The food, natural fiber and agriculture system is currently undergoing the most
dramatic and comprehensive structural change in our history. From the retail
counter to the farmer in the field, the system is changing in response to global
economic, social and political pressures. Increasing consolidation in all market
segments and intense efforts to reduce costs at every level continue to force a
reexamination, redefinition and restructuring of traditional business forms and
operations.

Farmer cooperatives play a significant role in this changing marketplace,
accounting for 28% of all farm supply sales and 29% of all commodities marketed. However, they must increasingly compete with firms that are much larger, better
capitalized and much more dominant in terms of market influence in both the U.S.
market and internationally.

Farmer cooperatives continue to be critical in protecting the economic interests
of their farmer members. They provide their members with competitively priced
inputs, they maintain market access for their commodities and related products
and they better enable their members to capitalize on new value-added market
opportunities beyond the farm gate.

In order to continue to serve their farmer interests in this rapidly changing
business environment farmer cooperatives have had to adapt their business
practices and structure over the years and the current business climate only
means faster and more comprehensive changes.

The speed and breadth of changes in the food, natural fiber and agriculture
system are a direct result of four significant market catalysts:

1. Demographics
2. Technology
3. Path of globalization
4. Regulatory change

**U.S. demographics** have been signaling a dramatic change in the U.S.
marketplace for some time. Population growth rates are slowing, the average age
of the population is increasing and the baby boomers remain the dominant market
segment. The U.S. market is reaching a mature status in which market share is a
more dominant factor than market growth. Food and fiber marketing will continue
to be more focused on the changing nature of consumer preferences and less
reliant on a growing market volume. The baby boomers redefined the role of the
equity market over the past decade and we now have a mutual fund industry with
assets nearly as large as the banking industry. The food and fiber value chains
will be completely redefined in the coming decades as consumers become
increasingly selective over what and where they consume their products. The
demographics will also have a major impact on the allocation of federal budget
revenues by the end of the decade. The first of the baby boomers will begin to
retire in 2010 and the demands on available funds will increase dramatically for
social security and Medicare.
Technology will continue to be the major "enabling catalyst". Advances in information and computer technology have changed the business landscape in terms of system coordination, information processing, inventory management and market analyses. Soft assets replaced brick and mortar and dramatically altered business strategies and competitive positions. Regional companies are now able to coordinate national and global systems at increasingly lower costs. Scanning technologies have created a wealth of consumer information that can be mined to extract strategic information on consumer preferences and serve as a basis for creating value chains to satisfy those preferences. At the same time the emerging life science technologies have created the potential to use biotechnology to enhance the presence of the selected traits that will satisfy those preferences. The process of integrating production agriculture into this information and life science value chain to satisfy consumer demands is now underway. The other catalyst will obviously influence the speed and structure of the integration process, but the process has become the key component of business strategies in the food and agriculture sector.

The path of globalization has also redefined the nature of the food and natural fiber markets. With the fall of the Berlin wall in 1989, the breakup of the former Soviet Union in 1991, the completion of the North American Free Trade Agreement in 1994 and the emergence of the World Trade Organization in 1995 there were great expectations for a rapid rise in global trade. However, the path of globalization took a decided turn with the Asian financial crisis in 1997. The economic turmoil in Asia and the emergence of the strong U.S. dollar set the world on a different path that increased the competitive pressures on U.S. agriculture. Trade tensions became more heightened and protectionist tendencies have reemerged. While the recent improvement in global economic growth and the weaker U.S. dollar has begun to ease some of the competitive pressures, the Doha Round trade negotiations and the aggressive U.S. approach to bilateral agreements has created concerns about the future path of globalization. As the developing countries continue to demand greater disciplines on domestic subsidies, as well as export subsidies, the pressures for change in domestic farm programs will continue to build.

Regulatory change has swept through significant sectors of the U.S. economy including energy, banking and financial services, telecommunications, etc. While much of the activity is at the federal level, we are seeing increased activity at the state and local level as well, particularly in the environmental and conservation arena. For the food and agriculture sector the pressures for change are building in several areas:

- Environmental concerns over air and water quality and the protection of natural resources through conservation practices is accelerating and placing increasing pressure on the cost, structure and location of major business activities in both crop and animal agriculture. These concerns are also becoming embedded in consumer preferences to know more about how their food is produced and whether it meets their expectations regarding impacts on the environment, animal welfare, etc.
- Food safety regulations continue to be re-examined to ensure that the confidence of the U.S. consumer in the food supply is protected. The recent BSE incident will lead to significant new regulations for animal agriculture and has demonstrated the increasing pressures to address food safety issues on a global scale.
- Food security concerns have already resulted in the registration of all food processing and storage facilities and a documentation of product flows. It will receive increasing focus over the next year, as concerns over bio-terrorism will require a greater monitoring of the food supply from production to final consumption.
Commodity programs continue to shape the structure and operation of production agriculture and will be under constant review as Federal budget pressures continue to build. The current farm programs will expire in 2007 and the next farm bill will be shaped by the Doha Round agreements, likely to be concluded in 2005-06, and the available funds provided under the prevailing Federal budget environment.

These catalysts have already forced major changes in much of the food and fiber system over the past decade. The retail food sector is now dominated by less than ten firms with the largest food retailer, Wal-Mart, expected to have a 35 percent market share by 2007. Consolidation in the food-processing sector and in the manufactured inputs sectors has mirrored the dramatic change in food retailing. Consolidation in production agriculture is also continuing as less than 10 percent of U.S. farms now account for nearly two-thirds of the value of agricultural production. Agricultural imports particularly fruits and vegetables have increased by nearly 50 percent since 1996 and the value of agricultural exports has just recovered to 1996 levels. Together, Brazil and Argentina now produce more soybeans than the U.S. Production in Brazil alone has increased by 97% since 1996. Countries of the former Soviet Union have gone from a major grain importer to a major grain exporter. The U.S. cotton industry must now export 60 percent of the cotton it produces because domestic textile mills have left the U.S. market. Just four years ago the domestic market absorbed 60 percent of the production.

Farmer cooperatives, like the rest of agribusiness, have undertaken numerous strategies to address this emerging market structure.

- Consolidation was the first option for many cooperatives that realized that the new market environment required increases in market share to spread costs over more units to sustain profitability. Additionally the scale of operations needed to be large enough to meet the needs of customers who were growing increasingly larger. Over the past decade the number of farmer cooperatives have declined by over one million largely due to consolidation.
- Some companies, such as Farmland Industries and ConAgra, sought to own and build complete value chains from production to retail. Those efforts were unsuccessful as both discovered that the magnitude of capital and the need for a unique business focus in every competitive segment of the value chain was not profitable. ConAgra has sold off virtually all of its production linkages and refocused on the consumer side of the market. Farmland Industries has liquidated most of their businesses.
- Joint ventures and alliances among cooperatives and with investor owned firms (IOF) has become increasingly common as companies have come to realize that managing the food value chains to maximize profitability requires unique management skills. Agriliance is a joint venture among CHS, Land O'Lakes and other cooperatives to achieve economies of scale in the farm supply business. It has allowed them to pool resources—people, facilities, products and capital—to reduce distribution costs, expand market share and seize new opportunities without detracting from other core business areas. GROWMARK was one of the early users of the alliance concept in forming a relationship with Archer Daniels Midland (ADM) in grain origination. Cooperatives now have alliances and joint ventures with most of the major agribusiness companies.
- Global partnerships and foreign sourcing of product are strategies currently being employed to address the international competitive pressures. GROWMARK now has member cooperatives in Canada. CHS has a joint venture, Ventura Foods, with Mitsui. Michigan Blueberry Growers has formed a partnership with a Chilean company, Hortifrut SA. Sunkist has announced a global sourcing
strategy to satisfy the needs of their retail customers on a year-round basis.

Cooperatives have utilized the limited liability corporation as a tool within the cooperative structure. Many cooperatives are creating wholly-owned LLCs in order to attract the necessary capital to seize new business opportunities.

Conversion to a limited liability corporation has been the choice of a number of cooperatives to address capital needs and in order to expand their share of non-member business. South Dakota Soybean Processors and Iowa’s Tall Corn Ethanol Cooperative have processing capacity that exceeds the raw product available from their members. By converting to an LLC they have greater access to outside capital and the profits generated by the non-member business will be taxable to the partners but not to the LLC. Under the cooperative structure the profits from non-member business is taxable at the cooperative level and again when distributed to the members.

Creation of the “new generation” cooperatives has also been a growing trend. These cooperatives are generally focused on well-defined value-added opportunities and have many of the same characteristics as the traditional cooperative. However, unlike traditional cooperatives a significant capital investment is required for membership. The membership is typically “closed” when the desired volume of product deliveries has been achieved. Members have the right and obligation to deliver their committed amount of production. The producer member has the responsibility of finding product to fill their shortfalls and selling any surplus. Delivery rights may be sold to other producers with the approval of the board and this permits members to cash out their equity investment when they wish to exit the cooperative. It also allows them to take advantage of investment gains if the value of the delivery rights increases with the profitability of the cooperative.

Some cooperatives have simply converted to a corporate business form to address concerns over foreign membership, capital acquisition and member access to equity investment. Calavo Growers voted to become a standard business corporation offering public stock.

Implementation of new capital acquisition and management strategies has also allowed many cooperatives to address their capital needs without greatly altering their business structure. CHS has sought to honor its commitment to redeem member equity investment and acquire capital for new business strategies by implementing a preferred stock offering. Several other cooperatives including Land O’Lakes have also issued preferred stock. Diamond of California established the Diamond Walnut Capital Trust, a limited partnership wholly owned by Diamond. The Trust took a fixed rate loan and in turn lent the money to Diamond, which will repay the loan over 12 years. Earnings from non-patronage business will repay the loan. This permitted Diamond to end the practice of retaining part of a member’s annual dividend to fund overhead and capital improvements.

This brief review clearly illustrates that cooperatives are not standing still as they seek to adapt to the changing business environment. Not all of the efforts have been successful and there have been some high profile setbacks. But the same thing has occurred among other business forms and in every sector of the economy.

The challenges will not lessen in the decade ahead. All of the catalysts previously identified are still active and major changes loom on the horizon. Some of the challenges are readily apparent in the marketplace today. Still others will evolve with the changing global marketplace. Several challenges are obvious:
• The consumer is the dominant force in this food and fiber system and the retail sector will define the system that will deliver the food characteristics that consumers are willing to buy. Value chains that want to know more about where and how the food is produced and processed will emerge. Heightened traceability will permit factors such as environmental and natural resource objectives or animal welfare to be integrated into the value chain objectives. Animal agriculture would appear to be on the verge of a new direction.

• International trade agreements and bilateral free trade agreements will continue to attack the justification for the traditional domestic commodity program supports as well as export subsidies. Federal budget deficits and the demands of an aging population will increase the pressures to reduce the budget exposure from traditional commodity programs. Payments linked to environmental objectives, food safety, food security and conservation will receive increasing support.

• More aggressive commitments to export market development and market access will be required to preserve the resource base currently employed in agriculture. Productivity gains in agriculture will require a downsizing in the resource base if the export market is not able to absorb the potential increases in production.

Farmer cooperatives will continue to be critical in protecting the economic interests of their farmer members in the years ahead. To do so they will need to become increasingly flexible in approaching new market opportunities and remain focused on business strategies that control costs, provide access to equity capital, manage risk and protect and expand market share.

The landscape is changing and there are numerous challenges for cooperatives to keep pace. Directors on farmer cooperative boards will need to be better prepared to anticipate market opportunities and set strategic directions. Cooperatives will need to be prepared to recognize the shifting attitudes regarding farmers, conservation and the environment and the business opportunities that might be provided to cooperatives. At the same time cooperatives must be mindful of the unintended consequences that could result from structural changes to address business challenges. Issues regarding coverage under Capper-Volstead or eligibility to borrow from CoBank are just two examples.

There are also a number of public policy issues relating to farmer cooperatives that need to be addressed. These include:

• Eliminating the "triple tax" on cooperative dividends paid on capital stock. Unlike regular corporate dividends, which are subject to double taxation, cooperative dividends are subject to a triple tax under what's known as the Dividend Allocation Rule. This unfair tax penalty results in cooperative dividends being taxed at a rate nearly 60 percent higher than non-cooperative dividends. Eliminating the Dividend Allocation Rule as several pending bills before Congress would do is critical to better enable farmer cooperatives to raise needed equity capital to modernize and expand their businesses to compete in a changing global economy.

• Modernizing the Federal Farm Credit Act. In another effort to better finance and capitalize their businesses, farmers and their cooperatives are looking at various business models and corporate structures that were not contemplated just a few years ago. Several states have also
begun the process or have under consideration changes in their statutes redefining what is a farmer cooperative to provide them with greater flexibility in meeting their capital needs for the benefit of their farmer members.

Minnesota, which ranks number one among states in terms of number of cooperatives, recently adopted a new state law that allows cooperatives for the first time to have outside investors, provided farmer members retain voting control of the organization. Wyoming has also approved a similar statute.

Many of these evolving and new entities, however, because of outdated eligibility requirements established under federal law, no longer qualify to borrow from CoBank, which itself is a cooperative, and has been the primary source of credit for farmer cooperatives for more than 70 years. Modernizing such requirements therefore is essential to keep pace with changing state laws, and to ensure that existing and new types of farmer cooperatives continue to have access to a competitive source of credit needed to compete in a global marketplace.

- Ensuring that any new tax incentives to maintain and strengthen global competitiveness of U.S. companies also benefit farmer cooperatives and their farmer members. This is a particular key point as Congress considers new legislation addressing WTO challenges involving current U.S. international tax policy.

- Completing action on comprehensive energy legislation. Farmer cooperatives account for an estimated 40 percent of on-farm fuel needs. Maintaining access to a dependable supply of energy at reasonable prices is critical, together with provisions that encourage development of renewable fuels and help increase demand for U.S. agricultural products.

- Making sure that farmers that choose to cooperatively market their commodities and related products are fully eligible to participate under current and future programs, including federal procurement programs. This includes ensuring continued eligibility for farmer cooperatives.

- Maintaining and Strengthening USDA programs, including research and education, in support of farmer cooperatives.
What Is A Cooperative?

Cooperatives are businesses owned and controlled by the people who use them. Cooperatives differ from other businesses because they are member owned and operate for the mutual benefit of members. Like other businesses, most cooperatives are incorporated under State law.

There are estimated to be over 40,000 cooperatives in the United States whose member owners include over 100 million Americans - nearly 1 out of 3. These include agriculture, child care, credit, health care, housing, insurance, telephone, and electric cooperatives to name a few.

Why Are Cooperatives Organized?

- Strengthen bargaining power
- Maintain access to competitive markets
- Capitalize on new market opportunities
- Obtain needed products and services on a competitive basis
- Improve income opportunities
- Reduce costs
- Manage risk

What Are Farmer Cooperatives?

In agriculture, there are nearly 3,000 farmer cooperatives whose members include a majority of our nation's 2 million farmers and ranchers. These include:

- **Marketing cooperatives** - which handle, process and market virtually every commodity grown and produced in the United States.
- **Bargaining cooperatives** - which bargain to help their farmer members obtain reasonable prices for the commodities they produce.
- **Farm supply cooperatives** - those engaged in the manufacture, sale and/or distribution of farm supplies and inputs, as well as energy-related products, including ethanol and biodiesel.
- **Credit cooperatives** - include the banks and associations of the cooperative Farm Credit System that provide farmers and their cooperatives with a competitive source of credit and other financial services, including export financing.

Farmer cooperatives exist for the mutual benefit of their farmer members with earnings returned on a patronage basis. For example, a farmer member who accounts for 10 percent of the volume of corn delivered to the cooperative would receive 10 percent of the net earnings derived from the handling, processing, marketing and sale of that corn or related products. Such patronage dividends help boost the income of farmers directly or by reducing the effective cost of the goods and services provided.

Farmer cooperatives also help contribute in another way to the economic well being of local communities, particularly in rural areas where they are an important source of jobs and payrolls - accounting for as many as 300,000 jobs and a total payroll of over $8 billion.

Being farmer-owned and controlled, farmer cooperatives are governed by a board of directors elected by their farmer members - generally based on one member one vote rather than on the basis of shares or percent ownership as in other types of businesses. This provides for a unique accountability.

Farmer cooperatives are farmers.
Cooperative Responses to Changing Market Structures

Presentation by Jean-Mari Peltier,
President of the National Council of Farmer Cooperatives
Farmer Cooperatives are major players:

- 28% of farm supply sales
- 29% of all commodities marketed
### Co-ops' Share of U. S. Farm Marketings, Selected Products

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<tr>
<th>Products marketed</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002*</th>
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<tr>
<td>Cotton / cottonseed</td>
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<td>27</td>
<td>49</td>
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<td>43</td>
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<tr>
<td>Grains &amp; Oilseeds</td>
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<td>34</td>
<td>44</td>
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<tr>
<td>Fruits / vegetables</td>
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<tr>
<td>All Other</td>
<td>12</td>
<td>12</td>
<td>13</td>
<td>12</td>
<td>12</td>
</tr>
</tbody>
</table>

*All products*  

29 26 27 28 28

*Estimated. Prior years from USDA*
# Co-ops' Share of Major U. S. Farm Production Expenses

<table>
<thead>
<tr>
<th>Farm production item</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002*</th>
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</thead>
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<tr>
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<td>43</td>
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<tr>
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<td>Feed</td>
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<td>19</td>
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<tr>
<td>Seed</td>
<td>10</td>
<td>10</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Total of products</td>
<td>29</td>
<td>27</td>
<td>27</td>
<td>26</td>
<td>28</td>
</tr>
</tbody>
</table>

* Estimated. Prior years from USDA
Why Cooperatives...

• Competitively priced inputs
• Maintain market access for commodities
• Capitalize on new value added opportunities
But, challenges too...

- Competitors are larger, better capitalized, and more dominant in market influence
Comparing the Largest 10 Farmer Cooperatives To the Largest 10 Firms in Other Segments Of The Food and Agriculture System

Average sales in billion dollars

- Input Sectors*: $22.2
- Farmer Cooperatives: $4.0
- Food Processing: $25.0
- Food Retailing: $28.2

* excluding oil companies
Significant market catalysts:

• U.S. demographics
• Technology
• Path of Globalization
• Regulatory Changes
U.S. Demographics

• Population growth slowing
• Market growth focused on changing consumer preferences, not larger population
• Baby boomers nearing retirement
Technology

- System integration, inventory management
- Regional companies able to coordinate national & global systems
- Scanning data -- mine exact info on consumer preferences
- Biotechnology enhances ability to build selected traits into production systems
Path of Globalization

- Soviet Union
- Asian economic crisis
- Dollar valuation
- Doha Round
- Bilateral agreements
- WTO obligations
Regulatory Challenges

- Environmental regulation
- Changing emphasis in Farm Bill programs
- Food Safety regulation
- Food Security concerns
CONSOLIDATION

• Retail food sector: 10 firms
• Consolidation in food processing
• Farmers: 10% produce 2/3 ag production
Ag Imports

- Up nearly 50% since 1996 (fruits & vegetables…)
- Soybeans -- Brazil & Argentina
- Countries of former Soviet Union
- Textiles and Cotton
- Fertilizer and competitiveness
In 2004 exports will match 1996 levels but imports will have risen by 49%!
Farmer cooperatives have responded in a variety of ways --

- Consolidation
- Owning complete value chains
- Joint Ventures
- Global partnerships; sourcing
- Limited Liability Corporations
- and others
Consolidation

• Increases in market share
• Spreads costs over more units
• Meet needs of larger customers, along with traditional customers
• *Resulting decrease in number of cooperatives...*
Owning Value Chains

• Examples: ConAgra, Farmland Industries
• Problems with profitability, capital needs & ability to support customer focus
  – ConAgra sold off production side
  – Farmland liquidated
Joint Ventures & Alliances

• With other Cooperatives
  – Agriliance, LLC: Land O’ Lakes, CHS and others

• With Non-cooperatives
  – GROWMARK w/ ADM in grain origination
  – CHS, Inc. with Cargill in flour milling
Global Partners

• CHS, Inc.
  – Ventura Foods
    • Joint venture with Mitsui

• Michigan Blueberry Growers (MGB)
  – Global Berry Farms, Inc
    • MGB partnership with Hortifrut SA (Chile), and Naturipe Berry Growers

• Sunkist global sourcing

• *Foreign membership and global strategies raise significant questions in coop community*
Conversion to Limited Liability Company

- South Dakota Soybean Processors & Iowa’s Tall Corn Ethanol Cooperative use of processing capacity for non-members
- Need for outside capital
- Non-member profits taxable at coop level & when distributed to members
“New Generation” Coops

- Well defined, often value-added focus
- Capital investment to join
- “Closed” membership
- Delivery rights have value
Coops no more...

• Conversion to corporations
• Address concerns over foreign membership
• Capital acquisition
• Example: Calavo Growers
Other options for Capital

- Issuing preferred stock (CHS)

- Limited partnerships wholly-owned by coop (such as Diamond Walnut)
The Landscape is Changing

• Challenges for coops to keep pace…
  – avoid the unintended consequences of realigning to address business challenges
    • loss of coverage by statutes protecting cooperatives
    • loss of eligibility to borrow from CoBank
  – training directors to anticipate market opportunities
  – taxation issues, particularly dividend allocation
  – strengthening USDA programs
  – shifting attitudes toward farmers and conservation -- unique opportunities for coops?
Brings new meaning to Benjamin Franklin’s words...

• We must all hang together
  ….or assuredly we shall all hang separately!