

PERSPECTIVES ON DRUG PRICING:

Is “Value-Based Pricing” the Answer?

**Uwe Reinhardt
Princeton University**

COUNCIL ON HEALTH CARE ECONOMICS AND POLICY

23RD PRINCETON CONFERENCE

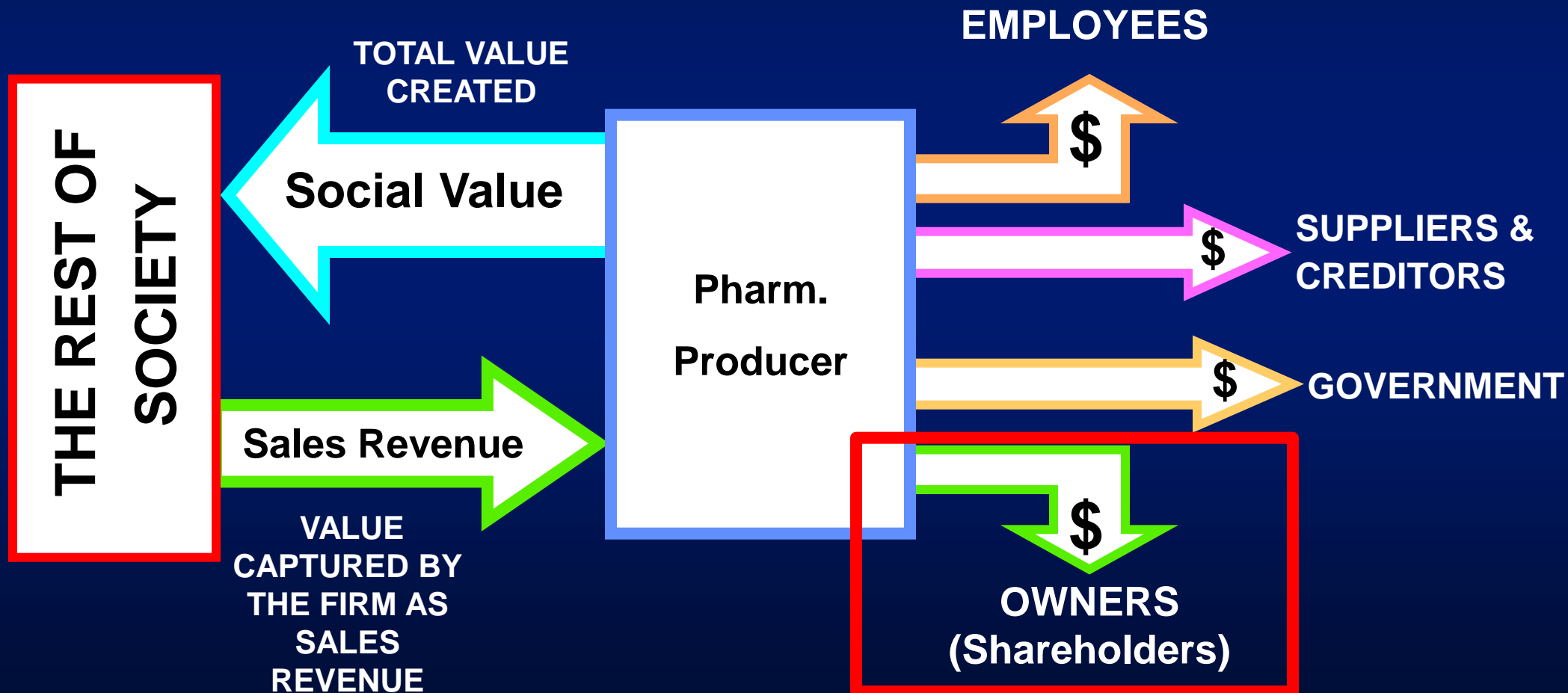
Princeton, New Jersey

May 25, 2016

I. VALUE CREATION IN MODERN CAPITALISM

CONSIDER THE “VALUE” CREATED BY A PRODUCER

DISTRIBUTION OF CAPTURED VALUE



ECONOMIST'S DICTUM

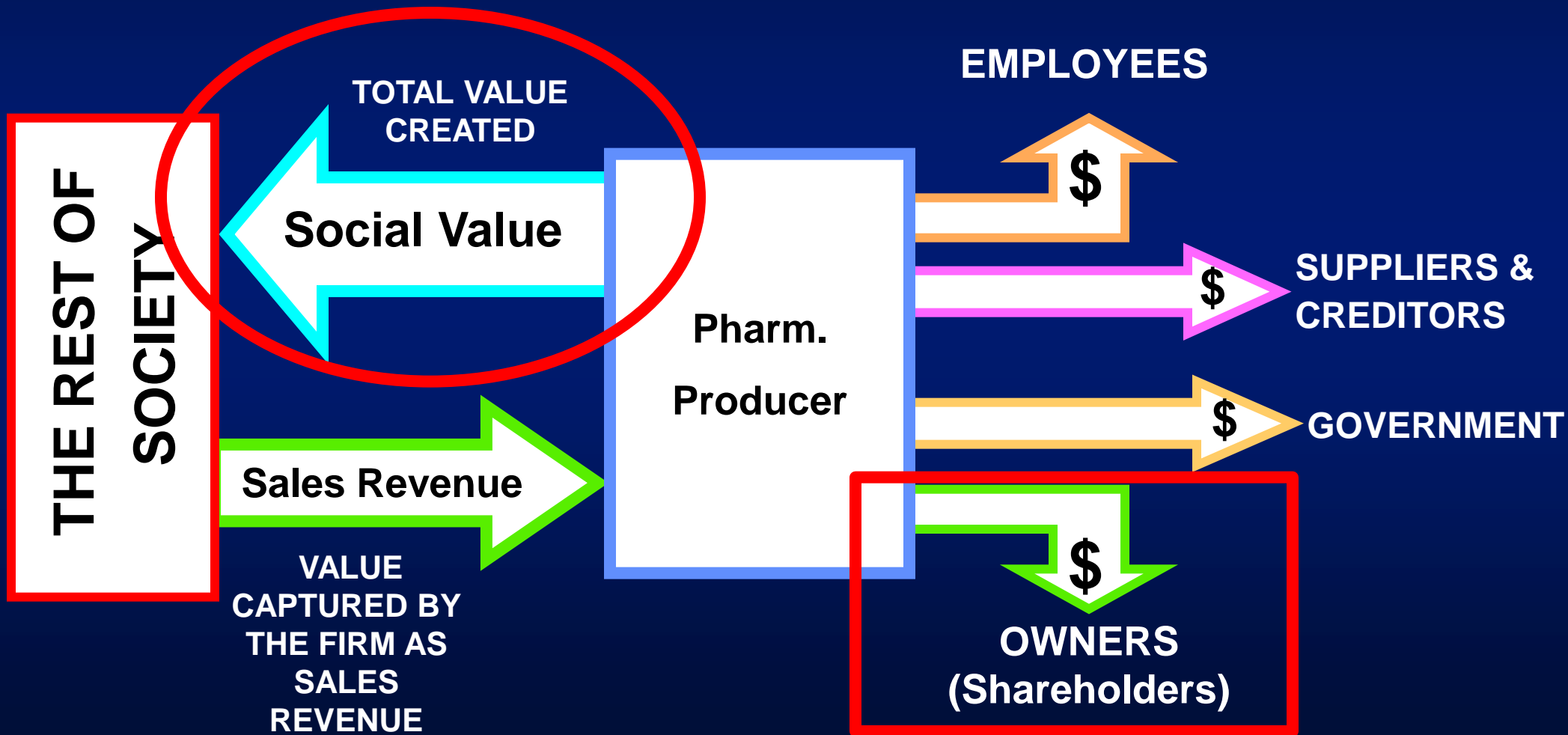
The social obligation of a corporation is to maximize the wealth of shareholders without violating the laws of the land. Period.

There are two ways of doing this:

- a. Creating new social value and taking a piece of it as sales revenue (e.g., Solvadi).**

CREATION OF GENUINE SOCIAL VALUE

DISTRIBUTION OF CAPTURED VALUE

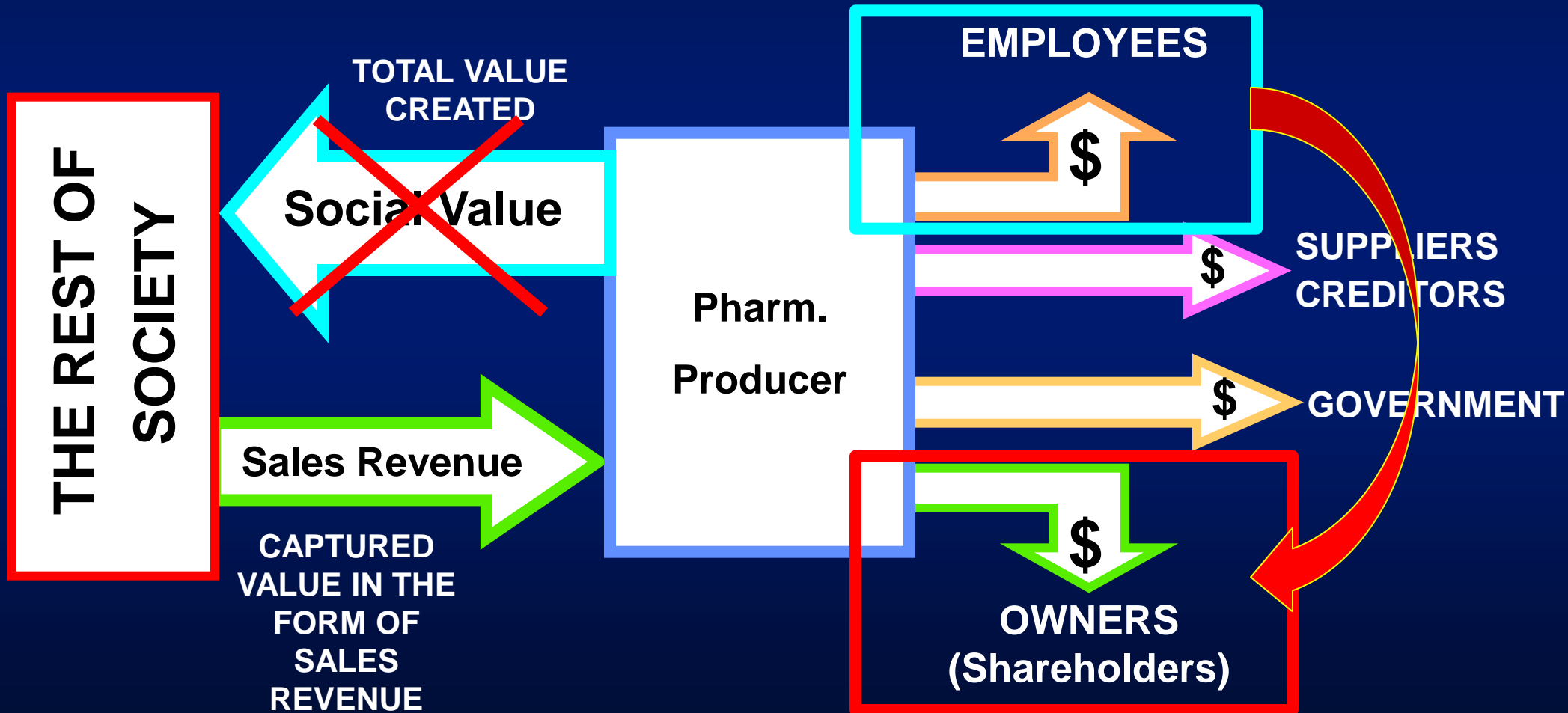


There are two ways of doing this:

- a. Creating new social value and taking a piece of it as sales revenue (e.g., Solvadi).
- b. Redistributing already existing value from some citizens (e.g., patients) to the firm's shareholders, but without creating new social value.**

CONSIDER THE "VALUE" CREATED BY A PRODUCER

DISTRIBUTION OF CAPTURED VALUE



Financial Times, May 16, 2016

American firms today
make more than
ever before by simply
moving money around

Comment

Too many businesses want a piece of the financial action

OPINION

Rana Foroohar

One of the great ironies of business today is that the richest and most powerful companies in the world are more involved than ever before in the capital markets at a time when they do not actually need any capital. Take Apple, which has around \$200bn sitting in the bank, yet has borrowed billions of dollars in recent years to buy back shares in order to bolster its stock price, which has lagged recently.

Why borrow? Because it is cheaper than repatriating cash and paying US taxes, of course. The financial engineering helped boost the California company's share price for a while. But it did not stop activist investor Carl Icahn — who had manically advocated borrowing and buybacks — from dumping the stock the minute revenue growth took a

turn for the worse in late April. Apple is not alone in eschewing real engineering for the financial kind. Top-tier US businesses have never enjoyed greater financial resources. They have \$2tn in cash on their balance sheets — enough money combined to make them the tenth largest economy in the world. Yet they are also taking on record amounts of debt to buy back their own stock, creating a corporate debt bubble that has already begun to burst (witness Exxon's recent downgrade).

The buyback bubble is only one part of a larger trend, which is that the business of corporate America is no longer business — it is finance. American firms today make more money than ever before by simply moving money around, getting about five times the revenue from purely financial activities, such as trading, hedging, tax optimisation and selling financial services, than they did in the immediate postwar period. No wonder share buybacks and corporate investment into research and development have moved inversely in recent years. It is easier for chief executives with a shelf life of three years to try

to please investors by jacking up short-term share prices than to invest in things that will grow a company over the long haul. It is telling that private firms invest twice as much in things like new technology, worker training, factory upgrades and R&D as public firms of similar size — they simply do not have to deal with market pressure not to.

American firms today make more than ever before by simply moving money around

Indeed, the financialisation of business has grown in tandem with the rise of the capital markets and the financial industry itself, which has roughly doubled in size as a percentage of gross domestic product over the past 40 years (even the financial crisis did not keep finance down; the industry itself shrank only marginally and the largest institutions that remained became even bigger). As finance grew, so did its

profits — the industry creates only 4 per cent of US jobs yet takes around 25 per cent of the corporate profit share.

Not surprisingly, non-financial businesses wanted a piece of that action. Airlines, for instance, often make more money from hedging on oil prices than on selling seats — even though it undermines their core business by increasing commodities volatility, and bad bets can leave them with millions of dollars in sudden losses. GE, America's original innovator, only recently stopped being a "too big to fail" bank.

The pharmaceuticals industry, perhaps the most financialised of all, has cut nearly 150,000 jobs since 2008, most in R&D, as companies focus instead on outsourcing, tax optimisation, inversions and "creative" accounting in ways that make them look suspiciously like portfolio management companies — a group of disparate firms operating separately and trying to make as much money as quickly as possible, with little thought to the long-term impact of their decisions.

Even Silicon Valley is not immune. Apple and other tech behemoths now

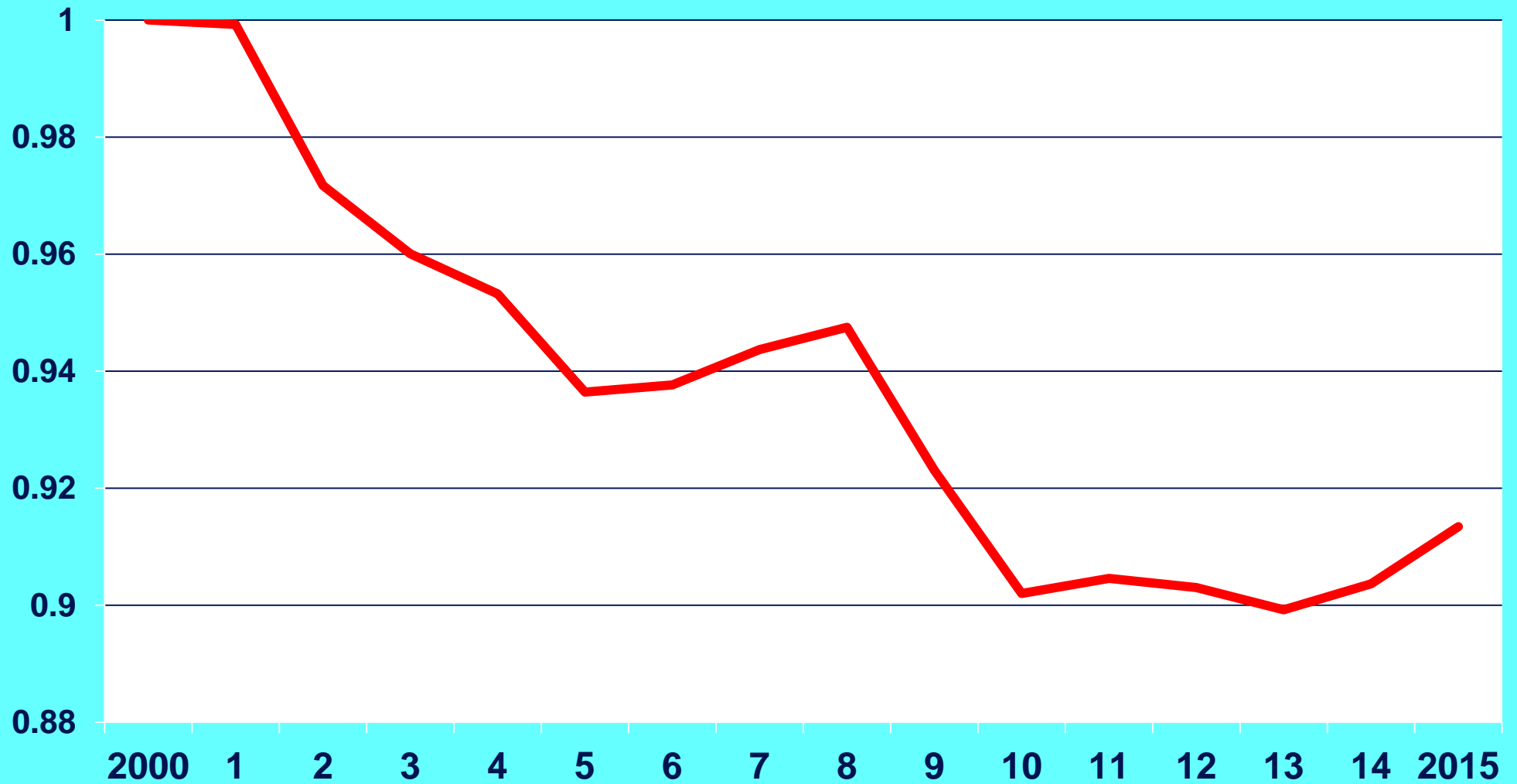
anchor new corporate bond offerings as investment banks do, which is not surprising considering how much cash they hold. If Big Tech decided at any point to dump those bonds, it could become a market-moving event, an issue that is already raising concern among experts at the US Treasury Department's Office of Financial Research.

None of this is good for the real economy; a wealth of academic research shows that not only has finance become an obstacle to growth, but also that financial engineering is destroying long-term value within companies. Buyback booms of the sort we have seen in the past couple of years tend to happen at the top of the market, when financially manufactured growth is tapped out. With corporate earnings under pressure, US businesses that have not been investing in real, underlying growth and innovation may be in for a fall. The result will be more economic stagnation — and more political populism.

The writer is author of 'Makers and Takers: The Rise of Finance and the Fall of American Business'

The pharmaceuticals industry, perhaps the most financialised of all, has cut nearly 150,000 jobs since 2008, most in R&D, as companies focus instead on outsourcing, tax optimisation, inversions and “creative” accounting in ways that make them look suspiciously like portfolio management companies — a group of disparate firms operating separately and trying to make as much money as quickly as possible, with little thought to the long-term impact of their decisions.

Fraction of U.S. GDP allocated to Labor

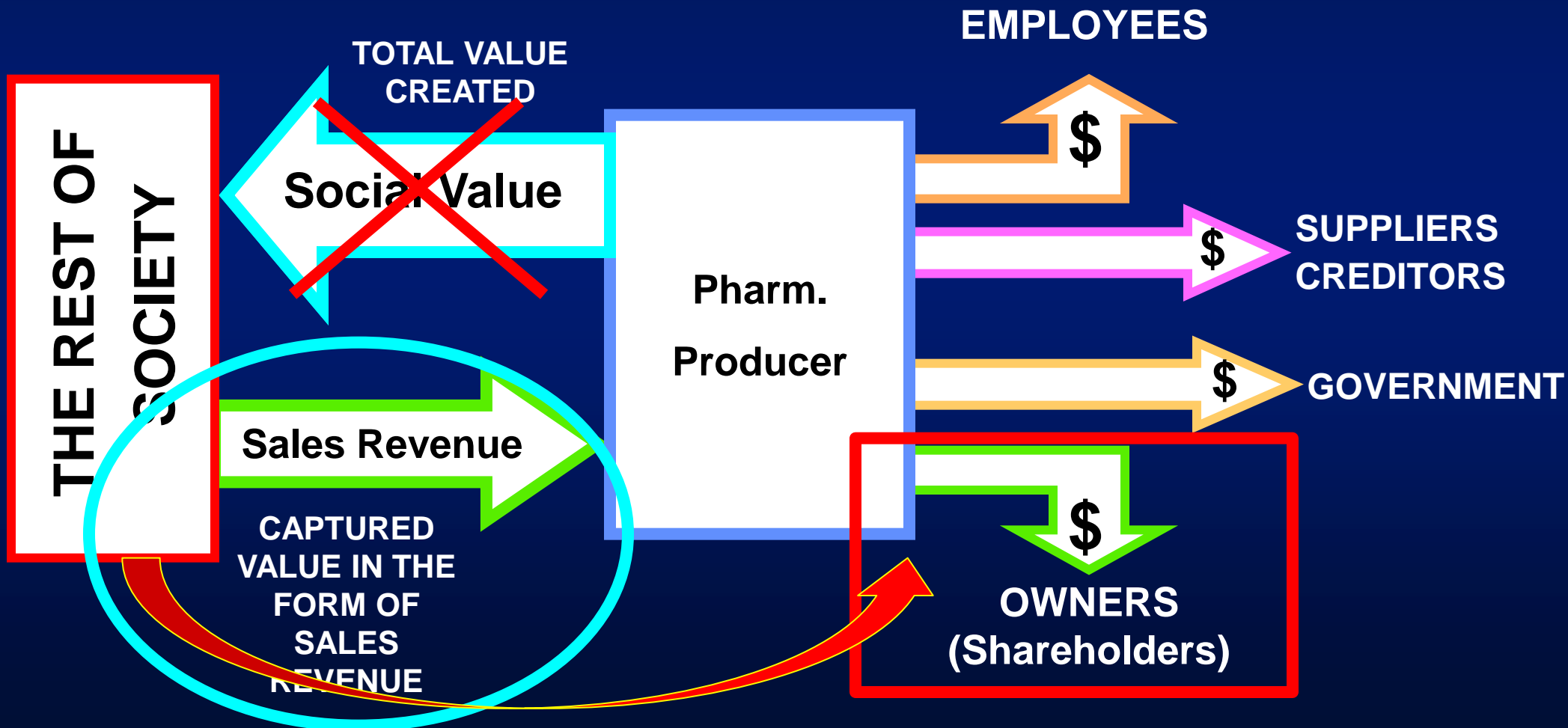


SOURCE: Federal Reserve Bank of St. Louis.

<https://research.stlouisfed.org/fred2/series/PRS85006173>

CONSIDER THE "VALUE" CREATED BY A PRODUCER

DISTRIBUTION OF CAPTURED VALUE



II. CAPTURING VALUE THROUGH “VALUE PRICING”

The term “value pricing” means different things to different people, to wit:

- a. Not paying for ~~exp~~ unnecessary services;**
- b. Paying a bit more for better “quality,” however defined and measured.**
- c. Basing prices not on costs but on the value the buyer of a product assigns to it.**





For a bottle of water, the dying man surrenders everything he owns to the leader of the caravan.

This is a classic case of “value pricing.”

The price is pegged on the value of the thing being traded to the buyer, rather than on the cost of producing the thing.

Because the deal is mutually beneficial, economists would judge it to be “efficient” and “welfare enhancing.”

But the rest of society might view the transaction as repugnant.

The pharmaceutical industry seems to be slouching more and more toward this desert model of “value pricing.”

From a political perspective that may not be wise.

The industry argues that it funnels the cash extracted from “value pricing” into R&D.

Really?

Where else might the extra cash from price hikes go?

a. Stock buy backs;

Wednesday 18 May 2016

Companies & Markets

FINANCIAL TIMES

Private affair China's waning enthusiasm for public markets
INSIDE ASIA, PAGE 12



Cnooc

3%
HK\$9.23

Sony Financial

4.9%
¥1,262

IAG

1.5%
518.5p

Sterling/dollar

0.6%
\$1,4477

WTI crude

0.9%
\$48.16

US groups step up share buybacks

◆ Repurchases 31% above year-ago period ◆ Companies support stocks amid volatility

NICOLE BULLOCK — NEW YORK

US companies stepped in to support their shares during the market tumult at the start of the year, potentially making the first quarter one of the biggest ever for share buybacks.

Based on preliminary data, share

hit the energy industry. Companies have been big buyers of their own stock in recent years, against a backdrop of low interest rates. That has helped to boost earnings per share even as revenue growth remains sluggish, while also appeasing activist investors who have pushed for better returns.

reducing their share count than previously," said Howard Silverblatt, senior index analyst at S&P Dow Jones Indices.

Almost 27 per cent of the companies in the index have already reduced their year-over-year share count by at least 4 per cent, increasing earnings per share by the same amount.

\$142.5bn

First-quarter buyback tally, compared with a \$172bn all-time high, set in 2007's third quarter

2014 and \$157.8bn in the second quarter of 2007.

Still, some have warned that buybacks could soon taper off. "Corporate buybacks represent the single largest source of equity demand but may wane during coming months," analysts at Goldman Sachs wrote in a recent report.

Where else might the extra cash from price hikes go?

- a. Stock buy backs;
- b. Marketing (pharma now basically finances TV entertainment and news).

You don't learn al that much about drugs from the TV ads anyhow.

From the Cialis ad I learned that you should buy another bathtub for your wife, eat the pill, watch the sunset with her, each in your own bathtub, and after 36 hours call your doctor.

Something like that.

III. REWARDING RISK TAKING IN PHARMACEUTICAL R&D.

Industry spokes people argue that drug prices must contain a premium to reward investors in R&D.

Economists, myself included, agree.

The question is:

How large does that risk premium have to be?



2005.08.04



2005.08.04



QUESTION

Why do we as a society reward risk taking so differentially?

**IV. IS THERE A RATIONALE FOR GOVERNMENT
INTERFERENCE IN THE PHARMACEUTICAL
MARKET?**

**Should not free enterprises in a free market
be able to price their products as they see fit?**

Far from being truly free enterprisers, the research-oriented pharmaceutical industry is like a little bird in the protective hand of government.



Given all the protection government gives the little bird, sometimes the little bird has to chirp the tune that the government wants it to chirp.

Some restraint on price increases is bound to be such a tune.

Over to Brother Nichols.