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AGRIBUSINESS MANAGEMENT

AGRIBUSINESS COOPERATIVES IN THE 21ST CENTURY

For a brief moment, consider the following scenarios; each of which actually occurred during the past 12 months.

Case I: A highly reputable food processing cooperative with over 30 years of operating history has just solicited a vote of its membership to consider converting to an investor-owned corporation. The conversion was approved, but within 8 months, majority control of the new corporate entity was acquired by an industry archrival. Just 4 months later, all local processing facilities had been closed, and operations moved elsewhere and absorbed by the rival firm.

Case II: Two competing fruit packing cooperatives undertook merger discussions and a feasibility study was underway. Board discussions had progressed well and early indications suggested that combined access to pre-sizing facilities would substantially reduce overhead expenses for area growers. However, 2 large member-growers had reached retirement age and were anxious to "cash out" their cooperative equities. Each threatened to cast a negative vote on the general membership election to merge, thereby exercising "dissenter's rights" and forcing both cooperatives to redeem equities at face value. This prospect of preferential treatment for the two dissenters caused an immediate collapse of merger considerations.

Case III: The loss of CCC storage revenues resulted in financial stress for a private grain handling firm and it was threatened with loosing its bonding capacity. A local cooperative had long expressed a serious interest in purchasing the storage and seed cleaning facilities, but the cooperative board could not reach an agreement on who would manage the new facility following its purchase. During the period of extended delay, the private firm suddenly announced that discussions with the interested cooperative had been terminated and their facilities had been sold to that cooperative's archrival. Within a year, this rival used its newly purchased facilities to attract area growers and the cooperative found its market share had decreased by nearly 30%.

In each of the scenarios described above, cooperatives appeared to function poorly in their contemporary environment. In case I, the patrons' desire to cash in on the asset appreciation of their cooperative resulted in the physical loss of the area's only processing facility. Any gains which producers realized from the sale of their cooperative were soon offset by the added costs of hauling their produce an additional 80 miles for processing. In Case II, the selfish interests of just two growers were so influential as to reverse any gains which might have accrued to all growers as a result of a merger. And in Case III, a simple personnel decision delayed a cooperative board's action so long that a rival firm capitalized on the opportunity, leaving the cooperative to struggle with a major loss of its market volume.

These general scenarios, repeated again and again throughout the Pacific Northwest, do not speak well for the future of our cooperative enterprises. It gives rise to the question of whether or not cooperatives are likely to remain as economically viable operations as we approach the 21st century. Most agribusiness cooperatives are creatures of the 20th century; their origins can be traced to the economic trials of the depression or post-depression years. These cooperatives were formed and grew into viable operations because they fulfilled an economic need. Does such a need remain today? Will cooperatives fill this need in the next century or has their time passed along with the buggy whip and the horse drawn carriage? The purpose of this paper is twofold. First, I shall attempt to review the various economic needs, which cooperatives have historically fulfilled. Second, I shall contemplate whether such basic economic needs are likely to remain in the 21st century and whether or not cooperatives are adequately equipped or prepared to address this contemporary environment.

PRODUCER/PATRON WELFARE

In one respect, little has changed since the early 1900s; i.e., agricultural producers are continually in search of high quality products and services at competitive prices. As we look forward to the 21st century, producers' economic welfare will remain indelibly linked to this pervasive search. Yet in a market economy such as ours, other types of organizational forms of business have proven themselves capable of addressing these needs. In this regard, cooperatives do not enjoy any comparative advantage because corporations, partnerships, and individual proprietorships are equally capable of addressing the growers' needs.

If all alternative organizational forms of business that are equally capable of fulfilling this economic need, why have some agricultural producers chosen to organize, finance, and manage cooperatives? At the time of their origin, cooperative organizers must have envisioned some real or perceived benefit. Such real or perceived benefits must have been based on the unique relationship cooperative patrons have with regard to the firm's control, ownership, and distribution of profit margins. As members (voters), owners (investors), and customers (patrons), the agricultural producer is entitled to receive a share of the cooperative's annual operating savings, based pro rata on patronage.

But producer welfare may be enhanced by means other than direct receipt of patronage dividends each year. For example, the grain producer may capture added profits resulting from the cooperative's storage, transportation, processing, and marketing of his/her grain. Such added profits appear as "value added" and do not become a portion of year-end patronage earnings.

Based on the principle that cooperatives provide goods and services to their patrons at cost, this feature remains their single most distinguishing characteristic. In essence, at the end of each accounting period (fiscal year), the cooperative provides refunds to its customers/patrons to adjust for overcharges on sales to patrons (of goods and services) and underpayments on purchases from patrons (of products the cooperative marketed). Historically, this operational characteristic was considered a very attractive attribute. But will this distinguishing feature be judged equally attractive in the 21st century? I think not. Numerous recent surveys show that patronage refunds are approaching minimal or insignificant levels. The complexities of patronage retained programs, time-value considerations, and the inability of patrons to rapidly capitalize on such investments suggest that the future will not judge well this cooperative practice. Those same surveys also show that providing goods and services at a competitive price remains the primary measure of patron economic welfare and that the generalized customer relationship is much more important than the owner-patron relationship historically fostered by cooperatives.

In my opinion, cooperatives can no longer sell themselves and base their long-range futures on their patronage refund practices. I'll offer this personal observation in support of my belief. For years I have patronized a local farm supply cooperative. Last year, after 14 years of continuous patronage, I received my first cash redemption of previously earned, but retained, patronage. The cash sum was welcome, of course, but the expectation of receiving it was not the major reason I chose to patronize this cooperative over the years. My local cooperative farm supply store opens for business each day at 8:00 a.m., long after I reach my office. To purchase my feed, hardware, and other supplies I must do so at a very early hour each day as I travel to my university office. Hence, I have often entered this store as early as 6:45 a.m., but never later than 7:30 a.m. In each and every case I have found the door unlocked and the resident manager willing to serve me long before the store is “officially” open to the public. Not once in 14 years have I been refused service or asked to return after the 8:00 a.m. hour. This level of service and the store’s willingness to accommodate my early morning purchases is the primary attraction of this cooperative entity. Even in the absence of this year’s cash patronage redemption, I would continue to patronize this cooperative because it fulfills my unique needs. I’m convinced that this special level of service will support my local cooperative as it prepares for the 21st century.

MARKET FAILURE

Any student of cooperative history can easily trace cooperative origins to periods of so-called “market failure.” A competitive market is one wherein a large number of active buyers and sellers participate and/or negotiate. While the number of agricultural producers (sellers) has diminished to less than 2% of the U.S. population, they remain rather atomistic in nature. On the other side of the market, buyers have also diminished in number, and grown in size due to the prevailing pressures of economies of size. Therefore, in general, the power to price at a level other than cost is conveyed to the oligopsonist (one of a few buyers) at the disadvantage of sellers. Other spatial dimensions of a market may result in an imbalance of market power and thereby contribute toward a “market failure.”

The least-cost organization of firms marketing farm products may mean there will be only one firm in the “best” position to serve any given farm or group of farms. In the rush to achieve efficiency in processing grain products, firms may be needed which are so large as to require in-shipments of grain from distant points of production. With fewer buyers for their products, farmers are faced with the prospect of downward pressures on prices or moving their products over great distances to access alternative markets. Either prospect characterizes a “market failure” and has, historically, given rise to creating cooperative entities, the purpose of which was to purchase and handle locally produced agricultural commodities.

Will this need for a local market for area produce continue to serve well the interests of agricultural cooperatives in the 21st century? The answer rests more heavily on our transportation network and less heavily on the historical role of cooperatives.

If you envision a 21st century transportation system that is much improved quantitatively and qualitatively, then we can forecast the gradual disappearance of local cooperatives and an increase in the direct shipment of commodities to regional markets or port cities. As farmers expand their use and ownership of high volume grain trucks, this too will reduce the need for and use of local cooperative storage and marketing facilities. However, the long-range future of the transportation system serving our agribusiness industry remains uncertain, at best. In the Pacific Northwest, railway abandonment, waterway user fees, and a deteriorating farm-to-market road system would suggest a cautious view of the future. Even as our nation’s interstate highway system suffers from overuse and we must wonder if locally provided agricultural services might become more, not less, important in the 21st century. Under this latter scenario, local cooperatives might well be in a position to best serve those needs which cannot be addressed by larger, but more distant entities.

PROFITS CAPTURED THROUGH VERTICAL INTEGRATION

Many farmers perceive that firms at any level beyond their own commodity production system are generating larger returns to capital invested than those accruing at the production level. It is not that difficult to gather data, which supports this perception. In any case, this perception creates a natural incentive for farmers to invest in a firm or a venture that is vertically integrated forward from the point of production. Their desire is to capture a share of those higher earnings from such functions as storage, processing, packaging, and merchandising. However, a single farmer operating alone is rarely in a financial position to capture these added profits and a cooperative composed of like-minded farmers becomes an appealing alternative. We can all think of numerous examples of cooperatives, which have served well the interests of their grower-patrons in this regard. “Middlemen” profits, which were once extracted from other firms in the food chain can be captured by cooperatives; the benefits returned to and shared with the producers.

A look into the 21st century would suggest that cooperatives face an ever-increasing opportunity in this regard. Farm gate prices for commodities produced comprise an ever-decreasing proportion of the retail dollars spent on food by U.S. consumers. The future suggests that this trend will continue as processing, packaging and merchandising becomes more complex and more capital intensive. Producers who voluntarily abrogate their interest in such activities beyond the farm gate face a future where sustainable levels of profits are rare. Cooperatives provide a vehicle through which farmers can vertically inject themselves forward into the food chain, thereby increasing their chances of extracting a reasonable level of return on their investment.

Cooperative enterprises which represent a vertical expansion of the on farm production system provide an added advantage not often cited in the literature; i.e., profits extracted from the process or function performed are not immediately “leaked” from the local economy. Investor-owned corporations, for example, are quite capable and willing to perform these same processes or functions. Profits thereby extracted are paid as dividends to investors who rarely reside in the rural community where the firm’s facilities are located. Corporate headquarters may be located thousands of miles away and through inter-corporate ownership the parent company’s stockholders may possibly even reside outside the U.S.

Cooperative entities, particularly those, which operate under a federated structure, are locally owned and controlled. Profits captured through vertical integration accrue to the local producers and those dollars remain to further stimulate the local economy. When a corporate entity closes its business in an isolated rural community, the loss of employment base can be substantial. But when a local cooperative fails or closes its place of business there is a similar loss in employment base AND a subsequent loss of local business volume, which had been supported by that firm’s profits which previously had been reinvested locally.

MISSING/UNFULFILLED SERVICES

A commonly stated reason for cooperatives is that they provide services (input or marketing) that otherwise would not be available. If you drive across northern North Dakota, you find ample support for this belief. Cooperative grain receiving and storage facilities can be found at regular intervals along the major railway running east to west. Local residents will tell you, with a deep sense of conviction, that if cooperatives had not been organized in the 1940’s and 1950’s, the state’s grain production would have suffered irreparably. Except for the emergence of these cooperatives, no one was willing or able to fulfill the needs of those grain producers.

In Washington, I'm sure that you can find marketing or supply-cooperatives which are still viewed as entities analogous to the R.EA.; i.e., if it were not for the efforts of the Rural Electric Administration to provide a deeply needed rural service (electricity), our farmers would still be listening to the morning hog market report on battery powered radios!

The economic logic of this perspective demands careful examination. Historically, I'm sure our rural areas were plagued by the absence of many services and that cooperatives served well and admirably the interests of those isolated communities. But as we look forward towards the 21st century, I'm doubtful that cooperatives can or will survive on the basis of providing products or services which are, "no where else available." Unless there are other compelling reasons for the service or product to be provided by a cooperative, in the future any activity that cannot give the ordinary investor a normal return would also be a mistake for a cooperative to provide.

ASSURED SUPPLIES OR MARKETS

Assuring a source of critical supplies or a market for a highly perishable product is another reason cooperatives exist. While this economic justification is similar to that mentioned above, the primary difference is the environment of "risk." The question is no longer whether, the service or product can be provided by an investor-owned firm, but rather whether that source or provider can be depended upon to place the needs of the producer above those of all others.

An example of this cooperative attitude surfaced in 1973 during the so-called U.S. energy crisis. During that period, fertilizer supplies were limited and products provided by investor-owned retailers were allotted based on the highest bidder. Conversely, cooperatives assumed a different philosophy and attempted to assure deliveries to their established patrons at pre-season list prices.

Those farmers producing a perishable product, face loosing their entire crop when faced with the sudden loss of their market. Delivering under contract to an investor-owned processor may appear attractive, but that contract is subject to annual renegotiation. Those who deliver to a processing cooperative are afforded some added security that their crop will be accepted year-in and year-out despite market volatility.

A look into the future would suggest that cooperatives would retain this particular economic appeal. While an investor-owned firm may chose to terminate product lines in times of sudden economic adversity, the element of grower control exercised by the users of a cooperative would seem to reduce this risk, at least in the short run.

MARKET POWER

Earlier I discussed the economic environment wherein farmers might chose to organize a cooperative (vertically integrate forward into the food chain) to displace a private firm, thereby ensuring high profits as a result of their market power. History can well document cases where cooperative entry has significantly decreased the market influence of private firms competing in that market. In some cases, this has proven so successful that bargaining/marketing cooperatives have achieved such a share of the commodity market that brand recognition and customer loyalty afford that cooperative the market power previously held by their private competitors.

A look into the 21st century suggests that while the potential for cooperative-held market power is large, cooperatives' ability to exercise such power to the benefit of their growers is seriously limited. Quite aside from Capper-Volstead considerations, cooperatives with an open-membership policy, or one dealing with a product not easily differentiated, will find it increasingly difficult to exploit their market power. We must also recognize that our society has become one where consumer welfare is judged paramount to producer welfare. Even if the 21st century should afford cooperatives the opportunity to exercise some small amount of market power, it's unlikely that an adverse impact on the retail price of food would long be tolerated.

A COMPETITIVE YARDSTICK

Students of cooperative enterprise have long held the position that cooperatives fulfill a major economic role as a competitive yardstick; i.e., the major reason cooperatives exist is to maintain a competitive and efficient system to supply inputs and marketing services for growers. The essence of this rather abstract argument is that cooperatives' major contribution to agriculture and society in general is in their providing a measure by which the performance of other firms can be judged.

In my own classes, I teach that if a truly competitive system/market is achieved, all firms are forced to use efficient methods and to operate at sizes that serve to minimize per-unit cost. Prices will be forced to levels that generate a normal rate of return to capital invested and management applied. A successful cooperative, therefore, will provide assurances that the going price charged by all businesses is equivalent to pricing at cost when all costs, including a normal return to capital invested, are considered. Of course, this argument makes for an interesting classroom /academic discussion and the "real world" is rarely so accommodating.

Unfortunately, to confirm or reject this hypothesis that cooperatives provide such a "yardstick" measure would require that all cooperatives suddenly close operations and the resultant level of economic activity be evaluated. If you believe that a "high-wire artist" is tempting death by his/her actions, that belief can only be tested when the safety nets have been removed and the results of the high-wire walk are assessed.

I sincerely hope that the 21st century will not provide such a test. I remain convinced that cooperatives comprise a very real competitive influence in a given market and the loss or closure of a cooperative is a high price to pay just to confirm or reject that belief.

SUMMARY

Most cooperatives in existence today are creatures of the 20th century. You can trace their origins to a multitude of economic factors or needs. That these organizations remain viable today is proof that they continue to fulfill such a need and perform some economically valuable function. But "times are changing" and the 21st century looms precariously near. Those economic factors, which have contributed towards cooperatives' past and current success may or may not be evident in the next century. This paper has reviewed the historical bases for cooperative formation and existence. Each basis is then assessed in light of the changes likely to characterize the future. Cooperatives cannot remain complacent. They cannot ride calmly into the next century based solely on the proposition that functions, services, or products provided in the past will serve adequately the future needs of their member-patrons.

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