

Emmy Williams
Educational Media Coordinator

Amy Hagerman
Extension Assistant

Dr. John Park
Associate Professor
Extension Specialist

Department of Agricultural Economics
Texas A&M University
2124 TAMU
College Station, TX 77843-2124
Phone: (979) 845-1751
Email: jlpark@tamu.edu

Cooperative Management Letter
is supported through funding from the
Roy B. Davis Distinguished Professorship
in Agricultural Cooperation at
Texas A&M University. © 2007

TC*CD
The Texas Center for
Cooperative Development

The New Generation Cooperative

New generation cooperatives focus on value added processing, allowing the farmer to hold onto a larger share of the consumer dollar and guarantee him a buyer of his commodities. While not strictly "new," this concept has gained new-found interest as state legislatures contemplate new cooperative business models.

A cooperative business allows agricultural producers to gather their resources together and act as one. Collectively, they are able to efficiently address competitive issues such as providing needed goods or services, lowering operating costs, and increasing member income. Because the cooperative's customers are also its owners, the business tends to focus on their needs, typically offering favorable prices and secure markets. Through cooperation, an unstable market is made into a more predictable industry that benefits the members and their communities.

The traditional cooperative described above is very capable of serving the needs for which it was founded. In fact, the cooperative business model works especially well in situations where relatively few members are united in a strong common purpose, a minimal equity investment is required by any one individual, and operations are based on a solid business plan that is balanced with the marketplace. As an example, service cooperatives (like cotton gins) often perform well due to their specific purpose and ability to pass on operating expenses to the member without the need to carry costly inventories. Unfortunately, most modern cooperative efforts are formed around very different circumstances.

Value Added Cooperation

Historically, the traditional cooperative focused on commodities. Since

then consolidation that has taken place throughout the food system has resulted in an increased need and desire for agricultural producers to integrate into processing activities that add greater value to their crops. Through value added processing, farmers might gain from acquiring a larger share of the production chain. For example, instead of a farmer selling grain at market price, a farmer might process the wheat to make pasta, and then sell the pasta. The farmer then gains from selling not only wheat but also pasta. A cooperative business that can add value to the farmer's production could take advantage of greater marketing opportunities.



However, these types of businesses have sizeable capital requirements and (if they are to be successful) a great need to regulate the flow of production. Clearly, the traditional cooperative model with open-ended commitments to its members is not geared to these needs. A processing facility that is designed for a specific capacity would face financial difficulty if forced to purchase unneeded inputs in a surplus crop year or forced to operate below break-even in a short crop year. Even worse, lags and disturbances in production and distribution may alienate wholesale buyers and final consumers of value-added, branded products.

While these operational complexities might be overcome by a traditional cooperative business, raising the funds necessary to start such a ven-

ture would still be a problem. Not only is a large amount of capital required by members, but individuals lack the incentive to provide a sizeable investment because equal benefits are available to those who are far less invested, the potential for adequate returns to investment are limited, and the investment is not easily redeemed or transferred.

An Alternative Structure

For these reasons, many have turned to an alternative business structure known as a New Generation Cooperative (NGC). Introduced in the 1970s, the NGC in its most simple form is not a specific legal structure, but rather an alternative way of defining the relationship of the members to the cooperative. Like a traditional cooperative, the NGC allows for joint ownership by the people who use the business. However, the NGC differs from the traditional model in some very important ways.

- Membership is closed
- Participation depends on contracted delivery rights
- Ownership is transferable
- Equity investments can appreciate/depreciate in value

To understand the NGC, you need to first realize that members of a NGC have a much more formal relationship with the cooperative—not only do they have an exclusive right to use the business, they are contractually obligated to use it.

An Example

Contracts with a NGC are centered on the optimal capacity of its plant or processing facility. For an example, a facility is needed to process 6 million bushels of corn each year. A steering committee of those interested in the facility has decided that 5,000 bushels is a reasonable increment of deliverable product. Therefore, the facility would offer 1,200 shares (6,000,000 bushels / 5,000 bushels per share) available for purchase. The owner of that share is obligated to deliver 5,000 bushels to the facility each season. If the owner has no crop to deliver, arrangements can be made by the owner or cooperative to purchase the contracted amount on the open market. If the owner has a crop larger than what is contract-

Determination of Delivery Rights

Facility Capacity	6,000,000 Bushels
Share Size	5,000 Bushels
Shares of Delivery Rights	1,200 Shares = 6,000,000 Bushels/5,000 Bushels per Share
Required Equity Capital	\$3,000,000
Share Price	\$2,500 = \$3,000,000/1,200 Shares

The number of shares and share price are determined by the capacity and cost of the proposed facility.

ed, only 5,000 bushels per share is deliverable to the cooperative, with the rest marketed through conventional means.

To sell these shares during the initial start-up of the cooperative, a value needs to be determined. The steering committee has determined that it will need \$3 million in equity capital to build this processing facility. Therefore, the cooperative will sell the 1,200 shares to members, at a price of \$2,500 each (\$3,000,000 / 1,200 shares).

members of the **New Generation Cooperative** are contractually obligated to use it.

Again, each share would then allow the delivery rights of 5,000 bushels of corn. Individual members could purchase multiple shares. Benefits will be distributed by the cooperative based on the number of shares an individual owns. The result is that the benefits that members receive are proportional to their level of investment in the firm.

With the exception of the cost of the facility, these numbers are arbitrary and should reflect the needs of the potential members. Prior to an equity campaign, the business would be incorporated with by-laws that would delineate the terms of ownership including how many shares an individual may own and how these shares may be transferred to others.

Member Equity

In this way, members of a new generation cooperative provide their equity investment at the onset of their relationship with the business, not as a consequence of subsequent use. Individuals are capitalized proportional to their contracted future use of the cooperative. Members hold a tangible stake in the business and have an increased interest in making the cooperative grow along with their investment. Indeed, if the business thrives as planned, the individual shares will increase in value. Unlike a traditional cooperative, a member may regain his/her investment in the cooperative by selling shares at market value according to rules and procedures outlined in the by-laws. By way of comparison, a member of a traditional cooperative is invested through retained patronage refunds. Patronage refunds are a percentage of the cooperative's profits set aside for producers in proportion to the amount of business the member gave to the cooperative in a given operating cycle. The cooperative may redeem this investment at its *initial* value according to the discretion of the board.

Normally, a new generation cooperative will pay the member a percentage of the market price when the com-

Traditional Cooperatives	Features	New Generation Cooperatives
Member Benefits	Focus	Value-Added Processing
Supported through Debt and Retained Funds	Finance	Supported by Sale of Delivery Rights
Nontransferable and is Redeemed when Co-op Chooses	Ownership	Transferable and Fluctuates in Value
Continuous with Use	Investment	Up Front
Open	Membership	Closed
Returned in Proportion to Member Business with Co-op	Benefits	Returned in Proportion to Investment
Retained Funds Accumulate Over Time	Distribution of Funds	Distributed within Operating Cycle

modity is delivered to the cooperative with the rest being held until the residual revenue of the processing facility is determined at the end of the year. With new generation cooperatives focusing on processing and adding value to commodities, producers have more business opportunities in the production chain within one cooperative.

The NGC Summarized

To summarize, the processing facility in a new generation cooperative is financed through the sale of delivery rights. If expansion is needed in the future, further investment could be made through the purchase of additional delivery rights as new generation cooperatives do not retain member earnings from years past. Membership is limited and linked to the purchase of delivery rights. Through these delivery rights, a member guarantees to sell a given volume to the cooperative and the cooperative is guaranteed to buy it. With this “closed” membership, the cooperative is designed to operate at capacity, an ideal rate. This helps to ensure efficiency in operations and maximization in profits. The cooperative also benefits from more unified inputs that are sure to come into the processing facility and the producer has a guaranteed a buyer.

If a farmer fails to deliver his share of raw commodity, the new generation cooperative can buy the commodity on the open market and take the costs from the member’s account. Also through board approval, a member can sell these delivery rights at a value that fluctuates over time. As processing is a major responsibility, an assured supply of raw material is essential to maintaining business. It is this relationship that links the farmer to a value-added business with an opportunity to enhance net income.

As the wants and needs of the American consumer are forever changing, a business must change in order to provide for the public and support its owners. Like any cooperative, members must support and invest in their

business, and like any business, the cooperative must turn a profit. The New Generation Cooperative is a potentially valuable choice of business structure as agricultural producers venture into value-added processing.

Cooperatives in the Future

The New Generation Cooperative became an important business structure because it addressed failures of the traditional model to adapt to the needs of a modern agribusiness. It seems to work well for capital intensive business activities, like food processing. However, in no way should it be considered some kind of miracle solution. Many successful cooperatives today are formed around the traditional business model. So too, many NGCs eventually succumb to the primary need of a growing business — more equity investment.

Quite clearly, if the cooperative is to remain a viable alternative for rural development, new cooperative business models that allow for outside investment need to be considered. Several states have already allowed for legal structures that combine the benefits of a cooperative and a limited liability company (Wyoming is often the stated example) and several more are considering similar changes to their legal statutes. These new business models are referred to by different names including “new generation,” causing some confusion with existing new generation structures. Some of the more favored names include, “hybrid”, “processing cooperative”, “LLC cooperative”, and “limited cooperative”.

Although this is a needed step to ease business development among agricultural producers, this is not to be taken lightly. The very definition and legal standing of a cooperative business is at stake. As they move forward, legislatures across the nation will turn to the very essence of the Capper-Volstead Act: allow agricultural producers to act together in a business that operates for the mutual benefit of its members.