FINANCING AGRICULTURAL CO-OPERATIVES

An Overview

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- *Cooperative Financing and Taxation.* Rathbone, R. C. United States Department of Agriculture.
- *Base Capital Financing of Cooperatives*. Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture.
- *New Generation Co-operatives: Revitalizing Rural Communities*. B. Stefanson, M. Fulton and A. Harris. Centre for the Study of Co-operatives, University of Saskatchewan.

A complete citation of these works as well as additional references are provided at the end of this booklet.

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The responsibility for the content and all opinions in this document are the author's alone. The report does not necessarily reflect the opinions of the federal and provincial governments which funded the project.

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About the Canada/B.C. Farm Business Management Program

The Canada/British Columbia Farm Business Management Program provides B.C. farmers the opportunity to increase or improve their business management skills. Projects funded under the Canada/B.C. Farm Business Management Program are reviewed by the provincial coordinating committee, which is chaired by a producer and comprised of farmers, agri-business, and federal and provincial representatives. Committee members contribute their knowledge, interest, and ability in farm business management.

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WHAT ARE AGRICULTURAL CO-OPERATIVES?

A co-operative is a type of business which is owned and democratically controlled by members—the people who use and benefit from the services provided by the business. Virtually any type of business can be organized as a co-operative. Indeed, co-operatives operate in almost every sector of the provincial economy, including the financial, consumer retail, housing, forestry and fisheries sectors. All are owned and controlled by the people who use and benefit from the services provided by the co-operative.

Agricultural co-operatives are owned and controlled by the producers who purchase goods and services from, or deliver products to, the co-operative business. Co-ops provide groups of producers with the opportunity to own and control businesses related to their production operations, allowing them to address common problems or develop market opportunities which they could not otherwise achieve alone (see page 2).

Defining Features

Certain features make co-operatives different from other types of business organizations, such as corporations. Basic features which distinguish co-operatives have to do with ownership, control, and the distribution of benefits.

Member Ownership

Co-operatives are financed by the people who use the services provided by the business. Investing risk capital is a basic responsibility of membership in a co-operative and a function of owning the business. Co-operatives are unlike other types of businesses in that only the members—the people who use the services provided by the business—can invest in the business. By contrast, corporations generally allow anyone with capital to invest to become an investor, regardless of whether or not they use the services provided.

Co-operatives are incorporated businesses. In British Columbia, co-operatives are incorporated under the Cooperative Association Act. Incorporation limits the liability of the individual members of a co-operative. Like the shareholders in a corporation, a co-op member can lose no more than the amount of money that he or she has invested in the business.

Member Control

It is the members of a co-operative who control the business. Member control is normally exercised through the election of a board of directors from the membership. Voting in a co-op is based on the principle of "one member, one vote" which maintains that each member has only one vote in the business, regardless of the amount of capital that member has invested. The central issue of control in a co-op typically focuses on determining the types of services provided by the business.

In a corporation, shareholders normally hold control over the business in proportion to the amount of capital they invest. Shareholders elect a board of directors who guide the affairs of the corporation in the interests of the shareholders. The directors may or may not be shareholders themselves. The central issue of control in corporations is typically the return on the shareholders' investment in the firm compared to other current investment opportunities.

Distribution of Benefits

The primary purpose of a co-operative business is to provide benefits to its members. These benefits

Why Do Producers Form Co-operatives?

Co-operatives offer producers distinct advantages in addressing a variety of market situations and issues. Producers form co-operatives to achieve individual economic benefits through group action and co-operation. These benefits are derived from meeting one or more of the following economic goals:

- **Improved bargaining power**

Co-operatives can provide groups of producers with marketing power more comparable to that held by processors and other market players. Co-ops do this by gathering market information and sharing that information with their members or by acting as a bargaining agent on producers' behalf.

- **Reduced costs**

Pooling capital and resources through co-op enterprises can enable producers to access services that they could not otherwise afford alone. Co-ops allow producers to focus on producing goods, rather than on finding buyers and suppliers for their products.

- **Achieving economies of scale**

By handling large volumes of product, co-operatives can reduce the per-unit cost of marketing and processing for producers. Similarly, the cost of inputs and services can also frequently be lowered if larger volumes are ordered through a central agency.

- **Increased returns**

Since the net income generated by co-operative businesses is returned to producers on the basis of patronage, co-operatives allow producers to capture additional profits beyond the farm gate.

- **Improved product and service quality**

Co-operatives can provide producers with the opportunity coordinate the timing of the delivery of commodities to markets. Co-ops can also enable producers to implement grading systems and standards. These activities can improve the services provided to retail and wholesale outlets and the quality of product available to consumers.

- **Reduced risk**

Agricultural commodity prices often fluctuate considerably throughout the year. Co-operatives allow farmers to pool their production with that of other farmers to minimize price and market risk.

- **Obtaining needed products or services**

Often producers require certain services or products which privately owned companies are reluctant to provide due to the small potential sales volume or uncertain profits. Such producers may join together to form a co-operative to assure the availability of vital products and services.

Adapted from *How to Start a Co-operative.* Rural Business/Cooperative Service, United States Department of Agriculture.

are distributed to members in proportion to their use of the goods and services provided by the co-operative.

Rather than generating a profit for investors, co-operatives endeavor to provide services to members at the lowest possible cost. Any surplus (gross income less expenses) generated through a co-op's business operations is either reinvested in the business or is redistributed to the members in the form of patronage refunds. Patronage refunds are calculated in proportion to a member's use of the services provided by the co-op, not the amount they have invested in the co-operative.

By contrast, corporations typically exist to generate profits for their investors. These profits are then distributed to investors in proportion to the capital they have invested in the firm. This is done by paying dividends on investment shares.

Types of Agricultural Co-operatives

Types of co-operatives common in the agricultural sector include supply, marketing and processing co-operatives. Another relatively recent form of agricultural co-operative is the New Generation Co-operative. Each type of co-op offers producers the chance to realize individual economic benefits through group action and co-operation.

Supply Co-operatives

Supply co-operatives provide producers with inputs and services at competitive rates. These co-ops sell a variety of goods to producers, including petroleum, feed and fertilizers. Services such as breeding, artificial insemination, and seed cleaning have also been organized on a co-operative basis. Supply co-ops can enable producers to reduce their operating costs and can provide access to needed inputs. Depending on the needs of the producers involved, supply co-ops can vary in complexity. They can range from simple buying clubs organized by producers to access bulk or volume discounts, to large wholesale and retail operations which provide a wide variety of goods and services to a broad range of producers.

A supply co-operative may either charge market prices for the services and products offered or it may provide these services or products at cost (the price paid for the products or services plus an operating margin). In the former case, surplus generated from charging the market price is returned to members at the end of the year as patronage refunds or is reinvested in the business. Members can also decide whether or not their co-operative will sell to non-members. Allowing non-members to purchase supplies or services can further increase the surplus generated by the business.

Marketing and Processing Co-operatives

Producers create marketing co-operatives to jointly market and distribute their products. Many marketing co-operatives also further process commodities on behalf of their members. Depending on their mandate, co-operatives may or may not market the product of non-members.

By handling large volumes of product, co-operatives can reduce the per-unit cost of marketing and processing for producers. By pooling their resources, producer-members can hire professional marketing specialists and have their products processed in plants in which they have an ownership stake. Many marketing co-operatives also facilitate producer investment in the creation of brand names as well as research and development.

Co-operatives use many methods to price and account for the raw commodities delivered by members to the co-op for marketing and processing. Some co-operatives pay producers a market price upon delivery, while others pay producers a pooled price. A pooled price is based on the average returns earned by the co-operative for a particular type and quality of product over a specified marketing period (see page 4). Still other marketing co-operatives simply facilitate the transaction between the producers and the final buyer, never retaining ownership of the product and charging the producer on a per-unit basis for this service.

Regardless of the type of marketing arrangement between the co-op and its members, producers may receive additional payments at the end of the marketing season. These payments are based on the co-operative's earnings in excess of operating costs for that period. Surplus generated from the co-operative's marketing or processing activities is either reinvested in the business or is returned to members in proportion to the amount of raw product delivered to the co-operative.

New Generation Co-operatives

The term New Generation Co-operative (NGC) refers to a type of processing co-operative which uses a unique share structure to raise the large capital sums required for value-added processing activities. To finance an NGC, shares are sold to producer-members. Each share obligates the member to deliver one unit of raw farm product to the co-op's processing facility.

The structure of an NGC can allow the co-op to operate its facilities at maximum efficiency. The co-op can also develop markets based on a secure supply of high quality raw products. For producers, NGCs provide a way to capture a greater share of the consumer food dollar by becoming involved in the production of value-added products. The financial structure and organization of NGCs is discussed in further detail in Section 4.

Co-operative Marketing Arrangements

Marketing and processing co-operatives use a number of different methods to price and account for the raw commodities delivered to their facilities by their members. Two alternative marketing arrangements include pooling and call-marketing.

Marketing Pools

In co-operative marketing pools, the producers of a specific commodity jointly pool their production to be marketed by their co-op. Under this practice, ownership of the harvested commodity is transferred to the co-op and the co-op's management determines the best time to sell, where to sell, and whether to subject the raw commodity to further processing. In return, members agree to accept the average return earned by the pool during the marketing season. The final return paid to participants in such pools is adjusted according to the relative quality of the delivered commodity. In a typical pool, producers receive advance payments at the time their harvests are delivered to the co-operative. The co-op then makes a series of progress payments as the crop is marketed. A final settlement payment is made when all costs and revenues for the marketing season have been established.

Depending on the commodity, the length of a seasonal pool may be as short as a few weeks or as long as two or three years. The pool may be closed at the end of the marketing season, and any product remaining unsold is transferred to the next year's pool at a price reflecting the average value of transactions taking place at the time the old pool is closed. Alternatively, each year's pool can be held open until all the product delivered to that pool is sold, regardless of how long it takes. The final settlement of earnings is distributed after the pool is closed and all revenues and costs are determined. Pools for commodities which can be easily stored without substantial loss of quality may be kept open for several years.

Seasonal pools can provide advantages to producers by placing the commodity in the hands of marketing specialists to be sold for the highest price available on any given day. Being in the market every day reduces the risks of failing to sell at the highest price offered by the market or selling all production at the market's low point for the year. Risk is further reduced by spreading it over a group of members instead of concentrating it in the production of one grower. No one participating in the marketing pool receives the highest price offered for a given commodity in a given year, but on an individual basis, each member is protected from selling at the bottom of the market. If the co-op has a significant market share, pool managers are better able to coordinate the flow of commodities with market demand. This, in turn, reduces the volatility of market pricing and enhances the opportunity for improved average returns.

Participating in seasonal pools also carries some disadvantages. Some producers do not feel comfortable surrendering control over decisions regarding when and where to sell their production. They are willing to sacrifice the relative security of weighted average prices for the opportunity to control the sales of their production according to their understanding of market conditions. Also, because the pool cannot be closed until the end of the marketing season, there are some delays in making the final settlement or equalization payments. These payments are normally a small portion of the total payments made to growers participating in marketing pools and can be managed to prevent significant disruptions of cash flows to members' individual business operations.

Several different commodities can be included in a single pool. Combining commodities into a single marketing pool becomes possible in part because a large portion of the processing equipment is used to process all the commodities in the pool. Similarly, most of the marketing and administrative costs are generated by a single staff. Only direct, separable, fixed costs such as depreciation, interest, and taxes attributed to handling specific commodities are charged to those commodities. The remaining overhead is spread over all commodities on the basis of a formula approved by the board of directors. Net returns are determined for each commodity and final settlement payments are made according to procedures acceptable to the general membership.

Call Marketing

Under a call marketing arrangement, the co-operative functions as a broker between buyer and seller. In this case, ownership of each unit of product remains with the member who produced it. At any time during the marketing season, the member decides when to sell each unit that he or she has produced. The co-operative's role is to sell its members' products and to guarantee the collection of proceeds for its members. In addition to giving members the right to determine the time of sale, the co-op may also allow members to set a minimum or reservation price at which the commodity may be sold. After the sale is completed and a portion of the proceeds is withheld to cover the co-operative's operating costs, the remaining funds are paid to the members.

Call marketing co-ops typically provide a marketplace where transactions between buyers and sellers are conducted in public. This serves to provide members with information on the most recent transactions, thus giving producers increased market power in the form of information about supply, demand, and the impact of the market situation on the prices being offered.

Adapted from *Starting an Agricultural Marketing Cooperative*, Center for Cooperatives, University of California, Davis.

CO-OPERATIVE FINANCE*

The general rules of finance apply to co-operatives in much the same way as they apply to any other type of business. Like all businesses, agricultural co-operatives must maintain sufficient levels of equity capital to ensure the financial viability of their operations. However, in a co-operative, equity capital also provides the basis for member ownership and control. This feature makes some of the financial characteristics of co-operatives different from other forms of business.

The following considerations factor into the financial decisions and policies of co-operatives:

- Control over the co-operative's future and direction must rest with the membership, and not with outside interests. Therefore, the bulk of a co-operative's equity capital should be obtained from members.
- Members, as the owners of the business, have a obligation to contribute capital to the co-operative in proportion to the benefits they expect to receive from its operation.
- Equity ownership should be held by the current membership of the co-operative, namely those who have recently used the services provided by the business.

These considerations influence the ways in which co-operatives finance their operations and handle equity in the business.

In this section some of the methods agricultural co-ops use to acquire capital, accumulate equity, and redeem member equity are outlined. In Sections 3 and 4, two specific types of co-operative capital structures are discussed in detail—the base capital plan and the financial structure used by New Generation Co-operatives.

Acquiring Capital

When forming a co-operative business, co-operative leaders must plan how they will acquire sufficient capital to finance the start-up of the business. Potential sources of capital for new co-operatives include member investment and debt financing. The investment of capital by people or organizations who are not members of the co-operative is prohibited under the British Columbia Cooperative Association Act. Provincial legislation also prohibits co-operatives from accepting most types of venture capital.

Direct Member Investment

Investing risk capital in a newly formed co-operative is a basic responsibility of membership—it is evidence of the members' expectation that they will benefit from the services provided and demonstrates their commitment to the successful start-up and continuing operation of the enterprise. Direct investment by members can also be a way for established co-operatives to raise capital for a special need, such as purchasing new assets or expanding operations.

Three types of direct member investment in co-ops include:

- the purchase of membership shares;
- the purchase of investment shares;
- the payment of fees.

Regardless of the amount of capital an individual member invests in a co-operative, he or she is entitled to only one vote when deciding on major policy issues and when electing the board of directors of the co-operative. This restriction is based on the control structure of co-operatives which is linked to membership, not ownership.

* Much of the material in this section is adapted from *Cooperative Financing and Taxation.* Rathbone, R. C. United States Department of Agriculture, Rural Business and Cooperative Development Service.

- **Membership shares**

Under the Cooperative Association Act of British Columbia, individuals are required to invest an initial amount of capital to become a member of a co-operative. To meet this requirement, all co-operatives must issue a class of shares specified as membership shares. Every member must purchase at least one membership share. The share value can vary, depending on the nature and mandate of the co-operative. Co-operatives do not usually pay interest on membership shares.

- **Investment shares**

In addition to membership shares, co-operatives can issue investment shares to members in order to raise capital. Investment shares may be divided into different classes, with different values and conditions attached. The interest paid on investment shares is determined by the board of directors, and, unless otherwise defined in the rules of the co-operative, is limited to an eight percent annual return.

Some co-operatives require members to purchase investment shares in proportion to the amount of business they conduct with the co-op (e.g., the number of units of raw product they deliver to a co-op's warehouse or the amount of product they purchase from a supply co-op). In this way the member's investment in the co-op reflects his or her use of the services provided by the business. Member investment in proportion to use is a defining feature of New Generation Co-operatives, discussed in Section 4.

- **Member Fees**

Co-operatives may charge an annual membership fee or a one time fee when new members join the organization. The amount and frequency of membership fees are determined by the members through the board of directors.

Debt Capital

Debt capital is money borrowed with a legal obligation to repay it under stated interest rates, terms, and conditions. Agricultural co-operatives use many of the same debt capital sources as other businesses. Primary sources are commercial banks, credit unions, and specialty lenders such as government agencies. Co-operatives may also borrow money from their members and, under certain circumstances, from non-members. Debt capital is divided into two general categories: short-term and long-term.

- **Short-term debt**

Short-term debt is repayable in one year or less. Most co-operatives establish an annual short-term operating line of credit with a lending institution. The loan commitment helps to manage the day-to-day cash flow and is usually established as a revolving line of credit, allowing the co-op to borrow and repay amounts throughout the year up to the limit of the credit line.

Short-term borrowing can be used to pay for supply purchases or to make payments to members on their product deliveries in advance of when the proceeds from co-op sales are received. Later, when product sales are made, the co-operative uses the proceeds to repay its operating loan.

In addition to borrowing short-term capital from institutions, co-operatives may also borrow from members by issuing certificates of investment.

- **Long-term debt**

A co-operative acquires long-term debt primarily to finance the purchase of fixed assets. Long-term debt may also be used to increase working capital for general operating purposes.

Long-term loans can be structured in many different ways in order to serve the needs of the borrower and the lending institution. Generally, long-term loans are granted in an amount equal to 60 to 70 percent of the cost or value of the asset being financed. The co-operative finances the remaining amount from its equity capital. Repayment is usually scheduled in annual installments over the life of the loan. The repayment period depends on the type of asset being financed and its useful life. For example, equipment loans may be for ten years while a loan to construct a building may be repaid over 30 years.

Depending on the financial strength of the co-operative, the lender may require certain conditions as part of the loan obligation. Conditions can include:

- a specified minimum level of working capital;
- certain minimum financial performance standards;
- limits on expenditures for fixed assets;
- the lender's approval to redeem, or pay-out, equity to members.

These conditions protect the lender in case the co-operative's financial condition declines. They also effect the amount of control the members have over the business. A financially stronger co-operative (i.e., one with a larger level of member investment) may encounter fewer conditions.

Leasing

Leasing can be an alternative to regular forms of debt. An operating lease or rental agreement may be arranged in the short-term for a seasonally used piece of equipment such as a forklift. Longer-term leases can also be an attractive alternative. The leasing company purchases an asset, and the co-operative arranges to use it for a specific period of time. The co-operative pays the lease company "rent" in the form of lease payments. At the end of the lease term, the co-operative either returns the asset to the leasing company or purchases the asset for a price set at the beginning of the lease.

Leases generally range from three to seven years, depending on the type of asset involved. Financial leases can be used for such capital items as vehicles, computers, and processing equipment.

In deciding how to finance the acquisition of an asset, a co-operative needs to analyze the relative advantages of using traditional debt financing versus some type of lease arrangement. This cost comparison must consider the impact each alternative will have on the financial return to the membership, and the long-term impact on the co-operative's finances. Some of the advantages of leasing include:

- an investment of equity capital in the asset being purchased is not required. This compares with the 30 to 40 percent investment of equity capital for a regular long-term loan;
- the effective interest rate is lower because the lessor can pass on to the lessee the tax savings realized from depreciation and other expenses;
- when dealing with expensive limited-use assets, the co-operative is not left with an investment in equipment that may rapidly become obsolete.

Accumulating Equity

Once the co-operative is up and running, it is generally hoped that it will be able to accumulate sufficient equity through successful business operations to cover continued operations, to finance growth and to build up the net worth of the co-operative. Co-operatives accumulate equity by:

- retaining a portion of the patronage refunds declared in a given year;
- retaining a portion of the net income generated by the co-operative as unallocated equity;
- collecting capital contributions from members through per-unit retains.

The above methods for accumulating equity can limit a co-operative's need for direct investment by members. However, members may be asked to invest in their co-operative under certain circumstances, such as a disaster or major expansion.

Retained Patronage Refunds

Retained patronage refunds are an important source of financing for many agricultural co-operatives. At the end of a co-op's fiscal year, a formal accounting determines the co-op's income and expenses. Any income left over after deducting expenses can be either allocated to members on the basis of their patronage or it may be retained in the co-op as unallocated equity. The net earnings which are allocated to members on the basis of their patronage are called patronage refunds or patronage dividends.

The board of directors of a co-operative may choose to pay out in cash all, or a portion of, the patronage refunds declared in a given year to the members. However, co-operatives typically elect to leave a portion of the declared patronage refunds within the business as equity to finance continued operations and growth.

Co-operative Equity - Allocated and Unallocated

Equity capital is money obtained by a business without assuming a legal obligation to repay it at a stated time and under stated conditions. This factor differentiates equity from debt. Equity capital in a co-operative occurs in two basic forms—allocated and unallocated.

Allocated equity is equity which is recorded on the co-op's books as corresponding to particular members' accounts. It includes capital which is invested by members either directly through the purchase of membership shares, investment shares and the payment of fees, or indirectly through retained patronage refunds and per-unit retains. Although allocated equity is a form of risk capital, co-operatives do hold an obligation to redeem allocated equity to individual members at some point in the future. The obligation to redeem member equity is unique to co-ops and stems from the feature of member-ownership. Member-ownership implies that ownership financing should be provided by the current users of the co-op. This feature necessitates that a co-op have a method for redeeming equity to members who are no longer using the services provided by the co-op.

Unallocated equity is not allocated to specific member accounts and therefore provides a permanent capital base for the co-operative. Unallocated equity is still owned by the members collectively, but it is usually only paid to members in cases where the co-operative is being dissolved. Unallocated equity can be generated in a number of ways, including revenues from sales to non-members; revenue from the sale of non-patronage products; net income retained in the co-operative which is not allocated to members; and capital from a special event such as a merger, acquisition or the gain on the sale of an asset. A disadvantage of unallocated equity lies in the removal of the direct link between an individual member's ownership in the business and the co-op's equity base.

Adapted from *Cooperative Financing and Taxation.* Rathbone, R. C. United States Department of Agriculture.

Financing a co-op through the reinvestment of patronage refunds is a simple and straightforward way for members to carry out their obligation to finance the business according to their use of the services provided. However, retained patronage refunds are not always the most reliable source of capital. The amount of capital available is determined by the co-operative's business success each year. In good years, a co-operative may have a large amount of capital to retain. In poor years, little new capital is available.

☑ **Accounting Note:** "Patronage refunds payable" is a current liability account unique to co-operatives. This amount is owed to members, in cash, based on the amount of earnings the co-operative's board of directors has decided to allocate to members' accounts. In a marketing co-operative which operates on a pooling basis, this category may be called "due members." It reflects the amount owed for product delivered, if the amount earned exceeds the amount advanced.

Unallocated Equity

In addition to distributing a portion of the co-operative's net earnings as patronage refunds at the end of the fiscal year, the board of directors may choose to retain a portion of net earnings within the co-operative as unallocated equity. Unlike retained patronage refunds, unallocated equity is equity capital which is not allocated to specific member accounts (see page 9).

In poor operating years, unallocated equity provides an alternative to charging losses against members' equity in the co-op. Some co-operatives (those which have not built up their capital reserves to a level specified in the B.C. Cooperative Association Act), are required to retain ten percent of net surpluses each year as a capital reserve in an unallocated account.

When deciding on whether or not to retain a portion of the net earnings of the co-operative as unallocated income, directors must be mindful of removing the direct link between an individual member's ownership in the business and the co-operative's capital base. While unallocated equity is still owned by the members collectively, members do not have a specific ownership stake in it. If too much of a co-operative's capital base is made up of unallocated equity, members may become reluctant to patronize or invest in their co-operative, as the benefits from doing so become less clear.

Per Unit Capital Retains

The amount of equity which can be retained in the co-operative as either retained patronage dividends or unallocated equity fluctuates according to the surplus earnings available at the end of each year. An alternative method for accumulating equity which does not depend on the level of net earnings, and which is therefore considered a more stable method, is through per unit capital retains.

Like retained patronage refunds, per unit capital retains are collected from members in proportion to the amount of patronage or business they have done with the co-operative. However, unlike patronage refunds, per unit retains are based on the number, or dollar value, of units marketed or sold. For example, for each physical unit of product handled by the co-operative, a certain amount of capital is retained as a member's capital contribution to the business. Alternatively, a certain percentage of the dollar value from sales is retained.

Marketing co-operatives, particularly those that use the pooling method of accounting for their product, typically use per-unit retains as a way of accumulating equity. Supply or service co-operatives frequently use retained patronage refunds to accumulate equity because their earnings are generally more stable from year to year. However, many marketing co-operatives also use retained patronage refunds as a source of equity, even though their earnings are generally subject to greater fluctuations.

Co-operative Taxation

Co-operatives, like all businesses, pay taxes. Agricultural co-operatives of all types, including supply, marketing or processing co-operatives, pay income tax at the same rates and under the same rules as their competitors. This is not to say that a particular co-operative's tax return will be similar to that of its competitors; there are likely to be differences, according to the choices made by the co-operative's board of directors. The same set of choices is available to a corporation's board of directors, but corporations typically choose to distribute their profits differently than co-operatives.

Consider the choices available to a co-operative's board of directors at the end of the fiscal year. If the co-operative generates a net surplus, the board must decide how this surplus will be distributed. First, if the co-operative has issued preferred shares, the dividend owing to the members must be paid. If, after dividends have been paid, additional surplus remains, the board can decide on one or a combination of the following options:

- distribute a portion of the surplus to the membership in cash (as patronage refunds) on the basis of business done with the co-operative;
- retain a portion of the surplus in the form of retained patronage refunds;
- retain a portion of the surplus in the form of unallocated retained earnings.

Patronage refunds: A co-operative's net surplus on business conducted with or for members is not taxable to the co-operative if this income is distributed or allocated to patrons on the basis of business done with the co-operative. Therefore, net income allocated to members on a patronage basis is taxable to the member and not to the co-operative, regardless of whether the patronage refunds are retained by the co-operative or paid out as cash in a given year. It is important to note that any type of business (including corporations, partnerships and sole proprietorships) can choose at year-end to pay amounts back to their customers in proportion to purchases, as cash or shares, and deduct these payments for tax purposes like any other cost. However, most businesses choose not to pay out patronage refunds since the people who have invested in these businesses expect returns based on their investment, not on their patronage.

Depending on the nature of the patronage, patronage refunds may or may not be taxed at the member level. For example, a farmer who purchases fertilizer at a supply co-operative and deducts the cost as a business expense must include any patronage refunds accrued from his purchases as business income—the net out-of-pocket cost was really the price paid by the farmer at the time of purchase less the patronage refund. However, a consumer who purchases groceries at a co-operative retail store would not include a patronage refund as income—the groceries are a personal, not a business, expense.

Whether a patronage refund is taxable or not, a co-op or any other type of business must withhold 15 percent tax when a payment exceeds $100. Patrons record the taxes withheld as a tax payment on the back page of their tax return. If the refund is not taxable, they will get this tax back. If it is taxable, they will likely owe additional tax.

Unallocated retained earnings: Unallocated earnings retained by the co-operative are taxed at the co-operative level, and are therefore subject to the corporate tax rate.

Adapted from "Who Says Co-ops Don't Pay Tax?" by Gary Rogers, Vice-President, Finance and Taxation, Credit Union Central of Canada.

Redeeming Member Equity

When a co-operative business acquires and accumulates equity which is allocated to its members, the co-operative is accepting the obligation to redeem, or pay out, this equity to members sometime in the future. Allocated equity is equity which is assigned to individual members' accounts within the co-op and includes equity generated from direct member investments, retained patronage refunds, and per-unit retains (see page 9).

A co-operative is not legally obliged to redeem allocated equity within a specific period, but there are advantages to having a structured plan in place to retire members' equity. As members patronize their co-operative, they assume the basic responsibility of providing capital to the business according to their use of the services and products provided. When patronage terminates, so does the financing responsibility.

Unless the co-op adopts a systematic plan to redeem equities, an increasing amount of capital will be held by inactive members. Such a situation can lead to conflicting objectives among the membership (as an extreme example, inactive members may lobby for the dissolution of the co-operative in order to get their equity out of the business, at the expense of members who continue to rely on the services provided). The periodic redemption of equity also serves to demonstrate to members the value of their investment, encouraging member support through patronage and further investment.

Although there are advantages to having a structured equity redemption plan in place, many co-operatives retain member equity for an unspecified number of years and may only redeem members' equity under special situations, such as death or withdrawal of membership. At a minimum, a co-operative should have a specific policy for dealing with the timely return of equities when a member dies, reaches a certain age, or retires from farming. Such a practice allows for estates to be settled more rapidly. This type of policy also allows an older member who has retired from farming to access the capital he or she has invested in the co-op when such access is likely to be beneficial.

Some co-operatives have policies for early equity retirement when a member's farming operation is liquidated by foreclosure or the operation is sold outright, regardless of the member's age. This keeps the investment in the hands of current members and, for the inactive member, provides the opportunity to have an out-of-the-ordinary transaction settled in a timely fashion. In some cases, a co-operative may agree to retire equities early, but at a discount from their face or book value in order to avoid weakening the co-op's capital position.

Two structured plans for redeeming member equity in a co-operative include revolving funds and base capital plans. Tradable equities provide an alternative to the redemption of equities.

Revolving Funds

Most agricultural co-operatives in North America which have structured equity redemption plans in place redeem members' equity through a revolving fund program. Revolving funds are based on a "first-in, first-out" method of redeeming equity. This method simply requires the co-operative to establish a target period or revolving cycle for returning capital to members.

The cycle to revolve equity should be kept fairly short to assure members that their investment in the organization is worthwhile. For most co-operatives, a reasonable cycle for revolving allocated equity is five to ten years. However, actual cycles depend on the nature of the co-operative's operations, business cycle and the type of capital acquired.

Co-operatives with revolving funds can be subject to volatility in their equity levels, reflecting the volatility in commodity prices and output. When implementing a revolving fund program, the board and management of the co-operative must be mindful to retain enough in the revolving fund to provide adequate equity financing for the business. This is an important consideration since the equity level must be sufficient to keep operating expenses, including interest expenses, low enough for the co-operative to be competitive. In addition, a co-op's lenders may establish specific equity levels to be maintained.

Base Capital Plan

A modification of the revolving fund is the base capital plan. Base capital plans provide co-operatives with a structured method for both accumulating and redeeming equity on an ongoing basis. Under a base capital plan, members' equity investment in the co-operative is maintained in proportion to their patronage. The proportional relationship between members' investment and patronage is accomplished through an annual assessment of each member's use of the co-op over a "base" period of years. This assessment serves to identify if members are either over-invested or under-invested, in relation to their level of past patronage and the capital requirements of the co-operative.

Co-operatives may use retained patronage refunds, per-unit capital retains, direct member investment or a combination of methods to obtain the required amount of capital from members who are under-invested. Members who are over-invested in relation to their patronage are refunded a portion of their equity in the business.

A more detailed description of base capital plans and how these plans are implemented is provided in the following section.

Tradable Equities

As an alternative to the redemption of equities, a co-operative may allow members to trade equities among themselves. This alternative is usually limited to co-operatives operating on a pooling basis and where member equity carries with it some type of delivery or purchase rights for the products processed or sold by the co-operative. The advantage of permitting this type of trading is that the co-operative's total amount of equity is not reduced when a member decides to leave the co-operative. Tradable equities are a defining feature of New Generation Co-operatives, discussed in further detail in Section 4.

BASE CAPITAL PLANS*

What is a Base Capital Plan?

A base capital plan is a financial management tool which co-operatives can use to:

- acquire and accumulate equity in accordance to the capital needs of the business;
- manage members' investment in the business according to their patronage;
- ensure that ownership and control of the business is kept in the hands of members who are currently benefiting from, and using the services of, the co-operative.

In many co-operatives, the methods for accumulating and redeeming equity capital are not directly related to the co-op's current capital needs. Usually, the amount of new equity capital available results from the organization's profitability or depends on the amount of product handled. For example, if the primary source of equity is from retained patronage refunds, operating results decide the amount of capital available for the business to use in financing capital needs. If a co-operative is using a per-unit retain, the amount of capital available depends upon sales generated or the physical volume of product handled during a given year. Under either method of equity accumulation, little financial planning can take place until the operating results are known at the end of the year.

Similarly, equity redemption decisions are often based on what is left over after other capital needs are met. The residual approach to equity redemption does not involve much financial management or planning. This approach also reduces a co-operative's ability to adjust its equity levels when faced with unforeseen capital demands in the event of operating losses, low volume of product, or demands arising from large capital expenditures.

With a base capital plan, however, the amount of equity capital needed by the business is decided in advance by the board of directors based on careful financial planning. The method for getting the needed capital from members is then established. A base capital plan also brings better control to the equity redemption process. The amount of capital to be redeemed to members during a given fiscal period is included as part of the capital requirements identified in the co-op's financial plan. Redeemable equity is set up as a capital need, similar to fixed asset purchases and long-term debt repayments.

How Does a Base Capital Plan Work?

The objective of a base capital plan is to have members' current level of equity invested in the business be proportionate to their patronage. For example, if a member's use of the co-op represents four percent of total patronage, a base capital plan provides a method for ensuring that the member's equity investment represents four percent of the total allocated equity required by the business.

Choosing a Structure

In order to implement a base capital plan, some decisions must first be made regarding the plan's overall structure. Specifically, a base period and measurement unit need to be determined in order to calculate members' average use of the services provided by the co-operative.

* Material in this section is adapted from *Base Capital Financing of Cooperatives*, Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture, Rural Business/Cooperative Service.

Determining the base period

The base period is the length of time over which a member's patronage or use of the co-operative is measured in relation to all other members. Although base periods generally range from one to ten years, each co-operative must decide on the length of base period which is best suited to the products handled, the nature of production cycles, and the type of business.

A short base period (from one to four years) is effective in adjusting for rapid changes in levels of patronage. It is also easier to calculate average patronage levels for one-year versus multi-year periods.

A longer base period (from five to ten years) can help smooth out year-to-year swings in patronage and provides a more representative picture of the long-term average use of the co-operative. A long base period could be important for co-ops which handle seasonal commodities such as fresh fruits and vegetables, where the year-to-year acreage and yield may change significantly.

As a rule, base periods should be as short as possible, making the program more responsive to changes in patronage levels and keeping ownership in the hands of current users. The shortest possible base period also increases the co-operative's ability to adjust members' equity levels to meet the changing capital needs of the business and to address unforeseen circumstances.

Determining the measurement unit

A unit is needed to measure each member's use of the co-operative's services over the established base period. The type of measurement unit used varies with the type of co-operative and the commodities handled or services provided. It can be a physical unit of product supplied or marketed, or it can be a percentage of the value of the products handled. The important factor is that the unit represents a common denominator which applies to each member's use of the co-operative.

A physical unit is easy to use and understand. For example, in a vegetable marketing co-operative, the measurement unit may simply be a case of product delivered, such as a case of tomatoes or lettuce. Supply co-operatives can use a physical unit of product sold to its members, such as a ton of feed or fertilizer.

Under a percentage of value method, a member's use of the co-operative is measured by applying a set percentage to the price of the products purchased at, or delivered to, the co-operative for each year in the base period. The percentage value method is a little more complicated than using a per unit method, but it takes into account the possibility that higher commodity values may require more equity to support them.

Calculating members' patronage and investment in the co-operative

Once the base period and the measurement unit are determined, the co-operative has the means to calculate each member's average level of patronage. This calculation is used to determine the relationship between each member's level of patronage and their level of investment in the co-operative.

For example, Table 1 illustrates a hypothetical co-operative of five members. A five-year base period is used to calculate average patronage. Member A's $10,000 current investment represents ten percent of total allocated equity in the co-operative. However, Member A's patronage over the five-year base period averaged 15 percent. This indicates that Member A's use of the co-op increased faster than his rate of equity investment. In order to reach an investment level which is proportionate to patronage, Member A would need to contribute $5,000, since he is under-invested by that amount.

Member C, on the other hand, is over-invested by $15,000 because his patronage during the 5-year base period averaged only 20 percent of the co-op's total patronage, while the level of investment stands at 35 percent of total member equity. The difference in the level of patronage and investment may indicate that Member C has stopped doing business with the co-op. To achieve proportionality, Member C would be due an equity redemption of $15,000 from the co-operative.

Table 1 Example of current equity investment levels compared with base period of patronage

Member	Allocated equity investment level: Total Dollars	Allocated equity investment level: Percent of Total	Average 5-year base period patronage: Percent of Total Patronage	Amount over (+) or under (-) invested: Percent	Amount over (+) or under (-) invested: Dollars
A	10,000	10	15	-5	-5,000
B	30,000	30	25	+5	+5,000
C	35,000	35	20	+15	+15,000
D	20,000	20	30	-10	-10,000
E	5,000	5	10	-5	-5,000
Total	100,000	100	100	0	0

Source: *Base Capital Financing of Cooperatives,* Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture.

Implementing the Plan

Once the structure of the base capital plan has been determined, the plan is implemented by determining the capital needs of the co-op; calculating the investment obligation or equity entitlement of each member; obtaining equity contributions from under-invested members; and returning equity to over-invested members.

▶ Determining the equity needs of the co-operative

One of the most critical components of any capital program, including a base capital plan, is determining the equity needs of the co-operative. The board of directors and the management of the co-op will need to establish the amount of capital required each year based on the organization's short and long-term financial plans. A typical planning cycle begins in the second half of the current operating year when some indication of the operating results for the year are known, and the preliminary capital requirements for the coming year can be identified.

To determine the equity needs of the co-op, the co-op's capital requirements for the coming year will need to estimated. Projected capital outlays should include fixed asset purchases, long-term debt payments, and any other special circumstances under which equity is redeemed separate from the base capital plan (for example, an allowance for the redemption of equities for members who may die or retire over the coming year would be included).

Next, the sources of capital are estimated for the coming year. Potential capital sources include estimates of patronage and non-patronage income to be retained, per-unit capital retains, new long-term debt to be obtained, and any other miscellaneous sources of equity capital.

Combining the sources of capital and the co-op's capital requirements provides an estimate of the total equity capital needed for the coming year.

▶ Calculating members' investment obligations and equity entitlements

Using the estimate of equity capital needed for the coming year, the co-operative can calculate each member's investment obligation or equity entitlement. For example, Table 2 shows an extended version of the hypothetical example laid out in Table 1. In this case, it is assumed that the board of directors have determined that an additional $20,000 is required to meet the co-op's capital needs for the upcoming fiscal period (for a total capital base of $120,000).

As in the previous example, Member A's investment at the end of the current year is $10,000. However, the required investment to support the capital needs of the co-op throughout the coming year is $18,000 (15 percent of the co-op's total capital requirements). Member A will need to satisfy the $8,000 shortfall. Of the five members presented in this example, Member C is the only member who is over-invested in relation to the co-op's required equity needs. Member C would therefore be due an equity redemption of $11,000. As is illustrated in Table 2, if the co-operative collects $31,000 from under-invested members and redeems the $11,000 owed to Member C, the co-operative is left with the $20,000 of additional equity required for the new fiscal year.

▶ Obtaining and redeeming members' equity contributions

For the co-op to obtain the required equity contributions from members, each member will need to be notified of their investment obligation. A statement should be prepared for each member showing his or her current year investment and the proportionate amount of capital needed to meet the required level of investment for the new fiscal period.

For the under-invested member, the statement shows how additional investments will be collected. For example, the co-operative's planned patronage retain or per-unit capital retain for the coming year may be sufficient to satisfy the new requirement. If not, the member may have capital retained at a higher rate than the member who is closer to being fully invested. Alternatively, members may be asked to make a direct cash investment to achieve parity. Over-invested members should be advised of the co-op's plan for refunding all or part of the over-invested capital.

Table 2 Example of required equity investment vs. existing investment level

Member	Share of required equity*	Current fiscal year allocated equity level	Next fiscal year allocated equity level	Amount over (+) or under (-) invested	Amount retained or added	Equity redeemed	Ending allocated equity level
	Percent	*Dollars*					
A	15	10,000	18,000	-8,000	8,000	0	18,000
B	25	30,000	30,000	0	0	0	30,000
C	20	35,000	24,000	+11,000	0	11,000	24,000
D	30	20,000	36,000	-16,000	16,000	0	36,000
E	10	5,000	12,000	-7,000	7,000	0	12,000
Total	100	100,000	120,000	-20,000	31,000	11,000	120,000

* Based on average patronage levels over the 5-year base period.

Source: *Base Capital Financing of Cooperatives*, Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture.

The adjustment of members' equity investments will typically be made over some prescribed time period, instead of all at once. Spreading out the contribution burden for under-invested members helps younger or newer members who may have limited capital resources to invest. This practice also decreases the capital burden of the co-operative in satisfying redemption obligations to over-invested members.

Advantages and Disadvantages of Base Capital Plans

Like any capital program, base capital plans have their advantages and disadvantages. A board of directors should carefully weigh all aspects when considering the suitability of a base capital plan for their co-op.

The advantages of base capital plans include:

- Members' investment is linked directly to patronage and the plan provides a mechanism for maintaining this relationship.
- A base capital plan permits the co-op to systematically adjust capital requirements up or down to meet the changing needs of the business.
- Members are encouraged to view their investment in a base capital plan as a "true" investment which they will have access to at some point in the future.
- A base capital plan provides the board and management with a tool to manage the co-op's capital and requires that an annual budget and financial plan be developed. Comprehensive financial planning is a key element in the success of any business, including co-ops.
- A base capital plan allows members who are phasing out farming operations or withdrawing from the co-op to have their equity returned over a reasonable period of time (depending on the flow of funds from current members).
- The ability to enhance member loyalty is increased because of the plan's equitable treatment and predictability.

The disadvantages of base capital plans include:

- Capital investment requirements can place a financial burden on new members. However, programs can be designed to help new members achieve required investment levels on an installment basis over a multiple-year period. This could cause the further disadvantage of slowing the redemption of equity of over-invested members.
- The base capital plan does not work well if there is a constant and large membership turnover. This situation puts a strain on remaining members to provide the additional capital which is no longer being supplied by members who are withdrawing from the co-operative.
- A base capital plan is difficult to manage if there are widely fluctuating capital flows.
- A base capital plan is more difficult to understand than traditional capital programs such as the revolving fund method of redeeming equity. This aspect should not be considered an obstacle to adopting such a plan, because these difficulties can be overcome with effective, ongoing education and communication programs.

NEW GENERATION CO-OPERATIVES

What is a New Generation Co-operative?

The name New Generation Co-operative (NGC) refers to a type of processing co-operative which uses a particular financial structure to raise the large sums of capital required to invest in value-added processing activities. This structure is based on investment shares which are tied to the right and contractual obligation to deliver raw product to the co-op's processing facility.

The investment shares in an NGC are tied to a marketing agreement which commits producer-members to delivering a specified volume and quality of raw product to the co-op's processing facility. In turn, the co-op is committed to accepting the delivered product (as long as it meets established quality standards) and to returning the profits generated from processing activities to members. As with other contractual agreements, contingencies are incorporated to account for unusual occurrences, such as crop failure.

The capital structure of an NGC is similar to a strict form of base capital plan—members are required to invest in the co-operative in proportion to patronage. However, unlike a base capital plan, member investment in an NGC is up-front, through the purchase of investment shares, and is based on members' assessment of their processing needs, not past patronage.

Despite the distinctive capital structure of NGCs, the co-operative features of producer control and ownership remain. In particular, NGCs:

- are democratically controlled by producer-members, based on "one-member, one-vote;"
- distribute the earnings generated by their marketing and processing operations to members in accordance to patronage;
- meet the bulk of their capital requirements through member-investment.

NGCs were first formed in the upper mid-western United States in response to depressed commodity prices and declining rural economies. This situation led producers to become involved in producer-owned, value-added processing ventures in order to:

- gain access to an increased share of the consumers' food dollar;
- reduce producers' reliance on the export of raw commodities to other regions for processing;
- create local employment opportunities and revitalize rural communities.

To date, no New Generation Co-operatives have been formed in British Columbia. However, the success of many NGCs in the United States has generated substantial interest in these co-operatives as models for the development of agriculture and other resource based industries in British Columbia.

As a result of the diversified nature of B.C.'s agricultural production and the changing regulatory environment under GATT and NAFTA, many B.C. producers currently face the need to develop new markets and create new marketing structures and institutions. While they may not be appropriate in all situations, NGCs represent an alternative worth considering by B.C. producers seeking solutions to shared problems or ways to capitalize on new opportunities.

With their emphasis on quality control, NGCs are well-suited to addressing the market development needs of producers involved in specialty niche markets, such as specialty livestock processing, the production of non-food products, and organic milling. They have also been used successfully by producers involved in more traditional, value-added activities such as corn sweetener production, sugar beet

Co-operative Marketing Agreements

A marketing agreement is a contract between the co-operative and its members which can benefit both the individual producer-members and the business. Producers benefit from knowing they have a "home" for a portion or all of their production—a particularly valuable asset when selling perishable commodities in markets where there are few buyers. For the co-operative, marketing agreements provide management the means to coordinate the volume of business with the size of available facilities, allowing the co-operative to achieve the lowest possible operating costs. Marketing agreements may also enable management to pre-sell members' produce on the basis of timing considerations included in these contracts.

Marketing agreements should be prepared with the help of an attorney and should include the following:

- A description of the commodities to be produced, packed, processed, and/or marketed by the co-operative, specifying the quantity to be delivered to the co-operative. Depending on the particular circumstances, the quantity to be delivered can be stated in terms of weight or the production of a specific acreage. If the contract is on an acreage basis, the co-operative assumes the yield risk. If the contract is based on a delivered weight basis, the producer bears the risk of being unable to deliver the specified yield.
- A statement concerning the disposition of production grown in excess of the contracted commitment. Some co-operatives require that all crop produced in excess of the marketing agreement be destroyed to prevent it from flooding the market and depressing prices. Other co-operatives require member-growers to deliver all the commodity they produce, while still others allow members to market excess production at their own discretion.
- The time and place where legal title of ownership is transferred from the grower to the co-operative.
- A description of how and when the producer will be paid and the method of determining the value of the commodity.
- A provision obligating the grower-member to notify the co-operative if a lien (such as a claim securing a bank loan) has been placed against the crop covered by the marketing agreement.
- A statement of the rights and obligations of the co-operative and the member in the event that a member fails or refuses to deliver the commodity specified. This section specifically defines those actions that breach the contract and the remedies to be applied.
- The life span of the agreement and the time period during which the contract may be extended or during which either party may withdraw.
- An "Act-of-God" clause which holds each party harmless in the event of natural disasters or events beyond human control.

Adapted from *Starting an Agricultural Marketing Cooperative*. Center for Cooperatives, University of California, Davis.

processing, pasta production, and hog operations.

NGCs are one way of allowing producers to become involved in value-added activities without having to shoulder all of the risk or bear all of the costs. Choosing a co-op structure over a corporate structure gives producers access to a greater share of the earnings generated from processing activities and keeps these earnings circulating in the local economy. Local ownership and control means that NGCs are more likely to stay in the community and will be less tempted to move to take advantage of tax breaks or lower operating costs in other provinces or countries.

How Does a New Generation Co-operative Work?

Three basic features define the structure of New Generation Co-operatives:

- member investment shares, also called delivery right shares, have clearly defined delivery rights and obligations attached to them through marketing agreements between the members and the co-operative (see page 20 for a discussion on co-operative marketing agreements);
- membership is limited to those producers who purchase delivery right shares;
- delivery right shares are tradable among members.

The decision to adopt these features as part of a co-operative business is made by the producers involved in the formation of a new processing venture or the restructuring of an existing business. The following paragraphs describe how the features of NGCs are applied and implemented into the start-up and ongoing operations of a co-operative processing venture.

Start-up

The basic steps involved in forming an NGC are much the same as those for any other type of co-operative venture. In general:

- The formation of an NGC begins with a group of producers who are committed to addressing a common economic goal by working together.
- A thorough feasibility study is conducted to determine the most appropriate way to meet the goals of the group.
- If a viable business opportunity is identified, a comprehensive business plan is developed and the co-op is incorporated. The business plan outlines the proposed strategy to produce and market processed products and the capital required to finance the venture. The plan also describes how the co-operative intends to raise the required capital. The price, quantity and features of delivery right shares are outlined in the business plan and the incorporation documents.
- If the potential members of the co-operative are in agreement with the proposed business and its financial structure, the business plan is approved and an equity drive is conducted.
- Providing enough shares are sold in the NGC, the co-operative is then ready to implement the business plan and begin operations.

▶ **Determining the initial price and quantity of delivery right shares**

The initial price and quantity of delivery right shares is determined according to the amount of product needed for the efficient operation of the co-operative's processing facilities and the amount of capital required to purchase these facilities.

The initial price of each share is calculated by taking the total amount of capital the co-operative wishes to raise for start-up and dividing it by the number of units of farm product that can be absorbed by the processing facility. In general, NGCs have followed recommendations to raise 30 to 50 percent of their total capital requirements through the sale of delivery right shares. Remaining capital requirements are met through debt capital.

As an example, consider a group of specialty livestock producers who have identified a viable business opportunity in the marketing of processed

New Generation Co-operative Profile

The Dakota Growers Pasta Company is one example of the many New Generation Co-operatives revitalizing the rural economies of North Dakota and Minnesota. In January 1992, a group of durum growers held an information meeting. Less than two years later, the Dakota Growers Pasta Company began production in Carrington, North Dakota. In the initial stages of the development process, various external advisors including co-operative development specialists helped the growers define the problems shared by the group and explore possible solutions. A thorough study of potential business opportunities in the area indicated that pasta production was a feasible enterprise which would serve the interests of durum producers. By establishing the enterprise as a grower-owned co-operative, producers would not only benefit from a market for the primary product, they would also receive a share of the earnings of the processing plant.

With a solid business plan in hand, the original group of producers began approaching other producers to convince them of the benefits of their proposed strategy. The drive to generate both interest and equity was an important and daunting task, as interested producers were asked to commit themselves as members of the proposed co-operative by purchasing a minimum of 1,500 shares at a cost of $3.85 per share—representing a minimum investment of $5,775 per farmer. In return, each share entitled members to deliver one bushel of durum to the future pasta processing facility.

The equity drive was a success. A total of 1,040 durum producers invested $12 million in the project, providing 30% of the $40 million needed to build the pasta processing plant. These numbers translate into an average investment of $11,538 per member, illustrating the high level of producer commitment and enthusiasm for the project.

Two years after start-up, share prices were approximately $7, reflecting the benefits members expected to receive from the co-operative. These benefits are twofold. Members receive 60 percent of the current market price when they deliver their durum to the plant. At the end of the year producers receive a second payment incorporating the returns generated in processing durum into over 50 kinds of quality assured pasta which is marketed both under the co-op’s own label and under private label for other food companies.

Future expansion of the co-operative will be financed in the same way as the co-operative was originally financed. Existing members or new members will provide 30 to 50 percent of the capital required for the expansion through the purchase of delivery shares.

Source: *New Generation Co-operatives: Rebuilding Rural Economies.* Stefanson, B., M. Fulton and A. Harris. Centre for the Study of Co-operatives, University of Saskatchewan, Saskatoon.

meat products to export markets. The total capital required to build the processing facility, and to start and operate the business for the first few years, is estimated at $2 million. The capacity of the proposed plant is 5000 head per year. In order to raise 40 percent of the total capital requirements of the co-op, the producer group decides to sell 5000 delivery right shares at an initial cost of $160 per share. Each share entitles and commits the member to deliver one head of livestock to the processing plant per year.

The specifics of the share structure and corresponding restrictions are outlined in detail in the co-op's business plan and are defined in the rules and incorporation documents of the co-operative (some sample rules for the incorporation of an NGC in British Columbia are provided on page 24). A marketing agreement, which is tied to the delivery right shares, is also developed. The agreement stipulates the quantity and quality of product to be delivered to the processing facility and specifies the action taken if this obligation cannot be met.

▶ Conducting an equity drive

After the share structure is determined, equity drives are held to solicit support for the co-op and to sell shares to future members. The fundamentals of the business plan are developed into a prospectus used in the drive to sign-up members.

Given that the equity shares in an NGC are tied to delivery rights, membership is restricted to producers who wish to deliver a portion or all of their production to the proposed processing facility. While there is no requirement that each member hold the same number of shares, an upper and a lower limit is typically placed on the number of shares an individual member can purchase.

Many NGCs have implemented special arrangements in order to avoid unfairly disadvantaging new producers or producers who may have difficulty raising the capital required to purchase shares during start-up. Such arrangements include the leasing of shares or allowing new producers to purchase shares based on projected future production rather than current processing needs.

Ongoing Operations

▶ Trading delivery rights

Once all of the shares in an NGC have been sold, delivery rights can be traded among members pending board approval. Members can therefore sell their shares in the co-op when they no longer wish to deliver product to the processing facility. The advantage to the co-op of permitting this type of trading is that the total amount of equity in the business is not reduced when a member decides to leave or reduce his or her patronage.

The price at which the shares are traded reflects the benefits members expect to receive from the co-operative over time. The benefits of NGC membership include:

- a guaranteed market for a portion or all of the member's production;
- the potential to share in the earnings generated by the co-operative's processing operations;
- the potential to realize a capital gain through the sale of equity shares.

Upon delivery of raw product to the plant, the member typically receives a predetermined portion of the market price. The producer then receives a second payment at the end of the co-op's operating cycle. The second payment represents the member's share of the net returns received from the sale of the final processed products.

As a result of members having financed a large percent of the co-operative's total capital needs through the up-front purchase of delivery right shares, a significant portion of the earnings generated by the NGC's operations can be returned to the members. Net earnings are divided among members in proportion to the amount of product delivered to the processing plant.

In the event that a producer is unable or unwilling to meet their delivery requirements, the co-operative purchases the required amount of commodity on the open market and charges the cost against the member's account. The member's share of net earnings will reflect the charge.

If members decide to sell their shares and forgo the right to deliver to the co-operative, they will receive a capital gain or loss, depending on the demand for shares by new or existing members and the performance of the co-operative.

▶ Controlling and managing the business

All member-owned organizations face a delicate balancing act in terms of serving the needs of both the members and the business. The key to balancing these needs lies in clearly defining the responsibilities of the board, the members, and management.

It is the responsibility of NGC members to deliver quality products to the processing facility in accordance with their marketing agreement and to elect a board of directors from the membership. Regardless of the number of shares purchased by an individual member, the principle of "one-member, one-vote" applies when electing a board of directors and when deciding on major co-operative policy issues. It is the responsibility of the board to set the co-operative's strategy, goals and objectives, and to hire a manger. The manager, in turn, is responsible for the day-to-day operation of the business to achieve the goals and objectives of the co-operative.

The importance of appropriate management selection to the success of NGCs is accentuated by the co-op's involvement in value-added processing. Management must have strong technical, production and marketing skills, as well as an understanding of the unique features and requirements of co-operative enterprise. Members must provide management with enough freedom to manage the operation efficiently.

▶ Financing expansion and growth

The expansion and growth of NGCs is financed the same way as the co-op was originally financed: new and existing members invest capital up-front through the purchase of delivery right shares.

Sample Rules for New Generation Co-operatives

The following are examples of rule provisions related to incorporating New Generation Co-operatives in British Columbia. They are provided for reference only. Before adopting any specific provisions, co-operative leaders should consult with an attorney to ensure the rule provisions are compatible with the Cooperative Association Act and the Companies Act of British Columbia. Rule provisions must also be compatible with the co-operative's incorporation documents and other legal documents, such as membership and marketing agreements.

Section —. Membership

Any natural person, or company, co-operative or incorporated society may apply to become a member of the Co-operative. Application for membership—wherein the applicant shall agree to be bound by and to comply with all of the provisions of the Co-operative's Rules—shall be made in writing on such form as is provided therefor by the Co-operative. No applicant shall become a member unless he has been accepted by the Board of Directors. On application, an applicant must:

1) Purchase one Membership Share in the Co-operative
2) Enter into contracts to patronize the Co-operative upon such terms and conditions as the Board of Directors may require, pursuant to reasonable policies of uniform application.

Section —. Contracts

The Co-operative shall make an individual contract with each member, which shall be the co-operative marketing contract, by which members agree to sell a [unit of specified product] to the Co-operative, and by which the Co-operative agrees to purchase the said [unit of specified product], and which may contain other terms and provisions as determined by the Directors from time to time.

Section —. Shares

The capital of the Co-operative shall consist of three classes of shares with the following rights and restrictions:

1) The Membership Share, which shall be redeemable on termination of membership, shall not be transferable, and shall bear no rate of interest.
2) The Equity Share, which shall bear no rate of interest, shall entitle the member to deliver to the Co-operative for sale one [unit of product], shall entitle the member to patronage dividends in such amount and under such terms as shall be determined by the Directors from time to time, and shall be redeemable on agreement with the Board of Directors to reduce the number of [units of specified product] that the member may deliver to the Co-operative for sale.
3) The Preferred Share, which shall not be transferable, shall bear a rate of interest to be determined from time to time by the Board of Directors, and shall be redeemed on termination of membership, or at such other time and under such other terms as shall be decided from time to time by the general membership.

On acceptance into membership, every member shall be required to purchase in addition to the Membership Share purchased on application,

1) One Equity Share per [unit of specified product] agreed to be provided for sale by the member to the Co-operative pursuant to Section— of these Rules, and
2) A number of preferred shares which shall be agreed to from time to time by the general membership,

    except that no member may purchase more than

    3) One (1) Membership Share,
    4) [specified number] Equity Shares, or
    5) [specified number] Preferred Shares.

No shares other than Equity shares may be transferred. Equity shares may be transferred only with the consent of the Co-operative and only to persons or corporations eligible for membership subject to Section— of these Rules. No purported transfer of Shares in the Co-operative, whether by any consensual transaction or by operation of law, shall be effective without the consent of the Co-operative. Consent may be granted or denied as the Board of Directors shall determine, pursuant to reasonable policies of uniform application consistent with these Rules.

The instrument of transfer must be in a form approved by the Directors, and when issued must be accompanied by the certificate of the shares to which it relates. No transfer will be deemed to have been made until the name of the transferee is entered into the register of members.

Advantages and Disadvantages of NGCs

The features of New Generation Co-operatives have their advantages and disadvantages. Co-operative members will need to consider these closely when deciding how their business will be financed, organized and incorporated.

Advantages of New Generation Co-ops include:

- Limited membership allows the co-op to coordinate the delivery of raw commodities with processing plant capacity, thus enabling the co-op to operate at maximum efficiency.
- The tradability of shares provides the co-op with a permanent source of equity and provides producers with the opportunity to realize the value of their equity without the co-op's dissolution.
- The price of delivery right shares will increase so long as people have a positive perception of the investment decisions made by the co-op. As a result, NGC equity shares provide an incentive for producers to become involved in the initial formation of the co-op and to further the continued success of the business.
- The generation of a significant up-front equity contribution from members facilitates the involvement of the co-op in capital intensive, value-added processing activities. The up-front equity infusion also allows the co-op to weather business cycles and makes it easier to secure debt financing, since lending institutions are given a solid indication of producers' commitment to the project.
- Delivery right shares guarantee a market for a fixed portion of members' production and can enable better planning at the farm level.
- The restriction of deliveries through clearly defined quality control mechanisms can enable the co-op to develop brand reputations based on specific product attributes. This can be particularly important for emerging industries where a co-op's entry is feasible only if it is assured a given quantity or quality of raw product.

Disadvantages of NGCs include:

- Some producers, regardless of their interest in the project, may have difficulty raising the capital required to purchase NGC shares during start-up. This barrier can be significant as the capital requirement for NGC membership is often high. To ensure new members are given an opportunity to join, many NGCs have implemented special arrangements, such as the leasing of shares.
- Large producers who have invested heavily in the enterprise may feel the co-operative feature of "one-member, one-vote" is unfair.
- Given that NGC members have committed relatively large capital outlays to finance the processing facility, members may be reluctant to provide management with enough freedom to manage the processing facility efficiently. This problem may be more pronounced for NGC members operating in emerging industries, as their dependence on the co-op is likely higher.
- The limited membership structure can have the effect of isolating a portion of producers within a given market—producers who are not members are not given the option of delivery to the co-operative.
- To date, no New Generation Co-operatives have been incorporated in British Columbia. Producer groups interested in forming an NGC in the province may face some difficulty in finding professional advisors familiar with this type of business. Effective communication and education can help to mitigate this problem.

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