Hospitals purchase enormous amounts of services from outside organizations. Each of these services represents an opportunity for strategic cost reduction. In some instances, there are opportunities to reduce costs by more prudent purchasing practices and more effective negotiation strategies. In other instances, service costs can be reduced by acquiring technology to reduce dependence on purchased services. In still other instances, service costs can be reduced by outsourcing or insourcing practices. Effective management of purchased services and periodic review of alternatives can identify excellent opportunities to achieve strategic cost reduction success.

What services do hospitals purchase? They purchase maintenance contracts for high-tech imaging equipment and low-tech elevators. They purchase laundry services from across town and medical transcription services from India. They purchase legal services and financial audit services. They contract for emergency physician coverage and pathology services. In essence, hospitals purchase thousands of services that they cannot provide themselves because of capital, economic, technological, or facility constraints. Strategic cost reduction success requires that services are purchased at the lowest green-dollar cost and the highest quality appropriate to perform the hospital function.
SERVICE OPTION CHALLENGES

Hospitals use purchased services to achieve certain operational or clinical outcomes. Purchasing the right services, in the right quantity and at the right time, is key to ensuring that the costs for purchased services are as low as possible. It is vital for hospitals to periodically consider options for all purchased services. For example, when purchasing accounting and legal services, hospitals may fall prey to past-practice inertia and rarely, if ever, consider options. Sometimes options are not considered because of conflicts of interest or sacred cow situations with physicians or even hospital board members. In other instances, hospitals may be lulled into a false sense of security with group purchasing arrangements, assuming incorrectly that the lowest possible service costs are always being delivered. All hospitals should rigorously consider options when purchasing services of any kind.

Sacred decorator

While a large community hospital was engaged in strategic cost reduction, department directors staged a mini-revolt. The CEO made it clear that strategic cost reduction initiatives would not be thwarted by sacred cows. Department directors took his words to heart, and years of frustration with the hospital’s contracted interior decorator boiled to the surface. Department directors carefully made a list of examples of “decorator excess” and presented it to the CEO.

The list was highly embarrassing. The interior decorator, over the rigorous objections of the director of housekeeping services, had insisted on purchasing a set of $800 trash cans for the hospital lobby. Over the objections of the nursing director, 20 new chairs had been selected for the intensive care unit (ICU) waiting room that were completely unsuitable for elderly visitors. A floor-covering material was chosen for the rehabilitation department that proved to be dangerously slippery for disabled patients, although beautiful in appearance.
The interior decorator had been retained for a decade at the recommendation of the chair of the hospital board of directors. For ten years she had exercised dictatorial power in selecting furniture, color schemes, and even trash cans. Until the strategic cost reduction initiative emboldened directors, no one felt empowered to challenge her authority. Subsequently, a different interior design firm, with more experience in the healthcare field, was selected to replace the “sacred decorator.” The green-dollar cost for the new contract service was much lower, and $800 trash cans were never purchased again.

COLLABORATION WITH PHYSICIANS

Physicians have a vital interest in purchasing the services directly related to clinical practices. For example, they may prefer certain reference labs for outside clinical testing. In other instances, physicians may prefer an outsourced emergency medicine service because of years of positive experiences. Overcoming inertia, momentum, and adherence to past practices is a purchasing services challenge related to the medical staff. In addition to inertia, sacred-cow issues with certain purchased services may preclude management from truly considering alternatives. However challenging, it is critical that physicians are meaningfully involved in evaluating alternatives for any purchased service with clinical implications.

CAPITAL INVESTMENT OPPORTUNITIES

In some cases, hospitals will incur excessive purchased service costs because of their inability to make capital investments. For example, acquiring a specialized piece of laboratory testing equipment may be costly initially, but eliminating a long-standing reference laboratory service is likely to more than offset the equipment’s initial
capital costs. Hospitals should be constantly evaluating opportunities to substitute capital investments for outsourced purchased services. It is the responsibility of senior management and middle management to be consistently vigilant for these opportunities and to rigorously pursue these alternatives.

**Rent versus buy**

A large community hospital involved in evaluating purchased service costs carefully compared the rental costs of specific clinical equipment, such as pumps and special trauma patient beds, with the capital investment costs of purchasing those pumps and beds. After analyzing rental costs for the previous three years, the hospital determined that it should invest $500,000 to purchase enough pumps and special purpose beds to avoid the necessity of renting them 90 percent of the time. The hospital was able to reduce rental fees by $350,000 per year by paying for the new pumps and beds in 17 months and saving $29,000 per month in green-dollar service costs thereafter.

**OUTSOURCING**

In some instances, outsourcing may present opportunities to strategically lower service costs. For example, if an outsourcing vendor can provide a service for a lower cost because of efficiencies of scale and consolidation of technology, using an outsourcing approach may strategically lower costs. In other instances, it may be possible to outsource services to improve quality while keeping costs at the same level or lowering them. In yet another situation, outsourcing can provide access to consolidated labor pools less expensively than a hospital can acquire them independently. Outsourcing opportunities exist for virtually every service that a hospital purchases. It is up to senior and middle management to constantly
evaluate opportunities and determine which opportunities can strategically lower service costs while maintaining or improving clinical quality and customer service.

**INSOURCING**

As the opposite of outsourcing, insourcing may also present opportunities to strategically lower service costs. Sometimes services are outsourced because of the hospital’s inability to manage a particular challenge. For example, housekeeping services are outsourced because of the hospital’s inability to retain a good executive housekeeper or a stable workforce of housekeepers. Over time, situations change. Perhaps the initial reason the hospital was unable to retain a good executive housekeeper or stable workforce has changed. In that circumstance, it may be possible for the hospital to bring the housekeeping services back in house and lower service costs at the same time. In this sense, the hospital is able to lower service costs by practicing an insourcing strategy.

**NEGOTIATING OPPORTUNITIES**

When a hospital purchases services, there are almost always opportunities to negotiate better prices with the service vendor. This is especially true in instances where effective negotiation was not historically present between the hospital and the service vendor. The first step in negotiating lower costs is to identify and evaluate realistic service-delivery alternatives. It is difficult to negotiate a better price if a vendor believes the hospital will never change the service being provided. On the other hand, if the vendor is constantly and constructively reminded that the hospital is considering other service choices, the vendor is more likely to offer the best possible price.

In addition to evaluating service alternatives, using the “position power” of senior executives is another consideration in obtaining the
lowest possible purchased service cost. It is not uncommon for hospitals to use middle managers for negotiating even large purchased-service contracts. If service vendors know they are dealing exclusively with middle management, it is unlikely they will deliver the best possible deal. On the other hand, if senior management executives, those at the vice president level for instance, are involved in the negotiating process, the hospital has a much better probability of obtaining the best possible deal.

**COO success**

A regional tertiary hospital was involved in a comprehensive review of all service purchases. One of its largest-dollar service contracts under review was in information systems maintenance. During a strategic cost reduction initiative, the COO became personally involved in the contract negotiation process for all service contracts in excess of $100,000. He demanded personal negotiations for the new contract with the service company’s CEO. After initially refusing to negotiate, the service company agreed to a 10 percent reduction in the new contract, saving $200,000 per year in green dollars over the previous contract. Before the COO’s interjections, no one above the department director level was ever involved in negotiating this $2 million per year service contract.

**COMMON-SENSE OPPORTUNITIES**

As with lowering supply costs, lowering service costs can be achieved through common sense. The person closest to the service purchase decision is the best person to apply this common sense. Consider the example of a hospital facilities manager who evaluated service contract costs for the hospital’s elevators. He determined that he did not need a 24-hour maintenance contract
because the service vendor was located only minutes away and was always available on call. By switching to an on-demand service arrangement, the cost of elevator maintenance was reduced by 75 percent with no reduction in quality. In many ways, opportunities abound for common-sense applications in the purchasing of services in a hospital setting.

**Courier abuse**

An urban community hospital evaluated many opportunities to make common-sense reductions in service costs. One of the best ideas came from an employee in the mailroom. She encouraged a comprehensive evaluation of the use of courier services. When the service was introduced a decade earlier, it was used only for urgent needs, such as delivering blood samples for a critically ill patient to a regional referral laboratory or picking up a highly specialized medical device for an emergency operation.

What transpired over the years, however, was that the courier service came to be used more and more for nonurgent pickups and deliveries. At the time the service was reevaluated, it was determined that 90 percent of courier use was for nonurgent items, like delivering hospital mail and memos to physician offices. As a result of the reevaluation, strict controls were put on the use of the courier service, which reduced green-dollar costs by 90 percent.

**MANAGING PURCHASED SERVICES**

A most important consideration in actively managing purchased services is the dedicated, periodic consideration of alternatives for each and every service purchased by the hospital. Past-practice momentum is the enemy of strategic cost reduction in service
purchases. When options are actively considered and evaluated, it is much more likely that green-dollar costs will achieve their lowest possible level and be sustained there. A middle manager should be accountable for evaluating every purchased service and considering alternatives on at least an annual basis. In addition, senior management executives should be accountable for actively evaluating the service purchases they directly control to ensure that the lowest-cost options are in place.

**Audit inertia**

A major tertiary hospital had used the same “big three” audit firm since the firm had been one of the “big six,” two decades previously. Many hospital board members had professional ties to this favored audit firm; the hospital’s CFO was actually a former partner. As part of the strategic review of all service contracts, the hospital’s financial audit was put for competitive bid using a formal request-for-proposal process. At the end of the process, the hospital selected a new audit firm, a regional firm instead of one of the national big three firms. Savings in green dollars exceeded $50,000 per year.

During the first year with the new audit firm, it became clear to both the board and senior management that the regional firm did a much more thorough job on the audit for a much lower price than the big three audit firm had done. One of the noticeable differences was in the management letter’s detailed questions that were presented to management at the conclusion of the audit. No one could escape the realization that the highly comfortable relationship with the previous audit firm resulted in less aggressive questioning of management. In this case, the hospital won on all counts. It achieved lower service costs and better service quality, and it eliminated a conflict-of-interest problem with the CFO and several board members.
ACTION PLAN CHECKLIST FOR REDUCING PURCHASED-SERVICE COSTS

Reducing purchased-service costs is a monumental commitment that requires constant vigilance and a multistep process to implement effectively. The following steps are essential:

• **Step 1: Develop a comprehensive master service list.** The type, quantity, and annual costs of each purchased service should be delineated and constantly updated. A responsible manager should be assigned to monitor and oversee each purchased service.

• **Step 2: Consider alternatives for evaluation.** For each purchased service, there should be a continuously updated list of alternatives for the service. The person responsible for monitoring the purchased services should periodically evaluate each alternative and determine if changing service vendors or approaches will lower costs and/or improve quality. In addition to evaluating service vendor options, consideration should be given to evaluating capital investment or technology substitutions to determine if the service purchased could be eliminated, either partially or completely.

• **Step 3: Evaluate effect on end users.** When considering alternatives, the hospital should constantly evaluate the effect on the actual end users of a purchased service. The overall goal should be to strategically lower service costs as much as possible while simultaneously improving clinical quality.

• **Step 4: Ensure effective purchasing.** Senior and middle management are responsible for evaluating service alternatives, obtaining competitive bids, and negotiating the lowest green-dollar service costs, on at least an annual basis, for each service purchased by the hospital.

• **Step 5: Select the lowest cost/and highest value.** It is the responsibility of senior management to ensure that all purchased services represent the lowest green-dollar cost and highest value to the ultimate end user.
When management, labor, supply, and service green-dollar costs are as low as possible, hospitals can find further strategic cost reduction opportunities in the area of clinical utilization, which is the subject of Chapter 9.