A perfect 10?

THE COMMUNITY SERVICE OBLIGATION (CSO) COMMENCED ON 1 JULY 2006 AS PART OF THE FOURTH COMMUNITY PHARMACY AGREEMENT. ITS GENESIS, THOUGH, CAN BE TRACED BACK TO THE REVIEW OF PHARMACEUTICAL WHOLESALING UNDERTAKEN IN 2001/02, THE REPORT OF WHICH WAS RELEASED IN SEPTEMBER 2002. IN A SERIES OF SHORT ARTICLES, **DR MICHAEL TATCHELL*** WILL EXAMINE ITS PURPOSE, ASSESS ITS EFFECTIVENESS AND IDENTIFY THE BENEFITS IT PROVIDES FOR PATIENTS, PHARMACISTS, WHOLESALERS AND THE AUSTRALIAN GOVERNMENT.

The Matthews Review of Pharmaceutical Wholesaling (named after its chair, the Hon John Matthews) was established in 2001 by the Howard Government to examine and report on a range of issues in pharmaceutical wholesaling and to recommend 'options for improving existing arrangements for funding wholesalers to achieve greater efficiency and effectiveness in the sector and realise savings to Government'.

A key feature of the report's fourth option was a 'Community Service Charter' which would require wholesale distributors to offer the full range of services needed to support distribution of all PBS products to pharmacy. This option, which Matthews believed best addressed the review's terms of reference, was supported by the National Pharmaceutical Services Association (NPSA) and the Pharmacy Guild of Australia.

Option 4 also envisaged a lower wholesale margin for those distributors not offering the full range of services, a Wholesale Payment Matrix, and the establishment of a PBS Supply Chain Task Force to pursue PBS supply chain initiatives and to establish a Supply Chain Development fund to fund the Task Force and any supply chain improvements that might be introduced.

The report's release in 2002 did little to stem the government's concern about the rising cost of the PBS, or its determination to find ways to rein in that cost and, in particular, to address what it perceived to be the inordinately large share of that cost attributable to the distribution of PBS medicines. This was made abundantly clear on more than one occasion by Philip Davies, a senior bureaucrat with the Commonwealth Department of Health and Ageing. At the Australian Pharmacy Professional conference (APP) and elsewhere in 2003 and 2004, Mr Davies spoke publicly about PBS supply chain costs, questioning the level of those costs (at that time in excess of 30 cents in the dollar) and asking whether they could be justified.

Mr Davies suggested the future sustainability of the PBS required action in two main areas:

- **to contain the costs of pharmaceutical distribution and supply, and**
- **to ensure that medicines are used appropriately.**

Media reports at the time also suggested the government was looking to cut the wholesaler margin. In one instance (*Herald Sun*, 20 December 2004) it was reported the government was looking to cut the wholesaler margin to 5% or to replace it with a flat fee.

In April 2005, at the commencement of negotiations for the Fourth Community Pharmacy Agreement, the government proposed for the first time a 'global sum' approach to remunerate both community pharmacists and wholesalers for their respective roles in the distribution of PBS medicines.

The government's initial negotiating position also envisaged there would be no agreed wholesaler payment or margin. Instead, each pharmacist would be required to pay for their medication deliveries from their PBS remuneration, leaving the wholesalers to set their delivery charges on a pharmacy by pharmacy basis with no reference to the Approved Price to Pharmacist, a fundamental component of the pricing of all PBS medicines.

Later in the negotiations, following Guild objections to this radical proposal, the government made it clear that the wholesaler margin would have to be reduced from its 2005 level of 10%. As part of a package of remuneration measures, it also agreed to consider introducing a CSO and to establishing a pool of funds for that purpose.

The rest, as they say, is history, for the CSO was then conceived and incorporated in the Fourth Agreement, and subsequently in the Fifth Agreement.

THE NEED FOR A CSO

In the early years of this century, pharmaceutical wholesaling was experiencing significant challenges from a number of quarters. The three major full-line wholesalers, in particular, were facing increased competition from short-line distributors and direct supply manufacturers.

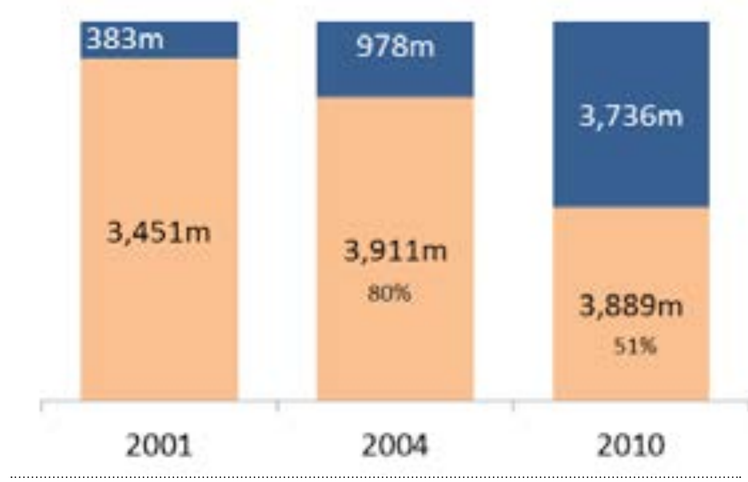
The consequent decrease in their returns was forcing full-line wholesalers to reduce the range of medicines they stocked. Ultimately this development was threatening to seriously erode their market share (see Figure One).

In large part this was due to short-liners and direct suppliers 'cherry picking' profitable high-volume, low-cost to deliver PBS lines, leaving the bulk of the less profitable business to the full line wholesalers.

The financial viability of full-line wholesalers largely depends on their ability to cross subsidise the distribution of unprofitable PBS products with profitable PBS products. This is clearly demonstrated in Figure Two, which shows that in 2004 only 10% of PBS medicines (90% of sales) were being distributed to pharmacies at a cost below the wholesaler margin, which at that time stood at 10%.

That meant the remaining 90% of PBS medicines (10% of sales) were being distributed at a cost above the wholesaler margin, in many cases significantly so. Furthermore, competitive entry into the profitable segments of the market was undermining the viability of the cross subsidy.

FIGURE ONE: **Full line PBS distribution market share erosion**



In other words, the business case for full-line wholesaling was being seriously eroded, making it increasingly difficult for full-line wholesalers to maintain the infrastructure necessary to service community pharmacies across the whole of Australia.

These market developments, coupled with the government's intention to reduce the wholesaler margin, were posing a very real threat to the survival of full-line wholesaling. If allowed to go unchecked, these developments would have put in jeopardy the nationwide distribution network for PBS medicines.

In particular, full-line wholesalers would no longer have been able to provide the full range of services and medicines to community pharmacies, especially those in rural and remote communities. Indeed, withdrawal of full-line wholesalers from the market would have meant that:

- **consumers would no longer have had access to PBS medicines when and where they needed them—an essential pillar of National Medicines Policy;**
- **pharmacies would no longer have been able to access the full range of PBS medicines unless they were prepared to pay the high costs of distributing low volume specialist medicines, and medicines to rural and remote locations;**
- **pharmacies stood to lose the financial support provided at that time by full line wholesalers; and**
- **manufacturers of low-volume specialist medicines would have needed to seek out and pay for alternative distribution channels.**

THE BUSINESS CASE FOR FULL-LINE WHOLESALING WAS BEING ERODED, MAKING IT INCREASINGLY DIFFICULT FOR FULL-LINE WHOLESALERS TO MAINTAIN THE INFRASTRUCTURE NECESSARY TO SERVICE COMMUNITY PHARMACIES ACROSS THE WHOLE OF AUSTRALIA.

So, what was the solution? The challenge facing the government, the Guild and pharmaceutical wholesalers was to develop a funding policy that would enable the government to achieve its National Medicines Policy objectives—ie. reliable and universal access for Australians to affordable PBS medicines on a timely basis—while at the same time preventing the withdrawal of full line wholesalers from the market.

The solution proposed by the Guild and the NPSA, and incorporated into the Fourth Community Pharmacy Agreement, was the CSO.

WHAT IS THE CSO?

The CSO, in common with other CSOs often found in telecommunications and postal markets, is a government contractual arrangement that binds a service provider to offer a specified range of services to consumers wherever they live in Australia, in return for a government payment.

Under the terms of the Fourth Community Pharmacy Agreement, savings from the reduced wholesaler margin were used to establish a pool of $150 million per annum (indexed annually) to fund the CSO. Payments from the funding pool were made to eligible wholesale distributors of PBS medicines who met a suite of specified service standards, including distribution and supply of the full range of PBS medicines generally within 24 hours. Importantly the Agreement, for the first time ever, also required CSO distributors to supply PBS items to pharmacies at a price at or below the approved price to pharmacy.

The objectives of the CSO, as defined in the Fourth Agreement, were to ensure that:

'a. All community pharmacies are able to obtain timely supply of the full range of PBS medicines, irrespective of the size or location of the pharmacy, the breadth of the PBS product range, the cost of the PBS medicines, or the cost of their distribution and supply to pharmacy.

b. All Australians have timely access to the PBS medicines they require, regardless of the cost of the medicines, or where they live.'

Importantly, the Agreement specifically recognises the value of full-line wholesaling by stating that 'the intention is to remunerate pharmaceutical wholesalers for the additional cost they incur in providing the full range of PBS medicines, available to wholesalers, as compared to those wholesalers who distribute and supply a lesser range of PBS products' (Fourth Agreement, Clause 23.4).

The CSO commenced on 1 July 2006. On that date, in accordance with the terms of the Fourth Agreement, the wholesaler margin

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was reduced from 10 to 7%, delivering substantial savings to government over the period of the Agreement. In effect, the CSO payments partly, but not fully, compensated pharmaceutical wholesalers for the 3% reduction in their margin.

At the outset, several eligible pharmaceutical wholesalers (or 'CSO distributors') were able to access the CSO funding pool:

- **Sigma Pharmaceuticals (as a national CSO distributor);**
- **Symbion Pharmacy Services (as a national CSO distributor);**
- **DHL Exel Supply Chain (as a national CSO distributor);**
- **Australian Pharmaceutical Industries (as a national CSO distributor); and**
- **Friendly Society Medical Association, also known as National Pharmacies (as a CSO distributor for South Australia and Victoria).**

It is fair to say that the first 12 months of the CSO were not without their problems. Community pharmacists, some wholesalers, the Guild and NPSA voiced major concerns about certain aspects of the CSO's operation. Questions were raised about the eligibility of one particular distributor (DHL) to receive a share of the funding pool. That distributor withdrew from the CSO in October 2007.

At the same time Alphapharm, the major generics manufacturer, announced its decision to distribute its products through API rather than through DHL. Other problems to do with the content and accuracy of the monthly data collected from CSO distributors by the CSO Administration Agency were identified and satisfactorily resolved, while the payment arrangements have generally functioned as intended.

DISASTER RELIEF

CSO in action: Tasmanian bushfires

'As the bushfires raged in Nubeena in the Tasman Peninsula, our full-line wholesaler Symbion was just fantastic and so supportive. We had around 7000 displaced people in Nubeena, and Symbion were just great in facilitating our delivery of medications.

'We had sporadic mobile coverage and no electricity and the staff down there would give me an order late on Saturday and Sunday and I would pass this on to Symbion. They would then go and pack that within the hour and deliver it to me so that I could get it on a boat down there reaching the Tasman Peninsula late that night or early morning.

'Symbion went over and beyond to ensure we had a system in place and despite all the hurdles not a single person in Nubeena went without.

'Symbion helped us solve people's medication problems by keeping our supply going.

'That was our sole objective and we were able to do our core role of medication supply.'—*Shane Jackson, pharmacist proprietor, Tasman Chemmart, Nubeena, Tasman Peninsula.*

CSO PERFORMANCE

Not surprisingly, the CSO came under intense scrutiny in the lead up to, and during the negotiations for the Fifth Community Pharmacy Agreement. Had it performed as intended, and should it continue in the Fifth Agreement? When judged against the objectives for the CSO, as set out in the Fourth Agreement, it was clear the CSO had more than adequately fulfilled its purpose:

> THE FINANCIAL VIABILITY OF FULL-LINE WHOLESALERS LARGELY DEPENDS ON THEIR ABILITY TO CROSS SUBSIDISE THE DISTRIBUTION OF UNPROFITABLE PBS PRODUCTS WITH PROFITABLE PBS PRODUCTS.

- **Timely distribution—the Deeds of Agreement between CSO distributors and the Commonwealth Government require them to distribute and supply the full range of PBS medicines to community pharmacies within 24 hours of the regular order cut off time. This requirement has been met by all CSO distributors judging by the small number of complaints about distribution delays that the CSO Administration Agency has received from community pharmacies. Importantly, CSO distributors are fulfilling the requirement to supply rural and remote pharmacies and low volume PBS medicines in a timely fashion.**
- **Full PBS product range—in this respect, the CSO has come through with flying colours. The requirement for CSO distributors to range all PBS medicines has effectively averted the threat posed to PBS supply from the erosion of full line wholesalers' market share. The reverse is now the case as NPSA data shows that CSO distributors now range more PBS medicines than ever before, particularly the more expensive PBS medicines.**
- **Daily delivery—CSO distributors are required to deliver their orders no less frequently than once a day. This effectively overcomes the threat to delivery frequency posed by market competition, particularly in rural and regional Australia. Furthermore, the CSO effectively outlaws the very real prospect of wholesalers imposing higher charges for ranging and delivering low volume, high cost medicines. Under the CSO, they are prohibited from charging pharmacies more than the Approved Price to Pharmacists for any PBS medicine.**

There are other aspects of the CSO's performance that point to its success. One is that competition in the wholesaling market has not been adversely affected by the introduction of the CSO. This is reflected in the fact that pharmaceutical wholesalers wishing to enter or exit the market are freely able to do so. Witness to this is the entry and subsequent exit of DHL to the CSO, and more recently the entry of CHS as a State based CSO distributor in Victoria.

Another indication of the CSO's widespread acceptance in the market place has been its strong backing by community pharmacies and the wider industry. Guild surveys of pharmacies have welcomed the maintenance of full-line pharmaceutical wholesaling and the service standards the CSO required of CSO distributors—daily delivery within 24 hours of the full range of PBS medicines.

The only adverse development of note since the CSO's introduction has been the decision by Pfizer, the largest manufacturer of PBS medicines, to withdraw its medicines from CSO distributors and, effective from February 2011, to have its medicines (which account for some 10% of the PBS by value) distributed to community pharmacies exclusively by DHL.

For pharmacies this means they are now forced to deal with an additional wholesale supplier and one which is not bound by the strict service standards required by the CSO. For CSO distributors, this means they are no longer able to stock and supply the entire PBS range of medicines, thus undermining one of the central tenets of the CSO.

To date, Pfizer's move to exclusive supply outside the CSO has not been replicated by other manufacturers. Were this to happen, the whole future of full-line pharmaceutical wholesaling and the Australia-wide PBS distribution network it supports could once again be put at risk.

CONCLUSION

It is now more than 10 years since the Matthews Report on the Review of Pharmaceutical Wholesaling recommended (*inter alia*) the introduction of a CSO as the best means of 'improving existing arrangements for funding wholesalers to achieve greater efficiency and effectiveness in the sector and realise savings to Government'. So how has the CSO fared?

First and foremost the CSO has ensured the continued timely provision of all PBS medicines to all Australians wherever they may live, a core element of National Medicines Policy. Indeed, the number of brands of PBS (and RPBS) medicines available through the PBS and distributed nationwide now exceeds 4500 compared to around 2700 in 2002—that's close to a 70% increase in a decade.

Second, the CSO has enabled the various pharmaceutical wholesaling business models—full line, short line, direct and exclusive supply—to continue to operate side-by-side, thereby maintaining competition in the market place, choice for community pharmacies and ongoing supply of medicines for patients.

Third, the CSO and its accompanying funding adjustments have achieved the government's desired result of improving efficiency and effectiveness in the wholesaling sector and of realising savings for government.

The CSO has certainly stood the test of time, and will no doubt continue to be an important element in the continued success of Australia's world acclaimed PBS. ■

** Dr Michael Tatchell recently retired after 27 years as director, Health Economics with the Pharmacy Guild of Australia. He was a core member of the Guild's negotiating team for all five Community Pharmacy Agreements.*

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