Cooperatives were created in US agriculture to serve the needs of the farmers and ranchers who own and control them. Processing and marketing cooperatives played a very strong role in California as growers sought economies of scale and market power, particularly during the 1920s (Garoyan).

Today, the ongoing consolidation of farms, global competition, and the structural changes in food processing and retailing are all challenging the traditional role of cooperatives in California, as well as in other parts of the US. Farmland, the largest agricultural cooperative in the US, declared bankruptcy in 2002, as did Agway, and there are rumors of an Ocean Spray buyout. In California, the bankruptcies of Lindsay Olive Growers, Tri Valley Growers and Rice Growers Association; the dissolution of Blue Anchor; the financial troubles at Calco; and the demutualization of Calavo, have all created doubt about the role and future of cooperatives in California agriculture.

However, some producers are taking a fresh look at restructured forms of cooperatives. For example, nontraditional cooperative leaders have acquired outside equity investors to overcome capital constraints, while others have created information sharing cooperatives to improve market power (via anti-trust exemptions).

To assess the future of cooperatives in California, brief background information is presented about the major types of cooperatives and the business activity attributable to agricultural cooperatives. Then, the strengths of agricultural cooperatives are reviewed, followed by an assessment of their weaknesses, and examples of how various agricultural cooperatives have overcome these weaknesses.

**TYPES OF COOPERATIVES**

To understand the future of cooperatives, it is important to recognize the broad range of functions performed by different types of agricultural cooperatives. There are five major types:

---

This case was prepared by Shermain D. Hardesty, Specialist in Cooperative Extension in the Department of Agricultural and Resource Economics at the University of California Davis, as the basis for seminar discussion rather than to illustrate either effective or ineffective handling of an administrative situation. No part of this publication may be reproduced or transmitted in any form without written permission of the University of California Davis.

Copyright 2004 © By the Regents of the University of California
**Production cooperatives**

Cooperative farming is rare in the US. Producers work together on land that they own or rent together. They may also have social living arrangements.

**Processing and Marketing Cooperatives**

These cooperatives are the most common type of agricultural cooperative found in California. Their primary function is marketing of products for members; most receive and grade and sometimes pack the raw product. Many are vertically integrated; they also process their members’ raw product, and package, distribute, and promote the food and fiber products.

**Bargaining Cooperatives**

Bargaining cooperatives bargain or negotiate with processors and other first handlers for better prices and other terms of trade for their members. They usually identify themselves as bargaining associations.

**Supply Cooperatives**

Supply cooperatives source and market various types of inputs, such as feed, seed, fertilizer, fuel, farm equipment, and packaging materials to their members. There are relatively few farm supply cooperatives in California.

**Service Cooperatives**

Farmers obtain a wide variety of specialized services from such cooperatives, including utilities, credit, insurance, ginning, trucking, storage, and drying.

Clearly, the strengths, weaknesses, opportunities, and challenges will vary for cooperatives of different types. The structural issues and market conditions they face are inherently different.

**BUSINESS ATTRIBUTABLE TO AGRICULTURAL COOPERATIVES**

In 1989, California led the nation in business volume conducted by all types of agricultural cooperatives, with 92% of the business attributable to marketing cooperatives (Table 1). In 1995, it ranked second in the nation for business volume conducted by all of its agricultural cooperatives, and still led the nation in the gross sales of its marketing cooperatives. The total volume of business conducted by agricultural cooperatives in California in 1995 was 22% higher than in 1989. By 2001, the total volume dropped by 16%, causing California to rank fourth in the business volume of all of its agricultural cooperatives. Furthermore, Minnesota and Wisconsin have now overtaken California in the business volume of marketing cooperatives, due to growth in dairy products marketed by cooperatives in their states.

Are cooperatives a viable business structure for California’s agricultural producers? What are their particular weaknesses? What strengths do they have? Can they be adapted to address the changing environment while still retaining their cooperative characteristics?
STRENGTHS OF AGRICULTURAL COOPERATIVES

Although agricultural cooperatives are formed for a variety of purposes, they are recognized in California primarily for providing economies of scale in vertically integrated activities and countervailing market power. Additionally, their direct product acquisition can be exploited as a key marketing strategy, and they can also provide important coordination functions.

Economies of Scale

One of the classic economic justifications for forming a cooperative is to obtain economies of scale. In a processing business, the average cost of operation tends to decrease as the volume of business increases—up to some point. Fixed costs of management, plant and equipment, and selling, general, and administration costs are spread over greater volume. Many processing and marketing cooperatives in California, such as Blue Diamond, Pacific Coast Producers, Humboldt Creamery Association and Calcot, achieve economies of scale that are unattainable by the individual producer in the vertically integrated activities they provide for their members.

Service cooperatives can also provide such economies of scale, as illustrated by Winery Services Cooperative. Headquartered in St. Helena, the cooperative was formed in 1972 by a small group of boutique wineries. It has expanded its storage capacity twice, and now has 39 members and a waiting list. The cooperative provides storage and shipping services, as well as inventory control.
and government reporting services. The cost of the space and staff for such services would be significant for a small- to medium-sized winery.

To join the cooperative, a winery must purchase lane rights from an outgoing member. A monthly rental fee is set annually to cover the costs of operation and debt service; members are required to pay it whether or not they use the space. However, unused space is rented to members needing additional space or to nonmembers, and the rental income is credited back proportionately. Overage lane charges rise at an increasing rate to discourage members from continually being “underinvested” in lane rights.

Winery Services Cooperative continues to thrive because it is a highly focused, service-oriented business. Equitable treatment of members is ensured through a detailed fee schedule for its numerous services. Members’ monthly rental rates are $ .035/case in the old building and $ .06/case in the new building. Since the commercial rate in the area is $ .12/case, members are receiving a substantial cost savings in return for the lane rights that they have purchased for approximately $2500. Similar cooperative ventures focused on special services such as cotton ginning, prune drying, citrus packing and storage, are continuing to provide California producers with economies of scale.

*Countervailing Market Power*

In the 1920s, Aaron Sapiro championed the formation of processing and marketing cooperatives to gain countervailing market power for agricultural producers; he was especially successful with his commodity cartel approach for specialty crops in California (Garoyan). The Capper-Volstead Act allows agricultural producers to set prices together, as long as they do not unduly enhance market prices. The consolidation of food retailers in the second half of the 1990s and current pressures to procure product at low cost may increase the importance of this role for cooperatives in the future.

NuCal Foods has used the cooperative structure to provide countervailing market power for its producer-members. It was created in 1996 as a federation of two large egg cooperatives, Nulaid Foods and Cal Eggs. The cooperative markets and distributes only shell eggs. While the majority of its products are marketed to retail grocery chains and box stores, it also services the food service industry. The eggs are marketed under many proprietary and licensed brands such as Horizon and Eggland’s Best, as well as private labels such as Lucerne and Albertsons.

The cooperative’s 75+% market share in Northern California provides its four members with market power. This market dominance allows NuCal Foods to negotiate effectively with its customers in the highly concentrated grocery industry. NuCal Foods is not dominating the market passively. It closely monitors market trends and has launched new products to protect its market from new competitors. Its newer products include organic, free-range and pasteurized eggs.

NuCal Foods’ producer members have utilized their cooperative structure to protect their marketing margins from the concentrated market power of their grocery store customers. By
processing and marketing their eggs cooperatively, NuCal Foods’ members are achieving economies of scale in processing, packaging and distribution, and limiting price competition.

Cooperative bargaining associations were formed for numerous commodities during the first half of the twentieth century, specifically to provide market power for large groups of producers. Many were in California. Bargaining associations for processing tomatoes, peaches and pears, as well as raisins and prunes, were relatively successful in negotiating fair returns for their members. However, the power of these bargaining associations began to falter as international competition increased and as pressures intensified to reduce costs throughout the supply chain. With their higher commodity prices and processing costs, US processors lost many of their export markets and began to incur greater pressure from imports. Some processors even began sourcing product overseas. As the bargaining associations lost their members and market share, their ability to influence commodity prices diminished.

The Raisin Bargaining Association (RBA), founded in 1965, is the largest bargaining cooperative in the US with approximately 2,000 members or 40% of the industry’s 4,500 raisin growers. The RBA negotiates price on behalf of its members with independent packers each year for a field price to be paid equally to all its members.

Since 1949, the raisin industry has been regulated by a Federal Marketing Order that utilizes supply management tools to stabilize the amount of raisins allowed into the market. Despite the Marketing Order (or because of it, as some in the industry would argue) the California raisin industry suffers from excess production, high production costs relative to global competitors, declining trade demand, and very low grower returns the past four years.

In 1999 the RBA negotiated grower price was $1,425 per ton, and in the past four years prices have declined to $877/ton in 2000, $880/ton in 2001, $745/ton in 2002 and $810/ton in 2003. With grower returns from the 2002 crop declining to their lowest level in 30 years, the raisin industry has been in a state of turmoil, with various growers and packers exiting the industry as it undergoes a painful contraction.

Due to poor weather conditions, the 2003 Natural Seedless raisin crop is estimated at 290,000 tons, well below the ten-year average of 346,000 tons. After four consecutive loss years, the RBA is finally in a better position to negotiate for a higher price for the 2004 crop.

Some bargaining associations could get displaced by marketing cooperatives that are joining together to form Marketing Agencies In Common (MAC). MACs are a group of marketing cooperatives, often with some individual producers, who market products under a common agreement. Historically, these agreements involved pooling resources for economies of scale, while allowing member cooperatives to maintain operational independence. Such strategic alliances have been particularly popular among dairy cooperatives.

The California Citrus Growers Association (CCGA) was formed in 2003 as a Marketing Agency In Common ("MAC"). As a non-profit agricultural cooperative its primary mission is to enhance grower revenues. For many years, California orange producers relied on a federal marketing order with prorate (flow-to-market) provisions to maintain an orderly market. The marketing
order was terminated in 1994. Having lost the prorate provisions as a product flow management tool, many growers have claimed that f.o.b. prices in recent years have fallen below their cost of production.

Recently, the major grower cooperatives and independent shippers elected to collaborate, utilizing the protections provided by Capper-Volstead. Members support the CCGA’s activities through a $.01 per standard carton assessment. The voluntary association now represents approximately 85% to 90% of the fresh market production of navel oranges in District 1 of California. CCGA intends to initiate a generic promotion program for the 2004/2005 navel orange crop; this will require increasing members’ assessment rates. Promotions will be concentrated between January and March.

The CCGA’s functions currently include managing product flows similarly to internally established prorates among the cooperative members, sharing information, and establishing quality standards such as color standard and sugar-to acid ratios. It may implement supply control measures if f.o.b. prices drop below a specified threshold minimum trigger price. This minimum trigger price is based on the costs of picking, packing, juice handling and juice income, hauling, and growing the fruit. Members have established compliance guidelines regarding reporting and adherence to supply management.

The six-month experience has been successful to date; f.o.b. prices have been consistently above the four-year average. According to one member, much of the success is attributable to the members sharing information about shipments and product availability. This success has bred confidence in the cooperative’s strategy of orderly marketing with high quality fruit, and the successful experience has instilled trust among its members.

The Eastern Mushroom Marketing Cooperative (EMMC) is similar to the CCGA. Formed in 2001, its mission includes product promotion as well as price stabilization. Its twenty members supply markets east of the Rockies; they have anywhere from 40% to 85% of the market, depending on the geographic area. However, EMMC’s supply control efforts to stabilize prices through restricting member production and implementing grade standards have not been very successful; price-cutting competition by domestic nonmembers and Canadian imports has been problematic. EMMC’s inability to control most of the fresh mushroom supply in major markets has hampered its ability to stabilize prices.

Producers are also forming cooperatives to gain market power solely by sharing information. Associated Fruit Producers was formed in 1991; it has approximately 100 members who produce peaches, apricots, nectarines, plums, table grapes, and pomegranates. The members, or their agents, meet weekly during their marketing season to share information about prices and supplies. They have recently started to communicate electronically. The convenience, timeliness and low cost of electronic mail could significantly improve such information sharing. By sharing information and controlling market supplies, producers can potentially stabilize prices and offset part of the market power of the highly concentrated grocery industry.
Direct Product Acquisition

Cooperatives can exploit the fact that they are acquiring raw product directly from their producer-members as a marketing advantage. Several food trends support using a farmer-based positioning for food products. Consumers’ concerns regarding food safety have been growing for some time, recently escalating due to the outbreak of Mad Cow Disease and other issues such as publicity about the adverse effects of farmed salmon. Growing numbers of consumers have a desire for a personal connection to agriculture. More consumers want fresher, less processed food. During the past ten years, sales of organic foods have been growing at a compound annual rate of 22%.

In a nationwide survey conducted by the National Cooperative Business Association during 2003, 69% of the consumers surveyed said that they were more likely to purchase food produced by a farmer-owned cooperative than those produced by other types of companies. Furthermore, 64% agreed that food produced by a farmer-owned cooperative was of better quality than food produced by other types of companies. Of course, it must be recognized that consumer preferences as expressed on a survey often do not translate into actual purchasing practices.

Surprisingly few cooperatives use their cooperative identity for their product positioning. The best-known example of such a message is Blue Diamond’s “A Can a Week” campaign. For several years, the cooperative ran television and print ads featuring its members standing in a mound of almonds with the tagline “A Can A Week Is All We Ask” to promote its flavored almonds. The cooperative is now featuring its growers as an image of high quality products in its advertising to the ingredients market.

The cooperative identity may be an ideal positioning for organic food products. Organic Valley/CROPP is a marketing cooperative formed in 1988 as the Coulee Region Organic Produce Pool (CROPP) with seven members in Wisconsin. It started by marketing organic produce, but quickly shifted into dairy products. Its membership has grown to the present 622 farmer members in seventeen states (including California). It markets dairy, juice, eggs, and meat products. Its sales have increased from $15 million in 1998 to $122 million in 2003. In 2002, Organic Valley’s dairy producer members averaged $17.95 per hundredweight compared to $10.95 for conventional product—a 64% premium.

Organic Valley differentiates itself by promoting its cooperative structure. It actively promotes itself as “…a cooperative of small organic family farms.” Its milk cartons feature profiles of local producers; they vary depending on where the product is being sold. It also provides grocery stores with large storyboards featuring some of its members. The producer-members provide an ideal marketing tool for marketing organic products as the cooperative promotes “…handcrafted premium quality organic products, and thoughtful stewardship of the land, water, air, and animals that are interconnected and dependent on a sustainable model of agriculture” (quotation from Organic Valley’s website). While this type of message may only be effective with a small segment of consumers, it is a growing segment.
Coordination

While the CCGA has focused primarily on price enhancement, generic promotion and product standards have been the focus of EMMC’s efforts. EMMC’s generic product promotion replaced the promotion program previously authorized by a federal marketing order. The Mushroom Council’s promotion program was discontinued due to the Supreme Court’s determination that the promotion activities were unconstitutional. EMMC promotes fresh mushroom usage in the US primarily through public relations targeted at consumers and food service operations. Each member uses its own logo. The EMMC does not market any product directly.

Curiously, the Mushroom Alliance appears to be serving a similar coordination function. The Mushroom Alliance was created in 1996 to enable mushroom producer/shippers to sell to large customers, such as Wal-Mart, while competing against each other for smaller customers. Three of the four original members are still with the cooperative. The cooperative structure has enabled the Mushroom Alliance’s members to maintain large customers that they could not supply individually; as a cooperative they coordinate among themselves to provide reliable supplies of consistent product to the large customers.

Each of the Mushroom Alliance’s six producer/shipper members is “assigned” to supply a specific distribution center with its own branded product, but meeting the chain’s product specifications. The cooperative provides the customer with a consolidated annual review of sales performance. Thus far, the Mushroom Alliance’s members have been able to increase their production volumes to match their customers’ growth in demand. Currently, their promotion activities have been limited to sharing booth space at trade shows. Although the Mushroom Alliance has offered centralized invoicing to its customers, the customers have opted to continue receiving separate billings at each distribution center.

Since there have been numerous challenges regarding the constitutionality of mandatory generic promotion programs, more cooperatives may be formed to serve this purpose. However, the voluntary nature of cooperatives poses a challenge; incentives need to be developed to minimize the free rider problem. If producers can benefit from promotion activities without having to join the cooperative and pay for their membership, they have little incentive to become members.

ADDRESSING TRADITIONAL WEAKNESSES OF COOPERATIVES

Cooperatives are a specialized form of a corporation, one that is characterized by the cooperative principles. While there are numerous strengths associated with the cooperative form of business, some structural aspects have challenged cooperatives’ ability to survive in today’s highly competitive economic environment. These weaknesses can be associated with traditional applications of the cooperative principles.

Three basic principles define the essence of a cooperative enterprise:
- user-owned—the cooperative is owned by the people who use it
- user-benefit—the benefits generated by the cooperative accrue to its users on the basis of their use
- user-control—the cooperative is controlled by the people who use it
These principles have been incorporated into government regulations, and the federal and state tax codes. They affect cooperatives’ business practices. It is important to assess objectively how some of these weaknesses can be overcome while maintaining the cooperative structure.

**WEAKNESSES ATTRIBUTABLE TO THE USER-OWNED PRINCIPLE**

It is broadly recognized that the user-owned principle has limited cooperatives’ access to capital. Cooperatives typically do not seek capital from certain sources, such as outside investors. Their ability to raise additional capital from their producer-members may also be constrained. The resulting business impacts are inadequate financing and avoidance of higher risk investments. It is revealing to analyze the causes of cooperatives’ capital limitations and to review some nontraditional forms of financing that have been developed.

*The Portfolio and Horizon Problems*

Many cooperatives have faced their producer-members reluctance and/or inability to provide adequate equity capital for their cooperatives. Economists have attributed this to the portfolio and horizon problems. The portfolio problem arises because producer-members are required to invest capital in an industry in which they have already invested significantly for their production. The horizon problem relates to the fact that the cooperative’s residual earnings are contractually tied to its producer-members’ current transactions, rather than to their investment, forcing them to prefer current cash flow to investment. Traditionally, members of cooperatives have been unable to recognize any appreciation in the equity they have invested. Thus, they exert pressure on their cooperative to maximize its current returns rather than investing for higher future returns.

The history of the successful marketing cooperative, Organic Valley/CROPP, was previously discussed. It has dealt with its equity capital limitations very successfully by utilizing two strategies: 1) it contracts with other firms to process virtually all of its members’ products, and 2) its products are marketed nationally through a grassroots program. In 2002, the cooperative generated $126 million in sales with assets totaling approximately $8 million. Organic Valley/CROPP maintains numerous long-term copacking agreements with manufacturers located in specific market areas to minimize its capital investment in plant and equipment while also reducing its storage and shipping costs. It has carefully developed back-up plans in each product area to address plant shutdowns.

The equity capital that Organic Valley/CROPP has retained from its members has been invested in its marketing programs. As previously noted, it heavily promotes its cooperative identity—particularly through its packaging, in store display materials, and its press releases. Its marketing budget is approximately 14% of its sales and relies heavily on public relations. Its limited advertising is directed specifically at the trade. Organic Valley/CROPP has structured itself strategically to minimize its capital requirements. However, its marketing budget may have to be enhanced considerably as competition in the organic market increases.
Preferred Stock

Several cooperatives have enhanced their capital by issuing preferred stock. Diamond of California is a nut marketing cooperative. Historically, it financed its overhead and capital investments through a 3.5% retain from growers’ net proceeds that was usually repaid after 5 years. The cooperative wanted to stop retaining a portion of its growers’ proceeds and also wanted to fund the expansion of market share in culinary nut sales. In 1998, Diamond implemented this change by issuing $15 million of trust preferred stock that was placed with an institutional investor. The stock has a fixed 7.2% cumulative preferred dividend rate and mandatory redemptions of $5,000 in 2009, 2010 and 2011. Similarly, Sunsweet obtained capital by issuing $20 million of 6.43% cumulative guaranteed preferred securities. The capital is classified as debt. This type of financing is viable only for larger cooperatives because of the significant legal and underwriting costs involved.

Perpetual preferred stock is another type of preferred stock. Unlike trust preferred stock, it does not have a repayment obligation. The payments are treated as dividends that are subject to the favorable 15% federal income tax rate. It is classified as permanent equity capital. CHS, Inc. was created in 1998 from the merger of two cooperatives, Cenex and Harvest States; it is the largest agricultural cooperative in the US and a Fortune 500 company. It provides a wide variety of products and services, from initial agricultural inputs such as fuels, farm supplies, and crop nutrients; to agricultural outputs that include grains and oilseeds, grain and oilseed processing, and grain-based food products. Its operations are divided into five segments: Agronomy, Energy, Country Operations, Grain Marketing, and Processed Grains and Foods. Currently, 75% of CHS’ earnings are derived from commodities; John Johnson, CHS’ CEO, has established a goal to generate half of its earnings from its processed food business.

Shortly after the merger, CHS’ Board established the goal of returning 50% of the net income in cash. Since then, more than $300 million has been distributed to 1,200 member cooperatives and their 350,000 producer members. However, CHS faced a growing need for additional capital and its members felt that redemption of their retain was too slow. Between 2001 and 2002, it issued approximately $9.5 million of 8% Preferred Stock (Old Preferred), but suspended sales of this issuance in late 2002.

In January 2003, CHS completed an $86 million offering of Perpetual Preferred Stock for $25.00 per share. The new preferred share sold out in the initial offering; the shares were placed with 8,000 investors in 39 states, increasing CHS’s permanent equity from $205 million to $290 million. Holders of Old Preferred shares were given the option to redeem them for cash or convert them into the new preferred shares. Dividends are fixed at $2.00 per share, payable quarterly and the shares carry no voting rights and are not convertible. Since the issuance, shares have traded from $25 to $29.50 on the NASDAQ.

In January 2004, CHS distributed $13 million in its preferred stock to its member cooperatives in exchange for their equity. The members have three options: 1) they can hold it and collect the dividends; 2) they can turn it over to the secondary market and turn it into cash; or 3) they can reissue it to their farmer members.
The structure of New Generation Cooperatives (NGCs) facilitates the acquisition of equity capital. The term NGC does not refer to a specific legal structure; rather, it describes how a firm operates, primarily the relationship between the firm and its members and how the firm is financed. NGCs differ from traditional cooperatives in 4 ways:

- They require members to purchase delivery rights in order to use the cooperative. These delivery rights obligate a member to deliver a certain amount of farm product to the cooperative each year.

- NGCs have a closed membership. In contrast to many traditional cooperatives that typically accept new members on a continual basis, membership in new generation cooperatives is restricted once the targeted amount of delivery rights shares are sold. If the NGC decides to expand its operational capacity, it issues more delivery rights shares, which provide the necessary equity financing for the expansion.

- The investment that NGCs require in delivery rights is typically higher than what traditional cooperatives would require. The price of each delivery right share is typically determined by dividing the total amount of equity capital that the cooperative requires to finance the business by the processing capacity of the cooperative’s facilities. NGCs typically raise between 30 and 50 percent of their total capital requirements from the sale of equity shares (Harris, Stefanson and Fulton 1996).

- The delivery rights are marketable. Members of the cooperative are typically allowed to transfer their delivery rights shares to other members or other producers who wish to become members, subject to board approval. The price of the shares in these situations is negotiated between the member who is selling and the producer who is buying. The price fluctuates according to the cooperative’s performance and earning potential.

The delivery rights system utilized by NGCs facilitates their ability to raise equity capital more easily than traditional cooperatives. The delivery rights ensure that members provide up-front equity capital to the NGC that is proportional to their level of use of the cooperative. Patronage returns generated by the cooperative are distributed to members according to the level of product that they delivered to the NGC. Both the transferability and opportunity for appreciation in the value of the delivery rights provide greater incentive for producer-members to invest in an NGC.

American Crystal Sugar, a sugar beet marketing cooperative based in Minnesota, is usually regarded as the parent of NGCs. In 1973, over 1,300 beet growers paid $86 million for American Crystal in an effort to maintain a market for their sugar beets and to improve the company’s operations. They based their structure on a California cooperative model utilized by Aaron Sapiro that called for producer delivery agreements and the upfront provision of equity capital. The producers paid $100 for each share, giving them both a right and an obligation to sell sugar beets produced from one acre to the cooperative. The NGC was successful; by 1994, the delivery rights were reportedly selling for $2,100 an acre. American Crystal Sugar is now jointly owned by three sugar cooperatives.

After serving as CEO of American Crystal Sugar, Joseph Famalette was hired as CEO by Tri Valley Growers (TVG). Shortly after his arrival, the marketing cooperative was converted into an NGC. Among other objectives, the new structure was expected to create a more stable equity
base and facilitate the raising of additional equity. Numerous problems led to TVG’s
bankruptcy, not just inadequate experience with the NGC structure. Nevertheless, the New
Generation Cooperative concept became associated with TVG’s demise and has not regained
credibility within California agriculture.

While many NGCs were formed and failed in the 1990s, several have been quite successful.
They include:
- **US Premium Beef**—Kansas-based beef processing and marketing cooperative with over
  1,800 members in 37 states. The cooperative’s founding members who delivered cattle
  realized an average annual total return on their original $38 million investment of 114%
in fiscal 2002; the returns were derived by combining total premiums paid of $18.5
  million, a patronage dividend of $11.7 million, and stock appreciation of $13.1 million.
- **Iowa Turkey Growers Cooperative/West Liberty Foods**—Iowa-based turkey processing
  and marketing cooperative with sales over $200 million. Its three plants process turkey,
  pork, chicken, and beef into products for retail and food service customers and co-pack
  branded meats for bigger companies like Hormel and Sara Lee.
- **Golden Oval**—Minnesota-based layer and egg-processing NGC, which ranks nationally
  within the top 15 egg producers and the top 10 processing companies. Members’ equity
  has increased from $4.1 million in 1994 to $22.8 million in 2002, and sales rose to $46
  million.
- **Mountain View Harvest**—A wheat processing NGC formed by 227 winter wheat growers
  who invested a total of $5 million to purchase Gerard’s French Bakery, a wholesale
  bakery of fresh and frozen products near Denver.

**Wyoming Law**

A legislative reform, the Wyoming Processing Cooperative Statute (commonly referred to as the
“Wyoming Law”), was passed in 2001 to facilitate equity capital formation in cooperatives. It
allows both patron and nonpatron investment in a cooperative. The legislation resulted from the
formation of the Mountain States Lamb and Wool Cooperative, which was organized as a limited
liability company (LLC). Mountain States pressed the Wyoming legislature to pass a law
allowing cooperatives to organize like LLCs, and the Internal Revenue Service subsequently
issued a ruling allowing pass through taxation for NGCs.

There are four key provisions to the statute:
- The cooperative’s owners are divided into two classes—“patron members” who have rights
  and obligations of delivery of product to the cooperative; and “nonpatron members” who have
  no product delivery obligations and are primarily investors. Patron members may also
  participate as investors.
- Voting rights are differentiated between patron and nonpatron members. Patron members
  vote on a one member, one vote basis, subject to certain exceptions. Nonpatron members
  have voting rights proportional to their investment; however, they are limited to a maximum
  of 85% of the total voting rights.
- At least one member of the cooperative’s board of directors must be elected by the patron
  members. Directors elected by patron members must have at least 50% of the voting power in
  Board voting decisions.
Patron members are allocated distributions based on their patronage, while investment members are allocated financial rights proportionate to their capital contributions. However, patron members must receive at least 15% of the cooperative's profit allocations and distributions.

The Wyoming Law has created considerable commentary among cooperative leaders and economists. The major concern is that producers will lose control over their cooperative and that the nonpatron members' interests are not consistent with those of the patron members. Mountain States Lamb Cooperative used much of the capital it raised to acquire a 50% share in a major distribution company for lamb products. In reality, its patron members have not lost control of their cooperative. Approximately 75% of the equity capital is held by producers. Producers own "A" shares while investors own "B" shares; approximately 50 of the 120 producers own "B" shares. Members are paid for the commercial value of the lamb they deliver. Investors receive a fixed dividend on their "B" shares. Depending on the cooperative's actual earnings, producers are also eligible to receive a dividend on the A shares they used for delivery.

Joint Ventures

Joint ventures can be considered a nontraditional source of financing. They encompass a variety of legal structures. They may be the only way a cooperative can afford to own part of an expensive facility with full or partial utilization. A joint venture can also allow a cooperative to market a new product nationally, "lock-in" access to a marketing capability, and prevent competitive inroads. Copacking agreements, such as those utilized extensively by Organic Valley/CROPP, are a form of joint venture; such arrangements reduce upfront capital requirements and decrease the risk associated with new products.

Agriliance, LLC was formed in 2000 as an agronomy marketing joint-venture between three cooperatives--Land O'Lakes, CHS, and Farmland. The company offers crop nutrients, crop protection products, seeds, information management, and crop technical services to producers and ranchers in all 50 states as well as Canada and Mexico. In 2003, Agriliance's sales totaled $3.5 billion and generated net income of $60.7 million. A critical element to a successful joint venture can be the similarity in the corporate cultures of the partners; the fact that all of the partners are cooperatives clearly aids the partnership.

CHS is engaged in numerous joint ventures, including 50% ownership of Ventura Foods; the other partner is Japan-based Mitsui. Ventura Foods is a major U.S. manufacturer of salad dressings, sauces, margarines and butter blends—value-added products made from CHS members' soybeans. Its mission is to provide products that capitalize on consumers' need for convenience-oriented foods. Ventura Foods' sales totaled $1.165 billion in 2003 and generated a net income of $42.8 million.

CHS also has 24% ownership in Horizon Milling, LLC, a joint venture limited liability company formed in 2002 with Cargill. Horizon Milling operates mills in 13 states (including California) that grind durum wheat, spring wheat, hard winter wheat, and soft winter wheat into flours for sale to retail and commercial bakeries, food manufacturers and retailers, government agencies; and the export market. Its products are sold in bulk, packaged for both private label and branded products for premium-quality bakeries.
Smaller cooperatives can also benefit from joint ventures. Naturipe, the oldest and largest strawberry marketing cooperative in the US, expanded its market access by joining forces with Global Berry Farms, LLC (GBF). GBF’s other partners are MBG/Michigan Blueberry Growers Association (another cooperative), and Hortifrut (a privately held company based in Chile). GBF is reshaping the berry category by offering year-round supplies of strawberries, blueberries, raspberries and blackberries. By marketing 100% of their production through GBF, Naturipe’s members have a more secure and broader customer base.

Despite the financing constraints imposed by the user-financed principle and various regulations, numerous cooperatives have developed a variety of innovative solutions. Cooperatives, such as Organic Valley/CROPP can be strategically structured to minimize equity capital requirements. Joint ventures also enable cooperatives to reduce their financial commitments. The tradable preferred stock that CHS just began issuing addresses the horizon problem; members have the potential to earn capital gains on part of their equity investment in CHS. It also begins to address the difficult portfolio problem; producer-members have a means of selling their stock while remaining as members of the cooperative. NGCs also offer members the opportunity to obtain capital gains when they sell their delivery rights, as do other closed cooperatives that require delivery rights. The Wyoming Law reform and issuance of preferred stock enable cooperatives to obtain equity capital from nonmembers.

WEAKNESSES ATTRIBUTABLE TO THE USER-BENEFIT PRINCIPLE

Like the user-financed principle, the user-benefit principle has also constrained agricultural cooperatives. According to USDA’s statement of “Cooperative Principles and Definitions”, a “cooperative’s sole purpose is to provide and distribute benefits to its users on the basis of their use.” The user-oriented principle can undermine the business effectiveness of a cooperative by causing its members to expect benefits that are not in the cooperative’s business interests. Members often envision their cooperative as operating as a vehicle to contribute to their own operation by marketing their products. Because cooperatives’ earnings are traditionally distributed to users in proportion to their current patronage, they are rewarding members’ usage rather than investment. This again raises the horizon problem; members are unable to recognize appreciation in their equity and the cooperative’s residual earnings are tied to the members’ current transactions. The resulting business impact is a focus on current returns, underinvestment in intangibles and perpetuation of excess supplies of member product.

Controlling Member Deliveries

Marketing cooperatives often were organized to serve as a home for their members’ products—a traditional member benefit. This “open” structure can cause a cooperative to have large fluctuations in its delivery volumes and processing requirements.

To maximize the efficiency of their production capacity and facilitate their market planning, some cooperatives have placed limits on their members’ delivery volumes. They typically issue “delivery rights” or “market rights”. Such cooperatives need not be structured as NGCs. The delivery rights may even serve as a two-way contract between producer-members and the cooperative, by obligating the producer-members to deliver a specific volume of product each
year to the cooperative, and the cooperative to accept delivery of the specific volume of product. The total quantity of delivery rights that a cooperative issues to producers depends on its total processing capacity.

Members purchase delivery rights, providing equity capital for their cooperative. Delivery rights are usually marketable among members and will fluctuate in value. The tradable rights permit members to partially or totally exit the cooperative by selling some or all of their shares, thereby providing a solution to the previously mentioned horizon problem. Delivery rights link a member’s patronage and investment in a cooperative. They enable a member to be a patron in the short term, and to obtain capital gains on their investment in the long term. They provide an incentive for cooperatives’ members to have a longer-term perspective on their cooperative.

Tree Top, an apple and pear processing and marketing cooperative in Washington, has a delivery, or market rights system. During the 1980s, it converted its members’ equity capital into market rights with a $75 per ton par value. Until recently, Tree Top was expanding its production and selling additional market rights to its members through a 3-year installment payment program (Easy Payment Plan). The current market value is about $60, which represents the discounted value of the installment payment program. Since the supply of market rights is now limited, Tree Top expects the market value of these rights to increase as it maintains its profitability.

Despite the worldwide glut of apples and juice concentrate, Tree Top has managed to earn returns for its members well above the market price (Table 2). During the past five years, members have earned an annual premium that has averaged 21.4% above the commercial value of their raw product.

### TABLE 2
**Tree Top, Inc.**
**Member Return on Market Rights**

<table>
<thead>
<tr>
<th>Per Apple Ton:</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>5 Year Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Return in Excess of Market Value</td>
<td>$27.93</td>
<td>$15.45</td>
<td>$18.80</td>
<td>$16.53</td>
<td>$1.41</td>
<td>$16.02</td>
</tr>
<tr>
<td>Par Value of Market Right</td>
<td>$75.00</td>
<td>$75.00</td>
<td>$75.00</td>
<td>$75.00</td>
<td>$75.00</td>
<td>$75.00</td>
</tr>
<tr>
<td>% Cash Return on Market Right Investment</td>
<td>37.2%</td>
<td>20.6%</td>
<td>25.1%</td>
<td>22.0%</td>
<td>1.9%</td>
<td>21.4%</td>
</tr>
</tbody>
</table>

Market rights have enabled Tree Top to control its processing requirements and reduce excess capacity. Such volume control measures are clearly beneficial to members; by reducing fixed costs and enhancing marketing planning, Tree Top is serving as a profitable home for its members’ product, rather than just being a guaranteed home for their product.

Pacific Coast Producers (PCP) is a marketing cooperative that processes tomatoes, peaches, pears, grapes and apricots. It concentrates solely on corporate brands; part of its success is attributable to the strict cost controls it employs by minimizing excess capacity. Thus, it is essential for PCP to carefully project its annual sales volumes and pack product accordingly. It
has a long-established delivery rights program through its “base tonnage” requirements to manage members’ delivery volumes. Members have base tonnage allocations for each product they deliver; the levels are determined from their past deliveries. PCP’s member delivery volumes for each commodity must match their base tonnage allocations. When the cooperative has excess inventories or anticipates facing a weak market, it will prorate members’ base tonnage.

PCP members’ base tonnage is marketable. Members who are reducing their deliveries to the cooperative sell part or all of their base tonnage to new or existing members; these sales are subject to PCP management’s veto. Management intentionally does not approve or monitor sales prices for the base tonnage. PCP’s base tonnage system provides management with the ability to control members’ delivery volumes; the capital gains members earn when they sell their base tonnage contribute to the long-term returns for their investment in the cooperative.

Expanding Beyond Member Product

Because cooperatives are often formed to provide a “home” for their members’ product, the resulting focus on processing and marketing member deliveries can cause a cooperative to have a limited product line and/or seasonal product availability. Members have been known to be resentful when their cooperative sources nonmember product to maintain a year-round presence in the marketplace, or other commodities to broaden the product line. Both types of nonmember product sourcing are critical for developing a strong brand. A company that does not have year-round presence on grocery store shelves will lose brand awareness among consumers. Similarly, a broad product line with strong shelf presence will build consumer awareness of the brand, both inside and outside of the grocery store. As previously noted, two cooperatives, Naturipe and MBG/Michigan Blueberry Growers have strengthened their market presence by becoming affiliated with a broader product line and year-round presence by partnering in a joint venture, Global Berry Farms.

Similarly, Sunkist Growers, the largest marketing cooperative in the world’s fruit and vegetable industry, recently began importing citrus from offshore sources to complement the citrus produced by its own growers. Sunkist, headquartered in Sherman Oaks, California, was founded in 1893 and has 6,000 grower-owners in California and Arizona. With increasing globalization in recent years, Sunkist has been facing more competition in Japan and other key markets from foreign citrus growers in Argentina, Chile, Australia and South Africa. With retail consolidation, major domestic and export customers are increasingly seeking suppliers that provide a year-round fruit supply.

After lengthy discussion and much resistance from members concerned about competition from fruit imported or handled by their own cooperative, in July 2003 the Sunkist Board of Directors approved a new marketing strategy designed to address current industry dynamics. The cooperative is handling lemons and grapefruit from Southern Hemisphere contra-seasonal producers South Africa and Chile to leverage its well-known brand into markets in Japan and Hong Kong. Sunkist had to respond to its customers’ demand for a single, year-round supply of citrus; otherwise it would have lost its position as the fresh citrus market leader.
Sunkist’s CEO, Jeff Gargiulo commented that by placing its brand on citrus not grown by its members, the cooperative is acknowledging that its growers cannot always supply what its customers want. Although some members may object that such actions dilute demand for members’ current production, Sunkist’s management recognizes that it needs to take the action to ensure that it will have the opportunity to sell its growers’ fruit in the future. In other words, if the cooperative is successful, then its members will benefit.

Diamond Walnut historically marketed shelled and inshell walnuts. Shortly after hiring Michael Mendes as CEO, the marketing cooperative shifted its strategy, changing its name to Diamond of California and expanding its product offerings to become an effective competitor in the culinary nut category. Mendes sought to enhance members’ returns by shifting a greater proportion of the cooperative’s sales into shelled nuts, where profits are higher and more stable from year to year. Grocery chains want one supplier to provide them with a complete line of culinary nuts presented in an eye-catching display. While its members’ walnuts are packaged in numerous forms and package sizes, Diamond broadened its culinary nut offerings by purchasing and packaging almonds, pecans, peanuts, pine nuts and other nuts to complement its members’ walnuts.

In January 2004, Diamond expanded its shelled nut offerings by launching a snack product line. Fourteen new products under the Emerald label are being marketed in approximately 1,100 Northern California supermarkets and drugstores, and will soon be introduced in Southern California. The cooperative is capitalizing on consumers’ health concerns, since numerous health benefits of various nuts have recently been identified. Emerald snacks include a variety of larger, premium quality nuts—walnuts, pecans, peanuts, cashews and almonds—as well as sweet and savory glazed nut combinations. All are packed in emerald green plastic canisters or resealable bags for convenient munching. Half of the products feature the members’ walnuts.

Cooperatives can overcome the weaknesses attributable to the user-benefit principle. Requiring delivery rights and sourcing nonmember product to expand product lines and year-round market presence can considerably strengthen a cooperative’s ability to provide future benefits to its user-members.

**WEAKNESSES ATTRIBUTABLE TO THE USER-CONTROL PRINCIPLE**

Another defining characteristic of cooperatives is that they are controlled, or governed, by their producer members. Economists have determined that this cooperative principle can cause the “Principal Agent” problem, in which the principals (producer members) lack the business expertise to provide adequate control of their agent (management). In a recent UC Davis study regarding the failure of the Rice Growers Association (RGA—Keeling), one of the contributing factors identified was “…the board of directors was passive and ill-equipped to scrutinize the business decisions it was charged with overseeing.”

USDA’s cooperative specialists recently conducted a nationwide study identifying issues affecting the future of agricultural cooperatives. They commented that cooperative board members often have a great deal of knowledge about production agriculture but limited experience and skills needed to deal with external business forces.
The USDA report documented numerous concerns regarding the effectiveness of cooperatives’ boards. One concern was the inability of producer-directors to deal with contemporary business issues, such as supply chains, technological innovations, complex business arrangements and globalization. Concern was also expressed about the inability of some producer-directors to expand their perspective beyond their own farming operations. There was also concern that producer-directors often make decisions based on internal politics rather than sound business principles; for example, they will favor keeping an underutilized facility open in order to get reelected. Related to this concern is the fact that some producer-directors want the cooperative to serve as an economic buffer for the producer-members, jeopardizing the cooperative’s business performance. Again, members often expect that the purpose of a cooperative is “to serve as a market for their product.” Members can unwisely force their cooperative to accept their product deliveries when the cooperative is faced with excess supplies of product.

A processing and marketing cooperative enables members to forward integrate into value-added products, and a farm supply cooperative enables members to integrate backwards to obtain certain inputs for production. Nevertheless, the cooperative must be managed as a business independent of the members’ farms. Members need to be educated that the cooperative’s objective is to maximize its returns, not those of its members.

**Board Education**

USDA’s specialists believe that cooperative education is an investment but that too many cooperative leaders and advisers consider it only a cost that must be cut whenever times get tight. In the RGA study, Keeling recommends that cooperative boards of directors receive regular instruction in strategic management and business finance.

Some cooperatives maintain active education programs for their board members. Some programs are conducted in-house, but cooperatives often send their board members to conferences with an educational focus. The National Council for Farmer Cooperatives has historically provided educational programs for the larger cooperatives. Land grant universities typically offer workshops for local cooperative leaders. Leadership training programs for current or prospective cooperative board members include timely topics such as cooperative finance, strategic planning, governance and management evaluation. Some cooperatives invite experts to board meetings for presentations regarding trade policy and marketing issues.

As cooperatives face increasingly competitive markets, board members need to be educated about their business environment and adhere to sound business practices. A board must understand its roles and responsibilities to have a good working relationship with management. Cooperative board members also need to be educated about hiring top management talent and compensating such individuals accordingly. Typically, cooperatives face a disadvantage in compensating their management because they usually do not issue stock or stock options.

**Outside Directors**

Outside directors can strengthen the boards of agricultural cooperatives. However, some cooperatives’ bylaws and some State incorporation statutes restrict board membership
exclusively to producers to promote the user-control principle. In such cases, nonvoting advisers can be appointed to provide some outside assistance. Canada’s Cooperative Act allows up to one-third of the boards of agricultural cooperatives to be nonproducers. In the RGA study Keeling concluded that one or more outside directors should be elected or appointed to strengthen the board’s business skills.

The cooperative, National Grape, uses a two-board structure. Welch’s is National Grape’s wholly owned subsidiary. The thirteen producer members on the National Grape board elect Welch’s board of directors annually, which consists of four National Grape directors, two executive officers of Welch’s and four outside professionals. Although the juice market has been very competitive as carbonated drink companies have acquired juice companies to diversify their businesses, Welch’s has maintained its profitability. Welch’s board recognizes that brands are fragile and that significant investment is required for brand advertising, product development and packaging innovation.

CHS has structured subsidiaries for its numerous joint ventures with investor owned firms. There are no producer members on the boards of these subsidiaries; the boards consist of CHS’ management and the executive officers of its joint venture partners. The board of the Global Berry Farms joint venture consists of two representatives from Naturipe (its CEO and a producer board member), two representatives from MBG (its executive officer and a producer board member), two senior management representatives from Hortifrut and a public member.

DISCUSSION ISSUES

1. Can marketing cooperatives overcome their marketing myopia or does their cooperative structure doom them to failure in a highly competitive global marketplace?
2. Should privately held or investor-owned firms participate in joint ventures with agricultural cooperatives? Why or why not?
3. Agricultural cooperatives come in many sizes and serve different functions. What circumstances make a cooperative an appropriate business structure?
4. What are the limitations of agricultural cooperatives as a business structure in today's environment?
5. Are cooperatives a necessary part of California agriculture? Do agricultural cooperatives have a future in California?

REFERENCES

---.”The Rise and Fall of Tri Valley Growers Cooperative.” California Agribusiness Executive Seminar, 2002.


Organic Trade Association, various press releases and publications.
