Iowa State University
Extension and Outreach / Department of Economics

Co-op 101: Does The Co-op Model Fit Your Needs?

Cooperating to Grow Your Farm

Iowa Farmers Union Webinar

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Keri L. Jacobs, Asst. Professor & Extension Economist
Iowa Institute for Cooperatives Endowed Economics Professor

A cooperative is…

"…a business owned and democratically controlled by the people who use its services and whose benefits are derived and distributed equitably on the basis of use." *USDA, 1997*

"…a user-owned and user-controlled business that distributes benefits on the basis of use."
Barton, D., 1968 in Cooperatives in Agriculture, p. 1

DRIVER OF CO-OP MODEL IN IOWA: NEED

The Problem

- Railroad movement (1840s – 1870s) led to rapid expansion and fueled the industrial revolution

- Farmers were largely left behind
  - little representation in Washington D.C.
  - no mechanism for organizing formally

Producers had no way to be on even footing with their trade partners, and no options.

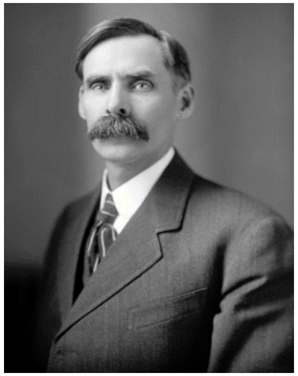
The Solutions

Beginning in 1850s, farmer associations began to form, but these came under attack.

- Sherman Antitrust Legislation, 1890
- Clayton Act, 1914

It wasn't until 1922 that producers could form organizations to act collectively, legally.

- Capper-Volstead Act



Capper-Volstead Requirements

- One member one vote OR limit dividends on non-farmer equity to 8%
- Member business must be greater than non-member business
- All voting members must be agricultural producers
- Association must operate for the benefits of its members

Allows producers to organize voluntarily to produce, handle, and market farm products to improve their terms of trade.

Iowa Cooperative Statutes

Chapter 499 – associations formed after 1935

- Voting membership limited to persons “engaged in producing a product marketed by the association…or uses the supplies or commodities…or the person uses the services that the association renders.” (499.13)
- Gives producer organizations the authority to engage in “any lawful purpose” and to exercise any power “suitable or necessary, or incident to, accomplishing any of its powers”
- Can have voting and non-voting members
- One vote per voting member (499.2)
- Effectively limits capital provision to members

Iowa Cooperative Statutes

Chapter 501 – "New Generation" cooperative

- Closed membership – members are only those that provide equity capital
- Often for value-added processing
- Members buy the right to delivery obligations – these are their equity shares (addresses undercapitalization problem)

Chapter 501A – 2005

- Allows capital contribution by non-patron members with voting rights
- Considered the "best of both worlds" of 499 co-ops and limited liability companies because the co-op can pay dividends on capital.

Rochdale Principles (1844)

- ✓ Open and voluntary membership (equality of sexes)
- ✓ Democratic control
- ✓ Economic participation by members
  - limited interest on invested capital
  - limitation on number of shares
- ✓ Net savings distributed according to patronage
- ✓ Goods sold at regular retail price (market pricing)
- ✓ Member education
- ✓ Cash trading
- ✓ Political & religious neutrality
- ✓ No undue assumption of risk

WHAT DOES IT MEAN TO BE A CO-OP MEMBER?

ECONOMIC PARTICIPATION – A MEMBERS' RESPONSIBILITY

Economic justification, even today

"Competitive Yardstick" role

- Measure against which other businesses can be compared
- Evidence of 'normal' returns to activities when savings are distributed

Establish markets to:

- Missing services
- Economies of size
- Efficiencies in transactions
- Capture market power
- Pool risks

Other Benefits To Producers

- Improve or standardize product quality
- Form a community of like-minded producers
- Favorable tax treatment
- Pooled skills

Economic motivations

A cooperative balances among many objectives:

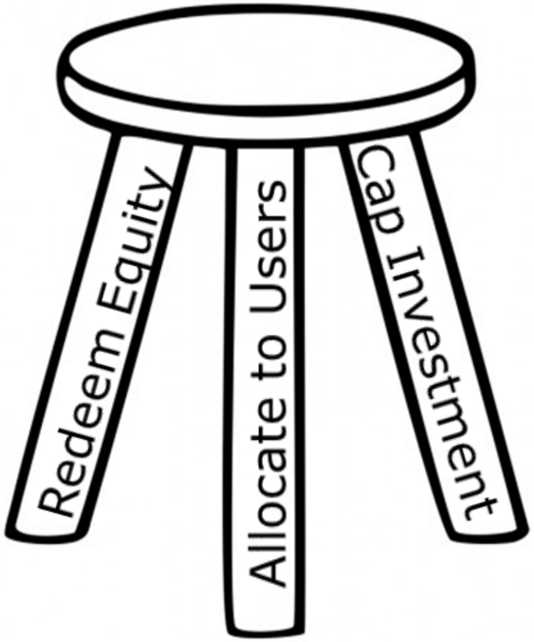
- Co-op profits
- Member profits
- Patronage
- Lowest/highest net price
- Cost minimization
- Quantity maximization

But, it cannot do all of these. Boards make decisions about what the co-op will pursue.

Cooperatives MUST be profitable

Profitability is necessary for…

- Financial sustainability of the cooperative
- Ability to reinvest in assets and productive resources
- Ability to revolve equity
- Funds for growth



Profits Contribute to Member Value

Patronage (cash or allocated equity)

- …a distribution of co-op profits (aka "savings") to those who did business with the cooperative.
- …a cooperatives adherence to the "service at cost" principle, and

Unallocated Equity – permanent capital, provision of investment in assets that generate returns at the co-op level and member-level.

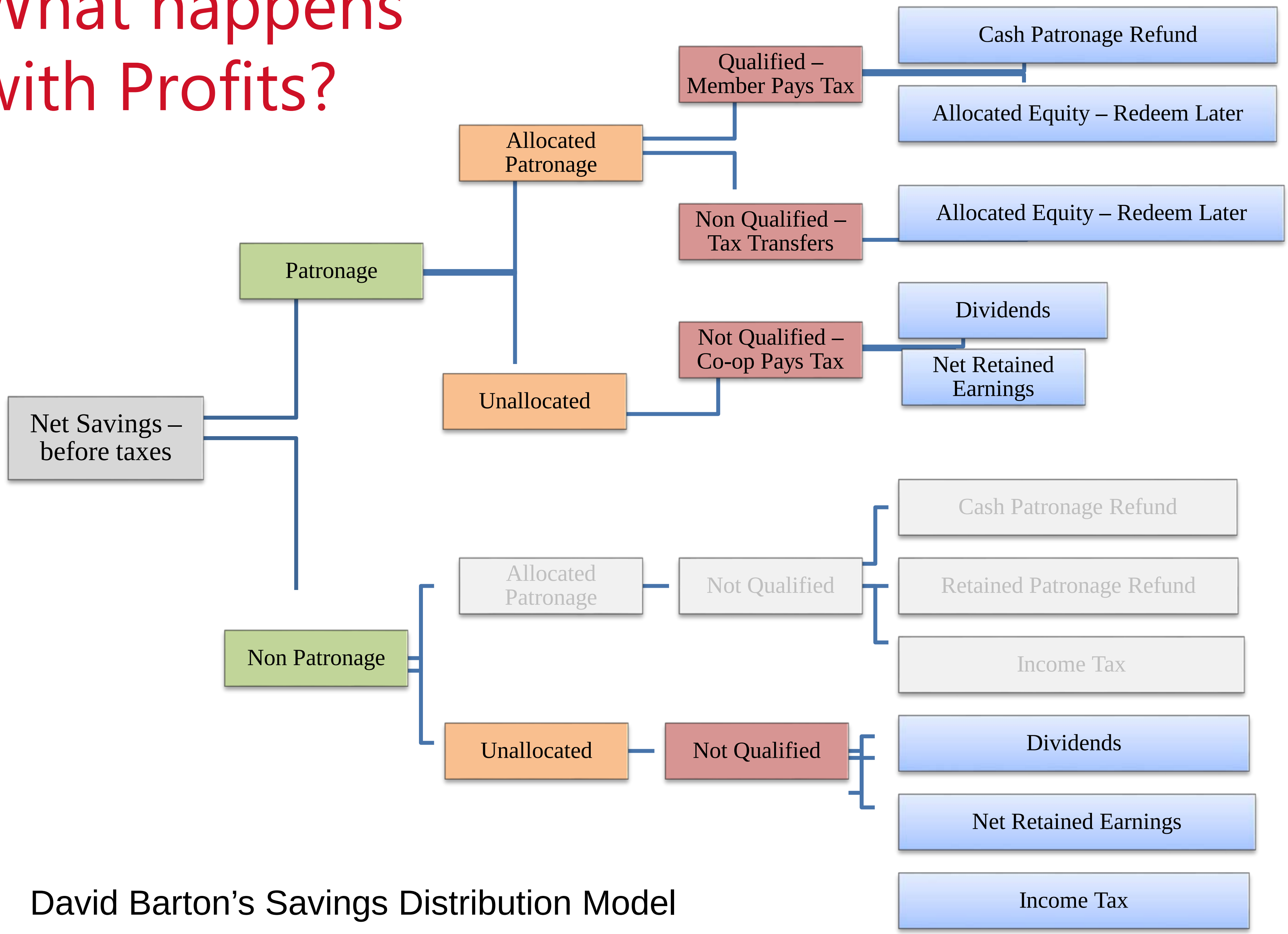
…but profits are NOT the only value

- Patronage - do your members understand it, and where it comes from? Why CAN'T they have their patronage up front?
- Governance – perhaps the least-appreciated and most over-looked component of value. Are you prepared to respond to the objection, "My vote means less now since there are so many members"?
- Community – are you telling the story about the impact of the co-op in the community? Taxes, wages, education support, etc.

…but profits are NOT the only value

- Price – an important component, but not the only one, and perhaps the co-op does not intend to be a price-leader. That is OK.
- Service – are you 'high touch, high service?" This costs money.
- Existence Value – what are the producers' options without their co-op? Would those competing companies behave in the same manner on price and service absent the co-op?

What happens with Profits?



David Barton's Savings Distribution Model

Type of Equity

1. Stocks and Subscriptions

- The direct initial investment (cash purchase) made to join the cooperative (partial is subscription)
- The new member gets a membership certificate or share of common stock.
- This conveys voting rights and Class A Membership.
- A new member may “earn” membership by doing business with the cooperative, the patronage from which is applied to the stock subscription fee until it is satisfied.

Type of Equity

2. Allocated Equity

- The portion of a cooperative's equity that results from member business with the cooperative.
- Members are allocated a portion of the year's profits, some of which is equity held in the cooperative with the member's name on it until it is redeemed to the them – NON-PERMANENT EQUITY
  - This is the member's allocated equity (allocated patronage).
  - The allocation of equity increases the member's ownership

Type of Equity

3. Unallocated Equity / Retained Savings

- The portion of a cooperative's equity that results from member or non-member business.
- A portion of the year's profits (net savings) are <u>not</u> allocated to members and instead held as common equity.
- This amount will not be redeemed to patron-members as patronage in the future - PERMANENT EQUITY.

Members Should Understand…

- the decision to use a cooperative is also the decision to capitalize one – the two cannot be separated.
- capitalization of a cooperative can be slow because co-ops generally cannot solicit non-member investors.
- members support the co-op by using it, and recognizing that profits (patronage) can only be distributed IF the co-op is profitable and has excess savings beyond normal returns to factor inputs (management, skill, assets, investments).

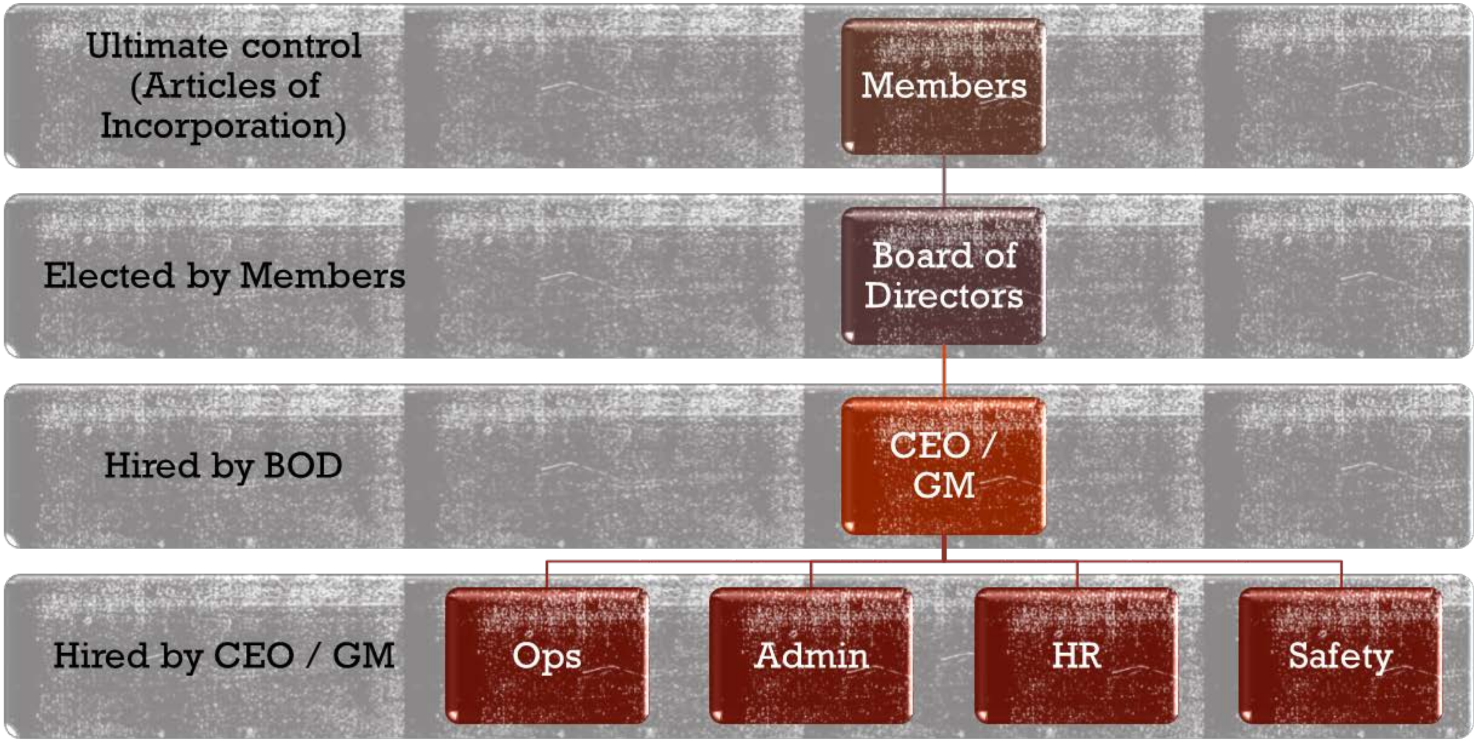
A Fundamental Difference

"By construction, cooperatives put the economic interests of a particular class of patron in front of all other stakeholders and look to patron owners for risk capital and leadership…"

WHO BEARS THE RESPONSIBILITY FOR THE FUNCTIONS OF YOUR COOPERATIVE?

GOVERNANCE

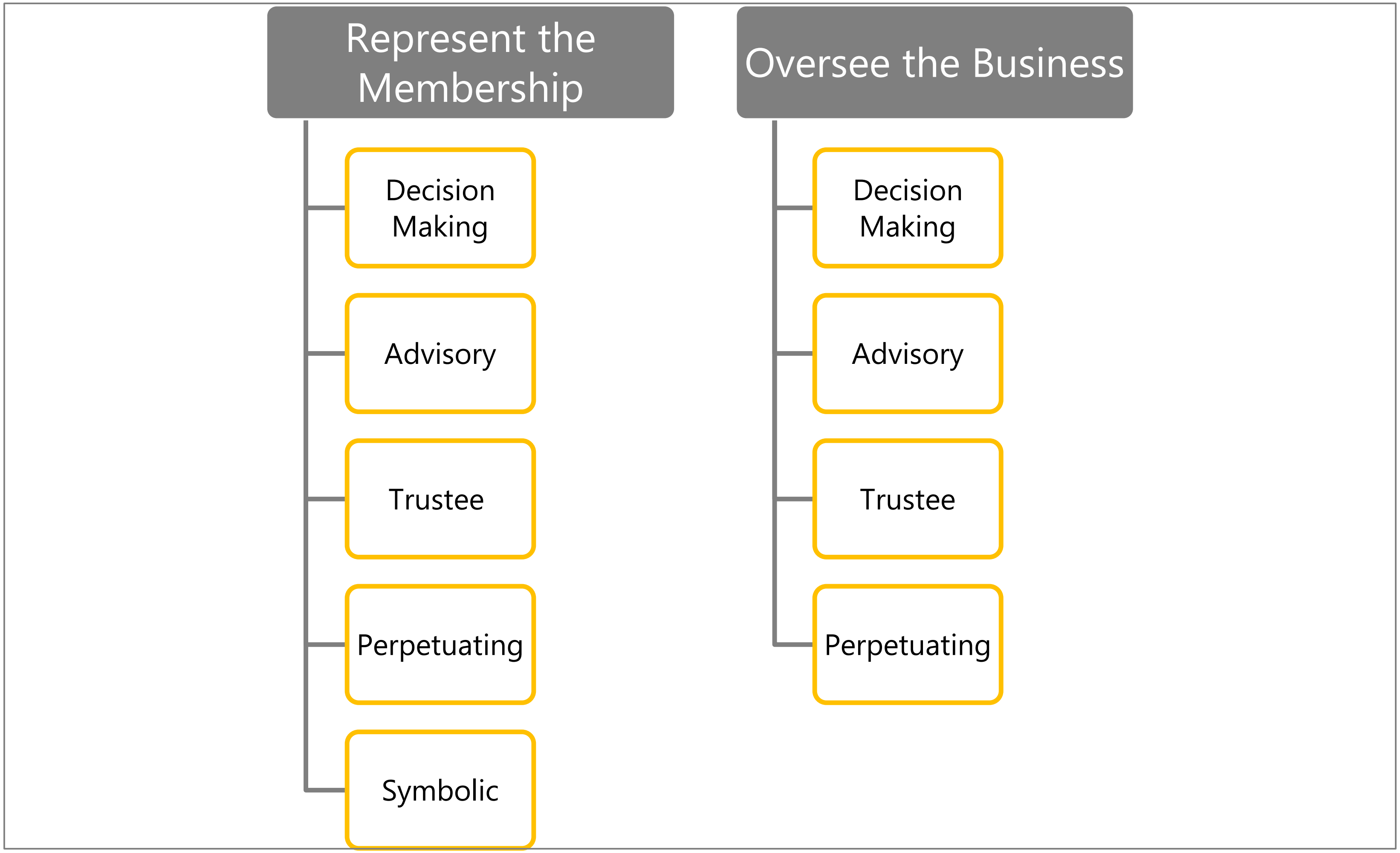
Chain of Command



In Iowa, there are only THREE things a co-op board alone cannot do…

1. Elect / remove directors
2. Change/amend the Articles of Incorporation
3. Lose control, sell, or lease more than 50% of the co-op’s assets

Board Functions



THE CO-OP MODEL IS UNIQUE

Business Structure Comparison

- Sole proprietorship
- Partnership
- Limited liability company
- Investor-owned corporation
- Cooperative corporation
    - Capitalized by users
    - Controlled by users

Differences in:
- ✓ Motives
- ✓ Decision Control
- ✓ Liability
- ✓ Benefits
- ✓ Taxes

Business Structure Comparison

Cooperative	Non Co-op Corporation
• Owners are users	• Owners not required to use
• Benefit tied to use	• Benefit not tied to use
• Democratic control: one member, one vote	• Vote proportional to stock shares
• Eligibility to vote requires approval	• Voter eligibility tied to investment
• Owners must qualify	• Contribute equity
• Single taxation on "savings" from member business	• Double taxation on "profits"

Business Structure Comparison

Cooperative	L.L.C.
Owners are users	Same
Profits distributed on use	Distributed on investment
Democratic control: one member, one vote	Control proportional to investment
Eligibility to vote requires approval	Voter eligibility tied to investment
Member/owners requires “production at risk”	Member/Owner requires contribute equity
Single taxation on “savings” from member business	Same

Questions?

Keri L. Jacobs
e: kljacobs@iastate.edu
www.econ.iastate.edu/people/keri-jacobs
Twitter @keriljacobs