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U.S. House of Representatives
Committee on Agriculture

Congress of the United States
House of Representatives
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HEARING

Hearing on New Generation Cooperatives

Statement of Thomas C. Dorr
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October 16, 2003

Thank you Mr. Chairman.

Mr. Chairman, Members of the Committee, on behalf of the President and Secretary Veneman, I appreciate the opportunity to come before this committee to discuss ways in which the Federal government can help farmers and other rural residents increase their incomes and improve their quality of life through more effective cooperative organizations.

It goes without saying that we are living in some of the most challenging times in our nation's history and foremost -- next to homeland security -- our rural Americans desire increased economic opportunities and an improved quality of life. Our realization that this is important to our constituents is critical to succeeding at rural economic development.

This is the foundation on which President Bush unveiled his Jobs and Economic Growth Plan. The President understands that a key element to economic success in rural America is allowing our farmers and ranchers to retain more of their earnings. By reducing the tax burdens on Americans -- farmers and ranchers and their families will have greater opportunity to invest in their own future.

USDA Rural Development

At USDA Rural Development, our vision is to serve rural America. The Rural Development mission area provides financial and technical assistance to foster growth in existing and new opportunities for business development, home ownership, and critical community and technology infrastructure. The return on this assistance is the economic growth realized through our direct investment and, more importantly, that stimulated by private market leveraged investment.

It is with this vision in mind that Rural Development's mission has been designed to deliver programs that will support our two goals: 1) increasing economic opportunity; and 2) improving the quality of life of rural residents.

In order to properly address these mission goals, it is important to recognize the changes that have occurred throughout rural America and within USDA. With this understanding and a renewed sense of purpose, Rural Development must utilize the tools and resources at hand to support new economic growth in rural America.

Traditional Cooperatives

For over 100 years, cooperatives have organized and operated according to a relatively static model. Equity financing and control were the responsibility of the member-patrons. Earnings were allocated to patrons on the basis of use. It was a corporate vehicle designed to provide access to beneficial interests generated by members. It was not designed to be an investment tool. This model has heretofore served rural America well, and has provided many important benefits to farmers and other rural residents.

Today, cooperatives, like much of rural America, face serious challenges. The companies they buy from and sell to are becoming larger, fewer in number, and more sophisticated at reducing costs and improving returns within their industry sector, which can impact other participants in these industries. Sweeping innovations in areas such as biotechnology, information services, transportation, and global sourcing have made many cooperative facilities and equipment obsolete. Also, governance structures and the resulting transparency have helped to make non-cooperative enterprises more responsive to change.

It is more evident than ever that global economic challenges are here to stay. Many foreign investors are using technology and lower labor costs to become lower cost producers of the same products we produce in rural areas. In many cases, they are becoming competitors rather than customers. One of our top initiatives at Rural Development is to look at the effectiveness of the current cooperative model for assisting farmers and ranchers in this increasingly competitive environment.

The traditional model has had a history of change and responsiveness. However, cooperatives are presently struggling to convert the equity and dreams of many rural Americans into the kinds of economic opportunity they need and desire. As Under Secretary, I am looking at ways to increase the profitability of producer cooperatives. I am also focusing our efforts on how the cooperative model can utilize local equity to stimulate economic stability and growth that will be beneficial to all rural Americans.

Given the opportunity, Americans will create strength through investment in their own economic future. I also believe it is our role at Rural Development to support these efforts in order to maximize the effect on local economies.

But first we must ask ourselves how we might keep rural America competitive? How do we ensure a strong rural economy? Agriculture remains an important component in many rural areas, and I firmly believe that American agriculture is at a crucial crossroad. When we look at what drives our local and regional rural economies, along with our agricultural industry, and in the context of global markets -- we must accept that in the future, the agriculture industry will require new strategies and an openness to adapting to new environments.

I believe the key for farmers, cooperative businesses, and rural areas to remain competitive is our ability to grasp and utilize the power of technology. The Internet, and the technology that has flowed from it, has resulted in a freer flow of capital and easy access to knowledge across borders. It has made it possible for competition to develop and build production and value-added systems unconstrained by yesterday's foundations. It has served to create international and non-traditional competitive pressures.

Embracing the benefits of technology will not alone provide our producers and business ventures the competitive edge needed in today's markets. We need to look at agriculture as a business, and in America that is often easier said than done.

The global economic realities that we face force us to understand and accept that while we hold dear the attributes of the traditional ways of life – we have a responsibility to our farm families and the future of American agriculture to paint a new picture -- one that allows us to respect our traditions and expand our tolerance and acceptance of new and innovative approaches to support our farmers and ranchers and the rural communities in which they live. It is time we paint a new portrait for the 21st Century.

Many suggest that the limited off-farm investment of farmers and ranchers means they don't have enough capital to invest. I don't agree.

Farmers have an enormous asset base – their land – that can provide investment capital. Instead of just rolling land assets into the relatively low returns from farming, producers could move some of that capital to other areas. If done effectively, this would simultaneously raise farm incomes, enable more farmers to stay on the farm, and promote rural growth.

Many farmers and ranchers have assets that can be used to make major investments in businesses that ultimately can exact a strong return on their investment. If the business plan is sound and convincing – <u>and</u> if farmers understand the untapped potential of their capital, I suspect they will invest.

We are challenged today to develop strategies for rural America that are effective and programs that make sense. We, in the public sector, simply have to do a better job. We have bound ourselves up with procedures, regulations, and approaches that reflect a rural America of the 1950s, using concepts from the 1930s.

We must work with our farmers and ranchers to help identify opportunities to use the untapped equity in their land to make serious investments in their local communities. This approach doesn't mean encouraging producers to leave farming or to take senseless risks. It's just the opposite. By increasing their return on investment – the value of their land – their ability to stay in farming and ranching can be enhanced, not lessened. That age-old solution of how to protect the family farm comes, as we have always known, in diversification.

But utilization of land equity as a form of capital investment must be accompanied by an evolution in how cooperatives support producers and value-added ventures. Cooperatives must be prepared to sail in relatively unchartered waters to bring the maximum benefit to producers who look to them for economic opportunities and security.

Patron cooperatives were designed to provide members a beneficial interest. The benefit they received as a patron member was either a cheaper price if they bought something from or through the cooperative, or a better price if they sold something to the cooperative. Any earnings derived from patron cooperative operations had to be returned to the members as cash patronage dividends or additional equity retained by the cooperative.

The effect was two-fold. Cooperatives had to commit most of their earned income to patronage dividends. Second, they have never been able to become investment vehicles. The result was that the primary way for either patron or federated coops to grow their business was through the use of debt. That worked reasonably well when competition for traditional U.S. agricultural commodities was limited and U.S. production agriculture was in a substantial growth mode.

There were occasions when local patron cooperatives, even in good times, made poor business decisions and were unable to sustain themselves. Usually these resulted in mergers with neighboring patron cooperatives. As a federated cooperative, Farmland went through these difficulties at least twice before their present bankruptcy.

As a cooperative business venture, the patron cooperative is the traditional institutional vehicle. Its purpose is well intended. The cooperative, as an institution, however, is struggling to convert the equity and dreams of many rural Americans and agricultural producers into the kinds of economic opportunity they need and desire.

We must change that. Rural Development should be at the focal point of this discussion and we intend to be.

To diversify farmer investment in businesses that add value to the products that rural Americans produce through processing, distribution, and perhaps even branding is paramount. This will allow producers to capture some of the dollars now going to the middlemen between producers and consumers. It creates jobs, payrolls, and tax revenues that support the entire community.

New Generation Cooperatives

If we begin to look at cooperatives with the idea that they can serve not only as a form of security, an outlet for farm production, but also as investment vehicles that pay dividends to their members -- one that is focused on creating an acceptable return on investment -- we will have gone a long way to strengthening rural America. The “new generation” cooperative model is a step forward toward meeting this objective.

Let me make it clear what we at Rural Development mean by a “new generation” cooperative. Some people use the term to include virtually any cooperative that adds value to agricultural production through processing and merchandising. We expand the term to refer to cooperatives that not only engage in value-added processing and merchandising, but also adhere to a fairly specific set of characteristics that provide producer-owners with economic incentives to patronize and invest in them.

A “new generation" cooperative will usually have several organizational and operational traits that include:

a. The membership is closed.
b. The amount of product it will accept from a producer is limited.
c. The investment of a member is tied to patronage rights. (I.e., in a traditional cooperative, each new member usually makes the same, relatively small, initial investment.)
d. The patronage rights are transferable at market value. (I.e., in a traditional cooperative, equity is only redeemed at the discretion of the board of directors. It is usually redeemed years after it is issued and rarely for more than face value.)

“New generation” cooperatives link producer equity contributions and product delivery rights. The delivery arrangement is more than a right, it is also an obligation. So if the member doesn’t raise enough corn, for example, to meet the delivery commitment, he or she must purchase product on the open market to fulfill the contract. The risks of fluctuations in production are borne by the individual producer-members, not the cooperative.

In a “new generation” cooperative, the members are free to sell their interest in the cooperative and the linked delivery rights to other producers at whatever price another producer is willing to pay.

Building on Today’s New Generation Cooperatives

While USDA Rural Development encourages and works with “new generation” cooperatives, we aren’t convinced that they are the only improvement on the traditional model that can and should be developed. We must build on today's "new generation" cooperative model by developing strategies and structures that will overcome obstacles, such as tax law and governance structures, still limiting cooperative success, most notably the difficulty cooperatives have in attracting sufficient equity capital. These approaches should be directed at encouraging greater investment by producers and opening avenues for investment by non-producers.

Farmers also have the resources to make these investments. *Agricultural Statistics 2003,* published by USDA's National Agricultural Statistics Service, reports that farm real estate in this country has an aggregate value of approximately $1.1 trillion (p. IX-8). Outstanding debt on that farm real estate totals only about $110 billion (p. X-9), only 10 percent of its value.

Our challenge is to help producers develop cooperative structures that will generate a return on the untapped value of their real estate sufficiently large and safe enough to entice them to invest in off-farm operations.

There is nothing magical about organizing a business on a cooperative basis. But if the business plan is strong and the implementation of that plan is focused and visionary, farmers and other rural Americans can expect a strong return on their investment.

There is another consideration. While many producers have substantial assets that are minimally leveraged, their numbers are declining. The amount of funds needed to finance a potentially lucrative agriculture-related business may be more than potential member-patrons can, or should prudently, invest. Steps should be taken to make investing in a cooperative attractive to local non-producers, and, when advantageous to the producers and the community, non-producer outside investing interests.

Impediments to non-producer equity are found in Federal and State laws enacted several decades ago. If non-producer outsiders are to invest in a cooperative, they may well expect to have a voice in its affairs and the opportunity to earn a return on their investment commensurate with the success of the cooperative. Good governance and increased transparency could also help improve the cooperative model.

Modifying rules could give cooperatives some of the flexibility enjoyed by limited liability companies. Cooperatives could be provided some options to pursue outside equity if the producer members believe doing so would strengthen their association. Such legislative reform must be done carefully and with much thought.

Non-producer outside investors will also not want to have their money locked up in a cooperative. Easy transferability of investment vehicles will need to be included in any package of incentives aimed at non-producer equity.

USDA Rural Development's Role

The public sector, and those of us in Rural Development at USDA in particular, must adopt new approaches in providing our services to rural America. Today, Rural Development is developing a multi-dimensional program to strengthen cooperatives as part of a bigger overall initiative to revitalize our rural economy and improve the quality of life for our rural residents.

Financial investment. In Fiscal Year 2003, USDA Rural Development placed nearly $16 billion into rural America at a cost of only $2.9 billion of discretionary budget authority. We invest in rural America through a variety of direct loan, loan guarantee, and grant programs in our 3 primary service areas -- housing, utilities, and businesses and cooperatives. I believe we do a good job of identifying worthy recipients and distributing the funds. These programs play a major role in sustaining our rural economy.

One area where Rural Development can do better than we have in the past is in monitoring and evaluating the effectiveness of these various efforts. We are developing tools to measure the return rural America gets for each dollar expended under these programs and to identify strengths and weaknesses in each initiative. In the future, we will be in a better position to work with this Committee and others in the Congress to explore possible changes in these programs that maximize the impact of the moneys we administer.

Financial assistance. We have some exciting new tools to use in this effort. For example, the Value-Added Producer Grant Program provides planning money and working capital for independent producers and producer groups to develop new value-added agricultural products. In 2001 and 2002, grants totaling $57.5 million were awarded to 291 recipients in 43 states. An additional $40 million is anticipated to be awarded this year.

The 2002 Farm Bill added a new dimension to our value-added efforts, by authorizing grants to establish Agricultural Innovation Centers. These centers will provide technical and business development assistance to producers and groups of producers, including cooperatives, who want to develop and market value-added agricultural products. The centers will be controlled by a board consisting primarily of representatives of the largest general farm organizations and highest grossing commodities in the State where the center is located.

On September 26, 2003, Secretary Veneman announced the awarding of grants totaling $10 million as start-up funding for 10 Agricultural Innovation Centers. We have high expectations that these centers will serve as incubators for new ideas, new products, and new strategies that stimulate economic growth in rural America.

Education and technical assistance. Rural Development is more than a source of funding, especially where cooperatives are involved. Our technical assistance and research efforts are used throughout the country by producers interested in developing new cooperatives and making existing cooperatives better able to serve the needs of their members.

We will be working harder to help improve business knowledge and skills in rural America. Serious education on business strategies, finance, marketing, and decision making will enable farmers, and business and community leaders, to lead dynamic, creative cooperative businesses that can succeed.

We in Rural Development need to make sure our efforts are focused on recognizing challenges and using techniques that look to the future and not the past. To achieve this goal, I am in the process of creating an Outside Program Review to study the research and technical assistance provided by our Cooperative Services area. Its purpose will be to identify steps we can take to make sure our support of cooperatives is provided as efficiently and effectively as possible.

Conclusion

Mr. Chairman, let me offer a few concluding thoughts on where I think, and hope, we are headed with regard to cooperatives in rural America.

I'm concerned about the long-term health of an agricultural system that focuses only on production, especially the production of basic commodities that are being grown at less cost in an increasing number of countries around the world. Cooperatives offer a vehicle to allow producers to turn their production into food, clothing, energy, pharmaceuticals, and, in the future, other value-added products that may not have even been imagined as yet.

To take advantage of these opportunities will require substantial new investments of equity capital. Farmers can, and should be expected to, invest in their own future. But steps should also be taken to facilitate and encourage non-producer outside investors to be part of the farmer-based cooperative businesses.

Creating new ways to invest equity capital in cooperatives may offer more flexibility in the organization and operation of cooperatives. While accomplishing this, these changes should not subvert the basic cooperative principle that they exist primarily for the benefit of their member-patrons and not non-producer outside investors.

Rural Development continues to work to ensure that both funding programs and research and technical assistance efforts that meet the challenges and seize the opportunities that lie ahead.

In addition, we look forward to working with Congress to encourage the changes and new initiatives that are needed for cooperatives and other rural entities to meet the challenges of the 21st Century.

Thank you for inviting me to be here today and I look forward to answering any questions you may have.