Patronage Refund Systems That Work

BY ELIZABETH ARCHERD

One of the great gifts of the cooperative pioneers is the unique way that co-ops handle profit. Profit. Say this aloud: "Co-op profit is good." Repeat several times.

Natural food co-ops have wrestled since their beginnings with the idea that there is something wrong about co-ops earning a profit. Early food co-ops were prone to minimizing profit—thus reducing their ability to pay for equipment, services, and improvements—by offering generous discounts in exchange for minimal stock or share payments or, even worse, small annual fees. It appears that we thought we needed to bribe people to join the co-op.

Member-owned businesses can generate wealth that is sustainable, equitable, and used in service to the community. Co-ops change the nature of how a business is conducted and serve as beacons of integrity. We should all be exemplars of the deep cooperative tradition of businesses built on the concepts of member equity and equality. We are not about fast deals and cut-rate sales—we are not Sam's Club or Costco!

The traditional cooperative way of handling surplus income (an old co-op term for profit) puts the needs of the many before the needs of the few. Additionally, patronage refund systems keep control of profit earned by well-run co-ops in the hands of co-op members.

A cooperative board's primary task is to ensure the financial soundness of the co-op. Among other things, that means distributing only what the co-op can afford. For start-up co-ops and those in the midst of major projects, this may mean that cash distributions to the members are limited to 20 percent. That is the minimum required by Internal Revenue Service code in order to shelter from taxation all member-generated profit in a given year. Distributions can be higher as business stabilizes.

Patronage refunds are a return of surplus profit, the extra the co-op does not need to retain while still effectively meeting member needs. Distribution is based on each member's patronage of the business. Effectively, members get back any excess profit generated by their own purchases.

There follow five examples of co-ops that distribute patronage refunds, with notes on why and how these co-ops adopted and adapted this time-honored practice—the real cooperative way.

Good Foods Co-op, Lexington: Building a Strong Foundation

For years, dating from the 1970s, Good Foods Co-op was a Kentucky non-profit corporation. Annual dues of $15 bought members a 5 percent discount on purchases. Annual fees engendered no real sense of ownership and were taxable income for the co-op—meaning that Good Foods did not even get to keep all $15 for its capital base. In 2002 the Good Foods board proposed to reincorporate as a Vermont co-op. The transition was supported by a membership vote and became effective on January 1, 2003.

While board and management were solidly behind the change, they knew that the views of the membership were susceptible to doubts among the staff. The co-op hired a consultant (yours truly) to teach employees about the advantages of equity-ownership and patronage refund systems. Staff members were reassured by hearing about the experiences of co-ops around the country. To visualize the difference in the membership structures, we used the image of houses built on a pile of pebbles (small annual fee) versus concrete blocks ($200 share purchase).

Once staff members were confident and positive about the change, management moved ahead with a comprehensive communication plan for the members, who approved the change by an overwhelming margin. Owner benefits now include NCGA coupon books and Good Foods Owner Discount Days, but the primary benefit is the patronage refund in profitable years.

Good Foods had nearly 5,000 members under the dues-for-discount system. After changing to equity, ownership was at 1,425 by year-end 2003. At the time of my 2008 interview with general manager Anne Hopkins, membership totaled over 3,700. Ownership increased 34 percent in 2007 and an additional 22 percent over 2007 from January to May 2008—an amazing 70 percent increase in 16 months. The secret? One highly motivated 17-year-old cashier decided to make a point of selling shares. He showed the front end how easy it could be, and the department revamped its procedures.

There was no patronage refund the first year following the change, since Good Foods experienced a loss when Wild Oats opened nearby. For the next two years the board refunded 100 percent of owner-generated profit in cash! More recently, Good Foods refunded 20 percent in cash, retaining 80 percent for a planned expansion. Checks are cut in-house by the accounting department, with supervision and database management handled by the membership manager.

Most years, the general manager recommends a percentage of cash refund for board consideration. Last year the board took a straw poll of the owners about how much to distribute, and the overwhelming response was to retain 80 percent for the co-op's expansion.

Good Foods Co-op has built a solid foundation and is poised for more growth. With owners who have embraced ownership and reinvestment concepts, it will be exciting to watch this little co-op that could over the next several years.

Wedge Co-op, Minneapolis: Debt Free, Ready for Opportunity

The Wedge Co-op has sent its members a patronage refund every year since 1990—over $2.5 million in cash since 2002. Open since 1974, the Wedge originally required members to work for the store in some capacity in exchange for discounts. As the volunteer pool shrunk in the mid-1980s, board members researched reconsidered co-op traditions and practices. The board increased the share purchase requirement and made member labor optional, expanding the membership and setting the stage for future growth.

After several reorganizations, the current system was adopted in 1989, in preparation for building a new store in 1991. Central to the plan was the patronage refund system, which would keep the board of directors in charge of the growing percentage of co-op profit that was generated by sales to member-owners.

After each annual audit, board and management assess plans for the coming year. A formula is then applied to determine the cash portion of the refund. The cash portion has been as little as 22 percent and as high as 60 percent. Checks are cut in-house and mailed to members with a letter from the board. The check stubs detail each member's purchases and the cash portion of the refund and also serves as the record of non-cash, non-voting stock that represents the retained portion. Checks are mailed in November, and many members use them to buy Thanksgiving groceries.

The Wedge board of directors has chosen to give low cash returns in years immediately following expansions, preferring to use the extra cash to retire loans. As a result, the co-op has no long-term debt and has been in that enviable position for a number of years. Because of its strong financial position, in the past three years the co-op tripled its wholesale warehouse operation (which delivers perishable products in five states), started an online store and bought an organic farm.

The member-owners vote every year on charitable distributions, amounting to tens of thousands of dollars, to non-profit organizations with missions that align with the co-op's values. Additionally, along with other Twin Cities co-ops, the Wedge funds an educational program that pays two teachers to deliver innovative lessons about food and agriculture in area schools.

With 76 percent of sales to members, the patronage refund system allows the Wedge board and management to retain control of 76 percent of the profit—a considerable resource for advancing co-op values and services.

THREE RIVERS MARKET
Knoxville's Community Food Co-op

Three Rivers Market, Knoxville: Turned Around and Poised for Growth

The co-op opened in 1981 and was the only food co-op in the state of Tennessee. Although incorporated as a non-profit, it operated as a for-profit business. Annual $25 dues (free for seniors) bought the members a 5 percent discount on every purchase. For years the co-op gave out twice as much in discounts as it collected in dues. It was truly more supportive of the co-op to shop without joining, unless one joined and did not shop!

In April 2005, Three Rivers Market became a Minnesota cooperative and adopted an equity-based system. It took several years to make that change. Jackie Arthur started as general manager in 2001 and realized that Three Rivers Market was not truly a cooperative. The board considered adopting cooperative status in preparation for an expansion. Once the board was in agreement, they pushed the structural change through fast.

After the switch from "members" to "owners," Three Rivers Market doubled co-op ownership in three years! Owners feel that they are offered more than they were as members of a club. The financial position has changed dramatically: owner equity went from $0 to over $86,000 after three years.

The new system requires members to purchase one $25 share per year. Eight shares are required for participation in the patronage refund system (paid in full is called Fair Share). After year nine, members still have to buy one share a year, to allow ongoing accumulation of capital for the co-op. A member may buy eight shares this year, get access to the patronage refund, and not have to purchase shares again until year nine.

Prior to the equity change, Three Rivers Market was barely profitable. The co-op became strongly profitable immediately after the change and has distributed a patronage refund every year so far. Stable and growing, Three Rivers Market is now planning its expansion, with the three years of data as a “real co-op” needed for the pro forma. Sales are strong, as local and organic food gain credibility in their area.

Because Three Rivers Market organized under a relatively new form of cooperative statute, its method of distribution is unusual in the food co-op world. Fifteen percent of Three River’s total profit must be returned every year. So far, they do not have enough Fair Share members to generate 15 percent of the profit, so the required 15 percent is distributed among the Fair Share owners.

Outpost Natural Foods, Milwaukee: Turning Profit Into More Stores

Outpost was a pioneering natural foods co-op, begun in 1970. It operated according to the customs of new food co-ops of the times. Owners received discounts of 5 percent on most purchases. When serious financial troubles hit in 1990, Outpost started searching for a more stable structure.

They took their time! Jessie Singerman, CEO of co-op wholesaler Blooming Prairie Foods, in Iowa City, suggested in 1993 that they consider a patronage refund system. The co-op started informing owners in November 1995 that the switch to a patronage refund system was coming in fiscal year 1997.

The long communications process with owners included education about co-op principles. Members approved the change at an annual meeting that was well attended for that time—about one hundred participants. Predictably, some members who had not attended the meeting were upset about the new arrangement. Even after it was a done deal the dialogue continued in the store, and sometimes managers had to be called to the sales floor to talk to shoppers who were upset.

The redesigned benefits package currently includes coupons at local businesses, Owner Bonus Buys, Get Fresh Sales (member-only specials in perishable departments), Owner Appreciation Days, and Bonus Cards. A unique feature at Outpost is the Early Bird Rewards Program, an incentive program that involves an early return on the patronage refund, distributed on a quarterly basis. The co-op sends out postcard coupons, based on patronage for the previous quarter. Owners have to spend a certain amount of money to earn a coupon.

During 10 years since the change, Outpost has had a good financial track record. The co-op sent out patronage refunds amounting to 20 percent in cash of owner-generated profits each year until 2000, when it opened a second store. And in 2003 there was no profit due to a major remodeling. The most recent distribution was in 2004.

Outpost opened a third store in 2005. No checks have been sent for the past three fiscal years, but the co-op has weathered increased competition and several expansions much better than it would have if it had been giving discounts on every purchase. The co-op is keeping its head above water, and profitability is in sight.

Rather than revisit the decision of how much to distribute each year, Outpost uses the IRS requirement as its guide. In profitable years the co-op returns 20 percent and retains 80 percent of owner-generated profit. It is a wonderful example of using co-op profit to increase access to good food, and to the cooperative way of doing business.

City Market, Burlington: Refreshing the Members, Renewing the Community

Located in northern Vermont, Onion River Co-op started in 1976. Several years ago the co-op moved and expanded from its small store to downtown Burlington, at which time it started doing business as City Market.

In the past, the co-op distributed coupons to members every year as a primary financial benefit. While the option of sending patronage refunds was in the bylaws, loan agreements that financed the move into the bigger store gave lenders the final say about actually sending a patronage refund to members. These lenders gave the green light last year but still want to approve the percentage that will be sent in cash.

To thank co-op members for their support, the board of directors decided to start the patronage refund program by eliminating the coupon program in December 2007 and giving a refund based on half a year of purchases, beginning January 2008. The board communicated the coming changes to members through newsletter articles and at meetings, and the transition went pretty smoothly.

City Market also added a member benefit at the same time: a bulk water machine (reverse osmosis) providing the water free to the members! That helped sweeten the loss of the coupons.

While the co-op follows standard procedures to track member sales, and the board (with lender approval) makes the decision about how much the co-op needs to retain, the City Market approach is unique in how it plans to deliver the money. The co-op sends out a notice to members that patronage refund checks are available at the store. Members can come in for checks instead of having them mailed. The co-op has established ties with several philanthropic funds. At the store, a member can take the check or sign it over to any of the funds. One fund has a mission of supporting local food systems. There also is a childhood hunger initiative and a fund with an international component.

The first refund will be this fall, at which point the board can assess how popular these options are among the membership. This will be an interesting experiment in offering members on-the-spot opportunities to use the distribution of their co-op profit for charitable purposes. ■

TALKING POINTS

EXPLAINING PATRONAGE REFUNDS: HOW TO TALK WITH MEMBERS AND POTENTIAL MEMBERS

- The amount of the refund varies from year to year based on: how much profit the co-op made and any upcoming projects.
- The decision about how much to return in cash is made by the cooperative's board of directors.
- In the past XX years, the cash return has ranged from X percent to X percent of purchases. (Last year it was X percent.)
- We hope returns will continue to be in this range, but there is no guarantee, since it is based on our profitability each year, and takes into account plans for [Choose from what is coming up, in process, or just completed at your co-op, such as: a new roof, truck, heating system, equipment, remodeling, etc].
- A patronage refund is not guaranteed—the store has to make a profit to send a refund.
- The more you shop, the more you get back, but all members get the same percentage.
- The percentage we hold back from distribution stays in the co-op. It belongs to the members as a group, not as individuals, and becomes part of what we own together.

A great way to talk about this is based on your own experience as a member. This can help people who think that co-op membership is a "too good to be true" sales pitch. Tell it like a story: "I plunked XX bucks down for membership in [year] and earned that back within a year [or two] of shopping here. I've already been paid back for my membership several times over."

Ways to characterize patronage refund:

- We're all in this together.
- We share the good times and bad.
- It's like recycling profit.
- Co-ops are the original "community reinvestment" program.
- We keep profits local.

Lastly, a patronage refund is just that—a refund. Co-op membership will not fund your retirement! It is an investment in community ownership and all things cooperative.