Biofuel Co-operative case study series –

Seaway Valley Farmers' Energy Co-operative

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Seaway Valley Farmers' Energy Co-operative

Cornwall, Ontario

Key Themes:

- The challenge of being one of the first players in a new game
- The relationship of time to capital
- The role of Board members vs. outside 'experts'

It's not easy being a pioneer. Just ask Moose Creek, Ontario grain producer Alain Leduc. As current President of the Seaway Valley Farmers' Energy Co-operative, Mr. Leduc knows that it's the pioneer who has to clear the bush, cut the trees and build the road before he can move forward, and that is how the Board members of the co-operative sometimes feel. For 15 years the Co-operative has had a dream of building a farmer- owned ethanol plant in eastern Ontario and, in some ways, that dream seems further away than when they first started.

The Idea

The story of the Seaway Valley Farmers' Energy Co-operative began in 1991 with ten individuals from Glengarry and Stormont counties in eastern Ontario. The group consisted of people involved in farming and agribusiness activities who came together to explore the idea of building a production facility to process corn into ethanol for use in motor vehicle fuel. The objective was to expand the market for corn, increase the income of grain farmers, and foster economic activity in eastern Ontario where they lived.

The First Step: A Preliminary Study

In 1991, the idea of building an ethanol plant was a very new concept and little was known about the product, the production process or what was involved in setting up an ethanol plant. As a first step in launching this project, a preliminary study was commissioned. It was undertaken by a local, retired engineer who had been an employee of a large, reputable engineering firm. The study provided basic information on the process for building an ethanol plant as well as a sense of how large and complex the project would be. It became abundantly clear to the original group that additional investors and capital would be required to make the dream a reality.

The History

Seaway Valley Farmers Energy Co-operative Inc. was incorporated in June 1992 under the *Co-operative Corporations Act* of Ontario for the purpose of developing a value-added market for Eastern Ontario corn by exploring the feasibility of fuel ethanol production in the area. The basic goal in forming the Co-operative was to provide a local market outlet that would add significant value to corn in years when its price was lower. Ethanol is an ideal hedge for volatile corn prices, and this is what has attracted farmers across North America to the ethanol industry. Since the cost of corn is the major expense component for an ethanol plant, lower corn prices will generally increase ethanol profitability, while higher corn prices will typically decrease ethanol profits but increase farm income. By investing in ethanol production, farmers gain an opportunity to stabilize their farm incomes and avoid the cyclical income patterns characteristic of producers involved in commodity production.

Seaway Grain Processors, Inc. ("Seaway"), a wholly-owned subsidiary of the Co-operative, was formed to carry out the financing, development and operation of the ethanol production facility in an industrial park in Cornwall, Ontario. The plan was for the Co-operative to retain voting control of the subsidiary and to own at least 51% of the equity, thereby ensuring member control of the operating company.

The First Equity Drive

In 1993, the original, incorporating members who formed the Board of Directors undertook to raise funds and build support among farmers in the area. For those not familiar with the co-operative equity drive process, this may sound easy, but it was a long, arduous process that required incredible vision and commitment on the part of the Board. Bud Atkins, President from 1994 to January 1995 worked unstintingly to turn the dream of the ethanol pioneers into reality.

Board members dedicated huge amounts of their time and energy to organize a series of 15-20 community meetings in the surrounding rural area over a period of four months. At least two Board members represented the Co-operative at every meeting; each meeting was attended by about 50 people, on average, from the surrounding area. Pledge forms were on hand to collect the names of interested people and prospective members. Some Board members estimate that up to three-quarters of the people attending made a pledge to join the Co-operative and invest in the ethanol vision. The Co-operative had an impressive 99% success rate in collecting the pledged funds and signing up the members who had made a commitment.

The Board used these community meetings to build awareness of the project, gauge the level of interest among farmers and community members, and invite farmers, agricultural businesses and community members to join the Co-operative. Meetings were advertised in local newspapers and through personal contact and word of mouth. The equity drive for the Seaway Valley Co-operative represented a major community engagement and mobilization process across most of rural Eastern Ontario.

According to the Co-operative's by-laws, membership in the Co-operative is open to all Ontario corn producers and other persons who support the aims and objectives of the Co-operative. Although there was discussion at the outset of the project about restricting membership to corn producers only, the need for a broader member equity base, as well as the increased access to Government programs for projects involving different parts of the community, led the Co-operative to open membership to the entire community.

Prospective members of the Co-operative were required to purchase a minimum of two thousand five hundred dollars ($2,500) in Membership Shares. Different classes of Preference Shares were also available to investors wishing to make additional investments in the Co-operative. Members were not required to, but had the option to enter into a supply agreement with the Co-operative to deliver corn to the ethanol plant.

A High Level of Interest

As part of the equity and recruitment drive, Seaway Valley invited farmers and experts with experience in developing ethanol projects in the U.S. to talk about their experiences, successes and failures and to answer questions posed by the farmers and community members. Board members found that there was significant interest among farmers, both cash croppers and supply-managed farmers, in supporting the project. In most cases, the public meetings had to be followed up by Board members with one-on-one meetings, kitchen table meetings, and phone calls to answer the additional questions and concerns of prospective members.

By the end of the membership drive, 1,926 people had joined the co-operative by purchasing a minimum of $2,500 in membership shares. Many members had purchased additional shares and the Co-operative managed to raise over $5 million in share capital by late 1995. The high level of interest in the project encouraged the Board members who had invested considerable time and energy in the pioneering initiative.

Feasibility Study

After the initial funds were raised from members, the proceeds were used as seed money to hire a U.S.-based consultant with experience in the ethanol industry to prepare a comprehensive feasibility study for the proposed Cornwall facility. Following the feasibility study, a detailed analysis of the ethanol industry in Canada and a comprehensive Business Plan were prepared. It took nearly 18 months to conclude the various market, technical and financial feasibility studies to determine the best possible location, size and product configuration for an Eastern Ontario ethanol facility.

Unlike most all of the other ethanol facilities built by farm groups elsewhere in North America, the Seaway Valley project initially called for the plant to produce both fuel ethanol and industrial ethanol, which is used as an ingredient for the beverage industry as well as a wide range of industrial and medical applications. The completed Business Plan not only demonstrated the viability of an ethanol plant in Eastern Ontario but also identified prospective buyers for the plant's ethanol and other co-products.

At that time the 54-million-litre project was estimated to cost $38 million. The plant would utilise nearly 5.5 million bushels of corn, substantially increasing the demand for local corn and putting upward pressure on local corn prices. In December 1994, the Board of Directors made a decision to proceed with the development of the Project.

Cornwall, Ontario on the St. Lawrence Seaway

The City of Cornwall, Ontario is strategically located on the St. Lawrence Seaway. It is, the City website notes, within a day's drive of over 100 million consumers, and a half- day drive from Toronto. It is about 60 miles from Ottawa and Montreal. Complemented by its scenic location on the St. Lawrence Seaway, its proximity to other major transportation routes, and its border location with New York State, Cornwall's location becomes a strategic advantage for any company situated there.

To the Seaway Valley Co-operative, Cornwall offered advantages as a business location. It is on Highway 401, only minutes from the U.S.A. and located in the triangle formed by Ottawa, Montreal and Toronto. It has good access to road, rail, sea and air transportation networks. In addition, it had excess capacity in water, a basic requirement in producing ethanol.

In January 1996, the Co-operative purchased a 23-acre parcel in Cornwall's east-end industrial park. One of the conditions of the Co-operative's purchase of this site was that Seaway had to commence construction of its ethanol plant on the site within one year of closing. Going against some of the advice it had received, the Board decided to construct a small office/administration building on the site. Although the City of Cornwall granted repeated extensions to Seaway, in Spring 2007 the Council voted not to grant any further extensions to Seaway and exercised its option to repurchase the property at 90% of the purchase price.

Unfortunately the funds invested in site development costs were lost when the City of Cornwall exercised its option to repurchase the land.

Still More Money Required

Following the completion of the Business Plan, it became clear that more money was required to move the project ahead to its next stage. Based on his experience with similar projects in the United States, the U.S.-based consultant advised the Co-operative that they would need to raise 27% of the project cost (about $10.5 million) as equity. (Over time it became clear that this level of equity was not regarded as sufficient by the banks and that, in fact, the Co-operative would require an equity investment of 40-50%.)

It also became clear that raising funds on an ongoing basis was a time-consuming process for the Board of Directors and not possible to continue entirely on their own. The Board decided to hire an Ottawa-based consulting firm to spearhead the next phase of the fundraising effort.

The consulting company came with a full team of "experts" which included specialists in sales, banking, grain marketing, crop insurance, government relations, fundraising and public relations. The firm was hired to undertake the entire process of raising funds from farmers, including advertising and organizing meetings, following up with individuals, etc.

The consulting firm hired a general manager to manage and oversee the Seaway Valley project.

Over time, the Seaway Valley Board of Directors was disappointed to discover that the company was not experienced, comfortable or effective in undertaking the equity drive. The consultants kept returning to ask Board members questions and to seek their advice on how to proceed with a community equity drive. In addition, some of the promotional materials distributed contravened securities regulations and had to be withdrawn. Although several of the sales people were effective in raising equity, overall the company was not successful in raising the required funds. With some negative feelings about the company, the task fell back to a small number of Board members.

A 3% commission was paid to hired sales people as well as the Board members who raised equity. However, some of the Board members did not take any commission or reinvested the commission back into the Co-operative.

In total, Seaway Valley issued four share offerings to raise equity:

- **First Offering (1993)**
  Target was $20 million; $480,000 was raised;
- **Second Offering (1995)**
  Target was $12.5 million; $5.0 million was raised;

- **Third Offering (1996)**
  Target was $10.5 million; $3.2 million was raised;

- **Fourth Offering (1999)**
  Target was $10 million; $7.7 million was raised.

In total, the Co-operative raised over $16 million in equity over the course of four separate offerings.

More Funds Required (1996)

When it was evident that more funds were required in order to get the project off the ground, the Co-operative issued a third share offering. The Bank which had expressed a commitment to finance the project required the Co-operative to raise an additional $4 million. Once again, funds were raised by the hard-working and committed Board members along with several of the successful sales people who had worked with the Co-operative in the previous offerings.

Dogged by Problems

The Co-operative continued to face many challenges.

In October 1998, a meeting was held to request an additional contribution of $6 million in equity from its 2,000 members. Although no actual plant construction had commenced, the Co-operative had spent $4.9 million during the previous five years for land acquisition and building an administrative office, financing charges, civil works, miscellaneous equipment, and construction and engineering contracts. Consulting and other professional fees had topped one million dollars.

The additional equity was required to satisfy the debt-to-equity requirements of an international bank which had promised to provide a financing proposal within weeks. Unfortunately, that bank was in the midst of merger talks with another major international bank. The uncertainty surrounding the anticipated merger along with a change in the bank's strategic directions appeared to be a factor in that bank's decision not to proceed with a financing proposal.

In the same month, an engineering firm put a lien on the co-operative under the Construction Lien Act as a claim for services rendered, alleging the Co-operative breached a contract signed for site preparation. It claimed damages against Seaway; Seaway responded to the legal action with a counter-suit against the engineers, claiming that charges for services provided far exceeded the fair value of those services. Needless to say, this development was not a positive one and created additional uncertainty.

At a members' meeting, members expressed concern about the financial impact of the lawsuit on Seaway's books and reputation in the community. Before any construction could proceed, the lien had to be removed, which required posting a bond with the court.

Fourth Offering (1999)

By the time of the fourth offering for $7.75 million, the project had grown into a 66-million-litre ethanol plant, or approximately 30% over the amount initially projected. This increase in plant size was projected to occur, without any increase in construction costs, as a result of a change in the construction contractor selected for the project and economies of scale achieved through the increased size of the facility.

At that time it was projected that Seaway would require $51.5 million to develop and start up the project in accordance with its budget projections at that time.

Government Support for Seaway

Although Seaway Valley did obtain substantial commitments of financial support from both federal and provincial Governments, the timing of the various Government programs never perfectly coincided with the project's own timing. In 1994, Seaway received $3 million in Jobs Ontario Community Action (JOCA) funding. In 1998, the Co-operative received approval for a loan of $2,000,000 from the federally-funded Agricultural Adaptation Council. Seaway also received approval for a contribution of $10,500,000 under the federal Ethanol Expansion Program in 2004. Even with various extensions, Seaway was unfortunately unable to take advantage of either of these federal programs because of their delays in obtaining financing. In 2006, Seaway was also approved for a capital grant of $6 million under the Ontario Ethanol Growth Fund.

Despite the significant level of Government support received by Seaway Valley, the timing of this support never perfectly coincided with Seaway's requirements to have funds in place in a timely manner so they could have sufficient capital available before project costs escalated.

Excessive Confidence?

As noted previously, the Co-operative had purchased a 23-acre parcel in Cornwall's east-end industrial park. Ownership of this site was essential so that site-specific engineering could proceed and the requisite permits and approvals could be obtained for the site. When the Co-operative proceeded to construct their administration building on the site, the Board thought they were so close to the ethanol facility construction that there was little risk they would lose their investment in the site if the City exercised its right to repurchase the land, which was possible if construction did not proceed in a timely fashion. The construction of an administration building was an important symbol of progress on the project and gave the Co-operative a tangible home. This symbol came back to haunt them many times in the coming years as delays continued to mount.

The funds invested in this building and in site development were lost when the City of Cornwall exercised its option to re-purchase the land at cost in April 2007.

The Co-operative believes that the City is no longer interested in having an ethanol plant so close to the community, since it is perceived by some to be a "polluting business." Members of council are focused on attracting "green businesses" to the industrial park.

More Challenges Facing the Project

- As the Co-operative was in the process of raising funds to complete the project, money was being spent on consultants, land and land preparation, bank fees, permits, engineering, lobbying government, fund-raising, staff and office costs, directors' fees, and so on. Not to incur such costs would have meant halting all progress on the project; but proceeding to spend these funds also meant that members' equity in the project was gradually being eroded, requiring additional funds to cover the growing equity needs of the project.

- The project suffered from a continuing inability to persuade commercial banks to provide the $30 million in financing required to begin construction of the plant. As the anticipated dates for project financing were repeatedly delayed, both members and lenders began to wonder if the project would proceed. Every delay in the project seemed to make subsequent efforts to obtain financing all the more difficult. In the language of bankers, deals grow 'stale' with time and interest in projects wanes even if the economics of the project actually improve.

In the case of Seaway Valley, ethanol production definitely became a better market risk for lenders as the niche for ethanol expanded and early concerns about not having markets for the ethanol gave way in the face of Government incentives for ethanol production and ethanol mandates. Regrettably, the scale of the project, which originally was considered appropriate for a start-up ethanol plant, eventually came to be regarded as uncompetitive because of the increasing size of other ethanol plants. While a 15-million-gallon plant was considered state-of-the-art in the early 1990s, today there are few plants still being built with a capacity of less than 40 million gallons, except where they are tied into a feedlot or have some other feature justifying a smaller size. Many plants being built today are 50-million-gallon plants, and 100- million-gallon plants, which were unheard of until two or three years ago, are now being built with increasing frequency. Ironically some of the lenders' earlier concerns about the plant producing too much ethanol for the market was transformed into a concern that the plant would not produce enough ethanol to be competitive.

- Informal agreements and letters of intent did not translate into firm commitments and solid, binding contracts. Although it is necessary to obtain Letters of Intent at the early stage of a project to be able to confirm that markets for the ethanol and other co-products really exist, these LOIs have to be translated into legally binding agreements in order to obtain financing. Between the time that the LOIs were originally crafted and the time that it was necessary to have executed agreements in place, circumstances had changed sufficiently that some of the prospective project partners had lost interest in the deal or would only proceed on changed terms. Timing is everything on a project like this one, and Seaway always faced a major challenge in getting the many pieces of a complex puzzle to fit into place simultaneously.

- With the strong North American and global economy of the past decade, all industrial projects have faced considerable upward prices on construction and equipment costs. In the past couple of years this has been fuelled by sharp jumps in the price of nickel, steel, copper and other materials. By 2002, the cost of the ethanol plant had risen to $50 million. By March 2007, following another re-costing of the project, the total project cost had reached $70 million, or approximately $1.00 per litre of ethanol to be produced. Needless to say, it is precisely this increase in per litre costs that has driven other ethanol projects across North America to build on a progressively larger scale, thereby keeping in check the per litre ethanol costs, but significantly increasing the initial capital costs required to enter the ethanol market.

Years in the Wilderness

Ironically, after a 12-year struggle in the financial wilderness with limited government support, and just as the Federal government announced major support for a home-grown ethanol industry, the city of Cornwall rejected the Co-operative's request for a three-month extension on the city land and decided to buy back its 23-acre plant site in the City's industrial park.

The local agricultural paper asked: "Considering Seaway's Shakespearean tragedy-like history, isn't it predictable that, just when the serious subsidies come rolling in, the co-op campaign is probably spent? While in many industries it can pay to be ahead of the curve, a co-operatively built and operated ethanol manufacturing plant in Eastern Ontario doesn't appear to be one of them. "[1]

[1] AgriView, Ahead of the curved ball. Tom VanDusen, Op-ed April 2007. (http://www.agrinewsinteractive.com/archives/archives_fullstory.htm?ArticleID=8344&ShowSection=From%20the%20Archives)

The Legacy for Co-operatives in Eastern Ontario

Alain Leduc thinks that Seaway Valley's struggles of the past 16 years have created a negative image in the agricultural and wider community, one that questions whether co-operatives are a viable form of ownership. Mr. Leduc notes that the wind power co-operatives currently being established in the area have found that farmers and others are wary of investing in another co-operative because of the Seaway Valley experience. Just as the success of the early ethanol co-operatives in the U.S. spawned many more successful farmer ventures in the ethanol sector, so too has the negative experience of Seaway made prospective proponents of ethanol projects more cautious. Yet there are many lessons to be learned from Seaway's struggles and other co-operatives would do well to spend time with the pioneers at Seaway to learn from their experience.

Steps in Seaway Valley Project Development

1991	Initial (informal) discussions & Preliminary study
1992	Formation of the founding Board of Directors & Incorporation of the Seaway Valley Farmers' Energy Co-operative (1992)
	Incorporation of the subsidiary / operating company (Seaway Grain Processors, Inc.)
1993	Feasibility Study
1994	Board decision to proceed with project. Estimated cost: $38 million.
1995	Co-operative purchased 23 acres ($200,000) in the City of Cornwall industrial park.
1999	Plant size increased 30% to 66 million litres.
2002	The cost of the project had risen to $50 million.
2005	Seaway receives $10.5-million share of the federal Ethanol Expansion Program
2005	Seaway is eligible for funding of $6.9 million under the Ontario government capital grants program
2006	The construction of two other (private) ethanol plants, both twice as large as the Seaway project, are announced for Eastern Ontario.
2007	The cost of the project has risen to $70 million. The City of Cornwall re-purchased the land from the Co-operative.

Lessons Learned:

Board of Directors

- A smaller Board (8-10 people) of committed people with business experience is essential.
- Each and every Board member (including professionals who bring skills necessary to the success of the project such as accountants, lawyers, engineers, etc.) must have a significant level of investment in the project in order to ensure that decisions are based on business rather than emotional considerations.
- Board members should have clear job descriptions and expectations regarding the level of responsibility and the time commitment required, especially for raising funds from members.
- Board members should receive training in their duties, how to work as a team, governance issues (legal liabilities and responsibilities), and in the skills required for developing an ethanol project such as reading financial statements and auditors reports; technical, engineering and planning issues; lobbying and communications, and other matters related to a project of this size.
- Board members should serve for a limited time (six years maximum) and Board renewal is necessary.
- Board members must keep shareholders informed and ensure they understand the development process and how long it can take.
- The Board must make decisions on the business case and sometimes must make difficult decisions, even if that is not popular at the time.

Consultants, Professionals, Suppliers & Contractors

- Be realistic about the costs of start-up and of doing proper feasibility studies and business plans.
- The Board should consider tying consultants' compensation to results and performance.
- Beware of people who make unrealistic promises about what they can deliver. Check references and confirm whether they have a track record of success in projects of similar scope and complexity.
- Letters of intent are not legally binding.

Financing

- The Board, Co-operative staff, consultants and professionals need to have the confidence of the banks and lenders in order to get financing. Keep this in mind is selecting a Board of Directors and hiring professionals.
- Co-operatives are competing with more established players in the ethanol industry, including big oil companies, and need to develop a competitive level of sophistication.
- Start-up businesses, especially co-operatives, face major challenges in obtaining access to bank debt. Project financing for companies with no resources outside of those being applied to the specific project is the most challenging kind of financing to obtain, especially where the project sponsors lack deep pockets.
- While $2,500 is an acceptable investment for "seed" money, the co-operative should set a higher level of entry to membership in the co-operative (Seaway recommended a minimum level of around $25,000-$30,000).
- Raising funds is a time-consuming process for members of the Board of Directors that requires a significant level of energy and commitment. Directors should understand this commitment and be willing to invest the time and effort in the task.