17

PDAAQ 490

EVALUATION OF THE PROGRESS AND PROSPECTS OF TONGA COOPERATIVE FEDERATION

project 879-0251

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Agricultural Cooperative Development International
and
Volunteer Development Corps

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Contents

		Page
I.	PROJECT OVERVIEW	1
	A. Background	1
	B. Design of Project	1
	C. Inception of Project	2
	D. Deviations from Original Plan	2
II.	STATUS OF PROJECT	
	A. Wholesale Business Volume	2
	B. Profitability	3
	C. Handicrafts	3
	D. Vanilla Marketing	3
	E. Records	4
III.	PROJECTS UNDER DEVELOPMENT	4
	A. Fish Marketing	4
	B. Agricultural Inputs	4
	C. Additional Warehouse Space	5
	D. In the "Pending" File	5
IV.	PROGRESS TOWARD GOALS	6
	A. Financial Indicators	6
	B. Organizational Indicators	6
V.	PROSPECTS FOR 1983	7
	A. The 1983 Budget	7
	B. Basis of Projection	7
VI.	FUTURE PROSPECTS AND FUTURE NEEDS	7
	A. Improvement in Gross Margin	8
	B. Successor Management	8
	C. The Primary Societies	9
	1. Member and Non-member Business	9
	2. Communication	9
	3. Management Contract Experiment	10

Table of Contents (continued)

	Page
D. Financial Aspects	10
1. The General Position	10
2. Distribution of Profits	10
3. Forecasting	11
E. Facilities for Further Development	12
VII. WHO BENEFITS?	13
VIII. SUMMARY	14

APPENDICES

A. Participants and Contributors
B. Staffing and Salaries
C. Condensed 1983 Budget
D. Persons Interviewed
E. Future Development Needs

I. PROJECT OVERVIEW

A. Background

In the spring of 1981 a feasibility study was undertaken with this mandate:

> "To render a considered judgement whether the Tonga Cooperative Federation, given feasible management, training and capital inputs, is a potentially viable institution for the promotion and implementation of programs of economic self-help among segments of the Tongan society otherwise economically disadvantaged, and to recommend the nature and scope of such inputs."

The federation, then dormant and virtually bankrupt, had been established in 1977 by some 60-odd primary societies (local co-ops in American parlance) to supply them with groceries and other household needs. This is its principal business and its basic reason for being.

The federation has branched into the marketing of vanilla for some of the primary societies, and into selling Tongan handicrafts. Further diversification into fish marketing is under way and entry into agricultural inputs is planned.

B. Design of the Project

The study referred to above concluded that the federation could become viable, given adequate financing and competent management. The plan was that expatriate management would be supplied for a period of two years, during which time Tongans would be found, selected and trained to succeed to the management positions. A package was put together including:

- A grant from the Tongan government
- A loan (and extension of existing loan) from the Tonga Development Bank
- Working Capital and funds for fixed assets from USAID
- A delivery truck from the Canadian government
- An expatriate manager for two years, supplied by ACDI and financed by USAID
- An expatriate accountant, also for two years, supplied by British Aid through ODA.

Other organizations have participated since the original proposal was developed (detail in Appendix A).

C. Inception of the Project

The study previously mentioned was completed in May of 1981. Monies for the project from the various entities involved became available from time to time during the fall of that year. The project may be said to have commenced with the arrival of the ACDI manager, John Kreag, on January 28, 1982. The financial manager, David Rushton, arrived on May 28, 1982. The new warehouse and store opened in September.

The project is therefore one year old, but has been in full operation on the present basis only a few months.

D. Deviations from Original Plan

Two events have caused minor changes from the original concept. The events were not related but the changes they caused were interrelated.

1. The principal warehouse of the federation in Nuku'alofa was extremely inconvenient and totally inadequate. It was intended that a new warehouse would be built, and funds for this were included in the USAID grant. Unexpectedly, a store immediately across the street from the federation became vacant and available. This excellent location was leased at a reasonable rent and serves as both a warehouse and wholesale store.

2. A violent hurricane struck Tonga in March 1982, causing damage to some facilities of the federation and its primary affiliates. The federation's warehouse on the island of Ha'apai was totally destroyed. Permission was obtained to use $20,000 of the money earmarked for the main (Nuku'alofa) warehouse to replace the structure on Ha'apai.

II. STATUS OF THE PROJECT

A. Wholesale Business Volume

The growth in volume of business is nothing less than spectacular. Merchandise sales by 1982 quarter:

January-June	$ 81,017
July-September	138,568
October-December	324,819

It will be seen that in the last quarter, merchandising activity, the principal business of the federation, was running at a million-dollar-a-year rate, greatly exceeding expectations.

B. Profitability

To date the business has not shown a profit. This was, and is, to be expected. The volume of trade is now sufficient so that a nominal profit may soon appear. The prospects for any substantial or even comfortable profit is threatened by:

- a low gross margin, and the difficulties involved in increasing it

- the inevitability of increased costs, as paid employees are put in place to succeed the present key management people

These matters will be covered more fully in Section III.

C. Handicrafts

This is a very small business, operating at present in Nuku'alofa and the northern island of Vava'u. It consists of purchasing artifacts made by Tongan craftsmen such as straw mats, handbags, shell jewelry, carvings and the like, and selling these products both locally (primarily to tourists) and for export. Business at present is running about $3,000 per month. A small profit margin appears possible.

D. Vanilla Marketing

Vanilla is grown primarily on Vava'u, although a beginning is being made on Eua and on the main island of Tongatapu. Several primary societies are engaged in this business. The growers bring their green vanilla beans to the society's curing shed where the beans are cured, then collected, graded, and packed by the federation for export.

The federation has been helpful to the primary societies in a number of ways:

- By providing a reliable and honest marketing system

- By arranging bank loans to build better curing sheds, and

- by promoting the use of better curing methods, specifically the "hot water" technique.

This last has produced a dramatic improvement in the curing ration-(the amount of green beans required to produce a given weight of dried beans) from 5.23:1 to 4.08:1. As a result, the growers who are members of the primary societies are receiving a much higher price for their green beans.

The federation has been charging the primary societies five percent of the selling price for its services to cover costs and provide a small profit. Unfortunately, the need for profit to provide a capital cushion for the operation is not understood, and dissatisfaction has arisen. A new marketing agreement allowing for some retention of earnings with ultimate distribution to member societies is now under consideration.

E. Records

Starting with an utterly chaotic and totally unreliable set of records, the financial manager has developed an accounting system which produces management information that is both accurate and timely. The few weaknesses which still exist, largely as a result of rapid growth, are being given careful attention.

III. PROJECTS UNDER DEVELOPMENT

A. Fish Marketing

The concept of this project is that the federation will act as marketing agent for the artisanal fishermen, first in Vava'u, and ultimately in the other islands. The business is being entered into gradually, carefully, and soundly. The recent report of fisheries expert Raymond Lewis has accurately summarized the present state of the project. A few supplementary observations:

1. A marketing specialist, Richard Elsy, supplied by CFTC for two years, is now in place to continue development of the project.

2. The equipment now in use is mostly on loan from the government, the rest rented. Some additional items and some replacements are needed.

3. Purchasing is direct from the individual fishermen. It is intended that primary cooperative societies will be formed to represent the fishermen.

4. The federation has also entered, in a small way, the business of fishing supplies. This will be expanded as needed.

B. Agricultural Inputs

Distribution of seeds, fertilizers, pesticides and other farm needs is largely in the hands of the quasi-governmental Commodities Board, supplemented to some degree by the big expatriate firms of

Morris Hedstrom and Burns Philip and a few others. There appears to be some dissatisfaction with this system concerning availability and price. The possibility of the federation entering this business has been under discussion for some time. The director of agriculture and the registrar of cooperatives, among others, have expressed interest.

A grant of $17,000 has been made by Christian Aid to inaugurate this activity. There are, however, obstacles to be overcome:

1. The business is highly seasonal.

2. It is extremely difficult to forecast probable consumption; yet such forecast is critical, since the goods must be imported and therefore cannot be made available on short notice.

3. Some of the commodities are not compatible with foodstuffs; segregation of sales facilities is necessary.

4. Most of the primary societies have very limited space.

It is intended that a pilot project will be initiated in Vava'u in the near future.

C. Additional Warehouse Space

The building occupied by the wholesale store and warehouse also houses the handicraft shop. This space is badly needed to store commodities, and handicrafts could well use some additional space.

A search is underway to find a rental property suitable for handicrafts. This will relieve pressure on the warehouse which, it is believed, will then be adequate for the federation's needs for two more years. It will probably be necessary to rent additional storage space from time to time on a short-term basis for large volume bulk commodities such as flour and sugar.

D. In the "Pending" File

Marketing of agricultural produce was one of the activities contemplated by the founders of the federation, but not as yet entered into. The possibility of marketing root crops from some of the outer islands is now under consideration.

A related consideration is the fact that, while the federation is a Tonga-wide cooperative, its facilities and activities are heavily concentrated in Tongatapu and Vava'u.

Several requests have been made to potential donor nations for aid in the further development of federation farm and fish marketing and wholesaling activities in the outer islands. These requests have been prepared jointly by the federation and the cooperative department, and submitted through the Tonga Central Planning Department. No positive response has yet been received.

Should this assistance be granted, it will complement development of other activities mentioned in this report.

IV. PROGRESS TOWARD GOALS

The Operational Program Grant Proposal set forth a number of goals. Several have been achieved or surpassed. Others are moving well toward accomplishment.

A. Financial Indicators

Goals	Achievements
Gross Sales:	
first year: $ 360,000 second year: $ 450,000	Second year goal exceeded in first year
Transportation costs:	
2 1/4% of sales, pass on to purchasers	Now at 2%. Competition will not allow costs to be passed on.
Administrative (total) expenses for consumer goods:	
8%	Now at 6%
Gross profit:	
8% of sales	Now about 6%
Current ratio:	
2:1 to 2 1/2:1	Year-end ratio 1.65:1

B. Organizational Indicators

1.	Institutional development plan to be drawn up and updated	No formal plan exists
2.	Organizational Chart to be drawn up and updated as needed	Done
3.	Job descriptions for all positions	Not done
4.	Standard operating procedures for significant recurring tasks.	Established, not all written out in detail

5.	Accounting and information systems installed, personnel trained in their use.	System not in place, training incomplete

V. PROSPECTS FOR 1983

A. The 1983 Budget

Management has prepared a budget calling for total sales of merchandise and handicrafts of $1,296,000 with net profits of $21,280 (Appendix C).* Vanilla is not included, since a new marketing contract, now under discussion, provides only for the recovery of costs, including allocated overhead costs, plus a withholding of three percent of the sales price as a revolving fund contribution to capital.

No projection has been made for fish marketing, since this is just getting started. The key marketing man is supplied by CFTC. Other expenses at present are low. No profit is anticipated this year, but neither should there be any considerable loss.

B. Basis of Projection

Sales are projected at the same rate as the actual performance in fourth quarter 1982. It is reasonable to expect continued, though slower, growth, so the sales projection may well be exceeded. The budget predicts a gross profit of eight percent, far above the five to six percent so far experienced. With substantial improvement in the percentage of goods imported, this may well be achieved in the third or fourth quarter, but it is highly dubious as an average for the year.

Another $200,000 or $300,000 of business can be handled at very little educational cost: one or two low level employees, and perhaps some short-term bank financing. In sum, greater sales may offset a lesser gross profit percentage, so a net profit in the $20,000 range is a reasonable expectation.

VI. FUTURE PROSPECTS AND FUTURE NEEDS

Management has correctly given highest priority to building a substantial and expanding sales volume and has been notably successful. It is time now to consolidate the gains and to place more emphasis on other critical aspects of the business. Management is doing exactly that.

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*Figures are in Tongan pa'anga (T$) which currently are exchanging virtually dollar for dollar with U.S. currency.

A. Improvement in Gross Margin

The federation cannot conceivably operate profitably without a substantially greater gross margin percentage. The road to improvement lies in increasing the proportion of imported goods.

There are three sources for the merchandise handled by the federation:

About 50% is imported

15% is locally produced (e.g., soap, toilet paper)
35% is purchased from other importers.

When goods are purchased from other importers, the wholesale margin is shared. Since margins allowed are already low, profits are out of the question.

The necessity for increasing total gross margins by increasing the percentage of imported goods is well understood and is being vigorously pursued. To establish the right contacts for each desired item and work out the best possible deal (discounts, rebates, free goods, advertising allowances, etc.) is a difficult, time-consuming, and patience-trying process. The goal will be achieved in time.

B. Successor Management

Selection, placement, and training of successor management is a high priority and difficult to achieve. Interviews were conducted with a few Tongans regarded as potential candidates, but no decision has yet been reached. Qualified accountants are especially scarce; it may be necessary to advertise in Fiji and even New Zealand, where some Tongans living abroad might be persuaded to come home.

1. Salaries may be a problem. Total annual salaries are at present $20,540. Six persons are now employed without charge to the federation. They are the general manager, from ACDI; the financial manager, from ODA; the merchandising manager and three others from the Peace Corps. All these must ultimately be replaced by Tongans. Management estimates that to attract persons of the ability, training and character needed to fill these positions will require salaries exceedingly high by Tongan standards:

Secretary-manager	$10,000
Financial-manager	6,000
Merchandising-manager	6,000
	$22,000

It will be difficult for the federation committee to swallow salaries at this level; it convulsed over the modest increases proposed at their meeting of February 22.

2. The budget effect will be significant. These counterparts will not all be hired at once - perhaps one in 1983 and two in 1984. The jolt to the expense budget will be severe. The eventual replacement of the Peace Corps volunteers will add perhaps another $5,000-$6,000 to salary costs.

3. Present key people must be retained at least two more years. The contract of the secretary-manager has less than a year to run, that of the financial manager a little more than a year. To have successor management in place and ready to run the business in that time is clearly out of the question. Further, there are many new developments underway which will need the support and guidance of the present experienced managers for some time to come. Requests will shortly go forth to both AID and ODA for continuance of these contracts for another two years.

C. The Primary Societies

1. Member and non-member business.

The merchandising business of the federation is in two categories: (a) delivery, which is essentially with the primary societies, and (b) sales out of the store, which are largely to non-members - small traders and individual buyers. This non-member business makes a valuable contribution to the federation by -

- helping to carry the overhead
- enabling larger purchases, with the economies this brings.
- adding to profits which can be carried to reserves.

There is some concern, however, in the cooperative department and elsewhere, over the fact that this non-member business is at least half, of the total turnover, and that it is growing faster than the member business. The remedy is not to cut back on non-member business but to place more emphasis on working with the primary societies.

2. Communication.

The only present lines of communication between the member societies and the federation are through -

-the elected representatives to the federation committee in their quarterly meetings

-the frequent informal contacts of some of the committeemen (and occasionally other members) with federation management

-the twice-weekly contacts of the driver-salesmen with the storekeepers.

This is wholly inadequate for sustaining membership relations, particularly on Tongatapu. Most of the cooperatives are on the main

island. They are also the weakest in several respects. Many of these cooperatives are not much more than family groups, interested primarily in saving on their own groceries, rather than in providing a cooperative service to the village.

Since the primaries are both the owners and the business base of the federation, strengthening them will benefit the federation. To do this, better communications are needed. Federation management has requested a PCV to do some pioneer work in this area, and the manager plans to participate in it.

3. Management Contract Experiment

A most promising experiment was approved at the recent federation committee meeting. The federation will try out a management contract with four Tongatapu primaries, under which it will provide credit of perhaps $250 for additional shelving and up to $1,000 for increased inventory, and will assume responsibility for managing the business. This means hiring, training and supervising the manager, but does not include bookkeeping. The arrangement should build volume and lead to a more business-like operation. If successful, the plan holds promise of wider application.

D. Financial Aspects

1. General Position

The balance sheet at the end of 1982 shows a strong picture. Current ratio was 1.65:1. The bank debt is being paid off at the rate of $4,200 per annum. The prospective write-off, over several years, of the past losses will greatly strengthen the capital structure. Vanilla will provide no profit, but the withholding of three percent of sales will give the federation the use of several thousand dollars as working capital .

2. Distribution of Profits

The federation, at its recent meeting, deferred action on management's proposal for distribution of profits, summarized as follows:

25% to statutory reserve

Of the remainder, that portion attributable to non-member business to apply toward write-off of past losses.

The residual, from member business, declared as a patronage refund, payable as follows:

40% at once

20% in each of the three following years.

The last seems to be the controversial part. Leaving this out of consideration, and assuming $20,000 profit:

To statutory reserve	$ 5,000
50% attributable to non-member business to reserve to liquidate past losses	7,500
Total to reserves	$12,500
Declare as patronage refund	$ 7,500

If the 60% withholding proposal is adopted, another $4,500 would remain in the federation as a long-term debt.

3. Forecasting

Volume of business times gross margin percentage minus expenses equals net profit. Volume should continue to grow. Expenses are well controlled at this time, but a substantial increase is in sight. Unless gross margin can be substantially expanded, it would seem that the federation will face a continuing tight situation.

The goal of eight percent gross by the end of this year seems reasonable. The manager thinks that this can ultimately reach ten percent. This observer is highly skeptical.

Let us postulate a merchandising and handicraft business two years from now as follows:

Purchases		$2,000,000
Gross margin 8%		160,000
Sales		$2,160,000
1983 expenses	$86,130	
Add for counterparts	22,000	
Replace PCVs	5,200	
	$113,330	
15% to handle growth	16,995	
	$130,325	
Gross margin		$160,000
Total Costs		130,000
Net Profit		$ 30,000

This is a black figure, but not very black for a business of this size - less than one and a half percent. An additional one percent in gross would make for a comfortable position. A gross of 10 percent, which seems unlikely would put the federation in clover.

Merchandising is the base of the federation's business. Handicrafts will grow but is not likely to reach substantial figures. Vanilla will contribute to overhead and ultimately provide its own capital, but no profit. It is highly desirable, not to say imperative, that fish marketing be structured to yield a profit to the federation.

At this stage of development, and in the face of all these uncertainties, it would be neither prudent nor profitable to develop pro-forma financial statements for future years.

E. Facilities to Accommodate Further Development

Expansion of the merchandising business, and particularly development of fish marketing will require some capital expenditures, now and in the next few years. There is a special need in the vanilla industry: government is expected to pass legislation governing the construction of vanilla sheds, which will make most present vanilla sheds illegal.

Management has prepared, and the committee has reviewed a complete schedule of current and future needs, detailed in Appendix E. A request is now being prepared for use of the funds remaining from the original grant for the warehouse, to be used as follows:

Vanilla curing sheds	$ 24,000
Ice boxes to sell or rent to fishermen	10,000
Commercial retail freezers	6,000
Large freezer for Tongatapu warehouse	15,000
Facilities related to management contract with primary societies	5,000
	$60,000

This request is highly recommended by the evaluator. Requests will be forthcoming both to AID and other potential donors, as needs are clarified and plans develop.

VII. WHO BENEFITS?

1. The first and principal beneficiaries of the project are the members of the primary societies at the village level, who are being provided an increasingly reliable supply of consumer goods at reasonable prices.

2. Vanilla farmers, who are able to maximize their incomes by using their cooperatives for curing and marketing their vanilla beans through the federation.

3. Craftspeople, mostly women, in the Tongan villages, who are provided an outlet for their handicrafts, and thereby a welcome addition to their income.

4. Fishermen, for whom a marketing system is being built to assure a reliable market for their catches.

At present there are 74 member cooperatives with approximately 2,600 members. Each membership usually represents a family of six or more members. Thus, over 15 percent of the Tongan population is represented by cooperatives.

The benefits these citizens reap by learning to work together are intangible and unmeasurable, but surely very real.

In short, the project produces and can continue to produce benefits to these primary members, almost entirely in rural communities, who are generally among the lowest income groups in Tonga.

VIII. SUMMARY

1. Progress to date, especially in development of the wholesale business, is outstanding.

2. Closer working relationship with the primary societies is essential, for both business and social (cooperative) reasons.

3. The wholesale business can be stable and moderately profitable, but is unlikely to produce the financial underpinning needed in the long term. Any new endeavors must be required to contribute something to profits.

4. Diversification, which is highly desired by several branches of the Tongan government, places a considerable strain on both management and finances.

5. Diversification should nevertheless be pursued, because it offers benefits to several groups of Tongan citizens in addition to the members and customers of the cooperative stores: farmers, fishermen, craftment. And to the Tongan economy.

6. As the business grows and diversifies, additional funds, beyond what can be generated internally, will be required for at least a few more years.

7. It may be desirable at some future date to consider developing a separate organization to handle fish marketing.

8. Finding and placing successor management is difficult but urgent. The shift to Tongan management must not be abrupt.

9. It is essential that the present manager and financial manager be retained for an additional two-year term.

10. The federation can, with continued support and continued good management, provide substantial benefits to Tongan individuals, Tongan society and Tongan economy.

APPENDIX A

Participants in and Contributors to the Project

Member Cooperatives

$15,000 investment in capital shares.

Tonga Government

Grant of $20,000

Tonga Development Bank

Loan of $56,000

Canadian Government (CIDA)

Three-ton delivery truck

British Government (ODA)

Financial manager for two years

Commonwealth Nations (CFTC)

Fish marketing specialist for two years

Christian Aid

$17,000 to start business in agricultural inputs

Foundation for the Peoples of the South Pacific (FPSP)

$1,000 for fishing supplies

New Zealand Government

$1,000 for development of handicraft business

Australian and British Cooperatives

$3,828 for hurricane relief (to the primary societies)

Appendix A (continued)

U.S. Peace Corps

An interim manager and four continuing volunteers

USAID

Through ACDI
$100,000 working capital
$ 85,000 for building construction
$ 6,000 for training needs
Secretary-manager for two years

Through VDC
Fisheries expert to organize procurement and marketing

APPENDIX B

Present Staffing with Annual Salaries Approved February 22, 1983

Nuku'alofa

Secretary Manager	ACDI
Financial Manager	ODA
Administrative Assistant	$1950
Merchandising Manager	PCV
Costing Clerk	1690
Clerk-Cashier	1170
Delivery Manager/Driver	1430
Store Salesman	1300
Delivery Assistant/Driver	1300
Shipping Manager	1690
Accounts Clerk	1300
Handicrafts Manager	1040*
Driver/Salesman	1300
Driver/Salesman	1300
Handicrafts Assistant	PCV

Vava'u

Manager	1690
Sales Clerk	1040
Sales Clerk	1040
Fish Marketing Manager	1300
Construction Supervisor	PCV

Appendix B (continued)

Fish Marketing Specialist	CFTC

Ha'apai

Manager	PCV
Total Annual Salaries	20,540

*Plus 3 percent of sales

Appendix C

Condensed Profit and Loss Budget - 1983

Merchandise and Handicrafts

Sales	$ 1,296,000
Cost of Sales	1,191,050
Gross Margin	104,950
Other Income	3,000
Total Trading Income	107,950
Less direct expense	66,960
Operating Profit	$ 40,990
Less Administrative Expense	19,170
Net Profit	$ 21,820
Gross profit	8.3% of purchases
Total Expense	6.3% of sales
Net Profit	1.7% of sales
Rate of Inventory Turnover	6x per annum

Appendix D

Persons Interviewed
(Other than TCF Personnel)

Richard Greenslade - Registrar of Cooperatives
Fonongaika Tuipeatau - Assistant Registrar of Cooperatives
Ron Vea - Assistant Secretary, Ministry of Labour, Commerce and Industries
Kerry Jowett - Chief Manager, Bank of Tonga
Geoffrey Schorr - Peace Corps Director
Lisiate "Akolo - Managing Director, Tonga Development Bank
Tomasi Simiki - Director of Agriculture
Clifford Ratcliff - Principal Fisheries Officer
Afu Matoto - Secretary of Finance
'Apolo Lufe - Chairman, TCF Committee
Hama Na'ati - Treasurer, TCF Committee
Paula Lavulo - Acting Director of Planning
Bernard Coleman - British High Commissoner
Baron Vaea - Minister of Labour, Commerce and Industries
Kelepi Tupou - Chartered Accountant and Import Agent
Kevin Makin - Project Economist, Central Planning Department

Visited Primary Societies:

Faingamalie
'Ahiohio
Uasila'a
Vai-Ko-Likisia
Ha'asini/Hamula

Attended Meetings of:

Tonga Cooperative Federation Committee

Appendix E

Future Development Needs

WHOLESALING ACTIVITIES

		Estimated Cost	Suggested Financing
1.	Larger delivery truck for Tongatapu, present truck to be sent to Vava'u.	$25,000	?
2.	Two-cab pick-up truck for Tongatapu, for both passenger and light freight use	9,000	Internal
3.	Large freezer for Tongatapu wholesale store. (This was included in the original plan for the warehouse	15,000	ACDI/USAID
4.	Extension or building of additional store for Vava'u (Not required for 1-2 years)	30,000	?
5.	New warehouse/store in Tongatapu (Not required for 2-3 years)	100,000	?
6.	Working Capital for loan funds to give management assistance to primary societies:		
	*Immediately for four societies	5,000	ACDI/USAID
	*Potentially for other societies in one year	20,000	?

FISH MARKETING

1.	Commercial Retail Freezers 1 for Tongagtapu	4,000	USAID/ACDI
	1 for Vava'u (for W/s and retail fish sales)	2,000	USAID/ACDI
2.	Ice boxes for sale or rent to fishermen (20 at $500.00 each)	10,000	USAID/ACDI
3.	Two and one half ton chip ice machines for Vava'u	35,000	?

ppendix E (cont.)

For Tongatapu in one year	38,000	?
. Freezer for 'Eua	18,000	?

ANILLA MARKETING

ssistance to Vanilla Cooperatives to uild new curing sheds Vava'u 5-7 sheds at 3,000 each (represents maximum 25% ssistance)	18,000	USAID/ACDI
uku'alofa 1-2 sheds at $6,000 each epresenting 50% assistance	6,000	USAID/ACDI

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*This item has not be discussed with the Management Committee

Note 1: Requests for extension of fish marketing and farm supply marketing activities, made to other potential donors, have not been included in the above list.

Note 2: As fish marketing expands to reach the exporting stage, as much as $50,000-60,000 working capital may be needed.

Note 3: A considerable amount of smaller office and store, equipment is expected to be purchased with internal funds in the next two years.