

A proposed design for Medicare DME auctions

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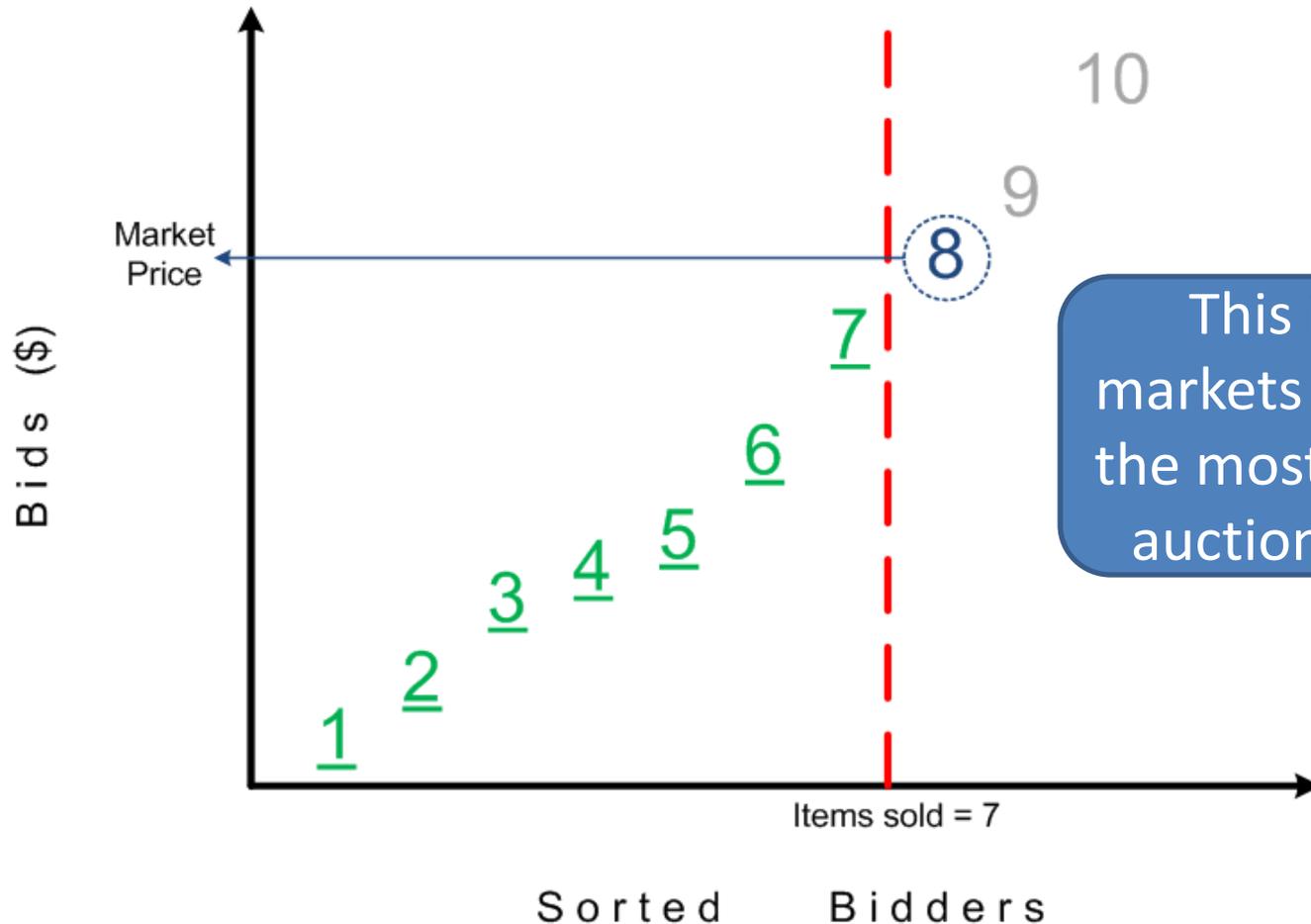
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CMS design flaws

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

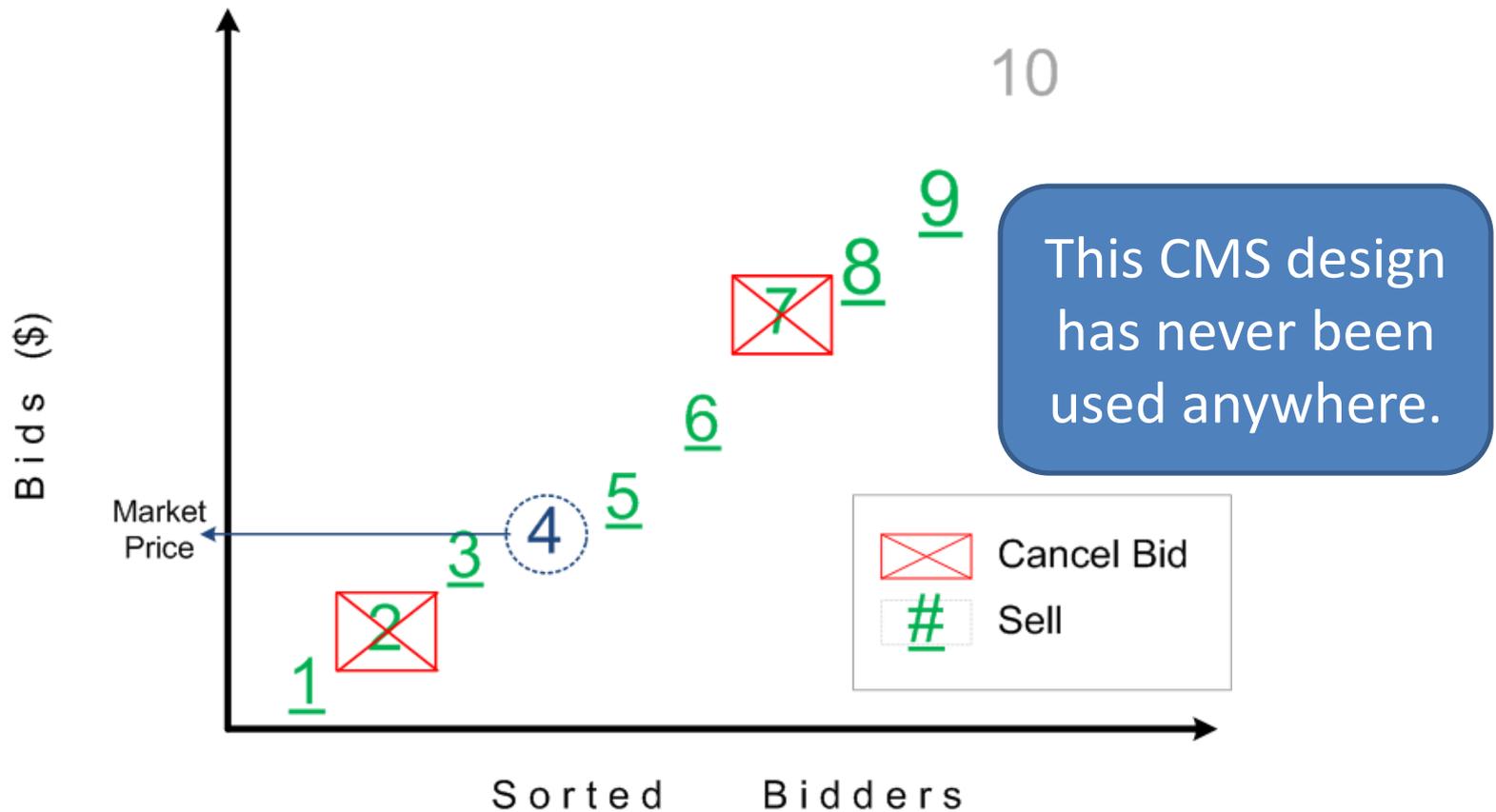
FIRST EXCLUDED BID



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

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

MEDIAN PRICE WITH CANCELATION



median pricing

+

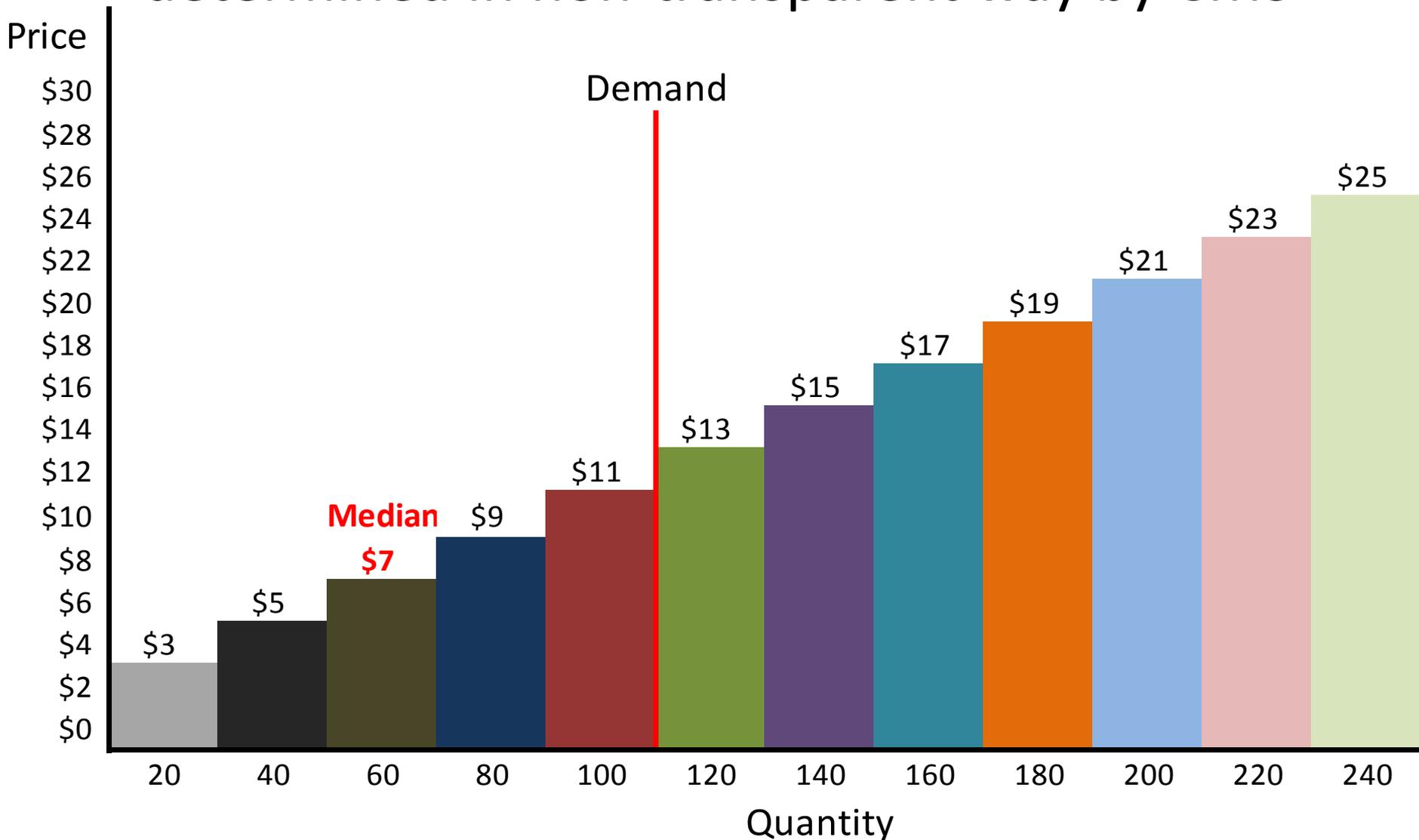
non-binding bids

= low-ball bids

Lack of transparency

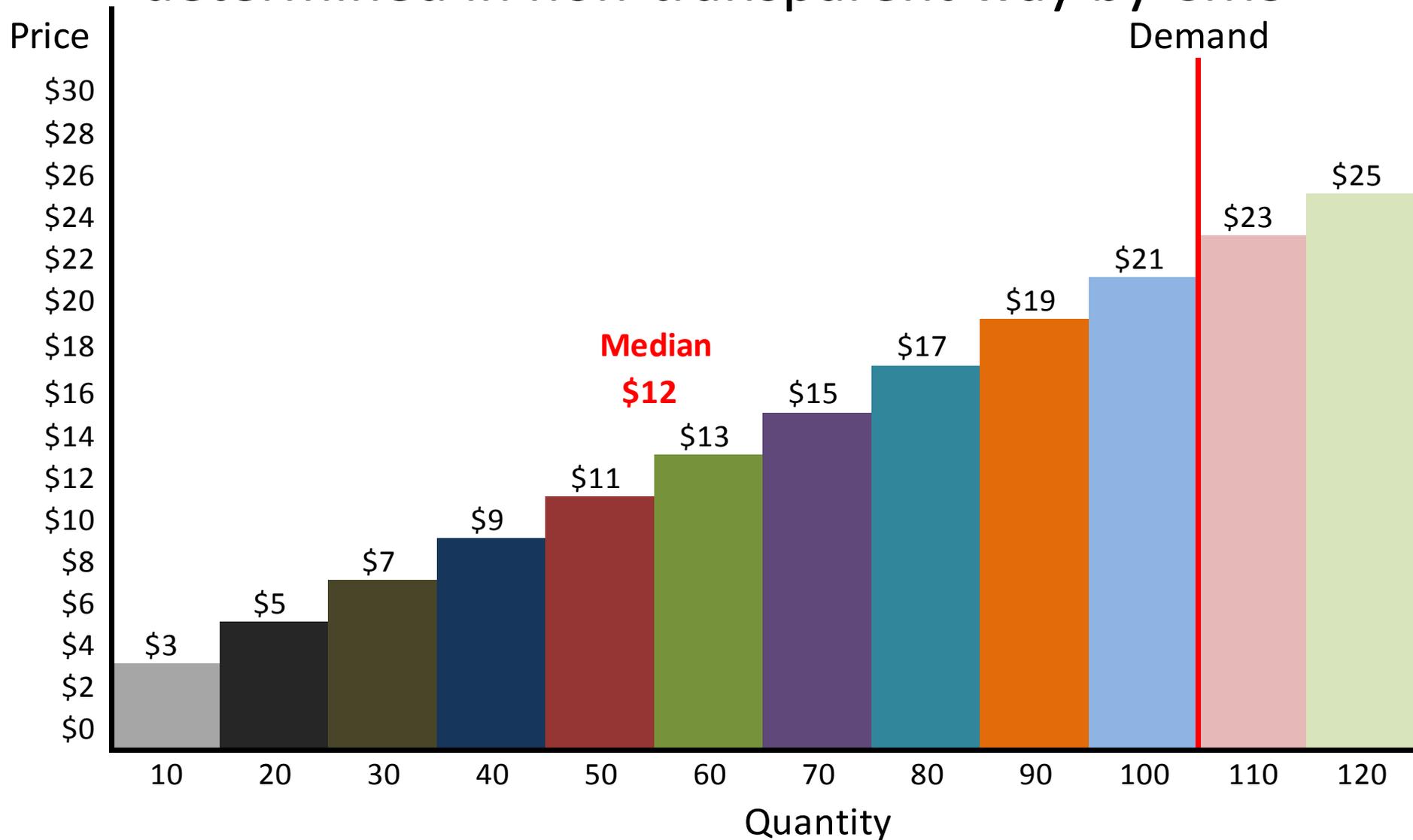
- Winners not disclosed until 1 year after bids taken in November 2009
- Unclear quality standards
- Unclear performance obligation
- Unclear how quantities are determined

Pricing is arbitrary, since bidder quantities determined in non-transparent way by CMS



Median = \$7 when CMS does not discount quantities at all.

Pricing is arbitrary, since bidder quantities determined in non-transparent way by CMS



Median = \$12 when CMS discounts quantities by 50%.

Evidence of program failure

- Theory
- Experiment
- Field

Summary

Competitive bidding can result in large cost reductions without sacrificing quality, *but it must be done right!*

Proposed design addresses flaws

- Bids are binding commitments
 - *Rigorous qualification one month before auction*
 - *Bid bond proportional to bidder's capacity*
 - *Performance bond proportional to a winner's capacity*
- Auction establishes clearing price for each product in each region

Capacities based on historic supply

- Each qualified new provider is assigned a capacity of 1 block (about 1 percent)
- *Any provider may supply more than its capacity, but its capacity is assumed in matching supply and demand and in setting performance obligations*
- *Capacities are determined in objective manner*

Auction competition comes from new entrants

- Given relatively low entry costs, especially from providers supplying in other regions or other categories, ample new entry can be expected at prices above competitive levels
- Financial guarantees ensure bidders exit at prices below competitive levels

Winning bidders and prices

- As soon as supply falls to 100 blocks or less, the clearing price is set at the exit bid of the bidder that caused supply to fall to 100 or less
- Each bidder still “in” wins its capacity
- If supply is less than 100 blocks, the blocks won is scaled up to $100/\text{Supply}$

Post-auction competition motivates quality

- After the auction, the winners compete for Medicare beneficiaries by offering quality products and services
- Medicare beneficiary choice is an important driver to motivate providers to provide high quality products and services

Prices of individual products are relative to price of lead product in category

- In qualification stage, for each category of interest, each bidder reports relative price of each product as a percentage of lead product's price
- Auctioneer computes relative price index for category as the *capacity-weighted* average of bidder reports
- *Auction determines price of each lead product in each category; other individual product prices are determined from the relative price index*

Product categories, products, and regions should be re-optimized for new approach

- Approach can easily accommodate more product categories, products, and regions*
- Optimization of categories, products, and regions is an essential task in the product design step with major input from HME providers*

Version 1: 100% auctioned on rotating basis

- Each year one-third of regions are auctioned with 3-year contracts
 - 3 groups of regions (West, Central, East)
 - 1 group auctioned each year
 - Establishes competitive prices in area for 3 years
 - Losers are excluded from supply in area
 - *Provides incentive to stay in auction*

Preferred variation:

Auction a representative 10% each year

- Approach does not disrupt market structure
 - Emphasis is on establishing competitive prices, rather than excluding suppliers

Apply competitive bid-based prices to non-auctioned areas

- Auction a representative 10% of regions each year
 - Auction establishes prices in remaining 80% with a simple econometric model based on the two most recent auctions
 - Each year a different 10% is used, so over 10 years each region is auctioned once
- In auctioned regions, only winners can supply during the two-year commitment period
 - Winners still must compete within the region
- *Any certified supplier can supply in any non-auctioned region (80% of country)*

Auction is easy for bidders

- Price process is easy for bidders to manage
 - Bidders interested in a particular category can focus on that category in all areas
 - Bidders interested in a particular region can focus on that area in all categories
 - Bidders with other interests can focus on the most relevant categories and areas for them
- Proxy bids allow small bidders to bid as in a sealed-bid auction

Auction is highly transparent

- Qualification and financial guarantees are reported publicly well in advance of the auction
- Capacities determined in objective manner
- Auction rules including product definitions, performance obligations, and penalties are known two months before auction
- Following each bidding round, excess supply at current prices as well as prices for next round are publicly announced
- Winners and quantity won are immediately announced at the conclusion of the auction
- An independent market monitor reports on auction outcome and any problems within two weeks of auction end

Proposed design based on proven methods

- Clearing price *approach used almost universally across all countries and industries*
- Simultaneous descending clock format has outstanding price discovery
 - *Approach proven in hundreds of auctions for spectrum, electricity, gas, diamonds, emission allowances, etc.*

Proposed design based on proven methods

- Bidders are bound by bid bonds and performance bonds to guarantee the integrity of the bidding, *as in all well run auctions*
- *Transparent auctions commonly used in highly successful government auctions*
- *In sharp contrast, the CMS design with non-binding bids and the median pricing rule has never been used in any country or industry*