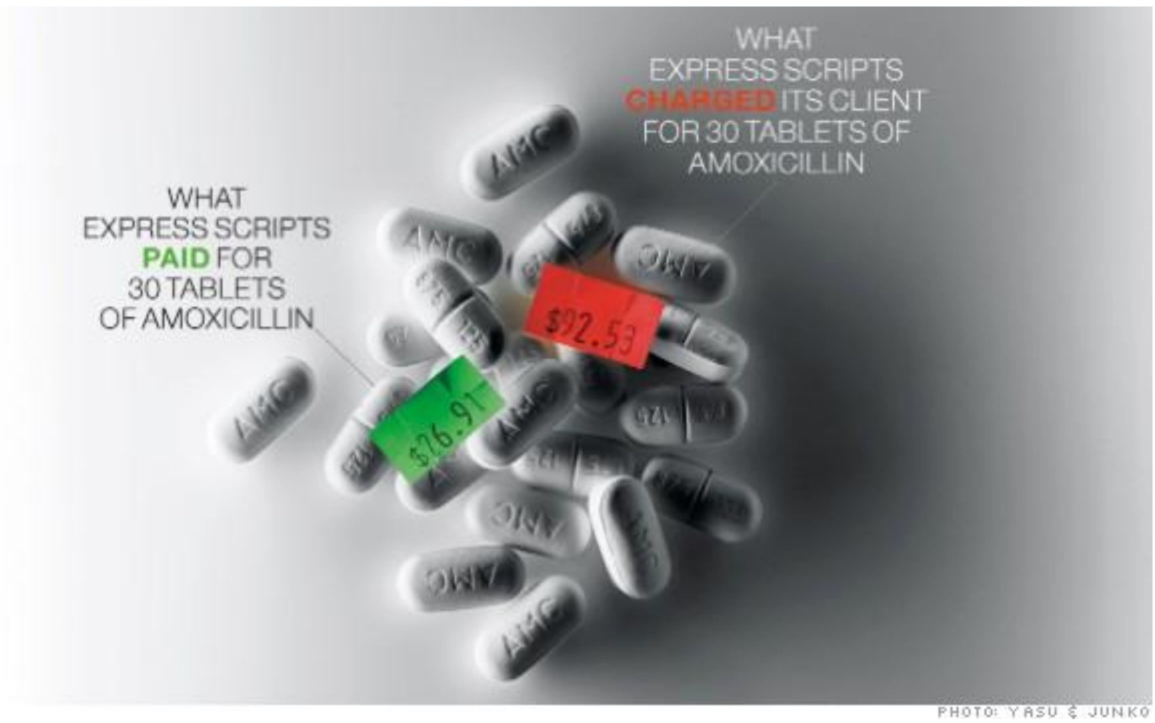
Painful Prescription

By Katherine Eban @FortuneMagazine

In late 2008, Meridian Health Systems, a nonprofit that owns and operates six hospitals in southern New Jersey, hired a new pharmacy benefits management (PBM) company to help reduce the surging medication costs for its 12,000 employees and their families. Express Scripts, which has since become the largest PBM in the country, projected that it would slice at least $763,000 from Meridian's $12 million in annual drug spending.



But just three months into the contract, Meridian discovered that its bills were soaring, on pace to balloon by $1.3 million in 2009. Express Scripts insisted that, in reality, Meridian was saving money.

Robert Schenk didn't buy it. He oversees Meridian's spending on medications for employees and its in-house pharmacy. Schenk, 57, had once owned two small-town drugstores but sold them in part because of relentless price-lowering pressure from PBMs. He knew firsthand how little pharmacies were paid relative to what customers were charged.

Schenk decided to figure out where Meridian's money was going and why its drug costs were escalating. That was no easy task because, like most PBM customers, Meridian received data only on what it was being charged for each employee prescription. Meridian didn't know what it cost the PBM to fill that order.

Then Schenk had a stroke of inspiration. He realized that Meridian had a second stream of data that almost no other PBM customers had: Its in-house pharmacy was paid by Express Scripts for many prescriptions. That meant Meridian could see both what the PBM was paying to buy drugs and what it was selling them for.

When he compared the two lists, the mild-mannered pharmacist was shocked: Express Scripts was making huge gross profits (known as "spreads" in the PBM world) ranging from $5 per order to many multiples of that. In one particularly extreme example, Meridian was billed $92.53 for a prescription for generic amoxicillin filled at an outside pharmacy. Meanwhile, Express Scripts paid $26.91 to Meridian's own pharmacy to fill the same prescription. That meant a spread of $65.62 on one bottle of a generic antibiotic.

Express Scripts vehemently insists it saves money for clients and that the vast majority are satisfied with its service. And like any company -- to state the obvious -- it's entitled to a profit. The question is, Who is making out better -- the PBM or its customers? Many experts say the former. They argue that many companies stick with traditional PBMs because drug pricing is so impossible to untangle that customers have no way to verify how much they're saving, if anything.

Meridian's experience is far from unique, these experts say. PBMs effectively pad bills by $8 to $10 a prescription, according to Susan Hayes, who has audited more than 100 PBM contracts for her auditing and consulting firm Pharmacy Outcomes Specialists. As Hayes puts it, **"The nation's employers are being taken for a ride."**

PBMs started as paper pushers: They began hand-processing medical claims in the 1970s and evolved into middlemen who touted their ability to use corporate customers' combined purchasing power to negotiate huge discounts from pharmaceutical companies.

Today the top PBMs are as big as or bigger than their clients. Express Scripts generated $94 billion in revenues last year after merging with Medco, putting it at No. 24 on the Fortune 500. Its annual profits have grown from $250 million a decade ago to $1.8 billion in the 12 months ended in June, according to S&P Capital IQ. The company now manages benefits for more than 100 million Americans.

Total industry revenues exceed $250 billion, according to J.P. Morgan analyst Lisa Gill. The big prescription managers -- Express Scripts, CVS Caremark, and OptumRx control about 70% of all U.S prescriptions -- have become some of the most potent players in health care. PBMs determine where patients fill their prescriptions. They decide what drugs people will take and how much pharmacists will get reimbursed for dispensing them. They shift patients to generic drugs and require them to fill basic prescriptions at the PBMs' vast mail-order pharmacies. And with some 30 million Americans expected to gain prescription-drug coverage through the Affordable Care Act, PBM use is likely to continue increasing.

The debate as to whether traditional PBMs save money for clients has propelled the rise of a renegade group of relatively small, so-called transparent PBMs. These mostly newer competitors now account for an estimated 10% of the market. The transparent PBMs offer a very different model. They don't profit from spreads on drugs or any secret incentives. Instead, they take a flat administrative fee for each prescription.

Unlike traditional PBMs, whose contracts often bar pharmacies from revealing what the PBMs are paying them, transparent managers disclose what they pay. Most of the 500 clients of transparent PBM Envision Pharmaceutical Services (which now includes Meridian) have defected from traditional PBMs, says CEO Kevin Nagle. And independent PBM consultant Linda Cahn says all her clients have abandoned traditional providers in favor of transparent ones because "traditional contracts gouge the client."

The traditional PBMs say they provide quantifiable value. In March, Express Scripts announced that for the first time in two decades prices for routine medications dropped, declining 1.5% in 2012. Express Scripts hailed the decrease as "the latest chapter of an ongoing success story for our utilization management programs."

Mark Merritt, CEO of the Pharmaceutical Care Management Association (PCMA), a trade group representing the 10 largest traditional PBMs, says that while "drug prices have gone up more than we'd like" over the years, his members have saved employers 25%. "We're kind of like a British civil servant," he says. "If you want to save money, tell us how much and we'll do it." Studies commissioned by his group project that over the next decade, PBMs will save employers, consumers, and the government more than $2 trillion, and have already helped reduce by a third the projected cost of the Medicare Part D program, a largely privatized drug benefit for seniors.

The PBMs' claims of cost savings are difficult to prove or disprove. Drug pricing is an almost impenetrable bog. The benchmarks the industry relies on, such as the published average wholesale price, are built on antiquated data and bear little relation to real costs. Drug companies offer undisclosed rebates to PBMs in exchange for market share. Generics are so cheap, and the prices so varied, that often the cost is whatever the PBM says it is, according to consultant Cahn.

A 2012 report by the Kaiser Family Foundation calls the PBM assertions of Medicare savings "overstated" and says the reduced cost probably stemmed from incorrectly high predictions of prices and from brand drugs going generic. Its author, Jack Hoadley, a research professor at the Health Policy Institute of Georgetown University, says, "PBMs like to say, 'We're the ones that really made that happen,' and that's partly true and partly not true. If you have a patient who's taking Lipitor two years ago, they're automatically switched to generic.

In that case, the PBM doesn't do anything to create that savings." Some experts contend that prices would be falling far faster if not for hidden spreads. "If your drug prices aren't flat or going down every year, I know who's getting the money, and it should not be happening," says Craig Burridge, the recently retired executive director of the New York State Pharmacists Society. "Billions of unnecessary dollars are being added every year to the cost of prescription drugs."

At Express Scripts headquarters in St. Louis, five sprawling buildings rise from a windblown highway crossing. There the PBM manages drug benefits, dispenses medications from its mail-order pharmacy, and studies how best to manage the patients taking them. Earlier this year chief medical officer Dr. Steve Miller led the way through the blond-wood interior of the Technology and Innovation Center and up a gleaming staircase. "We now represent the interests of 100 million Americans," he says. "We are truly the voice for the payer."

Pushing open white double doors, he reveals one of the world's largest and most mechanized pharmacies. One of six distribution facilities that Express Scripts operates, it's the size of six football fields. Suspended conveyor belts traverse the cavernous space. Orange plastic bottles zip along soundlessly, then enter glass control booths, where robotic arms swing in and out.

Of the 110,000 prescriptions filled here daily only 3% require human intervention. The executives stress the benefit to patients. The pharmacy here is Six Sigma perfect, a production standard that results in about one error for every million bottles filled. At that rate, this facility will prevent about 2 million errors a year, says Miller.

That was the sort of cost-saving efficiency Meridian was looking for in 2008. For years it had seen its drug costs rise under a contract with a different PBM. Meridian executives decided to make a change and spent months looking for the right replacement.

Express Scripts seemed like a good bet. It guaranteed significant discounts on drugs and used the word "partnership" to describe the relationship. Meridian's consultant explained that Express Scripts would profit from spreads on low-cost generic drugs (though Meridian's contract with Express Scripts never specified their magnitude). But the consultant contended in an email that the PBM's profit motive would benefit Meridian: "Since they have this money at stake, they will work harder to increase the use of generics." Like the consultant, Express Scripts emphasized that its interests would be aligned with those of its customer.

That's not how it played out. Just three months after Express Scripts began handling its prescriptions, Meridian calculated that it was facing that potential increase of $1.3 million in costs in the first year alone. Meridian executives were taken aback by the PBM's response to this news. Rather than expressing sympathy or contrition, Schenk says, the Express Scripts representatives complained that the company wasn't getting enough mail-order prescriptions from Meridian. Recalls Schenk: "Their attitude was, 'Hey, you're not giving us enough business.' "

Express Scripts argued that Meridian's projections had failed to account for rising drug prices. But those estimates weren't Meridian's alone. Kathleen Boushie, Meridian's director of health and wellness, dug up Express Scripts' original presentation, in which the medications, particularly very expensive specialty drugs (such as new biomedications and drugs for rare diseases). Boushie researched this claim and found that utilization had not increased.

In October, 10 months into the contract, Schenk asked Express Scripts for all of Meridian's specialty-drug claims. He got data for 800 claims -- a total of $1.52 million, averaging $19,000 per claim. As he compared each charge with the industry wide average wholesale price (AWP), he discovered that Meridian was not getting the contractually agreed-upon discount of AWP minus 18%. Instead, it was getting AWP minus 13%, leaving Meridian with a $106,000 overcharge.

Express Scripts responds in a statement: "Because of a setup error, there was a discrepancy in how specialty medications were being billed. Once we were made aware of the error, we addressed it and made sure Meridian was being reimbursed. The situation was not typical, and the error was an anomaly."

Even as the PBM industry has grown over the past two decades, it has been dogged by state investigations, class-action suits, and allegations that the industry uses opaque contracts to maximize profits. PBMs have been accused of everything from shorting pills in mail-order prescriptions to selling patient data they didn't own to covertly shifting patients to higher-cost drugs. As a federal judge in Maine put it in 2005, PBMs "introduce a layer of fog to the market that prevents benefits providers from fully understanding how to best minimize their net prescription-drug costs."

In 2008, Express Scripts paid $9.3 million to settle a suit by New York and 28 other states that claimed it deceptively inflated costs for state employees, in part by secretly switching to higher-cost drugs, and that it allegedly pocketed millions in manufacturer rebates. Express Scripts agreed to reforms to make it more transparent. Mark Merritt of the PBM trade group says this settlement helped establish the "rules of the road" for an "emerging industry."

Five years later the battles over transparency persist. Critics say the profit centers and the "spreadsheet games," as PBM auditor Susan Hayes calls them, have changed. The PBMs' biggest profits no longer lie in maximizing rebates on brand name drugs or shifting patients to higher-cost medication. Instead, they come from maximizing spreads on generics.

PBMs do this in a variety of ways, according to experts. Generic prices are typically set through lists of maximum allowable cost (MAC), which the PBMs establish. The PBMs may use multiple MAC lists to maximize spread, giving one set of prices to pharmacies and another to clients.

Most employers have no idea their contracts permit this. "Basically it's a 'confuse-opoly,' " says Gary Gustavson, vice president of account management for ClearScript, a transparent PBM. ClearScript was started by Fairview Health Services in St. Paul out of frustration with its experience with Express Scripts. "Buyers don't understand the PBM industry," he says, "and that's why they hire consultants -- who don't understand it either."

Merritt scoffs at the notion that clients are duped or befuddled. "We only deal with large, sophisticated payers," he says, and benefits programs are "built to their specifications." He adds, "Each client gets whatever kind of transparency they want." **But many people administering drug benefits don't have a clue that their contracts lack transparency.** As Meridian's Boushie puts it, "I am fortunate to work with savvy pharmacists ... That secret spread that those guys understood -- that was a new concept for me."

Imagine you want to buy a shirt. You go to a discount store and you see a very average shirt selling for $20 -- with a tag that says MARKED DOWN 90%!!! If you know anything about discount stores (or shirts), you'll know it's inconceivable that this item ever sold for $200, or even $100. More likely, its true retail value is closer to, say, $22. But, hey, either way you get a discount, and if you're saving money, why quibble?

That, critics say, is what occurs with traditional PBMs -- with one additional twist: In this instance, the discount store bought the item for $3 before selling it for $20. In this analogy, the PBM makes $17 and the customer saves $2. If that were the case, the customer might feel as if he wasn't getting a discount at all.

That's precisely what Robert Schenk came to believe once he was able to gather the data to compare what Express Scripts was charging Meridian for medications with what the PBM was paying Meridian's own pharmacy to buy them. **The spread leaped out**. For example, a Meridian employee filled a prescription for a five-day supply of the antibiotic azithromycin, known as a Z-Pak, at an outside retail pharmacy on Dec. 17, 2009. Express Scripts billed Meridian $26.87. The next day a patient filled an identical Z-Pak order at Meridian's pharmacy. The PBM paid the pharmacy $5.19. That meant a spread of $21.68 on just one prescription.

Schenk went down the list of drugs, finding prescriptions that matched exactly. The margins were enormous. Schenk was convinced that, as he puts it, "this has to be illegal." He was certain Meridian would report egregious fraud to state authorities. But his greater shock came when he combed through its contract. "I couldn't believe it," Schenk recalls. **The contract had no restrictions on the PBM's spreads.**

Express Scripts spokesperson Brian Henry says Meridian's dissatisfaction was highly unusual and adds, "When evaluating spread pricing, it's important to take into account all drugs, including the drugs where we take a loss or make only a few pennies per prescription. Again, we make money when the client saves money." Henry referred Fortune to a client, the Tampa Electric Co., which says it's very satisfied. Notes Brad Register, Tampa Electric's director of compensation and benefits: "I wouldn't say we've reduced cost, but we're controlling the cost of increase." Adds Henry: "Across the more than 3,500 clients who hire us (and our renewal rates are typically 95% and higher), we deliver the savings we promise by providing solutions that drive out pharmacy waste, control costs, and improve patient outcomes."

A survey conducted by a PBM-funded industry group recently concluded otherwise. According to the 2013 Pharmacy Benefit Manager Customer Satisfaction Report, just released by the Pharmacy Benefit Management Institute, Express Scripts was ranked by its customers lowest in overall satisfaction and second to last in delivering promised savings and having no conflict-of-interest issues.

Meridian struggled to decide whether to jettison Express Scripts. Its own consultants recommended retaining the PBM, insisting that both sides' interests were "aligned." Finally, though, Schenk came across another study that confirmed his own findings. The Advisory Board Co., a consulting firm that advises medical and educational institutions on a variety of issues -- including their health care spending -- had completed a survey of 80 hospital members. It concluded that traditional PBMs charged 40% more than their transparent rivals.

Meridian chose Envision Pharmaceutical Services, which charges a flat fee for every prescription filled -- nothing else. In the first year of Meridian's new contract, its drug bill dropped by $2 million.

Recently, transparent PBMs have gained support from another quarter. Last April the federal government added a modest transparency amendment to the Affordable Care Act. It requires PBMs managing Medicare contracts to disclose to the government the amount of rebates they are getting from manufacturers and the size of the spread.

The PBMs' trade group lobbied hard against the provision and in the end won a concession: an amendment requiring the government to keep the PBMs' incentives and spreads confidential. "We'll save you money," the industry seemed to be saying. "Just don't ever ask us how."

This story is from the October 28, 2013 issue of Fortune.

