were held with industry stakeholders, either formally or informally. For the pricing exercise in December 2004, the Commission invited all stakeholders to present their position, either in writing or in person. Many accepted the invitation. |
| Participate in Agriculture and Agri-Food Canada's Dairy Round Table | The Round Table has not been created. There does not seem to be an interest from producers or processors for this forum at this time. |

GOALS

Goal 4 – Further develop profitable markets for Canadian dairy products.

| PERFORMANCE INDICATORS FOR 2004-2005 | ACHIEVEMENTS |
|---|---|
| Develop, recommend to the Canadian Milk Supply Management Committee (CMSMC) and fund an expanded innovation program for dairy product development and marketing | The expanded program was approved in October and is called the Dairy Marketing Program. It is an expansion of a pre-existing program, called the Dairy Ingredient Marketing Program. Details of this program are available on page 22. |
| Investigate new markets for solids non fat and provide proposals to CMSMC | Following a recommendation by the CDC, the CMSMC approved a new class of milk for solids non fat used in non-standardized processed cheese products. |
| Stimulate growth through partnership initiatives | Following discussions between the CDC and dairy farmers, the CDC will sign partnership agreements with provincial agencies to promote consumption of fluid milk products in Canada. |
| Maximize subsidized exports allowed under the World Trade Organization | Each category of subsidized exports has been maximized and the data reported quarterly to Agriculture and Agri-Food Canada. |
| Develop policy alternatives to reduce structural surplus | Following the advice of the CDC, provincial marketing boards have put in place a series of measures aimed at reducing the structural surplus at the farm level. These measures reduced the structural surplus by almost 6,000 tonnes in the first year. |

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

| PERFORMANCE INDICATORS FOR 2004-2005 | ACHIEVEMENTS |
|--|---|
| Monitor negotiations and provide any technical assistance and advice required by the Canadian negotiating team | The CDC staff has monitored the WTO negotiations and has provided help as requested by the Canadian negotiating team. The CDC also participated in the Agriculture Trade Negotiation Consultation Group. |
| Evaluate, anticipate and communicate any potential impact on the Canadian dairy industry | The CDC hired a trade policy analyst. Her duties include monitoring WTO negotiations and evaluating their impact on the Canadian dairy industry. This information could then be communicated to the industry. |

PERFORMANCE AND

Goal 6 – Facilitate effective national milk quota management.

| PERFORMANCE INDICATORS FOR 2004-2005 | ACHIEVEMENTS |
|--|---|
| Provide various quota management analyses and recommendations to the CMSMC | Various options for tighter quota management were proposed to the CMSMC. The Committee adopted one of these options in July 2004. |
| Assist in the implementation and the administration of the chosen system | The new system was implemented on August 1st, 2004; the CDC now helps the industry to monitor and adjust it as required. |

Goal 7 – Review farm gate pricing beyond 2006.

| PERFORMANCE INDICATORS FOR 2004-2005 | ACHIEVEMENTS |
|--|--|
| Hold consultations on farm gate pricing beyond 2006 and its dependency on CDC support prices | Following further advancements in the Doha Round of WTO negotiations, the CDC intends to put together a Task Force to develop recommendations on the determination of support prices beyond February 2006. |

Outlook

Over the years, the Canadian supply management system has adapted to many changes. Trade liberalization has been a major factor in these changes. As the Doha round of negotiations progresses at the World Trade Organization (WTO), discussions on the possibility of reduced tariffs on imports and increased market access cause a great deal of concern for the dairy industry. Furthermore, the elimination or any reduction in the level of subsidized exports allowed under the WTO would have serious repercussions. The CDC intends to continue its leadership role in the dairy industry to respond to all these challenges.

The Canadian Dairy Commission will need to take a leadership role in deciding on the future of pricing of industrial milk. Until February 1st, 2006, the drivers of the pricing decision are clear. The CDC will fulfill

its commitment, taken in January 2002, to gradually increase the support prices for butter and skim milk powder to ensure that, by February 1st, 2006, 50% of Canadian dairy farmers recover their cost of production. This commitment will be fulfilled at the next pricing announcement, in December 2005. The pricing method to be used beyond that needs to be discussed, analyzed, and implemented. To this end, the CDC wants to undertake consultations with the industry, from producers to consumers, to hear their views on the direction that the pricing methodology should take.

Since its creation in 1966, the CDC has worked to increase the level of harmonization in dairy policies from sea to sea. Many agreements underpinning the industry are up for review in the coming year.

GOALS

The All Milk Pooling Agreement (of Eastern Canada) and the Comprehensive Agreement on Pooling of Milk Revenues contain a clause asking for their review in 2005-2006. The pricing agreement in Class 5(c) (milk ingredients for the confectionery industry) ends in 2005-2006 and negotiations are required to arrive at a new agreement. The CDC is facilitating these discussions and is starting active discussion on a national pool for all milk classes.

The structural surplus of skim milk solids has grown beyond Canada's export limits and the industry is implementing ways to deal with it. Pricing and quota policies at the farm level have been reviewed to remove incentives that lead to a larger structural surplus. The structural surplus totalled 55,400 tonnes of skim milk powder in 2004-2005, compared to 67,820 tonnes the previous year. It is hoped that this downward trend will continue although this will depend on the level of imports of milk protein. In the meantime, the CDC will continue to purchase the entire surplus and to dispose of it in a way that will maximize producer returns.

In addition to reducing the production of structural surplus at the farm level, new uses for these solids non fat must be found and the industry is also looking at this, with support from the CDC. The expanded Dairy Marketing Program will assist in this regard, along with the creation of a new class of milk that encourages the use of milk solids non fat in non-standardized processed cheese products.

Increasing the per capita consumption of dairy products is also a good way to create new markets for all milk components. Promotional activities can take many forms and the CDC wants to ensure that it does not duplicate efforts already undertaken by other industry

stakeholders. At its May meeting, the Commission decided to establish partnerships with provincial agencies for additional promotion of fluid milk and cream products.

All these measures should decrease the quantity of skim milk powder that the CDC needs to buy from the industry and dispose of on domestic and international markets.

As the work continues at the WTO, the Commission feels that it is important for the organization to increase its expertise and capacity in the area of trade. The Commission needs to be better equipped to monitor the WTO negotiations and understand the impact of the decisions made at the WTO on the various programs and systems in place in the Canadian dairy industry. The CDC also needs to be in a position to explain these impacts to the industry and help it implement the new rules.

Furthermore, the CDC commissioners feel it is important to ensure the future availability of specialists in the areas of dairy policy analysis and dairy food science. To that end discussions will be undertaken with several Canadian universities to pursue the possible funding of graduate student scholarships in those areas.

Public corporations are under more and more public scrutiny and governance is taking centre stage. The public demands ethical and honest behaviour from its public servants and appointees and the Commission must be able to show that measures are in place to encourage proper governance and prevent abuse. The CDC subscribes to this trend and is continuously improving its accountability framework. For example, the CDC has put in place a Code of Ethics and Professional Conduct to formalize this requirement from its employees.

PERFORMANCE AND

The CDC intends to continue in this direction. For the coming year, a particular emphasis will be put on the promotion of CDC values, internal communications, records management, human resources management, and efficiency.

Based on this outlook, the CDC has identified four areas of priority for the next years:

Leadership in the Canadian dairy industry

Many issues will require leadership, bringing stakeholders to the table, and ensuring that proper solutions are chosen and implemented. The CDC has had a very important facilitator role in the industry, especially in the last 10 years and it is generally seen as a competent, neutral advisor. Based on these factors, the CDC intends to assume the leadership role in the dairy industry for the following issues:

- industrial milk pricing beyond 2006;
- increasing the level of harmonization among provinces; and
- implementing a new price agreement for confectionery Class 5(c).

Developing new markets for Canadian dairy products

The structural surplus has decreased, but is still significant. New uses and applications must be found for milk solids non fat. At the same time, the dairy industry can only look at increasing domestic consumption for its growth, since the WTO rules severely restrict its exports. The *CDC Act* allows the CDC to get involved in the promotion of dairy products and the Commission will increase its involvement in promotion

by supporting efforts of existing agencies engaged in promoting fluid milk and cream products.

The Commission will also use current programs to find new markets for solids non fat, and to promote innovation in the manufacture and use of dairy products and ingredients.

Expertise in trade issues

The importance of the WTO negotiations and rulings is paramount to the Canadian dairy industry. In order to be better able to provide advice to the industry and to the Canadian negotiating team, the CDC intends to increase its expertise and capacity in the area of inter-provincial and international trade.

Governance and efficiency

The public sector is increasingly being asked to be more transparent, more accountable, and more efficient. The Commission wishes to do its part in the Federal government's efforts toward these goals. To be better prepared to fulfill its mandate in the future, the CDC needs a comprehensive human resources plan, better internal communications and better information management. As Treasury Board recently published a review of the Governance Framework for Crown Corporations, the CDC will closely monitor the results from this review and act accordingly.

GOALS

Goals for the period 2005-2006 to 2009-2010

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

STRATEGIC GOALS

Goal 1 – Provide leadership to the Canadian dairy industry

| OBJECTIVES | PERFORMANCE INDICATORS FOR 2005-2006 |
|---|--|
| Adopt a methodology for industrial milk pricing beyond 2006 | <ul style="list-style-type: none"> ■ Establish a pricing review process ■ Receive recommendations from review process ■ Approval by the Commission ■ Implement recommendations |
| Increase the level of harmonization among provinces | <ul style="list-style-type: none"> ■ Complete the All Milk Pooling Agreement (Eastern Provinces) review by March 2006 ■ Start active discussion on an All Milk National Pooling Agreement ■ Coordinate a national auditors meeting by March 2006 ■ Review the National Milk Utilization Audit Manual by March 2006 ■ Monitor the national milk quota management ■ Complete the review of the Comprehensive Agreement on Pooling of Milk Revenues and present it to CMSMC in January 2006 |
| Implement a new price agreement for class 5(c) | <ul style="list-style-type: none"> ■ Create a 5(c) Price Committee ■ Present Committee's report to the CMSMC ■ CMSMC decision |

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

| OBJECTIVES | PERFORMANCE INDICATORS FOR 2005-2006 |
|---|---|
| Develop additional solids non fat (SNF) markets with higher utilization and returns | <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 average producer revenue per unit of SNF |
| Review the elements necessary for the growth of Special Classes | <ul style="list-style-type: none"> ■ Report to CMSMC the results of the evaluation of the Special Milk Class Permit Program ■ Act according to CMSMC direction |
| Establish partnerships to increase promotion of dairy products | <ul style="list-style-type: none"> ■ Sign partnership agreements with provincial agencies |
| Increase utilization of Canadian dairy ingredients | <ul style="list-style-type: none"> ■ Fully implement the Dairy Marketing Program ■ Reduced stocks of skim milk powder |
| Maximize WTO allowed exports | <ul style="list-style-type: none"> ■ Fulfill close to 100% of WTO export commitments without exceeding them |

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

| OBJECTIVES | PERFORMANCE INDICATORS FOR 2005-2006 |
|---|---|
| Improve CDC's working relationship with the agriculture negotiating team | <ul style="list-style-type: none"> ■ Train the new trade policy analyst to increase CDC's expertise in trade issues ■ Provide expertise and advice to the Canadian WTO negotiation team |
| Provide information and expertise to various stakeholders regarding trade | <ul style="list-style-type: none"> ■ Evaluate the impact of WTO decisions on Canadian dairy industry ■ Report to Commission and stakeholder/government committees |

GOALS

OPERATIONS GOAL

Goal 4. – Enhance the governance and operations of the CDC

| OBJECTIVES | PERFORMANCE INDICATORS FOR 2005-2006 |
|---|--|
| Create and implement a comprehensive HR Plan | <ul style="list-style-type: none"> ■ Identify key positions by March 2006 ■ Develop competency profiles of key positions by March 2006 ■ Develop and implement a self-identification methodology by March 2006 |
| Finalize CDC Rules | <ul style="list-style-type: none"> ■ Commission approval |
| Implement the Public Service Modernization Act (PSMA) | <ul style="list-style-type: none"> ■ Implement the PSMA elements as per Treasury Board timelines |
| Improve employees' knowledge of CDC's activities | <ul style="list-style-type: none"> ■ Have each team offer short presentations on their role ■ Post CMSMC decisions on Intranet site ■ Regular information sessions by the Chairman for staff |
| Increase emphasis on team management | <ul style="list-style-type: none"> ■ Increase the frequency of team meetings |
| Monitor the review of Governance Framework for Crown Corporations | <ul style="list-style-type: none"> ■ Analyze the impacts of this review on the CDC ■ Present this analysis to the Commission ■ Implement relevant changes, in collaboration with the Minister's office |
| Develop and implement an Information Management Policy and Guidelines | <ul style="list-style-type: none"> ■ Hold consultations with CDC teams ■ Commission approval of final version ■ Train all employees on the Guidelines ■ Integrate the Policy and Guidelines in daily operations of all employees |
| 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 the Office of the Auditor General |

FINANCIAL REPORT



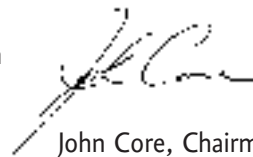
Management Responsibility for Financial Statements

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.

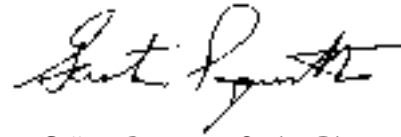
In discharging its responsibility for financial reporting, management maintains and relies on financial and management control systems and practices designed to provide reasonable assurance that transactions are authorized, assets are safeguarded, and proper records are maintained. These controls and 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.



John Core, Chairman



Gaëtan Paquette, Senior Director, Finance and Operations

Ottawa, Canada

September 30, 2005

FINANCIAL REPORT

Management's Discussion and Analysis

for the year ending July 31, 2005

The following discussion and analysis of the operating results and financial position of the Canadian Dairy Commission (CDC) for the year ending July 31, 2005 should be read in conjunction with the financial statements of the Commission enclosed herein and the Annual Report.

SELECTED KEY RESULTS OF OPERATIONS

(in thousands)

| | Dairy year 2004-2005 | | Dairy year 2003-2004 | |
|-------------------------------------|----------------------|------------|----------------------|------------|
| | Export | Domestic | Export | Domestic |
| Total sales | \$ 32,999 | \$ 205,576 | \$ 36,624 | \$ 135,418 |
| Total cost of sales | \$ 32,071 | \$ 195,195 | \$ 37,195 | \$ 129,976 |
| Margin (loss) on sales | \$ 928 | \$ 10,381 | \$ (571) | \$ 5,442 |
| Carrying charges | \$ 5,779 | | \$ 4,232 | |
| Surplus at year end | \$ 29,182 | | \$ 21,405 | |
| Inventory on hand at year end | \$ 147,849 | | \$ 133,598 | |
| Loans from the Government of Canada | \$ 106,126 | | \$ 98,337 | |

On export activities

Sales

Total export sales revenue is lower by 10% or \$3.6 million as compared to the previous year mainly as a result of a 16% reduction in sales revenue from skim milk powder. The reduction of \$5.8 million in skim milk powder sales is partly offset by revenues of \$2.2 million for 871 metric tons of export butter while there were no butter sales last year.

The main reason for the reduction in revenues from skim milk powder is that the CDC sold less skim milk powder to manufacturers of blends for export. Exports of blends were performed using 5(d) permits, enabling exporters to source the solids non fat directly from manufacturers.

It is for that reason that the CDC sold only 1.2 million kg of skim milk powder for blending purposes compared to 5.2 million kg last year. This approach was taken to maximize returns to producers.

A higher Canadian dollar and a high domestic price on February 1, 2005 also had a negative impact on the quantity of skim milk powder that could be exported within Canada's WTO commitments.

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, 2005, cost of export sales was lower by 14% as a consequence of reduced exports. Sales prices higher than anticipated for butter and skim milk powder generated a small margin of \$0.92 million as compared to a small loss of \$0.57 million for the previous year.

On domestic activities

Sales

In total, revenue on domestic sales increased by 52% in dairy year 2004-2005 mainly resulting from higher Plan A and Plan B sales and skim milk powder sales to domestic users in animal feed. The volume of import butter sold was slightly lower than the previous year but contributed the majority of the total margin on butter.

The Plan A and Plan B butter was sold at the prevailing domestic prices, contributing also to the total margin on butter but to a lower degree.

The volume of skim milk powder sold to the animal feed industry increased by 430% from 4.2 million kg to 22.3 million kg. The CDC had to sell this product on the domestic market due to structural surplus that could not be exported in the previous dairy year. This product contributed to most of the margin on skim milk powder since it was purchased in the previous year at a price lower than the price it was sold this year. The low purchase price was set at the time of purchase due to 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 International Trade Canada. The CDC imported the butter at prevailing world prices. This product is directed to the further processing sector through butter manufacturers.

The Plan A and Plan B butter and Plan B skim milk powder were purchased at the prevailing support prices.

FINANCIAL REPORT

Carrying charges, inventories and loans from the Government of Canada

Carrying charges increased substantially due to higher inventories for most of the dairy year.

The CDC's level of butter stocks at year end was 18.3 million kg as compared to 14.4 million kg in the previous year, due to lower demand for domestic butter.

Inventory value increased by 11% from \$133.6 million to \$147.8 million this year, causing a corresponding increase in the loans from the Government of Canada.

Administrative expenses

Total administrative expenses increased by 6% compared to the previous year. This increase is mostly attributable to higher salary costs and to the purchase of computer software.

Challenges for the Future

The dairy industry will face new challenges in the near future given the uncertainty of the results of the Sixth WTO Ministerial Conference to be held in Hong Kong in December 2005.

In order to meet these new challenges, the Commission has recently hired a trade policy analyst to monitor the WTO negotiations and to evaluate their impact on the Canadian dairy industry.

In addition, the Commission, under the authority of the Canadian Milk Supply Management Committee, has developed and implemented a new quota management system which will mirror more adequately the Canadian requirements and should reduce surplus milk production that could not be sold on the domestic market like we experienced in 2004-2005.

However, two challenges still remain: finding ways to dispose of surplus skim milk powder in niche markets; and finding novel ways of marketing solids non fat products such as blends and high protein functional powder. These markets may generate better returns for producers by reducing the need to sell in markets with lower returns such as animal feed.

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, 2005 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, 2005 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.

Ronald C. Thompson, CA
Assistant Auditor General for the Auditor General of Canada

Ottawa, Canada
September 30, 2005

FINANCIAL STATEMENTS

Balance Sheet

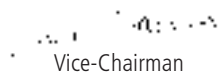
as at July 31
(in thousands)

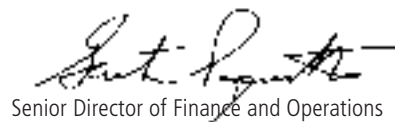
| | 2005 | 2004 |
|--|------------------|------------------|
| Assets | | |
| Cash | \$ 130 | \$ 375 |
| Accounts receivable | | |
| Due from provincial milk marketing boards and agencies | 24,637 | 33,221 |
| Trade (Note 3) | 2,386 | 432 |
| Inventories (Note 4) | 147,849 | 133,598 |
| | \$175,002 | \$167,626 |
| Liabilities | | |
| Bank indebtedness - pooling account (Note 5) | \$ 1,290 | \$ 1,422 |
| Accounts payable and accrued liabilities | | |
| Due to provincial milk marketing boards and agencies | 21,799 | 30,484 |
| Trade | 14,425 | 14,039 |
| Other liabilities | 2,180 | 1,939 |
| Loans from the Government of Canada (Note 6) | 106,126 | 98,337 |
| | 145,820 | 146,221 |
| Surplus (Note 8) | 29,182 | 21,405 |
| | \$175,002 | \$167,626 |

Commitments (Note 12)

Approved:


Chairman


Vice-Chairman


Senior Director of Finance and Operations

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

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

| | 2005 | 2004 |
|--|------------------|------------------|
| Sales and cost of sales | | |
| Domestic sales | \$ 205,576 | \$ 135,418 |
| Cost of sales | 195,195 | 129,976 |
| Margin on domestic sales | 10,381 | 5,442 |
| Export sales (Note 9) | 32,999 | 36,624 |
| Cost of sales | 32,071 | 37,195 |
| Margin (loss) on export sales | 928 | (571) |
| Total margin on sales | 11,309 | 4,871 |
| Pooling of market returns activities | | |
| Contributions from provincial marketing boards and agencies | 115,287 | 133,313 |
| Equalization payments to provincial marketing boards and agencies | 107,931 | 126,128 |
| Contributions withheld to fund operating expenses | 7,356 | 7,185 |
| Results before net operating expenses | 18,665 | 12,056 |
| Operating expenses (Schedule of Operations by Product) | 14,560 | 14,255 |
| less: funding of administrative expenses by the Government of Canada (Note 10) | 3,672 | 3,472 |
| Net operating expenses after funding by the Government of Canada | 10,888 | 10,783 |
| Results of operations after funding by the Government of Canada | 7,777 | 1,273 |
| Surplus at beginning of year | 21,405 | 32,440 |
| Refund of surplus to producers | – | (12,308) |
| Surplus at end of year | \$ 29,182 | \$ 21,405 |

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

FINANCIAL STATEMENTS

Statement of Cash Flows

for the year ended July 31

(in thousands)

| | 2005 | 2004 |
|--|-------------------|-------------------|
| Cash flows from operating activities | | |
| Cash receipts from customers | \$ 236,621 | \$ 184,110 |
| Cash paid to suppliers and others | (254,044) | (251,127) |
| Cash receipts from provincial milk marketing boards and agencies | 123,871 | 120,183 |
| Cash paid to provincial milk marketing boards and agencies | (116,616) | (113,810) |
| Cash receipts from the Government of Canada | 3,597 | 3,515 |
| Interest paid on loans | (1,331) | (528) |
| Cash flows from (used in) operating activities | (7,902) | (57,657) |
| Cash flows from financing activities | | |
| New loans from the Government of Canada | 146,430 | 161,234 |
| Loan repayments to the Government of Canada | (138,641) | (91,599) |
| Refund of surplus to producers | – | (12,308) |
| Cash flows from (used in) financing activities | 7,789 | 57,327 |
| Net decrease in cash | (113) | (330) |
| Net bank indebtedness at beginning of year | (1,047) | (717) |
| Net bank indebtedness at end of year | \$ (1,160) | \$ (1,047) |
| Components: | | |
| Cash | \$130 | \$375 |
| Bank indebtedness - pooling account | (1,290) | (1,422) |
| | \$ (1,160) | \$ (1,047) |

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

Notes to Financial Statements

July 31, 2005

1. The Commission

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

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

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

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

2. Significant accounting policies

Inventories

Inventories are valued at the lower of cost, 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 marketing boards and agencies and equalization payments to provincial marketing 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 the statement of operations in the period of change. The Commission's forward exchange contracts are hedges and are therefore not recognized in the balance sheet but are only disclosed in note 12.

Sales and purchases in foreign currencies that are not hedged are translated into Canadian dollars at the exchange rate in effect on the transaction date. Foreign currency gains and losses are included in the operating results of the year in which they occurred.

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 \$10,000 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.

3. Accounts receivable — Trade

Most of the trade accounts receivable are in foreign currencies and their Canadian dollar value has been determined using the rate to be paid under forward exchange contracts for those being hedged, as further explained in Note 12, or at the rate of exchange at year end.

4. Inventories

| | 2005 | 2004 |
|------------------|-------------------|-------------------|
| | (in thousands) | |
| Butter | \$ 109,132 | \$ 88,872 |
| Skim milk powder | 38,717 | 44,726 |
| Total | \$ 147,849 | \$ 133,598 |

The Commission's inventory includes 12,290 tonnes of butter and 2,426 tonnes of skim milk powder (2004 — 11,372 tonnes and 1,947 tonnes) with a total cost of \$83.87 million and \$13.89 million respectively (2004 — \$71.03 million and \$10.50 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 6,024 tonnes of butter and 21,502 tonnes of skim milk powder (2004 — 3,003 tonnes and 30,775 tonnes) with a total cost of \$25.26 million and \$24.83 million respectively (2004 — \$17.84 million and \$34.23 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 (2004 — \$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, 2005 was 4.25% per annum. The bank indebtedness is repaid monthly.

6. Loans from the Government of Canada

Loans from the Government of Canada, to a maximum of \$120 million (2004 - \$100 million), are available to finance operations. Individual loans are repayable within one year from the date the loan is advanced. Principal and accrued interest are repaid regularly during the year when funds are available. Interest on the loans is at the normal rates established for Crown corporations by the government and varied from 2.10% to 2.96% (2004 — 2.06% to 3.32%) during the year and totaled \$1.48 million (2004 — \$0.95 million).

7. Fair value of financial instruments

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

8. Surplus

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

FINANCIAL STATEMENTS

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

9. Export sales

Export sales include \$0.13 million representing net losses (2004 — net gains of \$0.27 million) arising from currency translation relating to transactions incurred in foreign currencies.

10. Costs funded by the Government of Canada

Funding of the Commission's administrative expenses is shared among the federal government, dairy producers and the market place. The Government of Canada has funded \$3.37 million (2004 — \$3.17 million) of the Commission's administrative expenses of \$6.66 million (2004 — \$6.28 million), as well as \$0.30 million (2004 — \$0.30 million) for professional services relating to costs of production data collection.

11. Employee future benefits

Pension Plan

Operating expenses include the Commission's contributions to the Public Service Pension Plan during the year totaling \$0.48 million (2004 - \$0.45 million), which corresponds to about 2.6 times (2004 — 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:

| | 2005 (in thousands) | 2004 |
|--|------------------------|---------------|
| Accrued benefit obligation, beginning of year | \$ 789 | \$ 742 |
| Cost for the year | 70 | 47 |
| Benefits paid during the year | (39) | — |
| Accrued benefit obligation, end of year | \$ 820 | \$ 789 |

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

12. Commitments

Forward exchange contracts

As part of its foreign exchange risk management, the Commission enters into forward exchange contracts with regard to its export sales contracts and purchase contracts requiring settlement in foreign currencies. At the end of the year, the Commission's outstanding forward exchange contracts totaled \$9.17 million Canadian equivalent (2004 — \$12.80 million Canadian equivalent). These contracts will mature over

the period ending January 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, 2005 are as follows:

| | | (in thousands) | |
|------------------|--------------------|----------------|--------------|
| Currency sold | Currency purchased | In USD | In Canadian |
| U.S. dollars | Canadian dollars | 1,676 | 2,029 |
| Canadian dollars | U.S. dollars | 5,858 | 7,137 |
| Total | | 7,534 | 9,166 |

Purchase commitments

As at July 31, 2005, the Commission was committed to purchase certain quantities of butter and skim milk powder. These commitments amounted to approximately \$8.06 million (2004 — \$8.80 million). Most of these commitments are in foreign currencies and are covered by forward exchange contracts.

Long Term Lease

The Commission is committed under a long term lease with Agriculture and Agri-Food Canada for office accommodation ending in 2007. The lease contains escalation clauses regarding maintenance costs and taxes. This lease may be automatically renewed at CDC's option for another period of 5 years with rates possibly revised in order to reflect the rental market value pursuant to Treasury Board's Policy on Real Property.

The remaining minimum lease payments totaled \$0.50 million 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 two years are as follows:

| | |
|-----------|----------------|
| 2005-2006 | \$0.30 million |
| 2006-2007 | \$0.20 million |

13. Representatives' fees

The Commission used the services of representatives for sale of dairy products on the export market. Total fees for the year were \$0.25 million (2004 — \$0.26 million) and are included in cost of sales.

14. Related party transactions

The Commission is related in terms of common ownership to all Government of Canada-created departments, agencies and Crown corporations. The Commission enters into transactions with these entities in the normal course of business and at normal trade terms. These transactions such as Employee Benefit Plans, accommodations and professional services, totaled about \$1.65 million during the year (2004 — \$1.58 million).

FINANCIAL STATEMENTS

Schedule of Operations by Product

for the year ended July 31

(in thousands)

| | 2005 | | | | 2004 | | | |
|--|-----------|------------------|-----------------|------------------|-----------|------------------|-----------------|------------------|
| | Butter | Skim Milk Powder | Other Products* | Total | Butter | Skim Milk Powder | Other Products* | Total |
| Sales and cost of sales: | | | | | | | | |
| Domestic sales | \$156,488 | \$ 49,088 | \$ – | \$205,576 | \$113,736 | \$ 21,682 | \$ – | \$135,418 |
| Cost of sales | 150,730 | 44,465 | – | 195,195 | 108,003 | 21,973 | – | 129,976 |
| Margin (loss) on domestic sales | 5,758 | 4,623 | – | 10,381 | 5,733 | (291) | – | 5,442 |
| Export sales | 2,167 | 30,832 | – | 32,999 | – | 36,624 | – | 36,624 |
| Cost of sales | 1,682 | 30,389 | – | 32,071 | – | 37,195 | – | 37,195 |
| Margin (loss) on export sales | 485 | 443 | – | 928 | – | (571) | – | (571) |
| Total margin (loss) on sales | \$ 6,243 | \$ 5,066 | \$ – | \$ 11,309 | \$ 5,733 | \$ (862) | \$ – | \$ 4,871 |
| Operating expenses: | | | | | | | | |
| Storage costs | \$ 2,014 | \$ 1,615 | \$ – | \$ 3,629 | \$ 1,613 | \$ 1,050 | \$ – | \$ 2,663 |
| Interest expense | 1,367 | 124 | – | 1,491 | 942 | 7 | – | 949 |
| Other carrying charges | 483 | 176 | – | 659 | 322 | 298 | – | 620 |
| Projects and promotional activities | 587 | – | 174 | 761 | 2,310 | – | 210 | 2,520 |
| Domestic dairy product assistance | – | – | 417 | 417 | – | – | 357 | 357 |
| | \$ 4,451 | \$ 1,915 | \$591 | 6,957 | \$ 5,187 | \$ 1,355 | \$567 | 7,109 |
| Administrative expenses | | | | | | | | |
| Salaries and employee benefits | | | | 4,905 | | | | 4,651 |
| Other expenses | | | | 1,752 | | | | 1,627 |
| | | | | 6,657 | | | | 6,278 |
| Cost of production, interest and bank charges related to the operation of the pooling of the market returns system | | | | | | | | |
| | | | | 916 | | | | 868 |
| Donation | | | | 30 | | | | – |
| Total operating expenses | | | | \$ 14,560 | | | | \$ 14,255 |

*Includes whole milk powder, concentrated milk and cheese.

