July 20, 2018

The Honorable Commissioner David Jones
California Department of Insurance
300 Capitol Mall, Suite 1700
Sacramento, CA 95814

Re: Letter from Locke Lord LLP on “The Proposed Acquisition of Aetna Inc. By CVS Health Corporation”

Dear Commissioner Jones:

I am writing regarding the letter from Locke Lord LLP on the June 19th hearing on “The proposed acquisition of Aetna Inc. by CVS Health Corporation” held at the California Department of Insurance. The letter and Exhibit A of the letter challenge some of the competition concerns related to the acquisition of Aetna by CVS raised by me and other academic experts. I would like to take this opportunity to briefly respond to the issues raised in this letter.

1. The letter claims that a key driver of consumer benefits from the merger is the ability to combine CVS’s pharmacy data and expertise with Aetna’s medical data and expertise.

I find this claim perplexing because as I explained in my report, Aetna claims in its SEC filings that it already performs its own core PBM functions and thus already integrates pharmacy and medical data to lower health care costs. The fact that Aetna performs its own PBM services is corroborated by a press release that announced a strategic agreement between Aetna and CVS about 8 years ago. In that press release, Aetna chairman and CEO Ronald Williams says¹:

“Through this strategic agreement, we retain our PBM and our ability to integrate medical care with clinical and pharmacy programs and actionable data. We will add CVS Caremark’s best-in-class clinical capabilities and broad market reach, enabling us to deliver better drug discounts and improved pricing and service to our customers.”

2. The letter claims that the PBM market is competitive and CVS Caremark is not a dominant PBM.

Several facts show that the claim in the letter that the PBM market is competitive or that CVS Caremark is not a dominant PBM is just false. First, the PBM market is highly concentrated. The

top 3 PBMs accounted for 73% of covered lives, nationally. Second, the letter uses data from California alone. This is misleading as the state is not the relevant geographic market. The PBM market is national as major PBMs operate on a national scale and compete for clients such as large employers or health plans who have a national presence.

Quoting from an April 2, 2012 FTC decision, the letter describes the PBM market as "a competitive market for PBM services characterized by numerous, vigorous competitors, who are expanding and winning business from traditional market leaders". However, the data on PBM market dynamics after 2012 paint a different picture. The data show that not only is the national market for PBMs highly concentrated, the degree of concentration has only increased overtime. In 2013, the top 3 PBMs accounted for 67% of covered lives and in 2017 the market has become more concentrated with the top 3 PBMs accounting for 73% of covered lives. CVS Caremark has been a top 3 PBM since 2013, if not longer, and its market share of covered lives has increased from 22% in 2013 to 26% in 2017. A market with such durable market shares for the top 3 firms cannot be considered competitive.

One of the reasons for the lack of competition in the PBM market are the significant barriers to entry. The magnitude of discounts that a PBM can negotiate with pharmaceutical firms depends on the number of covered lives represented by the PBM, with the size of the discount rising with the size of the PBM. Therefore, a new PBM has a distinct disadvantage compared to incumbents who represent millions of covered lives. In addition, a PBM needs to form a national pharmacy network with the ability to contract and process claims from pharmacies within the network. This is no small feat for a new entrant. Finally, a new PBM entrant might need to enter both the health insurance and PBM markets given that most of the major incumbents are vertically integrated insurers and PBMs.

The significant barriers to entry in the PBM market were acknowledged by the CEO of one of the largest PBMs even when a formidable competitor such as Walmart tried to enter the PBM market in 2008:

> “Many people shake in their boots when they hear the name Wal-Mart in any industry,” Medco CEO David Snow told the Newark Star-Ledger. “This is a very complicated business with serious barriers to entry. I just don’t think they’re going to pull it off. You just don’t snap your fingers and say you’re going to be a pharmacy-benefits manager.”

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3. The letter claims that CVS is not dominant in the pharmacy market.

Page 3 of Exhibit A of the letter states that:

With respect to pharmacy competition, the opposing witness testimony is not accurate. One witness argued that the combination “will further strengthen the already dominant position of CVS in the pharmacy market. However, CVS’s share of retail pharmacy stores in California is 21.3% and nationally is 16.2.”

This market share observation fails to recognize that the pharmacy or drugstore market is not a national or state market. Consumers from California do not drive to Massachusetts to get their prescriptions drugs. Even mail order pharmacies are not a good substitute for a local drug store because of the time it takes to ship prescription drugs to consumers and the lack of ability to consult with a pharmacist in person. This is likely why regulations in both Medicare Part D and ACA markets mandate that health plans provide access to retail pharmacies. Therefore, the relevant markets are more local, perhaps MSAs or smaller localities within MSAs. In fact, CVS acknowledges that markets are local in its own financial statements to the securities and exchange commission and also provide data to corroborate my assertion that CVS is a dominant firm. CVS’s financial statement with the SEC states:

We currently operate in 98 of the top 100 United States drugstore markets and hold the number one or number two market share in 93 of these markets.

Moreover, as noted on page 13 of the AMA statement to California Department of Insurance:

CVS’s high local market shares understate the likelihood of market power. CVS pharmacy chains may be considered “must have” pharmacies. They are “must have” because health plan sponsors prefer geographically comprehensive networks – pharmacies located in close proximity to their patient population. Reportedly, 76 percent of the population of the U.S. lives within five miles of a CVS pharmacy.

One of the reasons for the dominant position of CVS is pharmacy markets is the high barriers to entry in the drugstore business. The CEO of CVS himself acknowledged the high barriers to entry. In an interview responding to speculation about Amazon entering the pharmacy business he stated:

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5 See 45 CFR 156.122 available online at https://www.law.cornell.edu/cfr/text/45/156.122, accessed July 18, 2018
There are many barriers to entry when you're looking at pharmacy. Most people are thinking about pharmacy as another distribution point, but pharmacy is also about the clinical outcomes that are provided. In an environment where there's a migration to more value-based care, those clinical capabilities are going to continue to grow in importance. It's highly regulated, so the barriers to entry are high.

4. The letter claims that CVS Caremark does not disadvantage independent pharmacies

The letter highlights data from the executive summary of a report on Medicaid managed care plans from Ohio which shows that CVS Caremark pays independent pharmacies roughly 3% more than its own CVS pharmacies. Interestingly, these same data show that CVS Caremark has a pretty hefty margin of about 9% based on spread between what it pays to pharmacies and what it charges health plans for drugs used by health plan subscribers. Perhaps it does not discriminate against independent pharmacies in Ohio Medicaid managed care market because it has a high profit margin in this market. The situation might be different in other markets. Therefore, to truly establish that CVS Caremark does not disadvantage independent pharmacies CVS Caremark should present data from its entire book of business to show that plan and beneficiary reimbursement to CVS pharmacies is the same as plan and beneficiary reimbursement to independent pharmacies and other competing chain drug stores. Without such disclosure it is difficult to verify the veracity of their claim that they do not disadvantage independent pharmacies.

Different reimbursement to CVS versus competing pharmacies is only one way for CVS Caremark to advantage CVS. CVS Caremark might be using other business practices (see page 13 and 14 of my written report) to steer patients towards CVS pharmacies. In the letter, they claim that “Even Caremark largely relies on other retail pharmacies, which accounted for a majority of its retail commercial prescription claims last year.” However, this statement does not establish that CVS Caremark is not steering patients towards CVS drugstores. In fact, analysis of data from CVS’s financial statements by an industry expert (Adam Fein) show that CVS Caremark is indeed steering patients to its own pharmacies. The data show that in 2014 Caremark accounted for 35% of CVS retail pharmacies revenue even though Caremark’s national market share was 24%.

5. The letter claims that post-merger CVS and Aetna will not use its PBM and Pharmacy network to disadvantage competing health plans

To support this claim they note that Aetna has a small market share nationally of about 8%. Then they cite the expert report of Prof Starc to note: “Although Aetna is the third largest insurer in the United States, foreclosure may be a risky strategy, as it involves not aggressively bidding for a large fraction of the market.” There are three problems with this reasoning.

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8 https://www.drugchannels.net/2015/03/cvs-health-newest-data-on-retail-pbm.html, accessed July 11, 2018
First, consumers shop locally for health plans that have negotiated significant discounts with desirable local provider networks. In certain MSAs, Aetna is the number 1 or number 2 insurer in the commercial market with significant market share (See Exhibit E of AMA report). In these markets, CVS-Aetna have a significant incentive to foreclose.

Second, I agree that foreclosure is a risky strategy in that CVS-Aetna might lose a PBM or pharmacy customer, but it still might be a profitable strategy. In my earlier report, I use data on profit margins in the health insurance, pharmacy and PBM market to show that gaining one health insurance customer is far more valuable than losing one PBM or pharmacy customer. In particular I note:

One might question the size of the incentives for CVS-Aetna to disadvantage health plans competing with the insurance arm of CVS-Aetna. After all, if it does not provide competitive PBM and pharmacy services then health plans might drop CVS-Aetna and seek the same services from elsewhere. Consider a consumer who spends $10,000 a year on average (this is roughly equal to US per capita health spending) on health care and $1,000 or roughly 10% of her total spending (this is roughly equal to the fraction of health spending on prescription drugs) is on prescription drugs. Data from SEC on the profitability of PBM and health insurance sectors suggests a net profit margin of PBM services of 2.3% and a net profit margin of health insurers of 3.0%. Therefore, if CVS-Aetna were to lose this consumer as a PBM customer then CVS-Aetna would lose about $23 (2.3% x 1,000) in profits. However, if CVS-Aetna were to gain the same consumer as a health insurance customer then CVS-Aetna would gain about $323 in profits stemming from $300 (3% x 10,000) in profits from providing insurance and $23 in profits from providing PBM services. Therefore, 1 insurance customer is as valuable as 14 PBM customers; providing strong incentives for CVS-Aetna to disadvantage competing health plans to gain insurance customers even if it risks losing some PBM customers.

It is noteworthy that the letter does not challenge the above calculation.

Third, the letter omits a key part of Prof Strac’s testimony on this issue. On page 10 of her report she notes: “Although Aetna is the third largest insurer in the United States, foreclosure may be a risky strategy, as it involves not aggressively bidding for a large fraction of the market. Aggressive bidding is unlikely especially to the extent that it will strengthen the position of Aetna’s rivals in the downstream insurance market” (emphasis added). Therefore, her testimony points to the risk of not aggressively bidding but still concludes that aggressive bidding is unlikely.

Overall, I maintain my position that the likely costs of reduced competition in the insurance, PBM and pharmacy market due to the vertical merger of CVS and Aetna outweigh the potential benefits. My assessment is based on but not limited to the following:

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• The claimed benefits of $750 million represent less than 0.5% of the combined revenues of CVS and Aetna. Therefore, the magnitude of claimed benefits is very small relative to the size of operations of the two companies.
• It is doubtful whether these benefits will materialize as Aetna already self supplies essential PBM services and has integrated insurer and PBM functions.
• Even if the claimed benefits materialize, it is unclear the extent to which they will be shared with consumers.
• Several of the claimed benefits can be achieved via contracting.
• The likelihood for anticompetitive effects is high as: (a) CVS and Aetna have large market shares in extensively vertically integrated markets of PBM, pharmacy and insurance markets, (b) asymmetric information and complex contracts make foreclosure difficult to detect, (c) the PBM, insurance and pharmacy markets are concentrated or highly concentrated.
• There are significant barriers to entry in the PBM, insurance and pharmacy markets.

I hope you find these remarks to be helpful as you deliberate on the potential consequences of the merger for consumers.

Sincerely,

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