



Peter Cramton

Professor of Economics

+1 240 479 9345 pcramton@gmail.com www.cramton.umd.edu

7 April 2011

Program Advisory and Oversight Committee (PAOC)
[via email]

Dear PAOC Members:

On 5 April 2011, you met at CMS headquarters in Baltimore to examine the status of the Medicare competitive bidding program. I was grateful that the meeting was open to the public and that I had an opportunity to meet many of you. I was also grateful that I had an opportunity to voice my views. Some of you asked if I would put my comments in writing, so that it could be part of the public record. That is the purpose of this letter.

We learned from presentations by CMS that the train wreck predicted by auction experts and others has not yet occurred. The program was implemented in nine regions beginning 1 January 2011. Part of the reason is that it takes some time for inventories to run out, for companies to go out of business, and other indicators of failure to appear. Ninety days is too short a time to see the impact of a poor market design, especially given the grandfathering rules for continued service.

In addition, despite the fact that low-ball bidding, [predicted by theory](#), was rampant (according to numerous bidder reports), the prices that came out of the auction's bizarre pricing rule were made more reasonable by CMS' manipulation of quantities. CMS can and did change the slope of the supply curve and hence the set of bids that were included in the median price. This non-transparent manipulation allows CMS to set nearly any price between the lowest and highest bid. Also, bids are already constrained by a floor and a ceiling. The "auction" is really not an auction at all, but an arbitrary pricing mechanism.

Despite the absence of a train wreck in the first 90 days, please do not sit back and conclude that all is well. One can think back on the early years of the California electricity market. Despite its poor design, the market appeared to work perfectly for more than two years before the market was stressed in late 2000 and crashed in crisis in 2001. The poor market design cost California tens of billions. The stakes are even higher here.

My comments during the public comment period are summarized in

["Public Comments of Peter Cramton at PAOC Meeting on Medicare DME Competitive Bidding Program,"](#) 5 April 2011.

I have attached the comments, which are brief and to the point.

My final comment has to do with the creation of an independent market monitor. The market monitor is distinct from the PAOC and serves a different role. The market monitor has access to all the data available to CMS including confidential data. The market monitor is an expert in market design and in the Medicare DME market in particular. The market monitor is hired by and reports to the Secretary of the Department of Health and Human Services. The use of an independent market monitor is standard practice in complex markets like electricity markets. The approach has been adopted by all electricity markets in the United States. The market monitor brings valuable expertise. Market problems are more quickly identified and addressed with the use of a market monitor as an independent check. The market monitor has the responsibility to advise the Secretary, the PAOC, CMS and the public on the market. The market monitor has the responsibility to periodically report on the state of the market, typically quarterly. The market monitor does not make decisions with respect to the market. Decisions are made by CMS and the Secretary. The market monitor's role is limited to advice and reporting.

Again, it was a pleasure meeting you in Baltimore. I hope my comments are helpful to the PAOC as we move toward the critical development of Round 2. My view is that it is essential to open the regulation to change. Pushing forward with the status quo—an auction design that all experts agree is fatally flawed—would be irresponsible. If you disagree with this sentence, then I urge you to study carefully the information on <http://www.cramton.umd.edu/papers/health-care/>. There is a wealth of independent and objective expert information there. As you can tell, I am a huge fan of transparency.

Many thanks for your public service.

Kind regards,

A handwritten signature in cursive script that reads "Peter Cramton".

PAOC Meeting
Remarks of Peter Cramton
5 April 2011
Peter Cramton
Professor of Economics
University of Maryland

1

Fact

- CMS Auction design is fatally flawed
 - Non-binding bids & median pricing
=> low ball bids that are unrelated to costs
 - Near zero transparency
 - Arbitrary pricing through manipulation of quantity by CMS
- Complete consensus among auctions experts
No expert thinks that CMS is doing this right!

2

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
 - Operation researchers and other engineers

3

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

4

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***

5

Medicare auction conference

- Most materials are already on the web
Google "cramton" click "health care"
- All will be available by April 10
- The mock auction demonstrated the feasibility of my proposal as well as its excellent performance
 - Despite the complex bidding environment, the mock auction achieved extremely high levels of economic efficiency
 - Moreover, the participants were able to understand the auction format and auction platform, and successfully execute bidding strategies for 6 products in 9 regions, all in a matter of hours
 - The conference also demonstrated the advantages of advancing the Medicare auctions through a collaboration among industry, government, and auction experts
- ***To avoid program failure, the Medicare auctions must be reformed to take advantage of modern auction methods***

6

Medicare auction conference: highlights

- Tom Bradley
Chief, Medicare Cost Estimator, CBO
 - “Program will fail with near certainty”
 - “Program results in arbitrary pricing”

7

Medicare auction conference: highlights

- 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”
 - (These insights are established in countless scientific studies.)

8

Medicare auction conference: highlights

- Evan Kwerel, Senior Economic Advisor, Federal Communications Commission
 - Many of the reasons given by those opposing auctions because they believe auctions can’t work apply equally well to the alternative of administrative pricing
 - At the very least, those who oppose auctions need to suggest an alternative that can be compared with the approach of fixing the current auctions

9

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

10