



**Australian
Competition &
Consumer
Commission**

**Report to the Treasurer on the relative
financial and corporate differences
between friendly society dispensaries
and pharmacist-owned pharmacies**

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Abbreviations

AFSPA	Australian Friendly Societies Pharmacies Association
Allens	The Allen Consulting Group
APESMA	Association of Professional Engineers, Scientists and Managers, Australia
ASIC	Australian Securities and Investment Commission
ATO	Australian Taxation Office
COAG	Council of Australian Governments
COSBOA	Council of Small Business Organisations of Australia
FSDs	Friendly Society Dispensaries
FSMA	National Pharmacies
PBS	Pharmaceutical Benefits Scheme
PC	Productivity Commission
PSA	Pharmaceutical Society of Australia
The Department	Commonwealth Department of Health & Ageing
The Guild	Pharmacy Guild of Australia

1. Summary

On 18 April 2002 the Treasurer wrote to the Australian Competition and Consumer Commission requesting it to undertake a review, as specified in the final report of the national competition policy *Review of Pharmacy* (the Wilkinson Review) into the relative financial and corporate differences between friendly society dispensaries (FSDs) and pharmacist-owned community pharmacies and whether this adversely affects competition in the pharmacy industry. Specifically, the Commission was requested to consider whether the tax treatment of FSDs and other competition related factors provide FSDs with significant competitive advantages over pharmacist-owned pharmacies.

By way of background, the Commission notes that for some time the issue of the taxation treatment of FSDs has been a source of contention between the Australian Friendly Society Pharmacies Association (AFSPA) and the Pharmacy Guild of Australia.

In this regard the Commission notes a publication entitled *A History of the Pharmaceutical Benefits Scheme 1947–1992*¹ which describes that in as early as 1947, the guild raised the issue that because friendly societies did not pay income tax, they had a significant advantage not enjoyed by the pharmacist-owned community pharmacies.

Further, the author noted that

the Friendly Societies Pharmacies Association of Australia has played an important role in the continued development of the Pharmaceutical Benefits Scheme providing the perfect foil to the Pharmacy Guild of Australia. The Guild has always been wary about the presence of the friendly societies as a distinct group in the PBS network, and has guarded against their possible expansion in numbers and influence.²

The Commission consulted relevant stakeholders to prepare this report. The Commission received 12 submissions from the industry, professional associations, the Department of Health and Ageing and other Commonwealth agencies. The Commission also engaged the Allen Consulting Group to provide independent expert information and advice in relation to a number of matters. The report has been prepared based on information contained in the submissions, information provided by the appropriate government bodies, information obtained by the Commission in the normal course of its work, and expert advice provided by Allens.

1 This publication was referred to in the Commonwealth Department of Health's submission to the ACCC Review of Friendly Society Dispensaries. The full citation for the publication is Clyde Sloan, *A History of the Pharmaceutical Benefits Scheme 1947–1992*, 1995, Canberra.

2 Clyde Sloan, *A History of the Pharmaceutical Benefits Scheme 1947–1992*, 1995, Canberra.

Upon examination of the relevant areas of the industry, and with analysis of the taxation treatment of FSDs, the Commission is of the view that there is a minor tax distortion arising from the mutual tax treatment of FSDs, specifically in relation to a cash flow advantage, which ultimately may place some larger FSDs at a competitive advantage over pharmacist-owners of pharmacy. However, the Commission considers it possible for pharmacist-owners of pharmacy to obtain similar taxation benefits enjoyed by FSDs by utilising a variety of tax minimisation arrangements, such as family trusts.

In addition, the Commission considers the extent of any such advantage to be insignificant when the fractional market share of FSDs, being 2.5 per cent nationally, is taken into account.

The Commission is of the view that given the current legislative restrictions in each jurisdiction, FSDs are unlikely to ever become a dominant player in the industry. Further, taking into consideration the recommendations arising out of the Wilkinson Review, it is also the Commission's view that any legislative changes that are made in line with the recommendations are also unlikely to result in FSDs acquiring significant market shares so as to dominate the industry.

Upon consideration of the other competition-related factors brought to the Commission's attention by the interested parties, the Commission is of the view that there are advantages and disadvantages to both pharmacist-owned pharmacies and FSDs. Therefore, the Commission considers that the competitive dynamics of the industry do not favour one pharmacy group over the other.

Taking into account the expert advice provided by Allens, and based on an assessment of the mutual tax treatment of FSDs and other competition-related factors, the Commission considers that FSDs do not have significant competitive advantages over pharmacist-owned pharmacies, particularly given that there is no competitive advantage accruing to FSDs as a result of their income tax treatment.

2. Introduction

2.1 Reference

On 18 April 2002 the Treasurer wrote to the Commission requesting it to undertake a review, as specified in the final report of the national competition policy *Review of Pharmacy* (the Wilkinson Review), into the relative financial and corporate differences between friendly society dispensaries (FSDs) and pharmacist-owned community pharmacies and whether this adversely affects competition in the community pharmacy industry. Specifically, the Treasurer stated that:

[The ACCC] review will need to consider whether the tax treatment of FSDs and other competition related factors provide FSDs with significant competitive advantages over pharmacist-owned pharmacies.

This report is prepared by the Commission in compliance with the above reference. It is important to note that this report does not attempt to re-visit issues raised and discussed in the Wilkinson Review and as such has confined discussion of other relevant issues, such as the Wilkinson Review and the Council of Australian Governments' response to the recommendations of the Wilkinson Review, to this chapter.

The Commission was also directed not to re-visit the tax treatment of mutual organisations, recently considered by the review of business taxation. Submissions to the Commission's review which suggest that the principle of mutuality is applied incorrectly to mutual gains of some FSDs are beyond the scope of the terms of reference and the Commission's review and would, in any case, be an issue for the Australian Taxation Office to consider.

In addition to the issue of whether the taxation treatment of FSDs enables a significant competitive advantage, the Commission also sought views from interested parties on other competition-related factors and how such factors may impact upon either an FSDs, or pharmacist-owned pharmacies, ability to compete in the market place.

In this report, FSDs are defined to be the friendly society group which owns and operates individual pharmacies.

2.2 The Commission

The Commission is the independent statutory authority responsible for, among other functions, ensuring compliance with and enforcement of the *Trade Practices Act 1974* (the Act). The statutory objective of the Act is to enhance the welfare of Australians through the promotion of competition and fair-trading and provision for consumer protection. The Act proscribes certain anti-competitive conduct and unconscionable, misleading, deceptive or false trading practices.

The Commission's stated objectives are to:

- secure compliance with the Act by responding to complaints and inquiries and by observing market conduct and initiating legal action when required

- foster competition, fair trading and protection of consumers by taking initiatives to overcome market problems
- inform the community at large about the Act and its specific implications for business and consumers.

Although the major policy underpinning the Act is the promotion of competition, the Act also allows the Commission to authorise some forms of anti-competitive conduct that would otherwise be at risk of breaching the competition provisions (Part IV) of the Act, where the total public benefit of the conduct outweighs the detriment caused by the anti-competitive nature of the conduct. Conduct authorised by the Commission receives immunity from court action, either by the Commission or by private parties.

People affected by a Commission decision on authorisation may seek an independent review of that determination by the Australian Competition Tribunal. In this way the Commission is not the final arbiter of net public benefit in the authorisation process.

2.3 Consultation process

The Commission consulted relevant stakeholders to prepare this report. A list of the parties contacted by the Commission is at attachment A.

The Commission received 12 submissions from the industry, professional associations, the Department of Health and Ageing and other Commonwealth agencies. Attachment B lists parties that provided a submission to the review.

The Commission also engaged the Allen Consulting Group to provide independent expert information and advice in relation to the following matters:

- the way in which friendly society pharmacies are taxed, including the current way in which the mutuality principle is applied to ‘mutual gains’ of friendly society pharmacies
- whether the mutuality principle results in friendly society pharmacies having a competitive advantage compared to pharmacist-owned pharmacies, and if so, whether that advantage is significant
- the taxation treatment of different entity structures available to pharmacist-owned pharmacies under current legislation (such as sole trader, a partnership or incorporated company), and the associated competition related factors arising out of the various structures
- advice in relation to other competition-related factors as they are provided to the Commission by interested parties.

The report provided to the Commission by Allens is at attachment C.

This report has been prepared based on information contained in the submissions, information provided by the appropriate government bodies, information obtained by the Commission in the normal course of its work, and expert advice provided by Allens.

2.4 National competition policy review of pharmacy

In June 1999 the National Competition Policy Review of Pharmacy (the Wilkinson Review) was commissioned by the Council of Australian Governments (COAG) in accordance with commitments made under the national competition policy. Mr Warwick Wilkinson AM was appointed to conduct the review. The Wilkinson Review was required to look at state and territory Pharmacy and Pharmacists Acts, and the relevant parts of the Commonwealth *National Health Act 1953*. In particular, the Wilkinson Review was requested to examine the restrictions that legislation may impose on three specific areas of pharmacy practice and the commercial operation of community pharmacy, namely:

- ownership of pharmacies
- location of pharmacies to dispense benefits under the Commonwealth Pharmaceutical Benefits Scheme (PBS)
- the registration of pharmacists.

The recommendations arising from the Wilkinson Review of Pharmacy are not reproduced in their entirety as part of this report.

On 8 February 2000 the report of the Wilkinson Review was presented to the Council of Australian Governments. On 2 August 2002 COAG released the working party's commentary on the Wilkinson Review of Pharmacy. The working group consisted of Commonwealth, state and territory officers. In its response the working party considered the recommendations made by the Wilkinson Review and commented on possible changes to be made within the industry over the coming years. Some of these changes are noted in this report.

2.5 COAG working party response

As part of its response to the recommendations in the Wilkinson Review, the COAG working party commissioned a report by Walter & Turnbull Chartered Accountants to provide advice in a similar context to the reference provided to the Commission in relation to this report. Upon consideration of limited material and consultation, Walter & Turnbull concluded that, in their opinion,

friendly societies do not have a significant competitive advantage over pharmacists-owned pharmacies and therefore in a post Wilkinson environment are no more likely to dominate community pharmacy than are pharmacists.³

It is also worth noting the industry's response to recommendation 5 (a) of the Wilkinson Review. Recommendation 5 (a) states: Friendly societies may continue to operate as pharmacies, but that: (1) regulations specific to the establishment and operation of pharmacies by friendly societies, that do not also apply to other pharmacies and classes of proprietors, should be removed; and (2) any friendly society that did not operate pharmacies in a jurisdiction on 1 July 1999 or any other prescribed date should not own, establish or operate a pharmacy in that jurisdiction in the future, unless it is an entity resulting from an amalgamation of two or more friendly societies operating a pharmacy at that date.

There were some arguments put forth that friendly society pharmacies should be able to operate without restriction on the basis that they have an important role to play in providing direct competition to pharmacist-owned pharmacies and that to restrict friendly society pharmacies is anti-competitive in nature, as it benefits non-friendly society pharmacies and may reduce savings to consumers.

However, a number of opposing views were put forth by pharmacist proprietors, including that friendly societies have an unfair tax advantage over pharmacist-owned pharmacies and further that friendly societies have an unfair competitive advantage because of their corporate structure that allows for economies of scale.

It is important to note that COAG states that

the Working Party considered industry concerns about permitting friendly societies to continue operating pharmacies but found, as did the Wilkinson Review, that friendly society pharmacies provide a safe and competent pharmacy service and see no reason to restrict their operations.⁴

The COAG working party concluded that

there has been much made of the advantages or otherwise friendly societies receive from their taxation arrangements flowing from their mutuality status. However, this issue has been considered by the Ralph Review and the mutuality provisions retained. The Working Group suggests that jurisdictions take the tax arrangements as a given and not to try to compensate for them through administrative means.

3 COAG Senior Officials Working Group Commentary on the National Competition Policy Review of Pharmacy, August 2002, p. 16.

4 *ibid.*

3. The pharmacy industry

There are two streams of pharmacy practice in Australia namely, clinical (or hospital) pharmacy and community pharmacy. As noted, the terms of reference to the Commission's review have requested the Commission to focus on the community pharmacy sector.

3.1 Community pharmacy

This section of the report will outline briefly the main features of community pharmacy.

Community pharmacy can be considered as consisting of shopfront pharmacies providing a network for the delivery of pharmacy services to the Australian community. Most community pharmacies are found in local shopping strips, shopping centres and malls, and in some medical centres.⁵

Community pharmacies are the principal distribution points for prescription medicines and for scheduled over-the-counter medicines. Unscheduled medicines, such as aspirin and paracetamol products, are shared with general retailers, for example, supermarkets, as are other general retail products such as hygiene and beauty products.⁶

Pharmacy legislation in most jurisdictions in Australia provides that pharmacies must be owned by registered pharmacists. However, there are exceptions to this requirement, including 'grand-parented' non-pharmacist corporations and friendly societies. The total number of these pharmacies is fractional alongside those owned and controlled by registered pharmacists.

3.1.1 Friendly society dispensaries

Friendly societies are mutual organisations where all the assets belong to their members. Profits are reinvested in the organisation to provide members with benefits and improved services.⁷

FSDs were first established in Australia in the 1840s to ensure the supply to their members of quality medicines as prescribed and at an affordable price. This was achievable because FSDs were established and operated by the friendly societies on a not-for-profit, cooperative principle. Greater detail regarding the development of FSDs is provided in chapter 5.

Today, in some jurisdictions, new FSDs are prohibited, or made subject to special ministerial approval processes before they can be established. In practice, these restrictions make new FSDs very unlikely in those states or territories.

Any member of the public can become a member of a FSD after they have paid an annual membership fee to the organisation. This fee entitles members to obtain

5 Final Report National Competition Policy Review of Pharmacy, February 2000, p. 14.

6 *ibid.*

7 National Pharmacies Information Pack.

discounts on a variety of goods including private prescriptions, over-the-counter medicines, vitamins, and general retail goods sold in the pharmacy. For example, the contribution fee for National Pharmacies is \$39.60 for a single member and \$66.00 for a family membership. Where allowed by pharmacy laws, National Pharmacies provides up to a 20 per cent discount to members on member purchases.

3.1.2 Pharmacist-owned pharmacies

Pharmacist-owned pharmacies are generally homogeneous regardless of the pharmacy brand they may operate under. Pharmacists of similar qualifications, experience and knowledge will run most pharmacist-owned pharmacies. Unlike pharmacists who work in friendly society dispensaries, pharmacists who work in pharmacist-owned pharmacies will generally be in charge of the business as a whole, combining duties of a full-time pharmacist and a business person.

Pharmacy legislation currently regulates the structure of pharmacist-owned pharmacies, as well as the number of pharmacies a private pharmacy proprietor can have a direct interest in, within any one jurisdiction. The Wilkinson Review recommended that the restrictions on the number of pharmacies that a person may own, or in which they may have an interest, are lifted.⁸ The COAG working party accepted this recommendation.

3.1.3 Banner groups

Banner groups are groups of retail pharmacies similar to franchise groups. They are principally marketing groups that allow for joint advertising and promotion. They are formed for the purpose of providing support to retail pharmacies. This support generally includes the provision of marketing services including assistance with store layout, promotions and business advice. Banner group members are in some cases also able to obtain products branded with the name of the banner group.

The majority of banner groups are operated by the three full-line pharmaceutical wholesalers namely, API, Sigma and Mayne. Banner groups operated by API are: Chemworld; Soul Pattinson; Pharmacist Advice; and API Health Care. Banner groups operated by Sigma are Amcal and Guardian. Mayne operates the Chemmart, Terry White, Healthsense and Synergy banner groups. Some independent banner groups also exist, such as Full Life and My Chemist.

As at July 2000, 2715 (or 54 per cent) of pharmacies in Australia were in banner groups, with 2550 (or 51 per cent) of these belonging to banner groups controlled by the three full-line wholesalers.⁹

3.1.4 Buying groups

Buying groups are formed by individual pharmacists whose aim is to act collectively in purchasing, and in doing so, obtain cheaper prices than would be possible if they were acting individually. Buying groups obtain products from both wholesalers and direct

8 Final report, National Competition Policy Review of Pharmacy, August 2000, p. 7.

9 Figures compiled from National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, appendix 1.4 (*Retail Pharmacy Magazine*, July 2000).

from manufacturers. Examples of buying groups include Barretts in VIC and Chemplus in SA, both of which run their own warehouse operations.

3.2 Overview of community pharmacy

There are around 4973 community pharmacies Australia wide, of which 125 (or 2.5 per cent) are FSDs owned by 33 different friendly societies. There are no FSDs in the ACT or NT due to legislation.

Table 3.1 shows that FSDs are located mainly in the states of Vic, SA, Qld and NSW. Victoria has the highest number of FSDs (56). In contrast, there is only one ‘grand-parented’ FSD operating in WA. It is interesting to note that there has only been one new friendly society approved in NSW in the last 50 years.¹⁰

Table 3.1 The number of community pharmacies in Australia, by state and territory¹¹

State	Total number of community pharmacies	Number of FSDs	Number of friendly societies
NSW	1748	10	5
VIC	1190	56	13
QLD	952	23	12
SA	470	32	2
WA	385	1	1
TAS	144	3	2
NT	27	0	0
ACT	57	0	0
Total	4973	125	33

As shown in table 3.2 below, a large proportion of FSDs are located in rural and regional areas. Pharmacies located in these areas provide benefits and services to those communities which might not otherwise be accessible. For example, National Pharmacies operates an optical service in Port Pirie, South Australia, for their members whereby members can have their eyesight checked at the mobile clinic.¹² National Pharmacies is the largest friendly society, owning a total of 42 pharmacies across SA, Vic and NSW. National Pharmacies owns 31 out of the total 32 FSDs in SA. The second largest friendly society is Australian Unity, operating a total of 12 pharmacies throughout Vic.

¹⁰ Final Report National Competition Policy Review of Pharmacy February 2000, Part B.

¹¹ National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, appendix 1.2.

¹² National Pharmacies Information Pack.

Table 3.2 The number of FSDs owned by each friendly society, per state, as at June 2001

Friendly society	No of pharmacies
Auburn and Lidcombe UFS Pharmacy	1 (NSW)
Combined Dispensaries Friendly Society	6 (NSW)
Friendly Societies Pharmacy Ltd	1(NSW)
Lismore and District Pharmacy Ltd	1 (NSW)
National Pharmacies*	1 (NSW) 31 (SA) 10 (Vic)
Victoria Park & Districts United Friendly Societies Council	1 (WA)
Hobart Friendly Society Dispensary Ltd	2 (Tas)
Launceston Friendly Society Pharmacy Limited	1 (Tas)
Friendly Care Chemists Friendly Society (Australia) Ltd	6 (Qld)
Ayr Friendly Society Dispensary	1 (Qld)
Bundaberg Associated Friendly Societies Medical Institute	1 (Qld)
Dalby and District Friendly Society Dispensary Ltd	1 (Qld)
The United Friendly Society Association of Gympie and District Ltd	1 (Qld)
Ipswich and West Moreton United Friendly Societies Dispensary	2 (Qld)
Mackay Associated Friendly Societies Pharmacy Limited	2 (Qld)
Maryborough/Hervey Bay Friendly Societies Chemists Ltd	2 (Qld)
CQ Friendly Society Ltd (AFS Dispensaries Rockhampton)	3 (Qld)
The Toowoomba Friendly Society Dispensary Ltd	1 (Qld)
Townsville Associated Friendly Society Pharmacy Ltd	2 (Qld)
Warwick Friendly Society Association Limited	1 (Qld)
Australian Unity	12 (Vic)
Ballarat United Friendly Societies Dispensaries	7 (Vic)
Bendigo United Friendly Societies Dispensaries	2 (Vic)
Friendly Society Dispensary	1 (Vic)
Box Hill Community Pharmacy Friendly Society Ltd	1 (Vic)
Brunswick and Coburg Friendly Society Dispensary Ltd	3 (Vic)
Cheltenham and District UFS Dispensary	2 (Vic)
Community Pharmacy Friendly Society Ltd	5 (Vic)
Eaglehawk United Friendly Societies Dispensary	1 (Vic)
Community Care Chemist Friendly Society	3 (Vic)
North West Dispensaries Friendly Society Ltd	2 (Vic)
Wonthaggi Miners Friendly Societies Dispensary	1 (Vic)
Yallourn Friendly Societies Dispensary	3 (Vic)
Mount Gambier United Friendly Societies Dispensaries (trading as UFS Chemist)	1 (SA)

Source: Table compiled from Australian Friendly Societies Pharmacies Association *Directory of Societies Members* June 2001 and National Pharmacies submission to the ACCC, 30 August 2002.

* National Pharmacies also operate 8 optical outlets.

3.2.1 Community pharmacy products

There are three main product categories in community pharmacy, two of which are restricted by law to be sold by pharmacists only. These are:

- prescription medicines (restricted to pharmacy only)
 - Pharmaceutical Benefits Scheme (PBS) and Repatriation Schedule of Pharmaceutical Benefits (RPBS) subsidised prescriptions
 - unsubsidised PBS and RPBS prescriptions
 - private prescriptions
- non-prescription medicines (restricted to pharmacy only, e.g. Sudafed)
- general retail
 - vitamins
 - general health items
 - beauty products; film development
 - optical.

The Federal Government, through the *National Health Act 1953*, subsidises medicines listed on the PBS on their sale to the public. Greater detail regarding the operation of the PBS is provided in section 3.3.3.

In 1999–2000 the average number of prescriptions dispensed per community pharmacy was 39 892.¹³

PBS and RPBS subsidised prescriptions are prescription medicines which receive a PBS subsidy and can only be supplied by a pharmacist. The government controls the price of these products.

PBS and RPBS prescriptions represent 74 per cent of total prescription sales and 48.1 per cent of total pharmacy sales.¹⁴

Unsubsidised PBS and RPBS prescriptions are those products listed on the PBS and RPBS which do not receive a PBS subsidy. For example, a drug may retail for \$12.00 so it falls under the standard \$22.40 PBS subsidy. Where the government does not provide a subsidy for a listed prescription, a pharmacy may add a prescribed surcharge under the PBS laws, and give discounts on the price.

Sales of unsubsidised PBS and RPBS prescriptions represent 20 per cent of prescription sales and 13.1 per cent of total pharmacy sales.¹⁵

13 The Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, attachment 21 (*2001 Guild Digest*, page 25).

14 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, appendix 2.1.

15 *ibid.*

Private prescriptions are those prescriptions which are not listed under the PBS. The price of private prescriptions is determined by individual pharmacists.

However, the Commission understands that approximately half of the community pharmacy sector complies with a pricing schedule for private prescription medicines issued by the pharmaceutical supplier, Arrow Pharmaceuticals.¹⁶ To participate in the program the participating pharmacist must sell private prescription products at no more than the maximum dispensed price set by Arrow.¹⁷

Private prescription sales represent 6 per cent of pharmacy dispensary sales and only 3.9 per cent of total pharmacy sales.¹⁸

Non-prescription medicines are medicines which do not require a prescription, but can only be sold to the public by a pharmacy under the Standard for the Uniform Scheduling of Drugs and Poisons pursuant to the *Therapeutic Goods Act 1989*. These are generally items scheduled as S2 and S3 medicines, the safe use of which may require professional advice from a pharmacist. These include products such as Sudafed, Claratyne and packs of 50 Panadol tablets.

Non-prescription medicines represent approximately 10 per cent of total pharmacy sales.¹⁹ There is price competition among pharmacies for non-prescription medicines, as there is no PBS listing or Arrow equivalent to control prices.

3.3 Regulatory controls

The community pharmacy sector is highly regulated. As noted in the Wilkinson Review²⁰, each state or territory has its own legislation which governs the regulation of the profession in each jurisdiction.

It is important to note also that the Commonwealth has a high degree of regulatory involvement by way of the *National Health Act 1953*, in that the legislation provides for the administration of the Pharmaceutical Benefits Scheme (PBS), including which pharmacies may provide PBS services to the community, and where such pharmacies are located.

16 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002.

17 Arrow Pharmaceuticals website at <<http://www.arrowpharma.com/about.cfm#market>>.

18 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, appendix 2.1.

19 *ibid.*

20 Final Report National Competition Policy Review of Pharmacy February 2002, p. 2.

3.3.1 State and territory legislation

As noted previously, the state Pharmacy Acts and the ACT Pharmacy Act, provide that the ownership of pharmacies is confined to registered pharmacists. FSDs, however, are excepted from the pharmacist ownership principle. In the NT the legislation is interpreted to mean that a pharmacist is only required to manage a pharmacy.

In addition to ownership laws, each state also has restrictions on the number of pharmacies in which a registered pharmacist may have a propriety interest, restrictions on the ownership structures of pharmacy businesses, and pecuniary interest measures ensuring only registered pharmacists have a pecuniary or proprietary interest in a pharmacy business.²¹ As noted above, one of the recommendations made by the Wilkinson Review which was accepted by the COAG working party was that the restrictions on the number of pharmacies that a person may own, or in which they may have an interest, should be lifted.

Significantly, the Commission notes that the COAG working party supports the removal of restrictions on the number of pharmacies an individual pharmacist can operate.

The regulation of FSDs varies between jurisdictions. In some jurisdictions for example, FSDs are prohibited, or are subject to special ministerial approval processes before they can be established.

Further detail regarding regulatory restrictions on pharmacist-owned pharmacies and FSDs is provided in chapters 4 and 5 of this report respectively.

3.3.2 National Health Act 1953—Australian Community Pharmacy Agreement

In 1990 the Pharmacy Guild of Australia entered into the Australian Community Pharmacy Agreement, provided for under the *National Health Act 1953*, with the Commonwealth Government to encourage a target of reducing the number of pharmacies in the industry by 1000. It was deemed at the time that there were too many pharmacies operating in Australia for the provision of PBS services, and thus the agreement incorporated the planned reduction of the number of pharmacies in Australia. The agreement contains provisions relating to strict controls regarding approving a new pharmacy, and on relocating an existing pharmacy, for PBS purposes.²²

The agreement included other provisions such as the terms of pharmacists' remuneration for the PBS dispensing activities. The original agreement was intended to save the Commonwealth from having to negotiate individual contracts with each pharmacy business for PBS services.²³

21 Final Report National Competition Policy Review of Pharmacy February 2000. p. 25.

22 National Competition Policy Review of Pharmacy—Preliminary Report, 1999, p. ii.

23 *ibid.*, p. 4.

The Commonwealth Government has entered into the third agreement with the Pharmacy Guild of Australia for the period 1 July 2000 to 30 June 2005.

3.3.3 The Pharmaceutical Benefits Scheme (PBS)

The PBS is a Commonwealth Government program aimed at providing timely, reliable and affordable access for the Australian community to medicines. A variety of mechanisms are in place to administer the PBS, including the approval of new medicines for PBS listing and setting of their costs. Access to medicines under the PBS is provided through the community pharmacy network.

The government establishes a price paid to pharmacists for items listed on the PBS. Theoretically, the price of a subsidised prescription is comprised of:

- manufacturers price (as negotiated by the government and supplier)
- plus a wholesaler margin of 10 per cent
- plus a mark-up by the pharmacist on the wholesale cost which is set by the government. (If the wholesale price is less than or equal to \$180 the mark up is 10 per cent, if the wholesale price is above \$180 up to \$450 the mark up is \$18 and if the wholesale price is above \$450 the mark up is 4 per cent)
- plus professional fees for the pharmacist set by the Australian Community Pharmacy Authority through the Pharmacy Benefits Remuneration Tribunal (\$4.62 per prescription on a pre-prepared item plus additional fees where applicable e.g. extemporaneously prepared items \$6.56, dangerous drug fee \$2.62).

Under the PBS, the current maximum cost to consumers for drugs listed under the PBS is \$22.40 for general beneficiaries (who are members of the public who do not hold concession cards) and \$3.60 for concessional beneficiaries (who are holders of Pensioner Concession, Commonwealth Seniors Health Cards and Health Care Cards), except when a special patient contribution, a brand premium, or a therapeutic good premium applies.

The greater part of community pharmacies' income (approximately 60 per cent) is underpinned by government-funded remuneration and the fixed prices of subsidised medicines dispensed on the PBS.²⁴

3.4 Pharmaceutical wholesalers

There is a high level of interdependence between community pharmacies and pharmaceutical wholesalers. Three full-line wholesalers, namely Australian

24 COAG Senior Officials Working Group Commentary on the National Competition Policy Review of Pharmacy, August 2002, p. 3.

Pharmaceutical Industries, Sigma and Faulding (now owned by Mayne), dominate the pharmaceutical wholesale sector.

Most community pharmacies receive at least one delivery per day from the wholesalers who distribute PBS listed drugs, non-PBS drugs which are classified as pharmacy only products²⁵, and general pharmacy supplies (such as paracetamol and aspirin).

The Commission understands other services offered to pharmacies by pharmaceutical wholesalers include:

- pharmacy guarantees. The wholesaler will give a guarantee to a bank or financial institution supporting the debt of a pharmacist, in return, they take security over the assets of the pharmacy
- plannogramming. That is, providing layouts of the best display of their products on pharmacy shelves, aimed at maximising pharmacy sales
- pharmacy refurbishments
- free services for the buying and selling of pharmacies
- banner groups for marketing of products.

25 Such as Schedule 3 drugs which can be sold over the counter with approval of the dispensing pharmacist.

4. Pharmacist-owned pharmacies

4.1 Professional associations

4.1.1 The Pharmacy Guild of Australia

The Pharmacy Guild of Australia was established in 1928 and registered under the then Conciliation and Arbitration Act, and is now registered under the Federal *Workplace Relations Act 1996* as an employers' organisation. It is the peak employer body for community pharmacy.

It is comprised of registered pharmacists who own their businesses. Associate and nominal membership is also available to pharmacists who do not own a pharmacy and for former pharmacy owners respectively. Its members are currently owners of 4500 pharmacies throughout Australia. Almost 90 per cent of all pharmacist proprietors are guild members.²⁶

The national secretariat in Canberra works to the national president and the national executive in performing its functions of servicing the council, the executive, the president and the national committees. The secretariat administers guild policy and plays a significant role in policy development.

Currently the national secretariat is involved in eight areas: communications, finance, quality care pharmacy program, health economics, industrial relations and training, economic analysis and information technology, strategic policy, and professional services and research.²⁷

Other guild activities include:

- to negotiate an ongoing agreement between the government and the guild to facilitate suitable conditions for approved pharmacies to dispense under the PBS, including an appropriate level of remuneration
- to maintain close liaison and negotiation with governments, manufacturers, wholesalers and other organisations involved in the health care delivery system
- to implement strategies to assist community pharmacists practising in rural and regional areas of Australia to ensure that the current network of community pharmacies in Australia is maintained
- to provide economic and management information to community pharmacists to assist them in making their pharmacies more efficient.²⁸

26 Pharmacy Guild of Australia submission to ACCC Review of Friendly Society Dispensaries, September 2002, p. 6.

27 The Pharmacy Guild of Australia <<http://www.guild.org.au>>.

28 Pharmacy Guild of Australia and Pharmaceutical Society of Australia Joint Submission to the National Competition Policy Review of Pharmacy, July 1999, volume 1, p. 10.

4.1.2 The Pharmaceutical Society of Australia (PSA)

The Pharmaceutical Society of Australia (PSA) is the national professional organisation for pharmacists in Australia. The PSA is a federation established by the state pharmaceutical societies in 1977, some of which had been in existence for over 100 years. The establishment of the PSA was aimed at providing the profession not only with a national identity, but an opportunity to more effectively regulate its affairs, to achieve better coordination in consultation and liaison with the Commonwealth Government, other professions and industry.

Membership of the PSA is not restricted to one particular group of pharmacists. In this way, the PSA is the leading advocacy organisation for all pharmacists, influencing attitudes, opinions and policies through representation, networking, consultation and a range of publications and health promoting programs and resources.

The PSA represents almost 10 000 pharmacists from pharmacist-owned pharmacies, FSDs, hospital, government, the armed services, industry and academic institutions as well as student members.

The PSA's purpose is to enable pharmacists to optimise their contribution to improved health outcomes for the community through excellence in the practice of pharmacy. The key objectives for which the PSA is established include:

- optimising the role of pharmacists in the health care system
- setting the ethical/professional standards and responsibilities of pharmacists
- developing education, continuing education and training programs
- formulating policies for the effective practice of pharmacy
- protecting the rights, privileges and professional status of pharmacy.²⁹

4.1.3 Association of Professionals, Engineers, Scientists and Managers Australia (APESMA)

The Association of Professionals, Engineers, Scientists and Managers Australia (APESMA) represents the interest of pharmacists in a vein similar to the union movement. APESMA represents approximately 50 per cent of Australian pharmacists.

APESMA is a non-profit organisation which operates for the benefit of its members. It is staffed by a team of experienced professionals, including expert industrial, legal, and remuneration staff, as well as an extensive network of honorary officers.

The Pharmacists Branch of APESMA was until 15 September 1997 the Salaried Pharmacists' Association.

²⁹ Pharmacy Guild of Australia and Pharmaceutical Society of Australia Joint Submission to the National Competition Policy Review of Pharmacy, July 1999, volume 1, p. 11.

As the recognised representative of professional employees, APESMA exists for the benefit of its members. All of its services are designed to provide practical assistance to members in maximising the rewards and opportunities of professional employment.

The Pharmacists' Branch aims to ensure that employee pharmacists are remunerated according to their qualifications, skills, responsibility and professional standing and that members have an effective and independent voice in all matters affecting their profession.

APESMA is independent in its view of the community pharmacy industry. It does not support nor discourage the structural arrangements of any type of community pharmacy and is primarily concerned with the professional development of their members, regardless of whether they work in a friendly society pharmacy or a pharmacist-owned pharmacy.

4.2 Restrictions on pharmacist-owned pharmacies

Pharmacist-owned pharmacies are subject to regulation by the various state and territory Pharmacy Acts, and also accountable to the relevant Pharmacy Board in the state/territory in which they operate.

As noted in chapter 3, various ownership restrictions are currently in place in most jurisdictions with respect to the number of pharmacies that any one pharmacist may either own or have a pecuniary interest in.

Currently, there are also restrictions on the type of business structure that pharmacists are permitted to operate under. These include sole traders, partnerships, limited partnerships between a practising pharmacist or pharmacists and external sources of capital, provided those persons are also pharmacists, bodies corporate in which all the shareholders and directors are pharmacists, and in some jurisdictions, bodies corporate in which pharmacists hold the majority of shares, with the balance held as non-voting shares held by specified relatives of the pharmacist.³⁰

Below at table 4.1 is a summary of the restrictions on who may own a pharmacy with respect to each jurisdiction. Table 4.2 is a summary of the maximum number of pharmacies currently permitted to be owned by any one pharmacist within particular jurisdictions.

30 It should be noted that while South Australia is the only jurisdiction in which non-pharmacist family members may have an interest in an incorporated company, the Wilkinson Review recommended that this be adopted by all jurisdictions, a view which it seems the COAG working party sees some benefit.

Table 4.1 Summary of relevant provisions of state and territory legislation relating to pharmacy ownership

State or territory	Regulations (who can own a pharmacy)
New South Wales	Pharmacists, and in limited exceptions, friendly society dispensaries.
Victoria	Pharmacists, friendly societies, registered funded agencies, private hospitals, and privately-operated hospitals.
Queensland	Pharmacists and friendly societies.
Western Australia	Interpreted as pharmacists and friendly societies.
South Australia	Interpreted as pharmacists, prescribed relatives of pharmacists, and friendly societies.
Tasmania	Pharmacists and friendly societies.
Australian Capital Territory	Pharmacists only.
Northern Territory	Unspecified ownership.*

Source: Department of Health & Ageing Submission to Wilkinson Review, page 78.

* The legislation provides that a pharmacist must manage the pharmacy during trading hours.

Table 4.2 Current restrictions on the number of pharmacies a pharmacist may own or have a pecuniary interest in

State or territory	Regulations (how many can be owned)
New South Wales	3 pharmacies, 1 additional partnership in an ‘after hours pharmacy’, and any number of approved ‘branch pharmacies’.*
Victoria	3 pharmacies.*
Queensland	4 pharmacies.*
Western Australia	2 pharmacies.*
South Australia	4 pharmacies.*
Tasmania	2 pharmacies, 1 additional ‘after hours pharmacy’, or 2 additional ‘after hours pharmacies’ if the pharmacist already owns 2 ordinary pharmacies.*
Australian Capital Territory	No restriction.*
Northern Territory	No restriction.*

Source: Department of Health & Ageing Submission to the Wilkinson Review, attachment D, p. 78.

* The Commission notes that there may soon be legislative changes on the number of pharmacies able to be owned in each jurisdiction as a result of COAG’s acceptance of the Wilkinson Review recommendation.

5. Friendly society pharmacies

Most friendly societies tend to be organisations that provide various products to their members in the form of services including insurance (health insurance for example), financial services, religious activities and the like. These organisations will operate for a number of reasons, the primary being to provide specific services to their members for an annual fee. Therefore, members of a friendly society will join up in order to receive the benefits of being associated with particular friendly societies, which may include access to discounted goods and services.

FSDs, generally being a mutual organisation, have a number of corporate obligations due to its responsibility to its members to comply with good corporate governance. Those friendly societies that are public companies are subject to various responsibilities under the Corporations Law which are often not incurred by smaller businesses. These include:

- a registered company auditor
- registration with ASIC
- election of directors.

Further, organisations such as friendly societies will often endeavour to provide regular information to their members. Such actions include:

- membership brochures, material and advertising required for communicating with members
- the issue of a membership card
- other services that may be provided to members at no additional cost.³¹

It is also important to note that FSDs do not make a distribution to their members, either by way of share distributions or other forms of capital (refer to section 6.2).

5.1 The history of friendly society dispensaries

As noted in chapter 3, friendly society dispensaries were first established in Australia in the 1840s. Their establishment was in response to two significant problems of the day, namely, the high cost of medicines for their mainly poor members, and, the fact that many chemists commonly adulterated their drugs.

Australian Friendly Societies Pharmacies Association (AFSPA) note that the purpose of friendly societies establishing their own dispensaries was to ensure the supply to their members of quality medicines, as prescribed by physicians, and at a quality price.

³¹ Information compiled with assistance of National Pharmacies submission.

They were able to do this because the dispensaries were established and operated by the friendly societies on a not-for-profit, cooperative principle.

AFSPA states that throughout the operating history of the friendly societies dispensaries, such not-for-profit pharmacies have struggled for their continued survival against the vested interests of the commercial chemists. AFSPA considers that the interests of the commercial chemists have, over many decades, been successful in restricting the growth of the friendly society pharmacies by lobbying for legislation which has prevented friendly societies from opening new pharmacies in various jurisdictions, and restricts the friendly societies' ability to relocate existing pharmacies.

5.2 Major friendly society organisations

5.2.1 The Australian Friendly Societies Pharmacies Association

The Australian Friendly Societies Pharmacies Association (AFSPA) is a not-for-profit national body representing the interests of its members who are not-for-profit friendly societies registered under the various state Friendly Society Acts or other relevant Commonwealth legislation.

The objects of AFSPA include:

- provide a not-for-profit Association of Friendly Societies Pharmacies which are registered under relevant legislation
- promote community pharmacy and the interests of affiliated Pharmacy Societies and their members
- monitor and closely consider all matters emanating from federal legislation that has or may have an effect on the association or its affiliated pharmacies or their members
- make representations and submissions where deemed necessary or desirable to the appropriate persons, entities or authorities in respect of any matter affecting the interests of affiliated pharmacies or their members.

AFSPA presently has 33 friendly society members operating a total of 125 friendly society dispensaries across a number of states in Australia. As noted above, almost half of the friendly society pharmacies that exist today operate in rural or regional areas.³²

Only two states operate state-based friendly society associations, which in their own right are members of AFSPA. The two state-based bodies are in Victoria (the Victorian Friendly Society Pharmacy Association) and Queensland (the Queensland Friendly Society Pharmacy Association).

32 AFSPA Submission to the National Competition Policy Review of Pharmacy, July 1999.

5.2.2 National Pharmacies (Friendly Society Medical Association Ltd)

The Adelaide UFS Dispensary opened in South Australia in 1911, and in 1914 the Friendly Society Medical Association (trading as National Pharmacies) was founded. By 1928 the organisation had seven pharmacies operating, which increased to 13 pharmacies by 1939. By 1947 this number grew to 26, of which nine pharmacies were restricted to only trade with National Pharmacies members (that is, non-members were not permitted to shop in those particular stores). At the same time, the number of pharmacies was capped by way of changes to pharmacy law. In 1961 an increase to 31 pharmacies was approved by the South Australian Government, and this situation remains today.

Until 1997 National Pharmacies, like other FSDs, was not able to own pharmacies in other jurisdictions. Following changes to the friendly society regulations in 1997, when friendly societies became subject to the provisions of the Corporations Law, National Pharmacies commenced buying pharmacies in Victoria and New South Wales in 1998.

National Pharmacies notes that only one pharmacy has been purchased in New South Wales due to the commercial costs of purchasing pharmacies in that state as the legislative restrictions on FSDs purchasing pharmacies is costly.

In four years, National Pharmacies has purchased 11 pharmacies outside South Australia, representing a growth of around three pharmacies per year.

National Pharmacies also operates a business of optical dispensing. National Pharmacies chose to enter the optical market during the time of restricted growth opportunities in the community pharmacy industry. National Pharmacies state that optical dispensing was seen as a logical extension of the pharmacy business being a specialist retailer of health-related products.

Today, National Pharmacies owns 31 pharmacies in South Australia, 10 in Victoria, one in New South Wales and eight optical outlets. To support the pharmacies, National Pharmacies operates its own warehouse in South Australia and distributes goods only to its own pharmacies.

As at 30 June 2002 National Pharmacies had 149 434 memberships, many of these with family membership. As a whole, National Pharmacies has around 300 000 people in rural and metropolitan areas that benefit from membership with National Pharmacies.

National Pharmacies submitted to the Commission that it is an expert in professional pharmacy management and does not operate any other business except pharmacy and optical dispensing. Apart from one store, their optical outlets are co-located with their pharmacies and are seen as an adjunct to the pharmacy business rather than a different business; that is, a pharmacy has a number of distinct components such as vitamins and cosmetics and National Pharmacies see optical dispensing as merely another category of health related products.

5.3 Restrictions on friendly society dispensaries

Initially FSDs were excluded from the operation of the restriction on the number of pharmacies allowed to be owned.³³ There are a number of restrictions still in place on FSDs which affects their ability to compete against pharmacist-owned pharmacies and grand-parented pharmacies across each jurisdiction in Australia. Such restrictions include the fact that an FSD is unable to own a pharmacy in certain jurisdictions or that the numbers of pharmacies able to be owned by a particular FSD in the one jurisdiction is restricted.

A summary of these restrictions is provided below:

Table 5.1 Restrictions in legislation that are placed on FSDs

State	Restrictions
Australian Capital Territory	<ul style="list-style-type: none"> Friendly societies are restricted from owning pharmacies; this has been a recently imposed restriction where no previous restrictions existed with regard to FSD ownership.
New South Wales	<ul style="list-style-type: none"> FSDs that owned a pharmacy prior to the legislation being enacted can only move the pharmacies they own within one mile of the original place of business. The legislation includes a provision that each new FSD pharmacy requires approval by the NSW Minister for Health.
Northern Territory	<ul style="list-style-type: none"> The restrictions placed on FSDs in this jurisdiction are the same as those imposed on pharmacist-owned pharmacies.
Queensland	<ul style="list-style-type: none"> FSDs that existed when the legislative restrictions came into place may continue to exist. An FSD is unable to purchase a pharmacy that is owned by a pharmacist; that is, an FSD can only purchase a pharmacy that is owned by another FSD.
South Australia	<ul style="list-style-type: none"> Only two FSDs can operate in this jurisdiction, with no new FSD players allowed into the market. There is no provision for cross boarder ownership in SA. While one FSD is able to own 31 pharmacy locations, it is limited to this amount.
Tasmania	<ul style="list-style-type: none"> FSDs are restricted to owning a maximum of two pharmacies. This restriction was recently imposed.
Victoria	<ul style="list-style-type: none"> Only FSDs that were registered under the Victorian Friendly Society Code on 1 July 1999 can own pharmacies.
Western Australia	<ul style="list-style-type: none"> Only one FSD is allowed to operate in this state and no interstate FSDs are allowed the right of cross border ownership. The single FSD that currently operates in WA is only allowed to do so provided it remains in the same location in which it operated when the legislation came into force.

Source: Table compiled from the Commission's own research and the National Pharmacies submission.

33 AFSPA Submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 6.

6. Regulation of FSDs and the mutuality principle

The ‘mutuality principle’ is an established common law rule which has the effect that some identified gains of some organisations from certain dealings with their members are not income for the purpose of income taxation. Where there is a contribution to a common fund created and controlled by members for a common purpose, any surplus arising in the fund is not income for tax purposes. Bodies such as clubs, associations and friendly societies and their dispensaries are subject to this rule.³⁴

In this report, FSDs are defined to be the friendly society group which owns and operates individual pharmacies.

6.1 Regulation by the Australian Securities and Investment Commission

The Commission sought information from the Australian Securities and Investment Commission (ASIC) regarding what obligations friendly society dispensaries were required to meet under the Corporations Law. The following information was provided by ASIC.

Prior to 1 October 1997 friendly societies continued to be regulated by state and territory friendly societies legislation. From 1 October 1997, in all jurisdictions except for Western Australia, friendly societies, including friendly societies that were pharmacies or dispensaries, were regulated under the state-based Financial Institutions Scheme. The part of the scheme relevant to the regulation of friendly societies was the Friendly Societies Code, Regulations and AFIC Prudential Standards for friendly societies.

On 1 July 1999 the regulation of friendly societies was transferred to the Corporations Law (*Corporations Act 2001*) as part of the second stage of legislation to implement the Commonwealth Government’s response to the recommendations of the Financial System Inquiry. This stage transferred regulatory responsibility for building societies, credit unions and friendly societies, from the states and territories to the Commonwealth, and introduced a range of legislative amendments to bring the regulation of building societies and credit unions into line with the regulation of other authorised deposit-taking institutions (including banks) and establish a single regulatory framework for life insurance companies and friendly societies, while recognising the special features of friendly societies. The Australian Prudential Regulation Authority (APRA) is responsible for the prudential regulation of building societies and credit unions, and for friendly societies that have benefit funds.

FSDs were regulated under the Friendly Societies Code immediately prior to the transfer date, along with other friendly societies. However, it was recognised that they had certain different characteristics in that they were not regarded as carrying on a ‘financial business’, in that they did not have benefit funds. Most friendly societies that

34 Ralph Review of Business Taxation, *A Tax System Redesigned: More certain, equitable and durable*, July 1999, p. 228.

are insurance agencies, financial institutions and the like generally offer multiple benefits, and member contributions for a particular type of benefit are isolated in a discrete ‘benefit fund’ similar to a trust. The management of all benefit funds in a society is paid for through a separate management fund.

FSDs’ differences were recognised in legislation after the transfer date. As they have no benefit funds and are not regarded as carrying on a ‘financial business’, FSDs are regulated as public companies under ASIC alone. APRA is concerned with prudential regulation of financial business.

The Commission understands there was no existing definition of mutuality in the Corporations Law. As such, ASIC set out its approach to determine this issue in Policy Statement 147 (PS 147). The Commission asked ASIC to provide information relating to how Policy Statement 147 impacted upon FSDs. ASIC stated that after the FSDs transfer to the Corporations Act, as part of its responsibilities under schedule 4, ASIC must determine if an unlisted transferring financial institution (TFI) has a mutual structure, when considering whether to grant an exemption from the demutualisation provisions set out in Part 5 of Schedule 4 of the Corporations Act. This provision imposes a disclosure regime on an unlisted TFI that is proposing a change to its constitution or proposing to make a share issue that may have the effect of modifying its mutual structure. Part 5 applies to FSDs.

PS 147 was preceded by an interim statement. Both policy statements were the subject of extensive consultation. The consultation confirmed that views about mutuality were nearly as diverse as the number of institutions and individuals that responded to ASIC’s consultation process or made applications for relief.

In the case of FSDs it was noted that:

- a variety of voting structures, roughly described as ‘collegiate’ which differed from the ‘one member one vote benchmark’ but were not necessarily inconsistent with a mutual enterprise
- not all customers were required to be members.

FSDs were not the only TFIs to have a variety of voting structures or to have non-member customers. For example, credit unions are dedicated mutuals to the extent that if they demutualise, they will not thereafter be permitted to use the term ‘credit union’ in their name.

In view of the variety of types of ‘mutuality’, ASIC determined that its approach in PS 147 should remain minimalist and flexible and care should be taken not to inadvertently exclude from the mutual umbrella the TFIs that had long operated in the belief that they were mutual. The explanatory memorandum to the transfer legislation stated in various places that the transfer to the new regulatory regime was intended to cause as little expense and disruption to TFIs as possible, lending support to ASIC’s approach. This may be inferred from clause 30 (3) (a) which provides that:

ASIC may take into account ... the particular structure and history of the company.

ASIC also determined that its objective was to ensure that proper regard was given to the rights of members of TFIs and that their members were fully informed prior to making a decision that may affect their rights, rather than to endorse mutuality as a meritorious philosophical concept.

The requirement for a strict ‘one member one vote’ structure was therefore not retained in PS 147. Each case, including where FSDs are applicants for exemption, will be examined on its merits and these factors may have some, though not a determining, influence on ASIC’s view as to the entity’s mutuality.

6.2 Regulation by the Australian Tax Office

The Commission also asked the Australian Taxation Office (ATO) to provide information in relation to the taxation treatment of FSDs by way of their mutual status. The following is the ATO’s response to the Commission’s request.

The principle of mutuality is based on the proposition that a taxpayer cannot derive income from itself. Generally, under this proposition, income derived by a registered/licensed club from its members is not treated as assessable income for taxation purposes. Conversely, income derived from ‘external sources’, i.e. from sources other than the members, is not mutual income and is therefore not subject to the principle of mutuality. Accordingly, such income is fully assessable.³⁵

The taxable income of a club, society or association is calculated in the same way as for other companies. Two particular aspects affecting many clubs, societies and associations are:

- exclusion of the effect of mutual dealings with members
- exclusion of the effect of the goods and services tax (GST), if the club, society or association is registered (or required to be registered) for GST.

The mutuality principle is applied to FSDs in the same way as it is applied to all non-profit companies. **Friendly society dispensary** is defined in section 995 (1) of the *Income Tax Assessment Act 1997* as meaning an approved pharmacist (within the meaning of Part VII of the *National Health Act 1953*) that is:

- (a) a friendly society; or
- (b) a body carrying on business for the benefit of members of a friendly society.

The *Income Tax Rates Act 1986* defines a ‘non-profit company’ as:

- (a) a company that is not carried on for the purpose of profit or gain to its individual members and is, by the terms of the company’s constituent

³⁵ Taxation Determination TD 1999/38, as provided to the Commission by the ATO.

document, prohibited from making any distributions whether in money, property or otherwise, to its members; or

(b) a friendly society dispensary.

The Commission considers that FSDs should not be considered in a separate class to part (a) above in that FSDs, being not-for-profit entities like those operating under the mutuality principle in part (a) above, do not make distributions to individuals members, as noted in chapter 5.

The taxation of FSDs was the subject of a change to the legislation commencing 1 July 1982, whereby FSDs would be taxed in accordance with the mutuality principle which applies in the assessment of clubs and other non-profit organisations generally.

The explanatory memorandum contained in Income Tax Laws Amendment Bill (No. 3) 1981 stated that:

... this (mutuality) principle excludes from the income tax base of such bodies all receipts from members, but leaves to be taxed net profit attributable to trading with and receipts from non-members and any investment outcome.

The ATO noted that the explanatory memorandum goes on to state at clause 4 that an FSD will be taxed on profits (taxable income) arising from the following classes of receipts:

- all amounts received from the Commonwealth under the National Health Act and the Repatriation Act for the supply of pharmaceutical benefits, whether to members or non-members
- any receipts from non-members for the supply of pharmaceutical benefits
- proceeds of sale or supply of pharmaceutical products and other goods and services, to non-members
- investment income.

Finally, the ATO noted that the mutuality principle recognises that one cannot make a profit out of oneself and that income can only be derived from sources outside oneself. A mutual receipt cannot be treated as income. However, it must also be noted that expenses incurred to derive mutual receipts are not allowed as an income tax deduction.

Non profit businesses that properly apply the mutuality principle are not liable to pay income tax on mutual receipts. This can lead to a lower cost structure for goods and services provided which in turn can mean a more competitive edge.³⁶

36 The ATO did not specify whether they considered that this competitive edge would mean a competitive advantage, or even a significant competitive advantage for FSDs compared with pharmacist-owned pharmacies.

6.3 Pharmacist-owned pharmacies' view of the mutuality principle

The Pharmacy Guild of Australia submitted that a typical friendly society pharmacy, as a mutual organisation, is entitled to use the mutuality principle in trading with its own members so that all receipts from those members, including their subscription fees and ordinary transactions, are excluded from its (the FSD) assessable income. Tax is paid at the relevant corporate tax rate only on amounts received from the Commonwealth for the supply of pharmaceutical benefits, whether to members or non-members, and transactions with non-members. Other profit from trading with members is tax exempt.³⁷

The guild provided the Commission with a copy of an advice received from legal counsel³⁸ relating to whether National Pharmacies, a group of FSDs operating predominantly in South Australia, is entitled to exclude from its assessable income the amounts received as contributions from subscription members and, further, if National Pharmacies is entitled to exclude from its assessable income any profit arising from sales to subscription members at a discount. Counsel's opinion was to the effect that National Pharmacies could not, and counsel provided a detailed explanation to this effect.³⁹ The guild notified the Commission that it had provided a copy of this advice to the ATO for its consideration. The guild recently advised the Commission that the ATO had considered the issues raised in the legal advice sent by the guild, but were unable to comment further on the matter at that time.

...While your concerns have been noted, I am sure you appreciate that the secrecy provisions of the Income Tax law prevent me from disclosing any information on the tax affairs of another taxpayer. This includes any decision to audit a taxpayer (or not to audit a taxpayer)...Also, any examination by the ATO of the income tax affairs of a taxpayer is only authorised for the purposes of the Income Tax law. It is not a proper exercise of the Commissioner's powers to access documents etc. to provide information for an ACCC enquiry.⁴⁰

6.4 Friendly societies' view on the mutuality principle

National Pharmacies submitted the following points to the Commission in relation to the application of the mutuality principle to FSDs.⁴¹

National Pharmacies noted that if income for a mutual organisation is derived due to a member's actions, but does not come directly from the member, it is also treated as

37 Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, September 2002, p. 7.

38 Rodney Garratt QC and Stephen McLeish.

39 The Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, September 2002, appendix 3.

40 Letter to Pharmacy Guild of Australia, from Michael D'Ascenzo, Deputy Commissioner of Taxation, dated 29 August 2002.

41 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, chapter 4, p. 4.

non-mutual income and is therefore fully taxed. For example, the PBS subsidises prescriptions for members of the public via the Health Insurance Commission for PBS items. The income from PBS items is paid directly to the pharmacy by the Health Insurance Commission, and not by the individual member. As the income is not paid directly by the member, but paid to the pharmacy, the income is not treated as mutual income and the profit on PBS receipts is fully taxable at the company tax rate.⁴²

A friendly society pharmacy pays tax at the full corporate tax rate on non-member taxable income, and it does not pay tax on that income if there is a loss. However, like any taxpayer, such as a pharmacist-owned pharmacy, any loss is deductible from taxable income in future years. However, where an FSD makes a profit on member income it does not pay tax, it is important to note that if the FSD makes a loss from member trading it is not deductible from taxable income.⁴³

Further, National Pharmacies raised the following points with the Commission:

1. Mutual income and expenses

If a member of an FSD buys goods from the pharmacy, the income is therefore derived from the member. Therefore, the profit arising from the sale is mutual profit and not taxable.

2. Contribution fees mutual income

FSDs charge members an annual membership contribution for individuals to become and remain a member. This income is contributed by members to the common fund to allow FSDs to achieve their objectives, and to develop the organisation into the future. As a FSD cannot raise share capital or equity, the contribution fees are the only method to build their 'capital' base to meet their objectives.

As a 'not-for-profit' organisation, profit from trading does not provide sufficient cash flow to build the organisation into the future. Income tax laws treat contributions received as mutual income and therefore they are not taxed.

A more detailed view of the stakeholder's opinions in relation to the application of mutuality, and taxation in general, is at part 7.1.

42 *ibid.*, p. 3.

43 *ibid.*, p. 4.

7. Assessment of competitive advantages and disadvantages

7.1 The mutual tax treatment of FSDs

The tax treatment of FSDs clearly differs from that of other community pharmacies. As mutual entities, FSDs use membership fees and other contributions from members to provide services to those members.

In summary, under the mutuality principle, an FSD is taxed as a non-profit company. The mutuality principle excludes from tax all receipts from members. For example, if a member of an FSD purchases a good from the pharmacy, the income derived from the member and the profit earned by the friendly society is considered to be a mutual gain and is not taxable.

However, the following classes of receipts are still exposed to tax:

- all amounts received from the Commonwealth for the supply of pharmaceutical benefits, whether to members or non-members
- proceeds of the sale or supply of goods and services to persons who are not members of the FSD
- investment income

By way of example, 43 per cent of National Pharmacies sales are non-member sales, including PBS sales. The balance of the sales by National Pharmacies is sales to its members, and represents 57 per cent of total sales. National Pharmacies submits that the profit on these sales is marginal due to normal operating costs and benefits provided on these sales of up to 20 per cent.⁴⁴

The profit after expenses generated from sales made by a FSD to non-member customers are fully taxable at the current company tax rate of 30 per cent.

Another example of taxable income is where income earned by a FSD is derived from a member's actions, but does not directly come from the member. As discussed in chapter 3, the PBS subsidises prescriptions for members of the public via the Health Insurance Commission for PBS items. The income, which is paid directly to the pharmacy by the HIC, is not treated as mutual income, and any profit on these receipts is fully taxed at the company tax rate of 30 per cent.

An example of the tax treatment of FSDs, and in particular the operation of the mutuality principle, is outlined in table 7.1 below.

⁴⁴ National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, chapter 4, pp. 11–12.

Table 7.1 Stylised example of the mutuality principle

Revenue		
PBS	\$ 550 000 (55% of gross revenue)	(a)
Shop and prescription transactions (members)	\$ 250 000 (25% of gross revenue)	(b)
Shop and prescription transactions (non-members)	\$ 200 000 (20% of gross revenue)	(c)
Gross revenue	\$ 1 000 000	(d)=(a)+(b)+(c)
Expenses	\$ 830 000	(e)
Pharmacist salary	\$ 70 000	(f)
Net profit	\$ 100 000	(g)=(d)-(e)-(f)
Less mutuality component	\$ 25 000	(h)=25% of (d)
Taxable income	\$ 75 000	(i)=(g)-(h)
Tax payable (30% of \$75 000)	\$ 22 500	(j)=30% of (i)

Source: The Allen Consulting Group, *The Income Tax Treatment of Friendly Society Pharmacies and Other Competition Related Factors*, September 2002.

Note: The Australian Tax Office has agreed to methods for the splitting of expenses between taxable and non-taxable income; however, the above example illustrates the principle of mutuality using a simple and stylised example.

Table 7.1 shows that the amount of tax payable under the mutuality principle is \$22 500. Without the mutual tax treatment, the amount of tax payable is \$30 000 (being 30 per cent of \$100 000). This equates to a \$7500 benefit under the mutuality principle.

In contrast, pharmacist-owned pharmacies, which are for profit entities owned either individually (sole trader), through partnerships or corporate structures, are required to pay the applicable rate of taxation on taxable income.

To determine whether friendly society pharmacies ultimately have a competitive advantage over pharmacist-owned pharmacies, it is necessary to examine **both** the advantages and disadvantages to FSDs as a result of the principle of mutuality.

7.1.1 Competitive advantages from the mutuality principle

The **guild** made considerable comment on the issue of the tax treatment of the largest FSD, Friendly Society Medical Association Ltd (trading as National Pharmacies), but did not make much comment in relation to the taxation implications of other FSDs.⁴⁵

The guild believes that the tax benefits available to Friendly Societies' pharmacies such as National Pharmacies give them a competitive advantage over other community pharmacies. The guild stated that:

Put simply, FSMA, or National Pharmacies, provides discounts to its "members" because of the tax benefits it receives under the mutuality principle. The discounts are the means of providing benefits to its "members"; that is returning 'income' to "members" as part of this mutual arrangement. It is because of this mutual arrangement that benefits/discounts are given and they would not be given if this mutual arrangement did not exist; ie if these pharmacies paid tax on all the income received at the normal company rate.⁴⁶

The guild added that:

Whatever is the case, it is certainly true to say that Friendly Societies' pharmacies no longer exist in their original form as dispensaries set up to assist in meeting the health and pharmacy needs of those less well-off members in the community. They are very profitable trading concerns seeking the highest possible market share. The concept of mutuality appears to be used to give Friendly Societies' pharmacies, such as National Pharmacies, a competitive edge through taxation benefits, rather than as a benefit to 'members'.⁴⁷

The **PSA** also considers that the income tax exempt status of mutual gains places pharmacist-owned pharmacies at a competitive disadvantage. The PSA considers that the question asked of the Commission is easy to answer. In particular, they submit:

...there can be no argument that the more favourable tax treatment of FSDs provides them with an advantage over pharmacist-owned pharmacies. If FSDs pay less tax on the same income than pharmacist-owned pharmacies, then the former have more scope to offer cheaper services or to accumulate more capital... The Society is not in a good position itself to judge the quantum of the favourable treatment although it notes that even if the effect were small, any such tilting of the playing field in favour of one party at the expense of another should require justification.⁴⁸

The PSA added that:

PSA believes the public interest is best served by a robust system of community pharmacies spread throughout Australia. They should operate in a financial environment that in all locations permits reinvestment in infrastructure to deliver enhanced professional services while

45 As noted above in chapter 6, the guild informed the Commission that they had sought advice from counsel regarding the application of the mutuality principle. Counsel provided advice to the effect that the mutuality principle should not apply to certain income of National Pharmacies. The Commission considers this argument to be outside the terms of reference for the Commission's review and will not be discussed.

46 Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, September 2002, p. 4.

47 *ibid.*, p. 15.

48 Pharmaceutical Society of Australia submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 2.

also returning an economic return sufficient to attract the participation of pharmacist owners. The paradigm of mutuality is based on the provision of services to members and justifies a lower economic return than might be acceptable to a pharmacist owner. Pharmacist owned pharmacies are hence competing in an environment where FSDs have a tax advantage and a diminished need for profit to remain in the market.⁴⁹

The AFSPA provided the review with quite detailed comment regarding the taxation treatment of FSDs, noting that FSDs have been subjected to claims of unfair competitive advantage for over 100 years and during that time, in AFSPA's opinion, the income taxation regimes and systems have undergone great changes.⁵⁰

In relation to whether a significant competitive advantage arises by way of mutual tax status, AFSPA argues:

It is AFSPA's submission that the taxation arrangements flowing to Friendly Society Pharmacies from their mutual status are not significant. And if there is an advantage, that advantage must be offset against other relevant factors. Other relevant factors include:

- Expenses of dealing with members are not allowable deductions. Dealings with members include: administrative costs of membership cards, member newsletters, notices of meetings, maintenance of register of members as required under the law;
- Payment of relevant fees and charges to ASIC; and
- Many Friendly Society Pharmacies are of a size to bring them within State/Territory payroll taxation levels.⁵¹

In relation to the state and territory payroll tax, AFSPA added that most commercial pharmacies do not attract payroll tax, as their salary expenditure does not meet the thresholds necessary to incur a liability. On figures quoted by AFSPA, they argue that some FSDs are paying in the order of 20–30 per cent of net profits in payroll tax, which AFSPA believes equates to those FSDs paying an effective rate of around 45 per cent in taxation.⁵²

In its submission, **National Pharmacies** provided a brief history to the Commission of some of the reviews undertaken by previous governments in relation to the principle of mutuality with respect to certain organisations. In particular, National Pharmacies sought to bring the Ralph Review of Business Taxation (the Ralph Review) to the Commission's attention. Whilst the Ralph Review extended to cover many aspects of business taxation, National Pharmacies provided the Commission with the following quote from the final report of the Ralph Review.⁵³

Statutory exclusion for 'mutual gains'

- (a) that the current common law exclusion from the calculation of taxable income of 'mutual gains' – being gains by certain mutual entities and organisations from some dealings with their members – be given explicit effect in the tax law, notwithstanding the general principal that income arising from dealings between entities and their members should be

49 *ibid.*, p. 2.

50 AFSPA submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 9.

51 *ibid.*, p. 14.

52 *ibid.*, p. 11.

53 *Review of Business Taxation: A Tax System Redesigned*. July 1999.

included in the taxable income of those entities...this rule applies to bodies such as clubs, Friendly Societies and their dispensaries ...

National Pharmacies argues that the purpose of principles such as mutuality within the tax laws is to enable what are described as ‘taxation expenditures’ to be used to purchase services for the community that would otherwise not be undertaken by government or for-profit providers. National Pharmacies considers that the taxation arrangements that apply to FSDs, as a consequence of the principle of mutuality, result in beneficial outcomes for the community as a whole.⁵⁴

APESMA considers that if there are taxation benefits for FSDs, under the mutuality principle, benefits arising from this status flow to the community of members of the FSDs. APESMA supports FSDs as they provide competition in the market place for private owner pharmacies, from which consumers benefit. Furthermore, excess funds generated are returned to the members in the form of better facilities and services to members and non-members alike.

The **Council of Small Business Organisations of Australia** (COSBOA) submits that individual pharmacists pay a higher rate of tax compared to the incorporated FSD. However, the solution to this, from a small business perspective, is to reduce the rate of income tax payable to a form comparable to the corporate tax rate.

Analysis of submissions

Allens considers the way in which FSDs compete with pharmacist-owned pharmacies should be unchanged regardless of whether income tax is, or is not, paid on any surpluses from their commercial activities. In particular, as the tax exemption relates to a tax on profit—rather than a tax related to the level of output—then the level of tax (and hence a tax exemption) should not affect the businesses’ pricing and output decisions.

Similarly, the Productivity Commission came to this conclusion when comparing the income tax-exempt treatment of charitable organisations in activities competing with ‘for-profit’ entities.⁵⁵

Notwithstanding the above, even if it were assumed that the tax exemptions enjoyed by FSDs gave rise to a competitive advantage that may distort competition in the community pharmacy sector, the next question to be asked is: How significant would any such advantage be from the tax-exempt status of mutual gains of FSDs over pharmacist-owned pharmacies?

In addressing this question Allens applied two measures to estimate the significance of any competitive advantage to FSDs arising from the principle of mutuality.

54 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, chapter 4, p. 6.

55 Industry Commission, *Charitable Organisations in Australia*, report number 45, 16 June 1995, AGPS, Melbourne, pp. K.3-K.4 and Productivity Commission, *Australia’s Gambling Industries*, report number 10, 26 November 1999, p. 21:34.

First, Allens measured the tax benefit from mutuality as a percentage of sales turnover. Using figures provided to the Commission from National Pharmacies, Allens calculated that the tax benefit from mutuality as a percentage of sales turnover ranged from 0.13 per cent to 0.51 per cent. This measure suggests that a competing, non-income tax exempt pharmacy would need to be between 0.13 to 0.51 per cent more efficient in its operations to be able to provide goods and services equivalent to those provided by FSDs.

Allens considers this percentage may not sound particularly high; however, if pharmacies compete on a high-turnover low-margin basis, this percentage becomes more important relative to the scenario where pharmacies compete on a high-margin low-turnover basis.

Allens considers one aspect which could be deemed to be a competitive advantage for FSDs is the improved cash flow of FSDs compared to pharmacist-owned pharmacies. In measuring the significance of any such advantage, Allens considered the tax benefit from mutuality as a percentage of reported profit. Allens believes this to be the better measure of whether a competitive advantage exists.

Again, using reported profit figures supplied by National Pharmacies to the Commission (see table 7.2 below), Allens calculated that the tax benefit from mutuality as a percentage of reported profit (before income taxation) from 1996–97 to 2000–01 ranges from 4 to 14 per cent. This range suggests that per dollar of reported profit, FSDs receive from between 4 and 14 per cent benefit from the principle of mutuality as a result of the higher cash flow as a consequence of their tax exempt status.

Table 7.2 Taxation of National Pharmacies

Year	Reported profit (\$m)	Tax benefit from mutuality (\$m)	Mutuality benefit (% of reported profit)
1996–97	2.903	0.121	4.1
1997–98	2.962	0.278	9.4
1998–99	3.010	0.186	6.2
1999–00	3.242	0.410	13
2000–01	5.139	0.733	14

Source: National Pharmacies and the Allen Consulting Group

This measure suggests that National Pharmacies, in particular, has a cash flow advantage compared to some pharmacist-owned pharmacies, all other things being equal. However, Allens considers this measure is not necessarily reflective of the cash flow advantage accruing to all FSDs compared to pharmacist-owned pharmacies. In particular, small FSDs may not necessarily achieve these because the size of their operations is quite small and is considerably smaller than large FSDs such as National Pharmacies and the Community Pharmacy group.

Further, Allens considers that the ultimate significance of any competitive advantage arising from an improved cash flow should be examined on an industry-wide basis. To this end the Commission noted that the National Pharmacies group has less than 10 per

cent market share in South Australia, and would only represent around 1.2 per cent market share in the industry as a whole. Further, upon examining industry wide figures, it is important to note that the number of friendly society pharmacies currently represents only 2.4 per cent of the entire retailing pharmacy industry nationally, or 2.8 per cent of total turnover of the pharmacy market.⁵⁶ Allens is of the view that the significance of the competitive advantage on competition at an industry wide level is minimal as a result of an analysis of these market share figures.

7.1.2 Competitive disadvantages from the mutuality principle

While there is a benefit in the form of improved cash flow to some FSDs as a result of the principle of mutuality in relation to income taxation, a number of interested parties submit that there are other implications from being a mutual organisation which place FSDs at a competitive disadvantage compared to for-profit pharmacist-owned pharmacies.

Lack of corporate flexibility

The Commission considered a number of submissions from interested parties relating to the business structures available to pharmacist-owned pharmacies and FSDs. Upon considering the structures, it was evident that there are advantages and disadvantages in the various business structures available to both groups. While there are limitations on the way in which FSDs can operate their business, there are also some benefits attached to their structure. However, the same can be said for pharmacist-owned pharmacies.

As previously discussed, the business structures available to pharmacist owners of pharmacy are, to some degree, limited under the current legislation. These structures include:

- sole traders
- partnerships
- limited partnerships between a practising pharmacist or pharmacists and external sources of capital, provided those persons are also pharmacists
- bodies corporate in which all the shareholders and directors are pharmacists
- in some jurisdictions, bodies corporate in which pharmacists hold the majority of shares, with the balance held as non-voting shares held by specified relatives of the pharmacist.⁵⁷

56 Allen Consulting Group, *The Income Tax Treatment of Friendly Society Pharmacies and Other Competition Related Factors*, September 2002.

57 Again, it should be noted that while South Australia is the only jurisdiction in which non-pharmacist family members may have an interest in an incorporated company, the Wilkinson Review recommended that this be adopted by all jurisdictions, a view which it seems the COAG working party sees some benefit.

In this regard the Commission notes the comments made by National Pharmacies that ‘these restrictions were put in place by pharmacist-owners of pharmacy. If the restrictions are now creating some disadvantages for them, this is completely their own responsibility. They have the capacity to lobby and remove these restrictions at any time’.⁵⁸

The Commission also understands that, in some cases, pharmacy businesses are divided so that the dispensary side is kept separate from the front of shop side of the business, the latter of which may be incorporated. This may provide for beneficial tax treatment.

In contrast, FSDs are limited in the corporate structures available to them due to their mutual not for profit status.

In its submission, **AFSPA** told the Commission that the variety of business structures available to be used by pharmacist-owned pharmacies permit them to take advantage of differing forms of tax minimisation from higher individual income tax assessment rates.⁵⁹ AFSPA argues, for example, that sole traders and partnerships may exercise superannuation contributions to minimise their taxation liability; a trust structure distributes the income across a number of individuals, thereby having the income assessed at a lower income tax bracket; and dispensaries can be operated as a break even (or loss) concern through rents and management fees in order that all profit is generated in the (incorporated) shop structure, thereby attracting a lower income tax rate.⁶⁰

The Commission notes this view was also expressed in the COAG commissioned report by accountants Walter & Turnbull.⁶¹ In particular, that report stated that small to medium enterprises, which most pharmacist-owned pharmacies are, can operate under many business structures, where those structures may be used to meet the commercial (limitation of liability) and taxation objectives of the owners. Further, they reported that most privately operated small to medium enterprises (such as pharmacist-owned pharmacies) tend to allocate resources to taxation planning in an attempt to defer and or minimise taxation liability.⁶² The report concluded that depending on the method of business structure, a pharmacist could significantly minimise their taxation liability if the right business structure for their business is implemented.

APESMA also made comment in relation to the taxation of pharmacist-owned pharmacies. It noted that there are a number of taxation vehicles available to pharmacists to assist them to limit their taxation liability, for example, partnerships or service companies, which APESMA noted were not available to FSDs.

58 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, chapter 4, p. 8.

59 AFSPA submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 10.

60 AFSPA provided a number of examples in relation to potential minimisation schemes by way of types of business structures which are all legally valid structures able to be operated within the legislation.

61 Walter & Turnbull Report, *Comment on Issues in Respect to Competitive Position of Friendly Society Pharmacies*, September 2000, p. 6.

62 *ibid.*, p. 7.

In considering the points for and against both structures, APESMA made a comparison between the deductibility of expenses for both FSDs and pharmacist-owned pharmacies. They noted that while expenses related to dealings with members were not tax deductible for FSDs, private owners are able to write off all business expenses against their income.

National Pharmacies concurs that there are legitimate methods available to pharmacist-owners of pharmacy to minimise taxation liabilities. These include:

- family trusts
- service companies/trusts
- ownership of property
- pharmacy companies
- franking credits
- income splitting
- employment of family members and individual tax rates
- superannuation
- small business tax concessions
- capital gains tax concessions
- payroll tax.

For example, a family trust is where the ownership of the pharmacy is placed in a trust. The profit of the pharmacy may then be distributed through the trust to the pharmacist and other family members. Where there are members over the age of 18 (who do not have significant other income), the income can be distributed and taxed at the lower marginal individual tax rates, and hence, pay less tax than a FSD notwithstanding the alleged advantage mutuality provides an FSD.

Similar to a company trust, a pharmacist can establish a trust which owns the premises from which the pharmacy operates. Rent would be charged from the property trust to the pharmacy, generally at market rates. Any profits made by the property trust could be distributed to family members in order to take advantage of lower marginal tax rates.⁶³

On this point, the **guild** submits that it is not aware of the taxation structuring opportunities available to pharmacist owners of pharmacy. The Commission requested a further response to the above claims from the guild. The guild explained that since

63 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, appendix 4.3 (Deloitte Touche Tohmatsu Report on Tax Planning Opportunities for Pharmacist Owned Pharmacies).

amendments to the South Australian Pharmacist Act, allowing incorporation of pharmacy among family members, only 109 out of 388 pharmacies have adopted incorporation. Incorporation of pharmacies is currently not permitted in other states; only in NT and recently in the ACT. The guild believes family trust utilisation has limited opportunities in pharmacy, but has the capacity to reduce the tax rate to the company tax rate of 30 per cent.⁶⁴

Additional obligations of mutual organisations

It is submitted to the Commission that comparing the income treatment of FSDs with pharmacist-owned pharmacies in the absence of all other respects of their structures, implies that they are equivalent entities, which they are not. FSDs are different to pharmacist-owned pharmacies in that they are required to incur additional costs and undertake activities of a non-commercial nature so as to provide service to its members, for example.

In particular, **National Pharmacies** submits that to become a mutual organisation and to obtain any tax benefit that might arise as a result, an organisation must take on a range of costs and responsibilities which are implicit in being a not-for-profit mutual organisation. These implications include:⁶⁵

- Issuing share capital is the cheapest and most accessible method of obtaining funds for any organisation. Mutual organisations have limited ability to obtain funds because they are unable to issue shares and still remain mutual in character.

A mutual organisation is further limited in obtaining funding by their lack of ability to service any borrowing due to their not-for-profit nature and supporting equity to form an asset base.

This lack of access to funding, and the restrictions it creates on their ability to compete, is the main reason that mutual organisations de-mutualise.

- National Pharmacies, with approximately 150 000 members, qualifies as a large public company. Accordingly, the Corporations Act imparts on it specific corporate compliance costs, which are not incurred by pharmacist-owners of pharmacy. For example, registration with ASIC, appointment of professional directors and engaging a registered company auditor.
- Costs associated with member obligations including membership brochures, magazines and the costs of issuing membership cards.
- National Pharmacies is legally required to keep its list of members in a shareholder register. Pharmacist owned pharmacies are not required to provide details of their customers on public record.

64 Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, September 2002.

65 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, chapter 4, p. 16.

- The financial accounts of mutual organisations have to be published on an annual basis. The results of pharmacist owned pharmacies financial figures do not have to be published.

Analysis of submissions

Allens considers a competitive advantage available to pharmacist-owned pharmacies is their ability to choose a corporate structure so as to minimise their overall taxation liability, using trusts for example. In contrast, FSDs are limited in the corporate structures available to them due to their mutual not-for-profit status. This flexibility to obtain tax advantages relative to FSDs would neutralise any competitive advantage provided to FSDs as a result of the principle of mutuality and subsequent income tax exemption on mutual gains.

Allens also advises that corporate pharmacist-owned pharmacies in particular are able to pass on franking credits to shareholders, which can either be claimed as a tax credit against dividend or other income, or paid as a cash rebate in the case of low-income earners. In contrast, while in theory friendly society pharmacies could pass on franking credits, this would require a distribution to members. However, friendly society pharmacies would be unlikely to (and indeed, seldom) make distributions as this would threaten their friendly society status. Accordingly, the tax paid on FSDs' non-mutual gains is 30 per cent whereas pharmacist-owned pharmacies have the ability to distribute income to various shareholders, such as family members, so as to reduce the overall marginal rate of tax paid so that it is lower than 30 per cent.

This different tax treatment in relation to franking credits neutralises some of the competitive advantage provided to friendly societies as a result of the principle of mutuality and subsequent income tax exemption on mutual gains.

Similarly, Allens believes any competitive advantage arising from the different taxation treatment of FSDs would be neutralised by a number of small business capital gains tax concessions available for entities with a net asset value of \$5 million or less, including:

- 15-year asset exemption—that is, capital gains may be fully exempt from income tax if asset owned by the pharmacist for 15 years
- 50 per cent reduction for active assets—that income tax is only imposed on half the capital gain of a small business (including goodwill)
- retirement exemption—capital gain may be fully exempt from income tax, provided that retirement exemption does not exceed the \$500 000 limit
- roll-over—capital gain is deferred, although above exemptions may be applied on subsequent sale of the business.⁶⁶

⁶⁶ CCH, *Australian Master Tax Guide 2002—Mid Year Edition*, 30 June 2002 chapter 13-005 to 13-030, pp. 609–617.

Pharmacist-owned pharmacies, and in particular sole traders and partnerships, would generally be eligible for these concessions, although friendly societies are unlikely to be eligible due to their size of operations. In addition to the above concessions, a capital gain earned by an individual (that is, a sole trader or partnership) may also be discounted by 50 per cent.

These capital gains tax concessions mean that for a given before tax capital gain, FSDs will have a lower after-tax capital gain than their eligible pharmacist-owned pharmacies, thereby placing friendly society pharmacies at a relative competitive disadvantage.

Finally, Allens considers that non-tax exempt entities also have a greater ability to benefit personally from profits via distributions, relative to mutual entities.⁶⁷ That is, a sole trader, a partner of a partnership and a shareholder of a for-profit company receives the profits from the operation of the pharmacy. This is because although an FSD can provide a return to shareholders, this cannot be the dominant purpose of the friendly society pharmacy if its mutual status is to be retained. Again this benefit neutralises some of the income taxation advantage accruing to FSDs due to their mutual nature.

Conclusion on mutual tax treatment

The Commission recognises the income taxation treatment of FSDs differs from pharmacist-owned pharmacies. While it has been found that there is a minor tax distortion, specifically in relation to a cash flow advantage, placing some (larger) FSDs at a competitive advantage over pharmacist-owned pharmacies, the Commission considers this ultimately to be insignificant when the fractional market share figures of FSDs is taken into account. The Commission considers it possible for pharmacist-owners of pharmacy to obtain similar taxation benefits enjoyed by FSDs by utilising a variety of tax minimisation arrangements, such as family trusts.

The Commission is of the view that given the current restrictions in place by way of legislation in each jurisdiction, FSDs are unlikely to ever become a dominant player in the industry. Further, taking into consideration the recommendations arising out of the Wilkinson Review, it is also the Commission's view that any legislative changes that are made in line with the recommendations are also unlikely to result in FSDs acquiring significant market shares so as to dominate the industry.

In addition, upon consideration of all the implications of being an FSD and operating in accordance with the principle of mutuality, the Commission considers that the extent of any competitive advantage accruing to FSDs as a result of their mutual tax treatment is neutralised by other offsetting factors (such as other taxation structures able to be implemented by pharmacist-owned pharmacies) found to place FSDs at a competitive disadvantage when compared to some pharmacist-owned pharmacies.

⁶⁷ Industry Commission, Industry Commission, *Charitable Organisations in Australia*, report number 45, 16 June 1995, AGPS, Melbourne, p. 313.

7.2 Other competition related factors

The Commission's reference to carry out this report required it to also examine 'other competition related factors' in assessing whether friendly society dispensaries have a significant competitive advantage over pharmacist-owned pharmacies. In order to consider what competition factors may be relevant, the Commission requested interested parties to address this issue in submissions provided to the Commission, and also sought advice from the Allen Consulting Group.

In putting forth its views in relation to other competition related factors that should be considered as part of the Commission's review, **AFSPA** considers that:

...the community pharmacy industry is very highly regulated and the barriers to entry into the industry are particularly high. The controls relating to approvals to open new pharmacies and the location and relocation Rules as negotiated by the Guild with the Commonwealth under the Agreement process provide a level of protection between pharmacy owners from competition within each other's market. These factors combined with the limited range of transactions where discounting is allowable, reduces the scope for competition even further. Accordingly, it could be expected that the surplus income of either the for-profit entity or the not-for-profit one should be sufficient to ensure competitive capacity between entities.⁶⁸

The **guild** believes that National Pharmacies already has a structural advantage over other community pharmacies. In particular, the guild believes that due to its large sophisticated structure, National Pharmacies has been able to set up its own wholesaling operation and buy large quantities of goods direct from manufacturers. The guild considers that this gives National Pharmacies purchasing power over other community pharmacies.

Further, the guild regards the tax benefit that National Pharmacies has enjoyed over the years has assisted the pharmacies in its group to develop into high-turnover retail outlets and, in particular, the guild believes the tax treatment has enabled National Pharmacies to expand its numbers.⁶⁹

National Pharmacies submits that that competitive factors such as economies of scale are open to all pharmacies, if they chose to use their own individual competitive advantages to the best of their ability.

Economies of scale relate to volume within a single pharmacy, not through the number of pharmacies owned. Increasing numbers owned by a single operator does not provide in itself a competitive advantage...The cost leadership strategy, and our differentiation strategies are both followed by other successful pharmacist owners of pharmacy to varying degrees, with Terry White Chemists being a very good example of a banner group achieving benefits from similar strategies...Mutuality, taxation etc do not determine the success of National Pharmacies or any Friendly Society pharmacy, but managing a successful competitive strategy provides this success.⁷⁰

68 AFSPA submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 16.

69 Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, September 2002, p. 3.

70 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, chapter 6, p. 8.

National Pharmacies indicated that a number of day to day considerations can also determine the likely success of a competitor in the industry, regardless of whether the pharmacy is a friendly society or pharmacist-owned. These factors include:

- diverse product range
- central location
- store range layout
- trust from customers
- extended operating hours
- store ambience
- quality of service
- staff training.

COSBOA believes that, for the smaller sized FSDs, the competitive advantage of having no tax on its profits is only a direct benefit to its members in the form of discounts that they receive as members.

In the case of the large FSD that has many sites, COSBOA considers the competitive advantage would be in its ability to purchase new sites. However, it acknowledges there are currently legislative restrictions in doing so in many states of Australia. In addition, the competitive advantage by achieving greater discounts on volume purchases would be equivalent to similar community pharmacy buying groups achieving the same outcome. The effect being that both large FSDs and other community pharmacies are able to offer similar discounts to consumers; however, the additional benefit of non-distribution of profits will go to the FSDs members as indicated previously.⁷¹

The **PSA** considers that other competition related factors would not have an effect on the net competitive advantage or disadvantage to FSDs. Further, if there were to be any net disadvantage to FSDs from other competition related factors, the PSA believes it would be small and not sufficient to compensate for the tax advantage created under mutuality arrangements.⁷²

The following is a discussion of the factors that were raised in oral consultations and written submissions by the various parties.

71 COSBOA submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 2.

72 Pharmaceutical Society of Australia submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 2.

7.2.1 Discounting

The **department** submits that there appears to be no significant advantage to FSDs from the extent of discounts offered to members. On this issue the department added that it was important to distinguish between items that could be discounted, and those that can not, particularly where PBS medicines were concerned. The department acknowledged that FSDs are able to discount private prescriptions; however, the department noted that the majority of prescriptions (filled in a pharmacy) are for PBS subsidised medicines, which, unless it is specified in the legislation, are unable to be discounted by any pharmacy.

Whilst the department acknowledged that PBS medicines may only be discounted by FSDs where specifically allowed by the legislation. Discounts could also be offered by pharmacist-owned pharmacies if they chose to do so.

AFSPA noted that not only members benefit from the discounts offered by friendly society dispensaries:

...Members (and the community) benefit from this (the application of the mutuality principle) by receiving discounts on all 'front of shop' transactions and the costs of private prescriptions...Not-for-profit entities do not participate in business activities for the same commercial purposes and reasons as for-profit entities. Their purpose is to serve their members and their communities and any surplus income goes back into the business to fund asset replacement and the services they provide.⁷³

The **guild** discussed the issue of discounting throughout its submission to the Commission. However, their argument centred around the National Pharmacies group rather than making specific comments in relation to FSDs in general. It is worthwhile noting that some mention was also made of the discounting habits of another FSD group, Community Pharmacy. In relation to Community Pharmacy, the guild stated that:

This Friendly Society is aggressively seeking to attract new 'members' by offering the same benefits which would be received by Friendly Society 'members'; that is discounts of 15% and 30%, to members of other Member Based Organisations such as credit unions. (The advertising brochures) demonstrates the emphasis this group places in their advertisements on the discounted prices which are available to their 'members'.⁷⁴

The point the guild wishes to note here is that by becoming a member of one friendly society affiliated with the Community Pharmacy group would entitle a member of the affiliated friendly society to obtain member benefits when shopping at a Community Pharmacy store. They consider that such a benefit should not be able to be obtained unless members specifically join the Community Pharmacy group, not just an affiliated friendly society.

In relation to National Pharmacies, the guild added that the discounts are provided because of the tax benefits received by National Pharmacies under the mutuality principle. Further, the guild believes that the discounts are the means by which

73 AFSPA submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 12.

74 Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, September 2002, p. 14.

National Pharmacies provides benefits to its members, or returns income to its members as part of its mutual status. The guild considers that without mutuality, and if tax were paid on all income received at the normal company rate, the discounts offered by FSDs would not be given.⁷⁵

The guild made a number of statements in relation to the discounting habits of National Pharmacies, in particular the fact that National Pharmacies appears to employ an ‘aggressive advertising campaign’. The guild believes that National Pharmacies is able to offer discounts to members because of its tax treatment, which the guild considers operates to the detriment of other community pharmacies in that it places those other community pharmacies at a competitive disadvantage.⁷⁶

The guild told the Commission that:

Advertising of significant discounts by a group of 31 pharmacies like National Pharmacies in South Australia, aims to create a perception in the mind of consumers that there are significant cost savings to be achieved by shopping at these pharmacies. The offer of a 20% discount on ordinary retail goods is very attractive, even though there is no mention of the price from which the 20% is deducted. Discounting in some cases in fact may be a perception rather than a reality. For example, National Pharmacies offers 30% off private prescriptions. The Arrow pricing model adopted by many other community pharmacies is cost plus 15 to 20% plus a dispensing fee of \$4.50. The National Pharmacies formula is generally cost plus 70% plus a dispensing fee less 30%.⁷⁷

In the above circumstance the Commission is of the view that pharmacist-owned pharmacies should be able to counter this alleged perception by way of utilising their own advertising in order to show that goods and services advertised by FSDs may be purchased from pharmacist-owned pharmacies at a competitive price. The Commission is of the view that such counter-advertising would neutralise the perceived price differences.

The guild also told the Commission that it was as a result of advertising discounts, that National Pharmacies has an advantage over other pharmacies, as it has created a perception in the marketplace that prices in National Pharmacies stores are lower than in other community pharmacies. The guild added they believe that because of the current tax treatment of National Pharmacies, goods are discounted in a way which gives these pharmacies a significant competitive advantage in the marketplace over other community pharmacies. The guild argues that if community pharmacies were to try to match the prices offered at National Pharmacies stores, it would be at the community pharmacists own expense and not at the expense of the taxation system.⁷⁸

75 *ibid.*, p. 19.

76 *ibid.*, p. 3.

77 *ibid.*, p. 13.

78 *ibid.*, p. 4.

Conclusion on discounting

While there was strong argument from the interested parties representing the interests of the FSDs that discounts are not a competitive advantage, there must be some acknowledgment of the fact that, generally speaking, FSDs do have an edge in discounting products sold in their pharmacies. However, the issue of discounting in a pharmacist-owned pharmacy will ultimately come down to commercial decisions of individual businesses. That is, some individual pharmacists may see a benefit arising where discounts are offered to customers in that discounts may encourage repeat patronage among consumers.

The Commission notes that loyalty programs that offer discounts among the various banner groups, i.e. pharmacist-owned pharmacies, are common in the industry. Loyalty groups operate in similar ways to larger FSDs in that a consumer can join a loyalty group and then receive discounts on particular items when shopping with that brand of pharmacy. For example, some banner groups offer baby clubs or seniors discounts on a variety of different items within the pharmacy.

In this regard the Commission notes the 'Friendlies Chemists' banner group (consisting of pharmacist-owned pharmacies) operating in Western Australia, is not associated with FSDs, despite its name. This group offers membership to a loyalty program to consumers at a cost of \$11 annually, and in return consumers receive a 15 per cent discount on non-PBS sales.

While the Commission notes the guild's concerns with regard to the advertising of discounts, the Commission is of the view that advertising can play a positive role in providing some quality and price information needed by consumers. Advertising must be accurate, and not misleading or deceptive. While the Commission is keen to see factual information provided to consumers, it is of course imperative that the information provided is honest, accurate and complete.

The Commission considers that any advertisement that complies with government regulations (in relation to the content of advertising) and is not misleading or deceptive, is useful in providing consumers with information as to the availability of goods or services offered by an organisation. The Commission is of the understanding that the advertisements that most FSDs tend to use to advertise their discounts are within the scope of what the government considers permissible advertising in relation to medicinal (pharmaceutical) products.

Further, to assist the health sector, and professionals in general, in preparing advertisements for goods sold or services offered, the Commission has issued a number of publications to be used by professionals as a guide for constructing honest and accurate advertising, including the *Fair Treatment* and *Advertising and Selling* publications.

7.2.2 Capital raising ability

As part of the consultation process the Commission sought comment from the main stakeholders about their views on the capital raising ability of different types of pharmacies, and whether the parties considered that this would have an impact on an entity's ability to compete against other pharmacies. The Commission also sought input from Allens to this effect.

National Pharmacies argues that both itself and FSDs in general have limited capacity to purchase pharmacies due to both number restrictions and capital raising ability. National Pharmacies noted that while issuing share capital is the cheapest and most accessible method of obtaining funds for an organisation, it stated that mutual organisations have a limited ability to obtain funds because they cannot issue shares if they are to remain a mutual organisation. National Pharmacies considers that the lack of access to funding and the restrictions it creates on a mutual's ability to compete is the main reason that mutual organisations (in general) de-mutualise.⁷⁹

In their submission National Pharmacies stated that:

A Friendly Society is limited in its ability to raise equity and therefore must raise borrowings, whereas a pharmacist owner of pharmacy can obtain equity from personal assets, family or friends to build their capital base.⁸⁰

In relation to the issue of financing, the **guild** commented that FSDs like National Pharmacies do not use finance as they have adequate cash reserves. The guild considers that given FSDs have no dividend policy or member return, their effective cost of capital is 0 per cent compared to current market rates for pharmacy finance of between 7.5 and 9.5 per cent. The guild considers that this is a competitive advantage that FSDs such as National Pharmacies have over pharmacist-owned pharmacies.

Analysis of submissions

Allens considers the capital raising ability of both a sole trader and partnership-structured pharmacist-owned pharmacies are limited relative to incorporated companies, which are able to attract outside investors. Although friendly societies are able to have a mix of mutual members and investor shareholders, their purpose is limited in that returns to shareholders cannot be a dominant purpose. Therefore, in terms of capital raising ability:

- friendly society pharmacies are placed in a competitive disadvantage compared to incorporated corporate pharmacists, while
- sole traders and partnership structured pharmacist-owned pharmacies are placed at a competitive disadvantage compared to friendly society pharmacies.

⁷⁹ National Pharmacies provided the example of the recent de-mutualisation of AMP to impress their point.

⁸⁰ National Pharmacies Submission to the ACCC Review of Friendly Society Dispensaries, August 2002, chapter 3, p. 19.

Conclusion on capital raising ability

The Commission considers that given that capital raising ability is also often a function of the rate of return to capital from investors' investment and given that friendly society pharmacies have a limited ability to make returns to shareholders, the identified capital raising advantage noted in the advice provided by Allens relative to sole traders and partnership structured pharmacists is not considered to be significant.

Further, the Commission considers that pharmacy businesses in general, be it an FSD or a pharmacist-owned pharmacy, are likely to encounter difficulty in raising capital in that the majority of the value of a pharmacy business is goodwill and, generally speaking, banks and other financial institutions are usually unwilling to lend significant amounts of money to a pharmacy business on the basis of goodwill. However, the Commission also notes that pharmacist-owned pharmacies have far greater opportunities to raise capital with the assistance of the major pharmaceutical wholesalers by way of security guarantees, whereas this opportunity is not generally afforded to most FSDs (see 7.2.5).

7.2.3 Banner groups

As noted previously, while National Pharmacies are considered by some in the retail pharmacy industry to be a chain of FSDs, similar groups also exist amongst pharmacist-owned pharmacies. Instead of chains, they operate in the form of a banner group which is usually associated with one of the main wholesalers, although some banner groups are wholly independent. Examples of banner groups operating within the industry include Amcal, Terry White Chemists, Pharmacist Advice, My Chemist, Blooms and Health Sense.

In their submission to the Commission, **National Pharmacies** noted that, similar to the benefits it is able to achieve due to its size, banner groups enable pharmacists to 'take advantage of the strength of combined numbers and economies of scale.'⁸¹

The **department** supports this view, and referred the Commission to the government's submission to the Wilkinson Review which stated ⁸²:

... through franchise arrangements, a significant number of pharmacist-owned community pharmacies (compared with FSDs) also derived benefits of economies of scale associated with bulk purchasing power, corporate advertising, and other marketing activities. Franchise arrangements, combined with the management support role provided by pharmaceutical manufacturer and wholesaler organisations, also mean that pharmacist-owned pharmacies are not working in a vacuum in terms of keeping up to date with best practice in business management. The powerful management support role played by the Guild in improving the business practices of their members is relevant to their competitiveness and market position.

81 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 9.

82 Department of Health & Ageing submission to the National Competition Policy *Review of Pharmacy*.

The **guild** submits that in order to join a banner group, individual pharmacists need to abide by store layout, colour scheme, logos and participate in promotional products and advertising. Member pharmacies are also required to pay a fee, which vary from \$14 000 to \$50 000 per annum. It adds that the banner groups are not established as buying groups but are marketing groups. Manufacturers provide discounts on the collective volume from the banner group members and in return get exposure through catalogues and newspaper advertising.

The Commission notes it is possible for an individual pharmacist to set up their own banner group. The ‘Terry White Chemists’ banner group before selling to Faulding (now part of the Mayne group), is a successful example of this. At one time Warren Harrison, a pharmacist, owned 19 pharmacies across Australia and became part of the Terry White banner group in 1999. On joining the group Mr Harrison noted that:

... patients and customers want reliability, consistency, excellence and quality. This can only come from creative discipline. I believe the Terry White Chemists team is the only organisation in pharmacy which is anywhere near delivering that and I am proud to be joining them ...⁸³

Table 7.3 below outlines the number of Pharmacy Guild members that belong to one of the recognised banner groups across Australia, and also the number of its members that belong to a banner group in South Australia where those pharmacies are in competition with the National Pharmacies group of friendly society pharmacies.

Table 7.3 Pharmacy marketing group membership

	National	South Australia
Amcal	396	47
Chemmart	235	48
Chemworld	147	12
Guardian	263	12
Terry White	100	4
* Soul Pattinson	228	3
Healthsense	92	13
API Healthcare	163	0
** National Pharmacies	39	31
*** Chemplus	46	46
My Chemist	41	2
	1720	218 out of total 388 pharmacies
+ Sundry	500	

Source: Pharmacy Guild of Australia additional submission to the ACCC.

Notes: * 16 of members are engaged in combined wholesale/retail activity.

** all 39 members are engaged in combined wholesale/retail activity.

*** 41 members are engaged in wholesale (part)/retail activity.

83 As adapted from the National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries chapter 3, p. 15, referring to an article in the *Retail Pharmacy* magazine in February 1999.

It is interesting to note that while the guild has highlighted the fact that there are 31 National Pharmacies stores operating in South Australia, this is not the largest banner group in operation. Amcal, Chemmart and Chemplus all have more than 10 additional stores operating in that jurisdiction compared to National Pharmacies.

Analysis of submissions

Allens considers that pharmacist-owners of pharmacy are able to join together in order to obtain equivalent economies of scale in purchasing and advertising to that experienced by some larger FSDs, thus enabling them to compete with their rivals. This is currently seen in the industry in the formation of buying groups and banner groups.

Conclusion on banner groups

Given the ability of pharmacist owners of pharmacy to combine together to achieve the benefits from economies of scale, which is normally achieved via larger sized entities, there is not a competitive advantage favouring FSDs at the expense of pharmacist-owned pharmacies. That is, pharmacist-owned pharmacies have an ability to operate within a chain and therefore achieve similar benefits to groups such as National Pharmacies or the Community Pharmacy group.

7.2.4 Volume purchases and buying groups

Individual pharmacy owners are also able to join together to obtain more favourable purchasing deals from wholesalers by joining a buying group.

A buying group may be made up of a small or large group of individual pharmacists for the purpose of purchasing some or most of the goods they require on a daily basis (excluding PBS items) for a discounted rate from the three major wholesalers, that being Sigma, API and Mayne. By being part of a buying group, the pharmacist is likely to obtain a higher percentage discount for high volume purchases than would otherwise be obtainable if they sought to purchase goods from the wholesaler themselves.

The Walter & Turnbull Report commissioned by the COAG working party noted that:

...due to National Pharmacies size, it appears this factor alone creates certain advantages to pharmacies operated by this organisation. Operating as a combined body, the National Pharmacies can use their combined “forces” to better leverage its position in the pharmacy market place with regard to such things as greater purchasing power, pricing and corporate governance...It is recognised that these are contributing factors that enable the National Pharmacy [sic] to provide concessions to its members, and consequently presents a competitive advantage that is not enjoyed by privately owned pharmacies.⁸⁴

84 Walter & Turnbull Report, Comment on Issues in Respect to Competitive Position of Friendly Society Pharmacies, September 2000, p. 8.

However, **National Pharmacies** provided some comment to the Commission in relation to whether buying groups and bulk buying enabled a community pharmacist to be able to achieve similar purchasing power to that alleged against National Pharmacies by other parties. National Pharmacies submitted that pharmacist owners of pharmacy often combine together to take advantage of economies of scale with assistance from the wholesalers, banner groups and buying groups, all of which National Pharmacies believe have developed systems and methodologies to allow pharmacist-owned pharmacies to obtain benefits of scale, through combined efforts.⁸⁵ National Pharmacies stated that:

The wholesalers such as Faulding also set up their own buying groups to restrict competition. The Faulding group is called 'Theme Promotions' and we understand 'Buyrite' is the API buying group. The purpose of the buying group is not only to obtain buying power for pharmacist owners of pharmacy on some purchases but also to give non-banner group pharmacist owners of pharmacy a range of promotional products that they can advertise under their own name. In the process this reduces the number of independent buying groups and the competition they generate to the wholesalers.⁸⁶

Analysis of submissions

Upon considering the issues raised in the submissions, Allens was of the view that some pharmacists join together in groups to obtain better purchasing power from suppliers, and in some cases set up their own warehouses to manage the stock purchased. As a result of this, Allens considers that this provides pharmacist-owned pharmacies with the ability to combine together to benefit from economies of scale, which is normally achieved via larger-sized entities.

Conclusion on volume purchases and buying groups

The Commission considers that as a result of the ability of individual pharmacists to join together in the form of a buying group to achieve volume discounts, and benefits such as economies of scale, there is no competitive advantage favouring friendly society dispensaries at the buying group and volume purchasing level at the expense of pharmacist-owned pharmacies.

7.2.5 Wholesalers

The Wilkinson Review discussed the nature of the involvement between wholesalers, distributors and retail pharmacy. It was noted that the pharmaceutical wholesale sector was concentrated in that three main participants controlled the industry, that being F H Faulding and Co (now part of the Mayne Nickless group), API and Sigma.⁸⁷

85 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, chapter 3, p. 1.

86 *ibid.*, p. 9.

87 Final Report National Competition Policy Review of Pharmacy February 2000. p. 17.

The Wilkinson Review noted that

the major wholesalers depend heavily on a diffuse community pharmacy network placing constant orders, and work hard to protect their considerable investment and exposed risk by nurturing strong relationships with individual pharmacy businesses and individual pharmacists.⁸⁸

National Pharmacies provided information in their submission to the Commission that a number of smaller wholesalers exist in Australia, and include groups such as Chemplus, SWAPS, Mutual Buying Group, My Chemist, Barrett Distributors, Lasco and Blooms. National Pharmacies note though that in total all the small wholesalers including National Pharmacies have less than 5 per cent of the total wholesale market. Of this 5 per cent, National Pharmacies has approximately 1.4 per cent market share.⁸⁹

Most community pharmacies receive at least one delivery per day from the wholesalers who distribute PBS listed drugs, non-PBS drugs which are classified as pharmacy only products⁹⁰, and general pharmacy supplies (such as paracetamol and aspirin).

The Wilkinson Review went on to mention the activities in which wholesalers participate with community pharmacies and noted the following:

- sponsoring and managing ‘banner groups’ of pharmacies, for example, Amcal. Although they have the outward appearance of franchise operations, the groups provide their services, signage and support arrangements to pharmacists for a fixed fee, thereby allowing participating pharmacies to remain ‘independent’ and not tied formally to the wholesaler
- developing positive arrangements with young and growing pharmacy businesses by standing as guarantors for pharmacy business improvement and start-up loans
- promotional activities, such as sponsoring professional and business training and continuing education for pharmacists and their staff, either directly or through professional bodies such as the Pharmaceutical Society of Australia.⁹¹

In relation to the second point noted above, a pharmacy broker informed the Wilkinson Review that the guarantee arrangement offered by the wholesalers makes pharmacy business proposals very attractive to banks as lenders. The Commission sought comment from the major wholesalers in Australia with respect to the terms of the Commission’s reference. No response was provided to the Commission, therefore the Commission does not have a response from the wholesalers with respect to the above point.

88 *ibid.*, p. 18.

89 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 8.

90 Such as Schedule 3 drugs which can be sold over the counter with approval of the dispensing pharmacist.

91 Final Report National Competition Policy Review of Pharmacy February 2000, p. 18.

As part of their submission **National Pharmacies** provided points in relation to what services it believes the major wholesalers provide pharmacists. Those points included:

- pharmacy guarantees—where a wholesaler will give a guarantee to a bank or financial institution supporting the debt of a pharmacist. In return the wholesaler takes over the security for the assets of the pharmacy
- plannogramming— where a wholesaler provides layouts of the best display of their products on the pharmacy shelves in order to allow a pharmacy to maximise sales
- pharmacy refurbishments— where a wholesaler assists pharmacists to develop new store layouts to maximise their sales
- banner groups for marketing of products and purchasing power.⁹²

National Pharmacies also stated that wholesalers provide financing and support to pharmacists to purchase and sell pharmacies on a non-commercial basis to maintain artificially created levels of goodwill. The pharmacists obtain further profit from the growth in their goodwill arising from this arrangement, and the wholesalers use the arrangement to protect their market share.⁹³

National Pharmacies considers that as financing in the pharmacy industry is one of the major issues of competitive advantage for pharmacist owners of pharmacy, the fact that wholesalers will provide non-commercial financing for the purchase of pharmacies can bolster their market share and provide security for loans based upon significant levels of good will.⁹⁴

As noted above in the conclusion on capital raising ability, National Pharmacies argues that because the banks generally will not lend against good will, and while the wholesalers will provide security to individual pharmacists in order for them to secure bank loans, wholesalers are generally unwilling to provide such arrangements to FSDs, but in particular will not provide these arrangements to National Pharmacies as the wholesalers see National Pharmacies as a direct competitor to their wholesaling businesses.

The Commission considers that this arrangement may result in a competitive disadvantage to FSDs if, because their mutual structure generally limits the way in which FSDs can raise capital, FSDs are unable to secure these favourable terms offered by the wholesalers.

92 National Pharmacies submission to the ACCC Review of Friendly Society Dispensaries, August 2002, p. 8.

93 *ibid.*, chapter 3, p. 1.

94 *ibid.*, p. 18.

National Pharmacies informed the Commission that as a result of various conduct by the major wholesalers, National Pharmacies was forced to set up its own wholesaling operations in order to continue business. National Pharmacies stated in their submission that:

Historically National Pharmacies was affected by the limited competition in the wholesale market as only Sigma, a co-operative, and Faulding operated in South Australia. As a result we had only Faulding as a serious option as our supplier of wholesale goods, and limited competition for this supply restricted our ability to obtain competitive wholesale prices. We therefore determined that we needed a Wholesale Dealers Licence to achieve the benefits of economies of scale.⁹⁵

The **guild** argues that National Pharmacies has the ability to achieve significant advantage compared to pharmacist-owned pharmacies by way of its purchasing power through its operations as a wholesaler. In the guild's submission, they noted the following:

The purchasing powers of National Pharmacies has enabled them to operate an "in-house" wholesaling division buying at wholesale prices ex-manufacturer to supply their own pharmacies. This gives them a 10-17% advantage over many independent pharmacies that rely on the full-line wholesalers, API, Sigma and Mayne/Faulding. Currently in South Australia National Pharmacies has 17% of the market share for their 31 pharmacies. Chemplus, a banner group with 46 pharmacies, has 14%, Sigma 20%, API 15% and Mayne 15%. This in-house operation does not incur the same level of costs as those of a full-line wholesaler and gives them some advantage over the latter in this respect.⁹⁶

The Commission put the figures of 10–17 per cent benefit to National Pharmacies, and in their response National Pharmacies said that while this figure may be appropriate in theory, it is unlikely that any such benefits would be realised once costs were taken into account. That is, once employment costs, plant and equipment costs, stock management costs and the like were taken into account, a claim of a benefit of 10–17 per cent on non-PBS items would be unreasonable therefore reducing any margin available to be made.⁹⁷

National Pharmacies said that the level of return on capital barely justifies their wholesaling investment. They added that they invest due to the competitive dynamics of the industry resulting from competition from pharmacist-owned pharmacies.

95 *ibid*, chapter 5, p. 2.

96 Pharmacy Guild of Australia submission to the ACCC Review of Friendly Society Dispensaries, September 2002, p. 12.

97 During a consultation session with National Pharmacies, the Commission was shown extracts of contracts between National Pharmacies (as a wholesaler) and the manufacturers of pharmaceutical products in order to provide the Commission with some information on what margins National Pharmacies wholesaling business received. These figures, while commercially sensitive, indicated to the Commission that it was unlikely that the benefits claimed by the guild were actually being realised by National Pharmacies.

The **PSA** noted in its submission that:

A particular issue which arose in discussion with the Commission is whether FSDs receive more or less favourable treatment from wholesalers (commercial terms, service etc). While we have not made extensive inquiries, we have no reason to believe that there is any difference in treatment in this respect, other than any difference that exists with all pharmacies related to the size of the business.⁹⁸

Analysis of submissions

While Allens did not make specific comment in relation to the habits of wholesalers in the industry, and the effect that their actions may have on competition among the participants in the industry, Allens did note that the buying groups and banner groups that were formed as a result of the wholesalers influence contributed to pharmacist-owned pharmacies not being competitively disadvantaged compared to groups such as National Pharmacies and Chemplus, who had set up their own wholesaling operations.

Conclusion on wholesalers

The Commission considers that it is important to note that any pharmacist can join other pharmacists in setting up and running a warehouse for a wholesaling operation. In South Australia, Chemplus is a group of pharmacists who run a promotional group with a larger membership than National Pharmacies. The Chemplus group also run their own warehouse. In Victoria, Blooms and Barretts are groups of pharmacist-owned pharmacies that run their own warehouses to supply their own stores. These pharmacists are also part of banner groups that may offer other additional benefits (see paragraph 7.2.3).

Further, the Commission considers that the favourable financing offers made to pharmacist-owned pharmacies may result in a competitive disadvantage to most FSDs.

7.3 Summary

The following table prepared by Allens is a summary of the Commission's view with respect to advantages and disadvantages arising to each group from assessment of the taxation treatment of the various groups, and consideration of other competition related factors.

98 Pharmaceutical Society of Australia submission to the ACCC Review of Friendly Society Dispensaries, p. 2.

Table 7.4 Summary of assessment of advantages and disadvantages for both friendly society dispensaries and pharmacist-owned pharmacies.

	Sole trader	Partnership	Incorporated company	FSDs
Favourable income tax treatment	✘	✘	✘	✓
Ability to pass on franking credits	n.a.*	n.a.*	✓	✘
Corporate flexibility and tax minimisation	✓	✘	✘	✘
Favourable capital gains tax treatment	✓	✓	✓/ ✘	✘
Distributions to individuals	✓	✓	✓	✓
Capital raising ability	✘	✘	✓	✘
Wholesalers as a source of capital	✓	✓	✓	✘
Economies of scale (buying groups and banner groups)	✓	✓	✓	✓

Source: The Allen Consulting Group

* This factor is not applicable to this particular group by way of its business structure. Note: A tick (✓) symbolises an advantage while a cross (✘) symbolises a disadvantage.

The table above shows that for certain groups there may be a number of competitive advantages and disadvantages accruing to that particular group. For example, under favourable income tax treatment, it is acknowledged that FSDs do receive some advantage compared to the different types of pharmacist-owned pharmacies.

In contrast, FSDs may suffer a competitive disadvantage compared to pharmacist-owned pharmacies in certain other criteria. For example, in relation to wholesalers as a source of capital, FSDs are at a competitive disadvantage compared to the pharmacist-owned pharmacy structures.

Therefore, upon analysing the information contained in this chapter, and by way of a summary in the above table, the Commission considers that FSDs do not have significant competitive advantages, as a result of tax treatment or other competition related factors, compared to pharmacist-owned pharmacies.

8. Conclusion

The reference provided to the Commission from the Treasurer required the Commission to examine the tax treatment of friendly society dispensaries, and other competition related factors, in order to assess whether FSDs have a significant competitive advantage as a result of their taxation situation.

When examined either at the individual business level or on an industry-wide basis, the Commission considers that the impact on competition from the mutual tax treatment of FSDs and other competition related factors is not significant.

Competition between individual community pharmacies

The Commission recognises the income taxation treatment of FSDs differs from pharmacist-owned pharmacies. While it has been found that there is a minor tax distortion, specifically in relation to a cash flow advantage, placing some (larger) FSDs at a competitive advantage over pharmacist-owned pharmacies, the Commission considers any such advantage is not significant.

In particular, the Commission considers it possible for pharmacist-owners of pharmacy to obtain similar taxation benefits enjoyed by FSDs by utilising a variety of tax minimisation arrangements, such as family trusts. The Commission acknowledges that generally speaking, FSDs do have an edge in discounting certain products sold in their pharmacies; however, the issue of discounting in a pharmacist-owned pharmacy, and indeed any business, will ultimately come down to commercial decisions of individual businesses. The Commission notes that loyalty programs, which offer discounts to customers of the various banner groups (that is pharmacist-owned pharmacies) are common in the industry, for example, the 'Friendlies Chemists' banner group, in Western Australia, offer discounts on non-PBS sales.

Competitive dynamics of community pharmacy

The Commission also considers that any competitive advantage arising from the improved cash flow of some larger FSDs, to be ultimately insignificant when the fractional market share figures of FSDs, being 2.5 per cent nationally, is taken into account.

The Commission is of the view that given the current legislative restrictions in each jurisdiction, FSDs are unlikely to ever become a dominant player in the industry. Further, taking into consideration the recommendations arising out of the Wilkinson Review, it is also the Commission's view that any legislative changes that are made in line with the recommendations are also unlikely to result in FSDs acquiring significant market shares so as to dominate the industry.

Upon consideration of the other competition related factors brought to the Commission's attention by the interested parties, the Commission is of the view that there are advantages and disadvantages to both pharmacist-owned pharmacies and FSDs. For instance, while FSDs may have an advantage in terms of cashflow compared to pharmacist-owners of pharmacy, pharmacist-owners of pharmacy have an advantage over FSDs in that they have more sources of financing and favourable terms

and conditions available for financing from the major pharmaceutical wholesalers. Therefore, the Commission considers that the competitive dynamics of the industry do not favour one pharmacy group over the other.

Further, the Commission considers that pharmacies like FSDs that operate in rural and outer-metropolitan areas provide benefits and services to those communities which might not otherwise be accessible. For example, National Pharmacies operates an optical service in Port Pirie, South Australia, for their members whereby members can have their eyesight checked at the mobile clinic.

Commission's view

Taking into account the expert advice provided by Allens, and based on an assessment of the relative financial and corporate differences between FSDs and pharmacist-owned pharmacies, including the mutual tax treatment of FSDs and other competition related factors, the Commission considers that FSDs do not have significant competitive advantages over pharmacist-owned pharmacies, nor does this adversely affect competition in the community pharmacy industry, particularly given that there is no competitive advantage accruing to FSDs as a result of their income tax treatment.

Attachment A. Consultation process

The Commission sought submissions from the following interested parties:

Allen Consulting Group

Association of Professional Engineers, Scientists and Mangers Australia

Australian Capital Territory Pharmacy Board

Australian Consumers' Association

Australian Friendly Societies Pharmacies Association

Australian Pharmaceuticals Industries Limited

Australian Securities and Investment Commission

Australian Self-Medication Industry

Australian Taxation Office

Consumers' Health Forum

Council of Small Business Organisations of Australia

Department of Health and Ageing

Mayne Nickless Limited

Medicines Australia

National Pharmaceutical Services Association

National Pharmacies

Pharmaceutical Council of Western Australia

Pharmaceutical Society of Australia

Pharmacists Board of Queensland

Pharmacy Board of New South Wales

Pharmacy Board of Northern Territory

Pharmacy Board of South Australia

Pharmacy Board of Tasmania

Pharmacy Board of Victoria

Pharmacy Guild of Australia

Sigma Company Limited

Walter & Turnbull Chartered Accountants

Attachment B. List of submissions

The Commission received a response from the following interested parties:

Association of Professional Engineers, Scientists and Managers Australia

Australian Friendly Societies Dispensaries Association

Australian Securities and Investment Commission

Australian Taxation Office

Council of Small Business Organisations of Australia

Department of Health and Ageing

Medicines Australia

National Pharmacies

Pharmaceutical Society of Australia

Pharmacists Board of Queensland

Pharmacy Board of South Australia

Pharmacy Guild of Australia

Attachment C. The Allen Consulting Group Report

**Report to the ACCC on The Income Tax Treatment of
Friendly Society Pharmacies and Other Competition
Related Factors**

Attachment D. References

Allen Consulting Group, *The Income Tax Treatment of Friendly Society Pharmacies and Other Competition Related Factors*, September 2002

CCH, *Australian Master Tax Guide 2002—Mid Year Edition*, 30 June 2002

COAG Senior Officials Working Party Commentary on the National Competition Policy Review of Pharmacy

COAG Senior Officials Working Party Commentary on the National Competition Policy Review of Pharmacy commissioned report by Walter & Turnbull Chartered Accountants

National Competition Policy Review of Pharmacy

National Pharmacies Information Pack

Review of Business Taxation: A New Tax System Redesigned