

# Pharmacy Benefit Manager Profitability and Valuation:

## Business Models Matter

By

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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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### **Table of Contents:**

Introduction

The Variety of PBM Business Models

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

The Express Script – Wellpoint Deal

A Comparison of PBM EBITDA / Adj. Rx

Leveraging Overhead Costs as a Factor

The Potential for MOPR to Drive EBITDA / Adj Rx

Express Scripts' Unspoken Plan: Business Model Conversion

PBM Valuation as a Function of Business Model

Evaluating Express Scripts' Statement of the Deal's Potential

Wall Street is Overestimating the Value of Aetna's PBM

Scale as a Factor in EBITDA / Adj Rx

A General View of the Relation between PBM Scale and Performance

Express Scripts as a Risk-Bearing Entity

## **Introduction**

On April 13<sup>th</sup> 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 to service the 25 million people, and their 265 million prescriptions.<sup>1</sup>

The Wellpoint – Express Scripts deal is not a typical outsourcing of benefits management where there is little risk to the benefits manager that its costs would not be covered by fees or reimbursements. What is different is that this deal involves a full “book of business” – revenues as well as costs – and it includes a substantial share of risky, fixed premium insurance plans.

Express Scripts’ current business of servicing self-insured plans is completely different from Wellpoint’s business of managing a mix of fixed premium and administrative services only (ASO) plans. Express Scripts is a benefits reseller, not a benefits administrator. Ingredient and dispensing costs from pharmacies and rebates from Pharma flow first to Express Scripts who is allowed by contract to mark-up these costs or retain a portion of the rebates before passing them on to self-insured clients. In Wellpoint’s ASO plans, 100% of claim costs are passed directly to the client without flowing through the insurer’s financial statements.

Contracts of the Big 3 independent PBMs do contain transparent management fees, but these pale in proportion to opaque margins made on pharmacy reimbursements and retained rebates. In a recent paper, we estimated that Medco’s management fees averaged \$6.52 per member per year (PMPY) while transactional gross profits averaged \$42.66 PMPY.<sup>2</sup> If Medco’s business model were ASO instead of benefits reseller, it would have to charge

management fees many times more than \$6.52 PMPY to cover overhead costs sufficient to maintain profitability.

The purpose of this paper is to present the case that the difference in profitability between Wellpoint's PBM business and other PBM operations stems more from differences in business models than from differences in the efficiency of operations. And Express Scripts is paying a premium for Wellpoint's business on the expectation that it will be able to convert ("decapitate") some of Wellpoint's fixed premium and ASO plans to more profitable benefits reseller plans.

Shortly after the Wellpoint deal was announced, the CFO and the CEO of Cigna, a large healthcare insurance company, remarked publicly that it was considering selling its captive PBM operations. The executives admitted that their motivation for selling received a tremendous boost after analyzing Express Scripts' bid for Wellpoint's captive PBM.

After the Cigna revelation, the financial press quoted a Wall Street analyst as valuing the Cigna PBM at \$1.3 Billion. We compare this valuation with the potential profitability of Wellpoint as implied by the Express Scripts bid and with the actual profitability of Express Scripts. The additional data provided by the Cigna valuation only strengthens our claim that that the differences in PBM valuations are mostly due to differences in business models rather than management efficiency.

Very little detail has been revealed by either party about the Wellpoint – Express Scripts deal.

Consider the following exchange during Wellpoint's 1Q2009 conference call:<sup>3</sup>

**Matt Perry - Wachovia Capital**

And if I could just ask a second question on the sale of NextRx.... Just wondering how the deal might be structured in terms of who gets that ultimate savings, does Wellpoint recoup certain amount of savings from [\$1] or is that just split in a certain way from the first dollar just wondering how that might be structured?

**Angela Braly**

Well Matt, we don't want to get into too great detail about that because obviously that we would lose a competitive advantage if we did.

Important detail about the deal was provided by Express Scripts CEO Jerry Hall in an interview granted to CFO.com.<sup>4</sup> He noted that most of the valuation was based on a projection of cash flow over the life of the contract and that there was also a significant payment to Wellpoint in consideration for structuring the deal so the tax consequences were favorable to Express Scripts.

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.

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.

There is also a quote from Wellpoint CEO Angela Braly suggesting that this deal would not result in a complete transfer of management responsibilities.<sup>5</sup>

Wellpoint will retain control of medical policy, formulary and integrated disease management, and will work alongside Express Scripts to offer best-in-class pharmacy management and data analytics. Wellpoint members will gain access to better Web, home delivery and customer service capabilities, and clients will benefit from enhanced reporting.

Wellpoint would be retaining control of some aspects of plan design. But, Wellpoint said nothing about who will be in charge of marketing and sales and who will handle claims and data management other than that they “will work alongside Express Scripts”.

This paper will present the case that, from an efficiency standpoint, it is likely that Wellpoint will continue to manage most of the sales and general administration. Express Script will take charge of the promotion of mail order and direct efforts to convert the largest plans to Express Script’s benefits reseller business model. Consistent with this division of responsibility, it is likely that Express Scripts will be making substantial payments back to Wellpoint for its administrative work.

The final section of the paper examines some regulatory issues that accompany Express Scripts’ take-over of the 47% of Wellpoint’s book of business comprised of risky, fixed premium plans held by small businesses, individuals, and seniors under Medicare Part D plans.

### **The Variety of PBM Business Models**

Wellpoint’s PBM business is comprised of a mix of plans covering the 25 million people and 265 million prescriptions per year. These plans include small and large employer plans, government employee plans, individual plans, and Medicare Part D plans. The group and individual plans also can be categorized by business model – the basis a company chooses for collecting revenue and incurring costs.

Wellpoint has two basic business models: risk-based insurance contracts based on transparent fixed premiums and self-insured administration service only (ASO) contracts also based on transparent management fees.

While Wellpoint does not report any breakdown of **PBM** plans by business model, we can derive a rough approximation of this distribution from 10-K data on covered lives in **medical** plans.<sup>6</sup> This is presented in Table 1 below. Note Wellpoint reports 35 million lives covered by medical plans but only 25 million lives covered by pharmacy plans. This means that a considerable number of customers “carve-out” pharmacy benefits and turn management over to an independent PBM.

**Table 1: Wellpoint's 2008 Distribution of Covered Lives by Medical Plan Type**

<b>Medical</b>	1,000s	%
<b>Group Type</b>		
Local Group	16,632	47.5%
Individual	2,296	6.6%
National Accounts	11,456	32.7%
Senior	1,304	3.7%
State Sponsored	1,968	5.6%
Federal Employee HBP	1,393	4.0%
	<b>35,049</b>	100.0%
<b>Business Model</b>		
Risk premium	16,529	<b>47.2%</b>
Self-Insured ASO	18,520	<b>52.8%</b>
	<b>35,049</b>	100.0%
<b>PBM Covered Lives</b>	<b>25,000</b>	

Table 2 presents our attempt at nesting group type within business model type. We assume that all national account, state-sponsored, the Federal Employee Health Benefit Plans (FEHBP) are self-insured ASO plans. We also assume that all individual and senior (Medicare) accounts are risky, fixed premium plans.

The only question is the distribution of local, small business plans by business model. Fortunately, this is only remaining group type and the amount is a “plug” once all the other line items are distributed. Table 2 becomes useful later in estimating the extent to which Express

Scripts can switch Wellpoint customers from low profit, risk premium plans to higher profit benefits reseller plans.

**Table 2: Estimated Distribution  
of Wellpoint's PBM  
Covered Lives By Business Model**

<b>Risk Premium</b>	
Local Groups	36.9%
Individuals	6.6%
Seniors	3.7%
<hr/>	
Total Risk Premium	<b>47.2%</b>
<b>Self-Insured ASO</b>	
<hr/>	
Local Groups	10.6%
National Accounts	32.7%
State-Sponsored	5.6%
Federal Employee HBP	4.0%
<hr/>	
Total Self-Insured ASO	<b>52.8%</b>

Express Scripts' PBM business is comprised almost entirely of self-insured plans. In the case of Medicare Part D prescription drug plans (PDPs), Express Scripts has chosen to avoid risk by becoming the "Intel inside" service provider to the nominal sponsor who must be registered with states as a risk-bearing entity.

Unlike the self-insured plans managed by Wellpoint and other large insurers, Express Scripts sets itself up as a benefits reseller with provider reimbursements flowing through Express Scripts' balance sheet. This reseller business model facilitates a deceptive pricing strategy where low ball, transparent management fees are subsidized by opaque transactional margins -- retail spread, retained rebates, and excess margins on generic drug prescriptions filled by its captive mail order pharmacies.

**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). All of the Big 3 PBM CEO's and CFO's include

a statement about EBITDA / Adj Rx at the beginning of quarterly conferences calls to Wall Street analysts. Adjusted scripts accounts for the fact that a mail order prescription is generally 3 times the number of pills as a retail prescription – 90 days versus 30 days. This 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 PBM operations is closely correlated with yearly EBITDA / Adj Rx.

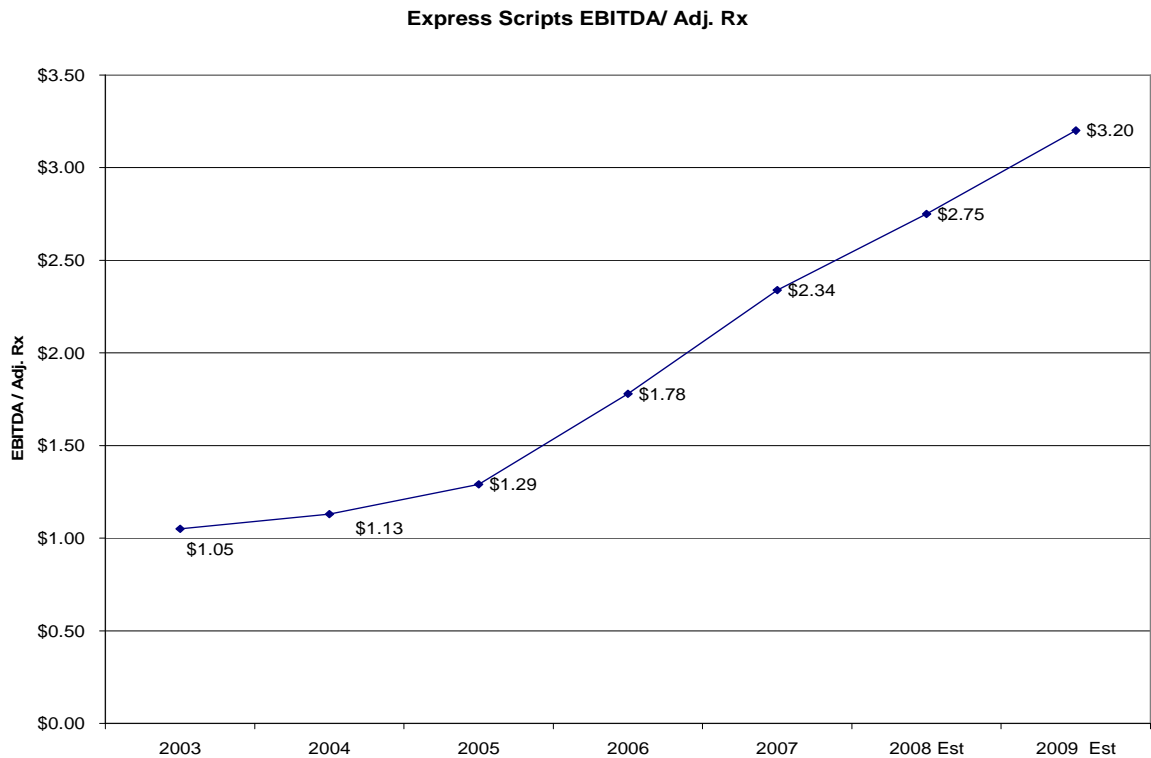
The Big 3 independent PBMs – Express Scripts, Medco, and CVS/Caremark -- have achieved a remarkable, uninterrupted upward trend in EBITDA / Adj Rx over the last seven years. This has occurred despite a radical shift in business model between 2004 and 2006 from a dependency on retained rebates to a dependency on mail order generic margins. The graph below is a typical element in an Express Scripts PowerPoint presentation to Wall Street analysts at investors' conferences.<sup>7</sup>

The EBITDA / Adj Rx. trend line has become the most popular performance metric of Big 3 PBM management. Trend in over all drug spend, which is a rate of growth measure, is also a popular performance metric with PBM CEOs, especially since 2006 as the growth rate in drug spend has declined dramatically. However, this decline is largely the result of the loss of patent protection for expensive blockbuster drugs and outside the control of PBMs.

It should be noted that CEO's choose not to measure their performance by trends in average drug spend / Adj. Rx, a measure of average unit prices delivered to clients. Despite dramatic increases in the generic dispensing rates in recent years, drug spending / Adj. Rx has gone up for clients during a time when PBM EBITDA / Adj. Rx also has gone up.

Often, there is a cost to large companies for increasing sales, market share and EBITDA. That cost is lower unit prices, lower unit margins, and lower EBITDA / unit sold. The Big 3 PBMs

represent a rarity for Fortune 50 companies in that they have been increasing EBITDA and unit EBITDA at the same time.



One difficulty with interpreting the above graph is determining how much of this trend is due to the traditional pharmacy business and how much is due to the specialty pharmacy business. For example, it is likely that the ratchet up in 2005 was due to the purchases of independent specialty pharmacy operations like Priority Health for Express Scripts.

It will be interesting to see how Express Scripts reports EBITDA / Adj. Rx after it closes the Wellpoint deal because the acquisition will likely reduce combined EBITDA / Adj. Rx. For the first year or so, our bet is that Express Scripts will report the Wellpoint financials on a separate line, claiming that this business is materially different than their core benefits reseller business.

## The Express Script – Wellpoint Deal

In a recent interview granted to CFO.com, Express Scripts' CEO Jerry Hall acknowledged that the key to the valuation of the deal was the projected cash flow of a 10 year contract to manage Wellpoint's PBM business.<sup>4</sup> 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 an estimate in Table 3 below of Express Scripts' valuation of the 10 year contract at \$3.475 Billion in terms of implied EBITDA / Adj. Rx.

Assuming cash flow from the deal is equal to its delivered EBITDA, it follows that a yearly EBITDA of \$472 Million over 10 year at 6% interest underlies Express Scripts' net present valuation 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 as a comparable metric of PBM valuation.

To realize a return over and above its purchase price of \$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 Contract**

Item	Row	Source	WLP - PBM millions
Total Purchase Price	r1	Note 1 below	\$ 4,675
ESRX Value of Tax Saving Structure of Deal	r2	Note 4 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
<b>Implied EBITDA / adj Rx in ESRX valuation</b>	<b>r7</b>	<b>= r5 / r6</b>	<b>\$ 1.66</b>

It is instructive to compare Express Scripts' valuation of \$1.66 EBITDA / Adj Rx with an estimate of what Wellpoint's PBM is generating now. This is done in Table 4, based on the key estimate that the Wellpoint PBM operation contributes less than 10% of the total company profit as reported by AP writer Dinah Wisenberg Brin, based on interviews with Wall Street analysts.<sup>8</sup>

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

Item	Row	Source	WLP - PBM millions
EBIT	r1	2008 10-K	\$ 3,112
Amortization	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 5	265
Adjusted Scripts	r7	Table 5 - row 8	284
<b>Wellpoint PBM Current EBITDA / Adj Rx</b>	<b>r8</b>	<b>=r6 / r7</b>	<b>\$ 1.16</b>
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
<b>ESRX Valuation of Wellpoint PBM 10 Year Contract</b>			
Valuation represent a premium over current EBITDA or	r11	= (r9 - r8) / r8	43.7%
Valuation represent a discount over ESRX EBITDA	r12	=(r9 - r10) / r10	-39.5%

### **A Comparison of PBM EBITDA / Adj. Rx**

What was the thinking behind Express Scripts' valuation that caused it to be 43% higher than Wellpoint's current's profitability? And, why was the current profitability of Wellpoint's PBM so much lower than the 2008 profitability of both Express Scripts (ESRX) 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 9 below	25	50	60	Note 9
Total scripts - unadjusted	r2	Note 1 below	265	420.4	586	2008 10-K
Generic dispensing rate - unadjusted	r3	Note 10 below	65%	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 11 below	10.0%	24.4%	39.8%	2008 10-K
EBITDA	r11	Table 4 - r6	\$ 329	\$ 1,378	\$ 2,461	2008 10-K
<b>PBM EBITDA / Adj Rx</b>	<b>r12</b>	<b><math>= r11 / r8</math></b>	<b>\$ 1.16</b>	<b>\$ 2.75</b>	<b>\$ 3.08</b>	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 benefit management efficiencies that presumably are passed on in part to customers in the form of lower prices with the rest going to EBITDA?

### Leveraging Overhead Costs as a Factor

Before we embark on an examination of the questions posed above, we want to consider first leveraging overhead costs as a factor. Express Scripts has talked only about realizing value through more efficient benefits management, starting with improving the mail order penetration rate (MOPR). Neither Express Scripts nor Wellpoint has mentioned anything about cost-saving or profit-enhancement via leveraging overhead costs.

Yet, when we talked to a Wall Street analyst, leveraging overhead was the first thing mentioned as a potential driver of value in this deal. Leveraging overhead has been one of the stated

value-enhancing benefits of recent mergers among independent PBMs and between PBMs and independent specialty pharmacy operations.

EBITDA per adjusted script can be increased in a horizontal merger of PBMs via spreading fixed overhead costs over a greater volume of scripts managed. For PBMs and integrated insurance companies, overhead is aggregated into one line called “sales, general, and administrative” (SG&A) in their reported financials. Note, though, that labor and facilities costs associated with captive mail order pharmacies are considered manufacturing costs and included in the cost of sales line rather than the SG&A line.

The potential to leverage overhead in this particular deal is much less than what could be obtained via a merger of two single line-of-business PBMs. This is because Wellpoint is an integrated insurance company with overhead driven by **account management** rather than **product management**. A sale of any single product line would not save Wellpoint much in overhead costs. Furthermore, any estimate of EBITDA generated from insurance company businesses that are secondary to their core medical benefit business, such as PBM or disability insurance, involves a somewhat arbitrary allocation of aggregate SG&A costs.

One of Wellpoint’s core financial strategies is to leverage SG&A by offering “one-stop” shopping for an array of benefits management products. SG&A costs for Wellpoint are driven more by the number of accounts managed than by the volume of products sold. The sale of an individual product line would not change Wellpoint’s SG&A costs much if the number of customer accounts remained the same.

We now want to use this argument as the basis for estimating the SG&A leveraging potential of this deal. Table 6 below first presents an estimate of aggregate SG&A / Adjusted Rx for Wellpoint (WLP), Express Scripts (ESRX), and Medco (MHS). The estimates for Express Scripts and Medco come straight from their 10-K’s with no additional assumptions.

However, the estimate for Wellpoint involves the assumption that the SG&A share of its PBM unit is the same as the PBM's reported share of aggregate EBITDA – around 9%. Based on this assumption, SG&A costs for Wellpoint's PBM operations is \$2.89 per adjusted script versus \$1.71 for Express Scripts and \$1.98 for Medco.

**Table 6: Comparison of SG&A and Gross Profits / Adj Scripts**

Item	Row	WLP-PBM			ESRX	MHS	ESRX /
		Source	WLP-PBM				MHS
Sales, General, & Administrative (SG&A)	r1	2008 10-K - 9%	\$ 812	\$ 760	\$ 1,425	2008 10 K	
Depreciation	r2	2009 10-K - 9%	\$ 9	\$ 98	\$ 158	2008 10 K	
SG&A -Before Depreciation	r3	=r1 + r2	\$ 821	\$ 858	\$ 1,583	=r1 + r2	
Adjusted Scripts	r4	Table 5 r8	284	502	798	Table 5 r8	
<b>SG&amp;A -BITDA / Adj Rx</b>	<b>r5</b>	<b>=r4 / r3</b>	<b>\$ 2.89</b>	<b>\$ 1.71</b>	<b>\$ 1.98</b>	<b>=r4 / r3</b>	
		Difference from WLP-PBM		<b>\$ 1.18</b>			
PBM EBITDA / Adj Rx	r6	Table 5 r12	\$ 1.16	\$ 2.75	\$ 3.08	Table 5 r12	
Difference from WLP-PBM		Difference from WLP-PBM		<b>\$ 1.59</b>			
<b>Gross Profits / Adj Rx</b>	<b>r7</b>	<b>=r5+r6</b>		<b>\$ 4.45</b>	<b>\$ 5.07</b>	<b>=r5+r6</b>	
			<b>WLP-PBM</b>	<b>ESRX</b>			
Reconstructed Gross Profits / Adj. Rx	r8	=r6 + r9	\$ 2.16	\$ 4.45		r7	
		Difference from WLP-PBM		<b>\$ 2.29</b>			
SG&A -BITDA / Adj Rx	r9	assume	\$ 1.00	\$ 1.71		r5	
PBM EBITDA / Adj Rx	r6		\$ 1.16	\$ 2.75		r6	

There is something wrong with this estimate. Realistically, on a unit basis, the cost of managing pharmacy benefits is much less than the cost of managing medical benefits. It would be inappropriate to apply a single overhead application rate across all of Wellpoint's insurance lines – medical the same as pharmacy the same as disability.

The \$2.89 figure at the top of Table 6 is too high of an estimate. On the other hand, if we could truly estimate Wellpoint's *incremental* cost of managing pharmacy benefits, we believe that it would be less than Express Script's \$1.71 figure because of Wellpoint's account leverage

capability. Despite the averages presented in Table 6, Wellpoint, not Express Scripts, is the more efficient entity at managing the PBM SG&A costs, especially the sales component, because of its ability to leverage account management costs over multiple product lines.

In order to minimize SG&A / Adj. Rx, we believe that it would be better for Express Scripts to have Wellpoint continue to manage the sales and general account management of its PBM book of business. It is likely that details about the division of responsibility for managing SG&A had not been worked out when the deal was first announced in April of 2009. Because this deal was not a clean transfer of a book of business, we believe that there will be ongoing friction between these two companies over who is responsible for SG&A management and how it is to be done.

If Express Scripts assumes complete SG&A responsibility for Wellpoint's PBM book of business, it could expect to incur an incremental cost somewhat less than its current average of \$1.71 due to increased script scale. On the other hand, Wellpoint might be willing to remain responsible for most of the SG&A function for a fee that covers the incremental SG&A cost of managing its own book of business. Because of account management leveraging, we believe that this incremental cost is, say, \$1.00, much less than Express Script figure of \$1.71.

Viewing the bottom of Table 6, we take this analysis a step further by reconstructing Wellpoint's PBM gross profits using a more realistic SG&A application rate of \$1.00 per adjusted script. Given the current estimated EBITDA of \$1.16, this implies a current estimated gross profit per adjusted script of \$2.16.

This means that differences in profitability between these two PBMs is much more than the EBITDA difference of \$.159 -- \$1.16 vs \$2.75. It is closer to \$2.29 -- the difference in estimated gross profits per adjusted script -- \$2.16 versus \$4.45.

In Table 4, we estimated that Express Scripts' \$4.675 Billion bid implied an EBITDA cash flow of \$1.66 per adjusted script. We believe that the \$4.675 Billion up-front payment was for the gross profits, not the net profits, cash flow from the book of business. A likely separate component of this deal, not yet reported, are yearly fees on the order of \$1.00 per adjusted script paid back to Wellpoint for continuing SG&A work.

A different way to articulate this deal is to say that Express Scripts is paying a present value of \$2.66 -- \$1.66 plus a continuing SG&A fee of \$1.00 -- for the rights to Wellpoint's book of business gross profits cash flow. This is a premium over the current gross profits cash flow of \$2.16 -- \$1.16 plus a realistic SG&A cost of \$1.00. The incremental EBITDA that Express Scripts needs in order to justify its valuation is still the same -- \$.60.

While we believe that Wellpoint will continue to be responsible for routine SG&A management, Express Scripts will be active when it comes to promoting changes in plan designs and business models. The first priority of Express Scripts will be to indoctrinate the Wellpoint organization on the importance of promoting mail order. They will urge the Wellpoint organization to promote mail order an "opt out" rather than a "opt in" option. The second priority will be to have Express Script people directly responsible for the pharmacy benefits management portion of the largest ASO plans with over 1,000 members. The objective here will be to try to convert these plans to a benefits reseller model. The third objective will be to try to convert all fixed premium clients over, say 150 members, to a self-insured ASO model.

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

Currently, Wellpoint's adjusted mail order penetration rate (MOPR) is said to be less than 10%.<sup>11</sup> What would be the EBITDA impact if Express Scripts could double that? Could that potential be the reason Express Scripts valued the deal at a 43% premium to current profitability?

On the other hand, what if much of the difference between the deal price and valuation based on current profitability were not due so much to the potential for more efficient benefits management but the potential for business model conversion – switching clients from risky fixed premium contracts with low EBITDA / Adj Rx to opaque, transactional contracts with high EBITDA / Adj Rx?

In a related paper, we estimated the EBITDA impact if Express Scripts could double Wellpoint's adjusted MOPR – moving approximately 16 million adjusted generic scripts and 16 million adjusted brand scripts from retail to mail order.<sup>12</sup>

We also needed an estimate of gross profits per adjusted script of mail order generic and brand prescriptions. We assumed that an improved MOPR generated additional gross profits that fall right to the bottom line without an additional operating costs being incurred. We used estimates of gross profits per adjusted mail order script derived in our quantification of Medco's business model.<sup>13</sup> The estimates are presented in Table 7 below.

The result is that Express Scripts would barely cover the 43% premium it paid for Wellpoint. Something else must underlie their belief that they can generate a return significantly greater than \$1.66 EBITDA / Adj. Rx.

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

Source	Row	Generic	Brand	Total - \$ Millions
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Incremental Rx through MOPR	Note 12 below	r1		16		16	
Gross Profits / Adjust Rx	Note 13 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	$= r5 / r6$	r7					\$ 1.70
EBITDA Implicit in Bid for Contract	Table 3 above	r8					\$ 1.66
Return on Investment as measured by incremental EBITDA over bid	$= r7 - r8$	r9					\$ 0.04
	$= r9 / r8$	r10					2.4%

### Express Scripts' Unspoken Plan: Business Model Conversion

We believe that Express Scripts has plans for boosting EBITDA in addition to doubling Wellpoint's MOPR. Express Scripts' unspoken plan is to convert Wellpoint's clients to its benefits reseller model. However, there are certain segments of Wellpoint's book of business that can't be weaned from fixed premium insurance: individual plans and seniors enrolled in Medicare Part D plans.

At best, we estimate that Express Scripts will be able to convert half of small businesses to self-insured plans. That leaves Express Scripts with risk exposure amounting to about 29% of Wellpoint's book of business, as presented below in Table 8. At best, Express Scripts will be exposed to premium risk for 7 million covered lives or about 10% of its expanded book of business. This exposure is far more than Medco or CVS / Caremark.

**Table 8: Estimate of Express Scripts' Exposure to Risk Premium**

	Before	After
<b>Risk Premium</b>		
Local Groups	36.9%	18.4%
Individual	6.6%	6.6%
Senior	3.7%	3.7%
<hr/>		
Total Fully Insured	<b>47.2%</b>	<b>28.7%</b>
<b>Self-Insured fee for service</b>		
<hr/>		
Local Group	10.6%	29.0%
National Account	32.7%	32.7%
State-Sponsored	5.6%	5.6%
Federal Employee HBP	4.0%	4.0%
<hr/>		
Total Self-Funded	<b>52.8%</b>	<b>71.3%</b>

In a later section, we present a quantitative estimate of the EBITDA that Express Scripts could achieve through business model conversion. But, this requires additional data developed in the next section where we present an estimate of the EBITDA implied by a valuation of Cigna's captive PBM.

We argue that the only substantive difference between Wellpoint's and Cigna's PBM is the mix of fixed premium and ASO plans with Cigna having only 25% fixed premium compared to Wellpoint's 47%. We present a simultaneous equation model where EBITDA is a function of plan mix. By solving this model, we can obtain estimates of the EBITDA of each plan component plus an estimate of the incremental improvement in Wellpoint's EBITDA due to "decapitation" as quantified above in Table 8.

### **PBM Valuation as a Function of Business Model**

After the Wellpoint deal was announced, the CFO and the CEO of Cigna, a large integrated insurance company, remarked publicly that it was considering selling its captive PBM operations. Cigna admitted that their motivation for selling received a tremendous boost after analyzing Express Scripts' bid.

Shortly thereafter, an Oppenheimer financial analyst, Carl McDonald, was quoted as valuing the Cigna PBM at \$1.3 Billion.<sup>14</sup> The purpose of this section is to present an estimate of the EBITDA / Adj. Rx implied by this valuation and use it as another data point in support of our contention that differences in PBM valuations are mostly due to differences in business model rather than management efficiency.

Table 9 shows how we derived an EBITDA estimate of \$2.08 that is implied by the \$1.3 Billion valuation for the Cigna PBM operation. This compares favorably with our Wellpoint estimate of \$1.66, but falls short of the 2008 actual EBITDA for both Express Scripts and Medco.

**Table 9 : PBM Valuation as a Function of Business Model**

Item	Row	Source	Cigna (CI)	UOM
Adj Rx in Contract	r1	Note 15	85	Million
Reported Valuation	r2	Note 14	\$ 1,300	Billion
Cigna Implied EBITDA / Yr	r3	NPV(.06,r2, 10 yr)	\$ 177	Million
Cigna Implied EBITDA / Rx	r4	=r3 / r1	\$ 2.08	per adj Rx
ESRX actual EBITDA / Rx	r5	10-K	\$ 2.75	per adj Rx
Wellpoint Implied EBITDA / Rx	r6	Table 3 r7	\$ 1.66	per adj Rx
<b>Share of Covered Lives by Business Model</b>	<b>WLP</b>	<b>Cigna (CI)</b>	<b>ESRX</b>	
Fixed Premium	47%	25%		
ASO	53%	75%		
Benefits Reseller	0%	0%	100%	
Total	100%	100%	100%	
<b>Valuation -- EBITDA / Adj. Rx</b>	<b>\$ 1.66</b>	<b>\$ 2.08</b>	<b>\$ 2.75</b>	
<b>% Valuation over Wellpoint</b>		<b>25.3%</b>	<b>65.7%</b>	

Like Wellpoint, the Cigna PBM offers two kinds of plans: fixed premium and ASO. Both models are transparent. But, unlike Wellpoint, fixed premium plans comprise only 25% of Cigna's book of business whereas these relatively unprofitable plans comprise 47% of Wellpoint's book of business.

The key assumption in the model we are developing is that the differences in valuation -- \$2.08 for Cigna and \$1.66 for Wellpoint – are solely due to differences in plan mix. This is a reasonable assumption in that the GDRs of the two operations are similar. We also assume that both valuations include a premium based on the expectation of easily improved EBITDA from increasing the MOPR to around 20%.

The remaining explanatory variables are script scale and plan mix. The fact that Cigna's implied EBITDA / Adj. Rx is greater despite Wellpoint being 3.3 times the script count tends to rule out scale as an important factor.

An estimate of the EBITDA of individual plan components is derived in Table 10 by solving a model with two equations and two unknowns. We estimate that the EBITDA valuation placed on a fixed premium PBM plan is \$.67 / Adj. Rx while the value placed on an ASO PBM plan is \$2.55 / Adj. Rx.

The difference in EBITDA estimates -- \$.67 vs. \$2.55 -- seems reasonable. But, there is problem with the \$2.55 estimate for an ASO plan as this is very close to Express Scripts' actual EBITDA / Adj. Rx of \$2.75 for benefits reseller plans. Because of the vast differences in transparency between ASO and benefits reseller plans, we would have expected this difference to be much greater.

**Table 10 : PBM Valuation as a Function of Share of Fixed Premium Plans**

Generic Dispensing Rate Adjusted Scripts Managed			<b>Wellpoint</b> 65% (note 10) 284 Million	<b>Cigna</b> 67% (note 17) 85 Million
	Unknown EBITDA	Solved EBITDA		
Fixed Premium Share of Plans	X	<b>\$0.67</b>	47%	25%
ASO Share of Plans	Y	<b>\$2.55</b>	53%	75%
Implied Valuation - EBITDA / Adj Rx			\$1.66	\$2.08
<b>Incremental EBITDA with a 1% point decrease in share of fixed premium plans</b>	$=(2.55-.67)/100$	<b>\$0.019</b>		

Solve for X and Y:

$$\begin{aligned}
 .47(X) + .53(Y) &= 1.66 \\
 .25(X) + .75(Y) &= 2.08 \\
 .88 - .28(Y) + .75(Y) &= 2.08 \\
 Y &= 2.55 \\
 X &= .67
 \end{aligned}$$

The problem with our comparison is that it does not take into account the relative SG&A efficiency of integrated insurance companies relative to independent PBMs. Earlier, we suggested that the true incremental PBM SG&A / Adj Rx of an integrated insurance company to be around \$1.00 versus Express Scripts' \$1.71. When that is factored in, the estimate of the gain from converting an ASO plan to a benefits reseller plan is much more than \$.20 in EBITDA. It is a business model conversion gain of \$.91 in gross profits offset by a \$.71 loss in SG&A as show in Table 11 below.

**Table 11: The Profitability of an ASO Plan Offered by An Insurance Company Versus a Benefit Reseller Plan Offered by an Independent PBM**

<b>PBM</b>	<b>100% ASO</b>	<b>100% Benefits Reseller</b>	<b>Gain (loss)</b>
Per Adj. Rx			
Gross Profits	\$ 3.55	\$ 4.46	<b>\$ 0.91</b>
Less: SG&A	\$ (1.00)	\$ (1.71)	\$ (0.71)
EBITDA	\$ 2.55	\$ 2.75	\$ 0.20

## Evaluating Express Scripts' Statement of the Deal's Potential

The initial announcement of Express Scripts – Wellpoint deal contained forward looking statements by Express Scripts that the Wellpoint acquisition would generate \$1 Billion in incremental EBITDA over a 12 to 18 month period once the deal closed.<sup>18</sup> This was three times the current EBITDA that we estimated for this operation in Table 4. The Express Scripts forward looking statement translates into an annualized EBITDA / Adj. Rx of between \$2.35 and \$3.52 over 18 months and 12 months, respectively.

In Table 7, we estimated that a doubling of Wellpoint's MOPR from 10% to 20% could improve profitability significantly to \$1.70, but that just covered the \$1.66 valuation underlying Express Scripts' \$ 4.675 Billion bid.

We have argued that the only way Express Scripts can improve EBITDA beyond the \$1.66 to the \$1.70 range is plan conversions from fixed premium to ASO and from ASO to benefits reseller. Based on our simultaneous equation model of EBITDA as a function of plan mix, we present in Table 12 below quantitative estimates of Express Scripts' potential to increase EBITDA through plan conversion.

**Table 12: Can Express Scripts Achieve Its Projected EBITDA for its Wellpoint Acquisition?**

Source of Incremental EBITDA	Factors in Valuation	Valuation	EBITDA
Current Wellpoint EBITDA	MOPR = 10%, Fixed=47%, ASO=53%		<b>\$1.16</b>
Valuation -- MOPR 10% to 20%	MOPR = 20%, Fixed=47%, ASO=53%	$=(.67 * .47) + (2.55 * .53)$	<b>\$1.66</b>
Fixed Premium - 47% to 29%	MOPR = 20%, Fixed=29%, ASO=71%	$=(.67 * .29) + (2.55 * .71)$	<b>\$2.00</b>
ASO - 71% to 35%, BS - 0 % to 36% and hold BS SG&A to \$1.00	ASO=35%,BS=36%	$=(.67 * .29) + (2.55 * .35) + (3.46 * .36)$	<b>\$2.33</b>
Forward Looking Statement			
	"\$1 Billion EBITDA 18 Months after close"	$= (1000 * (12/18)) / 282$	<b>\$2.35</b>
	"\$1 Billion EBITDA 12 Months after close"	$= 1000 / 284$	<b>\$3.52</b>

Even assuming great success at plan conversion, we believe that Express Scripts will just meet the low end of its guidance of \$2.35, but fall way short of its upper limit of \$3.52 EBITDA / Adj. Rx.

It's as if there were two sets of Express Scripts' analysts involved in valuating the Wellpoint book of business. One set developed the initial bid based on a clear understanding of the limited profitability of fixed premium plans. The Express Scripts analysts that developed the forward-looking statement of deal potential seem completely oblivious to the limited potential to convert relatively low profit, fixed premium plans to ASO or benefit reseller plans.

### **Wall Street is Overestimating the Value of Aetna's PBM**

On July 27, 2009, the Wall Street Journal reported that Aetna had hired investment bankers to shop its captive PBM operations.<sup>19</sup> This represents the 3<sup>rd</sup> major integrated insurance company that put up its PBM book of business for sale in the space of four months. The Journal article mentioned a \$2 Billion valuation for Aetna derived by analysts at Stanford Bernstein Research. Later that day, a Reuters report mentioned unnamed analysts as valuing the deal at between \$1.6 Billion and \$1.8 Billion.<sup>20</sup>

Table 13 below presents our own valuation of Aetna based on our model of PBM valuation as function of plan mix. Based on an Aetna mix of 33% fixed / 67% ASO, which is less profitable than the Cigna mix of 25% fixed / 75% ASO, we arrived at an estimated weighted average valuation of \$1.92 EBITDA / Adj Rx for Aetna versus our earlier estimate for Cigna of \$2.08.

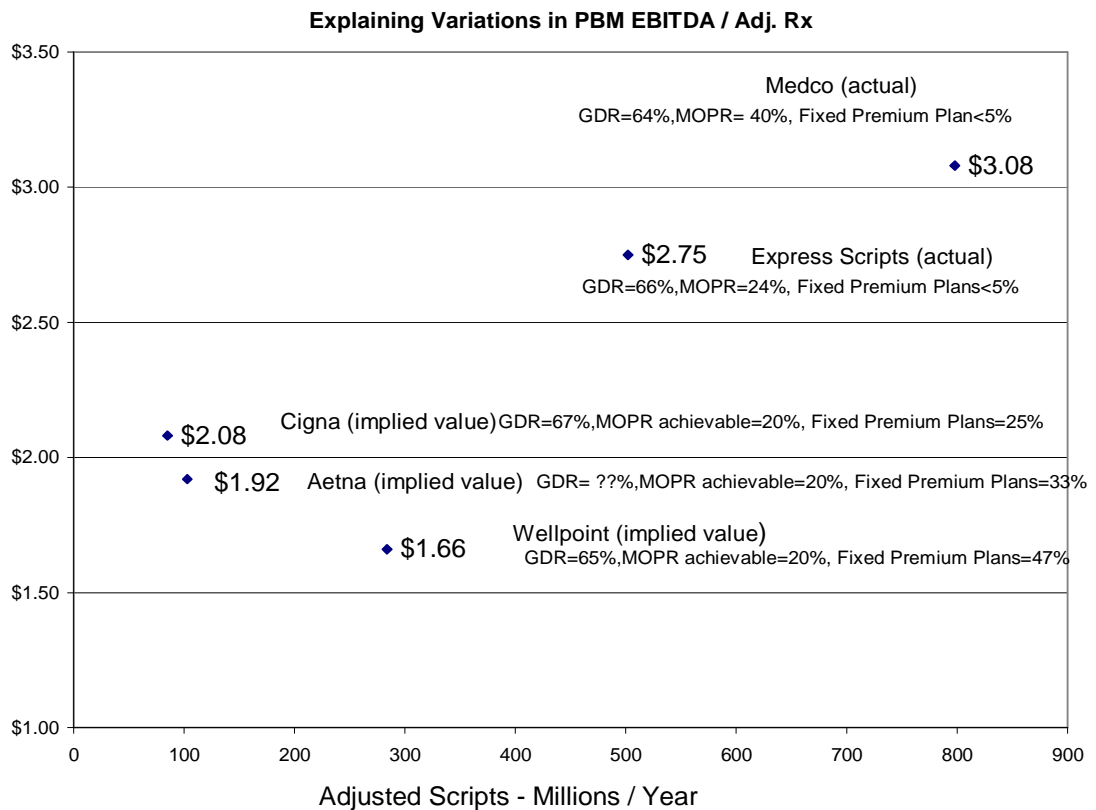
Our estimate for Aetna translates into a valuation of \$1.3 Billion, much less than Wall Street estimates of \$1.6 Billion to \$2.0 Billion. Again, we think that Wall Street does not sufficiently take into account business model as the most important factor in the profitability of a PBM book of business, focusing more on real and imagined variations in benefit management efficiencies and scale as the key to PBM valuation.

**Table 13 : Comparing Valuations of Aetna's PBM**

Item	Row	Source	Aetna	UOM
Adj Rx in Contract	r1	Note 15	102.9	Million
Reported Valuation -1	r2	Note 20	\$ 1,600	Billion
Reported Valuation -2	r3	Note 20	\$ 1,800	Billion
Aetna Implied EBITDA / Yr -1	r4	NPV(.06,r2, 10 yr)	\$ 235.4	Million
Aetna Implied EBITDA / Yr -2	r5	NPV(.06,r3, 10 yr)	\$ 264.8	Million
Aetna Implied EBITDA / Adj. Rx - 1	r6	=r4 / r1	\$ 2.29	\$ / Adj Rx
Aetna Implied EBITDA / Adj. Rx - 2	r7	=r5 / r1	\$ 2.57	\$ / Adj Rx
<b>Aetna's Plan Mix - 1Q2009 (Note 21)</b>				
		<b>Premium</b>	<b>ASO</b>	<b>Total</b>
Commercial		5,656	12,060	17,716
Medicare		419	0	419
Medicaid		284	647	931
Total		6,359	12,707	19,066
Share by Plan Type		33.4%	66.6%	100.0%
EBITDA Model Plan Valuations (Table 12)		\$0.67	\$2.55	
Aetna Valuation Based on Model Valuations	r8	weighted average	\$ 1.92	\$ / Adj Rx
Aetna Valuation Based on Model Valuations	r9	=r8 * r1	\$ 197.6	Million
Aetna Valuation Based on Model Valuations	r10	NPV(.06,r9, 10 yr)	\$ 1,344	Billion

### Scale as a Factor in EBITDA / Adj Rx

Express Scripts' bid and the follow-on Cigna valuation has supplied important new data to our understanding of the relation between PBM scale, business model, and profitability. The graph below highlights that relation using data for Wellpoint, Cigna, Express Scripts, and Medco.



We argued earlier that the difference between the Wellpoint and Cigna valuations can be explained entirely by business model mix. Management efficiency was ruled out because both have similar GDRs and both valuations imply an improvement in MOPR to the 20% level. Differences in SG&A leverage was also ruled out as an explanatory variable as both were large integrated insurance companies with the same account management approaches managing SG&A.

Wellpoint's PBM is three times the size of Cigna's as measured by script scale. But, whatever advantage scale gives Wellpoint over Cigna, it is completely negated by Wellpoint's relatively high proportion of low profit, fixed premium plans.

We next want to offer an explanation of the difference in profitability implied by the Cigna valuation and the actual profitability of Express Scripts. Express Scripts is almost 6 times the

size of Cigna as measured by script scale – 502 Million vs 85 Million Adj. Rx. It also manages 5.4 times the number of covered lives that Cigna manages – 50 Million versus 9.2 Million.

But a good portion of Cigna's business is made up of Fortune 50 accounts with 100,000+ members that can be managed very efficiently as measured by SG&A / Adj. Rx. The difference between Cigna's valuation of \$2.08 and Express Scripts' actual profitability of \$2.75 can be explained by a combination of differences in business model offset by differences in SG&A efficiency as we have demonstrated in Table 11.

What remains is an explanation of the differences in actual 2008 profitability between Express Scripts and Medco. We believe that this difference -- \$2.75 versus \$ 3.08 – is partly attributable to Medco's industry leading MOPR of 40% versus Express Scripts' MOPR of 24%, and partly attributable to business model differences, although they are both benefits resellers.

We should mention that the Medco MOPR is inflated by the fact that it manages the mail order portion only of the large Federal Employee Health Benefit Plan. We have estimated that this anomaly contributes 3 percentage points to Medco's MOPR.<sup>22</sup>

As we have show in our update at quantifying Medco's business model, prescriptions filled by Medco's captive mail order pharmacies contributed 49.9% to Medco's 2008 aggregate gross profits whereas prescriptions filled by the retail channel contributed only 4.9%.<sup>22</sup>

Clearly, a higher MOPR improves EBITDA / Adj. Rx. In fact, one might reasonably expect a greater EBITDA gap between these two PBMs given Medco's 16 point MOPR advantage over Express Scripts.

However, Medco's extraordinary MOPR comes at a cost. We believe that Medco is the industry-leader in MOPR because it presents clients with an extraordinary gap between negotiated retail prices and mail order prices. In order words, Medco's relatively high MOPR is the result of a relatively low unit gross profit on mail order prescriptions. Medco is still enjoying

an elasticity of demand for its mail order that is greater than one. But there is a point after which increasing MOPR via lower mail order prices and unit margins would result in less, not more gross profits.

This trade off between MOPR and gross profits / Adj. Rx is the reason why Medco's overall EBITDA / Adj. script is not that much greater than Express Scripts' despite a 16 percentage point MOPR advantage.

While both Express Scripts and Medco employ a benefits seller business model, we have argued that it has been Medco that has exploited the opacity of this business model most. Although both PBMs have similar rebate retention rates, it has been Medco who has augmented gross profits the most from opaque retained rebates.<sup>23</sup> It has been Medco that has extracted from Pharma significantly higher gross rebates as a percentage of total reimbursement. We have argued that Medco receives more rebates than Express Scripts because it gives Pharma more in return. This *quid pro quo* takes the form of rebates received in exchange for abstaining from brand to generic therapeutic interchange. We say that if any PBM is guilty of "sins of omission", it is Medco. .<sup>23</sup>

Even with extensive pass-through of rebates to customers, Medco's success in obtaining rebates is actually a net loss to clients in terms of lower GDR and drug spend / Adj Rx delivered. Four years ago, the GDR gap was 4 percentage points, but in 2008 the gap has narrowed to 2 percentage points. Express Scripts has been promoting GDR as a key metric for comparing PBM performance and this may be why Medco has worked to close this gap.

### **A General View of the Relation between PBM Scale and Performance**

We want summarize our general view of PBM scale as a source of PBM performance. This paper has questioned the importance of scale as a source of performance as measured by unit **profit**. Prior work has questioned PBM scale as a factor in containing drug spending / Adj. Rx, otherwise know as the average unit **price**.

Our general view is that scale is overrated as a source of PBM performance as measured either by average unit prices or by average unit profits. Theoretically, scale could be beneficial in negotiating rebates with Pharma and reimbursements with retail pharmacies, but the business model of large independent PBMs makes it more profitable for these PBMs to abstain from the exercise of this power.<sup>24 25 26</sup>

As far as mail order operations are concerned, scale can lower dispensing costs and reimbursements paid by clients. But, the unit dispensing costs for an individual mail order pharmacy bottoms out around 30,000 to 50,000 Rx a week, which is far below the operating scale of dispensing pharmacies of the Big 3 PBMs.<sup>27</sup>

Scale can also lower the costs and reimbursements for claims processing. But that does not imply that a client has to contract with one of the Big 3 PBMs to access these economies. Small, independent PBMs can tap into claims processing scale by contracting out claims processing to SXC, a PBM software application service provider.

Finally, many of the important techniques for lowering the average unit price to clients has nothing to do with “brawn” but everything to do with “brains” and “smarts”. Average unit price is the weighted average of unit prices of generics and brands with the weights being a function of the generic dispensing rate. While the Big 3 PBMs can deliver hard to match unit prices for brands and generics as a result of scale, smaller PBMs can overcome this disadvantage by delivering about a five percentage point higher GDR to clients.

Superior GDR is a function of smart benefit management, not scale. This includes a cost-effective formulary design, and use of design elements such as co-payment structure, prior authorizations, and step-therapy programs to promote generics that are therapeutic equivalents to more costly brand brands.

If scale is overrated as a source of PBM performance, how is that the industry today is dominated by three large independent PBMs? The reason is that scale is the resultant of

performance not the source. The history of the PBM industry is not scale leading to price leadership leading to market share without profit leading to further scale via price competition leading finally to profit.

The path to PBM concentration begins with an opportunity to capture opaque rebates leading to a deceptive pricing strategy that uses retained rebates to subsidize low-ball, transparent prices on benefits management, claims processing, and mail order brands leading to contract wins, scale, and profit. Today opaque margins on mail order generics have replaced retained rebates as a source of excess gross profits necessary to afford low-ball prices wherever there is contract transparency.

But there is another reason for the continued dominance of the Big 3 PBMs and that their excellent, unmatched IT systems for managing claims. Even if large integrated insurance companies could match the Big 3 PBMs wherever contract pricing is transparent, large plans over 300,000 members justifiably are reluctant to switch due to the a history of poor performing IT systems developed internally by insurance companies. In particular, Coventry and Wellpoint have had enormous problems with managing Medicare Part D plans using internal IT systems.

Coventry was forced to abandon its internal system and contract Medicare Part D claims processing to Medco. Consider the following quote from Coventry's CEO Alan Wise during their 1Q2009 Conference Call: <sup>28</sup>

We've also put a huge effort toward cleaning up some operational issues in our Medicare business. During our last quarterly conference call I shared with you a view that we've had organizational and operational stress in our company which really resulted from the multiple years of very substantial revenue growth.

As an example, during the enrollment period in 2009, we added approximately 650,000 new Part D members alone. The result of all this was significant administrative shortfalls in our enrollment area which affected our ability to provide accurate and timely information to CMS. Once our new Medicare team understood the shortfalls we devoted very substantial resources toward addressing all these issues and we feel that we're now making rapid progress.

.Also, Wellpoint was forced by Medicare to suspend any new enrollment in its Medicare Part D plans due to internal IT snafus. Consider the following quote from Wellpoint's CEO Angela Braly during their 4Q2008 Conference Call: <sup>29</sup>

Over the past 6 months, we've been working with CMS to resolve issues identified as a result of our internal compliance audits and findings from a recent CMS audit. ...

While our IT resources are an important part of the compliance program, these issues were not related to a migration of a legacy system, and we who have been meeting with CMS on a regular basis regarding our remediation process, we were surprised by their recent actions. We're working closely with CMS and marketing an enrollment of the company's Medicare Advantage, and Medicare Part D products have been suspended until remediation efforts have been substantially completed.

But, slowly the sources of Big 3 PBM dominance – mail order generic margins and unmatched IT systems – are being undermined. The Wal-Mart's \$ 4 prescription announcement in September 2006 marks the end of an era of "competition by convenience" and the beginning of an area of "competition by price" in the drug supply chain. We view the Wal-Mart announcement as more than an innocuous "publicity stunt". The specificity of the \$4 price was designed to be the tipping point of an "idea epidemic" that large, independent PBMs might not be negotiating the best possible deals for clients.

Wal-Mart's strategy is to induce plan sponsors to put more pressure on their PBM vendors to bargain harder with the large drugstore chains. This pressure would destabilize tacit collusion among the Big 3 pharmacy benefit managers (PBMs) – Medco, and Express Scripts, and CVS/Caremark -- to hold up retail prices in order to make their mail order operations price competitive without margin erosion.

The emergence of SXC as a large, independent PBM software application service provider capable of handling large accounts is another development that can contribute to the undermining of Big 3 PBM dominance.<sup>30</sup> The existence of SXC puts smaller PBMs in position to win bids based on smart, cost-effective plan designs while contracting out the "heavy-lifting" of claims processing to SXC.

Also, the availability of independent mail order pharmacies, such as Walgreen and Wellpartner, enables smaller, independent PBMs with transparent ASO business models to offer competitive mail order prices even though these PBMs are a fraction of scale of the Big 3 PBMs.

## **Express Scripts as a Risk-Bearing Entity**

The final section of the paper examines some of the regulatory issues that accompany Express Scripts' take-over of Wellpoint's risky, fixed premium plans held by small businesses, individuals, and seniors under Medicare Part D plans.

While Wellpoint will be the nominal underwriter of these contracts, the deal turns Wellpoint into a "front" while Express Scripts become the "risk-bearing entity". In other words, the Express Script – Wellpoint deal is a "fronting arrangement" according to the following definition from the Reinsurance glossary,<sup>31</sup>

In a fronting arrangement, the licensed insurer (ceding company) that obtains regulatory approval for an insurance product, sells the product, and cedes all or most of the risk to a company that is not licensed to do business in the jurisdiction.

State governments have the responsibility for licensing "risk-bearing entities". They do this by requiring that such entities have adequate reserves on their balance sheets to cover potential losses, and by requiring that periodic financial statement be filed as support. Determining status as a risk-bearing entity and the need for licensing has presented state regulators with a number of problems in the healthcare area.

For example, physician group practices and hospitals sometimes accept capitated contracts providing them with a fixed PMPY fee regardless of actual patient usage. Such contracts involve a degree of risk and have raised the question for the need of physician practices and hospitals to be licensed as risk-bearing entities. The trend toward capitated payments will increase as healthcare reform involves replacing usage as the basis for reimbursements.

Another area presenting problems to state regulators has been independent PBMs who accept outsourced contracts from insurers or plan sponsors. Normally, outsourced benefits managers operate on an ASO model where all healthcare costs flow directly to the insurer or plan. However, the Big 3 PBMs operate on a benefits reseller model with reimbursements flowing

through their balance sheets. In this case, there is some financial risk of failure to reimburse providers due to lack of working capital.

Generally, the Big 3 PBMs avoid being the nominal underwriter of pharmacy benefits contracts. For example, they have preferred to be the “Intel-inside” Medicare Part D prescription drug plans (PDPs), avoiding exposure to the risk inherent in these government-subsidized, but nevertheless, capitated plans. However, both Medco, under its own name, and CVS/ Caremark, under the name Silverscript, have decided to come out and sponsor Medicare Part D PDPs themselves. Accordingly, they have created insurance subsidiaries that they have registered in just about every state.

On the other hand, Express Scripts mostly has avoided any direct sponsorship of Medicare Part D PDPs. While they have created an insurance subsidiary, it has been licensed and reports activity in only a few states relative to the insurance subsidiaries of Medco and CVS/Caremark.

Consider the following statement by Express Scripts in its latest 10-K regarding the need to obtain state licensing as a risk-bearing agent.<sup>32</sup>

*State Regulation of Financial Risk Plans.*

Fee-for-service prescription drug plans are generally not subject to financial regulation by the states. However, if a PBM offers to provide prescription drug coverage on a capitated basis or otherwise accepts material financial risk in providing the benefit, laws in various states may regulate the plan. Such laws may require that the party at risk establish reserves or otherwise demonstrate financial responsibility. Laws that may apply in such cases include insurance laws, HMO laws or limited prepaid health service plan laws.

Currently, the Company does not believe that its PBM business currently incurs financial risk of the type subject to such regulation. However, if it chooses to become a regional PDP for the Medicare outpatient prescription drug benefit at some time in the future, the Company would need to comply with state laws governing risk-bearing entities in the states where it operates a PDP.

Below is a table published by the National Association of Insurance Commissioners listing the 2008 business activity undertaken by Express Scripts’ insurance company in the 13 states where Wellpoint’s PBM book of business is located.<sup>33</sup> Note that there are 5 states – Colorado, Kentucky, Maine, Nevada, and New Hampshire -- where no activity has been reported. Also, notice that in 10 states, Express Scripts’ status is below that of “fully licensed”.

Express Scripts plan's for Wellpoint's PBM business should be monitored closely both by current Wellpoint PBM clients and by state insurance regulators. Clients should be skeptical of any attempt to convert their plan to Express Script's benefits reseller model. Insurance regulators in the states where Wellpoint-Anthem currently does business should consider the status of Express Scripts as a risk-bearing entity in light of their purchase of Wellpoint's PBM book of business.



Consumer Information Source

**Express Scripts Ins Co**

**NAIC#:** 60025 **Home Office:** Arizona

**Business Type:** Life/Accident/Health

Other Reports: [Complaints](#) [Financial Information](#)

[Company Search Help](#)

EXPRESS SCRIPTS INS CO  
 LICENSED STATE REPORT  
 YEAR END 2008

State	Active Status	Direct Business Written
California	E	\$226281
Colorado	E	\$0
Georgia	E	\$339422
Indiana	L	\$452563
Kentucky	E	\$0
Maine	E	\$0
Missouri	E	\$452563
Nevada	L	\$0
New Hampshire	E	\$0
New York	L	\$1357688
Ohio	E	\$113140
Virginia	E	\$113140
Wisconsin	E	\$452563

Legend for Active Status column

<b>L - Licensed or Chartered</b>	Licensed Carrier and Domiciled Risk Retention Groups. In some states referred to as admitted.
<b>R - Registered</b>	Non-domiciled Risk Retention Group
<b>E - Eligible</b>	Reporting Entities eligible or approved to write Surplus Lines in the state. In some states referred to as non-admitted.
<b>N - None of the above</b>	Not allowed to write business in the state.
<b>Q - Qualified Reinsurance</b>	
<b>"-" - Unknown</b>	Status could not be determined

## Notes

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