CANADIAN DAIRY COMMISSION ANNUAL REPORT 2001–2002

Canadian Dairy Commission
Commission canadienne du lait

CDC | CCL

Canada

Service Standards

In carrying out its responsibilities, the Canadian Dairy Commission will strive to treat every client request:

In a timely manner – when unusual circumstances arise, we will explain the steps that we will take to respond fully with the least delay.

Courteously – we recognize the importance of your request, and will politely help you understand the procedures, regulations and requirements that we must apply.

Fairly – we will treat all requests equitably. If, in your view, a matter is not resolved to your satisfaction, we will promptly explain how to seek redress.

Clearly – you have a right to know, in plain courteous language, how we are handling your request.

Commission staff is available to serve you, in either official language, from 8:00 a.m. to 4:30 p.m. eastern time, Monday to Friday (statutory holidays excluded). We welcome comments on our procedures and always appreciate suggestions for improvement.

Should you require further information on the activities of the Commission or on the dairy industry in general, we would be pleased to assist you.

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"But nightly when we dine alone,
My grateful praise I utter
Unto that good old stand-by, known
As mother's bread and butter."
Edgar A. Guest – American Poet

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LETTER TO THE MINISTER

Mr. Minister,

We are pleased to submit the Canadian Dairy Commission's Annual Report for the 2001-2002 dairy year. In this, the Commission's 35th year of operation, a great deal was accomplished to strengthen the industry and bring us closer to meeting our overall objective of achieving harmonized dairy policies to maintain a viable Canadian dairy sector.

The year 2001-2002 was a year of progress for our industry. It was a year of growth in the domestic demand for dairy products. This growth is especially noticeable in the case of yogurt, cheese, and ice cream.

The market for dairy ingredients is still strong. Under the Special Milk Class Permit Program, 3.7 million hectolitres of milk were used to make dairy ingredients for products such as frozen entrées, soups, baked goods and confectionery products. This market is important to Canada's dairy industry but foreign competition is increasing. The CDC is therefore pursuing the activities that were planned in its Dairy Ingredients Marketing Program to promote an increased utilization of Canadian dairy ingredients in manufactured products. This year, these activities resulted in better links with this segment of the industry.

At the same time, we held a series of consultations with Canadian dairy industry stakeholders, from producers to consumers. Despite the presence of irritants within the industry, there is a general recognition of the challenges that await the sector in the coming years. The increased use of substitutes and the growing quantity of milk ingredients that come into Canada from other countries are certainly raising concerns. New technologies and more concentrated processing, further processing and retailing sectors also present challenges for supply management in the dairy industry. The CDC believes that the industry needs to develop a concerted response to emerging challenges and opportunities, and is acting as a facilitator, where possible, to support the industry in this direction.

The Canadian Milk Supply Management Committee (CMSMC) approved important measures to achieve greater harmonization of policies. The Committee agreed on a new method to remove milk surpluses.

The CDC continues to provide advice and technical information to the legal team that defends Canada's compliance to its obligations under the World Trade Organization.

During the year, the CDC also participated in the consultations and discussions related to the implementation of the Agriculture Policy Framework. Even though the CDC is only involved in certain areas of the Framework, we feel that our participation benefits the Canadian dairy industry. We are confident more progress will be made as we continue to support the supply management system of the Canadian dairy industry. We believe that this system is an important tool to provide stability and risk management for producers, as well as reasonable prices of dairy products for consumers.

As you will note through the report, there was a great deal of progress made in the year 2001-2002 and we expect to build on our accomplishments in the year ahead. In making these important gains, we would like to recognize the hard work and dedication of our staff in contributing to the tasks set out to achieve the CDC's objectives. We also want to express our appreciation for the co-operation we receive from industry stakeholders and provincial governments with whom we work on an ongoing basis.

Louis Balcaen, Acting Chairman

Carl Harrison, Commissioner

THE CANADIAN DAIRY

INDUSTRY

Key Highlights of 2001-2002

The Canadian dairy industry operates on a "dairy year" basis which runs from August 1 to July 31 each year.

The dairy industry in Canada has made some great strides over the last year and can be proud of the progress achieved during the 2001-2002 dairy year. Some of the key highlights include:

- For the first year, Newfoundland and Labrador fully participated in the National Milk Marketing Plan;
- A new surplus removal method creates more fairness across the country; and
- Market growth for the fifth consecutive year.

Milk Production

Farm cash receipts

As a key contributor to the Canadian economy in the 2001 calendar year, the dairy industry ranked third behind meats, and grains and oilseeds, generating $4.2 billion in total farm cash receipts.

Number of farms and production per farm

In the 2001-2002 dairy year, Canada had 18,673 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 become more effective and efficient in operation. The average production per farm in the 2001-2002 dairy year was 3,940 hectolitres, a 5 percent increase from the previous year.

In the 2001-2002 dairy year, Quebec and Ontario had the greatest number of dairy farms at 81 percent, followed by 13 percent in the Western provinces and 6 percent in the Atlantic provinces.

In 2001, there were 1.14 million dairy cows in Canada producing an average of 9,242 kilograms of milk per cow.

NUMBER OF DAIRY FARMS, COWS, AND TOTAL MILK PRODUCTION*

1997-1998 to 2001-2002

	Number of farms	Number of cows (millions)	Total production (million hl)
1997-1998	22,643	1.20	79.1
1998-1999	21,561	1.18	79.5
1999-2000	20,576	1.14	78.6
2000-2001	19,363	1.14	78.1
2001-2002	18,673	1.14	78.3

** At 3.6 kg of butterfat per hectolitre.*

NUMBER OF MILK AND CREAM PRODUCERS IN 2001-2002

	Cream	Milk	Total
Newfoundland and Labrador*	0	48	48
Prince Edward Island	18	296	314
Nova Scotia	1	359	360
New Brunswick	0	309	309
Quebec	0	8,891	8,891
Ontario	118	6,126	6,244
Manitoba	7	612	619
Saskatchewan	0	336	336
Alberta	1	845	846
British Columbia	0	706	706
TOTAL	**145**	**18,528**	**18,673**

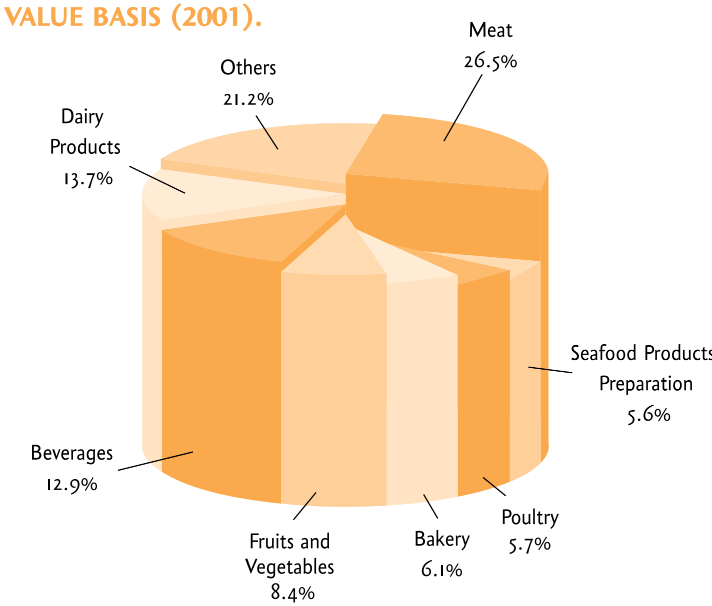
** Newfoundland and Labrador joined the National Milk Marketing Plan in 2001-2002 and is now included in CDC statistics.*

Milk Processing

In the 2001 calendar year, the processing industry generated $9.8 billion* worth of products shipped from approximately 243 processing plants, accounting for 14 percent of all processing sales in the food and beverage industry. During the 2001-2002 dairy year, the dairy processing sector employed approximately 21,000 people, representing 9 percent of all employees in the food and beverage industry.

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

SHARE OF MANUFACTURED SHIPMENTS IN CANADA — VALUE BASIS (2001).



INDUSTRY

Milk markets

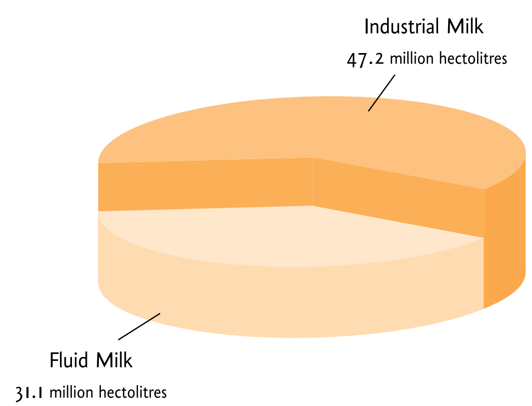
Canadian dairy producers supply two main markets:

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

In the 2001-2002 dairy year, the fluid market accounted for approximately 40 percent of total producer shipments of milk, or 31.1 million hectolitres*. The industrial market accounted for the remaining 60 percent, or 47.2 million hectolitres* of total producer shipments.

** At 3.6 kg of butterfat per hectolitre.*

INDUSTRIAL AND FLUID MILK PRODUCTION 2001-2002



Ingredients market

As part of the industrial milk market, dairy products are also sold as ingredients that are incorporated in food preparations. This segment of the market is very dynamic and new uses are continuously found for dairy ingredients.

The dairy ingredients market includes traditional ingredients such as:

- butter used in a variety of bakery products;
- milk;
- cream;
- condensed and powdered milk used in confectionery goods, dry mixes and baby food formulas; and
- cheddar, mozzarella, and cream cheeses used in frozen, dried, or canned finished products such as frozen dinner entrées, sauces and soups.

A fast growing ingredients market is the functional food market, which uses non-traditional ingredients such as whey powder and whey protein concentrates, which are by-products of the cheese-making process and used to manufacture products such as nutritional bars and drinks.

Harmonized Milk Classification System

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

HARMONIZED MILK CLASSIFICATION SYSTEM

Class	Products	Milk Utilization based on End Use (2001-2002): Milk (000 kg butterfat)	% of overall use
Class 1	a) fluid milks	81,612	29%
	b) fluid creams		
	c) milk-based beverages		
	d) fluid milks for the Yukon, Nunavut and Northwest Territories (these markets are supplied by British Columbia and Alberta)		
Class 2	yogurt, sour cream and ice cream	27,355	10%
Class 3	a) specialty cheeses	46,461	16%
	b) cheddar cheese	47,462	17%
Class 4	a) butter, butteroil, powders and concentrated milk for ingredient purposes	55,403	20%
	b) concentrated milk for retail	1,479	<1%
	c) new products for the domestic market	(b, c, d, m)	
	d) inventories and losses		
	m) domestic marginal markets		
Class 5	a) cheese ingredients for further processing for the domestic and export markets	13,337	5%
	b) all other dairy products for further processing for the domestic and export markets	(a, b, c)	
	c) domestic and export activities of the confectionery sector		
	d) planned exports and other exports, the total of which shall not exceed Canada's WTO commitments	8,042	3%
TOTAL		**281,151**	**100%**

THE CANADIAN DAIRY

Corporate Profile

Authority

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 dairy.

Funded by the federal government (44 percent), dairy producers (36 percent) and the marketplace (20 percent), the CDC supports the interests of all dairy stakeholders — producers, processors, exporters, consumers and governments.

History

In the early 1960s, the dairy industry was experiencing a substantial build-up of butter stocks. Producers were coming to the realization that there was a need to coordinate federal and provincial policies concerning the marketing of milk. Accordingly, the First Canadian Dairy Conference was convened in Ottawa in February 1963.

Following the conference, a Canadian Dairy Advisory Committee was set up and in its August 1965 report, recommended that a national board or authority be established for the marketing, regulation and administration of dairy policy. As a result, the House of Commons passed an Act on June 23, 1966, providing for the establishment of a Dairy Commission for Canada. The *Canadian Dairy Commission Act* was proclaimed on October 31, 1966.

Mission

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.

As a central facilitator for the multi-billion dollar Canadian dairy industry, the CDC works closely with industry stakeholders represented by organizations such as Dairy Farmers of Canada, the Consumers' Association of Canada and provincial boards and agencies. The Commission also works in co-operation with processors, represented by provincial organizations, and further processors, represented by the Food and Consumer Products Manufacturers of Canada, the Baking Association of Canada, and the Confectionery Manufacturers' Association of Canada.

From left to right: Michel Pagé, Louis Balcaen and Carl Harrison

Chairman
Vacant

Louis Balcaen
Acting Chairman
(Vice-Chairman)

Carl Harrison
Commissioner

Gilles Froment
Acting Senior Director
Policy and
Corporate Affairs

Gaëtan Paquette
Acting Senior Director
Finance
and Operations

Robert Hansis
Director
Audit

Structure

The Canadian Dairy Commission is comprised of three Commissioners appointed by Governor in Council:

Chairman and Chief Executive Officer

Michel Pagé, *appointed in March 2001 — resigned in June 2002*

Vice-Chairman

Louis Balcaen, *appointed for a third term in December 2000*

Commissioner

Carl Harrison, *appointed December 2000*

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 and approve its strategic direction as outlined in its five-year Corporate Plan. Since the departure of the Chairman, Michel Pagé, Louis Balcaen has been acting as Chairman, as specified in the *Canadian Dairy Commission Act*.

The CDC places great importance on improvement and therefore has been re-examining and adapting its services and organizational structure to better respond to current and future client needs and to effectively pursue the CDC's mandate in the Canadian dairy industry. As a result, the CDC has adopted a new structure during the year.

Human Resources

The success of the Canadian Dairy Commission depends largely on its human resources as well as on their pursuit of excellence in the services they offer. The CDC is committed to maintaining the quality of its work environment and management procedures. With that in mind, the CDC continually implements programs and internal initiatives that are aimed at encouraging and supporting good individual and organization performances. Equitable treatment, employee respect, continuous skill development and improvement, leadership, responsibility and teamwork are all essential elements for success.

The Commission's offices are located in Ottawa, Ontario and accommodate approximately 65 staff.

Activities and Programs

Main Activities

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

- Through its chairmanship and work for the Canadian Milk Supply Management Committee (CMSMC), the CDC provides ongoing support to the Canadian dairy industry while operating in close co-operation with provincial stakeholders and provincial governments;
- It acts as a facilitator and provides secretariat services to the revenue pooling and market sharing systems. Provisions for these functions are set out in the All Milk Pooling Agreement (P6), the Western Milk Pooling Agreement (WMP), and the Comprehensive Agreement on Pooling of Milk Revenues. The CDC also administers the financial mechanisms set out by these agreements;
- It calculates and makes a recommendation to the CMSMC on the level of the national milk production target for industrial milk, or Market Sharing Quota (MSQ);
- It has the authority to purchase, store, process, or sell dairy products within Canada's World Trade Organization (WTO) commitments. Under this authority and on behalf of the industry, the CDC manages the TRQ butter import requirement;
- The Commission determines support prices at which it will purchase butter and skim milk powder.
- It administers the Special Milk Class Permit Program and issues permits to further processors for purposes of obtaining access to competitively-priced dairy ingredients, and to exporters for the export of dairy products within Canada's WTO commitment levels;
- 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;
- It acts as facilitator in advancing the harmonization of procedures of plant audit in the industry; and,
- Until January 31, 2002, it administered the federal government's industrial milk subsidy payments to dairy producers, reducing the returns required by producers from the marketplace.

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

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

The National Milk Marketing Plan contains the key elements of how to manage and monitor the industrial market for milk. For example, it contains a formula that is used to calculate the national production target, or Market Sharing Quota (MSQ), to ensure that consumer demand for various dairy products is met. The Plan establishes each province's share of the MSQ and the mechanism for sharing in any increase or decrease in the quota. Each province in turn allocates its share of the MSQ to its dairy producers, according to provincial policy and other agreements established for the sharing of markets and producer returns.

PRODUCTION OF INDUSTRIAL MILK AND CREAM*
(thousands of kg of butterfat)

	1999-2000	2000-2001	2001-2002
Newfoundland and Labrador	n/a	n/a	57
Prince Edward Island	3,063	3,041	3,088
Nova Scotia	2,173	2,099	2,332
New Brunswick	2,183	2,094	2,158
Quebec	83,326	83,117	81,835
Ontario	49,725	49,267	50,420
Manitoba	6,609	6,467	6,394
Saskatchewan	5,375	5,728	5,516
Alberta	10,045	9,285	9,400
British Columbia	8,208	8,440	8,769
Total	170,707	169,538	169,969

** Before pooling*

Production and Demand

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

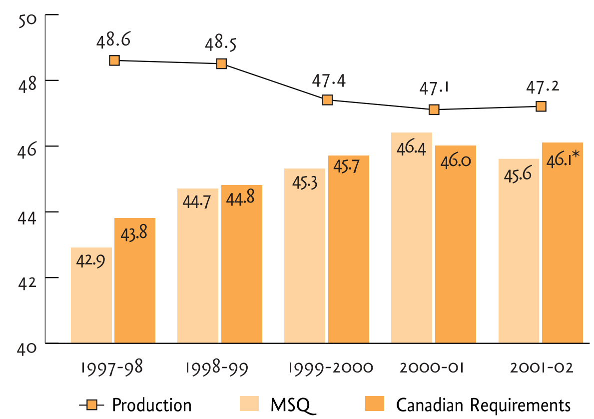
In the 2001-2002 dairy year, Canadian Requirements were 46.1 million hectolitres (subject to review by the CDC), a 0.3 percent increase over the previous dairy year. During the same period, industrial milk and cream production totalled 47.2 million hectolitres, a 0.2 percent increase over the 2000-2001 dairy year.

Market Sharing Quota

Each year, the CMSMC determines the national production target for industrial milk, called the Market Sharing Quota (MSQ). This target is constantly monitored and, when necessary, adjusted to reflect changes in the domestic demand for industrial milk products, as well as changes in planned export activity. It includes a buffer called the Growth Allowance. The objective is to minimize the possibility of shortages on the domestic market.

MSQ at July 31, 2002 was 45.62 million hectolitres. For the 2001-2002 dairy year, industrial milk and cream production exceeded the Market Sharing Quota by 0.72 million hectolitres.

INDUSTRIAL MILK PRODUCTION, CANADIAN REQUIREMENTS AND MSQ (million hl)



*Subject to review by the CDC.

PROVINCIAL SHARES OF MSQ*

July 31, 2002

	Butterfat (thousand kg)	Milk (million hl)	%
Newfoundland and Labrador	126	0.035	0.1
Prince Edward Island	3,054	0.848	1.9
Nova Scotia	2,057	0.571	1.2
New Brunswick	2,069	0.575	1.3
Quebec	76,607	21.280	46.6
Ontario	51,684	14.357	31.5
Manitoba	5,845	1.624	3.5
Saskatchewan	4,377	1.216	2.7
Alberta	10,035	2.788	6.1
British Columbia	8,364	2.323	5.1
Total	164,218	45.617	100.0

* *Base MSQ before sharing of markets*

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

Pooling of Producer Returns

Changing conditions in the global trading environment as well as in the domestic markets in recent years resulted in new pooling arrangements across Canada for the marketing of milk. In its role as a national industry facilitator, the Canadian Dairy Commission administers these pooling arrangements on behalf of the dairy industry.

Comprehensive Agreement on Pooling of Milk Revenues

Under the Special Milk Class Pricing and Pooling System implemented in August 1995, industrial milk is classified and made available for use in dairy products and products containing dairy ingredients at prices that vary according to end use. Formerly known as the Comprehensive Agreement on Special Class Pooling, 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. During the 2001-2002 dairy year, revenues were shared (or pooled) among the ten provincial signatories to the National Milk Marketing Plan.

Agreement on All Milk Pooling (P6)

Since August 1996, the Agreement on All Milk Pooling has provided a means for revenues from all milk sales (fluid and industrial) to be pooled among dairy producers in Manitoba, Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island. Transportation costs are also pooled, along with responsibility for skim-off. This year, the P6 undertook to further harmonize provincial quota issuance policies, quota management and possibly over-quota responsibilities. Also, a Special Committee was struck to study certain unresolved issues between signatory provinces. A sub-group called the P5 (which excludes Manitoba) adopted a Harmonized Transportation Cost Model to be operational at the end of 2004. Finally, processor representatives developed and presented a harmonized milk allocation method that could be implemented in the P5 provinces.

Western Milk Pooling Agreement (WMP)

In March 1997, the four Western provinces (Manitoba, Saskatchewan, Alberta and British Columbia) also implemented an all milk pooling system. Although Manitoba is part of the Western Milk Pool, it also participates in revenue sharing under the Agreement on All Milk Pooling. This year, members of the Western Milk Pool completed negotiations for an agreement dealing with the transportation and processing of surplus milk. A further agreement is being negotiated with a second processor. A harmonized industrial milk price schedule was implemented on February 1, 2002, and a policy to deal with residual milk as a pool was adopted on a trial basis for one year. The WMP Coordinating Committee took steps to increase the flow of information concerning promotion activities at its meetings.

POOLS IN NUMBERS 2001-2002

	Fluid milk produced (million hl)	Industrial milk produced (million hl)	Blend price to producer at 3.6 kg/hl butterfat*
All Milk Pool**	21.6	38.8	$57.67
Western Milk Pool	9.1	8.4	$60.43

** In quota milk*

*** Newfoundland and Labrador is not a member.*

Special Milk Class Permit Program

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

Processors, exporters and further processors can access certain quantities of dairy components through permits issued by the Canadian Dairy Commission. There are three types of permits. The first type is a permit issued to further processors using dairy products for specific purposes as ingredients. Permits are issued under Class 5(a) for cheese as an ingredient, under Class 5(c) for dairy products used in the confectionery sector, and under Class 5(b) for all other dairy products used as ingredients.

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

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

Further processors used the equivalent of 3.7 million hectolitres of milk in the 2001-2002 dairy year. A total of 971 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 773 in 2001-2002, up from 747 in the previous year. A total of 51 businesses operating in the confectionery sector used Class 5(c) permits during the year.

SPECIAL MILK CLASS PERMIT PROGRAM

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

Class		1997-1998	1998-1999	1999-2000	2000-2001	2001-2002
5(a)	Volume	1.535	0.912	1.517	1.791	1.633
	Price	$39.01	$44.20	$37.17	$35.48	$45.35
5(b)	Volume	1.817	0.875	1.452	1.221	0.728
	Price	$38.74	$43.21	$38.84	$42.87	$42.61
5(c)	Volume	0.829	1.152	1.033	1.053	1.344
	Price	$32.73	$33.03	$33.60	$31.91	$30.03
Total	Volume	4.181	2.939	4.002	4.065	3.705
5(a),(b) and (c)	Price	$37.54	$39.50	$36.61	$36.37	$39.29

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

Pricing

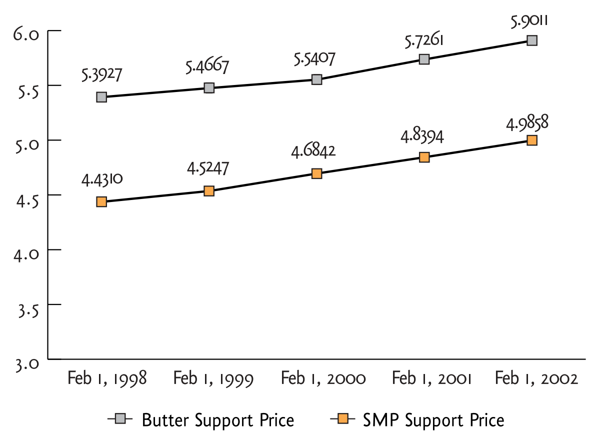
Until recently, the Commission's role in pricing was two-fold. The Commission administered the payment of a federal subsidy that reduced the returns required by producers from the marketplace until last January. Secondly, the Commission annually reviews and announces support prices for butter and skim milk powder. Support prices are used as references by provincial milk marketing boards and agencies in setting the prices for milk sold to processors.

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

The pricing decision announced by the CDC in December 2001 was effective on February 1, 2002. The support price for skim milk powder rose from $4.8394 to $4.9858 per kilogram, and for butter, from $5.7261 to $5.9011 per kilogram. The CDC made this decision after careful consideration of the views of dairy industry stakeholders, as well as other factors such as the results of a national cost of production survey conducted by the CDC and other economic indicators.

The market revenues resulting from these higher support prices provided dairy farmers with an additional amount of $1.86 per hectolitre. Of this amount, $0.85 per hectolitre was included for the purpose of continuing to allow for the recovery of the consumer subsidy from the marketplace — which was eliminated on January 31, 2002. Consequently, net returns to dairy farmers increased by $1.01 per hectolitre or 1.7 percent above the previous year's net returns.

SUPPORT PRICES FOR BUTTER AND SKIM MILK POWDER FROM 1998 TO 2002 ($ per kg)



Federal Subsidy Program

The Government of Canada has provided funding under the federal subsidy program since before the establishment of the CDC in 1966. However, in 1996, as part of the federal budget, it was announced that the program would be phased-out over a five-year period until its elimination on January 31, 2002. The last of the annual reductions of $0.76 per hectolitre was applied at that time.

Payments to producers under the federal dairy subsidy program in the 2001-2002 dairy year totalled $16.197 million for the production of 142.3 million kilograms of butterfat or 39.53 million hectolitres of industrial milk produced for domestic consumption.

FEDERAL SUBSIDY TO PRODUCERS FROM 1997-1998 TO 2001-2002[1] (thousands)

	1997-1998	1998-1999	1999-2000[2]	2000-2001	2001-2002
Newfoundland and Labrador	n/a	n/a	n/a	n/a	$6[3]
Prince Edward Island	$2,024	$1,610	$1,205	$742	309
Nova Scotia	3,514	2,730	2,002	1,225	332
New Brunswick	2,658	2,103	1,563	956	309
Quebec	57,824	46,430	34,525	21,073	5,510
Ontario	51,081	39,923	29,725	18,208	6,612
Manitoba	4,158	3,425	2,441	1,515	412
Saskatchewan	2,996	2,465	1,754	1,075	201
Alberta	8,501	7,018	5,016	3,096	1,315
British Columbia	8,485	6,994	4,945	3,087	1,191
Total	$141,241	$112,698	$83,176	$50,977	$16,197

(1) In 2001-2002, the subsidy ended on January 31.
(2) Modified for cream producers' year-end adjustments.
(3) Newfoundland and Labrador obtained some MSQ for the first time during the 2001-2002 dairy year.

Imports of Dairy Products

Prior to 1995, Canada maintained a range of measures that placed limits on dairy product imports to uphold the stability of its national milk supply management system. These controls changed significantly in 1995 as a result of the World Trade Organization (WTO) Agreement on Agriculture. In signing this Agreement, Canada and the other signatories agreed to replace former import restrictions with tariffs and Tariff Rate Quotas.

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

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

Domestic Dairy Product Innovation Program

The Domestic Dairy Product Innovation Program (DDPIP) encourages the manufacture of new and innovative products on the domestic market by adding specific volumes to provincial milk quotas in order to ensure that necessary milk supplies are available. Accordingly, DDPIP allows for a certain amount of flexibility within the national supply management system.

The DDPIP was first implemented in 1989 following approval by the CMSMC. It was renewed in July 1999 and extended until the end of the 2004-2005 dairy year.

During the 2001-2002 dairy year, Canadian firms in Quebec, Ontario, Alberta and BC used approximately 22.1 million litres of milk under the DDPIP. In 2000-2001, the total was 22.0 million. The maximum limit for this program is set at 1% of MSQ, which is about 46.0 million litres.

The selection committee, a CMSMC initiative, had representation from three regional and three national organizations. However, with the disappearance of the National Dairy Council of Canada, the committee has had to function with only five members for the year.

This year, four applications were received, compared to eight last year. Following the trend, most applications concerned new specialty cheeses. Two applications were accepted, one was rejected and the fourth requires additional information before a decision can be reached.

The appeal process, in which a second body, comprised of the three CDC Commissioners, reviews the decision of the selection committee, was reviewed by the CMSMC during the year. It found that the process needed clarification. As a result, no new information can be introduced to the appeal body by the applicant, and if the appeal body reverses the decision of the selection committee, a justification has to be provided. No appeals were filed this year.

Dairy Ingredient Marketing Program

The purpose of this Program is to contribute to increasing the visibility and utilization of dairy ingredients in the Canadian further processing sector, with an emphasis on finished products such as baked goods, confectionery and nutraceutical products.

This year, the CDC sponsored a conference on dairy ingredients for processors, further processors and distributors. The conference was a success and will be given again next year in other areas of the country. The CDC also took part, with great success, in a baking industry trade show.

At the same time, the CDC continues to develop and update the MILKINGREDIENTS.CA Web site, which has grown to over 5,000 visits a month. This site offers a wide range of technical and business information, for the benefit of current and potential dairy ingredient users. A CDC-sponsored training fund will be launched in the next year to support further processors seeking to improve their knowledge about dairy ingredients in food processing.

The Dairy Ingredient Marketing Program was first implemented in October 2000 in collaboration with industry partners. In July 2002, the CDC renewed its commitment to the dairy industry to pursue its marketing program activities until the end of the 2003-2004 dairy year.

Domestic Seasonality Programs

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

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

Storage Programs

Butter

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

Within this targeted level, two types of programs are operated to manage stocks. Plan A is a storage program for butter which is held in 25 kilogram blocks. The CDC purchases the butter and holds it for resale in the domestic market at the support price when manufacturers run low on the supply of cream to make butter. During the 2001-2002 period, the goal for Plan A normal stocks as at July 31 was 2.0 million kilograms.

Plan B is a storage program used by manufacturers to balance the seasonality of their own production and sales during the calendar year. Under the Plan B program for butter, manufacturers can sell butter to the Commission in retail packaging (454 g) or in 25 kilogram bulk blocks. They must then repurchase this butter within one calendar year from the date of the product's manufacture. Companies make their own decisions on the level of butter they want to put in storage under this program. Because of the need to repurchase the product, this program is self-limiting and for this reason, there is no set limit on the quantity of product accepted by the CDC. A Plan B also exists for butteroil.

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

Milk Powders

The CDC operates a program for the storage of specialty types of milk powders. It encourages manufacturers to make these products when the supply of milk is plentiful and minimizes the demand for

fresh milk to make these products in the fall when milk production is usually low. Stocks held under this program act to balance the supply and demand of non-fat milk solids.

Concentrated Milk Assistance Program

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

Inventories

The Commission began the 2001-2002 dairy year with 14.40 million kilograms of butter and 8.79 million kilograms of skim milk powder in inventory. During the year, the CDC purchased 25.69 million kilograms of butter and 46.54 million kilograms of skim milk powder. Sales of 24.38 million kilograms of butter and 46.18 million kilograms of skim milk powder left respective closing inventories of 15.71 and 9.15 million kilograms as of July 31, 2002 (butter statistics include imports and butteroil).

Surplus Removal Program

The CDC administers a Surplus Removal Program (SRP), on the industry's behalf. The program is designed to minimize the manufacture of products for unplanned exports when unfulfilled domestic and planned export opportunities exist. The program ensures that milk that is surplus to the domestic market is removed in the form of dairy products that are most suited for export.

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

Exports

The CDC's role in exporting dairy products underwent important changes over the last few years. Because most exports are done by private firms, the CDC's role is increasingly limited to removing the structural surplus of skim milk powder.

Because of a surplus production, the CDC had to remove other products this year, such as butter and whole milk powder. This was also necessary in 2000-2001, but to a lesser extent.

The CDC removes these products and sells them either to the Mexican or Cuban governments, or to Canadian exporters. At the exporter's request, or if the product to be removed is not the kind traded by the CDC (such as cheese), the export is performed using a 5(d) permit issued by the CDC. In these instances, the CDC neither buys nor sells the product. The manufacturers sells directly to the exporter, who ships the product abroad.

During the dairy year 2001-2002, the CDC exported 41.8 million kg of skim milk powder. The CDC also sold 1.0 million kg of butter and 5.2 million kg of whole milk powder (regular or instant) to Canadian exporters. These products were for clients located mainly in the Caribbean, Middle-East and Africa.

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 almost a century. All these quantities, as well as those associated with 5(d) permits issued to exporters who did not use CDC inventories, are accounted for in Canada's export commitments under WTO.

Warehousing and Charges

The Commission enters into contracts with public warehouses across Canada for the safe storage of its products. In the 2001-2002 dairy year, the CDC stored mostly butter and milk powders in 63 warehouse locations across Canada.

Carrying charges associated with the CDC's Domestic Seasonality Programs for butter and skim milk powder totalled $5.25 million in 2001-2002. In order to defray the costs associated with storing the normal levels of butter stocks, an amount is collected by the Commission through pooling arrangements and is adjusted as required to correspond to the actual costs associated with these stocks. On February 1, 2002, the CDC increased this charge from $0.07 to $0.08 per hectolitre of industrial milk.

Audit

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

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

This dual accountability is emphasized by the joint funding provided by both the government and dairy producers.

Internal Audits

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

During the 2001-2002 dairy year, internal audits carried out by the CDC had an important emphasis on security. Access to and transmission of data used and generated during the administration of the pools were examined. The new computer-based records management system was also audited in terms of security, efficiency and effectiveness. Finally, the CDC reviewed the physical security of its new office building. The CDC auditors work with management in order to ensure that operations are carried out economically, efficiently and effectively. They also cooperate with the Office of the Auditor General of Canada with its annual audit by providing relevant reports and information on CDC practices.

External Audits

External audits are, in large part, performed on companies participating in the Special Milk Class Permit Program. During the 2001-2002 dairy year, 43 companies were audited, resulting in claims of $428,000 against companies for which discrepancies were found relative to their use of their permit. These claims were returned to Canadian dairy producers. Risk assessment is used to identify high risk companies among the close to eight hundred companies that generated $272 million in revenue under the program during the 2001-2002 dairy year.

The CDC also establishes mandates and reviews the work contracted with professional audit firms in each province. This provides assurance on the reliability of revenues reported to the Commission within the national and regional pools. In cooperation with provincial milk plant auditors, the CDC developed a national Milk Utilization Plant Audit Manual establishing a set of minimum audit standards to be followed in the performance of milk plant audits. Following Newfoundland and Labrador's entry into the National Milk Marketing Plan on August 1, 2001, these audit standards now apply to all ten provinces.

PERFORMANCE AND

GOALS

Goals and Achievements for the Planning Period 2001-2002 to 2005-2006

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

In collaboration with provincial signatories, the Commission ensured that the new Comprehensive Agreement on Pooling of Milk Revenue was signed, and that the terms of this Agreement, as well as the amendments to the All Milk Pooling Agreement, and the Western Milk Pooling Agreement, are implemented.

The CDC continues to provide technical support to the team defending the changes made by Canada to comply with the 1999 WTO Panel ruling on Canadian exports. A second Compliance Panel was convened in April 2002. The results of the Panel came out in June and were unfavourable to Canada, who appealed. The appeal hearing will occur in the fall, with the Appellate Body decision expected in early winter.

2. Co-ordinate and facilitate efforts to refine and harmonize Canada's pooling systems administered by the Canadian Dairy Commission and support industry deliberations to consider the establishment of an all milk national pool.

This year, the CDC continued to take the opportunity to bring members of the pools together to discuss, analyze and consider options for the harmonization of issues. Concerning the establishment of a national all milk pool, it must be noted that the industry is currently dealing with other priorities. Although the formation of this pool is still on the horizon, it is not imminent.

The CDC also worked on finding a common approach to removing surplus milk components from the domestic market and promoting the implementation of the CMSMC Special Committee recommendations within the pools.

Commission staff assisted the province of Newfoundland and Labrador as it entered the National Milk Marketing Plan for the 2001-2002 dairy year. In doing so, Newfoundland and Labrador received 3.5 million litres of industrial milk quota, or MSQ, in the first year. This quota could rise to as much as 31 million litres in the 2015-2016 dairy year. In exchange, they became part of the Comprehensive Agreement on Pooling of Milk Revenue and agreed to contribute to national promotion programs for industrial milk.

3. Conduct a comprehensive review of the administration of the Special Milk Class Permit Program to improve administrative processes, structure, and management of the program.

Following this review, changes were made to the administrative process of this program. These improvements included the following elements:

- permits are issued for five years instead of one;
- participants submit their inventory at the end of their financial year, instead of at the end of the dairy year;
- new client categories allow certain participants to submit fewer reports within a year;
- documents related to the program were revised and shortened; and
- human resources allocated to the program were restructured.

4. Implement and coordinate an audit system that will ensure that Canada's obligations under international trade agreements are being respected, and that the integrity of the domestic market is protected.

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

In May 2002, the CDC reconvened the Audit Committee, which includes provincial auditors. The CDC thereby continues to work with the provinces to implement a strong audit system that protects the integrity of the milk supply used in the domestic market.

5. Improve communications with industry stakeholders and assess and establish a comprehensive means of communicating with the CDC's client groups.

Commissioners arranged meetings with stakeholders to discuss a range of issues. Meetings addressed subjects such as pricing, dairy product substitution, and the structural surplus of skim milk powder. A complete report of these consultations is available on the Internet site of the CDC at www.cdc-ccl.gc.ca.

The tools that the Commission uses to provide information to stakeholders and all Canadians were examined. As a result, a distinct Communications Services unit was created and the CDC Internet site was entirely redesigned.

6. Achieve administrative efficiencies through the implementation of the Financial Information Strategy, the relocation of the CDC's offices and a records management system.

The Financial Information Strategy and a computer-based records management system were implemented. This allows better management of human resources, operating budgets and information used at the Commission.

GOALS

The offices of the CDC moved to Building 55 on the Central Experimental Farm, in Ottawa. The move had positive financial implications and employees are satisfied with their new working environment.

In April 2002, the CDC underwent a reorganization of its structure. The Commissioners felt that better services would be provided to stakeholders and the public if the following changes were implemented:

- The Policy and Strategic Planning, Economics, Human Resources and Communications sections have been merged to form one larger administrative unit called "Policy and Corporate Affairs";
- The sections of Marketing and Commercial Operations and Finance and Administration have merged into one larger section called "Finance and Operations"; and
- The structure and operation of the Audit section remained unchanged.

The CDC also established an internal process to ensure that more planning and performance indicators are used throughout the Commission for assessing the delivery of programs and services. This Plan proposes a cycle of evaluations in support of ongoing performance measurement.

PERFORMANCE AND

Outlook

The business world is adapting to the new trade rules and the Canadian dairy industry is no exception. In a supply management context, the free market economy is generating specific challenges.

Harmonization of dairy policies remains one of the industry's priorities. However, its importance has abated in light of the current market challenges. As a result, implementation of the recommendations made by the CMSMC Special Committee continues, albeit at a slower rate than planned.

The CDC, in collaboration with the provincial organizations, continues its efforts to improve and adapt the auditing of milk marketing and pooling systems. During the past year, several significant steps were realized.

The CDC continues to closely follow the volume of subsidized exports of dairy products to ensure that Canada respects its commitments to the World Trade Organization (WTO). The CDC also acts as first receiver of the butter that Canada must import in accordance with these same commitments. Moreover, the CDC provides technical support and relevant data to the legal team responsible for defending Canada's dairy marketing system before the WTO Compliance Panel. Since the challenges by the United States and New Zealand will continue into next year, the CDC will have to devote important resources to this activity.

GOALS

During consultations with various industry groups, the CDC's Commissioners noted the growing concerns related to the substitution of Canadian dairy ingredients in the manufactured goods by non-dairy ingredients or by dairy ingredients of foreign origin. This observation impels the CDC to continue the marketing activities directed at further processors that are set out in the Dairy Ingredients Marketing Program.

Goals for the Period 2002-2003 to 2006-2007

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

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

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

Increase administrative efficiencies through better use of electronic information technology, the planning of employee training, and the implementation of an Evaluation Plan.

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

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

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

FINANCIAL STATEMENTS

Management Responsibility for Financial Statements

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

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

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

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

Louis Balcaen, Acting Chairman

Gaëtan Paquette, Acting Senior Director, Finance and Operations

Ottawa, Canada
September 24, 2002

FINANCIAL STATEMENTS

Significant Factors Affecting Financial Statements

Total sales revenue for the dairy year was $262 million, which is an 18% increase over the previous dairy year's total sales of $222 million. In contrast, operations for the current dairy year generated a loss of $4.4 million, compared to a $19.2 million margin achieved in the prior year.

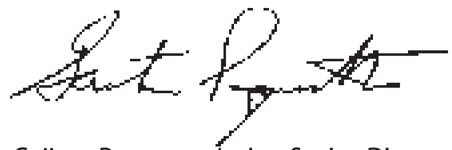
The Commission had anticipated this shortfall at the beginning of the year due to the purchase price of its skim milk powder for export being higher than the prevailing world price. Consequently, this loss reduced the previous years' accumulated surplus available for refund to producers. In January 2002, the purchase price of skim milk powder was aligned with the world market price to ensure that losses would not be generated from the sales of stocks purchased during the rest of the year.

Contrary to last year, this year's over quota production required the export of butter and whole milk powder, which contributed to the overall loss. As in the past, purchases and domestic sales of butter continued to generate favourable returns for the Commission.

Inventory levels remained relatively constant compared to the previous year. The Commission was required to take a provision to make up for loss of value on its inventory at year-end destined for export.

Our outstanding loans during the year benefited from favourable interest rates, which resulted in proportionally lower carrying charges per unit of inventory.

During the year, eligible dairy producers received the last payments totaling $16.2 million in subsidies for their shipments of industrial milk and cream with regard to the Federal subsidy program, which ended on January 31, 2002.



Gaëtan Paquette, Acting Senior Director, Finance and Operations

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, 2002 and the statement of costs funded by the Government of Canada, the statement of operations and surplus and the statement of 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, 2002 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.

Sheila Fraser

Sheila Fraser, FCA
Auditor General of Canada

Ottawa, Canada
September 24, 2002

Balance Sheet

as at July 31, 2002
(in thousands)

	2002	2001
Assets		
Cash	$ 957	$ 1,024
Accounts receivable		
Trade (Note 3)	8,440	13,417
Government of Canada (Dairy Support Program)	25	8,550
Due from provincial milk marketing boards and agencies	19,190	23,376
Inventories (Note 4)	102,237	110,266
	$ 130,849	$ 156,633
Liabilities		
Accounts payable and accrued liabilities		
Trade	$ 11,597	$ 19,280
Other liabilities	3,810	1,445
Due to provincial milk marketing boards and agencies	18,899	22,092
Subsidies payable to producers	–	8,525
Loans from Government of Canada (Note 6)	81,411	78,523
	115,717	129,865
Surplus (Note 8)	15,132	26,768
	$ 130,849	$ 156,633

Commitments (Notes 11 and 13)

Approved:

Acting Chairman

Commissioner

Acting Senior Director, Finance and Operations

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

Statement of Costs Funded by the Government of Canada

for the year ended July 31, 2002
(in thousands)

	2002	2001
Subsidies to producers of industrial milk and cream	$ 16,197	$ 50,977
Operating expenses	2,873	2,775
Costs of production and dairy policy studies	300	542
Total costs funded by the Government of Canada (Note 9)	$ 19,370	$ 54,294

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

Statement of Operations and Surplus

for the year ended July 31, 2002
(in thousands)

	2002	2001
Export sales	$ 125,503	$ 114,262
Cost of sales	135,633	101,628
(Loss) margin on export sales	(10,130)	12,634
Domestic sales	136,548	107,739
Cost of sales	130,789	101,186
Margin on domestic sales	5,759	6,553
Total (loss) margin on sales	(4,371)	19,187
Pooling of market returns activities		
Contributions from provincial marketing boards and agencies	122,877	117,324
Equalization payments to provincial marketing boards and agencies	115,421	110,138
Contrbutions withheld to fund operating expenses	7,456	7,186
Operating expenses (Note 10)	15,466	12,726
Net results of operations before Government funding	(12,381)	13,647
Operating expenses funded by the Government of Canada	2,873	2,775
Net results of operations after Government funding	(9,508)	16,422
Surplus at beginning of year	26,768	17,146
	17,260	33,568
Refund of surplus to producers	2,128	6,800
Surplus at end of year	$ 15,132	$ 26,768

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

Statement of Cash Flows

for the year ended July 31, 2002
(in thousands)

	2002	2001
Cash flows from operating activities		
Cash receipts from customers	$ 267,028	$ 220,723
Cash paid to suppliers and others	(277,559)	(241,732)
Cash receipts from provincial milk marketing boards and agencies	134,522	134,611
Cash paid to provincial milk marketing boards and agencies	(126,068)	(130,874)
Cash receipts from the Government of Canada	27,895	60,082
Subsidies paid to producers of industrial milk and cream	(24,722)	(56,765)
Interest paid	(1,923)	(2,461)
Cash flows from (used in) operating activities	(827)	(16,416)
Cash flows from financing activities		
New loans from the Government of Canada	196,812	198,857
Loan repayments to the Government of Canada	(193,924)	(178,713)
Decrease in the bank indebtedness-pooling of market return system	–	(364)
Cash paid to refund surplus to producers	(2,128)	(6,800)
Cash flows from (used in) financing activities	760	12,980
Net decrease in cash	(67)	(3,436)
Cash at beginning of year	1,024	4,460
Cash at end of year	$ 957	$ 1,024

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

Notes to Financial Statements

July 31, 2002

1. The Commission

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

The Commission administered subsidy payments to producers (the program was terminated on January 31, 2002) and administers other costs funded by the Government of Canada. In co-operation with the Canadian Milk Supply Management Committee (CMSMC), which it chairs, the Commission undertakes the management and administration of operations funded by producers. The results of the Commission's operations in each of these areas are presented in the Statement of Costs Funded by the Government of Canada, and in the Statement of Operations and Surplus, respectively, in order to distinguish and reflect the accountability relationships for them. The Statement of Cash Flows reflects transactions of both areas of operations.

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

The Commission administers, on behalf of the industry, a pricing and pooling of market returns system, which provides milk components to further processors and exporters through processors at competitive prices. Accordingly, this system is administered by the Commission in accordance with the "Comprehensive Agreement on Pooling of Milk Revenues" to allow dairy producers to share special class revenues nationally as well as the "Western Milk Pooling Agreement" and the "Agreements on All Milk Pooling" to allow dairy producers to share revenues regionally.

2. Significant accounting policies

Inventories

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

Cost of sales

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

Foreign currency translation

A portion of sales in foreign currencies are hedged by forward exchange contracts and are translated into Canadian dollars at the exchange rates provided therein. Sales in foreign currencies that are not hedged are translated into Canadian dollars at the exchange rate in effect on the transaction date.

Contributions to Public Service Superannuation Plan

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

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

Measurement uncertainty

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

3. Accounts receivable — Trade

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

4. Inventories

	2002	2001
	(in thousands)	
Butter	$ 79,186	$ 78,299
Skim milk powder	22,234	29,155
Other dairy products	1,458	2,812
	$ 102,878	$ 110,266
less: allowance for inventory write down	641	–
Net book value	$ 102,237	$ 110,266

5. Bank indebtedness — Pooling of market returns system

To provide bridge financing and ensure the efficient operation of the pricing and pooling of market returns system, the Commission established a $10 million line of credit with a member of the Canadian Payments Association. The bank indebtedness incurred under this line of credit is due on demand and bears interest at prime which on July 31, 2002 was 4.50% per annum. The bank indebtedness is repaid monthly and was fully repaid at year-end.

6. Loans from Government of Canada

Loans from the Government of Canada, to a maximum of $100 million, are available to finance operations. Individual loans are repayable within one year from the date the loan is advanced. Principal and accrued interest are repaid regularly during the year when funds are available. Interest on the loans are at the normal rates established for Crown corporations by the government and varied from 2.03% to 4.54% (2001 — 4.29% to 6.02%) during the year.

7. Fair value of financial instruments

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

8. Surplus

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

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

9. Costs funded by the Government of Canada (Dairy Support Program)

Agriculture and Agri-Food Canada provided funding to the Commission for subsidy payments to producers of industrial milk and cream shipments produced to meet domestic requirements. The rate of subsidy payments from August 1, 2001 to January 31, 2002 was $0.211 per kilogram of butterfat or $0.76 per hectolitre of milk containing 3.6 kilograms of butterfat (August 2000 to January 2001 — $0.422 or $1.52 and February 2001 to July 2001 — $0.211 or $0.76 respectively). This dairy support program ended January 31, 2002.

Funding of the Commission's administrative expenses is shared among the federal government (44 percent), dairy producers (36 percent) and the market place (20 percent).The Government of Canada has funded $2.9 million (2001 — $2.8 million) of the Commission's administrative expenses of $6.7 million (2001 — $6.5 million), as well as professional services relating to cost of production and dairy policy studies.

10. Operating expenses

Operating expenses included the Commission's contributions to the Public Service Superannuation Plan during the year, totaling $496 thousand (2001 — $473 thousand), which corresponds to about 2.6 times (same in 2001) the employees' contributions to the Plan.

11. Forward exchange contracts

As part of its foreign exchange risk management, the Commission enters into forward exchange contracts with regard to a portion of its export sales contracts. At the end of the year, the Commission's outstanding forward exchange contracts totaled $19.5 million Canadian equivalent (2001 — $18 million equivalent). These contracts mature from August to November 2002. 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.

12. Representatives' fees

The Commission used the services of representatives for sale of dairy products on the export market. Total fees for the year were $0.9 million (2001 — $1.1 million) and are included in cost of sales.

13. Purchase commitments

As at July 31, 2002, the Commission was committed to purchase certain butter, skim milk powder and other dairy products produced prior to that date. These commitments amounted to approximately $2.0 million (2001 — $2.4 million).

14. Related party transactions

The Commission is related in terms of common ownership to all Government of Canada-created departments, agencies and Crown corporations. The Commission enters into transactions with these entities in the normal course of business. These transactions totaled about $1.4 million during the year (2001 — $1.1 million).

15. Financial statement presentation

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

Schedule of Operations by Product

for the year ended July 31, 2002
(in thousands)

	2002				2001			
	Butter	Skim Milk Powder	Other Products*	Total	Butter	Skim Milk Powder	Other Products*	Total
Export sales	$ 1,769	$111,409	$12,325	$125,503	$ –	$114,162	$ 100	$114,262
Cost of sales	3,788	118,623	13,222	135,633	–	101,528	100	101,628
(Loss) margin on export sales	(2,019)	(7,214)	(897)	(10,130)	–	12,634	0	12,634
Domestic sales	128,776	7,772	–	136,548	96,350	11,389	–	107,739
Cost of sales	122,863	7,926	–	130,789	89,838	11,348	–	101,186
Margin on domestic sales	5,913	(154)	–	5,759	6,512	41	–	6,553
Total (loss) margin on sales	$ 3,894	$ (7,368)	$ (897)	$ (4,371)	$ 6,512	$ 12,675	$ –	$ 19,187
Operating expenses								
Domestic dairy product assistance	29	–	274	303	44	–	345	389
Carrying charges	3,740	1,512	90	5,342	3,770	1,261	4	5,035
Promotional activities	2,000	–	–	2,000	–	–	–	–
Inventory writedown	441	78	122	641	–	–	–	–
	$ 6,210	$ 1,590	$ 486	$ 8,286	$ 3,814	$ 1,261	$ 349	$ 5,424
Administrative expenses				6,704				6,487
Cost of production, interest and bank charges related to the operation of the pooling of the market returns system				476				815
Total operating expenses				$ 15,466				$ 12,726

** Includes whole milk powder and evaporated milk*

The accompanying notes are an integral part of this schedule.