Volume V, Number 16 Monday, November 30, 1998

From the Desk of R. Lewis Dark...

THE DARK REPORT

RELIABLE BUSINESS INTELLIGENCE, EXCLUSIVELY FOR MEDICAL LAB CEOs / COOs / CFOs / PATHOLOGISTs

R. Lewis Dark: What's Next
For Regional Laboratory Networks?.................................Page 1

Health Insurance Costs
Begin New Upward Spiral...Page 2

Medicare Refund Request
Issued To AmeriPath, Inc..Page 4

Analysis & Insight: PPM Giant MedPartners
Exits Doctor Management...Page 6

Washington's PacLab Network
Succeeds With Standardization....................................Page 9

The Dark Index: Improved 3rd Quarter
Posted By National Laboratories..................................Page 15

Intelligence: Late-Breaking Lab News..........................Page 18

Restricted information, see page 2

Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher

What's Next For Regional Laboratory Networks?

SINCE THE CONCEPT OF REGIONAL LABORATORY NETWORKS burst on the scene in 1995, I have ardently believed in their potential to help hospital laboratories remain relevant in the world of managed healthcare. The early victories of Pittsburgh's **Regional Laboratory Alliance** and San Francisco's **Bay Area Hospital Laboratory Network** inspired all of us.

Indeed, in 1995, 1996, and 1997 there was a flurry of activity throughout the United States to organize similar laboratory networks. But potential did not convert into reality. Pittsburgh's network died two years ago. San Francisco's network withered and barely clings to life. More attempts to organize a viable network have failed than succeeded.

With the hindsight of these years, I would like to point out a simple truth. The economic potential of a properly-designed regional laboratory network is unquestionable. Given this fact, I believe that the "regional lab network" movement is ending one market cycle and about to embark on another.

In this next market cycle, an emerging class of regional laboratory networks will become operational. They will be successful, because they studied and copied the handful of regional lab networks which got it right during the first market cycle. They will copy the best aspects of **PacLab Network Laboratories** in Washington; of **Joint Venture Hospital Laboratories** (JVHL) in Detroit; of **Middle Tennessee Healthcare Network** (MTHN) in Nashville; of **Regional Laboratory Alliance** in Kansas City; and other solid operational networks.

In the coming year, THE DARK REPORT will write about these networks. Like PacLab, they will blend the best of local commercial laboratory resources with those of participating hospital laboratories. They will incorporate modern business management methods into their operation plan. This new class of networks will go outside the laboratory industry for their executive directors, marketing managers, and sales people.

Most importantly, both the business design and the ongoing management of these regional laboratory networks will make them winners in their service area. As a local laboratory resource, this new class of regional laboratory network will provide competitive laboratory testing services to physicians and MCOs in their service area. In the process, this new class of regional laboratory networks will prove that the movement has come finally come of age. **TDR**

Health Insurance Costs Begin New Upward Spiral

Health premium increases for 1999 reverse multi-year trend of flat or declining costs

CEO SUMMARY: Health insurance costs are climbing again for the nation's employers. Premium increases for 1999 average in excess of 10%. After losing money in 1997 and 1998, managed care companies are serving stiff premium increases to their customers. For clinical laboratories, the impact of these national trends are too soon to predict. But there is no expectation of increased reimbursement for laboratory testing.

HEALTH INSURANCE PREMIUMS for 1999 are again spiraling upward. Benefits consultants report hefty premium increases for all catagories of employers.

"Thirty days ago, the average increase already was 14% to 15%, and just since then, the average has moved into the high teens," observed James Mueller, President of **Frank Haack & Associates**, a health insurance broker based in Milwaukee. "It's not uncommon for smaller employers to now see increases of 30% to 50%."

A recent survey of Fortune 500 companies by **BT Alexander Brown** determined that benefits managers expect to see an average increase of 10.3% in HMO healthcare premiums for 1999. This contrasts with an average increase of 5.9% for 1998.

Experts say that HMOs are aggresively raising premiums in response to their huge losses at the end of 1997 and into 1998. Another factor supporting aggresive premium increases is that, unlike past years, managed care companies stopped slashing prices to employers as a strategy to build market share.

Clinical laboratory executives know that insurance premium increases have been minimal during the years 1994 through 1997. This was the result of employers shifting significant numbers of their employees away from indemnity insurance plans and onto managed healthcare plans. Currently 85% of Americans are enrolled in some type of managed care health plan.

During these years, as employers moved their employees into closed panel-HMOs and similar types of plans,

THIS PRIVATE PUBLICATION contains restricted and confidential information subject to the TERMS OF USAGE on envelope seal, breakage of which signifies the reader's acceptance thereof.

THE DARK REPORT Intelligence Briefings for Laboratory CEOs, COOs, CFOs, and Pathologists are sent 17 times per year by The Dark Group, Inc., 1731 Woodland Terrace Center, Lake Oswego, Oregon 97034, Voice 1.800.560.6363, Fax 503.699.0969. **(ISSN 1097-2919.)**

R. Lewis Dark, Founder & Publisher. Robert L. Michel, Editor.

SUBSCRIPTION TO THE DARK REPORT INTELLIGENCE SERVICE, which includes THE DARK REPORT plus timely briefings and private teleconferences, is $10.80 per week in the US, $11.40 per week in Canada, $12.45 per week elsewhere (billed semi-annually).

the HMOs themselves shrank the reimbursement they offered providers, including hospitals, physicians, and clinical laboratories. This dual trend allowed HMOs to report record profits, at least until the end of 1997.

So it is not surprising that managed care plans are pushing double digit premium increases onto employers for 1999. Given the economic squeeze facing HMOs, predictions are that stiff premium increases are expected in the years following 1999 as well.

HCFA's Annual Report

At the same time that the managed care industry is pushing premium prices upward, the **Health Care Financing Administration** (HCFA) released its annual report on national healthcare costs.

HCFA disclosed that healthcare spending was relatively stable in 1997, with the national bill growing by less than 5% for the third consecutive year. This is the smallest increase since 1960, when the government began keeping these statistics.

Medicare expenditures grew by 4.8% in 1997, staying in line with 1995 and 1996, which increased 4.9% and 4.9%, respectively. Total private healthcare spending rose by only 3.2% in 1997.

In the private sector, hospital care spending increased just 2.9% in 1997. Physician expenditures grew only 4.4%, maintaining a single-digit streak extending back to 1992. Home healthcare agency expenses increased by 3.7%.

Big Pharmaceutical Increase

According to HCFA, the only category that increased by double digits was pharmaceuticals, which climbed 14.1% in 1997 (and 13.2% in 1996). This is attributed to consumer advertising and the introduction of a number of new high-priced drugs.

From the perspective of THE DARK REPORT, these numbers paint a contradictory picture. If spending with healthcare providers, such as hospitals and physicians, increased by less than 3% during 1997, why do managed care companies need to raise premiums by 10% or more for 1999?

It is our opinion that managed care companies, taken as a collective industry, are not yet capable of adding value to the clinical and operational aspects of healthcare. Quite the opposite, these companies tend to suck funds out of the healthcare system to feed their bureaucracies and stockholders.

Charles Peck, M.D., Director of Physician and Managed Care Services for **Arthur Anderson & Co.** in Atlanta, says the same thing in a different way. "They got the easy piece under control by getting [hospital] bed days cut in half. Now comes the really hard work: redesigning the way we deliver healthcare, preventing illnesses, changing bad habits."

Think Critically

THE DARK REPORT recommends that laboratory executives and pathologists think critically about the dichotomy between managed care premium increases for 1999 and the reported changes to the healthcare producer price index in recent years. The disconnect between the two demonstrates the failure of managed care to tangibly deliver its promise of improved healthcare at reduced cost.

But lab executives and pathologists should go beyond that analysis. This dichotomy points to the greatest business opportunity available: using laboratory and pathology data to improve clinical outcomes while reducing cost of care.

Managed care companies desperately need the added value that clinical laboratories and pathologists are capable of providing. As THE DARK REPORT has consistently demonstrated, those labs and pathology practices which create diagnostic services with recognized value usually get paid a lot more money for those services. **TDR**

(For further information, contact Robert Michel at 503-699-0616.)

Medicare Refund Request Issued To AmeriPath, Inc.

Demand for $2.95 million refund causes AmeriPath's stock price to decline by 65%

CEO SUMMARY: Regulators believe AmeriPath's Ft. Lauderdale laboratory submitted claims during 1996 which were based upon improper procedure codes or lacked adequate documentation. AmeriPath "vigorously" disputes the situation. It is still uncertain as to whether this action represents a larger campaign that will target laboratories and pathologists for new issues involving Medicare billing and reimbursement.

PATHOLOGY'S LARGEST PHYSICIAN practice management (PPM) company was hit by a Medicare refund demand of $2.95 million for claims submitted in 1996.

AmeriPath, Inc. of Riviera Beach, Florida announced the news last week. The refund request came as a result of an April, 1997 site audit of the company's Ft. Lauderdale laboratory.

An "Operation Restore Trust" team of federal and state regulators looked at 1996 claims submitted from the Fort Lauderdale site. Apparently the team used a random sample of 30 Medicare claims from 1996 as the basis for the refund request.

Improper Procedure Codes

"Medicare Program Safeguards (MPS)" sent AmeriPath the refund request with a statement that the Ft. Lauderdale facility "accepted payment for services which were either billed using an improper procedure code or were not adequately documented."

AmeriPath "vigorously" disputes the findings of MPS, but declined to return telephone calls from THE DARK REPORT on this matter. AmeriPath states that it has not been given the "opportunity to present its case or be heard on the issues presented."

The day following AmeriPath's November 23 announcement, its stock price fell by almost 65%. In October 1997 AmeriPath stock hit its all time high of $19.00 per share. By the end of last week, share prices were trading around $5.00.

Wall Street analysts reacted with surprise and concern. **Morgan Stanley Dean Witter** cut its AmeriPath rating from "outperform" to neutral. Analyst Robert Lunbeck from **Hembrecht & Quist** also reduced his AmeriPath rating, from "buy" to "hold." He said "If the government prevails, AmeriPath faces potentially serious implications for revenue and earnings. We believe such a worst-case scenario is not likely, but will be at least countenanced by investors."

AmeriPath got additional bad news the following day. On November 25, the New York law firm of **Wolf Haldenstein Adler Freeman & Herz** announced that it was preparing to file a class action lawsuit against the company. The suit will represent purchasers of AmeriPath's stock between October 22, 1998 and November 23, 1998. It claims violations of federal securities laws, centered around allegations that AmeriPath executives issued "false and misleading statements."

Lawsuits such as these are frequently filed immediately after a company's stock price suffers a precipitous and unexpected decline. Regardless of the merits of this particular case, AmeriPath executives will have to spend time and money dealing with it.

Government's Actions

Preliminary indications are that the government's actions against AmeriPath are *not* the first moves in a major audit effort focused on anatomic pathology. On the other hand, government regulators have a learning curve. As they understand more about specific billing practices in one segment of healthcare, they tend to use this knowledge to pursue other providers in the same clinical services area.

Government regulators used knowledge gained in the **National Health Labs** Medicare fraud case of 1993 to eventually accuse every large commercial laboratory of Medicare fraud. For this reason, the AmeriPath case bears watching to see if it leads government regulators to pursue other anatomic pathology providers.

Immediate Response

For AmeriPath, the Medicare refund demand of $2.95 million requires an immediate response. MPS seeks recoupment or refund of this money by December 10, 1998. MPS notified AmeriPath that, should the matter be unresolved, beginning December 20, 1998 it will "offset the alleged overpayment (plus interest of 13.5%) against any pending or future Medicare payments."

AmeriPath may face an uphill battle, regardless of the legal merits to its position. In Medicare cases relating to improper billing for laboratory services, government enforcers generally take a hard line and are intractable in negotiations. Further, the array of onerous penalties which government enforcers can bring to bear on healthcare providers like AmeriPath tilt the appeals process in the government's favor.

Pathologists and clinical laboratory executives should follow the developments in AmeriPath's Medicare billing case. Government enforcers may decide to look for similar violations in other laboratories. TDR

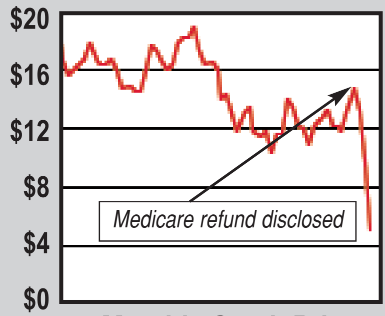
(For further information, contact THE DARK REPORT at 503-699-0616.)

AmeriPath Undergoes The Stock Price Woes

Below is a chart which shows the weekly closing stock price for AmeriPath since its initial public offering (IPO) in October 1997.

Share prices reached $19 as recently as March 1998. As a result of last week's announcement of the $2.95 million Medicare refund request, AmeriPath's shares dropped from the $14 level to under $5, a decline of 65%

Plummeting Share Prices



Monthly Stock Price
10/24/97 Thru 11/27/98

Analysis & Insight

PPM Giant MedPartners Exits Doctor Management

Surprise move by industry leader raises additional questions about pathology PPMs

By Robert Michel

THIRD IN A SERIES

WHAT DOES IT MEAN WHEN the largest companies in a multibillion dollar industry announce that they will "get out" of that business?

That is the question which must be answered after **MedPartners, Inc.** joined **PhyMatrix Corp.** in publicly declaring that they would abandon the physician practice management (PPM) business.

MedPartners announced its decision on November 11, startling Wall Street in the process. PhyMatrix had disclosed its decision in August. MedPartners, with over $6 billion in revenue, is the largest PPM and has agreements with more than 11,000 doctors. PhyMatrix, with 8,000 doctors, has been one of the PPM industry leaders.

Divesting PPM Operations

What will MedPartners and PhyMatrix do after divesting their physician management operations? Those answers are revealing. MedPartners will shift emphasis to pharmacy services. It owns **Caremark**, the drug distribution network it purchased in 1996. Caremark has 53,000 affiliated pharmacies and a mail order distribution center. CareMark has annual revenue of $2.6 billion. It represents 38% of MedPartners' revenue, but 64% of its earnings before taxes.

At PhyMatrix, the emphasis will shift to clinical trials site management organizations. PhyMatrix will use existing hospital and physician clinic relationships to develop this business. "We see clinical trials site management as a fragmented, low penetration, high-growth business," stated Robert Miller, President of PhyMatrix.

Warning To Pathologists

Taken together, these actions by the nation's larger PPMs companies should provide a warning to pathologists: tread carefully when a PPM approaches your practice with an acquisition offer. The marketplace has yet to validate the concept of a physician practice management company.

For clinical laboratory executives, there is a different message. As PPMs cease to be a major player in physician practice management, the vacuum may be filled by hospitals and integrated delivery systems. If this comes about, it will alter how clinical laboratory services are marketed and sold to physician offices.

A physician practice which is owned or managed by the local hospital represents a different sales challenge to a clinical laboratory than a physician practice owned and operated by a PPM with corporate headquarters in Birmingham (MedPartners) or West Palm Beach (PhyMatrix).

PPMs are the market consolidators for physician practices. For that reason, the emergence of PPMs has given clinical laboratories a new marketing and sales challenge. For example, in Southern California, over 4,000 physicians are affiliated with MedPartners. Whenever a clinical laboratory approaches a doctor's office to sell its testing services, MedPartners becomes an additional factor in the sales closing cycle.

> ***"They (MedPartners) are selling into a buyer's frenzy...either the physicians want to buy it back or the local health system has a priority to buy it."***
>
> ***Michael LeConey***
> *Analyst, Security Capital Trading*

For pathologists, market consolidation is a real threat. In just seven years, upwards of 42,000 of the nation's 600,000 doctors have sold their practices to PPMs. This number does not include those physicians who sold their practices to hospitals and integrated delivery systems.

Such widespread activity to consolidate ownership of physician practices finally began to spill over into the pathology profession. **AmeriPath, Inc.** of Riviera Beach, Florida went public in October, 1997 and became the first pathology-based PPM. Since that date, AmeriPath has grown into an organization employing 226 pathologists in ten states.

Pathology is highly-vulnerable to consolidation. Of the 3,300 pathology practices in the United States, more than 67% number three or fewer pathologists. Almost a third of pathology practices represent solo practitioners.

As clinical and operational integration of healthcare becomes a realty, these fragmented pathology practices are destined to become evolutionary dinosaurs. They will be gobbled up by business-minded pathologists who recognized the reality of today's healthcare marketplace and acted accordingly.

Are PPMs The Answer?

But will pathology PPMs be the right market answer to pathology practice consolidation? The jury is still out. Problems seen at MedPartners, **FPA Practice Management**, PhyMatrix and other PPMs have not yet surfaced at AmeriPath.

The newest pathology PPMs, such as **Pathology Consultants of America**, **Pathology Partners** and **PathSOURCE**, are moving slowly in their efforts to build a book of pathology management contracts. Their executives are carefully watching the PPM industry and hoping to avoid the negative experiences of that industry.

Meanwhile, another business model which is gaining strength within the pathology profession is **Pathology Service Associates** (PSA), based in Florence, South Carolina. PSA is a national pathology network organization. It has statewide networks in eight states. Collectively, there are 31 owner practices representing 250 pathologists. With those numbers, PSA actually represents more pathologists than AmeriPath.

"Do Nothing & Wait" Strategy

The rapid growth of both AmeriPath and PSA demonstrates that many pathologists realize that a "do nothing and wait" strategy is unacceptable. Survival in the managed care world requires a proactive business strategy.

Since most pathologists are risk-averse, they find it difficult to deal with the uncertainties of the marketplace. After all, it is difficult to predict what will happen in coming years to each local healthcare market. Which HMO will become dominant? Can individual hospitals remain independent and not go bankrupt?

Will one integrated delivery system outcompete others in the area?

For pathology practices looking at strategic business options, making the wrong choice can be disastrous. However, making no decision at all is even more dangerous.

THE DARK REPORT believes that pathology PPMs will mutate into a different type of business operation. Survivors will be sustained because their activities at consolidating two-man and three-man pathology practices will leave them with a consolidated pathology practice that has market clout within its metropolitan area.

Favorably Positioned

As clinical services undergo extensive integration, THE DARK REPORT predicts that, in the future, pioneers at pathology practice consolidation may well find themselves favorably positioned to provide services, acquire managed care contracts, and build market share. Fragmented pathology practices which resisted consolidation in preference to preserving their independence will be the ones to find themselves locked out of lucrative opportunities.

From that perspective, the problems now plaguing MedPartners, FPA Practice Management, and other struggling PPMs were timely warning to the pathology industry. Pathology PPMs and their evolutionary spin-offs must organize themselves differently if they are to add value to pathologists and bring enhanced services to the clinical marketplace.

How they accomplish this will be determined by three factors: 1) unique differences in healthcare between communities; 2) the organizational structure of the pathology PPM; and 3) management's ability to successfully implement the business plan.

Taken collectively, this means that pathologists need to understand their local healthcare market, choose an appropriate consolidation vehicle, and work with a competent management team that knows how to win. Achieve that, and financial success should follow.

TDR

(For further information, contact Robert Michel at 503-699-0616.)

California Path Group Signs With PCA

Associated Pathology Medical Group (APMG) of Los Gatos, California recently signed a management agreement with **Pathology Consultants of America** (PCA).

APMG is a diversified pathology practice. Its ten pathologists serve three hospitals from an independent histology laboratory in Los Gatos. APMG also contracts to provide medical direction and pathology services to **Unilab's** San Jose laboratory.

PCA is a Nashville-based pathology practice management (PPM) company. *(See TDR, January 19, 1998.)* With the APMG contract, PCA is now involved with eight practices and 80 pathologists in various areas of the United States.

This is PCA's first transaction in a number of months. The company is choosing to move deliberately. Up until now, most of its activities have been centered in Nashville, Memphis, St. Louis, and Denver.

Expect to see PCA sign additional management contracts in the San Francisco bay area in the coming months. The company's strategy is to build a consolidated pathology practice around its core management contract in a region. APMG gives PCA a financial foundation from which to build such a consolidated pathology practice.

Pathologists should see this as a sign that the pathology PPM movement will not go away, despite current financial problems within the PPM industry. Regardless of such problems, the move to consolidate and integrate physician practices will continue and PPMs will have a role in that process.

A TOUGH CHALLENGE FOR REGIONAL LAB NETWORKS

Washington's PacLab Network Succeeds With Standardization

PART TWO OF TWO PARTS

CEO SUMMARY: In part one of this two-part series, we looked at how changes to healthcare in the state of Washington brought about the creation of PacLab Network Laboratories. In this concluding installment, we explore how PacLab is standardizing laboratory operations and information systems capabilities across the statewide network. PacLab's organizers demonstrate that cooperation between independent laboratories brings improved economic and employment benefits for employees at all sites. PacLab's experience also demonstrates that regional laboratory networks can succeed, but only if member labs decide to cooperate and support the network's joint service requirements.

MANY WOULD AGREE THAT THE Achilles heel of regional laboratory networks is their inability to get independent participants to cooperate with standardization efforts.

Such is not the case for **PacLab Network Laboratories**, a network of eight hospital laboratories and one independent commercial laboratory in the state of Washington. This regional laboratory network has achieved an extraordinary level of technical, operational, and information systems standardization.

These standardization efforts were supported by all the participating laboratories because PacLab's leadership made a compelling case for standardization. Further, representatives from all nine laboratories participated in the design and execution of the various standardization initiatives.

"PacLab's organizers recognized that our regional laboratory network could become a tough competitor only if we were able to seamlessly integrate our laboratories into a statewide provider system," said Lawrence Killingsworth, Ph.D., Chief Science and Technology Officer for PacLab. "Given the fact that our constituent laboratories were nine independent organizations, this meant standardizing a variety of technical, operational, and informational capabilities across all laboratory sites."

Killingsworth's comments were made at last May's *Executive War College* in New Orleans. He was describing how PacLab's strategy of laboratory integration was necessary to develop competitive laboratory outreach services.

"During the time required to organize PacLab and bring it into existence, our participating labs began to agree that three things were necessary for PacLab to succeed as a regional laboratory network" explained Dr. Killingsworth. "First, we had to integrate laboratory operations so that physicians, patients, and HMOs in any region of the state would get identical laboratory services from any PacLab member.

"Second, it was important to implement improvements in the member laboratories to achieve maximum efficiencies and to avoid unnecessary duplication throughout the network," he continued. "Third, laboratory testing is still about science. It was important to help each of our members stay at the leading edge of laboratory medicine.

"These three goals were supported by a shared value system," noted Dr. Killingsworth. "Although the notion of shared values can get touchy-feely, it is essential that PacLab and its members have a common vision for their network. Establishing a shared vision was an important step that made our standardization efforts both easier and faster."

Technical Operations Team

To address these goals, PacLab created a technical operations team, with Dr. Killingsworth as Chair and Gail Sorenson as Technical Director. To insure that all interests in the network were represented, each PacLab member provided laboratory supervisors to serve on the technical operations team.

PacLab's goals for standardizing operations across all laboratory sites were ambitious. For that reason, PacLab proceeded step-by-step. "First, we surveyed all our members," said Dr. Killingsworth. "Which tests did they offer? What methodologies and instruments were they using? As you can imagine, we found a fair amount of variability among our member laboratories.

"As this information was collected, we wanted to establish analytical correlation for all major analytes," he added. "We quickly learned that existing test data sources, such as CAP surveys, were not sufficiently sensitive for our purposes.

"That led to a decision that PacLab would act as its own internal survey authority for this phase of standardization," explained Dr. Killingsworth. "We sent a set of samples to all the laboratories for them to assay. When the data was returned, it was statistically evaluated, analyte by analyte. Our goal was to learn which analytes were within acceptable correlations and which were not.

"This information allowed us to create action plans for each hospital laboratory. As you can imagine, each lab had some analytes which correlated and some which did not. The action plan was to bring all our PacLab sites into acceptable comparability."

This was a major undertaking, since PacLab included all high volume outpatient tests in the survey. Analyte correlations were done in the areas of chemistry, ligand assay, therapeutic drug monitoring, urine chemistry, urinalysis, hematology, and coagulation. "In fact, a statewide survey of this type is unprecedented," added Dr. Killingsworth.

"Once we determined existing correlations for individual analytes across all the network's laboratories, each laboratory implemented its action plan," he said. "We then went back and reverified that all the lab sites were within acceptable comparability. This was done more than once and now periodic retesting occurs to all our facilities for major analytes. PacLab also has a standard protocol for corrective action when a particular analyte in a particular hospital lab falls out of compliance."

PacLab's Technical Standardization Areas

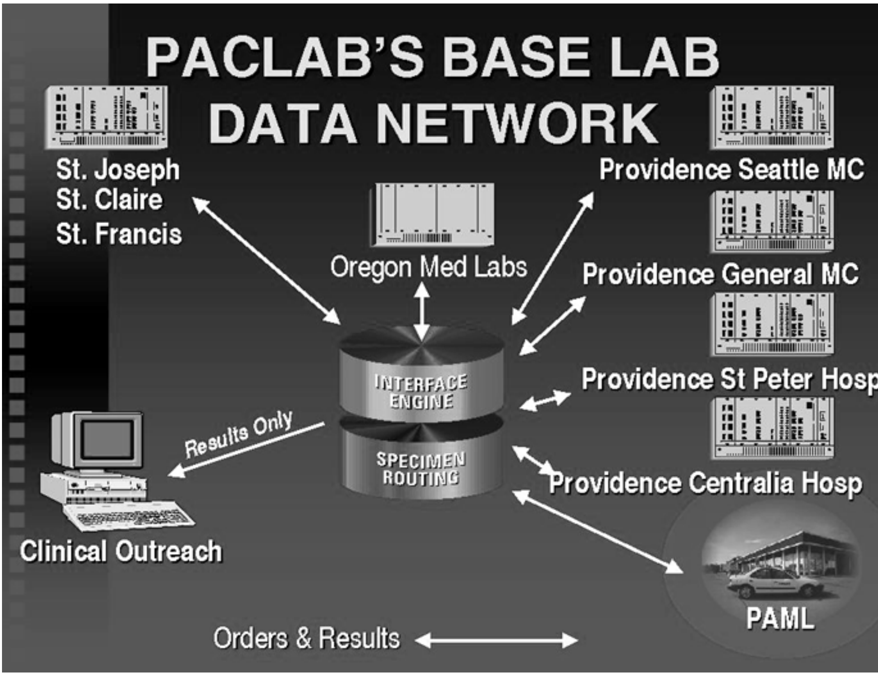
PacLab instituted an extensive standardization program involving all laboratory sites in the network. Few regional laboratory networks have accomplished the level of standardization which now exists at PacLab.

1. **Analytical correlation on all major analytes.**
2. **Optimum and acceptable requirements for specimen collection, transport, and storage.**
3. **Normal (reference) ranges.**
4. **Reporting units**
5. **Fields reported for multi-parameter tests.**
6. **Interpretive comments.**
7. **Formulas for calculation of derived parameters.**
8. **Quality control procedures.**
9. **Proficiency testing programs.**
10. **Record-keeping protocols.**
11. **Introduction of new methods and equipment.**

No New Instruments

One interesting aspect about this standardization project is that members were not required to get new instruments. "We were fortunate that a couple of major instrument manufacturers were used at most of our sites. But we still have variability of instrumentation within PacLab.

"In fact, we think it is important that any regional laboratory network, seeking to put out the same 'brand' of testing, do this type of study," advised Dr. Killingsworth. "It is vital that your network establish the fact that all participating laboratories are putting out



the same values for calcium, progesterone, and so forth, whether or not they use identical instrumentation.

"Another major effort was our reference range study," he went on. "We wanted to establish a statewide PacLab reference range. We accomplished this by collecting specimens at each of the partner hospitals, based on NCCLS guidelines for normal range studies. An analysis was done on the pooled data from all member hospital laboratories.

"Because we had already done our correlation studies, we understood variability (or lack of variability) across our member sites," said Dr. Killingsworth, "our statistical analysis was much easier. We did parametric and non-parametric statistical analysis of the data and developed tentative reference ranges.

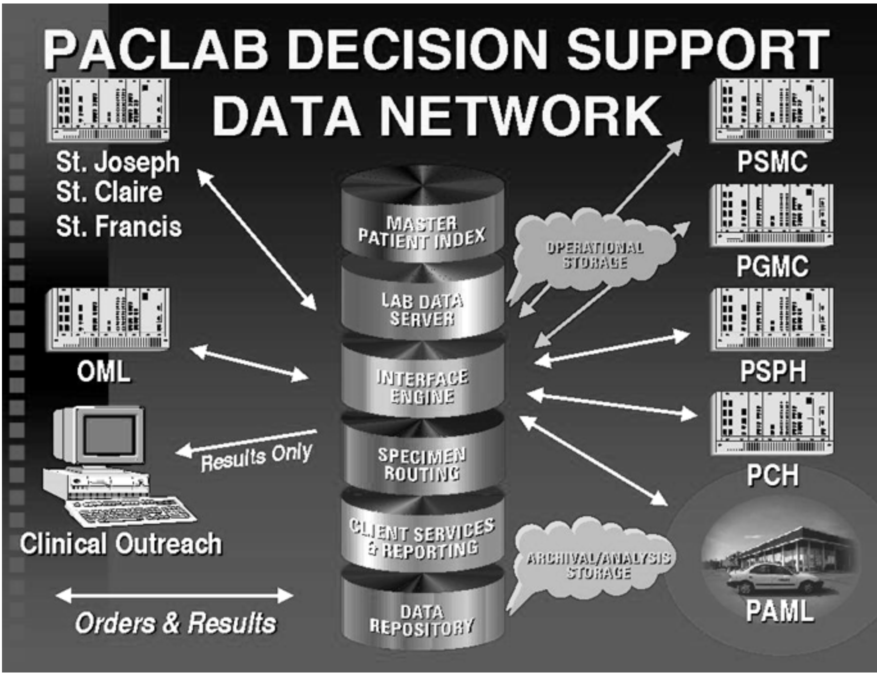
"These were taken to the technical operations committee," he stated. "We had a data base of 40,000 outpatients. When we superimposed our tentative reference ranges over this data base, it allowed us to make some adjustments.

"As a result of this effort, we were able to develop statewide reference ranges for all our major analytes," noted Dr. Killingsworth. "I believe a study of this type is unprecedented and it is a source of pride for the laboratorians who worked on this project."

PacLab next developed network-wide toxic ranges for therapeutic drugs. A subcommittee of PacLab's microbiologists are currently at work on standardization of infectious disease testing. "They have collected information on our high volume outpatient micro tests," noted Dr. Killingsworth. "They are well along the way to standardizing all of our protocols for high volume outpatient microbiology testing."

Lab Information Systems

Information systems is another area receiving major emphasis at PacLab. Because of the huge acquisition and implementation costs required to move to a common information system platform, PacLab chose another approach.



"The basis of our data network is an interface engine and a specimen routing computer," said Dr. Killingsworth. "Our information systems partner is **Sunquest**. They worked closely with PacLab's members to develop our IS capabilities.

"We wanted the interface engine to allow computers at the member hospitals to talk with each other and with the computer at **Pathology Associates Medical Laboratory** (PAML)," he continued. "PAML is the network's reference laboratory. The interface engine uses an HL-7 client protocol and TCP/IP connections between laboratory sites."

Achieving interconnectivity through the interface engine was the first objective in PacLab's IS strategy. "Phase one allowed us to offer client services and test reporting in a consistent manner at all member laboratories," explained Dr. Killingsworth. "The next phase involves stacking additional components into our information system capability. This includes a master patient index and a laboratory data server for operational storage of data.

"As these pieces are put into place, PacLab has the capability to mine laboratory data and produce utilization studies and outcomes information that has value to clinicians and managed care companies," he added. "Within Washington state, it keeps PacLab at the forefront as a state-wide laboratory resource. Also, because we have access to hospital inpatient test data which is correlated across the system, we believe we have a competitive advantage on commercial lab competitors in our market."

Specimen Tracking System

"Our specimen tracking computer is called the SMART System," Dr. Killingsworth said. "It stands for Specimen Management, Routing And Tracking. It is the engine which drives our regional laboratory network. SMART routes specimens throughout the enterprise within each laboratory. It tracks the path of the specimen, triggers downloads for the analytical instruments, generates site-specific bar code for specimens, provides courier lists, and gives us transit time information for samples within the system.

"SMART is also capable of routing specimens around a downed instrument and sending them forward to another member facility for testing," he added. "It is quite sophisticated and a valuable tool for PacLab. It gives us a high degree of control over specimens, even though independent member laboratories are performing the testing. It shows how a regional laboratory network can function while maintaining the fundamental autonomy of individual member laboratories."

PacLab's Accomplishments

Since most regional laboratory networks cannot move past organizational talks, why has PacLab accomplished so much operational standardization among its nine affiliated laboratory organizations? "Don't think this was easy and automatic," responded Dr. Killingsworth. "We have worked through a number of difficult issues. But the critical factor is trust.

"There must be trust by all partners within the network. And trust is tightly linked to control. If a network lab does not trust its partners, it will not cede the network control," explained Dr. Killingsworth. "In the case of PacLab, the critical success factor was trust by the highest decision makers at each partner hospital. From that trust came acceptance of PacLab's need to control and direct certain aspects of technical and service operations at each member laboratory.

"Complexity plays a part in this," he said. "Laboratory medicine is itself a complex field. A laboratory network is even more complex. It requires resources and management talent to pull the network concept together and make it work in the real world."

In the first installment of this two-part series on PacLab Network Laboratories, THE DARK REPORT explored the reasons why nine independent laboratory organizations came together and formed this network.

New Lab Competitor

As a new competitor in the marketplace, PacLab has increased its member's share of the market. It has generated a healthy increase in outreach specimens to its member laboratories. At the same time, PacLab is enabling its member laboratories to sustain a multi-year decrease in average cost per test.

These are worthy goals. But the importance of PacLab's success at correlating all high volume analytes across all laboratory sites should not be underestimated either. By establishing statewide reference ranges and developing an integrated laboratory information system resource, PacLab is maintaining a competitive position as a first-rank laboratory services provider.

This means that PacLab should be a tough competitor in Washington for outreach lab testing. It also means that PacLab is well positioned as an integrated clinical resource that links hospital inpatient testing and physicians office testing.

Clinical Integration

Because clinical integration is definitely under way, PacLab's members are establishing themselves as a relevant provider of laboratory testing for both integrated delivery systems and managed care provider panels.

PacLab's successes should encourage other regional laboratory networks toward further operational and technical integration. PacLab demonstrates that cooperation among network laboratories can bring increased benefits to all members of a regional lab network. TDR

(For further information, contact Lawrence M. Killingsworth, Ph.D. at 509-455-3029; email: drlmk@aol.com.)

The Dark Index

Improved 3rd Quarter Performance Posted By National Laboratories

Third quarter financial performance at all three national laboratories improved over the same period of 1997. It is an important sign that the three companies are stabilizing their finances.

All three national laboratories continue to emphasize cost-cutting as a major corporate priority. That is to be expected, since increased penetration of managed healthcare maintains a downward pressure on reimbursement for laboratory testing.

Laboratory Corporation of America posted net sales of $398.3 million for the quarter. This is a 5.8% increase from last year. Net income almost doubled, from $5.4 million in third quarter 1997 to $11.4 million this quarter.

First Gain In Three Years

The most notable fact about this accomplishment is that it is the first time in three years that LabCorp has seen a quarterly increase over the same quarter of the previous year. That is a significant fact, because it indicates that some level of financial stability is returning to the clinical laboratory marketplace.

LabCorp also indicated that the 5.8% gain in revenue was attributed to two facts. First, 4.4% of the increase was the result of higher test prices. Second, 1.4% of the increase was attributed to additional testing volume. LabCorp also reported that its revenue per accession jumped 2.6% over that of third quarter 1997.

LabCorp's EBIDTA (earnings before interest, depreciation, taxes, and amortization) showed strong growth. It totaled $54.1 million for the quarter, up 14% over the same period in 1997. EBIDTA is an important measurement of the cash flow available to pay corporate expenses.

Two Acquisitions In 1998

During the first nine months of 1998, LabCorp's revenue was helped by the company's acquisition of two laboratories. In April it announced the purchase of **MedLab, Inc.**, a $20 million laboratory in bankruptcy court in Delaware. *(See TDR, May 4, 1998.)*

LabCorp followed that acquisition with another. In July, it purchased the laboratory testing business and related assets from **Universal Standard Healthcare, Inc.** of Southfield, Michigan. This chunk of business brought another $37 million per year of lab revenues to LabCorp. *(See TDR, July 27, 1998.)* The full impact of these acquisitions will show up in LabCorp's earnings for 1999.

Experts familiar with LabCorp's operational issues know that the company has struggled with its billing and collections. During 1996 and 1997 this area was the source of many problems. For third quarter 1998, LabCorp reported a DSO (days sales outstanding) of 84 days. That is an improvement over 1997, but still leaves room for further gains.

Next up for review is **Quest Diagnostics Incorporated**. Relative to its two national competitors, Quest has aggressively strived to identify and purge unprofitable accounts. So it is not surprising that Quest reports a modest decline in revenues. Third quarter 1998 revenues were $360.7 million, compared to $373.7 million for the same quarter of 1997. This is a 3.5% decline.

However, reflecting the improved profitability of the remaining accounts, Quest saw net income increase by 103%, from $3.0 million last year to $6.1 million this year. EBIDTA climbed modestly, increasing from $35.7 million for third quarter 1997 to $37.6 million this year.

Although Quest's requisition count was down by 5.6%, its revenue per requisition went up 1.4% over the same period last year. DSO (days sales outstanding) stood at 61 days.

In contrast to LabCorp's strategy of doing selected acquisitions, Quest is choosing to pursue strategic alliances. In October, a joint venture with **UPMC Health System** (formerly University of Pittsburgh Medical Center) was announced. *(See sidebar at right.)*

Whereas LabCorp's acquisitions generate an immediate surge in requisitions, frequently a joint venture takes some time before there is a net increase of specimens to both partners. Quest also entered into a similar joint venture with **Unity Health System** of St. Louis this year.

Time-Consuming Initiatives

Along with Quest's developing relationship with **Premiere, Inc.** these are all business initiatives which require time to bear fruit. Historically, such ventures are time consuming to negotiate, complicated to organize, and slow to generate profits.

On the other hand, Quest, as a joint venture partner, becomes embedded in the local healthcare community. It brings Quest inside the integrated healthcare system. If clinical and operational integration of healthcare is the wave of the future, then Quest should benefit from these efforts, even though the eventual pay-off is years away.

An interesting aside about Quest. During the first nine months of 1998, the company was able to pay down $44.1 million of debt, of which $20 million was a prepayment. Quest also purchased $12.4 million of its shares. The fact that Quest is using cash flow for these activities indicates an easing of the financial pressure experienced in past years.

13% Growth At SBCL

At **SmithKline Beecham Clinical Laboratories** (SBCL), the most striking development during third quarter 1998 was growth. Compared to third quarter 1997, revenues were up 13% and specimen volume increased 10%. SBCL's revenues for the quarter totaled $396 million.

The downside at SBCL was a decline in operating profit, which decreased 8% to $38 million. Because SBCL is a division of **SmithKline Beecham, PLC** and

Quest And UPMC Decide To Dance

Once again Quest Diagnostics Incorporated is on the strategic alliance trail. This time the partner is UPMC Health Systems.

UPMC Health Systems (formerly University of Pittsburgh Medical Center) is the strongest integrated delivery system in the Pittsburgh metro. Quest operates a large regional laboratory in the town. This joint venture combines two strong players.

Each partner is contributing existing laboratory assets to the venture. Equity ownership is split, with 51% to Quest and 49% to UPMC. The management board will have equal representation and the joint medical leadership team will be chaired by a physician from the Pathology Department at the University of Pittsburgh Medical School.

What few laboratory executives realize is that UPMC has advanced technical expertise in laboratory and pathology information systems. This is an interesting side benefit to Quest, as they will have access to cutting-edge projects under way at UPMC and the medical school.

is based in London, the parent company does not disclose the level of financial detail required by U.S.-based companies like LabCorp and Quest.

What explains SBCL's spurt in specimen volume and a decline in operating profit? Clients and readers of THE DARK REPORT know that SBCL has pursued a managed care strategy based on exclusive sole source contracts with national MCOs. *(SEE TDR, OCTOBER 19, 1998.)*

Specimen Volume Gains

In particular, during the last year it was implementing the **Prudential Healthcare** contract and building strong relationships with **United Healthcare**. Some unit volume gains at SBCL can be attributed to implementation of these types of contracts.

The specimen volume pickup from SBCL's sole source contract with **Aetna/U.S. Healthcare** is too recent to impact its revenue and earnings. But during 1999, as the implementation of the contract proceeds, that source may fuel increased specimen volume for SBCL.

As to reduced profitability, the company cryptically reports that "the decline in operating profit is due to the continuing difficult pricing and reimbursement environment and start-up costs associated with the implementation of the **Tenet Healthcare Corporation** contract."

SBCL's Pricing Strategy

During 1997 and 1998, THE DARK REPORT received anecdotal reports on SBCL's pricing strategy in various areas of the United States. The consistent theme of these reports is that SBCL was willing to bid for incremental *new* business using "marginal cost" pricing.

This stood in contrast to LabCorp and Quest, as those companies were attempting to live up to their public statements about renewing laboratory services contracts at price levels adequate enough to cover full costs.

Since both LabCorp and Quest are reporting increased revenues per accession for third quarter, it may be that one contributing factor to SBCL's decline in operating profit is its own strategy of capturing incremental business using "marginal cost" pricing.

The Tenet contract involves SBCL's involvement in helping Tenet consolidate laboratory operations at 30 Southern California hospitals. *(See TDR, January 19, 1998.)* SBCL's role is as consultant and project manager.

The parent company's comment about start-up costs involved in the Tenet contract is "corporatese." It is specific enough to disclose a material fact to investors that things are not going as well as planned. But it is vague enough that it doesn't have to provide details about the project's difficulties.

Requisition Count Decline

Analysis of the third quarter financials of the three blood brothers does validate the conclusion that the marketplace for clinical laboratory services has ceased its downward free fall.

Further, the financial experience of each of the three national laboratories indicates that their individual business strategies and initiatives are leading each in a slightly different direction.

For those laboratories competing against the three blood brothers, the message should be clear: don't delay in aggressively pursuing new business.

The reason why should be obvious. As the three blood brothers slowly regain their financial strength, they will spend increasing dollars to gain market share in all the regional markets they serve, making them even tougher competitors than they are today. **TDR**

(For further information, contact THE DARK REPORT at 503-699-0616.)

INTELLIGENCE LATE & LATENT

Items too late to print, too early to report

For pathologists interested in preserving and enhancing their income, THE DARK REPORT's *Private Pathologist Income Symposium* was just the item. Held in Scottsdale on November 13-14, it attracted a sell-out crowd of pathologists and practice administrators. Interest in the symposium was so strong that registrations sold out two weeks before the event.

MORE ON:...PATHOLOGIST SYMPOSIUM

Experts at the symposium hammered at similar themes: 1) become proactive at making your pathology practice a preferred provider in your community; to sit and do nothing is to fail. 2) develop "value added" AP services for clinicians and managed care companies because reim- bursement is more generous for such services. 3) marketing yourself and your practice will be the difference between success and bankruptcy. It's time to invest money in marketing...now!

LAST TAG...SYMPOSIUM

Pathologists at the symposium were in general agreement with these themes. Look for increased marketing by individual pathology practices in the future.

HOW MUCH DOES Y2K PROTECTION COST A LABORATORY?

Two of the three blood brothers have released information on their year 2000 readiness plans. At **Quest Diagnostics Incorporated**, executives established a dedicated program in 1997. It is comprehensive, covering seven areas: infrastructure, applications, lab instruments, facilities, desktop PCs, external suppliers, and payers. To date, Quest has spent $20 million on Y2K readiness. The company estimates an additional $40 to $60 million will be required to address all Y2K needs, including new systems.

ADD TO:...Y2K

At **Laboratory Corporation of America**, similar Y2K readiness efforts are under way. LabCorp finished an initial assessment and inventory of needs. A strategy to handle these issues is expected by year-end, followed by contingency planning in first quarter 1999. LabCorp has already spent $2.5 million on Y2K readiness. It estimates additional costs of between $20 and $25 million, not including the purchase of new systems.

Congratulations to Michael Bechich, M.D. for his success with this year's conference on *Anatomic Pathology Informatics, Imaging and the Internet* (APIII) at the **University of Pittsburgh School of Medicine**. Held November 5-7, it attracted 275 registrants and 32 vendor participants eager to learn the latest applications of new information system technology to anatomic pathology. The conference is becoming the place where recognized innovators in anatomic pathology technology come to share their knowledge.

Acute care hospital prices fell for the month of September, according to the **U.S. Department of Labor's** Producer Price Index. The September index fell by 0.1%, and climbed only 0.5% for the 12-month period ending in September. The physician service price index jumped 0.5% in September, and rose 2.1% for the 12-month period ending in September. Although HMOs are pushing double digit premium increases on employers for 1999, it is certainly not healthcare providers who are driving costs upward.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, December 21, 1998

THE DARK REPORT

UPCOMING...

- 1998's Top Ten Laboratory Industry Stories Reveal Surprising Trends.
- New Power Shift Between Hospital Lab Outreach and Commercial Lab Competitors.
- Technology Update: Transformational Technology Heading For The Laboratory.
- Management Magic In The Clinical Lab: How One Adminstrator Supercharged Her Hospital Lab Into A Money Machine.