Statement of
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Testimony before the House Committee on Agriculture

February 10, 2011

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, thank you for the opportunity today to discuss the role of the over-the-counter (OTC) derivatives' market in helping farmers and farmer-owned cooperatives manage commodity price risks, and some of the key issues we see in implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

I am Edward Gallagher, President of Dairy Risk Management Services, a division of Dairy Farmers of America (DFA), and Vice President of Economics and Risk Management at Dairylea Cooperative. Together, those two cooperatives represent more than 17,000 dairy farmer members in 48 states.

I also serve on the National Council of Farmer Cooperatives' (NCFC) Commodity Futures Trading Commission (CFTC) working group, which was formed to provide technical assistance to NCFC on commodity markets, including implementation of Title VII of the Dodd-Frank Act. On behalf of the DFA-Dairylea dairy farmer-owners, and more broadly the more than two million farmers and ranchers who belong to farmer cooperatives, I appreciate the committee for holding this hearing on the key issues of implementing the Dodd-Frank Act.

Farmer cooperatives – businesses owned and controlled by farmers, ranchers, and growers – are an important part of the success of American agriculture, and provide a comprehensive array of services for their members. These diverse organizations handle, process and market virtually every type of agricultural commodity produced. They also provide farmers with access to infrastructure necessary to manufacture, distribute and sell a variety of farm inputs.

In all cases farmers are empowered, as elected board members, to make decisions affecting the current and future activities of their cooperative. Earnings derived from these activities are returned by cooperatives to their farmer-members on a patronage basis thereby enhancing their overall farm income.

America's farmer cooperatives also generate benefits that strengthen our national economy. They provide jobs to nearly 250,000 Americans with a combined payroll over $8 billion. Many of these jobs are in rural areas where employment opportunities are often limited.

Cooperatives' Use of the OTC Market

As processors and handlers of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of the futures exchanges as well as the OTC derivatives markets. We are considered end users because we own, produce, manufacture, process and/or merchandise agricultural commodities. Often times, the end-user status is based on our operations being the aggregators of our individual farmer-owners risks – either the risks directly associated with operating their individual farm business or the risks associated with operating the multi-farm aggregated risk of manufacturing or processing plant operations.

Due to market volatility in recent years, cooperatives are increasingly using OTC products to better manage exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces costs to the cooperatives and their farmer members.

In addition, OTC derivatives offer cooperatives the ability to provide customized products to producers to help them better manage their risk and returns. A cooperative can aggregate its owner-members' small volume hedges or forward contracts and offset that risk with a futures contract or by entering into another customized hedge via the swap markets. More and more producers are depending on their cooperatives to provide them with these tools to manage price risk and to assist them in locking in margins or creating insurance-like margin safety nets.

Some examples include:

- Local grain cooperatives offer farmers a minimum price for future delivery of a specific volume of grain. The local elevator then offsets that risk by entering into a customized hedge with a cooperative in a regional or federated system.

- Cooperatives offer livestock producers customized contracts at non-exchange traded weights to better match the corresponding number of head they have, while also reducing producers' financial exposure to daily margin calls. The cooperative offsets its risk of those contracts by entering into a corresponding hedge with another counterparty.

- Customized solutions are developed by the cooperative to assist individual farmers with their fuel hedging needs as individual farmers do not have the fuel demands necessary to consume a standard 42,000-gallon monthly NYMEX contract.

- A cooperative aggregates its members' small volume hedges or forward contracts and transfers that risk to a swap partner. A swap dealer or other commercial counterparty would otherwise not have the interest in servicing such small entities.

While my colleagues at grain, farm supply, and livestock cooperatives could provide greater details on how the above programs work for those sectors, they are all similar in concept and purpose to the risk management programs we provide to our Dairylea-DFA producers. We enter into OTC derivatives to hedge the price risk of the commodities we supply, process or handle.

Our member-owners include small farms (such as a 50-cow member-owner in Pennsylvania), mid-size farms (such as a 350-cow member-owner in Wisconsin) and larger farms with 1,000 or more cows. This diversity in member-owners requires us to offer a broad range of tools to meet their risk management needs, including services to help members mitigate the commercial risk associated with the high volatility in milk and input prices.

We offer our members a forward contracting program as a primary means of mitigating commercial risk. As one alternative under the forward contracting program, we offer our member-owners a fixed price for their milk and a hedge on their feed purchases. These risk mitigation tools are critical for our farmers. Many producers are not able to use the futures markets to hedge input risk because of the larger volumes underlying the relevant futures contracts. Furthermore, corn and soybean contracts do not trade on a monthly basis – while most of our members purchase livestock feed on a monthly basis. However, through our forward contracting program, we can offer a more customized solution for our member-owners. Yet, we can only provide this service to our member-owners because of our ability to enter into swaps for customizable volumes and time periods different from the applicable futures contract.

Implementation of the Dodd-Frank Act

Dairylea-DFA and NCFC support elements of the Dodd-Frank Act that bring more transparency and oversight to the OTC derivatives markets. We also recognize the complexity involved in crafting the implementing rules. We have had a number of opportunities to express our concerns to the CFTC and they have been accessible and engaged on our issues. We thank them for being open to NCFC members and staff in gaining a better understanding of how cooperatives are using the OTC market. In fact, several CFTC commissioners recognized this at their public meeting on January 20th.

However, the current "definitions" proposed rule appears to be headed down a path that would sweep farmer cooperatives into regulations intended for swap dealers and would increase costs and inhibit our ability to provide risk management tools to producers.

We do not believe this was Congress's intention and would urge this committee to reiterate that with the CFTC. Furthermore, we do not believe that any member of this committee would want any action taken that would reduce the price and risk management options available to our producer-members, especially during these highly volatile economic times. Yet on its current path, that may well be the consequence of the rulemaking process unless the committee makes known its desires otherwise.

Our overall objective in the implementation of the Act is to preserve the ability of cooperatives to use the OTC market to manage commercial risks, and at the same time support the growing demand from our member-owners for hedging products to help them mitigate the growing volatility in commodity prices.

At this juncture, our largest concerns are in the uncertainty around the "definitions" and "capital and margin" rules. While the CFTC continues to propose regulations for swaps and swap dealers, it is unclear to us what transactions, and who, will be subjected to those additional regulations.

Further, the above examples are activities that would appear to be captured under the "swap dealer" definition contained in CFTC's initial draft regulations. We believe that by applying the "interpretive approach for identifying whether a person is a swap dealer" as outlined in the proposed rule, CFTC would likely capture a number of entities that were never intended to be regulated as swap dealers, including farmer cooperatives. This is because cooperatives engage in activities that look very similar to those of a dealer when they enter into swaps with farmers, local elevators, and customers as they provide risk mitigation services and products throughout the agriculture and energy sector.

If farmer cooperatives were to be regulated as dealers, increased requirements for posting capital and margin, complying with reporting, record keeping and other regulatory requirements intended for large systemically important institutions could make providing those services uneconomical to our members. Such action would result in the unintended consequence of increasing the very risk the law intends to mitigate.

It is also our understanding that there will be no requirements for imposing margin on end users who are hedging or mitigating commercial risk – we trust that will be the case when the regulations are put in place. However, we would be concerned over excessive margin requirements on dealers and major swap participants on transactions entered into with end users who are hedging. We fear an increased cost structure associated with our hedging operations due to higher transaction costs would ultimately be passed on in the form of higher prices for inputs to our farmer-owners while discouraging prudent hedging practices.

Lastly, it is vitally important to the economic viability of our members to continue to utilize forward contracting transactions with their cooperatives as a means of mitigating their commercial business risk. These forward contracts create cash-price delivery contracts allowing our members mitigate risk and have more certainty over future price, input costs and margins. We ask that the definitions acknowledge that forward contracts, including those using embedded price options – allowing for such forward contracts as a minimum milk price that gets adjusted upwards if feed prices rise, but the minimum milk price does not change if feed prices fall – continue to be excluded from CFTC swap regulation.

In closing, NCFC seeks the following:

- Treat agricultural cooperatives as end-users since they aggregate the commercial risk of individual farmer-members and are treated as such by the CFTC, currently;
- Exclude agricultural cooperatives from the definition of a swap dealer; and,
- Exempt agricultural cooperatives from mandatory clearing or margining but allow them to perform either at their discretion.

Thank you again for the opportunity to testify today before the Committee. And thank you for your leadership and interest in the implementation of the Dodd-Frank Act. We appreciate your role in ensuring that farmer cooperatives will continue to be able to effectively hedge commercial risk and support the viability of their members' farms and cooperatively-owned facilities.

Recently, the CFTC wrote: "Permitting agricultural swaps to trade under the same terms and conditions as other swaps should provide greater certainty and stability to existent and emerging markets so that financial innovation and market development can proceed in and effective and competitive manner."[1] We whole heartedly agree with the CFTC. As it relates to agricultural cooperatives, who are the primary source of hedging innovation for farmers, we trust the rules permitting these actions will not stifle the very innovation it is trying to create – or worse yet reduce our ability to help producers manage their ever increasing commercial risks.

Thank you.

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[1] Federal Register, Vol. 76, No. 23, Thursday, February 3, 2011, page 6103.

Curriculum Vitae

Edward W. Gallagher

Relevant Experience

- Leading authority on milk pricing, milk forward-contracting programs and Federal Milk Orders.
- Frequent keynote speaker, at dairy industry events, addressing these topics.
- Manage dairy cooperative forward contracting programs since 1997.
- Operate forward contract programs for Dairy Farmers of America, Inc., Dairylea Cooperative Inc. and St. Albans Cooperative Creamery (Dairylea and St. Albans are member cooperatives of Dairy Farmers of America).
- Developed industry leading dairy-cooperative forward contracting programs offering members a variety of valuable management tools to mitigate their commercial price risk on milk and feed.
- Member, National Council of Farmer Cooperatives, Risk Management Work Group.
- Member, Innovation Center for US Dairy Industry, Risk Management Work Team.
- Member, National Milk Producers Federation, Milk Price Insurance Task Force.

Professional Work Experience

Dairy Farmers of America, Inc.

- President, Dairy Risk Management Services, May 2010-present
- Vice-President, Economics and Risk Management, 2007-2010

Dairylea Cooperative Inc.

- Vice-President, Economics and Risk Management, 2004 – present
- Vice-President, Planning and Regulatory Policy, 1999 – 2004
- Director, Planning and Regulatory Policy, 1996 - 1999

Office of the Market Administrator, NY-NJ Milk Marketing Area

- Chief, Market Analysis, Research and Information, 1990 – 1996
- Agricultural Economist, 1987 - 1990
- Cooperative Relations Liaison, 1984 – 1987

Gallagher Family Dairy Farm

- Laborer and assistant manager, through 1984

Education

- M.S. Agricultural Economics, ***The Ohio State University***, 1987-1989
- B.S. Agricultural Economics and Farm Management, ***Cornell University***, 1980-1984

Organization Memberships

National Council of Farmer Cooperatives
- Risk Management Work Group, member

National Milk Producers Federation
- Member, Federal Order Task Force
- Member, Price Insurance Task Force

Eagle/Dairy Direct, former board member
- Dairylea joint venture that is a supply business providing dairy feed and other inputs to members

Cornell University's National Dairy Economist Group

Northeast Dairy Farmer Cooperatives, former board member

Greater Northeast Milk Marketing Agency
- Member, Economics Committee
- Member, Government Affairs Committee

21st Century Dairy Club
- 21st CDC is a private group made up of 30 dairy farmers and 25 agri-businesses that meets to discuss the advancement of the dairy industry

New York State Milk Marketing Advisory Council, former member

New York State Dairy Task Force, Economic Development Co-chair

Senator Kirsten Gillibrand's Agricultural Advisory Group

Former Senator Hillary Clinton's Agricultural Advisory Group

New York Agricultural Society

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, 2008.

Name: EDWARD GALLAGHER

Organization you represent (if any): DAIRYLEA / DPA / NCFC

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: ____________________ **Amount:** __________

Source: ____________________ **Amount:** __________

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2008, as well as the source and the amount of each grant or contract:**

Source: ____________________ **Amount:** __________

Source: ____________________ **Amount:** __________

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

Signature: Kerri Nolan for Ed Gallagher

* 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.