

Price Strategy Bulletin

Japan's FTC Wants Manufacturers to Conduct Selling Price Negotiations

Introduction

Japan's competition authority, the Fair Trade Commission (FTC) (*Kotorii*), has seemingly reversed a long-standing policy in a surprising call for pharmaceutical companies to negotiate selling prices with hospitals and clinics instead of wholesalers, as previously allowed.

The announcement came in a recent FTC report investigating delays in market penetration by generics at a time when drug expenditure under National Health Insurance (NHI) reached almost Yen 6,800 billion (\$57 billion), or about 21% of total medical expenditure. Examples where brand manufacturers had disseminated inappropriate information to hospitals about generics, including falsified concerns about generic quality, safety and efficacy, were cited.

The FTC also looked at how medical institutions buy both generic and branded medicines, and queried why 98.8% of manufacturers were not involved in price negotiations. To be involved would surely be a breach of the Anti-monopoly Act, bemused respondent companies replied, but the FTC assured them that it would not be illegal to propose prices to a medical institution if the wholesaler's role was limited to delivery only and the manufacturer actually sold the drug.

Former System

What the FTC is proposing is unlikely to mark a full return to practices widespread in Japan prior to 1992. A system of quotation prices then applied, through which manufacturers wielded *de facto* control over the discounts offered by wholesalers and hence the prices actually paid by medical institutions. The system worked like this:

- The wholesaler's purchase price was initially set at about 7% below the NHI reimbursement price to provide a provisional, primary margin.
- A wholesaler would contact a manufacturer about its interest in selling to a specific hospital a specific amount of a specific product, and ask for a quotation price for the transaction.

- Depending on the importance of the hospital, the manufacturer might instruct the wholesaler to sell at say the NHI price less 30%.

- The manufacturer would then give the wholesaler a discount compensation amount to cancel out its loss on the deal, and a further margin for it to secure a trading profit. Additionally, the wholesaler would receive rebates from the manufacturer every six months related to the volume and achievement of sales targets.

In the late 1980s/early 1990s, the FTC was highly critical of these traditional business dealings. The method of pricing drugs along the distribution chain was more ill-defined than for other commodities and was against the Anti-monopoly Act, it pointed out. Prices 'charged' or appearing on invoices at a particular stage did not correspond to the amount of money that actually changed hands.

The rebate portion was often larger than the first gross margin the wholesaler received. FTC saw this as particularly abnormal, and believed the practice had the effect of making the wholesaler overly dependent on the manufacturer. Rebates were not illegal if their purpose was to promote sales, but their use to maintain the sales price to the end user was questionable at best. The FTC also saw as anomalies situations where higher discounts were given to small clinics than to large hospitals for the same product, despite the latter buying in far higher volumes, or national hospitals purchasing drugs at higher prices than privately-owned facilities.

Reforms

Pressure from the FTC and a government advisory body, the Drug Distribution Modernisation Council (*Ryukinkyō*), led to stricter enforcement of the Anti-monopoly Act. Following receipt of revised FTC guidelines, the pharmaceutical industry agreed to make fundamental reforms to its market pricing mechanisms with effect from April 1992. The changes, which continue today, required companies to:

- Clearly indicate trading pricing on invoices to wholesalers

- Abolish post-transaction discount compensation schemes
- Minimize the importance of the rebate as part of the distribution margin
- Introduce more transparent criteria for setting the rebate
- Refrain from intervening in wholesaler delivery prices.

Most manufacturers use the weighted national mean of actual market prices to arrive at a single value, which after incorporating the 2% discount allowance and a primary margin for the wholesaler, becomes the product's target invoice price across Japan. There is some variation from wholesaler to wholesaler, but once set, the invoice price for that product and for that wholesaler is generally left unchanged until the next NHI price revision.

To strengthen the long-term and continuous nature of the business, wholesalers still get post-transaction rebates for their performance, based primarily on total sales volume, but also on a host of other factors (e.g. opening of new accounts, sales promotion, prompt payment to manufacturers, logistics co-operation, information supply, speed of market introduction, and achievement of sales targets). Manufacturers usually offer rebate payments twice yearly through offsetting accounts receivable, though they pay some in cash or reserve them as guaranteed deposits for later business dealings.

Implications for Strategy Development

Following the 1992 changes, there were widespread fears that wholesalers would use their then new price negotiating powers to discount heavily to gain market share. These discounts would then be picked up in the surveys ahead of the regular NHI revisions, and affected products would suffer severe price cuts as a result. In general this hasn't happened, indeed many point to the useful buffer role that wholesalers have played between manufacturers and medical institutions.

The apparent U-turn by the FTC is motivated by its current thinking that faster price decline might occur were manufacturers directly involved in price negotiations, some believe. One observer said the FTC was acting more like the Ministry of Finance rather than an antitrust authority.

Both wholesalers and manufacturers oppose the change, and they are likely to be supported by many small medical institutions which would prefer dealing with a few wholesalers rather than a large number of manufacturers. However, there are local market reports that one major manufacturer has already been requested to meet with some national hospitals to discuss prices directly.

For manufacturers, the burden of price negotiations would fall on their 55,000 medical representatives at a time when cuts in this area are being contemplated in line with global trends.

Another fear, that biennial price revisions would become annual events (first raised during discussions leading up to last April's price revision), seems to have receded. Discussions have stalled suggesting introduction of an annual price revision is now unlikely until fiscal 2008 at the earliest.

Japan is a significant market showing signs of growth after years of stagnation. It is critical that local staffs are knowledgeable and aware of the implications of any pricing decisions that they make in the new circumstances to ensure their company sales continue to grow.

PriceSpective is an international firm of pricing strategy experts, focused on providing strategic guidance in pricing and reimbursement to the pharmaceutical and biotechnology industries. PriceSpective has specific expertise on a wide range of policy matters and detailed knowledge of P&R rules in all major markets worldwide.

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