An Analysis of Market Power in the PBM Market

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Express Scripts and Medco, the two largest pharmacy benefit manager (PBMs), have proposed merging. PBMs manage prescription drug plans for sponsors (corporations, governments and unions), acting as a middleman between the sponsors, drug manufacturers and pharmacies. This ConsumerGram analyzes the nature of the market and the potential risks that may result from the merger. To understand whether the proposed merger would benefit or harm consumers, this analysis considers the market's structure, conduct and performance.

Market Failure

Who do PBMs represent? Typically, when a firm (a principal) contracts with an agent, they expect the agent to act with the firm's best interest in mind. The agent is often incentivized to perform well. However, there are cases where conflicts of interest create what is commonly referred to as the *principal-agent problem*. These problems can arise from a lack of transparency between the principal and agent, or in this case, when it comes to the prescription plan's sponsors and PBMs. While plan sponsors understand the direct financial effects of the particular prescription plan being offered to its members or employees, only PBMs have a complete understanding of revenue streams, pricing and costs surrounding the many facets involved in management of prescription plans.[2] This is because PBMs are involved in more than just administering prescription plan between the sponsor and its members. PBMs also interact and negotiate with pharmacies and drug manufacturers, creating what becomes a conflict of interest between the various parties. The lack of transparency leads to asymmetric market information, where PBMs have much better information on costs and prices than do all of the other parties

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[2] Allison Dabbs Garrett and Robert Garis, "Leveling the Playing Field in the Pharmacy Benefit Management Industry," *Valparaiso University Law Review*, Vol. 42, Rev. 33, 2007, pp. 33-80.

involved in the process, which gives PBMs leverage over dealings with these other parties.[3] In this way, asymmetric information represents a *market failure*. When there are substantial costs at stake, market failures could require regulatory and legal remedies to protect consumers.[4] In addition to this market failure, the proposed merger will lead to an increase in PBM industry concentration that will exceed DOJ/FTC current guidelines. This begs the need for addressing market conduct and performance, in order to determine whether there is a presence of sustained market power that poses serious anticompetitive risks for consumers.

Market Conduct

Plan sponsors hire PBMs to run their prescription insurance plans and manage its costs. PBMs get paid by the plan's sponsors for running the plan. However, PBM's cut deals with pharmacies, promising them access to the plan's subscribers in return for cutting fees for what the pharmacies would normally earn for filing a prescription. This adds additional profits for the PBMs over and above what plan sponsors pay PBMs for managing their plans. In other words, as the middleman, the PBM profit from the spread between plan sponsors and pharmacies. This profiting occurs without the sponsors knowing the various wholesale prices paid by various parties or the recovery of pharmacy fees.

Next, PBMs promise manufacturers higher volumes of drug sales in return for manufacturer discounts and rebates. This again represents another source of profits for PBMs. Once again, the specific terms and conditions agreed between PBMs and manufacturers are unknown by either the pharmacies or the plan sponsors. In other words, PBMs profit from their dealings with drug manufacturers and by squeezing pharmacies, in addition to having plan sponsors pay them for managing the plan.

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[3] Asymmetric information always favors the party with better information. For example, say that a consumer negotiates to buy a used car. If the used car dealer has better information on the vehicle than the consumer has, then the consumer is more likely to overpay than the dealer is to undercharge.

[4] Some of the policy options are laid out and discussed by Ruth G. Thomas, "Consumer Protection, Education and Information: A Consumer Incentives Perspective," *Review of Policy Research,* Volume 2, Issue 3, p. 445-454, February 1983. Thomas analyzes policy alternatives as they impact consumer incentives in the context of different characteristics among consumers, products and market contexts. Also see, Aidan R. Vining and David L. Weimer, "Information Asymmetry Favoring Sellers: A Policy Framework," *Policy Sciences*, 21:4, 1988, p. 281. Vining and Weimer give the following guidance: "Three questions are important: first, under what conditions does the potential for significant inefficiency due to information asymmetry exist? Second, under what conditions are private responses likely to prevent the inefficiency from being realized? And third, what are the different potential, public interventions for reducing any inefficiency that does occur?"

While it is logical to conclude that PBMs profit when they reduce prescription plan costs, the end result is not necessarily so. Because PBMs will work with manufacturers to change their formulary (the menu of drugs offered to patients for their prescription plans) in exchange for higher discounts, rebates, and kickbacks from the drug manufacturers, these added incentives drive PBMs toward maximizing profit, which may not minimize the plans cost. For example, if a manufacturer pays a PBM an incentive to offer a higher cost generic drug, by adding the drug to the plan's formulary, the sponsor's costs increase, as will the PBMs profits. This clear conflict of interest suggests that PBMs do not necessarily represent the interest of the plan's sponsors or their subscribers. Thus, the incentive for PBMs to do what is best for the plan and consumers are in direct conflict with the PBMs incentive to profit.

To summarize the sources of profits, when PBMs manage the sponsors' plans, they profit when: 1) the consumer and plan sponsors pay a bit more; 2) PBMs funnel sales to favored manufacturers in return for kickbacks and discounts; and 3) PBMs threaten to drop qualified pharmacies in order to squeeze concessions for prescriptions filled at pharmacies. Nowhere are all of the wholesale and average prices between the various parties published or transparent – not to the drug manufacturers, not to the consumers, not to the pharmacies, nor the sponsors who offer their employees prescription plans. So, it is not always clear who PBMs represent. They are making money on all sides.

As PBMs have grown, they are able to leverage their size. Imagine a pharmacy working with only two PBMS in a particular community. In this example, the pharmacy's access to the market (consumers) is highly restricted, since it must work through one or two PBMs to serve many of its customers. Now, if the Express Scripts and Medco merger takes place, a pharmacy could see its ability to reach consumers reduced from two PBMs to one PBM. In this way, the PBM now becomes the *price-maker*, and the pharmacy a *price-taker*, which means that the pharmacy must either comply with the PBM's demand or exit the market. In other words, the merger can facilitate legal collusion by consolidating a few channels that aggregate the majority of customers in a community, thereby curtailing the pharmacy's access to the market. Moreover, even if pharmacy discounts are conceded, there is no market pressure for the PBMs to flow these savings through to sponsors or to consumers in the form of lower prices. Therefore, the merger would provide no obvious benefit for consumers.[5]

There is yet another conflict of interest. Large PBMs also provide mail-order prescriptions. If you are a customer that regularly gets drugs for a particular medical condition, PBMs can easily capture that customer for (typically lower-cost) reoccurring business, thus bypassing the pharmacy. In other words, PBMs can *cream-skim* customers to its own mail-order business. By virtue of these various conflicts of interest (self-dealings) and the lack of transparency contributing to a market failure, PBMs engage in market conduct which permits the influence of market power. For this reason, some have concluded that the PBM industry's conduct is "anticompetitive and, in some cases, plainly illegal conduct,"[6] as well as others calling for industry regulation.[7]

Market Performance

With the risk of anticompetitive conduct, profitability is the most acceptable means to test for market power, and indications suggest that the BPM market is very profitable, including the profitability of Express Scripts and Medco, the two merging companies.

According to financial reports, from 2005 to 2010, company earnings before interest and taxes grew for PBMs – at about twice the average rate of its peers in other healthcare industries. Specifically, data on Medco and Express Scripts (the two merging PBMs) had pre-tax profits far exceeding retail pharmacies (collectively Walgreen and Rite Aid), CVS Caremark, wholesalers (collectively McKesson, Cardinal and Amerisourcebergen), pharmacos (collectively Pfizer, Johnson & Johnson and Merck) and medical device companies (collectively Medtronic and Baxter) and managed care organizations (collectively UnitedHealth, WellPoint, Aetna, Humana and Cigna).

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[5] For example, an article by Express Scripts' Senior Director defends the merger as good, but cites not a single benefit that does not already exist with the unmerged companies. See, Brian Henry, "Express Scripts and Medco Together Will Lower Healthcare Costs," *The Hill*, Congress Blog, Nov. 3, 2011, at http://thehill.com/blogs/congress-blog/healthcare/191649-express-scripts-and-medco-together-will-lower-healthcare-costs.

[6] Mark Meador, "Squeezing the Middleman" Ending Underhanded Dealing in the Pharmacy Benefit Management Industry Through Regulations," *Annals of Health Law*, Vol. 20, 2011, pp. 77-112.

[7] Meador, at p. 111. Also see Regina Sharlow Johnson, "PBMs: Ripe for Regulation," *Food and Drug Law Journal*, Vol. 57, 2002, pp. 323-369.

Other data also suggests strong performance. Express Scripts profits have grown 400 times in the last decade.[8] According to company reports, Express Scripts extracts $3.72 in earnings (before interest, taxes and depreciation) per prescription, representing a 110% increase from the 2006 rate of $1.77."[9] As another benchmark, in 2010, Medco's return on equity (35.2%) was lower than Express Scripts (48.8%), but higher than Bristol-Myers Squibb (30.2%), Wal-Mart (23.2%), Costco (13.1%), Walgreen (18.6%), and Kroger (23.0%). By several measures the merging company is highly profitable.

From this quick analysis, PBMs are more profitable than their peer industries. The rate of profitability suggests that market entry and subsequent competition is not sufficient. Pre-merger, the presence of sustained profitability suggests a potential for market power, which poses anticompetitive risks for consumers. Thus, on a post-merger basis, the combination will likely result in increased market power and substantial consumer harm.

Summary: PMB Market Power

From a structure, conduct and performance assessment, there are indications that the PBM market is anticompetitive and that it exhibits market power. This is due to a *principal-agent* problem, a market failure caused by asymmetric information and a lack of transparency, conflicts of interest both vertically and horizontally, the collusive pricing of group plans, profiting on the spread, self-dealing, and manufacture kickbacks in return for a favorable formulary placement. The profitability of the industry confirms market power and provides evidence that total social welfare is being adversely affected. The merger will only increase these problems.

In summary, this *ConsumerGram* addresses the risks associated with the proposed Express Scripts/Medco merger. Even without the merger, our analysis finds that there are already serious problems, including a potential market failure, within the current PBM market. Because of these findings, the merger of the two largest PBMs will likely exacerbate these problems, leading to an additional increase in market power and posing substantial anticompetitive risks for consumers.

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[8] "Express Scripts, Inc. (ESI): Overdosing on Greed," *News Blaze*, Dec. 01, 2010, SEIU Healthcare Pennsylvania, at http://newsblaze.com/story/2010120110400200001.pnw/topstory.html.

[9] According to company financial reports (includes data through third quarter 2011).