# Generics and the crystal ball

COMMUNITY PHARMACIES NEED TO ANALYSE VARIOUS RECENT REFORMS TO GENERICS AND TAKE CORRECTIVE ACTION TO MINIMISE THEIR FUTURE IMPACT ON DISPENSARY AND PHARMACY PROFITABILITY, WRITES **NORMAN THURECHT**.*

The passing of legislation enabling the Federal Government's Memorandum of Understanding (MoU) with Medicines Australia highlights the Government's continued agenda of reducing the overall cost of healthcare in Australia. The purpose of the legislation is an extension of previous Pharmaceutical Benefits Scheme (PBS) reforms—to reduce the cost of medicines (originator and generic alike) to government.

This comes at a time when community pharmacy is feeling the effects of a weak economy, slow script volume growth, heightened competition through warehouse, supermarkets, discount department stores and online offerings and, now, the redistribution of Pfizer medicines to pharmacy from 1 February 2011.

But it's important not to be overwhelmed by all that is going on around us. The right attitude is to embrace it and understand the effects of all this change on your pharmacy. Only when you understand how it impacts on your pharmacy practice can you adapt.

## PBS REFORMS

The announcement of the original PBS reforms in 2006 (commenced August 2007) introduced concepts such as:

- **formularies (F1 and F2); and**
- **price disclosure.**

The price disclosure mechanism allowed government to receive pricing information on certain molecules which included details of discounts and incentives provided by suppliers. This disclosure mechanism was designed to enable the 'Weighted Average Disclosed Price' (WADP) to be calculated.

The price of medicines would only be affected (reduced) under this mechanism if the WADP was more than than 10% lower than the current ex-manufacturer price (ie. excluding wholesaler mark-up).

In an attempt to create certainty for its members, Medicines Australia agreed to the MoU between it and the Government in May 2010 (legislated on 22 November 2010). This, of course, comes well before the longer-term effects of the original price disclosure mechanisms were felt throughout the industry, except oncology service providers who have seen some savage price cuts.

While there has been much spoken about these reforms, general community pharmacy awareness of the outcomes remain unclear.

## IMMEDIATE EFFECTS OF MOU

The outcomes from the passing of the Legislation that community pharmacists need to be aware of are:

- **from 1 December 2010, all brands of drugs in the F2 formulary are subject to price disclosure.**
- **the provisions requiring the first month's data of any new brand subject to price disclosure to be collected will not be used in the weighted average price disclosed—a continuation from previous PBS reforms;**
- **from 1 February 2011 a 16% price reduction applied to single-brand PBS drugs upon listing of a competitor brand (previously 12.5%);**
- **on 1 February 2011 a 2% price reduction applied to all drugs listed in F2A as at 30 September 2010;**
- **on 1 February 2011 a 5% price reduction applied to all drugs listed in F2T as at 30 September 2010.**

### KEY POINTS

- Understand the breadth of PBS and other reforms.
- Analyse their impact on your business—each pharmacy is different.
- Take action and plan to minimise the loss of future dispensary earnings by considering a range of strategies—inside and outside the dispensary.

As well as the above points, those drugs in compulsory price disclosure will be subject to a minimum 23% price reduction effective 1 April 2012 (ie. six months after the initial disclosure period concludes 30 September 2011).

Price adjustments will be notified three times a year (1 April, 1 August and 1 December)—previously twice a year. This has the capability of bringing forward price adjustments.

It should be noted that the disclosure process and ultimate price adjustments occur at the 'Price to Wholesaler' (PTW) not the 'Price to Pharmacy' (PTP). Irrespective of this, the minimum 23%[1] price adjustment on 1 April 2012 will mean that the PTW and PTP on a molecule such as Simvastatin 40mg may fall below $30 as shown in Table One.

Table One highlights the exaggerated reduction of generic discounts per molecule during the next 18 months—my assumption of consistent generic discount percentage suggests there is a $2.32 differential of the generic brand net into store between now and from 1 April 2012. A big question is whether the generic manufacturers will wear all or some of this difference (as they did in 2008), hence whether the $4.29 loss of discounts to pharmacy could be greater?

Table Two outlines the loss of discount dollars (2010 to 1 April 2012) based on data for two pharmacies I reviewed for the June 2010 financial year. In other words, both of these pharmacies know that by 1 April 2012, they have to replace $1,639 and $2,158 respectively of gross profit to maintain the same dollars as last year because of the reductions on just one molecule strength, simvastatin 40mg.

## TAKING ADVANTAGE OF TIMING

The calculation of the WADP excludes the first month of data, although this data is still collected by government. The purpose of collecting and not including this first month is to ensure that the initial period of market competition does not unduly influence the WADP.

This means that if pharmacies make large purchases of generics in the first month of data collection, there is a higher probability of any price adjustment not happening until the second year of disclosure. While this is only a short-term advantage, it is an advantage nonetheless.

The difficulty in making a buying decision based on the first month's deals is that pharmacy management must try and guess how much switching will occur and therefore how much stock to buy. However and importantly, better deals can often be obtained after this first month's activity as competition in the market increases. And to make a tangible difference, a significant number of pharmacies must participate, thus bringing into question who and how it would be funded, its impact on supply chain and whether sufficient quantities are available.

## MASKING THE TRUE POSITION

For many years the business model of pharmacy has been characterised by location convenience, product supply and minimising costs.

The early effects of PBS reforms were not directly felt by pharmacy because compensation mechanisms were negotiated as part of the reforms (eg.$1.50 premium-free fee now indexed to $1.56) while heightened competition in the generic market meant better trading terms were gained as substitution increased.

When reviewing dispensary reports, which include all discounts in gross profit calculation, managers and owners will have noticed the effects of flat script volume on the dispensary sales while the GP$ earned rose.

TABLE ONE: **Price disclosure impact on simvastatin**

| Simvastatin 40mg | Originator (ex BPP) | Generic |
|---|---|---|
| Current PTW | $ 31.18 | $ 31.18 |
| Current PTP | $ 33.53 | $ 33.53 |
| Current Disc $ | $ 1.84 | $ 21.79 |
| | | |
| 5% Price cut 1 Feb 2011 (off PTW) | $ 1.56 | $ 1.56 |
| New PTP 1 Feb 2011 | $ 31.85 | $ 31.85 |
| Disc $ | $ 1.51 | $ 20.70 |
| | | |
| Min. 23%[1] price cut post 1 April 2012 (off PTW) | $ 6.81 | $ 6.81 |
| New PTP post 1 April 2012 | $ 26.92 | $ 26.92 |
| Disc $ | $ 1.28 | $ 17.50 |

*Calculations assume that the wholesaler discount is adjusted down on 1 February 2011 for the Pfizer withdrawal but will remain the same in 2011 and 2012. The generic discount percentage is assumed to remain the same throughout the period which, depending upon market forces, may fall.*

1. The 23% is an average of the pool of drugs in the cycle and this molecule's price may fall by a greater percentage.

TABLE TWO: **Simvastatin discount $s lost by two pharmacy types**

| Simvastatin 40mg | Originator | Generic |
|---|---|---|
| **REGIONAL PHARMACY** | | |
| Units | 18 | 350 |
| Substitution | 95.1% | |
| $ Discounts lost | $10.65 | $1,628.53 |
| **SHOPPING CENTRE PHARMACY** | | |
| Units | 108 | 450 |
| Substitution | 80.64% | |
| $ Discounts lost | $63.80 | $2,093.82 |

The masking effect of rising substitution will continue for the next few years. It will not be until after Crestor and Lipitor come off patent and they experience their first price reductions that most dispensaries will feel a real decline in profit.

Five years ago the generics market in Australia was a minnow. For the period to June 2010 it was running at 73% of substitutable items (according to the Guild Scriptmap reports). This has further increased since June 2010 with opportunities around other molecules such as clopidogrel.

There will be other off-patent opportunities in the future, however Crestor and Lipitor will be the largest over the next few years.

## PFIZER'S DISTRIBUTION DECISION

Pfizer's decision to distribute its prescription medicines direct to pharmacy is a reaction to the genericisation of the PBS. At the heart of the matter is the patent expiry of Pfizer's number one drug, Lipitor, expected in the first half of 2012—and its desire to mitigate the impact on profitability.

The flow-on effect to pharmacy will mean that most trading terms on Pfizer medicines and remaining lines supplied by the three wholesalers will decrease. In fact, the wholesalers have already suggested the range of reduced trading terms could be between 15–25% of existing terms.

Because of the range of terms of trade in the market, it is difficult to speculate how much the Pfizer decision will affect the net profit for each pharmacy. The effect on the two pharmacies I have analysed for this article show that the regional pharmacy with a $1.8m turnover may lose about $5,000 and the shopping centre pharmacy, which turns $4.5m, about $13,000 in wholesaler and adjusted Pfizer terms from 1 February 2010.

## EFFECT OF COMPETITION

The cascading effect of price disclosure on the price of medicines is to ultimately save the Government money in its healthcare budget. The side-effect, however, is that over time many items will fall below the current general co-payment amount of $34.20 (see Table One), saving the PBS even more although opening these lines to price competition.

Reviewing the simvastatin example, a quick search of pharmacy websites in Australia highlights that the generic is being used as a traffic generator and the price differential is aiding substitution in these pharmacies.

While I do not advocate discounting, I do recognise that to compete and retain (or grow) your customer numbers there is a need to be competitive. Unfortunately many pharmacies resort to low pricing as a sole strategy to combat competition because they have insufficient differentiators (eg. no special services offerings, no structured medication compliance programs and/or undifferentiated product ranges) for the customer to experience. The customer in the current environment is therefore making choices mainly (often solely) on convenience and, more recently, price.

So, while most community pharmacy attention has been focused on trading terms and reduced prices of molecules, what if any thought has been given to delighting the customer, thus giving them a reason not to defect?

## THE CRYSTAL BALL

While we can see and describe the drivers of all the change affecting the business of community pharmacy, it is rarely easy to gaze into the crystal ball and view in a broad sense what will happen in a few years.

The two pharmacies I reviewed show that total generic discounts contribute 42.7% to the net profit for the regional pharmacy and 37.2% for the shopping centre pharmacy. The difference is caused mainly by substitution rates and a proportion of non-dispensary sales as the trading terms are not significantly different.

With such a large portion of the profit susceptible to external forces, much of the crystal ball gazing must be about changing the business model of pharmacy. No longer will it be possible to survive in the long term purely by minimising costs, reactively processing scripts and meeting customer requests. The future is about achieving customer and script growth while improving efficiencies, particularly in the dispensary, and seeking alternative income sources not impacted as much by external forces. The investment in driving growth, customer outcomes and profitability must start now.

We now know the time line by which the model has to change. The question for pharmacy owners and managers is: how they will replace this income to ensure sustainability?

## DISCOUNT THE DISCOUNTING OPTION

Indiscriminant discounting is not an option. Many pharmacies have been able to turn to discounting in recent years in an attempt to compete. But most are not designed to be discounters and this strategy is therefore not sustainable in their current format. Most pharmacies, for example, might reside in expensive locations, with stock weight not large enough, weak buying power, higher wage costs and therefore an inability to maintain a discounting strategy.

To play at that end of the market, the reality is that the discounted price has to be at least 20% cheaper than the competition in order for it to have a lasting effect on customer perception/numbers (ie. to grow customer numbers). This type of customer is, therefore, not loyal to anyone, only price.

Pseudo discounter pharmacies have been able to survive on the false sense of security of trading terms, buoyed by increased PBS substitution in recent years, which is masking the true impact on their net profit.

## OTHER OPTIONS

Below is a list of things to consider implementing now (ie. not in three years when profit starts to dry up). Because each community pharmacy has different priorities, these options are in no particular order. But you must choose to do some, if not all.

1. **Revolutionise the dispensary and the dispensing process. This includes who is doing the dispensing, reviewing the layout to maximise efficiency (where and how is the stock held?) and whether the pharmacist is constantly available to interact meaningfully with the customer.**
2. **Improve the presentation of Pharmacy (S2), Pharmacist-only (S3) and general medicines area (within the relevant laws). These are the product lines that pharmacy must own and stand for and are the biggest net profit generators outside dispensing. They nearly always need more space and greater stock weight and will sell more if the customer knows you have these products. They also often help to provide a solution to the customer if treated as such by the pharmacist (ie. offering health solutions, not just selling products).**
3. **Employ more pharmacists. We already see an increase in pharmacists available to work. Rightly or wrongly, this should take some pressure off pharmacist wage inflation. Employ one and get them to stay on the front counter (refer to point 2). The customer wants them and they will sell more solutions than assistants. The incremental cost of labour is irrelevant because of the enhanced solution sales opportunity and healthcare service levels must rise—there is no choice.**
4. **Implement the government-funded programs under the Fifth Community Pharmacy Agreement. These include pharmacy practice improvement initiatives worth $339m over five years or about $14,000 per pharmacy on average. Most importantly, many of these programs will attract and retain customers.**
5. **Align the pharmacy with strong supplier relationships focusing not only on trade terms but services and other benefits that will improve the pharmacy service offer.**
6. **Reduce debt and manage the relationship with the bank (ie. keep them informed of what is happening in your pharmacy).**
7. **Don't overpay for pharmacies unless you are clear on how you will increase the net profit quickly and sustainably.**

**The investment in driving growth, customer outcomes and profitability must start now.**

Managing the financial impact of the changes facing pharmacy in the coming years will be paramount. No longer is it satisfactory to be only technically competent and convenient—customers are already telling pharmacy this by defecting to lowest price.

How you react to these reforms will ultimately depend on how well you understand their impact on your pharmacy. The upshot of the reforms and downstream effects is that there is a wonderful opportunity to change the way pharmacy interacts with the customer to generate/sustain net profit.

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