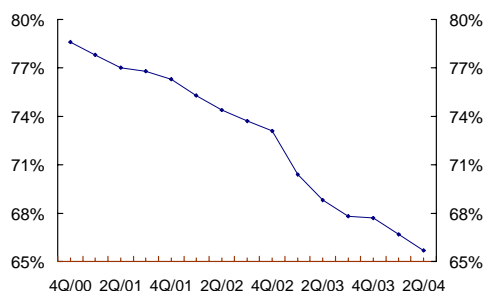


Thursday 1 April 2004

GP bulk billing rate still in free fall



Source: HIC February 2004

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Medical services

Volume weakness yet to abate

Event

- We review trends in the medical services industry following the release of monthly Medicare data.

Impact

- Weakness in GP services continues to drive down volumes across medical services disciplines. On a rolling 12 months basis, **GP service volume growth has contracted by more than 2% pa for the past 10 consecutive months.** With the GP bulk billing rate still in free fall (see chart to left), patients are responding to the price signal in their hands and simply not choosing to visit their GP as often.
- For the first time in over six years, diagnostic imaging volume growth has fallen below 1% pa on a 12 month rolling basis. As a result, Medicare spend has fallen around 1.8% (or \$25m) below targeted FY04 government outlays (under the new "revenue cap" agreement). **We now view the balance of probabilities in favour of a ~1.5% radiology services price rise from 1 May.**
- Again on a 12 month rolling basis, **pathology volumes have fallen to just under 2.0% pa; their lowest levels in over 12 years.** The reduced GP volumes (and hence less pathology referral opportunities) are potentially being compounded by an ongoing government drive to suppress unnecessary pathology ordering.
- In terms of broad trends in industry fundamentals, the revenue generation of service providers is somewhat clouded by the impacts of MedicarePlus. The safety net component of the package appears, at least in theory, to be highly inflationary in terms of its scope for providers to charge additional patient "out of pocket" charges. However it remains unclear as to how the additional revenue could be pragmatically extracted, and as to the extent to which the government would attempt to contain its resultant outlay exposure.

Action and recommendation

- MIA, DVC, SHL and MAY (in order of relative magnitude of impact) will significantly benefit from the likely price rise in diagnostic imaging services despite the ongoing volume weakness.
- The pathology exposures of SHL, GGL, PRY and MAY have already benefited from the December price rise and are now exposed to the falling volumes until greater certainty arrives through the negotiation of the next pathology agreement (which comes into effect 1 July 2004). PRY has avoided GP volume weakness via its bulk billing strategy.
- While these negative trends will undoubtedly feature in 2H04 result discussion, we expect the short term performance of medical services stocks to continue to be driven by issues beyond those of domestic industry trading conditions. Our order of preference is DVC, SHL, MIA, MAY, PRY and GGL.

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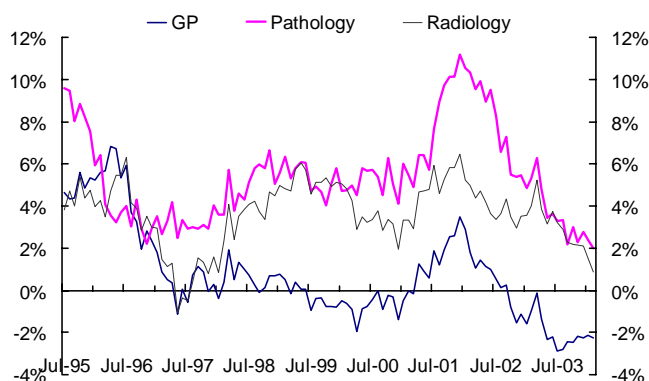
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GP volumes dragging the industry down

- GP bulk billing rates have continued to plummet as GPs chase the disposable incomes of their patients in order to cover their rising costs. The resulting damage to the patient's pocket has provided the price signal to make the average Australian think twice before visiting their GP; thus reducing industry volumes.
- The broader public is clearly demanding an increase in bulk billing, and the Federal Government has "attempted" to address this with the MedicarePlus package, and its \$7.50 incentive to bulk bill healthcare concession cardholders and children under 16.
- GPs who have moved away from bulk billing have already absorbed the resultant patient backlash, and have generally accepted the substitution of lost volume for the additional margin gained from charging out of pockets. In our view, these GPs will generally not go back to bulk billing just to chase the extra \$7.50 from approximately half of their patients.
- Instead, we expect MedicarePlus to provide little more than an interim stall in the ongoing collapse of bulk billing.
- In any case, MedicarePlus is yet to take effect on industry trends and the following chart shows the impacts of the existing funding structure on GP volumes, and to the downstream effects to diagnostics volumes.

Relationship among disciplines evident in recent years (12 month rolling averages)



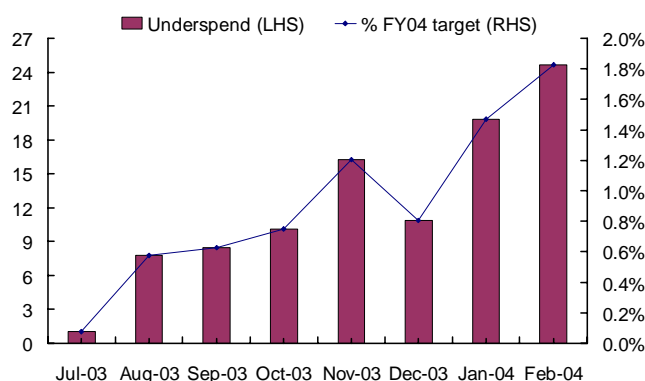
Source: HIC March 2004

- The correlation of the volume trends is evident in recent years. With GP volume growth trending below -2% pa for 10 consecutive months, growth in pathology volumes is at its lowest point in over 12 years and Diagnostic Imaging at its lowest point in over 6 years.

Issue is then price adjustment for diagnostics

- The current pathology agreement runs until the end of June 2004, by which time a new "revenue cap" agreement will be negotiated. In order to meet the targeted outlays under the current agreement, the government allowed a 3.1% price rise effective 1 December 2003. While the volume trends (since that price rise) may mean that the targeted outlays are still not met, such a shortfall would be relatively immaterial to the target and would most likely be incorporated into the negotiations for the next agreement.
- However, diagnostic imaging has not received a recent price rise and the declining volume growth has eroded cumulative government spending relative to the FY04 target agreed with the industry as of 1 July 2003.
- The following chart shows the cumulative monthly shortfall of government spending by month since the start of the agreement. The months have been adjusted for working days under the methodology employed by the committee that manages the agreement. The cumulative underspend is also shown as a percentage of the agreed FY04 target outlay.

Cumulative underspend under the DI agreement, and % of FY04 targeted outlay



Source: HIC, MRE March 2004

- The agreement management structure calls for service prices to be assessed should the tracking of expenditure (to targeted yearly outlays) vary by more than 1% over periods of at least 6 months. This has clearly been the case over the first 8 months of the agreement.
- While it is still early in the agreement, the industry could justifiably argue it has been materially underfunded over this period, and that the agreement is designed such that periods of over/underfunding are minimised.
- Pricing adjustments for Medicare services are typically afforded in November and May, and we would now expect the diagnostic imaging industry to receive a price rise of the order of ~1.5% from 1 May.