It’s unwise to pay too much, but it’s unwise to pay too little, too. When you pay too much you may lose a little money…that’s all. When you pay too little, you sometimes lose everything because the thing you bought was incapable of doing the thing it was bought to do. The Common Law of Business Balance prohibits paying a little and getting a lot…it can’t be done. If you deal with the lowest bidder, it is well to add something for the risk you run, and if you do that, you will have enough to pay for something better.

– John Ruskin

8 February 1819 – 20 January 1900

Medicare Auction Reform

Peter Cramton
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7 September 2011

Summary

Bad news: CMS is doing an atrocious job with the DME auction program

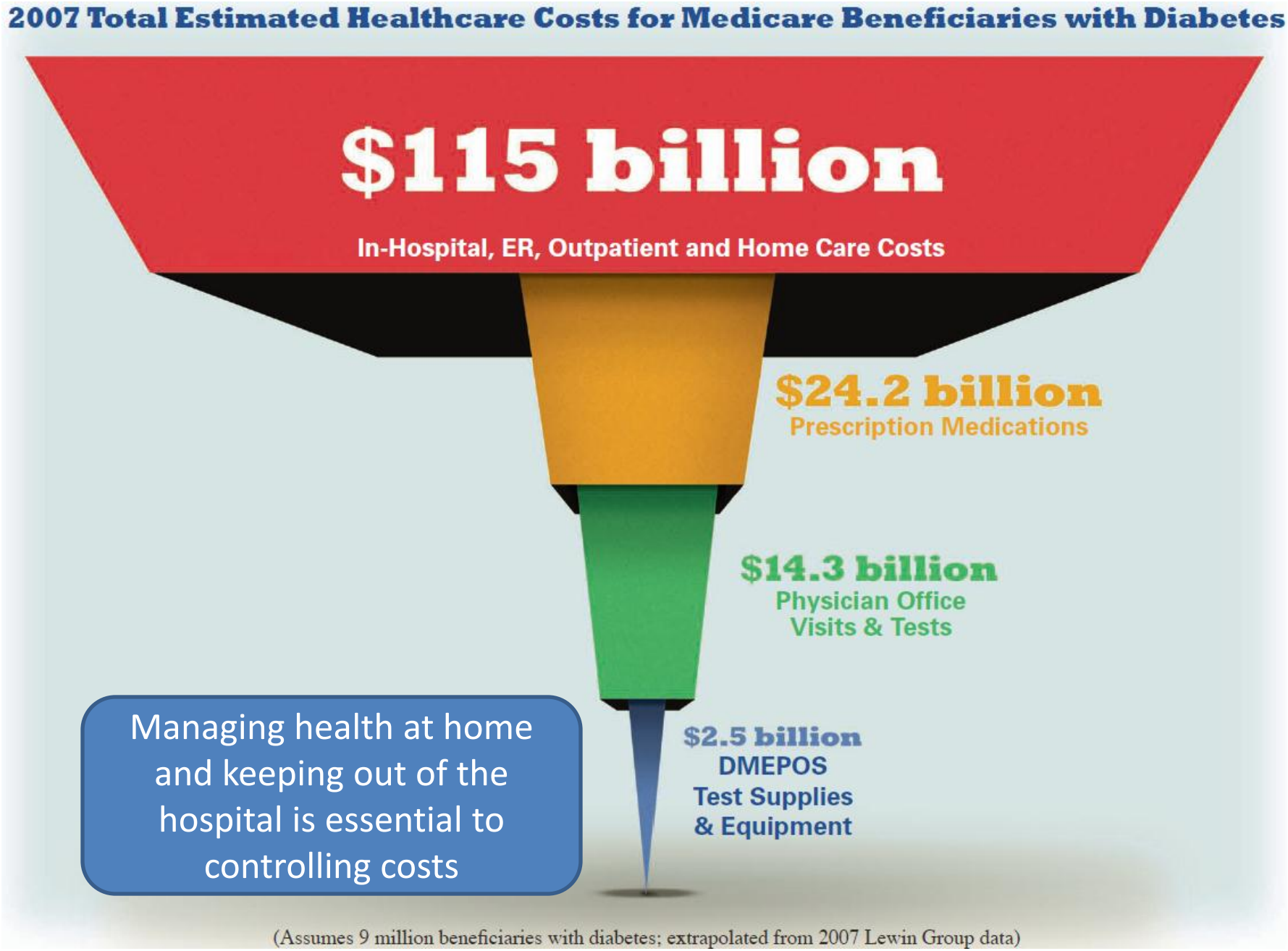
Good news: Competitive bidding, if done right, can result in large cost reductions without sacrificing quality

Motivation

Unfunded Medicare expenses

About $70 *Trillion!*

Diabetes Medicare costs

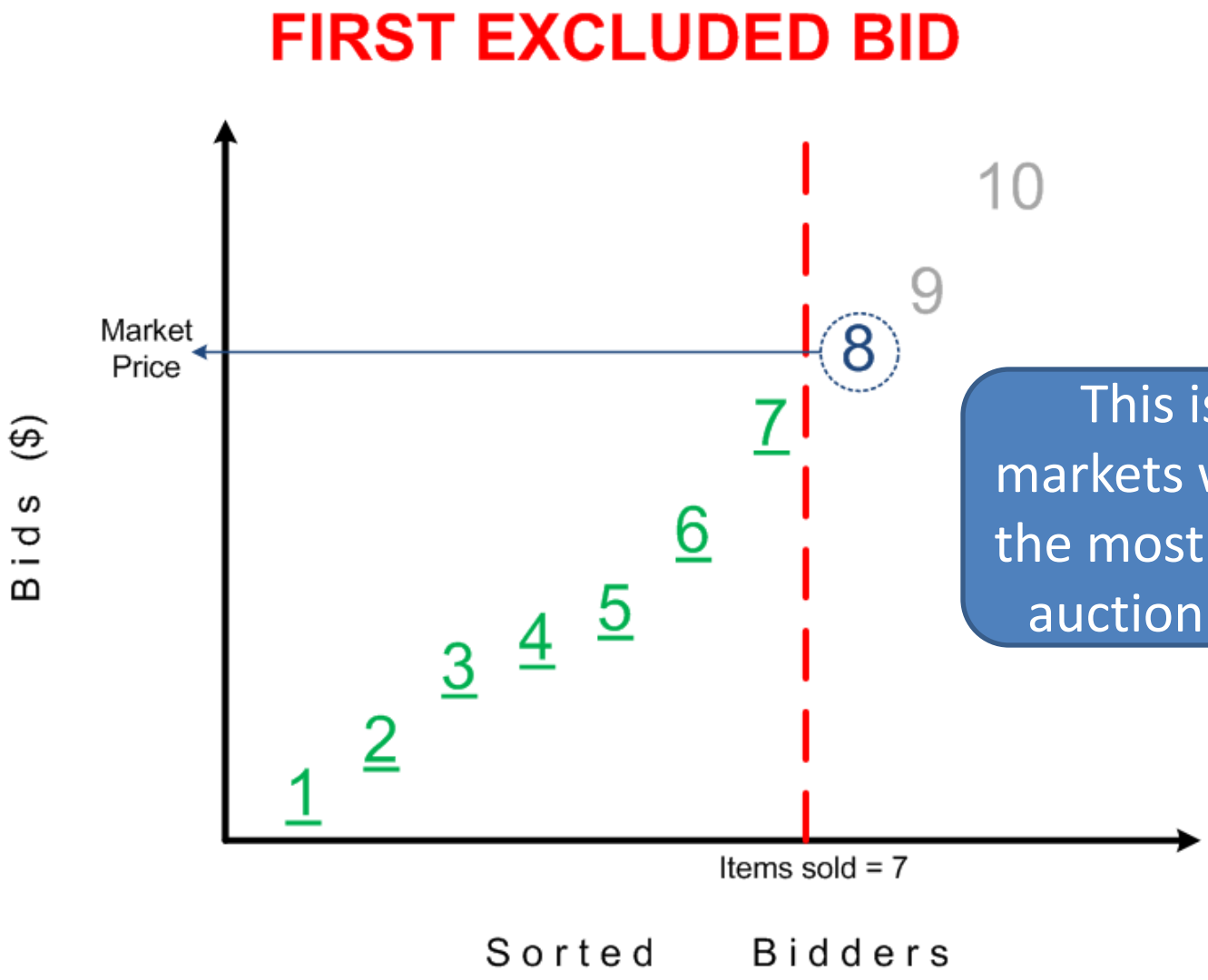


Fact:
CMS design is fatally flawed

Complete consensus among auctions experts

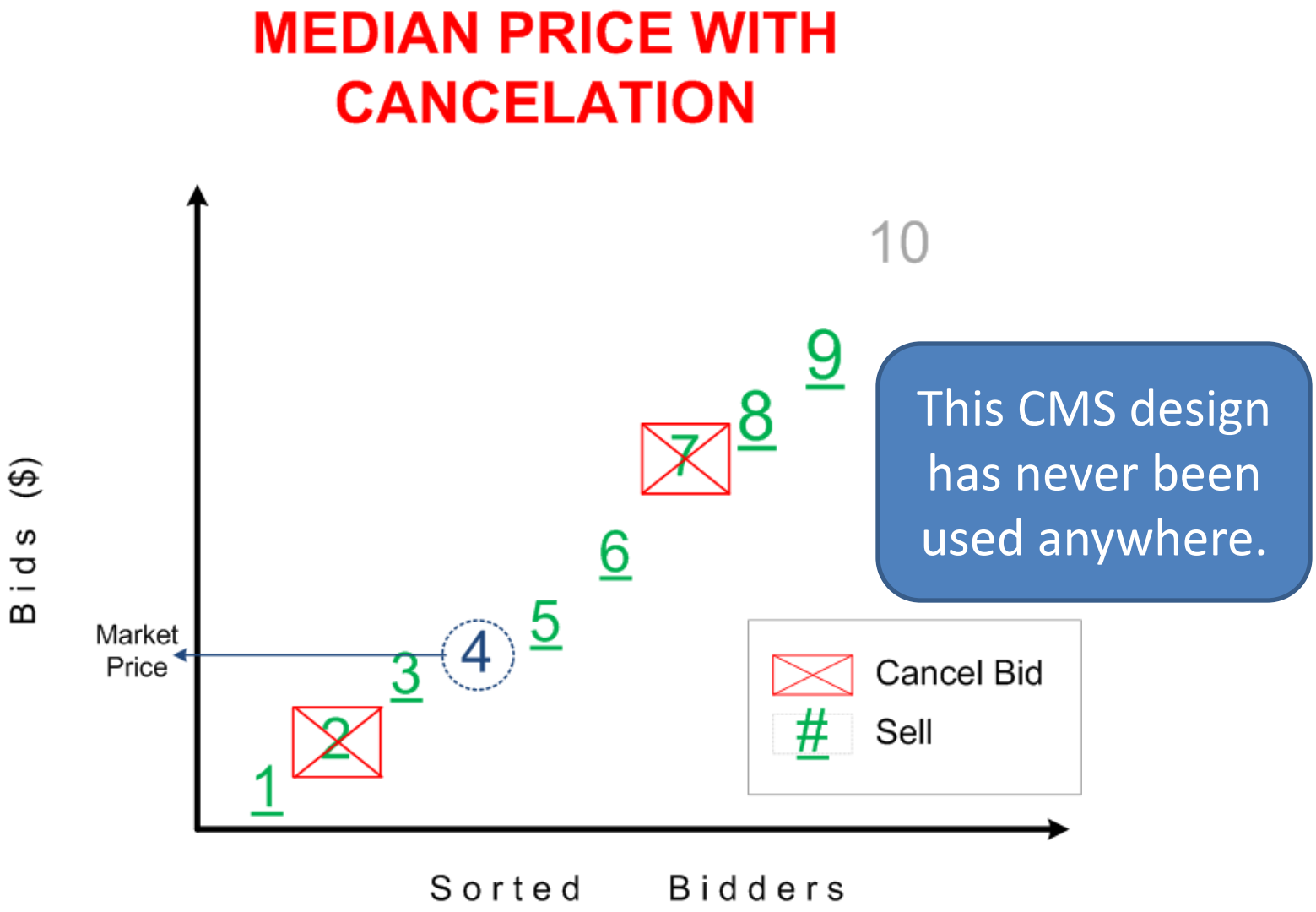
No expert thinks that CMS is doing this right!

An efficient “clearing-price auction”: demand = 7; price = 8th lowest bid



This is how markets work; it is the most common auction format.

Inefficient CMS auction: demand = 7; price = 4th lowest bid



median pricing

+

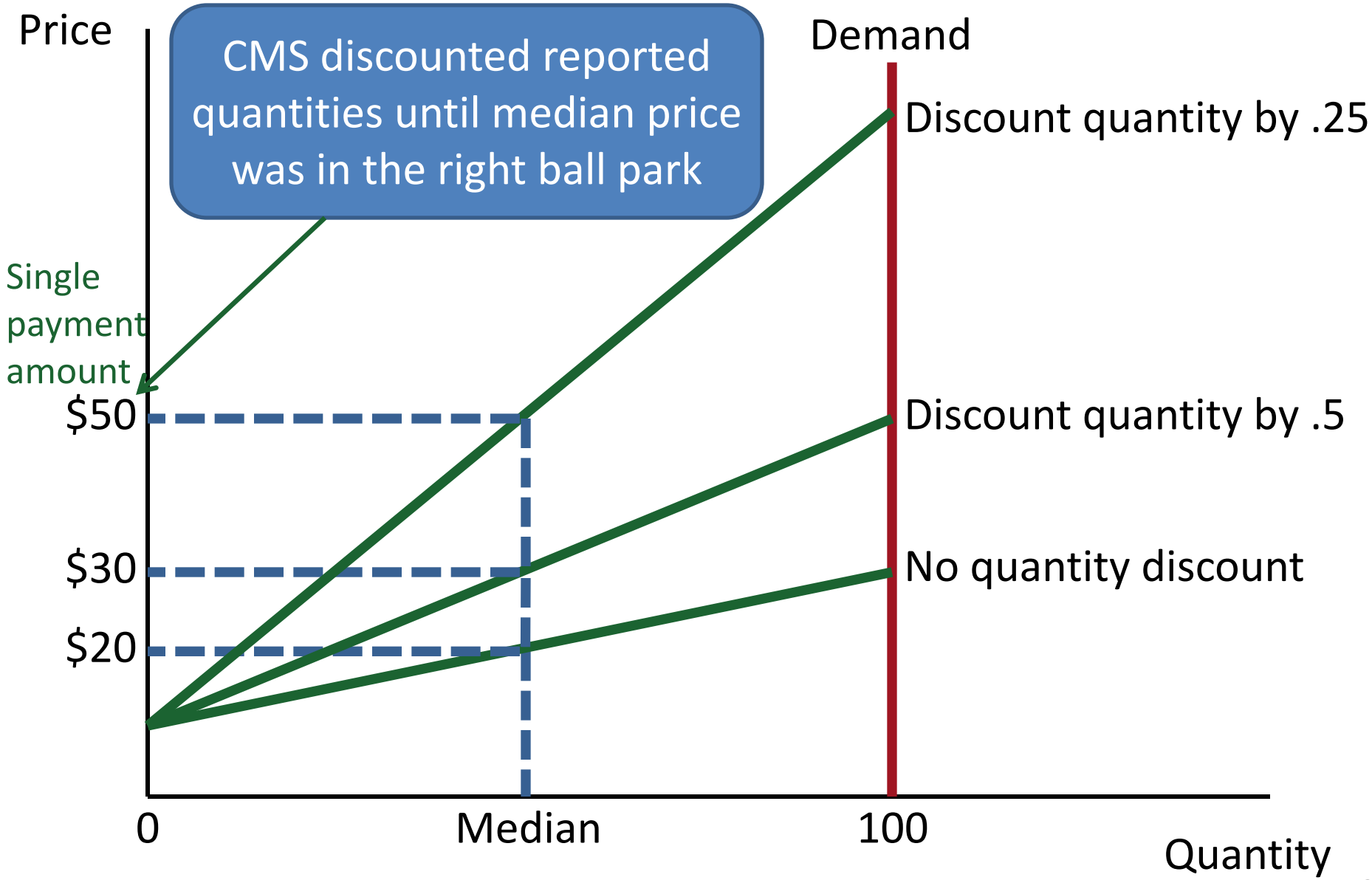
non-binding bids

= lowball bids

Why no train wreck yet?

Lack of transparency lets CMS manipulate prices until they are in the realm of reason

Arbitrary pricing from manipulated quantities



Evidence of program failure

- Theory
- Experiment
- Field

www.cramton.umd.edu/papers/health-care

Fact

- Modern auction methods apply to health care
- Auction theory and practice is a well-established discipline within science and industry involving:
  - Economists
  - Computer scientists
  - Engineers

Obama Executive Order of 18 Jan 2011

Section 1. General Principles of Regulation. (a) Our regulatory system must protect public health, welfare, safety, and our environment while promoting economic growth, innovation, competitiveness, and job creation. ***It must be based on the best available science.*** It must allow for public participation and an open exchange of ideas. ***It must promote predictability and reduce uncertainty. It must identify and use the best, most innovative, and least burdensome tools for achieving regulatory ends.*** It must take into account benefits and costs, both quantitative and qualitative. ***It must ensure that regulations are accessible, consistent, written in plain language, and easy to understand.*** It must measure, and seek to improve, the actual results of regulatory requirements.

Market Design Process

- Engage auction experts to build auction markets, just as you would consult a bridge expert to build a bridge, or consult a dermatologist to address a skin disease
- Engage industry and government in a collaborative effort to design the auction market

Market Design Process

- Use auction theory to inform the basic design
- Use simulation to test the design
- Test critical features of design in experimental lab
- Test design in pilots in the field
- ***With each step refine the design to better achieve objectives***

Medicare auction conference

- Demonstrated the feasibility of proven methods
  - Despite the complex bidding environment, the mock auction achieved extremely high levels of economic efficiency (97%)
  - Participants were able to understand the auction format and platform, and successfully execute bidding strategies for 6 products in 9 regions, all in a matter of hours
- ***To avoid program failure, the Medicare auctions must be reformed to take advantage of modern auction methods***

Medicare auction conference: highlights

- Tom Bradley
  Chief, Medicare Cost Estimator, CBO
  - "Program will fail with near certainty"
  - "Program results in arbitrary pricing"
- Evan Kwerel
  Senior Economic Advisor, Federal Communications Commission
  - "When the gov't tries to go it alone it doesn't work"
- Nancy Lutz
  Program Director, Economics, National Science Foundation
  - "If the auction design doesn't work in theory, it won't work in practice"
  - "If the auction design doesn't work in the experimental lab, it won't work in practice"

Independent market monitor

- An independent market monitor plays an important role in the development of well-functioning markets, especially complex markets
- Market monitor provides an independent voice and expertise to identify problems and identify solutions quickly
- Market monitors are used in many complex auction markets; for example following the 2000-2001 California Energy Crisis, all electricity markets in the US have independent market monitors; the approach has proven highly effective

Efficient auctions are better than repeal alone

- Repeal alone is not a coherent strategy
  - ➢ Eliminates badly flawed auction, which resulted in arbitrary pricing and winners
  - ✘ Adversely impacts budget
  - ✘ No sustainable pricing mechanism
  - ✘ Large regulatory uncertainty
- Repeal and replacement with an efficient auction is a coherent strategy
  - ➢ Eliminates badly flawed auction, which resulted in arbitrary pricing and winners
  - ➢ Improves U.S. budget
  - ➢ Sustainable pricing mechanism
    - ➢ Efficient providers are able to earn profits and grow
    - ➢ Regulatory risk is minimized
    - ➢ Market gradually evolves to efficient market structure
  - ➢ Medicare beneficiaries get quality services at lowest sustainable price
  - ➢ All stakeholders benefit except inefficient providers

Next steps

Going forward

- Draft legislation for efficient Medicare auctions
- Educate stakeholders on benefits of an efficient auction
  - April 1, Medicare auction conference
  - May 24, Hill briefing on Medicare auctions
  - Summer, Hill and administration briefings
- CBO score of an efficient auction legislation, recognizing savings
- Pass bipartisan legislation to repeal and replace with an efficient auction as part of deficit
- Design and development until first-half 2013
- Implementation of initial auction in first-half 2013 with contracts starting 1 July 2013

Savings to taxpayers from efficient auction vs. status quo

Hidden costs of current CMS approach

- Failure of supply
  - Substitution from lower cost DME supply to hospital supply, possibly after complications
- Destruction of efficient suppliers (inefficient market structure)
- Higher costs following failure of market
- Substitution from low-priced mail order diabetes to high-priced pharmacy diabetes
- More costly administration of current system
  - Handling of problems, avoiding shortage, higher fraud

Reduced costs from efficient auction

- Least-cost sustainable prices
- Promotion of efficient suppliers (efficient market structure)
- Promotion of innovation through product optimization
- Elimination of products with poor benefit/cost performance
- Expansion of products with high benefit/cost performance
- More rapid introduction of electronic systems and paperwork reduction

Repeal and Reform Statutory Language

Statutory language: Repeal and replace

- Repeal the Round 1 (Rebid) and restore prices to the administrative fee schedule effective on the day this new law is enacted
- Develop efficient auctions as detailed on the following pages

Note: The following has more detail than would appear in the actual legislation. This detail is provided to give the reader a better sense of how an efficient auction would work. Some of the specific numbers given are meant as examples and could be adjusted in the actual legislation. Further details are provided in

"Auction Design for Medicare Durable Medical Equipment," Working Paper, University of Maryland, March 2011. [**.pptx**]