

Summary of Presentation

“PBS reform: there’s more to it than meets the eye”

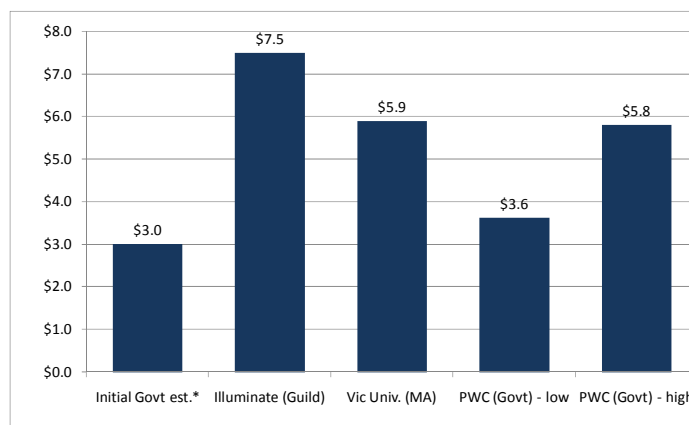
The government is determined to save money on the Pharmaceutical Benefits Scheme (PBS). Even with the PBS reforms to date and those recently announced by the government, Access Economics estimates that government outlays on the PBS will double as a share of GDP over the next thirty years (from 0.6% today to 1.5% in 2041-42). We can expect more reforms going forward, all aimed at reducing the amount of money the government pays for PBS medicines and for the related services of dispensing and wholesaling.

To date, specific PBS reforms include:

- the 12.5 per cent price cut policy introduced on 1 August 2005;
- the staged 2 per cent price reductions for F2A drugs introduced on 1 August 2007;
- the 25 per cent price reduction for F2T drugs effective from 1 August, 2008; and
- the progressive implementation of a system of price disclosure-based adjustments to the *approved price to pharmacy* of PBS medicines.

Victoria University’s Centre for Strategic Economic Studies estimates savings from the 12.5 per cent price cut policy alone at \$3.5 billion over the decade 2008-09 to 2017-18.¹ Estimates of savings from the other measures vary (see Chart 1.1). The government itself produced an early estimate in 2006 of \$3.0 billion over ten years. This was followed by estimates from Illuminate Health Consulting (commissioned by the Pharmacy Guild of Australia) and Victoria University (commissioned by Medicines Australia) which put the savings considerably higher at \$7.5 and \$5.9 billion, respectively.² The government then asked PricewaterhouseCoopers to re-work its original estimates and they came in at \$3.6 billion (low) and \$5.8 billion (high).³

Chart 1.1: Projected savings to Government from PBS reform[^]



[^]Includes the impact of the 25% and 2% price cuts and price disclosure and *not* the 12.5% price cuts. *Refers to the period 2007-08 to 2016-17 while others refer to the period 2008-09 to 2017-18. Differences in methodology employed by each of the analysts mean comparisons should be undertaken with a level of caution.

The main reason these estimates vary is the different assumptions analysts make about the impact of price disclosure. In particular, they make different assumptions about:

- the extent of price discounting from manufacturers;
- the market share of originator brands versus generic medicines; and
- the dates of patent expiry of the various molecules.

But whichever way you cut it, the government looks to save billions of dollars on the PBS over the next decade.

¹ Victorian University - Centre for Strategic Economic Studies (2009), *The impact of PBS reforms on PBS expenditure and savings: actual and projected from 2008-09 to 2017-18*; research commissioned by Medicines Australia.

² Illuminate Health Consulting (2009), *The annual impact of the PBS price disclosure policy on PBS expenditure to 2014-15*; research commissioned by the Pharmacy Guild of Australia.

³ PricewaterhouseCoopers (2010) *The impacts of Pharmaceutical Benefits Scheme Reform*; research commissioned by the Department of Health and Ageing

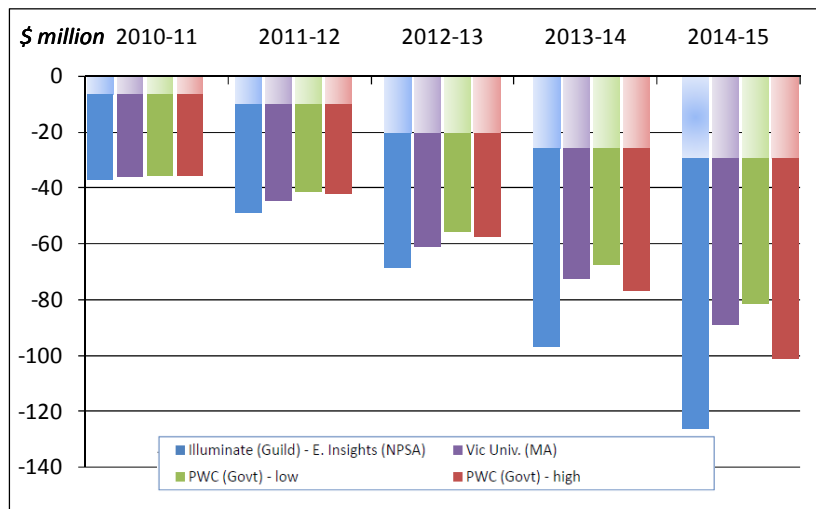
Impact on the wholesale margin

Most discussion of PBS reforms emphasises the impact on pharmaceutical manufacturers. After all, it's their prices that are being cut by the reforms. But price reductions also affect pharmacists and wholesalers since the pharmacy mark-up and wholesale margin are both directly linked to the approved price of PBS medicines.

Chart 1.2 shows various estimates of the impact of PBS reforms on wholesaler earnings.⁴ These estimates include the impact of the 12.5 per cent price cuts first announced in 2005 as well as the more recent 2 per cent and 25 per cent cuts and the estimated impact of price disclosure. Estimated revenue losses to wholesalers range between \$35 and \$37 million in 2010-11 and between \$81 and \$126 million by 2014-15.

Putting these numbers into perspective, the high-end 2014-15 estimate is equivalent to around \$25,000 per pharmacy or a loss of around three-quarters of the current EBIT margin earned by full-line wholesalers. Put another way, this is equivalent to shaving around 1.4 percentage points off the 7 per cent wholesale margin.

Chart 1.2: Projected impact on wholesaler earnings from PBS reform and 12.5% price cuts[^]



[^]Gross impacts: off-setting effects of the additional PBS reform-related CSO funding are not captured. Differences in methodology employed by each of the analysts mean comparisons should be undertaken with a level of caution.

Implications for the sector

Revenue loss of this magnitude is significant and is unlikely to be offset by cost economies and/or productivity improvements. There isn't that much 'fat' available to be trimmed in such a competitive business as wholesaling where productivity improvements are automatically passed through to customers. The implications are clear:

- wholesalers will review their commercial practices, including especially the trade terms they offer to pharmacies; and
- pharmacies should expect a very different negotiating environment going forward, as wholesalers seek to recoup some of the revenue loss that PBS reform will cost them.

Pressure for further reforms to the PBS will intensify. The government is determined to extract further savings over time as the Minister (to quote her words), "examines PBS prices very closely".⁵ Access Economics has been commissioned by the National Pharmaceutical Services Association to develop an index measure and to report annually on the unfolding impact of PBS reform. We are just at the beginning of a long process of reform.

Professor Ian Harper

Access Economics

13 March 2010

Disclaimer

While every effort has been made to ensure the accuracy of this document, the uncertain nature of economic data, forecasting and analysis means that Access Economics Pty Limited is unable to make any warranties in relation to the information contained herein. Access Economics Pty Limited, its employees and agents disclaim liability for any loss or damage which may arise as a consequence of any person relying on the information contained in this document. The presenter's views are his or her own, and not necessarily those of Access Economics Pty Limited.

⁴ These estimates are based on calculations made by NPSA and Economic Insights Pty Ltd.

⁵ *Pharmaceutical costs continue to grow*, Media Release by the Minister for Health and Ageing; 9 February 2010.