
**NEW GENERATION CO-OPERATIVE DEVELOPMENT:
THE ECONOMIC ENVIRONMENT IN NORTH DAKOTA AND MINNESOTA
AND LESSONS FOR SASKATCHEWAN**

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▲ PART I ▲

▲ INTRODUCTION ▲

The term New Generation Co-operative (NGC) refers to a new type of co-operative enterprise that has formed in rural North America throughout the 1990s. The emergence of NGCs has been especially prolific in the Upper Midwestern states of North Dakota and Minnesota where, in the last 10 years, more than 100 have been established. A key feature of these co-operative ventures is the processing of agricultural products, from sugar beets and soybeans to bison and potatoes (Stefanson et al, 1995).

The objectives of this paper are twofold. The first objective is to examine the economic and social factors that have motivated and facilitated farmers to vertically integrate forward into processing their products using a NGC. To achieve this objective, the paper investigates the legislative framework, taxation policy, financial infrastructure and non-financial support system surrounding NGCs to determine whether the co-operative model holds advantages over other organizational forms for these value-added initiatives. The paper focuses on North Dakota and Minnesota, where NGC development has been most active.

The second objective of the paper is to use the lessons obtained from the analysis of North Dakota and Minnesota to draw conclusions about NGC development in Saskatchewan. Although the NGC concept was introduced to Saskatchewan nearly four years ago, the development of NGCs has been slow. The paper examines some of the reasons for this lack of development and what could be done to encourage development.

The paper is structured so that the conclusions about NGC development in Saskatchewan are presented first, followed by the examination of NGC formation in the US. Part II of the paper presents a brief overview of the lessons learned from North Dakota and Minnesota. It then uses these lessons to discuss NGC development in Saskatchewan and to develop suggestions as to what the next steps should be in NGC development in the province. Part III provides a detailed description of NGCs and examines the factors that have influenced NGC development in North Dakota and Minnesota, thus creating the background material for the discussion in Part II.

▲ PART II ▲

▲ NEW GENERATION CO-OPERATIVE DEVELOPMENT IN SASKATCHEWAN ▲

The development of a large number of NGCs in Minnesota and North Dakota over the past decade has led observers to ask why this development has been occurring there and not in other places. NGC development has not been nearly as widespread in Canada and elsewhere in the US, thus suggesting that something specific to this region lies behind the high rate of NGC formation.

The answer to why NGC development has been focused in these two states is not simple, since there are many factors behind the NGC phenomenon. Factors that have been raised as part of the story include the common ethnic background of farmers in these two states, the long experience with co-operatives, the success of the early sugar co-operatives that were structured as NGCs, and state governments that were not hostile to co-operatives regardless of their political affiliation. Taxation regulations and the Capper-Volstead exemption from anti-trust legislation have clearly influenced the selection of the co-operative model (and/or the Limited Liability Company (LLC) model) over other organizational forms.

While the factors listed above help explain the organizational form taken by the farmer-owned enterprises that have developed, other factors are required to explain the formation of farmer-owned enterprises in the first place. Part of the reason for the formation of farmer-owned enterprises lies in the economic and social conditions in which farmers found themselves during the late 1980s and the early 1990s. Simply put, the economic hardships of this period and the continuing decline of rural areas led farmers and rural residents to search for activities that would encourage economic activity. However, while this factor was important, it was not the sole factor behind the development of farmer-owned enterprises, since similar economic conditions existed in other states during the same period and in Canada during a somewhat later period. Yet farmer-owned enterprises did not form in nearly the same numbers in these other geographical areas.

An important factor responsible for both the formation of farmer-owned enterprises and their subsequent incorporation as co-operatives is the development support provided by state governments and other co-operative organizations in Minnesota and North Dakota. While it is impossible to provide a detailed and comprehensive comparison of the development support that has been provided in North Dakota and Minnesota relative to other areas of Canada and the US, there is no question that the level of support in these two states has been higher.

The Centre for Cooperative Development in North Dakota and the St. Paul Bank for Cooperatives in Minnesota are examples of the development support that is available. While Saskatchewan, for instance, has some co-operative development support in place, nothing is as focused as is the effort in North Dakota. Interestingly, the focus of the Centre for Cooperative Development is not solely co-operative development, but is rather rural business development. It is largely this focus on developing rural businesses that has led to the development of farmer-owned enterprises. These enterprises, in turn, have chosen the co-operative as their organizational form largely because of some of the inherent advantages it has over other forms. While tax advantages, anti-trust exemptions, ethnic considerations, and previous co-op experience have resulted in a preference for co-operative enterprises, these factors do not appear to have been the root cause of the development.

As the analysis in Part III indicates, development support in North Dakota and Minnesota takes a variety of forms. Some of this support is in the form of development officers that work closely with groups that are exploring options. Other support comes from resources provided by the state for feasibility studies and business plan development. Still other support comes from the financial sector, whether it is the state banks or the St. Paul Bank for Cooperatives, which not only stand ready to provide financing, but also provide support in proposal development to ventures with a strong potential.

One of the important factors in the support is the wide variety of organizations that are involved. Development support is not seen as the purview of only one organization, but is rather shared by a number of organizations. For instance, both the Rural Electric and Telephone Co-operatives and the USDA help fund the Centre for Cooperative Development. Financial institutions, both co-operative and non-co-operative, are involved in providing financing and support. Universities play a role as well.

The result is a network of development support that creates an atmosphere and environment much different than in Saskatchewan. On the NGC bus tour to North Dakota and Minnesota in April 1996, one of the participants remarked “Am I missing something, or is there not just a lot more support for co-operatives here than in Saskatchewan?” This observation came from somebody who was very familiar with co-operatives in Saskatchewan, and who was able to compare what he was seeing and learning on the tour with what he knew was happening in Saskatchewan.

NGC DEVELOPMENT SUPPORT IN SASKATCHEWAN

It has been nearly four years since NGCs were introduced to Saskatchewan audiences at the *Building Our Future: Economic Development and Co-operatives Into the 21st Century* conference held in Saskatoon in June 1995. In the fall of that year, the Centre for the Study of Co-operatives held its first seminar on NGCs in Estevan. Despite considerable discussion about NGCs over the period since then, virtually no NGCs have actually been developed. Approximately 15-20 NGCs are currently in the discussion stage.

There are a number of reasons for this lack of NGC development. Part of the reason has to do with the direction of development taken by farmer-owned enterprises, while part of the reason lies in the decisions made by farmer-owned enterprises as to which organizational model they would like to follow.

Over the past five to ten years there has been considerable investment by farmers and rural residents in agricultural-based enterprises. Examples of this investment include the inland grain terminals and community hog barns. These investments involve much less processing and value-added activity than is the case with the investments in North Dakota and Minnesota. While Saskatchewan farmers and rural residents have invested in some processing operations – an example is Eagle Creek Processing Co. in Rosetown – for the most part the investment has been in activities that are only one step removed from the farm operation.

For a number of reasons, the organizational form chosen for these investments has not been co-operatives. One of the reasons is that a number of the farmer-owned enterprises – I am thinking here particularly of the inland grain terminals – were established because farmers did not feel the existing grain handling industry was active enough in reshaping itself. Many of the farmers who spearheaded these efforts chose a structure that was explicitly not a co-operative, since the view was that what was needed was a more market-oriented approach and the perception was that co-operatives could not operate as well in this fashion as other organizations.

Many of the developments had begun before the NGC concept was known in Saskatchewan. As was the pattern in North Dakota and Minnesota, the formation of farmer-owned enterprises in Saskatchewan typically occurred around a development model that was applied over and over again. This pattern reflected the fact that a common group often facilitated development of new projects and that once a model was developed, the transactions costs of using this model again were low – both because farmers had greater familiarity with the model and because the initial costs of development had already been incurred. In the case of the inland terminals, Ernst and Young

played a key role in the development of a model that was then used with a number of client groups. In the case of hog barns, Quadra developed a model that it used over and over again in different communities.

There are also some legal and taxation issues that have been important in raising the transactions costs so that co-operatives are not being selected as the development model. On the taxation side, groups often began their operations as limited partnerships, a legal form that allowed the initial costs of development to flow back to the individual investors where costs could be used to offset personal income. While it may be possible to roll a limited partnership into a co-operative structure, the ease with which this can be done in a corporate structure has made the corporate structure more attractive. On the legal side, many of the enterprises that have been formed wished to involve other people besides farmers as investors. The co-operative structure makes it very difficult, if not impossible, to have non-farmers as voting investors.

Finally, some of the specific characteristics of NGCs have resulted in them not being chosen as an organizational form. For instance, in a number of cases farmers have indicated that they do not want to lock themselves into delivery contracts with a co-op, since they believe this limits their options to achieve better prices and terms elsewhere.

Although there is no hard data on this issue, the general perception is that farmer-owned enterprises in Saskatchewan have generally been less focused on value-added activities than have their counterparts in North Dakota and Minnesota. There are a number of reasons for this pattern of development. The Crow Rate, with its subsidization of primary product exports, has been partly responsible for engendering the belief that concentrating on primary production rather than on processing best created value.

Another factor that has also been important is the lack of development support for farmer-owned processing activities. In short, the wide support for development that is present in North Dakota and Minnesota is not present in Saskatchewan. While the co-operative sector has supported co-operative development as a principle, they have provided few resources to this activity outside of the development activities they wish to pursue on their own. While some co-operative organizations – such as credit unions – have expressed an interest in development activities, none have felt that they had the capability to get into this area on their own.

The government has provided some development support through the Department of Economic and Co-operative Development. However, this support has been generally generic in nature, rather than being targeted specifically at the needs of farmers and others that would like to invest in value-added activities. In addition, support for co-operative development has not been forthcoming from

the Crown Corporations. In particular, SaskTel and SaskPower, which are the equivalents of the Rural Electric and Telephone Co-operatives in North Dakota, have shown no interest in supporting rural – let alone co-operative – development.

This lack of development support is important because research shows that farmer-owned enterprises face unique challenges that stem from the collective nature of these enterprises. The collective nature of these organizations creates free rider problems: while each individual benefits from the organization being in place, no single individual has the incentive to undertake the actions necessary to create the organization. To create these collective organizations requires the coordination of the activities of many individuals and the development of the assurance among a critical mass of people that the others in the group will work together. While this coordination and assurance development is very difficult for the members of a group to create and foster, it can be created and fostered by outside development agents. These agents can also reduce some of the other transactions costs such as the development of a basic organizational model that can be used over and over again (Harris et al. (1998), Stefanson (1999)).

The creation of farmer-owned enterprises that are well integrated into the value chain is becoming increasingly important. Agriculture is becoming less and less commodity oriented and more and more product oriented. As this happens, the role of primary agriculture in the agriculture and food system is becoming smaller and smaller. In addition, primary agricultural production is becoming increasingly specialized; at the same time the interdependence of these specialized areas is growing. One of the implications of these changes is that individual farmers – acting on their own – will be less and less successful. Farmers need to develop ways of working together, whether it is through strategic alliances, co-operatives, or other forms of joint ownership. They also need to find ways of more fully integrating themselves into the segments of the food chain beyond the farm gate (Holmlund and Fulton).

STEPS FOR THE DEVELOPMENT OF NGCs IN SASKATCHEWAN

The development of NGCs in the U.S. has occurred in the context of a fairly comprehensive system of co-operative development support. Without similar levels of support, the large-scale development of NGCs is unlikely to occur in Saskatchewan. While Saskatchewan is likely unable to match this support system, there are some measures that can be taken to better encourage NGC development in the province. Indeed, without such measures, NGC development will remain small.

New Generation Co-operatives can be developed in Saskatchewan if some of the barriers to their development are reduced. The main barriers to the development of NGCs include the transactions costs involved in the selection of co-operative forms of farmer-owned enterprises and a general lack of development of farmer-owned enterprises that are specifically directed at value-added processing.

While the development of NGCs will require the direction of financial resources to this end, the resource costs must be kept at a reasonable level. Government budgets are limited and there are many competing uses for government funds. Thus, support for NGC must be kept in line with other government spending. In addition, the history of co-operatives in Saskatchewan – and indeed elsewhere for that matter – suggests co-operatives do best when they do not receive large direct financial infusions.

At the same time, however, history also indicates that co-operatives generally do not form by the actions of the members alone. While the notion that members “pull themselves up by their bootstraps” is often cited, it does not reflect the experience of most co-operatives. Indeed, without outside support, the free rider problems associated with collective action are simply too large.

The elements required for a successful NGC development strategy are:

- ▲ Changes in legislation and taxation rules that reduce the transactions costs associated with using the co-operative form.
- ▲ The provision of support for the development of farmer-owned, value-added enterprises.
- ▲ Linking R&D efforts in new food product development with the development of NGCs.

Each of these will be considered in turn.

Legislation and Taxation Changes

Current co-operative legislation does not adequately allow for the development of NGCs. In particular, the legislation does not provide a mechanism that can easily distinguish between membership shares and delivery/equity shares. The legislation also does not allow for the value of shares to fluctuate. The possibility of outside investors participating in the financing of the co-operative has to be considered, as does the question of what NGCs need to do to meet the needs of the Securities Commission.

On the taxation side, a mechanism needs to be developed that provides equitable tax considerations for people interested in pursuing the co-operative model versus the corporate model. In particular, attention must be paid to the issue of whether NGCs can be formed from a limited partnership, or whether some other method can be found to provide similar tax advantages.

Development Support

To be successful at NGC formation, NGC development support needs to be focused first and foremost on the development of farmer-owned enterprises that process agricultural products. To be effective, the support must be more than the generic support offered to co-operatives at the current time. Instead, the support has to be directed specifically at the unique needs of farmer-owned value-added agricultural enterprises.

In addition, an independent body that can act as an advocate of the projects must provide the support. This all important advocacy role is not possible when either the government or some other organization is directly providing the development support. Decisions regarding the selection of project champions and steering committees, the surveying of producers, the determination of the project's feasibility, and the development of the business plan are activities that must be done on the basis of the project's merits.

At the same time, the independent body must have strong linkages to many organizations, including the government, the major co-operatives, credit unions, Crown Corporations, and community groups. These groups must provide financial resources to the development group, and they need to be ready and willing to work with the development group to provide other types of support, such as project assistance, to NGC development.

R&D Efforts

The real strength of the NGC model lies in the processing of agricultural commodities into niche and specialty products. Given the current consolidation in the commodity segment of the agricultural industry, NGCs will have a hard time penetrating the value-added chain in this part of the industry. However, there is a real potential for the development and production of new specialty items. The NGC model, with its high equity levels and delivery contracts, is ideally suited to exploiting niche markets. While the returns to these markets are often quite good, the returns are also risky – the high equity of NGCs will better position the co-ops to survive the ups

and downs. The delivery contracts are an excellent way to provide both the farmers and the processor the assurance that a market is available and that production is forthcoming.

To fully capitalize on their niche market strength, NGCs need to be closely tied to the research that is being done on new food products. For example, a formal connection could be made between the Food Centre at the University of Saskatchewan and the independent development agency described above. Agricultural research commissions, which use check-off money collected from agricultural producers for R&D, could be formally linked into a network that would involve the Food Centre and NGC development people.

In short, the best opportunities for NGCs lie in new products and the best way to become involved in new products is to be integrated into the development of these products. In the future, new product development has to consider more than simply the agronomic potential of growing the basic inputs and the technical details of processing the inputs. Product development also has to consider the market potential for the new products and the organizational structures that will best allow a supply of the product to be obtained and the markets to be realized. Since NGCs are one of the best candidates for allowing these potentials to be achieved, their development needs to be intimately linked to the development of the product.

▲ PART III ▲

▲ NEW GENERATION CO-OPERATIVES IN MINNESOTA AND NORTH DAKOTA ▲

This part of the paper provides an overview of the unique structure of NGCs and considers the factors that have led to their development in North Dakota and Minnesota. The factors considered include the economic and social climate of the past two decades, the general and individual project support for NGC development, and taxation and legal issues.

WHAT IS A NEW GENERATION CO-OPERATIVE?

NGCs differ from the “traditional” co-operatives that were formed earlier this century in several fundamental areas. The NGC’s main purpose is to process the agricultural produce of its members in co-operatively owned processing facilities, rather than merely co-operatively marketing the commodity to other processors. NGCs are more market-driven than traditional co-operatives because members base their decisions of what and how much to process on consumer demand for the processed product. The membership of NGCs is restricted to a limited number of members, determined by the optimal capacity of the processing plant.

Membership shares in NGCs are also different that in traditional co-operatives and are designed to fulfill two purposes: to raise equity to contribute towards the cost of constructing the processing facility and to give members the right to purchase delivery right shares. Delivery right shares provide the link between producer capital contributions and product delivery rights (Harris et al, 1996). According to the number of delivery right shares purchased, the producer is committed to supply, and the NGC is committed to purchase, a specified quantity of product. In return for delivering product, the farmer receives an agreed price, which may or may not be the market price, and a share of the plant’s earnings by way of a patronage refund. Since delivery rights are integral to equity shares, membership of NGCs is restricted to producers that deliver raw materials to the processing operation. Membership entitles producers to vote for a board of directors and, like traditional co-operatives, voting rights are governed by the principle of one-member, one-vote, not by the number of shares owned.

Each delivery right share contracts a member to supply one production unit, such as one bushel of grain, to the NGC. The initial price of delivery right shares is determined by dividing the targeted amount of capital by the optimal number of production units to be supplied to the processing

facility. Unlike traditional co-operatives where equity shares can only be redeemed at par value by the co-operative, NGCs in North Dakota and Minnesota are legally entitled to allow equity shares to fluctuate with respect to their market value. NGCs are not obliged to redeem the shares of a disassociating member. Instead, the departing member usually has to find a buyer and negotiate a share price that takes into consideration the capital value of the processing facility. Although this feature of the NGC offers members an easier exit from the venture than with traditional co-operatives, most participants in NGCs still view the investment as a long-term commitment.

NGCs usually raise between 30 to 50 per cent of their target investment capital through the membership equity drive. The remainder of the capital requirement is raised through debt financing or non-voting preferred shares.

ECONOMIC AND SOCIAL CLIMATE

A major factor encouraging mid-west farmers to vertically integrate into processing activities has been the bleak economic and social climate in rural areas. During the 1980s, farmers in Minnesota and North Dakota were experiencing low commodity prices and declining farm income. For instance, by 1990, the price of a bushel of durum wheat had fallen to \$2.20, one dollar below its cost of production. Similarly, corn produced in Wahpeton, North Dakota was fetching the lowest price in the entire country, 20 cents per bushel below the national average after discounting for its high cost of transportation (Patrie, 1997). Low prices and diminishing farmer income has contributed to the decline in the number of family farms and caused the rural population to dwindle.

Vertical integration by farmers into the processing of agricultural products is seen as one response to these economic and social problems. By diversifying into more profitable regions of the agri-food chain, producers have the potential to augment incomes and are less vulnerable to fluctuating commodity prices. Farmer-owned and operated processing plants also help to stem the flow of rural migration by creating jobs, both directly and indirectly, in the local community. However, most processing activities are far too capital-intensive and risky for one farmer to bear alone. Consequently, farmers must co-operate with each other in a joint venture to take advantage of processing opportunities.

Another economic motive for producer-owned processing initiatives is to create a market for locally grown produce. The high cost of transportation from the mid-west states encourages producers to add value to agricultural products before they are shipped. This was a major factor driving Minnesota sugar beet producers to form the American Crystal Sugar Company (ACS) in 1972. The

existing processor was moving its operations away from Minnesota and the sugar beet producers were in need of a local processing market for their output. Consequently, producers joined together to finance and operate their own processing facility. Today, ACS operates a total of five processing plants in Minnesota and North Dakota, and its continued success has inspired producers of other agricultural products to integrate forward into processing ventures. ACS is widely acknowledged to be the first NGC and has been the archetype for subsequent NGC ventures. The creation of a local processing market has been particularly vital to producers of specialty crops and livestock because mainstream processors are often unable or unwilling to accommodate these “niche” products.

Although the economic and social conditions in North Dakota and Minnesota provide an incentive for producers to add value to their products, the development of a processing plant ultimately depends on the willingness and determination of farmers to work together to overcome these economic problems through their own entrepreneurial efforts. Since processing facilities require a substantial financial investment, it is vital for farmers to share a common goal and to have confidence in the viability of the project if the venture is ever to succeed. Consequently, such investments tend to attract certain types of individuals. For instance, Cobia (1997) has observed that investors in NGCs “are younger, better educated, have more net worth, view themselves in the food processing industry and have a more positive attitude toward new co-operatives” compared to non-investors.

Low commodity prices, rural de-population and farmer attitude are all factors that induce producers to add value to their commodities by investing in local processing facilities, but do not necessarily explain why farmers might choose to conduct these value-adding activities through the formation of NGCs. There are several alternative organizational structures that would also allow producers to diversify into processing activities, such as limited liability companies and stock corporations, yet most of the processing initiatives pursued by producers in North Dakota and Minnesota have adopted the co-operative model. One reason cited for the preference of the co-operative structure over other organizational forms is the historical tradition of agricultural co-operatives in the mid-west states which makes the co-operative model familiar and acceptable to many farmers (Gerber, 1997). Furthermore, the success of co-operative ventures such as ACS has provided a stimulus to the NGC movement in North Dakota and Minnesota. While these cultural factors may have some bearing on the organizational decision, legal and financial reasons have also been important in choosing the NGC model. The following sections investigate the impact of government development policy, industry associations, financial institutions, taxation policy and business law on NGC development.

GENERAL EXTERNAL SUPPORT SYSTEMS FOR NGCs

Although the driving force behind all value-added initiatives must be the producers themselves, there are nevertheless external support systems in place designed to help farmers become involved in processing. Government agencies have addressed difficult economic circumstances with rural development strategies, many of which advocate the NGC organizational structure. For example, in North Dakota, the economic conditions were so dismal that Popper (1984) predicted that North Dakota was destined to revert to its former use as a buffalo range. The “Buffalo Commons” argument motivated North Dakotans to respond with an economic development initiative called Vision 2000. This initiative led to the creation of a program known as “Growing North Dakota”, which aims to encourage value-added processing of agricultural products within North Dakota. The program recommends co-operative enterprise, especially through NGCs, as one way of achieving this goal. In order to facilitate the program, the Agricultural Products Utilization Commission (APUC) was given a greater role in funding projects that would “create new wealth and jobs through the development of new and expanded uses of North Dakota agricultural products” (APUC, 1995).

Non-government organizations and associations have also been instrumental in promoting the formation of NGCs in rural communities. In particular, rural utility co-operatives and associations of existing co-operatives are extremely supportive of NGCs since their own survival largely depends on maintaining a healthy rural economy. In North Dakota, the state’s Association of Rural Electric Co-operatives (NDAREC) and Association of Telephone Co-operatives (NDATC) have partnered with Farm Credit Services, the North Dakota Farmers Union, the North Dakota Credit Union League and other co-operatives to form the North Dakota Co-ordinating Council for Co-operatives (NDCCC). The NDCCC played a significant role in the creation of the Centre for Co-operative Development based in Mandan, North Dakota. The Centre is financed mainly through private funds, with some financial assistance from the USDA’s Rural Development Administration, and supports a Rural Development Program Director and a Co-operative Development Specialist. Both individuals are key players in providing encouragement, technical assistance and business advice to producer groups, and have been directly involved in the establishment of many NGCs in the region. In Minnesota, the Minnesota Association of Co-operatives (MAC) is a vital source of information about NGCs to the agricultural community. The Ag Utilization Research Institute (AURI) and the state universities of North Dakota and Minnesota actively conduct research on the subject of co-operatives. Knowledge about NGCs is also shared with farmers through university extension services.

An important function of government and quasi-government agencies is to connect producer groups with other external resources necessary for NGC development, such as lawyers, business consultants and financial institutions. These linkages between different organizations form a comprehensive network that supports producer-owned processing ventures through the provision of resources and information. While it is difficult to quantify precisely the extent to which this external support network has contributed to the proliferation of NGCs in North Dakota and Minnesota, most producer-members of NGCs emphasize the important role played by external agents in facilitating producer groups to take advantage of value-added opportunities.

INDIVIDUAL PROJECT SUPPORT FOR NGCs

Before a NGC can be established, co-operating producers must conduct a feasibility study, formulate a business plan and undertake an equity drive. Typically, most of the direct support from government and quasi-government agencies is designed to assist farmers over these early hurdles. Many fledgling NGCs seek the help of an external consultant to co-ordinate and guide the group through feasibility studies, equity drives and business plans. Bill Patrie, the Director of the Centre for Co-operative Development, is widely recognized as the leading catalyst in NGC development. His success in facilitation is attributed to his extensive knowledge and expertise in economic and co-operative development, his assumed role as an advocate rather than a champion of the NGC cause, and his independence from political influences. The publication *Creating 'Co-op Fever': A Rural Developer's Guide to Forming Co-operatives* outlines the approach that Patrie has taken in co-operative development.

In North Dakota, most feasibility studies are financed with the help of grants from APUC. This agency also contributes towards the legal and accounting costs associated with the business plan and equity drive. All grants awarded by APUC require matching funds from potential NGC members. The St. Paul Bank for Co-operatives offers assistance to farmer groups with feasibility studies, both financially by providing loans and non-financially by evaluating their content (Estenson, 1997).

The business plan should include estimates of the venture's start-up capital costs in terms of property and equipment, as well as an assessment of the working capital required to maintain day-to-day operations. The purpose of the equity drive is to persuade other producers to purchase membership and delivery right shares in the NGC. In general, NGCs must raise around 50 per cent of the capital through the equity drive before banks will approve of financing the remaining portion with debt.

In the difficult start-up phase of a business venture, NGCs benefit from having access to external resources. An experienced consultant can distinguish between good and bad business propositions, and assist the fledgling organization through the feasibility study, business plan and equity drive. Meanwhile, government grants provide much-needed financial support for these commercial prerequisites. In some instances, the effectiveness of this direct project support may be the deciding factor as to whether an NGC is launched successfully or not.

FINANCIAL RESOURCES FOR NGCs

Financial institutions in North Dakota and Minnesota play an important role in the development of NGCs in the area. Since 1916, the finance needs of the U.S. agricultural sector have largely been met by the Farm Credit System, consisting of six regional Farm Credit Banks, and two national specialty banks: the St. Paul Bank for Co-operatives and CoBank (Stefanson, 1997). For the most part, the Farm Credit Banks mainly offer financial services to individual producers, while the St. Paul Bank and CoBank focus their attentions on financing rural businesses, such as agricultural co-operatives and utility companies. The St. Paul Bank for Co-operatives in particular has been integral in supporting the establishment of NGCs in Minnesota and North Dakota.

The St. Paul Bank for Co-operatives is itself organized as a co-operative, so that patrons of the bank receive a refund based on the amount of interest paid on their loans. The bank's mission statement is "to help build sound, well-managed co-operative associations and sound rural communities" (Stefanson, 1997). This means that, unlike most commercial banks, the St. Paul Bank for Co-operatives is concerned with rural development issues in addition to its profitability. The bank first became involved with NGCs when it assisted in the financing of American Crystal Sugar. Since then, the bank has gained considerable experience and expertise in the specific financial requirements of NGCs.

The St. Paul Bank for Co-operatives usually becomes involved with a farmer-owned value-adding project during the very early stages by providing information and advice and access to loans for financing feasibility studies and equity drives. Depending on the riskiness of the venture, the bank expects the NGC to raise 35 to 50 per cent of the total capital required through equity before agreeing to lend the residual amount. The NGC can reduce some risk, and hence its equity obligation, if it is able to secure marketing agreements for its processed product. The specified loan repayment period is normally between 10 and 15 years, with interest rates at their highest during construction of processing facilities and falling once this has been completed (Estenson, 1997).

The St. Paul Bank for Co-operatives, along with CoBank, often finances NGC ventures that would otherwise be rejected by regular commercial banks. The reason for this is that these specialist banks tend to understand the co-operative structure better than other banks and therefore consider them less risky. With respect to NGCs, the St. Paul Bank for Co-operatives places considerable merit on the fact that membership shares enable producers to acquire delivery rights with the organization. These delivery rights represent a commitment from the members to support the co-operative, and without this commitment, the bank would demand a higher equity/debt ratio.

Those that are familiar with the NGC movement in North Dakota and Minnesota (e.g., Patrie and Gerber) emphasize the significant contribution made to its success by the St. Paul Bank for Co-operatives. Without its knowledge of co-operatives, understanding of delivery rights, and commitment to rural development, the St. Paul Bank would be less willing to offer financial services to NGCs and many successful value-adding farmer-owned enterprises would never have developed.

TAXATION POLICY AND NGCS

When deciding on an organizational form, producer groups must look ahead to profitable times and consider the way in which earnings will be taxed because different enterprise structures are subject to different tax rules. This section examines federal taxation policy in the U.S. to determine whether the co-operative model has a tax advantage over other business arrangements.

For most corporations in the U.S., income tax is levied at both the corporate level and the shareholder level. Most co-operatives, on the other hand, are governed by the single-tax principle, defined in subchapter T of the Internal Revenue Code. This tax rule allows co-operatives to deduct patronage refunds from net income before taxation, so that effectively co-operative earnings are taxed only once (Royer, 1989). In addition, many agricultural co-operatives are able to take advantage of section 521 of the Internal Revenue Code, which relates to income earned from non-patronage sources, such as rents or investment income. Co-operatives that qualify for section 521 status are entitled to deduct non-patronage source earnings that are distributed to patrons from taxable income. Consequently, co-operatives enjoy a significant tax advantage over most other corporate structures as a result of the co-operative's ability to deduct both patronage and non-patronage revenue from taxable income. The federal government justifies this tax treatment by viewing co-operatives as non-profit processing and marketing offshoots of the members' core business, *i.e.*, farming.

For NGCs, perhaps the most immediate advantage of acquiring section 521 status is that it also relieves the new venture from registering securities with the Securities Exchange Commission and issuing a prospectus, as outlined in the Securities Act of 1933. Furthermore, the National Securities Markets Improvement Act rules that federal exemption from securities registration pre-empts any state-level legislation on this issue. This exemption from security registration benefits the NGC both in terms of time, enabling rapid incorporation, and cost, saving on legal fees. NGCs therefore have an incentive to file for section 521 status immediately, even though the income tax benefits will only start to accrue later once profits are made.

There are, however, certain constraints a co-operative must meet before it can qualify for section 521 exemptions. First, the co-operative must be involved in the business of marketing agricultural produce or procuring farm supplies and equipment. Second, most of the co-operative's equity must be owned by farmers who patronize the organization. This condition is designed to limit the amount of investment in the co-operative from non-farming interests. Non-producer investment is also discouraged by the third condition, which restricts dividends on preferred shares to 8 per cent per year. Finally, the value of business conducted with non-members must not exceed 50 per cent of a co-operative's total business for it to be eligible for section 521 status. Co-operatives that depend to a greater degree on non-members, either as investors or customers, sometimes find the conditions of section 521 too restrictive and may prefer to operate without this exemption. This may be particularly relevant to growing farmer-owned processing operations that require a large number of investors to finance huge capital projects. Furthermore, the Internal Revenue Service (IRS) is beginning to perceive a difference between NGCs that process agricultural products naturally, for example livestock feed through a hog operation, and mechanically, such as flour milling. The eligibility of the "natural" value-adding co-operatives for section 521 status has lately been brought into question by the IRS (McFall, 1997).

There are alternative business structures to the co-operative that also benefit from the single-tax principle, namely partnerships, limited liability companies (LLCs) and subchapter S corporations. A disadvantage of partnerships is that at least one partner is fully liable for all debt incurred by the organization. Investors in subchapter S corporations and LLCs are only liable for the sum invested, like co-operative members. However, membership of subchapter S corporations is limited to 35 shareholders, which is impractical for most value-adding farmer initiatives. Consequently, the LLC is the most viable enterprise alternative to the co-operative model for producer groups wishing to integrate into processing activities (Frederick).

One advantage of the LLC over co-operatives and corporations is that investors can withdraw capital without incurring capital gains tax (Lawless et al, 1996). However, most shareholders in

NGCs are producers that invest in the venture for the long term, and so are less concerned with speculative capital gains than corporate shareholders. Although LLCs are not subject to the same constraints as section 521 co-operatives with respect to non-farmer investment and patronage, the IRS imposes other restrictions on LLC organization. The LLC must select only two out of four corporate characteristics to qualify for single tax treatment: limited liability, centralization of management, free transferability of interests and continuity of life. The centralized management option allows shareholders to elect managers to run the business, which may be necessary for large-scale processing operations. Without the free transferability of interests option, a member wishing to transfer their shares to another individual must first gain the unanimous approval of other members. Finally, the LLC is effectively terminated when one member dies and requires agreement from remaining members to continue the operation. With a large number of investors, the LLC might be oblivious to its legal termination through the death of a shareholder. The continuity of life provision enables LLCs to avoid this situation. All four corporate characteristics may be beneficial to an organization, particularly as it grows in size, yet the LLC cannot take advantage of more than two of them without forfeiting its eligibility for single taxation.

The voting rules of different enterprise structures can also influence a producer group's decision regarding organizational form. LLCs and corporations typically allocate voting rights to members based on the proportion of capital invested in the enterprise, although other allocation rules are possible. In contrast, equity-based voting is prohibited for organizations wishing to be recognized as co-operatives under federal law. Most co-operatives satisfy legal voting requirements by invoking the one-member, one-vote rule. In some organizations, the amount of capital invested by different members varies widely. In this case, the co-operative voting rule may be considered unfair and a share-based voting system may be preferred. As the number of members increases, an unequal distribution of shares becomes less significant and shareholders are usually more willing to accept the one-member, one-vote rule.

This section examined U.S. taxation policy with respect to co-operatives and highlighted some of the income tax advantages gained as a result of the single-tax principle. Unlike most corporations, taxation of patronage-source and non-patronage source income earned by agricultural co-operatives is borne either at the entity-level or individual member-level, but not both. LLCs also qualify for single-tax treatment and represent perhaps the most viable organizational alternative to the co-operative model. However, while the LLC may avoid some of the non-farmer constraints affecting co-operatives, the IRS imposes restrictions on LLCs which become more binding as the number of members increases. Most farmer-owned processing ventures require a relatively large number of members in order to raise sufficient funds for capital-intensive projects. Under such conditions, the co-operative model is usually considered to be the most appropriate way for value-adding

enterprises to benefit from single tax treatment. Moreover, section 521 status exempts co-operatives from the costly and time-consuming task of security registration, which is especially beneficial to NGCs in the start-up phase.

LEGISLATION AND NGCs

In addition to taxation issues, there are also strong legal reasons supporting the decision of many value-adding producer groups in North Dakota and Minnesota to organize as NGCs. This section examines legislation applicable to NGCs in the U.S. and in particular investigates the treatment of co-operatives under federal antitrust laws.

Federal antitrust legislation has been in effect in the U.S. since the *Sherman Act* of 1890. This law prohibits parties combining or conspiring to restrict free trade and monopolize markets. However, one of the main justifications for farmers to combine together in a co-operative is to increase their market power. Typically, co-operating producers also agree on a sale price for the commodity, an activity which directly violates antitrust laws against price fixing. Consequently, in the early years of co-operative development, farmers were often sued on antitrust grounds.

Co-operatives thus need special protection from antitrust legislation to operate legally in the U.S. Such protection eventually emerged in the form of the *Capper-Volstead Act* of 1922. This legislation effectively gives farmers permission to combine their efforts in the marketing and processing of agricultural products. The law has interpreted these marketing activities to include pricing, and so has afforded co-operatives protection from litigation when pursuing several forms of price-fixing arrangements. In addition, the *Capper-Volstead Act* entitles co-operatives to coordinate activities with other co-operatives, and provides for co-operatives to maintain a variety of marketing and supply contracts with buyers and sellers. As many of these activities could not be conducted by corporations without violating antitrust laws, organizing as a co-operative offers the producer group certain commercial advantages over other business structures. Even so, the *Capper-Volstead Act* does not give co-operatives complete exemption from antitrust laws. As with corporations, co-operatives are still prohibited from introducing predatory practices that aim to monopolize the market. Therefore, a co-operative must be careful to comply with the terms of the *Act* to ensure that it retains protection from antitrust legislation.

The *Capper-Volstead Act* is comprised of two sections. Section 1 outlines the requirements that an organization must meet to be eligible for protection from antitrust legislation, and imposes certain restrictions on the activities of protected co-operatives. First, the law states that the co-operative

membership must consist only of producers of agricultural commodities to qualify for antitrust protection. Even the presence of one non-farming member will disqualify the co-operative and render it vulnerable to litigation. This condition is becoming increasingly restrictive for larger co-operatives that could benefit from an investment from the non-farming community to help finance capital-intensive processing ventures. In addition, some of the most progressive NGCs are processing agricultural commodities into unconventional products, such as construction materials and pharmaceuticals. This brings into question whether co-operative members can still be viewed as farmers at the marketing stage of the business, and whether such NGCs should still qualify for antitrust protection from the *Capper-Volstead Act* (English, 1997).

The second condition of the *Capper-Volstead Act* states that the co-operative must abide by at least one of the following options. The first option is to adopt a voting system in which votes are not allocated on the basis of equity. The traditional co-operative voting rule of one-member, one-vote fulfills this specification. However, this rule may not be considered fair by members of organizations in which equity is distributed unevenly. In this instance, voting based on the number of shares owned might be preferred. The second option is to impose an upper limit on dividends from stock or membership capital of 8 per cent. The 8 per cent constraint on dividends is of particular concern to NGCs because these value-adding co-operatives typically represent more capital-intensive and risky investments than traditional co-operatives and hence need to yield a greater return than 8 per cent to attract investors.

The third condition of the *Capper-Volstead Act* specifies a limit on the amount of business a co-operative may conduct with non-members. The 50 per cent rule states that the value of non-member patronage must not exceed the value of member patronage. Since NGCs do not tend to purchase supplies from outside their membership, this condition is not considered to be much of a constraint.

Under section 2 of the act, the Secretary of Agriculture is given the authority to regulate organizations that abuse the privilege of Capper-Volstead protection to gain an “undue price enhancement” for their products (Baarda, 1989). However, this authority has rarely been exercised and to date has never resulted in a ruling against a co-operative. There are two main reasons why section 2 of the *Capper-Volstead Act* is seldom enforced. First, it is difficult for regulators to define what constitutes unduly high prices. Second, it is difficult to prove that a co-operative is using monopoly power or restrictive practices to inflate prices.

With the exception of dairy co-operatives that have to file antitrust exemptions with the USDA, it is sufficient for an organization to proclaim itself a co-operative with protection under the *Capper-*

Volstead Act. Even so, the co-operative must be prepared to prove to investigators that its organization meets the qualifying conditions of the act and that its activities do not violate antitrust laws. Consequently, most co-operatives employ antitrust lawyers to prepare a defence proving their compliance with the *Capper-Volstead Act* in case a competing firm files a law suit against them. Co-operatives must also take precautions to comply with antitrust laws at both the federal and state level. Fortunately, in most states the antitrust laws resemble federal law, and there is often federal pre-emption that prevents state antitrust legislation from conflicting with federal legislation.

The protection from antitrust laws provided to co-operatives through the *Capper-Volstead Act* offers a commercial advantage to producer groups wishing to integrate into processing activities. Indeed, such value-added ventures necessitate the co-operation of farmers on production, processing, marketing and pricing issues and so organizing as a NGC with *Capper-Volstead* protection is often the only legal way to proceed. However, NGCs tend to pursue riskier, more capital-intensive activities than traditional co-operatives and as a result, investor returns are more critical for NGCs. This investor-dependence means that NGCs may find some of the prerequisites of the *Capper-Volstead Act* too confining, especially the 8 per cent limit on share dividends. Furthermore, some NGCs have grown to become very large operations with a significant share of the market. According to English (1997), these large co-operatives will probably draw more attention from regulators and competitors and attract more lawsuits against them on antitrust grounds in the future. For these reasons, there is increasing pressure from NGCs to relax some of the organizational constraints of the *Capper-Volstead Act* to take into consideration the special needs of value-adding co-operatives.

CONCLUSIONS

A new variety of co-operative, known as NGCs, has emerged and flourished in North Dakota and Minnesota since the 1980s. NGCs differ from traditional agricultural co-operatives in their emphasis on processing commodities beyond the farm gate. Responding to difficult economic conditions, producers have attempted to reduce their vulnerability to low commodity prices by adding value to their output. work together in value-adding ventures, projects have been facilitated by a sophisticated external support system. Government development programs, industrial associations and financial institutions provide information, resources, advice and financing to producer groups in order to help promising value-added initiatives through their commercial infancy.

There are several different types of organizational form that could be used for processing operations, yet most of the producer-owned ventures in North Dakota and Minnesota have been structured as NGCs. Part of the reason is cultural, since farmers from the mid-west have a long tradition with co-operatives and tend to feel most comfortable with the co-operative model. However, farmers predominantly decide to organize as NGCs for financial and legal reasons. Taxation policy in the U.S. levies income tax on co-operatives either at the entity level or the individual member level but not both, which gives it an advantage over double-taxed corporations. While LLCs also benefit from single-tax treatment, they tend to be less suitable than co-operatives for organizations with a large number of members. Furthermore, using the co-operative model is the only way a large organization can avoid costly security registration. Legally, agricultural co-operatives can qualify for *Capper-Volstead Act* protection from antitrust laws. This protection entitles NGCs to pursue certain types of marketing and pricing activities that would be considered antitrust violations if performed by a corporation.

Taxation policy and antitrust legislation in the U.S. was originally adapted to take into account traditional agricultural co-operatives and was designed long before NGCs became prevalent in the mid-west states. However, the new value-adding co-operatives are significantly more capital-intensive and investor-driven than traditional marketing co-operatives. As a result, many NGCs are finding the prerequisites for co-operative tax treatment and *Capper-Volstead Act* protection too restrictive, particularly as organizations expand their operation. It may be necessary to relax some of these conditions in future if NGCs are to continue to thrive in North Dakota and Minnesota.

▲ PART IV ▲

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