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AARP Bulletin

Fourth in a Series: The High Cost of Drugs... Drug Profits vs. Research

By Patricia Barry
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Consumers keep hearing that laws to lower prescription drug prices would harm research, stifle innovation and, ultimately, wreck hopes of cures for major diseases.

Critics call this argument the drugmakers' "scare card," accusing them of using it whenever their bottom line is threatened.

It's certainly a scary idea. Most people are thankful for the medicines the drug industry has produced over the past 20 years. Most look forward to more drugs for diseases that as yet can't be treated.

But is it true that we can kiss such hopes goodbye if drug prices are lowered?

That's what the industry claims. When Maine legislators were debating a tough law to curb drug prices, the Pharmaceutical Research and Manufacturers of America (PhRMA) ran full-page ads in Maine newspapers showing an old lady looking frail and wistful. The headline: "She'll Just Have To Wait."

The ad continued: "If the government imposes cost controls on prescription medicine, pharmaceutical companies could be forced to make deep cuts in funding for drug research. Finding more effective treatments for Parkinson's [etc.] could take years longer—years of unnecessary suffering for patients."

In defending this argument, PhRMA says the United States leads the world in bringing out new drugs because the American free market rewards innovation. It says that research and development (R&D) is costly and high-risk, and high profits are needed to attract the level of investment that allows research to continue.

"We need to make sure that incentives for pharmaceutical innovation remain strong," said PhRMA President Alan Holmer in a recent speech.

Critics, however, say drug R&D is neither as risky nor costly as the industry claims, that it spends more than twice as much on marketing and administration as research, that many drugs derive from basic research funded by tax dollars,

and that many new medicines are "me-too" drugs that offer little more benefit than existing ones.

At the heart of the debate:

- Do price cuts harm research? "This argument has always puzzled me," says Uwe Reinhardt, an expert on health policy at Princeton University. "The truth is that R&D spending [as a percentage of revenue] is equal or higher in Europe than here," yet European countries all control drug prices.

The top 10 American drug companies plow back an average of 12.5 percent of their sales revenue into R&D, according to company reports. PhRMA disputes this figure, saying that company spending on R&D for prescription drugs alone (not including other products made by the firms) is 17.7 percent according to its own survey of drug firms. In contrast, the price-controlled British drug industry says it spends about 20 percent of sales revenue on R&D.

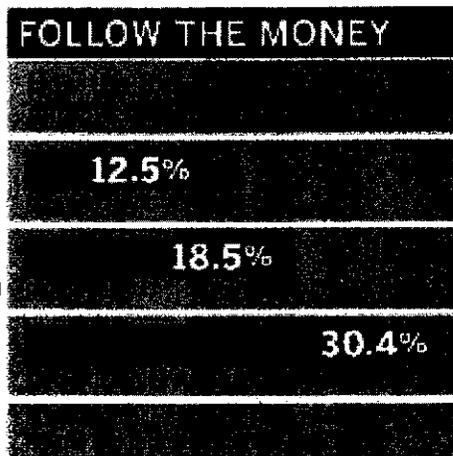
American drugmakers have used the same argument against several laws that would curb prices—notably the 1984 Hatch-Waxman Act, which opened up the market to less expensive generic drugs.

"So far none has had an effect on R&D," says Stephen Schondelmeyer, an expert on drug trends at the University of Minnesota. "In fact, R&D and profits accelerated after these laws put pressure on prices."

- **How much do drugmakers spend on research?** PhRMA estimates the industry spent \$30 billion on R&D last year. It claims the costs of bringing new drugs to market average \$800 million each. The watchdog group Public Citizen disputes the way this figure was calculated—arguing that, for example, it does not take into account the large tax deductions companies can claim for R&D.

Public Citizen says the actual cash outlay for each new drug (including failures) after tax rebates is about \$240 million. PhRMA says it stands by its own number.

- **How risky is drug research?** The latest Fortune 500 analysis shows that the drug industry is still by far the most profitable in America on all three counts: return on revenue (18.5 percent), return on assets (16.3 percent) and return on shareholders' equity (33.2 percent). (These are three to eight times the medians of all other industries.)



"It defies logic that R&D investments are highly risky if the industry is consistently so profitable and returns on investments so high," notes Public Citizen.

Reinhardt says individual research projects are certainly risky, as few will turn into blockbuster drugs, but big drug company stocks overall are "no riskier than a diversified mutual fund portfolio."

- **Is research as important as sales?** The drug industry spends more than twice as much on marketing and administration as on research.

PhRMA spokesman Jeff Trehitt says that administrative costs are "an essential part of doing business." But, critics say, that cost includes large salaries—from \$6 million to \$40 million a year, exclusive of stock options, for the highest paid executives in the top 10 companies—which doesn't sit well with retirees on fixed incomes who can't afford drugs.

Researchers at Boston University found that from 1995 to 2000 drug industry staff employed on research declined slightly from 49,000 to 48,000 whereas sales staff grew from 55,000 to 87,000.

"That's a phenomenal increase in five years," says health economist Alan Sager, the study's co-author. "It suggests that drugmakers can make more money by investing in marketing than in research."

Trehitt says a "surge" of new drugs in that period required more sales reps to sell them to "tens of thousands" of doctors.

- **How innovative are American drugs?** PhRMA says that eight out of the world's best-selling 10 drugs originated in this country, compared to two from Europe.

But only about one-third of new American drugs are truly innovative in that they provide new treatments or are safer or more effective than existing drugs, according to another study. The rest include "me-too" drugs (which differ little from others already on the market) or modifications of older drugs.

The study, by the National Institute for Health Care Management, relies on classifications made by the Food and Drug Administration for more than 1,000 new drugs introduced from 1988 to 2000.

"In this period of incredible growth in research spending and profitability, the drug companies have not demonstrated any significant increase in innovation," says Nancy Chockley, the institute's president. "The numbers just don't show it."