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Private label generic drugs: what's the impact on plan sponsors?

February 22, 2010 | Mike Sullivan



Shoppers Drug Mart created a stir on February 11 when they announced their fourth quarter and full year results by confirming the rumour that they would be expanding their famous private label line in 2010 to include generic drugs. What are the ramifications for plan sponsors?

One would think that since private label products are almost always more competitively priced than their comparator products, this must be a good news story. However, the world of prescription drug pricing is far different and more complex than that of dish soap, paper towel and crackers.

It's an irrelevant development for private plan sponsors, as private label generics will have no impact on private sector costs for the foreseeable future. Before exploring why this story isn't relevant to private plans, it should be noted this move to vertically integrate the drug supply and distribution chains is nothing new in Canada.

The widely respected Jean Coutu Group in Quebec started the integration ball rolling in late 2007 through their acquisition of what was then the 14th largest generic drug maker in Canada – Pro-Doc of Laval. At the time, the news barely caused a ripple because Jean Coutu was dealing with write-offs related to its troubled Rite-Aid investment in the United States. Further, the situation only applied to the Quebec market. When Jean Coutu acquired Pro-Doc, the generic company's sales were reported to be in the range of \$12 million annually. In 2010, Jean Coutu expects Pro-Doc sales to exceed \$100 million.

Fast-forward to today, where it seems anything related to drug pricing, especially generic drug pricing, is noteworthy. Pharmacists and pharmacy chains are becoming increasingly frustrated that generic drug pricing is such a central focus for provincial governments, not to mention private plans sponsors. They point to the fact that while approximately half of the prescriptions in Canada are filled for generics, these medications still only account for about a 25% of drug spending. There seems to be palatable exasperation in pharmacy circles that the amount of money spent on brand name drugs and the opportunities to drive more cost-effective drug utilization is not commanding more attention.

The reason why generic prices are such a focal point in private plans is that an enormous variation in generic drug costs has emerged in private plans across the country. Let's take the case of Plan Sponsor ABC that spent \$3.8 million in prescription drug costs for its employees in 2009 across approximately 70,000 claims. In looking at every major generic molecule within that plan experience in Ontario (where a majority of claims were incurred), the range in *eligible* generic ingredient cost between the lowest cost claim and the highest cost incurred for a given product was between 40-48%.

Put another way, a plan member in one region was paying between 40-48% more for the same generic drug than another plan member with the same plan coverage. It's for this reason that generic pricing, to the dismay of pharmacists and pharmacy operators, has become a central issue for private plans. By comparison, the range of eligible ingredient costs on the most widely claimed brand drugs for Company ABC only ranged between 7-11%.

Many plan sponsors have trouble understanding how prices can range by 40% or more. Most claims processors in Canada will set one price per region in their system for a given plan, and allow a pharmacy to charge up to that maximum for a given ingredient cost. Those maximums for generic drugs are based on Manufacturer List Prices plus an allowable mark-up tolerance. However, since pharmacies buy generic drugs at different prices depending on their size and vendor relationships, a significant range in actual acquisition cost exists. That is very different from the case with brand name drugs where most pharmacies have to buy directly from wholesalers and will pay close to the same amount for a given brand name drug.

If one pharmacy provider decides to sell a generic drug at a price below the Manufacturer List Price, but another takes full advantage of the maximum eligible cost they are allowed to charge thanks to the one maximum price per region set-up, that is where differences of 40-48% emerge. That's why this move to private label generics is only an interesting story if you own Shoppers Drug Mart stock and are concerned about their profit margins.

You have to give industry leaders like Shoppers Drug Mart and the Jean Coutu group credit. Their senior management teams are intelligent, understand the landscape very well, and are always ahead of the curve. You don't get to bump your dividend by 5% and set ambitious growth targets by not maximizing profitability.

The pharmacy community is worried about the outcomes of pending provincial government negotiations in Ontario that are likely to impact public sector generic pricing and will set the stage for the rest of the country. The Shoppers Drug Mart move is a defensive one to deepen margins and gain more control of the supply chain during a period of uncertainty where provincial governments may start to aggressively cut away margin on generic drugs in a bid to contain their own plan costs. They are well within their right to do whatever they can to insulate themselves.

There has been speculation that the provincial government in Ontario (and other jurisdictions that follow suit) could mandate significantly lower generic costs for both public and private sector plans. Alberta was successful in establishing unified pricing for the public and private sector, but that was because their price reductions on generics were not overly significant and there is less control in Alberta on pharmacy and generic vendor relationships.

That scene appears to be very unlikely to reproduce itself in Ontario because if regulating drug costs for the private sector was a priority in the province it would have been a feature with Bill 102. Why would the Ontario government risk its ability to achieve the best possible pricing structure through legislated decreases in generic drug costs and listing agreements with brand companies by insisting those sale deals also be made available to the other 50% of the market? When did the government start to care what Plan Sponsor ABC pays for drugs, especially when many plan sponsors don't know that answer themselves?

What this means for private plans is that there is no incentive for pharmacies to not submit the highest eligible prices for a drug when someone else (i.e. a private plan) is picking up a vast majority (if not all of) the tab. If the adjudication process allows you submit a cost of x and you can now source generics cheaper and still charge x to maximize profits within the private sector to make up for revenue losses on your public sector book of business, what would you do?

What would shareholders want you to do?

There are some excellent opportunities for pharmacies and private plan sponsors to partner for their mutual benefit, and for the benefit of the plan members within these plans. However, that will come from proactive initiatives between both parties, not through the introduction of private label generics.