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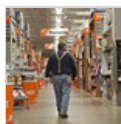
1 of 12



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HEALTH

Medtronic Makes Pact-Ending Move

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By JON KAMP

Feb. 25, 2011 6:05 p.m. ET

[Medtronic Inc.](#) (MDT -1.87%)'s canceling of contracts negotiated by a group representing hospitals is an aggressive move, coming as the \$200 billion U.S. medical-device industry defends itself against slumping product prices and tougher bargaining from hospitals.

Citing expected cost savings, Medtronic has canceled five contracts with Novation LLC, the largest group-purchasing organization, or GPO. Medtronic's move could escalate a battle between device makers trying to protect product prices and their leverage in negotiations, and GPOs trying to cut cost-saving deals for hospitals.

J.P. Morgan Chase & Co. analyst Michael Weinstein called it a "bold" move and a potential "watershed moment" that could eventually help the whole device sector, which pays fees to GPOs. He expects Medtronic also will walk away from other GPO deals.

"We believe other firms may well want to move in the same direction" when it comes to pricier, specialized products, William Blair analyst Ben Andrew said. Some already have, said Curtis Rooney, president of the Health Industry Group Purchasing Association, though he declined to disclose names.

Medtronic wouldn't comment about other GPOs but confirmed it canceled the Novation pacts.

"With an eye on removing costs from the healthcare system, Medtronic believes that we will be best able to address the varied needs of our customers by managing our business interactions and relationships locally instead of through Novation," the company said in a statement.

Other top GPOs include hospital-owned Premier Inc. and [MedAssets Inc.](#) (MDAS +0.51%) MedAssets shares plunged 34% to \$14.06 Friday after a disappointing fourth-quarter release and multiple analyst downgrades.

Novation—owned by a network of nonprofit health organizations plus an alliance of academic medical centers and affiliated hospitals—announced the Medtronic contract cancellations late Thursday. The five contracts cover cardiovascular and orthopedic products.

Novation said its owners represent \$2 billion in annual purchases for Medtronic, which compares with analysts expectations for nearly \$16 billion in sales this fiscal year. Medtronic didn't confirm the contracts' value but said it already negotiates the "vast majority" of contracts locally, rather than through GPOs.

The contract cancellations highlight a long-running dispute between GPOs and the devices industry about whether GPOs add value or are middlemen that add costs,



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particularly fees that device makers pay GPOs to reach customers. In this case, Medtronic said it believes the move will ultimately take costs out of the health-care system; the company wouldn't confirm the fees it paid Novation, but Sanford Bernstein analyst Derrick Sung estimated them at \$40 million to \$60 million.

Novation claimed Medtronic's exit will likely raise costs for member hospitals by eliminating price protection. Device makers often require confidentiality agreements that block hospitals from disclosing product prices to third-party groups that aggregate data and shed light on the market. But Novation said its contracts guard against such clauses.

Mr. Rooney, president of the GPO association, said he thinks device makers leaving GPOs are trying to keep their prices secret. But Mark Leahey, president and chief executive of the Medical Device Manufacturers Association, had a different take.

"I think companies are probably getting fed up with having to pay these fees to GPOs, just for the privilege of selling to hospitals," he said.

Speaking on an earnings call Friday, Chief Executive [Trevor Fetter](#) at hospital operator [Tenet Healthcare](#) Corp. (THC +4.09%) said manufacturers paying for GPOs has always appeared strange, and that customers paying the fees is an appropriate model. He said he wouldn't be "overly panicked" about Medtronic's contract cancelation, while adding "GPOs play an essential role in the supply chain."

Medtronic's move entails risks, because it could lose customers to competitors while alienating Novation members, analyst Mr. Sung said. Novation noted that 16 hospitals sent a letter to Medtronic Chief Executive Bill Hawkins stating "extreme disappointment" with the company's move. Medtronic said it doesn't expect any disruption in day-to-day operations with hospital customers.

But Medtronic's move could be a long-term positive, Mr. Sung said, in a devices industry feeling pressure on multiple fronts. The economic downturn and health-care overhaul rules have pressured hospitals, which are looking for ways to save on costs they pay for devices.

Hospitals have been steadily acquiring doctors' practices in a move that waters down device makers' ability to leverage relationships with product-choosing doctors. The threat of pricing pressure is an ever-present topic on device-industry earnings calls.

Medtronic's move "could help to limit the influence of the GPO and thus shift some bargaining power away from the hospital and back to the device manufacturers," Mr. Sung said.

—Dinah Wisenberg Brin contributed to this report.



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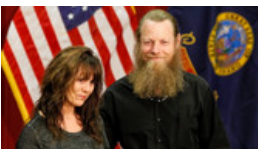
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