# De-Capitation:

## Express Scripts' Unspoken Plan for its Wellpoint PBM Acquisition

**by**
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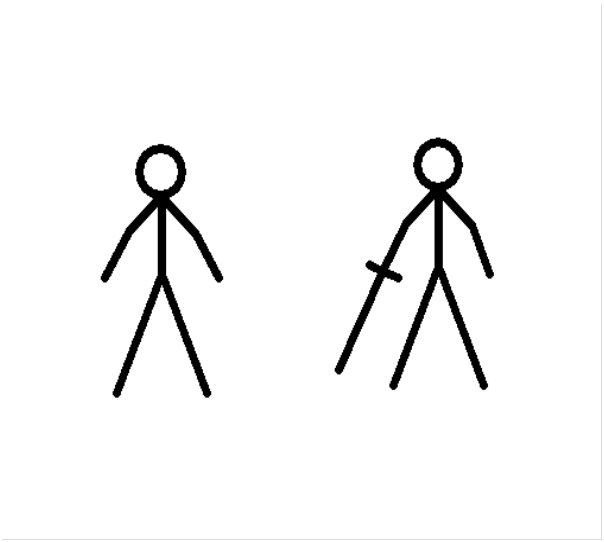

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**Disclosures:**

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### Introduction

On April 13th 2009, Express Scripts, the third largest independent pharmacy benefit manager (PBM), acquired the captive PBM business of Wellpoint, one of the largest integrated healthcare insurance companies and the largest Blue Cross Blue Shield (BCBS) licensee in the United States. The deal was for $4.675 Billion, little of which was for the rights to physical assets and human capital. Most of Express Scripts' valuation was based on obtaining a 10 year contract to service the 25 million people, and their 265 million prescriptions, currently managed by Wellpoint's PBM. The valuation also included a significant consideration given to Wellpoint in return for structuring the deal to be tax advantageous to Express Scripts. According to Express Scripts' CFO, Jeff Hall [1]

> Although he refused to give a dollar figure for what the service contract was worth, Hall noted that it was a "significant portion" of the $4.675 billion purchase price.
>
> Also included for the purchase price was consideration for the value of a future tax benefit for Express Scripts based on the structure of the transaction. As a result of the arrangement, the company will be able to claim depreciation on most of the purchase price over 15 years, according to Hall. Assuming the company's 37 percent tax bracket, it would get about $300 million a year of tax deductions, which will amount to $100 million to $125 million a year in tax savings. Without that advantage, Express Scripts would have paid a billion dollars less for the deal, says Hall.

**The purpose of this paper is to present the case that this merger would be anti-competitive as measured by increases in risk-adjusted prices paid by plan sponsors and their members for pharmacy benefits.** The Federal Trade Commission should not allow this merger to close without an extensive investigation.

**The Big 3 PBMs: Not an Oligopoly, Not an Oligopsony**

On the surface, the deal is essentially a horizontal merger of resellers of prescription drugs. PBMs buy drugs either from retail drug stores or from their captive mail order operations and resell them as pharmacy benefits to plan sponsors. Table 1 presents a view of what we believe is an intermediate market dominated by 3 firms with pricing power on both the buy-side and sell-side.

**Table 1: Concentration in the PBM Industry**

| PBM | Source | Managed Rx Un Adj Millions 2008 | % of Outpatient Rx |
|---|---|---|---|
| CVS / Caremark / Longs | 2008 10-K | 633 | 16.1% |
| Medco | 2008 10-K | 586 | 14.9% |
| Express Scripts | 2008 10-K | 420 | 10.7% |
| Big 3 PBMs | | 1,639 | 41.6% |
| Wellpoint NextRx | Note 1 | 265 | 6.7% |
| Total Managed by PBMs | Note 2 | 3,943 | 100.0% |

Source:
Note 1: Estimate of Rx managed by Wellpoint PBM available at
http://www.nytimes.com/2009/04/14/business/14drug.html

Note 2: Total Rx managed by PBMs available at
http://www.pbmi.com/PBMmarketshare2.asp

The simple view is to analyze the likelihood that this pricing power will be passed on to consumers as lower prices or used to restrict demand/supply and raise prices. But the problem is that the Big 3 PBM business model is vastly more complicated than the theory of the firm. The Big 3 PBM business model simply is not structured to favor a strategy of maximizing profits by limiting supply.

Indeed, the Big 3 PBMs earn more money by NOT disrupting the drug supply chain. They are in the protection business. They maximize profits by protecting Pharma and retailers from price competition. We say they have a “Tony Soprano business model”.

**PBMs as Conflicted Countervailing Powers**

PBMs are buyers as well as sellers of prescription drugs  This fact complicates any competitiveness assessment of a horizontal merger among large PBMs  The Big 3 PBMs claim that their size enhances their bargaining power with retail pharmacies and brand drug manufacturers. They act as "countervailing powers", a term coined by John Kenneth Galbraith in the 1960s.  This bargaining power is enhanced by the threat of "self-supply" via captive mail order operations.  The Big 3 PBMs claim that horizontal mergers are pro-competitive because they lead to lower negotiated prices from retail pharmacies and higher rebates from manufacturers, which are passed on to plans.

While it is possible that large resellers can be countervailing and pro-competitive, we have presented the case elsewhere that the Big 3 independent PBMs are conflicted.[2]

Because of a business model that still depends on retained rebates, the Big 3 PBMs are co-opted partners with Pharma in a series of bilateral oligopolies, as embodied in therapeutic classes in formularies. The Big 3 PBMs shelter blockbuster "me-too" drugs from price competition by cheaper generics that are therapeutic equivalents.  Contrary to most who analyze the rebate issue, we believe that the Big 3 PBMs do NOT receive rebates for switching prescriptions from generics to higher priced brands, an easy to detect sin of commission.  Rather, they are paid rebates for abstaining from switching a "me too" brand like Lipitor to a therapeutically equivalent generic like simvastatin, a hard to detect sin of omission.

The failure to countervail retail pharmacies can be traced to the evolution of PBMs as both payers and providers of pharmacy benefits. The Big 3 PBMs all have captive mail order operations that have become their leading source of transactional gross profits.  Historically, PBMs may have decided to invest in captive mail order as a "threat of self supply" if they did not get favorable

prices from retailers like Walgreen or CVS. Up to a point, the practice of self-supply by retailers is pro-competitive.

However, when resellers become too dependent on the profits from captive supply operations, they become reluctant to bargain hard with alternative, outside suppliers. A powerful incentive is created to pay intentionally high prices to outside suppliers in order to price "self-supply" lower without margin erosion. This seemingly perverse practice makes sense for the Big 3 PBMs only because their contracts with plans sponsors specify 100% reimbursement of all retail prescriptions.

There are three deterrents to the Big 3 PBMs practice of holding up retail prescription reimbursements: (1) Other PBMs with channel neutral business models would not go along with the retail price hold up and initiate price competition in the retail channel via preferred provider contracts, like, say a CVS/Caremark or Prime Therapeutics; (2) Plan sponsors would not renew contracts with the hold-up PBMs and switch to other PBM demonstrating a more aggressive stance toward retail reimbursements; and (3) A retail pharmacy, say a Wal-Mart, enters into direct contracts with plan sponsors offering competitive retail prices in return for preferred provider status.

The only PBMs with the incentive to hold-up retail reimbursements are the ones with contracts guaranteeing 100% retail reimbursements coupled with a dependency on captive mail order operations to generate a majority of gross profits. There is no incentive for PBMs operating on fixed premium contracts to participate in the hold-up. This combination of reseller features – ability to hold up prices of alternative suppliers without incurring consequences coupled with substantial self-supply -- causes individual action to appear as if it were the result of some coordinated effort to be anti-competitive. Among antitrust professionals, this is known as a facilitating practice.

**Business Model as an Issue in the Express Scripts – Wellpoint Deal**

Were this just another horizontal merger among large independent PBMs, like Express Scripts' bid for Caremark in 2006, we would not feel compelled to go beyond our conflicted countervailing power argument summarized above and explained in detail in our two papers "The CVS-Caremark Merger and the Coming Preferred Provider War," and " Pharmacy Benefit Managers as Conflicted Countervailing Powers".[2]

But, this is not a merger of independent PBMs with the same business model based on opaque transactional margins. This is buyout of a captive PBM of an integrated insurance company with a mix of contracts. We estimate that close to half of Wellpoint's PBM business is based on fixed-premium, or capitated contracts.[3] The rest of Wellpoint's PBM business is similar to the Big 3 PBMs – contracts with public and private plans that are self-insured where the PBM earns income from such transactional margins such as retail spread, retained rebates, and mail order generic dispensing margins. Table 2 compares the distribution of contracts by type for Express Scripts, and for the captive PBM operations of Wellpoint and Coventry.

Another issue specific to this merger is the efficiency of the benefit management side of the business – the use of management techniques to drive cost-savings through mail order penetration rates (MOPR) and generic dispensing rates (GDR) – which is independent of scale. Specifically, the Big 3 PBMs have demonstrated superiority in driving mail order penetration rates, with Express Scripts MOPR now standing at 24.4% while Wellpoint's MOPR is estimated to be only 10%. The industry leader is Medco, with 39.8%, but this is skewed by the mail-order only contract for the Federal Employee Health Benefit Plan (FEHBP).

It is said that because integrated insurance companies are focused primarily on managing medical benefits, they do not manage the pharmacy benefits business as carefully as a fully focused independent PBM.

**Table 2: Members by Type of Healthcare Contract**

For insurance companies, assume that breakdown of contract type is the same for pharmacy as for overall

| Type of Plan | Sector | Business Model | Covered Lives | |
|---|---|---|---|---|
| **Express Scripts** | Public & Private | non-risk, transactional margins | 50,000,000 | 100% |
| Service Provider to Insurance companies and self-insured plans | | | | |
| Estimate of Express Scripts covered lives available at http://www.aishealth.com/MarketData/PharmBenMgmt/PBM_market01.html | | | | |
| **Wellpoint** | | | | |
| **Fixed Premiums (capitated)** | Public & Private | At risk, capitated premiums | 11,750,000 | 47% |
| **Self-Insured plans** | Public & Private | non-risk, transactional margins | 13,250,000 | 53% |
| | | | 25,000,000 | 100% |
| Estimate of Wellpoint NextRx PBM covered lives available at http://www.nytimes.com/2009/04/14/business/14drug.html | | | | |
| Estimate of Wellpoint membership by type of contract available at http://industry.bnet.com/healthcare/1000204/wellpoint-holds-the-line-for-now/ | | | | |
| **Coventry** | | | | |
| Commercial | Private | at risk, capitated premiums | 1,500,000 | |
| Individual | Private | at risk, capitated premiums | 122,000 | |
| Medicaid | Public | at risk, capitated premiums | 371,000 | |
| Medicare Advantage | Public | at risk, capitated premiums | 380,000 | |
| Medicare Part D | Public | at risk, capitated premiums | 931,000 | |
| **Fixed Premiums (capitated)** | | at risk, capitated premiums | 3,304,000 | 71% |
| Commercial | Private | non-risk, transactional margins | 714,000 | |
| Public Sector Employees | Public | non-risk, transactional margins | 610,000 | |
| **Self-Insured Plans** | | non-risk, transactional margins | 1,324,000 | 29% |
| Coventry Total | | | 4,628,000 | 100% |
| Estimate of Coventry's membership by type of contract available at http://yahoo.brand.edgar-online.com/displayfilinginfo.aspx?FilingID=6444926-127108-130317 &type=sect&dcn=0001054833-09-000013 | | | | |

The purpose of the rest of the paper is to present the case that Express Scripts' valuation for Wellpoint's PBM business implies a return on investment greater than what could be achieved by a doubling of the MOPR. A return on the valuation can only be achieved through a significant conversion of capitated contracts into self-insured transactional contracts. We call this "decapitation". This is Express Scripts' unspoken plan for its Wellpoint PBM acquisition.

**What is a PBM Worth? Valuation as a Function of EBITDA / Adjusted Rx**

A common measure of PBM profitability is earnings before interest, taxes, depreciation, and amortization (EBITDA) per adjusted script (Rx). Adjusted scripts accounts for the fact that a mail order script is generally 3 times the number of pills as a retail script – 90 days versus 30 days. The measure of profitability excludes usage – scripts per member per year (PMPY) – as usage varies by plan design and member demographic, which are generally out of the control of the PBM. Cash flow from operation is closely correlated with yearly EBITDA / Adj Rx.

In a recent interview with CFO.com, Jerry Hall, the CFO of Express Scripts, acknowledged that projected cash flow of the 10 year contract to manage Wellpoint's PBM business was the key to its valuation of the deal:[1]

> When Express Scripts acquired the pharmacy-benefit-management business of Wellpoint in a $4.675 billion deal announced Monday, an important part of the linchpin of the deal for Express Scripts was its acquisition of ten years worth of projected cash flow and 25 million new clients, says Jeff Hall, the company's CFO.
>
> In putting the acquisition together overall, the finance chief was particularly focused on getting an accurate assessment of how much cash Wellpoint's business would produce in the future.

Hall also noted in the interview that a significant portion of the $4.765 Billion bid contained a consideration for Wellpoint's structuring the deal to shift the tax benefit to Express Scripts.

> Also included for the purchase price was consideration for the value of a future tax benefit for Express Scripts based on the structure of the transaction. As a result of the arrangement, the company will be able to claim a depreciation on most of the purchase price over 15 years, according to Hall. Assuming the company's 37 percent tax bracket, it would get about $300 million a year of tax deductions, which will amount to $100 million to $125 million a year in tax savings. Without that advantage, Express Scripts would have paid a billion dollars less for the deal, says Hall.

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By subtracting a tax benefit of $1 Billion – the present value of $100-$125 Million per year over 10 years -- and a $200 Million estimate for the value of physical assets, we derive in Table 3 below an estimate of Express Scripts' valuation of the 10 year contract at $3.475 Billion.

Based on the Express Scripts CFO quote, that valuation of $3.475 Billion represents an estimate of the net present value (NPV) of the cash flow generated by a 10 year contract. Assuming cash flow is equal to EBITDA, then yearly EBITDA of $472 Million over 10 year at 6% interest underlies the NPV of $3.475 Billion. Divide that by our estimate of Wellpoint's currently adjusted Rx under management of 284 million and we arrive at $1.66 EBITDA / Adj Rx. **To realize a return over and above its purchase of the 10 year contract for $3.475 Billion, Express Scripts must generate more than $1.66 EBITDA / Adj Rx. from Wellpoint's PBM operations**.

**Table 3 : Estimate of EBITDA / Adj Rx Implicit in ESRX's Valuation of 10 Year Contact**

| Item | Row | Source | WLP - PBM | |
|---|---|---|---|---|
| | | | | millions |
| Total Purchase Price | r1 | Note 4 below | $ | 4,675 |
| ESRX Value of Tax Saving Structure of Deal | r2 | Note 1 below | $ | (1,000) |
| Estimated Valuation of " Bricks & Mortar" | r3 | Our estimate | $ | (200) |
| Value of 10yr Contract | r4 | =sum(r1:r3) | $ | 3,475 |
| Implied Yearly EBITDA flow over 10 yr at 6% | r5 | NPV( r5 at 6%, 10 years) = 3,475 | $ | 472 |
| Adjusted script | r6 | Table 5 Row 8 below | | 284 |
| **Implied EBITDA / adj Rx in ESRX valuation** | **r7** | **= r5 / r6** | **$** | **1.66** |

It is instructive to compare Express Scripts valuation of $1.66 EBITDA / Adj Rx with an estimate of what Wellpoint's PBM is now generating. This is done in Table 4, based on the key statistic that Wellpoint's PBM "contributed less than 10% of the total company profit" as reported by AP writer Dinah Wisenberg Brin, based on interviews with Wall Street analysts.[5]

**Tabel 4: Estimate of Current EBITDA / Adj Rx of Wellpoint's PBM**

| Item | Row | Source | WLP - PBM millions |
|---|---|---|---|
| EBIT | r1 | 2008 10-K | $ 3,112 |
| Amorization | r2 | 2008 10-K | $ 428 |
| Depreciation | r3 | 2008 10-K | $ 105 |
| Wellpoint EBITDA | r4 | sum(r1:r4) | $ 3,645 |
| Wellpoint - PBM EBITDA @ 9% | r5 | r4 * .09 | $ 328 |
| Unadjusted Scripts | r6 | Note 4 | 265 |
| Adjusted Scripts | r7 | Table 5 - row 8 | 284 |
| **Wellpoint PBM Current EBITDA / Adj Rx** | **r8** | **=r6 / r7** | **$ 1.16** |
| Implied EBITDA / adj Rx in ESRX valuation | r9 | Table 3 - row 7 | $ 1.66 |
| Current EBITDA / adjust Rx of Express Scripts PBM | r10 | Table 5 - row 12 | **$ 2.75** |
| **ESRX Valuation of Wellpoint PBM 10 Year Contract** | | | |
| Valuation represent a premium over current EBITDA | r11 | = (r9 - r8) / r8 | 43.7% |
| or | | | |
| Valuation represent a discount over ESRX EBITDA | r12 | =(r9 - r10) / r10 | -39.5% |

## Explaining Differences in EBITDA / Adj Rx

What is the thinking behind Express Scripts' valuation of the Wellpoint PBM that causes it to be is 43% higher than its current's profitability?

And, why is the current profitability of Wellpoint's PBM so much lower than the profitability of both Express Scripts' and Medco (MHS) as measured by EBITDA / Adj Rx, and summarized in Table 5 below?

**Table 5: Comparison of EBITDA / Adj Scripts**

| Item | Row | WLP-PBM Source | WLP-PBM | ESRX | MHS | ESRX / MHS Source |
|---|---|---|---|---|---|---|
| Covered Lives | r1 | Note 4 below | 25 | 50 | 60 | Note 5 |
| Total scripts - unadjusted | r2 | Note 4 below | 265 | 420.4 | 586 | 2008 10-K |
| Generic dispensing rate - unadjusted | r3 | n.a | | 66.2% | 64.0% | 2008 10-K |
| Mail Order penetration rate - unadjusted | r4 | = (r10) / (3 - (2 * r10)) | 3.6% | 9.7% | 18.1% | =r5 / r2 |
| Mail Order Rx - unadjusted | r5 | = r2 * r4 | 9 | 41 | 106 | 2008 10-K |
| Mail Order Rx - adjusted | r6 | = r5 * 3 | 28 | 122 | 318 | 2008 10-K |
| Retail Scripts | r7 | = r2 * (1 - r4) | 256 | 380 | 480 | 2008 10-K |
| Total Scripts - adjusted | r8 | =r2 *(1 +( 2 * r4)) | 284 | 502 | 798 | 2008 10-K |
| Adj Scripts / Cover Lives | r9 | = r8 / r1 | 11.4 | 10.0 | 13.3 | = r8 / r1 |
| Mail Order penetration rate - adjusted | r10 | Note 8 below | 10.0% | 24.4% | 39.8% | 2008 10-K |
| EBITDA | r11 | Table 1 - r6 | $ 329 | $ 1,378 | $ 2,461 | 2008 10-K |
| **PBM EBITDA / Adj Rx** | **r12** | **=r11 / r8** | **$ 1.16** | **$ 2.75** | **$ 3.08** | 2008 10-K |

To what extent are these differences in profitability due to superior negotiating power based on scale? How much is due to focused benefits management driving mail order penetration rates (MOPR) and generic dispensing rates (GDR)? In other words, how much is due to the ability of large independent PBMs to drive cost-saving efficiencies that presumably are passed on in part to customers in the form of lower prices with the rest going to EBITDA?

On the other hand, what if much of these differences are not due so much to efficiency differences, but due to business model differences – the distribution of contracts between transparent, capitated contracts with low EBITDA / Adj Rx and opaque, transactional contracts with high EBITDA / Adj Rx?

**The Potential for MOPR to Drive Improved EBITDA / Adj Rx**

The purpose of this section is to present an estimate of the potential to improve Wellpoint's current EBITDA by improving mail order penetration rates. Currently, Wellpoint's adjusted MOPR said to be at 10%.[8] What would be the EBITDA impact if Express Scripts could double that? Could that explain the 43% premium Express Scripts paid for Wellpoint's PBM?

Wall Street analysts most often mention MOPR as where Express Scripts could have the greatest impact on Wellpoint's profitability. This is because Express Scripts has become the leader in applying behavioral economics to benefits management. Behavioral economics justifies making consumer choice an "opt-out' rather than an "opt-in" proposition. Express Scripts has recently promoted mail order as an "opt-out" rather than an "opt-in" choice with spectacular results.

Table 6 below presents an estimate of the additional generic and brand scripts dispensed by Wellpoint's mail order operations if Express Scripts could double its adjusted MOPR -- approximated 16 million adjusted generic scripts and 16 million adjusted brand scripts moved from retail to mail order.

**Table 6: Estimate of the Incremental EBITDA Impact of Increased MOPR**

| Item | Row | Source | Millions |
|---|---|---|---|
| Incremental Scripts Due to MOPR from 10% to 21.1% | | | |
| Generic | r1 | see below | 16 |
| Brand | r2 | see below | 16 |
| Total | | | 32 |

**Express Scripts 24.4% MOPR**

Scripts by Channel by Type - unadjusted - Millions

| | Retail | Mail | Total | MOPR |
|---|---|---|---|---|
| Generic | 255 | 23 | 278 | |
| Brand | 124 | 18 | 142 | |
| Total | 380 | 41 | 420 | 9.7% |
| **GDR** | 67.3% | 55.6% | 66.2% | |

**Express Scripts 24.4% MOPR**

Scripts by Channel by Type - adjusted - Millions

| | Retail | Mail | Total | **MOPR** |
|---|---|---|---|---|
| Generic | 255 | 68 | 324 | |
| Brand | 124 | 54 | 178 | |
| Total | 380 | 122 | 502 | 24.4% |
| **GDR** | 67.3% | 55.6% | 64.4% | |

**Wellpoint 10% MOPR**

Scripts by Channel by Type - unadjusted - Millions

| | Retail | Mail | Total | MOPR |
|---|---|---|---|---|
| Generic | 161 | 5 | 166 | |
| Brand | 95 | 5 | 99 | |
| Total | 256 | 10 | 265 | 3.6% |
| **GDR** | 63.0% | 50.0% | 62.5% | |

**Wellpoint 10% MOPR**

Scripts by Channel by Type - adjusted - Millions

| | Retail | Mail | Total | **MOPR** |
|---|---|---|---|---|
| Generic | 161 | 14 | 175 | |
| Brand | 95 | 14 | 109 | |
| Total | 256 | 29 | 284 | 10.0% |
| **GDR** | 63.0% | 50.0% | 61.7% | |

**Wellpoint - 21.1% MOPR**

Scripts by Channel by Type - unadjusted – Mill\lions

| | Retail | Mail | Total | MOPR |
|---|---|---|---|---|
| Generic | 136 | 10 | 146 | |
| Brand | 88 | 10 | 98 | |
| Total | 224 | 20 | 244 | 8.2% |
| **GDR** | 60.7% | 50.0% | 59.8% | |

**Wellpoint - 21.1% MOPR**

Scripts by Channel by Type - adjusted - Millions

| **Wellpoint** | Retail | Mail | Total | **MOPR** |
|---|---|---|---|---|
| Generic | 136 | 30 | 166 | |
| Brand | 88 | 30 | 118 | |
| Total | 224 | 60 | 284 | 21.1% |
| **GDR** | 60.7% | 50.0% | 58.5% | |

To get an EBITDA estimate of the switch to mail order generics and brands, we need an estimate of gross profits per adjusted script of generic and mail order brands. We assume than an improved MOPR generates additional gross profits that fall right to the bottom line without an additional SG&A being incurred. We use estimates of gross profits per adjusted mail order script derived in our quantification of Medco's business model.[7] The estimates are presented in Table 7 below.

**Table 7: Estimate of Incremental EBITDA from MOPR**

| | Source | **Row** | Generic | Brand | Total - $ Millions |
|---|---|---|---|---|---|
| Incremental Rx through MOPR | Table 6 above | r1 | 16 | 16 | |
| Gross Profits / Adjust Rx | Note 7 below | r2 | $ 7.67 | $ 1.95 | |
| Gross Profits = EBITDA | r3= r1 * r2 | r3 | $ 123 | $ 31 | $ 154 |
| Current EBITDA - Wellpoint PBM | Table 4 above | r4 | | | $ 329 |
| Potential EBITDA via MOPR | = r3 + r4 | r5 | | | $ 483 |
| Adjusted Rx | Table 4 above | r6 | | | 284 |
| Potential EBITDA / Adj Rx via MOPR | =r5 / r 6 | r7 | | | $ 1.70 |
| EBITDA Implicit in Bid for Contract | Table 3 above | r8 | | | $ 1.66 |
| Return on Investment as measured by incremental EBITDA | = r7 - r8 | r9 | | | $ 0.04 |
| over bid | = r9 / r8 | r10 | | | 2.4% |

The result is that Express Scripts would barely cover its valuation of the 10 year contract via a doubling of the mail order penetration rate (MOPR). Something else must underlie their belief that they can generate a return significantly greater than $1.66 EBITDA / Adj. Rx.

**Decapitation: Express Scripts Unspoken Plan for its Wellpoint PBM Acquisition**

As indicated in Table 6, there are striking differences in the EBITDA of a captive PBM of an integrated insurance company like Wellpoint's -- $1.16 -- versus the EBITDA of the Big 3 PBMs -- $2.75 and $3.08, for Express Scripts and Medco, respectively.

Based on our estimates of the impact of improved MOPR on EBITDA, we believe that such differences cannot be explained by efficiency differences stemming from scale or management focus on MOPR and GDR. They must be due to something else.

We suggest that the differences are due to the differences in business models of the PBMs. Almost half of Wellpoint's customers are covered by transparent, capitated contracts whereas all of Express Scripts' and Medco's customers are cover by contracts without any capitation on PMPY reimbursements. We believe that the very transparency of capitated contracts cause them to be less profitable than contracts based on opaque transactional margins.

The root cause of Wellpoint's current low EBITDA / adj Rx is its business model of rather than any significant operational inefficiency. Decapitation - greatly reducing the percentage of Wellpoint customers covered by fixed premium, capitated contracts -- is Express Scripts' unspoken plan for realizing a sizable return on its investment.

While decapitation will raise EBITDA, what will be the impact on prices paid by customers for pharmacy benefits. Nominally, decapitation will lower the price of pharmacy benefits, as measured by PMPY benefit costs, because fixed premium PBM contracts historically exceed PMPY expenses incurred by self-insured plans. Indeed, the possibility of lowering PMPY costs in return for risk-assumption is the reason why companies of any size switch from fixed premiums to self-insurance. Especially in times of high drug spend trend, we believe that the decapitation of Wellpoint's PBM business would lead to higher prices for pharmacy benefits on a risk-adjusted

basis. For this reason, we believe that the Express Scripts' bid for Wellpoint's PBM would be anticompetitive.

The FTC should conduct an extensive investigation into the competitiveness of this deal. It might consider some provision that requires Express Scripts to guarantee customers currently covered by capitated contracts the right to continue this form of contract. For example, customers would be guaranteed that an upward adjustment to current premiums could not exceed a broad average trend in PMPY drug spend.

**Decapitation as a Blow to Managed Competition**

Managed competition is a system of healthcare cost containment based on defined contributions rather than defined benefits. Employees are presented with a wide array of plans covering medical, pharmacy, and other healthcare benefits. Each plan specifies a transparent, fixed premium that is paid by employees out of their defined contributions. The Federal Employee Heath Benefit Plan, often cited as a model for healthcare reform, is an example of managed competition.

The availability of fixed premium pharmacy benefit plans would diminish greatly if the Big 3 independent PBMs were allowed to buy the PBMs of captive insurance companies. We believe that if the Express Scripts – Wellpoint deal is approved, other insurance companies with captive PBMs exhibiting low EBITDA / Adj Rx, not some much because of lack of scale or efficiency, but because of a sizable portion of transparent, capitated contracts, will want to sell out to the Big 3 PBMs. Consider the following quote from the CFO of Cigna,[9]

> "In light of Wellpoint's recent announcement with Express Scripts, we are open to looking at strategic alternatives," Cigna CFO Mike Bell said in response to a question at a Bank of America conference, which was broadcast over the Internet.
>
> The main benefit of owning the pharmacy benefit business, Bell said, relates to Cigna's ability to offer customers integrated clinical information that can improve health of their members, such as data about whether they are staying on their medications.
>
> However, he noted, "The price tag of the Wellpoint acquisition certainly got a lot of people's attention, certainly ourselves included."

Further concentration of pharmacy benefit management in the hands of the Big 3 would be a blow to health care reform based on consumer choice of a wide variety of fixed premium, capitated plans.

**Notes**

(1) David M, Katz, cfo.com, "Want to Add a Decade of Cash Flow? Buy it," April 15, 2009, Available at http://www.cfo.com/article.cfm/13491841/c_13481387?f=home_todayinfinance

(2) LW Abrams, "The CVS-Caremark Merger and the Coming Preferred Provider War," December 2006 Available at http://www.nu-retail.com/CVS_Caremark_Coming_Preferred_Provider_War.pdf and LW Abrams, "Pharmacy Benefit Managers as Conflicted Countervailing Powers," January 2007 Available at www.nu-retail.com/quantifying_Medco_business_model.pdf

(3) Estimated of Wellpoint's distribution of contracts by type is available at http://industry.bnet.com/healthcare/1000204/wellpoint-holds-the-line-for-now/

(4) Reed Ableson, "Wellpoint Sells Its Pharmacy Benefits Division, NYT April 13, 2009 Available at http://www.nytimes.com/2009/04/14/business/14drug.html

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