The CVS-Caremark Merger:
The Creation of an Elasticity of Demand for Retail Rx

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11/1/06

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Disclosures:

I have not received any remuneration for this paper nor have I financial interest in any company cited in this working paper.

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The CVS-Caremark merger is supposedly a merger of equals based on the prospects of greater purchasing power.

But, really it will be Caremark attempting to save CVS as it transitions its business model from being dependent on a profitable pharmacy operation subsidizing a front store with low to nil net profits.

This merger is an attempt to cope with a new era of "competition by price" replacing an era of "competition by convenience".

The tipping point has been the Wal-Mart announcement and the First Databank admission of an arbitrary increase in the AWP mark-up ratio.

These recent events will trigger demands by plan sponsors that their PBM vendor negotiate steeper discounts with retail pharmacies.

No longer will PBMs be allowed to "hold up" retail reimbursements so as to make it easy to show that their captive mail order operations are cheaper.

Merger or not, Caremark has to force CVS to accept steeper reimbursement discounts. But, now with the merger, Caremark has the incentive to create greater retail volume to offset lower unit margins on retail prescriptions.

In economic terms, Caremark has the incentive to create a "price elasticity of demand" for retail prescriptions that has not existed before. Elasticity of demand is the *sine non qua* of price competition.

Without the merger, Caremark has no incentive to steer demand to any retailer.

Caremark will create this greater price elasticity of demand for CVS by moving toward a "preferred provider" retail network with real incentives for both plans and their members to choose CVS.

Currently, PBMs create extensive retail networks with upwards of 60,000 pharmacies. Usually, the co-pay is the same for all pharmacies within the network.

Also, PBMs generally are content to set a single reimbursement rate for all retailers – large or small. This benevolence allows low cost retailers like CVS and Walgreen to retain the "producer surplus".

All of this will likely change with the CVS-Caremark merger.

Caremark will try to convince its clients to adopt a "preferred provider" network that favors CVS. As an incentive to use the preferred provider, Caremark will suggest the following:

(1) Low to nil co-pays if CVS is chosen, higher co-pays if another retailer is used
(2) 90-day retail prescriptions at CVS only
(3) OTC drugs, maybe even vitamins, covered by plan if bought at CVS only

Of course, to insure enthusiasm for this differential treatment, Caremark might have to offer plans lower reimbursement rates if their members choose CVS over some other retailer.

If there were no prospects for a price elasticity of demand, drugstore chains would be forced to make changes designed to increase the net profitability of their front store operations.

This would mean high prices for convenience goods and/or reduced operating expense margins through reduced store expansion in order to prop up front store sales per store.

But such moves play right into the hands of Wal-Mart.

Wal-Mart can compete on price, but not on convenience. By forcing drugstores like CVS to eliminate cross-subsidies in its business model, Wal-Mart will be raising the cost of convenience.

Wal-Mart is after CVS's front store as much as its pharmacy.

The merger is designed to shore up pharmacy gross profits –increased volume offsetting lower unit margins – so as to avoid increasing the cost of front store convenience.