DIFFERENCES BETWEEN NEW GENERATION COOPERATIVES AND TRADITIONAL COOPERATIVES

By

David Coltrain
Extension Assistant, Arthur Capper Cooperative Center
Department of Agricultural Economics, Kansas State University
For information call 785-532-1523 or e-mail coltrain@agecon.ksu.edu

David Barton
Director, Arthur Capper Cooperative Center
Professor, Department of Agricultural Economics, Kansas State University

Michael Boland
Assistant Professor, Department of Agricultural Economics, Kansas State University

May 2000

Arthur Capper Cooperative Center
Department of Agricultural Economics
Cooperative Extension Service
Kansas State University

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INTRODUCTION

Significant changes in the agricultural economy are having profound effects on the viability of rural communities that are dependent on profitable and innovative agricultural businesses. The trend toward fewer, larger and increasingly corporate farms has created a concern among rural residents that many small and midsize family-owned farms would disappear.

One way for small and midsize farms to remain viable businesses is to increase income to their operation by participating in profitable value-added processing and marketing activities. A popular strategy being used by producers to achieve this goal is to pool their limited resources through cooperative development. Cooperatives can play a greater role by helping producers earn a larger share of the consumer's food dollar. While producers are examining alternatives for continued success, consumers are challenging the food industry to tailor food products for precisely defined market niches – niches that individual producers cannot always fill, but are attainable with the coordination of producer groups and alliances. This coordination has led to producer-owned processing and marketing cooperatives with the potential to generate rural wealth and purchasing power.

Most of these cooperatives have used the New Generation Cooperative (NGC) model. NGCs vertically integrate and provide producers larger earnings by selling processed products instead of raw products (Nilsson).

In other words, NGCs have been established by producers to increase their share of the consumer dollar and to add value to their basic commodities through processing and forward linking to the market place by selling processed products instead of raw commodities. NGCs are expanding into value-added enterprises and forming creative joint ventures and strategic alliances with successful marketing companies. NGCs allow farmers to work together in marketing, while maintaining independence on their own farms (Cropp). Many consumers prefer and trust food that is produced and sold by farmers. By moving up the food chain, NGCs take advantage of this opportunity (Morris).

Both traditional cooperatives (TC) and NGCs are a form of vertical integration with similar objectives. However, they are very different in the way they manage the marketing and finance business functions. Understanding the difference is critical for those producers who choose to participate in value-added activities through cooperatives.

EXAMINING SPECIFIC DIFFERENCES

A cooperative is defined as a business operated primarily to provide benefits to members through marketing transactions and through a distribution of earnings from these transactions. In return, members have a responsibility to provide equity capital and govern the business. Both TCs and NGCs fit the definition. A NGC, or closed cooperative, is more restrictive in terms of marketing and finance. The NGC's members or users are (1) customers who have a contractual right and obligation to deliver a particular quantity and quality of product as specified in a marketing agreement and (2) owners who are required to purchase shares of equity stock, as specified in the stock subscription agreement, which conveys the right to deliver a certain quantity of product consistent with the marketing agreement. For example, a member may be required to buy one share of stock at $3.00 per share for each bushel of grain the member delivers annually to the cooperative. Current members may transfer or sell equity stock to new members at an agreed upon price. Transfers must be approved by the cooperative's board of directors.

Many specific characteristics of NGCs are different than TCs. Table 1 summarizes the characteristics that differ between NGCs and TCs. The differences can be categorized into four groups based on the producer's role or relationship with the cooperative and the associated cooperative business functions. The categories are (1) customer marketing transactions, (2) patron profit distributions, (3) owner investment obligations and (4) member voting control.

Table 1: Characteristics of Traditional (TC) and New Generation (NGC) Marketing Cooperatives

PRODUCER ROLE BUSINESS FUNCTION	TC	NGC
CUSTOMER MARKETING TRANSACTIONS		
Delivery Rights	**Unlimited**	**Limited to purchased**
Delivery Obligation	**None**	**Required**
Quality Accepted	**Broad**	**Narrow**
Identity Preserved	**Usually not**	**Usually is**
Initial Payment	**Market price**	**Contract price**
PATRON PROFIT DISTRIBUTIONS		
Cash Patronage Rate	**Low**	**High**
Investment or Retained Profits	**High**	**Low**
Pooling Distributions	**Rare**	**Common**
OWNER INVESTMENT OBLIGATIONS		
Initial Investment	**Very low**	**Very high**
Proportionality to Use	**Low to high**	**Very high**
Liquidity of Exchangeability	**Low**	**High**
Exchange Value	**Fixed at par**	**Variable at market**
Redemption Obligation	**Ability to pay**	**None**
Business Expansion Investment	**None**	**High for delivery rights**
MEMBER VOTING CONTROL		
Eligibility Restrictions	**Low**	**High**
Voting Power	**Usually one vote**	**Variable number**

All types of businesses engage in activities related to the four business functions of marketing, income or profit distribution, equity investment, and control or governance. Each function includes a collection of related activities. Cooperatives differ from investor oriented businesses in the way they operate with respect to these four business functions. TCs and NGCs also differ from each other with respect to the nature of the activities in each business function. The relevant activities for each function are listed in Table 1.

Associated with each business function is a unique stakeholder role or relationship. In the simplest view, members (or sometimes patrons) are those who do business with or use a cooperative, receive a share of the income (based on use), and own and control the cooperative. It is generally true that a member engages in all four functions, so using one term (member) is sufficient to refer to all four relationships. In reality, some stakeholders have only one, two or three of these four relationships. To represent reality and to better understand the nature of a cooperative it is useful to identify separate roles for each of these relationships.

The four roles are (1) customers, (2) patrons, (3) owners and (4) members. Customers are those who use the cooperative by buying inputs or by selling products. Patrons are those eligible to receive a share of the profits, usually as patronage refunds. Owners are those who invest in or own equity. Members are those who have voting power to govern or control the cooperative, elect directors, adopt articles of incorporation and bylaws, and vote on other major member issues such as mergers, acquisitions and dissolution.

Traditional or open cooperatives often have users who have various combinations of these roles. For example, many users may be customers; but not patrons, owners or members. These users are called nonpatronage customers. Other users may be customers, patrons and owners, but not members, and are called non-

member customers or patrons. In contrast, new generation or closed cooperatives usually require users to fulfill all four roles.

1.1 Customer Marketing Transactions

There are five characteristics that differentiate how cooperatives perform marketing transactions with individual customers when comparing traditional (open) and new generation (closed) cooperatives. The five characteristics are (1) delivery rights, (2) delivery obligation, (3) quality accepted, (4) identity preserved and (5) initial payment.

1.11 Delivery Rights

In a TC, delivery rights are normally unlimited. Most traditional cooperatives allow any amount of product to be delivered by customers and the cooperative then markets the total amount delivered by both member and non-member customers. Some TCs have contractual marketing agreements with members that control the amount of product each member can deliver, but they are a small minority.

In contrast, the delivery rights of customers of NGCs are limited to the level of stock each member has purchased in the cooperative. As an example, each share of common stock in the 21st Century Grain Processing Cooperative entitles a member to deliver 2,850 bushels of wheat.

1.12 Delivery Obligation

Delivery obligations and delivery rights are usually paired together. They either exist in a marketing agreement or they do not exist. TCs normally do not have delivery obligation agreements with their customers. Customers may market their products elsewhere because of higher prices, more convenience or personal relationships. However, delivery obligations are required for NGC members. This delivery obligation is coupled to the total supply of product that will be needed by the NGC in its value-adding processing and marketing. NGC members are expected to deliver the amount specified in their delivery rights. If extenuating circumstances prevent sufficient production, NGC members or their agent usually purchase the contracted amount elsewhere, possibly from other members, or a penalty is imposed. Most often, members only contract a portion of their total planned production for delivery.

1.13 Quality Accepted

Since TCs usually do not have marketing agreements with members, the quality accepted normally covers a broad range. A TC is expected to find a market for all qualities of product that are delivered. NGCs usually have a much narrower range of quality that can be delivered since they usually are processing or marketing a specific product with certain desired characteristics and traits.

1.14 Identity Preserved

With a wide range of quality accepted, TCs typically have not handled identity-preserved (IP) commodities, although that is changing. Increasingly, an opportunity is available to market IP commodities along with non-IP commodities in TCs.

NGCs commonly process and market an identity-preserved product as a means to ensure an acceptable quality product is produced. However, some large grain-oriented NGCs “trade” member deliveries for other grain that is procured in a manner more suitable and economic for a particular processing plant.

1.15 Initial Payment

The initial payment price received for commodities marketed through or sold to a cooperative is an important aspect that differs between TCs and NGCs. A traditional “buy-sell” cooperative pays the current market price at the time the commodity is marketed since it is not relying on a marketing agreement or pooling program. In contrast, NGCs pay the contracted price stipulated in the marketing agreement between members and the cooperative. The contracted price could be either lower or higher than the current market price. Producers should recognize that they are not just producing raw commodities, but are really producing processed goods. Total revenue or income is based on the initial payment and other payments, usually as

income distributions based on returns from further processing and/or marketing of raw commodities.

1.2 Patron Profit Distributions

Many important differences between TCs and NGCs become evident in the activities relating to the income or profit distributions by cooperatives to their members. Three characterizing activities are (1) cash patronage rate, (2) investment or retained profits and (3) pooling distributions.

1.21 Cash Patronage Rate

A patronage refund is a payment cooperatives make to members from total patronage income or margins based on the quantity or value of business done by each member. Part of the refund is paid in cash and part is retained as an equity investment by the member. In TCs, the cash patronage rate is relatively low. Payments of 20 to 35 percent are common. The retained patronage refund amount is then redeemed later based on the cooperative's redemption program.

The cash patronage rate is often much higher in NGCs. Cash rates are usually 65 to 85 percent. Since each member has invested equity in the cooperative "up front" to purchase marketing rights when the cooperative is established, a high cash patronage rate can be paid each year.

1.22 Investment or Retained Profits

Equity investment can be from external sources or from internal cooperative operations including retained patronage refunds, retained earnings and per unit retains. In TCs, most new equity comes from internal operations, especially retained patronage refunds. Therefore, a high percentage of the income distributed to patrons is retained and invested to finance assets including business expansion and improvement and to replace the "old" equity of those using the cooperative less with "new" equity of those using the cooperative more.

This contrasts with NGCs, which usually invest a small percentage of the members' profit distributions back into the cooperative. NGCs usually have a high proportion of their equity from directly invested, permanent capital when they are established. Members intending to use the cooperative less sell their stock to members desiring to use the cooperative more.

1.23 Pooling Distributions

Pooling is an alternative way to set and pay the price for the products each cooperative member markets through the cooperative. Pooling is based on using a marketing agreement and then setting the price paid after the pool has been marketed and a net margin has been determined. In effect, a delayed pricing or payment mechanism is used. An initial or advance payment is made upon delivery and then one or more progress payments are made until the pool is closed and a final margin is known and paid. A pooling distribution in TCs is relatively rare, but more common in NGCs.

1.3 Owner Investment Obligations

In a cooperative, users who are patrons and members are also expected to be the owners. Many significant differences surface when comparing the investment obligations that members (owners) are responsible for in TCs and NGCs. Six ownership activities or characteristics can be used to describe the differences in TCs and NGCs. The six are (1) initial investment, (2) proportionality to use, (3) liquidity of exchangeability, (4) exchange value, (5) redemption obligation and (6) business expansion investments.

1.31 Initial Investment

One of the most significant differences between TCs and NGCs is the initial equity investment. In TCs, the initial investment is usually very low, often less than $100. However, each member of many NGCs typically invests $10,000 to $12,000 to purchase marketing rights. For example, to become a member of United Spring Bakers, Fargo, North Dakota, a minimum of 800 delivery right shares at $6 per share plus $200 in membership stock, or $5,000 total, was required. Many members purchased more than the minimum amount. As another example, the 21st Century Ladder Creek Dairy, Tribune, Kansas, offered a minimum of five shares at $1,000 each. In lieu of cash stock purchases, this cooperative also allowed farmers to transfer ownership of corn, grain sorghum or alfalfa hay in exchange for their shares. Often NGCs limit the total amount of shares that one member can purchase.

1.32 Proportionality to Use

Proportionality to use is the extent to which members have invested equity in proportion to the use of the cooperative. For example, if a producer did one percent of the business, they would be expected to have an investment equal to one percent of total producer allocated equity. In traditional, open cooperatives, a member might choose to employ the cooperative as the marketing agent for a great deal of their products or, at the other extreme, to not use the cooperative. From one year to the next, the range of use and proportionality could vary as the member chooses. Even if the amount of business is uniform each year, over time proportionality is low because equity investment comes from operations and accumulates during the “life cycle” of the member.

However, NGCs have a contractual delivery obligation with members who are required to market their products at a steady, agreed upon amount. Furthermore, marketing rights are purchased with equity investments and so investment is proportional to use in the beginning. Proportionality may decline over time if significant amounts of patronage refunds are retained.

1.33 Liquidity or Exchangeability

Liquidity or exchangeability refers to the extent to which ownership can be transferred between owners. In publicly held companies, an open market exists for stock on a stock exchange. In almost all cooperatives, and many other companies that are closely held, no open market exists and transfers are highly restricted. TCs are much more restrictive than NGCs. Members increase equity in TCs primarily through retained patronage refunds and per unit retains. Members decrease equity through equity redemptions made by the cooperative. These are transactions with the cooperative and are at the discretion of the board of directors. Transactions between members are rare.

NGC members increase equity primarily by purchasing stock that represent or convey

transferable delivery rights. NGC members can decrease equity by selling their stock to other members, approved by the board, at a negotiated price. NGC members therefore have much more ownership flexibility or liquidity than TC members. At the same time, NGCs have a much higher proportion of allocated equity that is "permanent" capital than TCs because NGCs have more purchased stock that does not get redeemed.

1.34 Exchange Value

One of the major differences between TCs and NGCs becomes apparent when examining the exchange value of equity investment when equity is transferred or exchanged. The exchange value of TC equity is fixed at the par value at the time of purchase or retention. In TCs the par value is the value used when equity is redeemed or purchased by the cooperative from members. New members are able to join TCs whenever they desire and their equity investment is valued at par.

The exchange value for stock in NGCs is variable and depends on the market price members obtain if they sell their delivery rights to another member. The price members pay for stock sold by the NGC is usually a set price at par value and provides equity so the business can be established. This exchange value feature of NGCs has the potential to increase (or decrease) the value of each member's equity stock compared to the price they paid. The value is highly correlated to expected profitability of the NGC.

1.35 Redemption Obligation

Redemption obligation refers to the expectation the cooperative will redeem the member ownership under specified conditions. For example, some cooperatives redeem the equity of those members who die or reach a certain age. The redemption obligation is based on the ability to purchase members' equity and the policies of the cooperative's board of directors. If the funds are available, member equity may be redeemed. In NGCs there is no redemption obligation or expectation of members for previously purchased equity stock. The transferable delivery rights of NGCs allow for the sale of equity stock in whatever manner their by-laws allow.

1.36 Business Expansion Investment

When a business expands by adding assets, a portion of those assets is usually financed with additional equity. When a TC business expands, there is usually no immediate investment obligation by individual members. This is because TCs do not directly link volume of business by members with up front direct equity investment by members. However, equity investment will come from operations by retaining more equity from the revenue or income stream and over time, total equity investment of a member will increase if no redemptions are made. This will gradually increase the equity investment of those members who continue to do business with the cooperative.

On the other hand, when a NGC expands in a significant way it usually sells stock and creates marketing rights to utilize this additional capacity. This process is similar to the process used when the NGC initially was formed. Therefore, there is an immediate investment obligation by those members who want to utilize the additional capacity.

1.4 Member Voting Control

Businesses are controlled by those who have the right to make decisions. Proprietorships, partnerships, LLCs and corporations each have governing mechanisms. Corporations, including cooperative corporations, vest those rights in voting stockholders or members. Voting members of cooperatives approve articles of incorporation and bylaws, elect directors and may approve other actions such as mergers, acquisitions and dissolution. TCs and NGCs may differ in terms of two control aspects (1) membership eligibility requirements and (2) voting power.

1.41 Eligibility Restrictions

TCs commonly have low eligibility restrictions for membership. In general, agricultural cooperatives require members to be producers or associations of producers. Some TCs require members to sign a marketing agreement stipulating certain conditions, such as growing or quality requirements, for membership. This type of marketing agreement is the rule and not just an

exception in NGCs. In addition, NGCs require the purchase of marketing rights or stock. This results in high eligibility restrictions for membership in a NGC.

1.42 Voting Power

The voting power for members in TCs is usually one vote per member, regardless of the patronage volume done by each member or the level of ownership. NGCs more frequently allow a variable amount of voting power for members based on stock owned. However, laws in many states only permit one vote per member. By far, most TCs and NGCs follow a one member, one vote rule, but NGCs are more likely to depart from this rule.

CONCLUSION

New Generation Cooperatives differ from Traditional Cooperatives in that NGCs focus on value-added products instead of raw commodities, which is usually one focus of TCs. A strategy that distinguishes NGCs from TCs is a restricted or closed membership, which stems from the market-driven nature of NGCs. This market-driven strategy often targets niche markets that desire specific value-added products.

There are many identifiable differences between traditional open cooperatives and closed new generation cooperatives. The differences can be categorized into four groups based on the producer's role or relationship with the cooperative and the associated cooperative business functions. The categories are (1) customer marketing transactions, (2) patron profit distributions, (3) owner investment obligations and (4) member voting control.

NGCs process their members' products in cooperatively owned processing plants and the profits from processing are then distributed back to the members in proportion to their share of equity stock in the NGC. However, their equity stock does not just convey membership rights, but also conveys and allocates delivery rights. A dual contract is established between each member of a NGC and the cooperative business. The producer member must deliver the units he has contracted and the cooperative must compensate each producer for his contracted share.

A major difference between TCs and NGCs is that a high percentage of the cash patronage from NGCs are returned to members each year. In TCs, cash patronage rate is relatively low. The retained patronage refund amount in TCs is then redeemed later based on each individual cooperative's redemption program.

One of the most significant differences between TCs and NGCs is the initial equity investment. In TCs, the initial investment is usually very low, often less than $100. However, each member of many NGCs typically invests $10,000 to $12,000 to purchase marketing rights.

Another important difference between NGCs and TCs is that equity stock may be traded; either among established members, or, usually with the board of directors' approval, to outside producers. The market value for equity stock is reflected by the expected profitability of the NGC.

Another distinction between NGCs and TCs is observed in business expansion, which is usually financed by additional equity. When a NGC expands, it generally sells additional stock and creates more marketing rights. However, when a TC expands, usually no immediate investment from members occurs. Over time in TCs, equity investment will come from normal business operations if relatively small or no redemptions are made to members.

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