

United States
Department of
Agriculture

Rural Business—
Cooperative
Service

Cooperative
Information
Report 60



Agricultural Cooperatives in the 21st Century

Preface

This report identifies challenges and opportunities facing farmer cooperatives in the years ahead and offers strategies to increase their chances for success. The external forces besetting cooperatives are examined as are their internal strengths and weaknesses. Priority issues are identified that cooperative members, leaders and advisers need to address. No easy solutions are provided, because there are none. Hopefully, this report will serve as a catalyst for further thought and discussion on how farmer cooperatives can enhance income and quality of life for their members.

1987 Study

In 1987, a USDA report, "Positioning Farmer Cooperatives for the Future," was prepared in response to a directive from the Senate Agricultural Appropriations Subcommittee. It reflected the views of cooperative leaders from across the country who gathered in a series of focus panels to discuss the future of farmer-owned cooperatives. While many different issues and strategies were discussed, panelists concluded that cooperatives must continually adapt to the changing marketplace and needs of farmers and that nothing inherent in the cooperative form of business prevents that type of evolution. The report affirmed the need and capability of cooperatives to change for the future.

2002 Methodology

This report examines the challenges producer-owned cooperatives face at the dawn of the 21st century. Several participants in the 1987 study revisited that report and commented on a range of topics regarding the continued relevance of its findings and new issues that have arisen since then. Then, prominent members of the cooperative community across the country participated in six focus panels (Appendix B). A discussion outline covering a range of conditions confronting agriculture in general and cooperatives in particular was sent to each participant before each focus group met (Appendix C).

The focus group panelists engaged in brainstorming sessions and free-form discussion, framed by the set of "contemporary" cooperative principles formulated in the 1987 study.¹ Commentary from each panel is reflected in this report. However, no comment is directly attributable to any panel member.

Goal

This report identifies challenges facing agricultural producers and their cooperatives as they enter the 21st century and suggests a foundation for developing options and strategies to meet those challenges.²

¹ The three principles: member-owned, member-controlled, and member-benefits succinctly define the unique aspects of the cooperative form of business and provide a framework for evaluating cooperative actions and practices.

² This report refers to various structures used by members to form cooperatives. Scholars have classified these structures and given them somewhat arbitrary labels. A summary of the meaning of various terms used to describe cooperative structures in this report is attached as Appendix A.

Contents

Preface	i
Introduction	v
Cooperative Principles and Assessment of Options	1
Cooperative principles	1
Inter-related principles	1
Principles guide analysis.	2
When changes are considered	2
Issues and Forces Shaping the External Environment of Cooperatives.	3
Changing farm demographics.	3
Technological innovation.	3
Changing competitive environment.	4
Role of the consumer	4
Industrialization: Farm to retail via the supply chain	5
Structural change in food processing and marketing	6
Globalization	7
The policy environment.	8
The price-income anomaly	8
Environmental regulation	8
Issues and Forces Shaping the Internal Environment of Cooperatives	9
Limited ability to accumulate equity	9
Diverging member characteristics and needs.	10
Board effectiveness	10
Management lack of cooperative focus.	11
Growing emphasis on value-added activity.	11
Pressures on the federated model	11

Contents

Reshaping the federated system	14
At the regional level.	14
Coordinated farm supply operations	14
Grain marketing alliances with IOFs	15
Food Processing growth	15
At the local level	16
Consolidation into super locals	16
Emphasis on getting the best deal	17
Priorities for Shaping Future Cooperatives	17
Strengthening cooperative leadership	17
Directors	17
Managers	19
Growth and consolidation among cooperatives	20
Foreign sourcing and functioning in a global market	20
Motivation and strategies	21
Legal questions.	22
Foreign memberships	22
Member relations issues	22
Equity accumulation	23
Improve member equity management	23
Outside equity	24
Sell assets.	24
Structural alternatives	25
New generation cooperatives	25
Alliances and joint ventures	26
Bargaining associations	28

Contents

Limited market innovations	28
Education	29
Public Policy and Cooperatives	29
Making member voices heard.	30
Trade association cooperative	30
Farm policy and farmer cooperatives	30
USDA and farmer cooperatives	31
Defining cooperatives: Where is policy heading?	31
Recommendations	32
Accept and embrace change	32
Be guided by competent directors	32
Maintain a solid equity base.	33
Emphasize education.	33
Seek efficient structures.	34
Forge a strong public policy presence	34
Make decisions based on cooperative principles.	34
Appendix A. Classifying Cooperatives By Structure	36
Appendix B. Forum Participants	38
Appendix C. Discussion Outline	40

Introduction

Facing the Challenges of the 21st Century for the Betterment of Rural America

The role of cooperatives as a critical dimension of market structure in agriculture must periodically be assessed to determine the future viability of the cooperative form of business. This report captures the ideas and observations of cooperative leaders and academic specialists who gathered in focus groups to share their perspectives on a set of questions posed by USDA RBS-Cooperative Services.

The areas covered included the changing external and internal competitive environment, cooperative principles, structure of cooperative systems, governance and finance. Also addressed were issues associated with educational efforts and institutional mechanisms, such as public policy and government-sponsored support programs.

Cooperatives are user-driven businesses that have contributed greatly to the development of one of the world's most productive and scientific-based agricultural systems. They have played an important role in strengthening market access and competitive returns for independent farm operators during the 20th century. They adapted their operations to agricultural technological innovations, such as the use of fertilizers, plant and livestock breeding, agricultural mechanization, electricity and other new sources of energy, and to new information systems.

Cooperatives have also played an important role in rural communities, where they are an integral part of the social fabric. They encourage democratic decision making processes, leadership development and education. The public-private partnership between farmers, land-grant universities and USDA programs has enhanced knowledge of the role cooperatives play as a tool for improving the economic well-being of the farming community and helping to boost the rural quality of life.

New forces are impacting the farm economy at the dawn of the 21st century that require the attention of cooperative business leaders. Recognizing the resiliency of self-help efforts directed to meeting member needs, focus group members addressed the new forces impacting farmers, rural communities and changing characteristics of markets. These forces, and suggestions about how to adjust to them, constitute a major part of the dialogue that focus group members engaged in during their deliberations. The compilation of thoughts and ideas contained in this report provides an important snapshot and reflection on cooperative principles, practices and structure by those on the firing line who are engaged in day-to-day operations.

It is the intent of this report to focus attention on issues and lessons that can be captured through the experiences of cooperative practitioners and service providers. The aim is to identify steps for improving the practice of cooperation for the betterment of rural America.

Randall E. Torgerson
Deputy Administrator for Cooperative Services
Rural Business-Cooperative Service
USDA Rural Development
Nov. 15, 2002

Agricultural Cooperatives in the 21st Century

John R. Dunn,
Anthony C. Crooks,
Donald A. Frederick,
Tracey L. Kennedy,
James J. Wadsworth
Rural Business-Cooperative Service

Agricultural cooperatives are part of a dynamic environment. The nature of production agriculture changes daily. So do agricultural markets and public policy. Many changes occur outside the cooperative system, which has little, if any, ability to directly influence them. Still, cooperatives have to recognize the changes and react to them.

Internally, cooperatives' mission, structure, and practices not only set them apart from other forms of business, but also influence how they respond to external changes. Many of the issues and challenges discussed here are interrelated and are not limited in their impact to farmers or cooperatives. But cooperatives, by virtue of their particular attributes, are often uniquely affected. This report discusses both external and internal issues facing cooperatives in the years ahead and panelists' perceptions of how cooperatives will be organized and operated in the 21st century.

The panel discussions emphasized marketing activities of cooperatives. However, this report's general recommendations and conclusions apply to all types of farmer cooperatives: marketing, supply, or service. These conclusions point out the central role of directors in cooperatives, the need for solid financing and organizational flexibility, the requirement for cooperative education, and the need for cooperative leaders to understand the application of cooperative principles.

Cooperative Principles and Assessment Options

"No one plan of organization is to be labeled as truly cooperative to the exclusion of others...."
Justice Louis Brandeis, *Frost v. Corporation Commissioner*, 278 U.S. 515, 546 (1929).

Basic cooperative principles define cooperative organizations, give them strength, and provide the cause and rationale for their public support, in terms of taxation, anti-trust considerations, public education, and promotion.

Cooperative principles

Any business organization can be defined in terms of three basic interests: ownership, control, and beneficiary. Only in the cooperative are all three interests vested directly in the hands of the user. These interests are commonly referred to as the contemporary cooperative principles. The 1987 USDA study, "Positioning Farmer Cooperatives for the Future," listed three basic principles that define the essence of a cooperative enterprise and establish a framework for assessing cooperative actions:

The User-Owner Principle. The cooperative is owned by the people who use it.

The User-Control Principle. The cooperative is controlled by the people who use it.

The User-Benefits Principle. The benefits generated by the cooperative accrue to its users on the basis of their use.

A cooperative is a business that is owned and controlled by the people who use its services and whose benefits (services received and earnings allocations) are shared by the users on the basis of use. Only an enterprise conforming to the spirit and intent of this definition should be labeled a cooperative.

Inter-related principles

These principles are inter-related. Tradeoffs can occur among them. To be a true cooperative, an organi-

zation must adhere to both the letter and the spirit of the principles. In this case, none of the three principles can be compromised.

Each principle can be viewed as one end of a continuum or spectrum. Any movement away from the pure application of the principles places the organization in jeopardy of compromising its cooperative identity. At the far end of the spectrums, all three principles are abandoned and the organization no longer resembles a cooperative.

Along these spectrums lie many options with varying degrees of adherence to cooperative principles. It is difficult to identify precisely where the lines are crossed that move the organization from being a cooperative to being another type of organization.

Ownership is expressed by equity investment in the enterprise and a claim on its assets. Complete user ownership requires a 100 percent equity investment and exclusive claim on the assets (after debts are paid). Ownership by non-active or retired members creates a separation of ownership and usership. Investment of equity capital by persons who have never patronized the cooperative even further disrupts the ownership-usership connection.

Control is the ability to exert authority over decision-making processes. Control takes many forms. It can be objective, such as allocating votes among members and deciding issues on the basis of the most votes. It can also be subjective, growing out of the subtle nuances of influence. People with strong personalities or other traits who are deferred to by their peers can exert influence that exceeds their voting rights.

Forces outside the cooperative can also exert control through their ability to limit its decision making. For example, the choices available to a cooperative are constrained by environmental regulations or tax laws. Likewise, a bank loan can include a covenant that restricts users' control. Control can also be forfeited if the members and directors fail to exercise proper oversight and review of hired management.

Benefits available to cooperative members include both the right to receive services and to share in the earnings. Sometimes, others indirectly receive cooperative benefits, such as non-members who get a better price for their product because a cooperative operates in their area and line of business. But internally, cooperatives must ensure that the benefits accrue to patrons on the basis of use and not to outsiders on the basis of investment or some other standard that undermines the value of the organization to its users.

Principles guide analysis

A non-cooperative business looking for solutions to marketplace challenges asks basic questions: Will the business be profitable? Will it thrive and grow? If the answers are "yes," the rest is a matter of details.

A cooperative, too, must answer "yes" to these questions about profitability and growth. If it cannot survive as a business, other considerations become moot. But cooperative principles provide an additional framework through which options for business strategies, organizational structures, and operations must be analyzed. Cooperatives must also ask, how will this choice affect the members' ownership interests? What influence will it exert on members' ability to control their cooperative? How will it affect the distribution of benefits flowing from the cooperative? And, most critically, if the business is to remain a cooperative, how will these user interests be protected?

Those who suggest that a cooperative can be run just like any other business either do not understand or do not respect the significance of these differences. Successful leadership within a cooperative requires all the skills and understanding required in an investor-owned firm, and more.

When changes are considered

When considering change, cooperatives leaders must ask themselves: How does it affect the basic interests in the cooperative? What steps, if they exist, might be taken to counter the net effect of moving away from being a pure cooperative? How can cooperatives guarantee that action taken won't adversely affect user interests?

Not only must cooperative leaders be pragmatic, but they are also responsible for evaluating the requirements and meaning of the basic principles. Any consideration that affects user ownership and control, or the distribution of benefits, should be discussed and evaluated in such terms. Members have a right to determine the nature and direction of their cooperative business. They must consider steps that change the character of their cooperative with a full understanding of the implications. This "principles-impact-assessment" means that cooperative decision-making includes considerations that non-cooperative firms can ignore. The possible responses to the conditions faced by cooperatives are discussed in the final section of this report.

Issues and Forces Shaping the External Environment of Cooperatives

The 1987 report, "Positioning Farmer Cooperatives for the Future," said that, "...to be successful in fulfilling the needs of farmers, cooperatives must be able to provide an appropriate economic response to marketplace situations faced by members. This response generally involves provision of competitive goods and services, or adoption of actions that balance or counter forces present in the business environment."

Both the domestic and international components of this environment have changed considerably since 1987. Structural changes from the farm gate to retail shelves are impacting the markets in which cooperatives and their members operate. Farmers and farming are also evolving. Cooperatives can no longer take for granted that the producers they served last year are the same or the same kind of producers they serve today, or will serve in the future.

The rapid pace of innovation in information technology is making the world smaller and altering forever the way business is conducted. Consolidation of agribusinesses, food manufacturers, and food retailers continues at an unprecedented rate, resulting in fewer, larger buyers that effectively control terms of trade. These businesses demand more from suppliers in specific product attributes, volume, timing, and costs. The need to add value and differentiate products from those of competitors is now accepted by all levels of agribusiness. The traditional roles of commodity handlers cease to exist. Layered among these changes are the myriad regulatory and policy issues that impose constraints on farmers and the agricultural sector.

Changing farm demographics

Even a cursory look at the demographics of the farm population poses the question, "Where will our next generation of farmers come from?" The average age of U.S. farm operators is in the mid-fifties. As older farmers retire, fewer new, younger farmers are taking their place. In Iowa, for example, 40 percent of farmers are more than 55 years of age. The fastest growing category is those 65 and older. Only 15 percent of the state's producers are under 35 years of age. From this rapidly aging farm population, cooperatives must identify the next generation of farmer-members and leaders.

Another demographic issue affecting cooperatives is the increasingly bimodal nature of farming. Fifty years ago, America's farms were predominately operated by a traditional family farmer who relied primarily on farming for his or her income and farmed with the assistance of family members, but little or no hired help. Since then, farm numbers have dropped by more than two-thirds, while production has doubled.³

Today, farms with more than \$250,000 in product sales generate 68 percent of all farm production (USDA). These "commercial" farms only comprise about 8 percent of the farm population. At the other end of the spectrum, farms owned by those who are retired or rely on other, off-farm sources of income account for 62 percent of the farm population, but generate only 8 percent of farm production. Between these two groups are what the USDA terms "intermediate" farms, which more closely resemble the traditional family farm. Only 30 percent of farms fall into this category. And they provide about 24 percent of agricultural production. These farmers consider farming their primary occupation but frequently supplement their income through other activities.

Much of the cooperative system was built to support traditional family farmers. Cooperatives now must adapt to a more diverse membership that requires different services, products, and structures. Setting priorities among competing and sometimes conflicting business objectives of their members is a growing challenge for many farmer cooperatives.

Technological innovation

Improved technology has been key to the growth of commercial farms. Mechanical innovations increase capacity and lower the cost of production. One panelist noted that a farmer with a 35-foot combine can now harvest more grain in one week than he could in the entire harvest season during his youth. Farmers use Global Positioning Systems to guide their machinery to maximize efficiency in the field and computer-generated digital imagery to assess strengths and weaknesses of individual parcels of land.

Biologically based innovations hold the promise of new products and new applications. Ethanol and bio-diesel are emerging as supplements and replacements for petroleum-based fuels. Soy-based ink is in commercial production. Plant-based adhesives, biopolymers and films are being developed. So are "far-

³ USDA's report, "Food and Agricultural Policy: Taking Stock for the New Century," (September 2001), p. 4.

macological" products that use tobacco and other crops with special traits making them good sources of raw material for beneficial drugs.

Biology-based innovations are not without controversy. The harvesting and marketing of herbicide-tolerant corn and soybeans, the so-called "Roundup-ready" varieties, are under attack for possible undiscovered adverse impacts on the health of people and animals that eat products made from these grains. But, over time, it is expected that the best available genetics will be combined with the best (i.e., most profitable) production processes to deliver products intended to meet the needs of an increasingly discriminating market.

An important issue for producers and cooperatives is the extent to which they will be able to participate in future biotechnology growth. For example, farmers, through cooperatives, have been active in using traditional crops to produce ethanol. Improved varieties of these crops have historically been developed by land-grant universities and made available to the public at large. Now, research and development is conducted by investor-owned firms and alliances of seed corporations with pharmaceutical firms, formed with the specific goal of developing genetically modified seed stock. University researchers are participating in some of these alliances and receiving a financial stake in the venture. Discoveries are being patented and newer seed is frequently sold to selected farmers under strict contracts that limit the farmers' legal right to save seed from current production for use in future years.

Research and development is capital intensive and financially risky. Cooperatives have limited access to capital and are often adverse to assuming risk. This restricts their participation in this arena. As a result, they have less access, for example, to newer and better seed to sell to their members. In addition, cooperatives may find that contracts between the alliances and farmers for use of the latest seeds also deny cooperatives access to the products farmers produce from those seeds. This could be a serious barrier to cooperative marketing efforts in the years ahead.

Information technology, like biotechnology, offers both opportunities and challenges to producers and their cooperatives. Computers make possible ever-faster collection, analysis, and dissemination of information among potential buyers and sellers of agricultural production and food products. This has shortened the time period in which purchase, inventory, and pricing decisions are made. Farmers are adjusting to the new technology, including the Internet. In

2000, nearly 60 percent of farm households had access to a computer and half of these used the Internet in their farming business. Farmers reported making more than \$375 million in online business purchases in 2000 and sold crops and livestock valued at nearly \$300 million online.⁴

While these numbers are large, they are but a portion of the potential "e-commerce" market. Cooperatives have traditionally been product-handling entities, with local supply stores and grain elevators symbolizing their presence in the local community and the business world. Cooperatives developing strategies for the 21st century must consider their role in a marketplace that values nimbleness, flexibility, and information vs. stationary structures and physical inventory.

Changing competitive environment

Consolidation of firms at the processing, wholesale, and retail levels of the U.S. food marketing system continues unabated. Market influence and bargaining strength of even the largest cooperatives are limited as a consequence. Food retailers flex their market muscle by imposing coordination mechanisms that demand strict discipline and conformity from suppliers. Food processors exert greater control over distribution channels by integrating back into the production of raw materials through a variety of ownership and contractual arrangements. Such arrangements rob producers of decision-making authority and market choices. Indeed, poultry industry-like integration in the hog and other industries and the pervasiveness of contract farming are leading to what one panel participant called the "'chickenization' of U.S. agriculture."

Role of the consumer

The consumer drives today's market. While exceptions exist, typical consumers want wholesome, tasty, convenient, and safe food products at the lowest possible price. They have the time, information, and mobility to identify stores that meet their criteria and patronize them on a regular basis.

The competition among various elements of the retail food sector—grocery chains, discount merchandisers, independent stores, and convenience stores—to satisfy consumers is leading them to impose new business practices on cooperatives and other suppliers of food products. It is also encouraging consolidation among food retailers to reduce costs and improve ser-

⁴ Id., pp. 33-34.

vice to consumers, while reducing consumer choices and power by reducing the number of competitors in a market.

The increasingly global market crosses national boundaries, exposing consumers to new products and changing expectations for familiar products. It opens new market segments and offers opportunities for suppliers to identify and meet the specific needs of a growing number of demographic groupings. Keeping up with these changes requires continuous spending on consumer research, new product development, innovative packaging, and advertising.

Many cooperatives are only beginning to recognize the idea of a consumer-driven marketplace. Some cooperatives—primarily engaged in marketing milk, fruits, vegetables, and nuts—have a proven record of understanding and accommodating consumer preferences. On the other hand, many commodity-oriented cooperatives have seemed satisfied to limit their roles to first-handler functions. Today, identity-preservation, genetic modification, and other differentiation strategies threaten to virtually eliminate the commodity business.

To gain consumer acceptance and loyalty, cooperatives must "unlock" value in their commodities through differentiation. For example, this might involve highlighting specific physical product attributes preferred by some consumers, such as organic, free-range, sustainable, fairly traded, humanely slaughtered, etc.

While consumers are sometimes willing to pay a premium for specific product attributes, suppliers find little evidence of general market acceptance of such premiums for providing food grown or processed to meet special standards and expectations. For example, domestic consumers have generally neither required nor been willing to pay extra for non-GMO products. Many foreign consumers insist on certain tolerance levels and segregation of non-GMO products, but not at a premium.

Cooperatives may be able to exploit the natural advantage of their inherently close ties to producers to create a positive, marketable image in the minds of consumers. Debate continues on whether a cooperative's identity is a marketable attribute. Some cooperatives, such as Blue Diamond and Florida's Natural, emphasize their farmer-owned cooperative status in advertising and when promoting their products. Close ties to producers should allow cooperatives to assure buyers of identity preservation and traceability to a degree not possible in other businesses.

Industrialization: farm to retail via the supply chain

As part of their response to the growth of consumer power, food processors and retailers are extending their influence over associated market channel activities. Firms that control key elements of the distribution and marketing system are attempting to control each level of the process, up to and including delivery to the consumer. These firms strive to assure: a) product quality that satisfies their customers' specific preferences; b) minimum costs subject to meeting the quality specifications; and c) that the associated risks are managed within acceptable levels. Competition gives way to coordination, as large consolidated firms internalize transactions through ownership or other coordination mechanisms that give them greater control of variables affecting profitability. It also results in thinner markets where the disparity in bargaining power among the parties becomes even more pronounced.

A common term to describe the tools used to consolidate this control is "supply chain management." In agriculture, it begins with contract farming. The production of uniform food products requires relatively uniform raw farm products. Drumsticks and pork chops won't be the same from week to week unless the chickens and hogs they come from are relatively alike. Supply chain management is a fact of life in the broiler industry and becoming common in the pork industry.

Early biotechnology helped develop relatively uniform chicks that produce consumer-preferred large-breasted chickens. Most chickens today are produced using an "industrial" model. A vertically integrated firm breeds and hatches the chicks, transfers them to a farmer who grows them to market size under a contract with the parent firm, and then transfers them back for processing and marketing. Every aspect of the "grow-out" process is controlled by the parent firm. Feed, veterinary services, and other supplies are provided to the farmer. The result is a uniform, low-cost poultry product that generally meets consumer demands. Integrated firms, seeking to ensure product quality and to reduce costs, negotiate directly with producers for contracted product delivery according to specific time, place, and performance standards.

Now genetics-based artificial insemination of hogs is resulting in piglets that, if raised in a certain manner, produce lean pork cuts that also meet consumer demands. The pork industry is developing an integrator/contract farmer production system based on the poultry industry model. Industrialization of beef and grain production is anticipated in the near future.

The implications of this integration for producers involve loss of independence, shortened planning horizons, and mounting cost/price pressures. Contract producers accept restricted decision-making and less autonomy for the relative security of a stable, albeit somewhat lower at times, income stream.

Industrialization is also moving backward from the supermarkets toward the processor. Led by Wal-Mart, retailers are forcing food processors to streamline their production and distribution systems. Retailers tell firms that want to be their suppliers where, when, how, and how much product to deliver. This top-down dominance is being facilitated by the concentration occurring in food retailing. Food processing and distribution firms that want these large accounts must develop internal supply management systems that satisfy the retailers and convince their suppliers to adjust to these systems.

Not long ago, retailers were like talent agents, vying for the privilege of carrying the best brands. But with their burgeoning size and market share, they are now landlords who own the only prime real estate in the area. They can collect slotting fees (rent for the use of shelf space within stores). The burden of carrying inventory is shifted to weaker links in the chain. Retailers reduce labor costs by compelling suppliers to stock shelves. Suppliers now bear more of the risks and costs of the marketplace.

Cooperatives are forced to evaluate where they stand in various supply chains from both the production and marketing standpoint. In the past, cooperatives provided a public price, making them vulnerable to undercutting and blame for perceived low product prices. Today, while many cooperatives still find themselves in that role, some of the larger ones emulate the integrated-firm practices in livestock production for which they were once supposed to be the antidote.

Structural change in food processing and marketing

Producers and their cooperatives are selling into markets increasingly dominated by fewer, larger buyers. A variety of ownership and contractual arrangements intensifies concentration and creates a dramatic disparity in market power. Even the largest agricultural cooperatives have much smaller sales and asset bases than many of their competitors and customers.

Economists suggest that if four firms have 40 percent of a market, that market is no longer competitive.⁵

In food manufacturing, this four-firm concentration ratio ranges from 49 percent to 80 percent in beef packing, pork packing, broiler processing, flour milling, dry corn milling, wet corn milling, and soybean crushing.⁶

Consolidation among U.S. retail food marketers is continuous. It is augmented by the entry of foreign firms into the U.S. market through aggressive acquisition strategies. From 1991 to 2001, the four-firm share of the retail food market increased from 23.3 percent to 27.8 percent, while the eight-firm share has increased from 35.2 percent to 43.6 percent.⁷ Retailers are positioned to dictate product requirements, prices, and other terms of trade to suppliers. Purchasing is centralized for logistical and pecuniary leverage as retailers seek to purchase as many products as possible from the fewest number of suppliers. Moreover, suppliers must be substantial enough to carry not only a nationwide presence, but also global networks of stores.

As traditional supermarkets expand in size and scope, volume discounters and warehouse clubs are entering food retailing and becoming dominant market participants. In 2002, Wal-Mart is the clear leader in national food sales (but wasn't even on the list of largest food retailers in 1990), while Costco is fifth and another Wal-Mart unit, Sam's Clubs, is sixth.⁸

The remarkable success of Wal-Mart's supply chain model, which demands suppliers provide service, dependability, and quality assurance—and at the lowest possible price—is pressing retailers and suppliers alike to conform to a new standard. Wal-Mart's success is driven largely by its ability to compel suppliers to meet their demands for products while simultaneously reducing delivery costs. In return, the retailer provides access to shelf space on a nationwide basis, state-of-the-art information technology, and a large data base on consumer demands and preferences.

Suppliers (including cooperatives) must conform to buyers' procurement systems by adopting specific information technology that both requires and facilitates better up-front planning by suppliers in inventory, transactions and billing. Although suppliers bear more risk and cost, these types of demands are considered positive by many, because they impose a discipline that can be applied not only to other buyers but also back to raw material suppliers as well. The ability

⁵ William Heffernan, "Consolidation in the Food and Agricultural System," National Farmers Union, (February 1999), p. 1.

⁶ Id., at 17-19.

⁷ Supermarket News, January 18, 1993, and the website www.supermarketnews.com as of March 28, 2002.

⁸ Supermarket news website, www.supermarketnews.com.

to do business with Wal-Mart is considered a benchmark of a supplier's ability to service other large retailers. Those cooperatives that can do business with Wal-Mart report that they are better, more efficient suppliers to all of their customers as a result.

Cooperatives, as sellers of farm production supplies, also feel the effects of structural change within their industry. Serving both large and small producers remains a continuous challenge, as does their ability to respond to demands for "one-stop shopping" and bundling of products and services. As buyers of inputs and ingredients, cooperatives feel the cost-price squeeze. They, like their members, face fewer, larger suppliers. Under increasing pressure to be more efficient, some cooperatives are exploring alternative purchasing avenues through buyers' consortiums or free-market auctioning. However, simple solutions to their challenges are not readily apparent.

Globalization

Cooperatives are groping to find their place in the 21st century's global, interdependent economy. Participation in the global economy is, in many ways, no longer an option. Slow U.S. population and income growth have dampened demand at home, requiring U.S. producers to look to the 96 percent of the world's consumers outside the United States. Attendant is the need to address the myriad demand-factors that world-consumers require—each in their own unique cultural context. Other international market conditions often mirror domestic markets. For example, U.S. producers face the same need for countervailing power in highly concentrated food industries both domestically and worldwide.

Producers are particularly hard hit by globalization. For decades, U.S. farmers were the most efficient and productive producers in the world. As we look ahead, U.S. producers may be extremely productive given their resource base. However, foreign producers have lower input costs. Labor costs are lower in other parts of the world. U.S. production subsidies have driven land prices to unprecedented heights. International production grows increasingly competitive on a price and quality basis. As less-developed countries become better able to meet their basic food requirements, they will be less dependent on for U.S. surplus production and may even become competitors in both our own and other countries' markets.

One book on the subject of globalization was mentioned repeatedly during the panel discussions. Steven C. Blank's *The End of Agriculture in the American Portfolio* looks at the economic realities of globalization

and concludes that we are approaching a time when all agricultural production will cease in the U.S.⁹ None of the panelists dismissed the book out-of-hand.

Although many said Blank may have overstated his case by suggesting that all agricultural production in the U.S. would cease, they take seriously his basic premise that farmers (and by implication, their cooperatives) will never again make money consistently selling basic commodities such as corn, soybeans, wheat, and cotton.

Increasingly, commodity suppliers take advantage of opportunities to source from multiple locations and reduce transactions costs. This is a challenge for U.S. cooperatives, which are tied to their domestic grower bases. Cooperatives may no longer be able to provide a home for all member product and be the market of last resort. Instead, cooperative marketers must identify ways to insulate themselves from volatile commodity markets by adding value and differentiating their products, if only by implementing and enforcing higher quality standards and terminating their relationship with producers consistently unable to make the grade.

Both the rules of the game and the players are changing. China's membership in the World Trade Organization positions it to displace U.S. agricultural products in both domestic and export markets. The reaction to these kinds of changes, added to the cyclic and unstable nature of the global economy, is often governmental intervention to protect domestic producers. Tariff and non-tariff barriers are used to protect domestic production, but also distort trade and throw markets out of balance. This produces a continuous cycle of market-access issues and actions to "level the playing field."

Panelists seemed unafraid of questioning whether cooperatives can position themselves to help U.S. producers compete globally under these conditions. They asked whether it is enough—as some grain cooperative leaders have suggested—to look for ways to increase domestic demand through livestock and renewable energy rather than rely on export market growth. And they wondered what unique features of the cooperative form of business define the ability of U.S. producers to influence policy and gain a foothold in international markets.

⁹ Steven C. Blank, "The End of Agriculture in the American Portfolio" (Westport, CT: Quorum Books, 1998).

The policy environment

Few deny the impact public policy has on agricultural producers and their cooperatives. Panelists were generally critical of how policy affected their members and cooperatives. And they were willing to share some of the blame for not being effective enough in educating legislators on the problems they face.

At the producer level, some panelists questioned a "cheap food" policy, chiding lawmakers for mollifying voters by perpetuating programs that dampen markets for producers. Others noted the results of fighting basic economics—encouraging production that exceeds demand and then providing subsidies, which keep land in production.

Government programs also influence the structure and success of cooperatives. This section reviews two policy issues discussed during the workshops. A subsequent section examines how cooperatives can be more effective in shaping policy in the years ahead.

The price-income anomaly

Entering the 21st century, market prices for basic farm commodities—wheat, corn, cotton, soybeans, rice—were at cyclical lows, the result of unrestrained domestic production, worldwide surpluses, and depressed demand in a weakened global economy. Yet, net cash farm income in the U.S. reached a record high of \$59.5 billion in 2001. The value of U.S. farm real estate rose 12 percent from 1999 to 2001, to more than \$1 trillion. The farm debt-to-asset ratio hovers between 15 and 16 percent, well below the level reached during the period of farm financial stress in the 1980s.

This anomaly is made possible by Government transfer payments. Of the \$59.5 billion in net cash farm income in 2001, \$21.1 billion came from Government payments to farmers. The 1996 farm bill was intended to wean agricultural producers from the financial support of the Federal Government and to provide a framework for a "market-oriented" production economy. But a series of natural disasters and related circumstances resulted in a less aggressive approach in congressional efforts to shape a more rational agriculture. As a consequence, farm land prices rose to record levels, putting U.S. producers at a disadvantage relative to those in other countries where land and other supplies are cheaper and technology has boosted product quality.

Environmental regulation

Another growing challenge to producers and their cooperatives in the 21st century is dealing with the production and business restraints brought about

by environmental concerns. Producers are caught up in a myriad of regulations that seek to constrain actions that may harm the environment. Areas of likely conflict include nutrient runoff, access to scarce water supplies, and protecting open space.

Cooperatives, like farmers, must deal with increasingly complex environmental regulations. Runoff from food processing facilities, disposition of chemicals, access to water, and noise and odor complaints from neighbors are some of the issues confronting cooperatives and other businesses.

Well-intended environmental rules can sometimes harshly affect cooperatives. One example is the Environmental Protection Agency (EPA) rule to substantially reduce the sulfur in diesel fuel and gasoline. This poses a serious threat to cooperatives that own petroleum refineries. Management estimates that it will cost at least \$200 million to bring their facilities into compliance with these standards. Investor-owned petroleum firms can raise the funds to upgrade their refineries in public capital markets. Cooperatives are concerned that their members don't have the money to do the same for their facilities. EPA's refusal to grant cooperatives an exemption from the rules, or more time to comply, places them in a difficult position. One or more refineries may have to be sold, reducing fuel availability and competition among sellers in rural areas.

Another concern for cooperatives involved in food marketing is the ever-present possibility of delivering products that are considered adulterated or unsafe into the marketplace. This issue is amplified by recent questions about possible long-term harm from the use of genetically modified farm products. Conflicts may arise between the technologies available to farmer-members and their impact on the integrity of the food delivery system, with cooperative marketing managers caught in the middle.

Some environmental programs may be perceived as beneficial by producers but impediments by cooperative managers. Agricultural-based conservation began in earnest after the "dust-bowl" days of the 1930s. The overriding objective has been to keep topsoil in place, reducing pollution and enhancing farm productivity. Significant strides have been made in achieving that goal. Ninety-two cents out of every dollar spent on direct conservation payments to farmers pays to idle land and for the management practices that enhance the environmental benefits of retired land.¹⁰ But this means reduced farm supply sales and products to market for cooperatives.

In the years ahead, producers, cooperatives, and Government will have to work to improve management practices on farms, in forests, and factories. Government dollars may have to be reallocated toward sustainable practices and a wider range of issues, such as incentives to conserve scarce water and energy resources on the farm and at cooperative facilities. As with all agricultural firms, farmer cooperatives will have to find ways to meet the cost of complying with various regulations or exit certain lines of business.

Issues and Forces Shaping the Internal Environment of Cooperatives

Internal challenges as daunting as the external ones confront cooperatives. The internal issues are largely related to the external ones, particularly as they complicate efforts to respond to outside forces. Some internal issues are inherent in the structure of cooperatives, others result from the attitudes of the people in cooperatives. All must be addressed for cooperatives to remain a viable business structure in the 21st century.

This section addresses issues common among all types of farmer cooperatives and special problems confronting the federated farm supply and grain marketing system.

Limited ability to accumulate equity

One of the stiffest challenges facing cooperatives in the years ahead will be accumulating sufficient capital, particularly equity, to finance improvements and expansion of services. Cooperative principles dictate that cooperatives are owned and controlled by the persons who use their services, and benefits flow to users on the basis of use, not investment. This makes investment in a cooperative unattractive to "outsiders," even those who support what the cooperative is trying to accomplish.

Equity accumulation is further complicated by the related axiom that the burden of financing the association should fall on current users. A cooperative is the only form of business that is expected to systematically return equity to owners.

Another hurdle is the common practice of encouraging membership by requiring only a minimum initial investment to acquire an ownership interest in a cooperative. Cooperatives are often expected to provide low-cost services to members and still generate sufficient earnings to redeem old equity, return substantial cash patronage refunds to members, and generate all the new equity the association needs.

Another impediment is farmer reluctance to finance new initiatives, especially unfamiliar and risky activities, such as vertical integration and value-added processing. Cooperative managers, particularly managers of regional cooperatives who want to enter new ventures, believe that many farmers have the resources to finance cooperative expansion but prefer to spend the money on their own farm or other investment opportunities.

Retained patronage refund financing is creating fissures within the system. Cooperative managers assert they need these retained earnings to sustain the business. Producers and local members of regional federated cooperatives want large cash patronage refunds and question the value of non-cash patronage refunds. They become frustrated with a cooperative that says patronage refunds are members' money but fails to redeem equity as rapidly as these member-patrons would like.

The environmental compliance problems facing cooperative refineries discussed in the previous section illustrate the equity accumulation problems for cooperatives. Some believe that if cooperatives that own petroleum refineries could simply sell stock on the open market as their investor-owned competitors do, it would be much easier for them to meet EPA edicts concerning reduced sulfur content in their products. But this conflicts with operating their business on a cooperative basis. So cooperatives must develop strategies to attract sufficient capital without subverting their cooperative character if they wish to remain in the petroleum refining business.

Some farmers are willing and able to finance their cooperatives. The development of numerous "new generation" cooperatives shows that if farmers are offered the proper incentive, such as a chance to participate in value-added processing and to realize a gain when they sell their investment in the cooperative, they will provide up-front equity.

However, in several instances, the farmer-owners of a "new generation" have determined that they couldn't raise adequate equity from the membership to seize important market opportunities. They voted to convert to an investor-owned firm to gain access to

¹⁰ USDA's report, "Food and Agricultural Policy: Taking Stock for the New Century," (September 2001), p. 10.

outside investment. The original farmer-members may still benefit from the company. However, those benefits will no longer be protected by user ownership and control.

Diverging member characteristics and needs

The growing diversity among producers is reflected in cooperative membership. Cooperatives in the 21st century will be expected to meet the various needs of an increasingly heterogeneous membership.

Some issues arise because of the diverging size and motivation among producers. For example, commercial-scale producers may expect discounts on supply purchases and special services to remain cooperative patrons because such benefits are offered by other businesses. Small producers sometimes resist what they see as efforts by larger producer-members to control the organization.

Cooperatives have always had members of various ages. But when children were raised on the farm, received all of their formal education in the local area, and became farmers like their parents, the generation gap was fairly narrow. Today, farm children are going away to college, acquiring technical skills and experiences that match their urban counterparts, and being offered opportunities not available to previous generations. While some older farmers scoff at technological advances and global opportunities, younger farmers accept them and expect their cooperatives to do the same.

A single cooperative may have at least one member, if not a representative group of members, with the following characteristics:

- A small-volume producer who enjoys living in a rural area and doesn't particularly care if the farm makes money (hobby farmer);
- A small-volume producer who wants to grow and will seek the best deal available for needed goods and services;
- A small-volume producer living in an area of less economic opportunity for whom farming is a necessary supplement to limited non-farm income;
- A large-volume producer-member who runs the farm as a business with a clear focus on profit;
- A new producer who is highly leveraged; and
- An older, long-time producer who is approaching retirement and has everything paid for.

Each of these members brings a specific set of interests and demands to the cooperative. Leaders and

advisers must find ways to blend this increasingly diverse base of farmers into a membership with a cohesive business interest in their cooperative.

Board effectiveness

Effective boards of directors are critical to cooperative success. Their position as the link between members and management makes them responsible for meeting member needs while maintaining the viability and cooperative character of the association. Given the complex and fast-changing circumstances facing cooperatives today, developing strong leadership at the board level will be a continuing challenge in the 21st century.

Cooperatives are organized as corporations under State law and have a general governance system based on the corporate model, but modified to reflect the cooperative system of user representation. Member-owners elect a board of directors to set corporate policy and oversee operations. The board selects the chief executive officer, usually referred to as the manager, who administers the board policies, hires other staff, and is responsible for the day-to-day operations of the cooperative.

Participants in the focus groups raised several issues about director effectiveness in cooperatives. One concern was that producer-directors too often make decisions based on internal politics rather than sound economic principles. Decisions made to curry popularity (e.g., to keep an unprofitable facility open) may get the directors re-elected but the decisions may be bad for the business. Good directors, it was suggested, vote for what makes the most business sense and let the performance of the cooperative determine whether or not they are re-elected.

A second concern is that some directors never grow, in a leadership sense, beyond being a producer member. For example, they resist equity accumulation through retained earnings because, as a grower, they want a high cash patronage refund each and every year. They are viewed as too willing to mortgage the cooperative's future for more cash today. Far-sighted directors will ensure that money invested in their cooperative protects and enhances their income over the long term.¹¹

¹¹ This also reflects the board's policy-making role where members may have divergent interests. If members want more cash, do directors have an obligation to respond accordingly? This may also be a member-education issue.

Panelists were also wary about the inability of many grower-directors to deal with contemporary issues. Farmer-directors may be outstanding producers, but often lack the experience and training to analyze options for dealing with supply chains, technological innovations, complex business arrangements, or globalization. They might not fully understand financial statements and might have trouble grasping complex business plans. Managers of regional marketing cooperatives in particular question whether their grower-directors are equipped to guide processed food companies in today's economic environment. Some believe grower-directors should limit their oversight to broad policy areas while turning over full responsibility for operational decisions to management.

Concerns about board effectiveness will be explored in more detail in the subsequent section on the changing federated farm supply and grain marketing systems. Ways to improve board performance will be addressed later.

Management lack of cooperative focus

Some aspects of managing a cooperative are similar to other comparable businesses. These tend to be the physical operations. A cooperative-owned dairy plant, feed mill, or farm supply store looks and operates much like a non-cooperative one. So do the trucks, warehouses, and fork lifts. Both types of businesses develop distribution channels, deal with unions, comply with government rules and regulations, etc.

But some management issues are unique to cooperatives. Managing one requires a clear understanding of cooperative principles, structure, and operations. Cooperative managers must be doubly qualified. They need to be well versed in the fundamentals of cooperation as well as the specific operations of the business.

In an investor-owned firm (IOF), the chief executive officer (CEO) often has a large, if not dominant voice, in selecting the board of directors. Strong CEOs look for persons who share their vision for the future of the company and respect their managerial ability in selecting directors. When a new CEO takes over, directors who don't share his or her views are often encouraged to relinquish their seats on the board. This places the manager in a position of strong control over both setting and implementing company policy.

In a cooperative, the CEO usually has significantly less influence over who sits on the board. Incumbent directors may have outlasted several managerial changes. When a board seat opens up, the influence of the CEO in the selection of the new director varies greatly depending on the culture of the association.

Some cooperatives look for guidance from the manager, others deeply resent any involvement by the manager. As a result, directors often don't feel beholden to the manager for their position and have the independence, if they choose to exercise it, to question management decisions and reject its recommendations.

Another difference is the daily relationship between the shareholders and the directors of an IOF and a cooperative. An IOF investor-owner may have no relationship with the business other than as an investor. Directors attend a quarterly board meeting, but they may also have limited additional contact with the firm.

In a cooperative however, user-owners and directors invest in and guide the firm specifically to obtain services for themselves and the other members. They often have regular contact with employees and other producer-owners. Their livelihood depends on the cooperative doing a good job. They know when they think it isn't meeting their needs and frequently tell management when they are displeased about even the smallest imperfection in goods or services received.

Thus, cooperative managers must be able to accept shareholders walking into their office with comments, often critical, while, in an IOF, the shareholders may not even know where the headquarters is located. They must also work with a board they didn't select and that may have very different ideas from their own as to how the association should operate.

When hiring a new CEO, a cooperative needs to consider how that person is likely to do in the close, personal environment that is part of working for a cooperative. This suggests that one good source of people with the appropriate skills for leadership in farmer cooperatives is managers whose careers developed in the cooperative system.

Growing emphasis on value-added activity

A final internal issue confronting cooperatives is the growing emphasis on value-added handling and food processing. Many panelists view value-added processing as the growth area for cooperatives in the 21st century. This raises serious questions about how other business segments that historically have been important to producer members will be treated and the extent to which cooperatives should invest limited resources in trying to be effective in markets dominated by powerful global food and retail firms.

Pressures on the federated model

One major theme to emerge from the focus group discussions is that the traditional federated grain mar-

keting and farm supply system is under intense pressures. It has already begun to change in response to those pressures and may be vastly different in the years ahead. All cooperatives are affected by major changes in the agricultural environment such as globalization and concentration. Yet, panel participants focused their expressions of concern on the traditional network of local grain elevators and farm supply stores and their federated regional grain marketing and supply buying cooperatives.

This focus is not surprising for at least two reasons. In 2000, nearly two out of every three U.S. farmer cooperatives marketed grain and/or provided supplies to grain producers. More than 75 percent of the 3 million producer-memberships held in farmer cooperatives were in these associations.¹² While most of these associations are local, centralized cooperatives, many are members of one or more regional, federated systems.

A basic cultural conflict exists between local cooperatives and their federated regional. Some locals will not recognize change. Federated managers believe the realities of the business world are demanding that they do. Panelists offered numerous explanations for, and examples of, this conflict.

The planning horizon of a local cooperative is often constrained by its older farmer-members, many of whom are nearing retirement. They want their cooperative to just keep doing what it has been doing and use any cash on hand to redeem their equity. This was described as older members wanting to "slide by" for another 5 to 10 years until they retire.

Younger producers are more likely to urge their association to invest in operations that will help them remain viable into the future. However, the older farmers control most of the board seats on many locals and have the authority to thwart change. For example, panelists suggested farmer-directors' limited vision is keeping cooperatives from making the necessary investments to become leaders in the hog processing industry. They asserted that these elders are relegating future hog farmers to "contract producer" status.

Many federated managers believe that locals embrace the cooperative culture of service over profit to such an extent that they are unwilling to take steps necessary to maintain profitability. This leads the locals to make unreasonable demands on their federated regionals to keep them in business. Locals expect

federateds to be the low-cost source of farm supplies, pay a premium for product delivered for resale, and issue a hefty patronage refund each year. Often, economic circumstances make this impossible.

Federated cooperatives could offer locals the opportunity to be more profitable by selling them supplies for less and/or paying more for farm products delivered for marketing. However, such activity would impair the federateds' ability to finance operations and pay the patronage refunds that command the loyalty of local cooperatives. Some federated managers don't trust their locals to use the funds wisely. Regional cooperatives want to enhance their own economic position rather than to further underwrite what they perceive as losing activities at the local level.

Many locals operate at a deficit and depend on federated association cash patronage refunds and redemption of retained patronage refunds of earlier years to stay in business. Rotan reports that in 2000, more than 40 percent of the locals surveyed had losses on their own operations and needed patronage refunds from federated cooperatives to show a profit.¹³

Regional federated managers are also frustrated by what they see as perception problems among local producer members. Because patronage refunds are often used to cover the losses of inefficient locals, producers seldom recognize the extent of the support they receive from federated cooperatives.

Federated cooperatives consider this an unhealthy situation. They question the ability of their affiliates to survive when they are unable to pay patronage for a period of time. Federated cooperatives want locals to be profitable on their own, instead of diluting regional assets to cover their inefficiencies.

Locals often encourage competition among cooperatives and fail to emphasize cooperation among cooperatives. Federated cooperatives are forming alliances with each other that create new, nationwide ventures focusing on single lines of business. They see this as a way to "take costs out of the market" while locals see it as a way to "take competition out of the market."

Hogeland observed that locals want, and are accustomed to, several bids for their business. They may belong to multiple marketing and supply federat-

¹² Charles A. Kraenzle et al., "Farmer Cooperative Statistics, 2000," U.S. Department of Agriculture, RBS Service Report 60, p. 2

¹³ Beverly L. Rotan, Sales Climb, Net Income Declines in Local Cooperatives in 2000, "Rural Cooperatives," USDA/Rural Development, (Nov/Dec 2001), pp. 25-26.

ed cooperatives to cherry pick the best bids available within the system. When the system only offers one bid, they look to IOFs for competitive bids.¹⁴

Federated cooperatives see the locals as ungrateful and somewhat disloyal when they look for the best short-term deal instead of supporting regional coordination aimed at capturing economies of scale that increase market power and reduce costs to the locals over time. The friction makes it difficult for federated cooperatives to achieve their business objectives.

Locals are seen as adverse to business alliances, either with other cooperatives or IOFs. Federated management, on the other hand, moves easily in a world where they compete with a firm on one front and partner with them on the next. The alignments of regionals with firms that some local leaders consider rivals creates considerable tension among regionals, their local affiliates, and their producer-members.

Communication is necessary to educate members on the need for joint ventures that appear to reduce competition and for ventures with "the enemy." An example of this is uproar over a federated cooperative's decision to sell grain through an IOF competitor. The cooperative's management saw no problem with this because the cooperative regularly does business with the IOF. Many producer-members, however, were upset because they perceive the IOF as "the competition." A larger investment in a member education campaign might have helped the cooperative limit the tension with its producer-members. The importance of thoroughly explaining pending partnerships with a competitor before the venture is approved cannot be overemphasized.

Federated managers view local members as less concerned with the value of their equity investment in their federated than in keeping their local cooperative alive. Federated cooperatives see the locals' penchant for service over profit manifesting itself as a justification for insisting inefficient local facilities remain open when economics demand that they be closed.

The evolution of transportation services, especially trucking and the interstate highway system, negates the need for a grain elevator and farm supply store every 8 to 10 miles. Grains, cotton, and even milk can be hauled hundreds of miles or more when it is economically advantageous to do so.

Several panelists viewed local grain elevators as dinosaurs bound for extinction. Their farmer- owners

will have to absorb the loss. They also cautioned against farmers investing in new sub-terminal elevators to get back on railroad main lines. Marketing commodity grain, they said, is not profitable now, nor is it likely to be in the future.

Investor-owned processors and exporters are perfectly willing to let farmers tie up their capital in basic commodity handling facilities, with their low return on investment. However, as the IOFs require grain, they are also somewhat willing to share the cost through joint ventures. The grain firms regard these elevators as costs and not profit centers, while many farmers still expect them to generate patronage refunds.

Farmers must recognize the additional costs associated with keeping a conveniently located but inefficient local in business. For example, two small cotton gins resisted merging because both sets of members wanted a cooperative in their town. It cost their regional cooperative an extra \$20/bale to serve both gins. When the situation was explained to the producers that they could decide either to merge or receive \$20/bale less for their cotton, the merger was quickly approved. Farmers have every right to place a "social" value on retaining their local facilities. But they must understand the economic cost of that choice.

Sometimes the cost of operating what appear to be inefficient locals may be justified. In another instance, two local cooperatives serving producers of a perishable crop would save \$200,000 per year by merging. However, the members are in a hurricane area and wish to minimize the risk of significant losses due to a harvest-time storm. Closed roads could prevent deliveries by some patrons to a single location, resulting in a substantial crop loss. As their potential loss might be greater than the extra cost of maintaining two locals, they decided to bear the additional cost—a form of market insurance.

Rural sociologists add a new perspective on the issue of closing locals. They suggest that the closure of a local cooperative tears at the social fabric of the community, just as when a school, church, or hospital closes. The reasoning is always the same: "The community can't support the facility." But the social damage caused by such closures is difficult to measure.

Panelists spent little time on supply cooperative issues. One executive of a farm supply regional pointed out that the costs of doing business through a multi-level supply cooperative come under real scrutiny when a farmer can order chemicals, for example, directly from the manufacturer and have them delivered for less total cost. While some farmers are willing

¹⁴ Julie A. Hogeland, "The Changing Federated Relationship Between Local and Regional Cooperatives," U.S. Department of Agriculture, RBS Research Report 190 (August 2002), p. 5.

to pay more for technical support provided through their cooperative, others simply use the Internet and bypass the cooperative system.

The many pressures on the federated system are placing managers of local cooperatives in an untenable position. When a local isn't profitable on its own, the survival of both the manager and the cooperative depends on something beyond their control: the success of their regional.

Managers at all levels within the system are rewarded for how well their unit does on a short-term basis. Perhaps, because of system inter-dependencies, a new approach to incentives should be developed that rewards performance of the entire system.

Reshaping the federated system

As cooperatives adapt to the 21st century business climate, producer-owners must recognize the fundamental shifts that are occurring and initiate policies and programs designed to succeed in the new environment. This includes adapting to globalization, technological innovation, and industrialization within agriculture.

Perhaps even more important is an underlying current drawing the economy in a new direction. Throughout the 20th century, the cornerstone of our economic thinking was free and open competition. However, as the 21st century begins, coordination is now a driving force. Cooperatives will have to position themselves and their producer-members to deal with this basic shift in business operations and market structure.

The focus groups discussed several inter-related issues including: streamlined decision-making, coordination among cooperatives, and capital accumulation. They concluded that the successful agricultural cooperative of the future is likely to be relatively large, centralized, and market driven. Important changes are already occurring within the federated system of grain marketing and farm supply associations. Regionals are spinning off their previously competing farm supply operations into product-line LLCs, turning grain marketing over to the multinational IOFs, and evolving into food processing firms. At the local level, changes include consolidation of local cooperatives, some large enough to be considered a so-called "super-local."

Not all restructuring needs to result in substantial increases to margins. Restructuring is also successful if it prevents a deterioration that would have otherwise occurred without the change.

At the regional level

The federated regional cooperative traditionally was a single-source supplier of all the important goods and services to local affiliates. Each federated purchased the major farm supplies in bulk for resale to its locals, who then resold them to their farmer-members. Regionals also maintained large facilities where stored grain was gathered, sold, or transported for either domestic processing by other firms or for export through port facilities.

These cooperatives are now openly questioning whether, as structured, they can compete with the large multinational firms in either of their two key functions: providing supplies to their farmer-members or marketing their production. They have initiated new business strategies. While it is too early to predict their success, these changes offer opportunities not likely to arise under the traditional mode of operation.

Coordinated farm supply operations. In recent years, Midwestern federated farm supply cooperatives made major changes in their delivery systems by organizing joint cooperative ventures to coordinate a single market presence.

Agronomy. On February 3, 2000, CHS Cooperatives, Farmland Industries,¹⁵ and Land O'Lakes formed Agrilience LLC. This firm provides crop nutrients, crop protection products, and seed to cooperatives and producer-members in all 50 states, Canada, and Mexico. The venture allows participants to use the fertilizer manufacturing capacity of Farmland and CF Industries more efficiently. It is developing a branded marketing program for crop protection products under the AgriSolutions label.

Feed. Land O'Lakes and Farmland also formed Land O'Lakes Farmland Feed LLC to manufacture and distribute feed. The venture has eliminated duplicate facilities, entered growing specialty markets, and through Land O'Lakes, purchased Purina Mills and its branded feed marketing program.

Energy. In September 1998, CHS and Farmland formed Country Energy LLC to deliver petroleum

¹⁵ This alliance (along with others) was viewed by many as way for Farmland to alleviate the pressure it was under to provide an array of services to its local affiliates despite the financial burden imposed by those services. In June 2002, Farmland Industries was granted bankruptcy protection under Chapter 11 to continue its business operations. According to the petition, this filing was spurred by "continued adverse market condition in the nitrogen fertilizer business and recent increases in cash demands."

products, propane, and lubricants to rural residents. However, energy coordination appears headed toward consolidation within CHS.

Farmland sold its interest in Country Energy to CHS, which owns 75 percent of National Cooperative Refinery Association (NCRA). If Farmland sells its petroleum refinery in Coffeyville, KS, the only two larger refineries in cooperative hands—the CHS refinery in Laurel, MT, and the NCRA facility in McPherson, KS—will be under CHS control. The only other refinery owned by a farmer cooperative is a relatively small unit operated by Countrymark in Mt. Vernon, IN.

A similar coordination in farm supply operations has occurred on the East Coast. In October 1998, Gold Kist sold its farm supply operations to Southern States Cooperative. In July 2000, Southern States began providing product distribution and marketing services to a network of farm supply stores in the Northeast previously served by Agway. Agway has announced plans to exit the agronomy, equipment leasing, seed, and insurance businesses. It will focus on lines of business where it has a strong market position in its trade territory (animal feed, energy product distribution) or sees a brighter future (fresh produce, food industry technology).¹⁶

These examples of joint ventures and restructurings reflect a growing realization among the federated cooperatives that they can no longer afford to aggressively compete against each other for farmer loyalty and business.

Grain marketing alliances with IOFs.

Cooperative grain marketers have created joint ventures with some of the largest grain merchandising and food processing firms in the world that are well positioned to participate in the global market.

In 1985, GROWMARK sold its river grain-marketing terminals to ADM for ADM stock. These elevators are operated by ADM/GROWMARK, a subsidiary of ADM. GROWMARK locals are encouraged to deliv-

er their grain to ADM/GROWMARK; ADM pays GROWMARK an origination fee for grain supplied by its members. Indiana Grain also formed a similar venture with ADM.

In May 2001, Farmland placed its domestic grain operations into a similar grain marketing joint venture with ADM, called ADM-Farmland, Inc. The new company leases and manages Farmland's 24 grain elevators in North America. In a related development, on March 5, 2002, Farmland announced plans to exit the international grain trading business by selling or liquidating its Tradigrain operations. Both agreements place ADM in the forefront of marketing the grain grown by farmer-members of local associations affiliated with these federated regional cooperatives.

In September 2002, Southern States Cooperative entered into a long-term lease agreement turning control of its 13 grain facilities over to Perdue Farms, which will operate the facilities. Southern States emphasized the need to reduce companies in the market and provide growers with more marketing options than Southern States could make available.¹⁷

Not all cooperative-originated grain is subject to a marketing arrangement with an investor-owned firm. For example, CHS markets substantial amounts of member-produced grain. But the trend over recent years has been toward affiliation with a global grain marketing company.

Food processing growth. Midwestern federated cooperatives have reduced their direct involvement in farm supply and grain marketing and redirected their resources to become food processing cooperatives. Farmland Industries and CHS Cooperatives are moving toward the model created many decades ago by Land O'Lakes (LOL). LOL members have enjoyed returns produced by the cooperative's prominent position in the branded butter and dairy foods markets for many years. This provided the financial strength and positive exposure to develop a farm supply line that supports dairy production and allows the cooperative to diversify its business without diluting its focus. One panelist suggested cooperatives that wish to succeed in the 21st century may need to follow this model: pick a product line where they can be successful on a national/international scale; build a structure (including joint ventures) to accomplish that objective, and convince growers to finance it (not pay half the earnings out as cash patronage refunds every year).

¹⁶ Agway News Release, "Agway Announces Plan to Strengthen, Refocus the Cooperative," March 6, 2002. Agway has, like Farmland Industries (see note 15), filed voluntary petitions to reorganize under Chapter 11 of the U.S. Bankruptcy Code. Agway cited insufficient cash flow to support the level of its debt as the reason for its action. At the time this paper was written, Agway had sold its insurance business and was negotiating to sell its seed, agronomy, and equipment leasing assets to reduce its debt load. Agway News Release, "Agway, Inc., Intends to File for Chapter 11 Reorganization to Restructure Finances and Reduce Debt," September 30, 2002.

¹⁷ Southern States news release, "Southern States Announces Grain Facilities Agreement with Perdue Farms Inc.," Sept. 17, 2002.

Farmland Industries chose to enter the processed meats business. Its affiliate, Farmland Foods, produces a full line of pork products. Funds are being invested in research and development and on advertising to build the Farmland CaseReady Brand. Food service agreements are in place with restaurant chains, hotels, Kroger, and Wal-Mart Super-centers.

Farmland National Beef, owned by Farmland and U.S. Premium Beef, is already the fourth largest beef processor in the United States. The venture's "CaseReady" beef is sold nationally through Wal-Mart. This unit is also looking overseas and has captured 20 percent of the market for chilled beef in Japan.

CHS is building a foundation as a processor and marketer of grain-based consumer products. CHS owns a 50 percent ownership interest in Ventura Foods, LLC, which generates \$1 billion annually in sales of margarine, salad dressings, and related products. This investment links back to CHS's soybean crushing and refining operations in Mankato, MN. Ventura Foods owns established brand names in Hidden Valley salad dressings and Saffola edible oil products.

In June 2000, CHS purchased Sparta Foods, Inc., a major manufacturer of tortillas and related products, opening new opportunities for its wheat, corn, and oilseeds producing members. CHS also entered the organic foods sector by purchasing an interest in Rocky Mountain Milling, LLC, a small organic flour mill in Platteville, CO.

On January 11, 2001, CHS and Cargill, Inc., announced a wheat milling joint venture known as Horizon Milling, LLC. It combines five CHS mills with 16 Cargill mills into a nationwide network that will retain the flour brand names of both companies and explore new branded product opportunities. Cargill manages the joint venture company.

CHS has also launched Oilseed Partners, LLC, a joint venture with 450 North Dakota producers. It crushes and markets crambe.¹⁸

In 1998, Gold Kist, Inc., sold its farm supply business to Southern States. Currently, Gold Kist's only major line of business is processing and marketing poultry products, although it also has a unit that markets pork products.

Gold Kist is now the second largest poultry processor in the United States. It markets a complete line of chicken products, Cornish hens, and processed

poultry products under its Gold Kist Farms brand name. An unanswered question is whether other full-service cooperatives will, or should, follow the example of Gold Kist and jettison all farm supply operations in favor of a total commitment to food marketing.

At the local level

Some local associations are bolstering their grain marketing and supply distribution business by transforming themselves into larger, centralized cooperatives. They have the strength to finance and manage investments in facility and service upgrades. In turn, they are becoming less dependent on the federated system for products and services.

Consolidation into super locals. Local cooperatives need the capacity to serve tomorrow's producer. When a commercial farmer has a large harvest of grain to be stored and marketed, the local cooperative facility must be able to handle it or that business will go elsewhere.

Like other elements of agri-business, local grain marketing and farm supply cooperatives are consolidating to form centralized "super locals." They cover a multi-county area and often accumulate sufficient capital to construct modern, high-volume grain elevators along a railroad main line. They can also provide a large enough market to attract favorable bids from providers of farm supplies.

In Iowa, as with other states, the rate of concentration is accelerating. Twenty percent of all grain and farm supply business is conducted by the largest 5 cooperatives. The largest 10 cooperatives conduct up to 35 percent of the grain and farm supply business.

The trend to create super-locals with a centralized structure will continue. Some may approach the size of existing regionals, but will have a single board and management team.

Some consolidation will be voluntary to take advantage of economies of scale, access to better financing options, and increased market power. Some will be involuntary, as floundering locals are merged into stronger associations. Some locals will simply cease to exist. Because alternative uses for a grain elevator are limited, the producer-owners of associations may lose most or all of their equity.

Super-locals will have fewer but larger physical facilities. They will purchase supplies for members wherever they can be obtained at the lowest cost consistent with good delivery service. Often, they won't take delivery of the product but will simply process orders with the supplies being sent directly from the manufacturer to the farm. Likewise, they will market

¹⁸ Crambe is a member of the mustard family, grown primarily in North Dakota. When crushed, its seeds produce an oil suitable for non-food, industrial uses.

member grain wherever they can get the best overall terms. A growing portion may be sold under contracts signed with private grain companies. These contracts may be part of a joint venture or alliance arrangement. The grain-marketing firm may help finance the cooperative elevator(s) in return for an assured supply of product at a reasonable price.

The business environment surrounding super-locals that only market grain and provide farm supplies will likely limit them to modest margins. Multinational grain companies prefer not to tie up their capital in rural storage facilities and will continue to support the origination role of cooperatives. Therefore, grain-marketing contracts will provide enough of a spread over cost for the association to cover business expenses. But the cooperatives won't be able to negotiate highly favorable contracts because they face so much competition from other growers throughout the country and around the world.

Emphasis on getting the best deal. Super-locals are considered a mixed blessing by federated cooperatives. They eliminate redundant facilities and staff and are generally more efficient than the locals that preceded them. They are also large enough to hire staff expertise and negotiate contracts with other firms. This gives them a measure of independence not enjoyed by their predecessors.

Super-locals have a full share of responsibility for a loss of some of the social or personal relationships associated with local cooperatives. Farmer loyalty, to the extent it still exists, is often based on a personal relationship with a local cooperative official, often the manager or a director. The emergence of super-locals diminishes those personal relationships.

The evolution of the cooperative grain marketing and farm supply system can be expected to continue in a rapid manner. The outcome is uncertain. There is near-unanimous agreement that small, isolated locals face a bleak future. And some recent mergers are considered simply a step toward an inevitable liquidation. Beyond that, the only certainty is that farmers and their elected leadership face difficult decisions as they guide their cooperatives in the years ahead.

Priorities for Shaping Future Cooperatives

Two themes permeate strategies for cooperatives to succeed in the 21st century. The first is that greater investment is needed in the people who make up cooperatives. Members, directors, managers, and advisers must receive the training required to deal with 21st century issues. Otherwise, they will neither completely understand the options available nor have the ability to analyze them and make sound business decisions.

The second is that an emphasis must be placed on pragmatism and profitability. Cooperatives are businesses and in the years ahead they must focus on solving business problems and providing value to their members. If they don't, members will stop patronizing them and they will just fade away.

Strengthening cooperative leadership

Little positive can happen for cooperatives unless they have leadership able to meet the challenges of the 21st century. Skills required to lead cooperatives must be identified and developed in directors and managers.

Directors

The board of directors is the central element of producer control in a cooperative. Directors are elected by the members to set policy and oversee its implementation. Most directors are cooperative members. Today's cooperative board is likely to be composed of older producers with a great deal of knowledge about production agriculture but limited experience and skills needed to deal with the external business forces bearing on cooperatives.

As the business environment evolves, farmers find it more difficult to manage their enlarging enterprises and keep abreast of marketplace changes. As one educator suggested in the extreme, trying to talk research and development, advertising, marketing, and supply chain management with a board of producers "is like examining Shakespeare." It is simply a foreign language to them. They just see short-term costs.

To broaden the experiences represented on their boards, cooperatives might pursue greater involvement of their absentee landlord members in the governance process. Off-farm owners are frequently treated with indifference, if not contempt. Yet, they may be

very knowledgeable about farming and cooperatives. Many are children of full-time farmers who were raised on the farm but left to pursue other opportunities. They are often still active in farm management. If they will serve on the board, they may be excellent directors because they bring experience not otherwise available to full-time farmers.

Outside directors. Panelists repeatedly urged the inclusion of one or more outside directors on cooperative boards. Outside directors are typically non-members who are experts in areas vital to the association but normally outside the experience of producers, such as finance and marketing. Preferably, the outside directors are given a genuine role in the cooperative's leadership by making them voting directors, not just advisors. Grower control is maintained by giving them power to remove outside directors that fail to meet their approval. If the cooperative's State incorporation law restricts board membership exclusively to members, non-voting advisers can provide some of the same outside assistance.¹⁹

Panelists said that board meetings involving outside directors tend to stay on topic and run smoother than producer-only boards. They also said outside directors bring objectivity to a board that has problems with conflict-of-interest issues, as occurs when the best interests of some directors may not be the same as the best interests of the association or the membership as a whole.

While outside directors may offer many benefits, the choice of who to bring in is extremely important. To be effective, an outside director must understand cooperative principles and practices and the special burdens inherent in managing a cooperative. An outside director must be compatible with the farmer-directors and understand the issues that producers and the cooperative face in the marketplace.

Outside directors cannot be too closely aligned with the manager. A strength of cooperatives is that directors are chosen by the membership, not management. While management may recommend people to fill outside director seats, producer control over the selection and retention of outside directorships is essential.

Producer directors must avoid being over-awed by the outsiders. The outsiders may have a polish that entices the farmers to just accept their word without real challenge. If that happens, the purpose of the out-

side directors is subverted. They aren't adding their knowledge to that of the producer directors, but rather eliminating the element of control the farmer directors were elected to exercise.

One governance system used in a limited number of instances is the two-board structure exemplified by the Welch's grape growers. Thirteen grower-members serve as directors for the National Grape Cooperative.²⁰ This board is responsible for the operation of the cooperative, such as membership and raw product issues.

The National Grape board controls Welch's, its wholly owned cooperative subsidiary, by electing Welch's board of directors. But Welch's is governed by a separate board consisting of four National Grape directors, two executive officers of Welch's, and four outside professional people.

This arrangement separates direct control of decision-making for the processed foods operation from the parochial politics and general reluctance to act that is commonly associated with grower-dominated boards. The decisions of the Welch's board are consistently unanimous because the outside directors have learned to appreciate grower needs and can explain to them why some services they may want can't be provided because of business reasons.

One specific advantage of this system is that it frees the cooperative to make arrangements with other firms without securing approval from the farmer board. A panelist used this example. Suppose a marketing cooperative was participating in a joint venture that needed an artificial substitute for a member product in a processed product. Under this system of control, it wouldn't have to deal with farmer directors who would likely say "you can't do that." This structure allows the cooperative to base decisions on economics, with a minimum concern for politics.

This section is not intended to suggest that farmer directors aren't doing, or can't do, a good job. Many large and successful agricultural cooperatives are governed entirely by farmer members. Many producers have acquired the skills necessary to be effective cooperative directors. And it is the level of competency, not one's status as a farmer or outside director, that matters.

¹⁹ Some question the use of outside directors for expertise that might be available from management or advisory consultants.

²⁰ Welch's was a family-controlled business for decades. In 1945, growers who sold grapes to Welch's formed the National Grape Cooperative. In 1952, the Welch family sold its business to the grower cooperative.

But when a cooperative integrates its marketing activities forward into processing and marketing, the impact of the external forces discussed earlier in this report increases. As the world in which cooperatives operate becomes more complex and corporate strategies are further removed from the farmer's natural comfort zone of agricultural production, the learning curve for farmer-directors becomes increasingly steeper. It's not that farmers can't fulfill this role, but that a process of identifying, electing, and training the ones who can is proving difficult. This is leading cooperatives, who need a board with diverse expertise and experience, to turn outside the membership.

Director training. Another step to improved board performance is for cooperatives and groups that support them to place new emphasis on director training. Too many cooperative leaders and advisers look at education as a cost, rather than an investment. Whenever times get tight, cooperatives, their trade associations, universities, and Government agencies tend to cut or eliminate training budgets.

Each cooperative must assess the skill deficiencies of directors and develop programs to eliminate weakness. Training takes resources. But the benefits far outweigh the expenses incurred if it helps directors avoid making poor or uninformed decisions because they lack the ability to assess the implications of various courses of action.

Director compensation. Cooperatives should also consider reasonable compensation for their directors. All cooperatives should, at a minimum, reimburse directors for any out-of-pocket costs incurred in their official duties. As cooperatives come to expect more of their directors, being a good director will take more time and expertise. Paying for that time and expertise will encourage more members to run for the board, stimulate directors to attend board meetings, and demonstrate that members appreciate the efforts of the directors. Experts may refuse to serve as outside directors on a gratuitous basis and reasonable fees should be included in a plan to add outside directors to the board.

However, cooperatives must be cautious not to set payments or honorariums to directors too high. Directors who seek office because of its income potential can be expected to make decisions based on how they can stay on the board, rather than the best interests of the membership.

Like training, director compensation should be treated as an investment, not a cost. It will help develop a leadership team that can successfully guide the cooperative over the hurdles of the 21st century.

Managers

A good manager knows both the business and the special culture of the cooperative. Attracting and retaining good managers is not an exact science. But cooperatives might focus on two areas in improving the performance of their management team.

Developing management from within. The manager arguably holds the most important position in a cooperative, outside of the board of directors itself. It is imperative that cooperative boards find and hire a person who can effectively carry out the duties required. Many cooperatives find that promoting internally, rather than hiring from outside the cooperative system, is the most beneficial way of picking a new CEO/manager. Some experts surmise that even with a professional CEO search, a cooperative is better off taking the second candidate who is internal rather than the first selection if that candidate comes from an investor-owned firm (IOF) and lacks cooperative management experience.

While there have been some successes, there have also been some major failures of cooperatives that brought in managers from the non-cooperative sector. Managers from the IOF environment often try to push cooperatives toward non-cooperative business practices and principles. It is widely felt that a successful cooperative manager must understand and embrace the unique principles and practices of cooperatives and be able to operate the business within that framework.

Successful managers, like successful athletes, have usually benefitted from natural ability and good coaching. As employees show the ability to become good, or better, managers, the cooperative should provide training and experience that prepares them for increased responsibility. When they are needed, they will be ready to succeed in their new job and help the cooperative succeed as well.

Providing competitive compensation. Many cooperatives struggle with establishing suitable compensation for their manager. Most observers believe that cooperative compensation generally lags behind that paid by comparable IOFs. This is especially true when deferred compensation and stock options for non-cooperative managers are considered.

Some cooperative boards have the reputation of choosing the manager-applicant who will accept the lowest salary and ask for the least vacation time. Successful cooperatives will find it necessary to develop compensation packages that will attract the best person for the job, not the cheapest one. Many cooperatives also struggle with evaluating the CEO/general

manager and adjusting compensation to reflect performance evaluations. These cooperatives usually lack established performance measures and objective standards to tie manager compensation to performance. These associations probably would benefit from the services of a consultant who can develop an evaluation package tailored to their specific situation.

Growth and consolidation among cooperatives

One of the rational responses of producers and cooperatives to the external changes they face is to consolidate. Just 200,000 farmers now do essentially what 7 million did 50 years ago: feed and clothe our nation and much of the rest of the world.

Cooperatives have also consolidated during those years. In 1950, USDA reported that 10,035 farmer marketing and farm supply cooperatives had \$8.7 billion in sales.²¹ By 2000, the number of farmer cooperatives had fallen to 3,346 while total net business volume jumped to nearly \$100 billion.²² Some of this increase in business-volume is due to inflation. But much resulted from increased product volume moving through cooperative associations. Panelists supported cooperative consolidation as a natural and necessary reaction to the consolidation occurring in production agriculture and among their customers and competitors.

Less enthusiasm was expressed about cooperative growth through the acquisition of non-cooperative firms. These are outside the scope of the antitrust immunity under the Capper-Volstead Act. Panelists expressed concern that such moves attract the attention of, and possible challenge from, Federal and State antitrust enforcement agencies.²³

Concentration in production agriculture and among producer associations has led some to ask whether one of the linchpins of public policy support for cooperatives is still valid. Is it still true that many, relatively small, farmers are selling into a market dominated by much larger and more concentrated buyers?

The General Accounting Office (GAO) has addressed this same question. In August, 1989, then

Senators Howard Metzenbaum and Bill Bradley asked GAO to study whether agricultural cooperatives, and particularly dairy cooperatives, still needed the limited antitrust exemption provided by the Capper-Volstead Act. Dairy cooperatives had been under almost constant scrutiny since the period from 1967 to 1971, when 170 predominantly local milk marketing associations combined into 3 large multi-market regional cooperatives—Associated Milk Producers, Inc.; Mid-America Dairymen; and Dairymen, Inc.—with nearly 64,000 producer members.²⁴ GAO concluded:

...dairy farms, in general, remain relatively small compared to the processing and distribution firms that, in the absence of cooperatives, would purchase milk directly from farmers. These firms have...become more concentrated and therefore have the potential for increased market strength. Without cooperatives, many dairy farmers, because of the size of their operations, would continue to be in a relatively weak bargaining position. Therefore, to the extent that the increased market strength of processing and distribution firms and of dairy farmers offset each other, the premise of the Capper-Volstead antitrust exemption for cooperatives—that farmers cannot effectively bargain independently because their operations are too small—remains.²⁵

Thus, GAO substantiated the view of producer association leaders and advisers that consolidation among producers and their cooperatives has been necessary for producers to protect even modest market power in the face of growing concentration among the buyers of agricultural commodities and processed food and fiber products.

Foreign sourcing and functioning in a global market

As competition in both domestic and foreign markets intensifies, and economic growth in developing countries creates new opportunities, cooperatives must formulate new strategies to protect traditional markets and to capture new ones.

²¹ USDA/RBS/Cooperative Services, "Cooperative Historical Statistics," Cooperative Information Report 1, Section 26 (revised April 1998), p. 7.

²² Charles A. Kraenzle et al., "Farmer Cooperative Statistics, 2000," USDA/Rural Business-Cooperative Service, Service Report 60 (December 2001), p. 2.

²³ See, e.g., *United States v. Dairy Farmers of America*, 2001-1 Trade Cases (CCH) 73, 136 (E.D. Pa. 2000) (Department of Justice challenges purchase of branded butter business).

²⁴ Donald A. Frederick, "Antitrust Status of Farmer Cooperatives: The Story of the Capper-Volstead Act," USDA/Rural Business-Cooperative Service, Cooperative Information Report 59 (September 2002), pp. 249-252.

²⁵ United States General Accounting Office, "Dairy Cooperative: Role and Effects of the Capper-Volstead Antitrust Exemption," GAO/RCED-90-186, (September 1990), p. 3.

Because they usually are not tied to a geographically fixed resource base, IOFs are free to respond to globalization by contracting for product from least-cost sources or by moving production or processing operations to less-costly foreign locations.

Cooperatives have also recognized that future growth requires them to look beyond domestic borders and traditional production and marketing systems.

However, cooperatives' user-owner nature and ties to a domestic production base can limit the scope of their involvement in foreign markets.

Because an important role of cooperatives is to ensure a "home" for member products, cooperatives are not free to substitute lower cost imported goods or abandon domestic operations for more profitable overseas locations. They must balance the interests of producer-members with their ability to compete in a dynamic market. "Non-traditional" options can foster long-term viability by enhancing the market position of the cooperative and the marketability of members' products. These options include tapping additional product sources through imports, foreign members, and overseas investment.

Motivation and strategies

Cooperatives share the same motivation as IOFs for sourcing outside traditional channels: the need to compete more effectively in today's rapidly changing markets. Price strategies based on reducing costs or non-price strategies built on adding value to products and services are the approaches most often employed for meeting this need. While domestic member and non-member products may fill some of these needs, foreign sources can offer significant cost savings or an array of unique or seasonal products.

Strategies for enhancing competitiveness vary by type of cooperative and by product handled. For example, supply cooperatives accrue cost savings directly by purchasing from the lowest cost source. Marketing cooperatives cut costs indirectly by supplementing member-grown products with imports. Cooperative marketers of fresh produce use imports to spread overhead costs over broader product lines, and cooperative processors import raw product to lower per-unit processing costs by higher utilization of plant capacity. When cooperatives are not able to position themselves as a low-cost producer, non-price strategies that add value to products or services become increasingly important. Flexibility about sourcing options can facilitate these strategies.

For example, fresh fruit cooperatives can enhance the marketability of member products by using

imports to extend marketing seasons. The ability to "be in the market" on a consistent basis protects carefully cultivated markets and market relationships. Use of foreign product to fill seasonal marketing windows is especially critical now that consumers expect year-round availability of some products. Stable, consistent supplies also help maintain consumer loyalty to branded products.

Imports can be used by a cooperative to broaden its product line. Retailers and wholesalers increasingly seek "one-stop" shopping—buying directly from suppliers who offer complete lines of related products. Purchasing decisions are often based on the supplier's ability to provide a group of products and the total cost of a group of products, rather than the availability and cost of each item. Some cooperatives may have to purchase foreign items to complete a package of products that will attract and retain customers for member product(s).

Purchases of foreign products may also be necessary as a stopgap measure to fulfill marketing commitments when disaster-related member production shortages occur. The need for longer term or permanent supplies can arise when urban expansion and other factors cause a cooperative's membership base to shrink.

Cooperatives must plan strategically for the integration of foreign-sourced product and must commit sufficient resources to managing those sources. Due to their distance from the cooperative's traditional trade area and differences in language, customs, and laws, overseeing foreign providers may prove burdensome for a cooperative.

Cooperatives must exercise caution in foreign sourcing to manage risks associated with transnational memberships or operations and food safety issues. Wholly owned subsidiaries can segregate a cooperative's core member business from non-member business and shield member equity from losses suffered by non-core activities, while allowing the cooperative to maintain full control of that aspect of the business. However, care is required to structure a foreign subsidiary in accordance with the tax and antitrust implications for the parent cooperative.

Imported product can also be handled through contracts or joint ventures with other cooperatives or IOFs. Selection of a method depends on the cooperative's access to equity and operating capital, the level of risk it can accept, desired degree of control, and what it has to offer to the venture.

Legal questions

State and Federal statutes covering permissible cooperative structures and operations do not specifically address the issue of foreign sourcing. However, certain elements in laws affecting cooperatives, such as membership eligibility requirements or allowable levels of non-member business, can influence the form and scope of foreign sourcing activities by cooperatives.

Most State cooperative incorporation statutes limit the proportion of business a cooperative may conduct with non-members to 50 percent. The 50-percent rule is also used to qualify cooperatives for limited antitrust protection under the Capper-Volstead Act, for tax treatment as an exempt cooperative under Section 521 of the Internal Revenue Code, and for borrowing from CoBank. Non-member business conducted specifically with a foreign entity is not addressed. Therefore, the issues surrounding cooperative sourcing from non-members are usually assumed to be similar, regardless of whether the sources are foreign or domestic.

Nor do Federal or State statutes involving cooperatives address the issue of foreign members. State statutes, Capper-Volstead, and Section 521 limit cooperative membership to producers of agricultural products. Beyond that, most statutes allow cooperatives to establish their own membership criteria. Some cooperatives limit membership to a particular State or region. Others have admitted foreign members with no adverse legal consequences.

Taxation of foreign members' income derived from the sale of product in the United States is another legal issue to consider. Generally, it is taxed at the same rates applicable to U.S. citizens and domestic corporations. However, if the United States is party to a tax treaty with a country in which the member resides, this income may be taxable at a lower rate established by treaty between the two countries. Tax treaties prevent international double taxation by limiting the right of each treaty partner to tax income earned from its territory by residents of the other country, and by requiring that the country of residence allow a credit for taxes paid to the source country. A cooperative with foreign members would also be affected if it is required to withhold funds at the U.S. rate or the lower treaty rate for tax purposes, from distributions to foreign members.

Foreign memberships

Global buyers learn to play growers in one country against those in other countries. One possible

grower response is to form international associations to counter-balance the power of multinational buyers and suppliers.

Integrating foreign members into an existing cooperative may require adjustments to the governance structure. For example, direct representation of foreign producer-members on the board of directors might be advisable. Foreign members might comprise a separate district and elect a director to a cooperative's board. The ease with which foreign growers are integrated into a cooperative's membership will also depend on careful attention to managerial or logistical matters, as well as attention to relations with current members.

One food-manufacturing cooperative just voted to admit Canadian members in hopes of acquiring cheaper raw product from across the border. The cooperative expects to lower its selling prices and compete more effectively with other firms. Although the bylaw amendment was adopted, cross-border purchases have not begun. The impact of this decision on the cooperative and its grower-members remains an open question.

Member relations issues

For better or worse, many growers have the same adversarial view toward foreign producers as they do toward other cooperatives and non-cooperative competitors. International joint ventures may be the closest many U.S. cooperatives can come to an alliance with producers outside our borders at this time.

One of the biggest concerns in introducing the subject of foreign sourcing—either on a member or non-member basis—is the perception that the cooperative is competing with its own current members. Marketing cooperatives must justify use of foreign-sourced product to their domestic members. Buying offshore member or non-member products for secondary (ingredient) uses may go unchallenged because the members usually see this as an enhancement, not a threat, to marketing their production. In contrast, members may view any use of foreign product for primary markets as threatening. This can occur even if the cooperative takes all of its members' production and the purchases are for legitimate business purposes, such as fulfilling contractual commitments following weather-related shortfalls or when member-product is not in season.

A cooperative's existing members may resist the admission of foreign members for fear it will dilute their returns on operations or established brand names built with "old" member equity. The use of partitioning

mechanisms—such as subsidiaries or even creation of a separate cooperative—can limit new member participation in activities to which they have not contributed equity capital. Members may also be concerned about preservation of a regional identity for markets in which origin is a point of product differentiation.

Member opposition to the use of foreign products and the admission of foreign growers can often be traced to conflicting views between management and members on the focus of the business and on the mission of a cooperative. Members may view the cooperative primarily as a home for their product. Managers may be striving to maximize earnings of the business. These goals can be totally compatible. Both parties must learn how this can happen and take steps to make sure it does happen.

Cooperative managers are in the best position to recognize the strategic implications of using alternative sources to facilitate better use of processing capacity, to extend fresh product into new markets, to offer a year-round supply, or to offer a broader product line. The key to gaining member support for foreign sourcing alternatives is to effectively convey the rationale for the venture and clearly communicate the benefits that will accrue to members.

Equity Accumulation

Perhaps the most important challenge facing cooperatives is accumulating equity capital. Without sufficient equity, cooperatives cannot meet the external challenges they face or continue to grow and offer services members and customers need.

The degree to which accumulating equity is a problem is influenced by the types of services a cooperative provides. A bargaining association, which limits its activity to negotiating prices and other terms of sale for its members, has a minimal need for capital. The fact that producers can use bargaining to increase their income without a substantial equity investment is one of its advantages. The more an association becomes involved in manufacturing and distribution of either farm supplies or food products, the larger the equity base it is likely to need.

As the demands for equity increase, farmers may be more reluctant or unable to provide the necessary funds. Cooperative leaders must either coax it from them or turn to external sources. In the years ahead, cooperatives will need to employ better equity management strategies and consider structural changes that will make more equity available.

Improve member equity management

Through the years, many cooperatives have successfully used the traditional equity management program—accumulate equity through retained patronage refunds and revolve equity by redeeming the oldest outstanding year's paper each year at face value. As long as redemption is kept on schedule, members rarely question leaving their patronage refunds with the cooperative as they have a reasonable expectation of having them paid out in cash at a definite time. This system may continue to work well for established cooperatives that are comfortable with the markets they serve and new cooperatives with modest capital requirements.

But in the coming years, farmers may seek more rewarding places to invest their financial assets than in cooperative paper that pays no direct return. If a cooperative's equity redemption timetable begins to slip, members may become reluctant to finance it. The fact that the money is used to provide services that augment farm income isn't always enough to convince producers to provide the funding. Cooperatives should examine options to improve the way they manage their member equity.

Marketing cooperatives can also accumulate equity from members through the use of per-unit capital retains. Per-unit retains, which are based on sales rather than earnings, provide a more dependable and predictable equity stream. They also allow for equity accumulation (and redemption) in years when the cooperative's earnings are minimal or it suffers a loss.

Cooperatives may want to consider paying a dividend on retained member equity. These dividends, like interest on debt, would be deducted from margins before patronage refunds are calculated. They are a mild diversion from the user-benefit principle. But dividends would compensate members for the use of their money and reinforce their allegiance to the user-ownership principle. Of course, any money paid as dividends would not be available for patronage refunds.

Cooperatives may also consider adopting a base capital plan. It helps bring investment in line with patronage or, in terms of cooperative principles, balance member-ownership with member-use. A member's capital obligation is determined on the basis of patronage over a base period, say the last 5 years. Newer members, who usually have a small investment in the cooperative but may make great use of its services, leave most of their earnings in the association until they have invested their fair share. Long-time members who have met their equity obligation receive

primarily cash patronage refunds. This usually tempers the resentment of older members toward those new ones taking advantage of the facilities and services developed by the long-time patrons.

Outside equity

Some cooperatives are soliciting outside equity investors. This is another step along the continuum from member-ownership. If the outside investors also acquire a voting interest in the association, both legal issues and conflicts with the user-control principle arise.

Non-voting preferred stock taps the outside equity market while raising only modest concerns over the cooperative status of the association. It can earn a market return and be offered to both members and non-members. Non-voting preferred with a modest dividend has some appeal at the local level, where the purchasers are often other local businesses who can consider it more of a contribution than an investment. Non-voting preferred stock must pay a solid dividend to appeal to disinterested outsiders who have large sums to invest and numerous parties bidding for their attention and funds. Any dividends, of course, reduce net margins available for patronage refunds.

In most instances, cooperatives have not allowed outside investors to acquire a voting interest in the association. Such voting rights would violate the terms of most cooperative incorporation laws. Several Federal policies that support cooperatives, such as the limited antitrust exemption for cooperative marketing under the Capper-Volstead Act, only apply to associations that limit voting to producer-members. And, depending on the extent of the voting power ceded to the outside investors, this also diminishes true member control.

Some experts suggest cooperatives are imprudently rushing to solicit outside equity investors. They recommend other strategies to secure necessary capital. One would be to maximize debt, another to lease facilities and equipment to better leverage existing capital. Either alternative would be less expensive and less divergent from the principles of user- ownership and owner-control.

A number of sources for cooperative funding exist, including private and government grants. For example, USDA's Value Added Development Grants can be used to fund new cooperative value-added ventures. Another option might be to develop a revolving loan program that provides sums similar to those made available to utility cooperatives through USDA's Rural Utilities Service.

Sell assets

Another way for cooperatives to raise equity would be to sell under-performing assets, or those that support services that don't fit into the association's long range strategic plan. For example, as some large federated cooperatives continue to place more emphasis on their value-added food marketing programs, they could begin reducing their direct role in basic farm supply manufacturing. If the move to become food companies is successful, the federated cooperatives may seek infusions of cash to purchase existing processes and brands or to develop new ones themselves. If the strategy fails, they may need infusions of cash to regroup and start over.

Redundant and underperforming assets are most likely to be sold. For example, cooperatives are combining their separate assets for each major farm supply product line into new nationwide structures. These new entities, with their expansive networks of customers and streamlined management structure, will likely be worth more than the separate and competing units within the various federated cooperatives would have been and conceivably could be sold in the right market and for the right price. Panelists identified grain elevators as another class of assets that might be sold, if buyers can be found.

Management initiatives in this direction might meet surprisingly little resistance from the local cooperative owners of the federated regionals. Locals are becoming less dependent on federateds for supplies and outlets for member grain. Panelists suggested that locals' reduced dependence on regionals may lead them to decisions that could greatly change the "cooperative system" as we know it. The locals could vote themselves a portion of the cash realized from assets sales and still have an ownership interest in a value-added food manufacturing cooperative. If they wanted to generate additional cash through the sale of that asset as well, their options might include conveying that interest to the producers providing raw farm products to the food manufacturing units (for a price); converting it to a non-cooperative structure so each could sell its ownership interest whenever it chose; or selling the firm in a single transaction.

Persons interested in maintaining a diversified cooperative presence in agriculture must be aware that these options have great appeal as a way to reduce redundant and underperforming assets to free up and redirect existing value tied up in traditional cooperatives. They may have the burden of proof to demonstrate that farm supply manufacturing, for example, is a preferential use of farmer-assets.

Structural alternatives

Some producers are looking at new ways to organize. These new structures offer alternative approaches to meeting the challenges of the 21st century.

New generation cooperatives

Farmers starting new cooperatives sometimes use the so-called "new generation" model. Thus far, this model has only been used to form agricultural marketing cooperatives engaged in value-added processing. These cooperatives may offer an alternative to overcome the problems confronting more traditional cooperative models without abandoning the principles that distinguish a true cooperative from other forms of business organization.

Similarities to traditional cooperatives. New generation cooperatives are similar to traditional marketing cooperatives in several ways:

- A. Only farmers can be voting members.
- B. Members reach decisions on the basis of one-member, one-vote.
or
Dividends on stock may not exceed 8 percent per year.
- C. The value of products handled for members exceeds that handled for nonmembers.
- D. Earnings are allocated to patrons on the basis of patronage.

Differences Between New Generation and Traditional Cooperatives. New generation cooperatives also differ from the traditional cooperative model in several important ways:

A. Focus

- 1. Traditional agricultural marketing associations usually seek to maximize the volume of product handled to secure economies of scale and market power.
- 2. New generation cooperatives seek to identify and obtain the volume of farm production that can be processed and sold consistently at a profit.

B. Membership

- 1. Traditional cooperatives usually have an "open" membership. They seek to sign up the largest possible number of eligible producers to maximize the volume of product handled.
- 2. New generation cooperatives have a

limited or "closed" membership. Once eligible producers have contracted to deliver the desired level of product, membership is closed.

C. Member Delivery Obligations

1. Traditional cooperatives usually either accept (a) whatever production the members choose to deliver or (b) require the members to deliver all they produce or whatever is grown on designated land. Under any of these scenarios, the cooperative receives an uncertain and varying amount of product each year that it is expected to "move" before the next crop arrives.

2. In a new generation cooperative, each member has the right to and is obligated to deliver a fixed quantity of product each year. This is true whether the member produces more or less of that product in a given year. Meeting a production shortfall or "moving" surplus production is the responsibility of the producer-member, not the cooperative.

D. Member Equity Investment

1. Traditional cooperatives usually require a minimal, uniform investment to join. This is consistent with recruiting the largest possible membership base and volume of production. Equity is accumulated over time through retained earnings and per-unit retains.

2. New generation cooperatives usually require a substantial up-front investment. The individual investments are not uniform but differ in proportion to the amount of product the member agrees to deliver to the association each year.

E. Equity Transferability

1. In a traditional cooperative, both the up-front investment and member equity accumulated through retained patronage refunds and per-unit retains can only be redeemed by selling it back to the cooperative at face value.

2. In a new generation cooperative, equity tied to the right to deliver product can only be resold to other producers eligible to use the service of the cooperative. Subject to approval from the board of directors, the transfer can take place at whatever price the parties can agree to, whether it is more or less than the price paid by the seller.

If a traditional marketing cooperative is successful, the farmer-members receive two principal benefits:

1. A home at a fair price for their production.
2. Patronage refunds.

In a new generation cooperative, farmer-members can realize additional benefits:

3. The option of cashing out their equity investment when they want to reduce or cease their dealings with the cooperative.
4. The opportunity to make a capital gain on their equity investment in their cooperative.

Several panelists touted new-generation cooperatives as well suited to solve many of the problems confronting traditional cooperatives. Members may have limited loyalty to traditional cooperatives because they don't have to make a meaningful investment to be a member. And they can cease doing business with a cooperative and then return again as a patron at no cost. This isn't possible in a new generation cooperative. The members' patronage obligations are tied directly to their level of up-front investment, which is often substantial.

Panelists said one of the allures of new generation cooperatives is that they create a new base of homogeneous members. Because they require a substantial up-front investment and an obligation to deliver a block of product each year, the members tend to be younger, better educated, and larger commercial farmers who focus on profitability and, more specifically, the value of their transferable delivery rights.

The manager of a new generation cooperative reported that at member solicitation meetings the older farmers sat in the back and showed no interest while the next generation, their sons and daughters, listened intently. Another said that at one organizational meeting a wife, who was a banker and supporting the family, literally grabbed her farmer-husband and made him sign up.

Traditionally, cooperatives have usually been organized to sell whatever product(s) the members wanted to produce. Many new generation cooperatives are developed on the basis of a marketing plan from a different perspective. The founders identify products consumers want that can be made from what local farmers produce and work with members to help them grow commodities that can be processed into products that satisfy consumer demands.

Quality control can be a sticking point with new generation cooperatives. Left to their own devices, farmers will continue to produce what they have always produced and expect the cooperative to turn it

into a quality product. A new generation cooperative manager said that the hardest thing he had to do early on was tell many of the members that the product they were delivering simply wasn't good enough. In an association started from the bottom-up, he probably would have been told to make it work or leave. But in a top-down situation, he had time to educate them on the need to meet quality standards and how to do it.

A manager of a multi-function cooperative questioned whether a weakness in new generation cooperatives might be their lack of product diversity. They focus on one commodity and one product. If that market deteriorates, so will the cooperative. North American Bison Cooperative was offered as an example. A panelist said it was doing quite well in Europe until the Mad Cow scare drove people away from meat. New generation supporters counter that they can focus on what they do best and aren't forced to balance conflicting interests.

One panelist suggested that if new generation cooperatives become a major force in various food product lines, they will need an effective communications program to educate consumers on their role. One point to emphasize is that cooperatives don't increase the grocery store price of food. They only reallocate more of the consumer's dollar from middlemen to farmers.

Alliances and joint ventures

For a long time, producers and smaller cooperatives that wanted to enter a business that required assets beyond their reach would affiliate with other cooperatives in the same position to form federated associations. Few new federated cooperatives are being formed today. As we enter the 21st century, the favored strategy for combining the resources of cooperatives, with each other and with non-cooperative firms, is the joint venture.

A joint venture is a business entity, created and supported by other businesses, that has a limited objective related to solving a problem facing each of its owners. Cooperatives are, in this sense, a joint venture. They are formed by their members to provide quality goods and services the members need at the lowest possible cost. The venture may be organized as an Limited Liability Company (LLC), partnership, corporation, cooperative, unincorporated association, or merely a contractual arrangement.

Cooperatives are part of successful joint ventures involving a variety of products and venture partners. A dairy cooperative formed a joint venture with the number one marketer of mozzarella cheese. The coop-

erative supplied the milk and most of the equity capital. The cheese company provided management and marketing. The cooperative received a modest premium for its milk and the two firms split the profits. It became a "win-win" situation for both parties.

Another joint venture with an IOF allows a cooperative to behave as a contract (custom) producing agent for a branded product. Agri-Mark purchased a cheese plant from Kraft, which freed Kraft's assets for market development. Agri-Mark sources member milk to make Kraft brand Cracker Barrel cheese. Kraft markets the cheese and pays Agri-Mark a per-unit manufacturing fee sufficient to assure that Agri-Mark has minimal risk and a healthy profit margin.

In January 2002, USDA approved the use of a protein found in dairy products on beef to protect it from *E. coli*, salmonella, and other harmful bacteria. The process was developed by LF Ventures in a joint partnership with Farmland National Beef, the nation's fourth largest beef company, and DMV International, a unit of Campina, a Netherlands-based dairy company. Farmland National Beef is itself a partnership between Farmland Industries, the nation's largest multi-functional cooperative, and U.S. Premium Beef, a young new generation cooperative of beef cattle producers and feeders. In this example, an important food-safety breakthrough was developed by a research and development operation funded by a joint venture among a European firm, a federated U.S. cooperative, and a new generation cooperative.

Late in 2001, Golden Oval Eggs, another new generation cooperative, announced a joint research and development, processing, and marketing alliance with Inovatech Egg Products, a world-wide marketer of value-added, specialty egg products based in British Columbia, but recently acquired by Michael Foods of Minnetonka, MN. The two firms intend to build a new plant in Thompson, MN, to manufacture food ingredients for food manufacturers throughout the world.

These ventures, and others like them, are not guaranteed successes. Raising the equity from farmers to even get off the ground can itself be a challenge. But they illustrate that cooperatives are looking in new directions for opportunities and adopting suitable, innovative structures to take advantage of those opportunities.

Sometimes a venture needs to expand its ownership base to achieve its objective. ProGold started as a joint venture of sugar beet marketing cooperatives and corn growers to produce sweeteners. It faltered initially, however, because the owners were too small to adequately finance and otherwise position their new ven-

ture in the marketplace. After the member cooperatives recognized their inadequacies, they invited Cargill to participate. Cargill assumed plant management and product distribution responsibilities and continues as a partner in the venture.

One suggested approach to the consolidation trend among grocery chains is for food product cooperatives to form alliances with the other chains. One such opportunity might be with the largely overlooked grocery wholesale cooperatives. Several are substantial businesses with annual revenues in excess of \$3 billion. They are also dispersed around the country and near major metropolitan centers.²⁶ Some panelists suggested that a single, national food cooperative may be the only way farmers and other smaller entities will be able to participate in the real profits of the food industry of the future.

Joint ventures allow cooperatives to pool resources—product, people, facilities, and financing—with any other entity it chooses to solve a problem or seize an opportunity, without disrupting the ongoing cooperative business organization or operations. These arrangements may provide a means to conduct due diligence and to build trust among two firms considering merger.

Another advantage of growing through joint ventures is that, unlike a consolidation or acquisition, a joint venture that doesn't meet its objectives may often be disbanded without becoming a major disruption to the participants. Joint ventures can be short-lived or continue for decades. Ventures tend to continue for as long as they meet the objectives of the participants. But because a joint venture is less stable than an integrated company, a cooperative should have an exit strategy from the beginning of the relationship.

The boards of larger cooperatives tend to accept joint venture failure (so long as it doesn't become a habit) as a manageable risk of trying new approaches to solve problems and seizing opportunities. Joint ven-

²⁶ The National Cooperative Bank listing of the 100 largest cooperatives by sales for 2000 has agricultural cooperatives in the top four slots (Farmland Industries, CHS Cooperatives, Dairy Farmers of America, and Land O'Lakes). Four of the next 5 associations listed are grocery wholesalers (Wakefern Foods, TOPCO Associates, Associated Wholesale Grocers, and Unified Western Grocers).

However, wholesale grocery cooperatives are also facing challenges. Some of their bigger and more successful members are being acquired by larger chains, leaving the cooperatives with the same fixed costs but must lower sales and income streams to support those costs. "How to Prevent Success from Ruining Your Cooperative," *Cooperative Business Journal*, (June 2002), p. 7.

tures are more risky for the manager of a local cooperative. When locals enter into joint ventures, especially ones that the farmers don't really understand, and the venture doesn't meet expectations, the manager is frequently fired. Farmers remember every promise of prosperity they were told the venture would bring, and feel betrayed by poor results.

Sometimes locals form joint ventures (feed mill, fertilizer plant) when they really should merge. This is often viewed as a prudent first step in a sequence of consolidating events. It helps the two feel more comfortable with each other, provides for friendlier due diligence, and if all goes well may lead to a merger.

The trend of cooperative involvement in joint ventures is expected to continue in the 21st century. So long as producers avoid the same pitfalls that can subvert the use of outside directors—having venture partners too closely aligned with management or being overawed by their venture partners—joint ventures can make it possible for producers to pursue otherwise unreachable opportunities.

Bargaining associations

Producer associations that limit their cooperative activity to negotiating prices and other terms of sale are called bargaining associations. They have been used for decades by dairy farmers and growers of fruits and vegetables used in processing. Producer-members of these associations have chosen to limit the extent of their joint marketing activity.

Bargaining associations have worked best where supply can be controlled. Supplies may be limited in different ways. If a crop can only be grown commercially in a limited geographic area, then supply is limited to what can be grown on those acres. If a product is highly perishable, supply is limited to what can be sold or processed quickly. Supply can be controlled by Government regulation. Bargaining associations have been particularly effective in commodities with agricultural marketing orders in place.

An offshoot of an industrializing agriculture is the trend toward fully integrated processors dominating the entire production cycle for poultry and meat products, and to a lesser (but increasing) extent, basic commodities. Growers in these systems contract to raise animals and crops owned by the processor. Yet they continue to be land owners, owners of production facilities, and provide production management of crops and livestock under contract.

An organizational option for contract growers is to form cooperative bargaining associations or professional associations for negotiating contract terms. This

type of association is relatively new and untested in industrializing agriculture. However, the American Farm Bureau Federation's American Agricultural Marketing Association developed considerable experience with its poultry grower division in the 1960-70 time period.

More recently, the National Contract Poultry Growers Association (NCPGA) has attempted to organize broiler growers for negotiating contracts. Processor intimidation has been a continuing problem in organizing such associations. This makes organizing contract growers more difficult and achieving a critical mass of grower membership a major challenge.

Limited market innovations

Some producer groups are experimenting with new uses for traditional cooperative structures or interesting derivatives.

Small farmer cooperatives. Small-volume farmers will remain an important part of the social and economic infrastructure of rural America. The push toward greater efficiencies and scale within production agriculture and cooperatives ignores the needs of small farmers. It also ignores the benefits to small farmers that cooperatives can provide.

Cooperatives will not lower small farmer per-unit costs to the level of costs to larger farmers. But cooperative buying can lower small farmer costs. Cooperatives might not be able to provide small farms with access to Wal-Mart or other major market players, but may none-the-less improve their overall returns by servicing local and regional markets.

Cooperatives may not save the small farm as an institution, but can improve the returns achieved by small farmers. Small farmers must explore options for working together. Existing cooperatives must work to develop programs to provide services to small farmers in a manner that recognizes differential costs, but otherwise provides fair access to the power of cooperative behavior.

Niche-market cooperatives. Some local cooperatives are seeking to serve a specialized clientele. These cooperatives don't strive to become large because their small customer base wants specialized products and/or services. Others are small by nature of the product they handle and the territory where it can be grown. While some of these cooperatives may be very successful, the opportunities they represent and their overall impact are both limited.

If a cooperative decides to be small, it must be very good. A cooperative comprised of 10 dairy

farmer-members, for example, does quite well because it makes award-winning cheese. Opportunities exist, but niche marketing isn't a guaranteed path to success.

One segment of food marketing that hopes to become more than a niche is organic foods. Cooperatives in this area are clearly responding to the environmental pressures on the food industry. So far, only a small number of consumers have been willing to pay higher prices to buy organic products. Cooperatives need to watch how the organic market, and other smaller markets such as various ethnic foods, develop. Such specialties offer another opportunity to become successful in value-added processing without necessarily having to compete with the industry giants.

Production-service cooperatives. Cooperatives that provide production services to their members offer a way for producers to become more productive by lowering their costs. For example, six grain farmers formed an LLC that works as a production services cooperative. Each member sold all his equipment and with the proceeds they purchased new equipment, consolidated their land, and operate as a single farm enterprise. They believe they can survive as producers now that their operating costs are significantly lower.

Education

Cooperatives have a tradition of educating their membership, leadership, and staff in both the principles of cooperation and sound business practices. However, in recent years, national and regional programs have been de-emphasized to redirect resources to meeting short-term profitability goals.

Educating employees and young members is an important part of leadership development. Some cooperatives do well in this area, sending employees to the Graduate Institute of Cooperative Leadership held annually at the University of Missouri, Columbia, MO, and other workshops and conducting active young farmer/cooperator programs. Others need to do more.

Training is critically important for directors. They must have the ability to learn and the time to be trained in areas in which they lack experience and expertise. Increasingly complex financial issues and business arrangements of cooperatives require directors to have substantial knowledge and/or experience in related business matters. Cooperatives must create an opportunity for directors to gain knowledge in areas in which they lack understanding.

Directors especially need to understand their role in the cooperative. Too many directors want to become involved in the day-to-day decision making, the realm

of the hired management. Directors need to learn more about their responsibilities in setting policy and overseeing the manager and not to directly interfere with the manager's handling of routine operations.

More attention is also needed to help directors understand cooperative finance and related business issues, so they can decipher complex financial reports, contracts, and proposals.

Continued structural change in cooperatives also imposes demands on directors to effectively assess various strategic options. Directors must learn how to evaluate restructuring proposals to determine whether a new organizational framework is necessary and, if so, how it should be designed and operated.

Cooperative leaders must seriously re-evaluate whether educational institutions are in place at universities, trade associations, other support organizations, and USDA that will provide the meaningful education effort needed to handle the issues of the 21st century. In addition, cooperatives must also evaluate their own commitment to education to improve the skills their leaders will need to realize the potential of their organization.

Public Policy and Cooperatives

Government has been, and will continue to be, a major influence on both agricultural producers and their cooperatives. Some governmental policies support cooperatives, while others present challenges. As the number of farmers continues to decline, it will become increasingly difficult to make the voices of farmers and their cooperatives heard in the public policy process.

Cooperatives provide a vehicle for people to organize for effective political action. They can gather to develop priorities and strategies. They can send representatives to meet with legislators and regulators. These persons will have more influence because they will be speaking for many, not just themselves. Cooperatives can also form coalitions with other groups having similar views on issues. The larger the voice calling for a specific action, the more likely that the system will respond with a favorable policy outcome.

But having the tools available is only one part of the equation creating favorable policies. The other is the willingness and skill to use those tools effectively.

Making member voices heard

Panelists agreed that a key factor in the long-term political support for farmer cooperative interests will be the willingness of the farmer members to become more active in the public policy process. Cooperative lobbying organizations receive good marks for their effectiveness, especially considering the reluctance of farmer-members to contact legislators and become directly involved in the legislative process affecting cooperatives.

This reluctance has at least two sources. Farmers are sometimes adverse to having their cooperatives involved in any political activity. They view politics as a "dirty" business that will taint the organization if it becomes involved in lobbying.

Many farmers also believe they are paying good money to support numerous commodity and general farm organizations. Farmers rationalize that it's the job of these associations to get the public policies needed. While these organizations may be supportive of cooperative-specific initiatives, they generally place most emphasis on broader farm-policy issues.

Cooperatives don't need to be involved in all public issues facing farmers. One panelist pointed out that cooperatives with a high-profile identity may find it bad business to oppose certain popular policy positions, even when members' farm interests are at stake. For example, a cooperative with a consumer products brand name may not want that brand portrayed as opposed to an environmental initiative, no matter how harmful it might be to grower members. In these instances, the cooperative may choose to take a low profile and let general farm trade associations carry on the battle.

Members must recognize that there are times when their cooperatives should stay out of public policy deliberations, but other times when only cooperatives can represent their public policy interests. Farmers must make sure their "cooperative interests" are appropriately expressed in public policy settings.

A related issue is the historic lack of "cooperative-oriented people" in high administration positions. While the doorway between the IOF world and public administrative / policy positions is two-way, it is rare to find a person who left a cooperative to accept a political appointment with a Federal agency. When cooperative leaders complain about the lack of support for and understanding of cooperatives among policymakers, they must accept some of the blame for not showing an interest in placing people in positions inside the administration's inner circles who set policy.

Political action skills should be a component of the education of cooperative leaders. An effective political action program requires a combination of lobbyists who can work within the complex structures of the legislative and administrative bodies and directors, members, and managers who will reinforce the message to their representatives that the issues being discussed really are important to them. Cooperative members need to be trained in advocating their positions. This will translate into support for specific cooperative policy being communicated to legislators and other Government leaders by their trade association leaders and spokespersons.

Trade association cooperation

While cooperative trade associations have generally been effective, their overall impact is limited by a tendency to concentrate on narrow issues that directly affect their membership. Unless an issue is of direct importance to their segment of the cooperative community, they hesitate to get involved. Panelists viewed this as a barrier to enacting legislation that might benefit both the various segments and the cooperative community as a whole.

To increase their influence in the future, cooperative trade associations will need to work more closely together. For example, one State cooperative council executive noted that he has a friend who manages a large urban housing cooperative. When an issue important to his farmer cooperative members comes up before Congress, he calls his urban friend. If housing cooperatives are neutral on the issue, his friend will contact his delegation and urge a vote for the farmer cooperative position. In return, on housing cooperatives matters, the cooperative council leader will put in a good word as long as no important interests in his State are known to object to the proposal. By working together, the interests of both farmer and housing cooperatives are better served.

Building alliances among cooperative associations can be just as important to political success in the 21st century as business alliances among cooperatives will be to economic success.

Farm policy and farmer cooperatives

The future success of farmer cooperatives will be heavily influenced by how they adapt to changes in national farm policy. The Farm Security and Rural Investment Act of 2002 (2002 Farm Bill) reaffirms the Federal Government's direct involvement in farm income protection. But the impact on individual cooperatives will vary, depending on variables such as the

crop(s) their members grow and the size and nature of their producer-members. Cooperatives will have to understand the law's provisions, foresee how it will affect their business, and plan to respond to any changes it stimulates.

For example, will the price protection provisions encourage production, or will landowners decide they can make more money under the conservation programs, idle land, and reduce production? Will the act keep relatively smaller producers in farming or will it continue the recent trend of smaller farmers selling out to large, commercial farmers? Will price protection discourage farmers from building effective market presence through cooperatives? How these and other issues play out on a national basis will not be as important to cooperatives as what happens in the areas they serve.

Another important aspect of the 2002 Farm Bill is its support for farmer-owned, rural-based value-added businesses. Cooperatives will want to investigate whether they can take advantage of these programs. They will also want to keep track of whether existing competitors will be strengthened, or new competitors emerge, as a result of access to funds made available through these programs.

The 2002 Farm Bill is only the first major farm policy pronouncement of the 21st century. In time, farm programs, like other forces affecting cooperatives, will change. Cooperatives will need to keep alert so they know when change is being proposed, analyze it, and be ready to shape it to their advantage.

USDA and farmer cooperatives

Farmer cooperatives have long been a major element of the farm policy and producer assistance strategy of the U.S. Department of Agriculture. USDA administers numerous programs that support producers and their cooperative associations. All of these programs require legislative authorization and funding. So producer and cooperative advocacy before Congress and the Administration is crucial to the enactment and long-term viability of these activities.

Panelists noted that the difficulties of adapting to changes in the marketplace are creating a growing need for governmental assistance to cooperatives. They expressed strong support for USDA's cooperative education, research, and technical assistance programs. These functions are assigned to USDA under the Cooperative Marketing Act of 1926 and are presently carried out through USDA's Rural Business-Cooperative Service (RBS) and the Rural Development offices in each State. In addition, RBS-funded coopera-

tive development centers are located at several institutions of higher learning or organized as non-profit development associations.

Cooperatives also benefit from several USDA financial assistance programs. As noted earlier, the 2002 Farm Bill authorizes and funds RBS grants to farmer-owned businesses engaged in processing and otherwise adding value to farm crops. RBS also provides guarantees to banks that loan money to producers to buy stock in cooperative value-added operations. Other USDA programs make loans to cooperatives, underwrite export market development efforts, and purchase surplus products for distribution to schools and welfare recipients.

Cooperatives sometimes appear to take this support for granted. Many other interests are actively seeking the government dollars necessary to provide these services and fund this financial assistance. Cooperative leaders say they want USDA cooperative services expanded and financial assistance liberalized and increased. But that will require a commitment to the public policy process sufficient to pass legislation implementing these objectives.

Defining cooperatives: Where is policy heading?

This report discusses how the tenets that distinguish a cooperative from other forms of business can be viewed as three inter-related continua. At one end is strict compliance with the user-ownership, user-control, and user-benefit principles. At the other end, all three principles are compromised to the extent that the organization is clearly not a cooperative. An issue of growing significance is determining where along the continua an entity crosses from a cooperative to a non-cooperative.

In the years ahead, State legislatures may play an increasing role in this area. The State of Wyoming recently enacted a statute that authorizes a structure, called a cooperative, that varies in many ways from the traditional perception of an agricultural marketing cooperative.²⁷

- Under this law, a cooperative can have an unlimited number of investor "non- patron" members

²⁷ The Wyoming Processing Cooperative Law became effective on July 1, 2001. Wyoming Statutes §§ 17-01-201 to 17-10-253. For an explanation of the Wyoming Processing Cooperative Law, see Mark J. Hanson, "A New Cooperative Structure for the 21st Century: The Wyoming Processing Cooperative Law," *The Cooperative Accountant*, Fall 2001, pp. 3-9.

who aren't required to do business with the association, but are entitled to vote and share in its earnings based on their level of investment. Patron members are limited to one vote each, while non-patron members may have unlimited votes.

- Only one of an unlimited number of directors must be elected by producer-patron members. Director(s) chosen by the producer patron members are entitled to 50 percent of the voting power on the board. But this may fall short of the level of producer control necessary to be operating as a farmer cooperative.

- No limit is imposed on the rate of return investor members can realize on their investment and up to 85 percent of each year's earnings may be distributed to investor members based on investment.

This new law challenges the traditional concepts of cooperatives. First, it is questionable whether an association organized to take full advantage of the flexibility offered by this law conforms with any of the three core cooperative principles:

- User-Ownership — Non-patron outside investors can own most of the firm.
- User-Control — Non-patron outside investors can control up to 85 percent of the member votes, all but one of the board seats, and up to 50 percent of the voting power on the board.
- User-Benefit — Up to 85 percent of the earnings can be systematically returned to outside investors based on their investments.

Second, it is doubtful that an association organized to take full advantage of the flexibility offered qualifies for the numerous laws enacted to support cooperative activity, including the limited antitrust protection of the Capper-Volstead Act, single tax treatment under Subchapter T of the Internal Revenue Code, and the exemption from the prospectus and registration requirements of the Securities Act of 1933.

Cooperative leaders in other States, including some with a rich history of cooperation, may ask their legislatures to approve a new State law modeled on the Wyoming statute. Before endorsing such legislation, cooperative leaders need to ask themselves, "Is a law that permits this much deviation from the cooperative norms of user-ownership and user-control, coupled with a provision that only 15 percent of earnings must be returned to users based on patronage, really a law authorizing the formation of cooperatives?" If the

answer is "yes," then a second question needs to be addressed, "What, if anything, does the term 'cooperative' mean?"

Unfortunately, simply suggesting the Wyoming Processing Cooperative Law goes too far in discarding cooperative tenets doesn't solve the bigger problem that it was intended to address: How can flexibility be built into the cooperative model without destroying the unique features that justify favorable public policy treatment?

Recommendations

An array of issues and potential strategies for addressing those issues were considered within the focus groups and further analysis for this report. It is neither the intent of this report nor within its scope to present a list of detailed recommendations. But, the following general recommendations are relevant to all farmer cooperatives, regardless of size, commodity involvement, or business setting.

Accept and embrace change

The business environment in which cooperatives operate today is not the world of 1962 or 1982, or even of 2000. Nor is it the world they will face in 2022 or 2042, or even in 2004. Wishing markets had stopped changing at a certain time, or managing a cooperative as if they had, is a strategy for disaster. Industrialization, globalization, and technological innovation are here to stay. They are continuously evolving and presenting new and different challenges and opportunities. And as cooperatives move through the 21st century, other developments will have an equal or greater impact. Cooperatives must accept and embrace change.

The recommendations that follow will not be implemented if this one is ignored. Cooperative leaders who refuse to accept change can be expected to take the easy way out when confronted by it: do nothing and hope for the best. Directors, managers, and advisers must reject this approach and implement strategic planning programs that systematically look at yesterday, today, and tomorrow. Where we have been and where we are should be viewed not as ends in themselves but rather as foundations for building cooperatives that thrive in the years ahead.

Be guided by competent directors

Directors are the single most critical component of a cooperative. Most cooperative successes and a large proportion of their failures may be attributed to

the board's performance, or lack thereof. The complexities of the decisions directors must make have never been more challenging. Directors who are not knowledgeable in finance and other business fundamentals will be overwhelmed by the dilemmas they face. Cooperatives must establish the highest of expectations for the performance of their directors and hold them accountable for their performance.

The basic standard for director selection in the 21st century should be business competency. Persons chosen for board seats should either already have the skills necessary to meet their responsibilities, or be capable of acquiring them. Popularity and length of service on the board should be only minor considerations as selection criteria. If sitting directors either are unable or unwilling to do what is required of competent directors—understand the business environment, identify what the cooperative is doing well and what needs to be improved, hire a CEO who can function in a cooperative setting, ask questions when something isn't clear, make decisions independent of the influence of management and advisers—then the membership needs to take steps to replace them with people who can do these things.

Whether through the use of outside expert directors or advanced training of farmer board members, cooperatives must ensure that their boards possess the knowledge and business acumen needed to assess and decide upon critical strategies. This involves both a method of identifying and grooming future board members and leaders and providing adequate training opportunities for existing directors.

Maintain a solid equity base

The message that cooperatives must pay special attention to building and protecting their equity base has been repeated many times. Without adequate equity, banks won't loan money to a cooperative and it will starve for lack of funding. Some cooperatives, mostly those with modest capital requirements, already have adequate financing. But for others with substantial capital needs—to either remain in farm supply manufacturing or engage in value-added food product processing—the challenge just won't go away. If anything, it will be harder in the 21st century.

Reliance on retained earnings to generate equity, when coupled with a program of systematically redeeming equity issued in prior years, places cooperatives in the position of decapitalizing themselves in years of modest earnings or losses. For many cooperatives, managing existing equity is as big a challenge as attracting new equity.

Many farmers have large asset bases, particularly the land that they own. They could safely borrow against those assets to fund new cooperative ventures. But first they have to be convinced that mortgaging land and investing in off-farm enterprises will increase their income enough to cover the interest and reward them for their risk.

Some farmers are using new and creative financing strategies compatible with cooperative principles. The new generation model cooperative gives farmer-owners the option to sell their equity to other producers at a market price. This complies with the user-owner, user-control, or user-benefit tenets. In other instances, outsiders may purchase dividend bearing but non-voting preferred stock. While this is a modest departure from strict user-ownership and user-benefit, it protects the key principle of user-control.

If cooperatives are to be adequately capitalized in the years ahead, either members will need to provide additional funding or cooperatives will have to turn to other sources. The pertinent questions then become, how much capital can farmers provide without jeopardizing their own financial health and how much can cooperatives accept from outsiders without jeopardizing their cooperative character?

Emphasize education

Cooperative education is an investment and should be viewed as such by both public and cooperative decision makers. While the importance of cooperative education has not diminished over the past few decades, the resources devoted to it have been severely curtailed. Cost cutting within individual cooperatives, in cooperative organizations, at educational institutions, and in Federal programs has been disproportionately targeted at expenditures on education.

In the name of adjusting to a more competitive business environment, cooperatives have, at times, focused on short-term returns, to the detriment of the long-term success of the association. Institutions that support cooperatives have also redirected resources to other initiatives. Ultimately, farmers will pay for this short sightedness. How, for example, can farmers acquire the skills to become competent directors of cooperative food manufacturing companies if solid training in those attributes isn't available? Without the proper training, the pressure will mount on farmer-directors to abdicate their role as stewards of their members' assets to outsiders with the expertise to run the business but not the appreciation for the importance of the member-user that makes a cooperative special.

This report emphasizes director training as the number one priority in the cooperative education area. However, cooperative education is urgently needed for other audiences as well: employees, members, youth, young farmers, and the general public. Cooperative leaders have allowed, even facilitated, an across-the-board erosion in cooperative education. In the long run, this failure to invest in cooperative education can be as damaging as any failure in financial oversight.

Seek efficient structures

For decades, the picture of a cooperative was pretty clear. It was a group of people who banded together and furnished all of the required equity for a company that provided a service they couldn't provide individually for themselves. After a number of years, the cooperative paid off the longest outstanding equity investments with current year's earnings. When individual cooperatives weren't big enough to meet member needs, they pooled their resources and formed a federated cooperative.

As farmers and cooperatives enter the 21st century, that traditional structure is under severe pressure. Cooperatives are finding that when profit margins are thin, internal conflicts among the layers of decision makers in a federated system—as each strives to capture what margins there are—can become debilitating. Cooperatives are also discovering that they lack both the human and financial capital to deal with all the change around them.

Cooperative leaders should consider whether the age of the large, federated cooperative has passed. Smaller, centralized associations, able to function with less capital and to make management decisions relatively quickly, may be the way to future success. When these associations see an opportunity to enter a new market or grow in an existing one, they may be better off forming a joint venture with other cooperative and non-cooperative firms than forming a federated cooperative. This allows them access to people, funding, and markets not otherwise available while allowing them to continue to function as an independent cooperative organization.

Farmer-members must ask themselves some fundamental questions: Do they have to own physical assets they can see and touch? Can they operate in an environment of shared control and benefits? Can they allow their cooperative businesses to evolve and change?

Forge a strong public policy presence

Since enactment of the Capper-Volstead Act in 1922 and the Cooperative Marketing Act of 1926, cooperatives have been a central part of public policy for the agricultural sector. While the specific applications of the cooperative form of business have changed, the value, from a public policy perspective, of this private-sector solution to agricultural market conditions, remains highly significant today.

In the 21st century, cooperatives must enhance their role in protecting and advancing the economic interests of farmers. This includes educating legislators on how cooperatives might receive stronger support in terms of access to and assistance from Federal and State programs. It also means collaborating with public program administrators to make sure producer-members receive the maximum benefit, or suffer the least possible harm, from public sector initiatives.

Make decisions based on cooperative principles

The core cooperative principles enunciated in the 1987 report (user-ownership, user-control, and user-benefit) are still valid and are likely to remain so in the 21st century. This makes the cooperative a unique form of organization with distinct characteristics, strengths, and difficulties. As directors and managers weigh options when addressing major business and organizational decisions, they must consider how the outcome will affect the association's status as a cooperative.

The earlier discussion of cooperative principles used a continuum analogy to introduce the issue of how far an entity can move from strict compliance with these tenets and still be a cooperative. While all three principles are important, the concept of user-control seems most critical to operating on a cooperative basis. As farmers and other cooperative members struggle to adjust to the demands of the 21st century, they may find that some flexibility on the matters of outside ownership and allocating benefits, particularly returns on investment, are necessary to protect the continued availability of a cooperative presence in the industries where they do business. But only through continued user control can the members ensure that these deviations from the norm don't transform their "cooperative" into just another investor-owned firm. It is through control that members ensure business outcomes consistent with their goals for their cooperatives.

Control is the ability to make the decisions that determine how the entity conducts itself. Member-users can have 100 percent of the voting rights and still give away control to management, lenders, outside

equity holders, or advisors. Thus, this report concludes by re-emphasizing the single recommendation that is most critical to cooperative success in the 21st century:

Cooperatives must have highly competent directors who understand how to exercise effective control over their cooperatives and do so in a manner that promotes the best interests of the member-users.

Appendix A. Classifying Cooperatives by Structure

Those with a background in cooperatives, including the focus group participants, frequently use various terms to describe different types of cooperatives. A brief review of the more common ways cooperatives are classified should help clarify the following analysis for readers with little experience with this topic. The more important ways to categorize cooperatives are by the geographical territory served, their governance system, and the functions they perform.

Geographic territory served

One way of looking at cooperatives is the size of the area served. Cooperatives are loosely categorized as local, super local, regional, national, and international.

- **Local** cooperatives operate in a small geographic area, typically a single county or two or three contiguous counties. They usually have only one or two facilities to serve members.
- **Super local** cooperatives operate in several counties, often with several branch facilities.
- **Regional** cooperatives usually serve an entire State or a number of States.
- **National** cooperatives serve a major portion or most of the United States.
- **International** cooperatives operate in more than one country, with headquarters in the United States or another country.

Governance system

Cooperatives can also be classified based on membership structure, as centralized, federated or mixed.

• **Centralized** cooperatives have individuals and business entities (partnerships, limited liability companies, family corporations) engaged in agricultural production as members. Virtually all locals and super locals are centralized. Regional, national, and international cooperatives may also be centralized.

A centralized cooperative has one central office, one board of directors elected by its members, and a manager (chief executive officer) who supervises all operations. Business may be conducted through numerous branch stores or offices staffed by employees responsible to the central management team.

• **Federated** cooperatives have other cooperatives as their members. Each member of a federated is a sep-

arate cooperative that owns a membership interest entitling it to voting rights in the affairs of the federated. Local cooperatives commonly form federateds to perform activities too complex and expensive for them to do individually, such as manufacturing production supplies, tapping major financial markets, and marketing on a national or worldwide scale. Each member of a federated typically has its own board of directors, manager, employees and facilities to serve its members. The federated has its own hired manager and staff and a board of directors elected by and representing its member cooperatives.

• **Mixed** cooperatives have both individuals and other cooperatives as members. Cooperative members are usually given voting rights representative of their own membership.

Functions performed

Cooperatives may perform one or more of three core functions: marketing products, purchasing supplies, and providing services.

• **Marketing** cooperatives sell products produced by their members, in either raw or processed form, to persons further along the food marketing chain. Some marketing cooperatives limit their activity to negotiating prices and terms of sale with buyers. Growers of fruits and vegetables for processing and dairy farmers are primary users of these cooperatives, called bargaining associations.

Other marketing associations assemble member production into large quantities for sale to further processors, wholesalers or retailers. This first-handler role is common for cooperatives of grain growers and producers of fruits and vegetables for the fresh produce market.

Other such associations add further value to member production by processing or manufacturing member products into other, more valuable products. These may serve as ingredients in further processed products or be sold to institutional buyers and restaurants for their direct use, to grocery chains for resale as private label products, or to brand-name companies for resale under their brand. Cooperatives that process dairy products, fruits, vegetables, grains, livestock, and fish exemplify these value-added processing activities. Still others put member products right on the grocery store shelf under their own brand name. Land O'Lakes, Sunkist, Ocean Spray, Welch, Tree Top, and Knouse Foods are examples of cooperatives with established brands.

• **Purchasing** cooperatives are used by farmers to gain access to affordable, quality production supplies

such as feed, fuel, fertilizer, and seed. Many local purchasing cooperatives have affiliated with other such organizations, often through regional and national federated cooperatives. The combined resources enhance buying power to lower per-member costs of securing supplies and make possible direct ownership of large-scale facilities such as petroleum refineries; phosphate, potash, and nitrogen manufacturing plants; feed mills; research facilities, and laboratories.

- **Service** cooperatives provide both farm-specific and general support to producers. Some farm-specific services include recommending and applying fertilizer, lime, or pesticides; animal feed processing; and crop harvesting. General services include credit through the Farm Credit System, electricity through rural electric cooperatives and communications service through rural telephone cooperatives.

Appendix B. Forum Participants

St. Louis Panelists:

Bruce Anderson, Facilitator, Cornell University
Robert Andersen, Nebraska Cooperative Council
Richard Bell, Riceland Foods, Inc.
Dennis Bolling, United Producers, Inc.
Barry Flinchbaugh, Kansas State University
Joan Fulton, Purdue University
Roger Ginder, Iowa State University
Steve Hunt, U.S. Premium Beef
Paul Lasley, Iowa State University
Joe Lieber, Kansas Cooperative Council
Frank McDowell, New Vision Cooperative
William Patrie, North Dakota Association of Rural Electric Cooperatives
Maura Schwartz, Minnesota Association of Cooperatives

Atlanta Panelists:

Robert Cropp, Facilitator, University of Wisconsin Center for Cooperatives
Gene Anderson, Southern States Cooperatives
Jim Baarda, The Ackerson Group
Larry Baumeister, University of Kentucky
Glenn Glover, Gold Kist, Inc.
Brian Henehan, Cornell University
Frank Hunt, Florida's Natural Growers
James O'Shaughnessy, Ocean Spray Cranberries, Inc.
Kathy Ruhf, New England Small Farm Institute
Carlyle Teague, Cooperative Council of North Carolina

Minneapolis Panelists:

Robert Cropp, Facilitator, University of Wisconsin Center for Cooperatives
Rodney Christianson, South Dakota Soybean Processors
Mike Cook, University of Missouri
Majid Dagher, Mississippi Small Farm Development Center
Dan Dillon, Welch's Corp.
Gary Hanman, Dairy Farmers of America
John Johnson, Cenex-Harvest States
Phil Kenkel, Oklahoma State University
Tom McKenna, United Sugars, LLC
William Nelson, The Cooperative Foundation
Al Shively, American Pride Co-op
Ed Smith, Texas A & M University
Curt Stofferahn, University of North Dakota
Walt Wosje, Michigan Milk Producers

Sacramento Panelists:

Ken Farrell, Facilitator, California Center for Cooperatives
Roberta Cook-Canela, University of California-Davis
Everett Dobrinski, CoBank
Ronald Giraridelli, Diamond Fruit Growers, Inc.

Stan Gomes, Land O'Lakes
Donald Gordon, Agricultural Council of California
Bill Heffernan, University of Missouri
Sue Hine, Colorado State University
Larry Kallem, Iowa Institute of Cooperatives
Barry Kriebel, Sun-Maid Growers of California
Richard Sexton, University of California-Davis
Theresa C. Tuttle, Tuttle and Van Konyenburg
Frank Van Konyenburg, Tuttle and Van Konyenburg
John Welty, California Tomato Growers
Dave Zollinger, Blue Diamond Growers

Washington, D.C. Panelists:

Bruce Anderson, Facilitator, Cornell University
Ken Auer, Farm Credit Council
Ron Gaskill, American Farm Bureau Foundation
David Graves, National Council of Farmer Cooperatives
Paul Hazen, National Cooperative Business Association
Julian Heron, Tuttle, Taylor and Heron
Gene Paul, National Farm Organization
Don Schriver, Dairy Farmers of America
Lee Swenson, National Farmers Union
Leroy Watson, National Grange

National Institute for Cooperative Education Panelists:

Richard Subia, Center of Outreach, Langston University
Stevin & Stephanie Armstrong, SE Arkansas Vegetable Growers Cooperative
Lewis Bruner & Rachel Bruner, Oklahoma Landowners & Tenants Association
LaDonna McCowan, Oklahoma Landowners and Tenants Association
Dr. Marte Daniels, Family Farmers Cooperative, Mississippi Association of Cooperatives
Fred Broughton, South Carolina State University
Canston Scott, Sr., Beat 4 Cooperative
Larry & Shirley Blakley, Beat 4 Cooperative
Sotero Agoot, Kona Pacific Farmers Cooperative
Joe Radford, Tyler, TX
Charles J. Henry, Jr., Coastal Georgia Small Farmers Cooperative
Faye Radyard, Department of Health Immunization, Tyler, TX
Lonnie John Johnson, Coastal Georgia Small Farmers Cooperative
David Richardson, Coastal Georgia Small Farmer Cooperative

Appendix C. Discussion Outline

Cooperative principles

Our focus today will be to build on the identity of cooperatives defined under the contemporary principles.

- User ownership - A cooperative is owned by its members.
- User control - A cooperative is controlled by its members.
- User benefits - The benefits of the cooperative accrue to its members.

Core issues

Let's begin by identifying some core issues faced by rural Americans.

- What do you see as the principal challenges confronting agricultural producers in the years ahead?
- What do you see as the principal challenges confronting agricultural cooperatives in the years ahead?

Changing nature of markets

Let's discuss the changing nature of markets for food and fiber products.

- How are cooperatives affected by changing competition?
As buyers?
As sellers?
- How are cooperatives affected by changing distribution systems?
- How are cooperatives affected by changing consumer characteristics?
- How might these and other changes in the food and fiber sectors be addressed by cooperatives?

Changing nature of production

We finish setting the scene by discussing the changing nature of production agriculture.

- How are cooperatives affected by the diffusion of farm characteristics (large corporate farms v. small part time farms)?
- How are cooperatives affected by the closure of agriculture through contracts and integrated production systems?
- How are cooperatives affected by the changing nature of farmers' loyalties, attitudes, lifestyles, and community?
- How might these and other changes in production agriculture be addressed by cooperatives?

Changing nature of cooperatives

Let's direct our discussion toward the evolution of the cooperative system.

- With regard for the evolving stresses in the local-regional cooperative system, describe the essential elements needed for cooperation among cooperatives. In other words, what enables cooperatives to work cooperatively?
- With regard to capitalization strategies, discuss the roles and implications of non-traditional alternatives to farmer cooperatives.
- With regard to inter-business relationships, discuss the roles and implications of alliances.

Leadership challenges

Given these changes, pressures and demands,

- What skills will cooperative leaders need in the years ahead?
- What steps are needed to build these capacities in present and future cooperative leaders?

Public policy

Finally, discuss the roles that cooperatives play to set and implement public policy.

- What larger roles can cooperatives play in the design and carrying-out of farm and agricultural policies?
- Are there any changes needed in existing laws and regulations that would strengthen cooperatives' ability to serve in the public interest?

U.S. Department of Agriculture

Rural Business–Cooperative Service

Stop 3250

Washington, D.C. 20250-3250

Rural Business–Cooperative Service (RBS) provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

The cooperative segment of RBS (1) helps farmers and other rural residents develop cooperatives to obtain supplies and services at lower cost and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs. RBS also publishes research and educational materials and issues *Rural Cooperatives* magazine.

The U.S. Department of Agriculture (USDA) prohibits discrimination in all its programs and activities on the basis of race, color, national origin, gender, religion, age, disability, political beliefs, sexual orientation, and marital or family status. (Not all prohibited bases apply to all programs.) Persons with disabilities who require alternative means for communication of program information (braille, large print, audiotape, etc.) should contact USDA's TARGET Center at (202) 720-2600 (voice and TDD).

To file a complaint of discrimination, write USDA, Director, Office of Civil Rights, Room 326-W, Whitten Building, 14th and Independence Avenue, SW, Washington, D.C. 20250-9410 or call (202) 720-5964 (voice or TDD). USDA is an equal opportunity provider and employer.
