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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

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Commentary & Opinion by...

R Lewis Dark

Founder & Publisher

Blood Brothers Prepare to Go to the Mat

LIKE MANY OF YOU, I WAS STARTLED BY THE NEWS that **UnitedHealth Group, Inc.** was willing to cut **Quest Diagnostics Incorporated** out of the health insurer's national contract for laboratory testing services. After all, there are many reasons, like economies of scale, why these two companies should be mutually interested in perpetuating their business relationship.

Nonetheless, it is now an announced fact that, as of January 1, 2007, **Laboratory Corporation of America** will be the sole national contract provider for UnitedHealth. As that date arrives, it will be a high-stakes game for all three parties. Quest Diagnostics has acknowledged that the UnitedHealth business is about 7%, or $385 million, of its $5.5 billion revenue. That business is going to be vigorously contested.

For its part, LabCorp has told Wall Street that it must spend more than $35 million in additional expenses and capital to put infrastructure into markets where UnitedHealth has beneficiaries and LabCorp has inadequate resources. Further, for it to benefit financially from its new national contract, LabCorp must convince large numbers of physicians who currently use Quest Diagnostics for their UnitedHealth patients to redirect those specimens away from Quest and over to LabCorp.

If you ask me, we are about to see one of the most interesting business battles between commercial lab firms since the 1980s. LabCorp has the challenge of executing its business strategy. It must swiftly build patient service centers and rapid response labs in communities where it currently has little presence. It must hire additional sales reps to call on physicians and convince them to switch. LabCorp must also create regional laboratory networks in selected areas and develop collaborative relationships with local labs in other markets.

Meanwhile, Quest Diagnostics will be doing everything in its power to retain these physicians as clients. Its sales reps will aggressively work to retain the status quo. Quest Diagnsotics is also likely to experiment with some unexpected strategies and tactics to retain this business.

Finally, I predict that there will be more at stake than several hundred million dollars per year of lab testing business. This battle will be over corporate honor. Given human nature, employees at both firms are likely to make this a personal grudge match. **TDR**

United Health: Quest Is "Out"–LabCorp Is "In"

UnitedHealth upends status quo and opts to use LabCorp exclusively

CEO SUMMARY: Effective on January 1, 2007, UnitedHealth Group will have one national contract laboratory. On that date, Laboratory Corporation of America becomes the preferred provider and Quest Diagnostics Incorporated becomes an out-of-network laboratory. With access to 34 million UnitedHealth beneficiaries at stake, competition is likely to intensify between these two lab companies.

IN THE TELEVISION SHOW "PROJECT RUNWAY," super model Heidi Klum tells winners they are "in" and tells losers they are "out."

That certainly describes what happened on October 3, when **UnitedHealth Group, Inc.** told **Laboratory Corporation of America** it was "in" and told **Quest Diagnostics Incorporated** it was "out."

At stake was contract access to provide laboratory testing services to UnitedHealth's 25 million beneficiaries across the United States. Because UnitedHealth spends $2 billion per year on laboratory testing, this development has major revenue and profit implications for both Quest Diagnostics and LabCorp.

Effective on January 1, 2007, Quest Diagnostics will no longer be a contract provider for UnitedHealth, with exceptions in several markets.

This development directly impacts the laboratory profession. First, it has the potential to cost Quest Diagnostics a significant amount of revenue and operating margin associated with its prior status as a national contract provider for United Health.

Second, it positions LabCorp to grab an increased share of lab testing done for UnitedHealth beneficiaries. Third, region by region, the new national contract may change the competitive status quo to the benefit of local laboratories. Each of these points will be discussed in order.

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LabCorp disclosed some basic information about the new national contract it signed with UnitedHealth. This contract becomes effective on January 1, 2007, extends for 10 years, and makes LabCorp the exclusive national laboratory provider for UnitedHealth.

Regional Lab Networks

LabCorp becomes responsible for developing and managing "a series of regional laboratory networks in selected regions across the United States." This is one way LabCorp and UnitedHealth will attempt to handle communities where UnitedHealth has beneficiaries and where LabCorp currently has little or no market presence.

On January 1, LabCorp becomes responsible for "managing the **Oxford Health Plans** laboratory network located in the Greater New York metropolitan region." On the same date, LabCorp also becomes the "exclusive national capitated United-Healthcare laboratory provider for the HMO benefit plans of **Pacificare Colorado**, **Neighborhood Health Partnership** in Florida, **Mid Atlantic Medical Services, LLC** (MAMSI) in Maryland and Virginia, and [it] will remain the exclusive provider for HMO benefit plans for **Pacificare of Arizona**."

$200 Million "At Risk"

LabCorp has an "at risk" clause in the contract. It stated that, during the first three years of the 10-year pact, it "has committed to reimburse UnitedHealth up to $200 million for transition costs related to developing an expanded network in the Oxford, MAMSI, and Neighborhood Health Partnership markets, as well as in California and Colorado." LabCorp officials told financial analysts that this reimbursement would be recognized as a reduction in revenue over the life of the contract.

Many important details about the new contract remain undisclosed. For example, LabCorp has deflected questions about whether it accepted significantly lower pricing when compared to its existing national lab services contract with UnitedHealth. *(See interview with LabCorp Executive Vice President on pages 9-15.)* As well, few details were discussed about the operation of the regional laboratory networks for which LabCorp will have responsibility.

In public statements, LabCorp officials were exultant. They declared that the new contract will bring in an additional $3 billion over its 10-year life. That is an expectation that the company will increase its business by an average of $300 million per year.

New York And Chicago

Now for the downside. LabCorp lacks patient service centers, rapid response labs, and logistics networks in several regions of the United States where UnitedHealth has plenty of beneficiaires. In these markets, Quest Diagnostics has a dominant share and is the primary lab testing provider to UnitedHealth patients. Two very large metropolitan markets where this is true are New York and Chicago.

For LabCorp to succeed in these markets, it must either build infrastructure, or recruit local laboratories into its regional lab networks. To that end, it says it is currently in the process of building new patient service centers. LabCorp is also hiring additional sales representatives. It will need an expanded sales force to call on physicians and convince them to switch their lab business to LabCorp.

For Quest Diagnostics, loss of contract status is something of a role reversal. For more than a decade, it has enjoyed status as the nation's largest laboratory company, with financial strength and a developed service network in most major cities. It has par-

UnitedHealth Takes Steps to Prepare For LabCorp as Sole National Lab Provider

TO PREPARE FOR THE JANUARY 1, 2007 IMPLEMENTATION of UnitedHealth Group's new exclusive national laboratory contract with Laboratory Corporation of America, the insurer has already distributed question and answer briefing papers to beneficiaries, physicians, and brokers.

On the subject of the laboratory provider network, UnitedHealth emphasizes that local laboratory providers will be part of the mix, stating:

> **3.** ***Does this mean that LabCorp is UnitedHealthcare's only contracted laboratory provider?*** In the overwhelming majority of the country, UnitedHealthcare's laboratory network will continue to include a combination of other regional and local laboratory service providers. In addition, in many areas we will be contracting with new providers and adding to the breadth of our network.

UnitedHealth warns that when a physician uses a laboratory that is out-of-network, beneficiaries will be required to pay some monies out of pocket, as follows:

> **10.** ***How will this affect UnitedHealthcare members?*** As long as physicians use one of the many UnitedHealthcare participating laboratories, there will be no effect on the patient who is a UnitedHealthcare member. However, after January 1, 2007, if patients or their specimens are referred to non-participating laboratories (including Quest Diagnostics), then UnitedHealthcare, its customers and its members will be subject to higher health care costs due to the nature of the various health care benefit plans offered and selected by purchasers and consumers. This would be an unfortunate result of physician inattentiveness to this issue and UnitedHealthcare will do all we can to work with physicians to prevent such consequences.

LabCorp will expand its service infrastructure significantly. UnitedHealth describes it thusly:

> **11.** ***Does the elimination of Quest Diagnostics create gaps in our network of lab providers?*** No. UnitedHealthcare has successfully expanded and will continue to expand our network of regional and local laboratory providers to round out our network in New York, Connecticut, Illinois, Missouri, California, and Colorado where Quest has historically rendered a higher volume of lab services. LabCorp will also be working to strengthen its presence in these markets. Specifically, LabCorp currently plans to add 377 new patient service centers by January 1, 2007 – 24% of which will be located in New York, Connecticut, and New Jersey. This represents about a 10% expansion in LabCorp's retail locations. By January 1, 2007, LabCorp plans to add another 250 sites located in MinuteClinics (located within CVS retail pharmacies). Also, another 170 new LabCorp locations are expected to be available in Q1 2007 at SmartCare walk-in clinics.

UnitedHealth also alerted its brokers and physicians to the impending sales effort that will occur as network laboratories initiate their sales programs to office-based physicians, observing:

> **12.** ***Will the remaining contracted laboratory service providers be calling on physicians who were Quest Diagnostics' users in the interest of gaining their business?*** Yes, we expect LabCorp and other contracted laboratory providers to call on Quest Diagnostics' customers to sell their services. UnitedHealthcare will support their efforts by briefing our Network Management and clinical staff to remind physicians that they are required to use contracted laboratory providers effective January 1, 2007.

layed those assets into contract provider status with most major national and regional insurance providers.

Effective January 1, it loses its preferred provider status with UnitedHealth and will be forced to compete with that handicap in those markets where UnitedHealth has lots of beneficiaries. The immediate financial impact is uncertain, and consequences are likely to result from three factors.

Third, Quest Diagnostics will need to defensively protect its existing physician clients by sending sales reps into those offices to retain the business.

First, after January 1, in situations where a physician continues to refer specimens from UnitedHealth beneficiaries to Quest Diagnostics for testing, Quest will need to begin collecting deductibles, co-pays, and out-of-pocket payments from UnitedHealth patients, as required by their specific health plans. That is likely to increase Quest's costs to service this business, as well as increase its level of bad debt.

Second, after January 1, Quest Diagnostics will be filing claims with UnitedHealth as an out-of-network provider. Its reimbursement will vary, depending on the any-willing-provider laws of individual states and other relevant regulations. In some cases, it may even end up being paid more as a non-network provider.

Steps To Retain Clients

Third, Quest Diagnostics will need to defensively protect its existing physician clients by sending sales reps into those offices to retain the business. That will raise its cost of doing business. It may also affect Quest's ability to generate new clients in selected markets, since the sales staff will be distracted by the need to respond to LabCorp's increased sales and marketing program.

For UnitedHealth, there are several risks. Because physicians like choice for their ancillary service providers, UnitedHealth may increase alienation by making it more difficult for them to utilize Quest Diagnostics. UnitedHealth may also see increased dissatisfaction by patients as they express their displeasure at having to pay co-pays and deductibles because their physician is using an out-of-network laboratory.

Offsetting these risks is the fact that UnitedHealth has LabCorp at risk for $200 million during the early years of this 10-year contract. So United Health has a degree of confidence that it will see the money it spends on lab testing decline by that amount during the early years of this new contract.

Rancorous Competition

THE DARK REPORT makes two observations about this new development in the competitive bidding for managed care contracts. One, because this event puts the honor and reputations of the two blood brothers into the spotlight, it may lead to increasingly rancorous competition between the two lab companies. That's because Wall Street investors will be carefully looking for evidence that one lab firm is gaining market share over the other, and neither company will want to be seen as losing to the other.

Two, because the exclusion of Quest Diagnostics from the UnitedHealth contract radically alters the current competitive status quo, it is likely that the lab industry will see the two blood brothers intensify bidding for other large managed care contracts as they come up for renewal. TDR

Evolving Strategy Guides American Esoteric Labs

An opportunistic AEL is acquiring strong, local routine testing lab companies

CEO SUMMARY: Back in April 2004, when American Esoteric Laboratories, Inc. (AEL) launched operations, its declared ambition was to become a national esoteric testing firm. However, given the positive experiences from its acquisition of Memphis Pathology Laboratories in September 2004, AEL has evolved its core business strategy to include routine testing and to focus on regional hospital and physician office opportunities.

WHAT'S IN A NAME? At its birth, **American Esoteric Laboratories, Inc.** (AEL) stated that it wanted to be a "full-service provider of esoteric clinical laboratory services to hospitals and specialist physicians." *(See TDR, April 26, 2004.)*

For that strategic vision, its name was certainly descriptive. Yet, in the 30 months since its formation, American Esoteric Laboratories has found itself acquiring three laboratories which primarily provide routine testing services to office-based physicians. The most recent example was just 27 days ago, when it announced the acquisition of **DRL Labs, Ltd.** (DRL), based in Tyler, Texas.

To learn about AEL's current business strategy, THE DARK REPORT recently caught up with the executive team of American Esoteric Laboratories, including Brian Carr, Chairman & Chief Executive Officer; Jim Billington, President & Chief Operating Officer; and Robert Walker, Vice President of Sales and Marketing.

"We've learned much about the competitive marketplace during the past several years," observed Carr. "AEL entered the market with a clear strategy and no legacy assets. We wanted to be close to our customers and learn how to differentiate ourselves from existing lab competitors.

"That's allowed us to spot opportunities for growth that were unanticipated at start-up," he continued. "Probably the first insight was that the best way for AEL to access a sufficient volume of esoteric specimens was to serve the physicians' office segment, along with the hospital market."

Building Relationships

"There are two reasons why this is true," noted Billington. "First, by providing specialist physicians with testing in their group practice, AEL is building a business relationship with these doctors that carries over into the hospitals where they admit patients. If they use us in their office-based practice, they will be comfortable having AEL as an esoteric test provider in their hospital.

"Second, it is widely-known that outpatient services are growing faster than inpatient services," explained Billington.

Are Esoteric Testing Margins Under Pressure?

COMPETITION AND PRESSURE on reimbursement for esoteric testing has eroded the profit margins on such tests in recent years. That's the belief of American Esoteric Laboratories.

"We think there is margin pressure on high-end esoteric testing work that originates from hospitals," stated Brian Carr, Chairman and CEO of American Esoteric Laboratories (AEL), with headquarters in Nashville, Tennessee. "That's a well-kept secret in the lab industry.

"Several facts support this conclusion," he continued. "For example, it is widely-recognized that, even at annual revenues of $150 million, **Specialty Laboratories** was struggling to make money. Further, both **Quest Diagnostics** and **Laboratory Corporation of America** tell the investment community that the volume of esoteric testing is growing steadily and this business line enjoys good margins. But confirmation of those facts cannot be easily teased out of either company's financial reports.

"Our belief is that, in today's competitive marketplace, the margins on hospital-sourced esoteric testing are under sustained pressure," explained Carr. "That is another reason why AEL's business strategy has evolved to support acquiring regional laboratories. The additional volume of testing helps us reduce our overall cost per test."

"In fact, this growth in outpatient procedures means that the volume of esoteric testing done in doctors' offices is, by our estimates, growing twice as fast as esoteric testing volumes done in hospitals."

"These two insights pointed us to a slightly different business opportunity," interjected Carr. "By offering both esoteric and routine testing directly to physicians, we would build a client base that provided strong rates of organic growth. At the same time, even as we cultivated client relationships with specialists, it would be easier for AEL to develop client relationships with hospitals in these same communities."

Reinforcing this business perspective was the experience of another national reference lab company. "We studied the success **Esoterix** has had developing business relationships with cancer centers and infectious disease specialists," observed Walker. "In today's health system, until the patient reaches the end stage of many diseases, care is provided by office-based physicians.

"These insights caused us to rethink several key aspects of our original business strategy," Carr stated. "If we wanted to emphasize esoteric testing services to office-based physician specialists, then routine testing now becomes part of the necessary service menu. To properly service office-based specialists, we need to provide the full spectrum of testing services, ranging from routine to esoteric. In turn, this quickly led us to realize that we could effectively provide superior service to primary care physicians in a profitable manner."

MPL Provided Insights

When AEL acquired **Memphis Pathology Laboratories** (MPL) in September 2004, it viewed the acquisition as one which opened a major channel for esoteric testing from both the hospital systems connected with MPL, as well as office-based physicians. "That acquisition helped us appreciate that several other resources were necessary to support both the routine and esoteric business," said Carr. "These include a well-developed courier and logistics network, electronic test ordering and results reporting, as well as access to managed care contracts, to name a few."

"Memphis Pathology Laboratories had these strengths," commented Billington. "It was also a dominant provider in its service market. That acquisition is a great success story for us. In each of

American Esoteric Labs' Acquisitions Since 2004

Lab	Date	Test Mix	Location
ThromboCare Labs	04/04	Coagulation	Dallas, TX
Viral Diagnostics	04/04	Virology/infectious disease	Dallas, TX
Cenetron Diagnostics	08/04	Molecular diagnostics	Austin, TX
Memphis Pathology Labs	09/04	Routine testing to doc's offices	Memphis, TN
Physicians Medical Lab	03/06	Routine testing to doc's offices	Morristown, TN
DRL Labs, Ltd.	09/06	Routine testing to doc's offices	Tyler, TX

the past two years, MPL has posted growth rates of 13% or more. During this same time, MPL's sales force has increased from eight to 13 people."

"Based on this experience and these insights about the esoteric testing marketplace, we've refocused our business strategy," said Carr. "We still intend to offer esoteric testing to our clients. What is different is that we want to develop a robust regional laboratory network that can service the needs of hospitals and physicians in their respective communities. We want our regional labs to have six characteristics.

"One, the regional lab has a dominant market share in the community it serves," he explained. "That is true of MPL, **Physicians Medical Lab**, and DRL Labs.

"Two, the regional lab must have close operational and professional connections with local hospitals," continued Carr. "Three, because of these hospital relationships, the regional laboratory offers an extensive menu of services. This includes a broad offering of routine, reference, and esoteric testing, along with enhanced informatics, and an efficient logistics network.

"Four, the regional laboratory must have access to important managed care contracts for that area. Five, if we are considering an acquisition, we like the candidate lab company to have a long history of serving the local community," noted Carr. "Six, in cases where we acquire a laboratory, we would like it to have a relationship with an anchor hospital in the local community."

Carr is quick to point out the AEL's three most recent lab acquisitions meet all six characteristics. "We like these types of laboratories because they provide a solid base upon which we can grow the business locally," he explained. "AEL is in active acquisition discussions with other labs which fit this profile."

Although in business less than three years, the experience of American Esoteric Laboratories already provides insights into the competitive marketplace for lab testing services. Clearly, AEL finds the sales cost—and the time to convert—a new hospital reference client to be expensive, particularly if the margins on esoteric testing are being squeezed.

Routine Testing Opportunity

On the other hand, AEL is finding good opportunities in providing routine testing services to office-based physicians, then growing the revenues of the acquired laboratories. With a strong core of three primary laboratories and already at $100 million in revenue, AEL has clearly established itself as a credible competitor in the lab industry. The unanswered question is whether the esoteric test referrals from office-based specialists in these same communities will continue to be a significant source of operating profits. TDR

Contact Brian Carr at 615-627-3252, Jim Billington and Robert Walker at 214-239-1542.

NEWS-INTERVIEW

LabCorp Exec Discusses Reasons Behind Its 10-Year Pact with United

"This 10-year agreement is unique in the laboratory industry. It speaks to the long-term commitment of both parties."—Brad Smith, *Executive Vice President, Laboratory Corporation of America*

CEO SUMMARY: It was unprecedented when UnitedHealth Group announced an exclusive, 10-year laboratory testing services agreement with Laboratory Corporation of America Holdings. This is a high-stakes development for both companies. To learn more about the motivations and goals that encouraged UnitedHealth and LabCorp to partner up in this fashion, THE DARK REPORT spoke with Bradford T. Smith, LabCorp's Executive Vice President for Corporate Affairs. Two key objectives are to lower UnitedHealth's cost of laboratory testing and to reduce leakage. Several subtle goals align the interests of both parties. Among them is a mutual interest in developing more standardized laboratory test data and using that information to support efforts in disease management and evidence-based medicine. The interview was conducted by Robert L. Michel, Editor-In-Chief of THE DARK REPORT.

EDITOR: There are many implications to the new, exclusive, ten-year national laboratory testing contract between **UnitedHealth Group** and **Laboratory Corporation of America Holdings**. In our conversation today, I'd like to explore the fundamental reasons why LabCorp was willing to tackle the challenge of becoming UnitedHealth's sole national laboratory provider. It would also be helpful to learn how LabCorp believes a national managed care contract like this may represent a shift in thinking by the nation's largest health insurers.

SMITH: For the past several years, improving our relationships with major managed care companies has been one of LabCorp's three key strategies. We attempt to do this by highlighting the strengths we can bring to national managed care companies, including our leading-edge esoteric and anatomical pathology test offerings, our standardized computer and lab testing systems, and our national coverage.

EDITOR: How is this new national contract with UnitedHealth consistent with LabCorp's long-term strategy for working with managed care companies?

SMITH: A large part of the answer is related to the widespread consolidation that has occurred in healthcare over the past decade. Acquisition activity in the managed care industry has resulted in several very large national health insurance firms. For example, **WellPoint, Inc.** has 34 million beneficiaries and UnitedHealth serves 25 million lives. We can not hope to grow our business without growing our relationships with all of the national and major regional managed care companies.

EDITOR: Please continue.

SMITH: Consolidation within the managed care industry changes LabCorp's relationship with many of these companies. If you look at our revenue, 40% comes directly from managed care companies. If you add indirect sources of revenue linked to managed care plans, such as physicians who pay us and then bill the managed care companies, or patients who pay us, then more than 50% of LabCorp's revenue is tied, directly or indirectly, to managed care plans.

EDITOR: It is logical that LabCorp would want to develop strategies to address the source of more than 50% of its annual revenue. What steps are involved?

SMITH: The core of our strategy is basic. In addition to stressing the strengths that I mentioned, we need to find ways that LabCorp can serve managed care companies in ways that meet their needs—while allowing LabCorp to achieve its own business goals.

EDITOR: Let's discuss this business objective in the context of the UnitedHealth contract. What were the factors that led UnitedHealth to align itself so closely with LabCorp?

SMITH: First, as a health services company, we believe that UnitedHealth wants to become more efficient in the delivery of healthcare in ways that benefit their patients while improving the quality of the healthcare that they receive. That certainly includes improving the cost-effectiveness of laboratory testing. But it is a misconception to emphasize only the pricing components of this contract.

EDITOR: Yet pricing has been a major point of speculation by the financial community. Speculation centers around what level of pricing caused UnitedHealth to exclude Quest Diagnostics and offer the national contract exclusively to LabCorp. What other factors contributed to UnitedHealth's decision?

SMITH: UnitedHealth has regularly expressed its interest in improving clinical outcomes through the better use of data. It actively manages data and uses it, not just for utilization, but for helping clinicians raise their effectiveness. One example of a UnitedHealth initiative in this area is use of data to support the early identification of patients likely to become diabetic. That's an effort to make medicine more proactive and preventative. With respect to price, we have said we are not commenting directly, but I will say that I know, based upon the marketplace, what prices have been offered in contracts by our competitors. So I am quite certain that UnitedHealth's decision to chose LabCorp involved much more than price.

EDITOR: Clearly laboratory test data plays a role in this type of initiative. UnitedHealth has repeatedly made public statements about its strategic objectives to collect better data and use it to improve the delivery of care and health outcomes.

SMITH: Correct. UnitedHealth is interested in developing extensive sets of standardized data that it can use in disease management and evidence-based medicine. Within the laboratory industry, LabCorp is uniquely positioned to support UnitedHealth in its data accumulation efforts.

EDITOR: Please explain.

SMITH: LabCorp believes it has achieved the most standardization of any large laboratory organization. Within our company, we have standardized systems for: test ordering, test reporting, test identification, and test platforms [instrument systems]. Each of these factors is important for a large managed care company like UnitedHealth. It means LabCorp is providing uniform sets of data that can be incorporated with other data sources and used by the managed care organization to guide decisionmaking.


Brad Smith

"UnitedHealth is interested in developing extensive sets of standardized data that it can use in disease management and evidence-based medicine."

EDITOR: That implies an ongoing relationship between UnitedHealth and LabCorp, because it takes time to understand the information contained in the laboratory test data from large numbers of people, then use that information to generate operational efficiencies and clinical improvements.

SMITH: That's true. I can say that UnitedHealth became intrigued with LabCorp as it began to understand our standardization and how that contributed to uniformity in the laboratory test data and other information we are able to gather and provide. To succeed in its efforts with disease management and evidence-based medicine, UnitedHealth must get control of the data flowing in from all types of providers, including hospitals, physicians, and clinical laboratories. LabCorp's ability to deliver standardized data on lab testing—which is an important part of every patient's clinical record—was a factor in helping us develop the agreement with UnitedHealth. When these capabilities are overlaid with our extensive geographic reach and comprehensive expertise in esoteric and oncology testing, we believe we offer a compelling solution in one package.

EDITOR: Is LabCorp doing anything internally to generate more value from the lab test data it produces?

SMITH: Yes. We have an ongoing project involving **Medicity** that uses LOINC (Logical Observation Identifiers Names and Codes) and other proprietary technologies to combine disparate laboratory data from multiple laboratories and other sources and feed it into a standard data set. From that single, standardized set of data, it is then possible to break out information by individual patients, by diseases, or by lab results that meet specific criteria.

EDITOR: That would certainly be of interest to UnitedHealth and other managed care organizations. It is the capability to gather laboratory results from many sources and create a standardized data set.

SMITH: That's the goal. It's also an example of how the idea of a partnership and ongoing relationship between UnitedHealth and LabCorp emerged from our years of discussion and business interaction. Our two companies recognized common interests and common opportunities. I've already mentioned two of them, which are disease management and evidence-based medicine.

EDITOR: Does this point answer the question about why these two companies decided to make the agreement for ten years?

SMITH: Definitely. I am not aware of any similar contract for laboratory services. This ten-year agreement is unique in the laboratory industry. It speaks to the long-term commitment by both parties. As you know, both parties have a lot at risk. That means each party has something in play. That aligns the interests of both companies and keeps us both looking forward.

EDITOR: Brad, this is a good point to shift the conversation to the risks and challenges in this agreement. My first question is about pricing. Wall Street and the business press are speculating about what level of pricing LabCorp was willing to accept that Quest Diagnostics considered "fiscally irresponsible" to its shareholders and the lab industry collectively. Would you speak to that?

SMITH: Much has been written and said about the statements by Quest Diagnostics that it couldn't do this contract on the terms offered—and that LabCorp says it can do it, while maintaining the industry's leading margins. My first observation is that people are likely starting from a false premise, by assuming the contract terms that Quest was unable to accept are ones that we accepted. I don't know what terms Quest found specifically objectionable. But, based on their public comments, we do not have the same types of terms that they appear to have found to be problematic. Second, the value of a contract and partnership may differ dramatically depending on the relative positions and objectives of the parties.

EDITOR: Would you explain that?

SMITH: Each of these two lab companies has an existing book of business with UnitedHealth. This business is anchored in communities where one laboratory may have more infrastructure than the other. Next, there is established pricing for existing business. That means each of our two companies is going to look at the contracting status quo with UnitedHealth and weigh the impact of various contract terms differently.

EDITOR: Let me speculate for a moment, and use the New York City metropolitan area as an example. It is widely-recognized that Quest Diagnostics is the dominant lab provider in that market. In the physician office segment, it has a market share that probably approaches 70%. Because of this dominance and existing market share, Quest Diagnostics could logically be expected to view certain levels of lower pricing for an existing major managed care contract to be untenable with their cost of maintaining that business in that market. LabCorp, on the other hand, with a different cost structure—and a less extensive service network—may consider that same level of contract pricing to be acceptable, since it creates the opportunity to capture new client accounts and specimen volume.

SMITH: Conceptually, that's one way to explain why Quest Diagnostics and LabCorp may have viewed the UnitedHealth contract from different perspectives. But again, I do not necessarily accept that LabCorp accepted a lower price than Quest would have been willing to accept. Remember, LabCorp was an active bidder for the **Empire Blue Cross Blue Shield** contract in New York. We publicly stated our disappointment when we weren't awarded the contract. New York is a market where we would like to expand our presence. That is one regional market where LabCorp and Quest Diagnostics would view the UnitedHealth contract from very different extremes.


Brad Smith

"We have stated, in unambiguous terms, that we are confident we can maintain our current margins while we use the UnitedHealth contract to increase specimen volume and revenues."

EDITOR: Essentially, you are saying that, when both Quest Diagnostics and LabCorp evaluated the United Contract opportunity, both companies had different levels of pricing risk for their existing book of business, and different opportunities to expand their share of the UnitedHealth lab business. These factors guided each company in how it viewed the combination of prices and other terms offered by UnitedHealth.

SMITH: To the degree I can comment on this point, it is consistent with how LabCorp would explain its evaluation of this contract opportunity. We have stated, in unambiguous terms, that we are confident we can maintain our current margins while we use the UnitedHealth contract to increase specimen volume and revenues. Again, our standardization is a key reason for that.

EDITOR: That's a definitive answer. Now, let's discuss the challenges that lie ahead in performing as the sole national laboratory provider. In simplest terms, UnitedHealth has beneficiaries located in many regions of the country where LabCorp has little or no existing service infrastructure, including sales reps, patient service centers, rapid response labs, and logistics networks. How is LabCorp planning to serve these regions on January 1, 2007?

SMITH: We've publicly discussed certain aspects of our plans. What I would like to stress up front is that, by its very design, this national laboratory testing contract recognizes that achieving the goals of both companies will be a long-term effort. That is why it is a ten-year contract.

EDITOR: However, LabCorp does have a contract clause that calls for it to reimburse UnitedHealth for up to $200 million in transition costs. So there is a big financial incentive for LabCorp to act quickly in moving business and helping to reduce UnitedHealth lab leakage.

SMITH: That's right. Let me address our implementation plans step-by-step. First is the existing lab networks. In the case of **Oxford Health Plans**, LabCorp will step into Quest's shoes and assume management and operation of the existing regional laboratory provider network. There are also specific insurance programs mentioned in the press release for which LabCorp is an existing provider, and will become the exclusive laboratory. These include the HMO benefit plans of **Pacificare of Colorado**, **Neighborhood Health Partnership in Florida**, **Mid**

Atlantic Medical Services, LLC (MAMSI) in Maryland and Virginia, as well as specific markets in California and Colorado. In selected areas during the contract term, LabCorp will also create and manage regional lab provider networks.

EDITOR: Will these be similar to the type of regional laboratory provider network used by Quest Diagnostics to serve Oxford Health Plans?

SMITH: Conceptually, yes. The details are under development. LabCorp will be discussing this opportunity with prospective laboratories in these markets. The reimbursement model will be based on RVUs (relative value units). Participating laboratories will be reimbursed under a proportional formula.

EDITOR: What about regions like New York City and Chicago? These are metro areas where UnitedHealth has many beneficiaries, but LabCorp has little infrastructure.

SMITH: First, we do have a presence in these markets but clearly we need to expand access points for United patients and logistical support for their physician providers in areas where patient concentrations require it. We have obligations and commitments to build out these and similar markets where UnitedHealth has beneficiaries. Even now, we are opening new patient service centers, establishing rapid response testing capabilities, developing logistics, and hiring new sales personnel, with an expectation that these resources will be operational on January 1, 2007.

EDITOR: This is an expensive proposition. For example, LabCorp told analysts that 200 new patient service centers were under development in this first phase.

SMITH: I can't comment on the specific numbers. We've announced that in 2006 we will spend about $14 million to $18 million in increased operating costs to support the UnitedHealth contract. There will also be another $15 million to $20 million in related capital costs. But, when you consider how this partnership presents the opportunity for LabCorp to grow its business, we feel the amount of investment is relatively modest.

EDITOR: Now it's time to talk about the toughest challenge: convincing physicians to switch from their existing laboratory provider to LabCorp. Over the past 20 years, the nation's largest laboratory companies have generally failed to succeed in one core business skill: the ability to put a sales force in the field and see that sales force profitably generate new accounts over a sustained period of time. What will LabCorp do differently that will allow it to shift tens of millions of dollars of market share away from other laboratories?

Brad Smith

"We do recognize that LabCorp must differentiate itself from competing laboratories. To move market share, we can't rely on the offer of lower prices or the same bundle of benefits that has been shopped in our industry for years. "

SMITH: I don't think that the problem has been in selling the business. I think the problem has been in keeping the business, or, in other words reducing "churn." The laboratory testing business is a very competitive business—with many difficult challenges for sales efforts. First, there are many "customers" for the same business. The ordering physician, the patient, the payer—each can sometimes have differing interests. Second, with thousands of tests and thousands of laboratories, historically it has been relatively easy to switch laboratories. What we need to do is to reduce the reasons that cause physicians, payers, or patients from wanting to switch once we get their testing business.

EDITOR: What will be different in how LabCorp uses its sales program to capture increased market share?

SMITH: At the center of our strategy is to partner with major managed care companies like UnitedHealth. Not just to meet their business needs, but rather to work with them to help meet the broader objective of bringing more cost effective, high quality testing to their patients and physician providers. We also recognize that the typical physician is not going to automatically switch from his or her existing laboratory just because a LabCorp sales rep knocks on the door. Physicians need to be convinced that LabCorp offers a different, unique, and useful set of benefits and advantages.

EDITOR: Any specific insights?

SMITH: We do recognize that LabCorp must differentiate itself from competing laboratories. To move market share, we can't rely on the offer of lower prices or the same bundle of benefits that has been shopped in our industry for years. That's where our leading-edge science, including our cancer testing and genomic testing laboratories, comes into play.

EDITOR: One truth about this new contract with UnitedHealth is that LabCorp's success in building market share will be directly linked to its success in putting an effective sales program into the marketplace.

SMITH: That is a valid point. However, we also believe that, while the sales effort is a key component, it will only be effective if we continue to offer industry leading service. Our company must execute. As we put the service framework into place, our people need to convince physicians to switch to a LabCorp solution for all their testing needs.

EDITOR: The $200 million risk pool must add motivation to be successful in selling and reducing leakage. This amount is the maximum LabCorp might pay to UnitedHealth during the first three years of the agreement.

SMITH: That's correct. It is a significant risk factor for us. We have the financial motivation to act quickly to increase market share by enough to generate the savings to UnitedHealth that are specified in the contract.

Brad Smith

"Over time, it wants to reduce this number. It was made clear to us that, moving forward, UnitedHealth wants data presented in more detail and in a standardized format, even as leakage on its national contract is steadily reduced."

EDITOR: What role will UnitedHealth play in helping to convince physicians to utilize its network laboratories?

SMITH: There is a commitment by UnitedHealth to proactively help encourage physicians over this point. Remember, both parties have entered into a ten-year agreement. That commitment is unique and speaks to UnitedHealth's determination to redirect its laboratory testing arrangements.

EDITOR: But how might UnitedHealth actually push physicians to move to a contract laboratory—without causing alienation and resentment?

SMITH: I can't answer for UnitedHealth, but I can say that we have discussed with UnitedHealth how we incentivize physicians to use their contracted providers, including LabCorp. UnitedHealth has told us they are committed to achieving the goals established in this sole source, ten-year, exclusive national laboratory contract and we expect their full and active support.

EDITOR: You are indicating that UnitedHealth will be more active in this role. Historically, managed care companies have been relatively passive about leakage and continued use of non-contract laboratories by physicians. Until recently, UnitedHealth was soliciting request for proposals (RFPs) from regional laboratories and appeared to be willing to expand its provider panel. Could you explain why the shift away from this approach and its decision to put LabCorp in front as the exclusive national contract laboratory and the primary manager of any necessary regional laboratory provider networks?

SMITH: Although I can't speak for UnitedHealth on this point, I can say that United has publicly stated their intention to do something with this laboratory RFP that was truly market changing. We take them at their word and are thrilled to be their partner as we work to achieve that goal. I also think it is true that UnitedHealth believes it has too many laboratory providers. Over time, it wants to reduce this number. It was made clear to us that, moving forward, UnitedHealth wants data presented in more detail and in a standardized format, even as leakage on its national contract is steadily reduced.

EDITOR: That is consistent with the long-term goals that are reflected in this ten-year contract. Can I be bold enough to say that, certain elements of this contract appear to be structured to help LabCorp establish laboratory testing infrastructure in regions where it currently has little or no presence? Thus, one unexpressed outcome from this contract is that it provides a bootstrap for LabCorp to expand its presence in more communities around the United States.

SMITH: Again, I can't speak for UnitedHealthcare, but, if we grow and strengthen our infrastructure, this expanded, strengthened infrastructure can be used to win and service other new testing business. There's also an efficiency aspect to this ten-year pact. UnitedHealth seeks operational efficiencies in how healthcare is delivered. It wants more detailed and standardized sets of data. And it wants to raise clinical quality.

EDITOR: It is easier to do this with partners who effectively support these goals over long periods of time than it is to engage a vendor in a three-year contract, then repeat the process and possibly start all over again with the new contract awardee. I can interpret this 10-year contract as an effort on UnitedHealth's part to break that cycle and establish a closer relationship with a lab provider, in this case, LabCorp.

SMITH: That is one interpretation.

EDITOR: But isn't it true that the structure of this contract does create an opportunity for LabCorp to establish a greater presence in existing and new regional markets?

Brad Smith

"There's an efficiency aspect to this ten-year pact. UnitedHealth seeks operational efficiencies in how healthcare is delivered."

SMITH: Yes. That is one benefit we expect to result from this contract. It allows us to build infrastructure in some areas and support our growth in other areas.

EDITOR: That response is another answer to my original question at the start of this interview, when I asked about the fundamental reasons which led LabCorp and UnitedHealth to enter into a sole-source, ten-year contract. You have provided a wide range of insights into the reasons why both companies entered into this contract. Thank you for your time.

SMITH: You're welcome. In closing, I would emphasize that LabCorp is excited about the opportunities to advance laboratory medicine and help improve health care outcomes by a closer collaboration with one of the nation's leading health insurance companies. Despite the risks, it is a goal worth pursuing. TDR

Contact Pam Sherry at 336-436-4855.

Lab Management Trends

New Book Offers Guidance About Management of POCT

Authors connect and integrate the trend of quality management systems with POCT

WHENEVER A TREND COMES OF AGE, books appear to offer guidance on how to best benefit from such a trend. In the laboratory profession, point-of-care testing (POCT) is an example of a trend which is now ubiquitous in most large healthcare organizations.

Another trend currently gathering momentum in both healthcare and the laboratory profession is the use of quality management systems, including Lean, Six Sigma, and ISO-9000.

So it is of interest that that a handy, concise tome called "Point-of-Care Testing for Managers and Policymakers: From Rapid Testing to Better Outcomes" was published in recent months by **AACC Press**. It is a book which has ambitious goals, for in just 115 pages, it tackles POCT from the perspective of policymakers, clinical laboratory administrators, and clinicians.

International Perspective

The two authors come from the United Kingdom and Australia. That gives their insights and conclusions a broad perspective that addresses issues common to healthcare systems in most developed countries. Christopher P. Price, Ph.D., FRCPath, FACB is a Visiting Professor of Pathology at the **University of Oxford** in the U.K. Coauthor Andrew St. John, Ph.D., MAACB, is Market Development Manager with **Ortho-Clinical Diagnostics** in Perth, Western Australia. Both individuals regularly visit the United States and are active in the **American Association of Clinical Chemistry** (AACC).

This book is one of the first to recognize that new management systems—which upend the traditional hierarchy of top-down management in favor of a patient-first orientation—require laboratories to deploy care testing for significantly different reasons than might have been true in the past. Price and St. John support these premises with specific examples and citations from published studies.

Analysis of Each Issue

For lab managers and pathologists dealing with the issues and politics of POCT in their institution, "Point-of-Care Testing for Managers and Policymakers" is likely to be a useful reference. It provides analysis of the issues in each dimension of POCT, ranging from the initial question of "Should we or shouldn't we?" to design and implementation of a POCT program and ways to measure the outcomes for all stakeholders.

As a sign of change, this book is also one of the first published by laboratorians with the goal of helping lab managers understand how to integrate new quality management methods with the successful operation of point-of-care testing programs. TDR

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

American Esoteric Laboratories, Inc. today announced that it has signed an extended, five-year contract to provide reference and esoteric testing services to the 14-hospital **Baptist Memorial Health Care Corporation** (BMHCC) in Memphis, Tennessee. This relationship was developed as part of AEL's acquisition of **Memphis Pathology Laboratories** in 2004.

NEW & STEPHANELLI LAUNCH AP COMPANY

Today, **Aurora Diagnostics, LLC** of Palm Beach Gardens, Florida, issued its first press release and announced that the company launched in July with the intent to acquire anatomic pathology and clinical diagnostic companies. It has already negotiated acquistion agreements with five laboratories. James C. New is Chairman and CEO. Martin Stefanelli is Chief Operating Officer. New and Stefenalli formerly worked together at AmeriPath. Aurora has lined up $300 million from **Summit Partners** and **GSO Capital Partners**. The company intends to focus on the non-hospital market.

PROJECT UNDER WAY TO SEQUENCE FULL NEANDERTHAL GENOME

Believe it or not, an effort is under way to sequence the complete Neanderthal genome. The research is being conducted by the **Max Planck Institute for Evolutionary Anthropology**, in collaboration with **454 Life Sciences**, a private company. The Planck Institute brings expertise in ancient DNA to the project. 454 Life Sciences is providing a next-generation, high-throughput sequencing technology. DNA from several Neanderthal specimens will be used. In 1997, Savante Paabo, Ph.D., Director of the Department of Evolutionary Anthropology at the Max Planck Institute, was first to sequence DNA from a Neanderthal fossil.

ADD TO: Neanderthal DNA

Neanderthal inhabited Europe and the Near East until about 30,000 years ago. Over the next two years, the project team hopes to produce a draft of the Neanderthal genome that contains approximately three billion base pairs. Researchers want to look at the part of the human genome and Neanderthal genome that is different from the chimpanzee genome. They expect genetic differences to help them understand how *homo sapiens* evolved. Chimps are the closest living relative to homo sapiens and share 99% of the *homo sapiens* genome.

A SIGN OF THE TIMES

The following is a help wanted ad recently published in *Urology Times*:

Michigan-based urology practice has an immediate full-time opening for a urologist M.D. or D.O. Will consider new graduates. ESWL and Cryo partnerships available. In-office pathology laboratory. DaVinci Robot surgical system for prostate and kidney cases, and possibility of corporate partnership available.

TDR Comment: Mention of the group's "in-office pathology laboratory" is obviously designed to alert potential candidates that physicians practicing in this urology group will be sharing in the profits from this ancillary service. This ad demonstrates how the urology profession is incorporating in-house anatomic pathology services into their business model.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, November 6, 2006.