

Bloomquist Lectureship Series 2003

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Turbulent Times: Reflections of the Role of Cooperatives in the Economic Organization of America

It is a welcome opportunity to participate in this Bloomquist lecture series sponsored by the Burdick Center for Cooperatives at North Dakota State University and other parties for three reasons. First, as a student of group action in agriculture for my entire professional career, I have a profound respect for the leadership of cooperative self-help initiatives by farmers in this region as they seek to become effective marketers of their members' outputs. Secondly, we need to recognize that leadership specifically provided by of Al Bloomquist, Wil Brekken and other board members in converting the American Crystal Sugar Company to cooperative ownership in the early 1970s represents a model of one type of strategic growth in cooperative enterprise. Thirdly, at a time of considerable stress and uncertainty in the National economy due to a prolonged recession, depressed commodity prices, corporate scandals of huge proportions, re-emergence of federal deficits and the Middle East war (each of which have an impact on the farm economy), it is a good time to reflect on the important role cooperatives play in the economic organization of agriculture and to assess some of the changes and challenges facing the cooperative sector. Coming to the North Dakota and Minnesota region, an area of considerable experience in managing cooperatives-- as well as experimentation with new forms of enterprise, provides an ideal setting to stimulate reflective observations as well as constructive insights regarding cooperative thought.

To start from a common departure point for interpreting my remarks, let's remind ourselves that cooperatives are a user-owned, user-controlled and user-benefited form of business enterprise. While they certainly have an impact on the communities, states and regions in which they are found, their primary role is to achieve economic and social benefits for members as users of the cooperatives services. Fundamental roles performed include providing market access for farmers, adding value to raw products demanded by consumers and industrial users, negotiating fair prices consistent with market supply and demand conditions, building a consumers franchise for members' products

through brand names and other forms of product differentiation such as identity preserved marketing, establishing grades and standards that emphasize quality for the sector as a whole, providing a voice regarding marketing policy, regulations and other program issues, and serving as an educational mechanism whereby members become much better informed about the intricacies of market forces and market development opportunities in their respective industries. As a dimension of market structure, cooperatives also have a role in enhancing competition in the industries where they exist based on their objective of improving farm incomes.

More fundamentally, the very nature of cooperatives creates an opportunity for farmers to remain independent and to enhance their independence through development of effective group action marketing strategies. In this way a dispersed ownership structure in American agriculture is maintained consisting of a relatively large number of independently owned and operated farm enterprises dotting the country side. Let's recognize that this component of the economic organization of agriculture becomes more, not less, dependent upon use of cooperative marketing as we look to the future. The alternative is the increasing presence of vertically integrated, industrial style corporate structure characterized by off-farm ownership and control of food and fiber production. This latter approach effectively displaces independent farm operators and replaces them with piece-wage contract growers or industrial production units. For those of us who grew up in robust Midwestern agriculture, we recognize that cooperatives serve as a tool for farmers to integrate forward in the market place and to carve out their share of benefits. There is a critical need to retain policies and institutional structure that allow farmers to retain their independence and to utilize cooperatives as a means for sustained market growth.

There were 3,229 farmer-owned marketing, farm supply and related service cooperatives operating in 2001 with combined net business volume of \$103 billion according to USDA's Cooperative Service. Total assets were \$48.5 billion and net worth was \$20.1 billion. Net income generated was \$1.3 billion. Here in North Dakota we find 239 farmer cooperatives and a business volume of \$3.3 billion, which represents farm supplies sold, and products marketed by all cooperatives operating in the state.

Professional Association Stimulus for Cooperative Development

Development and expansion of cooperative enterprise often results from the stimulus of farmers' professional associations and/or cooperative bargaining associations. These are associations of farmers that represent farmers on issues involved in the business of farming. They may be general farm organizations such as Farm Bureau, Farmers Union, Grange, or NFO, or commodity associations such as those representing producers of cattle, pork, sheep, corn, durum, soybeans, wheat, fruit and vegetables and other commodities. The formation of American Crystal as a cooperative is a classic example of the influence and role of professional associations because it emanated from the Red River Valley Sugar Beet Growers Association of which Al Bloomquist was manager. Similar conversions of corporations to cooperative ownership are found in many sectors, such as the acquisition of Welch Foods by the National Grape Growers, and California Canning Pear Growers Association support for organization of Pacific Coast Producers to purchase plants that were leaving the area. More recently, turkey growers in Iowa and Michigan have developed new cooperatives when existing processors determined they would terminate operations in the region. In the red meats sector, beef producers

organized U.S. Premium Beef and purchased a 40 percent ownership of Farmland National Beef, and are poised to exercise their option to purchase more. Oklahoma and Texas Cattlemen's Association helped foster the organization of Consolidated Beef Producers. The Iowa Cattlemen's Association encouraged formation of Iowa Quality Beef Supply Cooperative, which has renovated a plant, purchased out of bankruptcy at Tama, IA, and is ramping up operations to harvest 1200 head of cattle per day. Similarly, Iowa Pork Producers Association helped form the Iowa Quality Pork Producers Cooperative which recently announced its intention to purchase the Iowa Packing Company.

You are all familiar with Michigan sugar beet growers' purchase of former Holly plants from Imperial Sugar, and the fact that western plains state beet growers have purchased plants formerly operated by Western Sugar Company owned by Tate and Lyle. American Crystal struck a deal to acquire Holly plants in Texas, Wyoming and Montana. The combined result is that ninety percent of annual sugar beet production capacity is now in the hands of grower owned cooperatives as shown in Table 1. Gains have likewise been achieved in ownership of sugar cane refineries. In fact, the grower-owned share of U.S. refined sugar has doubled in the past four years measured as a percent of production capacity (see Figure 1). The sugar industry represents a prime example of how farmers can organize a sector of American agriculture enabling them to better guide their own destinies. It is a sector – that like the dairy industry—can be held up as examples of what farmers can accomplish in the economic organization of agriculture. Each of these business development efforts by farmers have been encouraged by farmers' professional associations or existing cooperatives.

Other efforts in creating new cooperative businesses from scratch are found in the conversion of biomass to fuel, pasta from durum, and baking products from wheat and corn, and meal, oil and lubricants from soybeans, etc. A majority of these new starts have similarly received an important stimulus from professional farmers' associations.

The important point to drive home is that professional farmers' associations and cooperatives perform separate and distinct roles. One of professional association's roles is advocating and fostering development of cooperatives. This role is important to the sustained growth of cooperative enterprise *and* to assuring that cooperatives continue to focus on bringing benefits back to farmers and ranchers. These are complementary organizational forms with a synergistic relationship but with each having their own functional roles representing farm interests. This relationship is found not only throughout the United States, but also throughout the free world.

Development of cooperative enterprise is also assisted by the USDA's Cooperative Service through national and state offices, cooperative centers like the one supported by USDA and the North Dakota Electric and Telephone Association, the Burdick Center for Cooperatives, extension service and alliances found in several states. These are important institutional support mechanisms for conducting feasibility studies, board training and broader educational endeavors.

Challenges Facing Cooperatives

Having identified examples of significant growth in cooperative enterprise, we would be remiss if we didn't recognize some of the challenges facing farmers and cooperatives. These are truly turbulent times for the farm community. External and internal forces are creating churning waters for

cooperatives and other forms of businesses operating in the food industry. Key external market forces are characterized by increased globalization, industrialization, and concentration in food distribution and manufacturing. The rule of three is often posited as a fact of life in today's market. It suggests there is only room for three big fish in the corporate pond. You either reach that scale of operation or face being swallowed up by one of them. In particular, the Walmartization of the food distribution industry suggests that retailers are wielding inordinate influence on who has access to shelf space, and are demanding strict delivery and specification requirements. Burdens of carrying inventories are often left to the weakest links in the marketing chain. A benefit has been that substantial logistical and administrative costs have been wrung out of the food system as just in time deliveries have been made possible by sophisticated information management systems. But the power wielded in the process is very pervasive and unyielding.

Other external forces such as technological developments in food manufacturing, bioengineering, use of robotics in animal and crop production, and continued advances in information systems are each influencing methods of conducting business among food and industrial users of farm products. As more food is eaten away from home, and food purchases for home use stress convenience and twenty minute or less meal preparation time, a whole new cadre of ingredient combinations sourced both nationally and internationally are entering the food stream.

One of the most important factors influencing farm markets is international trade and the access sought to the large U.S. market by marketers from other countries. This is an especially sensitive area to sugar producers saddled with side agreements made with Mexico in the last trade round, and a number of bilateral negotiations currently ongoing with the Central America states, Australia and South Africa.

Internal forces affecting cooperatives include the bi-modal makeup of farm production units leading to a more heterogeneous membership base, mentality of some large farm operators who think they can cut their own deals rather than utilizing effective forms of group action, adaptation of federated systems to changing membership needs, and the aging of the farm population which affects capitalization strategies. Three very disquieting developments are the few failures among several highly visible regional and local cooperatives, attempts to convert cooperatives to corporate business forms, and attempts to modify state incorporation statutes by allowing investment and control by outsiders.

Time does not permit a full-blown discussion of each of these external and internal issues. However, I would like to elevate a few critical issues that require attention from farm leadership in cooperatives and farmers' professional associations. A number of these derive from some of the internal factors I have identified. My purpose in raising these is again to stimulate your thought, since answers will largely determine if there is a vibrant cooperative sector, so critical to the economic of organization of American agriculture, as we look to the future.

Causes of Recent Cooperative Failures

Since the stock market crash in 1999, we have seen a number of business failures in the corporate world often caused by accounting shenanigans to bolster appearances of strong earnings, but also from

greed among top officers. A few cooperative failures have caused a stir in farm country and brought out some finger pointing as well as casting a pall with some questioning whether cooperatives are still a viable business form. The fact is that there are a large number of highly successful cooperatives that continue to operate today and provide strong measures of benefits to farmer members and the rural economy as a whole.

A cursory examination of recent failures of businesses as cooperatives such as Farmland Industries, Agway, Agrilink Foods, St. Paul Bank for Cooperatives, MSI Insurance, Tri Valley Growers, Farmers Cooperative Association of Lawrence, KS, and Crestland Cooperative in Iowa suggests lessons to be learned for all cooperatives. Among them are the following:

Maintain a strong balance sheet with strong member equity base

Select top management that is knowledgeable about cooperatives

Strengthen board effectiveness

Reduce system costs, utilize proven technology, emphasize profitability

Focus on core competencies and don't try to be all things to all people

Recognize need to rationalize operations in a mature industry

Work to keep cooperative system viable, strong

Keep up with farming trends

Maintain Member Educational Programs

Failure to adhere to any of these lessons can certainly erode the status of the organization as a business and limit its effectiveness in representing member interests. A recent USDA study entitled Agricultural Cooperatives in the 21st. Century strongly encourages cooperatives to select managers who know the industry they are operating in and who embrace a strong cooperative philosophy that can be imparted to employees and members.

FOUR SIGNIFICANT ISSUES REQUIRING ATTENTION

Aside from these lessons from cooperative recent cooperative failures, there are several areas of particular significance that need to be addressed in more detail including cooperative capitalization and non-member related business activity, changes in cooperative statutes, issues regarding new generation cooperative practices, and maintaining standards of operation on a cooperative basis.

There Are No Silver Bullets

The issue of capitalization is often mentioned as the number one issue facing cooperatives today. This is predicated on the perceived need for growth in scale of business activity to meet the needs of large buyers, as well as the desire for entering more value-added lines of business. It is recognized that one of the opportunities for increasing farm returns is more involvement in processing farm produced goods beyond the raw commodity stage and converting them into products demanded by consumers and industrial users. Once entering this phase, there are continuing needs to replace depreciated assets and to stay on the cutting edge of new technology. No industry is more familiar with these requirements than the sugar industry since it is known for requiring huge amounts of operating capital.

It is also recognized however, that cooperatives can only grow as fast as the capital base of their membership permits them. Capitalization requirements in cooperatives are complicated by the aging farm population. One Kansas City Federal Reserve Bank official recently observed that the over one-half of farmers today are over the age of 55. This focuses attention on the requirement for new farmers or ones expanding their operations to pick up responsibility for providing equity in a transfer of ownership as older members retire. New generation cooperatives, like others face this issue through the transfer of delivery rights.

Continuity of cooperative business operations is clearly dependent upon strong capitalization by cooperative members. An adage is that if farmers want to control their cooperatives they have to capitalize them. Many cooperatives are in excellent shape financially and managing their equity with a great deal of proficiency. However, a few that tend to be very growth oriented, or some experiencing weak capital bases are seeking outside sources of equity capital.

Here we must raise a red flag cautioning producers that they are about to enter a very slippery slope regarding farmer control and future benefits derived from their business. Outside equity capital creates a mixed ownership and a different fiduciary interest in a business. Members seek high returns for the farm products marketed through the cooperative. Investors want the high returns on their invested capital as is clearly demonstrated by the owners of American Crystal before it became a cooperative. A conflict in purpose of the business therefore exists. Each party has a different financial interest and perspective of the business. Mixing the two inevitably results in lower returns for farmers as well as erosion of their control over the business that was originally organized to serve them.

One of my old bosses, Secretary Earl Butz was fond of saying that there is no such thing as a free lunch. We might also add that it is difficult to be half pregnant. Just to show you how ridiculous and extreme this thinking can become, one cooperative recently stated in its annual report that next year it will refund the final year of capital retains and will become one of a select few agricultural cooperatives that does not require the owners to capitalize the business! How long do you think such a business will remain a cooperative and under farmers' control?

My forty years as a student of cooperatives suggests there are no silver bullets regarding cooperative finance. Maintenance of a strong member equity base is essential for preserving ownership, control and benefits for farmers. Those that have sacrificed control have found it difficult to take control of their cooperatives back.

Reliance on other forms of financing such as licensing brand names, building large amounts of tax paid surplus derived from non-member business, or various offerings such as preferred trusts are also means of reducing reliance on the membership base. It would appear that those attempting to make hybrid businesses out of cooperatives do not have farmer member interests as their focal point. Such efforts appear to give management more license to seek earnings from non-member related activities. Over time, member orientation erodes and can even become lost, and farmers regard their cooperative's treatment of them as just another business.

Maintaining Legal Foundations

There exists a very strong legal foundation for cooperatives in state incorporation statutes and in federal laws relating to antitrust, taxation and securities. There are advocates today for creating new "cooperative" statutes. The so-called Wyoming law establishes patron and non-patron members. Under it and some other variations promoted in nearby states, the bylaws may provide that patron members have as little as 15 percent of the total votes on issues to be decided by the membership. This minimal user control can be further diluted if articles or bylaws prescribe giving a creditor, security holder, or "other person" a right to vote patron membership interests. USDA cooperative legal specialists call this statute and similar proposals anything but a cooperative law since it erodes significant member control, and hence ultimate benefits. These efforts should not be dignified by calling the resulting business a cooperative.

Much of current interest in creating a new law in Minnesota and some other states apparently stems from the utopian idea of creating opportunities for community supporters to invest in new "cooperative" operations. This community development approach apparently is done on the belief that investment by bankers, veterinarians and others in new ventures will carry the day. Obviously this concept of a "cooperative" does not square with farmer success stories like those represented by American Crystal, Associated Milk Producers, Minn-Dak and others. This type of enterprise has some of the same limitations as previously mentioned regarding outside equity sources. It raises fundamental benefit for whom questions.

A number of ethanol ventures identify conflicts of interests on their boards of directors based on outside director positions representing mixed ownership arrangements. Cooperative leaders are well advised to carefully consider the ramifications of those promoting new statutes changes before jumping headlong into support of such legislation, or altering their existing incorporation statutes to accommodate them. In instances of both outside equity capital and statute changes, there appears to be a herd mentality enveloping some facets of the cooperative community that may be as dangerous as it is unnecessary from a long term perspective.

Practices Leading To Demise of New Generation Cooperatives

One of the vexing issues for cooperative leaders is the cessation of a number of new generation cooperatives. After all, North Dakota and Minnesota were widely recognized in the 1980-2000 period as the mecca of "cooperative fever". A North Dakota farmer recently told me that new generation cooperatives in which he had an investment such as Dakota Growers Pasta, Minnesota Corn Processors, Pro Gold had all forgotten their farmer members and have all been lost. The only

organization that he felt really performed in his interest is American Crystal. This feeling of exasperation, even sellers' remorse, is expressed in a number of quarters today. It has certainly taken the bloom off of advocacy of this model which has been chronicled as the new wave of cooperative enterprise.

In a previous talk at Market Place in Grand Forks a year ago and at its sequel the Tennessee Market Place of Ideas this past January, I have observed that any short comings with new generation cooperatives were mainly the result of groups following faulty cooperative practices, and that the concept is a work in progress, not a final chapter.

Let's examine briefly the type of practices followed that may have had an influence on the demise of some of these cooperatives. They can be categorized as follows:

1. Ownership of delivery rights outside of one's own production.
2. Predominant use of off-market purchases (no traceability).
3. Leasing of delivery rights (ownership not in hands of current users).
4. Involvement of non-user investors (conflicts and benefit for whom?).
5. Loss of fundamental values (Patrie proposition).

Each of these practices require review and scrutiny so that they do not become an impediment leading to further loss of farmer control and cooperative presence in the market place.

The Price of Lapses in Cooperative Education

The USDA study previously referred to "Agricultural Cooperatives in the 21st. Century" resulted from a series of focus groups involving top cooperative leaders from throughout the United States. One of the salient conclusions from this study is that education on cooperatives should be viewed as an investment by both cooperatives and public decision makers. While the importance of cooperative education has not diminished, resources devoted to it have been seriously curtailed. So has the institutional structure supporting it within the cooperative community as well as many places in the university, extension system, and USDA.

Director training was identified as a number one priority. Without proper education, pressures will continue to mount on farmer-directors to abdicate their role as stewards of members' assets to outsiders, many of whom do not appreciate the importance of the member-user orientation that makes a cooperative unique. Cooperative education is also urgently needed for other audiences such as employees, youth, young farmers and the general public. Work at developing curriculum and projects in 4-H, FFA and community colleges helps lay the foundation for awareness and future use of cooperatives throughout rural America. The report concluded that erosion in cooperative education is as damaging in the long run as any failure in financial oversight.

One of the critical roles of education about cooperation is to set a standard for what constitutes operating on a cooperative basis. Lapses in these standards is what is leading to some of the off the wall changes promoted by outsiders in finance, governance, and business undertakings that have led to conversions, major losses in farmer equity, and cooperative presence in the market place not only in this country but also in places like Canada, the Netherlands and elsewhere.

Summary

A lot of ground has been covered in this lectureship identifying the important role that cooperatives play in the economic organization of agriculture and how they enable farmers and ranchers to compete in a changing food industry. The role of professional farmers' associations has been highlighted as a means of advocating and fostering cooperative development along with efforts of other institutional providers in the public and private sectors.

Key external and internal challenges facing cooperatives in turbulent times have been identified including some disquieting developments such as cooperative failures and faulty cooperative practices. I have identified lessons to be learned from some of these experiences and also raised serious questions about efforts to dilute farmers' control of their own organizations through outside equity and changes in incorporation statutes.

Control follows money. Farmers must continue to build on success stories like those found in the sugar industry here in the Fargo-Moorhead region and adhere to basic cooperative principles and sound operating practices. Educational efforts by cooperatives, the Burdick Center for Cooperatives and others are important to establishing what constitutes operating on a cooperative basis. Deviations lead to a loss of farmer control and rewards from effective group action.

Cooperative marketing is one of the key ways farmers can retain their independence, avoid being displaced, and pursue their rights beyond production in continuation of their vital role in American agriculture.

Randall Torgerson

Torgerson recently retired from the U.S. Department of Agriculture's Rural Business—Cooperative Service where he served as Deputy Administrator for Cooperative Services. He became Administrator of the Department's Cooperative Services in 1975, and served as its leader for over 27 years until his retirement in January, 2003. During his tenure at USDA, Dr. Torgerson directed the research, technical assistance and educational efforts of a staff ranging from 43 to 88 persons, primarily agricultural economists and cooperative specialists. The program also administered value-added marketing grants to applicants from throughout the country and cooperative research agreements with university personnel. In 1982, he received the USDA's highest performance recognition, the Distinguished Service Award.

He initially went to Washington, D.C. in 1974 as staff economist to the administrator of the Agricultural Marketing Service. He had been an associate professor at the University of Missouri-Columbia where he taught courses including cooperative business organizations, management problems of cooperative firms, and the economics of collective action in agriculture. He helped organize the Missouri Institute of Cooperatives, helped form the Graduate Institute of Cooperative Leadership at the University of Missouri.

Torgerson lectures frequently to farm leadership groups at seminars, workshops, and board meeting and annual meetings. A prolific writer of articles, speeches, editorials and position papers on group action in agriculture, Dr. Torgerson also authored two books: "Producer Power at the Bargaining Table" and "Farm Bargaining."