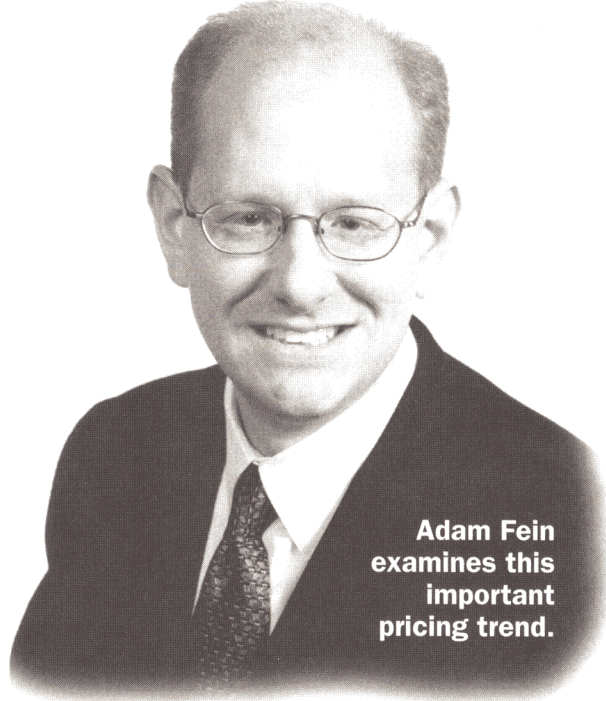


# The Promise and Perils of Fee-for-Service Wholesaling



Adam Fein examines this important pricing trend.

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Over the next five years, the use of fee-based services and fee-for-service pricing models will grow sharply by pharmaceutical wholesalers, although significant barriers remain. This conclusion comes from Pembroke Consulting's new study, *Facing the Forces of Change: The Road to Opportunity* (available at [www.nawpubs.org](http://www.nawpubs.org)), which examines the future of distribution channels and supply chains across multiple lines of trade, including health care.

The fee-for-service trend is spreading like wildfire throughout many distribution channels. Our data, which include responses from over 1,000 wholesale distribution executives in more than 50 different industries, show that over 80 percent of distributors plan to charge fees separate from product costs.

Fees radically alter traditional channel economics by splitting support and other services from product price. Wholesalers have been moving to a services business model for some time now. However, the shift to fee-for-service has the potential to radically reshape the power dynamics in the industry.

## Forces of Change

The economics of pharmaceutical wholesaling differ from other channels because approximately 85 percent of

wholesalers' gross margin dollars come from the buy side. Manufacturers support the legitimate costs of distributing products with forward buying opportunities, trade promotions, rebates, and cash discounts. Large customers pay virtually nothing for the actual distribution of pharmaceutical products in the U.S. Pharmaceutical wholesalers have survived on slim gross margins due to phenomenal operating efficiencies and skill at creating innovative value-added services for customers.

Fee-for-service is really just a 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. By separating product costs from service costs, fee-for-service pricing provides a more accountable way of measuring and compensating for the value activities in the supply chain.

We have identified four key factors driving this trend based on our *Facing the Forces of Change* research study. Any one of these four factors alone is probably not enough to trigger a move to fee for service in health-care distribution. Yet together they provide reinforcing incentives for both manufacturers and distributors. Let's examine some of the compelling reasons this trend is evolving.

First, the growing concentration of health-care buyers has shifted power downstream. Although large customers can negotiate away distribution margins, someone still has to pay for the services and activities of pharmaceutical wholesalers. As a result, manufacturers rely on trade promotions, rebates, etc., to support legitimate business and operating expenses. Wholesalers can't pass these promotions or discounts on to customers without facing financial ruin.

Second, the underlying costs of running a wholesale distribution business continue to rise. Compensation and payroll expenses are among the largest costs for wholesalers, still representing 60 percent to 70 percent of operating expenses in this automated supply chain. These costs have been growing at 3 percent to 5 percent per year for the past decade, driven in large part by benefits costs and insurance. Wholesalers have been struggling to grow the top line and gross margin dollars fast enough to veil this ongoing pressure.

Third, the current system of rebates and discounts is fundamentally broken. Since so much of a drug wholesaler's gross margin comes from manufacturers, channel relationships have predictably become overly focused on supplier nego-

See **FORCES OF CHANGE** on page 22

tiations. Customers deny the value added by wholesalers in the supply chain, forcing manufacturers to step in and fill the gap. A vicious cycle ensues, as customers demand lower prices and distributors seek payments from the manufacturer to keep them whole.

Cash discounts and trade promotions also warp incentives to lower supply-chain costs because these practices add nothing beneficial to the customers or health-care system. For example, the pressure to meet Wall Street expectations creates pressures for manufacturing executives to “rent” market share at the end of every quarter.

The fourth factor driving fee-for-service arrangements is the actual experience showing services can be more profitable than the core wholesaling business. A services business has a very different economic model. Revenues are lower because fee-based services do not include the pass-through cost of goods sold. Return on total assets rises because services do not add to inventory assets and add relatively little to accounts receivable.

Pharmaceutical wholesalers have been channel leaders in adding higher margin services for customers, such as on-site inventory management, pharmacy staffing, and technology consulting. Instead of struggling to get customers to pay for previously “free” services, they have built new fee-based services as well as acquired existing service companies. These services help hospitals and pharmacies provide better end-to-end patient care and increase operating efficiencies. AmerisourceBergen, Cardinal Health, and McKesson have all demonstrated the disproportionate profit impact of their service operations versus product distribution.

### The Basics of IMAs

Inventory management agreements (IMAs) are a newer type of fee for service arrangement in the pharmaceutical wholesale channel. In a basic IMA, the wholesaler agrees to reduce or eliminate forward buying — purchases to stock not tied to demand. In return, the manufacturer provides a fee structure or payment to offset the wholesaler’s economic losses from the discontinuation of forward buying.

Essentially, manufacturers are pay-

ing wholesalers not to speculate with inventory. This is a fundamental shift in the pricing model. Rather than throwing money at wholesalers, hoping for loyalty and share, manufacturers can link fees and incentives to reach mutually beneficial outcomes:

- Manufacturers have the opportunity to improve production efficiencies and overcome the traditional disconnect between marketing and operations. Too often in this industry, sales and marketing will use a trade promotion for strategic reasons. Suddenly, manufacturing is flooded with orders and must unexpectedly produce extra volume. In theory, wholesalers under an IMA will purchase to actual demand instead of stocking up.

- Wholesalers can benefit from IMAs because they remove risk from the business. Forward buying is just arbitrage across time. Even if the financial return under an IMA is less than forward buying, wholesalers have the opportunity to lower risk and return at the same time.

### Unforeseen Risks

I have spoken to some wholesale executives who see fee-for-service as a positive change for the industry. However, our research has identified three little-discussed risks of moving to more fee-for-service pricing.

First, fee-for-service pricing will increase a wholesaler’s accountability in the supply chain. Fees force wholesalers to deliver specific, measurable results — or risk not being paid.

In the case of IMAs, fee-for-service will change relationships between manufacturers and wholesalers by removing the smoke and mirrors around a wholesaler’s promise not to forward buy. The wholesaler is selling a service to the manufacturer. The manufacturer is now explicitly a customer and can hold the wholesaler accountable. Without an IMA, a manufacturer’s only recourse is to switch wholesalers. That’s not really a possibility in an era of three dominant wholesalers. We have not yet seen the full implications of this power shift.


Second, fees create more transparency and integrity in the drug supply chain. Fees can be reported as a cost of doing business on an income statement. In contrast, existing accounting standards and reporting requirements allow

manufacturers to bury the distribution costs of their products and wholesalers to hide the profit contribution of vendor payments. Fees are an appropriate solution for today’s new era of accountability.

Third, wholesalers are stepping onto the slippery slope of *a la carte* pricing. Fee-for-service can give customers and manufacturers the ability to cherry-pick the help they need and pay only for the support they receive. Powerful customers and suppliers may begin demanding that the cost of the service be deleted. In the end, this gives customers what they seek: more power and lower prices without compromise. Sensing their buying power and being rewarded for their efforts, customers and manufacturers will turn the screws again and again, seeking more concessions and squeezing distributors even tighter.

### Future Trends

So far, we have limited experience with the newest and most innovative fee-for-service offerings. For instance, most IMA agreements are less than two years old. Like many supply-chain arrangements, initial savings can be significant in the first few years, but are often tied to one-time gains. In this case, the gains come from the reduction in forward buying. Manufacturers will need something else once reduced inventory levels become the new normality.

Pharmaceutical wholesalers are evolving into suppliers of customized and differentiated relationships that provide products with related services instead of merely reliably providing goods. Just like products, services have a life span and require reinvention over time to appear relevant and new. Wholesalers will have to run fast to deliver new service innovations for ongoing success with fee-for-service pricing. 

© 2004 Pembroke Consulting Inc. Adam J. Fein, Ph.D., is the founder and president of Pembroke Consulting, a firm that helps senior executives at wholesale distribution, manufacturing and B2B technology companies build and sustain market leadership. He can be reached at 215-523-5700 or on the Web at [www.PembrokeConsulting.com](http://www.PembrokeConsulting.com). This article is adapted from *Facing the Forces of Change: The Road to Opportunity*, which is available at [www.nawpubs.org](http://www.nawpubs.org).