CHEMIST WAREHOUSE SUBMISSION TO THE COMPETITION POLICY REVIEW

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1. Introduction

Chemist Warehouse is a collective of like-minded pharmacists committed to providing Australian consumers with the best quality healthcare at the most affordable prices. Chemist Warehouse is Australia's 13th largest retailer by turnover, with sales of $2.7 billion and more than 10,000 staff.

Chemist Warehouse has in excess of 260 stores, representing about 4 per cent of all retail pharmacies across Australia. However, Chemist Warehouse sales make up 20 per cent of total retail pharmacy sales, dispensing around 15 per cent of medicines covered under the Pharmaceutical Benefits Scheme (PBS).

The pharmacy market is highly regulated. These regulations have the effect of artificially preventing business models within the pharmacy industry from evolving in the same way as has occurred in other, similar but unregulated retail markets.

Nonetheless, it is clear that there are two business models that are growing in popularity as consumers preferences change. The first is for large, high volume, lower margin pharmacies offering deep price discounts. Chemist Warehouse is the market leader of this approach and has been rated the number one pharmacy group for customer satisfaction (Roy Morgan Survey Data). The second model is for high service pharmacies offering detailed personal health advice and testing services in addition to retail distribution of medicines and health products.

In addition, online health and pharmacy websites are rapidly growing in popularity. Chemist Warehouse itself operates chemistwarehouse.com and epharmacy.com.au, the number one and number two Australian pharmacy websites by traffic and transactions (Hitwise).

The development of the pharmacy industry into these models is consistent with the experience in many retail industries and suggests consumer preferences in the consumption of pharmaceutical goods and services are no different from those for other retail goods and services.

Chemist Warehouse acknowledges that ensuring access to medicines at affordable prices, particularly for disadvantaged consumers, is an important matter of public policy. However, the present policy settings not only fail to serve this end, but are preventing competitive market conduct that would be more effective in delivering more medicines at lower prices to more consumers.

These restraints on ordinary trade should be removed in favour of a competitive approach to pharmacy in line with consumer demand and other retail industries. Overseas examples have demonstrated that once market limiting regulations are removed, outcomes are improved for industry participants and consumers.

2. Outlet location decision-making

Chemist Warehouse has grown rapidly since it opened its first store in 2000. The Chemist Warehouse business model focuses on providing price competition and volume sales, while maintaining the highest standard of professional service and health advice to consumers.

Chemist Warehouse expansion plans target areas of strong and emerging population growth and need. Restrictions on where Chemist Warehouse can establish its outlets mean some locations are in areas not usually associated with traditional chemists, such as semi-industrial areas adjacent to new residential areas. In some cases, these are not the optimal locations from a commercial perspective, but the investment decisions have to take into account the regulatory imposts and restraints.

3. Discounting

Chemist Warehouse is able to reduce retail prices by significant margins because of its scale and business philosophy of remaining tightly focused on cost control. As a result, it is able to offer many PBS medicines at below the PBS co-payment threshold price, resulting in lower prices for consumers and savings for the government. Chemist Warehouse estimates that it provided savings of about $15 million to the government through discounting of PBS medicines in 2010/11.

4. The true cost of regulation

Chemist Warehouse understands the rationale for the extensive regulation of business models and conduct of Australian pharmacies is related to a desire to ensure equitable and universal access to medicines.

However, Chemist Warehouse submits that the effect of these regulations threatens the opposite. The impact of regulation has been to raise costs for consumers, to prevent innovation in the industry and to undermine the value of investments. In the medium term, the heavy handed regulation of the industry could put at risk its long term viability.

Chemist Warehouse believes that two areas of unnecessary and damaging regulation that should be reformed as a matter of urgency relate to:

a) restrictions on who can own pharmacies
b) constraints on where pharmacies can be established (location rules)

Restrictions on who can own pharmacies

The requirements that pharmacies must be owned by pharmacists, and that a pharmacist can own only five pharmacies in any one state, is archaic. Further, these constraints are creating financial instability that is more likely to threaten than secure the ability of the industry to continue to provide equitable access to medicine over the medium term.

The ownership rules, coupled with changes in the supply chain relationships in the industry in recent years, have created a serious capital constraint for the pharmacy industry. In practice, a group of pharmacies cannot accurately demonstrate their financial success or ability to meet substantial repayments because pharmacy businesses must be registered in the name of individuals, rather than as part of a group.

For individual pharmacists, ownership restrictions limit the market for those wishing to dispose of their business, supressing prices and limiting credit worthiness.

For larger pharmacy enterprises, such as Chemist Warehouse, the ownership structure required by the current regulatory regime prevents capital raising to support innovation, expansion and modernisation.

The complex ownership arrangements these regulations force on pharmacists who wish to be part of the Chemist Warehouse group of companies means the banks cannot be confident that they will be able to secure collateral against their loans.

These capital constraints are having increasingly serious impacts on the operation of the pharmacy industry. In the past, the pharmaceutical wholesaling industry was able to offset the inability of retail pharmacies to raise capital from the usual sources by extending generous trading terms to the retail industry. Crucially, this has included extended credit terms for wholesale products.

However, as PBS reforms have, in recent years, squeezed margins, the ability of the wholesale industry to provide this financial support has been eroded.

The constraint on pharmacists from owning more than five pharmacies in a state, and locational rules that prevent pharmacist entrepreneurs from opening wherever and whenever they believe they can profitably do so, has had the effect of denying consumers the benefit of competition.

Chemist Warehouse's experience demonstrates that the introduction of competition into the market for pharmaceutical products in a particular geography is not confined to pharmacies. Chemist Warehouse has observed a competitive response by all retailers of medical products once it enters a market and introduces its price discounting strategy.

For example, when Chemist Warehouse entered the Tasmanian market, the price for the popular hay fever medication *Telfast* was more than $75. Chemist Warehouse retailed the same product at $29. Within months the prices charged by other providers had fallen to similar levels.

The ability of Chemist Warehouse to deliver the benefits of price competition is directly constrained by rules that prevent the expansion of their business model into locations where the market would support the establishment of new outlets.

Constraints on where pharmacies can be established (location rules)

The conditions that must be satisfied for new pharmacies to be established can be described as bizarre.

Before a pharmacy can be established in a newly established community, it must demonstrate, in writing, that there is a large supermarket and a prescribing doctor within 1km, and no existing pharmacy within 1.5km. How this is intended to serve to ensure better and more affordable services to Australians is unclear. However, it prevents Chemist Warehouse from bringing affordable medicines to new communities often most in need of services.

Taken together, these rules do not represent a safety net for consumers. Rather, they represent a distortion of the market and barriers to entry that:

- are grossly anti-competitive
- artificially constrain consumer choice
- inflate prices
- prevent entrepreneur innovation
- create unnecessary costs for tax payers
- encourage and protect lazy and out-dated business practices, and
- prevent some communities, particularly in new estates, from gaining access to services in a timely manner

5. The overseas experience

Regulation of the location and ownership of pharmacies has been common in many countries, although the precise forms of regulation vary widely. Deregulation of the pharmacy sector has also occurred in some jurisdictions.

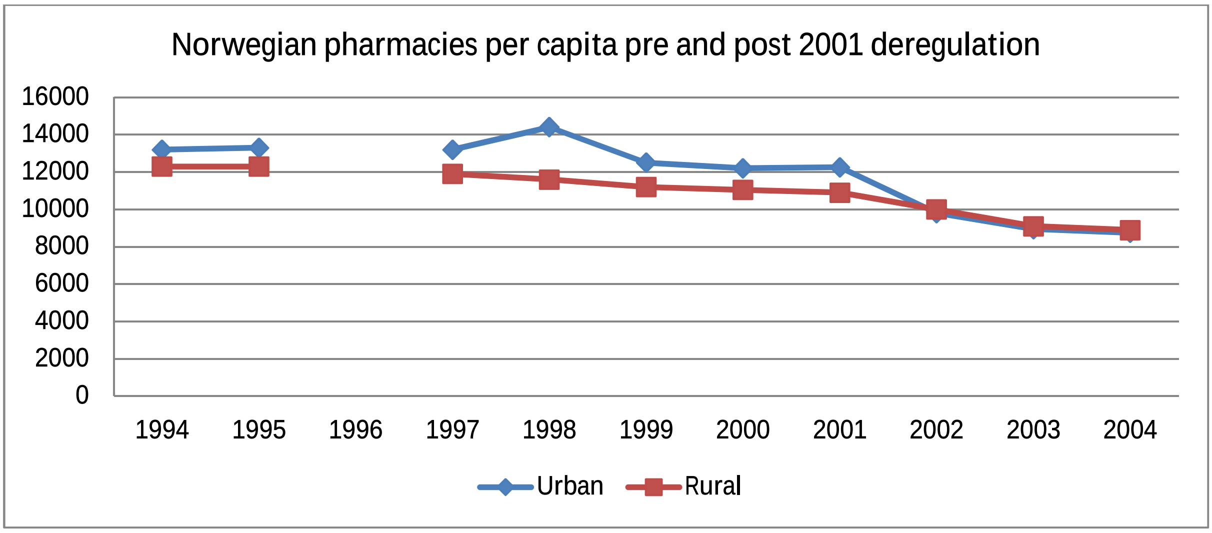
Pharmacies in the Nordic countries

The OECD has recently (2014) assessed the impacts on competition of the deregulation of the pharmacy sector in several European countries. The review found:

- Accessibility of medicines to consumers increased due to the establishment of new pharmacies and the extension of opening hours.
- Price decreases were observed in many countries – including a dramatic 42 per cent decrease in retail pharmacy prices in Denmark. No country reported increases.

Among the most striking findings were:

In Norway, where the pharmacy market was deregulated in March 2001, there were 128 new pharmacies established, a 32 per cent increase – between January 2001 and March 2004, compared to only 71 from 1991 to 2000.



Source: Deregulating the Norwegian Pharmaceuticals Market, 2007

A separate study of Nordic pharmaceutical markets found the number of pharmacies in Iceland, the first Nordic country to deregulate, increased by 41 per cent.

In Iceland, Norway and Sweden, opening hours increased on average from 42 hours per week to 53 hours per week after each introduced deregulation of their domestic pharmacy sectors.

Pharmacies in the United Kingdom

In the UK, regulation restricting new entry in the 1980s was followed by partial liberalisation as the negative impacts of this regulation became apparent. The UK therefore offers a unique and compelling case study in both the cost of regulation and the gains from the relaxation of those rules.

A study (2003) of the UK pharmacy market by the Office of Fair Trading (OFT) examined the impact on consumers of the restrictions on market entry that were introduced in 1987 in that jurisdiction.

Among the findings were:

- The average number of new pharmacies opened per year fell from 130 per year before the restrictions to five per year following the restrictions
- The regulations restricted competition between pharmacies, on both price and quality grounds
- The prices of over the counter medicines in national supermarkets (where those products could be sold competitively) were offered at about 30 per cent below the prices charged by pharmacies. The OFT concluded that this indicated that substantial price reductions should be expected from deregulation
- Opening hours of pharmacies were restricted compared to other retailers such as supermarkets. The average pharmacy opened only 50 hours a week.
- The administrative cost to taxpayers directly attributable to the entry regulations was about £26 million annually.

As a result of these findings, and following recommendations from the OFT for full deregulation of control of entry restrictions, there was a partial deregulation of control of entry rules.

The OFT commissioned a subsequent evaluation of the partial deregulation in 2010. This report noted that the regulation of the prescription of pharmaceutical products meant:

> "(P)harmacies compete largely for a fixed aggregate volume of prescription business, and do so primarily on location and convenience, and on service dimensions such as waiting times, opening hours and quality of advice and service".

The study found:

> "Entry and competition in the pharmacies market as a result of the 2005 reforms have delivered benefits of choice and access to consumers and stimulated investments and improvements in service that would otherwise not have been made. None of the feared ill-effects – net exit of pharmacies, disruption of services, or reduced investment overall – have materialised so far".

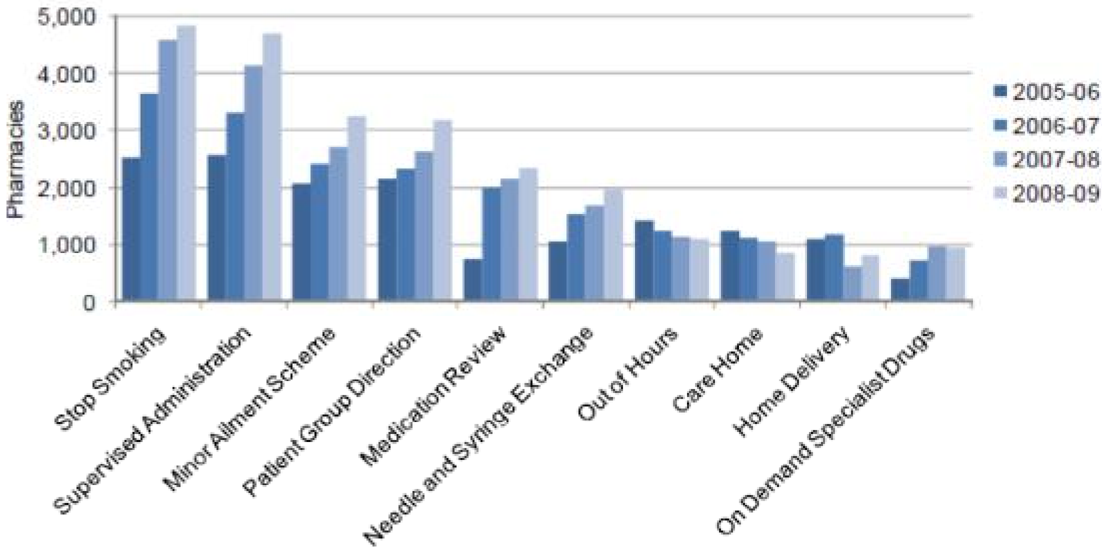
Among the specific outcomes observed were:

- An 8.8 per cent increase in the number of pharmacies in England
- A reduction in annual travel time for consumers of 2.6 to 3.9 million hours, valued at £16.4 to £24.5 million
- Estimated waiting time savings of £3.3 million

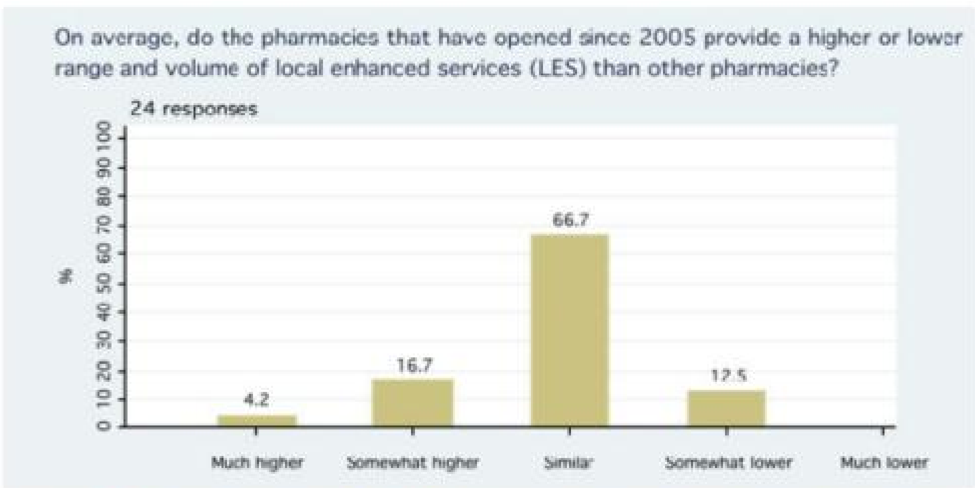
- A redistribution of 1.6 million visits from the hours 9am to 5.30pm due to extended opening hours, with most of the redistribution to the 5.30-7pm post working hours period.

In addition to longer opening hours, there was also strong evidence that pharmacies sought to compete with enhanced service levels to consumers. This move to service competition was led by new entrant pharmacies, including discount pharmacies.

Pharmacies in England offering local enhanced services



Entrant pharmacies in England and enhanced services



Source: DotEcon survey of English Primary Care Trusts, Nov 2009-Jan 2010

The study calculated the total consumer benefit from the reforms at between £21.1 million to £68.1 million per annum. It regarded these as conservative estimates.

6. Proposed way forward

Chemist Warehouse submits that there should be no restriction on who can own pharmacies or on where they can be located.

There should be no restriction on pharmacists from risking their own capital to establish a business in a location where they believe they can make a profit. Existing pharmacies should not be protected from competition under the guise of ensuring services to all Australians. This policy approach does nothing more than penalise those consumers who might otherwise be in locations that would attract competitive investment.

If there are locations where the commercial conditions are such that citizens would not be able to access medicines without intervention, a limited and targeted incentive to address points of proven market failure is preferable to the present approach. The present draconian restrictions on commercial behaviour have had such a distorting effect on Australia's pharmacy market that they represent a serious risk to the stability of the industry.

Chemist Warehouse notes that the proposals made in this submission are consistent with the recommendations of the Federal Government's National Commission of Audit Report 2014. Chemist Warehouse would welcome the opportunity to discuss the matters raised in this submission with members of the Competition Policy Review or its secretariat.

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