

Comment on Hoerger: Early Pilots of Medicare Auctions Brings No Solace to Auction Experts

PETER CRAMTON AND BRETT E. KATZMAN

Dear Editors,

Our *Economists' Voice* column summarized the severe problems with the current and proposed Medicare auctions. The column was based on a careful reading and analysis of the auction rules. Since that time we and other auction experts have studied the Medicare auctions with theory, experiment, and the limited amount of field data that the Centers for Medicare and Medicaid Services (CMS) has made available. This substantial body of evidence is available at www.cramton.umd.edu/papers/health-care. The evidence strongly supports our preliminary analysis that the auction program is fatally flawed and must be fixed.

Dr. Hoerger suggests that we should find comfort in his evaluations of early pilots that showed that prices were reduced with little impact on access and quality. Very little can be learned from the pilots. They were essentially a one-sided test. Failure would have been telling but success means little. The administrative Medicare prices were generally high and therefore the price reductions found in early pilots were easily absorbed by suppliers. Hoerger's evaluation supports this widely held view. Whatever success the pilots had has little bearing on the long-term efficiency and stability of the current auction design. The true measure of the auction rests on whether it leads to sustainable, least-cost prices going forward, without creating any shortages. It will not.

Imagine that a bridge builder is caught using faulty cement to build a train trestle and that bridge building experts all agree that the bridge will collapse under a “heavy load.” Would the experts accept that everything is right simply because the builder points out that the bridge is still standing? Or would they rely on their knowledge of structural engineering and immediately repair the bridge before a catastrophic event occurred?

Auction design is really no different than bridge design. It is an established science offering a wealth of knowledge and experience that should be accessed in the formulation, implementation, and evaluation of new auction markets. Hoerger speculates that the 167 auction experts would be less pessimistic about the Medicare auctions if they only knew about his pilot evaluations. We believe that this is as likely as the bridge experts ignoring the laws of physics and waiting for the train wreck.

The California electricity crisis of 2000-2001 provides a vivid example of how improperly designed auctions can appear successful, but ultimately fail. That new

auction-based market was introduced in 1998 and operated without incident for two years. Then in the summer of 2000 the “heavy load” of water shortages and other factors arrived. The market spiraled to catastrophic failure, ultimately costing Californians about \$40 billion and extended periods of rolling blackouts. The problem was that the market suffered from severe design flaws that have since been fixed. However, the early “success” of the market was irrelevant to the market’s eventual failure in 2000-2001.

There is no debate among experts about the flaws in the Medicare auctions. All experts agree that the program is a train wreck waiting to happen. Non-binding bids and the median pricing rule lead to low-ball bids that ultimately will bias prices downward until they are unsustainable. How long this will take will vary by product and region, and secretive CMS decisions. For now, the catastrophe is being avoided as CMS uses various tactics to mask the inevitable in pilot markets around the United States.

The current auction rules and lack of transparency give CMS almost complete

discretion to set any price by manipulating the quantities used to form the supply curve. For instance, if CMS finds that low ball bidding has led to unrealistically low auction prices, CMS can arbitrarily raise the price by discounting the bidders' reported quantities. This raises the slope of the aggregate supply curve and brings prices into the realm of reason. But make no mistake: the resulting "auction" prices are arbitrary and unrelated to bidder costs.

Indeed, there is evidence that CMS adjusted quantities in the Round One (Rebid) to make sure that one or more large national providers became a winner in each region and product. In doing so CMS delays the disaster, but in absolutely no sense are they letting competitive forces set the prices.

In sharp contrast, it is straightforward to achieve competitive prices without playing the quantity game and sacrificing long-term sustainability. To prove this point, we held an auction demonstration for suppliers, experts, and government representatives on April 1, 2011. In less than one month, an alternative auction design was developed, tested, and shown to achieve competitive

prices without quantity manipulation. The nearly full-scale mock auction achieved efficiencies of 97 percent, consistent with the experimental results. The CMS auction rules result in complete market failure in theory and efficiencies well below 50 percent in the lab. There is no debate about whether the CMS auction rules need to change.

Peter Cramton

University of Maryland

Brett E. Katzman

Kennesaw State University

REFERENCES AND FURTHER READING

Cramton, Peter and Katzman, Brett E. (2010) "Reducing Healthcare Costs Requires Good Market Design," *The Economists' Voice*, 7(4): Art. 8. Available at: <http://www.bepress.com/ev/vol7/iss4/art8>.

Cramton, Peter and Ulrich Gall, and Pacharasut Sujarittanonta (2011) "An Auction

for Medicare Durable Medical Equipment: Evidence from an Industry Mock Auction” (working paper), University of Maryland. Available at: <http://www.cramton.umd.edu/papers2010-2014/cramton-gall-sujaritanonta-industry-mock-auction-for-medicare-dme.pdf>.

Cramton, Peter, Sean Ellermeyer and Brett E. Katzman (2011) “Designed to Fail: The Medicare Auction for Durable Medical Equipment” (working paper), University of Maryland. Available at: <http://www.cramton.umd.edu/papers2010-2014/cramton-ellermeyer-katzman-medicare-auction-designed-to-fail.pdf>.

Hoerger, Thomas J., Richard C. Lindrooth, and Jennifer L. Eggleston (1998) “Medicare’s Demonstration of Competitive Bidding for Clinical Laboratory Services: What it Means for Clinical Laboratories,” *Clinical Chemistry*, (44)8:1728–1734. Available at: <http://www.clinchem.org/cgi/content/full/44/8/1728>.

Merlob, Brian, Charles R. Plott, and Yuanjun Zhang (2011) “The CMS Auction: Experimental Studies of a Median-Bid Procurement Auction with Non-Binding Bids” (working paper), California Institute of Technology.

Available at: <http://www.cramton.umd.edu/papers2010-2014/merlob-plott-zhang-cms-auction.pdf>.