



**SUBMISSION TO THE DEPARTMENT  
OF HEALTH AND AGEING:  
PHARMACY WHOLESALING**

**AUSTRALIAN MEDICAL ASSOCIATION**

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## EXECUTIVE SUMMARY

The Australian Medical Association (AMA) has a strong interest in ensuring the Pharmaceutical Benefits Scheme (PBS) remains sustainable. The PBS plays a very important role in the health financing jigsaw and is a key instrument for providing access to affordable medicines for Australians.

The AMA appreciates that the prospective ageing of the Australian population poses challenges for all elements of the health delivery and financing systems. It is important that the PBS be sustainable and affordable to the nation as a whole, as well as giving individuals timely and affordable access to medicines.

There are points of difference between the Australian Government and the AMA in relation to the most appropriate framework for decisions on the PBS.

The AMA has previously stated its concerns that in negotiating the Fourth Community Pharmacy Agreement, the Government ought not overcompensate those involved in the distribution of medicines as that can only detract from patient access. The AMA reaffirms those concerns and notes the importance of adopting a financing framework which encourages productivity gains to lower the real costs of distribution.

Traditionally, the supply chain was seen as comprising manufacturers, wholesalers and retailers. Wholesaling activity has undergone considerable change in many industries. In some areas of the economy, the wholesaling function has been absorbed by manufacturers or consortia of retailers (vertical integration) and independent wholesalers have all but vanished.

The AMA believes the arrangements promulgated by the Fourth Community Pharmacy Agreement should not stand in the way of improvements in the way medicines are distributed. In that regard, it does expect electronic prescribing to become the normal with electronic transmission of scripts to a pharmacy of the patient's choice. The AMA concurs in the Department's assessment that electronic claiming for benefits will become more popular.

The AMA sees option 1 as the preferred option because it is the least interventionist option while still providing ample funding to cover the costs of distribution. In short, the AMA contends that the Government should allow market dynamics to work.

It considers option 4 to be highly inappropriate. A highly interventionist approach can only serve to reduce likely productivity gains and delay desirable changes. These changes are desirable because they will increase efficiency and lower the real cost of distribution.

If (as we expect) the existing wholesalers render a service of value to community pharmacy, then they will be able to demand compensation to keep their businesses viable. If the retail pharmacy sector and/or the manufacturers of prescription medicines wish to explore new paradigms for logistics, then they should be free to do so.

# 1 INTRODUCTION AND CONTEXT

The Australian Medical Association (AMA) is pleased to have the opportunity to make this submission to the Department of Health and Ageing in response to the consultation paper issued on 9 August 2005.

## 1.1 Sustaining the PBS

The Australian Medical Association (AMA) has a good deal of common ground with the Australian Government in relation to the aims and structure of the Pharmaceutical Benefits Scheme (PBS). The very important role that the PBS plays in the health financing jigsaw is now very widely acknowledged.

The AMA appreciates that the prospective ageing of the Australian population poses challenges for all elements of the health delivery and financing systems. It believes that those challenges are manageable provided that Governments in turn accept the inevitable that in future the Australian people will wish to see a higher proportion of the nation's resources allocated to the health care sector. The AMA foresees that this desire will be reflected in both personal health care expenditure and in the expenditure of taxpayers' funds.

Within that broader context, the AMA and the Government see the importance of the PBS being sustainable and affordable to the nation as a whole, as well as giving individuals timely and affordable access to medicines. Medicines play a larger role in health delivery than once was the case and the AMA concurs in the Department's assessment that the role of medicines will increase further in the future. New discoveries in pharmacology are expected to further extend the opportunities to use medicines effectively.

There are points of difference between the Australian Government and the AMA in relation to the appropriate framework for decisions on the PBS. In particular, the AMA is concerned that decisions on the listing of new medicines are too narrowly based with too much emphasis on the Federal Budget bottom line. There is not enough emphasis on the other implications for the cost of health service delivery (eg, potential savings in hospital, medical and allied health services) and not nearly enough emphasis on the benefits for patients in terms of productivity, reduced carer burden, quality of life and years of healthy life. In relation to the latter, the AMA contends that the Department's notional valuation of a year of healthy life is far too low and completely out of step with international estimates<sup>1</sup>.

The AMA accepts that doctors and acute hospitals are expensive elements of health services delivery. It is all the more important, therefore, that we maximise the value of our medical workforce by giving them access to the tools they need (including the ability to prescribe modern and effective medicines) and that we not misuse expensive and scarce hospital resources by using them as a substitute for cheaper and more effective pharmacological treatments.

Excessive rationing of medicines and excessive constraints on PBS spending put at risk the wider objectives of a modern, effective and affordable health system.

## 1.2 Distribution ought not be overcompensated

Over the past year, in both public utterings and submissions to Government and parliamentary inquiries, the AMA has stated its concerns that in negotiating the Fourth Community Pharmacy Agreement, the Government ought not overcompensate those involved in the distribution of medicines as that can only detract from patient access. As the peak body representing medical practitioners, the AMA has a completely legitimate interest in engaging in this issue and it rejects the Pharmacy Guild's contention that it has no right to express its opinion.

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<sup>1</sup> Viscusi and Aldy, 2002.

The AMA reaffirms those concerns about the cost of distribution. It remains of the view that retail pharmacy is afforded unprecedented and excessive protection from competition and believes that restrictions on the ownership and location of community pharmacy should be reviewed. Some of those issues have been set aside in the negotiation of the Fourth Community Pharmacy Agreement but setting them aside only delays the inevitable in our view. The Government cannot ignore the claimed savings in distribution costs identified by ACIL Tasman of \$500 million per annum.

Obviously, with certain desirable steps already ruled out, some opportunities for productivity gains will be lost. It is all the more important, therefore, that in finalising the arrangements for wholesaling of prescription medicines, the Government adopt a framework which encourages productivity gains so that real costs of distribution are as low as possible within the many constraints.

## 2 LOGISTICS: EVOLUTION OR REVOLUTION

### 2.1 Will wholesaling vanish altogether?

In many industry sectors, independent wholesalers have all but vanished. At one level, the reasons include:

- ❑ **vertical integration:** either the manufacturers have chosen to distribute directly themselves or the retailers have formed buying chains or established consortia to manage the wholesaling function;
- ❑ **the larger size of retail businesses:** taking food retailing as a stand-out example, the large supermarket chains have captured a significant market share and have become huge businesses. They have no need of a wholesaler to intermediate for them. They can deal directly with manufacturers and they manage (or outsource) the distribution to their retail outlets; and
- ❑ **faster supply chains:** changes in the manufacturing and transportation sectors (many of them related to the use of IT) have reduced the response times, allowed for lower stock-holdings and reduced transaction costs. There is now less need of warehousing, one of the roles traditionally played by the wholesalers.

Will wholesaling vanish altogether? We suspect the answer is no. The wholesalers may have a reduced role and may even vanish as narrow spectrum service providers. The wholesaling function is still required but that service may be rendered by a contractor as part of a much wider suite of supply chain services or rendered internally by a specialist business unit. And the way in which wholesaling works may be completely different. For example, logistics companies may render services for the distribution of supplies without actually owning those supplies. The capital locked up in supplies in the chain may be ventured by the manufacturer or the retailer instead of by the wholesaler. The upshot may be that the wholesaling function requires fewer resources.

There is a host of innovations in or related to warehousing and distribution which have been made possible by developments in and much lower costs of information technology. These include real-time stock control systems and real-time tracking of stock in the distribution system itself, the automating of orders when stock level control points are reached. These changes enable wholesalers to manage their stock levels more efficiently and reduce costs. The key issue is to ensure the savings in distribution costs are made available for people to access medicines, not as abnormal profits for wholesalers or retailers.

### 2.2 The process of change will continue

Change in warehousing and distribution have been rapid. Considerable further change is inevitable. The direction of this change may be difficult to predict in any explicit detail but it is

safe to predict that innovations in information technology have not run their course. Further automation in stock control, ordering and distribution systems is likely to affect all players (manufacturers, wholesalers/logistics companies and retailers).

Rapid technological change makes life difficult for government payers. First, it is no easy task to assess what is happening to real costs and to determine appropriate remuneration if those costs are falling. Second, technical innovations may involve significant new amounts of risk capital. Government payers find it difficult to assess how administered prices should take account of the cost and consumption of capital. Sharp real falls in the prices of IT software and hardware can mean that different producers have very different historical costs. Finally, the payments systems themselves may constraint the pace of change in the system, may deter new players and deter new and better ways of doing things.

For this reason, the AMA places a high store on the option which involves the least intervention by the Government in the wholesaling function, the one which most encourages efficiencies in the wholesaling function to be passed on to taxpayers and the one which does not entrench the existing players in any preferential position.

### 3 ASSESSMENT OF OPTIONS

#### 3.1 Option 1

**Option 1 is the modified pricing formula, involving a reduced wholesale margin with a two-tiered structure supplemented by special handling subsidies for medicines requiring special handling and allowing the possibility of higher prices for delivery to remote locations.**

The existence of kickback payments to retail pharmacy is widely acknowledged but not quantified. The reduced wholesale margin is, therefore, appropriate in the view of the AMA, striking a balance with a fair price that is still fair to the suppliers while helping the aims of an efficient and affordable distribution system.

This option still allows room for market processes to operate. If market forces allow the pharmacies to buy better than price implied by manufacturer price plus wholesale margin, so be it. There is no need for the Government to intervene.

The trickiest issue under this option is the possibility of higher prices for delivery to remote locations. An argument could be made for uniform pricing regardless of location (cross-subsidising rural pharmacy through the prices paid). It may, however, create an incentive for suppliers to try to lower the level of service to remote areas in the hope that the pharmacies will buy elsewhere, thus imposing costs on a competitor. Allowing differential pricing against the knowledge that the cost will be met by other subsidies creates an incentive for suppliers to load up those costs and reduces the incentive for them to find more efficient ways to effect the distribution.

Whichever way you go, it is difficult to guarantee equal prices and prompt deliveries to remote locations but the AMA would support all reasonable initiatives to achieve these outcomes.

#### 3.2 Option 2

**Option 2 is a comprehensive wholesale service incentive designed to allow the Government more say over the commercial behaviour of wholesale pharmacy with payment either through pharmacies or direct to the wholesalers.**

The AMA believes that these issues should be left to the market to determine. That is, it should be a matter of negotiation between wholesale and retail pharmacy as to what services are supplied and at what price. Retail and wholesale pharmacy businesses do not need to be molycoddled. Where a wholesaler can provide a better service at a competitive price, it will win market share. This option risks stultifying innovation in service delivery by backing the wrong horses.

### 3.3 Option 3

**Option 3 is a wholesaler funding pool also designed to allow the Government more say over the commercial behaviour of wholesale pharmacy.**

Option 3 has aims that are similar to option 2 and invites the same concerns about inappropriate and ineffective intervention in the market.

### 3.4 Option 4

**Option 4 involves the complete separation of the remuneration systems for retail and wholesale pharmacy and the appointment of an approved panel of wholesalers, thus making the wholesalers service providers to the Government rather than other players in the industry (manufacturers and retailers).**

Option 4 is highly interventionist. It will no doubt ensure the long term survival of an independent wholesale industry regardless of whether or not that is appropriate given changing technologies for distribution and warehousing. It is the option which offers the most protection to wholesale pharmacy. It seethes with problems. The experience with the wholesale margin in past years demonstrates the difficulty the government faces in striking an appropriate administered price. This option assumes that the Government knows better than the market as to what level and quality of services is required. It is an option engineered for failure. When things go wrong (as they most certainly will do), the blame will fall directly at the feet of the Minister and the Department. Innovation in distribution and warehousing will be stultified. The administered price will almost certainly be wrong.

Stated simply, government does not need to intervene to specify what level and quality of services should be provided by those who render wholesale-type services (and this may include manufacturers) or to set the price for such services.

## 4 CONCLUDING COMMENTS

### 4.1 Preferred option

Of the four options presented, the AMA prefers Option 1. Of the four options, it allows the most scope for market forces to determine the “right” wholesale price. That said, a case could be made for more market freedom (see 4.3 below). The other options all involve more intervention in the market (with option 4 the most interventionist) and all are based on the errant assumption that the Government knows best what wholesalers should do and at what price.

The reduced margin in Option 1 may imply that there is less scope for wholesale pharmacy to make kickback payments to retail pharmacy. The AMA is not concerned about that. It is simply a case of the administered price following the real price down (albeit with a lag).

The AMA has stated openly its view that the retail margin arrangements overcompensate retail pharmacy and it believes that the funding offered by the Government for the fourth

community pharmacy agreement is more than sufficient to generously fund a high quality community pharmacy service. The loss of some kickback payments does not change that assessment.

## **4.2 Implementation**

The wholesale margin should be bundled into the remuneration for pharmacists (who will in turn pay to wholesalers whatever market forces demand). There should be no separate system of remuneration between Government and wholesale pharmacy.

## **4.3 Other options**

The Government could consider doing away with the wholesale margin altogether and readjusting the dispensing fees and retail pharmacy margin to produce about the same total funding for wholesale and retail distribution. This would allow more freedom in the wholesale market so that wholesale prices would more accurately reflect costs per item, including the lower costs in the case of high volume medicines. Far from threatening wholesale pharmacy, this option might offer them more protection from manufacturer cherry picking. The AMA acknowledges that this option may scare the wholesalers. It remains of the view, however, that if (and for as long as) the wholesalers are rendering a valuable service to the manufacturers and retailers alike by acting as the “middle man”, then the market will resolve that value and their businesses will remain viable.

## **4.4 Other comments**

Option 4 should be avoided at all costs. This highly interventionist option carries the greatest risk of locking in an inefficient and needlessly high cost system of distribution.

## REFERENCES

Viscusi WK and Aldy JE (2002) "The value of a statistical life: a critical review of market estimates throughout the world" Discussion Paper No. 392, Harvard Law School, Cambridge MA, November, downloadable from [http://www.law.harvard.edu/programs/olin\\_centre/](http://www.law.harvard.edu/programs/olin_centre/)

## APPENDIX: RESPONDENT INFORMATION

### Contact details

1. Name: **The Australian Medical Association Ltd (AMA)**

2. Are you responding as a company, peak body or individual?

**Peak Body**

3. What is the nature of your interest in this area?

**The AMA is Australia's peak medico-political body. It represents the interests of Australian doctors and enjoys the support of some 28,000 members. Doctors, in turn, advocate on behalf of their patients (as does the AMA). The AMA has an interest in all aspects of the health financing and delivery systems including the PBS. The arrangements for the forth community pharmacy agreement have implications for the efficacy of the PBS. The AMA acknowledges community pharmacy as a valuable partner in the health delivery system and will support a framework that encourages the efficient and cost-effective distribution of medicines with fair remuneration for pharmacy.**

1. Contact: **John O'Dea, Director, Medical Practice Department**  
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