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Strategic Position


Selling Generic Drugs by Mail Turns Into Lucrative Business

Benefit Managers Say They Save Employers Money, As Their Own Profits Rise

Off-Patent Bonanza Ahead

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In many industries, middlemen scrape by on small margins. Not so in generic drugs.

Documents from 2001 filed in an Ohio court case show that **Medco Health Solutions Inc.** paid \$90 that year for the pills to fill 114 prescriptions for a generic copy of Valium. Medco sent its client, the State Teachers Retirement System of Ohio, a bill of \$1,028 for the drugs, which also reflected its dispensing costs. Medco paid \$766 for the pills to fill hundreds of prescriptions for the blood-pressure medicine atenolol. It billed the Ohio teachers \$25,628.



**HEALTH-CARE
 GOLDMINES**
 Middlemen
 Strike It Rich

Today, **Caremark Rx Inc.**, another middleman, charges the federal government and employees \$96.88 for 90 pills of generic Prozac, according to a Caremark Web site. The same pills can be bought wholesale for less than \$5.

Medco, Caremark and **Express Scripts Inc.** are the big three "pharmacy benefit managers," or PBMs. Employers that offer prescription-drug coverage hire PBMs to do the paperwork and keep costs down when an employee needs a prescription filled. More than 100 million Americans carry a card with the logo of one of the big three, using it at the pharmacy to show they're covered.

It's a hugely lucrative place in the food chain. Generic drugs are popular because they save money by offering alternatives to expensive brand-name drugs. But the PBMs have figured out how to use mail order to turn generics into a bonanza. Buying in bulk, the PBMs typically pay a few cents per pill, then turn around and bill employers a quarter, 50 cents or even a dollar a pill. A Medco spokeswoman, Ann Smith, says final profit is much smaller than that spread because of administrative and dispensing costs.

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For the employers, the generic prices look like a bargain because they're generally still much lower than those of brand-name drugs. The employers often don't know the

spreads enjoyed by the PBMs.

The big three PBMs' perch could grow even more valuable over the next five years as brand-name drugs with \$47 billion in annual sales lose patent protection. Copies of top sellers such as the cholesterol drug Zocor and antidepressant Zoloft will take a big bite out of the drug industry's profits, while giving PBMs more chances to sell high-margin generics.

More than half of Medco's net income comes from filling generic-drug prescriptions at its mail-order facilities, although the mail business including brand-name drugs represents just 37% of revenue. Collectively, the big three recorded net income of nearly \$2 billion last year.

The business has brought gains for PBM shareholders and made some PBM executives rich, chiefly from valuable stock options, even as many employers and employees struggle to afford health insurance. Caremark's chief executive, Edwin M. "Mac" Crawford, has sold \$185 million in stock since November. (See [article](#)².) At Express Scripts, Chairman Barrett Toan has sold \$64.8 million in stock since last fall.

It helps the PBMs that many employers are unfamiliar with the economics of manufacturing pills. While a brand-name pill such as Lipitor or Prozac may cost employers \$2 or more, most of that goes into marketing, research into future drugs and profit for the drug company. The cost of actually producing the pills is usually only a few cents each.

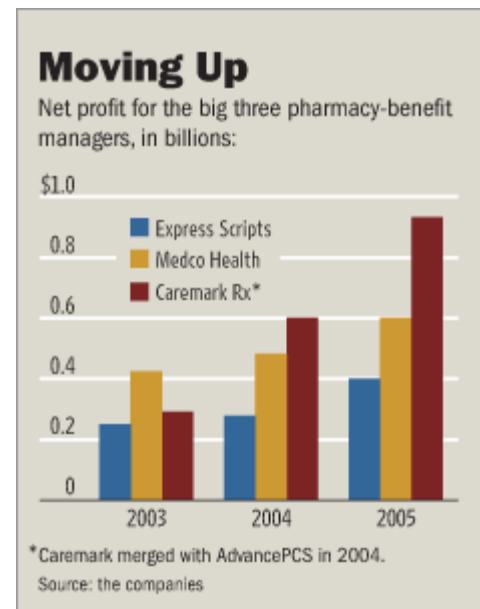
After the patent on a drug expires, brand-name makers lose the monopoly that allowed them to charge a high price. But for customers accustomed to the old prices, it may seem like a bargain to get pills that used to cost \$2 for just 50 cents.

The PBMs defend their lofty margins on generics, saying that they need the profits there to make up for overhead costs and losses or slim margins on brand-name drugs. They say employers benefit from their efforts to switch patients to generics. Pharmacies also add huge markups on generic drugs for some customers, such as uninsured people who pay for medicines out of pocket.

Recently, some states have been pushing back against PBMs, weighing laws to force the middlemen to reveal where their profits come from. The laws would also make PBMs fiduciaries of their clients, just like accountants or lawyers. That would limit the PBMs' ability to grab lucrative margins through pricing methods that employers find hard to follow. Meanwhile, a handful of employers are looking for ways to buy generics for a price closer to what they cost to make.

But for now, the generic mail-order business is booming. It represents the latest evolution of an industry that has played a key behind-the-scenes role in the \$250 billion U.S. pharmaceuticals business.

The PBMs started out by promising to liberate employers from the grunt work of offering a prescription-drug benefit for employees. They could handle the paperwork when prescriptions



were filled at pharmacies and make sure employers paid only for approved drugs.

PBMs were early adopters of technology. When people needed a prescription filled, they could simply hand over their Medco or Caremark card to the pharmacist, who could tap into the PBM database to confirm coverage and figure out how much the employee owed out of pocket.

For a while, a good chunk of the PBMs' profits came from incentives provided by drug makers. PBMs would try to badger doctors into switching prescriptions to a particular brand. The PBMs could reap lucrative rebates from drug makers for doing this. After an outcry about the practice a few years ago, PBMs started sharing more of the rebates with employers.

Early on, PBMs came up with the idea of cutting pharmacies out of the equation altogether. Many people fill prescriptions on regular schedules, and have no need to go to a drugstore every time. PBMs could receive orders by phone or online and send pills directly to patients. It would be more convenient for patients and reduce the risk of errors.

It took a while, but gradually employers warmed to the mail-order idea. PBMs sold it in part by promising to switch employees as quickly as possible to cheaper generic copies whenever they were available. Even if the prescription was for a patent-protected drug, the PBMs would try to switch it to a similar generic. PBMs also offered lower prices on brand-name drugs if employees used mail order.

Today, big facilities like Medco's can fill prescriptions in minutes and put them in the mail with barely a human hand intervening. At its Willingboro, N.J., facility, which Medco calls the world's largest automated pharmacy, trays of bottles get filled from 1,200 bins containing almost every major pill for chronic diseases prescribed in the U.S. Robots cap and seal the bottles after their two-mile journey and drop them into plastic mailing bags. The factory churns out more than a million mail-order prescriptions a week.

When the allergy drug Flonase lost patent protection this March, Medco says it converted 95% of brand prescriptions to generics within two days. A similar conversion in 2001 when Prozac went off-patent took more than six months, it says.

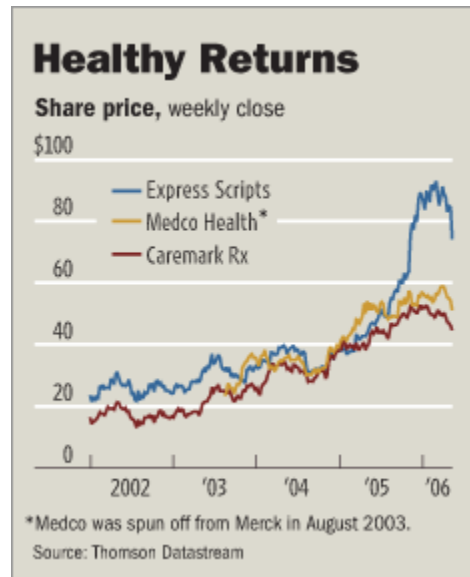
An even bigger opportunity is coming in June, when Merck's cholesterol fighter Zocor goes off-patent. Medco vice president Ken Malley says Medco has a "very overt, very aggressive program" to push generic Zocor. Medco will fax letters to 50,000 doctors urging them to put their patients on the generic pill. The letters say, "Help keep your patients' benefits affordable."

Timothy Wentworth, a top Medco executive, says switching to generics will lower employers' costs. Medco plans to waive co-payments for six months for Zocor patients who switch to its mail-order pharmacy from a retail store. That's the longest waiver it has offered, and Medco says experience with shorter waivers suggests many patients will sign up. "We are incredibly motivated" to get patients on generics quickly, says Mr. Wentworth. "Every day we make more money."

Medco's spread can be wide, as documents from the Ohio court case show. In one case in 2001, Medco paid \$514 for the pills to fill 666 prescriptions for a blood-pressure drug. It charged the Ohio teachers' retirement system \$5,806. In 2000, the group paid \$10.5 million in total for generic drugs that cost Medco \$2.3 million.

Medco says that after overhead its profit margin on mail-order generic drugs for the retired Ohio teachers was only 23% and its total margin, after losses on brand-name drugs, was 1%. Ms. Smith, the Medco spokeswoman, adds: "To make generalizations on five-year-old pricing of a selective sampling of drugs would be misleading."

The state of Ohio sued Medco, accusing the PBM of cheating the teachers. Medco denied that, saying it acted according to their contract. The judge told the jury to disregard the margins on generics because contracts allowed them. The jury ruled that Medco should pay the teachers' retirement system \$7.8 million for fraud and for breaching what the jury called its fiduciary duty. Medco is appealing.



The Ohio data are unusual: Even today, it's difficult to find clear numbers on how much PBMs pay for drugs and how much they charge for them. However, some examples come from a Web site operated by Caremark, which manages the prescription-drug benefit for federal-government employees. The site says it shows federal employees how much Caremark bills the government for many drugs.

According to the site, 90 pills of generic Prozac cost \$96.88 via Caremark's mail-order pharmacy -- a bill that the federal government must foot, minus a small co-payment by the employee. Pharmacies, whose business is threatened by PBMs, say those pills cost less than \$5 to acquire wholesale. On its Web site, **Costco Wholesale Corp.** sells 100 pills of generic Prozac to retail customers who lack insurance for \$13.59.

In some other cases, the government is also getting a worse deal from mail order than it would if employees filled their prescriptions the old-fashioned way at a pharmacy. According to the Caremark Web site, the government's cost for a full year of atenolol, the widely prescribed blood-pressure pill, is \$28.92 if the employee goes to a pharmacy. But when the drug is ordered through the mail, the government's cost rises to \$81.12. The employee's co-payment would be higher, too: \$40 instead of \$9.60.

Mr. Crawford, Caremark's chief executive, says it's irrelevant to look at the price of one drug because PBMs negotiate a pricing system with clients that saves them overall. He says Caremark "loses a lot of money on branded drugs" because of competition with other PBMs. He adds that Caremark has invested significantly in its mail-order facilities and needs to earn a return.

A Caremark spokesman says the prices on the Web site shouldn't be considered actual prices because the company's contract with the federal government "is not based on pricing per individual prescription." Nancy Kichak, a federal government official who oversees benefits for employees, says the government does pay for individual prescriptions. "What you see on the Web site is very close to what we're paying," she says.

Ms. Kichak agrees with Mr. Crawford that just because the government is paying five to 10 times the wholesale cost in some cases doesn't mean it's being taken to the cleaners. "We have to get the absolute best deal possible in total," says Ms. Kichak, associate director for strategic human-

resources policy at the Office of Personnel Management. She notes that the government's biggest expense is still for brand-name drugs, not generics.

Ron Lyon, who until recently was a consultant at Towers Perrin helping employers negotiate contracts with PBMs, says some consultants are beginning to insist that PBMs eliminate the big gap between the mail-order price and pharmacy price. But employers won't get that guarantee unless they ask for it -- and many aren't savvy enough to do so, Mr. Lyon says.

Gabriela Garcia is head of human resources at **Alamo Group Inc.**, a Seguin, Texas, manufacturer of tractor-mounted mowing and other equipment with 1,500 employees. Ms. Garcia says she never used to look at individual prescription claims to estimate how much profit Alamo's PBM, one of the big three, was making on generic drugs. When a smaller rival showed her some figures a year and a half ago, "the amount of the markups were a surprise," she says. Alamo switched to the smaller PBM, Hyde Rx Services Corp.

A big part of the PBMs' strategy is selling employers on the idea of requiring patients to fill all prescriptions, except in emergencies, through the mail-order pharmacy. **General Motors Corp.**, **International Business Machines Corp.**, and **Southwest Airlines** have "mandatory mail" programs. About eight million beneficiaries served by Medco come from employers with such rules, up from two million in 2003.

Medco says clients save 8% to 10% with the program because it has a good track record of switching mail-order patients to generics. According to Medco, the current generic substitution rate for chronic medicines through its mail pharmacy is 95.3% while at a retail pharmacy it is 92.6%.

The results didn't please one customer, Horizon Blue Cross Blue Shield of New Jersey. Medco "sold us on mail order to say it would be cheaper and sometimes it turned out not to be cheaper," says Debra M. Lightner, Horizon's associate general counsel.

The health insurer hired Medco in 1993 to manage pharmacy benefits for its three million members. Now, Horizon is suing Medco in New Jersey state court. It alleges that Medco violated contract terms. However, in recent weeks Horizon dropped its claims that Medco's mail-order pricing violated the contract. Ms. Lightner says that was designed to "streamline" the case as it heads for trial, perhaps next year. Ms. Smith of Medco says the abandoning of the claim "speaks for itself."

PBMs typically advertise that they offer attractive discounts -- sometimes 50% or more -- off the "average wholesale price" of a drug. Publishers of drug-sales data report this price but it rarely reflects actual market prices. The average wholesale price for generic Prozac, as reported by one pharmacy-pricing magazine, is \$2.60 a pill, nearly 100 times what generics manufacturers actually charge wholesale customers.

In several states, legislators are pushing bills aimed at bringing more transparency to PBM pricing, but they have run into stiff opposition from the PBMs. The first such law was passed in Maine two years ago, requiring PBMs to reveal where their profits come from. It was recently upheld by a federal appeals court. The Pharmaceutical Care Management Association, which represents PBMs, asked the U.S. Supreme Court last month to review the case. Legislators in about a dozen other states are working on similar legislation.

PBMs say their services are part of health benefits that are governed by federal law, and states can't impose their own laws. They also say that requiring them to disclose proprietary information violates the Fifth Amendment of the Constitution, which bars the government from taking private property except for public use and with just compensation.

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