

PROF. DR. HAGEN
LINDSTÄDT

QUARTERLY INSIGHTS ON STRATEGY AND MARKET DYNAMICS

DRUG DISCOUNT CONTRACTS IN GERMANY: WILL WE BE FACING A CLAIM GAME?

SPOTLIGHT ON THE PHARMACEUTICALS INDUSTRY



JULY 2010

HAGEN LINDSTÄDT, PETRA DIETL, DOMINIK DRERUP

Recent years have seen several health reforms in Germany. Faced with exploding health care costs, government is attempting to reduce public expenditure and promote price competition among suppliers and providers. Among other things, health insurance companies are now entitled to directly negotiate discount contracts with Pharmaceutical manufacturers – which will clearly redefine the rules of the game in the market for prescription medicines. But what will be the outcome? Where is the pharmaceuticals industry heading in the longer run? Is a major price decline inevitable, as some experts claim? We have our doubts.

THE CHALLENGE

Until recently, life was relatively easy in the German pharmaceuticals market. As doctors were free to prescribe the products of their preference, suppliers had plenty of leeway to set their prices as they deemed right. Now a major change is underway: in its efforts to curb sky-rocketing healthcare costs, the German government has been putting increasing pressure on the prices of medicinal products.

Foremost among the government's initiatives are several new pieces of legislation concerning reimbursement policies for public health insurance funds. What branded product suppliers will probably find most painful is that, when there are several products with the same active ingredient, the pharmacist has to dispense one of the three lowest-price ones.

NEW REGULATION PERMITS PUBLIC INSURERS TO NEGOTIATE INDIVIDUAL DRUG DISCOUNT CONTRACTS WITH PHARMA COMPANIES

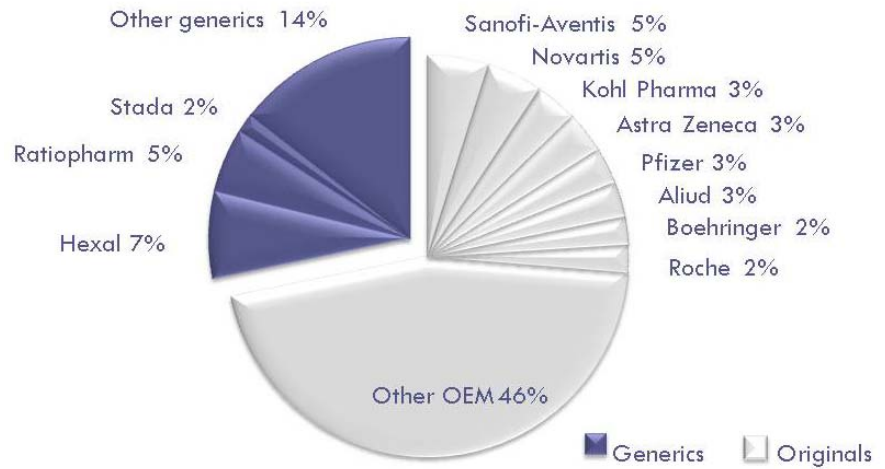
Another key element of the new regulation is that it permits public insurers to negotiate individual drug discount contracts with pharma companies: these contracts commit pharmacists to hand out the drugs made by this manufacturer; while the insurance company obtains discounted prices in return. In effect, the new system is promoting the use of inexpensive drugs through a system of tenders.

So far, the only suppliers that have taken advantage of the new discount scheme are manufacturers of generic drugs; branded drug suppliers have stayed out of the game entirely. For very obvious reasons, as the latter's business system, which is directed at the high end of the market, does not lend itself to price competition. After investing enormous sums in the development of innovative drugs, companies attempt to recoup that investment from the (higher) profits gained while their products are patent-protected.

Once these patents expire – which is usually 20 years after their registration, or an average 10 years after market launch – the generic drug makers come into the game. With almost no R&D expenditure at all, they are able to sell same-substance products at much lower prices, thus reaping the benefits of a tried and tested medicine. Often they also save on advertisement and packaging, as customers are already familiar with the substance and its benefits. In short, it is a low-cost business system which is clearly favored under the new legislation.

At present, generics suppliers hold approximately 28 percent of the market based on turnover (a share which is rapidly growing). Most of it is in the hands of the three leading German generic companies Sandoz-Hexal, Ratiopharm (recently acquired by the Israeli market leader Teva) and Stada. The remaining 72 percent of the market is dominated by the research-based pharma companies (see figure 1).

Total GKV Sales 2009: €28.6 bn



Note: In part preliminary data estimated on 2009 figures
 Source: Pro-Generika, Arzneiverordnungsreport 2009

INDUSTRY EXPERTS NOW PREDICT A PROFOUND RE-SHAPING OF THE HEALTHCARE MARKET

Industry experts now predict a profound reshaping of the healthcare market. With discounts ranging from 20 to 80 percent (according to estimates, as actual levels are kept secret) the average price level in the pharma market is expected to decline dramatically.

A price war will break out, observers say, in particular among generic suppliers who, in a fierce battle for market share, will keep lowering both their list prices *and* their discounts. In the end, smaller generic drug makers may even disappear from the market. Research-based pharma companies, on the other hand, will hold on to their premium prices and continue to keep out of the discount game, focusing on the (smaller) market segments where price elasticity is low – which also means that shortly after patent expiration, generic drug makers will take over much of their market share.

This, more or less, is the low-price scenario currently discussed throughout the industry. It is what policymakers are aiming for, and what suppliers really dread.

But then again, things might play out very differently...

THE RESPONSE

Before considering a possible alternative scenario, let us take a quick look at the market structure. From a supplier's point of view, the pharmaceuticals market can be divided in three segments: The largest – about 80 percent of all units sold – comprises the so-called "aut idem" prescriptions for people insured in public health funds. "Aut idem" (from the Latin "or equal") means that the physician, in prescribing a certain product, allows it to be replaced by another one with identical active agents. The second segment (some 10 percent) comprises all "ex aut idem" prescriptions – i.e., cases in which the doctor prescribes one specific product to the exclusion of all others, which means that even public insurers have no alternative. The third segment (the remaining 10 percent) comprises the clientele of private health insurers.

Quite obviously, the only segment relevant for discount contracts is the first one: here, insurers will get a virtual "market share guarantee" in return for the discounts they grant, thus offsetting much of the margin-reducing effect. In the "ex aut idem", discounts will only lower end-user prices without having any market share effect; in the third segment, drug discount contracts make no sense as patients get what the doctor prescribes.

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What this implies for manufacturers is that they can structure their prices accordingly and differentiate their strategies by market segment. Instead of launching price attacks across all fronts, generic drug makers might choose to keep list prices high and, in an attempt to keep the industry's profitability up, offer generous discounts to selected insurers only. Branded drug makers might follow the same rationale, exploring the less price-sensitive segments while selectively negotiating discount contracts with a few choice insurers in order to gain access to the largest market segment. (Of course, this would only make sense in segments with few ex-aut-idem cases, and where fixed cost is high enough to provide an effective entry barrier to competitors; this way they could grant discounts while still achieving sustainable profits.)

**THE OUTCOME
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Continuing on this line of thought, the outcome might be a market where all suppliers, both branded and generic, have staked their claims by focusing either on contracts with specific public health funds or on specific indications. This could spare them from a price war and help them to keep their overall profits at a comfortable level. In the course of several years, each supplier might have occupied one or several segments – which could be selected insurance companies, regions, or substance classes. Some branded drug manufacturers might even choose to establish their own generics affiliate. Things like that have happened before, as examples from other industries show. There is often an unspoken agreement on how the market is divided up, with the occasional skirmish about trifles going on at the market fringes.

The conclusion from all this is certainly good news for suppliers, but potentially alarming for policy-makers. In the long run – once everybody has found their segment "home" and gotten comfortable – the new drug discount contracts might result in the exact opposite of what had originally been intended: it might lead to higher instead of lower prices. Whatever the outcome will be, it is a prime example of how regulation can impact the dynamics of an entire industry – be it for the better or the worse.



Prof. Dr. Hagen Lindstädt (lindstaedt@ibu.uni-karlsruhe.de) is the head of the Institute for Management and the Scientific Director of the Center for Strategic Business Wargaming, both at Karlsruhe University/KIT.

As a renowned expert for Strategy, Competitive Intelligence, Pricing and Strategy Simulation, Prof. Lindstädt is a sought-after adviser to leading German and European corporations (DAX30, Top 100).

Prior to his academic career, he was a management consultant with McKinsey&Company for five years.