



## *Understanding and Teaching New Cooperative Structures*

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August 3, 2005  
ACE – Alexandria, VA



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## *Frameworks*

- Framework: Evolution Approach
- Framework: Life Cycle Approach
- Framework: Ownership Rights Approach



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## Framework I

### *Evolution of the Cooperative Business Model*



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*In the beginning — agricultural cooperatives were - . . . . . ?*



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*“ . . . . cooperatives were:*

- Strategically Defensive
- Organizationally Simple
- User Driven
- Exclusively Inclusive “



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*“ . . . . cooperatives were:*

- Proportionately Funded
- Disproportionately Controlled
- Geographically Homogeneous
- Focused “



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**////** *Today, agricultural cooperatives in general are:*

- Attempting to be Strategically “Offensive”
- Organizationally Complex
- User - Investor Driven
- Increasingly Exclusive

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**////** *And*

- Disproportionately Funded
- Still Disproportionately Controlled
- Geographically Heterogeneous
- Struggling with Ambiguous Multiple-Purpose Objective Functions
- A Membership with an Increasing Set of Objectives

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**////** *The Original Model of an Agricultural Cooperative Was*

- Easy to Understand
- Relatively Transparent
- Generated Member Passion, and
- Usually Achieved Its Defensive Objectives  
(i.e., protected the value of their members’ assets)

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*Framework II*  
*A Lifecycle Approach*



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*Phase One*

- Economic Justification
- Origin — High Degree of Economic Homogeneity



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*Phase Two*

- Organizational Design
- Period of Strong Commonality



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***Phase Three***

- Growth and Consequences
- Onset of Heterogeneity
- Emergence of Organizational Conflict



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***Phase Four***

- Recognition of Conflict
- Introspection
- Debates Over
  - Ownership rights
  - Control rights
  - Capital structure



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***Phase Five***  
***Restructure Time***

Options

Choice One: Exit

Choice Two: Tinker (moderate)

Choice Three: Radical Change



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**Choice One: Exit**

- Liquidate
- Merge / Combine with Other Cooperative
- Demutualize

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**Choice Two: Tinker**

Moderate Changes

- Patronage Pools - Multiple
- Capital Pools - One / Two
- Governance Pools - One

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**Choice Three: Radical**

- Patronage Pools - Multiple
- Capital Pools - Multiple
- Governance Pools - Perhaps Multiple

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*Once the choice is made, the life cycle starts over again – but now members are more aware of ownership and control rights*



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***The Life Cycle***

- Phase I = Economic Justification
- Phase II = Organizational Design
- Phase III = Growth and Consequences
- Phase IV = Introspection
- Phase V = Restructure Time



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***Cooperative Life Cycle  
Phase II***

**Organizational Design**



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### *Early Stages:*

Cooperatives were formed around

- Common geographic locale
- Common grievances
- Common visions
- Relatively homogeneous group of farmers



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### *Early Stages:*

This commonality provided

- Strong sense of member ownership
- Strong sense of member control
- Strong sense of member commitment
- Strong sense of “them against us”



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### *Definition*

**Defensive:** Form to PROTECT Value of Members’ Assets

**Offensive:** Form to ADD to Value of Members’ Assets



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**Origin**

- Low Prices — Excess Supply
- Low Prices — Market Failure
- An Opportunity

} Defensive

} Offensive



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**Reasons for Collective Action**

- Defensive
  - Market power abuse
  - Risk reduction
  - Better terms / service
  - Missing service / market



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**Reasons for Collective Action**

- Offensive
  - Scale / scope economies
  - Profit at another level
  - Coordination advantages



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**////** *Six Major Types of Rural Cooperatives Emerged*

- Farm credit
- Rural utilities
- Local multipurpose
- Regional multipurpose
- Bargaining cooperatives
- Marketing cooperatives

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**////** *1920 – 1935 Cooperative Philosophy*

<u>Nourse</u>	<u>Sapiro</u>
- Grassroots	- Single Commodity
- Multipurpose	- Centralized
- Geographic	- Monopolize
- Federated	- Contract
- Cost of Goods Sold	- Pooling
- Competitive Yardstick	

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**////** *1920 - 1935*

- “Defense” Grand Strategy Dominated
  - keep them honest
  - force prices toward market price
  - limited offense

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*Cooperative Evolution  
Phase III*

Growth and Its Consequences



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*Let's review what  
organizational design  
emerged during this  
embryo stage.*



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*What is a Traditional  
Cooperative?*



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- Open membership
- No supply control
- Growth capital: earnings
- No secondary market



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*For cooperatives that maintained high degrees of homogeneity of economic interest, the traditional model continued to work well.*



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*Within several generations, the original commonalities began to erode*



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- Membership started to become more heterogeneous — (size, off farm income, scope, etc.).
- Common grievances began to fade.
- Cooperatives began to expand their services to meet the growing, diverse needs of their members.
- Grievances against the cooperative began to emerge.



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*Cooperatives whose membership profile — especially from an economic interest point of view — started to become less homogeneous, encountered a set of emerging organization conflicts.*

*We'll call these the vaguely defined property rights challenges.*



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***Free Rider Problem***

Members/Nonmembers Use Resource For Individual Benefit -- Property Rights Not Sufficiently Defined Or Enforced to Ensure Members/Nonmembers Bear Full Costs And/Or Receive Full Benefits



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### ***Horizon Problem***

Member's Residual Claim  
On The Net Income  
Generated By An Asset  
Is Shorter Than Productive  
Life Of That Asset



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### ***Portfolio Problem***

Members Prevented From  
Adjusting Their Cooperative  
Asset Portfolio  
To Match Their Personal Risk  
Preferences



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### ***Control Problem***

Agency Costs Associated With  
Divergence Of Interests  
Between Principal And  
Agent



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***Influence Costs***

Distribution Of Wealth  
Decisions Generally  
Create Influence Activities

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***Organizational Structure  
Characterized by***

- Free rider problem
- Horizon problem
- Portfolio problem
- Control problem
- Influence problem

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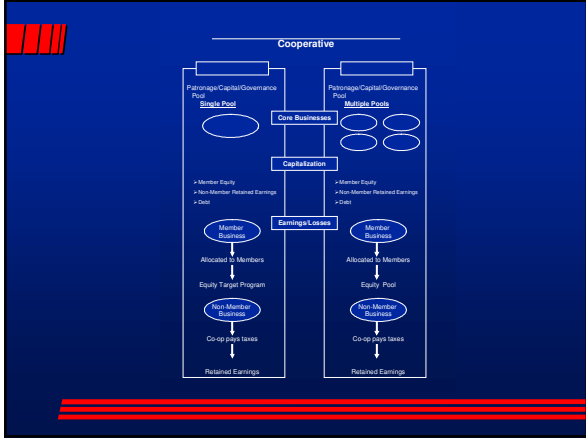
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*Cooperative Evolution  
Phase IV*

Introspection



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*The late 1980's was a period of deep introspection and reflection on the part of U.S. agricultural cooperative leaders. They had witnessed unimaginable events:*



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- Had the concept outlived its usefulness?
- Was it a business structure of the past?



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*In the mid-1980's the U.S. Senate asked the same questions about cooperatives. They commissioned a study which resulted in the 1987 USDA report:  
Positioning Farmer Cooperatives for the Future.*  


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*The report, written with contributions from many cooperative leaders and organizations, revised the cooperative principles to:*  
*user owned*  
*user control*  
*user benefit*  


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*Cooperative Evolution*  
*Phase V*  
  
Restructure Time  


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- Exit
- Moderate Remodeling (Tinkering)
- Radical Remodeling



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*Exit Options*

- Liquidate
- Convert to IOF Structure
- Drop Out and Start New Generation Cooperative



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*Moderate Remodeling Options*

- Proportional Capital
- Alliances
- Business Unit Focus
- Consolidations
- More Pools
  - Patronage
  - Capital
  - Control?



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**Radical Restructuring**

- Complete Mergers
- Conversion to New Generation
- Allow for Nonmember Ownership Rights
- Allow for Nonmember Control Rights

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**Simple Observation :**  
**Can't Separate**  
**Risk Capital Issues**  
**from**  
**Overall Organizational Design**

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**Issues**

Control    *versus*    Ownership

Control    *versus*    Capitalization

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***Framework III***

Ownership Rights Approach



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*Once the choice is made, the life cycle starts over again – but now members are more aware of ownership and control rights*



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***Basic Question***

Can the evolving cooperative model be as successful as the original ?



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*Let's develop a simple framework to facilitate exploration of this critical question.*

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- An original – pure cooperative has the following ownership rights:*
- Restricted to member-patrons
  - Redeemable
  - Non-transferable
  - Non-appreciable
  - Distributed proportionally to patronage

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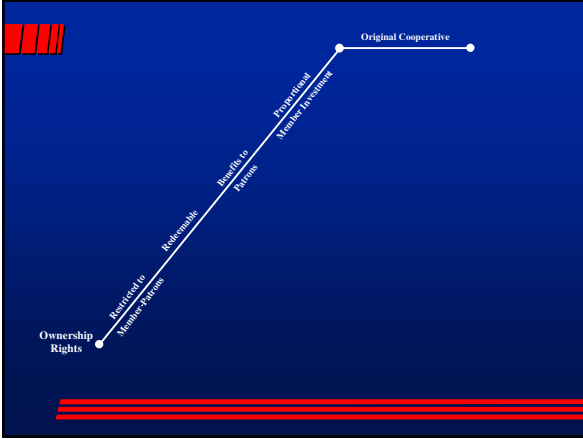
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**Analytical Framework is Derived from a Property Rights Theoretical Foundation**

— Argument is:  
Property rights (residual claims and residual control rights) are more clearly defined in an investor-oriented firm than in a user-oriented firm.

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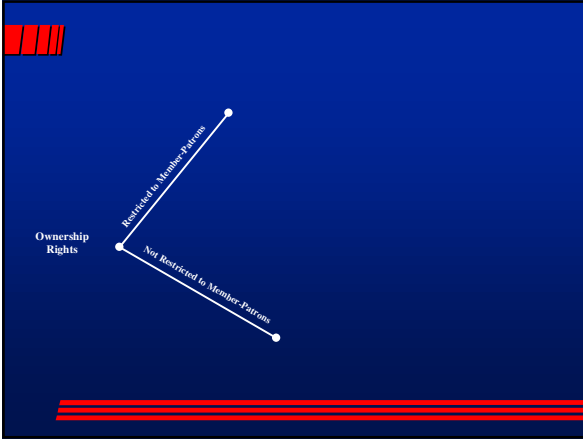
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**But over time a horizon problem emerges:**

- All members receive some user benefits
- Senior members have a disproportionate amount of the capital invested
- Market value of organization can not be unlocked
- Exit does not mean capital is returned
- Voice vs. exit

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*And the membership becomes (from an economic point of view) more heterogeneous — that is to say — less homogeneous. Thus the portfolio problem emerges.*

- Size
- Income source
- Farm portfolio
- Cost structure
- Ownership structure
- Age



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*These Investment Constraints*

- Horizon
- Portfolio
- Internal Free Rider

*Affect the Control Mechanisms, thus Creating*

- Agency Costs
- Influence Costs



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*Consequently, as cooperatives evolve, many lose their original organizational characteristics.*

*Using equity capital investment as a proxy for ownership rights, a disproportionate distribution of ownership rights begins to emerge.*



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## Emergence of Internal Conflicts: Capital Acquisition

### Emergence of Capital Constraint Arguments

- a) Cooperative residual claims are restricted to members
- b) Members have inappropriate incentives to invest
- c) Growth capital acquisition tied to patronage
- d) Equity capital is not permanent
- e) Limited access to external finance



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A traditional cooperative has the following property rights attributes: ownership rights are

- restricted to member patrons
- redeemable
- non-transferable
- non-appreciable
- distributed disproportionately among patrons



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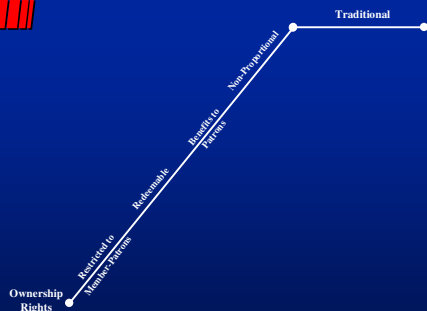
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*GICL uses these approaches and many cases to explain, explore, and learn about the changing cooperative structures.*



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*GICL = Graduate Institute of Cooperative Leadership*

**Founded by**

- Small endowment
- A visionary Dean
- Energetic Assistant Professor



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*GICL now enters its 35<sup>th</sup> year based on two beliefs:*

- Cooperation provides both
  - Private goods, and
  - Collective goods⇒ Consequently cooperation is a win-win
- Cooperative education matters.



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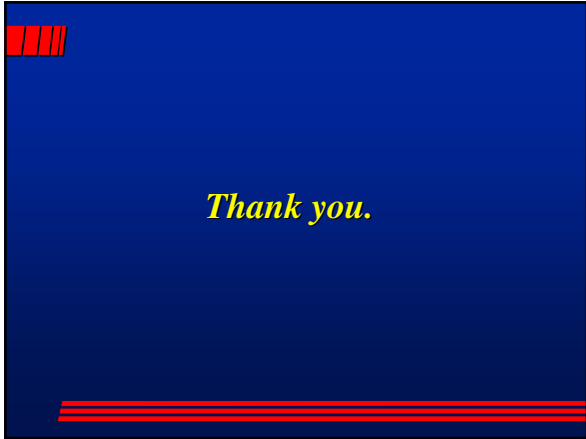
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*Thank you.*

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