CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Dan L. Crippen, Director

July 26, 2002

Honorable William "Bill" M. Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

You asked for further explication of CBO's cost estimate for H.R. 4954, the Medicare Modernization and Prescription Drug Act of 2002, in regard to three issues: the construction of our cost management factor (CMF), the explanation for savings from exempting Medicare from Medicaid's "best-price" requirements, and our estimates of participation in the proposed benefit. I appreciate the opportunity to add whatever clarity I can to those issues.

There has been confusion about the meaning of the 30 percent cost management factor that CBO applied in analyzing H.R. 4954. The CMF is an analytical construct to estimate the effects of policy changes on total drug expenditures, not on prices. The CMF does not solely represent expected lower prices. It is an amalgam of three types of savings from management —savings due to price discounts or rebates from manufacturers and pharmacies, savings due to controlling overall drug use, and savings due to changing the mix of drugs used. Many factors dampen the full effect of the CMF. First, many beneficiaries are expected to have drug coverage from another source (such as an employer or Medicaid). To the extent that their other coverage insulates enrollees from out-of-pocket spending, it will be harder for the plan to manage costs. Second, adding or expanding insurance coverage for prescription drugs is expected to increase both the use and price of drugs. Third, if a proposal requires competing plans that bear financial risk, savings from the CMF are offset by the plans' costs for marketing to beneficiaries and for being at financial risk for the benefit (such as the cost of purchasing reinsurance). Thus, the CMF for H.R. 4954 reflects potential savings but not the costs of the mechanisms to achieve those savings. Further,

the savings are stated as a proportion of total spending and do not represent a per-prescription discount.

H.R. 4954 would eliminate the requirement that any discounts realized by Medicare prescription drug plans must be made available to Medicaid (the so-called "best price" provision). As discussed in a CBO study, drug manufacturers offer a variety of discounts and rebates to various purchasers as they compete for sales.[1] The best-price provision constrains price competition. Manufacturers are less willing to give large discounts to private-sector purchasers because they must give the same large discounts to Medicaid, which constitutes about 10 percent of the market for outpatient prescription drugs. Similarly, manufacturers would be less willing to give large discounts or rebates to Medicare purchasers if the best-price provision were to apply. Exempting Medicare prescription drug plans from Medicaid's best-price requirement would allow such drug plans to negotiate lower prices. CBO estimates that amending H.R. 4954 to remove that exemption and make Medicare prescription drug plans subject to Medicaid best-price requirements would increase the costs of the bill by $18 billion between 2003 and 2012.

Finally, you asked about participation by Medicare beneficiaries in the new Part D drug benefit established by H.R. 4954. CBO estimates that in the first year of implementation (2005), 89 percent of beneficiaries enrolled in Part B would participate in Part D. For purposes of our modeling, CBO assumes that 7 percent of beneficiaries, who would have other prescription drug coverage, would not enroll in Part D. Combining those who participate in the new Medicare drug benefit and those who have drug coverage outside Medicare leaves 4 percent of Part B beneficiaries without drug coverage in 2005. By 2007, 3 percent of Part B beneficiaries would be without drug coverage, CBO estimates.

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1. *How Increased Competition From Generic Drugs Has Affected Prices and Returns in the Pharmaceutical Industry* (July 1998).

If I can provide any further clarifications of our cost estimate, please do not hesitate to contact me.

Sincerely,

Dan L. Crippen for
Director

cc: Honorable Charles B. Rangel
Ranking Democrat

Honorable W. J. "Billy" Tauzin
Chairman
Committee on Energy and Commerce

Honorable John D. Dingell
Ranking Member