

Canadian Dairy Commission

Special Examination Report

**Presented to the
Commissioners**

on 24 June 2005



Office of the Auditor General of Canada
Bureau du vérificateur général du Canada

29 June 2005

To the Commissioners of the Canadian Dairy Commission

We have completed the special examination of the Canadian Dairy Commission in accordance with the plan presented to you on 26 April 2005. As required by Section 139 of the *Financial Administration Act*, we are pleased to provide the attached final special examination report.

We were pleased to meet with you and respond to your comments and questions on our report at our meeting on 24 June 2005.

I would like to take this opportunity to express my appreciation to you and management and staff of the Commission for the excellent cooperation and assistance offered to us during the examination.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Ron Thompson'.

Ronald C. Thompson, CA
Assistant Auditor General

Attach.

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SPECIAL EXAMINATION OPINION

To the Commissioners of the Canadian Dairy Commission

1. Under Part X of the *Financial Administration Act* (FAA), the Canadian Dairy Commission is required to maintain financial and management control and information systems and management practices that provide reasonable assurance that its assets are safeguarded and controlled; its financial, human, and physical resources are managed economically and efficiently; and its operations are carried out effectively.
2. The FAA also requires the Commission to have a special examination of these systems and practices carried out at least once every five years.
3. Our responsibility is to express an opinion on whether there is reasonable assurance that, during the period covered by the examination (from December 2004 to May 2005), there were no significant deficiencies in the systems and practices we examined.
4. We based our examination plan on a survey of the Commission's systems and practices, which included a risk analysis. We submitted the final plan to the Commissioners on 26 April 2005. The plan identified the systems and practices that we considered essential to providing the Commission with reasonable assurance that its assets are safeguarded and controlled, its resources managed economically and efficiently, and its operations carried out effectively. Those were the systems and practices that we selected for examination.
5. The plan included the criteria that we selected specifically for this examination in consultation with the Commission. The criteria were based on our experience with performance auditing. Our choice of criteria was also influenced by legislative and regulatory requirements, professional literature and standards, and practices followed by the Commission and other organizations. The systems and practices we examined and the criteria we used are listed in the appendix to this report.
6. We conducted our examination in accordance with our plan and with the standards for assurance engagements established by The Canadian Institute of Chartered Accountants. Accordingly, it included the tests and other procedures we considered necessary in the circumstances. In carrying out the special examination, we relied on internal audits of the Special Milk Class Permit Program.
7. In our opinion, based on the criteria established for the examination, there is reasonable assurance that there were no significant deficiencies in the systems and practices we examined.
8. The rest of this report provides an overview of the Commission and more detailed information on our examination findings and recommendations.



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

Ottawa, Canada
30 May 2005

OVERVIEW OF THE CANADIAN DAIRY COMMISSION

Background

Mandate and mission. The Canadian Dairy Commission (the Commission) is a Crown corporation named in Part 1, Schedule III of the *Financial Administration Act* (FAA). Established by the *Canadian Dairy Commission Act*, it reports to Parliament through the Minister of Agriculture and Agri-Food Canada.

The Commission's mandate, as specified in its Act, is to provide

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

The Commission identifies itself as the national facilitator and chief administrator for the dairy industry. It works in close co-operation with federal and provincial governments and industry stakeholders, including dairy producers, processors, and further processors. Its mission, as stated in its *2003-04 Annual Report*, is to "enhance the vitality of the Canadian dairy industry for the benefit of all stakeholders."

Resources and activities. Three executives—the Chairman, Vice-Chairman, and Commissioner—guide the operations of the Commission, which employs approximately 65 staff. Its activities are mainly funded by the Canadian dairy producers; however, it receives an annual federal contribution of approximately \$3 million. The federal government also provides interim financing to the Commission with short-term loans. The authorized limit of these loans has recently increased from \$100 to \$120 million. They are used to finance the Commission's stocks, which totalled approximately \$134 million at the end of its last dairy year (1 August 2003 to 31 July 2004).

The Commission's activities deal with industrial milk (and not fluid milk, which is a provincial responsibility) and are as follows:

- **Market Sharing Quota (MSQ).** It calculates and recommends, through the Canadian Milk Supply Management Committee (CMSMC), to the industry the level of the national industrial milk production target, known as the Market Sharing Quota. It regularly monitors the use of the quota against Canadian requirements, which include planned exports.
- **Cost of production (COP).** It calculates annually the estimated cost of production (COP) of milk (COP per hectolitre), which it later uses as an indicator to establish support prices.
- **Support prices.** It establishes support prices for butter and skim milk powder, which are generally adjusted annually. They represent the prices at which the Commission will purchase butter and skim milk powder. They are used by the provinces as references when establishing provincial milk prices for fluid milk or for manufacturing dairy products, such as butter, cheese, and ice cream.
- **Purchases and sales.** The Commission purchases, stores, and sells dairy products—mainly butter and skim milk powder—on the domestic and export markets under its domestic seasonality and surplus removal programs. The domestic seasonality programs

allow the Commission to buy at the processor's request surplus production with the obligation that the processor buys it back from the Commission within a year. This ensures that the domestic market has a constant supply throughout the year. For example, butter purchased under the domestic seasonality programs forms part of the "normal" inventory of butter.

The surplus removal programs allow the Commission to purchase dairy products that are surplus in the industry to balance production with domestic demand. The surplus dairy products, essentially skim milk powder, are exported up to the allowable limit agreed to by Canada under its World Trade Organization (WTO) commitments.

As granted annually by the Government of Canada, the Commission is the first receiver of butter imported under Tariff Rate Quotas. These quotas allow countries to export to Canada a certain quantity of butter under a low tariff or tariff free. The quota for butter in 2003–04 was 3,274 tonnes; the Commission imported the butter tariff free at the then world market price of approximately CAN\$2.00 per kg and resold it to further processors at the domestic price under classes 5(a), 5(b), or 5(c). According to the Commission's accounting records, the net accumulated surplus from these operations totalled approximately \$19 million at the end of the 2003–04 dairy year.

- **Special Milk Class Permit Program.** It administers the Special Milk Class Permit Program, which allows further processors of classes 5(a) and 5(b) to access certain quantities of dairy products and/or products containing dairy ingredients at competitive prices, negotiated between processors and further processors. These negotiated prices are generally comparable to U.S. prices. The Program also provides exporters with a permit (5(d)) to export dairy products on an individual transaction basis for the exports of dairy products, which must fall within Canada's WTO commitment levels.
- **Pooling system.** It administers the industry's pooling system. The Commission acts as a facilitator and provides secretariat services to the three pooling agreements in place in Canada—All Milk Pooling Agreement, Western Milk Pooling Agreement, and the Comprehensive Agreement on Pooling of Milk Revenue. It also administers the financial mechanisms required by these agreements.

Operating environment

The Canadian dairy industry operates under a supply management system, implemented in the early 1970s that is guided by the following principles:

- Canada's aggregate quota is based on the total demand for butterfat (BF).
- Producers are financially responsible for the export and disposal of dairy products surplus to domestic needs.
- The target producer price (an estimate of what the dairy producer should be receiving for a hectolitre of milk produced) for industrial milk is based on the cost of production.

One key element of the supply management system is the National Milk Marketing Plan administered by the Canadian Milk Supply Management Committee, which the Commission chairs. The Plan, a federal-provincial agreement, sets out the structure to calculate the national industrial milk production target (or Market Sharing Quota) for the domestic and export markets. It also provides for the allocation of this quota to the provinces. In turn, provincial milk boards or agencies allocate, according to their policies, their share of the quota to producers in their province.

The Canadian Milk Supply Management Committee also includes non-voting, observer-status representatives from national consumer, processor, and producer organizations.

Quebec and Ontario have approximately 80 percent of the total dairy farms in Canada, and in the 2003–04 dairy year, produced approximately 77 percent of total industrial milk (50.2 million hectolitres). Total Canadian milk production for that year reached 81.5 million hectolitres, including fluid milk of 31.3 million hectolitres, or 38 percent of total milk production (28 percent on a BF basis). The trend over the years has been a constant decrease in the number of dairy farms (17,931 farms in 2002-2003 to 16,970 in 2003-2004). However, the number of dairy cows has only decreased very slightly over the last four years with total production in hectolitres increasing.

In every province, processors buy milk from producers at prices set by the provincial milk board or agency. The price paid by processors to the provincial board (who collect on behalf of the producers) depends on the end product that is being manufactured (fluid milk for consumption, ice cream, cheese, etc.).

Other key stakeholders. In addition to the dairy producers, the other key stakeholders are the processors, further processors, the foodservice industry (including restaurants, pizzerias, and quick-service establishments), the federal government, and the consumer. Dairy processors transform milk from dairy producers into dairy products such as table milk, butter, cheese, ice cream, yogurt, and milk powders. In recent years, the number of processors has significantly decreased due to consolidation. Currently, three companies account for approximately 80 percent of all the milk processed in Canada.

Role of key federal departments in the dairy industry. In simple terms, the Commission administers the supply management system in Canada. Agriculture and Agri-Food Canada (AAFC) is responsible for domestic policy, including advice to the Minister, on the dairy industry. International Trade Canada (part of the Department of Foreign Affairs and International Trade) is responsible for trade policy, with input from the AAFC on agriculture. As such, International Trade Canada (ITCan) is the lead department for multilateral and bilateral trade negotiations. In practice, the AAFC is the lead for the agriculture elements of these negotiations. ITCan, with support from the AAFC, deals with trade disputes under the WTO and the North American Free Trade Agreement, and implements Canada's obligations for dairy import quotas. The Commission provides technical assistance, when requested.

Key challenges

The key challenges facing the dairy industry are as follows:

- **Continuing increases in the cost of dairy products in Canada.** Processors and further processors are concerned with the increase in prices for dairy products and believe they are increasing faster than world prices. They are looking to reduce the cost of production through technological improvements and using substitutes to dairy ingredients. The foodservice industry (particularly pizzerias) and consumer groups are also concerned about the increase in prices and have stated so. Also, consumers could start substituting more dairy products with other food products.
- **International trade commitments.** Canada's trade commitments under the WTO have had significant impact on its dairy industry over the last decade. These trade commitments have reduced Canada's authorized exports of dairy products to a current annual level of "allowed subsidy value" of approximately \$100 million. In simple terms, the "allowed subsidy value" represents the excess of a product's Canadian domestic price over the world market price. Therefore, the greater the excess of the Canadian price, the less of that product can be exported. Total Canadian exports of dairy products, including the Commission's exports, have decreased from \$443 million in 2001 to

\$264 million in 2004. On a butterfat (BF) basis, approximately one percent of annual milk production is exported.

- **Increasing structural surplus.** Production quotas are measured by kilogram of butterfat (BF), and the demand in Canada is greater for the BF portion of milk than the solids non-fat portion (SNF). As a result of meeting the demand in BF there is a surplus of SNF, mainly as skim milk powder. This surplus is known as a structural surplus. The structural surplus of SNF is larger than Canada's export limits, and the industry and the Commission must find ways to dispose of it. Some current measures include revising the pricing and quota policies to remove incentives that increase the surplus, and searching for new markets.

FINDINGS AND RECOMMENDATIONS

Our examination focussed on the Canadian Dairy Commission's four expected corporate results (ECRs), and the criteria that we agreed to with the Commission on 26 April 2005, which are presented in the appendix to this report. We defined ECRs as those results that the Commission has to achieve to be successful in meeting its mandate. The four ECRs are

- Articulating and disseminating a clear, long-term strategic direction;
- Maintaining orderly production and marketing of industrial milk and cream;
- Actively encouraging consensus among stakeholders on supply management policies and programs; and
- Actively encouraging stakeholders to be in a position to respond to an increasingly competitive, changing, and global market structure

We also looked at the "board" of the Commission.

Composition of the "board"

The Commission is composed of three executive members—the Chairman, Vice-Chairman, and Commissioner—appointed by the Governor in Council; they form the "board." The *Canadian Dairy Commission Act* states that the Chairman is also the Chief Executive Officer (CEO), and the three members serve as the Audit Committee. All three members have extensive experience in the dairy industry, either as a dairy farm owner (or former owner), or as a career in the dairy processing industry.

Current best practices and expectations for the governance of Crown corporations include the following:

- The Chairman of the board and the CEO should not be the same individual.
- Members of audit committees
 - should not be employees of the Crown corporation; and
 - should be financially literate, and have at least one member with expertise in accounting or financial management.
- The role of the audit committee should be clearly articulated and understood by the members.

While the Commission's governance structure conforms to the Act, we found that it is not consistent with current best practices. For example, the Chairman is not only the CEO but also a member of the Audit Committee. Also, the Commission's internal audit policy does not clearly articulate the role of the Audit Committee.

In relation to the role of the Commissioners, one of the key annual decisions that they take is the establishment of the support prices for butter and skim milk powder. Each decision on support prices requires the majority decision of the three Commissioners. As is publicly known, one of the Commissioners and his family are currently involved in dairy operations as producers. We feel that there could be the perception of an apparent conflict of interest, which could raise concerns about the overall objectivity of pricing decisions.

Recommendations

The Commission should discuss with the Minister its current governance structure which falls short of current best practices.

The Commission should revise as soon as possible its internal audit policy in order that it clearly spells out the role of the Audit Committee.

The Commission should take appropriate means to ensure that none of the Commissioners are perceived to be in any apparent conflict of interest position for pricing decisions.

Commission's responses

The Commission will discuss with the Minister its current corporate governance structure once Treasury Board finalizes its guidelines in this area. Consideration may be given to add an outside member on the Audit Committee to add transparency and independence to the Committee.

The Commission will revise its internal audit policy in the next few months to clearly define the role of the Audit Committee—in accordance with the Treasury Board's guidelines.

The Commission will take this recommendation into consideration in the future appointment process.

Articulation and dissemination of a clear, long-term strategic direction

The Commission's legislative mandate is "...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."

In order to achieve its mandate and to meet our audit criteria, we expected the Commission to have done the following:

- Developed an approach to identify and monitor the key risks facing the dairy industry and to have in place a formal risk-management framework.
- Developed and disseminated a clear, long-term vision for the dairy industry, consistent with its clear, long-term strategic direction.
- Established a performance management and reporting framework that included performance indicators to fairly and reliably manage and report against outcomes.

Risk management. We examined the Commission's planning processes including key planning documents, such as its corporate plan, and we interviewed the three Commissioners,

management, and key stakeholders. The Commission has identified key issues (e.g., risks) facing the industry and its related strategic direction in its latest *Corporate Plan* and *2003–04 Annual Report*. The most significant risk relates to Canada's trade commitments under the WTO and the potential impacts of the current WTO negotiations (referred to as Doha round), including the effectiveness of tariffs in the future. Other risks include the increasing structural surplus, using substitutes for dairy ingredients, and pricing (support prices). The Commission has also identified internal risks, such as improving governance and succession planning.

These key risks are discussed on an on-going basis by the Commission and with stakeholders through formal (Canadian Milk Supply Management Committee) and informal meetings. However, other risks that have not been formally identified and assessed through a formal process may not be formally managed and monitored. If these other risks occur the impact could be high.

For example, the Commission has not formally identified and assessed the risks to the supply and quality of dairy products. The Commission believes that the industry is primarily responsible for the supply and quality (including safety) of dairy products, and other government partners have key roles for inspecting and monitoring these issues. As part of its formal risk assessment, it is our view that the Commission needs to clearly describe and document the roles played by all key parties in the management of these risks.

In 2001, the Treasury Board Secretariat issued its *Integrated Risk Management Framework*. This framework provides a way to develop an approach to manage strategic risks and discuss, compare, and evaluate substantially different risks in the same manner. The framework applies to an entire organization and covers all types of risks (for example, policy, operational, human resources, financial, legal, health and safety, environmental, and reputation). The first step of the framework is to develop an appropriate corporate risk profile. The profile would include examining the internal and external threats and opportunities to an organization's mandate, objectives, and available resources. A key outcome of the profile is to identify key risk areas, assess their likelihood and impact, the risk tolerance, and the organization's ability and capacity to mitigate them.

Recommendation

The Commission should develop and implement in a timely fashion a formal risk management framework, including developing an appropriate risk profile, consistent with the best practices.

Commission's response

The Commission intends to work toward the development of a risk management framework suited to the Commission but based on the Treasury Board's guidelines, starting with the establishment of a corporate risk profile.

Long-term vision, strategic direction, and performance management. The Commission has yet to develop a formal strategic plan. Its corporate plan and annual report contain certain key elements that would be part of a strategic plan; but, they fall short of the current best practices. The two documents present the Commission's mission statement and identify some key issues and strategies. For example, with international trade and the Doha round of negotiations, the Commission's strategy is to provide technical assistance to the Canadian negotiation team and to evaluate the potential impact of these negotiations on the dairy industry. For pricing decisions (support prices) beyond 2006, the Commission plans to hold consultations for its future review of pricing. One of the Commission's goals in the coming years is to develop a clear vision for the dairy industry and for itself, and to communicate it to all industry stakeholders and its employees.

Current best practices for important elements of a strategic plan include, among others, the following:

- a clear vision and mission: What is the Commission trying to accomplish and where does it want to go?;
- specific measures and targets to judge progress in achieving macro-level vision and mission; and
- significant internal and external strategic risks that have been identified and assessed (against likelihood of occurrence and potential impact).

The Commission's *2003–04 Annual Report* presents information on achievements for each of the four goals it identified in the prior year. That report includes a discussion on the outlook for the immediate future and also identifies seven goals for 2004–05 and the performance indicators that it plans to use to measure achievements. This is all valuable information, but it tends to focus on activity information rather than report on tangible and measurable results. There is little information on how the Commission sets expectations or measures its performance in achieving its legislative mandate, particularly with regard to the notion of providing to efficient producers an opportunity to obtain a fair return on investment and labour. Clear and concrete performance measures and reporting on the results would allow Canadians to assess the Commission's performance in carrying out its mandate.

The Commission believes that establishing support prices for butter and skim milk powder constitutes the provision of the opportunity for efficient producers to obtain a fair return on their labour and investment. It feels that support prices are closely related to a producer's average cost of production (COP), which includes direct costs, amortization of capital assets and livestock, the producer's labour, and the return on equity. The Commission also believes that by using the median COP—the mid-point COP between the lowest and highest cost at a farm level—it appropriately considers its legislative requirement with regard to efficiency. This approach is consistent with its prior 2002 commitment to cover the COP of 50 percent of the dairy producers by 1 February 2006. The Commission states that this commitment means that covering the COP of 50 percent of the producers meets its legislative requirements with regard to fair return to an efficient producer. However, the Commission did not have analyses to support this conclusion. Therefore, we were not able to obtain evidence demonstrating how this commitment met its stated objectives. While we do not question whether covering 50 percent is appropriate, we are concerned about the lack of formal documentation. Further, the Commission has no current analyses to support whether this target is still appropriate, including the short- and long-term impacts of its commitment.

However, aside from the above, the Commission has not determined and set expectations as to what constitutes a fair return for an efficient dairy producer and how it could measure whether such producer is obtaining such a return under the current system. Elements of what constitutes a fair return could include rates of gross and net annual profit (adjusted for unusual and discretionary elements) on dairy operations, the rate of return on equity, the ratio of debt to equity, and working capital. While it may be difficult to determine what constitutes an efficient producer, we believe that the Commission needs to examine this and set formal measurement indicators. The section *Estimating the COP and establishing support prices* on page 10 presents further information on how the COP is calculated.

Recommendation

The Commission should develop in a timely fashion an appropriate strategic plan that includes, among other elements, a clear vision and mission statement, performance indicators at the macro-level, and significant internal and external strategic risks that have been identified and assessed.

Commission's response

We will re-examine our current planning process, developed over the last two years, to determine if it is appropriate in relation to this recommendation.

Maintaining orderly production and marketing of industrial milk and cream

This section deals with the Commission's key operational areas:

- Establishing and monitoring the Market Sharing Quota (MSQ)
- Estimating the cost of production (COP) and establishing support prices
- Managing the Special Milk Class Permit Program
- Administering the pooling system
- Managing stocks
- Disposing of structural surplus and managing export activities.

Market Sharing Quota (MSQ) and how it is monitored. We expected the Commission to have prepared reliable forecasts of the estimated demand for industrial milk, identified shifts in supply or demand that required adjustments to the MSQ, and made timely recommendations to the Canadian Milk Supply Management Committee (CMSMC) to implement appropriate changes when required.

We examined the methodology and factors used to estimate domestic demand for industrial milk. The formula is simple; the total annual demand at any given time is estimated as follows:

Beginning inventory (butter and evaporated milk) plus production expressed in butterfat (BF) less ending inventory (butter and evaporated milk) and adjusted on a BF basis depending on its use (upwards for imports and downwards for exports and domestic uses, such as the Commission's Domestic Dairy Product Innovation Program).

We noted that all the elements in the formula, except for production data, relate only to the Commission's activities. For example, the beginning and ending inventories include the Commission's stocks and none of the processors'. The stakeholders agree with this approach; they feel that excluding other parties' activities does not significantly change how domestic demand is estimated because the main purpose of the estimate is to determine whether the MSQ needs to be adjusted. Based on our examination, we found that the Commission's approach is reasonable. We also reviewed the practices to ensure that MSQ adjustments are made on a timely basis and in response to changes in demand. We found that the practices are reasonable and that they support the Commission's recommendations to the CMSMC to adjust the MSQ.

However, domestic demand versus Canadian processing requirements may need to be clearly defined:

- Domestic demand would include the data used to monitor the MSQ.
- Canadian processing requirements would include, among others, imports of dairy products (butter oil, whole milk powder) used by the processing industry. These imports

need to include operations under the Import for Re-Export Program administered by the Department of Foreign Affairs and International Trade.

We believe that estimating the Canadian processing requirements would better reflect the total demand in Canada for dairy products. Also, comparing the processing requirements with domestic demand, as determined for MSQ purposes, would show the producers the portion of Canadian processing requirements that are being filled by foreign markets.

Estimating the COP and establishing support prices. We found that the processes the Commission used to gather and analyse information in estimating the COP were reasonable. For example, using cost data from a representative sample of farms to estimate the weighted average COP per hectolitre and the carrying-out of consultations with stakeholders regarding the support prices that came into effect on 1 February 2005.

However, in order to meet its commitment to cover the COP of 50 percent of the producers by 2006, the Commission has changed, over the last two years, how it uses the data from the COP analysis to establish the support prices. Previously, the Commission used a weighted average COP as a key element that it considered in establishing those support prices. The weighted average COP included two efficiency factors:

- dairy farms with a milk production equal or above 60 percent of the provincial average; and
- from those farms, it excluded the top 30 percent of farms with the highest COP per hectolitre.

We noted that it had established, as part of its last pricing exercise, the weighted average COP at \$58.17 per hectolitre after adjustments for indexing. We also noted that the sample of farms used in these calculations included some farms below the 60 percent threshold; however, their impact on the weighted average COP was not significant.

The Commission used the median COP, as opposed to the weighted average COP, in its pricing exercises at the time of our examination. The Commission determined the median COP by adding farms to the original sample of farms (253 farms in the last sample). The provinces selected these additional farms and, as they did for the original sample, calculate each farm's cost of production. These additional farms were usually smaller dairy operations, and they totalled 37 farms for Quebec and Ontario in the latest pricing exercise. These additional farms added a net increase of \$2.33 per hectolitre to the indexed median COP of \$65.91 per hectolitre, which the Commission used for the 1 February 2005 support prices. These support prices are \$6.8695 per kilogram of butter and \$5.7282 per kilogram of skim milk powder.

The Commission indicated that the support prices include an add-on of \$1.66 per hectolitre to offset some of the negative impacts of the BSE (mad cow disease) crisis on farms. The Commission also stated that it will review the need for this add-on at its next pricing review in December 2005. The Commission estimated this add-on using cost data from the COP formula. This approach may not reflect the actual additional costs associated (e.g., feed, labour, etc.) with carrying higher inventories of cows. We would have expected such costs to be the basis for the BSE add-on. We believe that the Commission needs to carry out its planned review in December 2005 to ascertain that there are adequate financial analyses for such add-ons.

In our 2000 special examination report, we recommended that the Commission ask the Minister of Agriculture and Agri-Food to re-appoint a consultative committee, as required by section 5 of the *Canadian Dairy Commission Act*. We felt that a reconstituted consultative committee could further enhance the credibility of the price setting process. Since our report, the Commission informed the Minister that it did not see the need to re-appoint such a committee, because it carries out extensive consultations on pricing. The Commission noted that the interested

groups—such as consumers, processors, and further processors—that could be part of such committee are consulted one-on-one during the pricing process. Indeed, in recent years, the Commission has carried out such consultations for its pricing exercise. However, section 5 of the Act is mandatory. If such a committee is re-established, it is up to the Commission to determine how it would make use of it.

Recommendations

The Commission should take the means to ensure that it complies with the Canadian Dairy Commission Act by either recommending the appointment of a consultative committee or an amendment to the Act.

The Commission should ensure that there are proper financial analyses to support elements added to the cost of production (COP) when it establishes support prices.

Commission's responses

We will undertake, as we have in the past, to discuss the consultative committee issue again with the Minister to have it resolved.

The Commission will fully document the process by which it will make a decision on the BSE add-on in December 2005.

Managing the Special Milk Class Permit Program. We expected that the Commission would

- issue permits to all applicants that meet the conditions of the Special Milk Class Permit Program, particularly for classes 5(a), (b), and (c);
- monitor the use of permits and the applicants' reporting; and
- follow up on potential improper use of permits and take necessary corrective action.

We reviewed the policies in place for issuing, monitoring, and following up on the Special Milk Class Permit Program, as outlined in the program design and procedures manual. We also reviewed the work of internal audit in following up on potential misuse of the Program. We found that the work of Internal Audit on this program provided additional assurance. Overall, we found that the Special Milk Class Permit Program is administered and monitored effectively.

However, we found that there is room for improving the efficiency of the Commission's monitoring process. The Commission indicated that it spends a considerable amount of time following up on the reporting discrepancies from permit holders. Also, many permit holders told the Commission, in the program evaluation it recently completed, that they find the paperwork burdensome. Consequently, reporting may not always be complete and timely. This can result in Commission staff, including internal audit staff, spending considerable time following up on missing or incomplete information.

Administering the pooling system. We expected the Commission to correctly record information submitted by provincial boards and agencies and to ensure that it is reasonable and in accordance with existing pooling agreements.

We reviewed the pooling agreements, external audit reports and examined selected recent pooling calculations and reports that the Commission prepared. Based on our work, including feedback from provincial boards and agencies, we have concluded that the Commission administers the pooling system efficiently and in compliance with the pooling agreements.

Managing stocks. We expected the Commission to

- have appropriate policies, including insurance coverage, to minimize the risk of losses on stocks; and
- ensure that staff complied with the policies on an ongoing basis, and that there was adequate reporting to management.

We reviewed the Commission's policies for managing stocks and found that appropriate insurance coverage was maintained for the stocks. Overall, we found that the Commission's stocks are adequately safeguarded through appropriate policies, and that management ensures compliance with policies through timely reporting.

Disposing of structural surplus and managing export activities. We examined the Commission's processes and activities for disposing of structural surplus and managing export activities. We found that its processes and internal reporting are appropriate to ensure compliance with Canada's trade commitments. We noted that the Commission has a clear and correct understanding of the relevant and significant elements of Canada's trade commitments, for example, with the World Trade Organization (WTO) on the dairy industry. We also found that its monthly reports to Agriculture and Agri-Food Canada and to International Trade Canada are accurate, complete, and submitted on time. These reports are used to monitor Canada's dairy subsidized exports and ensure that the "subsidy value" of the exports is within the annual allowed limits related to the trade agreements. At the time of this examination, none of the allowed limits had been exceeded. However, we noted some improvements that could be made to the Commission's internal management information system to disclose more clearly actual, planned, and anticipated exports.

We also found that the Commission disposes of its dairy surplus, essentially skim milk powder, on the export market at the prevailing prices and that it looks actively for ways to dispose of the portion that cannot be exported. We found that once the Commission identified opportunities, it signed contracts with purchasers at the best possible price.

We noted that the structural surplus in the last dairy year totalled approximately 68,000 tonnes from an original estimate of 46,000 tonnes, an increase of 48 percent. The Commission has identified a number of factors for such an increase, for example, technological changes in processing of dairy products, increased imports of dairy products for processing, increase in demand for butterfat and changes in the milk composition at the farm level. Many of these factors are beyond the Commission's direct control. The Commission has estimated the current's year surplus at 55,000 tonnes, lower than last year's partly as a result of the implementation of tighter quota policies.

Actively encouraging consensus among stakeholders on supply management policies and programs

Supply management is an area of much debate and conflicting views among the stakeholders. The Commission mainly uses the Canadian Milk Supply Management Committee (CMSMC) meetings and its annual consultation process on support prices to facilitate such discussions on supply management.

We reviewed the Commission's relevant documentation and correspondence, interviewed stakeholders, and attended a CMSMC meeting as observers. We noted that the Commission meets and/or corresponds with stakeholders on a regular basis. It identifies and brings forward emerging significant issues to stakeholders for discussion and presents the issues objectively to them and other interested parties. We found that such an approach is conducive to consensus. However, there are situations where consensus is not possible because of strong diverging views

by different parties. For example, during the Commission's last pricing exercise and consultation process, some stakeholders informed the Commission that they were opposed to all or a significant portion of the increases in the support prices the Commission was proposing. They felt that the increases were not properly supported or justified. In such cases, additional information or analyses may contribute to the Commission's credibility among all stakeholders.

Actively encouraging stakeholders to be in a position to respond to an increasingly competitive, changing and global market structure

To facilitate consensus on key issues and programs, the Commission needs to understand the global market structure and its impact and share appropriate and relevant information with stakeholders.

We found that the Commission understands the dairy operating environment and monitors events on the global dairy market. Its latest *Corporate Plan* and *2003–04 Annual Report* clearly show that the Commission is, for example, very aware of the potential impacts on the milk supply management system if there were significant tariff reductions arising from the WTO Doha round of negotiations. We note that the dairy industry currently focusses its efforts to prevent such possibility.

By identifying key dairy issues in its official publications, at CMSMC meetings and other forums, such as provincial dairy producers' conferences, the Commission keeps dairy producers and other stakeholders up-to-date on the changing global market and thus should lead them to be in a position to respond and adapt.

CONCLUSION

We have concluded that there is reasonable assurance that for the period covered by our examination that there were no significant deficiencies in the systems and practices we examined. However, in our view, there are areas where improvements could be made including:

- Governance structure
- Internal audit policy
- Commissioners' potential interest in pricing decisions
- Strategic planning, including risk management
- Financial analyses in support of pricing decisions
- Compliance with the Act.

We have identified a number of recommendations which could assist the Commission in carrying out its mandate. While these recommendations provide opportunities to improve how the Commission is managed, we do not believe these weaknesses have had a serious impact upon the Commission's ability to carry out its mandate.

Appendix—Systems and Practices Examined and Criteria

Articulation and dissemination of a clear, long-term strategic direction

- The Commission should identify the key risks facing the dairy industry and develop appropriate strategies to address them.
- The Commission should elaborate its long-term vision for the dairy industry and, afterwards, a clear, long term strategic direction.
- The Commission should ensure that the price-setting process provides efficient producers with the opportunity of obtaining a fair return.

Maintaining orderly production and marketing of industrial milk and cream

- The Commission should, in consultation with the CMSMC, determine market demand for industrial milk to ensure an adequate supply of dairy products and should also manage its programs to ensure a continuous supply of dairy products in the domestic market.
- The Commission should ensure that the Special Milk Class Program is administered efficiently and delivered in a fair fashion.
- The Commission should ensure that the pooling system is administered efficiently and in compliance with the relevant pooling agreements.
- The Commission should ensure that it has appropriate policies to prevent losses of inventories and that those policies are applied on an on-going basis.
- The Commission should determine the level of supply of industrial milk in excess of domestic requirements and manage its programs so as to dispose of this excess at the best possible returns to producers.
- The Commission should ensure that its export activities are in accordance with Canada's export commitments under international trade agreements (for example, the World Trade Organization (WTO)).
- The Commission should ensure that Canadian exports of dairy products are within Canada's export commitments to the WTO
- The Commission should report accurately on the exports of dairy exports.

Actively encouraging consensus among stakeholders on supply management policies and programs

- The Commission should have the necessary knowledge, resources, and ability to act as a facilitator of well supported discussion or conflict resolution among all stakeholders.

Actively encouraging stakeholders to be in a position to respond to an increasingly competitive, changing and global market structure

- The Commission should develop and maintain the necessary knowledge, so as to be able to identify—including in consultation with stakeholders—the potential effects of international trade agreements on dairy industry programs and activities.

- The Commission should actively facilitate communication and discussion of potential changes and work with stakeholders to implement required changes, so that dairy policies and programs are geared toward improving industry efficiency, competitiveness, and readiness for change.