Cargill

Testimony

Before the House Committee on Agriculture

On

The Derivatives Markets Transparency and Accountability Act of 2009

February 4, 2009

Mr. Bill Hale, Senior Vice President
Grain and Oilseed Supply Chain North America

My name is Bill Hale, Senior Vice President, Grain and Oilseed Supply Chain North America. I am testifying on behalf of Cargill, Incorporated and have been in the grain merchandising business for 35 years. I am also joined this morning by David Dines, President of Cargill Risk Management.

Cargill is an international provider of food, agricultural, and risk management products and services. As a merchandiser and processor of commodities, the company relies heavily upon efficient and well-functioning futures markets. Cargill is also active in the energy markets, offering risk management products and services to commercial customers.

Cargill encourages policymakers to develop regulatory systems that foster efficient, well-functioning exchange-traded and over-the-counter markets for agricultural and energy products.

This can be best achieved by:

- Establishing better reporting and transparency for market participants
- Establishing and ensuring enforceable position limits

This past year was a period of remarkable volatility driven by many factors and, by large measure, the agriculture and energy commodity markets responded appropriately.

The existing draft of the Derivatives Markets Transparency and Accountability Act of 2009 takes several positive steps, especially in the area of reporting which will enhance the ability of the regulator to properly monitor market activities. However, the draft bill has two areas of concern:

- Section 6: Position limits, which are not constructed in the same manner for exchange-traded and OTC markets
    - This can be addressed by modifying how the position limits are structured. This is not a question of whether they should apply.

- Section 13: Mandatory clearing, which will stifle activity in the OTC market and reduce hedging opportunities in the agricultural and energy markets
    - This can be addressed by increased reporting requirements for OTC providers and segmenting credit default swaps from traditional agriculture and energy contracts.

While Cargill supports better reporting, transparency and enforceable position limits, we urge caution and restraint for policymakers. The agricultural and energy over-the-counter markets are not the source of systemic risk and abuse that the credit default swap market has been. We believe there is real danger in treating all over-the-counter products across all asset classes the same.

In addition, the changes needed to improve some commodity-specific exchange-traded markets, particularly wheat and cotton, are very often contract issues that have to be resolved between the exchanges and the market participants. A well-informed regulator can be helpful in making sure balanced decisions are made that ensure contract functionality and market integrity, but broad legislative measures are poor instruments to resolve these specific issues.

Role of Commodity Futures Markets and Over-the-Counter Markets
The objective of a commodity futures market is to provide a price discovery mechanism and allow for effective risk transfer. For a commodity futures market to meet this objective, there must be both convergence with the futures price relative to the underlying cash value of the commodity at the time of delivery and a balanced range of market participants to provide adequate liquidity and efficiency.

In addition to buyers and sellers with a physical interest in the underlying commodity, speculators also play a vital role in enhancing liquidity and futures contract performance. In effect, they help bridge the gap between buyers and sellers and ensure that contracts are quickly filled with the least possible transaction costs.

Beginning with farmers and other commodity producers, and extending all the way through the supply chain to end users, it is critical to have well-performing futures markets. Futures products allow farmers to know what their product is worth and to better manage their risks by setting a price for the commodity that is close to their actual delivery time. For consumers or processors, the same is true in allowing them to hedge their risks and gain greater certainty over their costs.

Products provided by the over-the-counter (OTC) markets help hedgers meet risk management needs with tailored alternatives that cannot realistically be provided by traditional commodity futures and options markets. Too often is it thought that the OTC market is solely used by speculators, however it is critical to note that a majority of our OTC activity is for commercial and producer hedgers seeking risk management solutions tailored for their business needs.

Unprecedented Commodity Market Volatility During 2008
During 2008, we experienced an unprecedented increase in commodity prices, only to be immediately followed by a decline of the same historical magnitude. This in itself has been tough for market participants to bear, but we now know that this has been followed by one of the worst economic crises in 80 years.

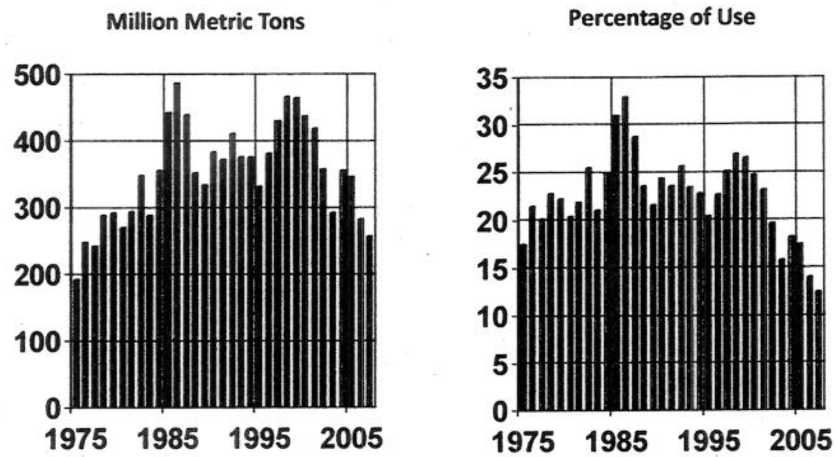
In the world of risk management, we often talk of stress events and this was one of epic proportions. No risk manager could have ever contemplated what the markets have just gone through. I mention this because if there was ever a test for the agricultural and energy futures and over-the-counter markets it was these past twelve months.

Fortunately, in many ways, these markets performed well as demonstrated by limited credit issues and limited contract defaults.

Most critically, during this unprecedented volatility, systemic risk was avoided because of the availability of both OTC and exchange-based hedging tools. Given the stress on the markets, some weaknesses were exposed and the bill seeks to address those areas, but much of the basic functionality of the agriculture and energy markets performed well.

Fundamental Factors Influencing Market Behavior and Speculation
It is important to remember that the dramatic volatility and price rise in 2008 was influenced by many variables. Ending stocks for many of the key commodities were tight. In wheat, for example global supplies had been reduced by two years of major drought in Australia, a major wheat exporter.

Global stocks of grain and key oilseeds



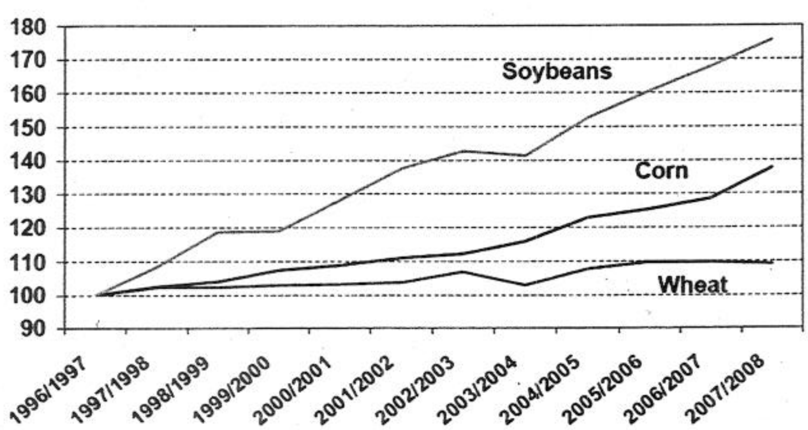
Source: USDA, Foreign Agricultural Service

The ethanol mandate increased demand for corn. In response, producers planted more corn acres during the 2007 crop year and fewer soybeans, resulting in a very tight carryout balance for soybeans prior to the 2008 harvest.

Also on the demand side, projections for continued growth in China, India and much of the developing-world showed growing needs for many of the basic agricultural and energy commodities. These factors were widely known within the farming, trading, processing, and investing communities.

USDA Ag Outlook 2008
Projected Demand Growth

1996 = 100



Source: USDA

With strong fundamentals, commodity markets attracted many participants, both hedgers and speculators, who believed commodity prices would rise. These fundamentals did not only attract capital to futures markets, but also attracted resources toward physical commodity production. Land costs increased for good quality farmland and producers stepped up investments in production technology through equipment, seeds and fertilizer.

It is also important to note that even exchange-traded markets with no index fund participation also experienced extreme volatility this year. The volatility and price movements of the Hard Red Spring Wheat contract traded at the Minneapolis Grain Exchange were especially dramatic. Prices rallied 500% from May 2007 through February 2008, reaching a high of $25 per bushel.

Derivatives Market Transparency and Accountability Act of 2008

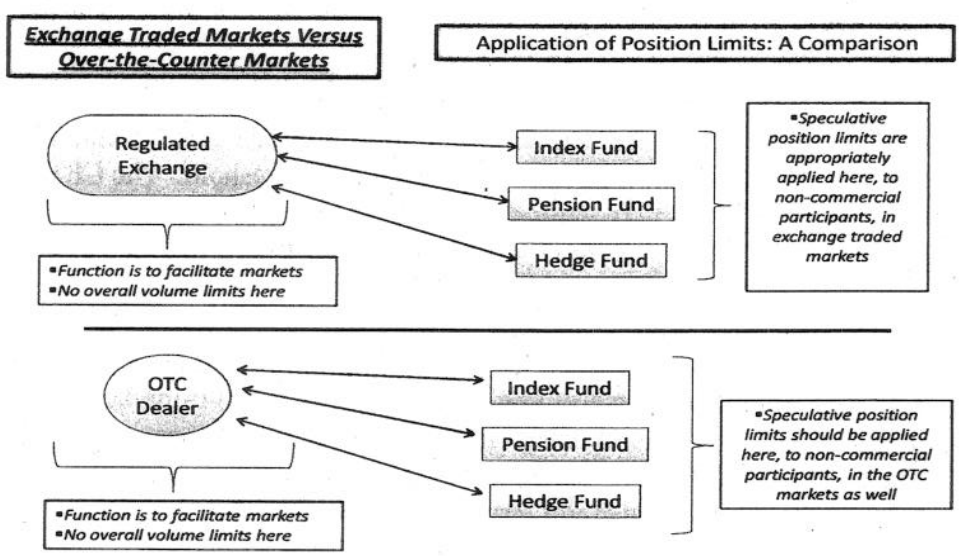
Cargill supports many of the components of the draft bill before the Committee today and appreciates the work of the Chairman. The bill would improve reporting and transparency. However, we are concerned with two specific areas under consideration by the Committee:

- Section 6, regarding how position limits may be applied to OTC product providers
- Section 13, regarding mandatory clearing of OTC transactions through a derivative clearing organization.

Both provisions have negative unintended consequences.

Section 6: Application of Position Limits

Cargill supports enforceable position limits for non-commercial participants. However, as designed in the draft bill, position limits are not applied in the same manner for the OTC market as they are in the exchange-traded markets. They should be structured in a similar manner for both markets.



Cargill

In exchanged traded markets, the clearing broker serves as an intermediary or aggregator of positions, just like the dealer does in the OTC market. Position limits are applied to non-commercial participants in exchange-traded markets and not to the clearing broker. Limits in the OTC market should be categorically applied in the same manner, only to the non-commercial participant and not the OTC provider.

The draft bill seeks to apply the same position limit to the OTC provider as it does to the non-commercial participant. This is too restrictive to the OTC provider since its role is to serve as an intermediary to more than one customer. This restriction would limit the size of the OTC market beyond the intended non-commercial position limits.

The Committee will be able to achieve its objective of ensuring position limits in OTC transactions by applying position limits to only the non-commercial participants. Addressing this issue in this manner will ensure enforceable position limits and continue the functionality of this segment of the market.

Section 13: Clearing of Over-the-Counter Transactions

- Substantial benefits can be achieved through better reporting by OTC providers
- Segment the OTC market to focus on areas with the greatest challenges
- Tailored risk management OTC contracts for hedgers cannot be cleared
- Standardized swaps convey substantial benefits to a wide range of market participants and these benefits will be lost if clearing is mandatory

A stated benefit of central clearing is better transparency and data reporting. However, this is a restrictive and expensive means for collecting data about OTC market positions and participants. Cargill believes that this can accomplished efficiently by having standardized reporting requirements to the CFTC by the OTC provider community. Other sections of the draft bill directly address the issue of better data and reporting, and will achieve the needs of the Commodity Futures Trading Commission and Congress.

One solution would be to have the CFTC restrict OTC activity to approved OTC providers. These approved OTC providers would have a reporting requirement to the CFTC in a standardized format and on a regular basis of all OTC transactions by customer that exceed a certain size threshold. The CFTC would have the ability to investigate and curtail any OTC customer whose position they believe is too large for the underlying commodity markets. The CFTC has this existing authority for investigating customer positions at the clearing broker on listed futures and it works well.

Another stated benefit of centralized clearing is the mitigation of counterparty credit risk, since it requires both initial margin and the daily settlement or margining of 100% of the mark-to-market differences between the two parties. While centralized clearing has a role and should be encouraged for financially weaker market participants, financially strong food companies, industrials, commercials and producers should have flexibility to negotiate their own credit terms.

As they stand today, the agriculture and energy OTC markets allow for efficient and prudent extension of credit by the OTC provider to financially strong hedging customers. Removing this flexibility for both simple and tailored OTC products will greatly reduce hedging activity due to the working capital requirements of margining. Changes to the current system would be occurring at a time when liquidity and credit are already critically constrained, and at a time when hedging should be encouraged, given the volatility in today's commodity markets.

Agricultural and energy OTC product providers for many years have effectively used margining agreements and other credit support mechanisms to manage credit exposures. OTC product providers, including Cargill, have developed processes and built systems that enable us to value our customers' OTC positions and send position statements daily with updated and transparent product valuations. Based upon these valuations and statements, the parties pay or receive margin collateral daily once a credit threshold is reached. This system works very well. Again, if there was ever a test for this it was during the past year.

Changing this flexibility in setting credit terms will have the perverse effect of reducing the hedging activity across financially stronger customers since they are the ones currently receiving margining credit from the OTC provider community. Financially weaker customers are either not receiving the margining credit from the OTC provider or they are already using futures because it is their only option. It must be recognized that centralized clearing penalizes participants with strong financial positions.

Mandatory Clearing Can Impact Producer Pricing Opportunities
Within the agriculture and energy markets, simple OTC swaps convey many benefits through the flexibility in setting credit terms. In the physical grain business, cash flow mismatches exist for grain buyers since they are required to meet the daily margining requirements of futures hedges and are not able to collect an offsetting margin payment from the farmer since physical grain purchase contracts are typically not margined with the farmer. Last Spring, many U.S. grain buyers, including Cargill, curtailed their deferred purchases of grain from farmers because of the historic run-up in commodity prices and the significant amounts of working capital that were needed for operational inventories and to fund the margin requirements of the underlying futures hedges for deferred contracted grain. This was an extremely difficult time for farmers and for grain buyers.

Critically, it was simple OTC swaps on the grains that helped enable Cargill and other grain buyers to reopen deferred purchases of grain from the farmer during 2008. Using simple OTC swaps, grain buyers were able to move their hedging for contracted bushels from futures to OTC swaps with OTC providers that put in place margin credit thresholds on the mark-to-market exposure. The bill in its current form only grants an exception to centralized clearing for highly customized swaps, but not for simple swaps. Had the bill been in place in its current form, Cargill and other grain buyers would not have been able to use simple swaps to help mitigate the margin requirements imposed on futures hedges. As a consequence, farmers would have been further burdened by a lack of pricing and liquidity for their crops.

Mandatory Clearing Is Extremely Difficult for Customized Products
While the bill currently has provisions that allow for exceptions to centralized clearing for highly customized transactions, it is unclear what will and will not qualify for this exception. It is critical that changes are not made that would in any way inhibit customized hedges, as this would also significantly reduce prudent hedging among market participants.

A key attribute of the OTC markets in agricultural and energy is the broad menu of product choices, as well as specific tailoring of the hedging instrument to precisely meet the hedger's needs. The advantages of product choices and tailoring are that they deliver both a more efficient hedge and a more cost-effective hedge because the hedger is not paying for something that they do not need. It also allows for diversification of products, which is so critical in today's marketplace. OTC product choices include protection size, protection periods, protection levels, and types of protection.

If you think of a futures contract as one type of product, Cargill has over 130 different types of OTC products that we are offering our hedging customers. From these 130 different product types, the hedging customer can choose to further tailor the protection timeframe, price level and transaction size. Given this, no two OTC transactions are identical, which is why centralized clearing is problematic. Clearing organizations do not have the systems and processes necessary to value and clear a wide range of products with a high degree of customization. If this were the case, tailored risk management services would have become available on exchanges years ago.

OTC providers such as Cargill create new products by having strong customer relationships, listening to and understanding our customers' commodity risks, and developing products to address these risks. This requires a significant investment of time, human and technological resources, and financial capital. Centralized clearing will put intellectual property in the public domain immediately which will eliminate any economic incentive that OTC providers have for new product development. Now more than ever, customers need new and better products to help them hedge.

Summary

Cargill appreciates the work of the House Agriculture Committee in ensuring that both the exchange-traded and OTC market perform well. These markets provide critical functions in allowing open price discovery and enhance risk management opportunities. Well performing markets benefit all participants across the supply chain.

This past year was clearly a volatile and difficult time for the commodity markets. Steps can and should be taken to improve market transparency and reporting, as well as ensuring that position limits are effectively enforced.

We have serious concerns about Sections 6 and 13 in the draft legislation, but we are confident that we can constructively work together with members of this committee to develop policy alternatives that will help ensure the integrity of the markets, while minimizing the unintended consequences.

Thank you for the opportunity to testify before the Committee today and we look forward to working together as the legislation continues to develop.

Committee on Agriculture
U.S. House of Representatives
Information Required From Non-governmental Witnesses

House rules require non-governmental witnesses to provide their resume or biographical sketch prior to testifying. If you do not have a resume or biographical sketch available, please complete this form.

1. Name: William M. Hale

2. BusinessAddress: Cargill Incorporated
15407 McGinty Road
Wayzata, MN 55391

3. Business Phone Number: 952-742-4600

4. Organization you represent: Cargill Incorporated

5. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee:

- 35 yrs in the grain merchandising business

6. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee:

- President, North American Export Grain Association 2002-2008

7. If you are appearing on behalf of an organization, please list the capacity in which you are representing that organization, including any offices or elected positions you hold:

- Senior Vice President Cargill Incorporated

PLEASE ATTACH THIS FORM OR YOUR BIOGRAPHY TO EACH COPY OF TESTIMONY.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

Name: William M. Hale

Address: 15407 McGinty Rd, Wayzata, MN 55391

Telephone: 952-742-4600

Organization you represent (if any): Cargill Incorporated

1. **Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: none **Amount:**

Source: **Amount:**

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2004, as well as the source and the amount of each grant or contract:**

Cargill is an international provider of food, agricultural and risk management products and services, with 160,000 employees and over 80 business units. The company routinely participates in the Commodity Credit Corporations commodity procurement programs to deliver US food aid, among other programs. We would be happy to comply with additional requests for specific information up requests from the Committee.

Please check here if this form is NOT applicable to you:

Signature: – on file with House Ag Cmte

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.