

Marvin Hoekema (President of Dairy Decisions Consulting and Milk Market Watch <http://milkmarketwatch.com>) is the author of the original comments on the Holstein GMP plan and drafted responses to Mr. Vandenheuvel to what appears to be a good discussion around what is driving milk prices as well as a discussion on what is needed to fix the current system. Marvin can be reached by email (mhoekema@mhoekema.com) or phone (559-827-1638). *Marvin's responses are drafted in green below.*

Responses in red below were drafted by Rob Vandenheuvel, General Manager for Milk Producers Council (www.milkproducerscouncil.org). If you have any questions, you can reach Rob via cell at 909-992-9529.

From: mhoekema [mailto:mhoekema@mhoekema.com]
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reader's note: I'm sorry if this gets too detailed or lengthy. But there is so much at stake in the system right now as you are very well aware. Unfortunately milk pricing is complex and I don't pretend to understand. My way to back into it is to see how other pricing mechanisms work/don't work and this usually helps explain milk market behavior. Our current price crisis is multi-faceted and not simply answered with 'too much milk'. Unless you get your mind around some of these factors, the root problems of milk pricing are not addressed.

Seeing this plan has gained quite a bit of traction the past month, I think it's time to point out some of the issues which could manifest themselves as not only fatal-flaws, but worse opening the door to increased milk imports all in the name of supply control.

I'm going further on the record that the dairy price crisis is not driven by supply issues but by a poor system of price signals. This was precipitated by the finance/bank crisis which affected each and every business/individual worldwide. Unless you start your analysis with those two FACTS, you are not going to come up with any fixes to the problem of low prices. So, where to start?

1. The banking crisis, as most of you are painfully aware, dried up overnight lending for most of Sep and Oct. With most of the bank failures now public knowledge and the whole TARP bit shoring up the have's and the have-not's, we are still sitting in a banking world that has fundamentally changed. Not only does this affect business lending for dairy producers, this also affected a) dairy end users which normally use credit to buy dairy products b) realigned currency rates which at first made the \$US strong but now with massive Treasury balance sheet, quite weak and c) is the driving force behind what will be a wave of business (including dairy) foreclosures and short-sales because new regs/lending standards as a result mean there is not only less capital to lend a majority of banks have had to borrow (from shareholders and the Fed) to get their own capital ratios in line. The results of this are far from over and is going to probably take years before you see 'competitive' lending take hold (and I take that observation from how long it took the S&L crisis to get over). The lending portfolio adjustments have barely started.

No argument. This is a volatile economy that will take a long time to completely get over. But while that is interesting, it does nothing to explain the growing volatility we've seen in the industry, which has resulted in deepening wrecks every couple of years. 2003 was the worst year seen by dairies – until they got to 2006. Then 2006 was the worst, until they hit 2009. The underlying incentives (which are due to the market-signal-muting effects of the government regulations) to grow-grow-grow anytime our industry has a positive margin, and our industry's ability to quickly expand production to meet any level of demand, make our industry destined to deal with a chronic volatility. That is, unless we address those incentives somehow.

Either the dairy market is influenced by the economy or it's not. Either the dairy industry evaded the effects of the capital bubble unlike ANY other industry worldwide or benefited/suffered the effects like everyone else. If those primary facts are not acknowledged then there is a serious credibility issue believing the GMP system's projections of stabilizing prices.

My balance analysis suggests that when there is a lack of NFDI inventory, the milk market will behave not only more seasonally (counter to the FMMO's original design) it also behaves as a carry market (front months priced lower than back months). It's not hard to figure out that volatility arises when there is not cheap powder to fortify the cheese vat which is countered with too much powder thanks to worldwide economic forces (remember 9/11?) that flood the market with cheap powder again.

Furthermore, Nicholson and Stephenson (in the GMP analysis) discuss at length that the run-up in 2008 dairy prices had exactly to do with world wide economic demand for input commodities and export milk. Here you argue that ongoing economic conditions will not have much influence on dairy pricing, nor had much to do with volatility. The major driver of volatility was the last FMMO reform in the late 90's (much of which was based on Cornell's modeling which you use to support the GMP). Ever since then, it's been big questions of 'do we have too much milk or do we not have enough?' A few traders on the floor of the Merc in the battle between two-three 800-lb. gorillas can have all the say in what prices will be (against one of which there was a one-sided fine by the CFTC and there is a class-action shareholder lawsuit pending against one of the others). The FMMO reform had the (un)intended result of consolidating pricing into the hands of very few. In that, price formulas were taken away from multiple orders, consolidated into more of a national scene and make-allowances to manufacturing plants continued to march higher, all the while unregulated MPC's flow in primarily from New Zealand to sustain higher cheese yields while domestic milk circles the country looking for the highest price home or processing space regardless of market conditions. That indicates a broken price signal system.

Additionally, volatility has as much to do with capital chasing expansion. Banks are shutting down ag lending or, if they maintain the accounts, will re-write with tighter repayments until the debt:capital ratios come back into line under tighter standards. It's not a coincidence that growth in milk production from the late 90's (and the advent of much larger farms) corresponds with the increased availability of debt capital in the general economy. I even argue that the dairy industry has experienced an expansion bubble similar to other industries formed in a

similar fashion: too much cheap, tax-shielded capital chasing too few dollars. And, it will not be a coincidence that the reverse will be true as banks retrench. The reason you have to start with the economy (and your price models, which Nicholson and Stephenson apparently did not) is the underlying inflow of capital is the source of energy for volatility. My argument is simply that the source of capital flow that has funded expansion had ended and will have to be repaid under the new banking rules. It's actually not an argument but a statement of fact.

The problem is that the FMMO system in the current form can't figure out how to discover dairy pricing in the economy. Part of that is because price discovery lands in the hands of the very few (some are co-op's, some not). Oligarchies are not efficient at setting prices. I do not see in the GMP how that fundamental problem is addressed.

2. So why is #1 important? Milk pricing does not happen in a vacuum. The dairy market has essentially been bracketed by exchange rates and import/tariff controls which have become increasingly liberal thanks to NAFTA and the WTO Uruguay round. As long as domestic pricing doesn't pull too much product in, prices for world traded product will stay above the world price. When prices get extremely high or low, that's when our price is bracketed because either competitive product moves in or it sits in caves because 80 cents is over world price (usually thanks to an amplified \$US cross rate). We can trade in a range of world pricing because usually when prices are high the world is short of product. But if the world is not short, the top end is compressed and will easily invite greater market share should the US become short under any supply management scheme. Exchange rates are a bigger factor than ever, now because Exports fell off in Q4 not only because of the banking crisis and Fonterra coddling, but the \$US surged, instantly putting US powder price at the bottom of the stack.

A large flaw in our "world trading" is that we, as a country, have been "opportunistic sellers" rather than building long-term business relationships. This is understandable, as our extremely volatile domestic price makes our marketers unwilling to enter into long-term relationships with fixed-price contracts. I would argue that a program that results in more stability in our domestic price (and doesn't enhance our long-term average milk price) will make us much stronger players in the world market.

As a side note, this assumes that we don't continue to rely on competitors like Fonterra to market much of our product for us overseas. If we truly want to make the world market a place we regularly sell product to, and not just a place we dump our excess, our marketers need to develop real business relationships.

On this we agree except we have not been opportunistic. If that was the case, why did Dairy America or Darigold not sell powder to China this year in wake of the Sanlu melanine tragedy (of which Fonterra owned 46%). The reason is Fonterra has coddled a vast majority of U.S. powder to back-fill their marketing activities (I believe nearly 1/2 of their marketings are sourced from milk outside NZ). If any, the U.S. in total has been lazy or worse, non-participatory market players (save DEIP).

But here's the problem, dairy prices still don't work in a vacuum. Once prices trade into world prices, it is going to bracket what we get paid. 2008 was the exception in that when vats ran out of cheap powder to fortify the vat, they ran out of cheap powder and had to start buying milk on the open market to do it. Prices got to the point that demand was destroyed and then along

came the capital crisis and here we sit. If either the EU or NZ had powder to land here, it would've easily put a ceiling on prices. But they did not (until August 2008) and we know what happened. The point here is that if that factor converges at any other time, the steady-cycled projected under the GMP is not going to play out in reality. You might set a different frequency to the cycles but unless you go out and hedge the US\$ cross rate, that product will move here when prices tell it to.

At least the cheese vat has cheap powder again.

3. Price signals are broke because of the continued lift in manufacturing make-allowances. In fact, the make-allowances are to the point that they more than likely not only cover all costs of production, they ensure a profit in addition to wholesale mark-up prices. Because of this, every plant wants to run full. So when farm gate-pricing says produce less milk, the plant wants more milk and continues to pay (in many cases) incremental volume incentives to keep the make allowances coming even if they can't move the product wholesale. Remember, at any given point, even with cheese at nearly 960 mil. pounds, this is less inventory than 10% of annual sales in stock. If plants wanted less milk, they would say, 'sorry can't pick it up today because we would lose \$ processing it'. Look at vegetable farming. Ever hear of the term 'bypass'? It doesn't exist for dairies and that's why every pound of milk is processed because the plants make the \$. The problem with the HAUSA plan is it seems to expand the FMMO system rather than fix it. There is no mention of abolishing NASS milk price surveys or the production report (which is the taproot of the dairy price problems).

You are absolutely right that government regulations are largely to blame for muting the market signals that individual dairies receive. I would argue that make-allowances alone are not the main problem though. Rather the overall "pooling" structure is really what mutes those market signals. Under pooling at the producer level, the risk of expanding production – even if there is no market for that additional production – is spread out amongst all the members of the pool. This creates a perverse incentive to grow-grow-grow even if there is no real market for your additional production.

But I add a dimension to the 'pool' argument. Under current arrangements of lifted make-allowances, all of the pricing risk is concentrated at the producer level. Not even close to shared by processor, distributor, retailer. I even argue that the processor wants the last pound of milk more than the first pound because that is the region of output thanks to the make allowance which is free and clear of fixed costs since a margin is basically guaranteed thanks to the manufacturing make-allowance. Vegetable farms have bypass-provisions. If the vegetables don't have a market, they aren't harvested. Milk is the polar opposite, every pound is processed and marketed regardless of whether there is a market. Somewhere in the middle will improve price signals.

So what do we do? Do we eliminate the pooling structure that makes up a majority of the U.S. milk production? So far, producers have not wanted to go that direction. There's a reason pooling exists, and it has served producers well for many years. Many California dairies remember the pre-pooling days that led to pooling being set up in California in the late 60's. Under pre-pooling, processors held all the control. They pitted one dairyman against another and set all the terms for the deals. So it appears that going that route would still result in "supply management", with the *processors* dictating the terms of growth.

I don't argue the pools go away. But there has to be a change in how the pools work. Pricing risk has to be spread out further through the supply chain or you are not going to get any reliable price signals. Conversely banks won't extend capital in this environment unless you have a fixed price contract. If the pool rules are not changed, I see the system quickly evolving that the large farms will negotiate direct fixed price contracts at the incremental cost to others in the pool. The reality is that is the only way banks are going to lend and the only way to avoid big gaping holes in the plants. I don't see that being tenable long among the co-op structure but is happening right now. This is effectively the same as you cited in the pre-pool days, so either the pool is not working, or not much has changed, or maybe both.

You have also not responded to the basic issue I raised, the lack of reconciliation in the NASS price and milk production reporting.

The other issue you do not address is that the entire FMMO is designed to the zip code to protect the sacred CL I differential. In multi-class markets, the fluid premium has been 'negotiated' away to manufacturing make allowances. So what's the point of the CLI differentials (aside from the milk deficit southeast) if the right pocket gives more of it back to the left pocket?

Rather than handing the future of our industry over to the processing sector, how about we try to offset all those market-distorting incentives with a modest financial incentive giving dairies a motivation to actually pay attention to their production? The HSUSA plan would give folks an option: expand your production and pay a modest fee for the first year to earn that new share of the market; or don't expand, stay within your allowable annual growth, and collect a tangible income stream.

This is very similar to the logic used to establish CWT. I (and I'm not alone) would argue that the combination of CWT and MILC work to amplify the volatility beset by the capital bubble of the past two decades. With lifted make-allowances and the lack of risk shared by the processors, I would argue the future of the industry has already been handed over to the processors, and a coddled few at that. With a GMP you will just price domestic milk above world price and without trade restrictions, lose market share to historically cheaper inputs.

4. I find a major problem with using the USDA to forecast the milk market. Why? They already do this monthly (LDP report) and their track record is that they are woefully inaccurate on price, OK for disappearance, hit/miss on production, and not so good on import/export balance. It's just inane to believe using the same people in a supply management system will create better forecasts. Because the forecasts are only updated occasionally, and they are notoriously inaccurate, and NASS/FMMO will continue as the price discovery mechanism, why on earth is this any better than the current system sans firm-level restrictions on volume? so you set your initial restriction at 187 bil. pounds and market wants more due to price and you lift to 194 bil. pounds but because there are no import restrictions cheap powder/MPC comes in to net out 189 but you already bought your cows and expanded your base. Because of the lag the price is worse. Does this solve anything? The LDP forecast didn't foresee the financial crisis. Do you really think they are smarter now and would send you the signal to contract when the next shock arrives? Controlling the supply is just another lethargic price distortion the market will price around.

The HSUSA plan is not about making precise projections of demand and lining up supply with that figure. It's about incentives. Anytime our industry has a positive margin, every dairy has a clear incentive to "chase" that margin and expand production. And furthermore, our industry is now able to quickly respond to any positive margin with huge production increases.

All the HSUSA plan is doing is giving dairies an option. Chase that margin and expand your production – pay a modest market access fee. Or choose to hold your production – get an income stream from your "refund." It's the "option" that is the crux of the plan, not the predictions of supply and demand. No one will ever be able to precisely predict supply and demand. **But what can be predicted without any doubt** is that given our industry's ability to quickly expand production, and the incentives that give you every reason to do so, **we are hard-wired to turn any market balance into a surplus situation in short-order, and will do so every time.** That is a prediction you can count on.

Maybe I missed something, but the plan specifically mentions the involvement of the USDA in *"a determination will be made as to the needed change in U.S. milk production to fulfill the market needs for each quarter of the next 12 months allowing for a producer raw milk price that is positive over operation costs as determined by the board"*. I call that projection and what I was reacting to. Tell me what I'm missing. I am just reading the plan verbatim and that is a major-major problem in predicting future balance.

Also, why is there no market access fee charged to imported dairy products AND imported dairy livestock?

5. On the imports/exports. Well unless this plan is going to use fees to hedge the plan against a basket of currencies, it's not going to work. Why? The month powder bumps up against NZ powder price, guess what happens? NZ powder goes to Mexico instead of US powder. Then powder piles up (because the price is still high) until the next cycle. Will the 'board' be able to say, 50 mil. pounds less powder next month...turn off the milk faucet? It happens that fast. Do you think the board will be able to accurately forecast US\$ cross-rates and amend their long-term base allocations? Fonterra spends a lot of time trying to understand this and actually sets prices and arguably they have more milk price volatility than we do. So why would this solve the volatility problem? Oh if the answer is tariff MPC's, look what happened when they got to 70–80 cents: somehow ingredient users found other proteins for their formulation and guess why they price crashed to 16 cents?

By a large margin, the New Zealand and Australia dairy industry is the low cost producer in the world. Their entire industry is engineered for exports. They will sell their production for whatever price they can get. If our strategy is to undercut them on price, we are destined to be unsuccessful. However, they are subject to weather-related variations in production and they are limited by land base as to what they can produce.

I think you missed my point. A key point of the GMP proposal is the board to set base. My point is that you won't be able to react soon enough on either side to interface with either domestic or international conditions. Fonterra attempts this day in and day out and has arguably as much volatility as the domestic market.

The other subtlety of the GMP is how it will affect livestock values. If base cannot be transferred or sold (which in itself raises property rights issues that in my opinion may not pass

legal hurdles), the value of dairy animals will very much be limited and erode, probably quickly. I don't think you are going to get much backing if banks realize their collateral value may erode further, particularly if the trade-off is only for \$16-something milk.

The other point is that MPC's come back to the U.S. unregulated, unpriced by FMMO, and easily make up a huge portion of incremental cheese production. Why can't your plan address that?

What limits NZ and Australia production is not land but the lack of available cheap protein in the feed (Australia grows a limited amount of canola but not much soybeans). There's also not enough irrigation water in Australia to grow Alfalfa reliably. Diet protein restricts milk production. Most of the milk is produced from N or NPN from fertilized grass. That restricts per-cow production. The reason it's cheaper is their cows give less and they maintain a strict stocking-rate on their pastures or their pastures go over and the cows starve. That's why the rain season is so influential on production pattern. There will be very limited and incremental growth in production from the S. Pacific because of this. Just because it's low cost doesn't mean that can be replicated on the next 20% of growth because that is the more expensive milk to produce.

As stated in an earlier question, a more stable supply/demand relationship in the U.S. will allow us to be a more long-term strategic exporter of our products. And as long as the HSUSA program is designed to take the huge "peaks" and "valleys" out of our industry without greatly enhancing our average milk price over the long-term, we are in an excellent position to be a strong exporter of our products. Outside of New Zealand/Australia and South America (which has its issues with unstable governments), the U.S. is extremely competitive and can be a major seller of our goods in the world market.

If you believe in exports (and I do if they are backed with a marketing effort, not simply wished away to the competition through an exclusive market agreement by the competition), why not simply charge the market access fee to create a NZ style dairy export board and go out and create a worldwide marketing presence for the clean, cheap, safe U.S. milk export products? Or why doesn't this include changes to the pooling provisions to force processors to pay NASS product pricing for MPC's (similar to including whey in the pricing formulas? Or even better, exclude MPC's from cheese making? Are you going to charge Fonterra the same market access fee? How about the other processors with import licenses? I think those questions merit responses as that is one of the major problems with FMMO's today.

6. The other part which befuddles me is why there is not any provision to control the 40–80,000 Canadian heifer imports. Essentially this program will effectively market Canada's surplus without charging the market access fee.

In the past, the evil "villain" has been BST. These days, that villain is sexed semen and Canadian heifer imports. Next year, it will be something else. In the end, it doesn't change the fact that the incentives our industry operates under, and our ability to utilize all those things mentioned above to quickly respond to any positive margin with production increases, leaves us hard-wired to turn any market balance quickly into a surplus. That is not a healthy industry. We need to put an incentive in place like the HSUSA plan does, and we need to focus the plan on milk production – not herd numbers or heifer imports. Give dairymen a tangible financial reason to actually pay attention to *production* and dairymen will respond.

It's really not a villain, but a fact. This is another case where the GMP does not address the leakage or interface at the borders. Why is Canada allowed to sell their surplus into the U.S. and we can't pool fluid milk in Canada? It's a basic question.

So I come back to what's broke: banks and price signals. This program not only does not fix the price signal/discovery mechanism but seems to believe that it could eschew future unforeseen economic shocks that were previously missed under the tutelage of the proposed caretakers. If you told me that they were going to fix NASS and FMMO's and spread the pricing risk throughout the supply chain, I'd say let's look at a tiered market access fee program. But this ignores that fact. Doing something, in this case, is probably as bad or worse than doing nothing. If you can't recognize the above drivers of the current crisis you need to study harder because some are solvable (i.e. changing the pricing system) and some are not (import/price controls and US\$ cross rates). The banking crisis will effectively limit dairy expansions for the foreseeable future either because they have to shore up the balance sheet or because owners want to.

There may be some "hangover" after this wreck where the banks will limit how much dairy expansion occurs. But unless we do something to combat the underlying incentives in the dairy industry, this volatility will continue...and will get worse with each cycle. Don't believe that? Read Cornell University's Program on Dairy Markets and Policy report on milk price volatility: http://dairy.cornell.edu/CPDMP/Pages/Publications/Pubs/GMP_Report.pdf.

Interesting on the model. Stephenson is the same person that not only provided the studies to implement the last major FMMO reform, his study was also the main piece to justify the USDA to lift make allowances in October 2008. I have a feeling (and the track-record) the models are retrenched to favor supply-chain consolidation, but I digress.

I've read their presentation before and now that I have my teeth in a bit more of the model background I can review whether it makes sense. I'm open to discovering more detail so am limiting my comments on what was disclosed in the models. I happen to do stochastic, dynamic programming modeling with the same methodology (since 1998) and also have a dairy firm model which does a pretty good job at assessing and understanding risk along all parts of the consolidated financial statements, not just net income. I also developed a model to project class pricing as a tool to understand and manage basis risk when hedging milk prices. My critique of the model you are using to justify an 'optimal' solution:

- When modeling capital decisions (which arguably is where the major firm decisions to expand/contract lie, not with marginal production decisions) is not usually incremental but follows non-continuous, discrete distributions. The capital model that decides whether the firm leaps through the investment hurdle is not then very well addressed through continuous distributions on NFOI but follows discrete methodology. The same is true in the reverse...the lenders will make decisions on loans in a non-continuous manner. As a result this will likely lead to a more staggered result and because it's not included in the base assumptions, I challenge the optimization because the characterization of financial response at the firm-level is not handled appropriately.

- It's hard to evaluate the model's assumptions without the variate-covariate matrix. All results in stochastic simulation models depend not only on the base distributions, but on the correlations of variables. It's not here so I don't even know if they are even appropriate (for instance, is milk production, heifer replacement prices, etc. even correlated with milk price?). I'm sure they were but it's not here so I can't interpret if the results were appropriate.
- I don't see how non-feed expense items are adjusted for inflation.
- To quote "the model does not incorporate international trade flows or US trade policy". Then how can it incorporate what's going to happen to domestic prices? Big problem here.
- I'm not going to divulge the methodology of my proprietary milk price model, but the authors used the wrong to approach the post-FMMO reform milk market the way they did, particularly when they use a linear demand assumption. The problem with modeling milk price is that it is both a storable and consumable commodity. One of the main reasons it's wrong is that it does not bracket prices with the world market.
- The authors assumed a static demand growth. As we've seen in the markets of the 2000's, demand is very much sensitive to prices (as you have argued yourself) and should therefore be correlated covariates in the pricing model. Perhaps at the projected prices against long-term US\$ cross rates, demand for US milk actually goes negative because it prices in cheaper imports. I'm not sure and I don't believe the authors may be either.
- The scenarios modeled I believe should actually be covariates in the model because to expect they do not work independent is a faulty assumption.

Until you fix the system that values the first pound of milk marketed the same as the last pound and the price risk continues to be unequally spread throughout the supply chain, it's going to continue to generate amplified, volatile prices. You might get 2–3 good years out of supply control, but as I see it, you just cede market share to dairy product substitutes, destroy demand with high prices, and encourage more plentiful imports.

What happens when milk hit \$20+ per cwt last year? We lost market share to dairy product substitutes and destroyed demand. That's the status quo. What would happen if we were able to have a better supply/demand balance that didn't have the massive boom/bust cycles? Would that result in maximizing our market opportunities? It sure would. We really have no idea what our domestic market opportunities are. Every time we hit the "peaks" in our milk price, we scare those markets away, and are usually unable to get them back. What we need is a better balance that takes the peaks and valleys out of the milk price, but doesn't enhance the average long-term milk price. And that's exactly what the HSUSA plan proposes to do.

As for the argument that we should "fix the system" of pooling, how would the writer propose we do that? The response to an earlier question explained why pooling is in place and why producers support it. It's a program that has served dairies well for many years. Some flaws have been exposed in the past decade due to our industry's incredible ability to respond to any demand level with quick production increases, but

do we really want to throw the whole system out? Or is there another "fix" that is being proposed by the writer? If so, let's hear the details and discuss. This is the time for ideas to be put on the table.

I've forwarded some very specific changes I have advocated through <http://milkmarketwatch.com> the past few months which you may not be aware of through this response which was specific to the GMP:

- 1) Roll-back a portion of the make allowances to share more of the pricing risk among the supply chain.
- 2) Replace FMMO's in some regions with co-op owned MAC's which can much better send regional balance signals and able to write direct priceXsupply contracts as opposed to what is encouraged by the 'pool all' FMMO's.
- 3) Require quarterly milk-flow reconciliation by NASS and the inclusion of 100% reporting on dairy commodity price points.
- 4) Require a quarterly sources/uses report on the who and where of milk pooling.
- 5) Use the CWT tax to fund a NZ-style export board to actually sell product instead of coddling NFDM exports with the competitor, Fonterra.

As I did mention in my closing comments if you address the FMMO and share of risk in the supply chain, a tiered GMP may have merit, so I am not against the concept. But putting the GMP as written on a broken system, again, may buy a few years, but by then market share will be further ceded to imports and the next price cycle hits.

I'd be very interested in learning more about the model used to create the optimal flat-line. Real life backed up against the world market isn't flat line and I suspect any models that portend such. I've explained the limitations and flaws (as I can best see them with the limited documentation of assumptions provided), but would be happy to independently review the model if you would like.

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