

# Wholesalers turning to fee-for-service model

BY JAMES FREDERICK

**A** seismic change is under way among the nation's drug wholesalers. Caught between evaporating deal-making opportunities from manufacturers on the one hand and increasingly powerful retail customers putting the squeeze on distributed inventory markups on the other, wholesalers are changing the way they do business and asking manufacturers to adapt along with them.

Drug distributors traditionally have relied on promotional opportunities, rebates from manufacturers and purchases of overstocks on the so-called secondary market. However, that model is changing fast.

Increasingly, manufacturers are tying production to actual market demand, drying up the sources of deal and overstock inventory that wholesalers used to bolster their profits. Forward buying is becoming less useful as a margin-enhancement tool. And on the retail side, consolidation has helped create a market dominated by powerful chains that demand growing price and service concessions from their wholesalers.

In response, wholesalers are shifting rapidly to a new, fee-for-service pricing strategy "in which customers or suppliers pay directly for wholesaling services rather than having those services bundled and paid for indirectly through gross margin and unseen discounts," noted Adam Fein, Ph.D., of Pembroke Consulting. That new model, he added in a report in *HealthCare Distributor*, separates a distributor's product costs from its value-added service costs.

A recent study from Pembroke addressed the changing economics that are roiling the industry and what Fein called "the promise and perils of fee-for-service wholesaling."

Fein predicted that fee-based services and fee-for-service pricing models both would grow sharply over the next five years. "Pharmaceutical wholesalers have survived on slim gross margins due to phenomenal operating efficiencies and skill at creating innovative value-added services for customers," he wrote. But fundamental shifts in the health care and pharmacy markets are forcing distributors to abandon that old business model in favor of fee-for-service, Fein added.

Among those changes, he wrote, is the growing concentration of retail and institutional health care customers, which "has shifted power downstream" and given those big customers the leverage to "negotiate away distribution margins" for wholesalers. The wholesale industry also is grappling with steadily rising operating and payroll

costs, a "fundamentally broken" system of manufacturer rebates and discounts, and the realization that "services can be more profitable than the core wholesaling business," according to Fein.

He concluded: "Pharmaceutical wholesalers are evolving into suppliers of customized and differentiated relationships that provide products with related services instead of merely reliably providing goods."

## A 'permanent shift'

All three of the power players in drug wholesaling—McKesson Corp., Cardinal Health and AmerisourceBergen—are engaged fully in the shift from an inflation-driven business model, based on charging a percentage for goods shipped, to a fee-for-service model. In the parlance of Amerisource-

*Drug Store News* in an Aug. 9 interview. "We're having a lot of conversations right now with manufacturers ... about how we get to that model."

Part of that shift has involved simply educating the supplier community over the last six months, said the Cardinal executive. "First they have to understand what the wholesalers have been doing for them, because we as wholesalers have been sort of our own worst enemies. The system works so efficiently, it's almost automatic. And people don't realize all the activity that goes into getting their products to market."

What's more, he said, "Manufacturers had to understand ... how much pressure there is downstream from the wholesaler at the retail level." Given that 90 percent of drug retailers' prescription reimbursements are dictated by third parties, said Parrish, "Pharmacies cannot absorb any of the impact of this change."

That makes it difficult, if not impossible, for wholesalers to absorb the old practice of "channel stuffing" that many suppliers engaged in as a way to pump up revenues at the end of a quarter because that practice failed to reflect the true costs of services being delivered on manufacturers' behalf.

Instead, he said, "We as wholesalers have to look at the costs of the services we provide and base our reimbursement on a more fair method of compensation."

Despite "some resistance" to a fee-for-service model, Parrish continued, "manufacturers are acknowledging ... that there is a very difficult marketplace for the provider customer. They recognize that they're going to have to continue to pay for the [distribution] services they receive."

Most of the change, Parrish predicted, will be transparent to retailers. "What we want to do at Cardinal is continue to service the customer as we have been, with minimal price impact to them. What they may notice is that as contracts come up for renewal, the pattern that has been the case in the last few years is that each contract [has yielded] greater and greater discounts. And I think we're coming to the end of that."

"I'm not saying that all of a sudden the prices are going to go back up. But the contract renewals that have led to price discounting of 50 or 60 basis points, I don't think you're going to see that going forward," Parrish predicted. "If there is any additional discounting, I think it will be proportionate to the efficiency of the relationship—if, say, [a chain account] is bringing more volume to the wholesaler. Our intent is to preserve the model, because it's working extremely well."



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Bergen chief executive officer R. David Yost, that shift involves a "transition to inventory management agreements with manufacturers."

A spokesperson for McKesson put it this way: "McKesson has traditionally benefited from profits earned through buy-side opportunities from manufacturers ... [and] invested our profits in serving customers by dramatically increasing service levels over time. However, the manufacturers' model is changing, shifting to just-in-time inventory models that reduce our buy-side opportunities.

"To support our investments in quality, technology and the future, we are making changes in how we do business. And while our goal is to insulate customers from changing economics whenever possible, we must make sure all our customers pay in a fair way for the value they receive."

Thus, noted McKesson, "We are moving toward a model in which manufacturers compensate us for distribution services on a fee-for-service basis."

Mark Parrish, executive vice president and group president of pharmaceutical distribution for Cardinal Health, is involved in similar negotiations. "This change from what we call the 'buy-and-hold' type of arrangement ... to a fee-for-service model does appear to be a permanent shift," Parrish told

