EMERGING CONTRACTING APPROACHES

Actual vs. Effective Fee for Service

How chargebacks from statutory and mandated discount programs raise what manufacturers actually pay their distributors and specialty pharmacies, and the contract language that corrects it.

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The short version

Most manufacturers negotiate a fee for service (FFS) rate with their distributors and specialty pharmacies and assume that is the rate they pay. In many agreements it is not.

Where chargebacks are involved, the fee is calculated on gross WAC sales while the manufacturer's actual realization on those units is materially lower. The result is an effective fee rate above the rate that was negotiated. On a product forecast at $200M in gross sales with a 6% contracted FFS and chargebacks running at 8% of gross, the difference is **$960,000 in a single year**.

How the mechanic works

1. Channel partners purchase product at WAC.
2. Product moves to a customer covered by a statutory or mandated discount program at a set contract price. This includes 340B Covered Entities, Federal Supply Schedule customers and the Big Four federal agencies.
3. The partner submits a chargeback to the manufacturer to be made whole back to WAC.
4. The fee for service continues to be calculated on gross WAC sales.

Steps one through three are routine and correct. Step four is where the fee basis and the manufacturer's economics separate.

What the gap costs

Table 1. Gross sales net of chargebacks fee calculation (example only)

Description	Financials
Gross sales forecast	$200,000,000
Contracted FFS %	6.00%
FFS payments @ 6%	$12,000,000
Chargebacks paid to distributors (8% of gross WAC sales)	$16,000,000
Adjusted sales after chargebacks	$184,000,000
Effective FFS % with chargebacks paid to distributor	6.52%
Additional FFS % to distributor vs. contract rate	**0.52%**
FFS payments (net of chargebacks)	$11,040,000
FFS savings to manufacturer	**$960,000**

Assumption is that chargebacks account for 8% of all gross sales across statutory and mandated discount programs.

The contracted rate is 6.00%. The rate actually paid, measured against the sales the manufacturer realized, is 6.52%. Expressed a second way, fees are **8.7% higher** than the same contracted rate applied to a net basis.

The gap widens as the mix shifts

Table 2. Effective FFS % at varying chargeback volumes ($200M gross, 6.00% contracted FFS)

Chargebacks as % of gross	Adjusted sales	FFS paid	Effective FFS %	Over contract rate
8%	$184,000,000	$12,000,000	6.52%	0.52%
12%	$176,000,000	$12,000,000	6.82%	0.82%
16%	$168,000,000	$12,000,000	7.14%	1.14%
20%	$160,000,000	$12,000,000	7.50%	1.50%
25%	**$150,000,000**	**$12,000,000**	**8.00%**	**2.00%**

This matters more than the dollar figure in any single year. The effective rate rises as chargeback volume rises, which means a channel partner's effective compensation improves as more of a manufacturer's volume moves into these classes of trade.

At the upper end this stops being a rounding difference. Where chargebacks reach 25% of gross sales, a 6.00% contracted fee is an 8.00% effective fee. The manufacturer is paying a third more than the rate that was negotiated.

> This is not an accusation of bad faith. It is a description of what the agreement, as written, rewards. There is no mechanism by which a partner benefits from helping a manufacturer manage that volume, and none by which they are exposed if it grows.

The correction

The agreement should establish that the negotiated fee for service is the actual fee for service and not the effective fee for service after chargeback processing.

It is worth being explicit about what this is and is not. It is not a takeaway. The negotiated rate does not change, and the channel partner is not being asked to accept less than the rate they agreed to. What the change does is ensure that the agreed fee for service is the fee for service actually paid.

In practice, payments from the manufacturer to the channel partner are calculated on gross sales net of the chargebacks paid, whether the fee is expressed as a percentage or as a per unit dollar amount. The negotiated rate does not change. What changes is the base it is applied to.

One point worth separating. The basis question addressed here is about what the agreed rate is applied against, not whether the rate itself is defensible. CDT recommends that all manufacturers obtain a fair market value assessment to support actual fee for service rates, for contract development and for execution. The two questions are independent and each needs a defensible answer.

How it settles in practice

Two administrative objections come up. Neither needs to be argued.

"Our billing runs on gross WAC sales. We are not set up to calculate fees net of chargebacks."

"Chargebacks are processed on a lag. When we invoice fees for a period, that period's chargebacks are not final."

The second is a fair description of how chargeback processing works. Neither matters, because the mechanics sit on the manufacturer's side and neither requires the partner to change anything. They continue to invoice fee for service exactly as they do today. The manufacturer applies the contracted fee rate to the chargebacks paid to that partner and deducts that amount from the partner's most recent fee for service invoice.

On the Table 1 figures, chargebacks of $16,000,000 at a 6.00% contracted rate produce a $960,000 deduction against the $12,000,000 invoice. The partner is paid $11,040,000, which is 6.00% of the $184,000,000 the manufacturer actually realized. The deduction method and the net basis arrive at the same number.

Because the deduction is applied to the most recent invoice rather than to the period the chargebacks originated in, the processing lag stops being a problem. Chargebacks are deducted as they settle and the arrangement self-corrects over the life of the agreement, with no separate reconciliation or true-up to administer.

What distributors and pharmacies will say

"We have already built this into our fee structure. If you move to a net basis, we will need to raise your fees."

This is the response to expect, and it is worth examining rather than accepting.

It is difficult to predict how much of this volume there will be at launch for a new product, and equally difficult to predict how much it will grow during the current term of a distribution or dispense agreement for a product already in market. That difficulty applies to both parties. A rate that had genuinely been priced for an anticipated mix would be close to indifferent to the basis it is applied against, because that mix would already sit inside the rate.

It is also worth noting what that response concedes. If the effective uplift was already priced into the rate, then the stated rate was never the rate either party expected would actually be paid. That is the manufacturer's point, not a rebuttal to it.

More directly: the current structure does not leave the channel partner exposed to mix, it leaves them advantaged by it. Under a gross basis every shift toward these classes of trade raises their effective rate, as Table 2 shows. They gain from more sales at off WAC pricing into these classes of trade.

A net basis removes that gain. In absolute dollars a partner will receive less under a net basis than under a gross basis, and at high chargeback volumes materially less. That difference is the uplift, not the negotiated fee. On the sales the manufacturer actually realized, the partner is still paid the rate both parties signed.

What to ask for at renewal

- Calculate your effective FFS rate on the last four quarters of actual data. Compare it to your contracted rate. That single number is usually enough to start the conversation.
- Confirm how the fee base is defined in each current agreement, distributor and dispense partner alike. The language is often silent rather than explicit, which is why the gross basis persists by default.
- Ask for the fee base to be stated as gross sales net of chargebacks paid, for both percentage and per unit dollar fee structures.
- Model the change at more than one chargebacks-to-gross ratio before you negotiate, so a proposed rate increase can be evaluated against the mix scenarios rather than against a single forecast.
- Apply the same review to every channel partner. A correction at one distributor while the others remain on a gross basis leaves most of the exposure in place.

> **Where CDT helps.** Most manufacturers can start this work themselves. The first item is usually where teams stop, because a true effective rate requires chargeback data reconciled against fee payments by partner, and few commercial organizations hold both in one place. If you want help running that number, drafting the fee basis language, or sitting on the manufacturer side of the negotiation, that is the work CDT does. New, emerging and established manufacturers alike.

Scope and caveats

This paper describes a commercial contracting approach to fee basis definition. It is not legal, tax, accounting or regulatory advice, and it is not a substitute for review by qualified counsel before any agreement is amended or executed.

All figures are illustrative. The $200M gross sales forecast, 6.00% contracted FFS and 8% chargeback assumption are an example only and are not drawn from any client engagement. Actual outcomes depend entirely on product economics, contracted rates, class of trade mix and the specific terms of each agreement.

This paper does not address government price reporting, class of trade classification for statutory calculation purposes, or eligibility and compliance obligations under any federal discount program. Those are separate matters requiring separate expertise.

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