


HEALTHCARE PHARMACEUTICAL SOURCING



UNIVERSITY OF WISCONSIN, PLATTEVILLE

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HEALTHCARE PHARMACEUTICAL SOURCING

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MASTER OF SCIENCE IN INTEGRATED SUPPLY CHAIN MANAGEMENT

By

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Abstract

The purpose of this research paper is to take an in-depth look at the current practices of healthcare facilities, particularly in the field of oncology as it pertains to containing drug costs. The goal is to understand the reasoning behind the overwhelming choice healthcare systems make to consciously obtain their pharmaceutical supply from a single source distributor instead utilizing a multi-source approach. To evaluate the reasoning behind this process a literature review is utilized primarily focused on the cost implications of the decision to utilize a single major pharmaceutical distributor versus using a multi-source or direct to manufacturer approach. Various perspectives will be looked at to understand not only why a single source approach is used in most cases but also what would the healthcare facility need to in order make a change to a multi-sourced approach.

Keywords:

SINGLE SOURCE, DRUG COST, GROUP PURCHASING ORGANIZATION,
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Introduction

The cost of healthcare in the United States is rapidly heading towards a critical tipping point. One area in which cost has increased the most is that of oncology drugs. These drugs exponentially continue to rise in price. This is not only for the end consumer but also to the healthcare facility in which patients seek treatment. As the cost of these drugs increase, the oncology space within health facilities continues to see diminished returns on drug margin which are relied on to ensure financial stability.

This increase in cost however is only half of the problem healthcare facilities have in terms of cost implications. As the overall cost of healthcare rises the government and third-party payors have begun lowering reimbursement for services, including the prescribing of medications. This has become extremely problematic for oncology practices as prescribing necessary medications to treat cancer patients is not only the primary revenue source, but also includes some of the newest and most expensive drugs on the market today. Not only do they have to contend with an increase in spend but also with the downward pressure from payors on reimbursements for that spend, in some instances even creating a negative margin. This decrease in revenue puts many oncology treatment facilities in jeopardy of remaining operable.

Since healthcare facilities have little to no control over reimbursement levels from the government or insurance companies, the emphasis to contain cost and find a competitive advantage relies heavily on the cost to procure the drugs needed to treat patients. Many healthcare systems rely on obtaining oncology drugs from a sole pharmaceutical distributor, often becoming part of a Group Purchasing Organization (GPO) offered through the distributor. This approach locks healthcare practices in via contract for a given period with the distributor and promises cost savings through the GPO as the practice becomes part of a larger

conglomerate. The purpose of this paper is to understand why healthcare facilities choose a single source distributor.

This is an important process to understand as many other industries choose to utilize multiple sources to procure products to drive down cost of goods. It is assumed that by joining a GPO and signing a contractual obligation to a single distributor is the most financially beneficial approach given that it is common in practice today. Through a literature review it will be examined to ensure that this is truly the case and if not, what prevents healthcare from undergoing the changes necessary to function like other industries and obtain pharmaceuticals from multiple sources or by going directly to the manufacturer.

Literature Review

GPO Role in Healthcare Pharmaceutical Supply Chains

The use of Group Purchasing Organizations (GPO) is widespread through the United States in healthcare. This holds true not only in the pharmaceutical realm but also regarding healthcare medical supplies and devices. Hu and Schwarz focused on the use of GPOs gaining popularity because of two primary advantages. 1.) It provided healthcare facilities the opportunity to join a conglomerate of other facilities and leverage the economies of scale and drive the price of drugs down. 2) The use of a GPO allowed for companies the ease of using a sole source to procure the needed pharmaceuticals required, which allowed healthcare to decrease overhead costs by decreasing the human resources needed to manage the supply chain.

This scenario however underwent a massive shift to the pharmaceutical companies creating their own GPOs and distribution networks. This began to drastically decrease the

number of GPOs available to healthcare facilities. “A 2005 study conducted for the Health Industry Group Purchasing Association reported that 72-80% of every healthcare dollar is acquired through group purchasing. More recently, Burns and Lee (2008) reported that nearly 85% route 50% or more of their pharmaceutical spending through GPOs... What is more interesting is “the seven largest GPOs account for over 85% of hospital purchases made through GPO contracts, and the two largest GPOs account for approximately two-thirds of all GPO purchasing. (Hu & Schwarz, 2011).”

The decrease of options and emergence of pharmaceutical companies owning the GPOs caused for the discounted drug prices to slowly begin to rise and other associated fees to charged back to the healthcare facility for managing the GPO itself. “The most common, most significant and most controversial source of GPO is the contract administration fee which is normally set at 3% of an organizations total drug spend. (Hu & Schwarz, 2011)”. To put this in perspective the American Journal of Managed Care states “the average drug profit margin for pharmaceuticals in a hospital setting is 14.4% of total sales”. The 3% contract administration fee ultimately equates to 21% reduction in revenue for the facility administering the medication.

Agility of Healthcare Pharmaceutical Supply Chains

A major area of emphasis when looking at weighing the options of utilizing a sole source vs a multi-source approach for pharmaceutical supply chains within healthcare facilities is the ability to operate an agile supply chain. The ability for the supply chain of a healthcare facility to be agile is a vital component of being able to provide quality patient care. The facility will budget and forecast for the types of ailments that they treat on an annual basis, but they are not able to predict what patient ailments will need to be treated daily. With this, to maintain tight inventory management, the supply chain needs to be agile enough to replenish medications

quickly. According to Mehralian” One of the targets of supply chain is to assure a continuous flow of drugs to patients at optimal price with minimal delays, low shortages and little room for error. (Mehralian, 2015)”

Without the ability to be agile the healthcare facility loses the ability to treat patients appropriately and risks losing market share to competing hospitals in the given region. The components needed for an agile pharmaceutical supply chain according to Mehralian can be seen here below in Figure 1.

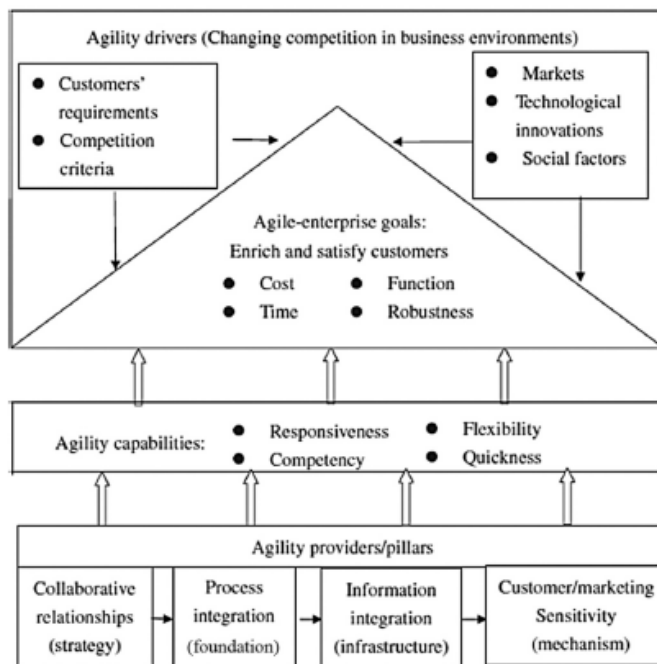


Figure 1

The area of opportunity for healthcare facilities to be increasingly agile is in the pillar of collaborative relationships. When facilities make the choice to use a sole source distributor through a GPO, they lose the ability to build additional relationships as GPO contracts typically require a 90% compliance rate for drug purchases. This disables the facilities ability to purchase a significant number of medications from another source in a time of need.

Custom Contracting

As the cost of pharmaceuticals rise within the GPOs most commonly used within healthcare in the United States today, healthcare facilities have begun to start looking at contracting directly to drug manufacturers as a cost reduction measure. According to Saha the cost of pharmaceuticals “on average is 20% of a hospital’s total expenses, only behind labor and supplies. (Saha, 2019). As many healthcare facilities have been part of a GPO for quite some time they have learned and understand the pricing and price increases that occur on a contractual basis. With the knowledge gained hospitals have” used the GPO price as a starting point and negotiated a lower price with the same vendor (the vendor selling through the GPO), making a direct contracting effort on their own.” (Saha). By overstepping the GPO some hospitals have been successful in lowering the cost of many medications by negotiating contracts directly with the drug manufacturer. “In examining 9 years’ worth of data, Litan et al. (2011) found that GPOs often failed to secure the best prices for their members and that hospitals were able to save, on average, 18%” (Saha,2019). This 18% saving on the total drug spend does not include the previously mentioned 3% CFA.

“Healthcare pharmaceutical spends have increase on average 4.6% per year from 2015-2019 pushing the average hospital pharmaceutical bill ever closer to 300 million dollars per year. (Saha,2019)” This increase is a large part of why hospitals have begun looking at purchasing strategies outside of a GPO. The estimated 18% reduction from directly contracting with the drug manufacturers to some facilities has been enough to justify expanding their supply chain departments from procurement, to purchasing, to logistics. The primary issue many hospitals have with making the change is they not only are locked into relatively long-term contracts, but they also need the specialized human resources to make the switch seamless. This is especially true in a field where each drug and supply are specifically tailored to each patient and scenario.

Healthcare Supply Chains

Increasing costs in healthcare particularly in drug spend has caused “healthcare executives are increasingly turning to the operations and SCM field to provide thought leadership and establish best practices around coordinating information, material, and financial flows in healthcare delivery” (Dobrzykowski, 2019). This shift in thought process from senior executives in healthcare is challenging not only because traditionally the supply chain departments in healthcare are primarily focused on the internal movement of medications and supplies but are further complicated by the regulatory requirements currently in place. This will cause the divergence to multi-sourcing to take exponentially longer as many healthcare facilities have not traditionally looked at staffing a supply chain department like other forms of industry.

In his paper Dobrzykowski, highlights the challenges faced by healthcare institutions to hire experienced supply chain personnel given the lack of a supply chain foundation and the onerous task of building departments, policies, SOPs and negotiating contracts from the ground up. This is a byproduct of years of relying on a single source most often a GPO. The primary focus of healthcare supply chains has been focused on the internal activities of supply chain including receiving items from the GPO and distributing them from central supply to the various hospital units. Very little emphasis has been placed on the external supply chain of healthcare pharma that would find opportunities in contracting, procurement, logistics and tighter inventory management controls.

Inefficiencies in Health Care Supply Chains

To begin to maximize the opportunity healthcare facilities may realize by moving away from the GPO based model for pharmaceuticals, the foundation of quality data and data analytics must first be looked at. The disparity between healthcare and many other industries begins with

the quality of data the facility has at its disposal. “Smith et al. (2012) found in their research that one of the major differences between the healthcare supply chain vs. other retail supply chains is also the lack of data standardization, in particular, the traceability and identification of products. (Chipponeri, 2014)” Much of this gap between healthcare and retail is caused by the lack of technology adoption and expenditure on processes that would allow for better data collection points. One example of this is the utilization of an IT system that can track and provide data feedback by utilizing a Universal Product Code “that is present in nearly all retail product lines has been in use for over 35 years in the retail that changed the way they conducted business by simplifying and improving inventory, rebate, and return processes (Smith et al. 2012). Unfortunately, the healthcare industry has yet to fully adopt and utilize the capabilities and benefits associated with barcode data standardization.(Chipponeri, 2014)”.

The increase in technology use and quality data would allow for healthcare facilities to make better decisions regarding the choice of single vs multi-sourcing their pharmaceuticals. This would provide them with the opportunity to analyze whether the use of a GPO would be sufficient or if effective cost cutting measures could be realized by moving away from that model. According to Chipponeri’ s “ research indicates that best practices in supply chain management align an organization's internal and external systems with those of its suppliers and customers to improve the flow of products, services, information and monies across the supply chain.” (Chipperoni. 2014). This use of data and technology not only helps to contain cost but also increase the potential for revenue generation directly from the pharmaceutical supply chain process.

Analysis

The literature reviewed in this paper displays that in terms of healthcare facilities deciding to continue utilizing a sole source method or moving towards a multi-source scenario is complex and has a variety of factors to contemplate. The use of a single source GPO in healthcare pharmaceuticals is prevalent still today because it provides these facilities with resources that many typically do not have at their disposal in terms of supply chain resources. With the GPO providing these resources the healthcare facility is bound to the cost and capped profit margin that is provided by the GPO/distributor. As GPOs and pharmaceutical companies become increasingly aligned the margin healthcare facilities see will continue to diminish as the cost of the medications they use continues to rise.

The literature does show that for healthcare facilities to make the change towards a multi-sourced approach they need to work towards developing many aspects of their supply chain. This comes in the forms of IT investment, data analytics and appropriately staffing these functions within their given facilities. These changes, however, will need some logistical planning of their own to ensure that the facility is ready to make the change in concordance with their existing GPO contract expiring to ensure there is no breach of their current contract. For many facilities this appears to be a large undertaking and may be viewed by as many as a large risk. However, as costs continue to rise along with increased pressure from third party payors to reimburse less, the risk may at some point be the only viable option these facilities have to remain fiscally responsible.

Methodology

The premise of the research within this paper is to understand why healthcare facilities choose to use a single source distributor for their pharmaceutical needs instead of using a

multisource approach to one of their largest annual expenditures. The methodology chosen to understand this pattern was a literature review of previously written research from a variety of reputable peer reviewed sources. The literature chosen was deliberately selected to ensure that perspectives were evaluated from multiple different origins including, supply chain, operations, and financial perspectives. The literature chosen from different vantage points allows for a holistic approach to the review of single source use vs multisource use as pharmaceuticals in a healthcare setting have a multitude of implications on each of the perspectives evaluated.

With the original premise of the research being that most healthcare facilities utilize a single source distributor and/or a GPO to obtain pharmaceuticals. Literature was reviewed to understand the benefits and drawbacks that healthcare facilities would face if they chose to make a change to multisource these products. With this information one can then compare the pros and cons of single source against that of a multisource system so that an analysis can be done to weigh the options that healthcare facilities are faced today when deciding which route is best for the supply chain, operational and financial functions within each organization.

With the methodology chosen for researching this topic a qualitative analysis can be done to evaluate which method may be the most beneficial for a healthcare facility. The methodology highlights why single source is the most prevalent practice today in healthcare primarily due to the ease of joining a GPO and being part of a larger group and the decrease of human resources needed to manage the pharmaceutical supply chains on the end of the healthcare facility. Using this same methodology, the literature also highlights what benefits a healthcare facility stands to gain if they made a switch to a multisource system. The primary advantage here is that of the potential for decreased purchase price but would add in the additional overhead of increased staffing.

The literature review methodology within this paper looks at the high-level decisions made by healthcare facilities and why they make them. While the literature review is helpful a quotative study into a specific facility would further strengthen the argument for or against the use of single source distributors. This would take the information derived from this research a step further to better understand the financial and operational impacts a specific facility would face prior to deciding as location of the facility, size, and utilization would be vital to understand before deciding.

Conclusion

The review of the literature highlights many key points of why many healthcare facilities choose to utilize a single source distributor in lieu of multisourcing these products out to various manufacturers. The literature shows that the leverage gained by individual healthcare systems by joining a single distributor and their respective GPO is deemed too important to risk moving away from. This is especially true given that the reviewed literature shows many healthcare facilities do not have the bandwidth nor have the capability to create the bandwidth to effectively manage the supply chain and logistics of multisourcing these pharmaceuticals. This in turn increases the associated risk of moving away from the single source distributor.

What could not confidently be found in any of the reviewed literature is the amount of additional overhead that would be created by a healthcare facility to increase staffing and storage locations by moving to a multisource strategy. This aspect is key to understanding how much potential cost savings on pharmaceuticals would be needed to support additional allocation of funds and develop a cost to savings ratio. Each facility would have specific nuances given the size and location of the facility but a general understanding of this could not be obtained. Additionally, what could not be discovered in the literature is what or if associated fees or are

collected by the GPO from the healthcare facilities or the distributors that partake in the GPO. These just may not be added to drug cost that is grouped with the cost of each drug.

What would be beneficial to enhance the research on this topic is a deeper dive into the financials of multiple facilities as it relates to the cost of drugs, utilization GPO membership to obtain a baseline of what an actual baseline is for facilities in terms of margin, expenses and cash flow. This baseline would help to better understand the current state and allow for sensitivities to be developed to assume changes in the market, utilization of drugs and government healthcare policies. With this information healthcare facilities could increasingly accurate assessments of whether to stay with a single source or look to multisource these products.

Recommendations and Implications

This topic of how healthcare facilities obtain their pharmaceuticals will continue to be one that is repeatedly evaluated as the healthcare economy continues to change. As the cost of expenses rises year over year and the amount of reimbursement diminishes healthcare facilities will have to reevaluate their supply chains in order to remain fiscally viable. The above research implies that in today's current environment many healthcare facilities will remain with a single source distributor. However, there is believed to be some opportunity that many facilities do not explore or there is currently no research on. This opportunity lies with the negotiations of contracting with the single source distributor. The healthcare facility can look to lessen the percentage threshold required by the distributor and begin to look at obtaining certain pharmaceuticals elsewhere. This may open the door for the trend to shift towards utilizing multiple sources within many facilities.

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