Testimony
United States Senate Committee on the Judiciary
Hospital Group Purchasing: Has the Market Become More Open to Competition?
July 16, 2003

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Before the Subcommittee on Antitrust
of the Judiciary Committee of the United States Senate

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I. INTRODUCTION

I am Said Hilal, and I offer this statement on behalf of Applied Medical Resources Corporation, a medical device company that has been committed to a motto of "Better Medicine, Better Value" from its founding in 1987. We have achieved that combination through innovations in technologies and practices. Based on an independent national study, in 2002, Inc. Magazine identified Applied as one of the top 50 most innovative companies in the United States with revenues less than $100 million.

Applied invests heavily in entirely new technologies as well as more efficient and less expensive ways to implement established technologies. True to the "Better Medicine, Better Value" motto, both forms of innovation improve the quality and affordability of health care. We are absolutely committed to having Applied's products incorporate advanced and unique technologies and, at the same time, considerable savings over competitors' products – in many cases we offer as much as 40 percent to 60 percent savings.

Our company offers fourteen different lines of innovative products used primarily by surgeons. One of our product lines is "trocars." Trocars are tubes with openings covered by advanced seals through which a surgeon inserts surgical instruments while maintaining pressure within the body cavity of a patient undergoing "minimally invasive" surgery. This type of surgery, using trocars, also is referred to as "keyhole" surgery, because the hole made by the trocar is about the size of an old-fashioned keyhole. Typically, the trocar provides a half-inch or smaller aperture for surgical instruments and a television camera to negate the need for large, open incisions and the lengthier recovery time typically associated with large, open incisions.

Because surgeons use our products, our products are sold to hospitals. We therefore are very much affected by and interested in the practices and policies of hospital Group Purchasing Organizations ("GPOs"), especially Premier and Novation. If GPOs were fulfilling their original purpose – enabling hospitals to acquire the best products at the lowest cost – there would be no need for these hearings. Unfortunately, GPOs have mutated from their intended role as collective bargaining purchasing agents, acting on behalf of member hospitals, into sales agents protecting the interest of a select group of large and dominant multi-product suppliers of medical devices. This mutation is the product of

incentives built into the current business relationships between GPOs and those dominant suppliers. By becoming economically dependent on payments from a few dominant sellers, the GPOs essentially have become commissioned sales representatives for these dominant suppliers, boasting their ability to "move market share." The GPOs inevitably allow, adopt and endorse the suppliers' use of bundling and related practices to freeze out innovation and cost savings of specialized suppliers like Applied, and thus negatively impact the quality and cost of health care for all Americans.

Applied repeatedly has been advised by hospitals that, even though they believe that Applied's products are superior to those of dominant suppliers such as Johnson & Johnson, they are compelled to purchase inferior and more costly products from the dominant supplier who could inflict serious economic penalties on the hospitals through a combination of GPO connections and bundling practices. In other cases, hospitals have been prevented by a GPO's threats of economic sanctions from even trying Applied's products. Some of these instances are described below.

Applied enthusiastically supports the efforts of this subcommittee to address these problems and to encourage others in the federal government – particularly the antitrust enforcement officials at the Federal Trade Commission and the Department of Justice – to pay attention to them as well. We also appreciate the efforts of members of this subcommittee to bring these issues to the attention of the Secretary of Defense.

In recent months, perhaps in anticipation of this hearing, some GPOs have shown improved willingness to purchase products based on their merits and their value. This, however, may be temporary. Congress needs to change the rules governing GPO and dominant supplier relationships to ensure that GPOs are able and willing to purchase the best products and value from vendors, large and small, without fearing the continuing ability of dominant suppliers to inflict economic penalties on them and their hospitals. To effect meaningful changes, enforcement and additional legislation will be required, to eliminate sole-source, bundling and minimum purchase requirements that currently handicap and blind collective purchasing.

In the following pages, we will describe our company, its experiences, and why we have come to these conclusions.

II. APPLIED IS AN INNOVATOR IN SEVERAL SURGICAL FIELDS

Founded in 1987 and headquartered in Orange County, California, Applied designs, develops, manufactures, licenses, markets, and sells fourteen lines of specialized devices for cardiovascular, vascular, laparoscopy, urology and general surgery. Our products are 99 percent manufactured in the United States.

At its inception, Applied recognized that the national trend of rapidly escalating healthcare costs would reach 20 percent of GDP within a decade. This presented a serious national problem and an opportunity for innovative companies that could affect improved clinical and financial outcomes concurrently. Accordingly, Applied's business strategy has been to develop products and practices that enhance performance while reducing the cost of products and procedures. Since 1988, Applied has evolved as a prolific developer of products and technologies that fulfill this dual requirement, resulting in 380 pending and issued medical device patents worldwide.

Our products have been safely, successfully, and satisfactorily used in many hospitals throughout the globe and for many years. Hundreds of thousands of our devices have been sold and used as testament to their acceptance and performance. Our outstanding record with the FDA also attests to the quality

and performance of our products.

Applied maintains one of the highest commitments to innovation and quality in its industry. Over the past decade, Applied has spent 22 percent of its revenues on R&D, resulting in impressive clinical results and financial savings. One example of the results of Applied's investment is our Acucise® product, which is used to treat ureteral strictures. Peer-reviewed clinical papers attest to the fact that the Acucise® product eliminated hospital stay, reduced costs by $14,000 per procedure and replaced a 210-minute surgery under anesthesia with a 42-minute minimally invasive procedure under sedative and achieved a hundred percent success rates in secondary procedures. Applied also has introduced new generations of atraumatic, minimally invasive surgical devices for occluding blood vessels and grasping tissue, and has eliminated sometimes life-threatening latex from its products.

Applied's trocar seal technologies set the standard for seals used in minimally invasive surgery and are utilized in the majority of trocars currently on the market. The Applied trocars were the first to accommodate instruments with a wide range of diameters to traverse the seal without adaptors, leakage or excessive friction. The patented seal technologies developed by Applied have resulted in real improvements in patient care in minimally invasive surgery by reducing time in the operating room and improving surgeon control during the procedure.

More recently, Applied introduced the GelPort™ product in the rapidly expanding field of minimally invasive hand access surgery. We were awarded Innovation of the Year 2002 by The Society of Laparoendoscopic Surgeons. Applied offers the GelPort™ product in a kit including Applied's trocars and clip appliers, instruments used to close off blood vessels and arteries in minimally invasive surgical procedures. And, t

Thhis year, Applied introduced the Separator™ product, a new generation of access products that uniquely separates the abdominal wall layers along their natural lines without the use of traumatic plastic or metal blades.

Despite these innovations, Applied has been prevented from obtaining more than 1 to 2 percent market share based on dollars (or 2 to 3 percent based on units sold) of the $300 million U.S. trocar market. This limited success is the result of practices that arise from the anticompetitive and exclusionary economic relationships between GPOs and the dominant multi-product vendors with which Applied attempts to compete. The dominant supplier in the trocar market, Johnson & Johnson, has and exercises the power to exclude Applied and its products and to exact penalties from hospitals that seek to purchase Applied's products.

In addition to using GPO fees in excess of the statutorily authorized 3 percent cap by disguising them as non-administrative fees or private label agreements, some of the tools used by the dominant supplier and GPOs to effect this exclusion include: bundling of unrelated products; sole-source contracting; high minimum purchase requirements to obtain discounts; prohibition of evaluations of competitive products; delayed payment of incentives; and forfeiture of rebates for being "out of compliance" with the GPO contract.

The practice of tying or bundling purchases of trocars to purchases of sutures and other minimally invasive surgical products is especially anticompetitive because of Johnson & Johnson's market share. Johnson & Johnson, through two subsidiaries, has an 80 to 85 percent share in the suture market, a 65 to 70 percent share of the trocar market, and an estimated market share for other minimally invasive surgical products exceeding 50 to 60 percent. Johnson & Johnson and its two subsidiaries have joint sole-source contracts with Novation, Premier and other GPOs, and thus have

tied up the market.

As a result of these market conditions, patient care is suffering because clinicians are blocked from the best product and value for their patients. And, despite Applied's diligent efforts to persuade GPOs to make Applied's products available to their member hospitals and save up to 40 percent or more, Applied's products remain unavailable in GPO-affiliated hospitals and the costs of trocars and certain other minimally invasive surgical products are maintained at artificial, supra-competitive prices.

III. CLINICIANS PRAISE AND PREFER APPLIED'S TECHNOLOGY

Applied offers a minimally invasive surgery abdominal access system that is advanced, complete, and interchangeable. It comes in disposable or reusable systems, and consists of advanced ports, cannulas, obturators, separators and seals. All configurations can be combined and interchanged. In the minimally invasive surgical devices field, Applied also offers clip appliers to close off blood vessels and arteries, and, as noted above, GelPort™ hand-access devices.

During documented evaluations in hospitals considering Applied's technology, surgeons have ranked Applied's trocars equal or superior to Johnson & Johnson's trocars, which are the only trocars on contract with Premier and Novation. Applied is aware of many customers who would prefer to purchase Applied's trocars if not for the GPO contracts, but they refrain from doing so solely because they have a sole-source GPO contract. Despite its recognized superior innovation, highly focused sales and marketing efforts, and the 40 percent cost savings, Applied has found that a majority of GPO member hospitals are unwilling even to speak with Applied about Applied trocar and clip applier products. The common given reason is the perceived sole-source contract in place and the fear of falling "out of compliance" with a GPO contract, and thereby risking forfeiture of rebates and discounts on bundled products.

We understand that GPO contracts are held confidentially and not available to hospitals to review and confirm or maximize savings. Hospitals instead depend on the suppliers to estimate and report the cost savings. The analyses conducted by the supplier, however, typically are flawed and purposely intended to mislead the hospital and prevent any conversion to a competitor's product. The ultimate judge of the hospital's compliance with the GPO contract is the sole contracted supplier, who often goes beyond the language of the GPO contract to ensure that the fear works in the supplier's favor.

At no time was this more evident than in May 2002, just after the original hearings held last year by this subcommittee, when Applied launched what we called a "May Day" campaign. We blanketed GPO accounts across the country and offered them a trocar kit at 60 percent savings compared to Johnson & Johnson's identical kit. We did not get one single account as a result of that effort. The common reason given was that the hospital had a sole-source contract and they were fearful of being penalized for failing to meet purchase percentage requirements under their GPOs' contracts with Johnson & Johnson. Avoidance of penalties was more important than cost savings or clinician preference.

IV. THE GPOs ARE PREVENTING COMPETITION

In progressive European and other foreign markets that do not have GPO exclusionary contracts, Applied's market share is approximately 15 percent of the total available trocar market. In 2002, Applied's sales of trocars in those markets grew by approximately 45 percent compared to perhaps 5 percent in the U.S. It is worth noting that 90 percent of our selling and marketing budget is aimed at the U.S. market. However, more than 50 percent of our overall trocar business is generated overseas.

This is in stark contrast to the rest of our business, which is at 80 percent U.S. and 20 percent outside of the U.S.

In the U.S., GPOs are the dominant means by which minimally invasive surgical devices are sold to hospitals, who are the dominant users of such devices. Novation in Irving, Texas and Premier in San Diego, California are the two largest GPOs, contracting for about two-thirds or more of hospitals in the U.S. Johnson & Johnson and two of its subdivisions have joint sole-source contracts with each of Novation and Premier.

Setting aside the issue of whether sole-sourcing, bundling, and minimum purchase requirements are appropriate in the first place, leaving the assessment of cost savings to the dominant supplier and the GPOs is a fox-in-the-hen-house problem. One example of Johnson & Johnson's "calculation" of compliance was documented recently. A customer supplied Applied with documents that presented Johnson & Johnson's flawed analysis of compliance with the Premier GPO contract. Exhibit. The first page says that if Applied product is purchased then compliance will fall below 80 percent, and the discount from the list price will drop from 47 percent to 24 percent on Johnson & Johnson's minimally invasive surgery products, including trocars, representing more than a 40 percent price increase. The document also says that there will be a 12.5 percent increase on Johnson & Johnson's suture pricing.

The numbers, however, do not support these "out of compliance" claims. The first page of the document says that the hospital currently purchases 5 percent from competitors. The second page indicates that $586,901 (about $587,000) represents 95 percent of the hospital's purchases under the Premier contract – so 100 percent of purchases is about $618,000. Excluding $94,000 in trocar purchases (see line item in "Current Spend") from the $618,000 total purchases yields $524,000 in trocar and other minimally invasive surgical products purchased under the Premier contract with Johnson & Johnson. Because the hospital then would spend $50,000 purchasing trocars from Applied and continue to purchase another $30,000 or so from other competitors, the total purchases would be about $604,000 ($524,000 + $50,000 + $30,000). $524,000 is 87 percent of $604,000, thus the hospital would be in compliance.

Johnson & Johnson and Premier thus had no basis for threatening to pull the hospital's discount. Still, that is exactly what was threatened using the GPO contract. This is not an isolated instance.

In similar instances, not until hospitals challenged the calculation of compliance and the matter escalated did Johnson & Johnson and Novation stop beating the "out of compliance" drum. In one specific instance, not until the matter escalated to the President of Johnson & Johnson's subdivision Ethicon Endo-Surgery and Lee Taylor, a Novation Senior Product Manager, was the math accepted to be wrong. Applied now is selling to that hospital.

We are seeing the very same tactics used in government-funded hospitals as well. In one instance, an army hospital in Texas was threatened with loss of discounts from the list price for bundled sutures, trocars and other minimally invasive surgery products under the Federal Supply Schedule in effect until March 2005 if the hospital purchased product from Applied. The army hospital was told that it was at 85 percent compliance and received a warning that erosion of its purchases from Johnson & Johnson to less than 80 percent would cost the hospital discounts as well as rebates directly from Johnson & Johnson.

Even in the few instances when these episodes end with Applied getting business from the hospital, that occurs only after months of delays and sales costs that are far higher, as a percentage of revenue,

than are borne by Applied's competitors. While Applied's costs pile up, customers continue to pay twice as much and Johnson & Johnson piles up the profits.

This kind of "raising rivals' costs" strategy is well recognized in the economics literature. It is not economically practical to correct this situation one hospital at a time. The rules need to be changed by legislation to prevent this problem.

In order to give surgeons the opportunity to try Applied's trocars and other minimally invasive surgical devices, Applied has included these products for free in kits containing its unique and highly desired GelPortTM products. Still the fear of penalties for non-compliance under GPO contracts has caused contracting hospitals to discard the free products from GelPort™ kits and then to purchase Johnson & Johnson contract products to replace the discarded products at additional cost to the hospital. The customers literally feared that the free trocars would cause them to be out of compliance with the Novation/Johnson & Johnson contract. Applied has documented at least twenty instances of this product dumping in several states, including Alabama, California, Florida, Massachusetts, Minnesota, New York, North Carolina, Texas and Washington. Such wasteful dumping does not reflect surgeon preference for the competing products but rather simple fear of "out of compliance" penalties. This waste is especially disheartening because many, if not most, of these hospitals are publicly funded, teaching hospitals.

Outside of GPO-controlled hospitals, where the playing field is somewhat more level, Applied enjoys much more success. The majority (over 60 percent) of Applied's 3 percent of the trocar market comes from hospitals outside of the Premier and Novation contracts. Although Premier and Novation make up over two-thirds of the market potential, they constitute only about 30 percent of Applied's 3 percent market share of trocar customers. Surgery centers, rural hospitals, and VA hospitals make up only 5 percent of the overall market potential, but are responsible for over 20 percent of Applied's current trocar business. Surgery centers, rural hospitals, and VA hospitals can more freely choose their products, because they are not held to the same unreasonable restrictions on product choice ("compliance requirements") to which the Premier/Novation members are held. Decision makers at these institutions have a clear understanding of the financial and clinical merits of these products and make their business decisions accordingly.

Another example of Applied's success outside of GPO-controlled markets involves the atraumatic occlusion market, in which we sell surgical clips and clamps. In or around 1990, when we entered the market, Baxter had about a 98 percent market share. By the mid-1990s, Applied had nearly 50 percent market share, and now has over 70 percent market share. During the past ten years, we have obsoleted our own product twice in the interest of bringing innovation to patients.

The impact of the dominant supplier/GPO enforcement efforts also can be appreciated by reviewing Applied's trocar business over a seven-year period. In the mid-1990's, Premier and Novation affiliated hospitals represented about 42 percent of Applied's business and Applied had no Premier or Novation contract. Hospitals simply preferred the Applied products and value. Surgery centers, rural hospitals, and VA hospitals then represented 10 percent of Applied's business, which is much closer to their proportion of the total hospital population (5 percent). In the late-1990s, Premier and Novation became more aggressive in enforcing the exclusionary provisions of their contracts. As this effort built up, Applied's share in GPO accounts was obliterated. The GPOs moved market share from Applied to Johnson & Johnson. Applied was forced to concentrate its efforts in the smaller market segments outside of the GPO dominance. Over the last two years, almost 50 percent of Applied's new trocar business has been generated from surgery centers, rural hospitals, and VA hospitals. These hospitals represent only 5 percent of the overall market potential. Applied's market share continues to

decrease in the Premier/Novation affiliated hospitals as the enforcement of compliance requirements continues to exclude other suppliers. In spite of continued investment in innovation, quality, value, and service, the majority of the market is not able to benefit from the latest technology and cost savings offered by Applied. It is clear that the more stringent enforcement by Premier and Novation has created a more limited marketplace. Today, with 4 to 5 times the sales people, the ratio of Applied's business in Premier and Novation member hospitals has been reduced from about 42 percent to less than about 25 percent while in non-Premier/Novation hospitals this ratio has grown from about 10 percent to about 50 percent.

Had Applied been able to compete on a level playing field, we believe that we would be growing faster in the U.S. than we are internationally, where our 45 percent growth rate in 2002 is testament to the power of innovation in a free market. We also believe that the real market price of products offered to GPO members would be considerably lower than the artificially inflated prices currently offered under GPO contracts. We echo the concerns expressed by Masimo Corporation before this subcommittee last year that other young, innovative medical device companies are being excluded from the market and investors are becoming increasingly unwilling to support breakthrough products and companies because of the major supplier/GPO-related threats to investors' opportunity to recoup investments.

V. APPLIED DILIGENTLY HAS TRIED TO GET A GPO CONTRACT FOR APPLIED'S TROCARS

Applied believes that recent changes in Novation's and Premier's responsiveness is a direct result of last year's hearings before this subcommittee. While both Novation and Premier recently have promised to seriously consider putting Applied's trocars on contract, to date neither has put Applied's trocar or other minimally invasive surgical products on contract or agreed to cease enforcement of their sole-source contracts with Johnson & Johnson. We are concerned therefore that Novation and Premier may be extending mere courtesies as opposed to real change. A brief summary of Applied's experiences with Novation and Premier follows:

A. Novation

Until recent months, Applied's efforts to get a contract with Novation were largely ignored. In 2000, Applied was invited to bid on the Novation contract for sutures, trocars and other minimally invasive surgical devices – a $2 billion contract nationwide. Applied offered a $150 price on laparoscopic cholecystectomy kits typically used for gall bladder removal. Johnson & Johnson offered a $250 price for the same kits. Our bid was dismissed. It took months to get an audience with Novation, at which time we were unceremoniously told that we did not have the rest of the products that Johnson & Johnson and Tyco bundled with the trocars. There is no legitimate business justification for bundling the purchase or sale of trocars with sutures; such bundling is obviously designed to exclude Applied's products from competition on the merits. We pointed out that Novation knew we did not offer sutures or bundle at the time we were invited to bid. We asked how we could ever stand a chance of winning the next bid and Novation's answer was: "Perhaps you shouldn't bid."

Having "lost" the 2000 bid, we believed that the three-year contract signed in 2000 would be up for re-bid in July 2003 and Applied would have an opportunity to bid on a new contract. Recently, however, we learned that just one year into the three-year term, Novation and Johnson & Johnson extended the contract by an additional two years without any re-bidding or additional discounts. This

was especially alarming because we also learned the contract includes the following additional exclusionary provisions:

• high minimum purchase requirements for qualification for discounts and rebates, e.g., 80 to 95 percent;
• bundling of unrelated products (suture products, trocars and other minimally invasive surgical products);
• bundling of rebates and discounts (four-tier pricing structure with best prices going to hospitals buying 90 percent of their suture products and 80 percent of certain minimally invasive surgical products from Johnson & Johnson, and $750,000 or more in suture products annually – they get an additional 2 percent rebate if they buy 95 percent of suture products and 85 percent of certain minimally invasive surgical products from Johnson & Johnson); and
• prohibition on evaluation of competing products.

The covert extension of the contract yielded Novation members no benefits of which we are aware. Novation members did not secure additional discounts or lower prices. The contract simply extended Johnson & Johnson's chokehold on a $2 billion market by two years. It is a testament to Johnson & Johnson's power over GPOs and hospitals that these buyers believe that the best prices they can ever get are prices that go up in single digits. In today's economy, buyers should not have to accept price increases as inevitable.

Even more disconcerting is the fact that Novation also bundles rebates for Johnson & Johnson's products with the products of other large suppliers on contract with Novation under the guise of the Novation Spectrum Program. To qualify for 5 to 7 percent in rebates, the Spectrum Program requires members to purchase at least 95 percent of all products from five vendors. While this rebate is paid to the hospital, the hospital must be "in compliance for the full term of the Spectrum Program – through March 2005 – otherwise the hospital risks forfeiture of rebates, even rebates already received by the hospital. We have seen at least one check exceeding $1,000,000.00 from Novation to a Spectrum Program participant. This is no small sum for a hospital to forfeit. The threat of such forfeitures is unreasonably exclusionary and anticompetitive. Such threats have the purpose and effect of canceling the otherwise attractive cost savings that suppliers like Applied can offer to hospitals and their patients.

Late last year, our efforts with Novation on another product met the same fate – rejection. Applied had submitted a bid on latex-free catheters. Even though the bid was unopposed, without explanation, Novation rejected the bid that was offered. They instead chose to award the contract to no one.

Only in the recent months preceding this hearing, and only in response to Applied's repeated direct and indirect requests to speak with Novation, has Novation engaged in meaningful discussions with Applied.

During meetings in late March and then May of this year, Applied asked Novation to terminate the sole-source contract with Johnson & Johnson in which sutures, trocars and other minimally invasive surgical products are bundled and to accept a bid from Applied on trocars. Novation initially refused, but more recently, in June, agreed to entertain a bid on Applied's trocars and a couple of other products. We do not believe that this opportunity would have materialized but for the efforts of your subcommittee to focus attention on these practices. We hold high hopes but as yet have not had any trocar bid accepted. Novation also has rectified the latex-free catheter situation, and we now have a contract on that product.

Unfortunately, we have no understanding from Novation as to whether they will cease sole-source contracts, minimum purchase requirements, bundling, or other anticompetitive practices. They have provided no transparency in this regard. Even if they do award a trocar contract to Applied, i.e., permit multi-source, without cessation of the minimum purchase requirements and bundling, any such contract would be meaningless. We hope that this subcommittee will draft and that Congress will enact legislation putting an end to these practices.

Aside from the bidding, sole-source, bundling and purchase requirement issues, one additional issue concerning Novation that we believe is important to address is its relationship with Neoforma, which operates as Marketplace@Novation as Novation's exclusive e-commerce partner. Neoforma's May 2003 Form 10-Q discloses, "Novation agreed to act as our exclusive agent to negotiate agreements with suppliers to offer their equipment, products, supplies and services through marketplaces sponsored by Novation or HPPI, including Marketplace@Novation." Novation is comprised of the 2,400 members of VHA Inc. and the University HealthSystem Consortium. The Form 10-Q further discloses, "In connection with the initial version of the outsourcing and operating agreement we entered into with Novation, VHA, UHC and HPPI, or the Outsourcing Agreement, we issued approximately 4.6 million shares of our common stock to VHA, representing approximately 36% of our then outstanding common stock, and approximately 1.1 million shares of our common stock to UHC, representing approximately 9% of our then outstanding common stock." Thus, Novation owns at least 45 percent of Neoforma. The Form 10-Q also discloses that Novation's shares may be increased even further if Novation members meet certain performance targets: "We also issued warrants to VHA and UHC, allowing VHA and UHC the opportunity to earn up to approximately 3.1 million and approximately 800,000 additional shares of our common stock, respectively, over a four-year period by meeting specified performance targets. These performance targets are based upon the historical purchasing volume of VHA and UHC member healthcare organizations that sign up to use Marketplace@Novation, which is available only to the patrons and members of VHA, UHC and HPPI. The targets increase annually to a level equivalent to total healthcare organizations representing $22 billion of combined purchasing volume at the end of 2004."

During recent discussions, Novation told us that to get a Novation Supplier Agreement we also must agree to use Neoforma. Applied repeatedly asked Novation not to require Applied to sign a Neoforma agreement as a condition of obtaining a contract. After much discussion, we have agreed that if a member requests to use Neoforma then Applied may accommodate that member. We remain of the belief, however, that Novation should sever its relationship with Neoforma and refrain from further involvement, including funneling business to Neoforma, since these relationships appear to increase costs with no corresponding increase in benefits to suppliers, hospitals, or patients.

B. Premier

Until recently, and subsequent to last year's hearings, Premier had never allowed Applied to submit a bid on any product. Despite repeated efforts, we couldn't get their attention.

In June 2002, Premier endorsed HIGPA's code of conduct, which we believe was a good first step. In August 2002, Premier's CEO Mr. Richard Norling submitted a letter to Senators Kohl and DeWine committing Premier to take additional actions above those under the HIGPA code.

As a result of Premier implementing some of these commitments, in April 2003, we did reach agreement on one product, our GelPortTM hand access product. We remain concerned, however, about serious implementation of these commitments. We understand that Premier shortly will be accepting bids on sutures, trocars and other minimally invasive surgical products. According to its

web site, Premier has separated bidding for trocars from bidding for other products. Thus, while they appear to intend to unbundle trocars, they also appear to be continuing to bundle sutures themselves and sutures with certain minimally invasive surgical products. This evidence of only partial compliance with the commitments it made last year shows the continuing power of the major suppliers to deter the GPOs from acting in the best interests of their member hospitals and the hospitals' patients.

Premier and other GPO's will only act in the best interests of their member hospitals when economic incentives and threats to do otherwise are banned. Legislation restoring GPOs to their proper roles as purchasing agents for the hospitals rather than sales agents and market-share movers for major suppliers is necessary if GPOs are to fulfill the purposes for which they were authorized to exist in the first place.

C. Other GPOs

The practices of other GPOs contracting for the one-third of the nation's hospitals not under either the Novation or Premier umbrella should not be ignored. In some instances, the contracting practices of these other GPOs are even more worrisome. For example, in recent months, in response to a customer request, Applied has attempted to get a trocar contract with Broadlane, which contracts for 540 acute care hospitals and another 1,735 sub-acute care facilities. To date, however, Broadlane has been largely unresponsive and refused to disclose to Applied the criteria for obtaining a contract. Applied understands that members must fill out a lengthy request for the GPO to consider Applied's products, yet Broadlane will not tell Applied what the criteria for consideration are. What one Broadlane administrator recently told us is that her job is to drive compliance with their current supplier to 98 percent regardless of cost savings to the member hospitals. We understand that the minimum purchase requirement for Broadlane members is 90 percent.

VI. SOLUTIONS/CONCLUSION

By holding hearings last year and this year and thereby focusing attention on the problems inherent in GPOs' relationships with major suppliers, this subcommittee has made a constructive contribution to the quality and cost-effectiveness of health care. Applied is very grateful for that effort. We urge you to push forward with efforts to draft and enact legislation that permanently reforms behavior in this area and restores GPOs to their proper and constructive role in the procurement process, for the sake of patients and hospitals, healthcare providers, and the continuing competitiveness of innovative U.S. suppliers in world markets. We also urge you to exercise your oversight responsibilities to encourage enforcement of the existing laws by the Federal Trade Commission and Department of Justice and at the same time as you act to strengthen those existing laws.

This nation has led the world in many fields where as capabilities increased, cost decreased, and, as volumes went up, so did availability and choices and competitive spirit. Consumers have more computing power for less, more telephone providers vying for the business unbundled. Local calls can be purchased separate from long distance, international, or cellular services.

But these trends in the economy generally have been frustrated in the markets for medical devices and supplies, where products are anticompetitively bundled and, as volumes go up, so does the cost. As the devices remain more or less the same, they become more expensive. Prices are contracted as discounts off a list price and suppliers change the list price once or twice a year, hardly ever downward.

My company and I urge you to return free market conditions and fair and open competition to the

markets for medical devices and supplies.

Thank you.