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Getting the Most from Your Contracts

By Aaron J. Garmong and Alison B. Flynn

Millions of dollars rest on the decisions made by those who source, negotiate, and manage a healthcare facility's contracts. In most hospitals, this aspect of purchasing belongs to select individuals who possess the expertise to simultaneously maximize vendor performance and minimize potential liabilities.

These are your supply chain professionals, faced with an ever-growing set of responsibilities, and less time to manage them. That said, adherence to a consistent methodology can streamline the contracting process—and result in significant financial rewards.

✓ Adhere to a Contract Approval Process

Both administrators and clinicians must be heard in the contract approval process, as consensus here is a necessity. We advise including the following staff in every review.

Department-level managers and clinicians.

These front-line authorities possess real insight that can help endorse or debunk a product or service that “looks great on paper.” For example, physicians and nurses can help validate claims from medical device manufacturers.

Materials and purchasing staff. Supply chain managers need to review contracts to ensure compliance with the organization's sourcing strategy.

Legal counsel. Attorneys typically review the legal aspects and related liabilities of any business proposition.

Improved Contracting Requires Adhering to the Specified Approval Process



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COMING SOON

Managing catastrophic disruptions to the supply chain

Choosing the right GPO

Improving inventory performance

Controlling orthopedic implant costs

The CFO or the CFO's financial designee.

In most organizations, a senior executive, like the CEO or CFO signs off on every binding agreement. In addition, we encourage organizations to define purchasing authorities. At a minimum, the party responsible for the impacted budget line should approve the agreement as well.

When completed, original, signed contracts should reside with the legal department, but other involved groups, such as finance, should retain a copy as well. For reference, copies should be provided to the department head who is expected to work with the vendor. Many times, those working most closely with a vendor are not fully aware of what the vendor may be obligated to provide—whether it's a product, service, or price. Unfortunately, for that reason, hospitals can occasionally miss out on already negotiated opportunities to enhance patient care or lower procurement costs.

☑ **Communicate Priorities**

With every contract, the goal should be to maximize the net benefit to the organization; by net, we mean the total value of the financial and nonfinancial contributions (for example, the impact on patient safety). Materials managers can easily, and quite unintentionally, stray off course if they don't understand the organization's strategic priorities. For example, a hospital materials manager might implement product conversions to save costs, but such a move could do more harm than good if it results in rattling physicians or risking patient care, all for negligible savings.

Supply chain managers also need to understand some basic information about the organization's financial health. For example, let's say a facility is fortunate enough to have access to significant cash in a low-interest rate environment. If the materials manager knew this, he or she might choose to take advantage of

Many hospitals have standardized contracts that include "must-have" language. Another option is to develop a checklist of key terms and clauses that should be included in every contract. Pilots operate from a checklist; so should materials managers.

certain early payment discounts to save the institution money.

☑ **Strive for Consistency in Contracts**

Materials managers should review and implement contracts methodically. While individual contracts may vary, certain elements should always be in place. As an example, "out clauses" allow parties, under certain conditions, to disengage from the specified relationship; every contract should have an out. The conditions may include payment of financial penalties, but typically provision of advance notice and purchase of any custom inventories suffice.

Many hospitals have standardized contracts that include "must-have" language. Another option is to develop a checklist of key terms and clauses that should be included in every contract. Pilots operate from a checklist; so should materials managers.

☑ **Address All Possible Risks**

It's easy for vendors to promise the world, but what happens if they don't come through? Building in the concept of "risk and reward" is one proven approach to handle this situation. For example, let's assume that a vendor touts 99 percent on-time delivery and defines "on-time delivery" in some satisfactory manner. Then, ask the vendor to explain what happens if, in the course of a month or a year (depending on product order volume), the vendor has not kept the promise. The vendor may talk about how third parties verify the numbers or about how the trend could only improve. Remind the vendor that contracts must address the worst-case scenario; then,

find a way to incorporate some penalty for this event. From a legal perspective, any monetary penalty should be no more than the actual loss of time and/or materials the hospital would incur.

☑ **Consider the Fine Print**

Be certain to run through all of the what-if questions and worst-case scenarios, even

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Spend Analytics Tool Helps Hospital Alliance Save Millions

As hospitals across the industry work to reduce costs in a demanding market, one of the oldest principles of effective business planning is becoming clearer: You need to know where money is being spent before you can save any. It's a simple philosophy, yet too many hospitals seem unable to access the proper information on some of their most expensive purchases, including pharmaceutical products.

At a Glance

In the past two years, Child Health Corporation of America, a business alliance of 41 North American children's hospitals, has saved more than \$4.5 million in pharmacy costs using a spend management tool developed by the hospital network's GPO partner. The spend analytics tool brings a variety of purchasing-related information together in an electronic form.

CHCA staff used the spend analytics tool to analyze off-contract purchases and encourage clinicians to improve compliance with standing pharmaceutical contracts. As a result, participating CHCA facilities achieved a 92 percent contract compliance rate on top 50 drugs by brand (up from 80 percent to 85 percent). Larger CHCA hospitals did even better.

CHCA staff have used the spend analytics tool in a variety of other cost-saving ways as well:

- **To identify lucrative market share deals with vendors**
- **To determine estimated savings opportunities available (for example, rebates) for a particular item or performance program**
- **To review invoice purchases to ensure the correct price was paid**

The need for better information has spawned the growing use of spend analytics tools, which provide detailed reports on where money is going, as well as how money could be saved. The tools involve software, usually from consultants or group purchasing organizations. Used properly, the resulting savings can be significant.

Child Health Corporation of America, Overland Park, Kan., a business alliance of 41 North American children's hospitals, is an example of how much can be achieved using spend analytics. In the past two years, the alliance has saved more than \$4.5 million in pharmacy costs using a spend management tool developed by the hospital network's GPO partner. The tool is available to all GPO members that use the GPO's online automated contract management system. The only commitment on the part of CHCA was setting aside time for staff to be trained on how to use the tool.

Contract Compliance Is Key

A key to success is contract utilization, and understanding there's a tremendous amount of money that can be saved by ordering pharmaceuticals from existing contracts. That, again, may sound like an over-simplified approach, but to someone

outside the purchasing department, it may be surprising how often expensive, off-contract products are purchased even though the organization has a contract in place that enables staff to purchase cheaper, clinically acceptable alternatives.

There are also instances when the contracted product is purchased, but neither the person placing the order nor the supplier receiving the order is aware that a contract exists between the two parties. Subsequently, a prenegotiated discount isn't applied, and the hospital pays a higher price for the product. A spend analytics tool is able to produce reports that analyze purchases and highlight when savings opportunities have been missed, so changes can then be made in the ordering process.

The difference in contract compliance can be significant, as was the case at CHCA. Before the spend analytics tool was brought in, most CHCA facilities were using contracts only about 80 percent to 85 percent of the time. CHCA leaders set a goal for the 33 participating hospitals: 92 percent adjusted contract compliance level for the top 50 drugs by brand. (The goal for the largest hospitals was set to 97 percent.) Using the spend analytics tool, CHCA staff developed a contract compliance report to educate pharmacy directors and buyers about contract compliance during face-to-face meetings.

In one instance, a single report of off-contract purchasing identified a drug at one CHCA hospital that resulted in a savings of \$334,000. The facility had been paying 10 times more for an alternative drug than the contract price.

In another instance, an alliance hospital was using a brand name drug while other alliance facilities were using a less expensive, generic form of the drug. A quick report using the tool became the springboard for getting the hospital's clinicians to make the cost-saving change they'd been resisting—and without compromising patient safety.

CHCA's goal has been achieved, and CHCA leaders are now trying to improve contract compliance for the top 100 drugs by brand.

Tool Provides Market Share Reports

Another important function of a spend analytics tool is the ability to quickly run market basket reports, which provide a vital reference to how much business a hospital or health system is giving a manufacturer for a specific product. Many contracts are priced based on market share percentage, and if a hospital is willing to promise that a certain percentage

of a specific drug purchased will be from a particular manufacturer, that manufacturer is usually willing to offer a price rebate. Typically a commitment to give a manufacturer a 95 percent market share will result in about a 5 percent rebate, but those figures can vary.

A hospital without a spend analytics tool doesn't always end up making the best

Although hospitals already have most of the necessary supply data in their facilities, those data are likely in paper form in various filing cabinets. A spend analytics tool brings all that information together in an electronic form that can be used for a variety of functions.

deal, because the process of determining the best offer can be complicated, and there are usually time deadlines associated with such deals. However, CHCA officials report that by using the spend analytics tool, they recently saved \$480,000 on one market share offer and \$54,000 on another market share deal.

These savings highlight the efficiencies created by the spend analytics tool. Vendor performance programs can be difficult to understand with market shares, tier placement, volume requirements, etc. In many cases, hospital staff rely on the vendor to tell them what they can achieve and where the hospital will be initially placed if there's a tier component. This tool allows hospital leaders to take a proactive approach in evaluation of vendor incentives.

CHCA uses the tool to evaluate performance programs and contract offerings



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more quickly. Since the evaluation is quicker, the savings begin sooner. In some cases, the tool has pointed out rebates that CHCA was qualified to receive from a vendor. However, CHCA staff use the tool more to determine the estimated savings opportunity available for a particular item or performance program.

All Contract Information Can Be Found in One Place

The key is in being able to use and compare data to make the best decisions. Although hospitals already have most of the necessary supply data in their facilities, those data are likely in paper form in various filing cabinets. A spend analytics tool brings all that information together in an electronic form that can be used for a variety of functions.

A good analogy would be in the difference between using the old-fashioned, hand-notated method of tracking a bank checking account, versus using software that can help balance a checkbook, run a large

number of category-specific reports, keep track of all transactions, and connect and download information from a variety of financial institutions.

A Win-Win Deal

The manager responsible for CHCA's adoption of the spend management tool noted several other useful functions:

- > **Price verification.** This report allows hospital staff to review invoice purchases to ensure the correct price was paid. The report compares the invoice price supplied by the wholesaler with the hospitals' GPO contract price file. If there's a price discrepancy, it's highlighted on the report.
- > **Off-contract analysis.** This report shows what products the hospital purchased off contract and lists the price paid for those items, as well as the on-contract equivalent. It also displays the price difference between the on-contract and the off-contract item.
- > **On-contract, on-contract alternate.** This report allows a hospital to review on-contract purchases made in

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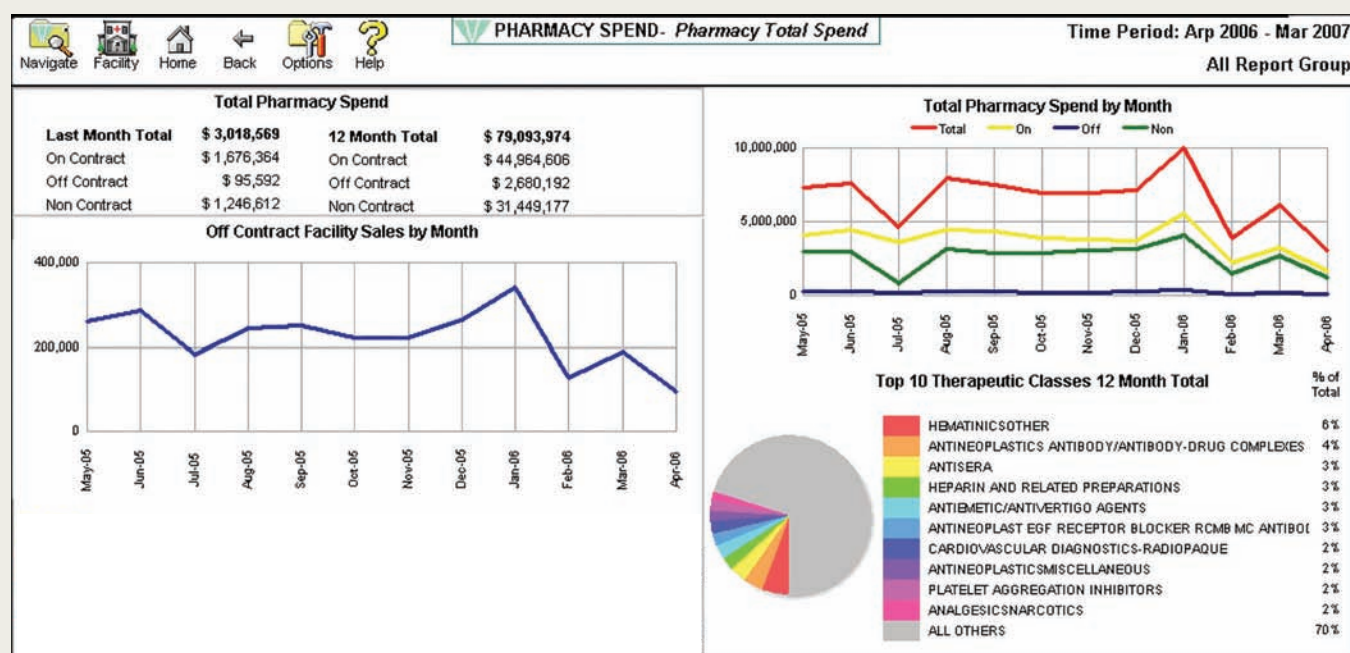
instances where there's an equivalent product on contract at a cheaper price.

With the pricing pressures affecting the entire industry, CHCA leaders say they considered the spend analytics tool a necessary part of the purchasing process.

Marla Weigert is a group vice president for Premier Purchasing Partners, Charlotte, N.C., the group purchasing and supply chain unit of Premier, San Diego, an alliance serving 1,700 hospitals and nearly 45,000 other healthcare sites (Marla.Weigert@PremierInc.com).

Identifying Supply Spend Issues

A spend analytics tool can help identify how much an organization is spending on off-contract as well as on-contract purchases.



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The Logistics of a Major Logistics Agreement

One of the most sacred duties that a hospital's material management department has is ensuring that an inventory of medical products is accurately maintained and available for the clinical staff when needed. It is, therefore, a source of great thought and planning when a hospital decides to turn over those duties to a third-party logistics company under a business deal that was somewhat unprecedented when initiated in 2002.

The hospital is The Nebraska Medical Center, a 512-bed teaching facility in Omaha, Neb., and the success of the agreement with the third-party company was covered in the March issue of *Supply Chain Solutions*. In the following interview, **Martin T. Carmody, FACHE**, the medical center's executive director of corporate services, talks about some behind-the-scenes details of the agreement, as well as the culture required to make such major change.

How many of your people were moved over to become employees of this third-party logistics company, and how was that handled?

Carmody: There were approximately 28 staff members, and one manager. Prior to the change, hospital material management staff was responsible for moving product from the dock to the respective departments. A third party warehoused and delivered all product orders to the dock in a "stockless" inventory model. Today, those employees are part of another company that we've contracted with—a third-party logistics company—and those employees are part of the integrated team that extends to that company's off-site warehouse.

These employees are still viewed as members of The Nebraska Medical Center team. The

Nebraska Medical Center recognizes the importance of people in any organization. From the beginning, leadership was open and honest with the materials management staff and informed employees of the vision that leadership had, what supported the vision, and our approach to exploring that vision. That approach included the staff's direct participation in the outcome. I believe the open, honest culture of The Nebraska Medical Center is what defines any success that we have had in transforming our supply chain, or the success we have in any of our excellent clinical programs.

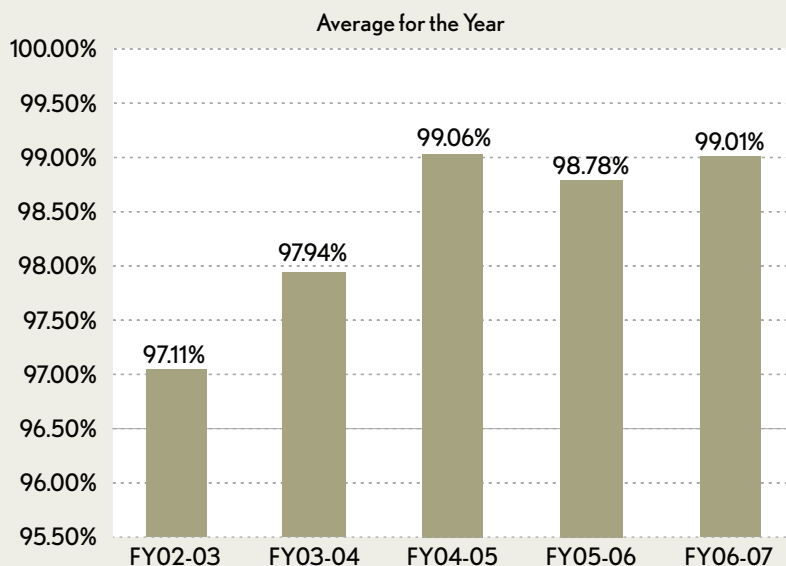
We attempt to engage our employees in the process and build acceptance through open communication and teamwork. This process required everyone's awareness and support to be successful. Leadership and the human resource departments from both organizations worked together to understand employee concerns and develop a transition plan that was supported with frequent and consistent communication. All employees of The Nebraska Medical Center recognized this effort as a part of the organization's strategic direction.

On a day-to-day basis, how does distribution in the hospital work?

Carmody: In the simplest form, a nurse interacts with point-of-use technology provided by our logistics partner when he or she needs medical supplies for a specific patient. The point-of-use technology is interfaced with the logistic partner's order management technology and generates a requisition to replace the product taken by the nurse. The order management system is interfaced with our general ledger and allows us to generate a charge for the product.

It is a bit more sophisticated than that, but ultimately, the integrated information systems allow the medical center's leadership to obtain accurate, real-time data on supply consumption. This model does not relieve hospital leadership of their operational or financial accountability. Rather, the team is working smarter, not harder. By leveraging the expertise and resources of our partner, we have a better understanding and more control over our supply chain than in the past. The end

Product Availability at The Nebraska Medical Center



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In the past five years, The Nebraska Medical Center has been able to significantly improve product availability at the point of use. (Note: In FY05-06, a 200,000-square-foot clinical building was commissioned and impacted this metric for a brief period.)

“What we have done with our supply chain is common place in other industries. That does not mean it is right for all hospitals.”

result is better service to our caregivers. The right product is in the right place at the right time at the right price.

Who owns the technology that's been put into the hospital?

Carmody: The logistics company deployed its inventory and order management systems into the medical center and interfaced those systems with our general ledger system. The third-party company manages the inventory from its warehouse to the point of consumption.

In our relationship, we have aligned our business objectives to achieve high-quality service while


reducing the overall costs. The Nebraska Medical Center pays a fee for that service. Based on a guaranteed savings model, the partners agreed to share savings once the guarantee is met. This approach creates economic alignment between the hospital and the third-party company.

This is a very long-term arrangement, with the technology that's been installed and the former hospital employees that are now providing services as part of the third-party company. Wouldn't it be very difficult to bring in another company to take over this operation?

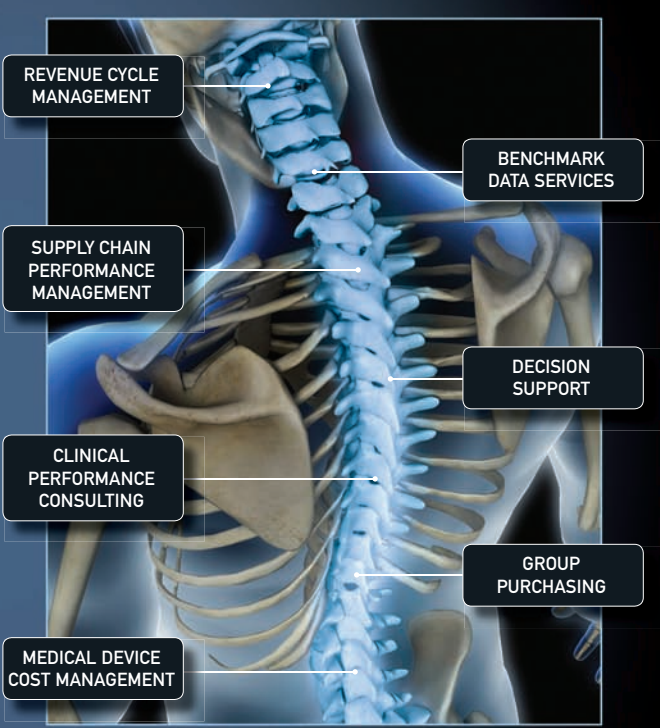
Carmody: Yes, we knew that going in. This goes back to an organization's culture and ability to execute outside of the normal way of doing business. What we have done with our supply chain is common place in other industries. That does not mean it is right for all hospitals. It requires senior leadership's commitment and support. Our senior leaders establish the vision for the organization. Transforming the medical center's supply chain

was a strategic business decision that made sense for The Nebraska Medical Center. The relationship we have with our logistics partner is highly collaborative and involves the senior leaders of both organizations.

What would you suggest other hospitals look at to determine if this type of arrangement is right for them?

Carmody: The senior leadership must champion the supply chain as part of the strategic business plan for their hospital. The business partner must truly be treated as a business partner, not a “vendor,” through a business model that is a win-win. This form of an arrangement is not appropriate for all hospitals. That's OK. But if an organization is going to enter into such an arrangement, it must be initiated and supported by the C-suite. 

Martin T. Carmody, FACHE, is the executive director at The Nebraska Medical Center, a not-for-profit, academic medical center in Omaha, Neb. (mcarmody@nebraskamed.com).



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Where Do Distributors Make a Profit?

Understanding how medical/surgical distributors do business—and make a profit—can help supply chain leaders better negotiate with these partners.

For example, the chart below shows that distributors primarily make their money from transactions involving specialty products—not on commodity goods.

Distributors carry commodity products because hospital customers need them. However, distributors really want to sell the more expensive specialty products because these transactions fund the companies' operations. Knowing this allows a materials manager to under-

Typically, distributors profit better with more expensive specialty products, which require less storage space and can generally cost less to ship and handle.

stand where—and where not—to look for cost savings opportunities. It may make sense to accept a slightly higher markup on commodity items if a slightly lower markup on more

expensive specialty products can be negotiated. 

John M. Julian, Jr. is executive director, materials management at MedAssets (jjulian@medassets.com).

Distributors Are Eager to Sell Specialty Products—for a Reason

Typically, distributors profit better with more expensive specialty products, which require less storage space and can generally cost less to ship and handle. In this example, the distributor ended up in the red on an underpad purchase. However, the distributor made a \$8.55 profit on a \$400 specialty product purchase. Additionally, the distributor can potentially earn additional revenue on that specialty product from backend fees, rebates, sales promotions, and tracing fees in transactions with the manufacturer.

Expense/Revenue for Distributor	Commodity Product: Underpads	Specialty Product: Sutures	
Price the distributor pays to the manufacturer	(\$14.00)	(\$400.00)	
Discount the distributor receives from manufacturer for paying for product within 10 days (2% discount for commodity item; 1.5 % discount for specialty product)	\$0.28	\$6.00	
GPO contract price the distributor receives after selling the product to a hospital	\$10.00	\$240.00	
Markup the distributor adds to the cost of the product (4% of GPO price)	\$0.40	\$9.60	
Distributor's operating expenses*	(\$0.90)	(\$12.48)	
Tax credit the distributor receives for inventory depreciation	\$0.19	\$5.43	
Pre-negotiated rebate the distributor receives from the manufacturer—equal to the difference between the original purchase price and the GPO contract price	\$4.00	\$160.00	
DISTRIBUTOR'S MARGIN	(\$0.03)	\$8.55	

* Using a leading distributor's standard calculations, based on overhead considerations that include a number of factors such as product storage and the actual cost of shipping
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Working with Nurses to Improve Clinical Inventory Management

In and out of operating rooms and catheterization laboratories all year long, Dee Donatelli, RN, BSN, MBA, CMRP, FAHRMM, vice president of supply chain services for VHA Inc., knows why supply cabinets overflow and carts sag under products that never will be used.

"All it takes is one time when you do not have the right size or the right exact product that a doctor needs or wants, and a nurse getting yelled at over the situation," she says. "You walk out of that room, and you vow that you will never, ever be without that product again."

That fear, she said, not only leads to overstuffed shelves—20 items in stock when two would be sufficient—but also to costly waste. How costly? One hospital department Donatelli toured recently carried \$1.2 million in inventory, of which

\$200,000 worth was outdated or set to expire in less than 30 days. Another \$550,000 worth of inventory had been sitting on the shelves for three to six months.

Here's some advice on working with nurses to improve clinical inventory.

Clean the Closet

Get rid of expired items and display inventory so that products do not fall "out of sight and out of mind." Shelves should be labeled to identify the product that belongs in each space, along with the number of items to be stocked and the person responsible for managing that inventory. Another organizing tip: Post wall signs that identify the "parking spot" for supply carts, making it easy to see inventory levels.


Turn Data into Useful Information

Use purchase history data to analyze what items are being used, how much of each item is being used and what variables affect usage patterns. "Sit down with the clinicians and ask, 'If we stock this amount, are you going to be comfortable that you're going to have enough of the right things?'" says Donatelli.

Set Up a System

Develop a process to document items currently in stock and ensure systematic replenishment to pre-set levels. Some hospitals may assign a person to check inventory levels daily and restock as needed, while others may restock weekly or invest in technology that automatically places refill orders. Regardless of the system, use it effectively to build confidence among physicians that the supplies they need are available. After things go along pretty smoothly for awhile, you can begin to reduce supply levels a little bit," she says.

Dee Donatelli, RN, BSN, MBA, MRP, FAHRMM, is vice president of supply chain services at VHA, Inc. (DDONATEL@vha.com).


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if they seem unlikely or impossible. For instance, what happens if you find a vendor has been overcharging year after year? Will your vendor pay interest to you? Also, thoroughly consider the use of words such as “list price” in the vendor’s proposal. What does that actually mean? A list price for what year and from what price book? Are there built-in price escalations? Are new technologies addressed? Is there a credit or exchange clause?

✓ **Get a Copy of the Vendor’s Contract**

Although your hospital may use its own standardized contracts, always ask the vendor representative for what he or she would provide. This way, you can see agreements that the vendor made in the past with your hospital and others. Undoubtedly, over many years, the vendor made alterations in the effort to minimize its own liabilities. Certain contract elements may stand out, and others may simply pique your interest or concern.

✓ **Request a Paragraph Review**

For more significant contracts, be sure to request a paragraph-by-paragraph review with the vendor. If done by conference call, a pair from materials management can attend, one focused on taking notes and the other on keeping the conversation fluid. Ask the vendor representatives to explain the underlying reason behind questionable clauses. Oftentimes, the representative can provide logic or examples that calm any doubts about the integrity of the vendor, the contract, and perhaps, the representative. You can glean so much more color about the vendor’s circumstances and approach from a live discussion. Is this really their “standard” contract, their best deal, their final offer?

✓ **Seek a Reasonable Contract Length**

Presumably, you chose a high-quality vendor, negotiated fair terms for the contract, and included an out clause (just in case). But be sure to make your effort count.

Depending on the product or service, seek a reasonable term for the duration of the agreement. For hospital products and distribution, three to five years makes sense. However, a special service contract may need only six months. That said, always ask the vendor to include a contract renewal clause that extends the length of the contract upon your request, but never automatically.

✓ **Reap Financial Rewards**

A centralized contract approval process and a checklist of contract items that address the hospital’s strategic direction can significantly improve a facility’s chances of developing the best possible contracts—while greatly impacting the organization’s bottom line. ☞

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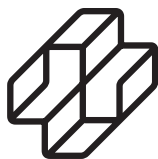
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