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Client Alert

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Lessons to be Learned from Amazon's Step Back from Entry into the Hospital Supply Chain

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Until recently, Amazon was making a series of moves to expand its current business of supplying health care commodities to small clinics and ambulatory surgical centers by getting into the drug and advanced medical device supply chain and expanding its clientele to include larger hospitals and health systems.[1] Amazon promised to be "something new"[2] for hospital and outpatient clinic purchasing departments. This led to much speculation over whether Amazon would be successful in breaking into the complex market of supplying products to hospitals. Ultimately, it appears that Amazon has determined that the hurdles to becoming a major hospital distributor are too high.[3] Amazon's abandonment provides another reminder of the unique challenges associated with becoming a hospital distributor—where market power depends on much more than price slashing. Amazon's entry into the health care supply chain for hospitals would have been an interesting test case in evaluating whether a marketplace approach, or any new approach, could ever effectively undercut the significant costs associated with some of today's health care middlemen, while at the same time addressing the unique challenges of distribution in the health care industry. Here, we evaluate some of the complexities of this market that likely caused Amazon to fold its plans, and which present either a challenge or an opportunity for any others trying to change the status quo.

1. The health care industry is highly regulated.

Any single patient encounter can involve the oversight of half a dozen or more federal and state agencies regulating every aspect of a drug or device's life cycle, including its manufacture, storage, distribution and dispensing. For example, with respect to products with limited shelf life that must be stored at certain temperatures, or products that contain radioactive or other similar material (like contrast media), compliance with regulations and the legal requirements to sell, store and transport are significant, difficult to comply with, and expensive. Harm to patients caused by defective drugs or medical products can cause injured patients to sue and providers to lose reimbursement and/or have their licensure or accreditation revoked. Generally, there is a significant amount of scrutiny from regulators and the public at large. Accordingly, there is no margin for error for vendors supporting hospitals, and a significant amount of financial and reputational risk.

2. Health care purchasing decisions are driven by a need for reliability, consistency and quality.

Timeliness of delivery and an adequate supply delivered in real time are necessary in order for a provider to maintain patient satisfaction and operational efficiency. If the pacemaker for Thursday's procedure is out of stock or a day late, then a patient is inconvenienced because of the resulting delay and the hospital has wasted the valuable time of its clinical staff. At 2–4 percent margins, hospitals generally do not have the cash flow to maintain large inventories of the specific products and materials that meet the hospital's quality and clinical standards and that staff and physicians are trained to use. For this reason, access to the precise product model, size and unit of measure through the hospital's supply chain partners is necessary. Quality assurance processes are necessary to ensure that each step of the supply chain remains responsible for validating and maintaining the state of a medical product, from manufacturing to ultimate delivery. Though cost savings are important to hospitals that are feeling a constant squeeze on revenue, the savings will be quickly lost if they come at the expense of reliability, consistency and quality. Today, hospitals balance these concerns by purchasing through organized arrangements with product manufacturers (directly or through their group purchasing organization or "GPO"), where there is a contract that sets the responsibilities of the parties clearly and allocates the risk. Through a standing contractual arrangement, as opposed to a one-off marketplace purchase as may have been proposed by Amazon, a health care provider and the product supplier can negotiate delivery expectations and guarantees, agree on product quality standards and associated risk allocations (e.g., returns, risk of loss on delivery, warranties and indemnification), and even set purchasing commitments that give the supplier adequate assurances to justify a discount.

1 This is in addition to news about Amazon moving into the direct-to-consumer health care business through its recent acquisition of the online pharmacy PillPack. Amazon's movement into the online pharmacy space via PillPack is in keeping with its existing strength as a direct-to-consumer supplier of commodities. Efforts to move into the business-to-business health care supply chain, however, present new and unique challenges, as we describe here.

2 Quote from Chris Holt, leader of global health care at Amazon Business. Source: The Wall Street Journal, "Amazon's Latest Ambition: To Be a Major Hospital Supplier," February 13, 2018.

3 CNBC, "Amazon has shelved a plan to sell drugs to hospitals, and insiders say there are two reasons why," April 16, 2018, *available at* https://www.cnbc.com/2018/04/16/amazon-business-not-selling-drugs-but-other-amazon-groups-might.html.

3. Health care providers and their suppliers have already developed a complex purchasing framework.

The health care supply chain has adapted to the realities of intense regulatory scrutiny through the creation of a network of buyers, sellers and middlemen under purchasing arrangements that set risk/reward trade-offs and balance the need for quality, timeliness and cost-efficiency. There has been much speculation over the years as to whether the current hospital purchasing framework saves the health care system money, or is actually increasing overall costs by creating mini health care monopsonies[4] that allow middlemen to reap profits by trapping market share from the highest bidding product vendors.[5] While the middlemen that created this framework have provided value to health care providers by allowing them to outsource price shopping, purchasing coordination, contracting and other services, the net result, fundamentally, is added cost to the overall health care system. However, in health care, the added value of these middlemen should be focused on the total cost of ownership, not simply the ultimate cost of products and supplies. In today's market, GPOs and others create value by providing technology, analytics, subject matter expertise and other resources to evaluate products and negotiate pricing and other deal terms that are valuable to most buyers in the health care market. These benefits are something that major health care purchasers have come to rely on in operating their businesses and cannot be easily replicated at a reasonable cost. As such, any new offering will need to supplant the value garnered through the technology and resources offered today by GPOs and others. In addition, in many cases hospitals are using supply chain technology and ordering systems that can tick-and-tie a hospital's purchases to a hospital's internal inventory systems. Any new offering likely will have to replicate this capability in order to be successful because most providers need to clearly and automatically track purchasing.

4. Purchasing networks bring other intangible affiliation benefits.

Through the existing purchasing ecosystem, hospitals have established longstanding relationships with their distributors and GPOs, any of which may be run by or relationally integrated with health systems and provider networks, which are important partners of a hospital. Any such organized purchasing arrangement may contain innumerable intangible relational benefits that are key to surviving and competing in the local business environment. Particularly with respect to GPOs, these arrangements offer the opportunity to share and gain key industry intelligence. For a hospital or health system to step away from purchasing through and with other industry-entrenched and potentially collaborative business partners, the replacement product source will need to be able to compete with these soft affiliation benefits and the opportunity for essential industry collaboration.

Ultimately, in order to see change in the health care supply chain and entice hospitals away from their existing purchasing frameworks, any disrupter will need to present opportunities for health care providers to gain market edge that are compelling in spite of the potential loss of their current tangible and intangible benefits. Any new entrant will not be able to rely solely on cost savings, as Amazon seemed to expect to accomplish by promising lower costs through real-time price comparisons in its standard marketplace approach. New entrants will need to provide no less in terms of reliability, consistency and quality, and must be able to offer additional opportunities for health care providers to compress costs and gain value from their purchasing data.

Opportunities include advanced technology to support hospital purchasing departments, such as the inventory tracking mentioned above, or the development of more advanced analytics on overall health care costs and care efficacy. Indeed, it appears that Amazon at one point was anticipating this need for analytics to complement its marketplace offering, as it had been involved in discussions to acquire Cerner's existing population health product, HealtheIntent.[6] Currently, health care systems are limited in their capacity to identify the overall cost of any one patient encounter or treatment plan. The ability to identify, segregate and connect costs would offer transparency to health care purchasing departments that could guide decision-making going forward and provide an opportunity to increase efficiencies, reduce the overall costs of a procedure, set competitive prices for patient care, and offer much-talked-about price transparency to consumers. However, in light of the heavy lift and costs associated with providing sophisticated technology, we face the question as to whether it is possible to actually change the system and cut costs overall, or if we will only ever replace today's middleman with a new one.

4 Meaning, a buyer's monopoly.

5 U.S. Government Accounting Office, Testimony before the Subcommittee on Antitrust, Competition, and Business and Consumer Rights, Committee on the Judiciary, U.S. Senate, "Group Purchasing Organizations: Pilot Study Suggests Large Buying Groups Do Not Always Offer Hospitals Lower Prices," April 30, 2002 (discussing the GAO's finding that a hospital's use of a GPO contract did not guarantee that the hospital saved money compared with direct contracting with the manufacturer); "Where Does the Law Against Kickbacks Not Apply? Your Hospital," *The Wall Street Journal*, May 7, 2018 (arguing that major GPOs act effectively as hospital purchasing monopolies by selling market share and barricading against competition).

6 CNBC, "Amazon's cloud is about to announce a huge health-care deal with Cerner, sources say," November 22, 2017, available at https://www.cnbc.com/2017/11/22/aws-is-partnering-with-cerner-on-cloud-deal-for-healtheintent.html.

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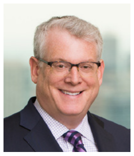

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