EXAMINE NEW GENERATION COOPERATIVES AND STRATEGIES TO MAXIMIZE FARM AND RANCH INCOME

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EXAMINE NEW GENERATION COOPERATIVES AND STRATEGIES TO MAXIMIZE FARM AND RANCH INCOME

THURSDAY, OCTOBER 16, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, DC.

The committee met, pursuant to call, at 10:06 a.m., in room 1300 of the Longworth House Office Building, Hon. Bob Goodlatte (chairman of the committee) presiding.

Present: Representatives: Pombo, Smith of Michigan, Lucas, Moran, Ose, Johnson, Osborne, Graves, Janklow, Burns, Rogers, King, Musgrave, Nunes, Neugebauer, Stenholm, Peterson of Minnesota, Dooley, McIntyre, Etheridge, Baca, Alexander, Ballance, Scott, Lucas, Udall and Larsen.

Staff present: Dave Ebersole, senior professional staff; Ryan Weston, Callista Gingrich, clerk; Kelli Ludlum, Teresa Thompson and Russell Middleton.

OPENING STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF VIRGINIA

The CHAIRMAN. This hearing of the House Committee on Agriculture to examine new generation cooperatives and strategies to maximize farm and ranch income will come to order.

The Committee on Agriculture convenes today to hear testimony on farmer cooperatives and the value they have brought to several generations of rural Americans since the Grange movement began to shape farm and ranch associations in the mid–19th century.

The primary focus of this morning's hearing is to examine how traditional cooperatives sustained themselves during the rapidly changing and globalizing agricultural economy, and to learn more about new structures of farmer associations that are focusing on maximizing economic returns to the U.S. agriculture industry.

As all of us who represent farming and ranching communities understand, and the Congress has understood since the New Deal, agriculture is a cyclical industry, and profits often are fleeting. Access to adequate capital at crucial times is critical to the success of agricultural economic enterprises.

Thus, the real subject of our hearing today may just as well be how we can assist the financing of U.S. agriculture. Debt financing has been the typical avenue with any profits generated by the operation being used for expansion. Today, agricultural producers are looking for outside, passive investors who may have interest in the community where the operation is located, but otherwise are looking for a reasonable return on that investment. That calls for new business structures that may abandon the traditional cooperative model. This morning, we hope to learn more about these organizations.

Finally, on credit, this committee has not done a thorough examination of the Farm Credit Act since the statute was amended substantially during the farm recession of the 1980's. Of course, that was a crisis situation, and although it was successful, I do not believe it was the kind of deliberative process that could be undertaken now that the system is adequately capitalized and relatively prosperous.

I look forward to the testimony this morning and, at this time, am pleased to recognize the gentleman from Texas, Mr. Stenholm, for his opening comments.

OPENING STATEMENT OF CHARLES W. STENHOLM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. STENHOLM. Thank you, Mr. Chairman, and thank you for holding this hearing to begin the review of the Federal statutes that govern agricultural cooperatives and, more specifically, consider how the marketplace has changed and impacted the ability of farmers to join together successfully in cooperative self-help efforts to improve their incomes within the marketplace.

As a farmer-manager of an electric cooperative, a member of a cotton cooperative and as a farmer with a partnership with my son today, I know all too well the potential that cooperatives can offer producers to add value and maximize our profits in the marketplace.

The Plains Cotton Cooperative Association, PCCA, of which my son and I are members, markets and adds value to our product by transforming our raw cotton into denim fabric. This is a very successful endeavor that has helped our family farming operation remain viable. In fact, since 1976, PCCA's denim mill alone has provided its members with over $300 million in added value for their cotton. The PCCA is an excellent example of how things have changed and also why there is a need to review and modernize Federal cooperative law.

For example, the PCCA added this denim mill in the 1970's at a cost of roughly $25 million. However, building the same mill today would cost between $100 and $150 million. Today, rural economies are starved for capital. Because the PCCA is dependent on its member producers for its capital, and with fewer producers than 30 years ago, it is unlikely PCCA could construct the same denim mill today.

We on this committee encourage and extol the benefits and virtues of value added on a daily basis, and vertical integration to maximize producer profits in the marketplace. In the 2002 farm bill, we included grants to assist farmers and ranchers in creating greater value for agricultural commodities and we authorized the establishment of agricultural demonstration centers for the purpose of providing training and technical assistance to new or expanding value added agriculture enterprises.

In late September, Secretary Veneman announced $10 million in grants to establish these centers in 10 States. While I am encouraged by our success in this area, there is much more work for this committee and USDA to do to ensure that farmer and rancher cooperatives have the means to compete in an era of rapid consolidation and technical innovation.

The issue we must consider at this hearing is what the future capital needs are for producer-owned downstream agricultural commodity processing. What are the changes in business and ownership structure, and who will provide the capital for these new needs and under what new structures?

I look forward to the testimony of our witnesses as we help begin laying the foundation for answering those very questions. I think it is critical for those of us in agriculture who intend to survive in agriculture, that we begin openly and honestly to look outside the box, thinking in ways in which we can work together. It should not be an adversarial approach between cooperatives and independent banks. Rather, it must be a cooperative approach, because rural America is dying on the vine, and unless we find ways to pump more capital into rural communities, there can be very little hope for our producers in the international marketplace as successfully as we would like.

There are many examples out there in which people are thinking outside the box. In my district, Rancher's Lamb, a cooperative that recognized when we lost the wool and mohair program that they had to think outside the box and begin to do things in order to allow lamb producers in America to be able to compete successfully. There are a of interesting things going on, including looking at ways to move cooperatively in the international marketplace, instead of an adversarial way. In the case of lamb, we need to look at Australia, New Zealand and American lamb producers and see if there can not be a way through cooperative effort to maximize the profit for producers in all areas.

It is an interesting experience, but it is one that truly must be continued. So, Mr. Chairman, I appreciate this hearing. I look at this as another step in laying the foundation for the future of agriculture in this country. We have to take a look, as you said in your opening remarks, at the laws that are there, see what needs to be changed in order that we might give our producers a level playing field in order to compete in the international marketplace.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman for his instructive observations, and I would advise the other members of the committee that we will make any opening statements that they might have a part of the record, and at this time, we would like to welcome our first panel.

Other statements for the record will be accepted at this time.

[The prepared statements of Members follow:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you Mr. Chairman for holding this hearing to discuss issues faced by agricultural cooperatives.

Farmer-owned cooperatives constitute a vital component of our Nation's agriculture industry, as evidenced by the approximately 3,000 farmer cooperatives scattered across the U.S. that market nearly 30 percent of our farm commodities. Over the last century, farmers have entered into cooperative arrangements to pool resources in an effort to enhance farm income by opening new markets for products, creating value-added opportunities, providing farm supplies, increasing farmer bargaining power, and decreasing input costs. Over this same time period, however, the farm sector has changed dramatically as we now have substantially fewer but much larger farming operations.

Paralleling the trend of increased consolidation of production agriculture has been an evolution in the types of farmer cooperatives that are required to compete in today's agriculture industry. As foreign competition on bulk commodities increases, producer profit margins get thinner, and the farmers' share of the consumers' food dollar continues to diminish, the focus, needs, and business structure of farmer-owned cooperatives are changing. Cooperatives are moving more towards value-added products and away from bulk commodity marketing. Such a shift creates a demand for elevated capital investments and more non-producer investors. While trying to meet these new demands and still retain farmer ownership and control, cooperatives have to change their business structures to remain viable. As this evolution of cooperative structure occurs, it is imperative that farm credit policies maintain the flexibility required to meet the financing needs of the new generation of cooperatives. Family farmers must be given every opportunity to form cooperatives that take advantage of the benefits provided by value-added products in order to compete with large, monopolistic food producing corporations.

As a long-time farmer and member of this committee, I look forward to finding ways that we can continue to foster farmer innovation and better meet the needs of our agricultural cooperatives.

PREPARED STATEMENT OF HON. SAM GRAVES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

I would like to thank Chairman Goodlatte for holding this hearing today and understanding the importance of farmer cooperatives. As a farmer myself, and a member of a farmer-owned cooperative, I hold this issue very close to my heart.

It is important most of all to know that farmers want to help themselves. When a farmer asks Congress for assistance, it is because we have not provided them with the tools they need to accomplish that goal. That is why Congressman Pomeroy and I have agreed to co-chair the Congressional Farmer Cooperative Caucus. A Caucus where the underlying goal is to "help farmers help themselves."

As member of this committee, anything we can do to strengthen the ability of farmers to work together is a great accomplishment determining long-term solutions challenges facing agriculture. As Members of Congress we need to think about what we are doing to do to help farmers be more successful in retaining a profit from their investment into the marketplace.

The farming community has changed greatly since our parents, and grandparents farmed. In fact, we are becoming more and more removed from the farming practices all together. We cannot allow the market to pass us by.

Thank you again Mr. Chairman for this opportunity. I look forward to hearing the testimony of your distinguished guest today.

The CHAIRMAN. We are especially please to have with us the Honorable Thomas Dorr, Under Secretary for Rural Development of the U.S. Department of Agriculture, the Honorable Michael Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration, has been unable to be with us this morning, but I am especially pleased that my own constituent and a member of the Board of Farm Credit Administration, Mr. Doug Flory, is here in his place.

Gentlemen, we are pleased to have both of you with us, and Mr. Under Secretary, we will start with you.

STATEMENT OF THOMAS C. DORR, UNDER SECRETARY, RURAL DEVELOPMENT, U.S. DEPARTMENT OF AGRICULTURE

Mr. DORR. 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 with you ways in which the Federal Government might help farmers, ranchers and other rural residents increase their incomes and improve their quality of life through effective cooperative organizations.

I am honored that President Bush has given me the opportunity to be at the helm of a consortium of dynamic and progressive investment programs within USDA. As a result, Rural Development has two goals, first to increase economic opportunity and secondly, to improve the quality of life for all rural Americans.

With an $86 billion portfolio, USDA's Rural Development is, by today's standards, a large bank. This year alone, with a budget authority of about $2.9 billion, we will invest nearly $16 billion in rural investments to build housing, support business development and strengthen our rural infrastructure of community water, wastewater, electric, telecommunications, as well as all community facilities.

Since arriving at Rural Development, I realized the critical need to look at the effectiveness of the current cooperative model for assisting patron members. Farmers and ranchers still retain a high level of confidence in cooperatives and this business model is still one of the most trusted tools of business development in rural America.

The traditional cooperative model and tax structure was developed with good intentions and has met our needs for many decades. However, 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, which has all altered the traditional marketplace.

Sweeping innovations in areas such as biotechnology, information services, transportation and global sourcing have made many cooperative facilities and equipment obsolete, and also governance structures and the resulting transparency appear to have helped to make non-cooperative enterprises become more responsive to change.

It is becoming more evident than ever that global economic challenges are here to stay, and that is why Rural Development has placed a high priority on looking at the current cooperative model for assisting farmers and ranchers in this increasingly competitive environment.

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, and cooperatives must be prepared to sail in uncharted waters, but with as much navigational assistance as Rural Development can provide.

I believe we should consider modifying existing cooperative concepts and developing ones that are more responsive as well as transparent. We need cooperatives that are attractive to investors and tax rules that are more flexible and favorable, and let me add that as someone who has spent over 30 years in farming, I understand that we probably can't improve production efficiencies a great deal, but I believe we can do better at investing and improving yields on our assets.

My written testimony, which I have submitted for the record, provides a more in-depth assessment of my views. We need to improve the ability of our farmers and ranchers to utilize a modified cooperative structure that will improve their profitability and ultimately, the quality of life for their families.

Mr. Chairman and members of the committee, cooperatives are an important part of rural America. Rural Development stands ready to offer whatever leadership and support we can to improve the business environment for cooperatives.

I am happy, and I will be happy to answer any questions you may have at this or whatever time is appropriate.

Thank you.

[The prepared statement of Mr. Dorr appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Dorr. Mr. Flory, welcome.

STATEMENT OF DOUGLAS L. FLORY, BOARD MEMBER, FARM CREDIT ASSOCIATION, McLEAN, VA

Mr. FLORY. Thank you.

Chairman Goodlatte and Ranking Member Stenholm, members of the House Agriculture Committee, I am Doug Flory, Board Member of the Farm Credit Administration. Joining me today is my colleague on the FCA Board, Nancy Pellett.

Mr. Chairman, FCA Chairman and CEO Michael Reyna had planned to present his statement today to the committee. However, he has been subpoenaed as a witness in a criminal case and is unable to be here in person. Because Chairman Reyna is unable to be here, he has asked me to deliver his statement on his behalf.

FCA delivered Chairman Reyna's written testimony to you earlier in this week. On behalf of the Board of FCA, Chairman Reyna wishes to thank you for the invitation to discuss the changing structure of agricultural cooperatives and the challenges that cooperatives face as they seek to increase the income of their farmer-members, while at the same time, finding new ways to finance their operations.

These challenges and how Congress chooses to address them are of prime importance to agriculture and rural America. The Farm Credit Administration is the independent Federal regulatory agency that is responsible for overseeing the mission and the safety and soundness of two separate, but related, agricultural GSEs, including the Farm Credit System and Federal Agricultural Mortgage Corporation, or better known as Farmer Mac.

We achieve our objective by conductive periodic financial safety and soundness examinations and by adopting regulations that provide for necessary guidance of the two GSEs. The system is a nationwide cooperative network of borrower-owned financial institutions that lend to agriculture and rural America. Establish in 1916, it is the oldest GSE in the United States and is the only GSE that engages in lending at the retail level.

The mission of the System is to improve the income and well-being of American farmers and ranchers by furnishing sound, adequate and constructive credit, and closely related services to that credit, and to their cooperatives and to the selected farm related businesses necessary for efficient farm operations. It does this by serving all eligible borrowers having a basis for credit, and as required by Congress, by providing a program for financing young, beginning and small farmers.

Cooperatives have played a crucial role in making agriculture prosperous, productive and efficient. They increase the sales revenue of farmers and lower the cost that farmers pay for supplies and business services. In addition to increasing revenues and lowering costs, cooperatives are vital and an integral part of rural America. Cooperatives strengthen the agriculture economy, improve living conditions in rural areas in many different ways. For example, earnings in the form of patronage are returned to farmers who contribute to the local community.

Cooperatives strengthen the economic base of that local community by adding to the tax base, creating new jobs, spurring retail sales and services. Cooperatives also help provide consumers with more choices and with new products. It is the unique structure of cooperatives that strengthens the market power of farmers, so they can earn more and live better.

For more than 80 years, Congress has sought to preserve and expand the benefits that cooperatives have offered. Specifically, Congress has devised a public policy that grants cooperatives certain legal protections, tax benefits and other advantages that may not be conferred on investor-owned agribusinesses. As a result, farmer cooperatives have direct access to the GSE funding that their competitors or investor-owned agribusinesses may not always have.

It is important to note that farmer cooperatives play an important role in America's agricultural economy, and the share of overall farm commodities marketed through cooperatives have been fairly steady over the past five years, and although the number of farmer cooperatives has declined 25 percent in the past decade, and most of these, of course, as you know, are through consolidations, the net business volume of cooperatives actually has increased.

While no empirical data is available to determine whether farmers have been reducing their use of the traditional cooperative farm structure in recent years, our Agency did, however, conduct a very limited survey, in which we contacted the 10 States with the greatest number of cooperatives to identify annual trends in new cooperative filings. Specifically, FCA staff found no consistent trend in the number of new filings over the period 1993 to 2003. While half of the States did displays a declining trend in the number of cooperative filings, two States displays an increasing trend and one showed no change at all, and two States were unable to provide us with that data.

Notwithstanding the numbers, trends and limited surveys, there are concerns being raised by some individuals and groups that traditional cooperatives are not resilient enough to endure the economic changes facing agriculture today, and to help farmers overcome new challenges.

The cooperative movement developed at a time when farmers comprised half of the American population, and farmer-owned, value added enterprises were very rare. Today, farmers comprise less than 2 percent of the American population. This means that there are fewer farmers who can join and contribute financial resources to their cooperatives. It is not uncommon for farmers to struggle to find sufficient capital to enable them to invest in their own value added enterprises, and when farmers cannot raise sufficient capital on their own, they must turn to outside sources of equity.

To attract outside equity capital or increase their businesses with non-members, some farmer groups are forming hybrid organizations or restructuring existing cooperatives. FCA staff has identified examples of value added cooperatives that had changed to LLC form or had formed a joint venture LLC with other cooperatives or subchapter C firms. In addition, some groups of farmers have chosen to form new value added enterprises as LLCs rather than a cooperative.

LLCs offer many advantages that cooperatives do not. Among those advantages, for examples, LLCs attract outside investors by giving them a say in management and a return in proportion to their investment, and while a few well-established cooperatives have been able to attract outside equity successfully, for a host of reasons, most outside investors have little incentive to invest in agricultural cooperatives. This is especially true for startups.

Recognizing the limitations of the traditional cooperative structure, Wyoming and Minnesota have enacted new laws that allow farmers and investors to join together to form new types of cooperatives. The two State laws are not identical and their treatment of certain issues are different. These cooperatives can best be described as hybrids between traditional cooperatives and LLCs.

These laws are newly enacted and at this early stage, it is unknown how many traditional cooperatives plan to convert to the hybrid cooperatives, or how many entities will be formed under these new State laws.

The FCA Board is aware that CoBank is developing a legislative proposal that would give it more flexibility to finance cooperatives that are adjusting their structure to respond to the changing marketplace. Depending upon the specific language ultimately adopted by Congress, this proposal may help preserve the cooperative way of doing business for farmers, ranchers and their cooperatives, and it may also prove to strengthen farmers' and ranchers' income in rural America.

While Congress is ultimately responsible for deciding the scope of CoBank's lending powers, FCA is prepared to implement and enforce any policy that Congress enacts. As always, FCA is ready to offer you assistance in crafting any changes to the Farm Credit Act and we look forward to working with this committee as it considers issues that are important to agriculture in rural America.

Mr. Chairman, I thank you for the opportunity to present Chairman Reyna's statement today, and we consider this a very important hearing. Nancy and I really appreciate being here, and I, like Tom Dorr, would be willing to answer questions.

The CHAIRMAN. Thank you, Mr. Flory.

Mr. Dorr, some other witnesses that we are going to hear from later today will call for the Rural Development program to refocus on cooperatives and their continued prosperity. Do you have any thoughts about those recommendations?

Mr. DORR. Yes, we do, Mr. Chairman. One of the four priorities that we laid out when I was appointed Under Secretary about a year and 4 months ago was to pursue an in-depth review of cooperative services at USDA's Rural Development. I was considered that a number of the issues that were enunciated here today by my colleague at the table, as well as from others, suggested that cooperatives were not in a position to respond to the changing economic environment and, consequently, we are in the process of putting together an in-depth review of our cooperatives services group in order to determine what our past work product has been, what our resources are, and what our intentions are for the ensuing number of years relative to both research and development in the cooperative area.

The CHAIRMAN. As co-ops change their business structures, some may possibly lose Capper-Volstead protections. Others may lose their relationships with CoBank. Do you see these changes ultimately threatening to farmers and ranchers? Does it potentially harm the expansion and growth of individual co-ops?

Mr. DORR. Well, I think there is a legitimate concern about the protection and what we do to enhance or degrade protection from Capper-Volstead, so at this point, I think what we need to understand perhaps better than anything is what we will require, what kind of innovations will be required to effectively capitalize the cooperatives, either in the traditional cooperative, the traditional patron co-op, or some of these new generation co-ops to enable them to compete, and yet do it in a manner that allows them to capitalize on their asset base in a way that doesn't get them crosswise with Capper-Volstead or preclude them from doing other things that they would like to.

The CHAIRMAN. Also, as a subset of the value added product development grant authorities contained in the farm bill, the Congress required the Secretary to establish agricultural innovation center demonstration projects. Do you have any thoughts on how that authority could be used to offer better assistance to cooperatives?

Mr. DORR. The way in which we understood what we call the Ag Innovation Center Grant Program to work was to set up a series by making these grants, a series of innovation centers around the country, based on a set criteria that were developed in the notice of funds availability as well as in the regulations that we are developing, to assist producers and producer groups who come in, to assist them in developing business models, pro formas, marketing strategies and other things that would be required to enable them to get into value added initiatives effectively and to be successful at that, and I think these innovation centers are clearly a good approach to beginning this process. So, the first set of those were just announced earlier in September. Obviously, it remains to be seen how well they work, but we have considerable hope that they will be successful in that regard.

The CHAIRMAN. Thank you. Mr. Flory, I apologize. My questions are directed to Mr. Reyna, particularly to his statement, but in that statement, he makes reference to a legal entity that is the parent of an eligible cooperative may borrow from the ACB if, first, it holds more than 50 percent of the voting control of the cooperative and, second, use the loan proceeds to fund the activities of its cooperative subsidiary, and I wondered if you have any examples, either of you have any examples of such an entity that may be——

Mr. FLORY. Mr. Chairman, I can't think of an example off the top of my head, but I will be happy to go back to the Agency and we will supply that to you in written form.

The CHAIRMAN. If you would ask Mr. Reyna if he——

Mr. FLORY. I will do that.

The CHAIRMAN. If he had anything specific in mind when he made reference to that——

Mr. FLORY. Right.

The CHAIRMAN. And also, on page 15 of his statement, he says that the CoBank proposal "may well be the change needed to save the cooperative way of doing business." Is a closed, investor-controlled organization still operating cooperatively?

Mr. FLORY. Under the cooperative rules that we have today, no, it would not be, I don't believe. The issue on the table for all of us to wrestle with is how they may be restructured in order to bring equity to the table for those struggling co-ops and beginning co-ops, and that is an issue that we all need to deal with, and we are looking at it. This committee, of course, has a great charge in looking at that.

The CHAIRMAN. Thank you. The gentleman from Texas, Mr. Stenholm.

Mr. STENHOLM. Thank you, Mr. Chairman. Secretary Dorr, in your testimony, you make reference to the $1.1 trillion in value of land with a debt of $110 billion, which is a very impressive equity. What I wonder is what percent of that $1 trillion is owned by producers that are still actively in producing and would be interested in investing in a value added, and what percent would be in landlords that may not have the same interests in a long-term capital improvement? Do you have any information that would divide that up?

Mr. DORR. No, I do not, but I expected that would be—I mean, that's a very good question. I think that is an underlying question to this whole issue. Clearly, as producer numbers have declined, land ownership control has shifted. The thing that I am cognizant of, and I don't have an answer for you and we will see if we can get an answer on those percentages, and I am not sure if that data is available, but the thing that I am inclined to point out is that in many cases where there has been generational transfer of land, there are frequently off-farm family landowners, who are very interested in investing, given the right opportunity, the right sorts of structures, the right transparency, the right liquidity in value added processes in rural areas, and I think that is a thing that we need to keep in mind when we look at that number.

Mr. STENHOLM. I would ask both of you a question that the chairman made reference to, and that is the CoBank proposal will allow it to lend to new generation cooperatives. Do either of you see anything in their proposal that would cause you concern from a safety and soundness standpoint for farm credit?

Mr. DORR. I am not aware of anything that we have done within the administration that would give us an indication one way or the other, but I would be glad to have our chief economist's office and others necessary take a look at it and see what their opinion would be.

Mr. FLORY. Mr. Stenholm, we have looked at it as it is structured right now. We believe, as always, if it is written giving us proper instructions, that we can do our good safety and soundness that we do on all of our institutions, and the loans, and so we have no problem in dealing with that. Our staff and our systems are set up to handle that.

Mr. STENHOLM. Secretary Dorr, before the USDA Reorganization Act of 1994, of which I was a principal author, there was a separate agency called the Agricultural Cooperative Service, whose primary mission was to help encourage and promote cooperative self-help effort by farmers. Those responsibilities have since been combined into what is now called the Rural Business Cooperative Service. Simply, are cooperative services receiving the same attention and resources as it did prior to 1994?

Mr. DORR. Having not been involved with the Agency and its previous structure, I really am not qualified to answer it in that regard. However, as I had indicated to Chairman Goodlatte early on in his first question, I am very concerned about what is going on in the cooperative area, particularly relative to co-ops' abilities to be competitive, to have access to capital and that sort of thing, and that is the reason that we have undertaken an in-depth review and we are in the process of trying to get that going now so we can get a better handle on that issue.

Mr. STENHOLM. When will you be prepared to give the results of your in-house study and survey?

Mr. DORR. We have just now got the initial draft of the proposed way in which we would go about this. I am not really prepared to say when, but surely some time within the next several months. It should not be more than a year.

Mr. STENHOLM. Finally, in his testimony, David Graves, of the NCFC will give later this morning, he makes what I think is a good point. He points out that a new position has been established at the Department of Commerce, an Assistant Secretary of Commerce for Manufacturing, to give greater priority to the challenges facing the manufacturing sector. Would that be a good idea for USDA to do for cooperatives?

Mr. DORR. Well, this gets back to your previous question, and it is one that I have heard. We have been approached with this issue in the past and, quite frankly, it is one that I think I prefer to assess the strength of that agency first to see where it is coming from, what its internal asset structure is and where they expect or anticipate we need to go relative to both research and the development of new cooperative sorts of structures. When we get that done, I think we will have a fairly clear insight as to whether or not this particular suggestion is one that we would support.

Mr. STENHOLM. Thank you. I think that outlines a very good procedure that this committee obviously will be very interested in working with you on. Thank you.

Mr. DORR. Thank you very much.

The CHAIRMAN. I thank the gentleman. The gentleman from California, Mr. Nunes.

Mr. NUNES. No questions from here.

The CHAIRMAN. The gentleman from Minnesota, Mr. Peterson.

Mr. PETERSON of Minnesota. Thank you, Mr. Chairman. Secretary Dorr, you mentioned the Minnesota and whatever other State it was that passed these new laws.

Mr. DORR. Wyoming.

Mr. PETERSON of Minnesota. Wyoming.

Mr. DORR. That was mentioned by my colleague here.

Mr. PETERSON of Minnesota. I am sorry. But you are aware of these——

Mr. DORR. Yes.

Mr. PETERSON of Minnesota. In your testimony here, you were talking about building on these new generation cooperatives. I don't know why they are called new generation. They have been around for some time, as far as I know, but I am a little bit concerned, and I think some people in Minnesota are concerned about the law that was passed there, in terms of—that we may end up having these equity owners take over these cooperatives, which has happened in my State already. One of the biggest cooperatives took on a private investor and then was taken over. You are talking about building on this and trying to develop new strategies and structures to overcome obstacles. Can you tell me, have you got any specifics worked out at this point, or are you just kind of talking generalities?

Mr. DORR. I don't think that at this point, we have specifics that we are prepared to discuss. I think, clearly, the issue relative to co-ops and these producer value added on organizations is one that you have already alluded to, and that is their ability to raise an adequate amount of equity and to run it within the framework of a successful and a sound business plan in order to be successful without reverting to preferred equity issuances that ultimately, if the situation devolves into difficulty, that it results in the non-producer ending up owning the organization. I think that is clearly the significant issue that we have to deal with, and we have to figure out how to capitalize on the available capital in rural America in a way that producers can participate in these value added operations without risk of always reverting to some loss of equity or, perhaps, all of the loss of equity in these value added ventures, and that is the challenge that we face.

Mr. PETERSON of Minnesota. Well, I understand that, and appreciate your comments. I don't know, maybe we can look at some tax law changes or some other things that would try to encourage this, but I think in my judgment, the problem is that in a lot of these areas that these co-ops are getting into, or considering, you have a marketplace that is controlled by three or four entities basically, and they can—if you get into these commodity type operations, these big guys can squash you like a bug, and I think part of the reason that farmers are unwilling to get involved in some of these new co-ops is that they are concerned about that, because it has happened. We put up a corn processing plant, the sugar guys in my area, and ended up having to sell out to Cargill. It didn't go over too well, so I think part of the problem with this whole thing is that we have got a marketplace that is so controlled by these big guys in some of these areas that people are concerned that they can compete, given the situation now.

Now, maybe we could change some tax laws and do some other things that would offset some of that, but you still have a situation where they can—when they control that much of the market, they can run down those prices and put you out of business, and then force you to sell out. I mean, that is, I think, a lot of the concern people have in some of these areas, and so in our part of the world, what we are tending to look at is more of niche markets, where the big guys aren't operating, and there is maybe some ability to make some money without having to go head to head with these big guys that control so much of the market, so I don't know what the answer is, but I think that is part of the reason we are not getting this investment, and I think we have to be careful about how we go about this, because we might lure people into situations where they are not going to end up making any money, and I think that is what my guys are concerned about, so I would, when you do get some specifics, I would be interested in seeing what you are looking at, and——

Mr. DORR. We will be delighted to share them with you.

Mr. PETERSON of Minnesota. I think that it is an important area, but I just—I think this whole market concentration issue is a big problem in this area.

Mr. DORR. I think, just as an aside, I think the point that you are making is also why it is very important to make sure that we clearly understand whatever we do and how it affects the Capper-Volstead provisions of the cooperative structure, and so I think your statement clearly points us in that direction.

Mr. PETERSON of Minnesota. Thank you.

The CHAIRMAN. I thank the gentleman. The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Certainly, in rural America, one of the big concerns is capital attraction, and generally, in rural America, we are capital deficient, and I know that there is some concern about the CoBank proposal, and that that would put CoBank in competition with the lenders within those communities. Are there some opportunities out there where we can begin to look at some proposals like—from my banking days, I used to do a lot of SBA lending, where we were leveraging the SBA guarantee with private lenders loaning the additional moneys, are there some opportunities here with some modifications, where we can protect the integrity of the system that is there today, but also hopefully increase the ability for the cooperatives and for the rural communities to attract that new capital?

Mr. DORR. Are you addressing that to me?

Mr. NEUGEBAUER. Both of you.

Mr. DORR. I am sure there are. I guess I will use an example that I have used before, and I think—I will try to make it very brief. Shortly after I was nominated and came to Washington, DC, I received a call from a group in Iowa who were interesting in involving themselves in a factory that was going to be built by the Winnebago company, $15 million project, 350 jobs, they wanted to know what Rural Development could do.

My point to them when we got all done was that if it was a good project, if it would legitimately turn an 18 to a 20 percent return on invested equity, like most business plans should require, they really didn't need any equity from us, because it—40 percent equity on a $15 million project, over $6 million, they had 350,000 tillable acres in their county, if they were, for example, interested in borrowing $200 an acre on whatever number of acres that required at the time, and it returned 18 percent, and if they borrowed the money from the Farm Credit Bank at 6 percent, they got 12 percent return, that is $24 an acre. That is truly value added. That is the kind of value added I think rural America should take some time to look at.

It keeps farmers involved in producing on their farms. It gives them off-farm employment. It gives their youngsters executive type positions to stay in the community. It creates a lot of opportunities. The risk in that, and I realize this, is the fact that we aren't traditionally reinvesting that money directly into production agriculture, but we are growing rural communities in a very creative way that involves both the Farm Credit System and, quite frankly, the private banking sector, so those kinds of opportunities that I would hope we could be more creative about looking at to leverage assets in very responsible ways, and I think they have—that has opportunity.

Mr. NEUGEBAUER. I agree.

Mr. FLORY. Congressman, a super question. That is right on top of what we are dealing with here today. And I firmly believe, you bring SBA guarantees, and I think that every lending opportunity and guarantee opportunity needs to be brought to the table, whether it be SBA, FSA, State programs and whatever. As an aside, CoBank does have the ability to participate with community and commercial bankers on these types of transactions, which helps leverage the opportunity out there in rural America.

Mr. NEUGEBAUER. Well, and I agree, and I think what we need to do is make sure that whatever changes, if we make changes in here, do not jeopardize that relationship, because I do know that community banks are working very closely with communities and bringing some diversification to those economies and not necessarily being totally dependent on agricultural, the production aspect of it. I know that in our district right now, we are working on a project for an ethanol plant, and getting the capital alignment and the right formation and the structure to get that plant underway in our area is taking quite a bit of time and difficulty, but if we can get the right tools and bring incentive, if we ever take the incentive away for private interests into these projects, there is probably projects we shouldn't be involved in. I think we have to have a balance here. I thank the gentlemen, and I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from North Carolina, Mr. McIntyre.

Mr. MCINTYRE. Thank you, Mr. Chairman, and thank you to our distinguished panelists. I just wanted to commend you all for the special work that you do, and the difference that it makes in rural America, and particularly rural North Carolina. Under Secretary Dorr, the premiere Federal agency in the public eye is USDA Rural Development back home, and with an area that has been hit by many hard times recently, with tough job situations and job loss situation facing textiles and also, some efforts we are making in regard to tobacco, we are very grateful for what your agency does, from the rescue squads and the fire departments to the community buildings, we just had a recent town hall open, we have got two more, including one in my home town of Lumberton and one right down the road in Pembroke, North Carolina, coming up next month, water and sewer lines, business incubators, USDA Rural Development is seen as the opportunity for jobs and the opportunity for a brighter tomorrow, quite literally, when times have been bleak and tough in the economy.

Your State Director, John Cooper, as I have mentioned to you privately, I want to say publicly, does an excellent job, and not only is he a pleasure to work with, but also, we are grateful for the work of him and his staff. Jerry Batten, who I know and work with personally in southeastern North Carolina, is an excellent Regional Administrator as well and Irma McPherson and Ronnie Pope. Erma are Ronnie are on the front lines every day with local business, local communities and local agencies, and when you have folks like Jerry Batten or Ronnie Pope and Erma McPherson, your agency has a lot to be proud of, so in addition to Mr. Cooper, I commend those folks from our regional level who do you well every day. USDA Rural Development has been heard of, but now it is well known, and I cannot think of a better way that this committee can help serve people in rural America than working with your agency, in terms of seeing immediate impact and immediate economic benefit, and for that, I thank you very much, and I yield back the remainder of my time, Mr. Chairman.

The CHAIRMAN. Thank you. I thank the gentleman. The gentleman from Michigan, Mr. Smith.

Mr. SMITH of Michigan. Mr. Chairman, and thank you for holding this hearing. I think that agricultural farm co-ops probably have the potential to be a great service to American producers if the co-ops and if Congress is smart enough to encourage that potential. We are going to be faced in the next several years, certainly by the time we rewrite the next farm bill, with lowering subsidies for agricultural production. The value added potential of passing on some of that profit to farmers rests with co-ops. If we are able to give co-ops, Mr. Chairman, the kind of advantages that they need to develop. With CoBank, I think we also need to guarantee a certain percentage. Maybe we guarantee 20 percent of the loans that go into the co-ops.

Capper-Volstead was designed to give farm co-ops, an advantage. That is now outmoded. We need to look at ways, it seems to me, to give co-ops a greater advantage. Tax advantages, free USDA services to help develop those co-ops, we are looking at a potential of helping farmers through value added, and that potential is only going to come with good management of co-ops. It is my experience that too often, the co-op boards have been pretty tight-fisted in terms of paying the kind of quality management that is going to make that co-op survive against a tremendous pressure from huge growing monopolistic type of private enterprise structures that have been moving in on co-ops. So I am interested to hear your comments, but also interested to hear the testimony of the other witnesses today that maybe can allude to this.

I think we need to go over—as we start reducing subsidy payments to farmers, one way to counter that is to make the kind of legislative changes that is going to give farm co-ops an advantage, and so, there is some concern that CoBank will take over the lending possibility, but I think we need to open up and change the laws for CoBank to be more helpful, but at the same time, the private financial institutions need to have the kind of support of some government guarantee for part of those loans going into CoBank, so I am just a strong advocate of pushing co-ops, because I think it has the potential of being our salvation as we look towards reducing subsidies in the next farm bill. Mr. Chairman, I just don't have a question, unless there is a response from the Secretary or Mr. Flory.

The CHAIRMAN. I thank the gentleman. The gentleman from North Carolina, Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman, and thank you for holding this hearing, and let me, Mr. Under Secretary Dorr, associate myself with my colleague, Mr. McIntyre, who has just spoke and lauded your agency and Mr. Cooper and others in North Carolina. And I think that is probably repeating in a lot of areas across the country, but I would add that as we look at rural America today, there is a reason why we have those subsidies for agriculture, because agriculture is hurting badly and rural communities are really having a difficult time, and that is why you see, across this country, more and more farmers moving off the farm.

North Carolina is a great example. We have had far more small farms than most States, and there is a reason for that, tobacco, a lot of other issues, well-diversified, but as a result of the changes in economics and the stress and pressures, we are seeing more and more farmers come under stress, pressure, moving off, that is having an impact not just on the farm operations themselves, but rural communities in general. So, let me thank you for the dollars that have flowed our way, and the dollars appropriated by this Congress, and I encourage my colleagues to remember that as rural America prospers, so does the whole country. We may have a very small percentage of our people engaged in agriculture, but I know in North Carolina, and it is true in most States, the largest industry in America is still agriculture, so there is a lot of people, it not only feeds our people, but feeds the people of the world, and we should not forget that as the numbers decrease, they have been very efficient, and we are going to have to continue to be very careful about the policies we structure, so that we don't do damage to an industry that has allowed us, I think, to gain a strong foothold and be a bulwark of democracy around the world, because we can still feed ourselves.

Thank you, Mr. Chairman, and I yield back. I don't have any questions, I just want to thank you.

The CHAIRMAN. I thank the gentleman. The gentleman from Iowa, Mr. King.

Mr. KING. Thank you, Mr. Chairman, and I would like to thank the panel for their testimony. The very future of our economy in the region I represent depends in a great deal, part on how well we put together a plan and a policy that is going to enhance the economic growth in our regions, and as I watch it change and shift over my adult lifetime, I just have to subscribe to the philosophy that we have a tremendous amount of new wealth that comes out of the land every year, and the key is how do we best arrange our business structures so that we can now build the most layers of capital as close to the cornstalk or bean stem or cotton plant, gentlemen, behind me, as possible.

With that in mind, and Mr. Dorr, you discussed to some limited degree the effect of technology on developing the value added industries, and I think one of the things that is missing from all of our minds is a very clear picture, or even a significantly vague picture, or what the future of agriculture can look like, and I know it will be different in different regions, and it will depend a lot upon the individual entrepreneurs and their ideas, but could you paint some kind of a picture on what a family farm operation might look like in, say, the year 2020 or 2030?

Mr. DORR. Well, I don't know that I am very good at painting pictures. I have tried it in the past, and sometimes, it creates problems for me. So, perhaps I had best leave painting to others, but I would attempt to answer what you are saying in this vein. First of all, the gentleman from North Carolina, in their reference to their State Director, Mr. Cooper, out there, is quite frankly, Mr. Cooper is representative of the CEOs that we have in rural development across this country. They are a very top notch group of people that are running an investment bank, and I think it is important to point out that Rural Development funds are actually being used for investment purposes. They are a very unique leverage device. We have $2.9 billion in budget authority. We will put out about $16 billion this year, mostly in loans and loan guarantees, not a lot of grants. This money is being leveraged into other business opportunities as well as into those in value added and production agriculture.

The unique part about all of this is one of the big components that we are investing in now is technology and developing a broadband technological infrastructure backbone in rural America that will enable us to compete. I think our understanding or our expectations of the technology footprint that is clearly being placed all across rural America is underestimated in its capacity to attract jobs, to attract investment opportunities, to attract people who are interested in investing in those areas.

And then, in conclusion to this comment, relative specifically to your question, as we reflect on where the new jobs are growing in this country, they are coming from small businesses. They are a result of small businesses having the ability to tap knowledge, to tap information that heretofore large corporations were the only ones capable of doing that. And in that vein, Mark Drabenstott, the Vice President of the Federal Reserve Bank of Chicago, clearly and deeply involved in rural development, points out that clusters of highly technical co-ops, small operators working together, can clearly be as capable and as competitive as anyone in the world if they want to be, and finally, one very brief example.

Over 2 months ago, I took a brief trip to northern Virginia, I stopped at a farm produce stand on the way back, it was run by a young lad who was 40, who had sold his dotcom company 2 years ago that he had operated for 15 years and lamented that the business was being competed out of the country to India, to Ireland and other places. I asked him, I said why is that? He said, well, we have got 3-hour commutes, we have $800,000 homes that are way too expensive, I can't compete. I said what happens if you go to a 15-minute commute, a $150,000 home and you can do it all in rural America and you don't have to deal with a legal, currency, or other trade issues sorts of situations and you can do it right here, and he said yeah, that is great.

I think that is the opportunity we have with technology, with small businesses, in maintaining vital, effective, rural-based businesses in this community and this country, whether they are predicated on agriculture or some other aspect of business in those rural areas.

Mr. KING. And then, the other trick question would be, we do have a lot of capital in the regions that I am familiar with as well, and as you described that capital, there is that sense that the safe investment of it is in the land and maybe other investments that—outside the region that doesn't get rolled back into agriculture and I talked about leveraging the land, but I think it is key also that this vision, this picture, for the future of agriculture be painted clearly so that we can attract that capital.

Do you have any further insight into the key on how we get that capital unlocked? How do we market that to the people that happen to hold it in their hands today?

Mr. DORR. I think as Congressman Stenholm said early on, it is a unique opportunity with a difficult question that is going to take a lot of cooperation. I don't think there is a right or wrong. I don't think we have clearly defined both the issues and the opportunities. We know it is there, but I think it has—there is a scope of potential opportunities and solutions that will take some time to work out.

Mr. KING. Thank you, Mr. Dorr. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The gentleman from North Carolina, Mr. Ballance.

Mr. BALLANCE. Mr. Chairman, I don't have any questions.

The CHAIRMAN. Not making much progress here. The gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS of Oklahoma. Thank you, Mr. Chairman, and first, I would like to offer an observation to the Secretary, and then discuss a few other concepts.

Now, Mr. Secretary, one of the key things, and I can't help but think about Mr. Smith of Michigan's comments about the challenges we face in the coming budget years, and the ranking member has always been very honest with us about the budgetary challenges we face, to implore you and the rest of the Department and your fellow Under Secretaries and Secretaries that as we work through each year's appropriations process, not only to diligently work to see that the rules are put into place, that these resources and what ever programs are authorized that you shepherd over are properly, fully and efficiently spent every time, because in the coming season, if we don't have the support of yourself and your colleagues in the Department to protect the resources that this committee was extremely successful in setting aside in the 2002 farm bill, we will be nickeled and dimed to death, and just as this committee found in 2002, there was a need for all of those rather impressive increases in a variety of programs funded, economic development or otherwise, through the farm bill.

So, it is a responsibility on our shoulders and yours too, Mr. Secretary, to use those resources, to fully use them and to defend ourselves from other committees within this body and other bodies within this institution as a Congress, so first, the free lecture from the mountain.

No. 2, I also have the privilege of serving on the Financial Services Committee, and that cuts to the chase, I think, in what we are talking about here. How do we make sure that the capital needs are adequately addressed in agriculture and in rural America. How do we make sure those resources, Mr. Flory, are there so that our fellow citizens can live up to their potential, whether it is traditional agriculture, traditional agricultural production or value added?

And over on the other side on that other committee, I have observed that the financial world is changing and changing rather rapidly. There seems to be a definite blurring of lines with the passage of financial modernization, Gramm-Leach-Bliley, and we in rural America and production agriculture can't ignore that either, but that takes me to my point here. With comments about Wyoming and Minnesota changing their laws, potentially altering the definition of co-ops, first to you, Secretary Dorr, is the Department monitoring these changes closely? Are you working diligently to make sure that whatever changes are implemented by the States will be reflected, or in the programs you administer, or should I say perhaps that the Department will be mindful of those changes occurring?

Mr. DORR. The Department is mindful of those changes. Whether or not we are monitoring them as thoroughly and effectively as we should be is what we are attempting to do in the study that we are—discussed earlier that we are embarking on.

Mr. LUCAS of Oklahoma. Because I can't think of anything more important than those precious taxpayer resources that you are shepherds of, that we work so diligently to help provide to you that are available to help, encourage that economic development, that they be spent in a way that, as I mentioned just a moment ago, makes it easier to go back to the well to show those accomplishments, but there again, the financial landscape is changing rather dramatically.

Mr. Flory, in your opinion, being involved in this process for some time, at what point as we adopt, or the States have adopted, or as some would advocate in Congress, that we adopt a changing definition of a co-op, at what point do you think it is not a co-op any more? And I am asking you for kind of a hypothetical answer, and that is not fair, but you are in front of a committee, I am afraid.

Mr. FLORY. And you are asking my personal opinion?

Mr. LUCAS of Oklahoma. Your personal opinion, yes.

Mr. FLORY. I think it all runs to whether or not farmers have control, and whether that is 50 or 51 percent, or some other percentage, is a debate that this committee and others will have to talk about, but I think in rural America, farmers must be in control in some fashion, and as we structure the new generation of, or whatever generation we want to call them, that we need to be mindful of that.

At the same time, I believe that we have got to do things that have been mentioned here today and other things that may be surfaced in order to bring equity capital into those co-ops and have tax laws and other structures so that both the investor and the farmer benefit.

Mr. LUCAS of Oklahoma. My time has expired, Mr. Chairman. I am sure we have several more panels and this is going to be one of many committee hearings on an exciting topic. Thank you.

The CHAIRMAN. I thank the gentleman, who is the chairman of the pertinent subcommittee with regard to this issue, and thank him for his work in this area. The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

My question is for you, Under Secretary Dorr. Co-ops are a strong source of economic well-being in our rural communities. In many cases, the FCS lenders such as AgSouth, which operates in my home State of Georgia, are one of the few sources, if not the only source, of funding for the much-needed new economic development initiatives undertaken by co-ops. Can you comment on ways the USDA can partner with co-ops to make the most of every opportunity for economic development in rural areas?

Mr. DORR. As you have already, are I am sure already aware, we have, within the Rural Development operation, a number of investments and loan and loan guarantee and grant programs. Probably, the most significant that have evolved in terms of working with co-ops and/or other small business development opportunities in these rural areas would, in terms of unique new things over the last few years, would be the value added development cooperative effort. That is one that is clearly focused on helping small producers and rural businesses or in farm and ranch groups to develop business plans and to provide them with some resources to analyze possible opportunities for adding value to their particular operations.

In addition to that, we have a number of other programs that have a little longer longevity. The Intermediary Relending Program is a program in which we put out funds to these rural areas at a very low interest rate, and sometimes a zero interest rate, that are relent by the RECs and others for purposes of building new business opportunities in the area. We have the Rural Business Opportunity grants and the Rural Business Enterprise grant programs. All of these are programs that are monitored in ways that we hope give us an insight in what not to do and what to continue doing in the future, relative to creating these economic opportunities.

I think I would also be remiss if I didn't point out that our top priority within Rural Development is to develop performance-based indicators to make sure that we do, as Congressman Lucas was alluding to earlier, marshal these resources in a highly effective and efficient manner, and we hope that through that development, we will have a better idea of what works and what doesn't work. And so, these are just a few of the programs, but we think they have a fairly broad effect in a lot of areas.

Mr. SCOTT. Thank you.

The CHAIRMAN. Has the gentleman completed his questioning?

Mr. SCOTT. Yes, I have, sir.

The CHAIRMAN. I thank the gentleman. The gentleman from Nebraska, Mr. Osborne.

Mr. OSBORNE. Thank you very much, Mr. Chairman, and I thank both of you for being here today. One of the most common complaints and concerns that I hear as I travel around rural America and particularly Nebraska, is the concerns of the bankers regarding some of the tax advantages given to farm credit, and my understanding is that FSA is the lender of last resort, but we hear a lot of complaints about red tape and how difficult it is to wade through the loan process. And it is my understanding that farm credit, because of the tax advantages, normally would be assumed to take a little more high risk loans, particularly those for young and beginning farmers, so recently, the bankers decided that instead of trying to remove the advantages that farm credit had, they would introduce legislation that would provide some of the same tax advantages for the bankers.

And when we had that scored, we found it was about $70 billion over 10 years, $7 billion a year, which leads me to believe that the tax advantage that farm credit enjoys is fairly substantial. I was just wondering what oversight you are providing or what you feel farm credit is doing to address some of the special needs people, particularly the young and beginning farmers, because the accusation, of course, always is that they are cherry-picking, that they are getting some of the soundest loans, because of their rates, and they are not really fulfilling their mission, and so in view of the fact that I get asked this question all the time, I would be interested in your response.

Mr. FLORY. You are addressing that to me, Congressman?

Mr. OSBORNE. I am addressing it to either one of you that would like to take a shot at it.

Mr. DORR. I think I could address it very quickly, in that the FSA farm operating loans and farm real estate loans are actually administered by the FSA and not Rural Development, so we don't have any direct involvement in that.

Mr. FLORY. I appreciate your statement, Congressman Osborne. To address the young and beginning farmer, we have a regulatory agenda that we are working on right now to look at how the system is providing funds and services to young and beginning farmers. That is an issue that we are interested in on a regulatory basis, and want to also mention that part of our stance, as I mentioned in my statement, is that the system furnish sound and adequate credit, that was the mission as it was originally set up. And you are correct that FSA is a lender of last resort, and the nice thing is that the system partners so many times to help rural American farmers and ranchers.

Mr. OSBORNE. Thank you. I might just also mention that as we look at young and beginning farmer loans, it is very feasible to have a young farmer who maybe is operating with his father and going to operate some land separately, who is in a pretty good financial position, as opposed to someone who is coming into the business, and is having to raise the capital to buy the land and do the whole thing. We would hope that there might be some separation of—when you begin to look at the data, when you begin to look at well, are you really serving young and beginning farmers, because it seems to me that some of those young and beginning farmers are given a leg up to begin with, and then some aren't. So we hope that as we look at this thing, that we do see the mission fulfilled of farm credit, because one of the biggest problems I see in rural America today is the lack of young farmers, and the fact that it is so capital-intensive that people simply can't get into the business unless they inherit the land from their parents, so bearing that in mind, I know you have a difficult job, but I just wanted to pass on my concerns and some of the things I was hearing.

I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from California, Mr. Dooley.

Mr. DOOLEY. Thank you, Mr. Chairman, and thank you both for attending. Secretary Dorr, there has been a lot of interest in terms of modifying some of the tax laws, that actually work counter to the ability of co-ops to expand the scope of their business to get involved in some value added enterprises. One of the specific tax issues is the dividend allocation rule, also commonly known as the triple tax problem that co-ops face, where they have income that is generated from non-patronage enterprises or commodities is subject, really, to the corporate tax rate. If it is allocated as dividends, it is subject to another tax there, and then it is subject to a personal income tax. I am just—there has been legislation introduced in the Senate by Bacus and Grassley and also in the House side by Herger.

Has the administration taken a position on this legislation, which has been scored only at a cost of $14 million?

Mr. DORR. To the best of my knowledge, I am not aware of a position on it at this point, but I would be delighted to check and get back to the committee with that.

Mr. DOOLEY. Well, I would encourage, the administration, and particularly USDA, I mean, when we have a bill that has been only scored at $14 million which works, which is so, I think, instrumental to the ability of co-ops to be organized, to really capture additional markets in value added, and you talked about the LLC issues and how some co-ops are doing that, if the administration would put their weight behind this and really ask the chairman of the Finance Committee as well as Chairman Thomas at Ways and Means to include this $14 million item on any tax vehicle that moves through the end of the session, I think we would be doing a great service to the cooperatives throughout this country, and I really would appreciate hearing whether or not that is something that you folks could do in the next couple weeks before we adjourn.

Mr. DORR. Yes, I am aware of the dividend allocation rule, and I will follow up on that for you.

Mr. DOOLEY. Thank you. And the other thing, and this is just a general comment, is we talk about rural development, we talk about value added, but when we, and it is something that we are guilty of in Congress, or a lot of our colleagues is well, this administration, I would see, and even past administrations, is that when we present budgets for USDA, they really don't reflect a true commitment to supporting this agenda as being a priority. And I would just point out our last farm bill, where we beefed up spending by, I can't remember now, but $10 billion, but we are allocating $19 billion out, 70 percent of that is going to the basic commodities in terms of payments that represent only 20 percent of gross agriculture receipts in this country, and yet we are spending very little in terms of making investments in the programs that you are talking about that actually can provide for a long-term, sustained income stream that can benefit rural America. There really is a vacuum here that has not been filled by this administration or previous administrations, to really back this up as a priority. And we had Mr. Osborne's comments about the difficulty of farmers getting involved in the business, but part of the reason of that is that so much of this $19 billion we are putting out is being capitalized into land values, which is creating a barrier to entry, and if we would just—we don't need a whole lot of that money that we are putting out in direct payments, but I am willing to work with anyone that would be willing to invest some political capital to say that we need to take a small portion of that money and allocate it into programs that capture or provide value added opportunities that can benefit even a larger sector of agriculture, and I think there is a real need for us to really try to shift this debate a little bit, and really develop a vision for agriculture in this country that is looking forward and is not relying on the past and the historical allocation of funding.

Mr. DORR. I concur, and the thing that I would like to make this point, that this administration has regularly, relative to the Rural Development programs, addressed the fact that we are leveraging a very small number of resources into nearly $16 billion worth of programs that directly impact all of the what we term roughly 65 million rural Americans out there, and we are doing that in the context of not necessarily viewing ourselves as lenders of last resort, but those who provide and facilitate the entrepreneurs and the business developers in rural America the opportunity to grow, to create job opportunities and quite frankly, we are very focused on that, and I appreciate your concurrence in that.

The CHAIRMAN. I thank the gentleman. The gentleman from South Dakota, Mr. Janklow.

Mr. JANKLOW. Thank you very much, Mr. Chairman. Let me start off by painting a picture of the world that I live in, and I don't say this in a derogatory way at all.

Sixty, 70 years ago, we had 6 million farms. Today, we have 2 million or less. By Federal law, a farmer is someone who has $1,000 a year or more of sales of food or fiber, so that includes a lot of people that aren't what we call traditional farmers. The State of North Dakota, or my State, South Dakota had 70,000 farmers. Today, they both have less than 30,000. I live in a State that is made up of 88 million acres, has 310 towns and cities, and the 15th largest has less than 5,000 people. The fate of agriculture is the fate of rural America.

Both political parties, the Republicans and the Democrats, mine and the other one, for decades have funded tens if not hundreds of billions of dollars into programs in rural America, and yet we come here today facing a situation where because of the economics in rural America in most all States with large rural populations, they are having trouble funding schools, they are having trouble dealing with their highways and byways and bridges, they are having trouble dealing with their medical services for their people, they are having trouble dealing with the economics of the situation, and we all talk about how are we going to get people to move or stay in rural America. The reality is we are not going to, and we need to face up and be honest with it.

Our problem isn't a co-op problem. It is not the legal structure of the business entities. Agriculture America, by and large, deals with commodities, and the vast amount of success in co-ops, and I am aware of things like U.S. Premium Beef, but we all point to that because it is such a unique thing in terms of being successful, given what a lot of other attempts that have been made.

Both administrations have been terribly guilty of politically allocating money, and not administrations, but parties, I should say, in allocating money politically as opposed to fiscally sensibly when it comes to investing in rural America and in specific areas. And when you give out money politically, you are always going to have those kinds of problems. When you are dealing with public money, it will always be allocated on some type of political basis.

But given the fact that we are dealing with commodities, and given the fact that the major companies, and I don't say this in a critical way, the Cargills, the Tysons, the Bungees, the Pillsburys, the ConAgras are all entrenched and have their marketing chains, have their business expertise. For you and I to start a co-op tomorrow with a group of others, you need management, you need labor, you need capital. We would have a difficult time bringing the skilled management to the table that we need that has got an institutional memory. In putting this together, were we to try to put something together like rural people do, the Cargills of this world have, you start out and you work your way up into those companies, and so my real question is, is there, putting aside the rhetoric that I use, is there a real future for rural America in the general sense? Or are we really dealing with the reality that we will face a continuing decline as we struggle to find a way to help certain specific areas, not unlike we are doing with foreign countries. Do you understand what I am saying, Mr. Dorr? And I am not picking on you. I think you are a terribly bright guy, and I think you folks and this administration, the last one, everybody struggles to help rural America, but it keeps going downhill.

Mr. DORR. You have clearly identified the scope of the issue, and I think perhaps the simplest way to reflect on it, there are regions of rural America that are going to do very, very well. Commodity production agriculture is a very difficult business, and how we sort through that and how we deal with it will tax all of us. I don't know that any of us have the magic bullet. I reflect on places like your State, there are regions within your State that are delightful, that are growing. They are very successful. They are not necessarily always tied to production agriculture. In Rural Development, we are focusing on those opportunities and to the extent that we are involved in value added initiatives and we see opportunities, we try to enhance those whenever possible. Thank you.

Mr. JANKLOW. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from California, Mr. Pombo.

Mr. POMBO. Thank you, Mr. Chairman. Mr. Dorr, on September 29, you signed a directive, No. 3894, that establishes a methodology for implementation of the 2000 Census for income information for grant program eligibility purposes. Under this directive, grant eligibility is based on the applicant being below the statewide non-metropolitan median household income for the State. Because only 3 percent of Californians live in non-metropolitan areas, this directive will have a severe negative impact on California's rural communities, access to fund eligibility for grant programs. As an example, the city of Byron, which is in my district, has a median household income of $35,938. Because their income exceeds the $35,680 non-metropolitan median household income in California, they are not eligible under this directive. My questions are, will there be exceptions for cities like Byron, which is in need of Federal assistance? I mean they are, I guess, $200, 200 and some dollars over your income level.

Mr. DORR. Well, my limited experience in Washington and USDA relative to these sorts of definitions, there are always cutoff points, whether they are population-defined or income-defined issues, and once the regulations are in place that guide these programs, that is what we have to operate by, sometimes there are exceptions that are made, but those are usually outside of our purview, and when they are made, we accommodate them accordingly.

Mr. POMBO. I notice that New Jersey is exempted from this cutoff point. I suppose the whole State is exempted. Is it possible for California to be exempted as well?

Mr. DORR. That is a more technical and detailed request than I am capable of answering at this point. We would be delighted to try to get some information and get back to you on that.

Mr. POMBO. Well, I would appreciate it and, in fact, I will submit to you a number of questions in writing that, if you could answer them for me. It appears that under this formula, a number of States that are heavily populated but still do have rural communities are negatively impacted by this formula that you have come up with here, that the Department has come up with, and the impact on districts like mine and Mr. Dooley's and others in California, even though the coastal areas of our State are heavily populated, most of the rest of our State is very rural, and the impact that that has on our State impacts all of our communities, so I would appreciate it if you could give me an answer, and I would really like to work with you on that, because it does have an impact on districts like mine.

Mr. DORR. I appreciate your concerns and we will definitely take a look at that.

Mr. POMBO. Well, thank you very much, Mr. Chairman, and I yield back.

The CHAIRMAN. I thank the gentleman. I understand the gentleman from Kansas does not have any questions, I think.

Mr. MORAN. I do not, Mr. Chairman.

The CHAIRMAN. Well, thank you very much, and we will thank our two witnesses for spending an hour and a half with us to go into this subject in considerable depth. It is one that we are going to spend a lot more time on, and we have a lot to understand in terms of what needs to be done to make investment of capital in agriculture in rural parts of our country more attractive, so I thank you again for your contribution and we will, at this time, dismiss you and go to the next panel. I thank you again very much.

Mr. DORR. Thank you, Mr. Chairman, thank you to the committee.

The CHAIRMAN. Thank you, Mr. Dorr. The next panel to the table. Mr. John Smith, chairman of the board of Southern State Cooperative of Rosedale, VA; Mr. Douglas Sims, chief executive officer of CoBank of Denver, CO; Mr. Steven Hunt, chief executive officer of U.S. Premium Beef, Ltd., of Kansas City, MO; Dr. David Graves, president and chief executive officer of the National Council of Farmer Cooperatives of Washington, DC; and Mr. Keith Kisling, who is a farmer from Burlington, OK.

Gentlemen, we welcome all of you to the table. We remind you that your complete statements will be made a part of the record and ask that you limit your testimony to 5 minutes, and Mr. Smith, we will begin with you.

STATEMENT OF JOHN HENRY SMITH, CHAIRMAN OF THE BOARD, SOUTHERN STATES COOPERATIVE OF ROSEDALE, VA

Mr. SMITH. Thank you. Chairman Goodlatte, Congressman Stenholm, other members of the committee and guests, my sincere thanks for the opportunity to testify today on a subject important to me and my fellow producer-members of Southern States Cooperative, as well as members of other farmer cooperatives throughout the nation.

My name is John Henry Smith, and I am a cattleman and tobacco producer from Russell County in southwest Virginia. Since you have my written statement, I will briefly summarize my main points in the interests of time. I have been a member of Southern States Cooperative since 1958, and use many of its products and services in my farming operation. Since 1991, I have had the honor of serving on the Southern States Board of Directors, and I was recently reelected by the producer delegates on the Board to a fifth 3-year term, and I have served as chairman of the board the past 3 years.

Our cooperative serves more than 300,000 farmer-members and other customers from Maryland to Florida. It includes some 237 farm supply store locations owned and managed by Southern States and some three dozen other facilities, such as feed mills, distribution centers, fertilizer facilities, et cetera. In total, these operations provide more than 3,200 full-time jobs and more than 600 seasonal and part-time jobs, with most located in rural communities.

Being farmer-owned, Southern States is focused on providing its farmer-members with a dependable supply of farm inputs and other services that will help contribute to their economic well-being and success.

One of the other ways we are trying to help farmers is through the Southern States Cooperative Foundation. We have worked with more than a dozen producer groups in developing new cooperatives in a variety of value added enterprises. Mr. Chairman, we have been able to do a great deal through USDA's Rural Cooperative Development Grant Program, and we certainly support continued funding for it.

The past 12- to 18-month period has been one of considerable challenge for Southern States. Due to a combination of drought and other adverse weather conditions, a difficult farm economy and some diversification and growth steps that did not generate the returns that Southern States had expected, our cooperative has been confronted with major financial challenges. I am happy to report that steps this cooperative has taken during the past year have gotten us back on what I believe is the right track.

The point in all this is to note the reactions of our members during difficult times. More times than I can count, this member-producers have told us how much they need Southern States and how much the well-being of their farming operation depends on Southern States.

It has been 81 years since the Capper-Volstead Act was enacted by the U.S. Congress and much has changed during those eight decades, but as the comments from my Southern States producer colleagues attest, farmers today still need and rely on their cooperatives as much as they ever did, all of which explains why we were pleased to see the formation of the Congressional Farmer Cooperative Caucus.

We appreciate the leadership of Congressmen Graves and Pomeroy in serving as House co-Chairs of this group. There is no doubt in my mind the 2002 farm bill, along with disaster assistance and other steps Congress has taken to boost farm income have played a key role in improving the farm economy that has also helped farmer cooperatives. We sincerely appreciate that.

As noted earlier, today's marketplace and the challenges it poses to farmers are different in many respects from what prevailed when Capper-Volstead went into effect, but they are no less daunting. Not only does today's U.S. farmer produce for a national marketplace, he must also compete with producers around the globe. I personally do not know of any farmer who is large enough to tackle any of these and other similar challenges on his own. Today's farmers still need a reliable place to turn, and co-ops provide that.

What are the actions Congress can and should take to improve the ability of co-ops to serve their producer members? While there are many possible actions, I limit my recommendations to those applying to farm supply and service cooperatives, because that is the area I am most familiar with from my involvement with Southern States.

First, Southern States believes the existing programs and tools within the U.S. Department of Agriculture can be strengthened. Among other things, we strongly support the establishment of a separate farmer cooperative agency within the USDA. Having a separate farmer cooperative agency would provide for greater accountability and promote greater support for farmers and their cooperatives.

Second, we urge Congress to approve legislation, House Resolution 1671 as introduced by Congressmen Herger, Graves and Pomeroy, to clarify what is known as the dividend allocation rule. This would be an important step in helping farmer cooperatives attract equity capital.

Third, to make sure that farmer cooperatives have continued access to a competitive source of credit, we support updating the Federal Farm Credit Act, especially in view of changing State laws. Updating the law would allow farmers to continue to have choices when it comes to organizing and financing their cooperative businesses.

My fourth point probably is a sub-point of my first comments about strengthening existing tools within USDA. However, it's an issue important enough to us that we wanted to make note of it separately. New provisions in the Business and Industry Guaranteed Loan Program in the 2002 farm bill provided loan guarantees up to 90 percent on the maximums of loans to cooperatives of up to $40 million. However, having Federal guarantees behind loans of up to $100 million, as originally proposed by this committee in the 2002 farm bill would come much closer to meeting the needs of today's larger, capital-intensive co-ops.

Fifty years ago, Southern States observed its 30th anniversary by producing a movie entitled "We". The main point of that movie was that cooperatives are farmers themselves working together to accomplish what none of them could do by themselves. In short, a more appropriate way to view our organizations is with an equal sign between the words we, farmers and cooperatives. That was true in 1923 when Southern States was founded and it remains true today.

Mr. Chairman, in closing, let me reinforce the invitation in my written statement to this committee and its staff to visit any of our nearby operations that would be helpful.

Thank you again for the opportunity to share these thoughts.

[The prepared statement of Mr. Smith appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Smith, and now, the committee turns to Mr. Sims, chief executive officer of CoBank in Denver, Colorado.

STATEMENT OF DOUGLAS D. SIMS, CHIEF EXECUTIVE OFFICER, COBANK, DENVER, CO

Mr. SIMS. Thank you, Mr. Chairman, and thank you to this committee for holding this hearing. My name is Doug Sims. I am the chief executive officer of CoBank, a major lender to agricultural cooperatives. I appreciate the opportunity to present testimony on business structures being used by new generation cooperatives and associations of producers. I am going to summarize my comments and ask that my complete testimony and supporting materials be included in the record, and we thank you.

CoBank provides financial services to about 2,600 customers throughout the United States. These customers are also CoBank's member-owners and include farmer-owned cooperatives, rural telecommunication companies and rural electric cooperatives.

We also provide financing to support the export of agricultural products. Farmer-owned cooperatives have and continue to play a vital role to support the American farmer, as you have heard here today. We estimate that CoBank provides about 80 percent of all credit extended to farmer-owned cooperatives.

My comments today will focus on finance-related matters, but CoBank, as a member of the National Council of Farmer Cooperatives, strongly supports the recommendations of NCFC pertaining to cooperative issues. The mission of serving the financial needs of farmer-owned cooperatives was assigned to us by this committee and Congress as set forth in the Farm Credit Act of 1971, as amended. I am here today because outdated provisions of that Act will increasingly make it difficult for CoBank to serve new generation farmer-owned cooperatives and associations.

As we view the farmer cooperative marketplace today and our role as a cooperative lender, I would just summarize a few key points. One, farmers and their cooperatives are changing, and as the marketplace and competition changes, many are aggressively seeking ways to enhance returns to farmers and address new challenges and opportunities.

Two, increasingly, farmer-owned cooperatives are seeking new approaches to return more income to their farmer-members through value added enterprises. Farmers often do not have the financial capacity to provide all of the equity capital required for many value added enterprises.

Third, to adjust to the marketplace, cooperatives are adopting new business models which allow more flexibility in raising equity capital from non-producer sources, minimizing tax liabilities and providing more operational flexibility for the cooperative. These new structures will often make the cooperative ineligible for CoBank financing.

Number four, as cooperatives and associations adjust to better serve their farmers, CoBank should be able to serve these farmer businesses. State laws are changing as you have heard today to reflect the needs of cooperatives in today's economic environment, and Federal laws will need to be modernized. Under the current situation, a farmer cooperative could be organized under the Minnesota cooperative law, have farmer control of the Board, and not be eligible for financing from CoBank, the bank that you have established and Congress has approved to serve farmer cooperatives.

Without action by Congress to update the cooperative eligibility provisions in the Farm Credit Act, CoBank will be unable to fulfill our congressional mandated mission of providing credit to associations of producers operating on a cooperative basis.

The competitive needs of farmer-owned cooperatives are placing them in a difficult position. By choosing the most advantageous business structure, the cooperative may be forced to forego access to the lender created specifically by Congress to meet the needs of farmer-owned cooperatives.

CoBank is recommending that Congress amend current law to ensure that these new generation cooperatives do not jeopardize their ability to borrow from CoBank. Key components of our recommendation would be to one, authorize associations that have both a producer and investor class of membership to be eligible for CoBank financing, provided that the producer class holds at least 50 percent of the voting control, and operates on a cooperative basis.

Second, permit agriculture cooperatives organized consistent with revised State laws to be eligible for CoBank Financing, and third, allow cooperatives that are existing CoBank customers, but which choose to restructure in a manner that would make them ineligible for CoBank financing to remain eligible for a five year transition period while they establish new lending relationships.

In closing, there are few lending institutions in today's financial environment with the necessary scale and expertise in capital and, most importantly, the desire to lead lending efforts to farmer-owned cooperatives. In many of the loans we make, there are only a few other lenders competing. Unless Congress adjusts the Farm Credit Act to reflect the new structure of cooperatives, many farmer-controlled businesses will lose access to the only consistent competitor for their financing needs.

Nothing in these recommendations expands our scope of lending to new areas. These changes simply allow us to continue to serve the same type of farmer-controlled businesses that we have served for the past 70 years, and these businesses are increasingly more complex and need increased flexibility.

Mr. Chairman, thank you for holding this important hearing. I appreciate the opportunity to provide this testimony today and would be pleased to respond to any questions. Thank you.

[The prepared statement of Mr. Sims appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Sims. Mr. Hunt, welcome.

STATEMENT OF STEVEN D. HUNT, CHIEF EXECUTIVE OFFICER, U.S. PREMIUM BEEF, LTD., KANSAS CITY, MO

Mr. HUNT. Thank you. Mr. Chairman and members of the committee, I appreciate this tremendous opportunity to appear before you today and discuss the challenges facing producer-owned ventures formed as cooperatives. I have provided written testimony. I encourage you to review that and like for it to be included in the record. Many of the statements that I have to make today have already been made and made very adequately, including Congressman Stenholm. I don't think I could say it better than he did already, discussing and outlining some of the challenges that are facing producers in these types of structures, so I will keep my comments brief.

My name is Steve Hunt. I am the CEO of U.S. Premium Beef. I am also a fifth generation cattle producer. While no longer involved actively in production agriculture, my family is, and certainly, my producer-owners. U.S. Premium Beef is, I guess, called many times the first large scale beef marketing cooperative owned entirely by producers. We have enjoyed a tremendous amount of success. We are formed of, I think, one would identify as a new generation cooperative or a closed cooperative. I think there is a number of terms out there or definitions that you would have that would address the type of structure we are, but we do face some challenges today.

I want to briefly talk about the success we have, and just so that you understand that there are opportunities out there today for producers. There are success stories, and I think at this point in time, we would consider ours one of those.

We started out with close to 300 producers when we began U.S. Premium Beef, and went out to raise capital and combine that capital with bank debt and cattle production to go out and address the needs of cattle producers, and eventually get us to the point where we are selling meat and meals instead of cattle.

Since we began, our membership has increased to over 1,800 members in 34 States. We have marketed more than 3.7 million cattle through U.S. Premium Beef since we began in 1997. We have paid out over $64 million in cash premiums over the stated market to our producer-owners. Additionally, we have earned over $80 million in profits to our producer-owners. Our share value has increased from $55 at the original offering to $150 today on the market. Again, I think that you can look to U.S. Premium Beef as a model of what producers can do by effectively cooperating and entering into these value added products and markets.

Another event that occurred just recently you may be aware of, we did enter into processing through a joint venture with Farmland Industries. Due to their difficulties, we bought out their interest in our beef partnership this past August, and so U.S. Premium Beef is majority owner of National Beef Processing, the fourth largest beef processor in the United States.

In many ways, we are the victim of our success. We have many challenges and most of those have been outlined today, but just to recap, the two primary challenges we have today as we grow to compete in a very competitive marketplace. We are not in a niche business. We are competing with the giants in the food industry today, as producers, but the challenges we have is attracting outside equity in the cooperative structure. The rules governing cooperatives restrict our ability to go outside of our already cash-strapped producers to raise equity.

No. 2, and it was alluded to earlier, we are restricted from entering into business ventures that are not directly related to patron business, that is, in our case, we have entered into a food safety initiative. We plan to commercialize and license that to our competitors. That is not deemed a producer-driven patron business, and therefore, under the cooperative rules, we are restricted from doing this. Under LLC rules or Wyoming co-op rules and other ventures or other structures, you are able to do this, and so today, we face a challenge of what do we do as U.S. Premium Beef to compete and continue to grow? Do we go forward and try to pursue changes in the cooperative rules, or do we convert to other structures like LLCs?

If we are to convert to other structure, there are barriers. One, again, we are a victim of our success. We have succeeded. We have done well, and if we convert, we have a tax on our gain. That tax on the gain would already strap or exacerbate an already difficult situation for a company that is continuing to grow.

One of the other challenges we have is that we could no longer borrow from our lender CoBank. Now, we don't just borrow from CoBank. We borrow from a host of banks as a consortium that have loaned money to U.S. Premium Beef and National Beef, enable us to succeed, but CoBank was the one that stepped up on day one and loaned U.S. Premium Beef the $35 million to get started, and so it is important for this committee to also understand the role that this bank and all banks can play in ventures that succeed.

I am a firm believer, as was stated earlier in one of the other testimonies, that if you really have a good venture, it should be supported by lenders, okay. It starts with the economics. We are not in the business of economic development, we are in a business of developing return for our investors, and so again, we have to be driven by the economics.

Getting to the solutions, today, I would suggest and recommend that we aggressively pursue either changes to the rules governing cooperatives or that we relax the rules on converting to other entities, and that would mean a conversion transaction would not be treated as a sale or an exchange of property, that there would not be a tax on the gain to the member, or the cooperative, if it chooses to convert, under this condition, that this entity remains controlled and owned by producers. If it is controlled and owned by producers, then we should allow it to convert to these other entities and allow the freedom of operation.

Those are my comments today. I look forward to questions that would come up later. I very much appreciate this opportunity to present my solution to the challenges facing us today. Thank you.

[The prepared statement of Mr. Hunt appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Hunt. Dr. Graves, welcome.

STATEMENT OF DAVID R. GRAVES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, DC

Mr. GRAVES. Thank you, Mr. Chairman. My name is David Graves, and I am president of the National Council of Farmer Cooperatives. On behalf of NCFC and America's farmer cooperatives, I want to commend you and Congressman Stenholm for your leadership in holding this hearing on the state of farmers working together for their mutual benefit. We also want to commend Congressmen Sam Graves and Earl Pomeroy for their leadership as House co-Chairs of the Congressional Farmer Cooperative Caucus, and to express appreciation to all members of the Caucus for their interest and participation in this important farmer forum.

The need for public policy to enhance the ability of farmers to join together successfully in cooperative efforts to improve their ability to earn income from the marketplace is more critical today than when Congress passed the Capper-Volstead Act and other measures in the 1920's to encourage and promote such efforts.

In fact, some argue that farmers have even less relative market power today than at that time. The chart attached to my testimony helps illustrate the challenge facing farmers today as they seek to improve their overall income from the marketplace. It shows how the farmer's share of the consumer food dollars has continued to decline, where it is now a record low of just 15 percent. At the same time, the farmer's share of net cash income derived from government support programs has continued to reflect a rising trend.

There are many reasons for both of these trends. Further, it is highly likely that the current trends will continue without a change in policy to reflect modern national and international market conditions. The critical question is what can be done to help farmers be more successful in capturing a greater share of their income from the marketplace.

It is within this environment that public policy aimed at helping farmers join together in cooperative self-help efforts need to be re-examined and strengthened. To begin this process, we believe Congress and the administration should focus on the following three major objectives.

The first objective that we recommend is that USDA programs to help farmers help themselves through cooperative efforts should be revitalized and given highest priority. Regarding this point, I want to highlight three specific recommendations.

The first recommendation, a separate agency should be established within USDA whose primary mission would be to carry out programs including research and technical assistance to encourage and promote these cooperative self-help efforts. Such an agency existed, as others have pointed out here today, especially Congressman Stenholm, prior to 1994. Congress and the administration recently combined, as Congressman Stenholm pointed out earlier, to establish the position of Assistant Secretary of Commerce for Manufacturing to give greater priority to the challenges facing the manufacturing sector.

We at the National Council of Farmer Cooperatives believe challenges facing farmers and their cooperatively owned businesses are critical and should be given a similar priority and standing.

The second specific recommendation, USDA research and technical assistance programs to assist farmers and their cooperatives should be specifically authorized and fully funded. These are now funded through USDA salaries and expense budgets as part of the annual appropriation process resulting in considerable uncertainty and planning and of course, then, lack of accountability.

The USDA, third point, the USDA's Value Added Grant Program, which provides matching grants to farmers through cooperative efforts to capitalize on new value added opportunities, should continue to be funded at not less than the $40 million level as contained in the 2002 farm bill.

The third major recommendation is the Farm Credit Act should be modernized to ensure that farmers continue to have access to a competitive source of credit capital for their cooperatively owned businesses. I know you have heard this recommendation already, but it is important for the committee to understand where this national trade organization that serves farmer cooperatives across the Nation stand on this point.

We believe that in addition to the changes that have already been made in the States of Minnesota and Wyoming, there will be other States to follow. In fact, we are aware that the National Commission on Uniform State Laws now has a project underway to determine whether to recommend adoption of a similar statute by all States as a uniform law.

Mr. Chairman, in addition to our statement, I have a letter that I want included in the record that contains over 125 names of national, regional and state agricultural groups that also support this recommendation. Our last and final recommendation, and this has been alluded to already today, generally in the discussion, that current tax policy should be modified to provide farmer cooperatives with improved access to equity capital needed to modernize and expand, meet costly government regulations, especially as we have seen recently in the petroleum industry and take advantage of new market opportunities for the benefit of their farmer-members.

While we recognize this committee does not have jurisdiction over such issues, we would like to take this opportunity to urge your support of these initiatives.

Mr. Chairman, strengthening the ability of farmers to join together in cooperative efforts is critical to any long term strategy to help farmers improve their ability to earn income from the marketplace, better manage their risks, capitalize on potential value added market opportunities and compete more effectively in a rapidly changing domestic and international marketplace.

Thank you again, Mr. Chairman, for the opportunity to appear here today. I look forward to answering any questions.

[The prepared statement of Mr. Graves appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Dr. Graves. We have three votes pending on the floor, which are going to take us away for probably about 30 minutes, so the committee will stand in recess. When we come back, Mr. Kisling, we will start with your testimony, and then we will move to the questions. I thank you for all for your forbearance. The committee will stand in recess.

[Recess.]

The CHAIRMAN. The committee will be in order. Mr. Kisling, welcome. Pleased to have your testimony.

STATEMENT OF KEITH KISLING, FARMER, BURLINGTON, OK

Mr. KISLING. Thank you, Mr. Chairman, and members of the committee. I sincerely appreciate the opportunity to be here today. The topic of this hearing is very important to the future of agriculture and to farmers and ranchers like me who are looking for ways to get more of our income from the marketplace, to take advantage of new value added business opportunities and to help create wealth in our rural communities.

For these reasons, I want to commend you for your leadership in holding this hearing. I also want to commend Congressmen Sam Graves and Earl Pomeroy for their leadership as House co-Chairs of the new Congressional Farmer Cooperative Caucus.

My name is Keith Kisling and I am a third generation farmer from Burlington in the Third Congressional District of Oklahoma proudly represented by the Honorable Frank Lucas.

I currently serve as secretary-treasurer of the Oklahoma Wheat Commission, and I am the vice chairman of U.S. Wheat Associations. U.S. Wheat is an organization funded by the Wheat Checkoff Program, whose purpose is to market our wheat products both here and abroad and research new ways for farmers to do business. We greatly appreciate your support of agricultural research through our land, because without that financial support, our industry would suffer immensely.

My farm is typical of most in my part of the country, with a majority of our revenue deri,ved from wheat, stocker cattle, alfalfa, winter wheat pasture and a 1500 head feedlot. For all of my career as a farmer, I have enjoyed incredible benefits as a member of our local Burlington Co-op Association where I served as director for 12 years, and as a member of four other agricultural cooperatives in Oklahoma and Kansas. I have always viewed the cooperative system as a vital instrument in producing and marketing agricultural commodities, but in the past four years, I have seen firsthand that cooperatives can be much more.

In 1996, a group of producers in our part of Oklahoma started looking at options on how we would add value to the high quality wheat product we were selling. This thought process hatched what is known today as Value Added Products, a new generation cooperative in Alva, Oklahoma that takes our wheat production and transforms it into frozen pizza crusts that are sold throughout the Midwest. We take 642,000 bushels of wheat and yield $20 million worth of pizza crusts per year, making us the largest single preproofed and frozen dough plant in the United States after only 4 years in operation.

But getting from the idea stage to the production stage was no easy task, and this is where your help is vital for this type of value added venture to work throughout rural America. Of course, our biggest challenge was collecting upfront capital in order to convince our lenders to buy into the deal. We held 40 meetings with a goal of raising $10 million to use against our $18 million total project cost.

One tool made this possible. In Oklahoma, we have a 30 percent State tax credit that can be utilized over 7 years when you invest in a value added venture. This tax credit was the only reason we were able to bring 850 producers in as investors, and it is a model we would like to ask you to consider. I was asked constantly in those 40 meetings we held if there was a similar Federal tax credit, and my response had to be no. A yes answer would be much more helpful in the future.

After raising the necessary equity capital, we were able to obtain the financing we needed with the help of USDA's Guaranteed Loan Program. We also obtained a grant under USDA's Value Added Grant Program, which provides funds on a matching basis to assist startup value added ventures and provide working capital for existing businesses in order to market their products better. Two years ago, value added products received an existing business grant, which allowed us to expand into new products.

We are now selling the world pizza crusts instead of a railroad car full of wheat. More jobs are available for our young people, and more sales tax revenue is going into our community to provide basic infrastructure and technology.

The 2002 farm bill, with the inclusion of Rural Development and Energy titles, sent a message to rural America that farm policy and rural policy are not necessarily the same thing. Granted, farming is the backbone of the rural economy, but for a body to function properly, it must also have arms and legs, which include our rural infrastructure and rural employers. We cannot survive without the full package.

If we are going to survive as an industry, we have to find new and better ways to capture more of the value of what we produce after our commodities and products leave the farm.

Farmer cooperatives, including new generation co-ops such as the value added products, can play an important role, but we also need programs in place that help encourage and promote such efforts.

Attracting equity capital is a critical challenge. Again, Federal tax incentives similar to our Oklahoma tax credit would help encourage investment in cooperatives. Value added grant programs should continue to be funded at no less than $40 million as provided in the 2002 farm bill. In fact, I believe the program should be expanded in dollars and eligibility to help make more rural business and producers bring more value added projects to the table.

As a food producer from America's breadbasket, I again thank you for the opportunity to testify. Your willingness to listen is what will ensure a strong tomorrow for American agriculture. It has been a real honor for a dirt farmer from Oklahoma to be here today to testify here to the House Agriculture Committee, and I would definitely encourage any questions that you might have for me at this time.

[The prepared statement of Mr. Kisling appears at the conclusion of the hearing.]

The CHAIRMAN. Well, thank you very much. I have got some questions for all of you. Let me start with the question about the climate which we are operating, with concern about corporate governance and disclosure of business and accounting practices. What are the risks for the Congress in undertaking to exempt from the securities laws any new, relatively undefined entities? Anybody want to jump in on that?

Mr. SIMS. Mr. Chairman, I will jump in and tackle that, because CoBank has 10 stockholder meetings across the country a year, and it is interesting you raised it, because the center focus of part of our stockholder meetings this year with our customers was to talk about the importance of all cooperatives embracing the spirit and intent of this new era in transparency and governance, that while cooperatives may not be required under Sarbanes-Oxley or SEC to do this, we have recommended to all our customers that they enhance their transparency and think about the corporate governance issues such as financial experts, outside advice, the audit committee, and I think you are seeing and we see cooperatives embracing this as a best practice, not because it is something that they have to do.

The CHAIRMAN. All this is a rather complicated area of tax and corporation law, which this committee doesn't usually delve into. However, let me see how you would respond to this general question, which is directed to any of you. If you change the structure of your cooperative so that it conforms to the Minnesota statute, won't the co-op lose its protections under Capper-Volstead, and is there any risk that a single non-producer investor could put the producer-members at risk for civil and possibly criminal liabilities? We will start with you, Mr. Smith.

Mr. SMITH. Well, Mr. Chairman, I come from a pretty different background than the new generation co-ops and Southern States, the traditional one. I would say any time you deal with someone who has the possibility of these outside partners being unethical, you would certainly be at risk and your board in anything you did, but some things in life can't be legislated. You just have to move forward on faith that you are going to deal with good, honest people and do the best job you can, and some of that may be in this situation. My colleagues may have a better answer to that than I.

The CHAIRMAN. Mr. Sims.

Mr. SIMS. Well, we have seen instances where an individual producer wanted to dominate a particular cooperative, and that group of producers resisted that, and I think what you see, and at least what we see, these outside investments aren't always by one party. They are multiple parties, and I think the issue here is that we have producer associations that are controlled by farmers doing business on a cooperative basis with the maximum flexibility for those farmers that control that business to decide who they want to bring in or don't want to bring in. In the earlier discussion, I think it was Congressman Peterson talked about a cooperative that had sold to a proprietary business, and I would just say in order for that to happen, that group of farmers had to make that decision that that was in the best interests of farmers, and I agree with Mr. Smith. My experience of 35 years working with farmers and their cooperatives, when the facts are there, transparency that you talked about and the facts are laid on the table, they will come to the right kinds of decisions in their fiduciary duty in representing other farmers.

The CHAIRMAN. Mr. Hunt.

Mr. HUNT. I don't really have anything in addition to add to that. There is probably counsel of others in the room that might be speaking on later panels that could address this more specifically, but again, I would just echo what the prior gentlemen have commented as well. Tremendous transparency, you have got a group of widely held, an entity owned widely by producers of all sizes that don't want an individual to control that entity. They operate through governing rules provided for in the articles and by-laws, so I have not heard anything as of yet in our research into looking at different entities as that would be an issue, as long as we are prudent and observe best practices, which I think as Mr. Sims has pointed out, we are all very cognizant of today and spending a tremendous amount of time reviewing and understanding.

The CHAIRMAN. Dr. Graves.

Mr. GRAVES. Mr. Chairman, not to try to offer up a legal comment, which I am not capable of doing, but I think your question surfaces again, the idea of oversight and accountability at our U.S. Department of Agriculture on these kind of initiatives. We don't see any other way to move forward in assisting farmers to earn income out of the marketplace without the farmer being able to have an equity stake in a business that is competitively structured, competitively operated in today's market environment.

There is a role there, then, we sincerely believe, for the Department of Agriculture to be engaged on an ongoing, continuous basis, and so we would just offer up the mere fact that as Chairman, you have raised those questions today suggests that, to us, again, that our recommendation is a very valid one that we move rapidly to establish within the Department of Agriculture pools of resources, both human and capital, who have a specific responsibility to study, research, develop information and report back to this committee on the development and operation and soundness especially of those type of ventures.

The CHAIRMAN. Thank you, Mr. Kisling.

Mr. KISLING. I am not familiar with other States, but I know in our situation with value added products and the way that we designed ours was that you had to prove, had to have proof that you were a producer of agriculture. Now, you didn't have to produce wheat. You had a to be a producer of agriculture, and the proof was on the person that was trying to buy membership, and they filled out a sheet saying that they were a producer of agriculture, and I think that was part of the reason, or part of the problem that we had that we—I would like to see some correction done.

The influx of initial investment is very important to a startup value added project, and by not being able to get some outside entities to come in, say my local co-op mill sells and some outside investor comes in from a large city and buys the mill and adds value to corn, wheat, soybeans that run through that mill. He owns that mill, but he is not a producer of agriculture, but he is adding value to what we raise. I think he should be an investor in that and a lot of times, those people have money to invest in something like that, which some farmers may not have, so it puts us at a jeopardy a little bit in being able to get some outside capital.

The CHAIRMAN. Well, I think that is a very valid point. What we are trying to achieve is some kind of balance here to maintain the original identity of a cooperative. Our legal—and I am going over my time here, but I just want to raise this last point. Our legal analysis of the new Minnesota law indicates that it theoretically allows for outside investor-members to hold as much as 99.9 percent of the equity of the cooperative and receive up to 85 percent of the profits from the cooperative.

I don't know if any of you are familiar with that enough to know whether you would agree with that and maybe somebody on the next panel can address it, but do we want to go that far in that direction to accomplish your goal? Because I think the goal you have cited is a good one, but I wonder if that really is a cooperative when you get to those kind of numbers.

Mr. KISLING. In my opinion, Mr. Chairman, that would be no. The farmers need to have 51 percent control of the operation as producers.

Mr. HUNT. I would agree with that statement as well.

Mr. SIMS. And I would, too. We have looked at that law and at least we don't think that some farmer-controlled businesses could be done under that law, but our view is it needs to be at least 50 percent control and do business on a cooperative basis.

Mr. SMITH. I would agree, too, with that, Mr. Chairman.

The CHAIRMAN. Thank you. Very good. Well, my time has expired. The gentleman from Texas, Mr. Stenholm.

Mr. STENHOLM. I would like to see the tenor of this discussion, in which there is some opposition to that which you have proposed here with the financing of new generational cooperatives. I would hope that as this proceeds that we would change the tenor of the debate to cooperation. We really need to be thinking in terms of how our community banks, our independent banks back home, can work cooperatively with our Farm Credit System in doing what is necessary to build rural America, instead of constantly looking at it as we have traditionally in the past in which we have always had the battle of the co-op versus the independent. Those days are gone.

Anyone that is trying to survive in agriculture today knows that we have got to play by the rules that have been dealt to us, and when we start looking at the world of international finance and the complexities of international finance and look that very soon, China will be the largest holder of debt of the United States of America. That is something that most Americans have not focused on as yet, but when they do, they get rather alarmed. That is big business, and that is big business way out of the spirit in which we are talking here today, but when we start looking at how we are going to do, which we must do, and that is assist our producers, in this case, we are talking farmers and ranchers, how we are going to assist them in getting more of the consumer dollar from the United States consumer as well as the international consumer into the farmer's pocket.

We have to get a think a little differently than what we have ever been willing to do in the past, and capital is key, and unless we are willing to cooperate together by those who are equally concerned about rural America, unless we are willing to find a way to cooperate together, we are not going to solve the problem, and just being against what is being proposed will not suffice if you want a solution, so I would hope we could think cooperatively, and I would hope that we would begin to realize that we are talking about all people interested in rural America trying to find ways to cooperate together. To do that, I think we are going to have to constantly look to see that we have a level playing field. Mr. Sims, do you pay taxes? Does CoBank pay income taxes?

Mr. SIMS. Yes, sir. We do.

Mr. STENHOLM. How does your tax structure differ from your competitor?

Mr. SIMS. We are organized as a cooperative, so we pay taxes under subchapter T concept, where we pay patronage dividends, anything we retain in the business, we pay taxes on at the corporate rate. Last year, we paid $68 million in income taxes, of which all but $10 million were Federal income taxes.

Mr. STENHOLM. How do patronage dividends differ from ordinary corporate dividends?

Mr. SIMS. Well, it is based on the usage of the business, not on how much money they have invested in the bank, and so we will pay a portion of earnings, somewhere between 30 and 50 percent in cash and the rest would be paid to them in stock in the bank, typically the way most all cooperatives pay their patronage refunds to their members.

Mr. STENHOLM. Would any of you at the table disagree with a basic flat statement that all competitive businesses should compete based on as close as reasonably possible a level playing field? A level playing field being defined as that which government creates through tax law, through environmental laws, through labor laws, through whatever, that if you are going to be a competing business, competing for the purpose of helping rural America grow, that everybody should basically as best as humanly possible, compete from a level playing field? Period. Anyone choose to differ a little with that statement?

Mr. GRAVES. May I comment?

Mr. STENHOLM. Sure.

Mr. GRAVES. Congressman, the question that we wrestle with is how it is farmers can come together to earn income from the marketplace. The chart that is in our testimony indicates that over these last 80 years or so, while that continues to be a goal, seemingly, we have not made as much progress as many have wished for, and when you talk about an absolute level playing field, that is all fine and well, we believe, if there is adequate interest in trying to support the group of people who have very little to no market power actually have a chance to get an equity investment in that whole chain of commercial activity, for the purpose of earning income. That would be not an objection, just a question or caveat to your statement, in terms of asking me to accept it just flatfootedly with that period.

Mr. SIMS. Mr. Stenholm, let me add something to what David has said. I think my 35 years of business experience is that you never, I have never seen a perfect playing field. There has been changes that go on all of the time, and some businesses have more competitive advantages than others and others have more competitive advantages.

I think one of the things this committee has done, and we applaud and just the fact that you are having this hearing, is what ways can we use new ideas and new laws to make our cooperative community more effective, easily attract capital, some of the suggests that I think are coming forward can be very helpful in revitalizing and keeping the cooperative concept, in terms of farmer ownership, control, as agriculture continues to consolidate and integrate. I don't think you are ever going to get it perfect.

Mr. STENHOLM. Mr. Sims, I have seen some of those, but they are always tilted a little ways in my favor when they are considered level, but that is the way we always look at it, but if I might, Mr. Chairman, present one additional question.

Just for general consumption, give me your, each of you, give me a definition of what the heck you are talking about with a new generational cooperative?

Mr. KISLING. I would be happy to address that. It is a closed co-op. Ours was a closed co-op. There was 4 months that we went out and made 40 visits around the State to educate the people of what the project was, tell them how much stock was going to cost, give them a business plan as to when they could expect dividends back, and then, after it was closed, then there would be no more investors, and so, as the thing starts to grow and become profitable, then dividends can get to be very good, as you could tell in my testimony. So, that is the new concept, the new definition of a co-op now, as opposed to the co-ops that we are familiar with, where you pay $100 and you have your stock built and then that is the last time you pay anything in, and you—there is a lot of people invested in it, and so, your dividend is diluted quite a bit.

Mr. GRAVES. Congressman, we would just be in the business of regurgitating what we know other people use in terms of a definition. We haven't generated the definition, but when we hear the new generation idea discussed, in our minds, we have an image in terms of a comparison, the old line co-op had open membership, therefore allowing any farmer who wished to be a member to become a member through patronage, and therefore, the co-operative was obliged to take, for example, any and all quantities of wheat that that member, if that is what the member was producing, would choose to deliver to the cooperative.

Those relationships create challenges in a business world. To help deal with the challenges in the business world, not only on volume, but in terms of quality of products received, the new generation idea seemed to evolve around the idea of a closed co-op not so much solely for keeping farmers out who might wish to join, but in order to give the co-op, cooperative business, a much better chance at dealing with the business challenges in terms of the quantity of grain, or any other product that that co-op would be expected to take in and market and return some benefit to all of the members.

So, those challenges seem to have set out the need for the cooperative that is described as a new generation cooperative to be more in control of some of the significant factors that impacts the competitiveness and profitability of the business.

Mr. KISLING. Mr. Chairman, I don't want to dominate the conversation, but as he was talking, I was thinking about our cooperative again, and what we tried to do was be vertically integrated, help the farmer get into an organization that he could be vertically integrated into something using products that he raises, and that is wheat, Hard Red Winter wheat in our case.

If you listened to the testimony of 640,000 bushels of wheat at $3 equates to about $1.2 million worth of wheat. From that point, we produce about $20 million worth of pizza crusts. That is pretty good increase in what they produce, so we are trying to help the farmer in this new generation co-op be vertically integrated, be involved farther down the food chain, so that they can get a piece of that pie.

Mr. HUNT. Congressman, I would say, again, Webster's doesn't have a definition of this, as I said in my testimony, there are plenty of definitions. I guess we are one. We are called one all the time, and that is U.S. Premium Beef, so I guess just describing what we are, we are a marketing cooperative versus a traditional concept of a farm supply cooperative. Our producers commit capital and commodities to this business, in the form of buying shares and attached to those shares are normally delivery rights. Those are rights and obligations to deliver *X* quantity to your marketing cooperative. It does tend to be more profit-motivated, and that does tend to more align with the producer-owners as they are transferring their commodity into their processing company at some value, and then hoping at the end of the day their processing company will convert that into a processed good that is sold to the consumer at a higher price. Again, I think new generation comes from the standpoint as compared to a traditional cooperative.

Mr. SIMS. I think it is a very interesting question you ask, and I wouldn't disagree with anything that has been said up to this point, with the exception that when cooperatives originally were formed in the 1920's and 1930's, and that is when most of them were formed, farmers were of similar size. Most had 160 acres and so the one member one vote concept made lots of sense for the cooperative movement. I think as you have moved into this era of consolidating agriculture, integration that has been talked about here, when farmers are asked to invest in their cooperative, they are now beginning to say I want a voice commensurate with what I invest, and that began to evolve particularly in the upper Midwest.

The first time I heard the term was in North Dakota, but Congressman Stenholm, in many ways, the denim plant that you described at the beginning of this hearing was a closed cooperative when it was first formed. We were involved in helping get that established, and to assume that all of this has just come about in the 1990's would be a poor assumption. We have got a lot of very successful cooperatives that have used the concepts, in the tree nut business, the dairy business, citrus business, and so, I think what it is doing is really defining, and what Mr. Hunt said, it is going from anybody can come in that wants to, and as long as you have a one member one vote, we are going to decide who gets in in this group, because we have got specific qualities that we want to produce, certain goals we want to achieve, and we need to have a common philosophy, and many producers are saying they want to vote with their investment, and have a voice commensurate with that, which is not consistent with the old traditional cooperative.

Mr. SMITH. Congressman, although my background is completely different, I come from a traditional farm supply service cooperative located in the South, I think the main differences in the new generation is more of a closed cooperative, and ours are, as Doug and my cohorts have said, an open cooperative with one man one vote. Someone said that the new generations were more profit-motivated than the traditional co-ops. I want to reassure my banker that that is not so, we are very profit-motivated, and I would also like to stress to your committee that capital is just as important for the traditional co-ops. We are really struggling. We are limited in how we can raise capital, and to compete with the marketplace in procurement supplies for your members and your producers. That is a need that we really have. Thank you, sir.

Mr. LUCAS of Oklahoma [presiding]. The gentleman's time has expired. The Chair will turn to the gentleman from Illinois, Mr. Johnson, for questioning.

Mr. JOHNSON. Thank you, Mr. Chairman. Just very briefly. First of all, I want to thank you, Mr. Chairman, and the committee for having the hearing, and these gentlemen for testifying. I think it is important, given the magnitude of this issue and the competing interests, or at least competing philosophies, to hear all viewpoints and that is what we are doing.

I direct this question specifically to Mr. Sims. Mr. Sims, in your written statement, you had mentioned and indicated that USDA has recognized the need to update their eligibility provisions for RUS lending because of changes in business structure. Can you just briefly expand on that? I know the chairman has questions to follow, and I don't mean to preempt the chairman, but if you could just briefly address that for me, I would appreciate it.

Mr. SIMS. Yes. I think in the rural electric business that we are in, they use some of these same forms that were, structure we are talking about, the LLCs, and through their RUS lending authorities, I believe it was 1998 or 1999, they went ahead and made the changes, so that the rural electric cooperative community can use this form of structure in their business model.

Mr. JOHNSON. Thank you very much, and thank you very much for your courtesy, Mr. Chairman.

The CHAIRMAN. Indeed, Mr. Johnson. To hearken back for just a moment to a couple of my earlier questions to previous panel gentlemen, and perhaps, the place to begin, Mr. Sims, with CoBank's involvement with so many co-ops across the country, could you just give us an eyelash analysis of what the financial health and well-being is of co-ops generally in this country, and I realize everything varies from region to region and product to product?

Mr. SIMS. In the agricultural cooperative community, I would say, in fact we are under examination and being checked by our regulator as we speak, things are in a very sound situation. That isn't to say that there aren't challenges in some areas, where companies either are dealing with weather issues, and I am going to use a couple of examples.

We had quite a drought situation that really hit the western wheat belt last year that affected the grain cooperatives in western Nebraska, Kansas, Colorado, a little bit into Oklahoma. This year, the rain here in the east coast, this has been a very difficult year for some of our cooperatives in that regard, but where you have got sound capitalization, good management, good focus, we are seeing a very strong and stable agricultural cooperative community.

Now, that being said, as farmers consolidate and get bigger, they are consolidating their cooperatives as well, and we are seeing consolidation of cooperatives, and in some cases, that means closing down some facilities, where the capacity is no longer needed, based on the changes in the marketplace.

Mr. LUCAS of Oklahoma. Keith, could you touch for a moment on how our enterprise up in Alva is doing? I mean, it has been an ongoing effort, well, how long now since the initial offering, solicitation?

Mr. KISLING. It has been in the running for 4 years. It started out, it is like any startup company. The first 3 years, they will tell you, it is tough, and it was tough. In fact, we had a lawsuit against us, and then we had 9/11 and we were sending to military bases, and those all shut down, and so we went for a year with very few orders, and the problem with that is that your expenses continue on, so it made it real difficult for us to abide by our business plan, and that is what we were trying to do was go by the business plan.

The first 3 years probably wouldn't make any money, but by the fourth year, there should be a dividend, the fifth year, and some of them, that is how they invested. They invested enough that they could use the taxes that they had in Oklahoma the first 3 years, use up their 30 percent, and by the fourth year, start getting a dividend to help pay on the initial investment. So, I would like for you to consider that as being an ideal. The only thing that would have really helped was if we could have included a Federal tax cut of some type in there, percentage-wise, to be able to encourage more investors, and what you do, you hamstring your big investors by having only a State income tax credit, because they don't pay enough Oklahoma taxes, the $100,000 investors can't use up in 7 years the amount that they need to to get their 30 percent. So, a Federal tax incentive would be great.

At the present time, the question you asked was how is it doing. It went from struggling and everybody knows that it did struggle, because you can't get big companies to come in and fill, and ask for orders on a company they are not sure is going to survive, and that is just the way it is on new startup companies, but now, we have started a second shift, and now we are employing a third shift, which we are up to like 50, 60 employees now at the facility. It pays well, the benefits are good, we have excellent staff of people there, and I just think the thing, it looked like from the start of the business plan, by year 8, you would have your initial investment all paid off.

And it is kind of, for the older people, it was an investment in time. They probably would not see a huge income from it, but for young people, it is the startup farmers in our area that new generation co-ops are trying to help, it is a big benefit, it is like an oil well, Mr. Lucas, to them. It could be a huge income thing for them, and so I just really encourage the legislators to come up with some type of help to help pay off their initial investment. A lot of them, we had three banks in the town that the plant is in, all three CEOs of those banks were on the Board, and towns surrounding the Alva area offered to loan the full investment, if it was reasonable, with no collateral, to get investors coming in, and so, the bankers are a huge item for getting started, and it looks like it is going to be good.

Mr. LUCAS of Oklahoma. Well, along that line, let us touch for a moment, in my early question to the previous panel about when a co-op is still a co-op. We have talked about new generation and we have talked about things going on in Wyoming and Minnesota and other places, and I, as you know, Keith, I do lots of town meetings, and I explain to my constituents, or attempt to explain to my constituents why we do the things, or occasionally, the things we do not do up here, but also, by the same token, on issues like this where you have got Tax Code matters and a variety of other situations that directly effect—we also have to work through Ways and Means, and we have to deal with the Internal Revenue Service and a variety of those other entities, too, so let us just discuss for a moment some concepts and give me your insights. In my earlier question, I think the comment was made, the response to what a co-op was, essentially, it was anything where the producers owned the majority and the business was run on a co-op basis, so to speak, on a participation basis. That means, conceivably, from my analysis, that outside investment in some of these concepts could be as high as 49 percent.

Tell me, from where you gentlemen sit, those of you who work directly in the industry, those of you who finance the industry, those of you who are so keenly involved, that 49 percent, that outside investor, do we visualize in this combination co-op, do we visualize that investor having the same kind of a tax circumstance as the 51 percent who are producers?

Mr. HUNT. Mr. Chairman, under our structure, we are currently a closed marketing cooperative. We are contemplating a Wyoming co-op or a Minnesota co-op, or just converting just directly to an LLC, so we have given a lot of thought to this, and under our analysis, the simple answer to your question is yes, that the co-op is a pass through entity. Just as a partnership, as a pass through entity, as is an LLC a pass through entity. The tax burden, the income is allocated to the owners, and therefore, the tax consequence, therefore, rests with the owners. So, in that scenario, whether it be 10 percent or 49 percent, an outside investor, they as well would realize the tax consequences or the income being passed out to them as owners.

Mr. LUCAS of Oklahoma. How do I explain to a Ways and Means Committee staffer that this kind of a circumstance wouldn't create an environment where investors who are interested in putting good resources into anything that was ag-related wouldn't search out opportunities to create co-ops, to create enterprises where, with a very diverse group of 51 percent ownership, versus a very strong-willed and focused junior owner of 49 percent, how do I explain to a bean-counter, a committee staff, that this won't create a huge number of co-ops, but that ultimately, the producers would wind up being the tail on the dog, so to speak. How do I explain that to a Ways and Means staffer?

Mr. HUNT. In all due respect, I think that is a great problem. I think in rural America today, we need people willing to invest in these communities, and as long as it is controlled by the producers, those benefits in these rural communities are great, fantastic, the producers are ultimately in control of that business, and that is exactly what we are really trying to do. We are trying to develop these businesses.

I think earlier in testimony, someone related the fact that a gentleman gave up his businesses, because they had challenges in large cities, and when they realized how easy it might be to invest in a smaller community, I think those are the types of people we would like to see, and I will tell you, our producers are savvy people. They are good businesspeople. They understand governance, they understand the difference between 51 and 50 percent, and the key here is that we are prudent because the risk would be, and we have talked a lot about this in U.S. Premium Beef as we face these challenges is if you need capital, additional capital within your company, is there a risk that you would become a minority player, if you were not able to address, let us say, a capital call, and that is why it is important for producers to treat these businesses as they would their own, that they keep them financially healthy, they keep their balance sheets in a place where they don't get a in a pickle.

So, again, we have spent a lot of time looking at this, but I would dare say that having a group of investors look to rural communities to put money would be a great thing.

Mr. SIMS. Mr. Chairman, I want to underscore that. I think as we look at these businesses, often these are the largest businesses in rural America, in the towns, and I thought about this as Congressman Janklow was talking about what he sees out there, and we need some incentives for people to look at rural America, but

I would also say I don't think people are going to just throw their money into an organization they don't have confidence in, the business model, the strategic direction, the management and the kind of board they are dealing with, because they have got fiduciary duty over that money as well, and I think whenever we see farmers deal with this issue, and we have got two here on the panel that can talk specifically, they think very carefully about who they bring in and why they bring them in. If they are not there to bring, to add value to the enterprise, my experience is farmers will say no, we don't want you.

Mr. HUNT. If you would allow me, I might add just a similar experience we had this past year. Because of the restriction of the cooperative, we could not bring in equity in U.S. Premium Beef to buy out farmland, completely. We could buy up to a certain percent, but we couldn't buy them out completely, because our producers didn't have enough cash to contribute, to capitalize the leverage, and so we were forced to really go outside of our cooperative and form an entity to attract an outside investor, and in this case, an outside investor was a company owned by a man and wife that had been in business for over 25 years, very successful people, that now are adding value to our business. They have come in as a minority investor, there in further processing of meets, and they have come in and contributed greatly to our business, shown us new technologies. We have done joint ventures with them to reap additional value, so again, I think to Mr. Sims' point, we have to look at those potential investors with our eyes wide open. What can they contribute other than cash, and what kind of veto powers do they have, what types of abilities do they have to dilute your interest. So, these producers had to step up and hire good management, good counsel, to advise them as they contemplate these kinds of decisions.

Mr. LUCAS of Oklahoma. I appreciate where you are coming from, and I am a supporter of the co-op movement, just as I think this entire committee is, just as Congress has shown down through the decades, but occasionally, we deal in the realm of unintended consequences.

Mr. HUNT. Absolutely.

Mr. LUCAS of Oklahoma. I see where, if you don't craft such language on a Federal basis in a very careful, careful fashion, you could wind up with your dough plants in the suburbs of Boston or Atlanta or Los Angeles that individuals who would have the kind of cash resources to become the 49.9 percent investor would be able to drive the equation and find the other 51 percent willing to benefit from that capital outlay and that expertise. I just—I want to make sure that we think carefully through this process, and whatever we come up with, we come up with something that actually benefits rural America. My home county, as Mr. Kisling knows, dropped 14 percent of its population in rural western Oklahoma between 1990 and 2000. I live every day with the challenges that rural America has as I watch my school enrollment numbers decline, reflecting my Census numbers that decline, but we have to move in a way that creates an end result that we intend for it to create.

Now, that said, as I mentioned at the beginning, we are a committee focused on rural American production agriculture. Many of the changes that a number of you have spoken to, about the Tax Code, or potential changes to the Tax Code, require other committees of this body to work with us, and sometimes, that is a challenge. That is an absolute challenge. But that is what we are here for, isn't it, Mr. Stenholm, is to rise to the occasion and work for our folks, and with that, speaking if a dedicated servant of the public from the great State of Kansas, Mr. Moran. Do you have any questions, sir?

Mr. MORAN. It is probably presumptuous of me to begin to reach for the mike before you finished your sentence, but since I am the only other Member here——

Mr. LUCAS of Oklahoma. If there was ever a doubt in your ability, Mr. Stenholm and I would take a private poll and report it you. There is not.

Mr. MORAN. Mr. Chairman, thank you for recognizing me. Mr. Hunt, thank you for being here. I appreciate the perspective of a Kansan, and as you know, U.S. Premium Beef has been a significant component of the economy, and particularly, the economy of Kansas, and the livestock sector, and we are very pleased with the success that you have had.

Mr. HUNT. Thank you.

Mr. MORAN. You indicated in your testimony that you have used CoBank funding, financing. You also indicated that you received funding from other banks. I assume those are commercial banks.

Mr. HUNT. Yes, sir.

Mr. MORAN. Can you describe for me when you find it appropriate to borrow from CoBank as compared to a commercial bank? What criteria, what is the difference? What goes into your decision-making process? What can the CoBank do that the commercial bank can't or vice versa?

Mr. HUNT. That is a very good question. I will attempt to answer it. We, in the type of borrowing that we are in, I would say in a medium to large scale borrowing, given the size of our business, it is, as I understand it, I used to be in banking years ago, but I understand, as banking has evolved, that the cooperative banks and others have developed a strategy of diversifying their risk greatly, and so typically, in our size of transactions, there are numerous banks that do become involved.

When we first started, however, when we entered the marketplace, CoBank was very supportive of the new generation concept, very supportive of producers getting into value added marketing strategies, and not to say other commercial lenders weren't, but No. 1 they were very knowledgeable about producer-owned ventures and comfortable, No. 2, they were involved in food production lending and other areas. Their packages were flexible, and their rates were very competitive.

Today, it is really not much different than when we first started. Most of our lenders do fill most of these criteria. You come back to good service, knowledgeable lending officers that do understand your business because they have the responsibility to their management and boards, to assess the credit quality of the potential loan, the ability to repay it, the quality of the collateral, and all of the other criteria they use to evaluate it. So I want to be sure that there is somebody there that knows our business, so a month down the road or a year down the road, they say well, I didn't realize that is the way this business was and start getting uncomfortable. And in this case, CoBank clearly fills that bill.

I think it is important as we look into agriculture in the future is we see the lending community concentrating, just like the food processing industry and other industries are concentrating, we see the lending community concentrating as well, and I think it is very important that we keep CoBank viable in our lending to our types of businesses, whether it be an LLC, Wyoming co-op, or a cooperative, so that we know we have good access to capital out there, debt equity, as well as a good competitive environment.

Mr. MORAN. Do commercial banks compete for the opportunity to lend you money?

Mr. HUNT. Yes, they do.

Mr. MORAN. Is there a rate differential that makes a difference in U.S. Premium Beef's decision?

Mr. HUNT. In our case, it clearly is part of the decision, but again, because of the size of our transaction, normally, it takes several of the banks to cooperate together, commercial and CoBank, and so typically, they end up at the same rate that they would loan to us.

Mr. MORAN. So, in your case, it is a loan package that is put together by a commercial lender and CoBank.

Mr. HUNT. That is correct, in our case.

Mr. MORAN. We had the Under Secretary here before, which reminds me to ask you, did you also receive funding through Rural Development and any USDA programs in your initial startup?

Mr. HUNT. We received approval to receive funding. We had great support from Representatives and Senators from the great State of Kansas and other surrounding States as well, and we did receive approval. I will say we didn't use the funding. The State of Kansas, however, provided us a loan for a feasibility study which we paid back the day after we closed our deal and encouraged them to use that and other good opportunities as well, but we did apply and receive good support from USDA.

Mr. MORAN. Mr. Sims, not all farmer cooperatives borrow from CoBank. True?

Mr. SIMS. It is true.

Mr. MORAN. Take a grain elevator, for example. They may be borrowing money from you or they may be borrowing money from a local bank. True?

Mr. SIMS. That is correct.

Mr. MORAN. Can you outline for me the kind of description of those two groups? Is there anything in common about the farmer cooperatives, the grain elevator that is borrowing money from CoBank as compared to the one that is borrowing from a bank? Different sizes, management, different——

Mr. SIMS. I don't know that there is anything that I would characterize, other than the individual choice of the company, and our best estimates, there are about $12 billion of debt outstanding to agricultural cooperatives today. We have just under $10 billion of that, and there are times when it might be the financial position, it might be relationships on that board and management with the local bank. We have basically a practice whenever our customers, and you have just heard Mr. Hunt explain how his is structured, when we sit down with the customer, we will ask them are there other financial institutions that they want to have involved in this transaction because it is important to them, and we will do our best to meet the needs of that particular customer based on what they tell us.

Mr. MORAN. Remind me, because the suggestion is that CoBank or Farm Credit is to be "the lender of last resort," that it is someone who couldn't get commercial financing. What is the story there?

Mr. SIMS. That is absolutely not true, Congressman. Having been at this 35 years, I have been at this hearing table a time or two, when it wasn't as much fun as it is today. We were reminded, as a system, in the mid-1980's, that we were not a lender of last resort, that we were here with a mission to serve farmers and their cooperatives as a system, and that we are to do that on a sound basis, and that is why we have a regulator, that is why we have capital requirements, that is why we have reserves, and that is why we have an insurance fund that was set up. And in fact, one of the things that I am pleased at, at least I have been CEO of CoBank 11 years now, I have never received political pressure to make loans or not make loans because we are a lender of last resort. I think everybody has expected us to run a sound business, and protect the GSE status that the Farm Credit System, of which CoBank is a part, has.

Mr. MORAN. I have another question, Mr. Chairman, but my time has expired. Thank you very much for your answers.

Mr. LUCAS of Oklahoma. Thank you, Mr. Moran. The committee wishes to thank the panel for your insights, observations, your responses and what you do for rural America out there every day, and with that, we will dismiss you and bring the next group of lucky citizens forward. We would like to invite our third and final panel to come to the table, please.

Mr. Roger Ginder, professor of agricultural economics at Iowa State University in Ames; Mr. Mark Hanson, attorney-at-law, Lindquist & Vennum, Minneapolis, MN; Mr. Douglas P. Peterson, president of the Minnesota Farmers Union, St. Paul, on behalf of National Farmers Union; and Mr. James Caspary, president of the First National Bank of Clifton, Clifton, IL, on behalf of the Independent Community Bankers Association; and Mr. Roger Monson, president and chief executive officer of the Citizens Bank of Finley, Finley, ND. And I believe by some comments that I have engaged in earlier, perhaps Mr. Monson is under a bit more of a time frame even than everyone else, so if it is all right with you, sir, let us begin with you, Roger, when you are ready.

STATEMENT OF ROGER D. MONSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CITIZENS BANK OF FINLEY, FINLEY, ND

Mr. MONSON. Thank you, Mr. Chairman, and I do appreciate the opportunity to go first. Mr. Chairman and members of the committee, I am pleased to be here to appear before you. I am Roger Munson, and I am president of the Citizens State Bank of Finley, North

Dakota, and I am also chairman of the American Bankers Association Agricultural and Rural Bankers Committee.

Today, I would like to express the banking industry's opposition to proposals that would fundamentally change the charter of the Farm Credit System's CoBank and to discuss a number of ways that the banking industry, working in partnership with the public sector, could do more to provide rural businesses with greater access to capital.

Recent legislation in Wyoming and Minnesota has changed the definition of a co-op in those States with the intention of attracting outside capital investment by giving outside investors a stake in the decision-making of the business and by allowing for a return on investment that exceeds the traditional cooperative model.

These new laws allow farmer-content businesses to be considered cooperatives. CoBank is asking Congress to consider very broad legislative language to rewrite their charter, to allow them to finance these hybrid businesses. CoBank's proposal would dilute their obligations to farmer-owned and farmer-controlled cooperatives, and would allow them to finance organizations that merely have some farmer content.

We are concerned that CoBank is asking Congress to sign away a major part of their jurisdiction by proposing language that would allow CoBank to lend to any entity that is defined as a cooperative by State law, not Federal law. As a GSE, they should be governed by Federal law.

CoBank wants to continue to lend to businesses that are no longer cooperatives for up to 5 years. This is unwise. If a farmer-owned cooperative disbands or changes its charter, it should no longer be eligible to borrow from CoBank. CoBank is a $27 billion institution that dwarfs the vast majority of banks that service rural America. Granting them authority to lend to farmer-content companies would be a great mistake that would harm access to capital for farmer-owned cooperatives.

Our bank finances cooperatives because they are good business for the bank. I would like to make some recommendations to you on how banks, working with the public sector, could provide more capital to rural business. I was able to finance an acquisition for a new cooperative in Finley with a USDA Business and Industry Loan Guarantee. Our bank was able to provide the loan to the cooperative because the USDA guarantee helps us manage credit risk and allowed us to exceed our lending limit.

As this committee looks for new ways to help cooperatives access more capital, please remember that the B&I guaranteed program works well, so well, in fact, that the funding is often overwhelmed. We were not able to utilize the B&I program for another cooperative because the B&I regulations do not allow lenders to finance revolving lines of credit, which was the type of credit that best fits this cooperative's needs. Instead of using the B&I program, I participated the loans with other local banks, and I recommend that the B&I regulations be revised to allow USDA to guarantee revolving lines of credit.

Several years ago, USDA announced a new guaranteed loan program that was targeted to help farmer-owned cooperatives. This program was intended to allow institutions like mine to make guaranteed loans to farmers to enable them to buy cooperative equity. To date, few loans have been written under this program. Congress again attempted to resolve some of the operational problems when it authorized B&I guaranteed loans for individual farmers to buy cooperative stock in the 2002 farm bill. USDA should undertake a review of all credit programs intended to help individuals make cooperative equity purchases to streamline a loan program that works.

Further, administration of the resulting programs should be turned over to the Farm Service Agency, which has expertise in loans to farmers. The farm bill authorized a new program to meet the needs of rural businesses, the Rural Business Investment Company. RBICs would allow banks and farm credit service institutions to charter institutions that would make equity investments in rural businesses and cooperatives. ABA is anxiously awaiting USDA's rule-making process on RBICs. Once USDA issues the regulations, we would call upon Congress to appropriate full funding for this important program to generate more equity capital in rural America.

My bank is in Finley because we have developed a market that produces a return that satisfies our local stockholders. We have been successful because we provide services that people in Finley want and need. If you allow CoBank to expand their lending to broadly defined farmer-content businesses, we may one day have a hearing about why there is no bank and maybe no real farmer-owned cooperatives left in Finley, North Dakota.

Mr. Chairman, thank you for the opportunity to share our thoughts about the future of the farmer-owned movement, and I would be very happy to answer any questions that you may have.

[The prepared statement of Mr. Monson appears at the conclusion of the hearing.]

Mr. LUCAS of Oklahoma. Thank you. Dr. Ginder.

STATEMENT OF ROGER GINDER, PROFESSOR OF AGRICULTURAL ECONOMICS, IOWA STATE UNIVERSITY, AMES, IA

Mr. GINDER. Mr. Chairman, Ranking Member Stenholm, my name is Roger Ginder. I am a professor of economics in the Department at Iowa State University. I appreciate the opportunity to present testimony at the hearing today, and I will address the topic of business structures used by closed cooperatives in my oral comments. As requested, I have also touched on the topic of restructuring occurring now in my written testimony. I would ask that that be included in the record, and I will be happy to answer questions on either or both topics.

Closed membership cooperatives differ from the typical open membership cooperative in several important ways. One of the key differences are capitalization in direct proportion to use, tradable shares, specified delivery rights for raw product, equity share values that may rise or fall with the value of the enterprise and a high fraction of patronage payments paid to members in cash.

When most farm groups begin to organize, a closed cooperative, with these traits, is what they have in mind. Added to the benefits cited above are the more traditional cooperative benefits, including single tax treatment, a patronage distribution, access to credit from

CoBank, limited exemptions from securities laws and Capper-Volstead antitrust protections. Despite these advantages and their initial intent to use the cooperative form, most farmer groups find that some of the restrictions associated with the cooperative form make it comparatively difficult and sometimes less than economic to use.

Other forms, including the limited liability company can incorporate some but not all the benefits offered by the closed cooperative structure without these restrictions. LLCs can offer the same single tax treatment as closed membership cooperatives, but they are not saddled with some of the membership restrictions and outside investment restrictions historically placed on the cooperative form, but the LLC cannot access the benefits of CoBank credit, or some of the Capper-Volstead exemptions that cooperatives enjoy.

In addition, the LLC form of organization provides for an even more favorable self-employment tax treatment than what has thus far been accorded to cooperatives. The self-employment tax is levied at a rate of slightly more than 15 percent on cooperative patronage distribution to their members. LLCs can make identical distributions that are completely exempt from the SE tax. All other things equal, the value of the distribution to the producer is 15 percent higher when received from an LLC than when it is received from a cooperative.

Limiting membership to active farmers is also a source of difference between the cooperative and the LLC, which may be formed with both non-farm investors and farmers holding full memberships.

Several State cooperatives statutes permitting more liberal membership requirements have either been passed or introduced into the legislature at this point. Iowa will introduce one such law at the coming session. The intent is to permit the formation of value added cooperatives that allow more non-farm investors in their membership.

Cooperatively organized ethanol plants have also encountered difficulties in passing through the small producer ethanol credits to their members. The Tall Corn Ethanol Plant in Coon Rapids, Iowa recently converted from a closed membership to an LLC because it could raise equity from non-farm sources and because it could distribute the small producer ethanol credit to members through the LLC form and not as a cooperative.

From a policy perspective, I think it is desirable to make it possible for farmers to enjoy the same benefits from a closed co-op that they would in an LLC. To the degree possible, they should be able to select the cooperative form of organization without significant economic penalties. Starting a value added enterprise is already a difficult task for producers, and it is useful to have as much flexibility as possible. Currently, the enterprise must select the LLC form if it is to avoid the SE tax and pass through the small producer ethanol credits, but in doing so, it must give up the ability to access CoBank credit services and the benefits and protections of Capper-Volstead.

The inability to access CoBank credit deprives these startup businesses of a stable, low-cost credit alternative with significant industry knowledge and a long-term commitment to providing financing to agricultural processing firms, and abandoning the protections of the Capper-Volstead Act could have future consequences if the value added enterprises wish to form marketing agencies in common as they grow.

Mr. Chairman, I see my time is nearing the end. I am grateful for the interest of this committee in this important topic, and for holding this hearing. I will be glad to respond to any questions you may have on either part.

[The prepared statement of Mr. Ginder appears at the conclusion of the hearing.]

Mr. LUCAS of Oklahoma. Thank you, Doctor. Mr. Hanson.

STATEMENT OF MARK J. HANSON, ATTORNEY-AT-LAW, LINQUIST & VENNUM, MINNEAPOLIS, MN

Mr. HANSON. Mr. Chairman, members of the committee. I also have provided written testimony that I would like entered into the record. My name is Mark Hanson. I am an attorney. My office is in Minneapolis, but my practice is throughout the country in areas where there is agricultural production and processing facilities. I work with a number of the members of my firm, but specifically 12 in an agricultural and cooperative practice group.

Our practice consists mainly of assisting and starting up new value added cooperatives and producer-owned businesses to process products, and also, we work with existing cooperatives. Both have a common issue in that they are looking at restructuring, for a lot of the reasons that have been mentioned in the testimony today. Frequently, the question comes up, well, are cooperatives necessary, and they are very necessary. They are an important business structure, and it offers an alternative that other business structures don't.

One of the primary things that an attorney looks at when assessing should a business be a cooperative or not is the one single thread that a cooperative allocates the profits and controls to the users or the patrons of a business. You don't have that in a corporation. You don't have that in a partnership, but you do have that in a cooperative. So, that is the one common thread that, as attorneys, we usually look at. In terms of cooperatives, there is another area that is very important for cooperatives, and that is that they are very important for local development. There is a book just recently published. I mentioned it in the written testimony. When I say recently, I got, I think, the first copy on Monday, so it is very recent, and in that book, there are a number of articles and chapters about how important cooperatives have been traditionally, and can still be today in terms of local development.

Cooperatives today face two major challenges, in my practice. One is capital and the other is liquidity. Obviously, when you are starting, you are looking at capital, and as you are ongoing, you are looking at liquidity. Now, this faces both the new startup cooperatives as well as the ongoing value added cooperatives. In other words, once you have invested the capital, and the business is continuing, how do you exit, how do you get your money out of the business, particularly if it is a growth business.

One of the challenges is that with the traditional form of cooperative, fewer farmers means fewer persons that have capital that can be accessed for the cooperative. Traditional cooperatives are based on new patrons redeeming the capital of prior patrons, and so as that base shrinks, it presents a problem. Member liquidity, we hear more questions and comments and requests and sometimes demands from members, saying as a member, I want to control when my patronage equity is redeemed, so member liquidity is a bigger issue.

As we look at the big picture, a number of States are responding to the capital challenges. Value added processing facilities is one of the most difficult things that we face. As you start a processing facility, as a cooperative, and you have a lot of complaints, not from investors in New York or Chicago or a large city, but from other people in the local town where the facility is going to be located. Why can't we invest? Or the farmer invests and allocates the crop from 160 acres, but has additional money they would like to invest in the project. There are things in the Federal law that would support these changes that States are making in their cooperative laws. One would be, as I mentioned in the written testimony, that existing cooperatives that are producer-owned or patron-owned would be given the benefits that corporate cooperatives have today, which essentially preclude cooperatives from having outside investors within their structure.

There is a provision called section 521 that have been called the producer's cooperative section. That section, again, doesn't allow anything but producers to be part of those farmer cooperatives, and again, if that was a producer-controlled entity, it would provide benefits.

As was mentioned, a lot of these businesses, when they started, they are the dominant business venture in the community that they are in. One of the things that is an impediment, particularly for facilities that are close to State lines, are the securities laws. There is a lot of regulation. I think there is opportunities, States have dealt with it in terms of saying that a cooperative can raise money from its patrons with proper disclosure, and also other entities that would otherwise be exempt from the securities laws. We don't have a similar situation in the Federal securities laws.

Last, the mention of how do cooperatives receive debt financing. We have been involved, and I am aware of a number of other projects that raise their equity, raise the 40 percent equity and are unable to find the debt financing. Sometimes that occurs because there isn't capacity in certain sectors, whether it is ethanol or it is grain processing or others.

So, with that, I think the authorization for the cooperative bank financing and the Farm Credit System, I would just say from my experience, I don't think I consider them the lender of last resort, but in many cases, they have had the vision to see that whether it is a pasta plant, or in Oklahoma, or beef processing in Kansas, that this is a business that the rural communities will benefit from.

Thank you very much.

[The prepared statement of Mr. Hanson appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Mr. Hanson. Mr. Peterson.

STATEMENT OF DOUGLAS P. PETERSON, PRESIDENT, MINNESOTA FARMERS UNION, ST. PAUL, MN, ON BEHALF OF THE NATIONAL FARMERS UNION

Mr. PETERSON. Thank you, Mr. Chairman, and members of the House Agriculture Committee. My name is Doug Peterson, and I am the president of the Minnesota Farmers Union, and it is a pleasure to be here today on behalf of the 300,000 family farmers and ranchers of the National Farmers Union to discuss the roles of farmer-owned cooperatives and contributing to the financial success of agriculture producers and also to economic prospects of rural communities.

Farmers Union, the National Farmers Union, has a long history of development and operation in support of the farm-owned co-ops. Our involvement in co-ops even predates the Capper-Volstead Act. Our commitment to success of cooperative development today continues through a variety of national education and consulting activities carried out by the National Farmers Union.

Co-ops were established to deal with the primary needs of production agriculture, and provide a mechanism to address the types of agriculture market failure in America. The first cooperatives were provided a broad range of the local available services to production agriculture that were not being met by the private sector.

Second, cooperatives foster market competition to reduce the concentration of market power among limited agribusinesses, companies. Cooperatives also allow farmers to participate in both the governance and earnings of the agricultural sectors in which they do business, and by creating new jobs.

National Farmers Union believes that the vital role of cooperatives can play in meeting these needs even more important today, and no one questions that times have change in agriculture, and we believe and think that we can agree that agriculture cooperatives should be reviewed and modified to reflect the current conditions and future business expectation.

National Farmers Union feels that Congress must take a lead in this reexamination process, rather than allowing the events or other institutions to determine the cooperative model that may, in fact, sacrifice the characteristics of a cooperative that distinguishes it from other business structures.

We know that there may be problems in this challenge of that system today. However, Farmers Union also believe that the level of restraint must be exercised to provide the opportunity for a full discussion of potential alternatives before engaging in a significant modification of the cooperative model.

Along with others, Farmers Union sees the largest single challenge facing the existence of our future cooperative business ventures as access to equity capital. For established co-ops, new infusion of capital are critical to the capacity to adapt and compete in a global setting, where the market power is becoming increasingly concentrated and integrated through mergers, acquisition and strategic businesses' alliances, and as many of you know, the recent farm bill created a Rural Business Investment Program to raise capital and provide operational assistance to smaller businesses, and to allow them to participate in government guaranteed programs.

The program also ensures that ownership of Rural Business Investment Company is not affiliated with the company's management. In our judgment, the RBIP program, when coupled with other cooperative development programs, offers an important opportunity for smaller rural cooperatives. We encourage this committee to impress upon the USDA the importance of expediting the implementation of this program.

We also further encourage the committee to look at ways to streamline the whole cooperative development process, and particularly, we believe, the Farmers Union believes that shifting some of the lending authorities, such as the various guaranteed loan programs to the Farm Service Agency, which has substantial agricultural credit experience, would further encourage farmer participation in new and existing cooperatives and expedite the cooperative development process.

Many proposals have been suggested, and in some cases, State governments have already acted. And they have acted in an attempt to enhance the ability of co-ops to attract outside capital. While we do appreciate the worthy intention of these efforts to address the equity shortfall problem, we are concerned about the long-term effects these proposals have on basic cooperative principles.

Our concerns include the issue of producer ownership and governance of cooperatives and the ability of cooperative ventures to provide alternative market opportunities. So-called new generation co-op schemes that blur the lines between a co-op and other organizational structures may put at risk existing preferential policy treatment for all co-ops, including but not limited to the issue of partial antitrust exemptions and tax considerations.

Because these proposals have been a substantial impact on the application of many Federal laws, we feel that Congress must get in front of the issue, rather than simply react to the actions taken by others, and we are very concerned that the new State laws, including one recently adopted in my State of Minnesota to encourage equity investment in cooperatives could effectively, if not technically, eliminate ownership, control and allocation of patronage earnings to the real producers. In this case, the old adage, who pays the piper calls the tune could certainly apply to the outside investors, who may be able to qualify as farmers under the current definition.

Non-farmer investors may be able to control or influence a majority of co-op board votes to change the traditional allocation of earnings away from patronage to a return on investment. They also may exert significant and substantial influence on merger, consolidations, liquidations, or other critical business decisions. In effect, the co-op, by accepting access to outside capital, may become nothing more than a regular stock company, except that the farmer-patrons will have collectively contributed substantial risk, or capital risk, that is, for a venture that may not be serving in their own self-interest.

We feel it is important that Congress should review the definition of a farmer as it applies to co-op ownership and governance. If, after all the thorough assessment, Congress determines that the benefits of encouraging the type of ownership and outside capital investment of these proposals outweighs and is not inconsistent with co-op principles and existing statutes, it should establish strict guidelines and limitations on the level of influence that these investors may exert over co-op business structure. At a minimum, these rules should be this. No. 1, require diversification among investors, particularly those with interests in competing business. No 2, ensure an adequate majority of voting power is retained by farmer-owners, and the final point, mandate an equitable sharing of any earnings distribution among outside investors and those who would be entitled to patronage allocations by the company.

Mr. Chairman and committee, these are our suggestions and observations and we would be glad to stand for any questions. Thank you.

[The prepared statement of Mr. Peterson appears at the conclusion of the hearing.]

The CHAIRMAN [presiding]. Thank you, Mr. Peterson, and the Chair now recognizes the gentleman from Illinois, Mr. Johnson, for an introduction.

Mr. JOHNSON. Thank you very much, Mr. Chairman. It is my distinct pleasure to be able to introduce the next witness, one of my constituents and very good friends, Jim Caspary of Clifton, IL. Mr. Caspary is the president of First National Bank in Clifton, the chairman of IBAA's Agricultural Rural America Committee and past president of the Community Bankers Association of Illinois.

His bank, First National Bank of Clifton, is a small midwestern bank in my district with about $30 million in assets. It has been serving this community, the community of northern Iroquois County, for over 100 years. It is located in the north central part of the State, and the primary agricultural commodities, as I assume everybody knows, are corn and soybeans. The bank also owns an insurance agency, which sells crop insurance and is one of the largest producers of crop insurance in the State of Illinois.

Jim has been active, I know, from personal observation and experience, in the community. He served as chairman of the Nursing Home Board, past president of the Clifton Lions Club, past vice chairman of the Central Hospital of Clifton, chaired the community zoning committee and in various other and numerous community advisory boards and committees, in addition to begin simply a good citizen of our area.

Jim and his wife have two very fine sons, John and Jeff, and with that introduction, it is just my privilege to have you here, Jim, and I know the committee is anxious to hear from you.

STATEMENT OF JAMES E. CASPARY, PRESIDENT, FIRST NATIONAL BANK OF CLIFTON, CLIFTON, IL, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. CASPARY. Thank you, Congressman, for that kind introduction. Thank you for conducting this hearing. As my Congressman mentioned, I am Jim Caspary, president of the First National Bank of Clifton, IL, and chairman of ICBA's Ag Rural America Committee.

We feel it is appropriate to explore ways to generate more equity capital for farmer-owned co-ops in rural America. This should be done in ways that don't potentially lead to the loss of legitimate farmer control of their cooperatives or in ways that drastically depart from the bedrock principles of what makes a cooperative a cooperative. It is important to ensure that policy actions do not spur greater consolidations in agriculture and consolidation of the businesses and cooperatives that serve agriculture.

First, let me say that the farmer-owned cooperative movement has a long and proud history. Many community banks finance farmer-owned cooperatives, and we believe that they are often essential building blocks of strong local communities. Locally owned, farmer-controlled cooperatives produce jobs in and around the community and add value to agricultural products, generating greater cash flows for both farmers and local economies. Several USDA programs that could help are standing idle, as has been mentioned before. The Rural Business Investment Corporations, we urge that the USDA publish regulations and we also urge that significantly reducing the capitalization threshold necessary for smaller RBICs to leverage funding.

On the Cooperative Stock Purchase Program, allow individual farmers and co-ops to receive loan guarantees to purchase stock for expanding or creating new co-ops. It is virtually unused. The authorities allowing guarantees to individual farmers should be transferred to the FSA, because of their experience with farm loans. Then, give the established co-ops the option of which agency to use, the FSA or the RCBS.

Under simplified loan applications for small B&I loans, the USDA should immediately publish regulations raising the loan threshold of the B&I low-doc loans to $400,000.

Wyoming and Minnesota passed laws to add greater flexibility to attract equity from outside investors. There is, of course, merit in devising ways to attract that outside equity, but the particular model used raises questions over governance and financial rights.

Outside investors could form LLCs labeled as farm-owned cooperatives even if farmers lack clear majority ownership or voting control. Let me share a quote from one cooperative source, and I quote:

> While recent events may seem troublesome, they provide no evidence that the cooperative model is failing. To the contrary, there are many successful cooperatives in business today. Cooperatives, like any other business structure, experience problems, failures, structures and evolution. Any number of major public stock companies have closed their doors or have been purchased by other entities, yet there is little talk that the public stock company has failed.

The two State laws allow for both a patron class and an outside investor class, a minimum of three directors, at least one director elected by patron-members. The patron-director has at least 50 percent of the voting power, and the patrons are entitled to 15 percent of the distributions.

Some questions that need to be asked would be should the board have more than one patron-member? Should patron-members have more than 50 percent controls? Does a 15 percent level adequately protect the patrons? If investors withdraw 85 percent of the profits, does this ensure adequate equity capital remaining in the cooperatives?

The CoBank proposal, we oppose the legislative proposal in its current form. It fundamentally rewrites CoBank's lending charter to allow loans to corporations that may have no farmer involvement and that may be unrelated to agriculture. It should not be adopted this year and more discussion is needed.

Some of our concerns are exactly who is a farmer is undefined, which raises concern when you consider limiting the farm proportion to either 50 percent ownership or farmer voting control. Combined with the fact that these LLC boards need only have three directors, question arise whether real farmers would be involved in some of these entities. Is Ted Turner, as a large landowner, a real farmer? Is Wal-Mart a farmer? Under FCA regulations, they appear like they may be.

CoBank wants to finance entities that become ineligible due to the decline in farmer ownership and voting control even below the watered-down 50 percent level. If farmer-owned co-ops are bought out by a large corporation, they receive the title association as a legal successor, thus CoBank could finance large corporations under this authority that are not associations of farmers, not operated on a cooperative basis, have no farmer ownership or farmer voting control.

Again, a non-farmer-owned parent corporation could be financed, any legal successor, as well as any entity, even though it may not be farmer-owned cooperatives, and even though its business may be completely unrelated to agriculture.

These and other legislative loopholes allow CoBank to completely alter their mission from farming, or financing farmer-owned co-ops, to financing corporations with no farmer involvement, the so-called legal successors.

In conclusion, there could be advantages to seeking outside capital for cooperatives. We must weigh these advantages with the potential for conflicts of interest with farmers who own these co-ops. The control follows the money. Should large corporations be called cooperatives under some State laws when they really aren't? Would they be eligible for benefits as cooperatives and receive financing from co-op banks and potentially compete against farmer-owned cooperatives. Will traditional farmer-owned cooperatives seeking financing from CoBank be told in the future that they need to secure significant outside investor equity and control to receive financing?

With various Federal statues on the books, Congress should help to ensure that farmers' interests are protected at the Federal level in any developing trends that may set the stage for how some cooperatives could be formed in the future.

Caution should be in order to ensure that large U.S. corporations do not have a tool to unfairly leverage their interests against family farmers. These issues should be thoroughly discussed before there is any rush to pass CoBank proposal that rewrites their charter to lend to non-cooperatives and non-agricultural corporations.

We look forward to working with you to address these important issues. Thank you.

[The prepared statement of Mr. Caspary appears at the conclusion of the hearing.]

Mr. MORAN [presiding]. Mr. Caspary, thank you very much, and I would recognize the gentleman from Texas.

Mr. STENHOLM. Dr. Ginder, I take it from your testimony that you do not believe existing laws and programs are enough, are sufficient for our farmers and ranchers to remain competitive under current conditions.

Mr. GINDER. Well, if we think back to when a lot of the Capper-Volstead provisions were put in, that put cooperatives with the single tax treatment, as a better alternative from a tax standpoint, at least, for farmers to use. With the advent of LLCs, they have the single tax treatment and the value added portion of that is not subject to self-employment tax. When farmers sit down and talk about how will we get the most benefits back, the LLC looks preferable in many cases to the cooperative structure as a result. In that, they are trading off, they are having to trade off, having to make the choice between access to CoBank lending and some of the other protections provided by Capper-Volstead.

Mr. STENHOLM. Mr. Caspary, in your testimony, you say you oppose the CoBank proposal in its current form. Do you have some suggestions of how it might be modified in which you might believe it would be supported? You or Mr. Monson.

Mr. CASPARY. Yes, I think that we would have some suggestions. I think that the definitions are very loosely defined in the proposal that they have, and it is subject to interpretations, and I think if we could get some of those defined, and defined what a farmer really is and what a co-op is, and how the private ownership of these proposed new co-ops don't disadvantage private ownership of other businesses in our towns. As it is proposed, for example, giving the tax, if a business in my town, the successful and a taxpaying business, if a group of people who have a few acres of ground that may or may not be, in my opinion, farmers, if they get together and form a co-op and have a business that would compete directly with one of my customers, and to call themselves co-ops, how will my customer, who is a corporation C, for example, that pays taxes and has to borrow at rates, compete against the other one, not necessarily the largest ones, but I am talking about my real customers, so I think that it really has to be defined as to the cooperative, it has to really be involved in agriculture and the producers have to really be involved and not in name only, and that is a little difficult to do when you are talking about 50 percent ownership, for example.

Mr. STENHOLM. Mr. Monson.

Mr. MONSON. Thank you, Congressman. Yes, I share those some issues as Mr. Caspary. The Congress chartered the Farm Credit System for some very definite goals and guidelines, that is to finance agricultural producers who own and control their entities, and as we look at what is being discussed today about the issue of bringing capital to agriculture, it is a good discussion, and I applaud you for doing this. I think the caution that we need to take is when does this entity not become farmer-owned, farmer-controlled and still remain a cooperative and is that within the charter of the Farm Credit System and particularly CoBank?

Mr. STENHOLM. I can appreciate and find myself in substantial support of that general thought, because as I represent a rural area, I have many community banks that, we constantly hear this concern that you both expressed. But I ask you to continue to pursue a compromise, if you wish, in which we can do what I believe both of you in your written testimonies acknowledge. There is a terrific need for attracting capital in rural communities, and it is sometimes difficult for producers alone to come up with the capital. Therefore, this new term now, new generational cooperative, closed cooperative, whatever it might be, if it is a structure that can be put together that everyone at this table and the previous witness tables could agree that this would offer a change in structure that might allow us to do things that we have been unable to do under current law, that most rural communities, I think, would be supportive of that.

I don't have to tell you in the private banking business, but business is changing. Competition is pretty tough. There is a lot of folks doing banking today that you complained regularly about, that they are not operating under the same playing field with you, and therefore, Congress has tried to be sympathetic to that in making many of the changes in financial laws that we need to make in order that we might maintain a community bank system in small town America. We are very receptive to that.

I would hope that we would maintain an open mind regarding our cooperatives, and that includes we farmers, Mr. Peterson, as far as things that we would like to see are sometimes difficult for us to get in the real world today. It is a little bit trying on those of us that remember things the way they were 20 or 25 years ago, and we are not going to go back to that any time soon, if ever, and so the challenge for this committee is to, again, we may not have the jurisdiction of some of this, but from the standpoint of where we do have jurisdiction, where we do have the cooperative structure, a closed co-op is still a co-op. If you have got individual producers that have joined together in order to help themselves get a little bit more of the consumer dollar in their pocket, that benefits banking and everyone else. That is the kind of borrowers you are looking for.

You mentioned Wal-Mart a moment ago. One of the areas that is real challenging to our cooperatives is how do you put a structure together that will cause a Wal-Mart to even look at you, because Wal-Mart is not interested in little people. I say that respectfully, because the very nature of their system is such, and therefore, you have to put together a structure that will be competitive with whatever you are trying to sell to the Wal-Marts, and I can say this for any other chain, and many of our producers, in this case, I am thinking specifically of lamb, is how we are looking at thinking outside the box in order to provide yes, a Wal-Mart, with a supply of lamb that might require importing some lamb from time to time, and having the producers at home benefiting instead of some other company.

Now, if that structure, under some of the line of testimony today, that would not be permitted for cooperatives to lend to that entity if they are going to lend to someone that has perhaps a foreign partner, as well as a corporate partner. I would rather us think in terms of how can we have the banks that you represent, by here today, how can we look at participation loans with cooperatives that would benefit your customers in your communities that you represent and do it on a participation, I used the world earlier, cooperative way. You can have cooperation between an independent bank and a co-op bank in a community. We heard the previous panel, in which they said that is the way it works.

In most cases, most cooperatives do, are good customers of their local bank, and yet, we have this participation question, so as we continue to pursue this, and why I ask you, Mr. Caspary, you say, when you said in its current form, that is encouraging to me. That is not saying we are just opposed to it, we don't want to look at anything else, we just—you just point out in your written testimony, you have got some troubles and these are some legitimate cases or questions that need to be answered. Mr. Monson, the same way with you.

And I could say the same for each of the witnesses here, but I would hope that we would not come to the conclusion that status quo is acceptable, because status quo is going to continue to contribute to the downfall of rural America. We cannot stand on doing business the way we have been doing it, whether it is cooperatives, or whether it is any other business structure. We cannot do that if we have any hopes of maintaining any portion of the remaining 500,000 producers that produce 85 percent of everything that is produced in America. We can't do it, and so I hope that you, with this committee, will maintain an open mind and will look at this from the standpoint as to how can we create a structure that will be as fair to the various viewpoints as we possibly can, while at the same time getting the job done that must be done at that local level.

So, thank you for your testimony. Your written testimony is excellent. I appreciate very much your participation here today. Very important, we are laying the foundation, in my opinion, for the future of agriculture in rural America with this discussion today. This is the foundation, and we haven't poured any concrete yet. We are just putting up the forms. We are going to pour the concrete a little bit later.

Mr. MORAN. I thank the gentleman from Texas. Mr. Caspary or Mr. Monson, Mr. Stenholm was encouraging you to work with Farm Credit or CoBank to try to see if there was another approach or a middle ground. Are those discussions ongoing? Has there been that kind of dialog, with the American Bankers Association or the Independent Community Bankers?

Mr. CASPARY. In our Ag Rural America Committee, the last that I chaired for a few years, I guess, if you want to look at it, each year, we have the FCA Board, a member of them come and we discuss with them the differences, the way that we can cooperate, some of the areas that the banks do, and obviously different areas of the country, react differently. If there is a real competitive nature, there are some bones to pick, but yes, we do work with them and try to cooperate in every way that we can.

We certainly are not ever opposed to creating equity capital in rural America and we fully support, and we would be happy to work with you, to do that as long as we keep that level, or that field, trying to get more level, or tilt it a little bit toward our favor, as Congressman Stenholm said. We support that effort. The thing, I guess, that comes to my mind is that we are talking now about equity capital, and let us not confuse that with equity lending. In other words, there is plenty of credit available in rural America.

We do not have a lack of credit in rural America. What we lack is that capital input to do, let us not say that because we can make more loans, we are helping rural America. We want to make sure that we generate some business opportunities, so that we can enhance the life in rural America.

Mr. MORAN. Mr. Monson.

Mr. MONSON. Thank you, Mr. Chairman. Yes, we have ongoing dialog, not only with CoBank, but also with the Farm Credit Administration. I have met with Mr. Reyna and others, and so there is that open dialog and discussion of the issues. We remain committed to this structure and the financial improvement of rural America. And I would again applaud Congress for making these tools available. Unfortunately, they have not had a chance to be implemented, and we go back to these RBIC, these Rural Business Investment Companies, in which banks and the Farm Credit System come together and make investments, available for these rural cooperatives. We are still waiting for the rule-making on that, Congress has put the tools out there, and along with the Guaranteed Cooperative Stock Purchase Program.

Those are good things. Those would allow for additional stock investment by these farmers whereby they wouldn't have to be committing just their farm assets, but rather, would have the USDA guarantee behind them, which would allow a bank to make these things happen, the tools are there. This is a problem that should be and will be solved.

Mr. MORAN. Do you agree that farmer cooperatives need the ability, this is aside from the issue of who lends to those farmer cooperatives, but is it true within the banking community that it is recognized that the structure of farmers' cooperatives need to be altered?

Mr. MONSON. I don't know in the banking industry if it is a structural that there needs to be a change in structure of the cooperative. I have financed cooperatives. I belong to one. I belong to a couple. I think from the lender's point of view, Mr. Chairman, is there sufficient profitability, is there sufficient capital, is the program put together correctly?

Mr. MORAN. If I understood Dr. Ginder and Mr. Hanson, there is a necessity for the structural organization of a cooperative to be altered to meet today's requirements for, presumably, raising capital, I assume, as well as tax considerations, and if I understood Mr. Peterson, there is some reluctance on the part of his organization to see that happen. He wants them remain more farmer-oriented than they might otherwise be with a new structure.

I wasn't certain whether either the American Bankers Association or the Independent Community Bankers have a position as to underlying changes in State law regarding the changing structure of farmer cooperatives, or if your issue is just about the ability for CoBank or Farm Credit to lend to those structures.

Mr. MONSON. Our position today is probably the latter. There has only been two States that have, I am looking at law in that regard, and there is, as you heard today, there are some varying opinions about how those laws are even applied, so I guess I am not in a position to talk directly about what structure is appropriate, but I think that we need to be mindful of the benefits and the advantages that the co-op, the true cooperative has, and that that be carried forward and be still used as an advantage in ensuring the success of whatever these new entities have.

Mr. MORAN. Mr. Caspary.

Mr. CASPARY. Yes, we definitely have one as far as the State-controlled, our association does not see how you can have 50 different States to come up with a definition of a co-op and then have the Federal Government say that all co-ops are the same. It just absolutely won't happen. I guess, to a certain extent, when you say they need to have a new structure, it brings to mind, I think, a little bit of Congressman Stenholm's early opening comments.

The people who are members of the co-ops, some of them are getting some age on them. They are interested in getting their capital back out of it, so it would seem there would be a need to retain capital, but on the other hand, when you come up with ideas such as you can have 85 percent of the capital, or 85 percent of the earnings going back to the private investors, to enhance them to come in, it doesn't work. I mean, it just doesn't work. You have to retain the earnings. You have to retain that earnings to build your business. That is the way we built our bank over the last 100 years. If we would have said I want to start my bank 100 years ago and I really think I need to get my money out, and every time somebody died and passed on, you took the money out of the bank, we wouldn't have been able to grow and to serve the community, you have to come up with an internal thought structure for the cooperatives that says I am putting my money in and it needs to stay in there. The farmers need to come up with that. It is not I will put my money in and then I want to get it out as soon as I can, or I want to get a really good return on it. You have to say I am going to put this money in, and in 20 years from now, if I don't get a dime out of it, I will have built my sales, I have built my production, or something. That is the mindset. So, it might be more the mindset change than a legislative change.

Mr. MORAN. If I can summarize what I am hearing, it is that if there is a change in the definition, the criteria by which we create a farmer's co-op, it needs to be a national change, not State by State, and then second, you are raising concerns about the opportunity for CoBank and others to lend to those entities. Is that fair?

Mr. CASPARY. I don't understand the last one.

Mr. MORAN. And then you are raising concerns about if we redefine co-ops, create different criteria by which they are created, then that may change the opportunity for CoBank to lend to those entities.

Mr. CASPARY. If, in fact, they retain the right to get their funding from a government-sponsored enterprise and if, in fact, they only are taxed once on the patrons' participation in that profit, then yes, we would oppose that portion of it.

Mr. MORAN. The banking community sees CoBank, sees an independent bank, an independent bank, at a competitive disadvantage, is that—with CoBank?

Mr. CASPARY. We do so in the neighborhood of cost. Their costs of funds are less because they have the government guaranteed of the GSE status.

Mr. MORAN. That is what I want to give you the opportunity to put on the record is what you think that the advantages that CoBank has over you as an independent banker.

Mr. CASPARY. Basically, the tax structure of the subchapter T, and the ability to use the Government Sponsored Enterprise would be my answer.

Mr. MONSON. Yes, I would agree with that. The ability to access the bond market as a government-sponsored entity is huge, and results in a lower cost of funds.

Mr. MORAN. And you see that in your ability to compete with interest rates on your borrowers' loans with CoBank?

Mr. MONSON. It does become a pricing issue. We have tried our best and used other methods available to compete, and I believe there was testimony today from Mr. Sims or rather, the individual from the beef co-op, that they were able to get similar pricing.

Mr. CASPARY. And one further comment. We are at a disadvantage on price at times, but one advantage we do have is our community banks reside in those rural communities. We don't, in the Farm Credit Service, for example, has reduced the offices, and a lot of the loan officers work out of a car, and I think we have Ford and Iroquois and Livingston and the counties right around, there is no office, our banks do have a presence in the community, so that is an advantage that we have that offsets the—but that is because we live in those communities. It is not because the government has given us a competitive advantage.

Mr. MORAN. Dr. Ginder.

Mr. GINDER. Well, from a standpoint of working with a group trained to organize, a lot of the projects are of such a size that at least in my experience, a lot of the banking for LLCs, which Farm Credit can't currently serve, have been coming from larger banks outside the State anyway. There ought to be a way to get consortia or something to——

Mr. MORAN. Let me join the dialog between the two of you, because that was kind of my next question, was in Kansas, where we have seen the need for capital for farmer type cooperatives is, for example, a new ethanol plant. Who is there to put the capital together to create that opportunity?

Mr. CASPARY. We have a perfect entity for that, if they would be giving access to funding through the GSEs and a tax advantage, would be the 30 some odd banker's banks that are in various States in Texas, in Kansas. Those banker's banks do put together consortiums of banks to jointly fund some of the larger ones, so we do have a facility. The disadvantage is that the banker's banks do not have access to the GSE funding at that particular rate and if they would come up with that and some tax incentives to pass on, then, the community banks would be an extremely good source of equity capital.

Mr. MONSON. Community banks have a long history, sir, of working together to finance rural American communities. I was involved in a consortium that raised $25 million in 10 days to fund an entity that wanted to disengage themselves from a former cooperative bank, and so the capital is there, and the infrastructure there is quite honestly through the banker's banks. The pricing can be a problem at time to time.

Mr. MORAN. So the capital is available, it is a pricing issue in many circumstances.

Mr. MONSON. Well, they are definitely, the GSE access to the capital market is an advantage.

Mr. MORAN. Mr. Stenholm.

Mr. STENHOLM. We have other GSEs. Who is the beneficiary of Ready Mac, Fanny Mae. Who benefits from the cheaper money that is made available by GSEs?

Mr. CASPARY. And that would be the homeowners at that point in time.

Mr. STENHOLM. Yeah. Who benefits from farm cooperatives' access to the GSE?

Mr. MONSON. It would be, I assume, their borrowers.

Mr. STENHOLM. That is my point. I mean, we have other GSEs which are designed to benefit the people. What we are talking about here is how do you maintain a so-called level playing field between competitors who are trying to serve the same people? And we seem to have been able to do that in Housing, which is the HUD, how the GSEs benefit the average consumer. We are a tremendous beneficiary of that approach. It has grown so large it is beginning to get a little bit concerning to a lot of folks today, myself included. And that is another story for another committee to continue to look at oversight.

We have a Farmer Mac program. Are you participating in that? And how is that working?

Mr. MONSON. I am a stockholder in the Farmer Mac organization. We have not utilized their product because, quite frankly, they have some stipulations in there relative to prepayment penalties and also some pricing structures that do not fit our particular needs. We were able to place the business elsewhere.

In regard to the other GSEs, that is an excellent point, Mr. Congressman. However, those GSEs are accessible, are accessed by all lenders. His bank, my bank, can access that, and in the case of the Farm Credit System, we can't access that pool of funds.

Mr. CASPARY. Again, if you give banks access to some of that GSA funding for specific portions in rural America, it would be very beneficial.

Mr. STENHOLM. That may be one way that we might end up wanting to go if we are trying to help rural lenders for the purposes of, that is always a possibility. That is what we were hoping to accomplish through Farmer Mac, and if we have still got some rough spots there, we will get out to sign paper and work on it, but we have got to think outside the box, because I don't think anybody has offered a different opinion.

From a rural America standpoint, we are dying. I don't know about your communities and what, but back home in rural Texas, small towns and communities are struggling, and we can say all we want to about the competitive nature, et cetera, but unless we find some ways to bring some capital and jobs in some nontraditional ways, we are going to have a very difficult time. That is what this is all about, and that is why I am encouraged by you continuing to be willing to look at how to take this proposal and make it work, because I think we need all of the capital we can manage in a responsible way, because you make the points, I mean lending to somebody that can't pay it back is not too smart, and I will not take any more time, except to say this. When we talk about some of our government, what used to be Farmer's Home lending and some of the aspects of the Guaranteed Lending Program, I get very perturbed at how little progress we have made in reducing the complexity of a guaranteed loan that a bank or a PCA or anyone else could be able to make so much more efficiently, if we could just the bureaucracy to adapt and do that which Congress has told them to do over and over and over again.

There is a real fertile field out there of things under current law that we could do to be extremely helpful that we seem to be incapable of doing at this moment.

Thank you all very much for your time.

Mr. MORAN. Yes, thank you very much, panel, for your testimony. Without objection, the record of today's hearing will remain open for 10 days to receive additional material and supplementary written responses from witnesses to any questions asked by a member of the panel. The hearing on the House Committee on Agriculture is adjourned.

[Whereupon, at 2:34 p.m., the committee was adjourned.]

[Material submitted for inclusion in the record follows:]

STATEMENT OF DOUG SIMS

Chairman Goodlatte, Ranking Member Stenholm and distinguished members of the committee, my name is Doug Sims. I am the chief executive officer of CoBank. I appreciate the opportunity to present testimony on business structures being used by new generation cooperatives and associations of producers. We commend the committee for holding this important hearing.

CoBank provides financial services to about 2,600 customers throughout the United States. These customers are also CoBank's member-owners and include farmer-owned cooperatives, rural telecommunication companies, and rural electric cooperatives. We also provide financing to support the export of agricultural products. CoBank is part of the federally chartered Farm Credit System and we, like the vast majority of our customers, are a cooperative.

Farmer-owned cooperatives (referred to as associations of producers in the Farm Credit Act) have and continue to play a vitally important role in support of the American farmer. Moreover there is a new generation of cooperatives emerging in rural America that offer future opportunities to enhance farmer income.

For 70 years, CoBank has been the principal source of financing for the vast majority of farmer-owned cooperatives. The mission of serving the financial needs of farmer-owned cooperatives was assigned to us by this Committee and Congress, as set forth in the Farm Credit Act of 1971, as amended. I am here today because dated provisions of that Act will increasingly make it difficult for new generation farmer-owned cooperatives serving the interest of their farmer members to obtain financing from CoBank.

We estimate that CoBank provides about 80 percent of all credit extended to farmer owned cooperatives. We have customers in most rural counties and our cooperative members are often the cornerstone businesses in the communities the members of this committee represent. Our members serve a wide variety of farm interests from wheat and corn to rice and cotton to fruits, vegetables and dairy. While other large lenders may at times be an important source of credit to agricultural cooperatives, their interest in cooperative lending varies over time based on agricultural conditions and other business objectives. Congress has assigned us, as a cooperative owned by our customers, the mission to be there in good and bad economic times.

A USDA study entitled "The Impact of New Generation Cooperatives on Their Communities" found that farmer-owned cooperatives added $9.6 billion in net value to their members' products. Simple economics is the driving force for farmers to form businesses that provide a better chance for increased profits and of success in the marketplace.

My comments today will focus on finance related matters, but CoBank is also a member of the National Council of Farmer Cooperatives (NCFC) and strongly supports the recommendations made by NCFC at this hearing to strengthen the role of the Agricultural Cooperative Service in USDA, to support programs such as the value-added technical assistance grants and commodity purchase program and to address key tax issues that negatively impact cooperatives.

As we view the farmer-cooperative marketplace today and our role as a lender I would summarize a few key points:

Farmers and their cooperatives are changing as the marketplace and competition change and they aggressively seeking ways to enhance returns to farmers and address new challenges and opportunities. Being able to adjust quickly to changing market conditions is a critical factor in the success of farmer-owned cooperatives.

Increasingly, farmer-owned cooperatives are seeking new ways to return more income to their farmer-members through value-added enterprises and creative partnerships. We believe these new approaches when based on sound management and strong capitalization, should be encouraged and enhanced. Farmers often do not have the financial capacity to provide all the equity capital required for many value added enterprises.

To adjust to the marketplace, cooperatives are adopting new business models, which allow more flexibility in raising equity capital from non-producer sources, minimize tax liabilities and provide more operational flexibility. These new structures will often make the cooperative ineligible for CoBank financing.

As cooperatives and associations adjust to better serve their farmer-members, CoBank needs to support these farmer-controlled businesses without the current restrictions that are placed on cooperatives under the Farm Credit Act. State laws are changing to reflect the needs of cooperatives in today's economic environment and Federal laws will also need to be modernized. Under the current situation, a farmer cooperative could be organized under the new Minnesota cooperative law, have farmer control on their board, and not be eligible for financing from CoBank, the bank established by Congress to serve farmer cooperatives.

Without action by Congress to update the cooperative eligibility provisions in the Farm Credit Act, CoBank will be unable to fulfill the mission it has for 70 years of providing credit to farmer-owned cooperatives.

THE ECONOMICS OF FARMER OWNERSHIP

Farmer-owned cooperatives are economic tools that exist for the purpose of providing farmers the means to improve their financial condition. This committee is well aware that most of the profits in the food system are generated after the farmer's product leaves the farm. A new generation of value added cooperatives offer farmers an opportunity to capture an increased part of the consumer food and fiber dollar. Cooperatives enable farmers to diversify their risk and earn greater returns through investments in our Nation's processing, marketing and farm supply systems.

A study conducted by the Quentin Burdick Center for Cooperatives in North Dakota identified the benefits to farmers of value added cooperatives. These benefits include:

- Increase farm income and productivity,
- Reduce marketing risk,
- Increase market access,
- Increase member networking and market knowledge,
- Provide new services, and
- Increase membership share values or economic returns to farmer-owners.

We are optimistic about the changes in approaches that we see with many farmer-owned cooperatives. They are seeking new market opportunities to strengthen returns to farmers. More than ever we are seeing farmer boards and management working to evaluate the best business approach that will create more value back to the farmer. Part of the discussion on how to be successful evolves around the most appropriate business structure to attract investment, minimize tax liabilities and allow operational flexibility necessary for dealing with market changes.

The ethanol sector is one of the areas where business changes are being contemplated. CoBank currently finances about 20 ethanol facilities that operate in Minnesota, Iowa, Missouri, South Dakota and Nebraska. Financing for plants in Illinois and Kentucky have been approved. The financing for these companies involves over $200 million in credit and they produce about 620 million gallons of ethanol annually. On an ongoing basis, the return on equity to the farmer-owners of these plants is typically 10 to 15 percent

For the new ethanol plants being planned and even for some existing facilities, the farmer-owners are faced with a choice of selecting the most appropriate business structure that maintains farmer-control. In some cases the best business structure will not be eligible for CoBank financing. Attached to my statement is a letter from Howard Roe, Treasurer of Tall Corn Ethanol in Coon Rapids, Iowa. Tall Corn has recently altered their corporate structure to attract equity investment from non-members. As noted in the letter, capital was not available from farmer members. Tall Corn Ethanol has been able to attract outside investment and will continue to be controlled by farmers. As a result of their business change, Tall Corn is no longer eligible for credit through CoBank. Another example of a business that has changed their business structure to benefit their farmers and therefore will no longer be eligible for loans from CoBank is South Dakota Soybean Processors. SDSP has been a customer of CoBank's since their inception in 1996 (note attached letter).

This current situation is putting the farmer-owners of cooperatives in a very difficult position—by choosing the most advantageous corporate structure, the cooperative may be forced to forgo access to the lender created specifically to meet the needs of farmer-owned cooperatives.

The need to update lending eligibility provisions to reflect new business structures is not unique to CoBank and the Farm Credit Act. In 1999 USDA took action to allow the Rural Utility Service to finance Limited Liability Companies (LLC). In making this rule change (7 CFR Part 1735), USDA states, "This direct rule is part of an ongoing RUS project to modernize agency policies in order to provide borrowers with the flexibility they need to continue providing reliable telephone service at reasonable costs in rural areas."

Financial Needs of New Generation Cooperatives

As an organization dedicated to helping cooperatives thrive and maximizing benefits to farmers, we are excited about the new business models that farmer cooperatives are considering. These models will at times work to minimize farmer risk and obtain greater returns to their members. Farmers are attracted to them for a variety of reasons:

- Enhance Profits to Farmers—In the past, cooperatives often focused on being "not-for-profit" organizations. The purpose of the cooperative was to provide a market for the product, not a return for the owner. Most cooperatives today recognize that the business must be able to provide a reasonable return to farmers.
- Commodity Margins Are Razor Thin—The farmer who grows the wheat enjoys the smallest portion of the profit derived from the loaf of bread. By becoming an owner in the processing and marketing system, farmers can improve returns and diversify to reduce risks.
- Access to Capital From Multiple Sources—New companies often require a 40 to 50 percent level of equity. In today's economic environment, that level of capital is not available solely from farmers participating in the enterprise. Cooperatives with solid business plans and achievable profitability targets can attract outside non-member capital to supplement the farmer investment. Often times this investment can come from the non-farmers living in the rural community. Non-farmer investment does not mean the farmer class of owners must give up control or forgo operating on a cooperative basis.
- Tax Advantages of New Structures—The new cooperative structures may also have tax advantages that are generally available to limited liability companies—a key consideration for farmer owners. An example is self-employment taxes, which are paid on cooperative dividends, but not on LLC distributions.

While we are enthused about these new models, the committee needs to be aware of some of the realities facing cooperatives. As noted above, CoBank finances the vast majority of cooperatives including a high percentage of the smaller ones. Nationwide, there are fewer than 1,500 farmer-owned cooperatives with credit needs. CoBank considers it part of our mission to work with groups of farmers who are interested in establishing new cooperatives. The risks of new ventures are high and must be carefully considered. By bringing in outside equity capital, farmers share the risk with non-farmers. A farm cooperative business that adds value to a product rather than just passing it up the processing chain can bring diversity and profitability to a farmer's investment—the opportunity to share that risk and reward with others is often a key indicator of success.

Policy Implications

Cooperatives are chartered under State laws and many States where cooperatives are prominent are on the verge of changing their laws to define a new generation of cooperatives. Minnesota and Wyoming already have changed their laws. Further a cooperative does not need to be located in these States to charter in Minnesota and Wyoming. Cooperatives physically located in other States can simply organize themselves under the Wyoming and Minnesota laws similar to the way in which many corporations organize under Delaware corporate laws. As a consequence, we believe that virtually no new cooperative will be chartered under the old statutory provisions that restrict the operation of farmer cooperatives. The key impediments of the old laws are outmoded dividend requirements and voting and ownership limitations for non-farmer members of the cooperative.

For CoBank, specific requirements that farmer-owned cooperative associations must meet in order to be eligible to borrow from the bank are spelled out in section 3.8(a) of the Farm Credit Act. As noted, these traditional requirements are based on a cooperative model that may no longer be suitable for many farmer-owned cooperative enterprises. The specific reason that an association of farmers under a new business structure may no longer be eligible to borrow from CoBank varies by each case, but may include the following:

- Because of the need to attract outside investment, the traditional Farm Credit Act requirement that a cooperative either operate on a one-member one-vote basis or restrict dividends to 10 percent (or less if further limited by State law), may not be met as a separate investor group is established and the cooperative utilizes more flexible voting requirements. Attracting outside investment may be done to enhance operations, build new markets with value-added products, or to help a cooperative avoid asking hard-pressed farmer-members to make additional capital contributions.

Because of the need to flexibly source some products from producers other than members, the new cooperative entity may not meet the Farm Credit Act requirement that non-member business not exceed member business.

CoBank is recommending that Congress amend current law to ensure that these new generation cooperatives do not jeopardize their ability to borrow from CoBank as they structure themselves to compete in the marketplace. Key components of this proposal would:

- Authorize associations of producers that have both a producer and investor class of membership to be eligible for CoBank financing, provided that the producer class holds at least 50 percent of the voting control and operates on a cooperative basis.
- Permit agricultural cooperatives organized consistent with revised State cooperative laws to be eligible for CoBank financing.

Allow cooperative customers that are adopting new business structures to continue to be eligible for CoBank financing as long as the customer maintains at least 50 percent farmer control or continues to be cooperative under State law.

- Provide that cooperatives that are existing CoBank customers, but which restructure in a manner that would make them ineligible for CoBank financing, can remain eligible for a five-year transition period while the cooperative establishes new lending relationships.

In today's financial environment there are very few lending institutions with the necessary scale, expertise—and most importantly—the desire to lead lending efforts to farmer-owned cooperatives. Nothing in these recommendations expands our scope of lending to new areas. These changes will allow us to continue to serve the same type of farmer-controlled businesses that we have served well for 70 years. Without this action, CoBank will not be able to meet its mission of serving farmer-owned cooperatives. The reality is that in many of the cooperative businesses that we finance, there are only three or four lenders that may be interested in considering the business because of the complexity and size of the loan. To eliminate the bank with the biggest and most consistent market share and the one with the greatest expertise does not make sense. Nor does it make sense to force an association of producers to use a traditional cooperative model in order to obtain financing from CoBank.

So that CoBank can continue to carry out our mission as established by Congress, we would appreciate the opportunity to work with you to update CoBank's eligibility requirements along the lines we have suggested for agricultural cooperatives. Without this legislation, farmers and the cooperatives they own will be denied access to CoBank as a source of financing as these new cooperative structures are employed.

This proposal has already received the endorsement of dozens of national, local and regional farm groups and cooperative organizations—including the American Farm Bureau Federation, Farm Credit Council and the National Council of Farmer Cooperatives. We encourage you to give this matter your most serious consideration.

Mr. Chairman, thank you for holding this important hearing. I appreciate the opportunity to provide this testimony and would be pleased to respond to any questions.

Statement of Thomas C. Dorr

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—and 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 1950's, using concepts from the 1930's.

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:

The membership is closed. The amount of product it will accept from a producer is limited.

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.)

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.

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.

STATEMENT OF DAVID GRAVES

Thank you, Mr. Chairman. My name is David Graves and I am President of the National Council of Farmer Cooperatives (NCFC). On behalf of NCFC and America's farmer cooperatives, I want to commend you and Congressman Stenholm for your leadership and for holding this hearing on the state of farmers working together for their mutual benefit.

We also want to commend Congressmen Sam Graves and Earl Pomeroy for their leadership as House co-chairs of the Congressional Farmer Cooperative Caucus and to express appreciation to all members of the Caucus for their interest and participation in this important farmer forum.

NCFC is a national association representing America's farmer cooperatives. There are nearly 3,000 farmer cooperatives across the U.S. whose members include a majority of our Nation's more than 2 million farmers, ranchers and growers. These farmer cooperative businesses handle, process and market agricultural commodities and related products, furnish farm supplies, and provide credit and related financial services. Earnings from these activities are returned to their members on a patronage basis. Farmer cooperatives also provide jobs for nearly 300,000 Americans, many in rural areas, with a combined payroll of over $8 billion.

The need for public policy to enhance the ability of farmers to join together successfully in cooperative efforts to improve their ability to earn income from the marketplace is more critical today than when Congress passed the Capper-Volstead Act and other measures in the 1920's to encourage and promote such efforts. In fact, it can be argued that farmers have even less relative market power today.

This chart, attached to my testimony, helps illustrate the challenge facing farmers today as they seek to improve their overall income from the marketplace. It shows how the farmer's share of the consumer food dollar—the blue line—has continued to decline to where it is now a record low of just 15 percent. At the same time, the farmer's share of net cash income derived from government support payments—the green line—has, though volatile, continued to reflect a rising trend. Even with improving grain, oilseed and livestock prices, direct government assistance is projected by USDA to account for over 30 percent of net cash farm income this year. Clearly, without such assistance as provided under the 2002 farm bill, the farm income picture would look very different.

There are many reasons for both of these trends. Further, it is highly likely that the current trends will continue without a change in policy to reflect modern national and international market conditions. The critical question is what can be done to help farmers be more successful in capturing a greater share of their income from the marketplace?

As farmers attempt to seek more income from the marketplace they are challenged by the new realities of a rapidly changing food and fiber system. The speed and breadth of change in the food, natural fiber and agriculture system in the last five years has been one of the most dramatic transformations in history. The path of globalization, new technology and an exploding equity market have fueled the transformation.

Farmers face rapidly emerging competition in the export markets and a rising tide of imported food products in the domestic market. In addition, the rapid consolidation throughout the food system has challenged traditional business structures and forced a reexamination, realignment and restructuring of business relationships from the combine to the consumer.

It is within this environment that public policy aimed at helping farmers join together in cooperative self-help efforts needs to be reexamined and strengthened. To begin this process, we believe Congress and the Administration should focus on three major initiatives:

USDA Programs to help farmers help themselves through cooperative efforts should be revitalized and given the highest priority.

- A separate Agency should be established within USDA whose primary mission would be to carry out programs, including research and technical assistance, to encourage and promote cooperative self-help efforts. Such an agency existed prior to 1994. Congress and the Administration recently combined to establish the position of Assistant Secretary of Commerce for Manufacturing to give greater priority to the challenges facing the manufacturing sector. We believe the challenges facing farmers and their cooperatively owned businesses are critical and should be given a similar priority and standing.
- USDA research and technical assistance programs to assist farmers and their cooperatives should be specifically authorized and fully funded. These are now funded through USDA salaries and expense budget as part of the annual appropriations process, resulting in considerable uncertainty and lack of accountability.
- USDA's Value-Added Grant Program, which provides matching grants to farmers through cooperative efforts capitalize on new value-added opportunities, should continue to be funded at not less than $40 million as contained in the 2002 farm bill.
- There should also be ongoing review of USDA and Federal programs to ensure they continue to encourage and protect the ability of farmers to join together in cooperative self-help efforts.

The Federal Farm Credit Act should be modernized to ensure that farmers continue to have access to a competitive source of credit capital for their cooperatively owned businesses.

This change is especially needed in response to new and evolving State laws to provide farmers and their cooperatives with more flexibility in terms of how they organize and capitalize their businesses. Minnesota, the largest State in terms of number of farmer cooperatives, and Wyoming recently changed their cooperative statutes, and other States are looking at similar changes. In addition, the National Commission on Uniform State Laws has a project underway to determine whether to recommend adoption of a similar statute by all States as a uniform law.

The problem, however, is that existing cooperatives that choose to reorganize as well as new cooperative ventures formed under these new laws, do not satisfy Federal law regarding eligibility requirements to borrow from CoBank, which itself is a cooperatively owned lender.

Legislation is needed to address this issue so that farmer cooperatives, including these newer generation cooperatives, continue to have as many choices as possible when it comes to seeking the financing and capital they need for the mutual benefit of their farmer members.

Current tax policy should be modified to provide farmer cooperatives with improved access to equity capital needed to modernize and expand, meet costly government regulations, and take advantage of new market opportunities for the benefit of their farmer members.

While we recognize this Committee does not have jurisdiction over such issues, we would like to take this opportunity to urge your support of such initiatives, including H.R. 1671 sponsored by Congressmen Wally Herger, Earl Pomeroy and Sam Graves to eliminate what is now an effective triple tax on farmer cooperative dividends on capital stock under the Dividend Allocation Rule. Such an unfair tax penalty puts farmers and farmer cooperatives at a competitive disadvantage relative to other types of businesses whose dividends are taxed twice and makes it difficult to raise the equity capital needed. Additional tax incentives, such as tax credits, reductions and postponements, should also be considered to further promote farmer cooperative capital formation.

Mr. Chairman, strengthening the ability of farmers to join together in cooperative efforts is critical to any long term strategy to help farmers improve their ability to earn income from the marketplace; better manage their risk; capitalize on potential value-added market opportunities; and compete more effectively in a rapidly changing domestic and international marketplace.

NCFC and our membership look forward to working with this Committee in addressing this important need of America's farmers, ranchers and growers.

Thank you again, Mr. Chairman, for the opportunity to appear before you. This concludes my testimony, and I look forward to responding to any questions you or members of the Committee may have.

STATEMENT OF DOUG PETERSON

Chairman Goodlatte, Ranking Member Stenholm, and members of the House Agriculture Committee, my name is Doug Peterson and I am the President of the Minnesota Farmers Union. It is a pleasure to appear before you today on behalf of the 300,000 family farmer and rancher members of the National Farmers Union to discuss the role of farmer-owned cooperatives in contributing to the financial success of agricultural producers and improving the economic prospects for our rural communities.

The National Farmers Union (NFU) has a long history in the development, operation and support of farmer-owned cooperatives. Our involvement in cooperatives even pre-dates the Capper-Volstead Act which enabled and encouraged the formation of agricultural cooperatives over 80 years ago and was the basis for the enactment of other public policies to further the objectives and provide special treatment for this unique business structure. Our commitment to successful cooperative development continues today through a variety of support activities carried out by both the NFU and our affiliated State organizations.

Historically, cooperatives were established to deal with four primary needs of production agriculture. They provided a mechanism to address two types of market failure that have existed in rural America throughout our history—providing a broad range of locally available services to production agriculture that were not being made available by the private sector and fostering market competition within the input, processing and merchandising sectors to reduce the concentration of market power among a limited number of agribusiness companies. Cooperatives also allowed farmers to participate in both the governance and earnings of the other agricultural sectors with which they do business. Finally, cooperatives contributed directly to the functioning of local economies by creating new jobs and added rural business activities and services. We believe the vital role cooperatives can play in meeting these needs is even more important today than it was throughout the last century.

No one questions that times have changed in agriculture. And I think we all can agree that the strategies employed in the public/private partnership that have fostered the development of agricultural cooperatives should be reviewed and modified to reflect current conditions and future business expectations. Congress must take the lead in this reexamination process rather than allowing events or other institutions to define a new cooperative model that may in fact sacrifice the characteristics of cooperatives that distinguish it from other business structures. We know that there are problems that continue to challenge the system, however, we also believe that a level of restraint must be exercised to provide the opportunity for a full discussion of potential alternatives and outcomes before engaging in a significant modification of the cooperative model.

Specifically, the largest single challenge facing existing or proposed cooperative business ventures is access to equity capital. For established co-ops, new infusions of capital are critical to enhancing their capacity to adapt to and compete in a global setting where market power is becoming increasingly concentrated and integrated through mergers, acquisitions and strategic business alliances.

In the case of start-up cooperatives, access to additional sources of equity is equally important if these new generation cooperatives are to have a reasonable chance of filling the existing void in local and regional market structures in a way that allows their member patrons the opportunity to participate in value-added opportunities and receive the benefits of enhanced market transparency and competition.

The 2002 farm bill authorized programs and appropriations to provide grants and loans to facilitate the development of new rural business ventures, including cooperatives, and also maintains a mechanism to provide access to loan guarantees in order to facilitate the purchase of participation shares in cooperatives by individuals. In addition, the farm bill created the Rural Business Investment Program (RBIP). The RBIP is designed to encourage venture capital investments in rural enterprises through rural business investment companies that are created to raise capital, provide operational assistance to smaller businesses and participate in a government guaranteed debenture program. The program also ensures that ownership of the rural business investment company is not affiliated with the company's management. We encourage this committee to impress upon USDA the importance of expediting the implementation of this program.

In our judgment, the RBIP, when coupled with other cooperative development programs, offers an important opportunity for smaller rural cooperatives to access the resources that are vital to their success. We also believe, however, that Congress should review the technical requirements of the enabling legislation to determine if they are too restrictive in terms of the net worth of the participating enterprise, limitations on participation by financial institutions and the capital requirements for participation in the guaranteed debenture program.

In addition, we encourage the committee to consider ways to streamline the whole cooperative development process. In particular, we believe that shifting some of the lending authorities, such as the various guaranteed loan programs, to the Farm Service Agency, which has substantial agricultural credit experience, would further encourage farmer participation in new or existing cooperatives and expedite the cooperative development process.

Numerous proposals have been suggested, and in some cases State governments have already acted, in an attempt to enhance the ability of cooperatives to attract outside capital. While we appreciate the worthy intentions of these efforts to address the equity shortfall experienced by many cooperatives, we are concerned about the longer term effects of these proposals on the basic cooperative principles. These include producer ownership and governance of coops and the ability of cooperative ventures to provide alternative market opportunities and enhance market competition. In addition, schemes that blur the lines between cooperatives and other organizational structures may put at risk existing preferential public policy treatment for all cooperatives, including but not limited to the issues of the partial anti-trust exemption and tax considerations.

Because these proposals may have a substantial impact on the application of numerous Federal laws, Congress must "get in front" of the issue rather than simply react to the actions taken by others.

We are concerned that new State laws, including one recently adopted in my State of Minnesota, as well as many other suggestions to encourage equity investment in cooperatives could effectively, if not technically, eliminate the ownership, control and allocation of patronage earnings to "real" producers. The old adage, "he who pays the piper calls the tune" could certainly apply to outside investors, who may in fact be able to qualify as farmers under the current definition. Non-farmer investors may be able to control or influence a majority of cooperative board votes to change the traditional allocation of earnings away from patronage to a return on investment. They may also exert substantial influence on merger, consolidation, liquidation or other critical business decisions. In effect, the cooperative, by accepting access to outside capital, may become nothing more than a regular stock company except that the farmer patrons will have collectively contributed substantial risk capital for a venture that may not be serving their own self interest.

Congress should review the definition of farmer as it applies to cooperative ownership and governance. Furthermore, if, after a thorough assessment, Congress determines that the benefits of encouraging the type of outside capital investment envisioned by these proposals outweighs and is not inconsistent with cooperative principles and existing statutes, it should establish strict guidelines and limitations on the level of influence these investors may exert over any cooperative business structure. At a minimum, these rules should require diversification among investors, particularly those with interests in competing businesses, ensure an adequate majority of voting power is retained by the farmer-owners and mandate an equitable sharing of any earnings distribution among outside investors and those who would be entitled to patronage allocations by the company.

Mr. Chairman, we believe the partnership between agricultural producers and the Federal Government to ensure the success of new and existing cooperatives can resolve the issues we have discussed today. We look forward to working with you and your House and Senate colleagues in an expedited, but well considered process that addresses these challenges without destroying the farmer-owned cooperative system.

I will be glad to respond to any questions you or Members of the committee may have.

STATEMENT OF JOHN HENRY SMITH

Chairman Goodlatte, Congressman Stenholm, other members of the committee and guests, my sincere thanks for the opportunity to testify here today on a subject that is of great importance to me and my fellow producer-members of Southern States Cooperative, Inc., as well as members of other farmer cooperatives throughout the Nation.

My name is John Henry Smith and I am a cattleman and tobacco producer in Russell County in southwest Virginia near the community of Rosedale. I have been a member of Southern States Cooperative since 1958 and use many of its products and services in my farming operation. Southern States is a farmer-owned, 80-year-old farm supply and service cooperative based in Richmond, VA. Our cooperative serves more than 300,000 farmer members and other customers in Virginia and the 11 eastern and southeastern States—from Maryland to Florida. It also includes some 237 retail store locations owned or managed by Southern States and some three dozen other facilities such as feed mills, distribution centers, fertilizer facilities, etc. In total, these operations provide more than 3,200 full-time jobs and more than 600 seasonal or part-time jobs, with most located in rural communities. Being farmer owned, Southern States is focused on providing its farmer members with a dependable supply of farm inputs and other services on a cost-effective basis that will help contribute to their economic well being and success.

One of the other ways we are trying to help farmers is through the Southern States Cooperative Foundation. We established this in 1999 specifically to help farmers explore ways to develop value-added agricultural products. We have worked with more than a dozen producer groups who have developed new cooperatives in a variety of value-added endeavors. With each project, we help them develop strategic and business plans, conduct board and management training, and market development.

Mr. Chairman, we've been able to do a great deal through USDA's Rural Cooperative Development Grant Program, and we certainly support continued funding for it. In our case, it has allowed us to bring sound business development to producer groups that might not otherwise have the resources for such development.

Since 1991, I have had the honor of serving on the Southern States board of directors. I recently was elected by producer-delegates in the geographic district I represent to a fifth, three-year term on the board and have served as chairman of the board for the past three years.

While I have always been a firm believer in and supporter of farmer cooperatives, those attitudes have been strengthened in the past 12–18 months. That period has been one of considerable challenge for Southern States and many other cooperatives. Due to a combination of drought and other adverse weather conditions, a difficult farm economy and some diversification and growth steps that did not generate the returns Southern States had expected, our cooperative has been confronted with major financial challenges. I'm happy to report that steps the cooperative has taken during the past year have gotten us back on what I believe is the right track. We're not out of the woods yet, but we already are seeing improvements and I'm confident we are headed in the right direction. The point in all this is to note the reactions of our members during this difficult period. At Southern States meetings and elsewhere, I and my fellow directors on the board have been approached by Southern States member-producers. More times than I can count, these member-producers have told us how much they need Southern States and how much the well being of their farming operations depends on Southern States. Hearing these and similar comments repeated scores of times has been a welcome, but at the same time, sobering reminder of what Southern States means to the farmers it serves.

If my history and math are correct, it has been 81 years since the Capper-Volstead Act was enacted by the U.S. Congress to better pave the way for farmers to work together in cooperatives in meeting their farm supply, service and marketing needs. Much has changed during those eight decades. But as the comments from my Southern States producer-colleagues attest, farmers today still need and rely on their cooperatives as much as they ever did. All of which explains why we were pleased to see the formation of the Congressional Farmer Cooperative Caucus. We appreciate the leadership of Congressmen Graves and Pomeroy in serving as House co-chairs of this group.

I mentioned a moment ago the challenges Southern States has been facing recently. One of the reasons the picture has improved markedly is because our cooperative has moved aggressively to reduce debt, cut overhead expenses and focus on our core market of production agriculture. Quite frankly another reason has been an improving farm economy. And there's no doubt in my mind that the 2002 farm bill, along with disaster assistance and other steps Congress has taken to bolster farm income, have played a key role in the improvement we've seen thus far and in what is projected. The producers I know prefer to generate their income through the marketplace, as opposed to "farming the mailbox." Nonetheless, we appreciate Congress's recognition that actions were needed to address issues faced by our Nation's most basic and important industry, agriculture.

As noted earlier, today's marketplace and the challenges it poses to farmers are different in many respects from what prevailed when Capper-Volstead went into effect, but they are no less daunting. For example, the consolidation of input providers and food processing companies has been dramatic in recent years and we see no halt in that trend. Similarly, a farmer's market no longer is limited to a nearby town or a plant in an adjoining county or State. Not only does today's U.S. farmer produce for a national marketplace, he also must compete with producers around the globe. I personally do not know of any farmer who is large enough to tackle any of these and other similar challenges on his own. Whether it involves securing the needed inputs and related services as efficiently as possible to gain the cost-effective production required to compete and generate an adequate return, whether it involves the marketing and/or processing of what he grows to gain a greater share of the food and fiber dollar, today's farmer needs a reliable place to turn.

When it comes to inputs and related services, the comments I mentioned earlier have made it clear to me that many producers in Virginia and other eastern and southeastern States rely on Southern States. I'm sure co-op members in other parts of the Nation would say the same thing about their cooperatives, including those engaged in marketing and value-added processing activities.

So the issue, in my mind, is precisely what this hearing is all about—namely, the actions Congress can and should take to improve the ability of cooperatives to serve their producer-members. While there are many possible actions, I'll limit my recommendations to those applying to farm supply and service cooperatives because that's the area I'm most familiar with from my involvement with Southern States. I know my colleagues representing other types of cooperatives here today can and will address the needs that they see.

First, Southern States believes that existing programs and tools within the U.S. Department of Agriculture-programs and tools created to help farmers help themselves—can be strengthened as a way of meeting that goal. Among other things, we strongly support the establishment of a separate farmer cooperative agency within USDA, an agency with the resources needed to carry out existing programs, as well as new ones, to maintain and improve the ability of farmers to join together in cooperative self-help activities. From our perspective, having a separate farmer cooperative agency would provide for greater accountability and promote greater support. We recognize that a separate agency for cooperative research, education and technical assistance existed within USDA from the early 1950's to the mid–90's, when it became part of an expanded Rural Business-Cooperative Service. That loss of agency status, as well as specific budget authority, has posed problems in program continuity and in the ability to respond effectively to issues posed by the rapid changes in today's global marketplace.

Second, we urge Congress to approve legislation (H.R. 1671) as introduced by Congressmen Herger, Graves and Pomeroy, to clarify what's known as the Dividend Allocation Rule. Because of the Dividend Allocation Rule, cooperative dividends are subject to a triple tax , while regular corporate dividends are taxed only twice. Eliminating this unfair tax penalty—an issue that both houses of Congress have acted on favorably in the past—would be an important step in helping farmer cooperatives attract equity capital.

Third, to make sure that farmer cooperatives have continued access to a competitive source of credit, we support an updating of the Federal Farm Credit Act—especially in view of changing State laws. The problem is that some of the newer business forms available to farmers interested in working together in the marketplace are very appealing. However, they do not now qualify as potential CoBank borrowers even though they clearly are cooperative in nature. Updating the law would allow farmers to continue to have choices when it comes to organizing and financing their cooperative businesses.

My fourth and final point probably could be a sub-point of my first comments about strengthening existing tools within USDA. However, it's an issue important enough to us that we wanted to make note of it separately. Our understanding is that new provisions of the Business and Industry (B&I) Guaranteed Loan Program in the 2002 farm bill could provide loan guarantees up to 90 percent on maximum loans to cooperatives of up to $40 million. That and other new B&I loan program provisions represent a considerable improvement over what they replaced. However, I would note that in today's environment, the $40 million cap doesn't meet the needs of many cooperatives, including Southern States. We're not advocating a re-opening of the farm bill to deal with this issue. However, from a realistic standpoint, having Federal guarantees behind loans of up to $100 million as originally proposed by this Committee in the 2002 farm bill would come much closer to meeting the needs of today's larger, capital-intensive cooperatives. One of the challenges cooperatives historically have faced, and continue to face today, is generating capital required for meeting operating needs and capital improvements. Many new generation cooperatives have addressed the latter by requiring substantial up-front investments from the producers they serve. Other cooperatives find that approach difficult to implement due to the nature of their business. Regardless of the circumstances a particular cooperative may or may not face, boosting the guarantee to the $100 million range would be extremely helpful.

Exactly 50 years ago, Southern States observed the 30th anniversary of its founding by producing a movie entitled "We." The main point of that movie was that cooperatives are not a set of buildings and facilities that represent the "them" in a "we and them" scenario. Rather, cooperatives are farmers themselves working together to accomplish what none of them could do by themselves. In short, a more appropriate way to view our organizations is with an equal sign between the words "we," "farmers," and "cooperatives." That was true in 1923 when Southern States was founded as Virginia Seed Service to provide farmers with a reliable supply of quality seed. It was true 50 years ago when "We" was produced, and it remains true today.

Mr. Chairman, should members of this committee or its staff have an interest in seeing the operations of a farm supply cooperative, I would note that Southern States has a number of locations with an hour's drive or so of the Capitol. We would be happy to show any of them to you.

Thank you again for the opportunity to share these thoughts with you.

STATEMENT OF STEVEN D. HUNT

Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you today and discuss solutions to the challenges and opportunities facing producer owned and controlled businesses that are formed as cooperatives. My name is Steve Hunt. I am a fifth generation cattle producer and the CEO of U.S. Premium Beef (USPB), the first large-scale producer-owned beef marketing cooperative in the United States. I am proud of the history of independence that is a stalwart of the beef industry. Historically, this has enabled us to survive and prosper. Though, today and in the future it will be our ability to build on our independent legacy through cooperative efforts that may ensure our survival and prosperity for years to come. By cooperatively and strategically aligning ourselves among the many segments of the beef industry, we are better positioned to compete in today's increasingly competitive marketplace, respond to consumer preferences and improve the safety of our products. Our unique integrated strategy has allowed producers the opportunity to move up the value-added ladder enabling them to profitably sell meat and meals instead of cattle. Please refer to exhibit A.

We will look back on this time as a watershed moment for a growing number of producer-owned cooperative businesses who are faced with the challenges of a restrictive cooperative structure and seeking a change. For producer owned ventures to compete and succeed today and into the future, they must have the ability to attract non-producer equity and diversify their business; both are restricted under the current laws governing cooperative structures. There exists today, alternative business structures in the form of L.L.C.'s that provide the benefits of a pass through tax structure, link producer ownership to the delivery of a commodity, allow unlimited earnings diversification and provide for recruitment of outside capital; all while maintaining control in the hands of the producer. While the issues surrounding this topic can be complex, it is my intent to present solutions that will insure producers can organize and cooperate in a way that enables them to compete and survive.

CHANGES IN THE MARKETPLACE

As one reviews the history of producer formed cooperative ventures, we see a structure that offered producers of commodities the opportunity to pool their resources, their commodities and capital, and move up the integrated value chain that no other structure allowed. Initially cooperatives were formed to deal with both social and economic needs in a much different marketplace. Today as we witness an acceleration of concentration among food industry participants, the need to achieve size, scale and market leverage is becoming paramount to their success. These changes require vast amounts of capital.

In the years ahead, cooperatives, like much of rural America, will face these serious challenges. Their customers and competitors are becoming larger, more sophisticated and utilize the latest technologies including biotechnology, information services and transportation. These evolving businesses can mass large amounts of equity through multiple sources. Under today's rules, cooperatives have only to look toward cash strapped producers to secure equity. The alternative is to leverage their business through debt equity; a strategy that has resulted in numerous public failures. One has only to read the headlines over the past several years to see the evidence of the growing number of agricultural cooperatives' inability to compete.

USPB Acquires Majority Interest in National Beef

While since 1997, USPB has enjoyed a successful partnership with Farmland Industries, in May of 2002, Farmland Industries' financial challenges, exasperated by its lack of liquidity, filed for bankruptcy. USPB ultimately acquired Farmland's interest in the National Beef partnership in August of this year through the bankruptcy process. As a result of the acquisition, USPB was able to secure a majority interest in the business. However, due to the restrictions in attracting equity outside of a pool of cattle producers, USPB was forced to form its venture outside of the cooperative and seek outside investors as partners in the beef business. Had USPB been able to attract alternative sources of capital within the cooperative, we would have owned a larger percentage of the beef business and increased our odds of maintaining producer control into an uncertain and very competitive future. Additionally, in order to achieve a majority position, since equity capital was limited, we were forced to rely more heavily on riskier debt equity thereby leveraging the company.

Challenges of the Cooperative Structure

The wave of new marketing cooperative businesses that dotted the high plains and Midwest over the last decades provided a vehicle for producers to pool their commodities and capital and enter further processing or value added ventures. These entities were formed under the cooperative pass through tax principal. As long as the cooperative is fully owned and doing business for and with its qualified members, it will achieve a single tax much like a partnership or LLC. If it fails to maintain its producer ownership or pursue non-patron business, the cooperative will lose its tax efficiency and be taxed at both the company and producer level.

In recent years we have witnessed many farmer owned cooperatives fail or convert to other corporate structures. The cause for these two events is related. Producer / member equity can not compete with the capital intensive, value-added processing prevalent in food processing. Today's cooperatives are faced with an ever growing and consolidating marketplace. To succeed requires vast amounts of capital in order to achieve economies of size and market leverage. Very public failures, such as Farmland Industries, have been observed to be the victim of their own cooperative structure where essential capital sources of liquidity were limited to a narrow pool of already cash strapped producers. Likewise, many other cooperatives, seeing the challenges of raising necessary equity in the future, are considering converted to other business structures that allow alternative sources of non-producer equity.

Additionally, many successful cooperatives, like USPB, have been exploring alternative business ventures that fall outside the scope of patron or producer sourced income. These alternative businesses can be essential to diversify a cooperatives' business. In the case of USPB, we have invested in a food safety initiative that we plan to commercialize and license to other food processors thereby generating income not directly associated with producer cattle delivered, processed and marketed through their company. Once again, in other forms of pass through entities, the owners realize a pass through tax while engaging in a wide range of diversified businesses. As a cooperative, we are restricted from pursuing these alternative businesses.

While converting to an alternative business structure seems the simple solution; unfortunately, there exists several sizable barriers to converting from a cooperative to a partnership entity such as an LLC. Successful companies like USPB and its members could be assessed a tax on the gain realized through the termination required in current tax law. The tax liability itself further exasperates the lack of liquidity many cooperatives face.

Converting to a non-cooperative structure could also restrict our company from maintaining a bank relationship with CoBank. CoBank has been an important provider of credit and financial services to USPB since inception. Their knowledge and expertise in lending to agricultural producer-owned businesses nationwide is invaluable. Their presence in a consolidating lending marketplace is key to maintaining access to credit and competition. Congressional action is needed to insure that farmer owned and controlled businesses, not formed as cooperatives, are eligible to borrow from CoBank.

SOLUTIONS

There is however, a solution to the challenges facing cooperatives considering a conversion. This solution is in the form of an amendment to the Internal Revenue Code providing for special rules for cooperative conversion transactions. In order to be defined as an association eligible for the special rules, the resulting association of the conversion would be required to maintain agricultural producer majority ownership and governance rights immediately following the conversion. I propose the following rule changes for eligible associations:

The conversion transaction shall not be treated as a sale or exchange of property; the shareholder or member of the cooperative shall not recognize a gain or a loss as a result of the conversion; the cooperative shall not recognize a gain or a loss as a result of the conversion; the basis of property that becomes property of the eligible association in the conversion shall be the basis of the cooperative before the conversion; the eligible association may adopt the same fiscal tax year as the cooperative before the conversion

A one-time conversion tax exemption on those cooperatives that convert to an LLC and still maintain producer control would allow for a viable solution to a critical problem. By requiring the converted entity to be majority owned and controlled by producers maintains the integrity of benefits flowing to agricultural producers. By targeting the most successful producer-owned ventures (those who have realized a gain) to aid in these changes, you have naturally selected a group who is most likely to succeed in furthering the integration of producers into value added markets. We must realize that achieving size and strength are essential to our success as producer-owned ventures and should not be considered a burden on the marketplace.

USPB, like many other successful producer-owned ventures formed as cooperatives, is facing significant challenges as it plans for its future. In order to survive and compete in our ever changing and consolidating food industry, we are going to need ready access to equity and have the ability to pursue diversified businesses.

Under the restrictions placed on the cooperative business structure, we are forced to consider alternative business structures that provide the needed flexibility to succeed. In order to provide us the opportunity to convert to these alternative structures, we need help in the form of an exemption from tax on gain realized at conversion and other cost savings such as maintaining the current fiscal year and an easing of securities requirements in the raising of equity. By requiring that the converting entity maintains producer ownership and control, you can be assured that this change will allow successful grass roots producer-owned ventures to succeed by showing up with the tools to compete with widely held public companies with unlimited access to equity.

We appreciate your continued support for our unique business. And, I respectfully ask that you consider supporting our need for changes in the tax rules that will facilitate changes necessary to continue the growth and development of producer owned ventures.

Thank you for the opportunity to testify before you today. I will be happy to respond to questions.

EXHIBIT A

THE USPB SUCCESS STORY

As early as the fall of 1995, midwestern producers from all segments of the cattle industry, seed-stock, cow-calf, farmer-feeder, and feedlot, began meeting to discuss the problems plaguing the current cattle marketing system and also to examine some solutions. After much research by a steering committee of these cattlemen committed to taking control of their own destiny, U.S. Premium Beef, Ltd. was formed. Founded on July 1, 1996, U.S. Premium Beef was structured as a new generation beef marketing cooperative, the first and only in the United States. Shortly thereafter, a business plan was established and a mission statement was adopted. This mission reads:

"To increase the quality of beef and the long-term profitability of cattle producers by creating a fully integrated producer-owned beef processing system that is a global supplier of high quality value-added beef products responsive to consumers' desires."

From there, more than 765 producers from 24 States committed both cattle production and capital to seek out the most economically feasible inroad into further processing and value-added products. After extensive research into the different alternatives of acquisition, building or joint venture, it became evident that the only viable avenue for producers to gain a greater share of their marketing dollar was through a joint venture.

In July of 1997, we announced that U.S. Premium Beef (USPB) had signed an agreement to enter a partnership with Farmland Industries, the Nation's largest farmer-owned cooperative, to purchase 29 percent of Farmland's National Beef Packing Company. Farmland National Beef is the only producer-owned beef processing company, and additionally an international leader in value-added branded products.

During the fall of 1997 USPB mounted a stock offering drive through the United States. By December 1, 1997 our efforts were successful. We had commitments for nearly 700,000 cattle annually, and over $72 million in capital raised. The following week USPB began operations, buying more than 10,000 member cattle on an individual animal basis over a progressive carcass value based grid.

At USPB, we designed a progressive grid system to increase the quality of cattle and the returns to our producer owners by providing monetary incentives based solely on quality. Since we began delivering cattle in December of 1997, USPB cattle have exceeded industry quality levels, and our producers have earned significant premiums over cash price.

By working together to produce a better product, it is our intention to improve the overall image of beef and hopefully earn more of the consumer's trust and business with our efforts.

USPB Acquires Majority Interest in National Beef

USPB ultimately acquired Farmland's interest in the National Beef partnership in August of this year through the bankruptcy process. As a result of the acquisition, USPB was able to secure a majority interest in the business. However, due to the restrictions in attracting equity outside of a pool of cattle producers, USPB was forced to seek outside investors as partners in the beef business.

Current USPB Operations

To date, USPB and its members have marketed over 3.7 million cattle through its plants and beef company. Membership totals include over 1800 producers from all segments in 34 States. While still in its infancy, USPB has paid out over $64 million in cash premiums over the USDA reported live cattle market. In addition, our stock holders / members have realized earnings of over $80 million through the profits of the Beef Company they own. Stock, initially issued at $55 per share, now trades at $155 per share.

Additionally, every producer member is insured a competitive carcass merit grid pricing, carcass data on individual animals, transportation credit up to 110 miles or $6 per head, and livestock and meat consulting, all at no charge.

Our results have far exceeded expectations. The level of premiums has steadily increased over the past six years. This has occurred in great part due to the utilization of carcass data and the financial incentives in place through grid pricing. Any producer armed with the correct system and information can achieve these results.

Statement of Keith Kisling

Thank you Mr. Chairman and members of the committee. I sincerely appreciate the opportunity to be here today.

The topic of this hearing is very important to the future of agriculture and to farmers and ranchers like me who are looking for ways to get more of our income from the marketplace, take advantage of new value-added business opportunities, and to help create wealth in our rural communities. For these reasons, I want to commend you for your leadership in holding this hearing. I also want to commend Congressmen Sam Graves and Earl Pomeroy for their leadership as House co-chairs of the new Congressional Farmer Cooperative Caucus.

My name is Keith Kisling and I am a third generation farmer from Burlington, in the Third Congressional District of Oklahoma proudly represented by the Honorable Frank Lucas.

I currently serve as secretary/treasurer of the Oklahoma Wheat Commission and I am the vice chairman of US Wheat Associates. US wheat is an organization funded by the wheat check off program whose purpose is to market our wheat products both here and abroad and research new ways for farmers to do business. We greatly appreciate your support of agricultural research through our Land Grant Universities because without that financial support, our industry would suffer immensely.

My farm is typical of most in my part of the country with a majority of our revenue derived from wheat, stocker cattle, alfalfa, winter wheat pasture and a 1500 head feedlot. For all of my career as a farmer I have enjoyed incredible benefits as a member of our local Burlington Cooperative Association, where I served as director for 12 years, and as a member of four other agricultural cooperatives in Oklahoma and Kansas. I have always viewed the cooperative system as a vital instrument in producing and marketing agricultural commodities, but in the past four years I have seen first hand that cooperatives can be much more.

In 1996, a group of producers in our part of Oklahoma started looking at options on how we could "add value" to the high quality wheat product we were selling. This thought process hatched what is known today as value added products, a New Generation Cooperative in Alva, Oklahoma that takes our wheat production and transforms it into frozen pizza crusts that are sold throughout the Midwest. We take 642,000 bushels of wheat and yield $20 million of pizza crust per year making us the largest single pre-proofed and frozen dough plant in the United States after only four years in operation.

But getting from the "idea" stage to the "production" stage was no easy task and this is where your help is vital for this type of value added venture to work throughout rural America.

Of course our biggest challenge was collecting up front capital in order to convince our lenders to buy into the deal. We held 40 meetings with a goal of raising $10 million to use against our $18 million total project cost.

One tool made this possible. In Oklahoma, we have a 30% State Tax Credit that can be utilized over seven years when you invest in a value-added venture. This tax credit was the only reason we were able to bring 850 producers in as investors, and it is a model we would ask you to consider. I was asked constantly in those forty meetings we held if there was a similar Federal tax credit and my response had to be "no". A "yes" answer would be much more helpful in the future.

After raising the necessary equity capital, we were able to obtain the financing we needed with the help of USDA's guaranteed loan program. We also obtained a grant under USDA's Value-Added Grant Program, which provides funds on a matching basis to assist start up value added ventures and provide working capital for existing businesses in order to market their products better. Two years ago, value added products received an existing business grant which allowed us to expand into new products.

We are now selling the world pizza crust instead of a railroad car full of wheat. More jobs are available for our young people and more sales tax revenue is going into our community to provide basic infrastructure and technology.

The 2002 farm bill with the inclusion of Rural Development and Energy titles sent a message to Rural America that Farm Policy and Rural Policy are not necessarily the same thing. Granted, farming is the backbone of the rural economy, but for a body to function properly it must also have arms and legs, which include our rural infrastructure, and rural employers. We cannot survive without the full package.

If we are going to survive as an industry, we have to find new and better ways to capture more of the value of what we produce after our commodities and products leave the farm.

Farmer cooperatives, including New Generation Cooperatives such as value added products, can play an important role. But we also need programs in place that help encourage and promote such efforts.

Attracting equity capital is a critical challenge. Again, Federal tax incentives similar to our Oklahoma tax credit would help encourage investment in cooperatives.

Value-Added Grant Program should continue to be funded at no less than $40 million as provided in the 2002 farm bill. In fact, I believe the program should be expanded in dollars and eligibility to help more rural business and producers bring more value-added projects to the table.

As a food producer from America's breadbasket I again thank you for the opportunity to testify. Your willingness to listen is what will ensure a strong tomorrow for American Agriculture.

Statement of Stephen Wright

Pro-Fac Cooperative, Inc. is an agricultural marketing cooperative doing business with over 2,000 fruit, vegetable and grain producers in 12 States across the country. Our members produce 20 different commodities that are marketed through the Cooperative to nine different processing companies, including Birds Eye Foods, of which Pro-Fac is a significant minority owner.

We thank you and Congressman Stenholm for conducting hearings on farmer cooperatives on October 16, 2003. We also commend Congressmen Graves and Pomeroy for their leadership as House co-chairs of the Congressional Farmer Cooperative Caucus and thank all members of the Caucus for their interest and support.

For many decades, cooperatives have enabled farmers and ranchers to realize a larger portion of the consumer food dollar than they could garner individually. As farmers' share of that dollar is now at an all-time low, strong and efficient cooperatives are needed more than ever before.

Since Pro-Fac's inception in 1961, its members have not only enjoyed secure markets for their raw products at competitive prices, but they have also shared in the Cooperative's earnings. Through member investments in capital stock and retained earnings, Pro-Fac owned its marketing arm, Curtice Burns Foods (now Birds Eye Foods). However, burdensome debt levels and the inability of a cooperative to access reasonably priced capital resulted in the sale of controlling interest in Birds Eye just over a year ago. That restructuring has proven successful to date and we are confident that members' equity has been protected. However, we are saddened that a well-known and respected company like Birds Eye can no longer boast that it is 100 percent farmer-owned.

We urge Congress to strengthen the marketing capabilities of farmers and ranchers through cooperative self-help efforts. This can be done by:

- Strengthening USDA programs designed to help farmers help themselves.

Establish a separate agency within USDA for farmer cooperatives to ensure that farmers have access to the tools they need to be successful.

Provide specific authority for USDA farmer cooperative research and technical assistance programs, to provide adequate funding for the benefit of farmers.

Maintain the ability of farmers, through their cooperatives, to participate in USDA programs, including agricultural, export, commodity purchase and other programs.

Maintain funding for the Value-Added Development Grants program at the full $40 million level authorized in the 2002 farm bill, so that farmer cooperatives and their members might capitalize on value-added opportunities.

- Modernizing the Federal Farm Credit Act to ensure that farmer cooperatives have continued access to a competitive source of credit and capital through CoBank for the benefit of their farmer-members.
- Changing tax laws to improve access to equity capital, including H.R. 1671 (Herger-Graves-Pomeroy), to eliminate the unfair triple tax on cooperative dividends under the Dividend Allocation Rule. Other tax changes are needed to help farmer cooperatives attract equity capital and encourage cooperative self-help efforts.

Thank you once again for your committee's interest in America's farmer cooperatives.

STATEMENT OF JOHN G. REIFSTECK

My name is John G. Reifsteck, and I operate a 1,500-acre cash grain farm in Champaign County, Illinois. I have been a board member of our locally farmer owned cooperative, Illini FS, Inc., since 1975 and currently serve as president. I also serve as vice chairman of the Board for GROWMARK, Inc., a regional farm supply and grain marketing cooperative headquartered in Bloomington, Illinois, which is owned by the local farmer cooperatives.

I want to thank you and ranking member, Rep. Stenholm, for holding the October 16 hearing on Farmer Cooperatives. Additionally, I commend the committee's efforts and those of Congress for the 2002 farm bill and other actions which have helped support farm income.

As an involved producer active in a local cooperative and GROWMARK, Inc. a regional cooperative, I fully support the testimony presented by David Graves, president of the National Council of Farmer Cooperatives (NCFC) at the House Agriculture Committee hearing. GROWMARK, a NCFC member, has discussed and will continue to address Congress on these issues of concern: (1) modify current tax policy improving farmer cooperative access to equity capital and support of H.R. 1671 to eliminate the triple tax on farmer cooperative dividends on capital stock under the Dividend Allocation Rule, (2) improve USDA programs developed to help farmers help themselves, and (3) modernize our farm credit system important to farmers and farmer cooperatives working hard to support themselves in rural America.

Chairman Goodlatte, thank you, I appreciate the opportunity the House Agriculture Committee provided to submit comments.

STATEMENT OF BRUCE ANDERSON

My name is Bruce Anderson. I am a farmer from Glenburn, North Dakota, as well as a director for the past 8 years for CHS Inc—a regional agricultural cooperative.

In a moment, I will tell you more about my own farming operation and my long-time involvement in producer-owned cooperatives, as well as their role in the ability of American farmers to succeed today.

First, however, I would like to thank Chairman Goodlatte and Representative Stenholm for scheduling this hearing and providing me—on behalf of CHS—an opportunity to speak on this important subject.

Second, I would also like to extend our appreciation to Representatives Graves and Pomeroy of the Agriculture Committee for their leadership as the House co-chairs of the newly formed Congressional Farmer Cooperatives Caucus. The establishment of this caucus last spring was an important step in bringing together a broad range of members of Congress to focus on issues that are extremely important to producers and rural America.

Finally, as harvest is wrapping up in much of the country, I would like to thank the House Agriculture Committee and the entire Congress for their efforts on the 2002 farm bill, as well as their leadership on a host of other issues including disaster assistance and measures to maintain and improve farm income.

As I address you today, I wear two hats. First, that of a third-generation North Dakota farmer. Our family has relied on cooperatives to help us succeed for more than 75 years. Today, my wife, Pam, and I raise small grains—primarily wheat—on our 1,000-acre operation located just north of Minot in the State's north central area. I am a member of Farmer Union Oil Company and Sun Prairie Grain, both co-ops that have undergone tremendous change, including mergers and joint ventures, in the years I've been associated with them, in an effort to continue meeting the needs of their producer-owners.

Beyond that, I've often said that I've literally been a member of a co-op my whole life. My father opened my first credit union account when I was a week old. I've also been a life-long user of electric and telephone cooperatives and been active on many boards.

From a farmer perspective, cooperatives are extremely important to me. I rely on them for all of my supplies and for access to grain markets. They offer me a chance to do business with a company I own and to share in that success when the cooperative does well. They provide opportunities I likely would not have on my own.Now I'll put on my other hat. Since 1995, I've been a director, representing the producers of North Dakota, on the board of what is now CHS.

For those of you who are not familiar with CHS, I will provide a brief background and scope of our cooperative. Although we're just over five years old as a company, our roots reach back to cooperatives formed in the 1920's to meet both the agricultural inputs and grain marketing needs of producers in many areas of the central and western States.

During the last seven decades, those original organizations have grown and changed dramatically. Many of you were probably familiar with us as the former Cenex and Harvest States cooperatives. Today CHS is a diversified supply and agricultural foods company committed to providing the essential resources that enrich the lives of those whose lives we touch. We are owned by farmers, ranchers and cooperatives from the Great Lakes to the Pacific Northwest and from the Canadian border to Texas.

The CHS of today provides products and services ranging from grain marketing to food processing to meet the needs of customers around the world—from the producers' farm to the consumer's table. We operate petroleum refineries/pipelines and, through a broad range of working partnerships, market and distribute Cenex brand energy products, along with agronomic inputs and feed to rural America. We're a Fortune 500 company and we do some type of business—from ag supply to energy to food products—in every State of the U.S. and market grain in 90 countries around the world.

We're owned by nearly 1,200 member cooperatives in 26 States who represent an estimated 350,000 farmers and ranchers. We're just finalizing our fiscal 2003 financial figures, but in fiscal 2002 our earnings were $126.1 million on sales of nearly $8 billion. Based on those earnings, we returned $56.5 million in cash—as cash patronage and equity redemptions—to our members in fiscal 2003.

Clearly we've grown in seven decades, but what hasn't changed is our commitment to the farmers, ranchers and the cooperatives who own us and our unwavering belief that the success of producer-owned co-ops—including CHS—is a vital self-help tool for American agriculture.

As a producer, I believe that for the long-term future of agriculture, it is essential that producers have an ownership stake in the businesses they need. It's important for American agriculture, as a whole, that the people who produce our food have a commitment to a business they own and that business, their cooperative, has a commitment to them in return.

Maintaining successful cooperatives that ultimately help producers and American agriculture succeed is no easy assignment today. It takes a multi-faceted approach.

First, cooperatives themselves must operate as economically viable businesses. At CHS, we spell that out in our vision and mission statements that say we exist to be an integrated supply and grain-based foods system that improves company profitability and stakeholder value by linking producers with consumers. Clearly our producer and member cooperative owners are the most important of our stakeholders. In achieving this, we are committed to operating our cooperative business with financial stability and the highest of integrity.

Equally important, however, is having a solid basis of support for producer-owned cooperatives within our Nation's governmental structure. This leads me to my primary purpose today, which is to urge this committee and Congress to take three important steps to strengthen the ability of farmers to join together in cooperative self-help efforts.

First of all, we call on Congress to strengthen U.S. Department of Agriculture programs designed to help farmers help themselves. Specifically, we ask Congress to:

- Establish a separate agency within USDA for farmer cooperatives, to help ensure that farmers have access to tools they need to be successful;
- Provide specific authority for USDA farmer cooperative research and technical assistance programs, to provide adequate funding for the benefit of farmers;
- Maintain ability of farmers, through their cooperatives, to participate in USDA programs, including agricultural, export, commodity purchase and other programs; and finally,
- Maintain funding for value-added Technical Assistance Grants Program under the 2002 Farm Bill to help farmer cooperatives and their members capitalize on value-added opportunities.

Second, we urge the modernization of the Federal Farm Credit Act to ensure that farmer cooperatives have continued access to a competitive source of credit and capital through CoBank for the benefit of their farmer-members.

Finally, we call for support for changes in tax laws to improve access to equity capital. This includes passage of H.R. 1671, which eliminates the unfair triple tax on cooperative dividends of capital stock under the Dividend Allocation Rule, along with other tax changes to help farmer cooperatives attract equity capital and encourage cooperative self-help efforts.

Approval of legislation in each of these three critical areas will do much toward the overall goal of helping farmers help themselves through the cooperatives they own, cooperatives that serve as the most useful tools available today for ensuring the long-term success of our Nation's production agriculture sector.

On behalf of CHS, and more importantly, on behalf of the millions of producers like myself who rely on cooperatives as tools for success in this rapidly changing global marketplace, I thank you for this opportunity to testify today. I respectfully urge this committee to provide leadership for the passage by Congress of these vital provisions for American agriculture.

STATEMENT OF MICHAEL M. REYNA

Chairman Goodlatte, Ranking Member Stenholm, and members of the House Agriculture Committee, I am Michael M. Reyna, chairman and chief Executive Officer of the Farm Credit Administration (FCA or Agency). Joining me today are my colleagues on the FCA Board, Doug Flory and Nancy Pellett.

On behalf of the FCA Board, I wish to thank you for the invitation to discuss the changing structure of agricultural cooperatives and the challenges that cooperatives face as they seek to increase the income of their farmer-members while, at the same time, finding new ways to finance their operations. These challenges, and how Congress chooses to address them, are of prime importance.

As you know, I have provided the committee detailed written testimony on the topic of today's hearing; hence, my opening remarks will be brief so as to be respectful of the committee's time and the time of other witnesses scheduled to testify.

As you know, the Farm Credit Administration is the independent Federal financial regulatory agency that is responsible for overseeing the mission and the safety and soundness of two separate, but related, agricultural Government Sponsored Enterprises (GSEs), including the Farm Credit System (FCS) and the Federal Agricultural Mortgage Corporation (Farmer Mac). We achieve our objective by conducting periodic financial safety and soundness examinations and by adopting regulations that provide for necessary guidance.

The System is a nationwide cooperative network of borrower owned financial institutions that lend to agriculture and rural America. Established it in 1916, it is the oldest Government Sponsored Enterprise (GSE) in the United States, and is the only GSE that engages in lending at the retail level.

The mission of the System is to improve the income and well being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations. It does this by serving all eligible borrowers having a basis for credit and, as required by Congress, by placing a high priority on financing young, beginning and small farmers.

Cooperatives have played a crucial role in making American agriculture prosperous, productive, and efficient. They increase the sales revenue of farmers and lower the costs that farmers pay for supplies and business services. In addition to increasing revenues and lowering costs, cooperatives are a vital and integral part of rural America.

Cooperatives strengthen the agricultural economy and improve living conditions in rural areas in many different ways. For example, earnings in the form of patronage are returned to farmers, who contribute to the local economy. Cooperatives strengthen the economic base of the local community by adding to the tax base, creating new jobs, and spurring retail sales and services. Cooperatives also help provide consumers with more choices and or new products.

It is the unique structure of cooperatives that strengthens the market power of farmers so they can earn more and live better. The characteristics of traditional farmer cooperatives include the following:

- Agricultural producers are a large majority of the voting members;
- Each member has only one vote, regardless of the amount of equity capital owned;
- Members earn patronage based on the amount of business they do with the cooperative,
- Dividend payments on equity capital are restricted, and
- The cooperative does more business with members than non-members.

For more than 80 years, Congress has sought to preserve and expand the benefits that cooperatives have to offer. Specifically, Congress has devised a public policy that grants cooperatives certain legal protections, tax benefits, and other advantages that are not conferred on investor-owned agribusinesses. As a result, farmer cooperatives have direct access to GSE funding that their competitors, which are investor-owned agribusinesses, generally lack.

It is important to note that farmer cooperatives play an important role in America's agricultural economy, with the share of overall farm commodities marketed through cooperatives being fairly steady over the past five years. And, although the number of farmer cooperatives has declined 25 percent in the past decade, the net business volume of cooperatives actually increased.

While no empirical data is available to determine whether farmers have been reducing their use of the traditional cooperative form of structure in recent years, our agency did, however, conduct a limited survey in which we contacted the ten states with the greatest number of cooperatives to identify annual trends in new cooperative filings.

Specifically, FCA staff found no consistent trend in the number of new filings over the period 1993 to 2003. While half of the states did display a declining trend in the number of cooperative filings, two states displayed an increasing trend and one state showed no change. Two states were unable to provide the data. A broader survey, as well as further study, may be warranted.

Notwithstanding numbers, trends and limited surveys, there are concerns being raised by some individuals and groups that traditional cooperatives are not resilient enough to endure the economic changes facing agriculture today and help farmers overcome new challenges.

It is not uncommon for farmers to struggle to find sufficient capital to enable them to invest in their own value-added enterprises. And, when farmers cannot raise sufficient capital on their own, they must turn to outside sources of equity.

To attract outside equity capital or increase their business with nonmembers, some farmer groups are forming hybrid organizations or restructuring existing cooperatives. FCA staff has identified numerous examples of value-added cooperatives that had changed to the LLC form or that had formed a joint venture LLC with other cooperatives or Subchapter C firms. In addition, some groups of farmers have chosen to form new value-added enterprises as LLCs rather than cooperatives.

LLCs offer many advantages that cooperatives do not. Among other advantages for example, LLCs attract outside investors by giving them a say in management and a return in proportion to their investment.

And, while a few well-established cooperatives have been able to attract outside equity successfully, for a host of reasons most outside investors have little incentive to invest in agricultural cooperatives. This is especially true for start-up cooperatives.

Recognizing the limitations of the traditional cooperative structure, Wyoming and Minnesota have enacted new laws that allow farmers and investors to join together to form new types of cooperatives. The two state laws are not identical, and their treatment of certain issues differs. These cooperatives can best be described as hybrids between traditional cooperatives and LLCs.

These laws are newly enacted, and at this early stage it is unknown how many traditional cooperatives plan to convert into hybrid cooperatives, or how many entities will be formed under these new state laws.

The FCA Board is aware that CoBank is developing a legislative proposal that would give it more flexibility to finance cooperatives that are adjusting their structure in response to changing market.

While Congress is ultimately responsible for deciding the scope of CoBank's lending powers, please rest assured that the FCA is prepared to implement and enforce any policy that Congress enacts.

As always, the FCA is ready to offer you assistance in crafting any changes to the Farm Credit Act, and we look forward to working with this Committee as it considers issues that are important to agriculture and rural America.

Thank you for the opportunity to testify at today's important hearing.

TESTIMONY OF

ROGER D. MONSON

on behalf of

THE AMERICAN BANKERS ASSOCIATION

presented to the

COMMITTEE ON AGRICULTURE

U.S. HOUSE OF REPRESENTATIVES

OCTOBER 16, 2003

organize in Wyoming or Minnesota. Personally, they do not look like the cooperatives that I know.

The larger question of what they are must be decided by leaders of the cooperative movement and ultimately by Congressional action. We do know that well-managed and well-capitalized businesses that organize under these state laws will have no problem accessing additional debt and investment capital from private sector banks, insurance companies, industrial credit corporations, and individuals.

CoBank is asking Congress to consider very broad legislative language to re-write their charter to allow them to finance these hybrid businesses. Our belief is that their proposal would dilute their existing obligations to farmer-owned and farmer-controlled cooperatives and would allow them to finance organizations that merely have some farmer content. CoBank's proposal is a very broad and fundamental re-write of their charter.

We are very concerned that CoBank is asking Congress to sign away a major part of their jurisdiction over their activities by proposing language that would allow CoBank to lend to any entity that is defined as a "cooperative" by state law, not federal law. We believe this would create a situation that would be impossible to regulate, as it would require their regulator, the Farm Credit Administration, to become familiar with different laws in all 50 states to determine if CoBank was making loans to eligible borrowers. As a Government Sponsored Enterprise ("GSE"), they should continue to be governed by federal law, not state law. If CoBank wishes to be governed by state laws, they should surrender their federal charter, and the funding advantages they receive as a taxpayer-supported and subsidized GSE.

Finally, CoBank's proposal would allow them to continue to lend to businesses that are no longer cooperatives (farmer-owned or even farmer-content) for up to five years so the businesses can "transition" to other forms of credit. This proposal should not even be considered. If a farmer-owned cooperative disbands, it is no longer a farmer-owned cooperative, and it is no longer eligible to borrow from CoBank. Under the proposal, taxpayer subsidized credit would be extended to a fortunate few businesses, while others would not be able to access the same taxpayer-subsidized benefits.

Over the years CoBank has grown into a $27 billion institution that, in addition to providing financing to farmer-owned cooperatives, provides export financing for agricultural products, finances rural telephone and other infrastructure, operates a nationwide leasing company, wholesales FCS funding to a large number of FCS associations, and provides cash management services to its borrowers. They are a formidable government sponsored institution when compared to the vast majority of banks and other financial institutions that serve rural America. We believe that granting them authority to lend to farmer-content companies would be a great mistake.

Banks Finance Cooperatives

While we oppose CoBank's proposal, we support farmer-owned cooperatives. Cooperatives are very important in North Dakota, and in all of rural America. In my state, cooperatives provide electricity, telecommunications, and other information technologies. They supply markets, and help develop new uses for agricultural production. Our bank finances cooperatives because they are good business for the bank, and because they provide many services that we need in Finley. I am a member of the Town and Country Cooperative, which has farmers and townspeople as members. I would like to share with you how Town and Country Cooperative came about because it is a great example of how we leveraged an important USDA program to provide the capital the cooperative needed to grow.

The cooperative had been affiliated with Cenex. However, financial trends were not good, and the patron/owners decided to close the business. The company sold farm supplies, fuels, clothing, tires, and hardware. All of us in town recognized what an important asset the cooperative was to Finley, so when some of the former patrons and people in town got together to see what could be done to keep the business open, the Citizens State Bank got involved immediately. Ultimately, a new cooperative was formed, Town and Country Cooperative. The patron/owners are farmers, local businesses (including our bank), and people that live in Finley. The new cooperative has added a convenience store with a deli and has started agronomy services for area farmers.

In order for Town and Country Cooperative to remain viable, they had to build their business base to increase cash flow. A cooperative in a neighboring town of 1,100 people closed, and Town and Country Cooperative bought their convenience store. Our bank financed $650,000 for the acquisition. By providing the capital the cooperative needed, we helped save 10 jobs and today, the cooperative has increased their payroll to 13 employees in that town. In addition to providing credit, we provide the cooperative with deposit services and will soon have automatic teller machines in each store.

Another local cooperative that we finance is the Finley Farmers Grain and Elevator Cooperative, a business that has been in the community since 1911. This cooperative, which is farmer owned, buys grain from area farmers. It is also a significant employer in town with 20 people on the payroll. In order to remain competitive and to be able to have the new unit trains stop in Finley to pick up grain, the cooperative had to finance the acquisition of a new 372,000 bushel grain bin, lay two miles of new railroad track, and acquire a locomotive. My bank was the lead lender in the $2.2 million package. We participated some of the loan with another local bank. Without the loan, the cooperative might have lost its access to the railroad. At a minimum, they would have been at a price disadvantage if they could not load unit trains, which have become the norm in grain transportation in my state.

USDA Business and Industry Guaranteed Loan Program

I was able to finance Town and Country Cooperative's acquisition of the new store with a combination of direct bank loans and with a USDA Business and Industry loan guarantee ("B&I"). Our bank was able to provide the loan to the cooperative because the USDA guarantee helps us manage credit risk and allowed us to exceed our loan limit because the guaranteed portion of the loan does not count against our legal lending limit.

As this committee looks for new ways to help cooperatives access more capital, please remember that the B&I guaranteed loan program works well for private sector lenders like us and for quasi-government lenders like the Farm Credit System ("FCS"). The biggest obstacle lenders confront using the B&I is funding. Annual demand for funding frequently exceeds annual allocations. In my state, B&I demand usually exceeds the North Dakota state allocation and the state is dependent upon national pooling to meet all of our B&I requests. Some years, not all requests get funded. Cooperatives are well represented in North Dakota, and the rest of the country, as recipients of these loans.

In the case of Finley Farmers Grain and Elevator Cooperative we were not able to utilize the B&I program because the regulations do not allow lenders to finance revolving credit, which was the type of credit that best fit the cooperative's needs. I recommend that the B&I regulations be revised to allow USDA to guarantee revolving credits, including revolving lines for short term working capital and longer term lines for capital asset finance. A revolving loan guarantee would have helped us in Finley, and I am sure that it would help businesses and cooperatives access capital in other states as well.

USDA Cooperative Stock Purchase Guaranteed Loan Program

Several years ago USDA announced a new guaranteed loan program that was specifically targeted to help farmer-owned cooperatives. This program, the Cooperative Stock Purchase Guaranteed Loan Program, was intended to allow institutions like mine to make loans to farmers to enable them to buy cooperative equity. To encourage banks and FCS institutions to make more loans for these purposes, USDA was supposed to provide up to 90% guarantees on these loans. The program was launched with much fanfare, and many of us thought that it was a great idea.

Many times small farmer-owned cooperatives do not have much of an asset base, so when I get a request to finance a cooperative equity purchase from a customer, I have to look at securing that loan against other assets owned by the customer. When we do this we take away from the customer's ability to borrow additional funds in the future for other business needs. The USDA cooperative equity purchase loan guarantee would allow my bank to make loans to finance cooperative equity purchases without always having to be cross collateralized by other assets. Typically these are small loan requests; a loan for $100,000 to purchase cooperative equity would be a very large loan.

Despite the promise of this program, USDA has had limited success. First, the program was given to the Rural Business-Cooperative Service ("RBCS") the agency that handles the B&I program in a very capable manner; however they do not have the experience with small loan requests, or with farmer-generated financial statements. Their area of expertise is with large complex credit requests. To date, very few loans have been written under this program.

Last year Congress again attempted to resolve some of the operational problems when it authorized B&I guaranteed loans to individual farmers to buy cooperative stock. Section 6017 of the *Farm Security and Rural Investment Act of 2002* ("2002 Farm Bill") allows USDA to guarantee such loans, and further allows farmers to provide financial information in a manner that is generally accepted by area agricultural lenders. We have yet to see if this additional clarification will result in any comprehensive change in USDA's lending for cooperative stock purchases. We hope that USDA will be able to promulgate regulations soon.

I am very fortunate to live in a state that has a willing partner to help us finance cooperative stock purchases for individual farmers and ranchers. The Bank of North Dakota, the only state owned bank in America, has a cooperative stock purchase loan participation program that works quite well. If my bank originates a loan to an individual to purchase stock in a cooperative, the Bank of North Dakota will participate up to 70 percent of the loan. I make my part of the loan at our normal bank interest rate, and Bank of North Dakota makes their part at prime minus one, thus providing the customer with a very favorable blended rate. We have made lots of loans under this program and they are good business for us, and good for farmer-owned cooperatives. I encourage USDA to contact the Bank of North Dakota to learn how they have been so successful with this program.

In addition, we believe that USDA should undertake a comprehensive review of all of the credit programs intended to help individuals make cooperative equity purchases to create a streamlined loan program that works for farmers, ranchers, and the credit community. Further, we believe that administration of the resulting program should be turned over to the Farm Service Agency ("FSA"). FSA has the expertise with small loan requests, understands farmer financial statements, knows the lenders that are likely to be making loans under this program, and has done an outstanding job of streamlining all of their existing guaranteed loan programs over the past five years. Making this program work for farmers and their lenders would go a long way in helping cooperative members capitalize their enterprises.

Rural Business Investment Companies

Section 6029 of the 2002 Farm Bill authorized a very innovative program, the Rural Business Investment Company ("RBIC"). Patterned after the successful Small Business Investment Companies administered by the Small Business Administration, RBICs would allow banks and FCS institutions to charter institutions that would promote economic development in rural areas by making equity investments in rural businesses and cooperatives that generally have annual sales of less than $2 million and a net worth of $6 million or less.

The Secretary of Agriculture is authorized to guarantee debentures issued by some RBICs to allow them to leverage their capital to make additional equity capital available to rural businesses. The Secretary is authorized to guarantee a total of $280,000,000 in debentures. Finally, the Secretary has been authorized to make grants of up to $44,000,000 to RBICs for the purpose of helping them administer their investment programs. This new program is highly targeted since RBICs would be required to make at least 75% of their capital investments in rural America. The balance of their investments could be made in non-rural areas, but the resulting investments must benefit rural residents.

We supported the creation of RBICs during the debate on the 2002 Farm Bill, and we have been anxiously awaiting USDA's rule making process. Once USDA promulgates the regulations, we call upon Congress to appropriate full funding for this important program to help generate more equity capital in rural America.

I live, work, and invest in Finley because it is my home and every day I have the opportunity to help my fellow citizens with their financial service needs. Above all, however, my bank remains in Finley because we can produce a return on investment that satisfies the needs of those that own the bank. If you allow CoBank to expand their lending to broadly defined farmer-content businesses, we may one day have a hearing about why there is no bank, and maybe no real farmer-owned cooperatives left in Finley, North Dakota.

Thank you for the opportunity to share our thoughts about the future of the farmer-owned cooperative movement. Our members have been meeting the financial needs of farmer-owned cooperatives, rural businesses, farmers, ranchers, and all rural Americans for a very long time. We support farmer-owned cooperatives because they provide many of the essential services farmers and ranchers need to succeed in their businesses. Our support is substantial; we provide credit, financial expertise, and other financial services every day to all of our customers--- cooperatives, for profit enterprises, municipalities, and individuals.

I am happy to answer any questions you may have at this time.

INDEPENDENT COMMUNITY BANKERS of AMERICA

Prepared Remarks of Jim Caspary
House Agriculture Committee Hearing
New Cooperative Business Structures
October 16, 2003

Thank you, Chairman Goodlatte and Congressman Stenholm for conducting this hearing today to examine the structure of agricultural cooperatives and issues related to their financing.

ICBA Members – Serving Agriculture & Rural Communities

I am the President of the First National Bank of Clifton, Clifton Illinois. I am also the Chairman of ICBA's Agriculture-Rural America Committee. First National Bank of Clifton is a small Midwestern agricultural bank with $30 million in assets that has been serving the community of Clifton since 1902. It is located in the north central part of Illinois where the primary agricultural commodities are corn and soybeans. The bank owns an insurance agency which sells crop insurance and is one of the largest providers of crop insurance in the state of Illinois.

75 percent of ICBA member banks are located in small communities of under 10,000 population and our members have a long-standing interest in providing credit to American agriculture and our rural communities. ICBA is the only national trade organization that exclusively represents the interests of our nation's community banks.

Importance of Today's Hearing

The hearing today affords us an opportunity to review options for enhancing the equity positions of farmer-owned cooperatives. Two states, for example, Wyoming and Minnesota, have passed state laws designed to add greater flexibility in allowing cooperatives to attract equity from outside investments, but this model law has also raised several questions from among those in agriculture that follow these issues closely. Under this model, outside investors could form LLCs labeled "farmer-owned cooperatives", even when farmers don't have majority ownership or voting control and be eligible for cooperative benefits.

We are opposed to the CoBank legislative proposal in its current form because of its far-reaching implications and because it would fundamentally rewrite CoBanks lending charter to allow loans to corporations that may have no farmer involvement and that may be unrelated to agriculture.

ICBA's general viewpoint is that we do feel it is appropriate to explore ways to enhance the accumulation of equity capital within farmer-owned cooperatives and in rural America – but this should be done in ways that don't potentially lead to the loss of legitimate farmer control of their cooperatives or in ways that drastically depart from the bedrock principles of what makes a cooperative a cooperative.

We also feel it is important to ensure that policy actions do not spur greater consolidation in agriculture and consolidation of the businesses and cooperatives that serve agriculture just for the sake of growth for some at the expense of survival for others.

Therefore, we will make some positive recommendations to attract equity capital in rural America, discuss some questions that have been raised regarding the model law adopted by two states and discuss our concerns with the CoBank legislation.

The Importance of Farmer-owned Cooperatives

First, let me mention that the farmer-owned cooperative movement has a long and proud history. Many community banks across the nation are involved in financing farmer-owned cooperatives and we believe they are often essential building blocks of strong local economies. The experience of community banks financing farmer-owned cooperatives has been mutually beneficial because the traditional farmer-owned cooperative structure serves the dual function of being responsive to the needs of local communities and also of helping to stimulate rural economic growth. And the cooperative model has proven successful at the regional and national levels as well.

In fact, we would suggest that the cooperative model can be considered an ideal model for local economic development because the structure provides for local ownership and control (one member one vote concept) and the net proceeds are distributed to its patrons – those who use the cooperative – based on the amount of their use, or their patronage. The cooperative principles compel cooperatives to also perform an important public function – serving the needs of their members – as opposed to being driven largely by a profit motive. Cooperatives achieve this by allowing their members to pool their collective resources to achieve a critical mass that provides for economic efficiencies.

In our rural areas, this means cooperatives can be controlled by local farmers and receive financing from the local bank or banks to promote the growth and interests of the local community, as opposed to an investor owned firm that would primarily be looking out for the interests of the investors, who may not be local citizens. If community residents control the cooperative, they can ensure the cooperative serves the economic interests of the community and not the objectives of people who may live far away from the community.

Therefore, cooperatives often provide services and products for local citizens rather then focusing solely on maximizing profits. Investor owned firms, by contrast, can be under pressure to grow as fast as possible, often outgrowing the community's interests – meaning the business may decide to relocate to a more urban or suburban setting as it grows instead of remaining in the local community. An investor driven company may decide to relocate away from the rural community to have greater access to a larger labor force, ample technology resources and a greater supply of services and social amenities. This can contribute to the "out-migration" problems affecting many of our rural communities.

Locally owned, farmer-controlled cooperatives also help the rural economy by producing jobs in and around the community and adding value to products that farmers grow, generating additional cash flow both to the farmers and to the local economy.

Ethanol plants are a good example, and a new energy bill that contains a front-loaded Renewable Fuels Standard (RFS) would be very helpful and we urge Congress to pass a new energy bill soon.

We should also keep in mind that there are thousands of cooperatives operating successfully in rural America today and new ones are being started. In fact, last week the Des Moines Register carried an article about the opening of a new farmer-owned beef cooperative, Iowa Quality Beef, which attracted capital from 900 farmers in a dozen states. Additional financing was provided by a major bank and a community bank provided the real estate loan for the project. Also, the Farm Bureau contributed $1 million investment to acquire 20,000 shares of Class C preferred stock with the promise of an 8 percent annual return once the plant becomes profitable. The plant is the first beef packing plant to open in Iowa in decades and will provide producers with an alternative market for the high-quality beef cattle raised in Iowa, known world-wide as "I-80 beef." The new cooperative will help create jobs and support the state's corn and soybean industries and the state's rural economies.

Financing the Farmer-Owned Cooperatives of Tomorrow & Today

Generally speaking, operating on a cooperative basis means that the organization exists for the benefit of its members. The return on capital is usually limited because the purpose is to either market products and then return the proceeds minus selling expenses, or to provide a service or product to patrons at the lowest possible cost. Benefits of being part of the cooperative are returned to the members on a patronage basis rather than on an investment basis. With cooperatives, democratic member control uses the one-person-one-vote system.

Obviously, any business, whether a cooperative, a single proprietorship, a corporation or other corporate structure, needs to have a certain amount of equity to begin, operate and maintain their business operations. In rural America, it has been evident that there are plenty sources of "debt" capital. Any credit-worthy business can get a loan from a commercial bank and often times there are several community banks vying for a potential customer's business within the community. It is also true that any business that opted to form an LLC according the two new state laws would have ample choices of financing available from the private sector.

But many suggest that attracting ample equity capital, as opposed to debt financing that lenders provide, is the real challenge in rural America. Certainly farmer-owned cooperatives have found this to be true at times. Beginning in 1998, the ag economy went into a tailspin as commodity prices became severely depressed, making it hard for many farmers to cash flow, let alone have income to contribute as equity capital to cooperatives.

In recognition of this, Congress has either adopted or updated several programs. Unfortunately, several of these USDA authorities either sit idle today or have yet to be fully implemented. These authorities are listed below along with our recommendations.

- ***Rural Business Investment Corporations (RBIC)*** – Section 6017 of the new Farm Bill establishes a new *Rural Business Investment Program* to provide $44 million in grants and $280 million in guarantees for rural business investment companies to establish a developmental venture capital program that provides equity investments for rural businesses. The program is modeled after the Small Business Investment Company (SBIC) program, used primarily in larger metro areas, but targets at minimum 75 percent of its resources to rural areas. The program would allow companies to considerably leverage their equity resources up to three times their capitalization; provides operating grants up to $1 million and other benefits to increase rural equity capital.

  As stated in the managers' amendment on the farm bill, it was the expectation that rules could be proposed in "a very short time", but we have seen no proposed regulations yet. We also note that institutions can form RBICs if they have capital of $2.5 million or greater. However, only those institutions with $5 million to $10 million are eligible for a guarantee on their debentures. While these levels may be appropriate for their city cousins, the SBICs, this amount of required capitalization is higher than necessary for rural areas and this threshold should be significantly lowered to attract the formation of more RBICs.

- ***Cooperative Stock Purchase Program*** – Section 6017 of the new farm bill also includes new authorities under the Business & Industry (B&I) program to provide loan guarantees for the purchase of cooperative stock. B&I loans can be guaranteed to farmers, ranchers or cooperatives to purchase start-up capital stock for expanding or creating an agriculture co-op. The Secretary may guarantee a loan to a producer to join a co-op in order to sell products the farmer produces. Also the program was modified to allow existing cooperatives to be eligible for the program in addition to start-up cooperatives.

  This program is virtually unused and we believe consideration should be given to allowing the Farm Service Agency (FSA) to manage the program either in part or in its entirety. For example, Sec. 6017 (2)(C) requires that financial information from a farmer or rancher as a condition of receiving a B&I loan guarantee be provided in a manner generally required by commercial ag lenders. Commercial ag lenders generally are heavy providers of FSA guaranteed farm loans to farmers and individual farmers are used to receiving farm loans, as opposed to larger business loans.

  Therefore, we believe the program would operate more smoothly if it were transferred to FSA, or at least allow FSA to be the agency that guarantees loans to farmers and ranchers for purchase of cooperative stock. Under this scenario, established cooperatives could continue to have the option of receiving guaranteed loans for stock purchases from USDA's Rural Businesses Cooperative Services agency. We believe aggressive use of this program would be a significant boost for rural farmer-owned cooperative equity enhancement.

- ***Value Added Ag Market Development Grants*** – This program authorizes $40 million per year from the CCC and relaxes eligibility to increase participation by allowing producer groups and "majority controlled producer based business ventures", as determined by the Secretary, to compete for grants designed to develop value-added products or markets. One of the purposes of these grants is to "provide capital to establish alliances or business ventures that allow the producer of the value-added ag product to better compete in domestic or international markets."

- ***Ag Innovation Centers*** – Congress has also authorized funding for a new Agriculture Innovation Center Demonstration Program to provide technical assistance, business and marketing planning, and other non-financial assistance to value-added businesses. The program should better meet producers' interests in start-up farmer-owned value added processing facilities while establishing resource centers to assist producers in value-added endeavors. The added funding will enable producers to capture more of the value of their commodities. The law emphasizes one purpose of these grants is "increasing and improving the ability of local agricultural producers to develop markets and processes for value-added agricultural commodities or products . . .".

- ***Additional Farm Bill Authorities for Large Farmer Cooperatives*** – The rural development title of the farm bill also contains a number of provisions sought by large cooperatives. These include provisions relating to being able to receive B&I loans in excess of $25 million; allowing cooperatives headquartered in metropolitan areas to receive loans if the loans are used for projects in rural areas; and allows for consideration of the cooperatives' brand, patents and trademarks in determining eligibility.

- ***Simplified Loan Applications for Small B&I Loans*** – There was also a provision in the rural development title advocated by ICBA that mandated the Secretary to provide "lenders a short, simplified application form for guarantees" on loans up to $400,000 under the B&I program and for loans up to $600,000 after fiscal year 2004. This would effectively be an increase in the loan amount that qualifies for the streamlined loan documentation form from the previous $50,000 level, which was ineffective because of its small size. The FSA farm loan level under the low-doc program was also supposed to be increased to $125,000.

  Increasing the low-doc level for the B&I loans should be a simple process but no regulations have come forward. Reducing the paperwork involved for lenders and their customers in securing rural small business loan guarantees is a complimentary step to attracting and/or maintaining adequate equity capital investments in their rural businesses. We ask the committee to urge USDA to immediately issue regulations on this provision in the farm bill.

A Model Adopted in Two States

A Question has also been raised as to whether we need to make the farmer-owned cooperative model more "flexible" in order to enhance the ability to raise equity capital and address other issues, such as ensuring ample product availability, greater market share and greater economies of scale. Some may suggest that cooperatives cannot survive in today's agricultural economy, characterized by intense international competition and costly new technologies, unless they can form strategic alliances, joint ventures and other relationships between companies, whether cooperatives or non-cooperatives, in an effort to attract greater capital and access more markets.

In discussing the structure of farmer-owned cooperatives, one cooperative source we reviewed noted that there have indeed been some recent failures among agricultural cooperatives, citing for example Farmland Industries and the sale of assets of the Minnesota Corn Processors to ADM. But then the source added this thoughtful comment:

> *"While recent events may seem troublesome, they provide no evidence that the cooperative model is failing. To the contrary, there are many very successful cooperatives in business today. Cooperatives, like any other business structure, experience problems, failures or structural evolutions. Any number of major public stock companies have closed their doors or been purchased by other entities, yet there is little talk that the public stock company has failed."*[1]

It is important to realize that there are many methods that can be used help farmer-owned cooperatives to attract equity capital. Obviously an important source is and should remain the capital generated by the patronage of the cooperatives' members. Cooperatives can also form joint ventures or strategic alliances with other cooperatives and with outside investors to share their resources for a particular project. My point is that several options are available that allow cooperatives to "cooperate" between different types of businesses, whether they share the same or a different corporate structure, without one business, the farmer-owned cooperative, being taken over by outside investors.

When Do Cooperatives Cease Being Cooperatives?

In viewing the laws that have been adopted by two states it is important to keep in mind basic principles of farmer-owned cooperatives: 1) Owned by farmers; 2) Controlled by farmers; 3) Each member has one vote – "one member, one vote" – a bedrock principal of cooperatives; and 4) Earnings allocated to farmers based on patronage, rather than to investors based on investment.

The two state laws allow: membership made up of both patrons and outside investors; a minimum of three directors; at least one member elected by patron members; and the patron member has at least 50% of the voting power.

Several questions have been asked regarding governance: 1) Should boards of these LLC entities be required to have more than one patron board member?; and 2) Should patron members have more than 50% control of their cooperatives if they are going to adhere to cooperative principles and be eligible for benefits as cooperatives?

The laws adopted at the state level in Wyoming and Minnesota allow for allocations and distributions on the basis of patronage for patron members and investment for investor members. For example, allowing for 15 percent of allocations and distributions going to patron members regardless of ownership level. This would leave 85 percent available for investors based on their investments. Questions include: 1) Does the 15% level adequately protect the patron members?; 2) If investors can withdraw 85% of the profits from the cooperative, does this adequately ensure more equity capital is available for the cooperative?

A USDA analyst raised several questions relating to the Wyoming state law: Basically, these concerns involved the following issues:

- Such entities may be incompatible with the traits that distinguish a cooperative from an investor-owned firm.
- Serious questions exist as to whether such an entity is eligible for the public policy benefits available only to cooperatives.
- Under this law, a cooperative can have an unlimited number of investor non-patron members who aren't required to do business with the association, but are entitled to vote and share in its earnings on the basis of their level of investment.
- Patron members are limited to one vote each, while non-patron members may have an unlimited number of votes.
- Only one of an unlimited number of directors must be elected by producer patron members.
- Director(s) chosen by the producer-patron members are entitled to 50 percent of the voting power on the board. But this may fall short of the level of producer control that is necessary to operate as a farmer cooperative.
- No limit is imposed on the rate of return investor-members can realize on their investment, and up to 85 percent of each year's earnings may be distributed to investor members based on investment.
- *One or more outside investors with two-thirds voting control can merge or consolidate the entity into another entity, or liquidate it without any support from the producer patron-members.* (emphasis added)

The analysis added this comment:

> *"Delaware could amend its laws to create another statute that lets General Motors or any other large investor owned firm call itself a 'cooperative.' But if such entities disregard the key cooperative characteristics of user ownership and control and benefits flowing to the users based on patronage the integrity of all cooperatives is called into question.*

The analysis then suggested that an entity structured under this law may have trouble qualifying for benefits that adhere to several federal statutes including anti-trust immunity; Subchapter T taxation treatment; exemptions from filing of securities under the Securities Act of 1933; and the Ag Marketing Act of 1929.

These issues may be worthwhile for federal policymakers to ponder and for the agriculture industry to consider at length.

CoBank Legislative Proposal

The issues mentioned above also relate to CoBank's legislative proposal as well. We do not see a dire need to immediately pass legislation before Congress adjourns this year that would dramatically alter CoBank's lending charter.

Rather, we believe there should be a broad discussion of these issues within the agriculture industry. This "discussion" should imply much more than simply circulating letters asking organizations to support broad concepts under the notion that some lenders cannot get involved in certain loans to legitimate farmer owned cooperatives.

It should be well understood that financing for these cooperative ventures, even if restructured as LLCs, is available from the Farm Credit System (FCS) direct lender associations as well as commercial banks. The CoBank legislation does appear to risk allowing CoBank, as a national discount GSE lender, to undercut local lenders, whether FCS associations or commercial banks. CoBank can currently participate in financing legitimate agricultural enterprises through loan participations with other lenders, which helps ensure local lenders are not driven from the local marketplace. Some additional concerns include:

Who is a farmer? We believe the current Farm Credit Administration (FCA) definition of who is a "bona fide" farmer is quite suspect. Current law requires the FCS to make loans to "bona fide" farmers and those farm related businesses that support them under certain conditions. However, the FCA defines a "bona fide" farmer as anyone who owns land that could one day be used for production. Anyone (individual, entity, corporation, etc.) who owns an acre of pasture land could therefore be considered a "bona fide" farmer by FCA regardless of whether the individual or corporation ever produces an agricultural commodity or has agricultural sales.

This issue has come into play recently because the FCA has asked for public comment on a proposal by the FCS to be able to make ***non-farm*** loans to anyone their local boards of directors determines is eligible. These loans, again, would be for ***non-farm*** purposes in any amount without any criteria that the loans serve an agricultural purpose or are related to an individual's farm production. We believe this is totally inappropriate and directly contradicts the statute's wording and the legislative history as well as the mission and charter of the FCS, which was created with specific advantages as a government sponsored enterprise (GSE) to serve farmers and ranchers.

Under FCA regulations, it appears that Ted Turner, Wal-Mart and a number of large corporations that own some land in rural America could be considered "bona fide" farmers. Since LLC's can be formed with only one or two members and since the two state laws allow the LLC boards to be comprised of only three individuals with one being the "patron" member, the "farmer-owned cooperatives" that CoBank could finance could include two large corporations and a couple of individuals (or companies) considered "farmers" because the "farmers" own a couple acres of land.

The issue is also important in the context of the CoBank proposal because they request authority to make loans to entities with ***both*** a producer and investor class of membership so long as the producer class holds at least 50% of the voting control **OR** ownership interest. This eliminates the current statutory requirement that producers must hold at least 80% of the voting control of their cooperatives.

It also would allow CoBank to finance entities defined as "cooperatives" pursuant to **State** laws, not Federal laws. In addition, they propose to finance any current customer for up to 5 years that by law would not be eligible to receive such financing because the customer is no longer a farmer-owned cooperative, i.e., does not meet the 50 percent farmer ownership OR farmer voting control criteria.

Therefore, one basic question that could be asked is whether the "producer" class is comprised of real farmers. In addition to weak or non-existent definitions of "farmer", these "new cooperative business structures" would have no restrictions on who the investors are and no requirements the business entity is majority owned or controlled by farmers – in other words by patron members who produce commodities for delivery to the Cooperative.

As written, this proposal will allow CoBank to finance these new types of businesses even if farmers hold significantly less than 50% of the ownership control. For example, outside investors could control 60%, 70%, 80%, 90% or more of the business, allowing them to dictate how the "cooperative" serves its members and markets.

Draft Language is Not Narrowly Drawn – The suggestion may be made that the draft legislative language is narrowly drawn to allow CoBank to finance newly converted or new farmer-owned agricultural cooperatives that form as LLCs. But the draft language does not define an "association of farmers". It also allows the "farmer-owned cooperative" to remain eligible even if the business ownership or voting control requirements are substantially weakened if the "association" continues to be designated as a "cooperative" under state law.

Once designated a "cooperative" how likely is it the State will actively monitor or FCA will review all the business structures to determine if they are still acting as "cooperatives"? How likely is it the State or FCA will review the business operations to determine if the LLC still contains 50% farmer ownership or 50% farmer voting control?

This weakening of the minimal 50% option for farmer ownership or farmer voting control is further watered down by allowing any ***ineligible*** entity to remain eligible for CoBank financing for 5 years after the beginning of the ineligibility. There is no need for such a provision since **businesses secure financing before major changes occur, not after**.

Who really believes that CoBank won't subsequently lobby to continue to be able to finance these ineligible entities at some point within the next five years to be able to "continue what they've been doing to meet the financial needs of . . ."?

Allows CoBank to Finance Corporations Outside of Agriculture – The draft language then allows for instances where the "farmer-owned cooperative" may be bought out by a large corporation since the title of "association" is then transferred to "any legal successor", which implies any non-farmer-owned, non-farmer controlled corporation. Thus, CoBank could be financing large corporations under this authority that are not "associations of farmers", not operated on a cooperative basis and that have no farmer ownership or farmer voting control.

The legal successor may be a large private corporation, foreign or domestic, where the agricultural interests are only a minor portion of the corporation's overall business activities, but the draft language suggests CoBank could finance **both** the large parent corporation **AND** any subsidiary or related entity that receives transferred assets.

These transferred assets would only need to comprise 50% of the assets of the subsidiary, based on **book value immediately after the transfer.** Such book value may have little bearing to the market value of the assets, which may be virtually worthless. This allows CoBank to finance the entity at a much higher level than the real value of the assets would suggest appropriate. The provision provides for no future accounting of the assets, as the book value is determined only at the time of transfer, not on an ongoing annual basis and not reflective of the market value of the subsidiary's activities.

Again, the language suggests the non-farmer-owned parent corporation could be financed (**"any legal successor . . . AS WELL AS any entity . . ."**) even though it may not be a farmer-owned cooperative in any way and even though its business **may be completely unrelated to agriculture.**

These allowances could cause tax-paying businesses to restructure as "new cooperative business structures" to take advantage of a lower tax burden, and cheap, subsidized financing from CoBank or form subsidiaries to take advantage of these benefits.

The combination of these changes would therefore allow CoBank to completely alter the mission of their FCS government sponsored enterprise charter, moving from financing farmer-owned cooperatives with 80% farmer ownership to financing corporations that have no farmer involvement (legal successors).

Conclusion

Mr. Chairman, thank you for the opportunity to express our views today. There can be advantages in seeking outside capital for cooperatives. We must weigh these advantages with the potential for conflict with the interests of the farmers who own these cooperatives. **Control follows money**.

For example, would large corporations be called "cooperatives" under some state laws when they really aren't, and be eligible for benefits as cooperatives, and receive financing from CoBank, and potentially compete against farmer-owned cooperatives? Will traditional farmer-owned cooperatives seeking financing from CoBank be told in the future that they need to secure significant outside investor equity (and control) to receive financing?

A USDA spokesman recently testified that a traditional benefit to farmers through farm cooperatives has been "the return of earnings to local producers on the basis of their use of their cooperative, rather than to outside investors based on their investment". These benefits include, "A diverse local ownership unlikely to sell out or close down unless forced to do so, thereby protecting the local economy from the loss of a valuable asset."

With various federal statutes on the books, Congress should help ensure that farmers' interests are protected at the federal level in any developing trends that may set the stage for how some cooperatives could be formed in the future. Caution should be in order to ensure that large U.S. corporations do not have a tool to unfairly leverage their interests against family farmers.

These issues should be thoroughly discussed – ***before*** there is a rush to pass the CoBank legislative proposal that would fundamentally rewrite CoBank's charter allowing them to lend to non-cooperatives and non-agriculturally oriented corporations. CoBank's very broad legislative proposal needs much further analysis given its vast scope and its potential to shape how future cooperatives and corporations may structure themselves and given that there is no pressing need to adopt the proposal this year. We also encourage Congress to urge USDA to implement the existing authorities contained in the farm bill to help attract equity capital to rural America. We look forward to working with you on these endeavors and further exploring the important issue of attracting greater equity capital to rural America's farmer-owned cooperatives. Thank you.

1 *Working Together*, directors message, "Lessons in Corporate (or is that cooperative?) Responsibility", UWCC, University of Wisconsin, pg 1

TESTIMONY TO THE HOUSE COMMITTEE ON AGRICULTURE

RESTRUCTURING IN THE COOPERATIVE SECTOR AND NEW GENERATION COOPERATIVE STRUCTURES: FINANCIAL AND CREDIT ISSUES

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October 16, 2003

Chairman Goodlatte, Ranking Member Stenholm and distinguished members of the Committee, my name is Roger Ginder. I am a professor in the Economics Department at Iowa State University. I appreciate the opportunity to present testimony on the restructuring now occurring in the cooperative sector, business structures being used by new generation cooperatives and associations of producers and the financial health and credit needs for U.S. cooperatives. I will first address the topic of restructuring in the cooperative sector then the topic of business structures used by new generation cooperatives. Financial and credit issues will be incorporated into both discussions.

Part I: The Restructuring in the U.S. Cooperative System.

Cooperatives serving U.S. agriculture were created to serve the needs of the farmers and ranchers who own and control them. As a result it comes as no surprise that the changes that have occurred in the farm and ranch sector of the economy is being reflected in the coop sector. Decades of farm and ranch consolidation into fewer and larger units have created a radically different set of needs and expectations for the cooperative sector that serves them. This has created an absolute necessity for structural change at the cooperative level in order to meet the new and changing needs of the producers who own them.

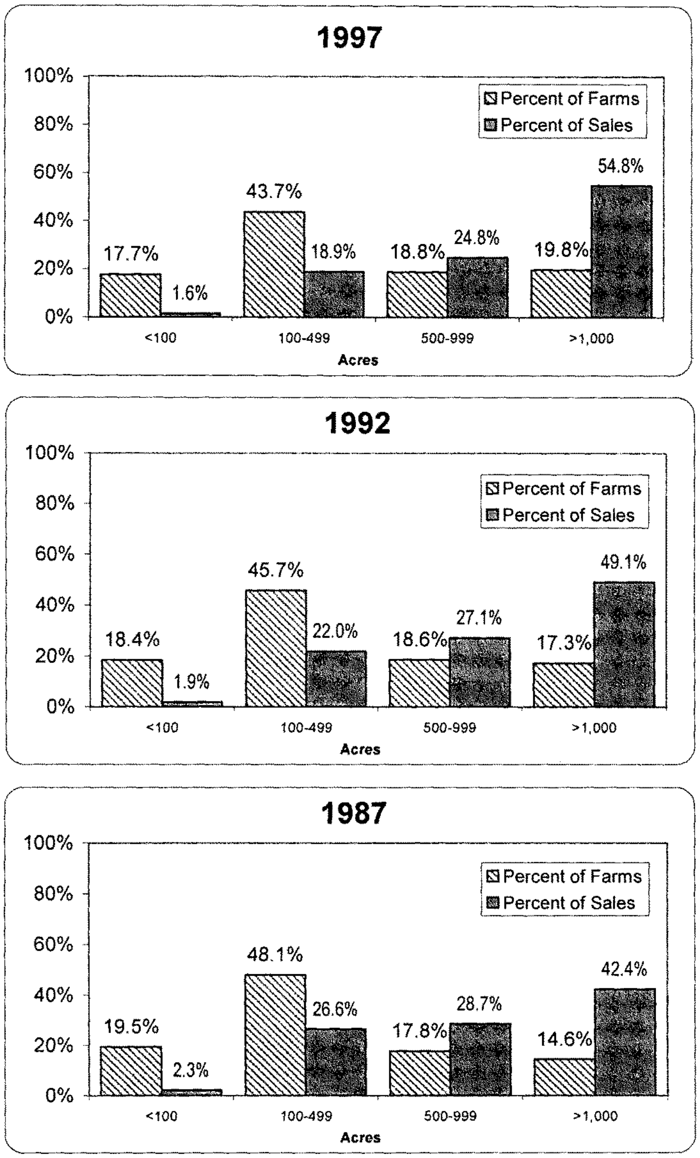
Most of the input supply and commodity marketing cooperatives operating today were formed in the period 1900-1940. At that time the number of farm operators was much larger and their operations were much smaller and more similar than is the case today. Farms and ranches tended to be full time operations that fully employed the family labor available. They were more diversified and much less reliant on purchased inputs and expensive technology than is the case today. The cooperatives they formed reflected the more or less homogenous needs of this kind of membership.

The number of farms has plummeted since then. In 1940 the number of farm operations in the U.S. was approximately 6.3 million. The most recent Census of Agriculture indicates that the number had fallen to approximately 1.9 million by 1997. But the decline in numbers tells only part of the story. Over the past 2 1/2 decades there has been an accompanying trend toward concentration of production into the hands of a smaller and smaller fraction of the remaining farms and ranches in existence. Thus the size disparity among the relatively small number of farms that continue to exist has increased remarkably. This phenomenon is illustrated in Figure 1 for grain production. A concentration of more than 55 percent of production is in the hands of less than 20 percent of the farms or about 116,500 farmers.

Much like the farmers and ranchers who created them, the number of U.S. cooperatives has declined and the size has increased significantly. Some would argue that the changes in the cooperative sector still lag behind the changes occurring among their membership. This is probably the case. To a large extent this has been possible because the gross

Figure 1

Distribution of Farms Producing Grain
by Farm Size



Source: Census of Agriculture, 1987, 1992 and 1997.

number of acres operated has remained more or less stable while the quantity of purchased inputs per acre has on balance increased. Although the number of producers is smaller, the more stable business volume has slightly moderated the need for cooperative consolidation thus far. But the continuing effects of declining farm numbers and the accelerating concentration of production into the hands of fewer and fewer farm operations will ultimately be the determining factor. The impact of concentration is rapidly overtaking any moderating effects arising from stable business volume.

It is clear that the relatively small group of farmers who now account for the majority of production will have different expectations for the cooperatives they own and use. It is also clear that this smaller group will not wish to own as many separate cooperatives as the previous and more numerous generation owned. There are fewer of them to capitalize the system and the demands for capital in their farming or ranching operations is significantly higher. They are not likely to be able to provide a sufficient equity capital base to finance the more numerous (and by today's standards sometimes duplicative) cooperative assets financed by the previous generation. These facts taken together mean that there is now (and will continue to be) a need for the cooperative system to restructure itself into fewer, larger, and in many cases refocused organizations in order to meet the needs of the current and future producers. It also means that consolidation and sometimes failure will occur among the existing local and regional cooperatives.

It is fair to ask the questions: Will these fewer and larger farm operations still need cooperatives? Are cooperatives still an important institution for grain farms of 3000-5000 or more acres? Are cooperatives still important to dairy farms with 2400, 4800 or more cows? I believe the answer is yes. By historical standards these farm businesses are quite large and when viewed in the context of a local rural area or local market they appear to be powerful and influential. However when viewed as part of the developing value chains for food and fiber, their individual economic power and influence is severely limited—possibly even more limited than it has been in the past when farms were much smaller and more numerous.

Farmer-owned cooperatives have long served as the farmer's link backward into the farm input chain and forward into the food and fiber value chain. The input value chains have recently undergone (and are continuing to undergo) rapid and at times radical change. On the supply side of the producer, huge firms have developed in the seed and agricultural chemical industry. They are armed with valuable patents and can negotiate from strength. Dealing with firms of this size with a degree of parity will require cooperatives with larger membership bases, more effectively deployed capital, and more bargaining power. It will require cooperatives that can create real economic value in the chain and bargain effectively enough to obtain their fair share of the returns for what they create.

On the food side of the producer the change is perhaps more subtle, but it is every bit as significant. Since 1996 there has been rapid and significant concentration in the food-retailing sector. Mergers among existing regional and national food retailing firms and growth in the case of general merchandise retailers such as Wal-Mart have created a very small cadre of national retailers that together account for a significant fraction of the total U.S. retail food volume. See Table 1. The five largest retailers currently account for nearly 40 percent of the retail food volume of the U.S. These retailers wield immense power and influence over the food side of the value chain and the firms in it. Regional food processors and manufacturers—both cooperatively owned and investor owned—will encounter pressures on brand margins and increasing difficulty in gaining access to the consumer.

Table 1. Market Share of Top Five U.S. Food Retailers

Retailer	**Number of Stores**	**Estimated Annual Sales ($ Billions)**	**Market Share (Percent)**
Wal-Mart (Supercenters + Sam's Clubs)	1,765	126.7	17.4
Kroger/Fred Meyer	2,461	52.1	7.2
Albertson's	1,346	35.7	4.9
Safeway	1,793	35.0	4.8
Costco	522	31.7	4.4
Total Top Five	**7,887**	**281.2**	**38.7**

Source: Prepared from data published by Supermarket News, 1-13-03.

These firms are in a position to select suppliers who have the capabilities to provide fresh and processed food products to a nationwide network of retail stores rather than a statewide or regional network. To reduce costs and increase performance the number of suppliers they choose to deal with is likely to be very limited. In other words they are in a position to select which suppliers will have access to the 40 percent of the retail food market they currently serve. They are also in a position to develop and promote strong house brands that will compete with established regional and national brands. Farmer-owned cooperative processors and manufacturers will need to have the size and the logistical capability to serve national markets if they are to compete effectively in the new arena. In many cases restructuring from a system well adapted to regional brands and regional distribution systems will be critical.

These changes are already underway in some cooperatives. Mergers and consolidations in the dairy industry have created cooperatives that are nationwide in scope and capable of serving national markets. A farmer-owned cooperative holds the number four position in the soy processing industry. The cooperatives operating in many of the fruit and nut industries such as Sun-Maid, Blue Diamond, Diamond Walnut, and Valley Fig are either dominant or significant national scope players. Cenex-Harvest States (CHS) has become a significant player in the grain based food sector. In the beef industry U.S. Premium Beef has established a strong national position capable of creating value for retailers. In the turkey processing industry West Liberty Foods has, in a very short period of time, established a significant market position. Strong positions are also held by sugar beet refining cooperatives in the Upper Midwest and Plains states.

The high profile problems encountered by Farmland Industries in the Midwest, Plains and South Central regions and its subsequent bankruptcy have raised serious concerns about the position of cooperatives on the supply side of the farmer. It is an event that has engendered sense of sadness and loss among many of the farmers, local cooperatives, employees, rural communities, and others that had been associated with the cooperative over a long period of years. The failure of Farmland will result in the loss of significant cooperative presence and activity in pork processing and to lesser extent loss of capacity in grain marketing.

However, it should be recognized that much of the asset base and service capacity held by Farmland Industries prior to 2000 remains in the cooperative system today and continues to serve the producers who operate in those regions. A series of joint venture agreements were executed among Farmland Industries, Land O'Lakes and Cenex-Harvest States. Under these agreements four joint venture companies were formed—one for each of the major input categories (i.e., fertilizer and crop protection chemicals, animal feed, petroleum products, and seed). The intent was to create world class farmer-owned and controlled farm input business capable of serving the needs of the farmers of the future.

The four joint venture businesses formed were intended to provide size and focus in the market thereby more effectively using the existing assets of the three cooperatives. The assets of all three cooperatives under a single management in a specialized firm with the critical mass to deal with an increasingly concentrated and competitive market has greatly enhanced the position farmers enjoy in those industries.

Agriliance, the joint venture fertilizer and crop protection product distribution company formed is currently the largest firm in that industry. Cenex-Harvest States the major partner in the petroleum joint venture company currently holds a significant market share for petroleum products at the farm production level. Land O'Lakes the majority partner in the joint venture for animal feeds is currently the largest (noncaptive) feed manufacturer in the U.S. Land O'Lakes seed is the fourth largest distributor of crop seeds in the U.S. This kind of asset restructuring and refocusing is an important step in making the most effective use of limited equity capital available from a smaller and smaller number of agricultural producers.

As stated above, the value chains for the food and fiber produced on U.S. farms and ranches are becoming increasingly coordinated and will continue to be heavily influenced by very large and powerful firms. The changes in the value chain on both the input side of the producer and on the food and fiber output side of the chain will confront producers and their cooperatives with serious challenges going forward. Maintaining a strong bargaining position for those at the producer level in the value chain will be more important than ever before. If farmers are to be more than passive participants, it will be necessary for them to develop a position of parity or near parity with the other firms operating in the chain.

Finding the debt and equity capital to meet these challenges will continue to be a serious constraint in the cooperative system. Declining farm numbers coupled with the need for capitalizing cooperatives that are capable of creating value in a more concentrated competitive environment will not be simple. Nor will it be easily accomplished. Ultimately cooperatives have to become "investment grade" firms and consistently perform as such to accomplish it.

Cooperative restructuring and the redeployment of the capital already in the system more effectively is a necessary first step in dealing with these challenges. As stated earlier, there have already been efforts underway in the cooperative system to do this. Sources of competitively priced debt capital from a lender committed to providing credit to agricultural cooperatives will also be necessary. A critical factor in addressing the problem will be continued access to farm credit system lending from CoBank to provide the layer of senior debt required.

A third piece of the puzzle will involve more creative and careful use of the equity capital already in the system. Conversion of allocated equity to tradable shares with a return is being tested by some cooperatives as a means to conserve the scarce equity in the system and at the same time provide value to those who hold the shares. The cash demands on cooperatives to revolve equity from internally generated funds is a major drain that is not incurred by their corporate competitors. Finally other means of accessing outside capital including partnerships and joint ventures with firms either outside the value chain or at other levels in the value chain may in some cases be a practical alternative.

From a policy perspective several items can be helpful in the process. Legislation that enables the Farm Credit system and CoBank to provide needed credit to farmers and their cooperatives continues to be critical. The new marketplace may require new lending approaches and in some cases new authorities for lending to both farmers and their cooperatives. The more coordinated value chain places a higher premium on the rights of farmers to work together and bargain for their share of value created. It will be more critical than ever to preserve the existing provisions for collective action by farmers in the Capper-Volstead Act—including the right to form marketing agencies-in-common. Policies regarding membership and tax treatment of patronage distributions will also be important in some cases.

Part II. Issues in the Formation of "New Generation" Cooperatives or "Closed Membership"Cooperatives.

Open membership cooperatives have been proven to work well for such activities as input purchasing and undifferentiated commodity marketing. These tend to be activities where there are fewer binding constraints on increased volume handled through the cooperative. For example in grain merchandising once the fixed costs for a grain merchandiser has been incurred, the volume marketed can be increased with little marginal cost. Grain elevator handling capacity also involves large fixed costs. The capacity is often underutilized so that additional volume can be handled at very low marginal cost. These conditions favor open membership policies because such policies make it easier to attract additional volume to the cooperative. The added volume tends to benefit all members including existing members by reducing unit costs or increasing bargaining power in the market.

However in activities where either: (1) binding facility capacity constraints exist on the amount of product that can be handled or processed or (2) market constraints exist on the volume that can be effectively handled, a closed membership cooperative is frequently used. For example, where the maximum plant capacity limits the volume that can be processed (at near minimum cost) limiting membership results in higher returns for existing members. Likewise where the market will accept only a limited amount of a differentiated product at margins above the commodity price, closed membership cooperatives are more attractive. Most of the value-added enterprises being formed have one or both of these characteristics. Additional volume in these cases tends to reduce the benefits to existing members rather than increasing such benefits. A membership policy that closes the opportunity to join when volume reaches the point of maximum efficiency serves to preserve the benefits to existing members.

The problem of reducing benefits for existing members is particularly important at the very early stages of cooperative formation and at the point where starting equity capital must be raised to finance the cooperative. Those involved in organizing the cooperative must expend a great deal of personal time and energy in the process of cooperative formation. The founding members typically receive little or no additional compensation or benefit from their efforts in organizing a new cooperative. Those who work to get the cooperative started will receive no benefit beyond the benefit received by members who subsequently join after the enterprise is already organized and operating.

Those who invest equity capital early in the life of the cooperative are in a similar situation. Since success is by no means assured it is safe to say that they are taking a significant risk in making this investment. Early investors must see and anticipate benefits from taking this added risk. They will prefer to add more members only up to the point where added volume will increase the efficiency of the cooperative and thereby improve returns for all existing members. There is little or no incentive for them to add more members (and volume) beyond that point since the added volume will only serve to reduce the benefits they already enjoy.

For these reasons many of the new cooperatives formed for adding value have been closed membership cooperatives rather than the more common open membership cooperatives involved in marketing undifferentiated commodities or purchasing production inputs. Fixing the membership at the level where the benefits will be highest for the membership and refusing to add volume beyond that point provides a necessary incentive for those to expend energy to organize the cooperative and those who make the initial investment in it. Permitting later volume to dilute these benefits would discourage the organization of these new cooperative ventures.

Closed membership cooperatives differ from the typical open membership cooperatives in several important respects that make them desirable for groups attempting to organize new ventures. Among the key differences are: (1) capitalization requirements in direct proportion to use, (2) shares that are tradable and not dependent on a board decision to redeem them, (3) specified delivery rights for raw product are typically granted, (4) equity share values that may rise (or fall) to reflect the value of the enterprise and (5) a relatively high fraction of the patronage payments to members are paid in cash and little or none of it is paid in the form of deferred patronage certificates. These characteristics of closed cooperatives provide several distinct advantages to farmers who are forming a new value-added venture.

Proportionality between the capitalization requirements for the member and the member's use of the cooperative insures parity between patronage refunds received and investment made in the coop. In other words distributions of net margins to individual producers based on their patronage are essentially the same as the amount they would receive if the distributions had instead been made based on the amount of equity they own. A sense of fairness is engendered.

Tradable shares permit members to partially or totally exit the cooperative by selling some or all of their shares. There is no need to wait for a board decision to redeem equities. It also provides the cooperative business itself a more permanent and stable equity position. There is no need for the cooperative to manage the cash flow demands associated with equity redemption. Once the shares have been sold and are in the hands of farmers it is up to the farmer to sell them to another producer when he or she wishes to exit.

Specified delivery rights and a specified delivery obligation provide the producer with an assurance that there is a market for the products produced. This assurance is quite important for commodities where few good alternative markets exist. Delivery obligations also provide added assurance that opportunistic behavior by individual members will be less likely to injure other cooperative members. There is assurance that the volume required for efficient operation will be available to the cooperative.

Share values that rise and fall with the success or lack of success of the cooperative provide producers with the incentive to manage the business more carefully and a return for taking prudent risks. The incentives and returns more closely resemble the incentives and returns that exist in non-cooperative businesses.

The requirement for capitalization up front and in proportion to the member's use of the cooperative permits most or all the distribution to be made in cash. This is in sharp contrast to the open cooperative which requires little or no up front capital but retains a significant fraction of the distributions it makes to its members as the primary means to capitalize the cooperative.

Added to these benefits are the more traditional benefits historically associated with both open and closed agricultural cooperatives. These include single tax treatment of patronage distributions, access to credit from CoBank, limited exemptions from securities laws and the Capper-Volstead anti-trust protections accorded farmer cooperatives. Indeed when most groups begin to organize, the cooperative form is what they have in mind. Despite the advantages cited above and their initial intent to use the cooperative form, most find that some of the restrictions associated with the cooperative form make it comparatively difficult and sometimes uneconomic to use.

Other forms including the Limited Liability Company (LLC's) can incorporate some but not all of the beneficial characteristics offered by the closed cooperative structure. LLC's usually adopt the delivery rights, tradability of shares, market valuation of shares, and other institutional practices of closed membership cooperatives. They cannot access the benefits of CoBank credit or some of the Capper-Volstead exemptions. LLC's can offer the same single tax treatment as closed membership cooperatives, but they are not saddled with some of the membership restrictions and outside investment restrictions historically placed on the cooperative form.

In addition, the LLC form of organization provides for even more favorable Self-Employment tax (SE tax) treatment than what has thus far been accorded to cooperatives. Those seeking to organize a value-added enterprise are almost invariably forced to weigh these advantages against the more traditional advantages of access to CoBank financing, limited exemption from securities registration, and the Capper-Volstead provisions that come with organizing as a cooperative. In the end it comes down to making a choice of one or the other and the immediate problems of raising capital from non-farm sources and more favorable SE tax treatment accorded to LLC's have often won out.

As a consequence, limited liability companies (LLC's) have become more prominent as a means for farmers to organize enterprises to conduct a value-added activity over the past several years. This has occurred primarily as a response to some of the limitations that the cooperative form of organization faces including the following: (1) Self-Employment taxation of distributions made to members, (2) limitations on who may be a shareholder, (3) ownership and voting limitations placed on non-farm investors and (4) limitations on the pass-through for the10 cent small producer tax credit to cooperative shareholders (in the case of some renewable fuels activities). These factors taken together have led most start-up ethanol groups organized within the past five years to select the LLC form over the cooperative form despite the other advantages. A significant fraction of other types of value-added enterprises have also made this choice based on the first three factors. Unfortunately, this also means that these organizations are denied the benefits of CoBank financing; thereby eliminating a competitive source of debt capital from a knowledgeable lender committed to lending to producer-owned agricultural processing firms.

The classification of cooperative distributions as ordinary income and the distributions from LLC's as passive income can result in significant differences in value. The SE tax is levied at a rate of slightly more than 15 percent on cooperative patronage distributions to their members. Distributions from LLC's in the vast majority of cases qualify as passive income and are not subject to this tax. All other things equal the value of the distribution to the producer is 15 percent higher when received from an LLC than it is when received from a cooperative.

In many cases the new value-added enterprise would not be making significant distributions to members during the start-up phase. However as soon as there are positive net margins and a distribution is made the differential tax treatment would immediately come into play. Requiring SE tax on the value of the raw commodity being processed (assume it is corn in this case) is not an issue. Since the Self-Employment tax would be levied on the producer's net income if he or she had delivered corn to an elevator and sold it at prevailing market price it could be argued that the value of the raw corn delivered to an ethanol plant should be subject to the same SE tax treatment.

However the added value (above the best local market price for corn) the farmer receives from investing in an ethanol plant, processing the corn and selling ethanol and by-products is also subject to the SE tax when the plant is organized as a cooperative. This is true despite the fact that the farmer typically plays no active role in managing or in providing labor for the plant. In contrast if we assume that the same set of producers, the same physical plant, the same management/employee group are operating as an LLC the added income would be classified as passive income and not subject to the SE tax. The cumulative effects of this disparity over time will be significant if the plant is successful. Despite considerable difficulties in converting a plant from a cooperative to an LLC, it may be the only rational choice when members are confronted with a recurring annual 15 percent disparity over the life of the firm.

Limiting membership to active farmers is also a source of difference between the cooperative form of organization and the LLC. LLC's may be formed with non-farm investors and farmers both holding full voting memberships. The majority of state cooperative statutes place strict limitations on permitting non-farmer members to vote. More recent state cooperative legislation (such as Ia. Chr. 501) currently permit some non-farm participation, but do not go far enough in the judgment of some who are attempting to include non-farm rural residents as participants in value-added ventures.

Several state statutes permitting more liberal membership requirements have either passed, been introduced into the legislature, or will soon be introduced. The first such bill was passed in Wyoming and signed into law in 2001. A very similar law passed in Minnesota in 2003. A similar bill has been introduced into the Wisconsin legislature for consideration later this year and Iowa has drafted similar legislation for introduction into its legislature when the 2004 session begins in January.

The intent in these cases is not to replace the statutes under which more traditional cooperatives are chartered. These statutes are to remain in place and those organized under them are under no obligation to convert. Rather the intent is to permit the formation of value-added cooperatives under a less restrictive statute that permits a cooperative to include more non-farm investors in its membership. Typically these statutes would permit up to 85 percent non-farm ownership of the cooperative but would limit the voting rights of non-farm shareholders to 50 percent. They also permit membership and frequently charter across state lines. These structures remain largely untested, but are expected to put the cooperative form of organization on more even footing with the LLC form with respect to membership potential and voting rights.

Structures to achieve similar results similar to those embodied in the "Wyoming" law have been already established within the ethanol industry, but they are much more cumbersome and unwieldy. Where farmers wanted to use the cooperative form and needed to include substantial investment from non-farm sources, a two-tier structure was formed. Farmers formed a closed membership cooperative with delivery rights and capital to invest under the traditional cooperative statutes. Investors formed an LLC with capital to invest. A third entity was then formed as an LLC with the voting rights evenly split (see Figure 2). Albeit a more cumbersome process, the net effect was similar to

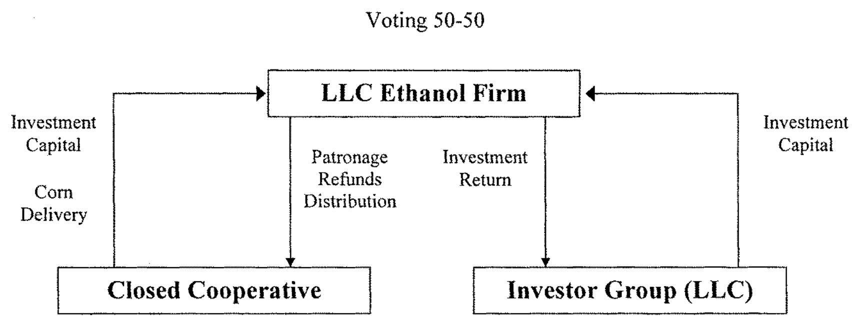


Figure 2. Alternative Organization Structures for Ethanol Production

what might be accomplished under the "Wyoming" type statutes. It should be emphasized that the problems of differential SE tax discussed above would still persist for any portion of the distribution that is issued on the basis of patronage.

Finally cooperatively organized ethanol plants have encountered difficulties in passing through small producer ethanol credits to producers. The inadvertent omission of cooperatives in the legislation has made it all but impossible for plants organized as cooperatives to pass through these credits. The recent conversion of the Tall Corn Ethanol Plant in Coon Rapids, Iowa from a closed membership cooperative to an LLC was associated with the problems of raising equity from non-farm sources. But another significant factor in the decision was the inability to distribute the small producer ethanol credit to members if it remained organized as a cooperative.

If this situation is not corrected soon, conversions by other plants now organized as cooperatives can be expected. Currently a plant producing 15 million gallons of ethanol per year is for all practical purposes unable to distribute the 10 cent per gallon credit to member producers if it organized as a cooperative. The net effect is to prevent the cooperative from making a potential distribution of $1.5 million each year to its members. This constraint does not apply to similar enterprises that are organized as LLC's. Current proposed legislation to increase the small producer credits to include plants producing up to 60 million gallons will only serve to increase this already serious disparity.

From a policy perspective it would be desirable to make it possible for farmers to enjoy the same benefits from electing the closed cooperative form that they receive from the LLC form when they organize their farmer-owned value-added ventures. To the degree possible they should be able to select the cooperative form of organization without significant economic penalties.

Starting value-added ventures is an already difficult task for producers and it is useful to have as much flexibility in designing the organization as possible. Currently the enterprise must elect the LLC form if it is to avoid the SE tax on distributions to members. Likewise it must elect the LLC form of organization if it is to be allowed to pass through the small producer ethanol credit to producer members. But in doing so it must give up the ability to access CoBank credit services. It must give up the benefits and protections afforded in a well-developed body of cooperative law including the Capper-Volstead Act.

The inability to access CoBank credit deprives these start-up businesses of a stable low cost credit alternative with significant industry knowledge and a long-term commitment to providing financing to agricultural processing firms. Abandoning the protections of the Capper-Volstead Act could have future consequences if the value-added organizations in any of the industries where they are currently being organized wish to form marketing agencies-in-common.

Mr. Chairman and members of the committee, thank you for your interest in this important topic and for holding this hearing. I am grateful to have the opportunity to provide this testimony. I would be glad to respond to any questions you may have.

Challenges And Opportunities For Cooperatives

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Agriculture in the United States has a heritage and legacy of producer owned cooperative marketing and processing. Today, some of the largest cooperatives are facing financial difficulty and some are in bankruptcy. Disgruntled farmer patrons are quick to place the blame on the business being a cooperative. While cooperatives have to deal with large scale changes in the food industry, some of their largest farmer patrons refuse to do business with cooperatives because their tax exceeds cash distributions and the revolvement period is too long. Changes in the farming population will force cooperatives to examine their business structure and business alternatives.

Cooperatives will be successful when their structure and business plans meet the needs of patrons and the marketplace. States are enacting new cooperative laws to allow new cooperative structures. Changes in federal law, however, are also necessary for cooperatives to:

(1) attract and raise capital efficiently from patrons and others to maintain competitiveness;
(2) change business structure to adapt to a changing patron base; and
(3) provide market liquidity for patronage equities allowing patrons to monetize their patronage equities upon retirement or exit from the cooperative and allowing cooperatives to better align equity with patrons.

The Marketplace For Producer Cooperatives Is The Food Industry. Producer cooperatives involved in the marketing and processing of agricultural products are generally in the food industry. The food industry covers the production of fruits, vegetables, crops and livestock through consumer purchase and is sometimes referred to as "farm to fork." Trends in various sectors of the food industry are affecting all participants. Food retailers and grocers are consolidating. The large grocers compete on price with thin margins. Many grocers charge slotting fees to food suppliers for the opportunity to stock products on their shelves.

Food ingredient companies include some of the largest companies such as Cargill, ConAgra and ADM, other small and large processors, as well as many producer owned cooperatives. This sector is driven in many areas to reduce costs. It is not uncommon for buyers to expect 2% per year cost reductions and shared benefits for cost reductions exceeding 5% or more. Competitors in this sector must drive down costs in commodity areas or develop new niche processing areas where better margins can be obtained. The food industry in all sectors are led by companies that are well capitalized and focused on cost competitiveness to gain or maintain market share. Producer cooperatives must adapt to these trends to be competitive and profitable.

The Challenge: Capital. The capital structure of a cooperative reflects where new capital will come from and when and how capital will be redeemed as well as the reasons for the capital plan and structure. A cooperative that conducts business with its members at market prices and is capitalized by retaining allocated patronage that is taxed to the member, will likely have members who consider the patronage (that is, the tax on the patronage) as a <u>cost</u> of doing business with the cooperative. Unless there are intangibles or other recognizable member benefits, patrons who are allocated and taxed on patronage that is not distributed will likely evaluate their patronage equity and the tax on its allocation as part of their decision to do business with the cooperative.

Most cooperatives that critically review their business plans find an expanding need for additional capital. Cooperatives have traditionally been capitalized through retention of member allocated income, and for many cooperatives retained patronage income has been the sole source of equity capital. Expansion, research and development, strategic acquisitions and other competitive aspects of a cooperative's business plan must be funded from retained income, additional debt financing, or new equity capital.

Some cooperatives have invested in non-patronage source businesses to generate capital. Generation of capital through these businesses are not tax efficient, generally being taxed at corporate rates (up to about 40% state and federal marginal rates) and will result in less capital available to the cooperative compared to member retained patronage capital (20% mandatory cash distribution).

Member retained capital does not usually receive any return or gain other than a revolvement potential at some time in the future and then at face value. Some larger producers have requested to waive patronage and decline to take patronage allocations into income because of the negative financial considerations. A producer in the upper income tax bracket can have a 30% to 45% state and federal marginal income tax rate. If a cooperative does not make a cash distribution to cover the producer's taxes and the redemption period is long, the allocation of patronage has adverse financial consequences, which may cause the producer to stop patronizing the cooperative.

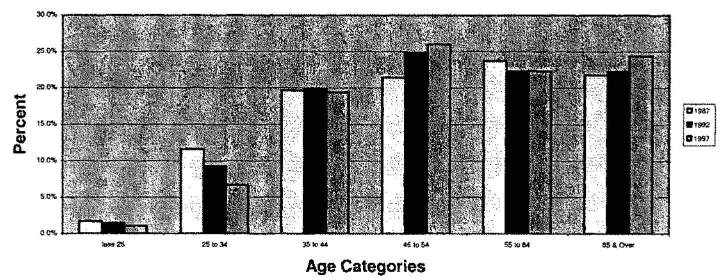
Obtaining capital from member patronage also competes with the pressure to revolve prior allocated patronage. The longer the revolvement period, the less attractive the patronage allocation becomes to members. Members recognize that they do not control when or how patronage equities will be paid to them.

Member Investment Capital. Cooperatives also seek direct investment capital from members. One form is to issue preferred stock at a rate not to exceed 8% or the legal rate. Under subordination of capital principles of corporate cooperative laws and federal cooperative tax and antitrust laws, a cooperative's return on invested capital generally cannot exceed that amount. In today's low interest environment there has been an increased use of preferred stock and fixed return investments; however, these have been limited in scope and duration.

Cooperatives may obtain capital from members by selling equity interests (shares) that are proportionately tied to patronage (delivery) obligations. In this model, if properly structured, the member obtains a return on the use of the members' equity through proportional patronage. Further, the members' investment with delivery obligations are transferable, and if properly structured, the member can realize the gain in the cooperative as an enterprise through the sale of the shares. This model has been used in value added or new generation cooperatives. This model is limited in that capital may only come from members and favorable tax treatment is limited to "patronage sourced business" which does not include many forms of further processing.

Cooperatives need to look at their member base as to the likelihood that members will be a new or continued source of capital. The following chart "Farm Operators By Age Category" derived from USDA statistics shows a concerning trend that the percentage of farm operators under age 44 are decreasing and the number age 65 and over are increasing. The Iowa State University Extension Service ("ISU Extension") recently released information on Iowa farmland ownership showing similar trends and a report from ISU Extension concluded that over one-third of Iowa farmland is owned by persons over retirement age. In general, this trend suggests a smaller number of younger, larger farmers will be supplying cooperatives capital for a large group of aging farmers whose focus will generally be on redemption and revolvement of their equity rather than reinvestment and growth.

Farm Operators by Age Category (1987, 1992, 1997)



Non-Member Capital. Member capital limitations have caused many cooperatives to seek non-member capital. State cooperative law and federal law regarding subordination of capital apply to nonmember and member capital and in general, returns on capital are restricted to 8% or a higher legal rate. As a practical matter, returns on investment sought by most investors can only be achieved in a cooperative through a patronage relationship.

The Challenge: Liquidity. More attention in recent years has focused on member liquidity, or the ability of members to sell or redeem their investment in cooperatives. Cooperatives that ignore member liquidity often struggle for adequate capital.

Most cooperatives are structured to require current members to acquire the capital of retired or former members. Members acquire other members' capital through allocation of a portion of today's patronage profits to pay members for the capital allocated in past years and by direct acquisition by members of stock or other shares of capital. In general, the pool of new potential members is decreasing – that is, there will be fewer producers in the future who will acquire or redeem the capital held by members today.

The ability of the member, rather than the cooperative, to determine when to liquidate or sell the allocated patronage or other investment in the cooperative is an important consideration in evaluating cooperative equity and member investment liquidity. In value added cooperatives, where the equity is appropriately structured, a patron member's equity interest is sold as a share of stock or equity units at a price paid by a willing buyer. In many supply and marketing cooperatives, the only liquidity for equity is redemption or revolvement by the cooperative at a time when income and capital needs allow allocated patronage redeemed. With the tax owed at the time of allocation and redemption sometimes occurring many years (10 to 20 or more) after allocation, a traditional cooperative must consider whether the capital structure can attract new members as a source of new capital.

States are Enacting Cooperative Structure Alternatives. Most cooperatives are organized as corporate cooperatives on principles the government determined were important to distinguish cooperatives from corporations approximately 80 to 100 years ago. Business organizations have evolved since 1960 to Delaware-style corporations and limited liability companies ("LLCs"). Until the Wyoming Processing Cooperative Law (2001) and the new Minnesota Cooperative Association (2003) statutes, the cooperative legal principles had essentially matured by 1925. Simply stated, the corporate cooperative form of business offers few advantages and a number of significant business disadvantages over other forms of business for today's processing businesses.

The food and agribusiness economy, and producers themselves, have changed significantly. In response to producers' requests, the cooperative form of business was changed by the Wyoming legislature in 2001 and the Minnesota legislature in 2003 to allow non-patron member investment in a cooperative business. These new forms of cooperatives offer more options to address capital requirements and member liquidity. Federal legislation would assist existing cooperatives to convert to these new cooperatives or change their existing structure. Only the cooperative form of business rewards the users of the business, which is why governments support continued development of cooperatives.

Federal Opportunities to Assist Cooperative Development. Federal legal principles originally developed in the 1910's and 1920's to support cooperation have become impediments for many cooperatives to further develop. The book chapter, "Legal Framework For Cooperative Development," which was written by Mark Hanson and is forthcoming in *Cooperatives and Development: Theory and Applications for the 21st Century* (to be published October 2003) and is attached as Exhibit A, describes the development of cooperative law and changes to state and federal law to assist cooperative development. Much of the following is excerpted from that book chapter. Cooperative development is best served when the ingenuity of the cooperator is allowed to apply cooperation to a competitive business plan.

CHALLENGES AND OPPORTUNITIES FOR COOPERATIVES

Tax Law Changes. Federal tax law has chilling effects on cooperative business development. The regulations and tax law theory that were developed before the advent of LLCs were based on the differences of a cooperative to a corporation. While corporate cooperative taxation provides some advantages over corporations, in most areas cooperative organizations compete with LLCs. The following changes would assist corporate cooperatives and the new Minnesota and Wyoming type cooperatives:

Section 521 Changes To Allow More Flexibility For Cooperatives. Almost all cooperatives in the United States are currently organized as corporate cooperatives. Corporate cooperatives are defined by the state incorporation law and by federal tax law. Federal tax law allows a corporate cooperative to deduct patronage sourced business from income at the entity level. Many of the new generation processing cooperatives are organized as Section 521 cooperatives because the cooperative can deduct certain patronage and nonpatronage sourced income from income taxable to the cooperative and pass the income through to the members on a basis of patronage. Many times a Section 521 cooperative is described as a "producers cooperative" because the stockholders or owners must be producers. In general, at least 85 percent of the stockholders or members must be producers or the cooperative will lose its Section 521 certification status. Section 521 cooperatives are limited in obtaining outside capital. A Section 521 cooperative may only pay dividends on outside capital of eight percent or the state legal rate, whichever is greater. As a result, it is rare that a Section 521 cooperative can attract outside capital to the cooperative.

Potential changes to Section 521 could be considered to authorize a corporate cooperative or an unincorporated association of producers to be certified under Section 521 if a majority of the stockholders or equity owners are producers of agricultural products who deliver their products to the cooperative for further processing or manufacturing. The potential changes would also allow Section 521 cooperatives to obtain outside capital and pay up to an 18 percent dividend on the amount for which the stock or other investment was issued. These changes would allow many existing cooperatives to certify as Section 521 cooperatives and also allow new Section 521 cooperatives to seek outside capital to enhance their processing and manufacturing capabilities. An example of potential changes for consideration is attached as Exhibit B.

Reorganization Of Corporate Cooperatives To Unincorporated Producer Associations. Most cooperatives are organized as corporate cooperatives and, due to a number of the restrictions or other impediments in state and federal law, these cooperatives are seeking to reorganize into an entity without restrictions, typically an unincorporated association. One of the impediments from an entity making that conversion is the tax that is imposed on the corporate cooperative upon reorganization. In general, the corporate tax provisions do not recognize that a corporate entity would reorganize into an unincorporated association. As a result, even though a corporate cooperative and an unincorporated association are generally considered to be pass-through entities, the corporate tax law treats such a reorganization as a liquidation of the corporate cooperative and a reinvestment of the proceeds of the liquidation by the members into the new entity. While some entities do not have a significant tax gain and can reorganize with little or no tax, many other successful cooperatives or other cooperatives with low cooperative and member basis cannot reorganize because the reorganization does not produce any new cash to pay the tax imposed. The changes described below would allow a corporate cooperative to reorganize into an unincorporated producer association without a corporate liquidation tax being imposed if after the reorganization a majority of the governance rights and financial rights of the corporate cooperative are held by persons or entities who were patrons of the corporate cooperative prior to the reorganization. Further, if the corporate cooperative reorganizes into a business entity that is not a cooperative under state law, a majority of the governance and income allocation and distribution rights must be held by producers of agricultural products. The reorganization should not change the tax year of the affected organization. An example of potential changes are attached as Exhibit C.

Securities Law Changes. When producer cooperatives start or expand businesses, capital is needed from producers and others. The federal and most state securities laws are not well-suited for producer entities raising capital. Cooperatives should not be treated as public companies in raising funds under the registration and public company reporting requirements because of their unique relationship with members. The securities laws should allow local and rural investors to participate with producer members in cooperatives without the cost and time of registration if certain conditions are met. An example of potential changes to securities registration and reporting requirements are provided in Exhibit D.

Markets For Cooperative Patronage Equities. Many cooperatives defer redemption of allocated patronage. The redemption policy may be based on age of the patron or years after the patronage was allocated. Many cooperatives have a priority on paying estates.

One of the disincentives of patronage allocated to members is that the current tax on the allocation often exceeds the present value of the allocation based on the cooperative's redemption policy. There is no efficient opportunity for the member to transfer the patronage allocation at current value (thus reducing the net tax burden) or for the cooperative to redeem the patronage allocation prior to the policy redemption date at a favorable market value.

Potential changes to federal law could specifically allow a loss for allocated patronage transferred for less than the allocation amount and allow cooperatives to redeem or otherwise acquire allocated patronage at less than the allocated amount after a suitable period of time without recognizing gain.

To make these options work efficiently, the allocated patronage could be transferable on an exchange where financial buyers could purchase and resell patronage allocations based on market value. Such an exchange would offer the members of cooperatives liquidity and allow cooperatives to repurchase patronage allocations that are undervalued. This alternative would require federal legislation for an exchange to be formed and to operate efficiently. An exchange could also be used for the purchase and sale of equity in value added or new generation cooperatives. With sufficient volume, many cooperatives and their members could benefit from the liquidity of an efficient market.

EXHIBIT A

DRAFT COPY

LEGAL FRAMEWORK FOR COOPERATIVE DEVELOPMENT

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Forthcoming in "Cooperatives and Development: Theory and Applications for the 21st Century", edited by Christopher D. Merrett and Norman Walzer. To be published in 2003, by M.E. Sharpe, Inc.

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LEGAL FRAMEWORK FOR COOPERATIVE DEVELOPMENT

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COOPERATIVES - LEGAL STRUCTURE BUILT ON PRINCIPLES

"Cooperation is not dead! The legal structure is tired, worn out and needs to be buried," announced a frustrated partner of mine. (One of my partners at Lindquist). The law practice of working with producer-owned businesses, cooperative and otherwise, throughout the country seems to focus on the unreasonable restrictions of co-ops and the flexibility of LLCs. The advance of business and economics has always outpaced the law. Producers and cooperators desiring social and economic change in the 1920s decried legal impediments to cooperation and the law changed.

In the past 20 years, producers have successfully formed hundreds of New Generation Cooperatives (NGCs), which are based on producer investment and proportional patronage returns; however, the financially successful co-ops are running into structural roadblocks resulting in conversion to limited liability companies (LLC) or taxable corporations, or the contribution of assets to joint venture entities that can operate profitably for the benefit of their owners. Now, many NGCs are starting the expensive conversion to LLCs because taxation issues have convinced their leaders that "all the co-ops are facing the same thing" and "everyone is making the change to an LLC" (Uecker and Talley 2002).

Successful NGCs do not fit well with many of the social and political principles developed and legislated 80 to 150 years ago that have remained part of American co-ops. These principles for member-financed cooperative stores simply do not work with the capital intensive, value-added processing co-op of the 21st century. The economics of agriculture have changed from gaining efficiencies through direct marketing of raw agricultural products to users to further processing of unique or higher-quality agricultural products into higher-valued consumer products. The new business model is capital intensive and necessarily so to derive competitive market presence and economies of scale.

A new cooperative model has been developed called a "Wyoming Processing Cooperative," which is essentially a co-op that operates in an LLC structure on the Rochdale cooperator's business principle of returning profits to the patrons of the co-op (Hanson 2001b). Wyoming's cooperative law allows outside investment and eliminates the restrictions imposed by federal corporate cooperative tax law while requiring profits returned to patrons based on patronage and allowing returns to investors based on capital investment. This structure has been praised by producers and cooperators as allowing the co-ops the flexibility to adapt their structures to changing business conditions, but it has also been criticized by traditional cooperators as not being a true cooperative law (Fredrick 2002; Torgerson 2002, 2).

CHALLENGES AND OPPORTUNITIES FOR COOPERATIVES

This chapter reviews the formation of cooperative legal principles codified through the development of state statutes to organize co-ops. The provisions of typical state cooperative statutes and modern corporate cooperative statutes are analyzed, and the formation of a valued-added agribusiness is compared under corporate cooperative statutes versus LLC or Wyoming Processing Cooperative structures. The federal control of corporate cooperative legal structure through federal tax law and other statutes is then examined.

For those who believe that cooperation is not dead and needs to be given the opportunity to further develop, a number of state and federal objectives and legislative changes are identified that will foster cooperative development.

FORMATION OF COOPERATIVE LEGAL PRINCIPLES

Farmers in the United States have organized companies to find markets for their products for 200 years (Goldberg 1928, 270). The development of legal principles to structure marketing companies as co-ops began with the National Grange of Patrons of Industry commonly known as the Grange, which spread concepts for collective action to farmers in order for them to organize as Rochdale co-ops (Evans and Stokdyk 1937, 20; Goldberg 1928, 272).

Rochdale Cooperation

Workers in England formed a cooperative store in 1844 called the Rochdale Society of Equitable Pioneers. Their plan emphasized participation in profits according to business conducted with the co-op rather than participation in profits based on invested capital (Holyoake 1908, 277; Woeste 1998, 20). This principle defined and differentiated Rochdale cooperation. The society published twelve principles, four of which became the legal foundation for American co-ops and are referred to as the "Rochdale Principles": (1) business at cost with net returns paid to members based on patronage, (2) democratic control--one person/one vote, (3) limited dividends on invested capital, and (4) ownership (or beneficial membership) limited to patrons (Woeste 1998, 20). The Rochdale store was not capital intensive and, in fact, limited the capital of its members (Holyoake 1908, 277).

The national Grange endorsed the "Rochdale Principles" to be adopted as rules by local organizations of farmers for any commercial organization (Nourse 1927, 35). The rules included organization as stock companies with the purchase of at least one share of stock required for membership, required purchases each year, interest on capital limited to 8 percent, and profits distributed in proportion to purchases (36). One vote per member was also a Grange principle (Goldberg 1928, 272).

The Grange Fails but Cooperative Principles Succeed

The explosive growth of the Grange movement relied in part on cooperative strategy to overcome failed or unprofitable marketing conditions. The Rochdale Principles were appropriately developed for purchasing co-ops, and the Grange rules were developed for cooperative stores, with the legal structure fitting the business. These same rules were applied to

Grange elevators and shipping associations with minor changes to the purchasing or store requirements (Nourse 1927, 37). The Grange's attempt to use a collective purchasing or cooperative store model for marketing ventures failed. Rochdale Principles restrict business volume to a level supported by the members' pooled capital, generally from operations. Marketing activities, especially those of storing, grading, or processing products, requires significant outlays of capital, and the Rochdale cooperative business model had limited capital per member (Woeste 1998, 24).

The meaningful operations of the Grange were short, rising rapidly and generally collapsing in the 1870s (Hanna 1931, 6; Nourse 1927, 34). Even so, the impacts of organizing farmers and promoting the Rochdale Principles as cooperative legal requirements have carried forward to co-ops today (Fite 1978, 8; Woeste 1998, 22).

DEVELOPMENT OF STATE ORGANIZATIONAL STATUTES

Farmers Allowed to Form Cooperatives Under General Statutes

In many states, the formation of corporations in the mid 1800s was by special legislative act. As states developed general business incorporation acts by industry, union movements and the Grange farmer protest movements led farmers to appeal to their state legislatures for general statutes to form local co-ops (Hanna 1931, 5-7; Nourse 1927, 39-50).

Michigan authorized the formation of cooperative stores in 1865 (Michigan Laws 1865; Nourse 1927, 39). Massachusetts passed a cooperative law in 1866 (Massachusetts Laws 1866) governing cooperative procedures that were a pattern for the statutes of Pennsylvania (1868), Minnesota (1870), Connecticut (1875), and Ohio (1884) (Nourse 1927, 40). The Massachusetts statute generally allowed co-ops to be formed as a corporation to conduct lawful pursuits, including agricultural businesses, with capital stock limiting a member's interest in the co-op to $1,000, voting power of not more than one vote per member, and limited liability of members. The statute also authorized a distribution of the profits to the purchasers and stockholders as described in the bylaws, provided that 10 percent of the net profits were deposited in a sinking fund until the amount of the sinking fund balance was a sum equal to 30 percent in excess of the capital stock (Massachusetts Laws 1866).

In 1877, Kansas, Wisconsin, and Pennsylvania enacted cooperative laws (Nourse 1927, 42-43). The Kansas law was brief, requiring "one-man-one-vote" (42). The Wisconsin law was similar to the Massachusetts law but limited debts to two-thirds of the paid-up capital and prescribed voting: "members and not shares of stock shall vote in electing officers and transacting any business of the association of whatsoever nature, but no proxies shall be allowed" (42).

The Pennsylvania law was longer and more detailed, covering limited voting, patronage dividends, trade for cash, etc.; it also included a unique base capital provision characterized as "permanent" and "ordinary" stock. "Ordinary" stock could be bought and sold, but each member held permanent stock allowing one vote and patronage dividends that were applied to payment for the stock until the $1,000 maximum was attained (Nourse 1927, 43).

The First Model Statutes. In 1911, Wisconsin and Nebraska enacted cooperative laws which prescribed by statute the distribution of profits by patronage dividends to members. Prior laws had allowed co-ops to distribute dividends as provided in the bylaws (Nourse 1927, 46). The Wisconsin law required earnings to be apportioned first to pay dividends on stock not to exceed 6 percent; then of the remainder not less then 10 percent for a reserve fund until it is equal to 30 percent of capital stock; 5 percent for education to teach cooperative development; then of the remainder one half according to purchases of shareholders and upon wages of employees; and the other half according to the purchases of shareholders and nonshareholders, providing that for processing co-ops the dividend would be on raw products delivered instead of purchases (Wisconsin Laws 1911). The Wisconsin law was generally adopted in 16 other states in the following eight years (Nourse 1927, 46). The cooperative laws based on the Wisconsin model generally required capital stock co-ops to operate on the Rochdale Principles of limited capital holdings, democratic voting, and distribution of profits based on patronage (48).

Non-Stock Cooperative Alternative

An alternative to capital stock co-ops was concurrently developed at the time of the Wisconsin and Nebraska state statutes primarily to avoid the corporate attributes associated with capital stock. Critics alleged that capital stock co-ops were merely a modified form of for-profit corporations and that an alternative organization should (1) avoid capital stock by putting all invested capital on a "loan" basis, (2) eliminate the competitive-price relationship with the member (transfer price for product) and substitute a net returns settlement, and (3) restrict cooperative transactions to members only (Nourse 1927, 52-58).

In 1909, California enacted a nonstock cooperative law (California Laws 1909), providing for a membership association on a nonprofit basis that allowed equal or unequal voting and property interests as provided in the articles of incorporation. Capital contribution from members was authorized as "membership" fees. Six states adopted nonstock cooperative laws based on the California model from 1909 to 1921 (Nourse 1927, 65).

Nonstock cooperative laws were further modified by provisions of a U.S. Department of Agriculture (USDA) model nonstock cooperative act under the title "Suggestions for a State Co-operative Law Designed to Conform to Section 6 of the Clayton Act" (Nourse 1927, 73-92). The USDA model act required co-ops to conduct business only with members. Seven states enacted statutes based on the USDA model nonstock cooperative act (Hanna 1931, 42).

The Capper-Volstead Cooperative Definition

The initial period of cooperative statutes allowed the farmer businesses considerable flexibility to form and adapt co-ops to business conditions. As co-ops formed to exert market power, the principles were litigated in the context of antitrust violations (Guth 1982; Sapiro 1923).

The Clayton Act provided certain exemptions for co-ops organized without stock. In 1922, the Capper-Volstead Act was enacted by Congress to provide an exemption from anti-trust enforcement for narrowly defined farmer co-ops organized as stock or nonstock co-ops that limit membership to agricultural producers, restrict voting to one vote per member or limit dividends on equity to 8 percent per year, and handle products for members that exceeds the value of products handled for nonmembers (Lauck 1999, 491-493).

The Capper-Volstead Act definition of co-ops continued to be the federal definition of co-ops for purposes of federal regulatory relief and financial assistance. The impact of federal financial assistance institutionalized the cooperative business structure. The federal government loaned $330 million to co-ops from 1929 to 1932, an additional $68 million by 1934, and more than $400 million on an annual credit basis by the end of World War II (Lauck and Adams 2000, 67-68).

By 1970, one third of the capital used by co-ops (subject to the Capper-Volstead definition with some modification) stemmed from debt, and the federally chartered banks for co-ops provided nearly all of the remaining debt financing (Lauck and Adams 2000, 68). The restriction of outside capital and limited capital returns did not impede cooperative development when favorable federal debt financing was available.

Commodity Marketing Acts

The most pervasive development in cooperative law occurred from 1921 through 1926, with more than forty states enacting a commodity marketing act to incorporate co-ops (Sapiro 1927, 8).

Sapiro's Plan. The movement was started by Aaron Sapiro based on his California commodity cooperative marketing experiences (Larsen 1967, 446-454). Sapiro's plan consisted of (1) organization of the association on a commodity basis; (2) limitation of membership to and democratic control by actual growers; (3) control of the deliveries by means of a long-term, legally binding contract signed by every member; (4) pooling of product according to grade, basing returns to each member on the average annual price received for the pool to which they contributed, and providing orderly marketing of the product throughout the productive period; and (5) control of a sufficient portion of the entire crop to be a dominant factor in the market and to make possible an economic distribution of overhead expenses (Knapp 1973, 9; Sapiro 1923, 200-201).

According to Sapiro (1927), the fruit growers in California experimented with cooperation to suit their needs and federated local associations of growers for marketing all of the growers' fruit:

> [T]his was an organization by the commodity in contrast to organization by locality . . . . This adjustment could not be made by a single farmer; nor by a local association or even a small group of locals. But it could be made by farmers who could control and be certain of the control of a large percentage of the commodity and could help guide the flow of that commodity into the markets of the world . . . . The inevitable happened. Law began to conform slowly to the

> economic advance. The farmers had found a definite trend; and law put flesh on its dry bones and grew again in the same measure. (2-3)

A national model: The Bingham Act. Sapiro, whose national stature with farm organizations allowed him to participate in preparing drafts of the Capper-Volstead Act, prepared a draft commodity marketing law based on the cooperative requirements of the Capper-Volstead Act and the California marketing principles. The first commodity marketing act was adopted in Texas in 1921, but the best form and most widely adopted model was The Bingham Cooperative Marketing Act ("Bingham Act") enacted by Kentucky in 1922 (Sapiro 1927, 7).

The Bingham Act was uniquely conformed to the Capper-Volstead Act and thwarted unwarranted judicial intervention of competitors by legislatively announcing public policy issues requiring farmers to cooperate while providing a legal framework for cooperative organization and operations. The key features of the Bingham Act are as follows:

- Public policy statements of the producers' right to conduct cooperative marketing
- Provisions for a preliminary investigation of the marketing conditions to ensure success of the co-op
- Statutory authority to conduct the commodity marketing for the members of the co-op
- Restriction of members to agricultural producers, including share crop landlords and tenants
- Authorization of district voting for directors, directors and officers elected from the membership other than by appointment, or election of directors to represent the interests of the general public
- Statutory authorization of a marketing contract with members, including remedies of liquidated damages and injunction as a penalty for breach of the contract
- Criminal penalty for inducement of breach of the contract or spreading false reports about the finances or management of the co-op
- Penalties against warehousemen for soliciting or persuading members to breach marketing contracts
- A declaration that commodity marketing or the marketing contracts shall not be deemed to be a conspiracy or combination in restraint of trade, an attempt to lessen competition, or an attempt to fix prices arbitrarily in violation of any law of the state ("Acts of Kentucky 1922" 1922)

A substantial amount of litigation ensued in many jurisdictions following the enactment of the commodity marketing acts, but the acts were held to be constitutional (Sapiro 1927, 10-11; Meyer 1927, 90-93; Tobriner 1928, 19-34). The general adoption of the Bingham Act started the uniform acceptance of legal principles for marketing co-ops and was referred to as the "Standard Act" (Evans and Stokdyk 1937, 298). Many legislatures modified the Standard Act with local concerns over operations; however, the main provisions of the Bingham Act were enacted.

A ten-year effort for national uniformity fails. The desire for uniformity of the commodity marketing acts was undertaken by the National Conference of Commissioners on Uniform State Laws in 1925. After consideration of five consecutive drafts over ten years, the Conference and the American Bar Association approved the draft for submission to state legislatures. A national uniform cooperative law was referred to as an "epochal development in the field of marketing law" (Evans and Stokdyk 1937, 300), but the uniform law was not widely received. Only two states had adopted the Uniform Act with modifications by 1945 (Jensen et al. 1950, 12). Even so, with the Uniform Act and substantial case law supporting the principles and language of the Bingham Act, the co-op as an organizational structure had reached legal maturity by 1950 (Ela 1950, 524).

Modern Corporate Cooperative Statutes

In the late 1980s and 1990s, Minnesota, Colorado, and Ohio redrafted their cooperative statutes. While commodity marketing acts were restricted to agricultural producers marketing their products, many states had modified these statutes to allow nonagricultural producers to form co-ops for other purposes. The modern corporate cooperative statutes are general cooperative statutes with certain provisions to accommodate agricultural producer co-ops. In Minnesota, five different stock and nonstock cooperative statutes were recodified and revised into one corporate cooperative statute (Hanson 1993; *Minnesota Laws* 1989).

Colorado repealed and reenacted one of its corporate cooperative statutes ("Colorado Session Laws 1996" 1996; "The New Colorado Cooperative Act" 1996), and Ohio adopted a corporate cooperative statute in 1998 (*Ohio Laws* 1998). The impetus for revision was the increased interest and formation of a new generation of value-added co-ops (Hanson 2001a, 41-42). Most of the NGCs are processing co-ops with a different focus than commodity marketing co-ops.

A comparison of modern corporate cooperative acts to a Commodity Marketing Act. The modern corporate cooperative acts generally differ from commodity marketing acts in facilitating modern corporate functions. The Rochdale Principles embodied in the commodity marketing acts are largely unchanged. Table 5.1 compares the major distinctions.

Table 1. Comparison of Modern Corporate Cooperative Statute With Commodity Marketing Act.

Modern Corporate Cooperatives	Commodity Marketing Act
1. Organization	
• *No similar provisions*	• Policy Declaration – orderly marketing stabilize marketing of agricultural products
• *Purpose* – any lawful purpose	• Marketing, processing, handling agricultural products of members, or manufacturing, selling or supplying members with machinery, equipment or supplies
• *Incorporators* – one or more persons	• Requires 10 to 20 persons, a majority must be residents of state
• *Stock and Nonstock Organization* – with same power and authority	• Grants powers to both
• No similar provisions	• Preliminary investigation of marketing conditions by university
• No similar provisions	• Statement that cooperative marketing is on public district
2. Articles of Incorporation	
• *Contents*	
– Board Authority to designate classification of shares if not designated in articles	– No similar provision
– General statement of rights and obligations of shares	– Similar
– Statement of governance rights (voting) – description of voting allocations	– One vote per member, no variance
– Statement of restrictions on share transfer (approval of board) and whether bylaws and board may further restrict transfer	– Bylaws required to only allow transfer to producers
– Limitations on dividends on stock (typically 8%)	– No similar provision
– Allocations and distributions of income in excess of dividend based on patronage	– No similar provision
• *Amendment* – by board majority and majority of members voting provided board may amend articles until cooperative has members or stockholders with voting rights; board authority to adopt specified amendments or without shareholder approval	• Approval by 2/3 of board and majority of all members; no authority for board amendments
• *Bylaws* – cooperative may have but need not have bylaws. Initial adoption by board Subsequent adoption by members unless bylaw authorizing board	• Must have bylaws adopted by members
– Admission, withdrawal, and suspension of members	– Note mandatory redemption upon withdrawal
– Voting rights, privileges of members	– One vote per member
– Reports and financial statements to members	– No similar provision
3. Powers	
• Generally, all acts necessary and proper to conduct cooperative's business or to accomplish purposes of cooperative	• Generally similar, may be more restrictive
• Accept Deposits from Cooperative Members	• No similar provision
• Acquire and Dispose of Stock or Ownership Interests in Other Entities	• Restricted to cooperatives with similar producer membership
• Establish, Pay and Operate Pension Plans, Share Bonus and Option Plans and Benefit Plans for Directors, Employees and Agents	• No similar provision
• Indemnify Directors, Officers, and Employees	• No similar provision

Modern Corporate Cooperatives	Commodity Marketing Act
• Create Subsidiary Corporations, Cooperatives, Limited Liability Companies, and other Business Entities	• Similar but related to tax, no authority for LLCs
4. Agricultural Marketing Contracts	• Generally same except no penalty for contract interference, and restrictions on warehouse men
5. Board of Directors	
• *Board Governance of Cooperative* – all authority of cooperative exercised by board unless otherwise provided by articles or bylaws	• Board governance authority to exercise powers not explicit
• *Limitation of Directors' Liability*	• No similar provision
• *Encumber all Assets Without Shareholder Approval*	• No similar provision
• *Sale or Disposition of All Property Without Shareholder Approval* – to subsidiary, in ordinary course of business	• No similar provision
6. Members	
• *Districts* – authorized in bylaws implemented by board	• Authorized in bylaws
• *Member Violations of Bylaws* – surrender or conversion of equity, cancellation of membership; redemption authorized not mandated	• Similar; however appraisal of interests and redemption within one year of withdrawal or expulsion required
• *Required Reports to Members*	• No similar provision
• *Access to Records by Members*	• No similar provision
• *Voting* – who may vote, mail and absentee voting, proportional patronage voting	• One vote per member
• *Limits of Liability for Corporate Debts*	• Similar
• *Approval Required for Certain Transfers of All or Substantially All of the Assets*	• No similar provision
7. Stock	
• *No similar provision*	• No member may own more then 1/20 of stock of cooperative, common stock may only be owned by producers
• *Authority and Rights for Preferred Stock*	• With or without right vote; purchase of property, value
• *Perfected Lien of Cooperative For Debts and Obligations to Cooperative*	• No similar provision
8. Allocations and Distributions	• No similar provision – referenced in marketing contract
9. Mergers and Consolidations	• No similar provision

Cooperative organization under noncooperative statutes. State cooperative statutes provide a framework for organization and incorporation (Baarda 1982). Co-ops can also be organized under general business corporation statutes to meet federal cooperative tax criteria and under LLC statutes to operate on a cooperative basis and to be taxed on a pass-through or partnership tax basis. Organization and incorporation under noncooperative statutes require substantial modification of articles, bylaws, and operating agreements to achieve operation on a cooperative basis.

CHALLENGES AND OPPORTUNITIES FOR COOPERATIVES

A New Model Under Old Statutes: New Generation Cooperatives

Starting in the 1970s and 1980s and rapidly developing in the 1990s, a new form of co-op--the "value added" or "new generation" co-op--was being organized throughout the Midwest by agricultural producers to further process agricultural products (Hanson 2000b; Patrie 1998).

The New Generation Cooperatives (NGCs) were formed under existing cooperative statutes but were capitalized and operated differently than supply and marketing co-ops. The NGCs acquired or constructed processing facilities through 40 to 50 percent member equity and 50 to 60 percent debt financing. The member equity is obtained from each member subscribing to stock in proportion to the amount of crops or livestock committed to be delivered to the co-op.

Through stock subscriptions, the member producers essentially purchase the processing and marketing capacity of the co-op to process and market the agricultural products committed for delivery under marketing contracts. Products delivered are in proportion to stock purchased, and patronage is paid to the producers based on product delivered. The different variations of this model utilize common stock for the voting membership stock, and preferred stock is divided into delivery shares. In both cases, the amount of product committed to be delivered under uniform delivery and marketing agreements are proportional to delivery share ownership (Hanson 2000a).

Non-Uniform State Cooperative Laws Impede New Generation Cooperative Organization

The non-uniform development of agricultural co-ops and cooperative law has resulted in significant variations in state cooperative statutes--many of which were enacted from 1910 to 1925. In fact, few states have the same cooperative statute. This author and his partners have formed NGCs under stock and nonstock cooperative laws of many of the agrarian states, and although some state cooperative statutes have impediments, generally these can be overcome by shareholder agreements, article or bylaw provisions, or financing provisions.

Organization under Commodity Marketing Acts: Indiana. Indiana enacted a commodity marketing act in 1925, which has had few amendments, to incorporate stock and nonstock, nonprofit co-ops whose members must be agricultural producers (*West's Annotated Indiana Code* 1998). Forty other states have similar commodity marketing acts. The statute requires all members to be individuals or political subdivisions of Indiana engaged in the production of agricultural products; the redemption of expelled or retired members' interests to be as provided in the bylaws. The co-op may restrict voting to one vote per member regardless of number of shares owned or capital invested. Distributions after restoration of deficits, payments of stock dividends, and allocations to reserved are as provided in bylaws to members, nonmembers, and patrons but only on the basis of patronage. The limitations of a commodity marketing act require skillful lawyering to organize NGCs.

Organization alternatives under separate stock and nonstock cooperative statutes: Missouri. Missouri enacted stock and nonstock cooperative statutes in 1923 and 1925. In these statutes, twelve persons may incorporate a stock co-op to produce or furnish goods or services; to conduct an agricultural or mercantile business on a cooperative plan; or to sell to or buy from all stockholders, groceries, or other merchandise (*Missouri Statutes* 2001, § 357.010). Stock may only be owned by natural persons, and co-ops must be organized in Missouri on a cooperative plan. As enacted until 1945, the directors were elected on a basis of one vote for each share of stock owned, but now the legislation requires one vote per shareholder and states that the policies of the co-op, including declaration of dividends, setting aside reserve funds, and method of distributing profits, are reserved and conferred upon the shareholders (§§ 357.090, 357.100). Profits are distributed to shareholders or, if authorized, to nonstockholders on a patronage basis after first setting aside 10 percent for a reserve fund until the fund equals 50 percent of the paid-up capital stock (§357.130). Dividends on stock may be declared not to exceed 10 percent.

Missouri also enacted a commodity marketing act which requires eleven or more persons, a majority of whom are residents of Missouri, to incorporate a nonstock, nonprofit co-op (*Missouri Statutes* 2002, §§ 274.010-274.300). Members are restricted to agricultural producers. The nonstock co-op is governed by the board of directors who must be members; however, one-third of the directors may refer any question to the membership (§ 274.150). In the case of the death, withdrawal, or expulsion of a member, the directors, when authorized by the membership, must appraise the value of the former member's property rights and pay the amount to the former member or the member's heirs or representatives as if the member had continued membership (§ 274.090). This requirement can be burdensome or cause the dissolution of an NGC in that the statute shifts the burden of the member to the co-op to find replacement equity for a member who leaves.

The Missouri stock cooperative restrictions on stockholders to natural persons or Missouri co-ops and the high statutory reserve in excess of paid-up capital stock (50%) significantly impair the formation of NGCs or other contemporary cooperative businesses, and, as a result, most new co-ops are organized on a nonstock basis with stock-like equity participation units established in the organizational documents.

Organization under unique for-profit and nonprofit distinctions: Michigan. Michigan generally organizes its corporations law into for-profit and nonprofit corporations. Each division has provisions for incorporating a co-op, while for both the operation is on a cooperative basis similar to other statues. Other than the differences in the operational provisions between a for-profit and nonprofit co-op, a primary consideration is that the shares or equity of a for-profit co-op offered to members is subject to the Michigan securities registration requirements, while the shares or equities offered to members of a nonprofit co-op are generally not required to be registered.

NGCs that organize in Michigan typically initially organize under the nonprofit corporation cooperative laws but are operationally better suited to the provisions of the for-profit cooperative corporation laws. The nonprofit and for-profit distinctions for corporations do not appropriately apply to co-ops.

A New Era: Unincorporated Cooperative Associations

As more NGCs were organized, farmers voiced their complaints about state law restrictions and impediments of federal law. Midwest states with anticorporate farming laws (*Iowa Code* 2001, Ch. 9H; *Minnesota Statutes* 2001, § 500.221) did not allow co-ops to participate in confined hog feeding, dairy, and egg laying operations. In these cases, corn farmers desired to process corn into feed to be fed to the poultry or livestock owned by the co-op and to realize profits from marketing pork, milk, or eggs. Iowa and Minnesota both modified their anticorporate farming laws to allow restricted farmer entities, including co-ops, to engage in these ventures.

Iowa Chapter 501 Statute. Iowa enacted a cooperative statute in 1996 "to provide an opportunity for producers of agricultural commodities to contribute a portion of their production for a single enterprise for purposes of enhancing the value of that production and to restrict control of these enterprises to agricultural producers" (*Iowa Laws* 1996, Ch. 1010, §1). This corporate cooperative statute required "farming entities" (*Iowa Code* 2001, §§ 501.101, 9H.4) to have at least 60 percent of the voting control and financial rights, and required "authorized persons" to have 75 percent of the voting control and financial rights (§§ 501.101(2)(6)), with the profits distributed on a patronage basis. Returns on ownership by interests in the co-op may not exceed 8 percent of the interests. Income may be allocated to reserves or retained savings (§ 501.503).

The statute also requires redemption of a member's interest over a period not to exceed seven years upon withdrawal or expulsion. Some ventures had incorporated and attempted to obtain a § 521 certification as a farmer's co-op from the Internal Revenue Service. The process resulted in questions as to whether such a co-op operated on a cooperative basis (Brown 1998). In 1998, the Iowa legislature substantially amended the corporate cooperative statute to eliminate the terms of "incorporation," "incorporators," "stock," "shareholders," and similar corporate terms and replace them with "association," "organizers," "members," "interests," and similar LLC terms (*Iowa Laws* 1999).

With these changes, promoters claimed that a co-op organized under the statute would be considered an unincorporated association and qualify for partnership type pass-through taxation similar to an LLC (Brown 1998). A revenue ruling confirming this approach has not been obtained.

Wyoming Processing Cooperative Law. In 1999, lamb producers in Wyoming and its surrounding states desired to acquire lamb meat, wool, and pelt processing and marketing businesses to make lamb production more profitable. The lamb producers realized that more capital would be needed than could be supplied by producers on a per lamb basis. They wanted to organize their business on a cooperative basis but the existing models did not fit their business plan (Hanson 2001b, 8-9).

The Wyoming legislature adopted changes in the existing cooperative statute, and a new processing cooperative statute was enacted to be effective on July 1, 2001 (*Wyoming Laws* 2001). A ruling request submitted to the Internal Revenue Service confirmed that a co-op organized under the Wyoming processing cooperative statute would be considered an "unincorporated association" and subject to partnership taxation or corporate taxation by election similar to an LLC (PLR 2001).

A Wyoming processing co-op may be formed and organized on a cooperative plan as provided in the Wyoming Processing Cooperative Statute to market, process, or otherwise change the form or marketability of crops, livestock, and other agricultural products and purposes necessary or convenient to facilitate the production or marketing of agricultural products by patron members.

A Wyoming processing co-op has flexibility in two important areas that are not available to corporate co-ops. The nature of the patronage relationship with its members can be determined by the organizational documents, and the co-op can enter what would otherwise be considered nonpatronage source business without tax at the co-op thereby passing income, losses, and tax credits through to the members; the co-op can also attract capital through outside investments (Hanson 2001b, 6-8).

The co-op's owners are its members divided into two classes. Patron members have rights and obligations to deliver the product to the co-op, while nonpatron members do not have product delivery obligations and are primarily "investment" members. Patron members may also participate as investment members. The patron members have preference in both governance and financial rights.

The voting rights of the members are differentiated between patron and investment members. Patron members vote on a democratic basis of one vote per member subject to certain exceptions. The patron member vote, however, is counted collectively based on a majority of the patron members voting on an issue. Investment members have voting rights proportional to their investment or as otherwise provided in the bylaws. The collective nature of the patron member's vote ensures patron members maximum representation in cooperative voting.

The co-op is governed by a board of at least three directors. At least one director must be elected by the patron members. Directors elected by patron members have at least 50 percent of the voting power of the board or voting power on an equal governance basis.

The financial rights are distinguished between patron members and investment members. The patron members are allocated financial rights (i.e., profits, losses, and distributions) based on patronage or business done by the patron member for or with the co-op. Investment members are allocated financial rights based on capital contributions. Financial rights are allocated between patron members collectively and investment members based on capital contributions provided, however, that the patron members collectively must receive at least 15 percent of the profit allocations and distributions.

Restrictions on member control, contributions, governance rights, and financial rights must be stated in the bylaws or within separate member control agreements. Investment members have redemption rights if bylaw amendments alter governance or financial rights that affect their investment. To protect both patron and investment members upon their entrance to the co-op, the co-op must disclose to any person or entity acquiring membership interests in the co-op the capital structure, business prospects, and risks of the co-op, including the nature of governance and financial rights of the membership interests being acquired and of other classes of membership and membership interests (Hanson 2001b, 6-8).

CHALLENGES AND OPPORTUNITIES FOR COOPERATIVES

Variations in Statutes Will Ultimately Lead to Organizational Forum Shopping

The modern corporate cooperative acts retain the cooperative principles of the 1920s but typically do not restrict the purposes for which a co-op may be formed. The Iowa Chapter 501 cooperative statute, while restrictive, made the first step in allowing co-ops to form without the restrictions of federal corporate cooperative taxation and allows up to 25 percent nonproducer ownership and control. The Wyoming cooperative processing law provides the most flexible format for organizing a business organization on the cooperative business principle of distribution of earnings to patrons on the basis of patronage with or without federal corporate cooperative taxation.

The large variation in cooperative laws among states invariably leads to shopping for the best state statute when a new co-op is to be organized. The business principles of operating successfully drive new co-ops, especially NGCs, to seek an organizational statute that accommodates their business plan and structure. Forum shopping has been in practice for many years, with many corporations throughout the country incorporating under Delaware corporate statutes.

IMPACT OF FEDERAL LAW ON COOPERATIVE STRUCTURE

A co-op is organized or incorporated under state law and must abide by the requirements of the organizational statute to maintain its charter to operate as a separate legal entity. While some state statutes under which a co-op may be organized offer more flexibility than others, federal laws require a co-op to have a certain legal structure (required by its articles and bylaws) in order to receive the corresponding benefit of the federal law.

Corporate Cooperatives Structured to Meet Tax Law

Virtually all corporate co-ops must be structured and operate on a cooperative basis as determined by the cooperative taxation provisions ("Subchapter T") of the federal Internal Revenue Code (the "Tax Code") in order to not be taxed as a corporation. The combined state and federal marginal tax rate is about 35 to 40 percent of taxable income in many states. Co-ops that operate on a cooperative basis under Subchapter T of the Tax Code are allowed to deduct patronage-sourced income that is allocated to patrons from the co-op's taxable income. Simply stated, a corporate co-op organized under state law may avoid a combined state and federal 35 to 40 percent tax at the co-op level by operating on a cooperative basis prescribed by Subchapter T of the Tax Code and properly allocating its patronage-sourced income to its members.

Two types of co-ops qualify to deduct income allocated to patrons: (1) an "exempt" or § 521 co-op and (2) a nonexempt co-op that operates on a cooperative basis for the purposes of Subchapter T.

Operation on a cooperative basis. The U.S. tax court has determined three guiding principles for operating on a cooperative basis: (1) subordination of capital; (2) democratic control by members; and (3) proportional allocation of income on the basis of patronage (*Puget Sound Plywood* 1965). In the 1990s, the IRS added four additional factors in considering whether a corporate co-op is operating on a cooperative basis: (1) existence of a joint effort on behalf of members; (2) a minimum number of patrons; (3) member business should not exceed nonmembers' business; and (4) upon liquidation, present and future patrons must share in the distribution of any remaining assets in proportion to the business each did with the co-op during some reasonable period of years (Frederick 2001, 26-27).

An exempt § 521 co-op has two additional deductions from gross income that are not available to a nonexempt co-op: (1) amounts paid as dividends on capital stock and (2) amounts allocated to patrons with respect to income that is not patronage-sourced. To qualify for these two additional exemptions, an exempt co-op generally must: (1) have substantially all (85%) agricultural producer members; (2) return profits in excess of expenses and permitted reserves to all patrons (members and nonmembers) on the basis of patronage with the co-op; (3) restrict dividends on capital stock not to exceed the legal rate of interest in the state of incorporation or 8 percent, whichever is greater; and (4) restrict nonmember marketing business not to exceed member business, and restrict nonmember nonproducer purchasers not to exceed 15 percent of all purchases (Frederick 1996; *Internal Revenue Code* 1992, § 521).

Deduction only applies to patronage sourced business. Co-ops that qualify for the ability to deduct income allocated to patrons are further restricted in that the deduction applies to patronage-sourced business for nonexempt co-ops and for patronage- and nonpatronage-sourced business approved within the exempt co-op's scope of business certified by the IRS (*Internal Revenue Code* 1992, §§ 521, 1381-1388). The limitations of both of these restrictions are beyond the scope of this article but have been discussed extensively by Donald Frederick (2001). In general, a qualifying deduction for patronage-sourced business must be related to the patronage business, and the income must not be derived from other products, ingredients, or further processing by others. In limited cases, the income from investments in joint ventures that further process and market a co-op's products may qualify as patronage-sourced business.

Many of the Tax Code regulations were promulgated in the 1950s through the 1970s prior to the advent of NGCs and LLCs. At that time, virtually all companies were organized as corporations and all income was taxed at the entity level. Deductions such as those for income generated from patronage-sourced businesses or for exempt co-ops, the scope of business for which the patronage-sourced business deductions applied, were narrowly construed and restrictively regulated by the IRS.

Antitrust: Capper-Volstead Protection

The Capper-Volstead Act (*U.S. Laws 1922* 1992) has been hailed as the "Magna Carta of Cooperative Law." The acknowledgment was appropriate because marketing co-ops and, especially, stock co-ops, were being successfully challenged under state and federal antitrust laws as illegal combinations that restrained trade in the early part of the 1900s (Guth 1982). The Capper-Volstead Act provided a limited antitrust exemption for co-ops that (1) limit membership as agricultural producers; (2) operate for the benefit of members as producers; (3) restrict voting to one vote per member or limit dividends on equity to 8 percent per year; and (4) handle products for members that have a value which exceeds the value of products handled for nonmembers. Subsequently, the Cooperative Act of 1926 was enacted which allows co-ops that meet these requirements to share marketing information ("Cooperative Marketing Act of 1926" 1992).

The criteria for a co-op qualifying for protection under the Capper-Volstead Act were developed primarily from the U.S. Department of Agriculture (USDA), but important is that these same criteria formed the basis of the commodity marketing acts adopted throughout the country (Guth 1982).

Agricultural Marketing Act of 1929

This act defines co-ops to include the requirements of the Capper-Volstead Act ("Agricultural Marketing Act of 1929" 1992). The act was originally intended to define which co-ops were eligible for cooperative bank financing but has subsequently been used as the test for (1) the protection against handler coercion and discrimination in the Agricultural Fair Practices Act; (2) the cooperative exemption from the registration requirements of the Securities Act of 1934; (3) the cooperative exemption from the trust provisions of the Perishable Agricultural Commodity Act; and (4) the cooperative trucking exemption from trucking regulations under the Interstate Transportation Act (Frederick 2002).

ENTITY SELECTION: CORPORATE COOPERATIVE VS. LLC OR THE WYOMING COOPERATIVE

Co-ops are organizations that have been developed on social and policy principles, primarily the Rochdale Principles and business principles of the patronage relationship. When producers are organizing an agricultural business that requires delivery and processing of products, an evaluation of the types of entity to organize focuses on corporate co-ops versus LLCs and now the Wyoming Processing Cooperatives (Wyoming Cooperatives).

Pass-Through Taxation and Limitations of LLCs

Limited liability companies (LLCs) offer pass-through taxation--that is, no tax at the entity level and a pass-through of gains, losses, and tax credits to members. An LLC can be organized to separate governance and financial rights (i.e., voting can be proportional or disproportional to the investment). Allocations and distributions can, but need not be, proportional to the investment. LLCs require operating agreements to be signed by all members and are cumbersome to amend. Unlike bylaws as organizational rules, operating agreements are viewed as member contractual rights.

The flexibility of an LLC requires a careful crafting of organizational documents to effect business provisions and a careful analysis of the tax ramifications. The federal partnership tax law was developed for partnerships and has not been revised to accommodate LLCs. If the business will require member delivery of the product to be processed by the LLC, the issue of transfer price and allocation of income based on the product delivered or on the investment must be addressed. An LLC structure can be adopted to allocate or distribute income based on product delivered but the documentation and agreements are cumbersome and complicated.

Corporate Cooperative Restrictions and LLC Alternatives

The business principle: Income allocated based on patronage. The most important business principle of a co-op is allocation and distribution of income based on patronage (i.e., business done for or with the co-op) rather than investment. In other corporations, the investor need not do any business or purchase or use any of the corporation's products or services to receive allocations through share ownership of profits of the corporation. A co-op is organized to benefit members who deliver or acquire product from the co-op. Noncooperative businesses can acquire and market products of their investors; however, the product procurement and marketing is done on a contractual basis typically based on the transfer price of the product.

A co-op is organized to allocate income to members based on business done for or with the co-op. In NGCs, members invest money to purchase stock or equity proportional to the amount of product to be delivered. In essence, the processing facility can be considered to be divided and allocated into processing and marketing units with each member purchasing a block of processing and marketing units through their equity ownership. This collective action on behalf of the members' units results in the income attributable to those members' units being allocated and eventually distributed to each member. The cooperative organizational statutes of the various states facilitate and, in many cases, mandate this principle.

If producers, with or without others, intend to form an agricultural business that does not utilize their products or is intended to reward producers solely on investment, the business should not be organized as a co-op.

Subordination of capital. Organization on this business principle as a co-op, carries several nonbusiness principles, especially with corporate co-ops. State and federal statutes have legislated that subordination of capital means outside investment should receive no more than an 8 percent dividend on equity. During most of the last 25 years, 8 percent would not have paid capital for its use and, in fact, would pay less than a commercial bank debt. LLCs and Wyoming Cooperatives can have outside investors and pay returns at market rates to attract that outside investment.

Dealing primarily with the products of members. Exempt corporate co-ops are to deal only with the products of producers, and the value of member products acquired by the co-op must exceed the value of nonmember products. Although nonexempt corporate coops may deal with a greater amount of nonmember products, this principle is embodied primarily in federal corporate cooperative tax law. Most processing and marketing businesses need a variety of grades and pricing of products to be successful marketers. Certain nonmember producers may offer to sell products at harvest at a substantial discount. A corporate cooperative processing entity would be at a competitive disadvantage if it could not acquire products from nonmember producers at the same discount as its competitors. If a corporate co-op is authorized to conduct business with nonmembers on a noncooperative basis, the income is not deductible as patronage-sourced business and, therefore, will be subject to state and federal tax at the co-op level. LLCs and Wyoming Cooperatives can acquire products from members or nonmembers at the most competitive price.

Limitation of patronage-sourced income. Although a corporate co-op is based on a single-level tax theory--income is either taxed at the entity or at the member level--the deduction at the co-op level is only available for patronage-sourced business, which, through years of IRS challenges, is restrictively interpreted to mean that level closely associated with the members' products. For example, if a farmer's corporate co-op produced a pharmaceutical drug in a plant that was extracted in the co-op's processing facility, combining that drug with other drugs in a capsule to be labeled and marketed to consumers, the drug extracted from the farmer's plants would likely have a small value relative to the overall capsule; therefore, the income from the sale of the capsules would not be patronage-sourced and would be taxed at the state and federal marginal rate of approximately 35 to 40 percent at the cooperative level. LLCs and Wyoming Cooperatives are able to pass this income to their members without tax at the entity level.

Tax credits and losses. Corporate co-ops that are taxed under Subchapter T have a number of corporate tax attributes under Subchapter C of the Tax Code, including the inability to pass losses or tax credits through to members. For an ethanol production co-op startup, operational losses are retained at the co-op, and tax credits, which may exceed $2 to $3 million, generally remain unused at the corporate co-op. LLCs and Wyoming Cooperatives can pass losses and credits through to their members.

Operation at cost with all profits returned based on patronage. Operation at cost with all profits being returned to members based on patronage is a principle embodied in federal corporate cooperative tax law, in case law, and in some state statutes. Nonpatronage-sourced investment venture partners and other participation in profits are precluded, which limits outside capital and management who desire profit participation as part of their compensation, similar to corporate management. An LLC or Wyoming Cooperative can allow outside investment and management participation in profits as part of their compensation.

Governance: Board of directors elected by--one member/one vote. Corporate cooperatives are governed by a board elected from members and membership voting on the basis of one member/one vote. This principle has two facets: (1) how the members vote and (2) who they can vote for to govern the co-op. The Rochdale Principle of one member/one vote was an alternative to voting based on investment and paralleled the Rochdale Principle of subordination of capital with no voice in management. Co-ops in some states have recognized that in the case of a federated co-op (i.e., a co-op with one or more co-ops as members), a fair method of member voting is on a basis proportional to patronage (Barton 1989, 26-33).

In addition, board governance frequently has directors selected from districts based on geographical areas, products, patronage, or other distinctions. The general principle of one member/one vote, while an alternative to voting based upon investment, does not vest voting authority with the patrons who have the most at risk with the success or failure of the co-op. Consequently, member governance tends to be less effective than it should be and board elections can be political and based on popularity.

Corporate co-ops usually require directors to be elected from the membership who are patrons and, in many cases, who are required to be producers. Representation of patron members on the board is important, but equally important is board representation to facilitate strategic planning; capitalization; and hiring, retention, and termination of management on appropriate terms. The producer board members of a capital intensive processing and marketing co-op may not possess the skills and knowledge that a diverse board with outside directors familiar with the processing and marketing industry or of capital availability possess.

LLCs and Wyoming Cooperatives can allocate voting based on patronage and investment. The directors elected by members need not be members, which allows the hiring of outside directors for their expertise.

STATE AND FEDERAL OPPORTUNITIES TO ASSIST COOPERATIVE DEVELOPMENT

State and federal assistance should recognize five factors in making changes to assist cooperative development: (1) the cooperative business model must compete favorably with other business models or it will not be used, (2) many if not most cooperative opportunities require capital beyond the means of producer members, (3) the cooperative business model must grow with the success of the co-op, (4) co-ops need more flexibility today to succeed than at any previous time, and (5) cooperative development can represent sustainable rural development and have exponential benefits beyond the cooperative business.

Legislative Changes to Remove Legal Impediments

Legal principles originally developed to support cooperation have become statutory legal impediments. The statutory changes and cooperative requirements of the 1910s and 1920s do not fit today. Cooperative development is best served when the ingenuity of the cooperator is allowed to apply cooperation competitively to the business plan. Today's cooperators who try to develop value-added processing businesses are hamstrung by restrictions applicable to cooperative stores of the mid-1800s and business conditions of the early 1900s.

Business organizations have evolved since 1960 to Delaware-style corporations and LLCs. Until the Wyoming Processing Cooperative Law, the cooperative legal principles essentially had matured by 1925. Simply stated, the corporate cooperative form of business offers few advantages and a number of significant business disadvantages over other forms of business for today's processing businesses; however, only the cooperative form of business rewards the users of the business, which is why state and federal governments should support its continued development.

Tax laws. Federal tax law has one of the most chilling effects on cooperative development. Much of the regulations and tax law theory were developed before the advent of LLCs and are only compared to the differences of a corporation. While corporate cooperative taxation provides some advantages over corporations, in most areas cooperative organization competes with LLCs:

- *Certification of Cooperatives Under § 521.* The certification criteria for producer co-ops under § 521 should be changed to certify co-ops in which 50 percent or more of the ownership or control is held by producers; dividends on capital do not exceed three times the prime rate on a preferred basis or the collective return on patron investment on an equity basis; and patron voting is not based on the amount of investment but on patronage or marketing rights. Certification should be allowed as a corporate co-op qualifying for Subchapter T taxation or a co-op on an Iowa or Wyoming plan qualifying for Subchapter K partnership taxation.

- *Patronage-Sourced Business.* The restrictions on the deduction for patronage-sourced business should be revised to allow producer co-ops to prepare and effectively market their product in the marketplace. A pasta co-op should not be taxed on the income attributable to a prepackaged spaghetti dinner just because the beef and tomato ingredients cost more than the spaghetti noodles.
- *Tax Free or Tax Deferred Reorganization of Corporate Cooperative to an Iowa or Wyoming Cooperative.* The reorganization of a corporate co-op to an Iowa or Wyoming co-op is taxed as a liquidation of the corporate co-op. The tax law should allow a corporate co-op to complete a tax reorganization from a corporate co-op to an Iowa or Wyoming co-op or, in the alternative, allow the deemed liquidation to be deferred until actual liquidation of the Iowa or Wyoming co-op after conversion.

Securities laws. When producer co-ops start businesses, capital is needed from producers and others. The federal and most state securities laws are not well-suited for producer entities raising capital. Co-ops should not be treated as public companies in raising funds under the registration and public company reporting requirements. The securities laws should allow co-ops with proper disclosure to raise $50 million or less from patrons, accredited investors, and nonaccredited investors within an influence radius (e.g., local rural investors) as certified by the securities division of any state without registration or reporting requirements. This would allow local and rural investors to participate in co-ops.

Cooperative laws. States should facilitate Wyoming-type cooperative laws to allow co-ops to organize without federal corporate cooperative tax restrictions. The federal laws such as the Capper-Volstead Act and Marketing Acts of 1926 and 1929, should be held to a 21st century definition of a co-op to meet their original intent of being effective tools to help cooperating farmers (Lauck 1999, 491-493).

Financial Assistance

Producers have limited financial resources to start up and develop co-ops. Much of the financial assistance available is in the form of grants and loan guarantees.

Equity. Financial assistance programs should be expanded to include subordinated debt and an equity investment on a match basis with producer equity with an exit strategy.

Incentives tied to market power. Government assistance programs should be targeted to enhancing producer market power. For example, more than eight farmer cooperative ethanol production facilities were built in Minnesota with state financing incentives. Some attempts were made to market the ethanol collectively on a cooperative basis, but it was never achieved. Today, these same plants market with four or more different marketers, and the corn farmers who organized cooperatively are competing against each other for ethanol markets.

EXHIBIT B

SEC. 521 EXEMPTION OF FARMERS' COOPERATIVES FROM TAX

Sec. 521(a)

(a) EXEMPTION FROM TAX. – A farmers' cooperative organization ***organized as a corporation or an unincorporated association*** described in subsection (b)(1) shall be exempt from taxation under this subtitle except as otherwise provided in part I of subchapter T (sec. 1381 and following) *or **subchapter K (sec. 701 and following)**.* Notwithstanding part I of subchapter T (sec. 1381 and following), such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

Sec. 521(b)

(b) APPLICABLE RULES. –

(1) EXEMPT FARMERS' COOPERATIVES. – The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', ***ranchers',*** fruit growers', or like associations organized and operated ***with respect to the patrons*** on a cooperative basis (A) for the purpose of marketing the products ***delivered by*** members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses, ***or (C) for the purpose of marketing and processing or manufacturing goods from products delivered by members or others, which goods may include packaging, ingredients, and marketing of other goods that exceed the value of the products delivered by members or others, provided the members who are producers of agricultural products deliver a majority of the products processed or manufactured by the association.***

(2) ORGANIZATIONS HAVING CAPITAL STOCK ***OR EQUITY UNITS***. – Exemption shall not be denied any such association because it has capital stock ***or other equity units***, if ***(A) for a marketing or purchasing association*** the dividend rate of such stock ***or equity units*** is fixed at not to exceed ~~8~~ ***18*** percent per annum, on the value of the consideration for which the stock ***or equity units were*** issued, and if substantially all such stock ***or other equity units*** (other than nonvoting preferred stock, the owners of which are not entitled or permitted participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) ***are*** owned by: ***for a marketing or purchasing association*** producers who ***deliver products,*** market their products, or purchase their supplies and equipment through the association; ***or for a processing or manufacturing association, the producers of agricultural products having a majority of the voting rights of the association and entitled to receive on a***

patronage basis a majority of the allocations and distributions of income and allocation of profits of the association.

EXHIBIT C

DRAFT OF AN AMENDMENT TO SECTION 1388 OF THE INTERNAL REVENUE CODE ADDING NEW SUBSECTION 1388(k)

Sec. 1388(k). SPECIAL RULES FOR COOPERATIVE CONVERSION TRANSACTIONS.

(1) TREATMENT OF CONVERSION TRANSACTIONS. If property of a cooperative corporation to which part I of this subchapter applies becomes the property of an eligible association (defined in subparagraph (2)(A) of this subsection) in a conversion transaction (defined in subparagraph (2)(B) of this subsection),

(A) the conversion transaction shall not be treated as a sale or exchange of property by the cooperative corporation or its shareholders and members;

(B) a shareholder or member of the cooperative corporation shall not recognize gain or loss as a result of the conversion transaction, and the adjusted basis of property contributed shall include the adjusted basis of their shares or other equity interests in the cooperative corporation immediately before the conversion transaction plus the stated amount of any qualified written notices of allocation or qualified per unit retains issued by the eligible association to the shareholder or member with respect to the final taxable year of the cooperative corporation;

(C) the cooperative corporation shall not recognize gain or loss as a result of the conversion transaction;

(D) the basis of property that becomes property of the eligible association in the conversion transaction shall be the basis of such property in the hands of the cooperative corporation immediately before the conversion transaction, and

(E) notwithstanding section 441, the eligible association may adopt the same taxable year as the cooperative corporation or designate a tax year relating to the seasonal nature of its processing or marketing activities.

(2) DEFINITIONS. For purposes of this section,

(A) ELIGIBLE ASSOCIATION. Eligible association shall mean an unincorporated association that is subject to Subchapter K of this chapter and is organized as a cooperative or a business entity under state law, provided that immediately after the conversion transaction producers of agricultural products own at least 50% of the total interest in capital and profits and at least 50% of all classes of equity interest entitled to vote.

(B) CONVERSION TRANSACTION. Conversion transaction means a transfer of property by the cooperative corporation to an eligible association, directly or indirectly, including a transfer of property that would be deemed to occur if the cooperative corporation becomes subject to Subchapter K of this chapter, that otherwise would be subject to sections 331 and 336, unless the cooperative corporation makes an irrevocable election to be subject to section 336 in its Federal income tax return for the taxable year in which the transfer occurs.

(3) PATRONAGE OBLIGATIONS OF FINAL TAXABLE YEAR OF THE COOPERATIVE CORPORATION. All provisions of this subchapter shall continue to apply after the conversion transaction to the extent necessary to allow the eligible association to discharge the obligations of the cooperative corporation to its patrons with respect to the patronage income of the cooperative corporation's final taxable year.

EXHIBIT D

CHANGES ALLOWING PRODUCER ASSOCIATIONS TO RAISE CAPITAL

This is an exemption from SEC registration requirements conditioned upon notice and compliance with state securities requirements and a federal SEC form of disclosure.

Securities Act of 1933

Section 3(a)(5) shall be amended as follows:

(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

5) Any security issued (A) by a savings and loan association, building and loan association, cooperative bank, homestead association or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution; or (B) by (i) a farmer's cooperative organization exempt from tax under section 521 of the Internal Revenue Code of 1954, (ii) a corporation described in section 501(c)(16) of such Code and exempt from tax under section 501(a) of such Code, or (iii) a corporation described in section 501(c)(2) of such Code which is exempt from tax under section 501(a) of such Code and is organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization or corporation described in clause (i) or (ii), or ***(iv) an association of producers of agricultural products organized either as a cooperative under the law of any state or as an unincorporated association in which a majority of the voting rights and the interests in capital and profits are held by producers of agricultural products, where such producers: are patrons of the cooperative or unincorporated association; receive allocations of income and loss and distributions based upon the amount of business conducted for or with the cooperative or unincorporated association; and hold voting rights either based on membership in such cooperative or association, on the amount of business conducted by each such producer for or with the cooperative or association or on a combination of membership and the amount of business conducted by each such producer for or with the cooperative or association. The exemption found in subpart (B)(iv) shall only be available to a cooperative or an unincorporated association if all of the following conditions are satisfied: (i) the total consideration to be received by the issuer from the sale of such securities in reliance upon the exemption found in subpart (B)(iv) does not exceed fifty million dollars ($50,000,000); (ii) the issuer, prior to the completion of the sale of such securities, provides each offeree or purchaser disclosure materials which, to the extent material to an understanding of the issuer, its business and the securities being offered, substantially meet the disclosure limitations and conditions found in rule 502(b) of Regulation D promulgated by the Commission; and (iii) such securities are offered and sold pursuant to either registration in the applicable state or states or pursuant to an exemption from registration contained in the securities laws of the applicable state or states, if notice is provided by the issuer to the state officials responsible for enforcement of the state securities laws in the applicable state or states.***

This is an exemption from SEC reporting requirements for producer associations.

Securities Exchange Act of 1934

The proposal is for the amendment of Section 12(g)(2) by the addition of a new subpart (G), with existing subparts (G) and (H) to be identified as subparts (H) and (I), respectively, if new subpart (G) is added.

PROPOSED LANGUAGE:

(2) The provisions of this subsection shall not apply in respect of—

(G) any security of any issuer which is an association of producers of agricultural products organized either as a cooperative under the law of any state or as an unincorporated association in which a majority of the voting power and interests in capital and profits are held by producers of agricultural products, where such producers: are patrons of the cooperative or unincorporated association; receive allocations of income and loss and distributions based upon the amount of business conducted for or with the cooperative or unincorporated association; and hold voting rights either based on membership in such cooperative or association, on the amount of business conducted by each such producer for or with the cooperative or association or on a combination of membership and the amount of business conducted by each such producer for or with the cooperative or association. No issuer shall be entitled to the benefit of this subpart (G) unless such issuer (i) provides quarterly financial statements, prepared in accordance with generally accepted accounting principles, to its members within thirty (30) days of the end of each of the first three quarters of each of such issuer's fiscal years and provides audited annual financial statements, prepared in accordance with generally accepted accounting principles, to its members within sixty (60) days of the end of each of such issuer's fiscal years; and (ii) prior to the issuer's approval or recordation of any transfer of securities of such issuer, verifies to its reasonable satisfaction that the security holder proposing a transfer of securities of the issuer has provided to the prospective transferee of such securities the most recent annual financial statement of the issuer and the quarterly financial statement for the most recently-completed fiscal quarter.

NCBA
National Cooperative Business Association

Statement of Paul Hazen
President and CEO
National Cooperative Business Association

Committee on Agriculture
U.S. House of Representatives
October 16, 2003

Hearing to
Examine new generation cooperatives and strategies to maximize farm and ranch income

NCBA is pleased to submit this statement regarding the role of new generation cooperatives in enhancing farm and ranch income.

NCBA is the only national membership organization representing all types of cooperatives operating across all industries in the United States. Though our membership is diverse, it retains a strong and significant focus on promoting the development of cooperatives of all types, including traditional farmer-owned cooperatives and new generation co-ops. Some of our new generation co-op members include Golden Growers Cooperative in North Dakota, Corn-er Stone Cooperative in Minnesota, and 21st Century Alliance in Kansas.

Each year, NCBA holds a Cooperative Development Forum with a special track dedicated to developing new generation cooperatives. Our next Forum, held in November in Minneapolis, focuses on farmer-owned renewable fuels cooperatives. It also includes a special pre-forum session by the Quentin Burdick Center on Cooperatives addressing the issue of co-ops and non-member capital—something that is the focus of this hearing and is a key issue facing every farmer-owned cooperative.

Though most farmer-owned cooperatives add value to their members' crops and livestock, new generation co-ops go beyond value-added. Unlike traditional cooperatives, their membership is necessarily limited by their niche marketing opportunities; they typically cannot accept all the farmers that may wish to join, nor can they take possession of all the volume those farmers may wish to sell to the co-op. New generation co-op members have both the obligation to deliver a set amount of product to the co-op and restrictions on delivering more than that amount. This allows the co-op to maximize returns to farmer-owners based on marketplace realities.

This committee is undoubtedly aware of the important role farmer cooperatives play in boosting this nation's economy. Not only have traditional and new generation cooperatives helped return more income to farmers, they have played a key role in sustaining communities across the countryside. The American public, too, recognizes this role. Results from a recent nationally representative survey of more than 2,000 adults, conducted by NCBA on behalf of a coalition of cooperative organizations, found that four in five

Americans believe cooperatives help farmers succeed and strengthen the rural communities in which they live. And more than two in three say they'd be more likely to buy a food product if they knew it was produced by a farmer cooperative.

The Cooperative Development Infrastructure

But both new and existing cooperatives need technical assistance to get started and succeed. To address that, in the early 1990's NCBA worked with the National Rural Cooperative Development Task Force to develop and promote legislation authorizing the creation of rural cooperative development centers and funding to support them. Now known as the Rural Cooperative Development Grants program, it remains the only dedicated source of funding to support the development infrastructure that supports new and existing new generation cooperatives.

That infrastructure is made up of a network of cooperative development centers across the country that work to help farmers and others in rural communities conduct feasibility analyses, develop business plans, run equity drives, and develop the organizational structure for new cooperative businesses. Today, a well-coordinated network of centers, known as CooperationWorks (CW), shares best practices, business development techniques and other information and conducts an annual training program for developers. The network allows the centers to serve their farmer-clients using the best available information and techniques. A list of the member-centers of CooperationWorks is attached at the end of my statement.

NCBA is the national supporting partner for CW. We help them coordinate their meetings, produce informational materials, and hold monthly best practices conference calls to share information, such as a recent information sharing call on the development of meat goat cooperatives that target ethnic markets.

While there are other programs, such as the Value-added Producer Grants program, which provide direct, project-related financial support for new generation cooperatives, the RCDG program is the only one exclusively devoted to developing member-owned businesses. Though the RCDG program has grown in size from less than $1 million in annual funding to $6.5 million today, it remains badly under funded and falls far short of its authorization for $50 million in annual appropriations. Each year, USDA's Cooperative Services receives far more applications for grants than it can meet at current funding levels.

NCBA urges this Committee's support for enhanced resources dedicated to supporting the cooperative development infrastructure.

Despite limited federal resources, the cooperative development centers have been the leaders and innovators in the development of new generation cooperatives. There's a good chance that the new generation cooperatives you're familiar with were developed with the help of these centers. Ultimately, the dozens of new generation cooperatives these centers have developed or assisted have generated higher returns for the farmers that own and govern them. An attachment describes some of the recent work of selected Centers.

The Implications of Equity Constraints

A key role of the centers is in helping farmer groups develop feasibility analyses and business plans to ensure the viability of a new business before farmers and ranchers begin investing their own capital and sweat equity in it. They also help them operate equity drives to secure equity commitments from potential members.

A hard lesson learned from the development of new generation cooperatives is that a good idea, a detailed feasibility analysis, and a solid business plan is not enough. Equity capital to start the business and secure debt financing is a key constraint in the development of new farmer-owned cooperatives.

Access to equity is a key problem for all types of co-ops because they are limited largely to investment by their own members. Larger farmer-owned co-ops are able to address this constraint, in some cases, by issuing preferred stock that does not confer voting rights on investors. However, this option is largely limited to our nation's largest cooperatives.

Small, farmer-owned, new generation cooperatives face particular equity constraints. More often than not, the business farmer-members hope to launch is capital intensive, requiring the construction of new processing facilities. Even when co-ops "rent" processing capacity from other businesses, capital requirements remain high.

If they wish to organize as a co-op, the business founders must rely solely on their own members for equity or seek outside investors willing to forego control of the business. Understandably, there are few such investors available.

Unfortunately, in rural America, and particularly among farmers and ranchers facing the current economic climate, the equity well is not deep. Too many would-be cooperatives never get off the ground because they cannot raise sufficient equity from within the potential membership. In other cases, members put up their entire farms as collateral to raise the equity required to access additional debt financing.

In some cases, the projects are scrapped. But in many others, the members decide instead to structure the business as a limited liability company, allowing them to bring in outside capital. However, issues of control between investors and members may, at times, cause tensions.

We would note that the equity constraint facing cooperatives creates an additional concern for farmers and rural communities. New generation cooperatives that *can* generate sufficient capital from within their own membership for start-up face additional capital needs as the business grows. They need to expand processing, improve marketing, engage in joint ventures and make other investments to remain competitive and facilitate expansion.

But sufficient expansion capital is often unavailable from the members—they've already invested what they had in the co-op. Too often co-ops must confront the question of whether they must convert their profitable farmer-owned business to a stock corporation—one of the few avenues available to access expansion capital.

Though the incidence of co-ops converting to stock corporations are limited, when they occur, conversion can ultimately eliminate farmer ownership of the business, putting beyond their control decisions as to where the product will be sourced, processed and sold. It's an outcome that is rarely beneficial to the rural communities in which these former cooperatives operated and generated jobs, income and wealth.

The Co-op/LLC Hybrid

States have recognized the impact of the equity constraints facing cooperatives on their own goals for rural economic development, in which new generation cooperatives play a key role. Some have responded by enacting new state statutes that allow a business to incorporate as a cooperative and retain member control, while also bringing in outside investors. These statutes confer some control and voting rights to those investors. Fundamentally, however, the business remains a farmer cooperative.

These statutes, as you know, have been enacted in Wyoming and in Minnesota. They are a response to the growing number of LLCs formed in lieu of cooperatives. They facilitate new economic development through the formation of more cooperatives, but address the financial reality that NO new business can be formed without sufficient equity capital.

In other states without such statutes, many farmer groups form LLCs to bring in outside investors and operate them as cooperatives and according to cooperative principles.

Debt Financing

Once equity is secured, co-ops can then secure the debt financing they need to begin operations. But it is a hard truth in the United States, that despite the prevalence of co-ops in all industries, with some exceptions, the conventional banking industry struggles to understand the co-op business structure and is often reluctant to lend to cooperatives.

Fortunately, Congress had the foresight to authorize lending institutions for cooperatives, including CoBank for rural cooperatives, and the National Cooperative Bank for other consumer cooperatives. These lenders fundamentally understand cooperatives because they are co-ops themselves. Together they have formed the financial girder in the co-op development infrastructure. For agriculture, CoBank has been the primary source of credit for farmer co-ops for more than 70 years.

However, as the financial and economic markets in which farmer co-ops operate have evolved, federal law has not. CoBank is effectively prevented from lending to cooperatives that have investor classes of membership, eliminating a key source of credit for many would-be cooperatives. Specifically, CoBank may lend only to cooperatives in which farmers or ranchers retain 80 percent of the voting control—eliminating from eligibility those cooperatives that retain control, but at lower percentage. For many new generation cooperatives that must seek outside investors, this restriction eliminates a primary source of debt financing. Other cooperative lenders do not face this eligibility constraint.

NCBA supports legislation that would modernize federal law to ensure that farmer cooperatives continue to have access to a competitive source of credit through CoBank. Doing so will not only help new cooperatives succeed, it may help existing cooperatives resist pressures for conversion to stock corporations.

And failing to modernize federal law in this regard will *not* stem the tide toward formation of cooperatives that have outside investors—that is already occurring. Failing to address the lending restrictions CoBank faces *will* eliminate a key source of credit for new and existing farmer-owned businesses, jeopardizing their chances for success and necessarily limiting economic development opportunities for rural communities.

NCBA thanks the Committee for its attention to this important issue and appreciates this opportunity to provide input into the Committee's study new generation cooperatives and the tools they need to succeed.

NCBA
National Cooperative Business Association

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Tall Corn Ethanol
1015 Grant Avenue
Coon Rapids, IA 50058
712/684-5102

September 30, 2003

To House & Senate:

We are writing to urge your support for legislation to modernize federal law to ensure that farmer cooperatives, including new generation cooperatives, continue to have access to a competitive source of credit through CoBank, which itself is a cooperatively-owned institution

Agricultural cooperatives are a proven method for farmers to gain greater control over their economic future. A major challenge facing farmers and their cooperatives, however, is access to equity capital needed to modernize and expand, and capitalize on new market opportunities. In an effort to better finance and capitalize their businesses in a rapidly changing global marketplace, 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 of redefining farmer cooperatives to provide them with greater flexibility in meeting their capital needs.

Because of dated eligibility requirements established under federal law, cooperatives, that adopt new business structures may no longer qualify to borrow from CoBank, which has been the primary source of credit for farmer cooperatives for more than 70 years. Modernizing the requirements is essential to reflect the changes taking place and to ensure that farmers are able to fully realize the potential of new cooperative business models. Without legislation, CoBank will be unable to finance agricultural cooperatives organized in certain states and, in some cases, will be unable to remain with current customers that are changing their business structure.

The legislation we support would:

- Clarify that entities that have both a producer and investor class of membership are eligible for CoBank financing, provided that the producer class holds at least 50 percent of the voting control and operates on a cooperative basis.

- Permit agricultural cooperatives organized consistent with revised state laws to continue to be eligible for CoBank financing.

- Allow cooperative customers that are adopting new business structures to continue to be eligible for CoBank financing as long as the customer maintains at least 50 percent farmer ownership or control.

- Provide that cooperatives that are existing CoBank customers, but which restructure in a manner that would make them ineligible for CoBank financing (fails to meet the 50 percent farmer ownership or control criteria), can remain eligible for a five-year transition period while the cooperative establishes new lending relationships.

We believe it is essential that Congress provide greater flexibility for farmer cooperatives to maintain their eligibility for CoBank financing, including new generation cooperative businesses, to help meet their capital needs for the benefit of their farmer members.

We appreciate your consideration of this request.

Sincerely,

Howard C. Roe

Howard C. Roe
Treasurer

GRAVES

October 14, 2003

To Members of the House Committee on Agriculture:

We are writing to urge your support for legislation to modernize federal law to ensure that farmer cooperatives, including new generation cooperatives, continue to have access to a competitive source of credit through CoBank, which itself is a cooperatively-owned institution

Agricultural cooperatives are a proven method for farmers to gain greater control over their economic future. A major challenge facing farmers and their cooperatives, however, is access to equity capital needed to modernize and expand, and capitalize on new market opportunities. In an effort to better finance and capitalize their businesses in a rapidly changing global marketplace, 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 of redefining farmer cooperatives to provide them with greater flexibility in meeting their capital needs.

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- Provide that cooperatives that are existing CoBank customers, but which restructure in a manner that would make them ineligible for CoBank financing (fails to meet the 50 percent farmer ownership or control criteria), can remain eligible for a five-year transition period while the cooperative establishes new lending relationships.

We believe it is essential that Congress provide greater flexibility for farmer cooperatives to maintain their eligibility for CoBank financing, including new generation cooperative businesses, to help meet their capital needs for the benefit of their farmer members.

We appreciate your consideration of this request.

Sincerely,

Agricultural Cooperative Council of Oregon
Agricultural Council, Sacramento, CA
Alabama Farmers Federation
American Farm Bureau Federation
Blue Diamond Growers
CHS
Colorado Cooperative Council
Diamond Walnut Growers
Farm Credit Council
Federation of Southern Cooperatives
GROWMARK, Inc.
Iowa Institute for Cooperatives
Kansas Cooperative Council
Land O'Lakes
MBG Marketing
Minnesota Association for Cooperatives
Missouri Institute for Cooperatives
National Cattlemen's Beef Association
National Cooperative Business Association
National Corn Growers Association
National Council of Farmer Cooperatives
National Grape Cooperative Association
Nebraska Cooperative Council
Northeast Cooperative Council
Oklahoma Agricultural Cooperative Council
Pro-Fac Cooperative
Renewable Fuels Association
Staple Cotton Cooperative Association
South Dakota Association of Cooperatives
Southern States Cooperative
Sunkist Growers
Sunsweet Growers, Inc.
Texas Agricultural Cooperative Council
Washington State Council of Farmer Cooperatives, Olympia, WA
Welch Foods, Inc.
Wisconsin Federation of Cooperatives

Local and Regional Cooperatives

Ag Partners, LLC, Albert City, IA
Agland FS, Inc., Pekin, IL
Agri-Coop, Holdrege, NE
Alcorn County Coop, Tupelo, MS
Amite County, Liberty, MS
Archer Cooperative Grain Company, Archer, IA
Assumption Coop Grain Co., Assumption, IL
Attala County Coop, Kosciusko, MS
Augusta Cooperative Farm Bureau Inc., Staunton VA
Cal/West Seeds, Woodland, CA
Central Counties Cooperative, Reinbeck, IA
Chem-Nut, Inc., Albany, GA

Cissna Park Co-op, Inc., Cissna Park, IL
Coffee Farmers Cooperative
Cooperative Credit Company, Sioux Center, IA
Cooperative Elevator Association, Ocheyedan, IA
Cooperative Producers Inc., Hastings, NE
Corn Belt FS, Inc., Decatur, IL
Country Pride Co-op., Winner, SD
Crockett Farmers Cooperative, TN
Crystal Valley Cooperative, Mankato, MN
Deland Farmers' Cooperative Grain Company, Deland, IL
Dickson Farmers Cooperative, Dickson, TN
Duncan Gin, Inverness, MS
Earlville Farmers Cooperative, Earlville, IL
Farmers Cooperative Association, Jackson, MN
Farmers Cooperative Company, Hinton, IA
Farmers Cooperative Company, Craig, IA
Farmers Cooperative Co., Farnhamville, IA
Farmers Cooperative Elevator, Bellingham, MN
Farmers Cooperative Elevator Co., Beresford, SD
Farmers Cooperative Elevator Co., Arcadia, IA
Farmers Cooperative Elevator Company, Ruthven, IA
Farmers Cooperative Elevator Cooperative, Rock Valley, IA
Farmers Grain Company of Dorans, Mattoon, IL
Farmers Grain Terminal , Greenville, MS
Farmers Union Association, Hardin, MT
Farmers Union Association of Big Horn County, Hardin, MT
Fisher Farmers Grain & Coal, Dewey, IL
George County Coop, Lucedale, MS
Gibson Farmers Cooperative, Trenton, TN
Giles Farmers Co-op, Pulaski, TN
Hardeman-Fayette Farmers Cooperative, Bolivar, TN
Hazelnut Growers of Oregon, Cornelius, OR
Heartland Co-op, Hastings, NE
Henderson Chester Farmers Cooperative, Lexington, TN
Heritage FS, Inc., Gilman, IL
Howard Farmers Coop, Howard, SD
Lawrence Farmers Cooperative, Lawrenceburg, TN.
MFA Inc., Columbia, MO
Macon Trousdale Farmers Co-op, Lafayette, TN
Madison Farmers Cooperative, Jackson, TN
Maury Farmers Cooperative, TN
McMinn-Loudon Farmers Cooperative, Athens, TN
Midland Co-op, Funk, NE
Midwest Farmers Cooperative, Sheldon, IA
Minier Coop Grain Co., Minier, IL
Minnesota Soybean Processors, Brewster, MN
Montgomery Farmer Coop., Clarksville, TN
Morrisonville Farmers Coop., Morrisonville, IL

Nebraska Turkey Growers Co-operative, Gibbon, NE
Neshoba County, Philadelphia, MS
New Vision Co-op, Worthington, MN
Nobles County Co-op, Worthington, MN
North Central Co-op, Wabash, IN
NuWay Cooperative, Trimont, MN
Prairie Centry Coop, Chenoa, IL
Pro Cooperative
Progressive Ag Partners, Bradshaw, NE
Putnam Farmers Cooperative, Cookeville, TN
Rockingham Cooperative, Harrisonburg, VA
Seafood Producers Cooperative, Bellingham, WA
Sequatchie Farmers Cooperative, Dunlap, TN
Sioux Honey Association, Sioux City, IA
South Central Coop, Lacona, IA
South Dakota Soybean Processors, Volga, SD
SouthFresh Catfish, Indianola, MS
Stonington Coop Grain Co., Stonington, IL
Sunrise Ag Service Co., Virginia, IL
Tall Corn Ethanol, Coon Rapids, IA
Triumph Cooperative Co., Triumph, IL
United Farmers Cooperative, George, IA
United Western Coop., Missouri Valley, IA
Valley Fig Growers, Fresno, CA
Valley Park Elevator, Valley Park, MS
Washington Farmers Cooperative,
West Bend Elevator Company, West Bend, IA
West Central Cooperative, Ralston, IA
Western Iowa Coop., Hornick, IA
Wilson Farmers Co-op, TN

THE FARM CREDIT COUNCIL
50 F STREET, NW • SUITE 900 • WASHINGTON, DC 20001 • 202/626-8710

October 7, 2003

The Honorable Bob Goodlatte
Chairman
Committee on Agriculture
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Farmer-owned cooperatives face a number of obstacles as they work to meet the challenges of an increasingly competitive global marketplace while returning value to their member-owners. Chief among these obstacles is access to equity capital to fund the growth necessary to evolve their operations. We are writing to ask your support for a legislative proposal that would facilitate access to capital for farmer-owned cooperatives.

Under existing federal law, farmer-owned cooperatives that accept non-member investment are effectively barred from access to their traditional lender, CoBank. For more than 70 years CoBank has been the primary source of credit to farmer-owned cooperatives. Today, CoBank provides financing to nearly 70 percent of these businesses. Changes in law are necessary to ensure that these businesses are not cut-off from their primary source of financing.

For many years, farmer-owned cooperatives relied on their farmer-members to provide all the equity capital necessary to run and grow the business. Recognizing this, state laws under which farmer-owned cooperatives organized effectively prohibited them from taking outside equity investment. In the past several years, however, the farmers that own cooperatives have been unable to continue to supply all of the equity needs for their organizations. Given the restrictions on outside investment in state law, some cooperatives already have ceased operation and reorganized as limited liability companies (LLC).

State legislatures are beginning to recognize cooperatives' need for outside equity investment and are reforming their laws to allow it. Unfortunately, as these cooperatives reorganize to take outside investment, either as LLCs or as newly authorized cooperatives, they are barred from obtaining credit from CoBank.

We strongly support and ask your support for a legislative proposal that would allow these farmer-controlled organizations to borrow from CoBank.

Thank you for consideration of this important issue.

Sincerely,

Kenneth E. Auer

Kenneth E. Auer
President and CEO

DIAMOND OF CALIFORNIA
The World Leader in Culinary and Inshell

October 13, 2003

Honorable Robert Goodlatte
Chairman House Agricultural Committee
1300 Longworth House Building
U.S. Capitol
Washington, DC 20515

Dear Mr. Goodlatte:

On behalf of Diamond of California, an agricultural cooperative owned by 1900 walnut growers, I would like to express my appreciation to the members of the House of Representatives Agriculture Committee for their willingness to conduct a hearing addressing farmer cooperative issues. While I am unable to attend this hearing, which will address "strategies to maximize farm and ranch income," I would like to provide some input for your consideration.

Diamond of California consists of farming operations that span much of California's Central Valley from Bakersfield to Red Bluff as well as several coastal areas. While our members' farms range from 10 acres to 3,000 acres, the average size is approximately 38 acres.

Diamond, which was formed in 1912, has been the industry leader and represents approximately half of California's supply of walnuts. In addition to walnuts, Diamond also markets a full line of culinary nut products and has begun the development of a full line of snack nut products as well.

Regarding strategies to maximize farm income, the following key areas have been identified for consideration.

FARM BILL PROGRAMS

The following Farm Bill programs have been very instrumental in improving on-farm income for our growers, as well as growing demand through market expansion.

Section 32 Funds: Maintaining the funding level of Section 32 for USDA purchases of fruit, vegetable and nut crops is critically important during this time of increasing production. This program has been very helpful in recent years in moving excess inventory and assisting in stabilizing market prices. Fortunately, the omnibus bill, which passed in January 2003, restored $250 million for Section 32 purchases.

Market Access Program (MAP): Diamond has utilized the MAP Branded funds and Western United States Agricultural Trade Association (WUSATA) funds to support market development efforts for California walnuts in foreign markets. The 2002 Farm Bill authorized a much needed increase in funding MAP.

DIAMOND OF CALIFORNIA
The World Leader in Culinary and Inshell

Value-Added Product Development Grant: Another Farm Bill program that will help specialty crops is the Value-Added Product Development Grant program. The funding for this program was expanded in the 2002 Farm Bill to $40 million. These grants, which require a 50% match from the industry, have the ability to accelerate the development and marketing of new value-added products and will sustain increased returns to the growers. We urge Congress to maintain the funding level at the amount authorized in the Farm Bill.

DIVIDEND ALLOCATION RULE

Under the Dividend Allocation Rule, cooperative's dividends on capital stock are subject to a triple tax, unlike corporate dividends, which are taxed twice. This additional tax burden creates a major barrier for cooperatives in accessing equity capital. We would ask Congress to pass legislation to relieve this additional tax on Cooperatives.

MODERNIZING THE FEDERAL FARM CREDIT ACT

In the ever-changing financial markets, farmer-owned cooperatives are looking at various business models and corporate structures that were not contemplated just a few years ago.

However, many of these entities 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.

Enactment of legislation is needed to provide farmer-owned cooperatives the access to capital in the modern-day financial market. Furthermore, we ask that legislation be passed to allow CoBank the ability to finance entities that have both a producer and investor class of membership, provided that the producer class holds at least 50 percent of the voting control and the producer class operates on a cooperative basis.

TRADE BARRIERS

Japanese and Korean tariffs: Shelled walnut products often have a higher tariff compared to other shelled nut products in key markets. For example, Japan has a tariff of 10% on shelled walnuts while applying only a 2.4% tariff on shelled almond products. Korea has an applied tariff of 36% on shelled walnuts while requiring a lower tariff of 8% on shelled almonds. Furthermore, many EU countries such as Germany, Spain and Italy have a 5.1% tariff on shelled walnuts, while conversely applying only 3.5% to shelled almonds.

Japan, with a population of 150 million people, imported 17 million pounds of shelled walnuts, and Korea with a population of 47 million imported 2.9 million pounds of shelled walnuts from California this past marketing year. A reduction in the tariff would greatly enhance the market potential for California walnuts in these two countries. If the Japanese and Koreans consumed

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DIAMOND OF CALIFORNIA

The World Leader in Culinary and Inshell

walnuts at the per capita rate of the United States, these markets would increase to 60 million and 20 million pounds per year respectively. As this current WTO round continues, we are seeking support to obtain lower tariffs in Japan and Korea.

PRODUCTION AND PROCESSING AIDES

Guaranteeing the highest quality walnuts for the consumer requires access to growing and processing aides. This access has come under increasing attacks both domestically and internationally.

Changes in federal laws have also greatly impacted accessibility to production and process inputs. Food Quality Protection Act, Clean Air Act and the Montreal Protocol regarding the phase out schedule for methyl bromide have individually and collectively impacted the availability of chemicals for agribusiness needs.

Internationally, new food protocols have been established, many times not based on sound science, which greatly reduces the tolerance of chemical residues. Extremely low residue levels for inorganic bromide and aflatoxins or restrictions on the use of BHT as a food preservative are examples of new trade restrictions.

Our industry has filed an application for a Critical Use Exemption with EPA, which would provide some limited use of Methyl Bromide beyond the 2005 phase out period.

Again, we appreciate the opportunity to address the Agricultural Committee. Furthermore, we appreciate your consideration of these key issues during this session of congress.

Best Regards,

Michael J. Mendes
CEO/President

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Farm Credit of Maine, ACA

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Southern Region and Executive Office
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Auburn, ME 04210
Phone: 207/784-0193
FAX: 207/784-0195

October 23, 2003

The Honorable Bob Goodlatte
Chairman
House Agriculture Committee
1301 Longworth House Office Building
Washington, DC 20515

Dear Chairman Goodlatte:

This letter is in regard to the House Agriculture Committee hearing held on Thursday, October 16, 2003 regarding agricultural cooperatives. I ask that this letter be made part of the hearing record.

Farm Credit of Maine is a cooperative lender that serves farmers, commercial fishermen, loggers and farm-related businesses throughout the state of Maine. We are committed to agriculture, commercial fishing and forest products industries in good economic times and bad.

Farm Credit of Maine works closely with CoBank to meet the needs of the industries that we serve – both on the farm and to the extent allowed under law with value-added enterprises. Farm Credit of Maine recommends the following efforts be taken by the House Agriculture Committee.

1. Modernize the cooperative eligibility provisions of the Farm Credit Act that limit farmer-owned cooperatives and associations of producers from eligibility for CoBank financing. Farmer-owned cooperatives and associations need to be able to access outside sources of investment to compete in today's competitive marketplace and remain eligible for loans from CoBank.

2. To help bring equity investments to Rural America, the 2002 Farm Bill provided for the creation of Rural Business Investment Companies (RBIC). We encourage the Committee to work with USDA to ensure action by USDA on the rules necessary for implementation of the RBIC provisions. While the Farm Bill passed in May 2002, USDA has yet to publish rules to carry out the RBIC provisions.

3. The 2002 Farm Bill also provided full funding ($40 million) for Value-Added Marketing Grants program. Unfortunately the House Appropriations Committee has reduced this funding level. We urge the Committee to ensure full funding for this program.

Thank you for your consideration.

Sincerely,

Raymond J. Nowak

Raymond J. Nowak
President and Chief Executive Officer

cc: The Honorable Olympia Snowe
The Honorable Susan Collins
The Honorable Thomas Allen
The Honorable Michael Michaud

Farm Credit of Western New York, ACA
and its Subsidiaries, FLCA & PCA
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Fax: 585-762-8227

October 23, 2003

The Honorable Bob Goodlatte
Chairman
House Agriculture Committee
1301 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Goodlatte:

I am writing in regard to the House Agriculture Committee hearing held on Thursday, October 16, 2003 regarding new generation cooperatives. We greatly appreciate the committee's efforts in holding this hearing. Please include this letter as part of the hearing record.

Farm Credit of Western New York serves farmers and farm-related businesses in a sixteen county area in the western part of New York State. Agriculture in our area is very diverse with dairy, fruit, vegetable and field crop production. We work with a number of agricultural cooperatives in our area. Many of our farmer-members are members of other farmer cooperatives in addition to Farm Credit of Western New York.

While some commercial banks in our area are pulling back from agricultural lending, Farm Credit of Western New York is committed to serving the agricultural community in good times and bad. Farm Credit of Western New York works closely with CoBank to meet the needs of agriculture – both on the farm and in value-added cooperatives. As the House Agriculture Committee considers future directions on issues facing agricultural cooperatives and associations of producers the following actions should be taken.

1. To ensure that the changing needs of agricultural cooperatives are met, we strongly support updating the cooperative eligibility provisions of the Farm Credit Act that limit farmer-owned cooperatives and associations of producers from eligibility for CoBank financing. Farmer-owned cooperatives and associations need to be able to access outside sources of equity capital to compete in today's competitive marketplace and remain eligible for loans from CoBank.

2. To help bring equity investments to rural America, the 2002 Farm Bill provided for the creation of Rural Business Investment Companies (RBIC). This was supported not only by Farm Credit institutions, but also by commercial banking trade organizations. We encourage the Committee to seek prompt action from USDA in publishing the rules necessary for implementation of the RBIC provisions.

3. The 2002 Farm Bill also provided full funding for Value-Added Marketing Grants program. The value-added marketing grants program is one of the few Farm Bill provisions that provide assistance for fruit and vegetable producers. We urge the Committee to ensure full funding for this program.

Thank you for your consideration.

Sincerely,

Michael Gerber
President and CEO

c: The Honorable Thomas Reynolds
The Honorable James Walsh
The Honorable Jack Quinn
The Honorable Amory Houghton

First Pioneer Farm Credit, ACA
Your First Choice For Financial Solutions

William J. Lipinski
President & CEO

October 23, 2003

The Honorable Bob Goodlatte, Chairman
House Agriculture Committee
1301 Longworth House Office Building
Washington, DC 20515

Dear Chairman Goodlatte:

On behalf of First Pioneer Farm Credit, I am writing in regard to the House Agriculture Committee hearing held on Thursday, October 16 regarding new generation cooperatives and farmer associations. I ask that this letter be made part of the hearing record.

First Pioneer Farm Credit serves farmers and farm-related businesses in six Northeast states. We are the dominant lender to agriculture in the area we serve - our market share is in excess of 75% in two states and exceeds 60% for the region. We are committed to agriculture with consistent and dedicated service to the agricultural community in good times and bad.

In our area many commercial banks no longer serve agriculture on a consistent basis. Recently we have seen some commercial bank lenders reduce or eliminate their commitment to production agriculture lending. First Pioneer works closely with CoBank to meet the needs of agriculture – both on the farm and in value-added enterprises. To ensure that we meet the growing needs of agriculture, the Farm Credit Act needs at times to be updated to reflect industry changes and needs.

As the committee considers changes to strengthen agriculture and agricultural cooperatives we recommend:

1. Strong support for updating the cooperative eligibility provisions of the Farm Credit Act that limit farmer-owned cooperatives and associations of producers from eligibility for CoBank financing. Farmer-owned cooperatives and associations need to be able to access outside sources of investment to compete in today's competitive marketplace.

2. Encourage USDA to promulgate rules for the implementation of Rural Business Investment Companies (RBIC). This will help bring equity investments to rural America. It has been nearly 18 months since the passage of the 2002 Farm Bill and USDA has yet to publish draft rules for RBICs.

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The Honorable Bob Goodlatte, Chairman
October 22, 2003
Page 2 of 2

3. Provide full funding ($40 million) for Value-Added Marketing Grants. For many commodities and commodity organizations, the value-added marketing grants are one of the few Farm Bill provisions that provide direct assistance.

Thank you for your consideration.

Sincerely,

William J. Lipinski

c: The Honorable Robert Simmons
The Honorable Nancy Johnson
The Honorable Frank LoBiondo
The Honorable John McHugh
The Honorable John Sweeney
The Honorable Sherwood Boehlert

Yankee Farm Credit, ACA

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October 22, 2003

The Honorable Bob Goodlatte
Chairman
House Agriculture Committee
1301 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Goodlatte:

This letter is in regard to the House Agriculture Committee hearing held on Thursday, October 16 regarding new generation cooperatives. I ask that this letter be made part of the hearing record.

Yankee Farm Credit serves farmers and farm-related businesses in Vermont and New Hampshire. We are the dominant lender to agriculture in the area we serve - our market share is in excess of 60% of commercial farm debt. We are committed to agriculture with dedicated service to the agricultural community in good times and bad. Yankee Farm Credit works closely with CoBank to meet the needs of agriculture – both on the farm and with cooperative enterprises.

Yankee Farm Credit recommends:

1. To ensure that the changing needs of agriculture are met, the Farm Credit Act needs to be updated. We strongly support updating the cooperative eligibility provisions that limit farmer-owned cooperatives and associations of producers from eligibility for CoBank financing. Farmer-owned cooperatives and associations need to be able to access outside sources of investment to compete in today's competitive marketplace and continue to be eligible for loans from CoBank.

2. To help bring equity investments to rural America, the 2002 Farm Bill provided for the creation of Rural Business Investment Companies (RBIC). We encourage the Committee to seek action from USDA in publishing rules necessary for implementation of the RBIC provisions.

3. The 2002 Farm Bill also provided full funding for Value-Added Marketing Grants program. The value-added marketing grants program is one of the few Farm Bill provisions that provide assistance for fruit and vegetable producers. We urge the Committee to ensure full funding for this program.

Thank you for your consideration.

Sincerely,

Dean Moreau

Dean Moreau
President and CEO

C: The Honorable Bernard Sanders
The Honorable Patrick Leahy
The Honorable James Jeffords

USDA

United States Department of Agriculture

Office of the Secretary
Washington, D.C. 20250

DEC 9 2003

The Honorable Bob Goodlatte
Chairman
Committee on Agriculture
U.S. House of Representatives
1301 Longworth House Office Building
Washington, D.C. 20515-6001

Dear Congressman Goodlatte:

Thank you for your letter dated October 30, 2003, providing questions following the October 16, 2003, House Agriculture Committee Hearing on "New Generation Cooperatives."

I was pleased to have the opportunity to testify before your Committee on ways in which Rural Development helps cooperatives, farmers, ranchers, and other rural residents improve their quality of life. Rural Development stands ready to offer whatever leadership and support we can to improve the business environment for cooperatives. I look forward to working with you and members of the Committee as we look for ways to facilitate rural America's growth through effective cooperative organizations.

Sincerely,

Thomas C Dorr

THOMAS C. DORR
Under Secretary
Rural Development

Enclosure

House Agriculture Committee
October 16, 2003
New Generation Cooperatives Hearing
Follow-up Questions

Question 1. In 1994 when the Agricultural Cooperative Service became part of the Rural Business-Cooperative Service there were approximately 4174 co-ops. Now in 2003 there are 2950 farmer cooperatives across the U.S. What are your thoughts on the decline in these numbers?
The decline in the number of farmer cooperatives over the past decade reflects the trend of much of the American economy toward fewer but larger and more efficient business units. Much of the decline results from mergers among cooperatives designed to: (1) capture economies of scale, (2) increase market power on both the purchasing and marketing sides of the business, and (3) minimize administrative and other overhead expenses.

While the number of agricultural cooperatives has fallen by about 1,200 since 1994, many former independent cooperatives have consolidated into larger, healthier cooperatives. In many communities, what used to be a single location cooperative is now a branch of a cooperative with facilities in several towns. Since 1994, there has been an increase of about 800 branches operated by farm supply and grain cooperatives. So even though there are fewer agricultural cooperatives, most of the rural communities that had a cooperative in 1994 still have a cooperative available. But now it may be a branch of a larger association that is better able to compete, maintain service, and sustain job opportunities in that community.

Question 2. How many people within your agency are dedicated to working on co-op related issues?
The Cooperative Services division of Rural Development is our primary resource solely dedicated to working on cooperatives and cooperative-related issues. The National Office Cooperative Services division is comprised of 43 positions. Approximately 25 of them are professional employees and supervisors engaged in traditional cooperative assistance activities, such as research, technical assistance to existing cooperatives, cooperative development for new cooperatives, statistics, and information and education. The remaining positions are comprised of support staff, statisticians, and personnel dedicated to administering new grant programs available to cooperatives and other organizations. Also, about 40 of our State Offices have an individual assigned to cooperative development activities.

Question 3. What do you see as the biggest challenges facing cooperatives in today's global marketplace?
Cooperatives need to find new and innovative ways to bring equity capital into their business models. Without proper capitalization, all other efforts may result in have diminished returns. Secondly, there needs to be some resolution of the differences between the relatively static patron cooperative model, where equity financing and control are the responsibility of the member-patrons, and the need for greater transparency and effective governance of the modern cooperative structure.

Question 4. What is USDA doing to help farmers and their cooperatives meet such challenges?
Rural Development is presently engaged in the following activities to help cooperatives meet their marketplace challenges.

- Streamlining the cooperative stock purchase program to facilitate ease of use of this innovative equity-building program.
- Initiating an outside program review to study the research and technical assistance provided by our Cooperative Services area division. It is our intention to work with cooperatives to determine the most efficient and effective ways for Rural Development to provide support and assistance to cooperatives.
- Rewriting our Business & Industry (B&I) loan program regulations to implement the 2002 Farm Bill provisions regarding cooperatives. When the new regulation is published, cooperatives will be eligible to receive a $40 million B&I loan.

Question 5. What additional action do you believe is needed?
Rural Development understands the importance of the cooperative business model to rural America and is committed to identifying improvements needed to ensure the highest quality service and assistance to our customers. The restructuring of the Cooperative Services division will take time. Rural Development looks forward to working with Congress to implement the changes we find will be necessary.

Question 6. In your testimony you mention the Agriculture Innovation Centers. Now that 10 Innovation Centers have been approved, what are your expectations for these centers? Are you hoping to fund specific niche agriculture ideas, or are you looking for a broader approach?
Rural Development cannot predict which cooperative businesses will seek and/or receive assistance from the demonstration centers, and therefore will not limit ourselves. It is our intent to foster greater sensitivity to market opportunities for agricultural producers and rural residents.

We expect these demonstration innovation centers to provide agricultural producers in their State with technical assistance to help agricultural producers with: marketing, market development, business planning; and developing the tools they need to increase their viability, growth, and sustainability of businesses which produce value-added agricultural commodities or products. We also expect the centers to measure their performance to determine those practices that were successful and those that were in need of improvement. Additionally, as part of President Bush's eGovernment Initiative, Rural Development will work with the Department to validate the use and value of these demonstration center grants.

The directors of these Centers include representatives from the four largest commodities groups in the State, the State Department of Agriculture, and two general agricultural organizations. Thus a broad approach to value-added technical assistance will be taken.

The purpose of the entire value-added program initiative is to put more money in the pockets of farmers, through value-added activities. Therefore, we are not predisposed to limit the types of business activities. We want the ideas to be driven by market opportunities that farmers can capture, develop, and profit from, not driven by government design.

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Question 1. Secretary Dorr, before the USDA Reorganization Act of 1994, of which I was a principal author, there was a separate agency called the Agricultural Cooperative Service whose primary mission was to help encourage and promote cooperative self-help efforts by farmers. Those responsibilities have since been combined into what is called the "Rural Business-Cooperative Service."

a. **Simply, are cooperative services receiving the same attention and resources as it did prior to 1994?**
b. **How much of the resources in terms of dollars and full-time staff with the Rural Business-Cooperative Service are currently dedicated exclusively to programs authorized by Congress in support of farmer cooperatives and how does that compare with previous years?**
c. **Within the Rural Business-Cooperative Service, what is the current level of funding for farmer cooperative research and technical programs and how does that compare with previous years?**

It is difficult to precisely define the changes in resource allocation and use for cooperative services since the time the Agricultural Cooperative Services was merged into the Rural Business-Cooperative Service (RBS) as a part of the USDA reorganization in 1994. The composition of responsibilities assigned to the Cooperatives Services division of RBS has evolved, so direct comparisons are difficult to make.

At the time of reorganization, the predecessor to the Cooperative Services division of RBS had assigned staff totaling 69. Some of the functions carried out within this number, most notably the publications unit, are now housed with Rural Development's Legislative and Public Affairs Staff. The current National Office Cooperative Services division is comprised of 43 positions. Approximately 25 of them are professional employees and supervisors engaged in traditional cooperative assistance activities, such as research, technical assistance to existing cooperatives, cooperative development for new cooperatives, statistics, and information and education. The remaining positions are comprised of support staff, statisticians, and personnel dedicated to administering new grant programs available to cooperatives and other organizations. Also, about 40 of our State Offices have an individual assigned to cooperative development activities.

Since 1994, several new grant programs have been assigned to the Cooperative Services division. The 2002 Farm Bill alone generated six new programs assigned to RBS, of which two are administered by the Cooperative Services division. The amounts allocated in fiscal year 2003, are:

- Rural Cooperative Development Grants, $6.3 million
- Value-AddedAgricultural Product Market Development Grants, $28.5 million
- Appropriate Technology Transfer for Rural Areas, $2.5 million
- Value-Added Resource Center, $2.0 million
- Agricultural Innovation Centers, $10.0 million

- University Research on Value-Added Initiatives, $0.3 million
- 1890 University Entrepreneurial Program, $1.8 million

In fiscal year 1994, a specific cooperatives program line item was no longer included in the annual Agriculture Appropriations bill. Since that time, resources expended for cooperative functions have come from the general salaries and expenses appropriated to Rural Development in the annual Agriculture Appropriations bill. Thus, the roughly $4.6 million allocated in 1994 to traditional cooperative research, education, and assistance activities cannot be compared to the present method of allocation, which includes salary and expense costs associated with the Cooperative Services division. No administrative costs for additional personnel to administer the new grant programs were included in the annual Agriculture Appropriations bills.

Funds and staff years devoted to programs administered by the Cooperative Services division over the period 1980 to the present are presented in the following tables.

Financial Resources and Staff Years Devoted to Cooperative Services Functions 1980 to 1994

Year	Appropriated Funds	Reimbursable	Program Increase	Other	Pay Costs	Total Funds	Employment Ceiling
1981	3,850,000	--	650,000	--	--	4,500,000	92[1]
1982	4,500,000	--	139,000	--	--	4,639,000	80
1983	4,639,000	--	--	--	--	4,639,000	70
1984	4,639,000	--	--	--	38,000	4,677,000	70
1985	4,639,000	--	--	--	--	4,639,000	66
1986	4,713,000	--	--	(229,000)[2]	--	4,484,000	64
1987	4,469,000	--	--	[3]	--	4,469,000	63
1988	4,611,000	--	--	--	--	4,611,000	63
1989	4,655,000	--	--	--	--	4,655,000	63[4]
1990	4,714,000	--	--	--	--	4,714,000	69
1991	4,864,000	--	--	--	--	4,864,000	69
1992	5,140,000	--	500,000	--	--	5,640,000	69
1993	5,640,000	--	--	--	--	5,640,000	69
1994	3,000,000[5]	1,400,000[6]	435,000[7]	--	--	4,593,000	69

1/ The Agricultural Cooperative Service was established as an Agency with an increase of 15 FTEs.
2/ Gramm-Rudman-Hollings Budget Reduction Act.
3/ Pay cost increases, if any, included in appropriated funds from 1986 through 1993.
4/ OMB proposed a ceiling of 45.
5/ Originally appropriated to Agriculture Marketing Service (AMS), then returned to ACS.
6/ Provided by Farmers Home Administration under a Memorandum of Understanding.
7/ Federal/State Research on Cooperatives from AMS.

Financial Resources and Staff Years
Devoted to Cooperative Services Functions
1995 to Present

Year	Total Program Funds[1]	Employment Ceiling
1995	1,750,000	69
1996	2,172,000	45[2]
1997	3,000,000	45
1998	3,000,000	45
1999	3,107,000	45
2000	6,000,000	45
2001	33,027,000	45
2002	8,250,000	45
2003	51,400,000	43[3]

1/ Funding increased as the number of authorized programs increased. Total may include the following programs: Rural Cooperative Development Grant, Value-Added Agricultural Product Market Development Grant, Appropriate Technology Transfer for Rural Areas, Value-Added Resource Center, Agricultural Innovation Centers, University Research on Value-Added Initiatives, and 1890 University Entrepreneurial Program.
2/ New ceiling figure for Cooperative Services (CS) is 45 as of October 1, 1995.
3/ New ceiling figure for CS is 43 (July, 2003).

d. In testimony, David Graves, of NCFC, will give later this morning, he makes a good point. He points out that a new position has been established at the Department of Commerce for an Assistant Secretary of Commerce for Manufacturing to give greater priority to the challenges facing the manufacturing sector. Would that be a good idea for USDA to do for cooperatives?

We agree that cooperative models must be better disseminated and used as a key part of developing our rural economies. We are committed to seeing that our cooperative programs can deliver the type of focused, contemporary support to rural cooperative strategies. The Commerce Department strategy is one approach. We see that a real challenge is to make sure that we have the capability to ensure that the performance of resources dedicated to this effort can be effectively measured and resources directed as effectively as possible. It is for this reason that we are embarking upon a review of our Cooperative Services division resources.

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On September 29, 2003, Rural Development issued an Administrative Notice to provide for use of U.S. Census Bureau information in the programs covered under the Rural Development mission area. The Administrative Notice will allow our State Offices to continue using 1990 median household income (MHI) data for those applications Rural Development had on hand on September 29, 2003, and for which we had made an eligibility determination in writing.

The reason we issued this Administrative Notice is because the U.S. Census Bureau recently made available the non-metropolitan MHI, which is one of data elements from the census that we use. The Census Bureau has been incrementally releasing data from the 2000 decennial census during the past couple of years.

Use of the non-metropolitan MHI data appears to be having an unexpected impact on some areas of the country and could adversely affect the eligibility of some rural communities for assistance. Other data is available that could be used in lieu of the non-metro MHI, but before we adopt other data elements, we want to understand the impact that those new elements will have on the program. To make that determination, we have established a small taskforce of Rural Development State Directors, who will work with Program Staff, to delve into the complexities of the census data and develop recommendations that can serve as the basis for any future changes.

As a result of the Administrative Notice, most applications submitted in fiscal year 2003 for Rural Development assistance should not be impacted by the new census data. This should ameliorate the impact for most rural communities in the short-term.

The programs most impacted by the Census Bureau MHI changes are the Community Facilities (CF) Loan and Grant Program and the Water and Waste Disposal (W&W) Loan and Grant Program. The rural housing loan programs use income guidelines established and used by the Department of Housing and Urban Development in their Section 8 Program. Other Rural Development programs do not use median household income as a basis for program eligibility.

Beginning October 1, 2003, all new CF and W&W applications received will be evaluated for eligibility utilizing the 2000 census data, including funding based upon the State's 2000 census non-metropolitan median household income.

The Consolidated Farm and Rural Development Act (ConAct) provides the authority for CF and W&W Direct Loan and Grant Programs. The ConAct requires the use of a State's non-metropolitan median household income in determining the interest rate for the CF and W&W Direct Loan Programs. It also requires a graduated scale for grant amounts by requiring higher amounts of grants for projects in communities that have lower community population and income levels. In order to ensure consistency in administering the programs, Rural Development adopted the use of State's non-metropolitan median household income in the eligibility criteria for CF and W&W grant programs.

Question 1. Under this directive [Administrative Notice], grant eligibility is based on the applicant being below the statewide non-metropolitan median household income for the state; because only 3% of Californians lives in non-metropolitan areas, this directive will have a severely negative impact on California's rural communities' access to funds and eligibility for grant programs. For example, the city of Byron has a median household income of $35,938. Because their income exceeds the $35,680 non-metropolitan median household income in California, they are not eligible under this directive.

Will there be exceptions for cities like Byron, which is in need of federal assistance?
As you know, the City of Byron, located in Contra Costa County, California, has a median household income of $35,938 according to the 2000 census. The State of California non-metropolitan median household income from the 2000 census is $35,680, meaning the City of Byron is not eligible for grant funds, but could obtain loan funds under both the CF and W&W Direct Loan Programs.

If there is reason to believe that the census data is not an accurate representation of the median household income within the area to be served, an income survey may be utilized. The reasons will be documented and the applicant may furnish, or the Agency may obtain, additional information regarding such median household income. Information will consist of reliable data from local, regional, State, or Federal sources or from a survey completed by a reliable impartial source.

Question 2. Will this directive [Administrative Notice] have a negative impact on other States that are heavily populated – yet still have rural areas?
The impact of the new census data varies greatly from State to State and from applicant to applicant. Both the CF and W&W Direct Loan and Grant Programs have used the State's non-metropolitan household income number to establish grant eligibility through numerous decennial census changes. Areas that experienced growth in the median household income, higher than the growth of the State's non-metropolitan median household income between the 1990 and 2000 census, will most likely be negatively affected by the implementation of the 2000 census data.

Question 3. Will this directive [Administrative Notice] benefit other States?
The impact of the new census data varies greatly from State to State and from applicant to applicant. Areas that experienced growth in the median household income, below the growth of the State's non-metropolitan median household income between the 1990 and 2000 census, will most likely benefit by implementation of the 2000 census data.

Question 4. Why is New Jersey exempted?
The State of New Jersey is not exempted from our use of the 2000 census data. However, the 2000 census determined that New Jersey has no non-metropolitan areas, and therefore, no non-metropolitan median household income data. The recent Administrative Notice provides for a State to use the State's median household income from the 2000 census, in place of the non-metropolitan median income from the 2000 census if no non-metropolitan income data exists. Therefore, some areas in New Jersey could be eligible for both the CF and W&W Direct Loan and Grant Programs.

Question 5. Can California be exempted as well?
Because the 2000 census provided a State non-metropolitan median income for California, it will be used for determining eligibility under the CF and W&W Direct Loan and Grant Programs.

Question 6. Why did you use non-metropolitan income vs. statewide median income?
We are statutorily required to use the State's non-metropolitan median household income in determining the interest rate for the CF and W&W Direct Loan Programs. We are also statutorily required to use a graduated scale for grant amounts by providing higher amounts of grants for projects in communities that have lower community population and income levels. In order to ensure consistency in administering the programs, Rural Development uses the State's non-metropolitan median household income for both the loan and grant programs for CF and W&W.