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From the Desk of R. Lewis Dark...

THE DARK REPORT

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

Restricted information, see page 2

Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher

Small is Beautiful

I MAY BE THE FIRST TO PUBLICLY DESCRIBE an emerging market trend in the laboratory industry. Starting in the mid-1980s, small laboratories disappeared from the landscape at an astonishing rate. Within the commercial laboratory segment, acquisitions of small laboratories fueled the consolidation process. Eventually three huge laboratory companies emerged as the industry behemoths.

Since 1990, the hospital industry has undergone a tidal wave of mergers, acquisitions, joint ventures and alliances. In its own way, this movement fueled the consolidation of hospital-based laboratories. The process of hospital laboratory consolidation continues at a frenetic rate today.

Tenet Healthcare Corporation's Southern California laboratory project (described on pages 2-7) is an example of this consolidation process. But it is also an example of the new trend I have identified. That trend is toward smaller laboratory business units and away from inter-regional or national laboratory systems.

There is an increasing volume of anecdotal evidence which documents that the most successful laboratory business models in those markets with advanced managed care possess four characteristics. First, they have total focus and concentration on the market area they serve. Second, the geographical region they serve usually encompasses the same area where the major managed care plans have beneficiaries. Third, the organization has a leader who imparts vision and strategic direction to the laboratory organization. Fourth, the laboratory understands how to meet and exceed the expectations of its physician users, and delivers such services better than its competition.

Tenet's Southern California project seems to have these four characteristics. Although not given a public profile, the leader of this effort may well be Neil Sorrentino, Senior Vice President and Chief Operating Officer of Tenet's Southern California region. Another good example in California is **Pathology Medical Laboratories** in San Diego. This laboratory demonstrates all four characteristics that I described above.

At our upcoming *Executive War College* in New Orleans (May 12-13), there will be more examples of these highly successful, but relatively small, regional laboratory systems. There will be reports by ancillary contract managers of major managed care plans on their growing appreciation of small, regionally-focused laboratory providers. These early indicators seem to validate my prediction that "small is beautiful" once again in the laboratory industry! TDR

30-Hospital Lab Contract Inked By Tenet & SBCL

SBCL to manage all laboratory operations for Tenet's Southern California hospitals

CEO SUMMARY: By signing this deal with Tenet, SmithKline Beecham Clinical Laboratories captured one of the largest hospital laboratory management contracts ever offered. The project's size, scale and far-flung geography make this a daunting challenge, particularly given California's competitive managed care marketplace.

FOLLOWING MONTHS OF STUDY and negotiations, **SmithKline Beecham Clinical Laboratories** (SBCL) and **Tenet Healthcare** announced on January 7 that SBCL would manage Tenet's 30 hospital laboratories in Southern California.

This agreement represents the largest laboratory management contract ever negotiated for a defined geographical area. Tenet operates 30 hospitals in Los Angeles, Orange and San Diego Counties. SmithKline assumes responsibility for managing laboratory operations at these facilities.

The scope of the project is staggering. Tenet's 30 hospital labs perform almost seven million tests per year. Assuming an average cost per test of $12.00, combined annual expenses of these laboratories could easily represent in excess of $84 million.

Another challenging factor is the geography. Tenet's southernmost hospital in San Diego is 150 miles away from its San Fernando Valley hospitals. Transportation of specimens between all the hospital labs must rely upon California's car-clogged freeway system.

Size and distance are two aspects which make the agreement significant. Another is its emphasis on service. "This is not a traditional arrangement between a hospital and commercial laboratory," stated Don Wheeler, Director of Operations Improvement at Tenet. "Typically that involves sending out as many lab tests as possible. Our goal is different. SmithKline will help us restructure laboratory operations at the 30 hospitals so as to improve service while maximizing the number of tests performed *within* Tenet facilities."

From Tenet's perspective, their agreement with SmithKline involves contract

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management of the hospital laboratories, not outsourcing inpatient tests to SmithKline's Van Nuys laboratory. As Wheeler states, Tenet's primary motive is to improve service while lowering costs.

Smaller Hospital Lab Facilities

"Because many of our laboratories are in smaller hospital facilities," said Wheeler, "they are not capable of meeting the changing needs of each hospital. California's competitive healthcare environment is always raising the service bar. Tenet needs to respond to those service needs, both today and in the future.

"That is why our primary goal in this contract management project is to improve service levels while consolidating the laboratory operations in sensible ways," he continued. "We are establishing flexibility to improve our laboratory capabilities as the healthcare market evolves."

Early details of how SmithKline and Tenet will revamp existing laboratory arrangements are sketchy. The basic plan calls for the creation of two core laboratories at Tenet's **USC University Hospital** in Los Angeles (Los Angeles County) and **Western Medical Center** in Santa Ana (Orange County).

Rapid Response Labs

The remaining hospital laboratories will be converted into rapid response laboratories. "Because we want to improve service," noted Wheeler, "we will determine the specific tests to be performed at each rapid response laboratory based upon turnaround time requirements, distance to the core laboratory and similar criteria. There is no 'cookie cutter' solution which can be applied to each hospital site."

Tenet's existing 30 hospital laboratory administrators will apply for 12 available laboratory directorships. Depending on the size of the individual rapid response labs, each new director will have responsibility for one to four sites. The laboratory directors will become employees of SBCL. As the new laboratory administrator positions are filled, it is these individuals who will help develop the specific reengineering plan for the rapid response lab sites under their purview.

Existing Tenet med techs at the various sites will apply for positions as specific staffing requirements are identified. They will remain employees of Tenet. "The announcement has been made that there will be no mass lay-offs," explained Wheeler. "It will take some time to organize individual laboratories into the appropriate rapid response lab structure. As this occurs, we want to retain and support our most effective employees while using normal attribution as one way to reduce overall staffing levels."

"For us to make significant break-throughs in lowering costs would require us to adopt new, possibly even radical, philosophies and techniques. We had to go outside Tenet for such resources."

"This project evolved over two years," Wheeler noted. "We studied a variety of approaches. On the cost-reduction side, we realized that our hospital laboratory administrators had done a good job of squeezing costs through conventional methods. For us to make significant break-throughs in lowering costs would require us to adopt new, possibly even radical, philosophies and techniques. We had to go outside Tenet for such resources.

"On the service side, we understood that we had to continually improve what our laboratories do for clinicians. That also requires radical thinking from most laboratory administrators, because they must call upon a different range of experience and management models to achieve this."

In searching for the outside management expertise, experience, and philosophy needed to create radical change, Tenet focused on the national commercial laboratories. "From our perspective, they bring objectivity to the process of restructuring and changing the organization," noted Wheeler. "They also possess practical skills in taking costs out of regional laboratory systems."

Tenet deliberately chose to partner with a commercial laboratory and not a laboratory consulting firm. "Commercial laboratories have hands-on experience at moving laboratory specimens from point to point. They have information systems capable of linking far-flung laboratory locations," explained Wheeler. "Also, with risk-sharing involved in this contract, the financial strengh of commercial labs complement their practical experience and resource base.

"Since finalizing our arrangement with SmithKline," he went on, "they have moved quickly. We are impressed with extensive resources rapidly committed to this project. They assembled a sizable implementation team which is already working with our laboratory administrators to fast-track the planning process and its subsequent implementation."

Financial Considerations

Neither party to the agreement would discuss the financial arrangements. It can only be speculated that there is some formula which reimburses SBCL for its management time. The amount of reimbursement is probably weighted by actual performance in cost reduction, service enhancements and performance against defined deadlines.

THE DARK REPORT believes that this Tenet-SBCL contract represents a watershed change in the marketplace. Tenet has credibility among hospital CEOs. The fact that Tenet is willing to rely on a commercial laboratory partner to restructure and manage 30 hospital laboratories will not go unnoticed. The Tenet-SBCL agreement will encourage other hospital systems to entertain similar proposals from national laboratories and their regional commercial lab competitors.

Judging Contract Success

It will take several years before the success of this Tenet-SBCL contract can be determined. Success must be judged against three criteria. One, did the contract management arrangement lower laboratory system costs by the expected amount? Two, did the reorganization of laboratory services create the capability to evolve value-added laboratory services in response to market changes? Three, did *both* Tenet and SBCL make money from this contract?

The last item is the one which laboratory executives should carefully watch. Will SBCL recover its costs and earn a satisfactory profit margin for the services it provides Tenet? Although the three blood brothers want to expand their activities in hospital laboratory management, it is crucial that such arrangements be as profitable to them as with their hospital partner. Earning revenue from contract laboratory management is a diversification strategy that only works if the commercial laboratory can make a satisfactory profit margin.

Because of the magnitude of this Tenet-SBCL project, both companies will be challenged to maintain deadlines while minimizing disruptions and problems. Wheeler acknowledged that fact. "I am relatively confident that there will be pain. But the benefits to a comprehensive realignment of our laboratory services will far outweigh any short-term discomfort. Most importantly, we are focused on the needs of our customers and we know these changes will enhance the laboratory services that they receive from Tenet's hospitals." TDR

(For further information, contact Don Wheeler at 972-702-6523.)

Consider Tenet-SBCL Deal As Timely Wake-Up Call

Market forces continue to work against those lab directors hoping to preserve the status quo

CEO SUMMARY: Expect the Tenet-SBCL contract announcement to trigger similar deals during the next 18 months. Competition and the need to gain economic advantage will drive some hospital CEOs to turn their laboratories over to commercial laboratory partners. The number of such joint ventures and contract management projects will increase rapidly.

BY ALL MEASURES, the laboratory management contract between **SmithKline Beecham Clinical Laboratories** (SBCL) and **Tenet Healthcare** is a milestone event for the lab industry.

It is an important wake-up call to hospital-based laboratory administrators, both in California and throughout the country. A respected hospital operator is choosing to place laboratory operations in the hands of an outside company. A careful reading of the circumstances leads to the conclusion that more such arrangements will occur between hospitals and commercial laboratories.

A more detailed understanding about why this contract was negotiated develops after sifting through the public comments of the two companies and combining that with market knowledge of circumstances in Southern California.

The goals are indeed about cost reduction and improving laboratory services. But that simplifies the more complex market dynamics which validate the premise behind this laboratory management contract.

Certainly cost reduction was a factor. But read carefully the public comments about this contract. Tenet realized that its internal cost-cutting capabilities had reached the point of diminishing returns. On their own initiative, most laboratory directors at the Tenet hospitals in Southern California had used the obvious techniques to squeeze costs out of the laboratory.

Fractional Cost Reduction

On a go-forward basis, Tenet was only going to get fractional cost reductions with the existing management arrangements. To create a quantum leap in cost-cutting capability, Tenet would need to radically change the status quo. Further, Tenet had to go outside the organization to access management techniques and knowledge that none of their existing hospital laboratory directors possessed.

By selecting an outside partner to drive its laboratory restructuring, Tenet accomplished both goals in one move. It is using the knowledge of an outside resource to introduce and implement radi-

cal change to the status quo. From the perspective of senior management and stockholders, this is a good strategic decision.

But where does that leave the other primary goal: improving clinical laboratory services? Again, Tenet recognized that existing laboratory arrangements at the smaller hospitals limited the service capability of that laboratory to meet the needs of physicians and other users.

Tenet also understood that physician users of the laboratory continue to undergo their own paradigm shift. The demands of integrated healthcare, declining reimbursement and better use of clinical information are forcing physicians to alter their clinical practice procedures.

"It is noteworthy that the Tenet-SBCL contract is happening in California. The state is a bellweather for healthcare trends which later migrate to other cities and states."

Director, Hospital Alliances
National Laboratory

This has a direct impact on laboratories. If laboratories are to meet and exceed the expectations of their physician customers, they must identify those changing needs and alter their laboratory operations to provide new services. Tenet understood this perfectly. For each Tenet hospital to remain a preferred clinical services hub in its region, it must constantly upgrade ancillary services.

THE DARK REPORT believes that senior hospital administrators in Tenet's Southern California region were ahead of their peers and competitors in understanding this market-driven phenomenon. As a for-profit hospital chain, they have a short window of opportunity to change with the market, or see competing hospitals steal their business.

Thus, the more compelling reason for this laboratory management services contract was the need to redesign a regional laboratory system that could better serve hospitals and physicians. Further, it was essential that this revamped laboratory service organization possess the innate capability of adding additional lab services as required by the changing needs of those physicians using the laboratory. The radical nature of the laboratory services contract between Tenet and SBCL accomplishes both primary goals.

It is also important to separate the "plan" from "implementation." Laboratory directors are famous nay-sayers. They can predict misfortune for any proposed change to their beloved laboratory.

But in the case of the Tenet-SBCL arrangement, there is sound business strategy underlying the logic of the deal. Implementation is a separate challenge. One or both companies could cause the implementation of this business plan to undergo significant problems, if not fail completely.

Frankly, THE DARK REPORT doubts that this project will run into trouble. There will be the usual potholes and unexpected surprises. But the overall gains to Tenet will far outweigh any implementation problems.

Significant Other Lessons

Now that an understanding of the more sophisticated business reasons underlying this laboratory service contract has been established, it is useful to point out significant other lessons.

First, regardless of the motives of both parties to the contract, the primary effect of laboratory reengineering will be to remove excess laboratory capacity from the marketplace. Testing will be consolidated among the 30 hospitals. Redundancies in staffing, instrumentation and management will be reduced, if not eliminated outright.

Second, Tenet's laboratory reengineering project will effectively create a unified regional laboratory system

within Orange County and Los Angeles County. This laboratory system will have both the capability and the motive to pursue outreach business from each medical campus around the 30 hospitals.

Both actions by Tenet illustrate the market forces described by THE DARK REPORT in recent years. It is laboratory overcapacity which feeds below-cost pricing. Laboratory reimbursement will not improve until enough excess capacity is taken off-line.

Regional laboratory systems meet managed care's need to contract only with providers who have service infrastructure in the same geography where the managed care plan has beneficiaries. Regional laboratory networks are the independent hospitals' response to this market dynamic. In Southern California, Tenet happens to be big enough to create their own regional laboratory network.

Outreach Program Next

We predict that Tenet will initiate a laboratory outreach program in the later phases of the restructuring. Simple economics makes this an accurate forecast: the easiest way to lower a laboratory's average cost per test is to increase the specimen volume going through the facility.

Tenet's Southern California hospitals and their competitors are subject to the same trend: regular annual declines in the number of inpatients. If no action is taken, declining specimen volumes from inpatient testing guarantees that Tenet will see predictable annual increases in their laboratory cost per patient.

They can forestall that event by launching an effective laboratory outreach sales and marketing program. The additional volume of outreach specimens will lower the average cost per test over a multi-year period. That is why Tenet will organize a laboratory outreach program in some future phase of this reengineering project.

We hope that laboratory administrators now understand the reasons why they should consider the Tenet-SBCL laboratory management contract as a wake-up call. There are sound business reasons why Tenet decided to pursue this project. Other hospital systems face the same circumstances and will consider the same options as Tenet.

A key point to emphasize is this: no matter how good a job any laboratory director feels they have done, it is not enough in today's managed care world. Developments in Southern California lead THE DARK REPORT to make the following recommendations to hospital laboratory administrators and managers.

First, *initiate change* in your laboratory that creates lower cost and improves your laboratory's ability to deliver "value-added" services to the clinicians.

Second, *think "out-of-the box*." Tenet realized that its laboratory managers had used up their personal bag of tricks. Radical improvement would not come from inside. SBCL will do what the Tenet's laboratory administrators failed to do on their own: consolidate testing among the facilities in a rational way, create a regional laboratory capability and begin enhancing those lab services which physicians need in an integrated clinical setting. Many of these management options were known to the existing Tenet laboratory administrators. But the usual excuses as to "why this couldn't happen" were given. No lab director took a leadership role and implemented such projects on their own initiative.

Third, *learn management techniques* for creating change, helping people become more productive and enhancing services. Become a management asset for your hospital.

Laboratory administrators who survive and thrive in the coming years will be the ones who decided to act upon the three recommendations above. This huge laboratory management contract is the wake-up call which should not be ignored. TDR

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

Viewpoints

A Health-Care Crisis That Doesn't Exist

Although Lawrence A. McAndrews' Letter to the Editor bemoaning the alleged health-care crisis for children is a slow-moving target, its thinly veiled political motivation makes it utterly irresistible "Uninsured Children a Growing Problem" (Dec. 3).

Mr. McAndrews trots out the threadbare assertion that there are 10 million uninsured children. Here are the facts; two million of these children live in families with incomes of $40,000 or more, another 1.2 million are not covered by their parents' work-based health insurance, though they certainly could be for a nominal charge; three million are eligible for Medicaid; about 700,000 are without insurance for brief periods because inconsistencies in their parents' income move them in and out of Medicaid; and about a million are uninsured because their parents are temporarily unemployed. That leaves the number of bona fide uninsured at about two million, not 10.

Underlying his charge is the common but patently false claim that health-care costs prohibit families from obtaining insurance: The Department of Health and Human Services has concluded that only 1.3 million children under 18 lack insurance because of its cost.

And notwithstanding his statement that premiums have risen four times faster than incomes between 1987-1997, the net percentage of children without health insurance between 1987 and 1997 has remained largely unchanged. What did change are the eligibility standards for Medicaid, which in 1987 were amended to include pregnant women and their children with incomes of 250% of the poverty level. That gave employers the incentive to write those employees out of their health insurance plans. What Mr. McAndrews is effectively championing is yet a further and more massive shift towards federal funding of children's health care.

Phil Mella

Colorado Springs, Colo.

Commentary:

This letter is reprinted from the *Wall Street Journal* of December 26, 1997. It is a fascinating rebuttal to one of the "health care crisis" issues which regularly surface.

The laboratory industry already suffers the financial burdens of the Medicare and Medicaid systems which arbitrarily reduce or deny adequate reimbursement for laboratory testing. It is certainly not a positive development for proponents of a government-funded healthcare system to manufacture a "crisis" among the so-called "uninsured children" which doesn't exist.

As the letter-writer points out, there is a relatively small pool of children who truly meet the definition of uninsured. But the true facts will not go reported by the media. Only the claims of those seeking to increase government involvement in healthcare seem to get wide-spread attention.

At THE DARK REPORT, we believe that our clients appreciate insights into the true facts underlying political debates which can harm the financial stability of clinical laboratories.

-Editor

Oldest Continuous Operating Lab Network

Market Forces Cause Detroit's Lab Network To Launch Operations

CEO SUMMARY: Joint Venture Hospital Laboratories' success rests on an essential fact: it exists to respond to marketplace demands. The network links laboratory operations of 24 hospitals owned by eight integrated delivery systems in Greater Detroit. Not only is it the oldest continuously operating regional laboratory network in the United States, but it is probably most successful at managed care contracting, with 400,000 lives currently under contract. The broad range of accomplishments of this network confirms that the regional laboratory network concept is viable.

HEALTHCARE'S EVOLUTION TOWARD managed care and clinical integration generated a distinctive new laboratory business model: the regional laboratory network.

Such networks are a relatively new phenomenon. Not until 1995 did laboratories in communities throughout the United States begin forming regional laboratory networks. Since that date, as many as 40 such networks are either organizing or in operation.

In fact, during 1995 and 1996, the laboratory movement received a lot of ballyhoo, much of it unwarranted. With few exceptions, regional laboratory networks have disappointed their organizers. The birthing process is lengthy, rancorous and seething with politics. Economic gains expected by members seldom appear.

Thus, it is ironic that the oldest regional laboratory network may also be the most successful. It is **Joint Venture Hospital Laboratories** (JVHL) in Detroit, Michigan, founded in 1992.

"Originally we were a partnership of four laboratories operated by different health systems," said Jack Shaw, Executive Director of JVHL. "Managed care is what caused us to come together. The early 1990s was the time when local managed care plans began to contract for exclusive provider arrangements."

"Each of the original four partners was a consolidated laboratory owned by an integrated healthcare system. Each of the four partners had significant outreach business," continued Shaw. "For that reason, every founding partner in JVHL stood to lose a considerable amount of outreach testing volume if it was excluded from provider status by any of the important local managed care organizations."

Because the network was formed in response to outside market pressures, it had clear-cut goals. This gave organizers a common purpose. Progress was swift.

"Gaining provider status for upcoming managed care contracts was essential if we were to retain our existing business," added Shaw. "Fear of loss motivated all our network partners to slice past politics and rapidly develop a viable business plan."

According to Shaw, by early 1993, the legal and organizational work was completed. JVHL began aggressive bidding for managed care contracts. Its first contract involved 90,000 lives.

No Models To Follow

"When we started this, there were no models to follow," noted Shaw. "It was not clear whether organizing a network was the right approach to the managed care problem our individual laboratories faced. But continued evolution of the healthcare market in Detroit has validated the foresight of JVHL's founding four laboratory partners."

JVHL was originally organized as a partnership. "At that time, there were no LLCs (limited liability corporations)," Shaw explained. "Later we decided to use the LLC model because it facilitated contracting. With an LLC, we can assume risk and create a withhold for each different managed care contract.

"Another distinctive aspect of JVHL is the fact that we do not use the messenger model. It has been our experience over the past five years that the messenger model is cumbersome and, quite frankly, inhibits swift responses to changes in the marketplace.

"We operate without the messenger model because JVHL acts as the external negotiating agent for the participating laboratory members. Our member laboratories sign participating hospital provider agreements that authorize JVHL to bargain for them. That is a key point in this arrangement."

Conflicts Of Interest

The individual interests and actions of participating members sometimes conflict with those of JVHL. "There have been occasions when an individual laboratory wants to bargain on their own. We've had to work through those situations. But with one exception, we are a

non-exclusive network. That exception is simple. If JVHL holds a contract, a member, by itself, cannot negotiate that contract away from JVHL.

"By no means is this the last word on that subject," observed Shaw. "As the marketplace evolves, each JVHL member laboratory has their own business objectives. We sometimes have to work through those situations."

The network's emphasis on gaining and keeping provider status with managed care plans is the glue which binds together the eight integrated health system laboratories.

"However, all members recognize that JVHL is a market-driven network," he continued. "It does not exist to consolidate testing and lower costs among network laboratories. Rather, the primary business objective of JVHL is to permit constituent laboratories to bid for, and service, managed care contracts to which they would normally be excluded."

The network's emphasis on gaining and keeping provider status with managed care plans is the glue which binds together the eight integrated health system laboratories. It allows JVHL to avoid the disagreements, political infighting and lack of focus which plague most laboratory networks. As a business entity, JVHL succeeds because of its well-defined objective and alignment of financial incentives for all the participating laboratories.

Operationally, JVHL designed a simple governance structure. The need for a paid executive director to advance the interests of the network was recognized. This led to the funding of a dedicated, part-time executive director beginning in 1996.

An executive committee meets monthly, for ten months each year. The executive director reports to the president (elected for a two-year term) of the executive committee. "Each member has equal representation on the executive committee," noted Shaw. "The executive committee operates primarily on the basis of consensus."

Subcommittees deal with five key areas: operations, marketing, quality assurance, finance and billing/LIS. "These committees are staffed voluntarily by our members. These committees are the working engines for our network. They are responsible for developing and maintaining the services necessary for the network to function.

"We also pay for centralized administration, marketing and finance," said Shaw. "We started by having these functions handled on a voluntary basis. That became overwhelming to the volunteers. With downsizing in their own laboratories, squeezing extra time for JVHL duties proved almost impossible. More importantly, the work itself was difficult to accomplish on a timely basis. During the last year we brought these functions in-house and run them from the office of the executive director."

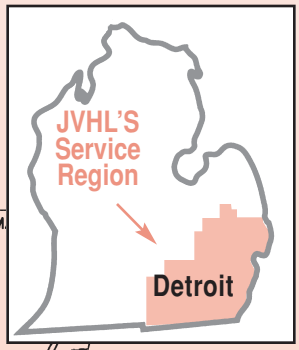
Dual Network Membership

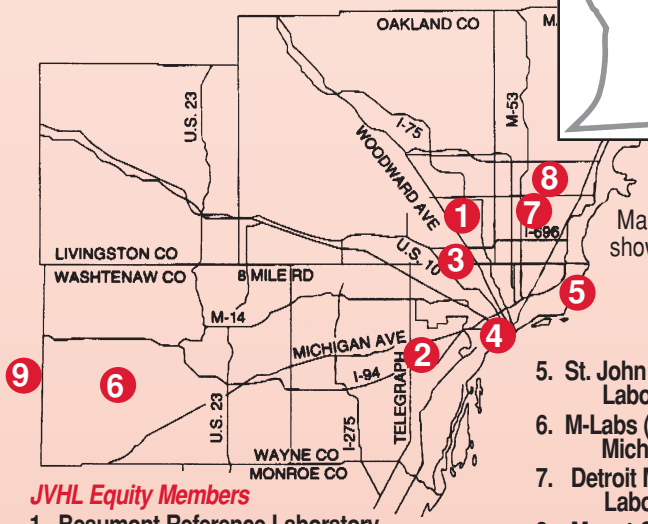
The system of dual membership between equity and non-equity members developed for two reasons. Shaw explained, "First, this permits us to expand the service area covered by our laboratory network. There are also logical partners for our network who may not wish to make an equity investment.

"The second reason for accepting non-equity partners comes from the managed care plans themselves," he said. "The MCO (managed care organization) may require us to include a non-JVHL provider. That MCO may have a key link with a healthcare organization outside our organization. If that is the case, we have the flexibility to include that provider in our network and gain provider status with that particular contract."

JVHL Offers Metro-Wide Coverage For Detroit's Managed Care Plans

Joint Venture Hospital Laboratories demonstrates that the concept of a regional laboratory network has merit when participating laboratories are willing to align their business interests, push past politics and emphasize a bias for management action. JVHL is becoming a major laboratory provider in the Detroit Metro area.





Map of Greater Detroit, showing member systems

JVHL Equity Members

1. Beaumont Reference Laboratory
2. Oakwood Laboratories
3. Hospital Consolidated Laboratory
4. Detroit Medical Center University Laboratories
5. St. John Clinical Pathology Laboratories
6. M-Labs (University of Michigan)
7. Detroit McComb Clinical Laboratories
8. Mount Clemens General Hospital Laboratory

Non-Equity Member:

9. Foote Hospital Laboratories

Shaw noted that JVHL's sustained operational success now requires it to expand in order to access additional managed care contracts. "We have matured to the point where we have confidence that JVHL now has a permanent place in the market.

"Currently our network serves an area which contains 60% of Michigan's population. We have eight equity members representing 24 hospital laboratories. This gives us a solid service infrastructure, including 90 PSCs (patient service centers and 84 courier vehicles.

"I might add that we've always considered these high numbers of PSCs and couriers to be a network strength. However, our thinking is evolving. Economics within our healthcare market may not warrant these numbers. Bigger may not make us better.

"Presently we have a study group looking at ways to realign this infrastructure to improve service and eliminate redundancy," stated Shaw. "Already our members recognize that MCOs don't want to pay for unnecessary infrastructure. For that reason, we want to initiate smart management changes before the marketplace forces them upon us. It reflects upon the maturity of our network that we are

responding to these kinds of dynamics in the marketplace."

Another smart management strategy is JVHL's approach toward information systems. "I am constantly amazed at how other regional laboratory networks make LIS such a major impediment to start-up. Our solution was both simple and low-cost," said Shaw. "We determined that all necessary information could be reduced to an ASCII format. One of our members took the initiative to develop a tape format.

"After three or four versions, we arrived at an ASCII tape format that every member laboratory could produce from their own LIS. Each reporting period, every member laboratory sends us a tape. These are loaded into our network host computer, run by one of the members. The necessary reports for JVHL are generated in this way."

But what about results reporting? "That is a capability we would like," responded Shaw. "We notice on RFPs issued by the national HMOs that they commonly want disease management information. Although we don't capture that information now, we have made the development of this capability a major goal for 1998. We believe we can accomplish this on a practical basis without buying a new computer system."

TIME LINE OF EVENTS FOR JVHL NETWORK

Here are key events in the development and evolution of Joint Venture Hospital Laboratories:

1992: *Organized as a partnership of four health system-affiliated laboratories in response to exclusive provider contracting initiatives by local MCOs.*

1993: *Obtained provider status on first managed care contract.*

1994: *Began providing laboratory services under this first contract, serving 80,000 lives.*

1995: *Awarded exclusive two-year contract on 350,000 lives. Added two equity members. Reorganized as LLC.*

1996: *Added one equity member. Hired first paid executive director.*

1997: *Added one equity member. Awarded fee-for-service contract involving 20,000 lives.*

Unique Funding Method

JVHL also has a unique method of funding itself. "We operate JVHL on a zero-income basis," Shaw explained. "JVHL collects the revenue, takes a portion to cover administrative expenses, and remits the balance to the members.

"During the last year, those administrative expenses totaled 8% of collected network revenues. Thus, 92% of the money went directly to the member laboratories. This money is divided quarterly, using a relative value methodology for the work performed that is loosely-based on Medicare relative values."

With the business savvy shown by JVHL leaders in the design and operation of the network, there is a continual awareness of the need to be a "value-added" provider to clinicians and managed care plans. "We regularly evaluate what we do, what the marketplace wants from a laboratory and how we can bring unique and valued services to our clients," commented Shaw. "We consciously avoid participation in national contracts with the three national labs if JVHL is restricted to providing access to our patient service centers and stat lab agreements. Our goal is to be the primary source for physician office testing in our market areas."

Value-Added Factors

"We want to provide value-added factors such as including emergency room testing," he added. "Since our laboratories are part of integrated systems, we can offer this service. Plus, we know how to properly price such services. Capabilities such as these set us apart from the national laboratories. Managed

care companies like to bundle as many laboratory services as possible. This is one example where JVHL increasingly becomes a single solution for the MCO."

Given that most regional laboratory networks are struggling just to get off the ground, why has Joint Venture Hospital Laboratories been successful? The answers are surprisingly simple.

First, an outside market influence motivated the network's founders to meet together, develop a business solution and implement it without delay. For JVHL members, the threat that managed care plans would exclude them from serving their own laboratory outreach customers was the motivation to organize the network and make it work.

Second, JVHL approached the network as if it were a stand-alone business. This is an important concept. JVHL's founders developed a cash flow program that funds the network's activities from current revenue. JVHL differs from the "shared testing" networks in that it finances its ongoing operating costs of the network from contract revenues.

Executive Director Needed

Third, JVHL recognized that a dedicated executive director was needed. A business plan was developed that funded that position, beginning in 1996. With a part-time, dedicated executive director on the job, JVHL's key business initiatives are regularly pushed forward. This gives the network an edge when competing against the national laboratories who want the same managed care contracts.

Fourth, JVHL has consistently delivered the support services required for the network to fulfill its managed care contracts. This is the credibility which encouraged other laboratories to join the network, either as equity partners or participants. Recruitment of these new members gives JVHL more market reach and added clout when negotiating managed care contracts.

Pioneer Networks Include Pittsburgh, KC & San Francisco

DURING 1995, THREE OTHER regional laboratory networks were operational. Like JVHL, these were pioneering efforts at the network business model.

In San Francisco, **Bay Area Hospital Laboratory Network** (BAHLN) launched operations with 18 participating hospital laboratories. The network's goal was to lower costs through shared test and pursue managed care contracts. Since that date, the network has met with mixed results.

In PIttsburgh, **Reference Laboratory Alliance** (RLA) brought 40 hospital laboratories into a network model. RLA was organized as a regional reference lab, with 36 community hospitals funneling send-out work to the four tertiary laboratory partners. RLA also gained provider status for the **Keystone/Blue Cross** contract, returning a substantial volume of outreach specimens back to member laboratories. The emergence of two competing healthcare systems rendered RLA redundant, and it ceased operations on January 31, 1997.

Kansas City's **Regional Laboratory Alliance** (RLA) likes to call themselves "the other RLA." Launched with four hospitals and a regional laboratory, its immediate goal was to prevent loss of outreach testing from a managed care contract. After three years, this network seems to be flourishing relative to San Francisco and Pittsburgh.

Fifth, JVHL used a "keep it simple stupid" approach to systems and management. It avoided the messenger model. Its unified reporting uses low-cost ASCII-downloads from each member's LIS. It achieved centralized billing and consolidated utilization reports with a minimal outlay of capital and time.

It should not be surprising that JVHL is poised to become a state-wide regional laboratory network. The design of its

business plan, its governance and actual performance have earned it the respect of both managed care plans and other hospital-based laboratories.

"One thing we are learning about the managed care companies in Michigan is that they do not like to change," declared Shaw. "Once they identify something unique about a laboratory provider and establish a contract relationship, there is inertia within the managed care plan to stay with the existing relationship."

Dominant Market Position

"THE DARK REPORT is demonstrating that hospital laboratories which offer competitive services and pricing do achieve a dominant market position within their chosen service area," he continued. "That is certainly the experience of our equity members and the network itself. Where we do a good job and provide good laboratory services, we get the business and keep it.

"What has made this possible is JVHL itself. Without the ability to contract for laboratory services at a regional level, our individual lab outreach programs would have been denied provider status years ago. The regional laboratory concept was the critical piece which allowed us to match our strong clinical resources at the local level with managed care's needs for a region-wide contract provider."

Marketplace Principles

Shaw's description of events in the Detroit marketplace aptly reinforce the marketplace principles expounded by THE DARK REPORT. Hospital-based laboratories must operate with a business mind set. They must utilize professional sales and marketing programs to increase specimen volume. They must adopt regionalization strategies to meet the needs of managed care plans.

Those hospital-based laboratories which implement these management initiatives will be rewarded with a financially stable operation, growing employment base and dominant market share...just like the member labs of Joint Venture Hospital Laboratories! TDR

(For further information, contact Jack Shaw at 313-271-3692.)

JVHL's Upcoming Strategic Initiatives

JVHL continues to evolve. As management capabilities are developed, the network then pursues new priorities which can improve its competitive market position. These are some current initiatives:

Expand Marketing of JVHL: JVHL wants to directly approach employers and TPAs (third party administrators) as well as gain more managed care contracts.

Provide Statewide Coverage: With statewide laboratory coverage, JVHL gains a strong selling point with MCOs.

Develop Integrated Information Systems: Continue evolution of IS capability, including TPA functionality.

Reduce Costs For JVHL Members: With administrative resources now in place, the network intends to explore opportunities for members to reduce their operational costs.

Shared Compliance Programs: To avoid unnecessary duplication of costs, JVHL intends to sponsor training, information.

Improving Utilization Of Existing Lab infrastructure: The network is looking at ways to better utilize existing draw stations, courier routes, instrumentation and excess capacity.

Group Purchasing: An obvious opportunity to help members achieve lower costs.

Internalized Esoteric Tests: Look at consolidating send-out work of member laboratories.

Investigate Strategic Alliances: Are there good opportunities for synergy with national or regional laboratories? Exploratory discussions are ongoing.

New Pathology PPM Hits Competitive Marketplace

Pathology Consultants of America becomes the latest business model to enter the race

CEO SUMMARY: Nashville hatched another pathology-based physician practice management firm. This newest competitor was capitalized by pathologists. Its arrival in the competitive marketplace signals further changes to the traditional practice of pathology. Increasingly, it will be business skills, not clinical skills, which feed pathology success.

PATHOLOGY CONSULTANTS OF AMERICA (PCA) is the newest pathology-based physician practice management (PPM) company to launch operations.

Based in Nashville, Tennessee, PCA already has management contracts with three pathology practices, involving 30 pathologists. The company issued a press release today announcing its formation.

"Our distinguishing feature is that we are owned by pathologists," stated PCA Chief Operating Officer Jim Billington. "Not only are we physician-owned, but pathologists comprise a majority of our board of directors."

Billington revealed that pathologists provided most of the start-up capital at PCA. "The pathologists themselves were the ones who funded this business. It demonstrates a high degree of confidence in our business plan that pathologists were willing to take the investment risk to form this company."

Haywood D. Cochrane, Jr. is Chairman. He was formerly President and CEO of **Allied Clinical Laboratories** prior to its acquisition by **National Health Laboratories**. He is currently President and CEO of **Meridian Occupational Healthcare Associates, Inc.** and a director at **Unilab, Inc.** PCA's President and CEO is Brian Carr. Most recently he was director of corporate services at **PhyCor, Inc.** He also served at Allied Clinical Laboratories under Mr. Cochrane.

> ***"Our board feels that the big driver in our business plan is the fact that we are owned and operated by physicians themselves."***
>
> ***Jim Billington***
> *Chief Operating Officer, PCA*

"We have management contracts with three pathology practices," noted Billington. "They are **Pathology Group of the Mid-South, P.C.** in Memphis; **Columbus Pathology Associates** in Columbus, Mississippi; and **Colorado Pathology Consultants, P.C.** in Denver."

"Negotiations are under way with several other pathology practices," he added. "It would be safe to say that we expect to

announce additional management contracts before the end of the quarter."

According to Billington, the business design of PCA is that of a standard equity model PPM. "Our physicians are vehemently opposed to employment-model PPMs. By choosing to organize this company around the equity model, all participating pathologists will shoulder the risk of both success and failure. This creates an incentive based on performance."

Equity Model PPM

Like other equity model PPMs, PCA seeks to acquire the assets of pathology practices, as well as execute contracts to provide fundamental business services. Terms will vary according to the circumstances of individual practices and their local healthcare market.

The addition of a new pathology-based physician practice management company brings one more competitor into the marketplace. To make money for its investors and the participating pathology practices, PCA will need to demonstrate growth in specimen volume and revenues within each local market area.

Pathologists Will Compete

Local pathologists should begin to understand that shortly they will be forced to compete against PCA and other pathology PPMs. The era of quiet, collegial relationships between traditional pathology practices in a city is coming to an end. A new era of "dog eat dog" competition is emerging.

Whether the economics of pathology support a PPM business model or not, in the near future these competitors will radically reshape how pathologists organize themselves to contract for, and provide pathology services. PCA is the latest arrival, and demonstrates that market forces are working to transform traditional pathology business models. TDR

(For further information, contact Jim Billington at 615-665-4600.)

Who are the other Pathology PPMs?

PATHOLOGY CONSULTANTS OF AMERICA will compete against several other pathology PPMs. Each has a different business strategy.

AmeriPath, Inc. is the largest and best-financed. Based in Florida, it is an employment model PPM. It ended 1997 with 17 practices and 134 board-certified pathologists. It completed a public offering in October, 1997 and its stock trades on NASDAQ.

American Pathology Resources is based in Nashville. Because it has operated for a number of years, APR is familiar to most pathologists, The company operates a number of pathology practices in Tennessee and several other states.

Pathology Service Associates (PSA) is not a PPM. Rather, it is a physician network model. Originally formed in South Carolina to pursue managed care contracts, PSA now has affiliate networks in the states of North Carolina, Tennessee, Florida, California and Washington.

Physician Solutions, based in Nashville, is an equity model pathology PPM which recently announced a commitment for venture capital funding of $18 million. Physician Solutions has yet to announce any investments financed by the venture capital commitment.

Another PPM model which has yet to make a public announcement is **PathGroup, Inc.**, in Nashville. This is a pathology PPM which has a unique twist to the PPM business model. It seeks to create a national company by pooling the equity of participating pathology practices.

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Interesting events continue unfolding at **Columbia/HCA Healthcare Corp.** Last November the hospital giant announced plans to spin off 108 of its 340 hospitals. Later that month the Columbia signs were removed from its corporate headquarters building in Nashville. Columbia hospitals in different cities around the country have quietly removed the word Columbia from their names. Indications are that Columbia intends to undergo a name change at some future point.

ADD TO:...COLUMBIA

Early in January it was revealed that the **Justice Department** is asking state officials to join its probe of Columbia's laboratory billing methods. A confidential Justice Department memo was circulated to state officials nationwide on the issue of laboratory test billing and medical necessity for these tests.

According to the **American Medical Association**, more than half of the 600,000 physicians in the United States negotiated through an independent physician association (IPA) last year. Estimates are that 3,000 IPAs and 3,000 physician-hospital organizations (PHO) currently operate. Laboratories sell their services to IPAs and PHOs in many markets. With half of the nation's physicians now participating in IPAs and PHOs, this demonstrates the rapid restructuring occuring to the traditional clients of clinical laboratories.

APR LOSES LEADER

There is a change of leadership at **American Pathology Resources** in Nashville, Tennessee. George Goodwin, President and CEO, left the pathology-based physician practice management (PPM) last week. Chairman Robert West, M.D. is the interim President and CEO. No public announcement was made concerning reasons for Goodwin's departure.

An interesting footnote to events at **SmithKline Beecham Clinical Laboratories** (SBCL). The company announced the sale of its SBCL SCAN® business to **ActaMed Corporation** of Atlanta last week. SBCL SCAN is the computer system used by physicians offices for ordering laboratory tests and receiving results. More than 60,000 clients are hooked up to this system. ActaMed will maintain service to SBCL clients and assume responsibility for ongoing product development of this system. SBCL officials declined to comment on reasons for the divestiture of this business unit.

PhyCor, Inc. and **MedPartners, Inc.** will not merge after all. Officials at both companies announced on January 8 that "significant operational and strategic differences" made it impractical to complete the proposed merger. The combination would have boasted annual revenues of $8 billion and affiliations with 35,000 doctors nationwide (about 5% of all physicians in the United States).

MORE ON:...MERGER

Regardless of the corporate cultures of the two firms, the most daunting task facing them individually is how to address the unique differences of each regional healthcare market. These national physician practice management companies are struggling to maintain relevant local services appropriate to each regional market's needs.

That's all the insider intelligence for this report. Look for the next briefing on Monday, February 9, 1998

THE DARK REPORT

UPCOMING...

- *How HCFA and the OIG use software tools to investigate clinical laboratories.*
- *Prudential's healthcare unit ready to be sold: Who's interested in buying?*
- *Hospital-based pathologists to soon see declining numbers of Medicare patients.*
- *Forthcoming laboratory acquisitions: Is Dynacare on the move again?*