Membership Policy Alternatives for Marketing Cooperatives

by

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Articles

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Marketing cooperatives operating pools that consistently obtain member returns in excess of cash market prices must accommodate new members. In some cooperatives, the membership policy is based only on the capital plan. This article presents alternative membership policies for the acquisition and transfer of rights to original members. Specific policy alternatives for each component are defined and examined. The analysis suggests that strategic planning in some cooperatives should involve explicit consideration of alternatives for membership policy.

Successful marketing cooperatives operating pools may create a long-term dilemma regarding membership policy. When marketing pools consistently obtain member returns greater than spot market prices, new members want to join. When policies governing membership are in accord with conventional basic cooperative tenets of return proportional to patronage and equal treatment of all members, friction may result among members. The original members of a pooling cooperative often feel that their initial risk capital, or at least their willingness to take a chance on a new pooling operation, is largely responsible for a successful operation.

Some producers initially do not join the pool but wait to see if the operation is successful. When these producers later wish to participate in the pool, the original members have an incentive to forsake conventional membership policies for ones that discriminate in their favor. They believe such a policy is justified as a return to the original risk capital they contributed. This situation eventually forces a cooperative to implement a planned growth strategy.

This paper outlines some major alternatives regarding membership in growth cooperatives. Specifically, policy alternatives are presented that address: (1) the acquisition and transfer of participation rights and (2) the equity contribution among members over time in a growth marketing cooperative. Participation rights determine which producers can deliver to a cooperative pool. They essentially deal with how membership is defined. Equity contribution policies determine the procedures by which all patrons, new or old, provide a "fair share" of equity to the cooperative.

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After a brief background on the reasons for limited or closed membership and the extent to which it exists among cooperatives, a framework for the membership policy alternatives is presented. Next, alternatives for the acquisition and transfer of participation rights are presented, and the objectives, mechanics, and evaluation of each alternative are discussed. Alternative policies regarding equity contribution among members subsequently are discussed. Throughout, the discussion is oriented toward marketing cooperatives that have marketing agreements for crops and are vertically integrated into further processing. The discussion does not investigate the societal or welfare implications of membership alternatives although this may be an important macro question.

The alternatives discussed represent a categorization based on the author's judgment. Personal interviews were held with chief executive officers and board chairmen of selected large processing/marketing cooperatives. The alternatives outlined are not intended to reflect exactly the policies used by any particular cooperative. Rather, they are synthesized across several actual cases.

Background

Some marketing economists think that the greatest potential for ensuring market access and control by producers lies with the growth of vertical integration by marketing cooperatives (Sporleder et al.). The rationale for this position is that the domestic food production and distribution system increasingly is becoming industrialized with fewer but larger processing and marketing firms with increasing market power (Connor). Participation in an industrialized commercial food complex may require producers to take action to ensure market access, protect markets, and/or ensure control by vertically integrating forward in the marketing channel.

Whether this view of the current status of the agricultural complex is correct is not to be settled here. Suffice it to say that one alternative for maintaining some degree of producer access or protection of markets is through vertical growth of marketing cooperatives. Indeed, in a recent article in this *Journal*, Staatz discusses the cooperative as a form of vertical integration. Although previous literature recognizes the possibility of restricted membership, specific policy alternatives for growth in membership are not available. However, expulsion of members was recently explored by Copeland.

Earlier literature recognizes that cooperatives may adopt a policy of restricting membership because of a market power incentive, but the reason is more likely to be a manifestation of limited processing capacity. This processing capacity was put in place by original members who contributed risk capital. The motive for forward vertical integration by committed marketing cooperatives may be market power rather than market access or protection. However, a much-quoted study by Youde and Helmberger based on 1964 data found that about 25 percent of 31 "leading cooperatives" had limited membership. Of these, only 4 were judged to have limited membership to enhance market power. The majority of limited membership cooperatives were judged to pursue this policy because of limited processing plant capacity or because federal milk marketing order provisions made such a policy advantageous. An update of this study found much the same pattern existing in 1977 (Youde).

Processing plant capacity constraints are very real in vertically integrated cooperatives. Especially with committed pool marketing and fixed processing capacity, membership growth calls for a conscious and judicious policy. There are two primary issues associated with membership policy: the mechanism for acquisition and transfer of participation rights and equity contribution by the original and new members of the cooperative.

Framework for Alternative Membership Policies

Success in an investor-owned firm (IOF) typically is measured through earnings. Earnings influence the market value of the firm's stock. When the IOF is successful, the original equity capital contributors are rewarded through share appreciation. Owners are, of course, synonymous with shareholders in the IOF.

In a cooperative, stock or share appreciation is not possible because shares normally are not traded. Also, the capital plan may be the method used to define membership. The conceptual framework of this article is that although the membership policy in many cooperatives typically is defined by the capital plan, it is not necessary for the membership policy to be centered on the capital plan. There can be distinct and separate considerations with regard to acquisition and transfer of participation rights, and equity contribution.

Mohn, Garoyan, and Butler discuss the three primary methods used by cooperatives to generate and redeem equity capital. These are base capital equity formation, the percentage-of-all-equities plan, and revolvement in the order collected. Each primary plan may have several variants in application, but all are means to define membership and also may be used to define who has the right to deliver to a pool.

Participation Rights Alternatives

Policy regarding acquisition and transfer of participation rights in a limited membership cooperative has many aspects. The central aspect of alternative policies essentially becomes a question of the "attachment" of the right. This means that the key difference among all alternative policies is whether the right of participation is attached to the land from which production is delivered, to the member, or whether the right is retained within the cooperative and controlled by the board of directors.

Four leading alternatives with regard to the acquisition and transfer of participation rights are: (1) land by description, (2) member, (3) member and land, and (4) membership rights not assigned to either member or land but retained by the board of directors.[1] This latter system of acquisition and transfer of participation rights will be called a nontransferable system. The rights are nontransferable in the sense that they flow from member to cooperative rather than from old member to new member.

Land-by-Description System

Purpose and Mechanics of the System

"Land by description" defines the acquisition and transfer of participation rights through land only. Rights to deliver to a pool are attached to a specific number of acres, typically described in a manner identical to the Agricultural Stabilization and Conservation Service (ASCS) description of the land. The purpose of the system is to stabilize volume delivered to the pool and/or membership in the cooperative. The land-by-description system purposely makes acquisition and transfer of participation rights difficult relative to other alternatives. Membership in the cooperative is obtained under such a system only through transferred land ownership.

In the case of a landlord/grower relationship, only the landlord would have the opportunity to sell rights. Over time, these rights would acquire value in relation to the average price differential between a cooperative's final settlement price and the open market spot price. Assuming that this differential was positive in favor of the cooperative, acres sold with rights to deliver to the cooperative would be more valuable than similar acres without those rights. Thus, in this system, the value of the participation rights is capitalized into land price.

Evaluation

Relative to the other participation rights alternatives, land by description is the most difficult for membership transfer. Stability in volume or members probably is the most important longer-run advantage. Pool deliveries of the most desirable quantities and qualities for processing may be easier to achieve in a stable membership cooperative. The costs of member education or of providing other services to members may decline as stability increases.

At the same time, a system that makes it relatively difficult to transfer participation rights also would be a disadvantage for the member. All other things equal, current members would prefer ease in the transfer of participation rights.

The primary disadvantage of this system is that production is frozen by the number of acres in use when the system is adopted. The expected long-term effect would be to increase the cost of production to the cooperative relative to noncooperative production. One long-term cost effect is that production cannot move to areas where cost of production is least. Another expected effect is that rights are capitalized into the cost of production and thus become an additional cost compared with spot production. Another way to look at the additional cost of production is to consider it as the opportunity cost of not coverting the gain into cash.

A mechanism for future expansion of acres is not part of the land-by-description system. Suppose the board of directors decides that expansion in acres is desirable. Initial assignment of these additional acres would be a decision for the board of directors, not prescribed as part of this policy. This could lead to arbitrary decisions concerning which additional acres are assigned rights.

Member System

Purpose and Mechanics of the System

The purpose of this system of participation rights is to assign rights to members rather than to land. The amount of product a member is entitled to deliver, either in acres or physical quantity, is carried on the books of the cooperative. No description of land is necessary, and members can shift the specific acres to which they apply their rights from one production season to another.

Initial assignment of rights under a member system is relatively easy compared with the land-by-description system. Records of the cooperative simply show the amount of production rights, and the member specifies the location of those rights annually in the case of acreage agreements. It does not matter whether owners wish to assign rights to their own farms or to other acres. Members are free to assign rights on an annual basis to whatever acres they designate. Also, rights could be leased unless expressly forbidden by board policy.

With regard to transfer, rights can be sold to any other farmer who wishes to purchase them, usually subject to the board of directors' approval of the new member prior to the sale becoming final. Sales are private treaty transfers at whatever price the seller can obtain. Once rights are transferred, the purchaser can face a requirement to use the rights or lose them within some period of time. For example, a two-year limit could be imposed.

Expansion of either pool acres, quantity, or number of members takes place by allocating new rights, usually to existing members. These members then have a choice of producing from the additional rights or selling those rights.

Evaluation

Implementation of the member system is relatively easy compared with land by description. Also, the system does not freeze the acres on which production occurs, as does the land-by-description system. Over time, rights should be assigned to whatever acres have a comparative cost advantage in production.

There is a possibility of speculation with the member system. It is conceivable that some members of a cooperative might buy membership rights of other members because they expect the value of those rights to increase. If desirable, speculation could be limited through a maximum on the percentage of acres acquired by any one member or by allowing the board of directors to rule that a member either uses the rights or loses them. However, conceptually someone still could buy a large number of rights and lease them, meeting production requirements so that rights are not lost.

The value of the right under the member system is capitalized into the cost of production although it does not manifest itself in the price of land when land is sold. The expected result of this is that cost of production would increase as participation rights increase in value. Of course, the cost of production increases only for those buying the rights at a price higher than the original cost. That is how this policy allows original members to capitalize on the value of their equity.

Determination of who gets any expanded or additional future rights still is a board decision. The board of directors normally will offer existing members assignment of rights to additional acres before producers outside the cooperative are offered additional rights (perhaps on the basis of how much they are willing to pay for them). Allocation of additional rights is a sensitive issue and likely will reflect the standards of fairness imposed by existing members.

Member-and-Land System

Purpose and Mechanics of the System

The member-and-land system for acquisition and transfer of participation rights involves a combination of some aspects from the member system and some from the land-by-description system. The purpose of the combination is to gain some advantages from each of those systems. The member-and-land system is purposely complex compared with the others, especially with regard to transfer. Members are assigned rights rather than land. However, transfer of rights can take place only with the sale of land. The member-and-land system is flexible in that it assigns specific pool acres or quantity on a seasonal basis, yet it attempts to stabilize membership by making transfer of participation rights from one member to another more difficult.

Initial assignment of participation rights under the member-and-land system is essentially identical to that under the member system. The primary difference between the member and member-and-land systems is with regard to transfer of rights to deliver to the pool, rather than initial assignment. If a member has rights to deliver from 1,000 acres, for example, the member can assign that right annually to specific acres. These acres may vary from one season to the next. However, if the member wishes to sell the participation rights to those 1,000 acres (i.e., leave the cooperative), he or she also must sell 1,000 acres of land.

New members are subject to approval by the board of directors. In the case of land sale with rights attached, the sale is contingent upon approval of the new member. Participation rights are capitalized into the price of land under this system. Leasing of rights usually is not allowed. If leasing were allowed, the purpose of the transfer of rights only with the sale of land would be defeated.

Evaluation

This system results in a more stable membership relative to the member system and does not freeze production on certain acres as does land by description. The system is cumbersome for transfer of participation rights. Value of the participation right is realized only through sale of land. Also, allocation of new or expanded rights remains a board decision under this system.

Nontransferable System

Purpose and Mechanics of the System

The purpose of nontransferable rights is to allow the board of directors of a cooperative to maintain maximum control over membership. No lateral or member-to-member transfers of participation rights are allowed under the system. If any current member wants out or a new member wants in, it is solely a board decision. Rights cannot be transferred from one member to a nonmember or from one member to another member under this system.

There are three possible ways to define the amount of participation rights that any particular member holds under the nontransferable system: (1) by number of acres, (2) by quantity, and (3) by an "unlimited" system where each member simply holds membership regardless of size. The mechanics of each is discussed briefly.

Under the acreage nontransferable system, initial assignment of rights is in proportion to the amount of current production or some average of production over a certain period of time, two or three years or seasons, for example. If a member ceases production, the rights revert to the board. Transfer of membership is from member to board and board to member. The board of directors has discretion over reassignment of those rights. They can be reassigned with or without a transfer of equity from the existing member to the new member. The board does not have discretion over the amount of rights that can be reassigned, however. If, for example, 500 acres of rights are turned into the board, only 500 acres can be reassigned to a new or existing member.

The final alternative for determining the amount of rights any particular member holds is an "unlimited" system. This means that membership is on a one-for-one basis, regardless of size. If a current member terminates, one membership becomes available. The board can reassign this membership to anyone, regardless of size of the expected deliveries from prospective producers. Again, transfer of membership is not allowed from one member to another, only from member to board and board to member.

Evaluation

The board of directors has nearly complete control over membership relative to other alternatives. This system is simple in implementation compared with other alternatives. Production can move to the lowest cost of production areas over time. Members can assign rights to specific acres annually. Under the unlimited system, no acreage assignment is necessary.

Under the nontransferable system, the board of directors has a great deal of discretionary power and is able to manipulate membership to a high degree. The system does not solve the question of who gets additional or expanded rights should future growth occur. Allocation of additional rights is arbitrary. Relative to others, the nontransferable system does not permit individual members as much freedom. Volume control by the cooperative is less than with other systems.

Equity Contribution Alternatives

A second membership policy concern is fairness to original members of a cooperative as membership grows. Regardless of the mechanics of particular policies, all are intended to ensure that each member of a cooperative contributes a fair share of equity to the operation. Original members contribute risk capital to enable building the facility. As the cooperative grows in membership, original members may be concerned that new members contribute to the equity base in sufficient magnitude to provide a reward to the original risk capital.

Each alternative regarding fairness discussed in this section allows for differential treatment of new members compared with original members. The alternative policies vary widely in their impact on new members (and to a lesser extent on original membership) and in their mechanical aspects. Policies include: (1) base contracts, (2) a front-end equity requirement, and (3) multiple pools.

Base Contract System

Purpose and Mechanics of the System

The purpose of a base contract system is to reward original risk capital while providing for membership growth. The system operates by establishing a negotiable (or marketable) marketing right that is allocated only to the original members of the cooperative. The value of the negotiable marketing right, or base contract, becomes the return to the original patron's risk capital. The market for these negotiable rights determines the amount of the return.

The base contract system is designed specifically to create a fixed amount of rights to deliver to the pool that will accrue value or a market price in a successful cooperative. The base acreage allotment is determined on the average of a specified number of years of production, three years for example, in terms of the equivalent acres delivered to the pool. Base acres can be sold in private treaty transactions among growers. Except for misfortunes such as hail or drought, base acres must be planted each season. If a producer does not use a base acre allotment within a specified amount of time, e.g., two years, it is lost or becomes nonnegotiable.

As an example, assume an equivalent pool size of 25,000 acres. Base acreage contracts initially are assigned on a proportional basis to each original member, based on delivery history. The fact that only base contracts accrue market value allows the original members to capitalize their risk capital in a way that reflects the overall success of the cooperative.

Temporary (e.g., one- to three-year) pool expansion can occur through action of the board of directors. The board can issue nontransferable term contracts valid for one to three years. Deliveries from all acres, term or base, share equally in pool proceeds. However, because these term contracts are not negotiable, they have no market value. The amount of the base contract in addition to the contract's price determines the extent to which an original member realizes a risk capital return.

Prior to each production season, availability of term contracts is made through a public announcement, or contracts are made available on a priority basis to existing base acre members. If existing base acre members do not wish to produce the additional amount desired, term contracts can go to producers outside the cooperative. Anyone who holds only term contracts has temporary rights to deliver.

Evaluation

The base contract system allows for reward to original risk capital, as do all the systems discussed in this section. The system is relatively flexible in meeting changing conditions or requirements of the pool in terms of size. It allows for either permanent or temporary pool expansion.

A possibility exists for speculation in base acres. Base acre contracts are negotiable and are bought and sold among existing members. This, however, is not likely to be a significant problem for the cooperative.

The expected long-run outcome of the base acre system is to increase the cost of production from base acres. Because any new acres with rights to deliver to the pool need a base acre contract, the cost of obtaining a base acre contract becomes an additional cost of production.

Under the base contract system, the board of directors has wide decision-making latitude. This may be both an advantage and a disadvantage. If the board decides to allocate all new acres to existing members, then young farmers might have difficulty becoming members.

Differential Front-End Equity Requirement

Purpose and Mechanics of the System

The purpose of a differential equity requirement is to ensure that future members provide a greater amount of equity than original members, resulting in an indirect return to the risk capital of original members. The requirement is called "front-end" because it represents a one-time payment of equity by new members at the time they join the organization. The front-end equity is separate from the equity supplied by members under the cooperative's capital plan.

The differential front-end equity requirement is a simple program to administer. It consists of the addition of equity capital to the cooperative when new members are accepted. The additional equity is permanent and based on the amount of new acreage or quantity to be delivered to the pool. The front-end equity calculation typically is based on some percentage of the crop value delivered the first year. This requirement usually is met by a per-unit capital retain deduction established without regard to earnings of the cooperative.

Evaluation

The system is simple. Capital is provided for the expansion of processing facilities at a later time. This system rewards original members of the cooperative indirectly, not directly as in the case of the base contract system.

Multiple Pools

Purpose and Mechanics of the System

Multiple pools are established under the philosophy that no fair way exists to treat original or new members in a single pool when expansion occurs. Establishing new pools is a board decision. Only original members share in the pool established for the original processing facilities. New members are part of a separate pool.

Evaluation

Some would contend that this sytem is fairest to both new and original members relative to the other alternatives. However, management of multiple pools can be a considerable problem. Incentives for new members to join a separate pool may not exist if they cannot capture processing margins. Multiple pools can be viewed as creating "nested" or multiple cooperatives.

Summary and Conclusions

Marketing cooperatives inevitably face the need for a planned growth strategy. Successful cooperatives are under long-term pressure to increase volume and membership although they may have fixed processing capacity in the intermediate run. Some cooperatives may have membership policies that are a residual of the capital plan for the cooperative. This need not be the case. The membership policy alternatives outlined here are specifically separate although they may influence the capital plan.

Obviously no one membership policy can be suitable for all cooperatives. However, several aspects seem to surface as important when choosing one policy over another. One important aspect is the extent to which acquisition and transfer are predetermined by the policy. That is, how much discretionary authority does the board of directors possess with the policy? Wide latitude by the board means a weak policy or no policy at all. Among the alternatives discussed here, clearly the nontransferable policy gives a board greatest discretion.

An aspect of membership policy worthy of consideration is the extent to which the policy incorporates economic criteria rather than arbitrary decision. For example, is a policy aimed at transferring membership in the cooperative through a negotiable marketing right that reflects market conditions, or is the value at the time of transfer established by edict?

An explicit definition and comparison of membership policy alternatives can provide managers and boards with valuable information. An unplanned policy serves neither member nor management well. Recognition and analysis of the alternatives are necessary for optimal strategic planning.

Note

1. All alternatives listed ultimately may require board approval. However, in all but the last, board approval of a new member is standard procedure. In the last alternative, the board determines, perhaps among many applicants, who becomes a member. In the first three alternatives, the new member is recommended by an existing member.

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