For decades, many hospital and health system executives have counted on relatively stable margins from laboratory departments. Gains with “outreach” lab services provided to local physicians, nursing homes, and other providers have covered some losses related to lab testing for registered inpatients and outpatients. Outreach services also have enabled hospital-owned labs to significantly enhance their lab volume, thus lowering total cost per test.

Additionally, insurers traditionally have paid hospitals more for lab tests than they pay lab companies. Higher payment has reflected their recognition that hospitals lack the scale of large labs and tend to have higher cost structures.

Such years are over. The economics of lab testing are changing dramatically due to market forces including the following:

- **Reduced Medicare payments**: Beginning January 1, 2018, Medicare will adjust Part B payments for lab tests to reflect what commercial insurers pay for tests. Fees are expected to decline significantly, particularly on high-volume, highly automated tests. The Centers for Medicare and Medicaid Services estimates total decreases of $400 million in 2018. Since fee schedules used by commercial insurers often are based on a percentage of Medicare fees, fee adjustments by CMS could have a cascading effect on all lab testing rates, potentially turning laboratory testing into a cost/loss service for many hospitals.

- **Competition from national labs**: With size and scale, LabCorp, Quest Diagnostics, and other large companies can handle huge volumes. This enables them to charge payers less per test than hospital labs and still make a profit (see sidebar). Large independent labs are gaining share in numerous areas.

- **Preferred lab arrangements with commercial payers**: Aetna, UnitedHealthcare, and other insurers have negotiated exclusive arrangements with commercial labs and are encouraging in-network physicians to refer patients to these “preferred labs”—or risk being excluded from their networks.

- **Higher cost sharing for patients**: Insurance coverage through high-deductible health plans (HDHPs), which involve bigger out-of-pocket costs for enrollees, is increasing steadily, with nearly 30 percent of covered employees now enrolled in HDHPs. Insurers are encouraging plan members to use preferred labs—often large lab companies—by charging lower copays or coinsurance for their use for outpatient tests.

### Large-Scale Competition in the Lab Space

**Source: Kaufman, Hall & Associates, LLC**

The hospital laboratory business has been disrupted by large-scale competitors that can do most of what hospital labs do at a lower cost point.

Following the 80/20 rule, about 20 percent of lab tests account for 80 percent of lab volumes. Commercial labs have become particularly efficient at doing high-volume lab tests. With national reach and efficient supply and production streams, they can handle huge testing volumes. Patients can get their labs drawn at conveniently located retail service centers. The companies then run the tests in centralized labs equipped with the latest technologies.

Hospitals and health systems are at a natural disadvantage in this changing market. Streamlining processes and lowering costs could increase efficiencies, but will not address the competitive challenges. Although hospitals may need a laboratory onsite or very close by for return of stat lab test results to physicians for critical treatment decisions, most cannot compete with the heavy volumes of tests performed by commercial labs.
• **Growth in bundled payment arrangements**: More testing likely will be rolled into bundled payments as the industry shifts to value-based payment structures that reward high quality and lower costs. Every cost item will be scrutinized.

**Five Partnership Strategies for Hospital-Owned Labs**

Senior hospital and health system executives should rethink their business model with labs. Proactive leaders are assessing their strategic options and considering potential partnerships with other health systems and/or commercial labs. These affiliations run the gamut of integration options, from management service agreements and joint ventures to full sales (see Figure 1). Executives may consider the five approaches to partnerships described on the following pages.

**Figure 1. Options with Laboratory Businesses**

*Note:* Brand names and/or trademarks listed in this figure are the property of their respective owners. The inclusion of these entities does not imply their association with, or endorsement of, Kaufman, Hall and Associates, LLC.

*Source:* Kaufman, Hall & Associates, LLC.
1. **Partner with other area hospitals or health systems to build lab business.** Health systems in nearby regions can combine their laboratory businesses to gain scale and compete with commercial laboratories. Typically, the organizations create one or more centralized labs that serve all of the systems' hospitals. This lab needs to be located near enough to each system to ensure timely turnaround.

Alternatively, each system might keep its lab and divide high-volume testing, with each system performing different tests. Decision making regarding which system does which tests can be challenging, particularly when the health systems have unique goals and compete for clinical services.

One example of a successful lab partnership between health systems is ACL Laboratories, which is jointly operated by Chicago-based Advocate Health Care and Wisconsin-based Aurora Health Care. In 2000, the two large systems combined their laboratories, forming a single lab entity with joint leadership, information systems, sales, billing, and marketing. One of the goals was to compete with the large national labs for Chicago-area outreach business.

A key success factor in the Advocate-Aurora partnership has been the systems' complementary geographies which abut, but do not overlap. This enables the partners to share lab services without competing for clinical services. The partners also have carved out a niche in the lab market, emphasizing the quality of services provided by a health system-owned and operated lab. Today, ACL Laboratories is one of the largest health system laboratories in the country, serving 27 hospitals and 110 clinic settings. It performs 24 million lab tests per year.

Health system lab partnerships require diligence to execute and operate successfully. Most non-affiliated organizations find it difficult to achieve because a lab partnership brings together two organizations that often have competing priorities and goals. Even regional health system-operated labs with synergistic goals may have trouble competing in price-sensitive markets against aggressive commercial labs that have a national footprint and the scale to offer payers lower prices.

2. **Perform tests for large labs trying to enter new markets.** The large national lab companies have an extensive number of reference labs, but in some areas, their lab capacity may not be as large as they would like. Hospitals that are located in these gap regions might want to approach the companies about the possibility of seeking new business together. Alternatively, the large labs may reach out to the hospitals.

In one example, West Tennessee Healthcare recently began performing lab tests for Quest Diagnostics. In this arrangement, the health system provides diagnostic and testing services to the lab company for a per-test fee, saving the commercial company the cost of building a local laboratory. The commercial lab then handles all sales, marketing, billing, and other administrative functions.

Commercial labs tend to have robust sales teams that effectively and efficiently attract outreach business from physicians, nursing homes, and others. Thus, the health system garners new business, which makes use of unused capacity, lowers the hospitals' overall costs per test, and can reduce front-end marketing and back-end billing costs.

3. **Affiliate with a large lab that can manage the hospitals' lab business.** Similar to an outsourcing arrangement, a health system might sign a management agreement with a commercial lab or a regional hospital lab to operate its lab business, including inpatient, outpatient, and outreach tests (if applicable). In the past few years, a number of health systems have made such arrangements.
For example, both New Jersey’s RWJBarnabas Health and Denver’s HealthONE affiliated with Quest Diagnostics. Under such partnership arrangements, the health system maintains ownership of the lab. The commercial lab partner assumes all of the costs related to operating the lab and, in return, charges the health system a fee. Typically, this fee is below the hospital’s current cost base, thereby resulting in savings for the health system. Large labs like Quest can offer lower prices and still make a profit because their supply contracts are more favorable, and their processes more streamlined.

In other partnership arrangements, the health system retains some of the lab assets, while certain of the assets are purchased by the commercial lab. In most cases, the lab company retains as many hospital lab employees as possible, and these individuals become company employees. The lab company typically makes changes to improve efficiencies and reduce costs, such as sending certain tests off site and consolidating multiple laboratories within a health system. Additionally, the lab company may provide other value propositions to boost a hospital’s lab business, such as access to the latest lab technology or IT systems, and a large footprint of convenient retail service centers for patients to access.

This partnership approach may be particularly attractive to hospitals and health systems that are looking to lower their laboratory costs but prefer to maintain control over their laboratory business.

4. **Sell outreach lab business to a national lab.** Some health systems are trying to monetize their outreach lab business through a sale. The outreach business consists of preferential client relationships that a hospital lab has built with physicians, nursing homes, and other organizations. The hospital agrees to sell its current outreach lab customer list to a national lab for a negotiated fee. The national lab partner looks to retain those existing clients and to use its sales and marketing talents to grow the client base further.

Examples of health systems that have monetized their outreach business in this way include Mount Sinai Health System in New York, which completed a sale to LabCorp in May 2017, and Connecticut’s Hartford HealthCare, which sold its outreach lab business to Quest in 2015.

Most often, these sales are arranged along with management service agreements. The large labs take over operating a health system’s inpatient and outpatient lab operations, and the health system sells the outreach business to the commercial company.

5. **Joint venture with a national lab to grow outreach business.** In certain regions, health system leaders may see an opportunity to grow their outreach lab services, but look to a partner’s capabilities—such as technology, scale, sales, marketing, client services, and billing—to do so. A joint venture arrangement with a national lab is one way to obtain access to these resources while retaining a continuing stake in the lab business. Health systems often look to retain some ownership in the lab due to its importance in the care continuum.

Western Connecticut Health Network (WCHN) used this approach. In early 2017, WCHN entered into a definitive agreement to joint venture with Sonic Healthcare, forming a new entity called Constitution Diagnostics Network. Together, WCHN and Sonic Healthcare aim to grow testing volumes from individuals and providers, stressing the quality of lab testing that can be provided by a hospital-based lab. About 80 percent of tests will be conducted at WCHN hospital labs, and the rest will be handled by Sonic’s laboratories.
Time Is of the Essence

The lab industry is changing rapidly. Importantly, the new Medicare Part B Clinical Laboratory fee schedule will be effective on January 1, 2018. Expected much lower rates for lab tests could significantly affect the financial performance of health systems’ labs. With large fixed costs for lab services, revenue hits likely would fall directly to the bottom line, impacting health system income.

To satisfy laboratory-related goals and objectives, health system leaders should consider partnerships and affiliations with other health systems or commercial lab companies. Advisors who are active in the hospital and health system/lab partnership space nationwide can help healthcare executives identify strategic options, which might include innovative collaborative and financial arrangements.

Proactive hospital and health system leaders who are pursuing new options can maximize the strategic and financial value of their lab businesses, while addressing the pressing competitive market environment.

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