Volume V, Number 8 Monday, June 15, 1998

Exclusive Interview With Premier On Clinical Lab Alliance!
see page 7

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

Executive War College Goes International

IT MAY SURPRISE MANY PEOPLE TO LEARN THAT THIS YEAR'S *Executive War College* in New Orleans attracted registrants from New Zealand and Germany. What may be even more surprising is the reason they traveled from overseas to come to this particular program. Our editor met with them and learned some intriguing and useful things that I would like to share with you.

First, the German contingent. Several German laboratorians came to the *Executive War College* because healthcare trends in their country are running parallel to the United States. They wanted to explore the management models and successful organizational strategies used by innovative laboratories in our country. Unlike the United States, Germany has a single payer health system (the government). But like the United States, Germany has a fee-for-service payment arrangement for non-hospital healthcare (to physicians, laboratories and other ancillary providers).

The Germans traveled across the Atlantic to New Orleans for two reasons. First, Germany is introducing forms of managed care into the health system there. So our foreign guests wanted to learn effective ways to respond to these new dynamics. Second, in Germany, outreach laboratories which service physician offices are privately owned. Our guests had become concerned that an American laboratory company might show up in Germany, purchase a lab or two, and become the nightmare competitor everyone dreads. So they decided to "check out the competition" and learn more about the intentions of America's commercial lab companies.

Our guest from New Zealand was here for one reason: consolidation and regionalization have arrived down under. He is already involved in a country-wide laboratory and pathology consolidation. He wanted to hear the case studies and develop a personal network with laboratorians who've already gone through the process. New Zealanders knew about the Alberta laboratory consolidation *(See TDR, January 6, 1997),* so our Kiwi friend was keenly interested in meeting someone from Calgary at the *Executive War College* and doing a site visit to Calgary on his return swing home.

Two lessons can be learned from our international friends. First, healthcare really is undergoing the same pressures worldwide. Second, the *Executive War College* continues to be a respected gathering place where movers and shakers in the laboratory industry can get the real story about what is happening to our industry. Because I am curious to learn more from our foreign guests, look for future stories on labs in Germany and New Zealand in THE DARK REPORT. TDR

Private Consortium Plans To Decode Human Genes

New group raises the stakes in the race to map the full human genetic sequence

CEO SUMMARY: Five years ago, the only option for mapping was to involve the government. New advancements in technology have lowered costs so radically that now private companies are willing to use their own funds to map the human genome. This brings the day ever closer when genetics-based diagnostic tests replace existing phenotypic-based diagnostics. Advances in genetics will also transform anatomic pathology.

MOST LABORATORY EXECUTIVES are unaware of a revolutionary development in the field of genetics. On May 11, instrument maker **Perkin-Elmer Corp.** announced a joint venture with J. Craig Venter, Ph.D. and Dr. Venter's **Institute for Genomic Research**.

The specific goal of the joint venture is to map the human genome on an accelerated basis. Using a new generation of technology, the joint venture expects to map the entire human gene sequence in as little as three to four years, at a cost of less than $300 million.

In contrast, the federal government's Human Genome project is a 15-year effort that was launched in 1990. Run by the the **National Institute of Health** (NIH) and the **Department of Energy**, it is budgeted at $3 billion. Currently the project is at the halfway point. It was scheduled to have 1% of the human genome sequenced, but is ahead of schedule with about 3% of the genes completely mapped.

Should the effort by Perkin-Elmer and Dr. Venter prove successful, the ramifications are significant. For example, a tidal wave of new diagnostic tests could hit the the clinical laboratory marketplace within the next seven years.

Based on new knowledge of human genetics, these tests could substantially change the existing mix of diagnostic tests currently in clinical use. Such new genetics-based assays would inevitably impact the economics and finances of clinical laboratories. Their introduction could create a new class of winners and losers in the clinical lab industry, affect-

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

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

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

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

ing hospital laboratories and commercial laboratories alike.

For the healthcare industry, a successful effort by Perkin-Elmer and Dr. Venter brings a host of concerns. First, if private industry pays for this research, would Congress reduce existing appropriations now funding the Human Genome Project?

Second, if a private company gains this knowledge, how will society resolve issues affecting patent rights, legitimate access to the knowledge by researchers, and patient privacy. There is little consensus on these issues today.

New Genetic Analyzers

This venture should interest laboratory executives for another reason. It is only feasible because of Perkin-Elmer's new generation of genetic analyzers. These machines cost $300,000 and will be available to the commercial market within six to eight months. In only 15 minutes of operator-assisted time, the machine can process 15,000 samples per day. The previous generation of instruments required eight hours of operator time for the same number of samples.

Michael Hunkapiller, President of the **Applied Biosystems Division** of Perkin-Elmer, states that these new machines are so fast that they could identify the human genes 10 times more cheaply than the National Institute of Health's estimates. In fact, the joint venture believes that it will take as little as $150 million to $200 million to accomplish this goal. Perkin-Elmer is providing most of the funding for the joint venture.

Rapid Scientific Advances

THE DARK REPORT considers this story to be of importance for two reasons. First, it demonstrates how rapidly genetic science is advancing. In just eight years, technology has compressed a $3 billion dollar project requiring 15 years into one which requires one-tenth the money and one-third the time.

Dr. Venter Responsible For First Complete "Map"

J. Craig Venter, Ph.D. is the founder of the Institute of Genetic Research. He made news in 1995 when he became the first to map an entire genome for a living system: the meningitis bacterium.

Since then, Dr. Ventor and his team have identified genetic sequences for microbes that cause Lyme disease, syphilis, and stomach ulcers. His partnership with Perkin-Elmer to map the entire human genome is controversial. Some critics are convinced that the joint venture will not be able to pull it off.

*But some observers believe differently. "It's not impossible at all that he could succeed," observed Dr. William Haseltine, CEO of **Human Genome Sciences** in Rockville, Maryland. "Dr. Venter has demonstrated a fine track record of innovation and organization."*

Second, it is vital that laboratory directors and pathologists understand that new genetics-knowledge will revolutionize both diagnostics and therapeutics. Speaking bluntly, the coming tidal wave of genetics-based discoveries will upend clinical laboratory science and anatomic pathology as we know it today.

Seen from the level of technology in 1990, the joint venture between Perkin-Elmer and Dr. Venter is nothing short of revolutionary. Because the introduction of new technology tends to be exponential in its impact over time, lab executives and pathologists should begin to pay close attention to developments in the field of genetics.

Those laboratories and pathology practices which flourish in the year 2005 will be the ones which were early implementers of emerging genetics-based diagnostics. The warning signs are clear for all who pay heed. TDR

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

Premier Explains Reasons It Sees Lab As Strategic

Expectation is that strategic services alliance will help foster improved clinical integration

CEO SUMMARY: Premier's strategic alliance with Quest Diagnostics Incorporated represents a fundamental shift in the marketplace for hospital-based clinical laboratory services. This was a project developed by Premier, in response to its evaluation of marketplace trends affecting hospitals and their laboratories. For that reason, lab industry executives should pay close attention to why this alliance was created.

MANY LABORATORY EXECUTIVES and pathologists underestimate the profound changes represented by the strategic services alliance between **Premier Inc.** and **Quest Diagnostics Incorporated**.

Clinical laboratories have traditionally been an environment where radical change was unwelcome and unwanted. This is even more true of hospital-based labs than commercial labs. Thus, it is not surprising that the May 18 announcement of the Premier-Quest alliance was met with skepticism by a sizable number of laboratory administrators and directors.

THE DARK REPORT defines this event as highly significant. Our opinion is that Premier is acting in concert with market trends. It has accurately spotted an opportunity to nurture radical change within the integrated healthcare community by altering the way hospital-based laboratories are organized.

In the last issue of THE DARK REPORT, we analyzed this strategic alliance from Quest's perspective. Ken Freeman, CEO and Chairman of Quest Diagnostics, outlined for our clients the reasons why his company was involved with Premier. *(See TDR, May 26, 1998.)*

In this issue of THE DARK REPORT, we begin our coverage of this alliance from Premier's perspective. The interview with a Premier executive which follows on pages 7-12 gives you an insider's understanding of how Premier came to see clinical laboratories as a linchpin to fostering clinical integration.

> ***"Our 'breakthrough' mission means that we try, every 18 months or so, to come up with a blockbuster concept that can change healthcare services for the better."***
>
> ***Bill Nydam***
>
> *Executive Vice President, Premier Inc.*

This strategic services alliance has the potential to be huge. Premier's members control about $6 billion dollars per year of laboratory testing. Quest Diagnostics performs $1.5 billion of testing. Combined, these two entities control 25% of the estimated $30 billion per year

of laboratory testing performed in the United States. Further, Premier represents 1,700 of the nation's 5,000 hospitals, about one-third of all hospitals.

Thus, lab executives should not lightly dismiss this strategic services alliance. Its potential to reshape the clinical laboratory landscape is huge. Further, it is consistent with other marketplace developments affecting hospital laboratories. For example, the **Tenet Healthcare** arrangement with **SmithKline Beecham Clinical Laboratories** to restructure 31 hospital labs in southern California was a response to the same marketplace trends identified by Premier.

"Premier wants to develop 'breakthrough' initiatives that help our member hospitals," said Bill Nydam, Executive Vice President at Premier. "These breakthroughs should fundamentally change the way healthcare services are delivered and generate benefits which had previously been unattainable. Our corporate mission concerning breakthroughs is directly responsible for the clinical laboratory alliance."

Ways To Add Benefit

"Originally we looked at pharmacy, we looked at lab, we looked at any number of hospital services for ways that Premier could add benefit to our hospital members," continued Nydam. "Clinical laboratories jumped to the top of the list, based on reasons familiar to every laboratorian. Up to 80% of diagnostic information generated on a patient in a hospital comes from the laboratory."

Because diagnostics information impacts length of hospital stay and therapeutic decisions, Premier and a core group of its hospital owners realized that clinical laboratory services could be the catalyst for widespread, even radical, change.

"Plus, our hospital owners were frustrated with the lack of speedy responsiveness that seemed to be common from many laboratories," observed Nydam. "Although they were focused on cost reduction, we found that it was happening in little steps. For example, they would try to become more efficient within their own hospital. Then they might try to organize a network or centralize testing among several hospitals, maybe with a core lab or joint venture.

"But it was taking as long as ten years for the laboratories, on their own initiative, to work through these incremental steps," he added. "This is why many of our owner hospitals were frustrated with the pace of change in their institutions."

Thus, Premier's senior management realized that clinical laboratories could be fertile ground for innovation for two reasons. First, because of the widespread use of laboratory testing within and without the hospital to guide clinical decision-making. Second, because lab administrators, on their own initiative, were making improvements at a pace that could be described as glacial.

The interview which appears on pages 7-12 describes the step-by-step process which Premier used to study the problem, identify solutions, and cre-

Strategic Services Alliance Between Premier And Quest

Premier Inc. and Quest Diagnostics Incorporated announced a two-part strategic alliance on May 18, 1998.

The Reference Testing Agreement is one component. It is a five-year contract covering the traditional range of pricing and services for reference laboratory testing. The agreement makes Quest Diagnostics the primary reference provider to Premier.

The second component is the Strategic Services Contract. Basically, this arrangement allows any participating hospital, Premier, and Quest to work together to create additional value in the laboratory. Premier can earn cash and Quest stock for the participating member hospitals.

ate the hoped-for breakthrough product in clinical laboratory services.

Clients of THE DARK REPORT should objectively weigh the facts and motives which caused Premier to finally appreciate the potential of clinical laboratory services to impact the entire healthcare community.

Non-Traditional Services

First, Premier wants to do something non-traditional to laboratory services. From the start of this particular project, Premier sought to develop a paradigm-shifting way to radically alter the organization and delivery of lab services.

Second, CEOs at some of Premier's more influential hospital owners recognized that clinical lab services could be the catalyst to clinical integration within their system. Laboratory services represented a way to do two things: 1) to increase the speed of clinical integration; and 2) to deliver improved clinical outcomes which enhance the quality of care while reducing costs.

Potential Grand-Slam

Third, as outlined in the interview which follows, Premier's own study team of lab directors, pathologists, hospital COOs, and a CFO agreed that problems and opportunities in the lab industry gave clinical laboratory services the potential to be a grand slam home run if the right structure for improvement could be developed.

Fourth, also as outlined in the following interview, Premier recognized that hospital laboratory overcapacity was probably the single most important factor affecting the cost of lab services. They would have to address overcapacity as part of this new project.

Fifth, Premier was willing to create, build, or fund whatever was necessary to restructure laboratory services in an effective way. After looking at all options, it was decided that partnering with a commercial laboratory which already had infrastructure, trained managers, and experience was the best way to go. This was for reasons of speedy implementation, to lower front-end capital costs, to access national managed care contracts, and to develop a national utilization and outcomes database.

Sixth, Premier has designed the strategic services alliance to be voluntary for its members. It created a win-win arrangement that gives incentives to hospitals, Premier, and Quest to work together. Strategic services stand apart from the standard national reference testing contract.

Short-Term Savings

Financially, the stakes are immense. Premier believes that short-term savings in the range of 10% to 20% are attainable. Longer term, Premier hopes to drive the cost of hospital lab testing down to levels comparable with the national commercial laboratories.

Given the fact that Premier members control $6 billion per year of testing, a 20% improvement would deliver $1.2 billion in savings to be shared by member hospitals, Premier and Quest. That is certainly a goal worth pursuing, and it is independent of other benefits, such as clinical integration and reduced test utilization.

Laboratory administrators and pathologists have screamed for years that hospital administrators tend to overlook the potential value of laboratory testing to impact healthcare costs on a grand scale. Premier has finally heard that message.

Now it will be interesting to see if these same laboratorians are willing to embrace radical changes to the laboratory's organization, structure, and leadership which can generate potentially huge benefits to the hospital and its surrounding medical community. **TDR**

(For further information, contact Bill Nydam at: 619-481-2727 or email B_Nydam@premierinc.com.)

Premier Executive Discusses Reasons For Lab Initiative

CEO SUMMARY: Because of Premier's influence with 1,700 of the nation's 5,000 hospitals, laboratory administrators and executives should realize that this strategic services alliance between Premier and Quest Diagnostics Incorporated will change traditional laboratory practices, regardless of whether the alliance proves successful or not. This interview with Premier Vice President John Biggers reveals the story of how Premier came to recognize the need for breakthrough changes to hospital laboratory management. It also provides an incisive look at which market trends Premier and its owner hospitals see as currently reshaping laboratory services.

Part One of Two Parts

THE FOLLOWING IS AN EXCLUSIVE INTERVIEW conducted by our editor, Robert Michel, with John Biggers who was Vice President of Corporate Business Development at Premier. He is now VP of Operations for Premier Clinical Laboratory Services.

EDITOR: John, I would like to set the theme for this interview. Many clients of THE DARK REPORT are pathologists and laboratory administrators running hospital laboratories. I would like to help them understand two things about this unprecedented strategic alliance between a major buying consortium involving 1,700 hospitals and a national laboratory. First, why did Premier decide it wanted to do something this radical in the area of clinical laboratory services? Second, what specific business reasons led Premier to create a strategic services program?

BIGGERS: Those two questions cut to the heart of the matter. Your first question is really about Premier and what we saw happening to our member hospitals. They constantly ask us to do more to help them lower costs and improve quality. It was feedback from members that made us realize that clinical laboratory services could be a potential breakthrough for creating positive change in clinical practices both within and without the hospital. It should go beyond the traditional reference laboratory purchasing agreement.

EDITOR: What was Premier's goal in looking at clinical lab services?

BIGGERS: Premier wants to be in the business of creating breakthroughs in the health care industry. The senior management of Premier has made this a prime directive for our organization. Premier ought to be changing the way healthcare is provided so as to create benefits which never before existed. That usually means doing things in a completely different way. For that reason, I like to say that the corporate business development unit of Premier is in the business of creating breakthroughs. It may take you 50 projects before you create a breakthrough, but that one breakthrough is worth the 50 attempts.

EDITOR: It is important for clients of THE DARK REPORT to understand how the philosophy of "breakthrough management" underpins this strategic services alliance. Could you talk a little about why Premier

"Premier's corporate mission concerning breakthroughs is directly responsible for the clinical laboratory alliance."
Bill Nydam, EVP, Premier, Inc.

thought that clinical laboratories could provide the kind of breakthrough that Premier seeks to create?

BIGGERS: When we started looking at the clinical laboratory area, there was really no directive. As a matter of fact, it was a blank sheet of paper, Robert. But we were getting feedback from some of our hospital CEOs. They said to us "I'm trying to create an integrated delivery system here. Maybe the laboratory area is a good rallying point. Maybe that's something that we can try as a collective effort." This alerted us to the potential. If successful, the core laboratory concept might be an effective way to reshape and further integrate clinical services in integrated delivery systems (IDS). I think this was the first time that people realized we could look at clinical laboratories with a radical new perspective.

EDITOR: Are you saying that it was input from Premier's hospital CEOs which brought recognition to the fact that laboratory services could be a critical success factor in fostering clinical integration?

BIGGERS: Yes. There is intense activity among hospitals to improve how clinical information is captured, stored and used. Everyone is aware of the fact that, although the clinical laboratory is typically around 5% of the hospital's budget, it generates as much as 80% of the useful diagnostic information in a patient's file. A number of CEOs among our owner-hospitals pointed out to us that clinical laboratory data might be a fulcrum to leverage improvement in both clinical and operational integration within their healthcare system. A lot of our hospitals recognized that this was a good area to rally around as they attempted to build up their networks.

EDITOR: What you are saying, then, is that a number of hospital CEOs recognized that the laboratory represented untapped potential to create change everywhere in the system. Is that right?

BIGGERS: Partially. Premier recognized that a number of our more innovative hospital CEOs were ready to consider "radical" proposals if it had the possibility to foster a breakthrough.

EDITOR: Then was your goal really to revamp both the way clinical laboratories are organized and how clinicians use diagnostic information?

BIGGERS: Basically yes. This is what caused Premier to look at laboratory services. Although I'm not a laboratorian, it was placed in my hands almost two years ago. The first step I took was to learn what was happening within the laboratory industry. I spent several months educating myself, finding out what kind of pressures our hospitals were facing, what was happening to clinical laboratories.

EDITOR: So you used this time to study the market and learn about the problems of clinical laboratories?

BIGGERS: Right. As I recall, there are five basic trends I identified as impacting laboratories of our member hospitals. One trend is the shift from inpatient testing to outpatient procedures. Two, reimbursement is declining, so hospital laboratories get less money for the tests that they do. Three, fundamental inefficiencies in how hospital laboratories operate have never been resolved.

EDITOR: For example?

BIGGERS: Not operating 24 hours a

EXCLUSIVE INTERVIEW

day. Not getting as much productivity from laboratory staff and testing instruments. These are issues familiar to any laboratory administrator. The fourth thing I saw was something I considered significant. Most hospital laboratories didn't have good access to managed care contracts. As the big commercial laboratories got national managed care contracts, our hospital labs were excluded as providers.

EDITOR: What you are saying, then, implies that Premier considers access to physicians office testing to be an essential part of basic clinical and operational integration?

BIGGERS: That must occur if our member hospitals are to develop integrated delivery systems. As we studied their need to access managed care contracts, we weren't sure if that was a fad that would evaporate or whether it was a trend that would continue. But we wanted to develop a way for the hospital laboratories of our members to be successful at achieving provider status with managed care plans on the national, state, and local level.

EDITOR: What was the fifth trend you identified?

BIGGERS: The big thing that was evident to me was the basic overcapacity. There's too many clinical laboratories out there. Period. In fact, I would say hospital laboratory overcapacity plays a key role in affecting the success in meeting the other four market trends we identified.

EDITOR: Once you identified the problems confronting Premier's hospital laboratories, what was your next move?

BIGGERS: I contacted laboratories at our member hospitals. Now I was ready to find out what they were doing to meet the challenges of the marketplace as well as the pressures from their hospitals.

EDITOR: Did you discover anything interesting in this phase of your search?

BIGGERS: Robert, I saw an entire spectrum of responses. Some of our hospital labs were doing nothing, just sitting back and waiting to see what would happen next. Others were quite aggressive and doing progressive things. In fact, from this group, just about everything I saw were steps in the right direction. But even the proactive labs were not doing everything necessary for them to be successful.

EDITOR: So you learned that most laboratory administrators were not going as far as they could...

BIGGERS: ...we saw some member laboratories that were forming networks, trying to represent themselves for managed care contracts on a state-wide basis, for example. But individually and collectively, we didn't see any kind of formalized approach on how they would cut their costs. This concerned me, because I didn't want our hospitals winning managed care contracts if they couldn't do them in a profitable way.

EDITOR: What other attempts at management solutions did you see?

BIGGERS: Other hospital labs were forming regional laboratories built upon the concept of a core lab. Some core labs were within the hospital walls, others were free standing. I also found some joint ventures with commercial labs, as well as a little bit of outsourcing. But the experience of our member laboratories with outsourcing seems to be that, after five or six years, whenever that contract was up, they typically took back their laboratories using new management. Outsourcing seemed to be a solution to stop financial bleeding. Once it was ended, the hospital wanted to step back in and assume direct control over their laboratory again.

EDITOR: After seeing what laboratory administrators were trying to accomplish on their own, how did Premier respond?

BIGGERS: Well, now I had a first-hand understanding of the basic problems facing clinical laboratories. I also had some knowledge about the best and worst of what our hospital laboratories were attempting to do in the marketplace. To form a plan of action, I recruited a group of laboratory experts. I went to our laboratory purchasing committee. This committee includes laboratory directors and material

managers. I outlined what Premier had learned about clinical laboratories, and our goals to develop a "breakthrough" arrangement for laboratory services.

EDITOR: So this is actually a different process than evaluating national reference contracts. This is when you first introduced the goal of developing a "breakthrough" strategy unrelated to national reference testing arrangements?

BIGGERS: Well, we tried to help them understand that laboratory services needed to contribute more to clinical integration. Given the nature of laboratorians to maintain current operations, they weren't overly excited about it. But two members of the committee, David Rabbitts of **Wuesthoff Health Systems** and Jay Schamberg, M.D. of **Aurora Healthcare**, were recruited to help us develop our strategic concept. We wanted representation and input from their committee because we knew that whatever emerged would certainly be related to any reference laboratory agreement this committee developed.

EDITOR: So you created a task force of laboratorians to develop the concept and structure of the laboratory "breakthrough," but do it in concert with activities to develop a national reference testing contract.

BIGGERS: That is correct. We eventually developed a team of ten people. There were three laboratory directors, two pathologists, two chief operating officers, two free-standing, for-profit commercial lab CEOs (owned by our hospitals), and one chief financial officer. It represented a good blend of different people that were affected by the clinical laboratory of the hospital. This committee commenced its work about one and a half years ago.

EDITOR: As you describe this process, it is Premier asking laboratorians and other hospital functions to initiate and refine the strategic service concept. What happened next?

BIGGERS: This group took the five trends I had observed and used those as a basis to begin their work. After editing and adding to my market assessment, we set out to develop what the characteristics of a winning laboratory of the future should look like.

EDITOR: This is interesting. So step one was to identify market trends affecting hospital-based laboratories. Step two was to identify the essential traits of a successful laboratory organization. What did the team learn in step two?

BIGGERS: It didn't take long to get consensus on what the successful laboratory of the future looked like. Once completed, it gave us a good framework to develop that winning laboratory.

EDITOR: It means that step three in your process was to actually design and build the laboratory of the future. And at this stage, it remained totally a Premier project, is that correct?

BIGGERS: Yes. As part of step three, we looked at the numbers. First, Premier is large enough to build this thing on its own. Premier members represent approximately $4 billion in laboratory testing costs within our hospitals. We represent another $1 billion of testing that's performed in physicians' offices and nursing homes affiliated with our hospitals. Finally, from all sites combined, we represent an additional $1 billion that is referred out to commercial laboratories. However, although this represents $6 billion per year in laboratory testing, we also realized that we have varying degrees of control over the different entities that refer out these tests.

EDITOR: That's interesting. The three national laboratories combined only do about $4.5 billion per year in laboratory testing. How did this change your thinking?

BIGGERS: By looking at the cumulative total of testing controlled by our hospital members, the study team realized that we could at least get the efficiencies of scale enjoyed by the three national laboratories. The ques-

tion was how to accomplish that.

EDITOR: I can see the evolution in the team's thinking. You got them to realize that quantum improvements in testing cost and quality could be achieved, but only if they could combine the laboratory testing from Premier's members in smart ways. What came next?

BIGGERS: We quickly identified several challenges. First, it costs money to try to build this much infrastructure. Second, it requires time to create the infrastructure. Maybe the healthcare market won't give us that time. Three, Premier is a voluntary organization. Unlike a corporation such as **General Electric**, we are not one big entity that can just drive a corporate priority through the system.

EDITOR: Yes, each of your members has their own needs. You must deal with a "United Nations" situation of competing interests.

BIGGERS: We also knew that if we tried to do this piece by piece and roll it out nationwide, we wouldn't have national coverage. That would affect our ability to immediately pursue managed care contracts. It was going to be a long road. Probably the most powerful road, but a long road. Next we looked at the feasibility of buying some of this infrastructure versus making it. We studied the commercial laboratory industry as if the labs were up for sale at an auction. What values would we pay? What values would we get for our money? Throughout this process, we remained open to all options, including acquisition of a commercial laboratory or to contractual relationships with selected commercial laboratories.

EDITOR: Even to this point, John, you are talking about a process that is internal to Premier. The issue on the table was how can Premier best create the winning laboratory organization model for the the future.

BIGGERS: That is true. In looking at the commercial laboratory industry, for us it sorted into two tiers. Tier one consists of the three major national laboratories. They have extensive reach, but compete against our hospital laboratories for physician office business. Tier two consists of those esoteric reference laboratories capable of providing testing services throughout the country, but which lack the local network of regional laboratories that provide routine and secondary testing in a region. As you know, these esoteric reference laboratories don't compete with our hospitals for the outreach business from doctor's offices. Our hospital members tend to like the tier two laboratories better, for that reason and their service to individual hospital labs.

EDITOR: But each tier offers benefits to the kind of "model laboratory" concept you were developing.

BIGGERS: Sure. For example, the three national labs offer something that the others didn't: a developed infrastructure. They've got regional laboratories with extensive courier services already in place in most areas of the country. They have information systems and integrated capabilities that are as good as anything currently in existence. They also have marketing and sales resources already trained and in the field.

EDITOR: It sounds like your study team realized quickly that it could avoid intensive capital investment and long start-up times by looking at how to use existing laboratory resources already in existence. What else went into your analysis?

BIGGERS: It was apparent to us that a lot of infrastructure operated by commercial laboratories was, in our opinion, duplicative to our member hospital labs. That is highly relevant when viewed against the industry problem of overcapacity, particularly of hospital laboratories. This is why we came to a decision that building our own system was not the answer. Probably the best

situation for us would be to partner with some combination of the three national laboratories. And believe me, everyone on the committee knew that this would be a tougher sell for our hospitals. But for us, it was clear that this arrangement delivered the most benefit when you look beyond just pricing, but the total cost of laboratory testing.

EDITOR: Given this decision, how did you evaluate the commercial laboratories which were potential partners?

BIGGERS: Only a handful of labs have the capabilities we require. These were the ones we approached. They included **Laboratory Corporation of America**, **Quest Diagnostics Incorporated**, **SmithKline Beecham Clinical Laboratories**, and the major reference laboratories, including **American Medical Laboratories**, **ARUP Laboratories**, **Mayo Medical Laboratories** and **Specialty Laboratories**.

EDITOR: To most people familiar with the lab industry, there are no surprises on this list. Did any one lab jump out as a favored candidate?

BIGGERS: No. We spoke with all of them. And, quite honestly, it wasn't decided until the last month which course of action we would take. During the evaluation process, however, it was narrowed down to the three national laboratories. But that was the point where we found making a choice to be more difficult, since they offer a very similar package of services, particularly in the routine testing which has become a basic commodity business.

EDITOR: Were there any tangible differences that you identified among the three national labs?

BIGGERS: Probably the main one is the regional variation. You can find geographical areas where each lab is strong. There seemed to be no way to find the right partner from a perception or reputation standpoint for Premier. Geographically, we have hospital members conducting business in virtually every corner of this country.

EDITOR: That means your decision was based less on geographical coverage by a potential partner. What other criteria did you consider?

BIGGERS: We next looked at the management philosophies of the three companies. Certainly their willingness and reputation come into play. The breadth of testing and related services were relevant. Of course, the structure of the financial package we could both work under was a main consideration. Here corporate ownership gave us some interesting considerations.

EDITOR: In what way do you mean?

BIGGERS: For example, the laboratory division of SmithKline is owned by a pharmaceutical company. That created some complexity, but that didn't stop us from looking at every opportunity with them. **Roche**, another pharmaceutical company, owns 49% of LabCorp. That creates some complexities as well as benefits. Quest was the only one that was strictly focused on the clinical laboratory business.

EDITOR: What about differences among the tier two labs?

BIGGERS: We see a similar variety of business structures and philosophies. Each one of them is just a little bit different, with its own unique aspects. But when everything was said and done, it was felt that Quest Diagnostics offered the greatest benefit to our owners and members. **TDR**

This ends part one of our two part interview. In the next installment, learn more about: 1) Premier's vision of the hospital laboratory of the future; 2) the plan to create value-added laboratory services for Premier members; and 3) how Premier views Quest's role in the strategic services alliance.

(For further information, contact John Biggers or Bob Hamon at Premier: 704-529-3300. Email to: John_Biggers @premierinc.com and Bob_Hamon @premierinccom.)

EXCLUSIVE INTERVIEW

Humana, Inc. Acquired By United Healthcare

Merger creates behemoth managed care firm as consolidation of national HMOs proceeds

CEO SUMMARY: Clinical laboratories will see increased concentration of laboratory purchasing as a result of this merger. The combined company will insure 19.2 million people in 48 states. This transaction confirms that consolidation proceeds in all areas of the healthcare industry, despite financial setbacks by large companies in several sectors.

IT MAY BE A CASE OF THE STRONG getting stronger. Minneapolis-based **United Healthcare Corp.** is buying **Humana Inc.** The resulting company will have a combined enrollment of 19.2 million people, the third largest number of enrolled lives in the nation.

Both companies earned strong profits in 1997, unlike most managed care companies. Their combined financial clout is one reason why this merger promises to alter the competitive balance in many regional markets. Once the acquisition is digested, clinical laboratories can expect to see changes in how United Healthcare contracts for laboratory services.

Strong Presence

What the merger does for United Healthcare is give it a strong presence in all 50 states, as well as Puerto Rico, Hong Kong, Singapore, and South Africa. After combining operations, the company will have added clout in several pivotal states.

They include Florida, Texas, and Ohio, where enrollees will number 2.3 million, 1.5 million, and 1.4 million, respectively. Some analysts believe the size of United Healthcare in these states will allow it to squeeze providers. "Market share is king in this game. It's critical," stated Thomas Hodapp, healthcare analyst at **Robertson Stevens** in San Francisco.

"As in the advertising campaign for 'Godzilla,' size does matter," agreed noted managed care consultant Peter Boland of Berkeley, California. Both commentators were referring to the double-edged sword created by this merger.

First, combining the two insurance companies will yield a projected savings of $400 million per year. Half will come from consolidating corporate overhead and merging overlapping regional operations. The other half will come from improving medical operations. Using this cost-advantage, United Healthcare could make larger profit margins even as it competitively prices its health plans to employers.

Second, the sword's other edge is United Healthcare's bargaining clout with hospitals, physicians, and other providers such as laboratories. This is particularly true in regions where it has substantial market share, like Florida,

Texas, and Ohio. As a huge buyer of medical services, United Healthcare could extract significant price concessions from healthcare providers worried about losing access to large numbers of patients in their region.

Laboratory executives will see several market trends validated in this mega-merger. It represents a huge consolidation within the insurance industry. "In healthcare, it is our view that this is the equivalent of **CitiCorp-Travelers** or **Daimler-Chrysler**. This is an industry-defining event," said Humana CEO Greg Wolf, as he compared this deal to mega-mergers in the banking and auto industries.

As a management strategy, United Healthcare's pursuit of size accomplishes several things. First, becoming bigger makes it more attractive for national and international employers to purchase its healthcare products. This is because United Healthcare now has insurance plans throughout the United States.

Economies Of Scale

Second, it believes it can extract economies of scale from its large size. In accomplishing this, United Healthcare can offer tighter premium prices to employers while still making higher profits than competing insurers.

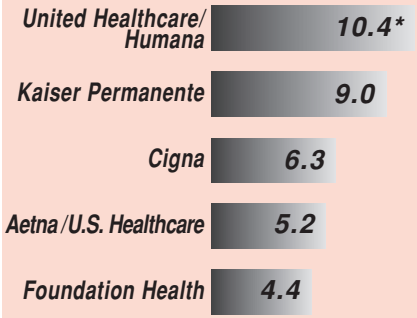
Third, its large size gives it more clout when negotiating managed care contract terms with hospitals, physicians and ancillary providers like clinical laboratories.

But strategy in business is only as good as management's ability to implement it with success. In this regards, management teams at United Healthcare and Humana have significantly different track records than most of their competitors.

Both companies made money in 1997, a time when many large managed care firms posted record losses. One reason is that both United Healthcare and Humana were aggressive at pushing up premium rates with their employer customers. Thus, revenues were better-aligned to meet the higher-than-expected healthcare costs experienced in 1997.

Managed Care's Top Five

Here are the five largest health plans listed by the number of full-risk, managed-care covered lives. Ranked by millions of members



*United Healthcare covers 6.0 million lives and Humana covers 4.4.million lives.

Note: Statistics come from individual companies and Baseline, Inc.

Another fascinating similarity between the two companies is that both are regarded as industry leaders in efforts to get physicians to improve the quality of care. Each has programs in place to encourage physicians to offer screening services and early disease detection testing which may not be reimbursed by other plans and Medicare.

This is one obvious place where clinical laboratories seeking provider status with the merged United Healthcare/Humana company can demonstrate added value. The corporate culture at this company supports progressive use of diagnostic testing which can be demonstrated to improve the quality of patient care while controlling or lowering costs. TDR

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

Managed Care Trends

HMOs Planning Double Digit Premium Increases For 1999

EXPECT THE HMO INDUSTRY TO PUSH double digit premium increases on employers for 1999. This will cause political and financial repercussions which impact clinical laboratories.

"I think the honeymoon is over," stated Henry Moyer, healthcare consultant with New York-based **Hirschfield, Stern, Moyer & Rose**. During the period of 1994-1996, employers saw increases to healthcare premiums of only 3% to 5% per year.

"Last year HMOs asked for 5% or more but backed down to preserve market share," observed Richard Sinni, healthcare practice leader at **Watson Wyatt Worldwide** in New York. "Real increases tended to be from zero to 3%. We don't expect that level of flexibility for 1999."

For the upcoming year, HMOs will be aggressive at seeking increased premiums from employers. The reason is simple. Most lost money in 1997. In order to survive, they must increase premiums as much as possible, since their cost to provide healthcare climbed sharply in both 1997 and 1998.

Employer Survey Results

Watson Wyatt Worldwide, a human resources company, recently polled all its clients with 500 or more employees. The poll revealed that double-digit premium increases were expected for all categories of healthcare plans except POS (point of service) and HMOs, where increases will average only 5% to 7%.

Kaiser Permanente's premium boost of up to 12% for 1999 has already attracted considerable attention. In 1997, Kaiser lost money for the first time in its history. During 1998, Kaiser's finances improved, but not dramatically.

As employers encounter stiff premium increases to their health insurance plans, expect political action. Already most state legislatures, as well as Congress, have numerous healthcare bills in the hopper. The consequences of well-intended, but bad healthcare legislation, will plague the industry for years.

Pushing Higher Premiums

Although health insurers are pushing higher premiums, it is unlikely that clinical laboratories will see much increase in reimbursement for laboratory testing. Since most managed care companies are struggling financially, they will probably not share increased premium revenues with providers.

In fact, THE DARK REPORT continues to stand by its prediction that the HMO industry is entering a phase of financial turmoil. *(See TDR, October 27, 1997.)* Most managed care plans have inadequate capabilities to accurately track costs and establish appropriate prices.

Further, the increase in members who upgrade from a basic HMO to an option which allows out-of-plan services will continue to constrain HMO profitability. We suggest clients re-read our analysis of this situation in the March 2, 1998 issue. This is a fundamental shift in consumer behavior which favors clinical laboratories. But it will be some time before laboratories actually reap benefits from this trend. TDR

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

The Dark Index

"Disease Management" Firms, Niche Labs Release Financials

TWO DISEASE MANAGEMENT FIRMS enjoyed strong revenue growth during the first quarter of 1998. **UroCor, Inc.** and **Impath Inc.** posted revenue increases of 31% and 49%, respectively, over first quarter 1997.

UroCor is the disease management company which serves urologists throughout the United States. The company's first quarter financial performance showed strong revenue growth but reduced operating margins. Although revenues climbed 49%, from $8.1 million to $10.6 million, operating income declined, from $798,000 to $488,000.

During 1997, UroCor expanded the number of sales reps in the field to 80. Additional overhead related to this expansion effort was one reason for the decline in operating profits. As these new sales reps build their production, UroCor should generate proportionate increases in operating income during the balance of 1998.

Specimen Volume Growth

In fact, at a time when clinical laboratories are seeing declines in specimen volume, UroCor saw specimen case volume increase by 21% for the quarter, to 79,000 cases. Further, the company's sales effort continues to show gains. UroCor announced that its market share of the 7,500 urologists in the United States is now 2,225, or 30%. At the end of first quarter 1997, the client base numbered just 1,910, or a 25% market share.

UroCor President and CEO William Hagstrom made a presentation at the *Executive War College* in New Orleans last month. He explained UroCor's strategy for partnering with urologists. To that end, UroCor is pioneering an area-wide network (WAN) which allows urologists to access diagnostic reports, utilization data and other information directly from the company. As of first quarter 1998, approximately 25% of the company's total diagnostic report volume can be accessed from its WAN.

Disease-State Data Bases

Hagstrom also told *War College* attendees about disease-state data bases which UroCor is creating from its ever-growing volume of urology specimens. Together with the **American Lithotripsy Society** (ALS), Urocor is creating a repository which standardizes data collection, includes outcomes reporting, and provides a national data base of lithotripsy and kidney stone disease. Another UroCor data base was the source of cases for a comprehensive prostate cancer study. About 1,400 of UroCor's urologists were the source for 62,537 first-time prostate biopsies, covering a two-year period. The results of this clinical study were published in a leading urology journal in March 1998.

At Impath, revenues and operating profits were up by 49% and 102%, respectively. Revenues for first quarter climbed from $7.8 million to $11.7 million. Operating profit increased from $831,000 to $1.7 million during the same quarter.

Impath offers disease management services to oncologists and those

involved in treating cancer. Unlike UroCor, which is growing through sales and marketing, Impath uses acquisitions as the primary source for increasing revenues and operating profits.

During the past 12 months, Impath acquired certain assets of **Oncogenetics, Inc.**, **Immunodiagnostic Laboratories, Inc.**, the **Gencare** division of **BioReference Laboratories, Inc.**, and **Aeron Biotechnology**.

Evaluate The Effectiveness

It is difficult to evaluate the effectiveness of Impath's sales and marketing team. Unlike UroCor, Impath does not reveal the number of client accounts it serves each quarter. Because Impath is not known for its sales prowess, its reticence to disclose quarterly changes to its client base is probably due to its current strategy that emphasizes acquisitions over sales as the source of growth.

DIANON Systems, Inc., which now describes itself as a full-service anatomic pathology company, saw a reduction in revenues during first quarter 1998. DIANON attributed this reduction to changes in Medicare reimbursement policies.

The company estimated that Medicare accounted for the major portion of a $1.8 million price decline experienced during the quarter. Another factor in the price decline was a 10% reduction in chemical chemistry services during the quarter.

Revenue Performance

Even though DIANON's revenues were down 3.3%, from $15.6 million to $15.1 million, operating income went up. Pretax income increased 20%, from $1.1 million to $1.3 million.

DIANON Systems is recognized for its ability to successfully introduce new diagnostic assays into the clinical marketplace. During 1998, DIANON is introducing a specialty test for H. Pylori and a genetic test for colorectal cancer.

It is interesting that neither test requires a blood or urine specimen. The H. Pylori test is based on a breath sample from the patient. The colorectal cancer test detects the presence of an abnormal gene associated with familial colorectal cancer among Ashkenazi Jews. The specimen is taken from a simple cheek swab.

To complement its specialty testing business, DIANON has been building a national program in anatomic pathology. In addition to long-standing AP services to urologists, DIANON also serves dermatologists, gastroenterologists and gynecologists. AP revenues from these sources climbed 26% during the first quarter of 1998.

Another major strategy at DIANON Systems is to introduce progressive programs for disease management. The laboratory's goal is to develop value-added services which are useful to managed care companies, clinicians and patients. It hopes to leverage these services into provider status with managed care companies at both the national and regional level.

Value-Added Services

THE DARK REPORT believes that clinical laboratories must begin investing resources to develop value-added services to managed care plans, physicians, and patients. These three companies are early business models which attempt to combine diagnostic testing with a menu of disease management services.

The strong revenue growth of UroCor and Impath demonstrates that physicians will respond to diagnostic services which are perceived to add value to their clinical practice. Although "lowest price" continues to drive many managed care contract awards, individual successes at UroCor, Impath, and DIANON Systems provide evidence that clinicians and managed care plans are willing to pay for disease management services which use laboratory test information in useful ways. **TDR**

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

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Clinical laboratories continue to find their customers undergoing major consolidation. This time it involves two giants in long term care. **Health Care Corporation** of Toledo, Ohio and **Manor Care Inc.** of Gaithersburg, Maryland are merging. The combined company will operate 292 long term care facilities, plus a large number of other healthcare facilities such as rehab centers, assisted living, and home health agencies. The new company will be called **HCR Manor Care** and will have revenues of $2.6 billion per year.

MORE ON...LTC Merger: Expect more consolidation in the long term care industry as a result of Medicare reforms which become effective on July 1, 1998. In April, **Paragon Health Network** acquired **Mariner Health Group Inc.** to create a $3 billion per year LTC giant. The three national labs are already downsizing or eliminating their long term care testing programs. But many regional laboratories still consider long term care to be an important source of business.

PATHOLOGY PPM GETS NEW NAME, NEW HOME

Physician Solutions, Inc. has a new name and new corporate headquarters. The pathology-based physician practice management (PPM) company will be called **Pathology Partners, Inc.** As of June first, its corporate offices were relocated from Nashville to Irving, Texas, near Dallas.

Here's welcome news for any clinical laboratory or pathology practice struggling to create the documented procedures necessary to meet a variety of regulatory requirements. The Technical Communication Program at the **University of Colorado** in Denver is offering to evaluate, at minimal cost, documentation provided to it by laboratories. They will test the documentation for comprehension and usability. Contact Professor James F. Stratman for details: 303-556-2884; email: jstratma@carbon.cudenver.edu.

As predicted by THE DARK REPORT, the lobbying clout hospitals have with Congress is getting results unattainable by the clinical laboratory industry. On June 5, June Gibbs Brown, inspector general for the **Department of Health and Human Services**, wrote a letter to U.S Representative Ron Klink, from Pennsylvania. In the letter, Ms. Brown states that the inspector general "will establish minimum monetary thresholds and/or percentage error rates" for each national investigation involving a specific procedure, such as pneumonia or lab tests.

ADD TO...INSPECTOR GENERAL This is the first concession by government regulators that "honest billing errors" should be recognized and factored out of Medicare fraud and abuse investigations. There is still plenty of disagreement about how to specifically implement such guidelines. But the acknowledgement by the government is a clear response to lobbying efforts by the hospital industry. The clinical laboratory industry was never successful in lobbying Congress for relief on fraud issues relating to laboratory billing practices.

That's all the insider intelligence for this report. Look for the next briefing on Monday, July 6, 1998

THE DARK REPORT

UPCOMING...

- *Part Two Of Our Exclusive Interview With Premier: The Plan To Create Value-Added Laboratory Services For Its Members.*
- *Professional Courtesy: Laboratories Find Out The Hard Way About The Downside.*
- *Pathology Innovator Develops New Model For Revenue Enhancement.*
- *Why A Shake-Up Lies Ahead For The Lab Industry's Market Leaders.*