

Healthcare Cost Containment



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Do You Know Your Supply Chain Cost Drivers?

By Vicki L. Smith-Daniels

Is your hospital prepared for escalating supply chain costs? Have you adjusted your supply budgets to reflect the impact of today's economic conditions? There is no better time than now to investigate the real cost drivers of your supply chain.

Across the globe, executives are pondering the impact of today's economic conditions on their future business performance. Besides the obvious challenges of a sluggish economy, today's media continue to report long-term concerns about the impact of rising oil prices, the weak dollar, and limited cash availability. These economic factors have a direct impact on sourcing and distribution functions. For hospitals, the potential impact of these escalating costs could be significant, potentially raising supply expenses to approach labor costs in a very short period of time. One has only to look to at the airline industry and Southwest Airlines' strategic decision to hedge oil contracts to realize that companies that think differently about their supply cost drivers can confront today's challenges in a more proactive and financially viable way.

Serious Problems on the Horizon

Hospitals and their trading partners will soon be forced to find innovative ways to control rising costs in the supply chain. By revealing the cost drivers and trade-offs among trading partners in the supply chain, hospitals are more likely to find proactive solutions to deal with these tough challenges:

- > Increased costs for freight and distribution
- > Increased prices for supplies based on petroleum products, products and services that are manufactured outside the United States, and purchased services that consume significant energy and chemical resources
- > Lower inventories in the distribution channel and fewer on-time deliveries

The Perfect Storm

With the changes confronting hospitals around pay-for-performance, quality indicators, and price transparency, should the supply chain receive more attention? How significant a problem are these economic trends, and will they really impact the bottom line? Here are some things to consider.

Focus on total cost, not price. To counter-balance price increases, hospitals need to shift from a price acquisition mindset to an integrated supply chain perspective. As a starting point, hospitals should track total delivered supply expense by departments and service lines using the Association for Healthcare Resource & Materials Management-HFMA supply expense definition (see the full definition under "Web Exclusives" at www.hfma.org/hcc). This industry standard measures supply expense as the sum of acquisition price, freight, standard distribution fees, sale tax, minus rebates. By using a standard definition and tracking total delivered costs at the department/service line level, hospitals can more clearly identify cost reduction opportunities associated with a specific activity. Several high-impact questions could be analyzed with these activity-based cost data, such as:

- > Which freight, distribution, and inventory models are most cost-effective in the operating room?
- > What is the bottom-line financial impact of consignment inventory in the OR?

> How will improved contract compliance increase rebates and lower total delivered cost for materials and supplies in the OR?

Without a financial system that can report total delivered cost in the high-supply intensity departments and service lines, identifying the potential impact of a new business model cannot be evaluated before making a significant investment in a new process. Hospitals can also find value in measuring purchased services and supply chain FTEs.

Reveal hidden drivers. Few healthcare and supply chain executives would disagree that there are significant non-value-added transactions in the healthcare supply chain. To reduce supply chain waste, trading partners must be willing to reveal their cost drivers and negotiate a solution that results in mutual profitability. This broader perspective of cost drivers recognizes that the prices paid by hospitals are based on a significant amount of overhead to support inter-organizational transactions such as order fulfillment, contract compliance, distribution, and inventory management. To achieve cost reductions, hospitals need to urge their suppliers to share data about their direct and indirect cost drivers and the impact of those cost drivers on overhead, assets, and productivity.

Evaluate total cost of ownership. Rather than continue with a “zero-sum game” of passing along inefficiencies to other partners in the supply chain, hospitals need to step up and put on the table a “value-based, data-driven” approach to negotiating lower prices and new ways of getting things done. To accomplish this, hospitals need to evaluate the costs and revenues gained from having the right products in the right place and at the right time and the right price. Total cost

Identifying the Total Cost of Ownership

	Hospital	
	A	B
Current Situation		
Supplies as a Percent of Operating Budget	15.0%	19.0%
Freight/Distribution as a Percent of Supply Costs	4.0%	6.0%
Acquisition Price as a Percent of Supply Costs	78.0%	83.0%
Potential Impact		
<i>Freight/Distribution Increase 50%</i>		
Supplies as a Percent of Operating Budget	15.2%	19.5%
Operating Expense Percent Increase	0.3%	0.6%
<i>Manufacturer Materials Cost Increase of 15%</i>		
Supplies as a Percent of Operating Budget	16.5%	20.9%
Operating Expense Percent Increase	1.8%	2.4%
Combined Impact - Percent Increase		
Supplies as a Percent of Operating Budget	2.3%	2.3%
Operating Expenses	2.1%	3.0%

of ownership (TCO) is a supply management philosophy for really understanding the supply-chain costs associated with doing business with a particular supplier. The TCO philosophy attempts to quantify acquisition, ownership, and post-ownership costs. For hospitals, a TCO analysis for a key supplier and/or key material should include:

- > Value analysis
- > Freight and distribution costs
- > Timeliness of delivery
- > Inventory carrying costs
- > Inventory risks
- > Technology cycles
- > Order fulfillment costs
- > Quality and defect rates
- > Customer service
- > Volatility of end-user demand
- > Cash flow
- > Warranty costs
- > Environmental costs

Engage trading partners. At the end of the day, supply chain success cannot be achieved by data and analysis alone. The intent of TCO is to improve mutual profitability for both suppliers and customers. The best, and perhaps only, way to address TCO in the healthcare supply

chain is to employ a cross-functional team representing the key stakeholders from both the buyer and supplier organizations including finance, operations, information systems, procurement, logistics, and clinicians.

Are You Ready?

To avoid escalating supply chain costs, hospitals need to embrace a new perspective on where to gain the most leverage in reducing costs in their supply chain. In the short term, hospitals should carefully measure and manage their total delivered supply costs by department and service line. In the long term, hospital executives should build the capabilities to take charge of supply cost reduction through data-driven, value-added collaborative decision-making. By shifting from focusing on acquisition price to focusing on an integrated supply chain, hospitals are more likely to make the waste in their supply chain visible and devote critical resources to improving patient care. ☞

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