



10 Indispensable Characteristics of a Successful Pharmaceutical Pricing Function

**A new study by SIMON ♦ KUCHER & PARTNERS
identifies the industry's benchmarks**

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After years of reducing costs and boosting sales, pricing is being re-discovered as a key profit driver.

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Maximizing long-term profitability is the cornerstone of corporate strategy. What methods for increasing profit offer the greatest potential? As we know from the profit formula, there are only three direct profit drivers: cost, volume and price. However, one has to admit, that while cost and sales have received a great deal of attention in recent years, price has often been neglected. Now, after years of reducing costs and boosting sales, pricing is being re-discovered as a key profit driver. Obviously, this also applies to pharmaceutical companies, and it poses a series of complex questions on to how to structure their pricing organization and process to exploit fully their profit potentials, generated by effectively creating and communicating value to their customers.

Should international pharmaceutical companies have a central pricing department? If yes, to whom should it report? Should the affiliates be involved in the pricing decision? At what point in the product development process? How should their involvement be formalized? How should health-economic considerations and primary research be integrated into the pricing process? Which organizational structure and process should be in place in order to be able to take up the challenge of developing the profit-maximizing global price strategy?

These questions, and many other related issues, are crucial to decision makers in the pharmaceutical industry. A survey of the industry shows that they are actively trying to tackle them: over the last 2 years, about 60% of pharmaceutical companies changed their pricing function. Still, many companies are painstakingly aware of the fact that there remains considerable room for improvement in both their pricing organization and their pricing process. These two components cannot be viewed separately: the best-planned structure is useless if no corresponding process is implemented, and vice-versa. Therefore, companies are struggling with the question of how best to organize the pricing function and integrate it into the company organization. In fact, they realize that having an efficient and effective pricing function provides huge benefits not only to the individual company directly by affecting the bottom line, but also to the industry as a whole. Irresponsible price moves or even the start of a price war by not very experienced pricers have had dramatic impacts on the profitability of more than one industry.

In a major in-house project, SIMON ♦ KUCHER & PARTNERS has conducted a benchmarking study on the organization of the pricing function in leading international life science companies (“pricing” refers here to price finding and definition, not to transfer pricing). The target group for the benchmarking study were the top 40 life science companies in the world. 21 companies

participated, of which 5 were from the top 10 and 3 from the top 5 (ranked by pharmaceutical sales in 2000). SIMON ♦ KUCHER & PARTNERS conducted personal interviews with senior representatives responsible for international pricing in the participating companies.

Integrating the Pricing Function

The Pricing Department

Of the life science companies participating in the study, only some 50% had a specific, headquarter-based pricing department or group. However, almost all top companies do have a central pricing department. The boundaries between formal and informal committee-based pricing structures are fluid. In any case, the companies which do have a committee-based structure perceive it to be more beneficial when it is formalized, regardless of whether a separate pricing department exists. Clearly, the existence of a pricing department is not a guarantee for a specifically formalized pricing process, although it may help in establishing one. Other conditions need to be fulfilled: a direct link to a relatively senior management level and a strong awareness of the importance of pricing decisions among senior management are most beneficial for ensuring and implementing a consistent pricing strategy. Staffing, too, is important: a correlation can be seen between a company's sales and the number of people it employs in a primarily pricing and health-economic function at headquarters level (see Figure 1).

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Staffing of Pricing and Health Economic Departments

of HQ people in a primarily pricing and/or HE function

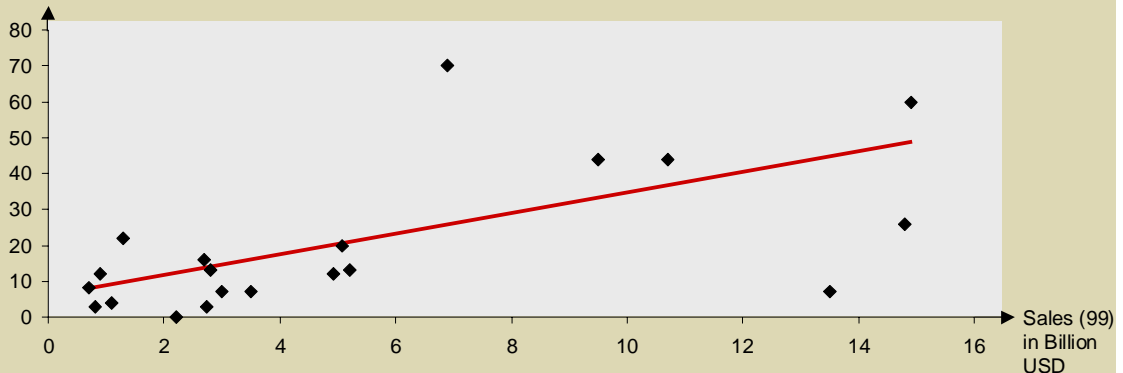


Figure 1

A well-structured organization and process can compensate for a relative lack of resources.

However, one has to be careful in interpreting this correlation: a large pricing and health-economic department is not a sufficient condition for increasing profit, and a well-structured organization and process can compensate for a relative lack of resources. This means that medium-sized companies can also benefit tremendously from reorganizing their pricing function,

without necessarily having to invest huge resources in additional staffing.

Apart from staffing, sufficient funding of the pricing department so that it is able to fulfill its task of developing consistent pricing strategies is decisive. Currently, only some 20% of companies participating in the study have special pricing research budgets. In more than 50% of the cases, the pricing budget is taken from the general market research or marketing budget. 70% of companies allocate pricing research budgets in an ad hoc manner, with no fixed annual amounts.

“Organizing the pricing function as a part of market research or the finance department is like putting a knife into your head.”

To whom should this pricing department report? “Organizing the pricing function as a part of market research or the finance department is like putting a knife into your head.” This statement by the participant of a pricing conference of the Professional Pricing Society reflects the pricing experts’ consensus about the top priorities when designing the organizational structure of a pricing function. The benchmarking study conducted by SIMON ♦ KUCHER & PARTNERS reveals that, in fact, in 60% of companies pricing is organized as part of international marketing, and only in about 10% it is attached to finance. In the remaining cases, it is organized as part of either strategic business development, therapeutic areas, or health economics – or it is linked directly to a board member. On average, the pricing function is clearly more centralized than other functions in the company, and there is a clear trend towards further centralization. In contrast, the degree of centralization of the overall organizational structure varies greatly across companies, with no clear trend in either direction apparent.

Integrating Health Economics

There is a strong awareness of the increasing importance of health economics in pricing, and companies have started to adapt to these demands. The clear need for early and more formalized cooperation between health-economic and pricing experts leads to the assertion that the health economic department should be either part of international marketing or, if part of R&D, linked more formally to marketing. Otherwise, communication and cooperation are perceived as too cumbersome and unfruitful. 65% of companies have individual health economic units for their key affiliates. Generally, there is a larger autonomy of affiliates to define their own health-economic studies than for deciding on pricing research. Health-economic studies are traditionally used mainly for negotiations with health authorities and/or payers, and less for the actual development of the pricing strategy (see below, *Pricing in the Product Development Process*).

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Integrating the Affiliates

Integrating the affiliates into the overall organizational pricing structure is perceived to be one of the most sensitive tasks facing the headquarters pricing function. Local marketing directors fear direct headquarters interventions which are not balanced by a constant information exchange, while headquarters decision makers are weary of implementation problems and a lack of concrete pricing responsibility and knowledge at the affiliate level.

Basically, the general trend towards and the need for centralizing the pricing function does not necessarily imply a diminished involvement and integration of the affiliates. On the contrary: an early involvement and input is not only necessary to learn about local implications of pricing decisions but especially to generate support for and acceptance of headquarters pricing decisions. Currently, one of the main obstacles to this integration is that more than 80% of companies do not have a special, defined person or department at affiliate level responsible for pricing-related issues. Instead, the affiliate General Manager, the Marketing Director, the Regulatory Affairs Director, the Therapeutic Area Head or an ad hoc combination of these take up the tasks associated with pricing, be it negotiations with health authorities or attendance at global pricing-related meetings and working groups. At the same time, the headquarters feels that a clear-cut responsibility of one person or department for each affiliate would be most appropriate, thus avoiding ad hoc responsibilities. This contact person should coordinate affiliate pricing, market research and health-economic activities, and give a regular feedback to the HQ pricing department or group. The affiliate pricing contact person can be, but not necessarily has to be, the person who leads the negotiations with the national health authorities and/or payers. There should also be a regular information exchange with the other affiliates, especially before and during negotiations with health authorities and/or payers.

Pricing in the Product Development Process

Apart from the organizational framework, designing the pricing function includes the decision as to which activities should be undertaken by which players at what point in time. SIMON ♦ KUCHER & PARTNERS discussed with participants the different pricing activities life science companies typically undertake during the development of a new product.

The development process was split up into 7 steps or stages (Figure 2):

Pricing in the Product Development Process

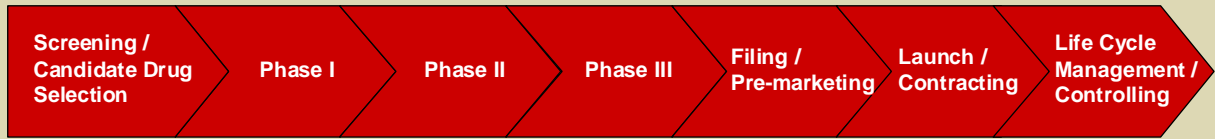


Figure 2

At what point in this process are pricing considerations especially important? Most companies agreed that, especially in the filing/pre-marketing and in the launch phase, pricing considerations should be a top priority on the company's agenda, while they are least important during Phase I trials. Since the foundations of all future price estimates and calculations are laid at the very beginning of the development process, a considerable effort should also be put into pricing questions at this stage (Figure 3).

Pricing Considerations in the Development Process

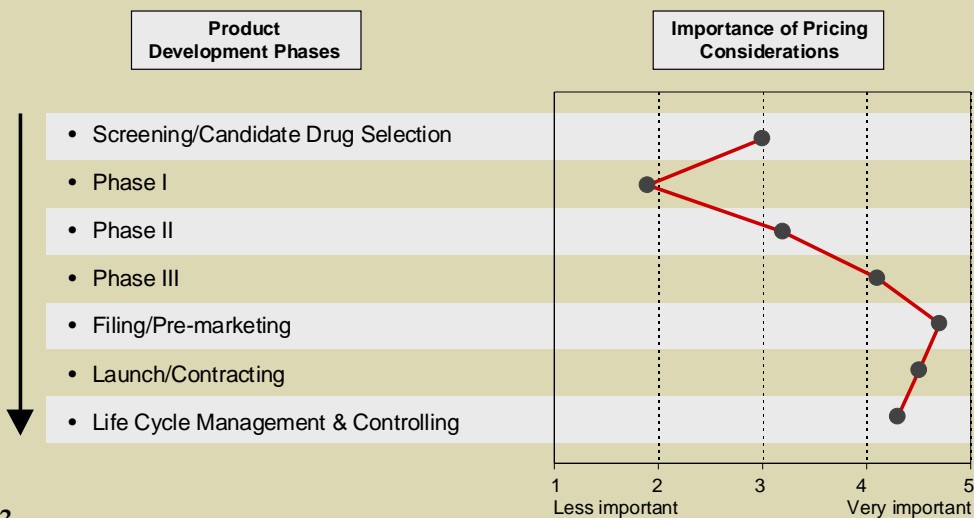


Figure 3

The First Price Estimate

The importance of this first estimate, usually 5-6 years prior to launch, cannot be underestimated. Therefore, it is surprising to see that, in more than 50% of companies, the process for determining the first price estimate is not yet formalized or structured. It is often not based on a solid database obtained through IMS data, desktop research and market assessment, but is generated out of a general "feel" for the market. Most frequently, it is generated at senior management or board level and reimbursement issues are not taken into account at this early stage. The current neglect of the first estimate is reflected by the fact that, even in 50% of companies

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which do have a pricing department, it is however not involved in the decision-making process concerning this first price estimate, and its detailed pricing expertise remains unused.

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Improving Pricing in the Product Development Process

In every phase of the product development process, concrete actions need to be taken to improve considerably pricing efficacy and quality. The first and most important action is to define a clear process driver, with accepted tasks and responsibilities for every stage. During screening & candidate drug selection, a structured analysis of market developments, competitors' pipelines, benchmarks, and potential pricing and reimbursement barriers should be combined with epidemiological research and a systematic identification of other potential indications, unique selling points and differentiation potential. Even if pure pricing activities are minimal (which they usually are), the next stage (Phase I) should contain a structured process of review and re-evaluation, with a clearly designated person/group for keeping track of all results and updates. During Phase II, it is time for the first structured pricing research: contacting opinion leaders and payers/health authorities, and conducting workshops, focus groups and expert interviews. The main goals are to determine design and possible outcome of the next clinical studies, to influence their endpoints, to identify in time pricing and reimbursement barriers, and to update and fine-tune the relevant product profiles. Also, a first test of the economic hypotheses should be conducted with the help of health-economic studies.

The appropriate time window for extended, large-scale pricing research is during Phase III and filing/pre-marketing: with the help of customer surveys (physicians, patients), a price-sensitivity analysis, a competitive positioning analysis, focus groups and workshops, the final pricing & reimbursement strategy is designed. It should include the optimal price ranges; an international price corridor, the pricing dossiers for the affiliates to be used for reimbursement and formulary access; and the detailed positioning strategy. Once this final pricing & reimbursement strategy has been defined, the pre-launch discussions with payers/health authorities can start. Here, the headquarters should not only be monitoring the process but also offer active support. This should consist first of all of the pricing dossier designed in the previous stage. It should be formalized and consistent across countries, and contain clinical trial data, health economic data, information on product properties, an individually tailored argumentation strategy, and general competitive market information. Second, an ongoing feedback and monitoring process between HQ and affiliates during negotiations should

be established, which allows rapid HQ reaction and facilitates country-to-country information exchange. Third, affiliate negotiators should be offered tactical negotiation training.

After the launch of the product, one might think that pricing is done, but the opposite is the case. A pricing strategy which is not constantly monitored and, if necessary, adjusted, can be as detrimental to the company's revenue as having no pricing strategy at all. In order to ensure discipline in adherence to the international price corridor, it requires constant monitoring, and a formal application procedure should be implemented for those affiliates which desire price changes – both upwards and downwards. It is extremely dangerous simply to implement price changes if local price elasticity is unknown. Risks and changes in market circumstances should be addressed pro-actively to prevent being surprised by market developments and to be able to re-calibrate the company's pricing strategy. This is also necessary when important line extensions are planned. Additional pricing research may be necessary to enable adequate estimates of changes in customers' willingness-to-pay.

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Tackling Parallel Trade

Price differentials across countries set the stage for parallel trade, in which distributors and other parties resell pharmaceutical products in countries where prices are higher than in the country of origin. Parallel trade in pharmaceutical markets does not result from market imperfections but rather from legal and regulatory differences across countries. It damages not only individual pharmaceutical companies and their profits but also the whole pharmaceutical pricing. Overall, parallel imports account for some 2-3% of all pharmaceutical sales within the EU. However, the parallel trade share for individual drugs can easily reach 50% and more. Typical parallel traders obtain 80% of their business from selling 20-30 products.

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The pricing strategies which companies have at their disposal can range between two extremes: maximum price differentiation and a single price. With the first option, affiliates are allowed to have varying prices, and to negotiate and agree on national price levels independently. As a result, the company as a whole may have enormous profit losses due to parallel trade (at least for their best-selling products). With the second option, companies apply a uniform price across all countries. This single price would certainly stop any parallel trade and turn the national health authorities' referencing systems into useless tools. However, it ignores the fact that different countries have different willingnesses and abilities to pay. It leaves money on the table; profits are

not realized.

A compromise strategy chosen by the majority of companies participating in the study is the price corridor strategy. Prices are differentiated to capture as much as possible of the maximum profit potential, but at the same time harmonized as much as necessary to avoid major problems with parallel trade and international referencing. However, designing an international price corridor is not an easy task, since the data needed is usually not available inside the company: national price elasticities, reimbursement probabilities, the perceived product values, the size of various markets, the dependence of parallel trade on price differentials and information on the international price referencing system have to be integrated into the price corridor design. Having realized the complexity of this task, more and more companies rely on external expertise in order to develop an international price corridor.

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Optimizing the Launch Sequence

Differences in national health systems force the company to consider carefully in which country to launch a product first. While pricing authorities typically select national comparator drugs, they will switch to international reference pricing if this approach would lead to lower prices. International referencing means that national pricing authorities compare the price of the new drug with its price in countries where it has already been launched. While some states use a formal list of reference countries, others take a more informal, ad hoc approach and select the reference countries case-by-case. Table 1 shows an example of the referencing practice in selected EU countries. Clearly, products should be launched first in those countries which are not only used by the other countries as a reference, but which are characterized by relatively high general price levels for pharmaceutical products (usually the free-pricing countries). The countries with the lowest price levels should come last in an optimized launch schedule. Now, it is important to consider that referencing practice is constantly in flux, and that Table 1 can only give an example of the intricacies of cross-referencing. Prior to any product launches, companies should update their knowledge of the referencing practice, in order to be able to optimize their launch schedule based on the latest developments.

International Referencing in Selected EU Countries

EU Country	Reference Countries/Method
Belgium	EU
Finland	EU (excluding Spain, Portugal, Greece) plus Switzerland and Norway, with special focus on Sweden and Denmark
France	EU, Ireland, Italy, Spain, Portugal
Greece	Lowest price in Europe
Italy	12 EU countries (at least four must have launched product; two must be price-controlled)
Netherlands	Average European price (Belgium, France, Germany, United Kingdom)
Portugal	Italy, France, Spain
Spain	Country of origin; lowest price in the EU

Table 1

Affiliate Compensation Mechanisms for Parallel Trade

Parallel trade can severely damage a high-price affiliate's bottom line, while representing an additional profit for a low-price affiliate. Therefore, internal compensation mechanisms between affiliates are an option if companies do not want to "punish" high-price countries. Two different types of compensation can exist:

- 1) Transfers from one affiliate to the other (via HQ)
- 2) HQ estimates parallel trade impact in order to evaluate an affiliate's true performance and calculate more realistic revenue goals.

About 25% of pharmaceutical companies have established an internal compensation mechanism for losses occurred due to parallel trade. However, only some 15-20% of all companies actually implement such mechanisms, while others openly admit that these mechanisms only exist on paper. Others again have not yet developed a compensation mechanism, but are planning to do so within the next 2-3 years, and are very aware of the fact that compensation mechanisms also increase affiliate acceptance of tighter HQ pricing control.

The 10 Indispensable Characteristics of a Successful Pharmaceutical Pricing Function

The benchmarking study conducted by SIMON w KUCHER & PARTNERS highlights the increased awareness among the leading life science companies that only a well-designed pricing function can handle the challenge of developing a consistent and successful pricing strategy. Clearly, there is considerable room for

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improvement in this area for the vast majority of companies – and they know this: on average, on a scale from 0% to 100%, they locate their own pricing function at only 56%. And even the most frequently mentioned best-in-class companies (regarding their pricing function) such as Merck & Co, Pfizer and Eli Lilly can further optimize their pricing function: on average, it is rated at 74%.

In the following box, the 10 indispensable characteristics of a successful pharmaceutical pricing function, as identified in the benchmarking study are listed:

1. **Clear organizational structure, with centralized pricing responsibility in one pricing department or group, allocated to global marketing**
2. **Clear structure of pricing process, with defined drivers and activities for every phase of the product development process**
3. **Early inclusion of pricing, reimbursement and health economic considerations into the product development process.**
4. **Regular and constructive involvement of affiliates in the decision-making process, with clearly defined responsibilities on both sides**
5. **Mutual trust and cooperation instead of confrontation**
6. **Full understanding of importance of global pricing at senior and affiliate level**
7. **Implementation and monitoring of an international price corridor**
8. **Prices based on analysis of decision makers' perception and willingness-to-pay**
9. **Pricing and health economic experts working in a team**
10. **Sufficient funding**

Clearly, tailoring a company-individual, optimal pricing function which follows these 10 principles is a task which cannot simply be implemented from one day to another, and which requires a detailed pricing expertise. Here, companies with an established pricing department have a comparative advantage.