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The Changing Federated Relationship Between Local and Regional Cooperatives



Abstract

The evolution of the federated relationship between local and regional cooperatives is examined from the perspective of local cooperatives' need for commodity-based farm supplies and regional cooperatives' identity as food companies. Because locals want many competing bids for the supplies they purchase, they resist a strong and close affiliation with regional cooperatives, which then find themselves with excess capacity. Regionals have responded by instituting tighter bonds with selected local cooperatives operating as "internal supply networks," in exchange for certain benefits. This adaptation reduces the impact of divergent goals among regionals and locals within the federated system.

Key words: Cooperatives, federation, networks, competition, regionalization.

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Highlights

Regional cooperatives have typically been regarded as leaders of cooperatively organized and owned marketing channels in the Midwest. They have relied on the customary power bases of channel leaders to induce member local cooperatives to follow their lead. These include rewards, coercion, legitimacy, referent (identification or association) power, and expertise.

These measures have been used in a cooperative culture that emphasizes the primacy of services over profits. This cultural model implies a regional will provide, essentially at cost, most if not all of the services and products locals require. In turn, they will supply the regional with the raw material it requires to manufacture supplies and process foods. Survival of the regional cooperative relies on the support and patronage of local cooperatives.

This model breaks down when any of the following situations occur: locals can use alternative suppliers; regionals have a higher cost of production than alternative suppliers; locals are affiliated with multiple regionals; locals need product regionals don't make or can't access; locals can meet their own needs internally; regionals need more product than locals can provide; and the regional acquires an identity and existence of its own, independent of locals.

The federated system particularly struggles with regionals' cost of production versus that of other suppliers. Cooperative norms stress the value of the "competitive yardstick" where the value of a cooperative lies primarily in its ability to provide an additional bid to enhance market competition. Local cooperatives have frequently translated this expectation into an implicit demand that the regional be the lowest bid. If it is not, locals may perceive that their regional has not necessarily "added value" to the marketing channel.

For their part, regionals with a strong presence in processed foods do not always know how their locals fit into the marketing channel. They perceive their strategies are driven by market forces first, and locals second.

Resolving these disconnects within the federated system could require a way for locals to benefit on a day-to-day basis from the processed foods business of regionals. Currently, patronage benefits are generally revolved only once a year. Locals need a formal, institutionalized link to the food operations of their regionals.

Regionals may not always meet locals' expectations as low-cost suppliers, because of regionals' approach to marketing and the rigidities of the cooperative system. So, some locals may work independently of regionals. In other areas, a particular regional and a selected group of member-locals may decide to collaborate on particular objectives. These locals would form an "internal supply network," using an organizational model more centralized than federated .

The Changing Federated Relationship Between Local and Regional Cooperatives

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Introduction¹

Questioning the value provided by alternative configurations of supply chains has become routine throughout agribusiness, and cooperatives are no exception. A business environment forced to measure the profit of many transactions in pennies, not dollars, has led local and regional cooperatives to ask whether their prominent ties should be maintained in the current form.

As suppliers to locals, regionals have sometimes had ties with investor-owned firms (IOFs). Increasing consolidation has brought a stronger market presence for several mega-IOFs. Locals are increasingly asking whether such companies are, in some cases, a better partner for them than regionals. They ask, "What can a regional cooperative do for me over and beyond what an IOF can do?" Such questions, inconceivable in an earlier era, have led regionals to wonder if locals will continue to be part of a cooperatively organized supply chain in the same manner as in the past.

Many locals, of course, are very satisfied with the way their regionals perform. But questions and challenges posed by some larger locals--superlocals or mini-regionals--may influence how and what regionals provide to locals in the future.

This report is an outgrowth of RBS Research Report 181, *Locals' Role in the Identity-Preserved Grain Industry* (by Hogeland, 2001). In that study, locals classified their approach to innovation as (1) rapidly changing despite some financial risk; (2) delaying in anticipation of further improvements; or (3)

focusing less on innovation than on perfecting service and pricing within a particular arena. These responses were classified as "innovator," "follower," and "status quo" positions. Respondents were evenly divided among these categories.

Innovators handled a much larger volume of identity-preserved grain than cooperatives in follower or status quo categories. Innovators often favored partnerships with regionals. Followers and status quo appeared to adopt the cultural framework evident in the grain industry, where regional cooperatives must compete for locals' grain the same as any other bidder. The two groups were also similar in other ways.

Results indicate that most cooperatives prefer a predictable environment where they function as dependable, reliable suppliers. Although cooperative culture favors incremental, slowly absorbed changes, recent strategic alignments among regionals have imposed uncomfortable change on some locals. It is not always clear what membership in a cooperative means, requires or provides in this new setting.

Where do locals get their standards to evaluate regionals? How are those standards defined? This study indicates many standards come from cooperative culture--attitudes and marketing practices that differentiate cooperatives from other business organizations. One of the most important is the familiar "competitive yardstick" role.

The balance of power between regionals and locals has shifted, altering how regionals express their power as leaders of a cooperatively owned and organized marketing channel. Locals have developed a degree of independent power, necessitating changes in the distribution of labor between local and regional, as well as in the expectations each has of the other. These changes will be illustrated through a critique of a model of cooperative behavior which focuses on the

¹ An earlier version of this paper was presented at NCR-194, Las Vegas, NV October 30, 2001.

primacy of services over profits. This study will also focus on specialization and the development of internal supply networks as regionals' response to such countervailing power.

This study arose from conversations with numerous local cooperative managers from June 2000 to June 2001. Executives of both federated and centralized regionals also provided their perspective. The results are expected to contribute to a more informed dialogue on what cooperatives realistically can and cannot accomplish, and not be evaluated by outdated standards.

This report is not a report card on the accelerated pace of mergers and consolidations during the past five years. That is a decision for those who own regionals, locals and farmers. Instead, this report will cast such events within a framework that will enable cooperatives to understand them as inevitable answers to challenges posed by market evolution.

Regionals' Functions

Federated regionals market farm supplies, and meat, dairy, and grain products. They include Farmland, GROWMARK, CHS (formerly Cenex-Harvest States), Land O'Lakes, MFA, Inc., and Southern States Cooperative. The specific focus is regional cooperatives serving the Midwest, where most realignments and mergers have occurred.

Farm supply regionals typically contribute to cooperative infrastructure and, indirectly, food processing and marketing. Activities include:

- centralizing purchasing and distribution on behalf of locals;
- building mills and other infrastructure needed for ingredient processing and marketing;
- facilitating transportation by truck fleets, unit trains or coordination with rail depots;
- lobbying regarding rail abandonment, trade restrictions and other economic events;
- providing financing and other risk-management tools; and
- training manager and employee and benefit systems,

As food companies, regionals typically:

- create branded identities reflecting particular standards of production or processing;
- provide an integrated marketing channel that reaches from the farm gate to the dinner plate;
- provide market access;
- invest in food processing assets;

- partner with other agribusinesses to provide the necessary complement of services and products for locals;
- perform marketing research and training that expands the reach of local cooperatives; and
- engage in overseas market development.

Who in the channel should perform these functions is a question increasingly open to discussion as some locals approach the size of early regionals. For example, locals point to Felco, a 1970 merger partner of Land O'Lakes, as an example of their own potential. Nevertheless, explicit dialogue about the division of labor among cooperatives at different levels has been obscured, to some degree, by the considerable structural realignments and mergers among regional cooperatives.

Functions and Sources of Power

Countrymark, Inc. (Countrymark), a regional cooperative formed from the 1991 merger of Indiana Farm Bureau Cooperative Association and the Ohio/Michigan-based Countrymark Cooperative represents an example of a "traditional" regional cooperative whose service-oriented approach² was jeopardized by the forces described in this report. In 1998, Land O'Lakes acquired what may be considered one of the "core" businesses of Countrymark, its seed, agronomy, and feed operations.³

Regionals like Countrymark can be regarded as leaders of a cooperatively owned and organized marketing channel with leadership based on locals' willingness to purchase or market in a particular way, through a well-defined system and process, such as:

- using a regional's brand name ("Farmland Foods," "Land O'Lakes Pork System," etc.);
- using product standards established by the regional (premixes with a particular nutrient content or pork certification programs);
- using farm production supplies and other products sourced or manufactured by the regional;
- adhering to managerial and professional standards either originated by or endorsed by the regional;

² Other regional cooperatives, like SF Services (acquired by Farmland in 1998), were similar to Countrymark.

³ Further details of this and other notable mergers and acquisitions among cooperatives can be found in Wadsworth, James J. Cooperative Unification: Highlights from 1989 to Early 1999, USDA/Rural Business-Cooperative Service Research Report 174, September 1999.

- using similar accounting systems; and
- adhering to the strategic vision proposed by the regional.

Adopting any of these practices is up to the local. They do not automatically do what the regional wants, unless they are owned (or centrally coordinated) by the regional and function like a dealership or franchise.⁴ Most federated locals, the subject of this report, selectively follow the lead of their regional. They are not obliged to do business with them.

Consequently, regionals must induce locals to follow their lead, and like other (non-cooperative) channel leaders, they use a combination of positive and negative reinforcements, such as:⁵

- rewards--potential benefits to locals, such as manager placement within the cooperative system; participation in advisory councils; financing or patronage refunds;
- coercion--unfavorable terms of trade or limited managerial opportunities;
- legitimacy--internalized values that obligate locals to accept regional influence;
- referent power--the value of explicit identification or association with a regional;
- expertise--greater knowledge or experience attributed to a regional.

These are examples of the power exerted by channel leaders.

Power may seem to be an unusual term to use in the context of cooperation, but the elements are largely positive. Countrymark provided a particularly tempting model for cooperatives. Countrymark was said to "do it all" and represented leadership based on the benefits or rewards of regional affiliation.

Service Maximization Model and Critique

Some felt Countrymark exhausted its resources serving member locals, in part by maintaining an

administrative structure perceived necessary to provide member services, as well as maintaining reputedly unprofitable locations.

In many ways, Countrymark's choices epitomize many of the dilemmas facing regionals. Cooperative culture emphasizes the primacy of services over profits, an orientation familiar to Countrymark. In its fullest expression, this model implies a regional will provide, essentially at cost, most if not all of the services and product locals require. In turn, locals will supply the regional with the raw material it requires to manufacture supplies and process foods. In this model, the support and patronage of local cooperatives is a necessary and, conceivably, sufficient condition for the survival of the regional. Essentially, the two exist in a closed, recursive (feedback) system, impervious to outside influence.

The service model has several implicit assumptions:

- the regional will be the primary supplier to locals;
- a local will be affiliated with only one regional;
- the regional's cost of production (COP) is sufficiently low so as to preclude competition from alternative suppliers;
- locals will get all needed services from the regional;
- locals will use the regional for market access or marketing;
- the product received from locals is sufficient to meet the regional's requirements; and
- the role of the regional is to sustain the locals that own it, but locals do not have a reciprocal obligation toward their regional.

In reality, these assumptions break down because:

- locals can pick and choose among suppliers, regional or not.⁶
- the regional, because of its multi-product and multi-service orientation, may have a higher cost of production than alternative suppliers;
- locals are affiliated with more than one regional;

⁴ GROWMARK, MFA, Southern States, and Tennessee Farmers Assn. fall into this category.

⁵ Hunt, Shelby D. and John R. Nevin, Power in a Channel of Distribution: Sources and Consequences, *Journal of Marketing Research*, Vol. 11 (May, 1974), 187.

⁶ GROWMARK, Tennessee Farmers Cooperative, MFA, and Southern States Cooperative represent important exceptions to this framework because their locals have institutionalized closer ties to their regionals. These cooperatives have a mixed federated-centralized structure

- locals need products regionals don't make or can't access;
- locals (or regionals) can meet their own needs internally;
- locals can market on their own or choose channels other than their regional;
- the volume or quality of inputs from locals fall short of the regional's needs;
- the regional acquires an identity and existence of its own, independent of locals;
- locals choose to be independent because they want to differentiate themselves from other agribusinesses, including their regional; and
- outside forces like government policies alter exchange relations between local and regional.

This reality alters the effectiveness of regionals in such culturally mandated roles as:

- being a competitive yardstick;
- creating change in the way industries are being run;
- being a purveyor of technical change to locals;
- having facilities commensurate with those of mega-IOFs;
- being a low cost supplier;
- being a multipurpose, multiservice organization;
- generating income (returning patronage, revolving equity);
- being a supplier of last resort (e.g., petroleum during shortages);
- providing an integrated food system from farm to grocer;
- maintaining staying power as a long-term supplier; and
- providing market access.

These roles, which were identified through interviews with local cooperative managers, may be considered culturally determined. Typically, managers viewed regionals' effectiveness through the filter of two or more potentially conflicting roles. For example, local managers chided regionals because they were not always the lowest cost supplier, and at the same time, expected them to be as "basic" in certain supplies as some mega-IOFs (presumably incurring high fixed investment costs). Others wanted low-priced supplies as well as a nice-sized patronage refund at the end of the year.

Such conflicting expectations weigh in against regionals' power as channel leaders. Coupled with some locals' tendency (or ability) to operate indepen-

dently of regionals in the ways suggested by the service model critique, they diminish the effectiveness of the traditional supports for channel leadership--rewards, legitimacy, etc.

Regionals have choices. They can try to "do more of the same and do it better" or they can try to compel locals' attention if the traditional motivations are no longer working. These include: (1) intensifying ties with locals through specific incentives and management structures (i.e., "regionalization"); (2) expanding the arena for cooperatives through globalization; and (3) making dealings with locals inevitable because the regional is national seller of particular farm supplies. Generally speaking, CHS has pursued regionalization; Farmland, globalization; and Land O'Lakes, size and scale.

In fact, these strategies are based on several of the culturally mandated roles noted earlier.

Regionalization represents the local "as an extension of the regional" in the context of a multipurpose, multi-service organization limited to a particular geographic area. Globalization stresses market access. Being a dominant vendor of particular farm supplies is perhaps a variation on the mega-IOF position of being "basic" in certain commodities. These strategies coincide with a more focused approach to delivering particular services through the recent formation of Agriliance (combining the agronomy business of Land O'Lakes, Farmland and CHS), Country Energy (consolidating the petroleum operations of Cenex, Harvest States and Farmland), and the Land O'Lakes/Farmland feed joint venture.

These arrangements represent a move by regionals away from being multi-product to being product-specialized.

Regional Specialization

The Resource Provider Function

In 1985, Prof. Brice Ratchford from the University of Missouri predicted that separate systems for feed, chemicals, fertilizer, etc., would replace the multipurpose farm supply distribution system. He also expected investor-owned competitors would have a profound influence on the optimal role and structure of cooperatives.⁷ In 2000, Harry Cleberg, past CEO of

⁷ C. Brice Ratchford, "Strategies for Cooperative System Design: The Case for Coordination Among Cooperatives: Discussion," in *Farmer Cooperatives for the Future, A Workshop* Nov. 4-6, 1985, USDA: Agricultural Cooperative Service, 116.

Farmland Industries, similarly expected that each regional would be associated with a single product area--agronomy, petroleum, meat, grain, or dairy.⁸ This realignment would occur in response to significant environmental stressors, and ultimately alter traditional ways of relating between locals and regionals.

These predictions concern regionals' fundamental identity as resource providers to locals, a function particularly evident when locals were smaller, single location, and more numerous. By providing centralized buying and distribution for locals, regionals eliminated the need for individual negotiation with suppliers. Typical of a supply channel comprised of isolated and autonomous decision-making units, locals were unable to program distribution activities as effectively as their regionals.⁹ The resulting asymmetrical power relations between regionals and member locals made regionals the natural choice for channel leaders. Locals seeking alliances almost automatically turned to the nearest regional cooperative.

Assisting this identification with a regional were territorial and cultural boundaries. Just as local cooperatives often represent a particular group's interest in having its "own" cooperative, regionals, too, became affiliated with specific commodity interests (Land O'Lakes and dairy); farm movements (Cenex and Farmers Union)¹⁰ and regions (Southern States Cooperative and the Southeast). Scale economies encouraged regionals, whose role as resource providers includes manufacturing, to expand their geographic boundaries, and in so doing, enter one another's territory.¹¹ This process meant locals often invested in--and therefore, were members of--more than one regional.

As regional cooperatives (those that survive today) broke through their traditional boundaries to expand market share and so implicitly create the foundation for specialization, locals learned to play a price game: to cherry-pick regionals for the best deal.¹² The price game has continued despite the formation of Agrilience and other ventures; locals simply substitute IOF bids for those of multiple regionals.

In this price game is the core of how locals as a group think of regionals: their purpose is to satisfy their own need for commodities--petroleum, fertilizer, feed, grain, some seed. These commodities are the gist of what locals sell to their own farmer-members. These members demand that locals help lower farm supply costs. What regionals are known for, in contrast, is selling processed foods--meats, dairy, pasta, etc. This is why interviewed locals referred to regionals as "food companies."

A commodity orientation entails different needs and resources than processed foods. Part of the reason some locals have, according to interviews, a particularly hard time valuing what regionals contribute to the federated relationship is that they have no institutional tie to the food operations of regionals. Farmers are tied to the food operations of regionals through direct membership. The better prices dairy farmers receive from branded cheeses and the market access attained by pork producers, for instance, flow from the regional straight to the producer. The local is sidestepped.

Moreover, this disconnect has been institutionalized through the mixed membership structure of Midwest regionals. Their membership is made up of both locals (as a group or federation) and individuals (representing producers in certain specialties). During the past decade, there have been efforts by regionals to tie locals to food production by having them sell specialty feed to the producers who are direct members. Discrepancies among locals' handling practices and other coordination issues have led regionals to abandon this effort. Their need to streamline distribution, to offer process-verified production systems for processed foods, and to meet other requirements of a marketplace geared to product consistency and food safety has become paramount.

⁸ Cleberg, H.D., "Remarks: Cooperatives Working Together," 2000 annual meeting of the National Society of Accountants for Cooperatives, San Antonio, Tex., August 9, 2000.

⁹ McCammon, B.C., Jr., Perspectives for Distribution Programming, in Vertical Market Systems, L.P. Bucklin, ed., Glenview, IL: Scott, Foresman, 32-51.

¹⁰ Egerstrom observes that Cenex was founded by Farmers Union organizations. Egerstrom, Lee, *Make No Small Plans: A Cooperative Revival for Rural America*: Rochester, MN, Lone Oak Press, 1994, 142.

¹¹ Egerstrom refers to competition among regionals: "Will Land O'Lakes" farm supply joint venture, known as Cenex/Land O'Lakes Ag Services, need to tread on other regional cooperatives' turf to expand its markets and assure future profits?" (p. 142). About Cenex, he says, "Changing rural demographics, changing agronomic practices on farms and environmental restrictions on use of its products, and what appears to be an inevitable geographic collision with Farmland and other petroleum supply co-op create problems that need creative responses" (p. 143).

¹² The centralized nature of GROWMARK, MFA, Southern States, and Tennessee Farmers Assn. means their member-locals will automatically purchase most supplies from their regional as a matter of course. The open market is much less of a factor in their relationship than it is with the more independent locals based in the core Midwest.

Regionals are torn by the requirement to be resource providers to locals and their own need to protect food manufacturing investments. The dual focus of the federated system continually confronts regionals with the strategic issue of whether a dollar of investment capital should go into providing the commodities needed by member locals or providing the processed foods that are the core of regionals' identity.¹³ This decision is complicated by the fact that food operations can strengthen a regional's balance sheet, diminishing the requirement for equity investment by local cooperatives.

The splintering of a multipurpose, multiproduct cooperative structure into a meats company (Farmland), a dairy company (Land O'Lakes); a grain company (CHS), and an agronomy company (Agriliance) represents an uneasy accommodation with locals because it does not contribute, necessarily, to an integrated food system--a seamless web from farm to grocer. As long as each is essentially operating on a different level--regionals in foods and locals in commodities--the ability of locals to identify with regionals (referent power) will be constrained. So, the specialization advocated by Ratchford and Cleberg can be seen either as a transitional step to a more fully coordinated system (with the next step still unclear) or as a way of formalizing the disconnect between the two levels by compartmentalizing it.

How far should specialization go?

Regionals perceive that Agriliance and other instances of horizontal integration "take costs out of the market," although, to some locals, eliminating multiple regional bids can appear more like "taking competition from the marketplace." Locals' position as middlemen limits their endorsement of a streamlined marketing system. The more bids they can sift through, the more they fulfill and justify their historically designated role.

Farmers innately fear situations where they get only one bid, and regional specialization is interpreted

by some as a move in this direction. So it's not surprising that the short-term consequence of specialization has been some degree of share loss. A year after implementation, interviewed regionals commented that their collective market share through the specialized and combined ventures has been less than what they used to get selling individually. Locals' reaction to restructuring makes it far harder for regionals to realize intended cost savings.

By massing the business of several regionals into one large entity, specialization opens up the possibility for each of the new companies to catapult into a position of industry leadership. From regionals' perspective, this is a good strategy. It diminishes the relevance of a price game and the dominant position serves to compel member-locals' attention. But it is not a strategy locals are used to. Despite the fact that the Capper-Volstead Act looks favorably on large cooperatives, members sometimes find them hard to accept, asking, "Is that what a cooperative should be?" This reveals a cultural preference for cooperatives that are "big--but not too big."

Culture aside, such a move conceivably positions regionals to take competition to the next level, from a focus on day-to-day commodity prices to a system orientation. The trace-back and identity-preserved methods of food production and safety embodied in a systems approach have become a way for food processors to differentiate themselves in the marketplace.

Farmland's speedy application of USDA-approved process-verified pork production demonstrated that regional cooperatives are aware of what they need to do.

Paper-thin margins industry-wide coupled with a cultural bias toward competition-as-a-way-of-life may prevent many locals from stepping back and assessing how--and whether--they will position themselves for this further evolution of the food system. Study of locals' response to identity-preserved grains indicates that most maximize the prices received for their producer-members' grain by maximizing the number of bids. Different paths to the same end (livestock feeding, processed products) were hard for all but the most adventurous and innovative to see. Therefore, for specialization or industry prominence to be accepted by locals, regionals must generate the patronage refunds that are the singular prerequisite of a dominant supplier that is also a cooperative. Patronage refunds are the link between the old and new ways of doing things, the one thing that can reassure locals that a system they may have trouble endorsing will in fact perform like--or even better than--the old.

¹³ In describing Harvest States, Egerstrom observes, "But the bulk of the cooperative's profits come from the processing businesses, not the grain trading for which the co-op is widely known" (p. 134). Egerstrom also cites Dr. Robert Cropp regarding a similar focus by Land O'Lakes, "There is still room for growth in all of Land O'Lakes business sectors, but the surest way to is to reach out territorially and to raise up the foods...We know there are going to be fewer and fewer animals in Wisconsin and Minnesota, this can't be the only place where the company does business": (p. 141). Regarding Farmland's business mix, Egerstrom says, "food sales {are expected to be} emerging on top by 1995" (p. 137).

To do this, regionals will have to consistently make money. Regionals put this goal as, "Make money every day. Run a commercial business." Twenty years ago, the pre-eminence of the service model would have made such statements sound heretical, if not impossible. Making money, achieving profitability, is the antithesis of the service model of cooperatives. Regionals that formerly sought to induce member business and loyalty through special programs or promotions (as the rewards of channel leadership) may have a better chance at overriding any tendency to stray from the federated relationship by commanding respect through patronage refunds and focused growth.

Competitive Yardstick

Some observers have interpreted specialization as a way of getting locals accustomed to one bid, to constrain their tendency to play one regional against another. This may be difficult behavior to modify because cooperative culture has looked favorably upon multiple bids and even used them to justify cooperatives.

Specifically, when multiple suppliers and differing production costs exist, cooperative culture ascribes the role of "competitive yardstick" to regional cooperatives: providing an additional bid in the marketplace to minimize the possibility of collusive or monopolistic behavior among suppliers. Note that the competitive yardstick argument does not require the regional to have the winning bid, but rather keep everyone honest by adding market competition.

The expectation that regionals will supply product essentially at cost (a dimension of the service model) apparently has led locals to expect that regionals will be, as one observer said, "always and at all times the lowest bid." If regionals turn out to be simply an additional bid because someone else was cheaper, interviewed locals have concluded that their regionals have been ineffective. Ironically, Nourse, the philosophical founding father of Midwestern cooperation, justified the formation of locally owned cooperatives based on this idea of providing an extra bid,¹⁴ but the role is apparently of little practical value when locals assess the performance of their regionals. Many locals themselves may owe their existence to producers' interest in maximizing the terms of trade on any particular day, without getting bogged down in investment requirements or equity valuation. As a group, locals seem to view regionals through the same lens.

In contrast, interviewed regionals see their role as providing "reasonable" or "fair" prices, measured by an

annualized rolling average, for example. They emphasize that they are "competitive in value," implying that the total package of auxiliary services and technical support combine with the product price to provide a satisfactory transaction for most locals, most of the time. Expertise continues to be a critical part of channel leadership, such as Land O'Lakes' continuing leadership and innovation in animal nutrition.

Many locals, fully satisfied with their regionals, would agree with these performance criteria. Nevertheless, the competitive yardstick is not enough to ensure regionals' future. They must make money consistently.

How regionals achieve such profitability is another issue. Although locals want their regionals to position themselves as low-cost suppliers (the regional would almost always be the lowest bid), regionals resist for a variety of reasons:

- A low-cost supplier position is eroded when the lowest price is adopted as the industry standard. When industry demand is fixed or overcapacity exists, such competition can become destructive. No one gains.
- Regionals want to convey a consistent vision to their farmer and end-use customers regarding product standardization and performance. The stand-alone price preferred by some member locals could lead to a mix-and-match approach (combining products of several vendors) that would dilute this message.
- A low-cost supplier position is always vulnerable to being eroded by import competition (i.e., fertilizer) or scale economies from the latest version of manufacturing technology. Cooperatives lack the financial resources to be at the forefront of every technological advance. Regionals prefer to emphasize quality over price because they believe that, long term, this will give them the ability to "pick and choose" their customer.
- Regionals have obligations of ownership, investment, and use that result in a certain rigidity in the federated system. Just because

¹⁴ Prof. Michael Cook from the University of Missouri, emphasizes the cultural imperative of the competitive yardstick role among local (and, by extension, regional) cooperatives: "Founded to provide a missing service or to avoid monopoly power or to reduce risk or achieve economies of scale, [local cooperatives] epitomize the Nourse philosophy of cooperation--that of a 'competitive yardstick' with the objective to keep investor-oriented firms competitive." See Egerstrom, 146.

an Oklahoma location would have a lower cost of production does not mean that a North Dakota cooperative can simply pull up stakes and move there.

- Getting multiple bids ("the price game") may be an economically rational activity for individual locals. From a systems perspective, however, their preference for shopping around means the federated system faces higher transaction costs than one conducive to forecasts of customer (local) demand and inventory levels. Because regionals must market themselves to member locals, resources are diverted from improving member-local service to ensuring a certain level of industry competition.

Detachment among Locals

Given their position as food companies with processing plants to run and contracts to fulfill, regionals can't depend on having the best bid on any given day. For locals that favor absolutes, all that matters is that the regional be the lowest bid today. That detachment has led some locals to operate in what several managers described as an "arms length" relationship with regionals. Detachment maintains the historically designated separation of roles in the federated system, but may be an anachronism in terms of agriculture's increasing emphasis on systems built from interdependent stages.¹⁵

Detachment may also create a free-rider problem within the federated system. Members may invest--and bid--only the minimum necessary to sustain the regional as an additional bid. This behavior is at odds with the interest expressed by other industry segments in partnering or supply chain management.¹⁶ When the bid is the singular measure of performance, all other aspects of locals' generally multifaceted investment in the regionals are vulnerable to being considered an "unproductive investment."¹⁷

As a strategy, detachment is useful in keeping suppliers off balance. No one can depend on getting an order at any given time. Short-term contracts are the norm, with negotiations continually re-opened on the basis of new market information.¹⁸ Moreover, buyers may be secretive about their needs, fearing market

share disclosures may result in pricing according to "what the market can bear." This attitude was not unknown among interviewed locals.

Detachment also presupposes suppliers are interchangeable. There is no difference in their ability to provide product enhancements, training, or other attributes important to locals.¹⁹

This strategy may have been reasonable when the marketing environment was composed of multiple, competing regionals. Now that interdependence, long-term contracts, or a systematic approach to addressing the needs of producers (or end-use customers) is needed, it is less adaptive.

Regional as Self-Sustaining Entity

Federated locals have the right but not the obligation to do business with their regional. They are free to sift among bids. Local managers interviewed for this study who operated closer to a dealership mode,²⁰ that is, routinely accepting some products or policies from their regional, did not manifest the dissatisfaction of other managers.

This is an important point. Even though conflict is an intrinsic part of any marketing channel (not as an end in itself but as a means to some economic objective),²¹ more regionals may find themselves favoring policies that make the local an extension of the regional and so minimize conflict. That policy virtually guarantees that there will be a market for the supplies sold by the regional as well as product from locals to fill processing and export contracts.

Industry competition in developing and sustaining branded processed foods (including slotting fees and advertising) reduces regionals' ability to control their own destiny. Industry observers comment that the profitability of particular brands depends on the product choices of the very small number of major grocers. Casting locals in the role of internal suppliers reduces one element of uncertainty. With this "captive market," there is less risk that a regional's facilities will be underused. Essentially, this is a way for regionals to protect their investment in manufactured foods, in particular.

¹⁵ Fulton, Murray, "Traditional versus New Generation Cooperatives," in *A Cooperative Approach to Local Economic Development*, Christopher D. Merritt and Norman Walker, eds. Westport, Connecticut: Quorum Books, 2001.

¹⁶ Coles, Gary J. and James D. Culley, *Not All Prospects Are Created Equal*, Business Marketing, May 1986.

¹⁷ This term was used by managers of five superlocals.

¹⁸ Day, George S., *Market Driven Strategy*. New York: The Free Press, 1990, 228.

¹⁹ *Ibid.*

²⁰ These were managers of locals affiliated with Growmark or CHS.

²¹ Stern, Louis W. and Torger Reve, *Distribution Channels as Political Economies: A Framework for Comparative Analysis*, *Journal of Marketing* (44), Summer 1980, 53.

Regionals are then taking actions to preserve their own self-interest. This is completely at odds with the notion (from the service model) that the regional's role is not to sustain itself, but the locals who own it.

Most core Midwestern locals interviewed for this study, particularly superlocals, resisted any concept of themselves as a captive market. Their individual strengths allow them to scrutinize the federated system more closely than smaller locals more dependent on regionals. Superlocals see that the federated system as a whole has developed an infrastructure reflecting the needs and priorities of multiple regionals (some no longer in existence) and, of course, multiple locals. This infrastructure may not necessarily be well positioned or sufficiently streamlined to meet some superlocal needs. So, they may build their own.

Such asset duplication, while not ideal from the standpoint of the system as a whole, is probably inevitable. It reflects the fact that the federated system is more parochial than centrally planned or administered. Federation's greatest strength, responsiveness to individual rural communities, is also a weakness, insofar as it creates a system somewhat improvised and piecemeal. This issue is not particular to the federated system. IOFs also struggle with top-down/bottom-up issues as they switch back and forth from centralized businesses to individual business unit (profit) centers.

Some Predictions

Internal supply networks will probably become a more pronounced feature of the cooperative landscape as a way to "force" a coordinated system. In the core of the Midwest, such networks have always implicitly existed because regionals had the power of channel leadership to decide, for instance, which of two locals would merit a new feed mill. Now these networks will become explicit as the federated system becomes more centralized, approaching (at the extreme) the manner defined by Cobia:

Centralized cooperatives have no autonomous local association members. Instead, they have branches, retail outlets and, in a few cases, franchise dealers. Operational control and authority are centralized in the headquarters of the cooperative. Individuals are direct members. . . . Operation of local units is vested in a manager hired by the management of the centralized cooperative.²²

Cobia observes that the local units of centralized cooperatives are more easily standardized in product and services, leading to a lower cost system. A low-cost system is just what is needed for commodities that have reached the stage of product maturity.

Cobia also identifies three disadvantages of a federated system--less control and coordination over product flow between regionals and locals; locals' freedom to bypass regionals; and divergent goals at each level. It is clear that these have emerged as destabilizing factors in the federated system. Although centralized regionals face the risk of operating at both the regional and the local level, they may offer locals more of a stake in the strategic goals pursued by regionals, and so, in important ways, may correspond to the needs of the emerging marketplace better than a purely federated system.²³

Need for Focus

GROWMARK, a federated cooperative serving Illinois, Iowa, Wisconsin and Ontario, has often been regarded as centralized because key distribution decisions are made by the regional. In important ways, it may be a prototype of the internal supply networks being spawned to the North and West. Focusing on a relatively narrow segment of agriculture, corn and soybeans, has given GROWMARK a unity of purpose not evident in the experience of other, more diversified regionals.

The potential to offset losses in one commodity with gains in another has been regarded as a powerful economic argument supporting diversified, multipurpose organizations. Nevertheless, cross subsidization does not necessarily appeal to cooperative members (local or producer). Those representing different commodity or processed foods constituencies have frequently challenged regionals to be industry leaders in each of their various enterprises--dairy, hog production, fertilizer, red meats, grains, poultry, etc. The greater the diversity, the greater the pressure.

Setting priority goals and perhaps settling for "second-best" in some areas does not seem to be an option for most of the federated system, due to politics and scale economies. Consequently, the cooperative record in commodities and foods is somewhat checkered--intense involvement in some areas followed by withdrawal, followed by a tentative re-entry. This may

²² Cobia, David (ed), *Cooperatives in Agriculture*: New Jersey, Prentice Hall, 1989, 45.

²³ Although greater centralization could offset some of the shortcomings of a federated system, it will generate a new set of issues and concerns for the cooperative sector. Identification of or speculation about what these might be is beyond the scope of this report.

be considered both an economic and organizational shortcoming indicating that the federated system does not respond well to complexity.

The less-diluted focus of the GROWMARK system may be aided by its relationship with Archer-Daniels Midland (ADM), which encapsulates the foods business and allows GROWMARK (as a regional) to focus on the more commodity-oriented concerns of member locals. This minimizes conflict between the two levels. GROWMARK also takes a bottom-up approach, allowing centralized decision-making to occur in a setting where the regional regards itself as "nothing more than what its locals are (or aspire to)." This philosophy moves GROWMARK closer to a definition of the federated ideal:

Distributor and manufacturer working partnerships [are defined as] the extent to which there is mutual recognition and understanding that the success of each firm depends in part on the other firm, with each firm consequently taking actions so as to provide a coordinated effort focused on jointly satisfying the requirements of the customer marketplace.²⁴

GROWMARK defines its purpose as serving member locals, and through them, the farmer. This is also the view of other regionals who have a large supply or agronomy business. The more specific or specialized a cooperative is, the easier it may be to identify and respond to the expectations of the member owner.

Customer choice is not a clear-cut decision for cooperatives. Diversified food-based regionals believe that the federated system's goal is to produce more of what the market (consumers or farmers) wants, when it wants. Although locals want to be seen as the driver of the federated relationship because they own regionals, the real driver is the customer. Interviewed regionals observed that customer decisions do not take into account whether a local was part of the marketing channel. Standardization, quality, timing of delivery, etc., matter far more than cooperative organization.

Consequently, regionals were not always sure how locals fit into the marketing channel, as shown by issues raised during interviews:

- Should we always go through a local?
- Does it stand in the way of the customer to do business with locals?
- How much of our energies and resources must be devoted to getting locals included in the solutions we have devised for our end-use consumers?
 - Who will be key in the relationship with the farmer, the local or regional?
 - At the end of the day, who is the customer of the regional--the farmer, local cooperative, or end-use consumer?

Most food-based Midwestern regionals define their customer as farmers or end-users, not locals.²⁵ They are also more directly and visibly involved in the food business than GROWMARK. Could they be as successful in foods if they defined locals as their customers? Most would probably say no. However, this issue remains an important conceptual and empirical challenge for the federated system because cooperative culture demands that certain stake-holders, like small farmers and locals, be included in the organizational framework, irrespective of their economic contribution.

New Rules for Competition

A centralized system or internal supply network can be viewed as a network of firms (or cooperatives). Market analysts have observed that global competition is increasingly occurring between networks of firms, such that "to be an effective competitor (in the global economy) requires one to be a trusted cooperator (in some network)."²⁶ Yet cooperatives' culturally based need for an adversary has prevented them from gaining maximum benefit from existing federations.

Bringing together an assortment of producers or locals may require a mechanism to dampen perceptions of individual differences so collective action can take place. Identifying an adversary--another regional cooperative, a mega-IOF or some other entity--may help define what a cooperative is by defining what it is not.

Prior to specialization, interviewed regionals viewed their competition almost exclusively as "other regionals." Interviews suggest that carryover from this "us against them" approach has made it harder for

²⁴ Anderson, James C., and James A. Narus, A Model of Distributor Firm and Manufacturer Firm Working Partnerships, *Journal of Marketing* (54), January 1990, 42.

²⁵ Regionals were asked, "Who is your customer?"

²⁶ Morgan, Robert M. and Shelby D. Hunt, The Commitment-Trust Theory of Relationship Marketing, *Journal of Marketing* (58) July 1994, 20.

cooperatives formed from mergers to transcend their previous cultures and commit to a new one. Lingering attitudes toward former IOF competitors may also forestall the interdependence necessary to surmount limited resources by learning to survive in a concentrated marketplace.

In an environment defined by a limited number of buyers and sellers, a firm--especially a mega-IOF--may be a competitor in one context and a partner in another. In their resource provider function, regionals have had sufficient exposure to IOFs on a day-to-day basis so that they can comfortably accept partnerships or joint ventures as a logical outgrowth of this process. Locals may have more difficulty with a complex "friend" and "foe" view. This could be an outgrowth of locals' cultural bias (evidenced in the price game) toward a "win-lose" mentality.

A particular example of market complexity arises when a regional's response to some market contingency (such as an acute, short-term need for facilities or resources to maintain production flow) leaves locals out of the loop. To locals that have invested heavily in the federated system, this is not what the cooperative system is about.

In turning to the nearest IOF (not the nearest local), regionals reveal that they are motivated less by governance issues, i.e., how market arrangements are governed, than by the dictates of competitive advantage, such as a speedy outcome or resolution. This means regionals will probably take other actions that, in a particular context, could appear to go against the grain of cooperative practices and norms. Regionals perceive that their strategies are determined by market forces first, locals second.

Since the federated system is critically dependent on the performance of the small number of regionals,²⁷ yet control rests with an essentially fragmented and diverse group of locals, regionals will probably try to push the limits of culturally accepted behavior. If likely conflicts with governance result, regionals will probably buffer themselves by increased reliance on internal supply networks.

Whether member complaints about how equity is being used will redirect the federated system is unclear. The lines of control and accountability are not necessarily firmly drawn in the federated system. Specialized ventures like Agriliance represent an effort by regionals to impose greater transparency on the

federated system, but overlap and fuzzy boundaries will probably persist due to the complexity of cooperatives as an organizational form.

Cultural Influences

Federated cooperatives are responsible to many stakeholders and influences. These include:

- Industry cultures as a context for cooperation--cooperation has a different meaning for dairy producers than for those specialized in grain or pork.
- Rural communities--cooperatives are often a mainstay of their communities. Closing a feed mill or elevator can cost a community jobs and income.
- Predecessor farm organizations--Farm Bureau, for example, differs from Farmers Union in governance preferences, scope of activity, and attitude toward cooperation.
- Geographic preferences--the South uses farm stores; the Midwest, local cooperatives; California does neither.
- American values--individualism and a "can do" pioneer spirit, traits usually associated with livestock producers, are generally considered incompatible with cooperation, although there are important exceptions.
- Particular stakeholders--notably, small or "family farm" operators.
- New Generation Cooperatives--these offer a competing model of ownership and investment structures.
- IOFs, particularly mega-IOFs--these are far more driven by profit than service concerns. Yet, cooperatives seeking to close outdated, out-of-position assets may turn to this model.
- European or other international models of cooperation.

These examples represent some of the particular contexts or situations in which cooperation can occur. Each culture will place a different value on cooperation and expect different things from cooperatives. Nevertheless, there are certain universal principles that will always define cooperatives or cooperation irrespective of context. These are:²⁸

²⁷ Positioning Farmer Cooperatives for the Future, A Report to the Senate Agricultural Appropriations Subcommittee. USDA: Agricultural Cooperative Service, 1987, 31.

²⁸ Dunn, John R., Basic Cooperative Principles and Their Relationships to Selected Practices, *Journal of Agricultural Cooperation* (3), 1988, 85.

- User ownership—A cooperative is owned by its members;
- User control—A cooperative is controlled by its members;
- User benefits—The benefits of the cooperative accrue to its members.

Cooperatives are collective organizations and so encompass more than one point of view or objective. But cultural influences can conflict, pushing and pulling a cooperative in different directions. Managing these interdependencies and agendas is the key task for the cooperative sector in the next decade, replacing the 1990s focus on managing scale economies. Interviewed regionals saw this as a primary way they could uniquely add value to the federated system.

Cooperatives are known as comparatively self-contained, even insular organizations. Maintaining the integrity of the universal principles will become an even more important task in the future as cooperatives necessarily engage other organizations in their quest to serve farmers.

Discussion and Conclusions

Regional cooperatives have typically been regarded as leaders of cooperatively organized and owned marketing channels. They have relied on the customary power bases of channel leaders to induce member local cooperatives to follow their lead. These include rewards, coercion, legitimacy, referent power, and expertise. These measures have been used in a cooperative culture that emphasizes the primacy of services over profits. This cultural model implies a regional will provide, essentially at cost, most if not all of the services and products locals require. In turn, locals will commit to the regional the raw material it requires to either acquire or manufacture supplies and, also, process foods. The support and patronage of member local cooperatives constitutes conceivably, a necessary and sufficient condition for the survival of a regional cooperative.

In reality, this model can break down in several ways. For example, locals may have other suppliers; regionals may have a higher cost of production than alternatives; multiple regional affiliations exist; locals may need that product regionals don't make or can't access; locals may meet their own needs internally; regionals may need more product than locals can provide; and the regional may acquire an identity and existence of its own, independent of locals.

The federated system particularly struggles with regionals' cost of production relative to that of other

suppliers. Cooperative norms stress the importance of the "competitive yardstick," where the value of a cooperative lies primarily in its ability to provide an additional bid to enhance market competition for commodities. Local cooperatives have frequently translated this expectation into an implicit demand that the regional be the lowest bid. If it is not, locals may perceive that their regional has not necessarily "added value" to the marketing channel.

Moreover, the patronage-generating processed foods operations of regionals do not "add value" to the federated system on a day-to-day basis in ways that would contribute to a more unified, cohesive system. An alternative mechanism is needed to give the commodity-oriented locals more reason to identify with the often food-oriented regionals. Otherwise, the divergence between the two levels of the federated system could increase to a point where the system is irrevocably fractured.

Locals and regionals necessarily pursue different goals. Among cooperative supporters, the promise of "farm gate to plate" has been an enticing vision. But this cultural mandate has required the federated system to twist and stretch itself to encompass two distinct systems, food and unprocessed commodities. They often conflict over issues of resources, infrastructure, and customer definition. It is not easy, and maybe not even possible, for the federated system to integrate inputs (farm supplies) with outputs (processed products). To date, the best the federated system has been able to do is to compartmentalize commodity and food operations. The recently formed, specialized ventures like Agrilience, Country Energy, and the Land O'Lakes/Farmland feed joint venture as well as the compartmentalized relationship between the grain operations of GROWMARK and the foods business of ADM are examples of this process.

For their part, regionals with a strong presence in processed foods do not always know how their locals fit into the marketing channel. They perceive that their strategies are driven by market forces first, locals second.

Locals derive meaning and existence from the constant comparative price-shopping imposed on them by the nature of the commodities they handle. Locals want regionals to fit into the demands of this system by being low-cost suppliers. Yet, the way regionals approach marketing and certain rigidities of the cooperative system may preclude this, to some degree. The multiproduct and multiservice aspect of regionals can prevent them from attaining the special-

ization that usually supports a low-cost supplier position. This may mean that some locals may at times operate outside the federated system.

Patronage refunds--the singular prerogative of a cooperative supplier--may bring these locals back. To accomplish this, regionals will have to consistently make money, every day. Running a commercial business and achieving consistent profitability is a tall order for a cooperative sector nurtured on the concept of service as an end-goal. But regionals that formerly sought to induce member business and loyalty through special programs or promotions (as the rewards of channel leadership) may have a better chance at overriding any tendency to stray from the federated relationship by commanding respect through patronage refunds and focused growth.

In other areas, greater commitment to the federated system may occur as individual regionals and selected member-locals decide to collaborate on specific objectives. These locals would form an "internal supply network" for their regionals, using an organizational model more centralized than federated.

The dual focus of the federated system is revealed in the structural tendencies of the system. Locals generally gravitate to a strategy of horizontal integration and regionals, vertical integration. Conflicts over the goals, commitment, and performance of the federated system as a whole are the result of perceptual differences at each level of cooperation. Often, regionals and locals each pay attention to and value different things. Continuous and severe industry competition reinforces this tunnel vision and distracts the federated system (as a whole) from developing a broad-based unifying vision, a concept of what could be. The promise of "farm gate to plate" will never be exploited to its full potential across the federated system until regionals and locals see themselves more as partners than as adversaries or competitors. Until then, implementation of this vision will be spotty and localized, restricted to areas where internal supply networks are in place.

The environment is ripe for new organizational forms *and terms*. The regional-local distinction may be outdated and may perpetuate paternalistic notions of channel leadership that have lost meaning in a world of locals, superlocals, and regionals. South Dakota Wheat Growers, the world's largest local cooperative, covers more territory than some "regionals." Is it really appropriate to call it a *local*, and bring to mind all the territorial and service limitations associated with this concept?

The challenge for the federated system is to evolve to a system of partnerships, of networks, to minimize or eliminate the top-down frame of reference embodied in the notion of regional cooperatives as channel leaders. This may be occurring in a small way with the development of internal supply networks, where groups of locals more closely associate themselves with a regional cooperative in exchange for certain benefits. It is possible prominent superlocals will develop their own internal supply networks and so the federated system will evolve to a level of greater complexity.

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