# New Generation Co-operatives and Related Business Structures

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## Introduction

To understand the concept of 'new generation' co-operatives it is useful to look first at 'traditional' co-operatives. This is because the new generation co-operatives have developed in response to perceived limitations associated with traditional co-operatives. The concept of a new generation co-operative can be somewhat elusive if not seen as a response to the limitations of traditional co-operatives. It is an evolving concept, and what might have been regarded as 'new' some ten years ago may now be seen as 'old'.

In this paper a distinction is made between new generation co-operatives and hybrid co-operatives. A distinction is also made between hybrid co-operatives which have members and investors within the one business entity (the co-operative), and multiple business structures where a co-operative holds a shareholding in an investor-oriented-firm (IOF) that undertakes value adding and consumer marketing. Some commentators group all of these alternative structures together as 'new generation co-operatives' on the basis that they are all attempts at overcoming limitations of traditional co-operatives. However, although they are sufficiently different to require separate analysis.

## Traditional Co-operatives

The concept of the 'traditional' goes back to the nineteenth century, but the influence of the traditional co-operative and its associated thinking can still be seen in many New Zealand co-operatives. Typical rules of traditional co-operatives are as follows.

1. Open membership

2. Low ('affordable') entry fees

3. No, or limited return on capital

4. No capital gain for members (‘cheap in and cheap out’). If capital is built up through retention of profits then it is typically held as unallocated reserves. Sometimes, because of historical valuations, much of the true equity does not show up on the balance sheet at all.

5. Capital often not proportional to patronage. In some cases capital requirements are ‘capped’. In other cases more wealthy members supply additional capital to ‘get the co-operative going’ and receive a semi-fixed dividend on this capital.

6. Each member has one vote.

These operating rules were and in some cases still are appropriate for a co-operative formed to provide countervailing power, and which is involved in simple servicing, processing and merchandising activities that do not require high capital. Many supply and some marketing co-operatives fit these criteria.

However, problems can arise when a co-operative either needs or wishes to become involved in capital intensive activities. Problems can also emerge when for some other reason a co-operative is in a position to capture an ‘economic rent’, i.e. an entrepreneurial profit. The traditional co-operative does not, typically, provide a structure that allows existing members to capture that benefit. This can lead to economic distortions and lost opportunities.

<u>Some typical problems faced by co-operatives wishing to expand</u>

1. Difficulty in funding growth from equity capital, as members cannot afford or do not wish to provide the capital.

2. Difficulty in raising debt capital (because of a lack of equity capital).

3. *Free rider* problems arising from new members being able to join and enjoy the benefits of membership without paying for their share of the capital associated with providing the services to them. This arises from the ‘cheap in and cheap out’ philosophy. In situations where this free rider problem occurs there are likely to be economic distortions and hence economic inefficiency. Existing members may be unwilling to fund growth in situations where there is potential for free riders rather than existing members to benefit from the investment.

4. Existing members are unable to obtain capital gain on their shares despite the increase in value of the co-operative. This affects all members but can be particularly irksome for those considering retirement.

5. *Income bundling* problems, where the value adding is based on addition of capital, but the additional returns are distributed according to patronage. This can lead to economic distortion and sub-optimal investment decisions by co-operative members. It can lead to price signals that members should increase their production activities whereas the correct economic price signals are to invest capital further down the chain.

Despite these problems, many traditional co-operatives have been very successful. Nevertheless, major questions have to be asked as to whether a traditional co-operative structure is appropriate for a forward-looking organisation in the 21st Century.

## New Generation Co-operatives

There can be some confusion as to what is meant by a new generation co-operative. Different writers use the term in different ways.

In this paper the term refers to co-operatives that are structured to deal with the limitations of traditional co-operatives in relation to capital funding, capital gain, free-rider problems, and income bundling problems, but which remain owned by the members who supply goods or receive services. Other structures that involve non-member investors will be considered separately.

In essence, the major issues of new generation co-operatives relate to how should capital be obtained so that co-operatives can function efficiently in a modern capital intensive economy, and where considered appropriate, integrate vertically up the value chain. In some situations it may also include integrating horizontally into new business activities and involving new business products.

Key Features

1. Members supply capital in proportion to patronage.

2. There is potential for capital gain on the shares

3. There are no substantial unallocated reserves

4. Membership and production may be limited. This may be essential if the co-operative is to be market led rather than production driven.

5. New members have to pay for a share of capital that includes intangible assets of the co-operative, e.g. brands and goodwill.

6. Voting rights will be proportional to patronage (and capital).

Problems of New Generation Co-operatives

1. High capital requirements may be daunting to new members.

2. High capital requirements to finance growth may be daunting for existing members

3. How should shares be valued?

4. How should growth be financed?

5. There may still be some income bundling problems.

**Which are the New Generation Co-operatives in New Zealand?**

It is not always a clear-cut decision as to whether a co-operative should be classed as a new generation co-operative. Many co-operatives have some features of new generation co-operatives while remaining traditional in other aspects.

The Tatua Dairy Co-operative appears to meet the essential requirements of a new generation co-operative, and may be the best New Zealand example of a new generation co-operative. Membership is closed, although it would in theory be possible for a new member to join as long as they were within the Tatua milk catchment area (as defined by Tatua), and subject to being able to purchase a milk supply entitlement from existing dairy farmers. These milk supply entitlements (MSEs) have been allocated to existing dairy farmers based on 130% of milk supplied in the year 1999/2000. These MSEs constrain the level of growth in milk that can be supplied to Tatua and which will receive the full payout. The milk supply entitlements are separate from the shareholding of five 50 cent shares per kg milk solids. The MSEs are tradable amongst existing members (either purchase or lease), or can be sold to non-Tatua dairy farmers who are farming within the Tatua milk catchment area. The price is freely determined by supply and demand. Many farmers currently hold excess milk supply entitlements, but the current value of about $17 per kg milk solids (up from only $8-10 per kg milk solids one year ago) reflects the future demand for this milk entitlement. (Milk supply entitlements are about 105% of production in 2002/2003.) Tatua members are achieving capital gain on their investment through the milk supply entitlement, without any ‘free rider’ leakage. In addition, the substantial discount for milk supplied without an MSE provides a strong disincentive for farmers to produce ‘commodity milk’.

The situation with Fonterra, which is by far New Zealand’s largest dairy co-operative is more complex. Fonterra is required by the Dairy Industry restructuring Act of 2001 to maintain an open membership structure. Fonterra has responded to the strictures this imposes by instituting its so-called ‘new economics’ which includes ‘fair value shares’. The value of these shares is determined not by the market (this would be impossible for co-operative that has open membership) but by valuers using discounted projected cash flows (known as the DCF approach). In essence the value is determined theoretically and is based on important assumptions about future earnings, future exchange rates, and the cost of capital. One of the attributes of the DCF mechanism is that it intrinsically includes intangibles (such as brands) which are usually understated in company balance sheets.

New dairy farmers joining Fonterra, or existing members who expand their dairy operations, are required to purchase shares at the fair value share price. Similarly, farmers retiring from farming can have their shares redeemed at this price. To reduce the potential problems of a major share resumption from farmers leaving the co-operative, Fonterra has the option of paying out the shares in the form of capital notes that earn interest that is linked to market interest rates. These capital notes are traded in the market.

Although Fonterra's new economics goes some way to meeting the attributes of a new generation co-operative, it can be argued that there are still some new generation issues that it has been unable deal with. In particular, the legislative requirement for open membership restricts Fonterra's ability to take a market led rather than a production driven approach.

The three regional Foodstuffs companies operating in New Zealand, which collectively have more than a 50% share of the supermarket trade, appear to have some elements of new generation cooperatives. For example, membership is limited to persons considered appropriate by the companies, and decisions about setting up new stores in new locations are determined centrally by the companies. However, there do appear to be significant unallocated reserves.

The Ravensdown Fertiliser Co-operative would appear to have features of both new and traditional co-operatives. It regularly revalues its assets and issues bonus shares to existing members. This results in an increasing share standard requirement for new members. For example, between 2000 and 2003 the number of $1 shares required by a new member has risen from 120 to 151 per 100 tonnes of product purchased. Most of the increase has come from retained earnings which have been used to reduce debt.

Ravensdown retains open membership. If Ravensdown were to close off its membership then it could be argued that this would be counterproductive in terms of its business strategy, which has a strong focus on maintaining and enhancing market share. Ravensdown is an example of a co-operative that has been able to grow rapidly and to also retain a very strong balance sheet through a high level of from retained earnings. In so doing it has delivered high rates of capital gain to its members, yet also managed to provide fertiliser products to farmers at declining prices in real (inflation adjusted) terms.

In contrast the two major meat processing and marketing cooperatives (PPCS and Alliance) can be classed as traditional cooperatives. In both cases membership is open, most of the net assets are unallocated, and there are upper limits on shareholding. Similarly, Westland Dairy Cooperative, Plumbers Supplies and Interflora are essentially traditional cooperatives although each of them may have some elements of a new generation co-operative.

There are of course many other co-operatives that could have been used to illustrate the range of situations that exist.

*These examples illustrate that there is no single co-operative model that is appropriate for all circumstances. However, there is scope for debate as to whether or not some of the traditional co-operatives might benefit from modifying their financial structure.*

## Hybrid Co-operatives

1. Hybrid co-operatives involve a combination of a co-operative structure plus investor shareholdings.

2. Some writers have used the concepts of new generation co-operatives and hybrid co-operatives interchangeably.

3. Under NZ cooperative legislation a hybrid structure can be accommodated as long as non-member investors control not more than 40% of the votes (but they can have more than 40% of the capital).

4. The big issue with a hybrid co-operative is how should profit be shared between members and investors. Associated with this is the problem that the interests of investor shareholders and members may be conflicting. Investors' interests will be maximised by maximising profits, but members interests will be maximised by minimising the cost of the services that the co-operative provides.

There are now three New Zealand co-operatives that have gone down the hybrid route. The first was a kiwifuit and avocado pack house now known as Satara who restructured to a hybrid model in 1999. Subsequently Eastpack, another kiwifruit packhouse, restructured as a hybrid in 2000, and in 2003 the Livestock Improvement Corporation (LIC) has been restructuring as a hybrid. So far there has been insufficient time to make any definitive judgements as to the long term success of these structures.

Satara has two classes of share, known as transactor shares and investor shares. Growers wishing to use become members of the co-operative must purchase transactor shares from the co-operative. Ownership of investor shares is optional. The investor shares were initially issued to members as a bonus issue from reserves in 1999 and can be purchased by non members.

The rationale for moving to a hybrid structure at Satara was that there were considerable unallocated net tangible assets. Existing shareholders, many of whom were heading towards retirement, were keen to gain access to these assets. Moving to a 'fair share value' would have raised the barrier for new members to join, and could also have led to potential problems of resumption risk. At this early stage, most of the investor shareholders are also recipients of Satara's services. Satara has a set of operating rules that it uses to determine its cost of capital, and from this it determines the returns to investors' capital (both members and non-members). Satara is registered under the Co-operative Companies Act of 1997 and the New Zealand Companies Act of 1993. It is able to retain its co-operative status be ensuring that no more than 40% of the voting power is held by non-member investors.

A key difference between the Satara and the Eastpack structure is that whereas anyone can purchase Satara shares (it is an open market) only co-operative members can buy and sell the shares in Eastpack.

A key feature of both Satara and Eastpack is that they operate in a market where there is considerable competition, and hence these co-operatives have limited power in relation to ability to influence the market. Because there is this market price, determined independently of decisions made by Satara and Eastpack, it is reasonably easy to separate out what are the returns associated with transacting activities from the investing activities.

Livestock Improvement Corporation (LIC) is the third New Zealand co-operative to move to a hybrid structure, and this has been occurring in 2003. The two classes of share in LIC are to be known as 'control shares' and 'investment shares'. Investment shares hold no voting rights and can only be traded amongst members (a closed model). Members must hold at least two investment shares and no more than 30 investment shares for each control share that they own.

A key issue with the LIC model is whether or not LIC is a price maker or price taker in the market place. LIC is currently the dominant provider of breeding and related services to the New Zealand dairy industry and it therefore appears to have some control over pricing of these services. If this is the case, then how should these services be priced? Should it be at minimum cost to members or at a somewhat higher cost? Clearly there is scope for the interests of transacting members and investing shareholders being in conflict. In mitigation of this, the specifics of the closed model used by LIC ensure that all members will have to retain some investor shares and all investors will also be members. Further, the proposed constitution for LIC states: '*In setting the prices to be paid for products or services…the Company should seek to create wealth for the company…and should supply good and services at commercial prices reflecting market conditions…*'. This would seem to resolve the potential conflict by saying that LIC should price its products as if it was an IOF, but in doing so it moves away from what some would see as a basic characteristic of a co-operative.

The use of the hybrid model is sufficiently new in New Zealand that case history has yet to build up. The initial outcomes and progress in regard to Satara would seem to be positive. In the case of LIC it is too early to make any judgement call. However, a cautionary note for any co-operative considering the hybrid route is the need to ensure that the two classes of members do not have interests that conflict. An example of what can happen if things are not fully thought through is the case of ENZA.

ENZA was a statutory marketing organisation with powers of compulsory purchase in relation to export apples and pears. It was not a co-operative. However, its structure in the years immediately prior to and including 2002 had some features of relevance to the hybrid co-operative model. Specifically, although it had only one class of share, it had two groups of shareholders with each group having different interests. Although all members had to have proprietary interests in an orchard, the reality was most shareholders were essentially supplier members with small ENZA shareholdings and a small number of shareholders were nominal suppliers with large ENZA shareholdings (i.e. investors). After a while it became very evident that the business interests of the two groups (suppliers and investors) were indeed in conflict and this precipitated major restructuring to an investor–oriented company model. The specific issue that caused much of the conflict was the question of which group (suppliers or investors) were liable for exchange rate hedging losses. However, the message from this event is the importance of having 'all bases covered in advance'.[1]

## Joint Ventures and Co-operative Shareholdings in Investor-Oriented Firms

These structures are different to hybrid structures such as Satara, which has one business entity containing both co-operative members and investors. Joint ventures and co-operative shareholdings in investor-oriented companies (IOFs) are different in that they involve additional business entities.

One possible such structure is a company in which the co-operative holds either a minority or majority shareholding (in effect the 'cornerstone' investor). Typically, joint ventures and investor spin-off companies are a structure for undertaking value adding and consumer marketing activities that are capital intensive.

A key issue with these structural arrangements is whether or not there is a *transparent market price* at which product can be transferred from the processing co-operative to the marketing/value adding company.

Arguably, a structure such as this might be appropriate for New Zealand Milk, (which is the consumer products subsidiary within Fonterra), if Fonterra members do not wish to make the required capital investments from their own funds. Fonterra is already involved in some joint ventures both with IOFs (such as Nestles) and other co-operatives (such as Bonlac in Australia and Dairy Farmers of America).

These structures that involve co-operative shareholding of an investor-owned firm have the potential to solve problems of obtaining sufficient capital. They also have the potential (depending on the structure of both the IOF and the co-operative, and the way in which the returns are paid out to members, including issues of production controls and how co-operative shares are valued) to solve problems of economic distortion from 'income bundling'. However, it is critically important that there is a transparent market price that can be used to set the product transfer price between the co-operative and the IOF. Also, by definition, co-operative members must be willing to accept only a share of the value adding returns.

Regardless of structure, there is no 'free lunch'. One way or other, co-operative members who wish to share in the benefits of capital-intensive value-adding have to be prepared to 'front up' with capital or else share the returns with others. Sharing is always difficult, as the concept of what is 'fair' is highly subjective. Often it is nothing more than a matter of opinion. Even where there is a transparent market price at which products are transferred from the co-operative to the IOF, there may be nothing 'fair' about this price. Indeed the whole concept of vertical

[1] I have been informed by one person involved in the processs of setting up ENZA that the creation of a structure in which there would be such tension was purposeful; in other words this person always saw it as a step along the way to an IOF. So at least for this person the issues probably had been worked through.

integration may be to capture downstream economic rents that are embodied in that market price, and hence avoid being subjected as a producer to that market price.

An example of a supply co-operative that has a JV structure is Ballance Agri-Nutrients. The Ballance Agri-Nutirents Co-operative has an 80% shareholding in Ballance Agri-Nutrients Ltd, with the remaining 20% held by Norsk-Hydro, which is the largest fertiliser producer in the world. The JV with Norsk-Hydro appears to be aimed at accessing the expertise of Norsk-Hydro rather than accessing capital

## Summary

It is highly unlikely that there will ever be one co-operative model that suits all situations. The traditional model suits situations where the aim is to achieve economies of scale in regard to a form of service (such as bulk purchasing of supplies or simple processing), or to achieve countervailing power. However, the traditional model can have serious limitations in situations where capital intensive investment is required. The new generation co-operative that controls production, and has mechanisms to ensure that capital is proportional to patronage, can solve these issues in some situations. However, in other situations where co-operative members are either unwilling or unable to supply the required capital, then other structures involving non-member investors become relevant. Whatever solution is chosen, there is one unavoidable reality. This reality is that in businesses that are highly capital intensive, it is those who supply the capital who are likely to captain the value chain and reap the economic rents.

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