Cooperatives: A Vehicle for Cost Sharing and Expansion

Susan L. Slocum, Research Assistant, Department of Resource Economics, University of Nevada, Reno
Kynda R. Curtis, Assistant Professor and Extension Specialist, Department of Resource Economics, College of Agriculture, Biotechnology, and Natural Resources, University of Nevada, Reno

What is a Cooperative?

Increased globalization, corporate agriculture, and competition have forced the agricultural community to reassess its distribution of resources and profit potential in current markets. Capital acquisition, human resources, and risk management tools are in limited supply for small farmers and producers. By combining these resources with other organizations in similar industries, producers are better able to compete in an unpredictable business climate.

A cooperative is a business entity that is owned and controlled by the membership that utilizes its services. Through joint investment and marketing ventures, combined resources, and reduced production costs, member producers can increase market exposure and improve sales. Cooperatives derive from small business owners, manufacturers, growers, or citizens who lack resources, training, or open markets for their products. Three characteristics make a cooperative different from other business organizations: (Rapp and Ely, 1996)

- User owned
- User controlled
- User benefited

Each characteristic requires participating partners to invest financially in start-up and operating costs, participate in governing over company decisions through a democratic process, and share the benefits and profits with others in the organization.

What Are the Benefits of Forming a Cooperative?

The key advantages to forming a cooperative are the enhancement of value-added products, including providing unique marketing strategies and product differentiation. Pooling limited resources through cooperative development provides farmers with increased access to consumer dollars and niche marketing opportunities.

History of Cooperatives in the U.S.

1752: The first successful cooperative was organized in the United States when Benjamin Franklin formed the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. It is the oldest continuing cooperative in the US.

1844: The Rochdale Equitable Pioneers Society was established in Rochdale, England. These pioneers wrote down a set of principles to operate their food cooperative which contributed to their success and spread to other cooperatives around the world. The successful establishment of the cooperative in Rochdale marks the beginning of the modern cooperative era.

1865: Michigan passes what is believed to be the first law recognizing the cooperative method of buying and selling.

1895: The International Cooperative Alliance (ICA) was established. Today over 200 national cooperative organizations representing 92 nations belong to ICA, the apex organization of all national cooperative movements.

1916: The first national cooperative association was formed, which is now known as the National Cooperative Business Association.

1922: Congress passed the Capper-Volstead Act allowing farmers to act together to market their products without being in violation of antitrust laws.

1920s & '30s: Congress established governmental agencies, such as the Farm Credit Administration (1929), the National Credit Union Administration (1934), and the Rural Electrification Administration (1936) to provide loans and assistance to cooperatives.

1978: Congress passed the National Consumer Cooperative Bank Act, establishing the National Cooperative Bank.
markets. Individual farmers lack resources to process their products, often selling raw commodities instead. Cooperatives aid in vertical integration, giving individual farmers more control in an ever-increasingly competitive industry. Individual producers often lack the resources to react to changing economies. By combining assets, farmers can better adjust to market fluctuations.

Cooperatives provide an opportunity to purchase bulk supplies, thus reducing costs and improving selection. Through cooperatives producers may diversify the products they offer, increasing economies of scale and often alleviating the increasing need for equipment and manpower. Sharing supplies, human resources, and financing reduces the cost of multiple products for one farmer.

Due to the ever-increasing rate of technological change, it is challenging to stay in touch with current events and environmental influences. Ongoing training requires an extensive investment of time and money. Since, many producers within the same industry require access to the same types of information, cooperatives offer members opportunities to stay informed through clubs, seminars, and networking. With value-added products, consistency between all members increases individual accomplishments and reduces local competition. Information sharing becomes essential to success.

What Are the Disadvantages of Forming a Cooperative?

Cooperatives bring producers of similar products together in order to increase profits. Hence, producers become integrated with their neighbors, relying on uniform compliance for success. Management practices at differing farms and ranches can have increasing influence over cooperative members negating uniformity among members. While economic downturns and environmental conditions tend to affect regional farms similarly, independent producers are rarely concerned with technical practices of regional growers. Quality standards and reputations become uniform when output is pooled under one brand name.

While most cooperatives allow individuals to determine their comfort level of investment, marketing agreements may force producers to provide certain types of crops, decreasing farmer flexibility. Personal hardships and land management practices must conform to obligations set forth in a cooperative agreement.

As with all businesses, there is a risk of failure. Having a feasibility study to determine the needs of producers and market conditions greatly reduces the risk. A solid business or marketing plan should be completed before the start of operations to ensure a strategic plan is in place.

Are All Cooperatives the Same?

While there are many forms of cooperatives, two distinct types include: traditional cooperatives (TCs) and new generation cooperatives (NGCs). The four key differences between these two entities include: 1) customer marketing contracts, 2) profit distribution, 3) owner investment responsibility, and 4) member voter control (Coltrain et al., 2001). Additionally, these four differences can be subdivided into distinctive practices and owner requirements.
are usually not included in TC's marketing agreements and members are free to sell their goods in the open market or through the cooperative.

TCs are usually required to find a market for products at all quality levels, so quality levels can span a broad range. NGCs, on the other hand, specialize in identity preserved branding and require a predetermined level of quality. Identity preserved products ensure a standard level of quality to all customers and a consistent level of output for the organization. TCs are beginning to break into identity preserved products, and both types of cooperatives can trade lower quality product for increased quality to provide more opportunities for members.

TCs reimburse incoming products at market prices since these do not rely on the pooling of resources. NGCs, through their marketing contracts, establish a contract price for inputs. Sometimes these prices are higher or lower than market levels.

While there is no minimum number of investors needed to begin a cooperative, financial start-up requirements and meeting supply goals should be considered during membership recruitment.

**What are the Initial Investment Requirements?**

There are significant differences between TCs and NGCs when comparing investment obligations. These include 1) initial investments, 2) usage proportions, 3) exchangeability, 4) exchange values, 5) redemption policies, and 6) business reinvestment.

The most noticeable difference between cooperative types is the amount of initial investment required to become a member. TCs generally have a relatively low start-up cost, sometimes less than $100. There are rarely limits on the number of shares a member can purchase. NGCs require a larger initial investment because marketing rights are also being sold with membership rights. NGCs can require over $10,000 per share and limit the number of shares each member can purchase.

Proportionality refers to the amount of use granted to a member based on their current investment. Since TCs do not require members to provide a certain level of use, there is a varied range in each participant's allocation from year to year. NGCs require a contractual delivery obligation along with the purchase of marketing rights. Ownership proportionality remains relatively constant over the life of the cooperative, unless members sell their shares or an extensive retained earnings policy is established.

The extent that ownership can be transferred between members is called exchangeability. Cooperative memberships are not traded in public markets; so cooperative members must establish a policy for the sale and acquisition of ownership between members. The TC's board of directors usually acquires or releases retained earnings to allow members to change their ownership status. A direct sale between participants is rare. NGC members usually purchase or sell stock options to other members or incoming parties. Stock sales are negotiated through the governing board at a negotiated price. NGC members have more flexible options than TC participants.

The exchange value of ownership is fixed at a par value at the time of purchase. In TCs, par values are determined by the rate equity is redeemed or released by the cooperative itself. New members are able to join at any time and their equity investment is valued at par. In NGCs, par value is directly correlated to the expected profitability of the enterprise. Based on the going market value for delivery rights and marketing rights, a member's value may be higher or lower than their initial investment and retained earnings.

The expectation that a cooperative will redeem ownership is referred to as redemption obligations. While policies are derived by the board of directors, the ability to redeem ownership is dependent on the cash reserves of the organization. For TCs equity can be redeemed if cash funds are available. For NGCs, the ability to buy and sell membership to other producers means there is no responsibility for the cooperative to provide redemption obligations.

The adding of assets to replace obsolete equipment or expand production can be financed with additional equity. In TCs, expansion is usually financed through increased retained earnings or the utilization of previously retained earnings. In an NGC, additional marketing rights are sold to new or existing members who plan to use this increased volume.
How Are Profits Distributed?

There are many important differences between TCs and NGCs in terms of income and profit distributions. Because of the differing goals of each cooperative type, organizational finance is handled in distinct ways.

Profits can be disbursed in two ways. Cash payments directly to members and investors are based on the total quantity or value of business each member provides less retained earnings needed to maintain operations. In TCs, initial investment is relatively low. This requires the cooperative to retain a higher amount of profits to reinvest back into the organization. Cash disbursements range from 20-35% and the remainder is kept as equity in the organization. Members may redeem these profits later as member usage changes based on the organization's redemption policy. NGCs, however, require a larger initial investment by members, allowing a cash patron rate between 65 and 85% (Coltrain et al., 2001). Due to the nature of NGC marketing agreements, members who wish to decrease participation sell their stock to other members who want to increase their participation.

Pooling is another feature of NGCs. Using marketing agreements and utilizing a delayed pricing and distribution policy allows the cooperative to assess its financial needs and retain a net margin that is reinvested into the organization. An initial payment is made at the time of receipt of goods, and one or more progress payments are made after the needs of the cooperative are assessed.

Many states regulate profit distribution. State statutes dictate the amount of profit that can be disbursed back to cooperative members and the amount that can be reinvested into the organization. This does not apply to the state of Nevada.

Who is in Control?

A key fundamental principle of cooperatives is the participation of all members in the decision-making process. Voting privileges accompany all ownership types, although eligibility requirements and voting power differs between cooperative types.

TCs do not usually restrict membership participation, although agricultural cooperatives may require members to be producers or associations of producers. In NGCs, marketing agreements are required, so membership is limited to those who produce cooperative inputs.

In TCs, each member is entitled to one vote, regardless of the quantity of ownership each member holds. Many state laws restrict NGCs to a one member, one vote policy, but deviations based on delivery obligations and ownership investments are increasing.

Where Can I Find Additional Information?

University of Nevada Cooperative Extension web site at http://www.unce.unr.edu/.
University of Wisconsin Center for Cooperatives web site at http://www.wisc.edu/uwcc. Information on cooperative start-up, including forms and sample documents.
Rural Cooperative Center, Davis, CA. See http://www.cooperatives.ucdavis.edu/.
Center for the Study of Cooperatives, Saskatchewan, Canada. See http://coop-studies.usask.ca/.

References