

Value Based Pricing- New Concept

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ABSTRACT

This article involves discovering how Value-Based Pricing (VBP) is creating a buzz in pharmaceutical sector. The goal is to make people understand what is exactly VBP. It will give valuable information regarding various pricing policies in pharma & pros & cons of VBP. Article also includes brief implication of this policy in UK health sector where this policy has been applied recently.

Keywords: Value-Based Pricing, FMCG, price control

INTRODUCTION

Just like while purchasing of FMCG (Fast manufacturing consumer goods) products we consider company's reputation, benefits provided by the products, compare prices between products of various companies we do the same while purchasing pharmaceutical products.

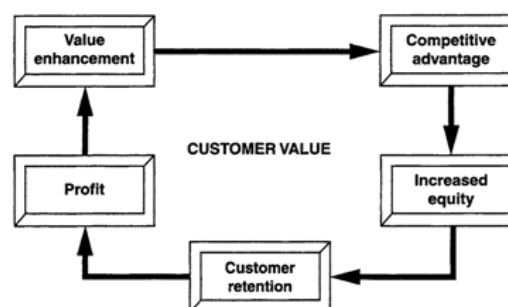
So now let's get deep into how company's priced their products to match the buyers values.

Price is the value attached to the products or services. Price has many names: fee, taxes, fares & rent. It is one of main elements of the marketing mix variables. Price is also related to company's revenue, its total turnover, employee's strength, co's position in the market. Prices are perhaps the easiest element of the marketing program to adjust; product features, channels, and even communications take more time. Price also communicates to the market the company's intended value positioning of its product or brand. A well-designed and marketed product can command a price premium and reap big profits. Pricing decisions are clearly complex and difficult though, and many marketers neglect their

pricing strategies. Holistic marketers must take into account many factors in making pricing decisions- the company, the competition, the customers & the marketing environment. Pricing decisions must be consistent with the firm's marketing strategy and its target markets & brand positioning. Value is the buyer's perception on the worth of seller's offering. This value is affected by 3 factors: the seller, the buyer, & competing sellers.^[1,2]

Thus,

Value= perceived benefits- acquisition cost
The key to perceived value pricing is to deliver more value than the competitor & to demonstrate this to prospective buyers. Basically co's needs to understand the customers decision making process. This can be done through surveys, price experiments, and statistical analysis.^[2]



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Fig.1. shows customer-value cycle^[6], that exists in all industrial sectors including pharmaceuticals. Value enhancement of the company's product offerings leads to the competitive advantage & this leads to increased brand equity. This in turn leads to customer retention, which generates profit that completes the cycle by perpetuating value enhancement process. The pharmaceutical sector is profit driven enterprise. The industry customers namely: prescribers & their patients, are largely unaware of the huge investment costs & years of R&D required to introduce a new pharmaceutical product in the market.

PRICE AS MARKETING MIX VARIABLES

It is related to sales volume & ultimately to the company's profit furthermore, price is the final determinant of the value customers will attach to the product & must reflect products characteristics & benefits closely. Characteristics of the price are following:^[2]

- 1) It is comparable measure,
- 2) It is the signal of quality & value,
- 3) It affects the image,
- 4) It is the competitive weapon,
- 5) It affects the sales volume.

1. Cost Price: the price levels that allow the company to merely cover its costs with sales revenue or break even.

2. Reference price: price level relating to a set reference, such as the initial product's launch price or national price or price of the product as related to the well established product. Types of reference price:

- I. Fair price(what the product should cost)
- II. Typical price
- III. Last price paid
- IV. Upper bound price(what most consumers must pay)
- V. Lower bound price(the least consumers would pay)
- VI. Competitor price
- VII. Expected future price
- VIII. Usual discounted price

3. Reservation price: price at a higher "reserved" level.

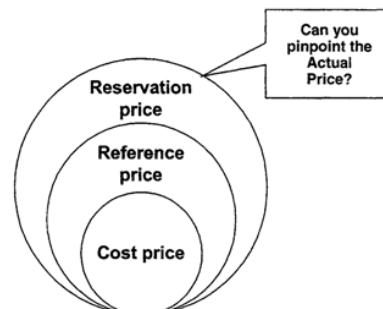


Fig.2: cost-price structure.^[6]

Government price control

National or local government significantly influences pharmaceutical prices around global market environment.



Fig.3: government influences on pharmaceutical pricing.^[6]

Price calculations: for formulations^[3]

$$R.P = (M.C + C.C + P.M + P.C) * 1 + MAPE / 100 + E.D$$

Where, R.P= retail price

M.C=material costs(inclusive of processing losses)

C.C= conversion costs as per norms notified from time to time

P.M= packing material costs, for packing charges

MAPE= maximum allowable post manufacturing expenses inclusive of trade margins

E.D= excise duty

Eg; retail price for strip of analgesics (15 tablets)

- M.C=10/-
- C.C= 5.44/-
- P.M=3.8/-
- P.C= 1.98/-
- MAPE= 70%
- E.D= 6.50

Calculation of retail price using above formula:
 $(10 + 5.44 + 3.8 + 1.98) * 1 + 70/100 + 6.50 = 28.22/-$

Maximum R.P would be 28.22/- approx.

Different pricing objectives



Fig.4: company’s pricing objectives.^[7]

A company’s pricing decision should closely reflect the company’s pricing objectives. Pricing objectives together with the organization’s product, distribution & promotion objectives constitute the organization’s market pricing objectives.

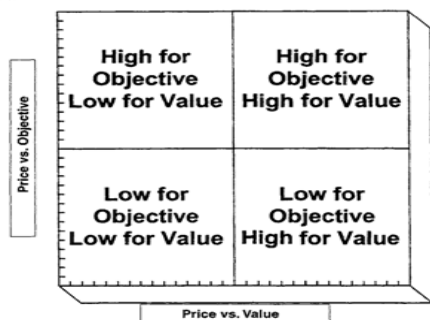


Fig.5: product pricing versus objectives value grid.^[7]

Based on different price-value and price – objectives relationships product’s final price level can be placed in one of the above four quadrant.

PRICE SETTING METHODS^[5]

Pricing the new products may present problems due to following facts:

- 1) Benefits may not be well known,
- 2) Reference products may not exists,
- 3) If a mistake is made, it is easier to lower than to raise price &
- 4) Product innovation may have value but eventually disappears. Commonly used price setting methods are:

- 1) Markup on selling price: simple pricing method that sets a fixed markup as a percent of the final selling price (25% markup on selling at a price of \$100 represent a cost of \$75).
- 2) Markup on cost: markup expressed as a percentage of cost 25% markup on the cost \$75 sets the selling price at \$93.75).
- 3) Cost plus method: estimates the total cost required for a quantity to be produced & then add a reasonable profit margin to set the final price.
- 4) Average cost method: applies desired profit margin on the average cost (i.e. total costs divided by the total quantity produced).
- 5) Target returning pricing: after identifying the fixed level cost for a given quantity, a target return is added, setting a target price for the given quantity variable costs are then added to each unit to arrive at the final unit price.

Break-even analysis is a pricing technique that determines the product quantity the firm must sell at a given price to cover total costs.^[5]

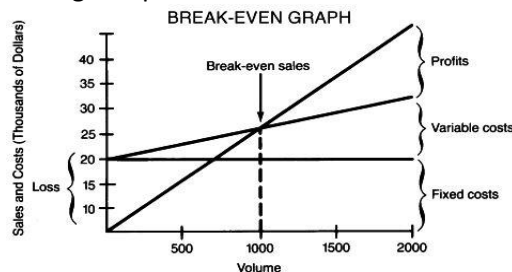


Fig.6: break-even analysis

Pharmaceutical pricing^[9]

<u>Differential pricing</u>	<u>Explanation</u>
Variable pricing	Set different prices in different markets, due to local regulations.
Second market discounting	If primary market covers fixed/variable costs, enter second market with lower price.
Skimming	Set initial prices high, then lower gradually.
Periodic discounting	Lower prices at periodic intervals (e.g., seasonally).
Random discounting	Lower prices unpredictably and infrequently.
 <u>Competitive pricing</u>	
Competition-meeting pricing	Offer products priced at the same level with competition. Avoid price wars.
Competition-undercutting pricing	Offer prices lower than competitors' to try to gain market share.
Price leadership	Capitalize on competitive advantage (e.g., unique formulation) to set high prices.
Following the leader pricing	Adjust prices according to the market leader's pricing moves.
Penetration pricing	Offer initial prices below cost, planning to capitalize as experience curve rises.
Predatory pricing	Set initial prices low to eliminate competitors, then raise them.
Traditional pricing	Set according to historic price of "reference" drug (e.g., the first NSAID).
Inflationary pricing	Adjust prices downward if inflation rises (lower purchasing power).
 <u>Product-line pricing</u>	
Total-profit pricing	Sacrificing an item's price so that store traffic and, thus, total profit increase.
Captive pricing	Price a basic unit low, with its necessary supplies high.
Leader pricing	If the market leader, add a price premium on preferred product.
Value pricing	Set prices according to customer perceived value.
Bait pricing	Offer an OTC priced low, planning to switch the customer to something higher.
Price lining	Instead of a wide range, offer three product classes at \$5, \$20, and \$100 per unit.
Price bundling	Offer discounts for buying a product package.
Multiple-unit pricing	Bundle products in large quantities and low prices (economies of scale).
 <u>Psychological/image pricing</u>	
Reference pricing	Offering a low priced generic next to an expensive "reference-priced" original.
Odd and even pricing	Odd prices (e.g., \$4.99) indicate low price, while even prices (e.g., \$200) indicate prestige.
Prestige pricing	Set very high prices to match a luxury item's prestigious image.

NEW CONCEPT OF PRICING-VALUE BASED PRICING

Proper pricing involves matching the price to buyer's value. Costs are only partly involved in the pricing process. If the buyer's perceived value is low, the price offered by the seller may seem much higher & thus, low product sales

may be inevitable. However, if the buyer's perceived value is high, the offered price may seem low in the eyes of buyer & thus results in high sales volume.

What does the value of pharmaceutical product represent to a prescriber/ patient?

Value represents product's high efficacy & safety, good tolerability, lack of drug interaction, ease of administration, fast onset of action, no dependence, sales location convenience & so on.

If the manufacturer estimates the relative values a customer is attaching to the different product alternatives & prices his products according to its perceived value, then the product will have good sales.^[8]

Price-Quality matrix				
		Price		
		High	Medium	Low
Quality	High	Premium position	Value position	Excellent value strategy
	Medium	Poor value position	Medium value position	Value position
	Low	Poor value strategy	Poor value position	Economy position

Fig.7: price-quality matrix^[7]

Value pricing is not a matter of simply setting lower prices; it is a matter of reengineering the firm's operations to become a low-cost producer without sacrificing quality, to attract a large number of value-conscious customers. In value based pricing we think carefully about how our product benefits our customer in economic & emotional terms. VBP is originally introduced by former health secretary Andrew Lansley. This policy looks to estimate the value of a drug based on the evidence available & reimburse the manufacturer accordingly. Countries like Germany, Sweden, Netherlands are following value-based pricing policies. Recently UK's government has planned to introduce this new system of drug pricing. Various elements of this policy:

1) It is designed & not invented, designed rigorously from deep understanding of economic & emotional impacts of the products or services on the customer's life & business.

2) It is communicated in terms of customer's context by sales-person.

3) VBP must lead to a win-win. This is about ensuring that customer gains from the transaction what he wants or needs & create a platform for future win-win transactions

Till now in UK Pharmaceutical Price Regulation Scheme (PPRS) was controlling drug pricing but this seeks to limit pharmaceutical company profits but also encourages investment & also National Health System (NHS) spends approx. 10% (9.3bn) of its budget on branded drugs every year. Introduction of VBP will control this spending thus, maximizing access to new pharmaceutical & encourages innovation, but it is challenging. VBP approach would incorporate a wider set of factors such as the burden of illness in society, whether drug addresses unmet needs, how innovative the drug is & wider social benefits it offers. Instead of Co. being paid according to the investment made & ensuring a return on that investment, Co's will be paid on the basis of the value products offers to the NHS & patients. This policy also intended to overcome problem of agencies like NICE (National Institute for Health & Care Excellence). VBP would apply to the new active substances launched after 1 January 2014 & some existing medicines.^[5]

Burden of illness- it is a combination of unmet needs & disease severity. In general, disease with high prevalence attracts investment. However if patient no.s are low even if the unmet need is high, new treatment may not be developed as ROI (Return On Investment) is low.

Evidence of possible benefits

- VBP is expected to improve patient or access to new drugs as it incorporates a broader range of benefits in its value-for-money assessment.
- Focus on innovation an unmet needs will also encourage industries to develop new technology to further benefit patients.

- Sustainable system- access to new treatments an encouraging the development of new treatments.
- Widespread electronic exchange of health information would allow pharma company's to gain access to broader data sets to monitor user outcomes.
- Cost for post marketing surveillance could decrease while quality of surveillance could increase because data stands, infrastructure could be improved due to VBP.
- VBP could reduce the risk of paying too high price for a pharmaceutical that may ultimately have low- value in real world.

Evidence of possible risks

- Price negotiation process has been criticized for its lack of transparency.
- Effectiveness and reimbursement process.
- Difficult to justify orphan drug prices.
- Difficulty of its implementation.
- The quest for valid & reliable measures of value-when a medication is indicated for combination & not monotherapy (eg: it must be used with one or more drugs) to treat a single disease, it will need to be determined how to measure value.
- The potential for adverse unintended consequences-the value metrics assessment could delay the release of new pharmaceuticals.
- VBP could also impose administrative burdens, requirements or stipulations on providers & consumers.

- Physicians might lose personal revenue due to a mandated switch from surgery to medication.

VBP is a system designed to align incentives between drug makers & drug purchasers invokes pharmaceutical manufacturers to demonstrate measurable, value based outcomes in relation to commercialization & pricing. VBP is intended to improve patient access to to medication with fair return on investment for pharmaceutical manufacturers: it will serve as the new paradigm that will systematically regulate pricing of new branded medicines with broader consideration of "value" as central principle. Introduction of VBP surpassing PPRS from January 2014 in UK has being criticized strongly. Success of this policy will all depend on how it will be implemented & will work to achieve its customer friendly approach.^[4,5]

CONCLUSION

Pharma co's are in the eye of this storm. The pursuit of a pivotal role in the quest of value needs for a change such as implementing Value-Based Pricing as a core strategy. But it seemed that pricing is reserved. It will allow to maximize our bargaining power & will provide a useful degree of consistency & stability to pharmaceutical industry. This approach if get successful will encourage countries globally to implement the same.

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