

*From the Desk of R. Lewis Dark...*

# THE DARK REPORT

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

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**R. Lewis Dark**

Founder & Publisher



## *Serendipity Or Response To Market Forces?*

THIS ISSUE OF THE DARK REPORT IS A GREAT EXAMPLE of how marketplace developments shape what we write. After the *Executive War College* in New Orleans, I spoke with our Editor, Robert Michel. We discussed his impressions from the collective information of 26 presentations. We also discussed what he had learned from conversations with the attendees, many of whom are just as innovative as the *War College* faculty.

Robert said he was surprised at the extent to which partnering was an important element of each case study. That has not been true of *War College* case studies in earlier years. But this was an important insight, because it is the necessary precursor to the creation of the regional laboratory systems which he and I firmly believe are the future for clinical laboratories. Accordingly, Robert prepared the story on partnering trends between hospital labs and commercial labs that you see on pages 9-13 of this issue. It represents his strategic perspective on the current direction of our industry.

No sooner was a draft of his story in my hands than I was faxed a copy of the **Premiere/Quest Diagnostics Incorporated** press release from May 18. The gist of this development was that Premiere and Quest Diagnostics have developed a long-term partnering template, to be offered to Premier's 1,700 member hospitals. It is designed to provide hospitals with an unorthodox way to extract "added-value" from their laboratories. The importance of this story was enough to bounce primary screening approval for **NeoPath's** AutoPap System off page one.

Both Robert and I recognized that this was not just validating the partnering trend he writes about on pages 9-13, but it could be a paradigm-shifting event within the hospital laboratory world. For that reason, it is our lead story for this issue (pages 2-6).

Was it serendipity which saw the conjunction of partnering in *War College* case studies with Premier's partnering announcement? I think not. It is a perfect reminder to us that the clinical laboratory marketplace is moving at the speed of light. Change is cascading through our industry.

Every laboratory administrator and pathologist must recognize that survival for their laboratory is now dependent on their ability to view new business models with an open mind. Stability of employment and profits will only result from introducing continuous change to keep laboratories aligned with the market's ongoing evolution.

**THE**

# Premier & Quest Devise New Service Arrangement

*National agreement creates service package designed to add value for Premier members*

**CEO SUMMARY:** *Pressure is intense for hospital buying consortiums to justify themselves and deliver added savings and services to their members. The recent announcement of a new national contract between Premier and Quest Diagnostics Incorporated demonstrates that both buying groups and laboratory industry suppliers are showing increased flexibility in creating new service menus.*

**L**ONG-STANDING RUMORS of a major new relationship between Premier, Inc. and Quest Diagnostics Incorporated were confirmed last Monday. The companies announced establishment of a two-part strategic alliance.

The Reference Testing Agreement is one component of the alliance. It is a five-year national contract which takes effect August 1, 1998. It involves a traditional range of pricing and services for reference testing and makes Quest Diagnostics the primary reference provider for Premier.

The second component is unique. It is the Strategic Services Contract. It creates the framework for any willing hospital, Premier, and Quest Diagnostics to work together to create additional value within the hospital labora-

tory. It is an exclusive agreement with Quest for a ten-year term.

For Premier, the unorthodox strategic alliance signals a new focus on how the buying service intends to reshape national contracts for laboratory products and services. Premier is developing new forms of cost reduction opportunities to offer its members.

For Quest Diagnostics, this new strategic alliance demonstrates the company's serious intent to reconfigure traditional business practices and create new value-added services. Quest Diagnostics views the Premier alliance as an opportunity to provide hospital reference testing through a partnering approach.

According to Ken Freeman, Chairman and CEO of Quest Diagnostics Incorporated, this alliance is a logical result of its strategic business plan.

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"Partnering with large buyers of laboratory testing is one element in our three-pronged corporate strategy," he told THE DARK REPORT. "Premier, representing about 1,700 hospitals and similar institutions, certainly fits that category."

The Strategic Services Agreement between Premier and Quest Diagnostics is intended to create an ongoing relationship between the participating hospital, Premier and Quest. Built upon the quality management philosophy of long-term customer-supplier relationships, the arrangement provides incentives for all three parties to add value and share in the benefits.

### Significant Capabilities

"Quest Diagnostics has significant capabilities and resources," explained James Chambers, Senior Vice President, Marketing and Business Development at Quest Diagnostics. "Premier worked with us to develop a way for hospitals to utilize these assets to their best advantage."

"Yes," affirmed Freeman, "the goal of this alliance is to shift the focus from strictly price to value. Historically it was easier for our industry to sell on price rather than value. Premier and Quest want to bypass price as the major deciding point. To access the increased value represented by other opportunities, hospitals must be willing to invest more management effort into evaluating and implementing these options."

### Aligned Interests Metaphor

Laboratory executives can better understand this strategic services agreement if they picture it like an alignment of interests. The individual hospital laboratory benefits directly from the arrangement. Premier will receive its share in the form of cash and equity in Quest Diagnostics, proportional to the volume of testing involved in the project.

The joint venture concept also affects outreach testing. Quest Diagnostics will purchase the outreach testing of a participating hospital as part of the partnering process. Equally impor-

tant, Quest can provide additional resources, such as sales and marketing, to expand outreach testing. Because of the ongoing relationship, all partners would share in the benefits of the increased specimen volume.

Both Quest Diagnostics and Premier are sensitive to the traditional animosity that some hospital lab administrators hold against national laboratories. That animosity has fueled rumors about the nature of the impending deal between the two companies.

"We understand the concerns some hospital laboratory managers have about national contracts," said Freeman. "We know that Premier is also sensitive to this issue. That is why we expect that success in the strategic services alliance will not come overnight."

"We expect to build this one hospital at a time," he continued. "Because this is a new approach to increasing the lab's value to its hospital, it will take a few examples to show other Premier hospitals how powerful this new model can be at enhancing service, controlling costs, and fostering clinical integration."

### Extensive Process

"It should also be stressed that Premier and Quest Diagnostics underwent an extensive process over the past year to develop this strategic alliance," Freeman added. "A significant amount of time and management effort went into creating an arrangement that shifts reference laboratory contracting away from a price-based process into something that can add substantial financial benefit to the participating hospital."

This attempt by Premier and Quest Diagnostics to recast their traditional relationship to hospital laboratories will have one consequence: never again will reference laboratory contracts be driven exclusively by price.

**TDR**

*(For further information, contact Gary Samuels at Quest Diagnostics Incorporated: 201-393-5597.)*

# New Alliance Is Example Of Coming Paradigm Shift

*Motives behind the Premier/Quest deal perfectly illustrate marketplace evolution*

**CEO SUMMARY:** *This strategic alliance represents a fundamental shift within the clinical laboratory industry. It is a response to market forces which should not be ignored by laboratory executives and pathologists anywhere in the country. Whether the alliance succeeds or fails, it will launch the laboratory industry into new directions.*

IT WILL TAKE SEVERAL YEARS before the success or failure of the strategic alliance between **Premier, Inc.** and **Quest Diagnostics Incorporated** can be determined.

Even if the thinking and design of the alliance is sound, many variables could trip up the alliance. Changes to the marketplace, inadequate reimbursement for lab testing, and management lapses are just some of the variables which could cause the alliance to fail.

But for readers of THE DARK REPORT, it is more important to understand the market forces driving this alliance. It is equally important to understand the management thinking which created this strategic alliance.

In an exclusive interview with THE DARK REPORT, Quest Diagnostics' Chairman and CEO Ken Freeman shared the vision which drives this strategic alliance. It provides a road map for the future direction of hospital lab-commercial lab relationships.

"This agreement comes after a very long dialogue with Premiere," stated Ken Freeman, Chairman and CEO of Quest Diagnostics. "There has been

intense discussion over the past year between our two organizations, involving a sizeable number of people at all levels. Our mutual goal was to create a break-through arrangement."

"To signal the different nature of this alliance," added James Chambers, Senior Vice President, Marketing and Business Development at Quest Diagnostics. "it will be marketed to Premiere's members under the term 'PACE,' for 'Partners Aligned For Clinical Excellence.' This alliance is a different way for Premiere to help its members create increased value."

According to Freeman, Premier shared a three-point strategic vision that drives its efforts to add value for its members. These three points are the reason for the unconventional nature of this strategic alliance between the national purchasing organization and a major commercial laboratory.

First, Premier wants to maintain its traditional activities at direct purchasing. It defines this as improvement to transaction costs.

Second, Premier wants to look at processing costs. Whether it is laboratory,

## Three-Pronged Strategy Drives Premier & Quest

*Premier works to develop member services using three strategic drivers:*

1. *Maintain continual improvement in transaction costs. (Traditional price-based purchasing contracts.)*
2. *Offer resources to help members lower processing costs. (Consulting expertise and other support to improve operations.)*
3. *Achieve "break-throughs." (Shift the paradigm by accomplishing things previously thought undoable.)*

*Quest Diagnostics Incorporated has a three-pronged strategy which guides its business development:*

1. *Be the highest quality provider of laboratory testing, because high quality goes hand-in-hand with low costs.*
2. *Become the preferred partner with large buyers of laboratory testing information services.*
3. *Reassert a traditional role as the ground breaker in the industry. (Tracing back the roots of Paul Brown, M.D. at **MetPath** and Al Nichols, M.D. at **Nichols Institute**.)*

radiology or other clinical services, can the process be done differently to achieve better results and more efficiency?

Third, Premier seeks to achieve a "breakthrough." This is a paradigm-shifting change from current practices which leads to significant gain in performance, quality, and cost reduction.

"Premier wanted to offer its members something more than simple savings from a low-priced national testing contract," explained Freeman. "Premier wanted to develop a new way for hospital laboratories to save significant amounts of money while improving service. That required both our companies to think 'out of

the box' and combine our knowledge and resources to the best advantage of Premier's members."

According to Freeman, Premier recognizes the market forces now plaguing the laboratory industry. "There is overcapacity in both the hospital and commercial laboratory segments," he noted. "Reimbursement declines continue to hammer away at the economics of laboratory operations. There is a fundamental shift away from inpatient to outpatient. Compliance is now a big issue for all laboratories."

## Forcing Change On Labs

"Both Premier and Quest realize how these pressures in the marketplace are forcing change upon laboratories," continued Freeman. "Healthcare providers that continue 'as-is' have a limited future. It is important to drive the paradigm for survival. The Strategic Services Alliance is designed to be a break-through product which can help hospital laboratories meet the new demands of the changed health-care environment.

"That is why Premier is willing to develop and offer a strategic sourcing arrangement to its members. Of course there is risk in trying something new," he added. "But look at the alternative. To do nothing means to wither."

Freeman's comments accurately describe any industry undergoing radical transformation. It is usually innovators and new companies which survive, not the historical giants. Who remembers **National Airlines** or **Pan American Airlines**? Where is **Zenith Television Company**? But adaptation and innovation can lead to long life. **Motorola's** successful switch from televisions to cellular phones and digital electronic equipment required radical shifts to management's thinking. But unlike its American competitors who used to make television sets, Motorola shifted to become a leader in the new generation of technology.



"Premier's goal of creating a breakthrough led to the dual contract nature of the alliance," explained Chambers. "The traditional reference laboratory contract will serve one segment of Premier's membership. The strategic services alliance is Premier's way of offering other segments of its membership a variety of choices for adding value in their laboratories."

To help the alliance stay close to the customer, there is a joint quality committee. "There will be eight or nine representatives from each organization," said Chambers. "It will include medical staff. The committee will keep the alliance responsive to needs of Premier's members while reacting to new developments in the marketplace."

Freeman's insights into the management philosophy that created the Strategic Service Alliance validate THE DARK REPORT's ongoing conviction that market pressures will force hospital laboratories and commercial laboratories to rationalize resources on a city-by-city basis.

### Tenet's Activities

The strategic alliance of these two companies represents a true paradigm shift in our industry. It must be viewed in combination with **Tenet Healthcare's** activities in Southern California, where **SmithKline Beecham Clinical Laboratories** is helping Tenet consolidate and regionalize the laboratory operations of 31 hospitals. (See *TDR*, November 17, 1997 and January 19, 1998.)

As hospital service companies, both Premier and Tenet have done the same thing: they identified national laboratories as having management experience, logistical infrastructure, LIS capabilities and sales/marketing experience which they could not find within their participating hospitals.

That should send a clear message to hospital lab administrators throughout the country. Hospital owners want a

degree of radical change that hospital laboratory management is perceived as incapable of accomplishing. So hospital "owners" are going to national laboratories to access this capability and introduce change into their hospital labs.

In the case of Premier and Quest Diagnostics, there will be no attempt to "cram" this strategic alliance down the throats of member hospitals. Both organizations are committed to the principles of quality management, which means understanding the needs of customers and dealing with them on a win-win basis.

But the reasons why Premier invested the time to develop this strategic alliance are the reasons why THE DARK REPORT believes it represents a paradigm shift. Our partnering article on pages 9-13 provides compelling evidence that progressive hospital laboratories now appreciate the value which the right commercial laboratory partner can bring to the table.

**TDR**

(For further information, contact Gary Samuels at Quest Diagnostics Incorporated: 201-393-5597.)

### Premier Adds Hamon To Its Laboratory Team

*Premier, Inc. is signaling its serious intent to develop a menu of value-added laboratory services for its member hospitals. The national health-care consortium has hired Robert Hamon, Administrative Director of Presbyterian Laboratory Services in Charlotte, North Carolina.*

*Hamon will join Premier's national laboratory team and will work from Premier's Charlotte offices. He is one of the more adept laboratory executives in our industry. He guided PLS through almost 14 years of non-stop growth and made the consolidated hospital-based laboratory a major player in the Carolinas.*

# AutoPap System Cleared For Primary Screening

*Neopath's automated cytology technology is first of more cytology products to follow*

**CEO SUMMARY:** *It is time for pathologists and cytologists to buckle their safety belts. The marketplace for automated cytology is entering a new cycle of rapid change. NeoPath's AutoPap System is now poised to demonstrate that it is economical and clinically viable. Expect continual improvements to automated cytology technology to eventually replace traditional methods of diagnosing Pap smears.*

**A** NEW ERA OF CYTOLOGY was launched when the **Food And Drug Administration (FDA)** formally approved **NeoPath, Inc.'s** AutoPap® System for use as a primary screener of Pap smears.

NeoPath announced the FDA's approval on May 7. Earlier in January the FDA's Hematology and Pathology Devices Advisory Panel had recommended to the FDA that it approve the AutoPap System for primary screening. (See TDR, February 9, 1998.)

Not only is this FDA approval an important milestone for NeoPath, but it is a seminal event for the entire cytology industry. This is the first time that the FDA has approved a machine to replace a human in the diagnosis of a cytology specimen.

## Marks The Beginning

It marks the beginning of a transition from a cytotechnologist-driven process of evaluating Pap smears to a process dominated by machines, with humans involved in the review and QA/QC process.

The FDA's action came in response to a pre-market approval (PMA) sup-

plement submitted by NeoPath. As requested by NeoPath, the approved supplement allows the AutoPap System to classify up to 25% of the Pap smears as normal. These slides would be reported out as normal and archived without human review.

*It marks the beginning of a transition from a cytotechnologist-driven process of evaluating Pap smears to a process dominated by machines...*

The remaining 75% of the slides are prioritized by the AutoPap System according to the probability of their containing abnormal cells. These slides are sent to cytotechs for human review, along with the priority ranking of abnormality. Quality control rescreening will be done to 15% of the slides in both groups of Pap smears.

NeoPath was prepared to act immediately once FDA approval was granted. The company had earlier announced a financing agreement with **Rockford**



**Industries, Inc.** of Santa Ana, California. This agreement makes it possible for NeoPath to offer a full range of purchase and lease options for laboratories which are interested in acquiring the AutoPap System.

This is in keeping with NeoPath's focused and deliberate marketing plan. Since 1995, when the FDA approved the AutoPap System for rescreening and adjunctive testing, NeoPath has successfully placed units with the major laboratory companies in the United States. It has also placed units with some large HMOs, such as **Kaiser Permanente**.

Laboratories doing a high volume of Pap smears have been the first to acquire AutoPap Systems. There are at least three laboratory sites in the United States today where ten or more AutoPap units operate daily. The volume of Pap smears read by AutoPap Systems monthly is increasing.

### One Question Mark

One question mark that continues to plague the introduction of all automated cytology technology is the reimbursement issue. If laboratories cannot recover their costs and a reasonable profit from such systems, they have little incentive to acquire and use this technology.

For that reason, NeoPath is working diligently to gain reimbursement determinations from major managed care companies (MCOs). The day after the FDA approval was announced, NeoPath released information that **Blue Cross/Blue Shield** organizations in ten states had issued reimbursement determinations. Six other major MCO organizations in five states similarly made reimbursement determinations in favor of the AutoPap System.

The PMA supplement approved by the FDA was based upon clinical data from a study of 25,000 Pap smears diagnosed in five laboratories.

The study demonstrated that AutoPap helped the participating laboratories detect 33% more suspicious cells, including two possible cancers that were missed by cytotechs involved in the study. Interestingly, the device missed 11 of 4,800 slides it had designated as low risk. But according to Susan Alpert, M.D., FDA device evaluation chief, they were of the least suspicious type.

### The First Step

Acceptance within segments of the medical community lags because Pap smear screening is just the first step in the detection process. "This device... tells you that something is abnormal," stated Ted Gansler, M.D., Director of Health Content at the **American Cancer Society**. "It removes the most tedious and stressful part of the Pap testing, which is identifying the abnormal cases."

"One of the most difficult things about Pap tests," continued Dr. Gansler, "is that, unlike many other types of specimens where you immediately see an abnormality, in the case of looking at Pap smears the first step is to find something. If you lose concentration for a minute, it could mean that you miss something that has life-or-death implications."

### Primary Screening

Primary screening of Pap smears by automated cytology technology is now a fact. NeoPath's AutoPap System is the first to gain FDA approval. But other automated systems are in the approval pipeline. Probably within two years, several other systems will get regulatory approval and enter the marketplace.

Developments in the field of automated cytology demonstrate how fast the market is changing. Clinical laboratories offering cytology services should keep a close watch on these developments, because they are changing the underlying economics of Pap smear testing. **TDR**

*(For further information, contact Robert Michel at 503-699-0616 or email to: labletter@aol.com.)*

**CEO SUMMARY:** *At this year's Executive War College in New Orleans, laboratory innovators convened to study hot new trends in the industry. They were surprised to learn that partnering relationships between hospital laboratories and commercial laboratories are finally gaining wider acceptance. Laboratory executives involved in partnering arrangements had good things to say about the success of these ventures. THE DARK REPORT predicts that partnering will soon be part of every successful regional laboratory provider system.*

## IN-DEPTH ANALYSIS & COMMENTARY

# Hospital Lab-Commercial Lab Partnering Is Upcoming Trend

**S**POTTING TRENDS in the clinical laboratory marketplace is seldom easy. But that's not the case with partnering arrangements between hospital labs and commercial labs. This trend is unmistakable...and it is here today!

Only a finite number of such partnering arrangements actually operate at this time. But we believe that partnering in the laboratory industry is currently at the slow part of the geometric curve. THE DARK REPORT predicts that the number of partnering arrangements between hospitals

and commercial laboratories will mushroom during the next 18-24 months.

For more than two years, THE DARK REPORT has chronicled the successes and setbacks of the limited number of such partnerships which began operating. It is our firm conviction that economic forces and managed care trends will force hospital laboratories and commercial laboratories to combine resources at the community level. This conviction is based on our site visits and consultations with leading hospital laboratory

administrators throughout the United States and Canada.

One source of unchallengeable information about management strategies and marketplace trends is the annual *Executive War College on Laboratory & Pathology Management* we host each year in New Orleans. It brings together more than 25 speakers and presentations by leading laboratory administrators, pathologists and executives.

On May 12-13, almost 300 senior laboratory administrators and pathologists gathered for this year's *Executive War College*. Case studies at this meeting provided convincing evidence that a tidal wave of partnerships will soon flood the laboratory industry.

A brief summary of the key presentations demonstrate the unique nature of partnering arrangements now sprouting throughout the country. These case studies reveal how hospital

ratory services to physician offices. The lab division's success caused the hospital administration to form a for-profit subsidiary to expedite expansion of the laboratory's outreach program.

UMASS Health System Laboratories is partnering with **Specialty Laboratories** of Santa Monica. Specialty Labs provides assistance with logistics and courier arrangements, as well as LIS linkage between hospital laboratory sites and physician offices.

Next on the *War College* podium was **Pathology Medical Laboratories, Inc.** (PML) of San Diego, California. This independent regional laboratory has remained profitable, despite the heavy inroads of managed care in San Diego County.

PML President Bob Prosek shared with *War College* attendees how PML used a laboratory partnership with **Scripps Healthcare System** to create a high-volume core laboratory near the Scripps medical campus. This original partnering

laboratory resources are being combined with commercial laboratory capabilities to best meet healthcare needs in different communities.

The *War College's* opening presentation was **UMASS Health System Laboratories** of Worcester, Massachusetts. Dr. Michael Snyder, Chief of Hospital Laboratories and Clinical Pathology, described how this academic and tertiary medical center created a dynamic program to offer both reference testing to nearby hospitals and outreach labo-

arrangement has led to laboratory management arrangements with six other hospitals.

Prosek demonstrated how PML's partnering approach improves the economics and service levels for participating hospital partners. He believes that PML's future partnering opportunities with additional hospitals will allow it to develop into a \$100 million laboratory in three to five years, doubling from its current size of more than \$50 million.

**PacLab Network Laboratories** of Seattle, Washington was another case study built

around a partnering model. This is a regional laboratory network where eight hospitals and one independent regional laboratory got serious about creating a business-based service network.

Thomas Tiffany, Ph.D. is CEO of **Pathology Associates Medical Laboratories** of Spokane, Washington. Dr. Tiffany explained how marketplace dynamics in Washington caused the network participants to combine forces. To emphasize the management effort invested in PacLab, he introduced Noel Maring and Lawrence Killingsworth, Ph.D. They are responsible for sales/marketing and operations, respectively.

Maring outlined the sales successes enjoyed by the network while Dr. Killingsworth impressed the *War College* attendees with a description of the rigorous operational standardization program enthusiastically implemented by PacLab's member laboratories.

### Partnering Arrangements

Case studies during day two of the *War College* reinforced the common theme of partnering arrangements. **Dynacare-Hermann Hospital Laboratories** (DHHL) of Houston, Texas is a 50-50 partnership between the two companies. Each partner sent a representative to the *War College* to share their organization's perspective.

Bill Pesci, COO of DHHL and Sylvia Skotak, Clinical Administrator of Hermann Hospital, described the reasons why Hermann Hospital decided to partner with Dynacare in 1995. Both individuals then detailed the operational progress of the partnership, including serious market setbacks which jolted the joint effort in its first years.

The net conclusion to this joint venture is that both partners have harvested substantial economic benefits. In the four years of the partnership, joint revenues have increased from \$16 million to a projected \$36 million for 1998. More importantly, the integrated health-

care system to which Hermann Hospital belongs is seriously considering rolling out this partnership arrangement to all the hospitals in its system.

### Traditional Backwater

Traditionally, the Veterans Administration has been considered a backwater for innovations in laboratory management. That is no longer true. Bruce Dunn, M.D., Chief of Pathology and Laboratory Medicine at **Milwaukee's VA Medical Center**, discussed how his laboratory division (VISN 12), which covers Wisconsin, northwest Illinois and the Michigan peninsula, consolidated laboratory testing from eight hospitals and a number of VA clinics into two core laboratories. The core laboratories are located in Milwaukee and Chicago.

One essential element in the operations plan for this region-wide consolidation was the contribution of **Quest Diagnostics Incorporated** as a partner with VA VISN 12. Quest provides logistics and courier services, reference laboratory testing, and LIS linkages between the VA sites where laboratory specimens originate.

An additional case study reinforced the theme of hospital lab-commercial lab partnering. **Shared Laboratory Services** (SLS) of Fairfax, Virginia was formed when four non-affiliated hospitals decided they wanted to build a core laboratory and pursue outreach business.

According to Raleigh Hamilton, CEO of SLS, the planning process quickly revealed that the consortium needed capital, management expertise, and sales/marketing experience. SLS determined that recruiting a commercial laboratory partner would be a cost-effective way to resolve these needs.

Using an RFP process, SLS selected **American Medical Laboratories** of Chantilly, Virginia to be an equity participant in the combined laboratory venture. Hamilton acknowledged

# Lab Innovators & Early Adapters Launch Partnering Arrangements

Case studies presented at this year's Executive War College on May 12-13 validate the emerging trend of hospital lab-commercial lab partnerships.



## **1** PacLab Network Laboratories:

Independent commercial laboratory joins eight hospital laboratories to provide statewide laboratory services, launch outreach testing program.

## **2** Physicians Medical Laboratories-Scripps Healthcare:

Independent laboratory in partnering arrangement with healthcare system operating multiple hospitals, utilizing off-site core laboratory.

## **3** Dynacare-Hermann Hospital Labs:

Joint venture between commercial laboratory and hospital involves consolidation of testing and aggressive outreach marketing efforts.

## **4** VISN 12-Veterans Administration:

Eight VA hospitals in three states consolidate around two core laboratories and use Quest Diagnostics Incorporated for reference testing and other support.

## **5** UMASS Health System Labs:

Academic/Tertiary hospital lab establishes thriving outreach program, recruits Specialty Labs to provide needed logistics and LIS support services.

## **6** Shared Laboratory Services:

Four non-affiliated hospitals build core lab and launch testing program. American Medical Labs selected as partner for management experience, resources.

*Besides the six examples listed above, there are more partnering arrangements in the United States. The number is limited, but growing steadily. New developments, like the Premier-Quest Diagnostics contract discussed on pages 2-6 of this issue, will make it easier for hospital laboratories to develop a beneficial partnership with commercial laboratories.*



that AML's experience and knowledge helped SLS design their core lab, initiate operations, and manage the business more effectively than they could have using their experience as hospital-based laboratorians.

## Market Message

Administrators of hospital-based laboratories should recognize the market message represented by these case studies. Whether or not they are personally comfortable with the concept of partnering with commercial laboratories, hospitals around the country are evaluating the benefits and moving forward. It is no coincidence that individual hospitals in each of these six geographically-dispersed organizations made independent determinations that the benefits of partnering with a commercial laboratory were substantial.

At THE DARK REPORT, we believe these six case studies represent an unmistakable shift within the entire clinical laboratory industry. They demonstrate that financial pressure upon hospitals is finally forcing them to objectively analyze the economics of partnering with commercial laboratories.

## Sizeable Revenue Gains

If done objectively, these analyses reveal that sizeable revenue gains and service enhancements are undeniable, assuming they associate with the right commercial laboratory partner. This is a change from past years, when traditional animosities harbored by hospital lab administrators toward commercial laboratories in their area subjectively clouded any type of serious partnering negotiations.

Another market trend revealed by these *War College* case studies is that viable partnering opportunities exist with regional laboratories, not just the three blood brothers. The case studies involving Pathology Medical Laboratories of San Diego, Pathology Associates Medical Laboratories of

Spokane, and American Medical Laboratories of Chantilly demonstrate that independent commercial laboratories are good partnering candidates.

The reasons are obvious. Independent commercial laboratories generally have four things going for them. First, they are owned and operated by local pathologists, who are personally acquainted with clinicians in the area. Second, they have excellent reputations within the clinical community they serve. Third, they have never compromised service to their physician clients the way the national laboratories have. Fourth, and most importantly, they have no national corporate standardization programs to distract them. Management spends 100% of its time and focus on competing locally.

## Anchored In The Market

This summary review of six case studies does not do them proper justice. But it permits clients of THE DARK REPORT to understand that the partnering trend is already anchored in the market.

Partnering will be a necessary component for successful laboratory regionalization. THE DARK REPORT will be reporting on additional partnering models as they emerge in the marketplace.

In the meantime, hospital laboratory administrators are well-advised to carefully research the partnering proposals they may entertain from commercial laboratories. Skilled sales people can sometimes oversell the capabilities of their company. It is essential that a hospital laboratory find the right partner before signing on the dotted line.

**TDR**

(For further information, contact Robert Michel at 503-699-0616 or email to: [labletter@aol.com](mailto:labletter@aol.com).)

Note: Audio tapes of these *Executive War College* Case Studies are available. Just call 800-560-6363 for details and an order form.

# Substance Abuse Testing Gains Increasing Favor

*An overlooked segment of lab testing quietly attracts increased competition*

**CEO SUMMARY:** *Here's an update to our earlier predictions that clinical laboratories would find substance abuse testing to be a profitable adjunct to clinical testing. Evidence accumulates that competition in the drugs of abuse marketplace is intensifying. While still a relatively small market, opportunities for non-SAMH-SA laboratories to build a profitable book of business should only increase in coming years.*

**T**ESTING FOR DRUGS OF ABUSE has long been considered a stepchild by clinical laboratories. This is beginning to change, however, as more laboratories reassess the revenue potential from this market segment.

Evidence supporting this conclusion comes from almost every clinical laboratory which offers a serious testing program for drugs of abuse. At **LabOne, Inc.** in Kansas City, revenues from substance abuse testing are increasing 50% or more per year.

annual revenues of \$14.0 million. Acquisitions account for most of this company's growth.

Substance abuse testing has two advantages over clinical testing. First, it remains on a fee-for-service reimbursement because private employers generally pay for these tests. Unlike capitated clinical testing reimbursement, this more generous reimbursement means additional money to the laboratory.

Second, the growth in substance abuse testing is steady. Utilization is not declining, but increasing. Studies reveal that employers with pre-employment and random screening programs gain measurable benefits through reduced employee turnover, increased productivity, lower disability claims, and lower insurance premiums.

Another sign that clinical laboratories consider substance abuse testing to be a viable growth area is the recent press releases by both **Quest Diagnostics Incorporated** and **SmithKline Beecham Clinical Laboratories**. Both laboratories now offer testing to determine whether specimens have been adulterated with nitrites.

***Substance abuse testing... remains on a fee-for-service reimbursement because private employers generally pay for these tests.***

One of THE DARK REPORT's favorite examples of a niche laboratory is **Laboratory Specialists of America**, based in Oklahoma City. This company only offers substance abuse testing. In 1994, it posted \$3.8 million in sales. For 1998, it projects



"Drug users are always looking for a way to beat the system," said Gregory Gallo, Vice President of Sales and Marketing for the Employer Division at Quest Diagnostics. "During the last twelve months, there was a noticeable increase in the number of specimens containing nitrites. An increasing number of users believe that nitrites added to the urine sample will generate a negative result."

### Nitrite Adulteration

"This creates the need to screen samples for nitrite adulteration," continued Gallo. "We did a pilot program with some national customers last fall. It was well-received and that led us to offer a test panel which includes screening for nitrites."

"Nitrite adulteration is an example of how the marketplace changes," stated Yale Caplan, Ph.D., Director of Forensic Toxicology at Quest's Baltimore laboratory. "Drug test numbers reported to the government showed this to be an increasing problem last year."

Caplan, who sits on the SAMHSA advisory board for the Human Health Services Department of the federal government, indicated that Quest has set up a basic chemistry test that screens for nitrites. This is included in the substance abuse panels.

### Growth Market

Just as smaller laboratories like LabOne and Laboratory Specialists have seen healthy growth in their substance abuse testing programs, so also has Quest Diagnostics. "We consider workplace testing for substance abuse to be a growth market," noted Gallo. "But if you look at national numbers, the year-to-year increase in aggregate testing is modest. It is typical of a more mature marketplace."

Workplace substance abuse testing probably totals around \$300 million. Other categories include rehabilitation

programs, corrections, hospitals, and probation/parole programs. Estimates are that each of the three national laboratories perform about 5 million substance abuse tests per year.

Gallo believes that his company is seeing regular growth in testing volumes in this category for several reasons. "Within the employer division, we have standardized across the country," he said. "This brings uniformity to our customers. We also have a great program for managing collections and handling billing."

There is another interesting aspect to workplace testing. "The majority of substance abuse testing comes from private employers who do not require SAMHSA-certified testing," said Gallo. "They want the benefits of pre-employment and random screening programs, but do not require SAMSA-certification."

### Central Laboratories

Quest Diagnostics has eight SAMHSA-certified laboratories. In contrast, both LabOne and Laboratory Specialists of America each operate one central laboratory, in Kansas City and New Orleans, respectively. Yet both of these labs successfully offer services on a national basis.

Two other primary competitors in the marketplace are **PharmChem**, based in Menlo Park California, and **MedTox**, based in Minneapolis, Minnesota. Each specializes in substance abuse testing and is publicly traded. Both companies have enjoyed regular growth in sales volume.

Compared to clinical testing in the market segments of long term care and home health, where reimbursement is undergoing drastic cutbacks, substance abuse testing remains an attractive option for clinical laboratories seeking to explore niche market opportunities.

**TDR**

(For further information, contact Gregory Gallo at 201-393-6463.)

## The Dark Index

# Unilab & LabOne Demonstrate Improved Revenues and Profits

**A**FTER AN EXTENDED MULTI-YEAR financial siege, **Unilab Corporation** seems to be regaining its balance. First quarter financials demonstrate respectable gains in revenue and net income at the California-based laboratory.

Big gains were posted by **LabOne, Inc.** of Lenexa, Kansas. For the quarter, revenue and net earnings increased 32% and 43%, respectively. Growth was evenly distributed across all three market segments served by **LabOne**.

### Improved Financials

In fact, most public laboratories and the disease management companies enjoyed improved financials during the first quarter. Combined with the performance of the three national laboratories (reported in the last issue of **THE DARK REPORT**), it would appear that strategies for responding to managed healthcare are beginning to pay off. Finances seem to be stabilizing in the public laboratory sector of the industry.

Unilab is an instructive example. The company suffered horrific losses since 1995 as the financial impact of rock-bottom laboratory reimbursement rates buffeted clinical laboratories in California. In fact, it was the only California-based public laboratory which did not file for bankruptcy.

Unilab responded to the financial pressure with extensive cost-cutting and operational restructuring. It finished 1997 with improved cash flow and carried that trend through first quarter 1998. Revenues for the quarter were \$54.5 million, up 2.8% from the same quarter last

year. Net income was reported at \$3.1 million, compared to a \$1.1 million loss last year.

A significant accomplishment at Unilab was improvement to EBIDTA (earnings before interest, depreciation, taxes and amortization). Unilab saw its EBIDTA jump from \$4.5 million last year to \$8.4 million this year. As a percent of sales, EBIDTA increased from 8.5% to 15.5%.

This demonstrates that Unilab's cost-cutting efforts, in combination with a diligent effort to reprice managed care contracts upward have contributed to improved cash flow. (See *TDR, February 17, 1997*.) In fact, requisition counts were about equal to first quarter 1997, but pricing increased by more than 4.0%.

Because California is a bellwether state, Unilab's financial performance provides good information as to how managed care trends are affecting clinical laboratory operations. Unilab is the biggest laboratory in the state, with annual revenues of about \$215 million.

### LabOne Shows Big Gains

Moving to America's heartland, **LabOne** continues to demonstrate its effectiveness at marketing specialized testing programs with good success. At \$79 million in annual sales, **LabOne** is the fifth largest publicly traded laboratory in the United States.

First quarter revenue at **LabOne** rose by 32%, to \$23.3 million. Net earnings increased from \$1.4 million to \$2.0 million, a 43% gain. Clients of **THE DARK REPORT** know that **LabOne** has pursued a market niche strategy in recent years in

three segments of testing. Blood testing for life insurance policies is LabOne's major revenue source. It increased 17% during the first quarter, to \$16.8 million.

Clinical testing climbed from \$1.6 million last year to \$3.7 million. Substance abuse testing was \$2.9 million, an increase of 61%.

### Value-Added Services

Persistent sales efforts and value-added services are two reasons why LabOne saw strong growth across its three main testing divisions. LabOne intends to maintain this pace of growth. It just announced another agreement with **Epitope** to market Epitope's OraSure oral fluid test to "public health, corrections, military, and college health markets." LabOne already offers OraSure to life insurance companies under an exclusive arrangement with Epitope.

Life insurance companies find it both cheaper and easier to test applicants for HIV using the OraSure test. Thus, they have increased the volume of tests ordered annually, to LabOne's benefit. LabOne's sales force is familiar with the test and both companies expect the relationship to further boost the volume of OraSure tests used in the market segments covered by the agreement.

### Additional Testing Volume

Another product which is helping to generate additional testing volume is LabOne's LabCard program. Marketed through third party administrators (TPA), LabCard is a way for insurance plans and self-insured employers to lower their laboratory testing costs.

The program now covers more than 1.9 million lives. It recently enrolled **Blue Cross/Blue Shield of Tennessee** as a client. LabOne predicts continued strong growth with its LabCard product.

The financial performance of Unilab and LabOne are representative of the second tier of public laboratories. Like the three blood brothers, they have endured several years of

## Universal Standard Still Posting Red Ink

First quarter financials for **Universal Standard Healthcare Inc.** (formerly **Universal Standard Medical Laboratories**) showed a net loss of \$0.2 million. This is an improvement from the \$.05 million loss for the same quarter last year.

Universal Standard is based in Southfield, Michigan. It is publicly traded and does considerable laboratory testing for the Big Three automobile companies. The laboratory has struggled in recent years, as its profit margins eroded due to declines in fee-for-service testing volumes.

Net revenue for first quarter increased by 17%, from \$13.5 million to \$15.8 million. This was due to a new laboratory services contract negotiated with **General Motors** that became effective January 1, 1998. CEO Eugene Jennings expects the General Motors contract will help Universal Standard return to profitability in 1998.

One sign that this might be true is the company's increased cash flow. EBIDTA increased from \$0.9 million last year to \$1.2 million this year. That is a 33% improvement.

financial stress. But performance in the first quarter of 1998 indicates that an industry-wide turnaround may be under way.

In the next issue of THE DARK REPORT, we will look at the financial performance of publicly traded laboratories involved in specialty testing and disease management.

**TDR**

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

# INTELLIGENCE

**LATE & LATENT**  
 Items too late to print,  
 too early to report



Another pathology-based PPM received venture capital funding. **Pathology Consultants of America**, (PCA) based in Nashville, Tennessee, just closed a \$16 million deal with two venture capitalists. **ABS Capital Partners** of Baltimore invested \$15 million. An affiliate of **SunTrust/Equitable Securities** ponied up the additional \$1 million. This gives PCA cash to use in purchasing pathology practices.

Meanwhile, **AmeriPath, Inc.** continues to expand its reach in the pathology marketplace. This time it acquired a pathology practice in Wisconsin. The five pathologists who own **Consultant Physicians in Pathology** of Beaver Dam, Wisconsin, signed a long-term management agreement with AmeriPath.

Even as national HMOs push premium increases of 7-10% on employers this year, the monthly Producer Price Index (PPI) for healthcare providers remained stable. For the 12-month period ending in April, the **Department of Labor** reports that acute care hospital

prices increased only 0.8%. The physician PPI was equally modest, with only a 1.8% increase for the same time period.

## COLUMBIA SHRINKS AS TENET GROWS

**Columbia/HCA Healthcare Corporation** entered into an agreement to sell 22 hospitals and other related facilities located in Kentucky, Tennessee, Alabama and North Carolina. Buyers are not-for-profit hospitals or systems located near the hospitals to be sold. The aggregate sales price is expected to be \$1.2 billion. This is another major step in dismantling the for-profit hospital empire assembled by former CEO Rick Scott.

Meanwhile, another for-profit hospital operator gains financial strength. To add to its cash flow, **Tenet Healthcare Corporation** is refinancing \$1.35 billion of corporate notes at interest rates averaging 2% below its existing notes. Tenet will be a tough competitor, as it has doubled its EBIDTA (a measure of cash flow) to \$1.75 billion in

just three years. Expect further hospital acquisitions as Tenet puts its additional cash to work.

## ADD TO...TENET

For those clients of THE DARK REPORT following integration attempts by Tenet and **Medpartners** in Southern California, here's an interesting development. MedPartners announced a lay off involving as many as 1,000 of its 9,200 employees in that part of the state. At least 48 physicians will be included in the cutbacks. This is the second staff reduction in a year, and demonstrates that managed care trends continue to make radical cost reductions a survival requirement.

For some reason, laboratorians like to office on Maryland Way in the Nashville suburb of Brentwood. Latest to take occupancy on that street is Christine Diehl. Most laboratorians know her as the corporate Director of Laboratory Services for **Columbia/HCA**. She recently left Columbia and joined **MDS Laboratory Services, U.S.**, where she is Director of Operations and responsible for developing customers for MDS' automated laboratory products.

*That's all the insider intelligence for this report.  
 Look for the next briefing on Monday, June 15, 1998*



## ***UPCOMING...***

- ***How Nichols Institute's ISO 9001 Certification Changes The Competitive Landscape.***
- ***Ancillary Contracts Manager For A Large Blue Plan Offers "Facts Of Life" For Labs.***
- ***Shake-Up In Pathology: A Look At Why Some Practices Enjoy Increased Income.***
- ***Innovation At The Veteran's Administration Revamps Underperforming Lab Division.***