Dairy co-operatives and Vertical market failure

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Co-operative form

- In legal terms, a cooperative is simply an incorporation by which many people act as one

- The cooperative form is a perfectly valid vehicle for doing business. It has pros and cons that should be evaluated objectively by shareholders in selecting the structure that most effectively enables their business objectives

- Structure should follow strategy. Some strategies can be best achieved by cooperatives

- To quote Bengt Holmstrom, Prof of Economics at Massachusetts Institute of Technology(MIT):

  > “[Cooperative forms are] not anomalies, but competitive institutions that form an integral part of a healthy market economy”

New approaches

A variety of hybrid forms are emerging in response to pressures requiring the co-operatives to adapt to changing market pressures

Traditional producer co-op	Variations in hybrid producer co-ops
Open membership	Closed
Right to supply all production	Tradable fixed supply contracts
$1 in, $1 out	‘Market’ value on entry + exit
Shares linked to supply	Some delinking or trading ‘B’ class shares
No return on shares	Pay dividends
Equal pricing across all suppliers of all volumes + locations	Equal pricing across all suppliers of *similar* volumes + locations
Cost averaging	More ‘user pays’
Product ‘out’ like product ‘in’	Product ‘out’ differs significantly from product ‘in’

Control v ownership

100% (exclusive) dairy farmer ownership is a paramount and deep-seated requirement of Fonterra’s supplier-shareholders.

However, as Prof Bengt Holmstrom of MIT pointed out in a 1999 paper on the future of cooperatives:

- The role of ownership is to gain the ability to influence decision-making via a direct governance
- However control involves trade-offs between –
  - Owners trying to maximise *their* share of the pie versus
  - Increasing the *overall* size of the pie
- It is not total ownership that counts, but control at the margin
- Ownership control is less of an issue if there is a market for entering and exiting
- Capital markets are much better at deciding the pros and cons of opportunities for a firm to diversify. Total closed control (with no trading of shares) denies shareholders this key benefit

Vertical market issue

- Structural choices in our dairy industry have been strongly influenced by claims or perceptions relating to ‘vertical market failure’.

- ‘Vertical market failure’ relates to the risk that, in some market configurations, sellers of rapidly perishable products that cannot be transported to alternative buyers may not receive a fair market price for their goods because the buyers may ‘hold out’ on the sellers.

- It also relates to the risk that, in some market configurations, the sellers could ‘hold out’ on the buyers, who have invested in very specific assets.

- In short, ‘vertical market failure’ is to do with relative bargaining strength of buyers and sellers of certain products, and the allocation of risk between them.

- Co-operatives are seen as a way of solving those ‘hold out’ risks. In short, the sellers vertically integrate – that is, the producers of perishable goods create and own the buyer of their goods (a cooperative), and their ownership is held in proportion to the volume they supply.

Vertical market issue *(cont'd)*

As Lew Evans and Richard Meade put it (Feb, 2006) –

- Cooperatives tend to arise more naturally where multiple, small and competing producers of a product face market power due to industry concentration further downstream in their supply chain, particularly where product perishability exacerbates their exposure to such market power.

- Additionally, what is required for cooperative development is a strong homogeneity of interest among cooperative owner-patrons, such as that facilitated by product homogeneity (as is the case for milk), and cultural homogeneity and stability (as is often the case in rural communities).

Vertical market issue *(cont'd)*

Evans and Meade again –

- "Cooperatives are a type of institution, being a distinct organisational form lying somewhere between a spot market and vertically-integrated firm. Left to their own devices, institutions will evolve in response to changing market imperatives, representing a balancing of the relative costs and benefits of that organisational form vis-à-vis others"

- "Thus cooperatives might be seen as a natural solution to particular market circumstances – such as when numerous, small farmers compete to supply large, concentrated agricultural processors or distributors (e.g. supermarket chains) having some market power. One organisational form may succeed at the expense of another where its structure offers competitive advantages."

- "Of course, certain organisational forms may also come to dominate others due to obstacles to organisational change – whether natural or artificial – and so the desirability of certain organisational forms coming to dominate others must be assessed with this in mind".

Vertical market issue *(cont'd)*

- The ascendency of producer co-operatives over proprietary dairy processors in New Zealand (which occurred between the early1900s and the early 1930s) appears to have been more the result of:
  - Heavy influence from Government actively fostering co-operatives and encouraging farmers to leave proprietary processors and create their own co-operative; and
  - Preconceived prejudice by dairy farmers against proprietary processors, which historians agree was unfounded.
- The rise of dairy co-operatives does not seem to have been related to actual or perceived 'hold out' practices by proprietary processors against dairy farmers (or even the risk of it occurring).
- This is outlined further in an accompanying set of slides **– 'Fonterra's foundations'** – at slides 12 to 22

Vertical market issue *(cont'd)*

- Vertical integration tends to occur when it the barriers are too high for sellers and buyers to agree by contract how to allocate risks and rewards. This does not seem to have been a key factor in the rise of co-operatives in our dairy industry in the first part of the 20th century.

- It would seem that all the conditions of 'vertical market failure' were not in place in the industry's early days when co-operatives became ascendant.

- Cooperatives appear to have displaced proprietary processors for others reasons more to do with prejudice and Government incentives. This was further entrenched over time by regulatory structures and pricing systems between the Government , or the government-mandated exporter, and co-operatives.

Sources:

- http://researcharchive.vuw.ac.nz/bitstream/handle/10063/3847/MAF_200306.pdf?sequence=1
- http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/when-and-when-not-to-vertically-integrate

Vertical market issue *(cont'd)*

- A variety of mechanisms other than a co-operative are available for resolving concerns about possible 'hold out' by buyers or sellers of rapidly perishable products.
- There are many relevant examples in industries such as vegetables, fisheries, wine.
- In some sectors involving highly perishable goods with fragmented sellers, buyers (processors /exporters) will agree a price in advance and assume the market price risk.
- This occurred in the early days of our dairy industry when proprietary processors were its main-stay. As historian H G Philpott points out:

> "One can scarcely overestimate the courage with which those early proprietors staked their scanty capital against a very doubtful return, well aware of the risk involved".

Vertical market issue *(cont'd)*

- "While admitting the force of the cooperative movement…, one should not forget that the industry owes much to the enterprise of the factory proprietors. When so-called cooperation had started the factory system and brought it to a standstill through bad management, it was the 'syndicator' who stepped in, bought up the discredited factories and built new ones, offered the public a fair price for their milk and put the industry on a sound financial basis." - 1897 report of the Department of Agriculture

- By dint of farmers' preconceptions and government regulatory arrangements, alternatives to co-operatives were, in effect, 'foreclosed' for most of the last century.