

# The Problem with CVS's "Guaranteed Net Cost" PBM Business Model

By  
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December 2018

## Summary:

**Consider this meta:** CVS **opaquely** is substituting one **opaque** source of gross profits -- guaranteed net cost markup -- for another **opaque** source -- retained rebates.

The pharmacy benefit manager (PBM) CVS Caremark has offered its self-insured corporate clients an alternative business model called "Guaranteed Net Cost". The pricing scheme features 100% pass-through of drug rebates and the end of rebate retention as an opaque source of PBM gross profits.

But, CVS has glossed over the fact that their "guaranteed net cost" price to plans is not the same as the net costs to them. Until CVS tells us otherwise, the new business model allows for a opaque markup on top of PBM net cost. In graphs below, we demonstrate how a markup of guaranteed net costs serves as an opaque offset to foregone rebate retention.

It is naive to think that CVS Caremark is about to give back a significant source of its annual gross profits without some sort of offset. In fact, CVS admits as much as [their spokesperson is quoted as saying](#)

" CVS' manager of corporate communications, Christina Beckerman, told Fierce Healthcare that the company does not expect CVS Health's profitability to increase or decrease as a result of the shift to 100 percent pass-through rebates"

It is not even clear that CVS's new business model lessens the incentives to Pharma to inflate list prices in order to compete on rebates for formulary placement.

We conclude the paper with a proposal for CVS to adopt a true transparent business model that would entail a single per member per year (PMPY) fee-for-service (FFS).

We estimate that a transparent FFS of \$169 PMPY would be sufficient to offset ALL small molecule and specialty drug rebate retention. While this \$169 PMPY FFS would offset the loss of retained rebates, it still preserves oligopolistic gross profits.

If the PBM industry were more competitive, and clients could compare PBM contracts on the basis of a single PMPY FFS replacing rebate retention, we estimate that the \$169 PMPY fee-for-service figure would be cut in half to around \$85 PMPY.

### **The Problem With the Current PBM Business Model**

The current PBM **reseller** business model features five major streams of revenue and gross profits. Four of the five are opaque.

1. Opaque rebate retention % on speciality (biotech) drugs in return for preferred or exclusive placement on formularies;
2. Opaque rebate retention % on small molecule brand drugs in return for preferred or exclusive status on formularies;
3. Opaque profit margins on 90-day generic Rx filled by captive mail order operations of the PBM;
4. Opaque "spread margins" added by the PBM on top of reimbursements to retail pharmacies included in their networks;

## 5. Transparent claims processing and data fees.

The opacity of drug rebates is magnified by the fact that reimbursements for brand drug Rx and related rebates come at different times. It is impossible for plans match up these two streams and calculate a single net price its pays per drug.

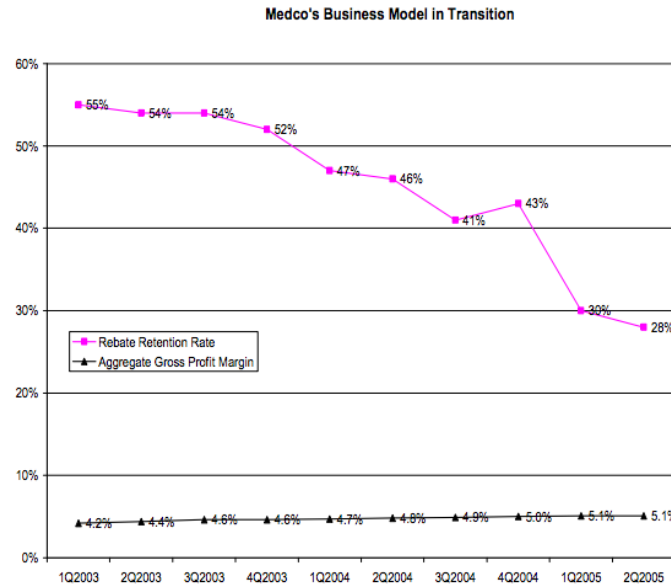
Since the early 2000s, PBMs have continually come under attack for not acting in the best interest of their clients. We have [written a number of papers since 2004](#) pinpointing an opaque **reseller** business model as the source of this misalignment.

The PBM **reseller** business model is in stark contrast to two other transparent business models used by managed care companies:

1. a PMPY fee-for-service agency model where 100% of all reimbursements and rebates are passed through to plans.
2. a risk-based insurance model with capitated premiums paid by plans.

Until the PBM Medco's merger with Express Scripts in 2012, Medco's financial 10-Q and 10-K reports to the SEC broke out gross rebates received -- a credit to cost of sale -- and rebates retained -- a credit to sales. We were able to calculate with certainty Medco's "rebate retention rate", a name we coined fifteen year ago in 2003.

We calculated that Medco's rebate retention rate -- the percentage of gross rebates retained -- fell from 55% in 1Q03 to 28% in 2Q05. This rapid decline was due to the sudden awareness by clients of the whole rebate retention scheme. To offset this loss, Medco began to push clients toward its captive mail order and fat margins it began to earn on mail order generic Rx fills.

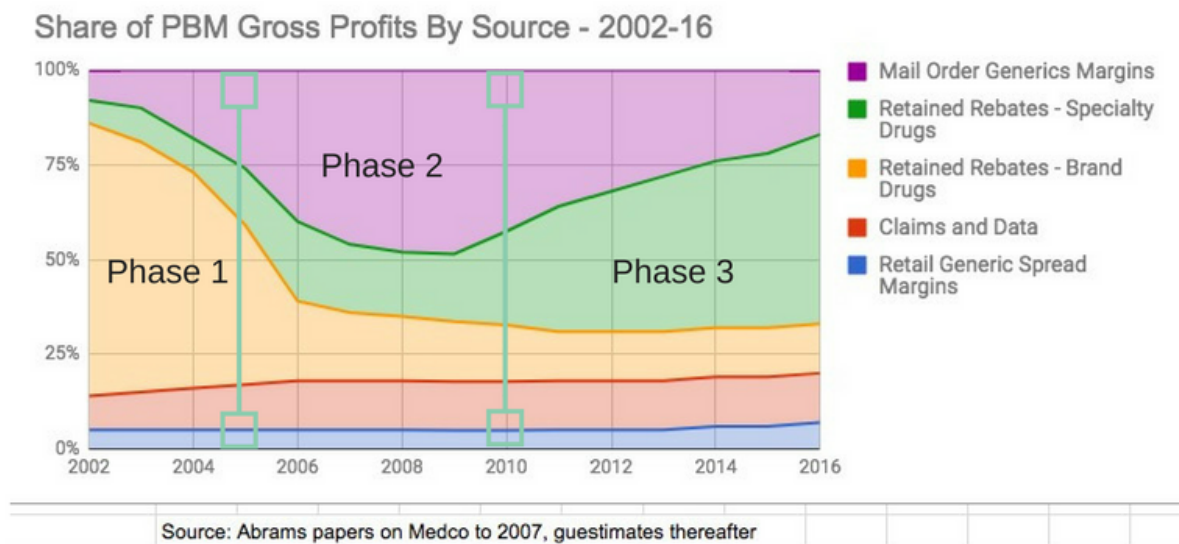


The share of Medco's overall gross profits coming from retained rebates reflected outrageous rebate retention rates. For 3Q04, [we derived with certainty](#) from Medco's 10-Q that **71%** of its gross profits came from retained rebates from small molecule brand drugs. By 2Q05, [we estimated with certainty](#) that Medco's retained rebate share of gross profits had dropped to **48%** with the difference going to their newly found focus on mail order generics.

In our 2017 paper "[Three Phases of the PBM Business Model](#)", we carried forward our mid-2000s work on disaggregating PBM gross profits by sources. Below is a summary of that work.

Data Sources on Distribution of PBM Gross Profits				
Source:	Medco 10-Q	Medco 10-Q	Medco 10-K	Guestimate
Date:	3Q04	2Q05	FY07	2016
Retail Generic Spread Margins	2.4%	3.0%	4.2%	7.0%
Claims and Data	11.7%	13.0%	13.1%	13.0%
Retained Rebates - Brand Drugs	71.1%	48.5%	18.6%	13.0%
Retained Rebates - Specialty Drugs	3.0%	3.1%	14.2%	50.0%
Mail Order Generics Margins	11.8%	32.4%	49.9%	17.0%
Total:	100.0%	100.0%	100.0%	100.0%
Rebate Retention Rate:	40.5%	28.1%	18.2%	10.0%
Derivation	<a href="#">Abrams, 04-2005</a>	<a href="#">Abrams 09-2006</a>	<a href="#">Abrams 11-2008</a>	Abrams 2017

Here is a graph of the above data:



### CVS's Guaranteed Net Cost Business Model

On December 5, 2018, CVS Caremark [introduced](#) a new pharmacy benefit manager (PBM) business model option for self-insured corporate drug benefit plans.

The core of this new business model is a simplified reimbursement price paid by plans to CVS that the company craftily describes as “Guaranteed Net Cost”. Craftily, in that this so-called “cost” is really a “price” where the difference between “cost” and “price” is a markup.

The company touts the following distinguishing features of this simplified reimbursement price.

- Drug cost predictability and simplicity
- 100% of rebates are passed through to plan sponsors
- Simpler payments flow -- no retrospective rebates or inflation adjustments
- Simpler way to compare different PBM contract proposals

Note this new pricing model is for **brand** drugs only dispensed at retail, mail order and specialty pharmacies. The generic Rx drug reimbursement pricing scheme remains the same. That is to say, it preserves an opaque “spread margins” that PBMs like CVS add on top of CVS reimburses retail pharmacies for a generic Rx drug fill.

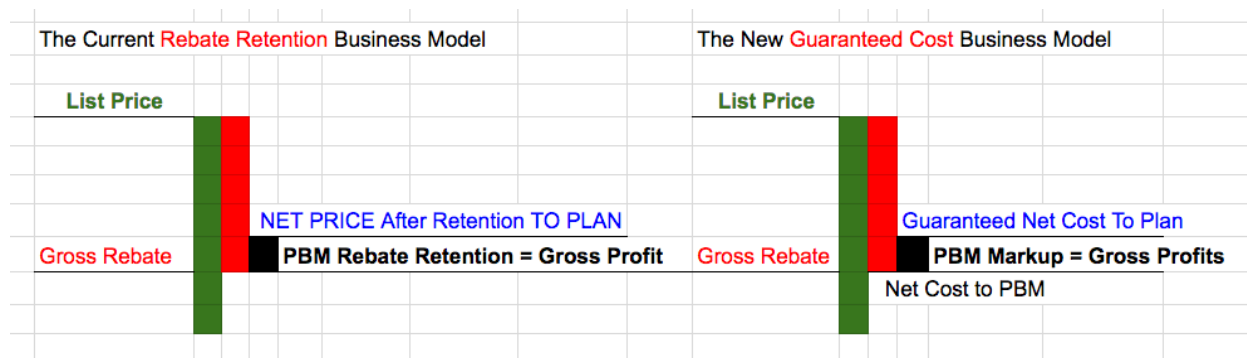
This new CVS’s initiative clearly is in response to the tsunami of criticism by plan sponsors over an opaque PBM business model and the difficulty in matching initial Rx reimbursements at an inflated list prices with retrospective rebates occurring months later.

## **The Problem with CVS’s Guaranteed Net Cost Business Model**

### **One: Opaque Markups**

Current <b>Retained Rebate</b> Business Model			New <b>Guaranteed Net Cost</b> Business Model		
	List Price	\$ 100	List Price		
	Gross Rebate to PBM	\$ (70)	Gross Rebate to PBM		
	Net Cost to PBM	\$ 30	Net Cost to PBM		
<b>OPAQUE</b>	<b>Retained Rebate</b>	<b>\$ 7</b>	<b>Mark-Up</b>	<b>OPAQUE</b>	
	Net Cost to Plan	\$ 37	Guaranteed Net Cost to Plan		
Retained rebate is equivalent to 100% pass-through with mark-up					

Here is a graphical depiction of our view that CVS is substituting an opaque markup for an opaque rebate retention:



To CVS's credit, its new guaranteed net cost eliminates timing complexity. It does this by taking a risk and netting the current period Rx reimbursement with an estimated "expected" rebate rather than wait to credit plans with the actual rebate when it is paid by Pharma months later.

CVS certainly is justified in including some markup as compensation for taking the risk that their estimated expected rebates turn out to be less than actual rebates.

Instead, CVS decided not mention markup at all, let alone a justified markup as a compensation for assuming timing risk.

## TWO: Doubtful Elimination of Incentive to Play the High List - High Rebate Game

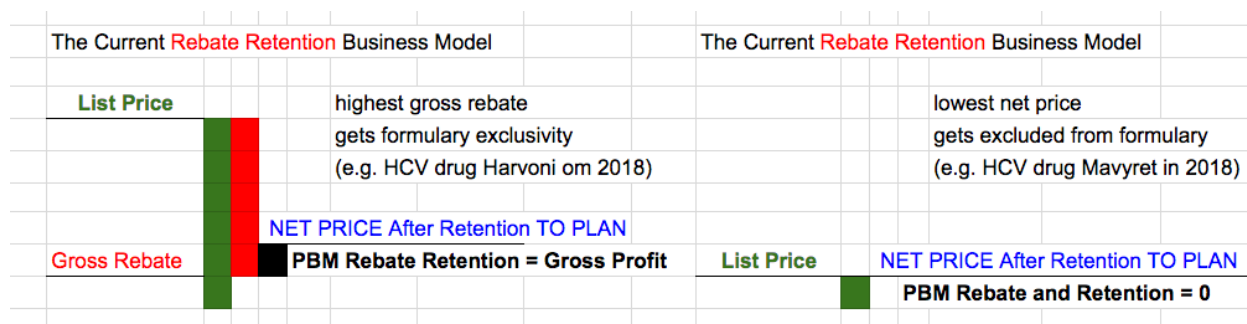
Under the current retained rebate business model, PBMs are incentivized to favor drugs with the highest gross rebates to the exclusion of therapeutically equivalent drugs with the lowest net cost. To be in a position to win this rebate game with the highest gross rebate bid, Pharma are driven by the PBM-created rebate game to inflate list



prices for its brand drugs. See our paper: [Blame PBMs \(Not Pharma\) for Drive Drug Price Inflation](#)

The list price - net price bubble began around 2010 and reached its peak in 2017. It was in 2017 that AbbVie [first broke the PBM rebate game](#) winning formulary placement by Express Scripts despite pricing its late entrant Hepatitis C Virus (HCV) drug Mavyret with an ultra low list price with no rebate potential. However, this was an exception and the norm remains that the basis for formulary placement is gross rebates over net price (list price - gross rebates).

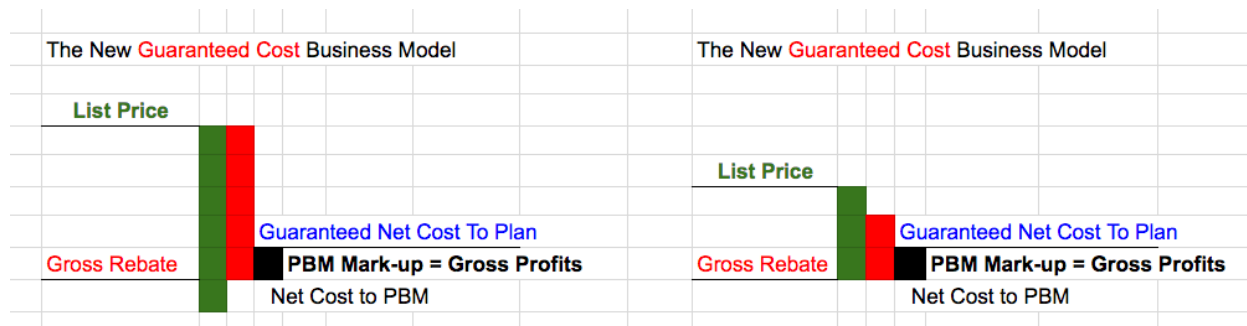
Below is a graphical depiction of how AbbVie broke the rebate game with its ultra low list = no rebate drug HCV drug Mavyret.



It is possible that the rebate game of high list - high gross rebate may be lessened under CVS's new guaranteed net cost new business model. This is because the basis for PBM profits -- markups -- could be any number as opposed to being tethered to something like % of gross rebates or % of net cost.

Below is a depiction of CVS's flexibility in choosing a markup that is independent of the list price or gross rebate. It is the new business model will be incentivized CVS to favor a low list - low rebate drug over a high list - high rebate drug.

Below is a graphical depiction of this possibility.



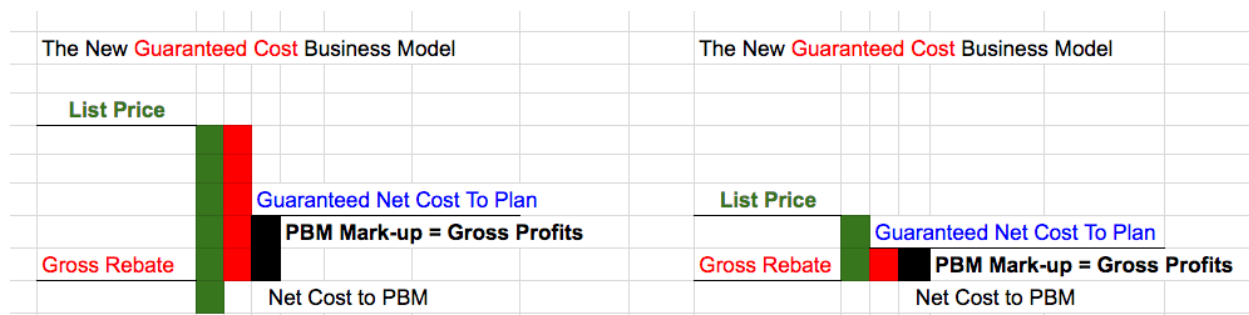
On the other hand, we can see the possibility that the new business model with preserve the status quo. Here is our line of reasoning for this:

it is likely that brand drug list prices, which are publically available, will serve as an upward bound for guaranteed net cost as it would look bad for CVS to set a guaranteed net price that exceeded a drug's list price.

To look good, CVS will want to show that guaranteed net costs is consistently 40% to 70% below the brand list prices.

To achieve these percentages while still having room for oligopolistic markups, CVS will signal to Pharma that, while formulary placement is no longer based on gross rebates, high list - high rebate drugs afford CVS latitude in setting guaranteed net cost markups.

Below is a graphical depiction of why, under the new business model, CVS still would be incentivized to favor the high list - high rebate drug.



## Towards a Transparent Fee-for-Service PBM Business Model

One of the stated reasons CVS why introduced this new business model was to make it simpler for plan sponsors to make better decisions between competing PBMs come time for contract renewal. However, we have demonstrated that the new business model leaves lots of room for opaque margins. It still lacks the simplicity for comparing PBM contracts on a pure management cost basis separate from delivered drug spend.

We propose a transparent alternative -- a simple fee-for-service (FFS) on a \$ / PMPY basis

Based on our prior estimates in our 2017 paper "[Three Phases of the PBM Business Model](#)" of the current distribution of PBM gross profits by source, specifically retained rebates, we derive a transparent fee-for-service substitute for opaque retained rebates:

Our estimate for a transparent FFS equivalent to retained rebates amounts to \$169 PMPY.

A Transparent Fee-For-Service Alternative To Opaque Sources of Retained Rebate Gross Profits					
Line					
A1	CVS Caremark -- Gross Profits 2017	\$ 5,901 Mil	<a href="#">Source: 10-K, p.181</a>		
A2	Plan Members - 2017	22 Mil	<a href="#">Source: CVS Company Facts and Figures</a>		
A3	Gross Profit (GP) - Per Member Per Year (PMPY)	\$ 268	= A1/A2		
A4	CVS Caremark 2017 DrugSpend Trend - PMPY	\$ 1,067	<a href="#">Source: CVS 2017 Trend Report</a>		
A5	Gross Profits as % of PMPY Drug Spend Trend	25%	= A3/A4	Comment: Oligopolistic	
A6	Estimated GP -- Specialty Drugs Retained Rebates	50%	<a href="#">Source : Abrams - 3 Phases PBM Business Model</a>		
A7	Estimated GP -- Small Molecule Drugs Retained Rebates	13%	<a href="#">Source : Abrams - 3 Phases PBM Business Model</a>		
A8	Estimate Gross Profit -- Total Retained Rebate	63%	= A6 + A7		
A9	Retained Rebates - 2017 PMPY	<b>\$ 169</b>	<b>=A10 * A17</b>		
<b>Estimated PMPY Fee-for-Service Alternative to Retained Rebates</b>					

If the PBM industry were more competitive, and clients could compare PBM contracts on the basis of a single PMPY fee-for-service replacing rebate retention, we estimate that the figure would be half of \$169 PMPY, or around \$85 PMPY.

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