

Letters, Testimony and Statements, Comments

**Statement of Paul Hazen
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Before the
Senate Subcommittee on Antitrust, Competition, and Consumer Rights
Hearing on
*Hospital Group Purchasing: Lowering Costs at the Expense of Patient Health and
Medical Innovation?*
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NCBA is pleased to submit testimony to the Subcommittee on Antitrust, Competition and Consumer Rights on the role of purchasing cooperatives in promoting the survival of small businesses in the U.S., and on the structure of these cooperatives.

NCBA is a national membership association, based in Washington, DC, representing cooperatives of all types and across all sectors of the economy. Our members include farmer co-ops, childcare co-ops, credit unions, housing cooperatives, health care cooperatives, small local food co-ops, mutual insurance companies, rural electric cooperatives, and purchasing cooperatives. VHA falls into this last category. It is a purchasing cooperative owned by non-profit community hospitals. It pools the purchasing power of its members, allowing them to secure lower prices on medical supplies.

NCBA's mission is to develop, advance and protect cooperative enterprise. NCBA also operates cooperative development and civil society programs in 16 developing countries. We are committed to co-ops because we believe they are the key to improving economic opportunity for people throughout the world.

NCBA does not wish to take a position on the underlying issue before the Committee today. But we do want to share with the Committee some fundamentals about purchasing and other cooperatives, how they operate, what constraints they face, how they differ from investor-owned buying groups, and why they are so critical to the survival of small businesses or non-profit community hospitals, in the case of VHA and its majority-owned subsidiary Novation.

As I'll explain shortly, Novation's practice of charging fees of its vendors is not an unusual or unique practice for purchasing cooperatives. Indeed, this practice is not only commonplace, it is often critical to the survival of the cooperative.

Before providing more detail on how purchasing cooperatives operate, I'd first like to outline some background on the cooperative business model.

Purchasing cooperatives are, like other cooperatives, businesses that are owned and democratically governed by their members. Today, there are approximately 48,000 cooperatives in the U.S. Looking at agriculture alone, in the year 2000, there were approximately 3,300 farmer co-ops with 3.1 million farmer-members and combined revenues of almost \$100 billion. These revenues are an indication of the substantial positive impact cooperatives have had and continue to have on our country.

There are four basic types of cooperatives:

- * **marketing cooperatives**, which include most farmer cooperatives, help their members aggregate their products and pool their selling power in order to realize better prices in the marketplace;
- * **consumer cooperatives**, which include credit unions, food cooperatives, mutual insurance cooperatives, housing co-ops, rural electric cooperatives and others, sell products or services to their member-owners;
- * **worker cooperatives**, which are 100 percent owned and democratically governed by their employees; and
- * **purchasing cooperatives**, which help their members pool their buying power to secure lower input costs that help them operate their businesses more cost-effectively and compete against larger competitors. VHA Inc., which is the majority owner of Novation, falls into this last category.

Though they operate in diverse sectors, cooperatives share fundamental features.

First, they are all owned, democratically governed and controlled by the people who buy their goods, or use their services, not by outside investors. In simpler terms-the customers are the owners. That means the co-op members democratically elect the board of directors from within the membership. The board oversees the operation of the co-op, hires and fires the CEO, and governs the organization. It also means that the cooperative is directly accountable to its customer-members, not to outside shareholders. Other types of businesses may make this claim, but only in a cooperative is it literally true.

Second, at the end of the year, the net earnings of a cooperative are returned to the members on a patronage basis. That is, each year, the member receives a "patronage dividend" that is proportional to the amount of business he or she has done with its cooperative. This is true of all cooperatives. It is best illustrated by the largest consumer cooperative in the nation, Recreational Equipment Inc., or REI, an outdoor equipment retail cooperative owned by 1.8 million members.

If REI has net earnings at the end of the year, the majority of those net earnings (about 85 percent, according to the co-op) are returned to the members in the form of a patronage refund. At the end of each year, each REI member receives a patronage dividend that is a percentage, usually about 10 percent, of the amount of purchases made by that member during the year. Patronage dividends are a key component of cooperatives. Net earnings go to the member-owners, not to third-party investors. VHA follows this same approach, providing dividends to its member and participating-patron hospitals based on the amount of business they conduct through the co-op.

It is also common practice for cooperatives to reinvest a portion of their surplus revenue back into the business. Because the business exists solely to serve its member-owners, members have a vested interest in ensuring the cooperative remains strong, develops new services and continues to grow and compete. Rarely is a co-op able to return all of its net earnings to its members and remain successful.

As many members of this committee are aware, cooperatives have played a key role in the development of the nation's rural economy, allowing farmers throughout the country to combine their marketing power to secure better prices for the commodities their member-owners produce. It became clear early in the 20th century, that without the power of a cooperative, farmers were powerless to negotiate reasonable prices from food processors and

manufacturers. Cooperatives like Associated Milk Producers Inc. in the Midwest, and Cabot Creamery Cooperative in the Northeast were formed specifically to ensure the economic survival and well being of their farmer-owners.

Similarly, non-agricultural purchasing cooperatives have formed over the last several decades to help their members-usually independent business owners-secure better prices from suppliers and reduce costs in an increasingly competitive and consolidated marketplace. These co-ops represent one of the only means of survival for small businesses. Simply put, purchasing cooperatives pool the purchasing power of many small businesses to create the buying power of a large market player. By allowing small players to survive, these co-ops protect local economies where small businesses operate and ensure the type of innovation that smaller firms bring to our national economy.

Although it is not generally known, purchasing cooperatives are prevalent in our economy. The largest floor covering retailer in the world, Carpet One, is a purchasing cooperative made up of individual owners of floor covering stores in hundreds of communities throughout the U.S. ACE Hardware and TruServ are purchasing cooperatives of independent hardware store owners. The hardware purchasing co-ops help the independent store-owner members compete with giants like Loews and Home Depot by amassing the purchasing power of a chain while retaining the independence of their members.

Owners of fast food franchises, like Dunkin' Donuts, Kentucky Fried Chicken, Taco Bell, Pizza Hut and Subway have formed purchasing co-ops among themselves so that they are not held hostage to the franchisor's prices for the inputs the franchisee is required to buy. Those are some well-known brands, but hundreds of other lesser-known purchasing cooperatives provide similar services for their members.

Independent Pharmacy Cooperative, based in Sun Prairie, Wisconsin, is owned by independent drug store owners around the nation. It helps them purchase pharmaceuticals and over-the-counter products at lower prices, allowing independents to compete with mass merchandiser Wal-Mart, which poses a serious threat to the survival of Main Street drug stores.

Just last year, a purchasing cooperative of independent specialty bicycle retailers formed to help these business compete against mass retailers and gain greater buying power and better prices from bicycle equipment distributors. The co-op helps members, like Wisconsin retailers Wheel and Sprocket and Williamson Bicycle Works, compete in an industry known for its tight margins.

A cooperative of drywall distributors, known as AMAROK, began with seven small distributors trying to compete with investor-owned hardware and building supply chains, and now has hundreds of members around the nation. Together those members now move more drywall than Loews and Home Depot combined. There are hundreds of other examples.

Each of these purchasing cooperatives exists to protect and promote the businesses of its member-owners. Similarly, VHA was formed in 1977 to help non-profit hospitals amass purchasing power and protect themselves from takeovers by health care giants. Small non-profit hospitals didn't create the "bigness" situation, but they had to respond to it if they were going to survive. They did that in the only way they could - by forming a purchasing cooperative that gave them the critical mass they needed to compete.

It's important to note that there are few business entities that embody the spirit of democracy of a cooperative. Most co-ops are governed on a one-member, one-vote basis, and every member

has an opportunity to run for the governing board. Members unhappy with the operation of the cooperative have an opportunity to do something about it.

Just last September, *INC Magazine*, the leading publication for entrepreneurs, featured purchasing co-ops as a key tool for the survival of independent businesses. I've attached the article, with permission from the publisher, for inclusion in the record. The writer, Susan Greco, contrasted the new trend toward purchasing cooperatives against what has historically happened to small businesses-acquisition by larger market players. She described the phenomenon like this: "The old strategic alliance is Goliath + David. The new one is David + David + David + David."

This metaphor aptly describes the purchasing cooperative phenomena and the effort of non-profit hospitals to protect themselves and their non-profit status from the trend towards buyouts by large, for-profit health care providers.

I want to take a moment to talk a little about the way purchasing cooperatives operate and finance their businesses. The way VHA operates, through its purchasing agent Novation, in terms of charging vendor fees and negotiating preferred supplier arrangements, is neither unique nor unusual. Both are common and necessary practices for many purchasing cooperatives.

Though some purchasing cooperatives actually take title and possession of the products their members buy, and distribute those products themselves, increasingly, new purchasing co-ops instead negotiate preferred-vendor arrangements with suppliers to secure lower prices for their members. Members then purchase directly from the supplier. By negating the need for distribution facilities, this model allows the cooperative to operate at lower cost for its members. Still, all cooperatives need an infrastructure to provide services to their members. That costs money. They need purchasing specialists, marketing specialists, educators, accountants, lawyers, communications specialists and they must cover their basic operating costs.

Cooperatives face a substantial barrier that investor-owned businesses do not encounter. Because they are owned and controlled by their members, they are significantly limited in the amount of outside investment they can accept to start and run their businesses. Bringing in outside investment dilutes cooperative ownership and member-control, defeating the purpose of forming a purchasing co-op. That means the members must capitalize the business themselves. For independent business owners and non-profits, that can be a substantial barrier. They simply don't have enough equity capital to start and operate the business.

Depending on the structure of a purchasing co-op, membership dues alone are not enough to run the business. And if many purchasing co-ops attempted to operate on membership dues alone, the cost of membership would be prohibitive for most independents and non-profits. By creating high barriers to membership through costly dues structures, the co-op would be prevented from amassing the buying power it needs to negotiate lower prices for its members.

That is why many purchasing cooperatives, including VHA, charge fees of their preferred vendors. Though the structure of those fees varies from co-op to co-op, without them many purchasing cooperatives could not run their business or serve their members. The fees, which are sometimes called rebates, help cover the operating costs of the cooperative and any excess revenues generated by the fees that are not needed for reinvestment in the business are distributed to the member-owners as patronage dividend in proportion to their purchases. Members benefit from both lower prices and increased income.

It is also not unusual for purchasing cooperatives to negotiate sole or limited supplier contracts with vendors of products their members buy. Such contracts can provide cooperatives with leverage to negotiate the best prices for their members, and provide suppliers with the incentive to agree to those prices. However, there are few cases in which members of purchasing cooperatives are required to buy *only* from the vendors with whom the co-op has a preferred-supplier arrangement. Generally, as in the case of VHA, members can buy from any supplier they want.

In addition, in most cases, the members, as owners, are directly involved in recommending and selecting the suppliers with whom they wish to negotiate preferred-vendor arrangements. That's all part of the democratic governance-member ownership and control-of cooperatives.

In many market niches, for-profit, investor-owned corporations have attempted to "roll-up" independent businesses, allowing the corporation to develop the scale of a national chain. In most cases, the corporation's new ownership of what were once independent business results in a reduction of service, innovation and profit. By contrast, a purchasing cooperative is driven and controlled by the independents, and the co-op allows those independent businesses to grow, thrive, and innovate.

Cooperatives have served this country well. They enable their members to work together on joint endeavors while still maintaining their independence. They step in where the marketplace has failed. They provide their members with ownership and control over the cooperative business which operates solely to serve them. And, in the case of VHA, they give nonprofit hospitals a way to solve economic problems, and continue to provide quality health care to the communities in which they operate.

NCBA understands the concerns of small businesses that manufacture medical devices. We recognize some of the market barriers they face as small players seeking market access in a highly competitive and increasingly concentrated industry. But cooperatives represent a solution for them in the marketplace as well.

Small manufacturers of medical devices may want to consider following the example of the nation's farmers who formed cooperatives to increase their bargaining power with large buyers. Medical device manufacturers, too, can come together to form, not a purchasing cooperative, but a marketing cooperative that pools their selling power and gives them greater leverage in the competitive health care industry, while allowing them to retain ownership and control of their businesses. A marketing cooperative could enhance the bargaining power of medical device manufacturers with large buying institutions.

"David + David + David + David" is a market-based solution tailor made for the entrepreneur seeking business success while maintaining independence.

Thank you for the opportunity to submit testimony for the record.

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