Positioning California's Agricultural Cooperatives for the Future

by

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Questions have been raised regarding the future of cooperatives in California. Although the cooperative principles Ê can constrain cooperatives, various cooperatives have implemented innovative structures to ensure their viability. Ê

Recent issues of *ARE Update* featured articles evaluating the failures of two California marketing cooperatives, Tri Valley Growers (TVG) and Rice Growers Association (RGA). Along with Blue Anchor's dissolution and Calavo's conversion, these combined events have created doubts about the future of cooperatives in California agriculture.

Restructured forms of cooperatives are emerging. For example, leaders of nontraditional cooperatives have acquired outside equity investors to overcome capital constraints, while others have sourced nonmember product to provide competitive product lines.

Economic Role of Cooperatives

Cooperatives were created in U.S. agriculture to serve the needs of the farmers and ranchers who own and control them. Processing and marketing cooperatives played a very strong role in California as growers sought economies of scale and market power, particularly during the 1920s.

By 1989, California led the nation in business volume conducted by all types of agricultural cooperatives, with 92 percent of the business attributable to marketing cooperatives (Table 1). In 1995, it ranked second for business volume conducted by all of its agricultural cooperatives, and still led the nation in the gross sales of its marketing cooperatives. By 2001, the total volume dropped by 16 percent to $8 billion, with much of the decrease in the fruit and vegetable sector. California then ranked fourth in the business volume of all of its agricultural cooperatives, with Minnesota and Wisconsin overtaking California in the business volume of marketing cooperatives.

To assess the future of cooperatives in California agriculture, brief background information is first presented about the economic role of cooperatives. Then, the weaknesses inherent in the cooperative structure are reviewed, followed by examples of how various agricultural cooperatives have overcome these weaknesses.

Economies of Scale

One of the classic economic justifications for forming a cooperative is to obtain economies of scale. In a processing business, fixed costs of management, plant and equipment, and selling, general, and administration costs can be spread over greater volumes. Many processing and marketing cooperatives achieve economies of scale unattainable by the individual producer through the vertically integrated activities they provide for their members.

Service cooperatives can also provide such economies of scale, as illustrated by Wine Service Cooperative. Headquartered in St. Helena, CA, the cooperative was formed in 1972 by a small group of boutique wineries. It has expanded its storage capacity twice, and now has 39 members and a waiting list. The cooperative provides storage and shipping services, as well as inventory control and government reporting services. Similar cooperative ventures focused on special services such as cotton ginning, prune drying, citrus packing and storage, are continuing to provide California producers with economies of scale.

Countervailing Market Power

The Capper-Volstead Act allows agricultural producers to set prices together, as long as they do not unduly enhance market prices. NuCal Foods was created in 1996 as a federation of two large egg cooperatives, Nulaid Foods and Cal Eggs. The cooperative markets and distributes only shell eggs and the majority of its products are marketed to retail grocery chains and box stores. With their 80 percent market share of the Northern California market, NuCal Foods' producer members have utilized their cooperative structure to protect their marketing margins from the concentrated market power of their grocery store customers.

Bargaining cooperatives were established for numerous commodities during the first half of the 20th Century to provide market power for large groups of producers. More recently, Marketing Agencies In Common (MAC) have been formed to create countervailing market power. MACs are a group of marketing cooperatives, often with some individual producers, who market products under a common agreement. The California Citrus Growers Association (CCGA) was formed in 2003 as a MAC when the major grower cooperatives and independent shippers elected to collaborate.

Table 1. California Cooperatives' Gross Business Volumes

	1989	1995	2001
Products Marketed	$7,249,017,000	$8,705,309,000	$7,165,107,000
Dry Beans & Peas	$53,215,000	$120,504,000	$21,543,000
Cotton	$618,189,000	$635,298,000	$419,924,000
Dairy	$1,959,019,000	$2,791,553,000	$2,748,360,000
Fruits & Vegetables	$3,277,924,000	$3,846,187,000	$2,877,242,000
Nuts	$640,636,000	$618,904,000	$719,236,000
Poultry	$48,426,000	$41,882,000	$30,601,000
Rice	$233,841,000	$230,729,000	$158,104,000
Miscellaneous	$158,701,000	$247,692,000	$64,834,000
Farm Supplies	$485,631,000	$460,794,000	$443,786,000
Services	$105,382,000	$399,299,000	$408,582,000
TOTAL	$7,840,029,000	$9,565,402,000	$8,017,475,000

The voluntary association now represents approximately 85 percent of the fresh market production of navel oranges in California. The CCGA's functions currently include managing product flows similarly to internally established prorates among the cooperative members, sharing information and establishing quality standards. Thus far, grower prices have been consistently above the four-year average.

Marketing the Cooperative

The cooperative identity can provide a different type of market power; cooperatives can exploit the fact that they are acquiring raw product directly from their producer-members as a marketing advantage. In a 2003 nationwide survey, 69 percent of the consumers responded that they were more likely to purchase food produced by a farmer-owned cooperative, and 64 percent agreed that food produced by a farmer-owned cooperative was of better quality than food produced by other types of companies.

The cooperative identity may be an ideal positioning for organic food products. Organic Valley/CROPP is a marketing cooperative formed in 1988 with seven members in Wisconsin. Its membership has grown to the present 622 farmer members in seventeen states, including California. It markets dairy, juice, eggs and meat products. Between 1998 and 2003, its sales rose from $15 million to $122 million.

Organic Valley differentiates itself by promoting its cooperative structure, using the slogan "a cooperative of small organic family farms." Its milk cartons feature profiles of local producers and it also provides grocery stores with large storyboards featuring some of its members.

Addressing Traditional Weaknesses of Cooperatives

While the cooperative form of business can provide several economic benefits, weaknesses associated with traditional applications of the cooperative principles have challenged agricultural cooperatives' ability to survive in today's highly competitive economic environment. Three basic principles define the essence of a cooperative enterprise:

- user-owned—the cooperative is owned by the people who use it
- user-benefit—the benefits generated by the cooperative accrue to its users on the basis of their use
- user-control—the cooperative is controlled by the people who use it

The User-Owned Principle: Weakness and Solutions

The user-owned principle has limited cooperatives' access to capital. Cooperatives typically do not seek capital from certain sources, such as outside investors. Their ability to raise additional capital from their producer-members is constrained, due to the portfolio and horizon problems. The portfolio problem arises because producer-members are required to invest capital in an industry in which they already have significant investment in production capacity. The horizon problem occurs because, traditionally, cooperatives' residual earnings are contractually tied to their producer-members' current transactions, rather than to their investment. Since members are unable to recognize appreciation in their equity investment, they exert pressure on their cooperative to maximize current returns rather than investing for higher future returns.

Organic Valley/CROPP has dealt with its equity capital limitations by utilizing two capital conserving strategies: 1) it contracts with other firms to process virtually all of its members' products; and 2) its products are marketed nationally through a grassroots program. In 2002, the cooperative generated $126 million in sales with assets totaling approximately $8 million. Organic Valley/CROPP maintains numerous longterm co-packing agreements with manufacturers located in specific market areas to minimize its capital investment in plant and equipment while also reducing its storage and shipping costs. Its members' equity capital has been invested in grassroots marketing programs that do not require large expenditures.

A new cooperative structure known as of New Generation Cooperatives (NGCs) facilitates the acquisition of equity capital. NGCs differ from traditional cooperatives in four ways.

- They require members to purchase delivery rights, creating a two-way obligation between a member and the cooperative for a specific amount of farm product each year.
- NGCs have a closed membership, in contrast to many traditional cooperatives that typically accept new members on a continual basis.
- The investment that NGCs require in delivery rights is typically higher than what traditional cooperatives would require from new members.
- Delivery rights are marketable. Prices fluctuate according to the cooperative's performance and earning potential.

While many NGCs were formed and failed in the 1990s, several have been quite successful. Iowa Turkey Growers Cooperative/West Liberty Foods had sales in excess of $200 million in 2002. Its three plants process turkey, pork, chicken and beef into products for retail and food service customers and co-pack branded meats for bigger companies like Hormel and Sara Lee. Mountain View Harvest, a wheat processing NGC formed by 227 winter wheat growers, invested a total of $5 million to purchase Gerard's French Bakery, a wholesale bakery of fresh and frozen products near Denver.

Joint ventures can be considered a nontraditional source of financing. They may be the only way a cooperative can afford to own part of an expensive facility or market a new product nationally. Co-packing agreements, such as those utilized extensively by Organic Valley/CROPP, are joint ventures; they reduce upfront capital requirements and decrease the risk associated with new products.

Naturipe, the oldest and largest strawberry marketing cooperative in the U.S., expanded its market access by joining forces with Global Berry Farms, LLC (GBF). GBF's other partners are MBG/Michigan Blueberry Growers Association (another cooperative), and Hortifrut (a privately held company based in Chile). GBF is reshaping the berry category by offering year-round supplies of strawberries, blueberries, raspberries and blackberries. By marketing 100 percent of their production through GBF, Naturipe's members have a more secure and broader customer base.

The User-Benefit Principle: Weakness and Solutions

Like the user-financed principle, the user-benefit principle has also constrained agricultural cooperatives. Marketing cooperatives often are organized to serve as a home for their members' products, with the earnings distributed to users in proportion to their current patronage. The resulting business impact is a focus on current returns, limited product offerings, underinvestment in intangibles and perpetuation of excess supplies of member product.

This "open" structure can cause a cooperative to have large fluctuations in its delivery volumes and processing requirements. Pacific Coast Producers (PCP) is a marketing cooperative that processes tomatoes, peaches, pears, grapes and apricots. As a co-packer, part of its success is attributable to the strict cost controls it employs to minimize excess capacity. PCP must carefully project its annual sales volumes and pack product accordingly. Through its long-established "base tonnage" allocations, members have volume restrictions for each product they deliver. Members who are reducing their deliveries sell part or all of their base tonnage to new or existing members.

Focusing on processing and marketing member deliveries can cause a cooperative to have a limited product line and/or seasonal product availability. Members have been known to be resentful when their cooperative sources nonmember product to maintain a year-round presence in the marketplace or other commodities to broaden the product line, both of which are critical for developing a strong brand.

With increasing globalization in recent years, Sunkist Growers has been facing more competition in Japan and other key markets from citrus growers in the Southern Hemisphere. After much resistance from members concerned about competition from fruit imported or handled by their own cooperative, Sunkist's board approved a new marketing strategy in July 2003. The cooperative is handling lemons and grapefruit from contra-seasonal producers South Africa and Chile to leverage its well-known brand into markets in Japan and Hong Kong. Sunkist had to respond to its customers' demand for a single, year-round supply of citrus; otherwise it would have risked losing its position as the fresh citrus market leader. Similarly, Diamond of California broadened its culinary nut offerings by purchasing and packaging almonds, pecans and other nuts to complement its members' walnuts. In 2004, Diamond launched the Emerald brand with fourteen new snack products featuring a variety of nuts.

The User-Control Principle: Weakness and Solutions

Cooperatives are controlled or governed by their producer members. Economists have determined that this cooperative principle can cause the "principal agent" problem, in which the principals (producer members) lack the business expertise to provide adequate control of their agent (management).

Keeling (*ARE Update* Jan/Feb. 2004) attributed the failure of the Rice Growers Association partially to its lax board governance, concluding that "…the board of directors was passive and ill-equipped to scrutinize the business decisions it was charged with overseeing." Similarly, USDA's cooperative specialists recently documented several factors compromising the effectiveness of cooperative boards, including the inability of producer-directors to deal with contemporary business issues. The USDA specialists concluded that cooperative education is an investment but that too many cooperative leaders and advisers consider it only a cost that must be cut whenever times get tight. Some cooperatives do maintain active education programs for their board members. While some education is conducted in-house, cooperatives often send their board members to programs on key topics such as cooperative finance, strategic planning, and governance and management evaluation. Several invite experts to board meetings for presentations.

Outside directors can also strengthen the boards of agricultural cooperatives by providing a broader perspective. Welch's is a wholly owned subsidiary of the cooperative, National Grape, which uses a two-board structure. The National Grape board elects Welch's board of directors, consisting of four National Grape directors, two executive officers of Welch's and four outside professionals. CHS, the nation's largest agricultural cooperative, has structured subsidiaries for its numerous joint ventures involving value-added products with investor-owned firms. There are no producer-members on the boards of these subsidiaries; they consist of CHS management and executive officers of its joint venture partners. The board of the Global Berry Farms joint venture consists of two representatives from each of the two cooperatives (the CEO and a producer board member), two senior management representatives from Hortifrut and a public member.

Concluding Comments

Cooperatives in California play a significant role in California agriculture generating over $8 billion in business volume in 2001. The future looks bright for California's supply and service cooperatives that remain focused on their key services. Marketing-associations-in-common and information-sharing cooperatives can effectively create countervailing power for producers facing the highly consolidated grocery industry. The cooperative identity can also be used as a powerful marketing strategy.

While the traditional application of the cooperative principles can constrain cooperatives' success, agricultural marketing cooperatives are continually innovating to ensure their futures. They are utilizing a variety of financing alternatives, including joint ventures and the new generation structure. Some cooperatives require delivery rights to minimize their excess capacity and others source nonmember product to expand product lines and year-round market presence. Furthermore, well-trained producer directors and the appointment of outside directors should greatly enhance their viability.

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