MEDICARE AUCTION CONFERENCE
INN AND CONFERENCE CENTER
FRIDAY, APRIL 1, 2011

SEGMENT 1
FILES 0543 & 0544

WELCOME BY PETER CRAMTON, PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND
AND
JONATHAN BLUM, DEPUTY ADMINISTRATOR, CMS

Transcribed for: Bart Woodward

Transcribed by: Aleva (Lee) Schneider-Pollard, TranscriptionBiz

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P R O C E E D I N G S

(01:40) SEGMENT I

WELCOME BY PETER CRAMTON, PROFESSOR OF ECONOMICS

MR. CRAMTON: Good morning, everyone. Welcome. Thank you so much for being here. Actually, this quote from John Ruskin was emailed to me yesterday as the Quote of the Day. And I thought it was just amazing how relevant this quote from the 1800's is and how much wisdom it embodies. It's definitely something to think about.

(02:19) So it was on August 24th that I received a phone call from Nancy Johnson, 24-year Congresswoman from Connecticut who asked me to take a look at the Medicare competitive bidding rules. And she knew I was an expert in auction design and that I would be an appropriate person to take a look at it. So I said, "Sure, I'd be happy to. That's my expertise. I'd be happy to."

Well, I looked at the rules, and within 10 minutes, I realized that the Rules were fatally flawed; that there were serious -- very serious problems. So then I looked some more, and I spent a little less than a week looking at the Rules and thinking about it.

(03:06) And then we had a subsequent conversation where I told her that these Rules are fatally flawed. The program is unsustainable. There's no way that this could work. And she said, "Oh, okay. Well, would you be willing to come to the Hill and tell some of the congressional offices about your views?" and I said sure.

(03:27) So on September 8th, we marched over together, to the Hill and spoke to a number of relevant congressional offices, including the Ways and Means Committee. And the staffers of the Ways and Means Committee were all very interested and actually quite knowledgeable about Medicare and the Competitive Bidding Program.

And when I was finished giving my view, they said, "Well, okay, but you're one expert; I'm sure that if we asked another expert, we'd get another story, and a third expert, a third story. So, you know, why should we believe what you're saying?"

(04:14) And I said, "No. In fact, every auction expert will say the exact same thing that I am saying." And they said, "Oh, really? Hm-m-m. Well, can you show us that?" And I said, "Sure. I'll write a letter that outlines the flaws quite firmly, and I'll send it to my colleagues, auction experts around the world. I'll give them 24 hours to respond either, yes, they will sign this letter or, no, they won't.

(04:53) I sent it to 250 Academics in the middle of September, a very busy time for Academics. I gave them the primary source documents, such as the Federal Registry and so on, that described the Rule. And within the 48 hours, I had 167 yesses -- signatures, including multiple Nobel Laureates and other very prestigious awards.

Not a single one of these 250 responded "No, I disagree." There were several people that responded "No, I don't have time to study all the primary documents, and so I cannot agree to sign." But not a single person raised any issues with any of the points that I was making in that letter.

(05:54) That letter, I think, is actually very important because it does say that there is complete consensus on this issue among auction experts, which is a very broad and knowledgeable community.

Now, CMS has historically been headed by medical doctors, and so let me give a medical analogy. I think that all doctors would agree that if you have a serious bacterial infection, that it's a good idea to treat that with the antibiotics. I think that that would be common practice.

(06:28) And so for me -- now, I'm not a medical doctor, but I could say, "Okay. Well, you know, I don't know what you should do with that. I think, you know, leeches sound like a good idea" or you know, "Let's -- let's bleed you or something." And to me, that would be maybe a reasonable thing to do since I don't have the expertise.

I think we have a similar thing going on here where CMS designed the auction program without any engagement of auction experts. Now, this was done well before Jonathan Blum arrived in his current position.

(07:10) It was -- this was done -- this has been going on for well over 10 years, and the design was developed over those 10 years with the prior Administration.

But now we have an opportunity to fix the design, and I'm hoping that this conference will help facilitate that fix.

So what happened, beginning in September, is the careful identification of the flaws in the auction design; then, in presentations to relevant groups, such as HHS, CMS, the Capitol, and the Administration -- then we used other tools -- and I say we -- there's many of my colleagues involved in this. We used the scientific methods that we have available to us as experts in auction design, and those tools include theory -- so economic theory.

(08:36) So a number of us did some what I think is very nice work demonstrating the theoretical implications of the CMS design and contrasted that with the theoretical properties of the efficient auction.

(08:56) And what we found is that from a theoretical point of view, the CMS design has absolutely terrible properties. The auction is chaotic. The pricing is uncertain. Those details are outlined in a paper that was posted -- a revision that was posted yesterday on my web site and so that you can see it. And my two co-authors, Brett and Sean, are sitting right back here. It's got some very nice mathematics that I'm sure many of you will enjoy.

(09:36) Then recognizing that, you know, that's theory, okay, it turns out actually theory often is extremely helpful in the analysis of complex problems. But it's true; that's just theory. So let's see how it works in a scientific lab.

So then I got a phone call from Charlie Plott, a very distinguished experimental economist at Caltech. And he said, "Would it be okay if I ran studies in my lab? We can bring in the Caltech students. I'll pay them money based upon the -- the profits that they earn in the auction, and we'll do a comparison, this CMS design versus the efficient auction."

(10:25) I said, "Great. That would be wonderful." So we did it in the Caltech lab. What happened? The CMS design crashed and burned. The -- had efficiencies of -- they were just atrocious -- way below 50 percent.

In contrast, the efficient auction had efficiencies with human subjects being paid based upon their performance of 100 percent. So this is not an auction environment that just is too complicated and it can't work, and we're doing the best we can -- no. Far from it. We can do much, much better by using modern techniques, and that's what this is about.

(11:10) So we also replicated those experiments at the University of Maryland, the same thing in the scientific lab, and Charlie Plott was very, very much involved with -- and his team. Actually, I was sort of a bystander of all this. And we got the exact same results.

So the evidence is very strong. Now, the third step in the scientific method would be to look at the field. Okay. You do some pilots. And one of the things that CMS has done right is they start with pilots rather than rolling out a nationwide program from the get-go, okay, because you want to do a pilot, see how it works, and then improve it. There's going to be some bugs -- and fix it.

(11:54) Well, that's what they've been doing. They've been doing the pilots; the problem is they haven't been doing the fixing. So there's been some -- there were some fixes between the Round 1 in November of 2008 and the Round 1 Rebid of November 2009. But the fixes were, you know -- granted there was some progress, but it was far from enough. We needed radical reform, and that we did not get.

And in fact, one of the changes, switching from average pricing to median pricing, actually exacerbated the poor incentive properties of the auction design.

(12:32) So -- and then the final step of the scientific method, when you're bringing something, a complex market into practice, is to do simulations and demonstrations, and that's what this is today.

And so I've got -- we have an incredibly talented team that has been working non-stop seven days a week across multiple countries, you know, literally dozens of people putting together the software which we'll use today, which is a state-of-the-art auction program. Our lead developer, Ulrich Gall, is sitting right here. It's just a brilliant piece of work, and I think you'll agree that it's quite remarkable.

(13:24) He -- I was getting emails from him towards the end of February saying, "Are we going to do this? You gotta tell me. We -- we -- you know, it's going to take us a long time to get this all together, and you know, we're approaching on 30 days."

So I got the final one of these emails on March 1st and actually didn't bite the bullet until March 7th. So March 7th I told Ulrich, "Yes, we're a hundred percent go, full steam ahead." And it's been a full team effort with dozens of people working extremely hard to pull together what you'll see today.

(13:57) Now all of these people, myself, Ulrich, all the others, are totally unpaid. We're not paid for this. We're -- we're doing this because we believe in it. And we believe in it, I think -- you know, certainly for me, I believe in it because I've seen how effective efficient auctions are in solving very important complex economic problems, and others in this room have a similar experience, such as Evan Kwerel from the FCC, who brought spectrum auctions to the United States and have been replicated around the world -- very effective.

(14:43) Jeff Wharff, who almost brought -- there's Jeff behind Evan -- who almost brought the auctioning of takeoff and landing rights at congested airports. That's something that's still in the works, but, you know, with some -- before we die that will happen. Congress passed a law banning the auction of slots at airports. So congressional power can have a role.

And there's several other agencies represented here. It's a very, very good group. Here it is -- the majority of you are Medicare providers or represent Medicare providers, and that's very good. That was my expectation, and we have just over half. There's 106 of you here today, and just over half are Medicare providers.

(15:33) There are a lot of auction experts, about 20, 18 from Government agencies. Very impressive, a long list. We've got HHS, CMS, CBO, FAA, FCC, Department of Interior, USDA. It goes on and on. NSF, one of our sponsors -- thank you very much, NSF, for supporting this effort, and thank you too for the University of Maryland.

MS. NANCY LUTZ: (Indiscernible) that we support Peter and Larry's research. We are not paying for the conference.

MR. CRAMTON: Yes, absolutely.

MS. NANCY LUTZ: (Indiscernible) NSF does not (indiscernible) policy.

(16:18) **MR. CRAMTON:** That's right. Yes. Yes, I should be clear about that. Yes. So -- yes.

MS. NANCY LUTZ: (Indiscernible) to that again.

MR. CRAMTON: Sure, okay. Yeah -- no. Nancy is the Director of the Economics Program at NSF, and NSF has as they -- they support many scientists, and Larry and I are currently being supported by NSF, our research, but, yes, they are not directly funding this conference. They're sponsors, but not funding sponsors. And they're not taking any political positions, of course, just scientific positions -- like gravity does exist. They will -- they'll go along with that.

(17:01) There's a number from congressional staff. Actually, you see the cameras here. The cameras actually are -- when we talked to people on the Hill, they said, "We would love to be there, but we cannot spend eight hours -- given what's going on in Washington right now, we cannot leave the Hill for eight hours."

And so they insisted that it be filmed and that then they be able to see that. So that -- that's the plan with respect to the congressional staff. I thank very much those congressional staff that were able to pull themselves away for eight hours.

(17:34) There's some journalists here, I believe, from the trade press, and there's one investment banker.

The last question on the questionnaire that I had you fill out said this, "Auctions, if done right, can be an effective method of pricing certain types of Medicare supplies and services. Agree, disagree?"

(18:00) So my expectation, given the group of participants and given the politics that I've been hearing, was that there would be roughly a 60/40 split, 60 disagree, 40 agree. I was surprised, and I think you may be as well. Of the 106, 84 agree with that statement, and only 22 disagree.

So I -- that actually means that there's a bunch of hopeful people here, and that is extremely impressive given what you've experienced over the last 12 years with respect to auctions because you really haven't seen the -- I'm sure CMS means very well, but you have not seen the state-of-the-art when it comes to auctions over those last 12 years.

(18:52) Why is it so important and why am I so engaged by this and -- and my colleagues so engaged? Well, it's incredibly important for our national economy. Right now we've got many tens of trillions of unfunded Medicare expenses looking forward, and that is a big number. We have our financial crises and maybe it doesn't seem like a big number, but 70 trillion is a big number. I don't know if it's 70. It might be 60; it might be 120, but it is a big number.

(19:24) And using innovative market methods to help price goods and services efficiently is the best approach, I believe, to rectifying this very difficult situation.

With respect -- now, of course, this DME we're talking about, home medical equipment, and that, in this picture -- I love this picture. This is just diabetes, and it's from 2007, so these numbers have grown. But for just diabetes, you can see that it actually -- we're not talking about that much money. So why are we talking about tens of trillions?

(20:11) Well, because this is sort of the test case, and if we can't do this test case, then we won't be able to use market methods in other areas where the savings could be larger.

But the other thing I love about this is if we mess up here -- just think about the Ruskin quote at the beginning -- what happens if you mess up here and so you don't get the quality goods that are needed? So what if I get diabetes test strips that are messed up? What if I do not get the oxygen? **(20:45)** Well, then I just move up here into the ER realm. And so I've just magnified my costs by -- I've taken a $20 cost and it's turned into a multiple thousand dollar cost, maybe a $20,000 cost.

So you can have a hundred-fold, thousand-fold increase in cost if you don't do a good job here. That's why this is very important.

(21:12) Okay. Finally, before I introduce Jon Blum, I'd just like to say that Obama appears to be very much on-board with fixing the Program, and I glean that from his Executive Order of January 18th. In particular, these are the basic principles that he lays out in that Executive Order, and it says things like "It must be based on the best available science." One cannot say that of the CMS auction. It's not based on any science; it's based upon some politics, but no science.

And there is a lot of science in this field now. There's -- there's literally thousands and thousands of papers that have been written and studies that have been done.

(22:02) So -- and it goes on, but I think that you'll find that there's actually many shortcomings of the current CMS Program that can be fixed and I hope will be fixed in Round Two.

With that, let me turn the floor over to Jon Blum, the Deputy Administrator of CMS, who is in charge of the Program and I know working very hard in trying to make Round Two as good as it can be.

[CONCLUSION OF FIRST TAPE - FILE 0543]

WELCOME BY JONATHAN BLUM, DEPUTY ADMINISTRATOR, CMS

MR. BLUM: Thank you for having me.

I just want to open or help open the conference, one, to express CMS thanks for Professor Cramton and his colleagues. That is rare, I think for an individual or a group to come together to help CMS build the best possible policy without funding, without -- with the best interests.

(00:31 - File 0544) Most conferences where I speak about the topic I hear push-back about the notion about competitive bidding in general. I think we're all here because we support the notion of competitive bidding, but we want to do it right.

I, unfortunately, can't stay for the day, but we have CMS staff here in the audience. They are going to participate. They are going to learn. They are going to take the experience and come back to CMS leadership, tell us what happened, tell us the results. So we are -- we are very much interested in today's simulation and will take back the information and will take back the input.

(01:15) I want to just kind of say from a CMS perspective why competitive bidding is so important to CMS. We have a fee schedule throughout the country that is ineffective from our perspective. We know we're paying too high for certain items, for certain supplies.

We have concerns about fraud and abuse. We have concerns about quality. We have concerns regarding appropriate use of certain items, certain supplies. This is not just CMS. This is the consensus throughout all the Government oversight agencies. And so we think that one key strategy to address these concerns is through competitive bidding, to get the right price, to get the right utilization, to get the right oversight, the right quality, and that is why it is so important to us to implement the Program in its current phases.

(02:09) And as we know, the Program is structured in phases. We have implemented Round One in nine parts of the country. We are carefully assessing the data, both clinical and costs and claims. We are going to present next week at our Tuesday PAOC Meeting -- we have some folks here in the audience from our PAOC -- the results so far, and so we'll have a lot of details to share regarding both the clinical experience of beneficiaries in those nine competitive areas, how have claims changed, use changed.

(02:45) We're comparing them to control groups. So, for example, we're looking at Orlando and comparing it to the experience of Tampa, you know, cities close by who have got similar populations, to ensure that we can assess the experience versus a control. And we're watching complaint data very carefully, both coming into our call centers, both experienced by the regions. We're assessing patient experience, and so we'll have a lot of data to share on Tuesday just in the interest of transparency just so folks can know what CMS is watching and also to form their own notions on how the program is going so far.

(03:30) So folks have asked me, have asked CMS what is CMS watching for. We have briefed members of Congress. We have briefed our political leadership. But the things that CMS right now is watching very carefully is, one, how has clinical use changed. And the foremost concern is to understand how our beneficiaries' clinical outcomes changed since January.

We're watching carefully changes in overall utilization, and we expect changes because we expect -- we know right now that in some cases, we have over-utilization of certain items, certain supplies.

(04:12) We are watching the changes in the overall delivery of services -- for example, diabetes test strips. Has diabetes test strips mail order use shifted it to the retailer? We're watching that very careful, and we'll have some data to present on Tuesday.

Again, we're watching very carefully beneficiary complaints. Those are being escalated to our case managers. And we're very pleased that overall beneficiary complaints coming into CMS is way -- much, much, much less than what CMS had expected.

(04:44) We're also watching customer satisfaction. We're surveying beneficiaries who are in competitive bid areas to assess customer satisfaction, and that is part of our ongoing efforts.

So while we're watching Round One very carefully, we're also going through the process to think through how to think about Round Two. Round Two, according to the law, will expand competitive bidding tenfold. So today it's in nine parts of the country. By law, CMS has to implement the Program to, I think, 91 parts of the country by January 1st, 2013.

(05:23) Tremendous expansion. Tremendous workload for all of us, and so we're thinking very carefully of how to think about how to implement Round Two going forward. Some of the questions that we're asking ourselves -- and I know this group here is here to help us address -- is one, what mechanisms, what structures, what calculations will produce the best prices.

So the notion is how to get more efficient prices than the current fee schedules that we have in place throughout the country. What's going to be the structure? What's going to be the mechanism that produces the best possible, most stable efficient prices.

(06:05) CMS also has to balance competing tensions. We have to balance competing tensions about the best price, but we also want to serve beneficiaries well. We need to ensure beneficiaries have choices, can choose from multiple suppliers. And sometimes those goals towards the most efficient price sometimes compete with the goals to have beneficiary choice.

(06:28) We also face pressure. We also face a lot of interest from small business interests to ensure that our bidding mechanism also addresses concerns about ensuring good participation from small business.

I think the last question that CMS has to think about very hard is how do we balance our constrained resources? We're going into a world of very, very constrained resources, constrained budgets, constrained staff resources, through CMS Baltimore, through our regional staff, through our call centers. And so we have to choose and implement a design that also considers CMS resource constraints going forward.

(07:10) So over the next several months CMS will be in the mode of thinking very critically, thinking very carefully about what changes to put in place to implement Round Two. We have not made any decisions. We are looking very carefully at data. We want feedback. We want the feedback from this conference.

(07:39) CMS staff will be here throughout to participate, to learn, to understand. That's going to go into our thinking. We want to hear from stakeholders. We want to hear from our PAOC on Tuesday about thoughts. And while we are open to suggestions for improvements, we believe very strongly that DME competitive bidding should continue to move forward, both for the reasons that Professor Cramton outlined, to ensure that we have a stable Medicare program going -- sustainable Medicare program going forward, but also in the interests to ensure that our beneficiaries pay the right price -- they pay 20 percent cost-sharing for DME items and supplies -- to ensure we have the best quality, to ensure Program integrity, and that that goal has not changed.

(08:19) On Tuesday, CMS will be outlining our proposed timelines for Round Two. Those proposed timelines will take into account the prospect for possible changes through rule-making, but, again, we have not made any decisions.

We're going to take this conference, we're going to take experience, we're going to take our claims monitoring, clinical monitoring, but we're going to propose some thoughts to our PAOC for feedback for advice on Tuesday. But, again, we are in the world of thinking about possible improvements, possible changes, and I want to thank everybody here for helping us go through that process.

(09:00) Unfortunately, I can't stay today. Would love the opportunity to stay all day, but we have a few crises back at CMS that I have to tend to; not about competitive bidding, but otherwise.

(09:12) But, again, I want to thank everybody here in the audience. It's rare to have a group come together to help CMS accomplish its goals. And we look forward to the experience, look forward to the simulation, and our staff will be participating and will bring back to CMS leadership the experiences, the results that will inform CMS decision-making going forward.

So thank you, Peter, and thanks to everybody here.

[APPLAUSE]

[CONCLUSION OF FILE 0544 & SEGMENT I]

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MEDICARE AUCTION CONFERENCE
INN AND CONFERENCE CENTER
UNIVERSITY OF MARYLAND
FRIDAY, APRIL 1, 2011

SEGMENT 2
FILE 0545
A PROPOSED AUCTION APPROACH FOR ROUND 2

Transcribed for: Bart Woodward

Transcribed by: Aleva (Lee) Schneider-Pollard, TranscriptionBiz

Date: April 7, 2011

File Name: 0545

P R O C E E D I N G S

[BEGINNING OF FILE 0545] SEGMENT 2

MR. CRAMTON: (In progress?) I want to just say one thing, and that is if you use -- switch to an efficient auction, it actually will greatly reduce CMS resources because in an efficient auction, one of the very nice features about it is that it actually really smooths the process enormously; whereas, if you have an auction process that has serious problems, you get lots of complaints, you get mispricing, you get all sorts of bad things happening, and you're constantly trying to put fires out, and that is a challenge.

(00:44) Okay. So next on the agenda is a quick review of the proposal that my colleagues and I have put together with respect to the CMS DME environment.

Now this actually is a very interesting market design problem, and we have lots of expertise in designing auction markets in complex environments. So this was an interesting challenge, and you'll see I'm going to try to highlight some of the things that we did that we find are very useful simplifications in order to make the process simpler, easier for everybody, and also ultimately effective. The idea is you want a design that is as simple as possible, but not too simple.

(01:49) So, first, let me just very quickly review the CMS design flaws. I suspect that most everyone is familiar with this. But the approach that is -- was used for Round One Rebid was this -- was not this. This is an efficient clearing-price auction. And the way it works -- and we'll actually see a picture like this again and again, which is what economists love, a supply -- this is a supply curve and this is -- are two axes or -- one is quantity, and the Y axis is price. And we've got our supply curve upward sloping when we order the bids from low cost to high cost.

Now in this particular example, we have a demand of seven. That's this vertical line, so that's our demand curve -- seven, and everybody can see that intersection of supply and demand where here's seven bids below the clearing price, and this is the last rejected bid, the lowest rejected bid, number eight. And in an efficient auction, that last rejected bid is what sets the price. So that would be our competitive price.

(03:14) In a world there's lots of desirable properties of this very simple auction. It has the property that's in a world of substitutes. It finds the competitive equilibrium prices, which are the least cost solution; the single price, it's Pareto optimal. That means you can't make everyone in the economy better off by doing something else. You can -- you'd have to harm somebody in the process. So it's efficient. So that's very nice.

And it's also incredibly simple, and it's used -- it has been used in thousands of markets for thousands of years. It's very basic.

(03:58) In contrast -- and this is exactly what we did in the laboratory experiments at Caltech and at the University of Maryland, and we're going to do a version of that today.

Now the CMS auction, instead, could be called median price with cancellation. And the way it works, it starts out the same way. Everybody submits a bid, and here I've simplified, so you just -- there's no quantities involved. Everybody is supplying a single unit. And we need seven, and so these are all the bids. We -- CMS orders them in a supply curve, and then they need seven, and so they would move up for these first seven.

(04:41) And then -- but rather than having the price be this one, the last rejected bid, they instead have this median price rule, which takes the median of these seven numbers, okay, which is this one right here, the one right in the middle. So that means that 50 percent of the people bid something less than that price and 50 percent of the people bid something more than that price.

Now the choice was actually a political choice, made at the highest levels. And why did they do that? They did that because this number right here is a lower number than this number right here. They did not think about the incentives, and in fact, in this case, it turns out that the health economist that was advising them advised them against the median pricing rule. So even the health economist, without any training in auctions, recognized it had some serious problems.

(05:48) It does, and so this was -- and then you'll recall in the Federal Register, there's some very -- and people in the industry actually pointed out that this is really fairly bizarre, and CMS responds in the Federal Registry with some contorted logic explaining why this makes perfect sense.

It does not make perfect sense; it makes no sense whatsoever. One of the properties is that you have to -- is that, you know, these guys might rightfully be upset about being forced to supply at prices below what they bid. And so CMS just asks, okay, "Well, you put in your bid; then we'll ask you afterwards whether you'd like to supply, and you can just say no."

(06:36) And so that's what's illustrated here. Here this guy said no for one reason or another, and this guy said no. And so we just -- then we asked this guy and this guy, and they said yes. Okay, but the price stays the same.

That is a very serious problem. Actually, the most obvious of the problems is not the pricing rule, but the non-binding nature of bids.

(07:00) Rule Number One of auction design is that bids are binding commitments. Incentives get distorted in dramatic ways when that's not the case, in undesirable ways. So that's a very serious problem.

Now I'd like to point out that this approach has never been used anywhere on the planet earth. Okay. Nobody anywhere; whereas, the one that I showed you before has been used in thousands of industries for thousands of years. And auctions have been used for thousands of years, trust me.

(07:36) So this combination of median pricing together with the non-binding nature of bids is especially problematic because it gives the bidders a very strong incentive to low-ball bid. You just put in the lowest number you can think of, and you've won a free auction.

You don't know what the price is going to be. CMS will tell you what the price is going to be. If I bid zero, I'm not going to be setting the price. The price is set by the median bid. And so I've just won a free auction, and in fact, if I was advising a bidder in this auction -- and I'm actually often asked to advise bidders in auctions like this -- I would advise them to do just that. Low-ball bid; let's find out what the price is. If you don't like the price, reject the price.

(08:30) So that's extremely problematic. Obviously, if a lot of people do it, then the prices are going to be dramatically distorted in a downward direction. Okay. So that's what the theory suggests. In fact, the theory shows that, in fact, there's lots of equilibria of this auction, the most plausible of which is complete market failure because everybody -- because the median is below everybody's cost, and so nothing is supplied.

Now that's not what happened in practice, and there are explanations for that. So we try it out in the lab; what happens? We get lots of low-ball bidding, and in fact, the low-ball bidding is more prevalent among those companies with very high costs which is kind of interesting.

(09:21) In fact, the theory proves that there does not exist any equilibrium in which your bid function is increasing in your costs. That's a property of all sensible actions -- would have that monotonicity property. The higher your costs, the higher your bid. And we're able to prove that, in CMS, you cannot have equilibrium behavior like that.

The last -- there's lots of other problems, but the last problem that I'd like to emphasize is the lack of transparency. This auction right now is just atrocious on the dimension of transparency. Especially for a public auction, it's important that there be transparency. There's concerns about corruption potentially, and in any event, this is very public. The public have a right to know.

(10:24) In this auction, so bids were initially taken in November of 2008, but there were such serious problems that Congress threw the auction out. They re-took bids in November of 2009. The bidders did not learn who won the auction until a year later -- no information.

We still have no information on the quantity side; that is, what was assumed about that -- the capacities of the various winners. And that's very important because those capacities is what forms that supply curve, And so essentially, if CMS has the ability to manipulate the quantities, they can, essentially, get any price they want out of the auction. So that's why I wouldn't actually call the CMS auction an auction. It's not an auction; it's an arbitrary pricing process.

(11:24) You know, unless I know more, I basically have to know more about what they did in order to determine what the relationship is between bids and prices. I'm not given that information, even today. I've asked for the information, but I'm not given that information.

Also, the quality standards are very unclear. The performance obligation is extremely unclear, and as I said, how the quantities are determined is far from transparent.

(11:53) Now here's an example of the problem if you've got flexibility with changing the capacities. This is the quantity dimension. You can see here with our demand here, our median is right here, and the price is $7.00. But one thing we could do is actually -- "Well, I don't actually trust these capacities. These guys said at qualification that they could do 10 percent of the market. I don't trust them; I think they can do 5 percent. So I'm going to put in 5 percent for them. And if I do that for all the bidders, then the picture, instead of $7.00 turns out -- yeah, there's the price. Now it's $12.00."

(12:27) So you can see if you give me the discretion to -- in a non-transparent way -- to vary people's quantities, which they certainly have that discretion -- they haven't mentioned what anybody's quantities are -- they can vary the price, and that's actually one reason why the low-ball bidding didn't lead to complete market failure in my mind -- because they discounted the quantities until they got a price that was low, perhaps too low, but in the ballpark of reality.

Now another thing that they do is they have -- they've introduced a floor and a ceiling on the bids, and that floor and ceiling also guaranteed that the thing is not going to -- you know, that something will come out of it that's sort of in the realm of reality.

(13:20) Without those floors and ceilings, what we would see would actually be much uglier. And in fact, you can make the CMS auction work perfectly, believe it or not, just by bringing the floor and ceiling together so they're identical and they're equal to the competitive equilibrium price that leads to least cost supply.

Now the only problem with that is, of course, then it's not an auction, because you have no discretion in your bid, you can't bid quantity or price, and the other problem with it is -- and this is the biggest problem -- CMS has no idea what the competitive equilibrium price is. That's why we're doing an auction. So it's very important that we have an auction.

(14:07) As I said, we've done theory, we've done experiment, we've looked at the field data. Looking at the field -- I didn't mention this yet, so let me mention it quickly now -- we see that the Round One Rebid is resulting in a radical transformation of the market structure.

I'm not opposed to transformation of the market structure. CMS's old system, the administrative pricing, were the wrong prices. I think all of us would agree those prices were wrong. They weren't the competitive equilibrium prices. Some were too low, some were too high. They were all wrong. And that's what's led to a market structure in DME that has been far from optimal.

(14:49) I don't know what the optimal market structure looks like, but I know it's not what we have right now. And so what I think is going to happen is over a period of time, a decade or so, it'll -- the market structure will gradually evolve with an efficient auction to an efficient market structure.

But I do know -- and what I think is a terrible shame -- is a radical restructuring of the industry in a way that is inconsistent with an efficient auction and/or an efficient market structure. It's just imposing a lot of costs on a lot of people.

(15:30) You know, it's one thing to get bid out of the market because other guys can supply good stuff at lower prices than you can. That's competition. But the Round One Rebid, instead, is an arbitrary reshuffling of the players which is traumatic to the beneficiaries in the long run -- I mean, we're only a few months into it. It might take some time because I've got my canisters of oxygen stocked up for me right now, thank you very much, and I've got 90 days of my diabetes test strips. So it'll take a while to see this thing crash, and quite frankly, I actually -- if CMS can show that things look wonderful after a full year or something, I still know that the auction is fundamentally flawed. There's nothing that can change that.

Okay. So now let me quickly summarize the proposal.

(16:31) First, I said agree that auctions, if done right, can work. So how do we fix the CMS design? First, binding bids.

Very natural -- we make the bids binding. We do that with suitable and rigorous qualification, bid bonds or deposits to guarantee the bids, performance bonds or performance deposits to guarantee the deposits. These are standard commercial instruments that are used in virtually every industry. It's not a big deal.

(17:03) Yes, it's a very important detail that will require a lot of work to get right, but it's something that can be done, and then simply have a simple effective price discovery process to identify those competitive equilibrium prices, market-clearing prices for the various products. That's how it works, and that's what I'll describe.

Now here's the first really big simplification, and this is one of the challenges in this application. If we were talking about electricity, what we would do is we would have an auction, we would -- the auction would -- the product would be a very well defined financial product actually that puts you in a particular financial position. And you honor that position physically in real-time or you settle any deviation in real-time based upon the real-time spot energy price. Okay. That's the way lots of markets work.

(18:15) We can't do that here because we don't have a real-time market, first of all. What we're doing here -- and we can't say, "Okay. You're going to supply 30-million test strips" because it's the -- we want the Medicare beneficiaries to be the ones to decide who they work with, and that hasn't been resolved. We don't even know who the beneficiaries are yet at the time of the auction.

So what the auction is going to identify is not a particular quantity of supply for each party with deviations settled efficiently; rather, what it's going to be is identify a pool of winning bidders that are eligible to supply the Medicare beneficiaries for that product in that region.

(19:14) The way -- but we still have to do something with respect to quantity, and so the way quantity is done in the proposal is it's based upon historic supply. So if you're supplying 10 percent of Charlotte diabetes test strips, then you're 10 percent of -- then you've got a capacity of 10 percent.

Now overall there's going to be a hundred percent, right? So how do I get competition? I need excess supply in order to drive the competition in the auction. Well, that comes from new entrants. So a new entrant might be somebody that's supplying in Miami and thinking "Well, I can supply in Charlotte too. Why not? So I'm going to move into that market." Or it could be somebody that's supplying walkers in Charlotte and says, "Well, look, I can expand into mobility devices too. That's not a problem for me," and that would be a new entrant. And if you're a new entrant, you get one block or something like that.

(20:19) The point is the quantity side is determined completely objectively which is important for transparency so everybody knows how this auction works. It certainly supports new entry, and in fact, it's the competition among the new entrants that is going to determine the price, and that's a good thing.

Now what you have to be concerned about is if you've got these fly-by-night new entrants that actually aren't going to do anything. They aren't going to perform on their bid. Then that would tend to bias the price downward.

(20:59) That's why the bid bonds and deposits are so important and the qualification. If you do that properly, the fly-by-night guys are no longer fly-by-nights. It's not an opportunity for fly-by-night guys.

Right now Medicare is rife for fly-by-night guys because they don't have adequate protections. So you bring in the adequate protections, and the bad behavior goes out. It addresses corruption and fraud, and that's very important.

(21:32) Now I know that -- and I know that a lot of you guys as providers are actually quite pissed off about the guys that are engaging in fraud because you get -- you know, people -- you say, "I'm a DME provider," and they're "Oh, okay. So you're a fraud artist or something" because people read about this in the press all the time.

I've spoken with many of you and I'm quite convinced that the vast, vast majority and perhaps -- I suspect -- everyone in this room who's a provider is doing it because they love it, they want to provide a valuable service, and they have no intention of just defrauding the Government.

(22:17) An efficient auction with proper qualification weeds out the bad apples and makes your life much better and makes the whole program work much better and makes CMS's life much better too. So that's why it's so important.

So the way the auction works, we will see in a moment simultaneous descending clock. It's a reverse auction. We start at high prices; we go down to low prices. That's because it's an auction to buy rather than an auction to sell, like on eBay, which would be a forward auction.

(22:46) And the rules are very simple. I tell you what the price is for each product in each region, and you simply say, "Am I in or am I out?" You have a capacity associated for you because of your historic supply, and that'll be given to you.

And then what happens is that any production region where supply exceeds demand, we lower the price, and we keep lowering the price until supply and demand balance; that's the market-clearing price.

(23:29) When that happens for all the product regions, the auction stops. The winners are immediately identified, and throughout this whole process, you actually get to observe the excess supply so you get to see how competition is changing in all of the product regions while you watch it, and that's very important.

The reason it's very important is it enables you as a bidder to piece together a portfolio of products and regions that make sense given your business plan. You might enjoy complementarities across products within a region. So you want to be the one-stop shop in Charlotte. You're going to serve all the products in Charlotte, and that may lead to you getting more referrals than somebody else that can't offer the one-stop shop.

(24:28) Another complementarity might be on the supply side where you specialize in mobility devices, and you do a really good job with mobility devices, and you can do them in Charlotte, you can do them in New York, you can do them in San Francisco. So you're interested in mobility devices across the country.

This auction lets you capture those complementarities, even if they're more limited. Let's say they're East Coast complementarities or West Coast complementarities or mid-West complementarities. Anyway, this auction lets you piece together a desirable portfolio.

(25:02) Now in contrast, the CMS auction is a crapshoot, simultaneous sealed bid, and it's a total crapshoot. You know, what you won was some -- you know, it was black magic, right? I mean, you had no idea what you were going to win. There's no way you could try to capture complementarities.

Now what if those complementarities don't exist? Maybe it's just substitutes. Everything is -- it's really actually "I've got my cost. It costs me 10 bucks to produce this, and it doesn't matter -- it's 10 bucks every region, every unit" -- then, in that case, that's what economists call the case of substitutes -- there's no complementarities. Then this auction works perfectly, gets full efficiency, and does so very quickly.

(25:50) So having this dynamic process, which you'll see is very easy, if we're in a world where there aren't a lot of complementarities and so you're really taking advantage of the price discovery, in that world, the auction still works perfectly. It just actually has -- it works more easily, and so there definitely isn't any extra cost resulting from the little bit of extra -- having a multiple round process.

And in fact, any bidder -- if you're a small bidder and you don't have any complementarities, you just want to bid on, say, walkers in Charlotte, and you know what your lowest price is, at the beginning of the auction you can put in that lowest price and go home. You don't have to watch it. And then you'll find out immediately afterwards whether you've won or not.

(26:44) Now one thing is you will find out immediately whether you won or not. So the auction is going to give you lots of information as we go through it, and you'll see that. And then you'll learn, at the conclusion of the last round, boom, all the information is available instantly. It doesn't take a year.

And one of the big reasons it doesn't is because your bids are binding commitments, and so those bids that you've placed you're on the hook for. It's just like signing a contract. You've already signed the contract. And that's the way modern auctions work.

(27:31) Post-auction competition is very important in terms of quality, and that's how the current market works, with the Medicare beneficiary deciding who's going to supply them. And if you're a shoddy supplier -- provider -- then you're not going to be selected quite so much.

We want to maintain that here, and that's exactly what happens. So after the auction ends, then there will be a set of suppliers for that product in that region, but then it'll be the Medicare beneficiary that will decide who will provide service. And that choice, I do believe, is very important, and that will remain.

(28:14) Here's a huge simplification that I think is extremely useful, and that is we've got a product -- let's take a mobility device, a standard mobility device. It's actually a whole category, right? There's a lot of things -- there's a lot of parts associated with that standard mobility device.

It's got a motor assembly. It's got a right arm, left arm, foot support, all these things. Those are all complementary products. And we know in auctions you actually want to bundle the complementary products together. And so if you're a winner on the mobility device, you want to be a winner on those complementary products -- the motor assembly, the battery, the arms, wheels, all that stuff.

(29:11) So what we do is we bundle it into a product category as is done now. But now what you do is you bid on those individual products within the category. What we're proposing is no -- instead, at qualification, you submit a relative price index which says that "Okay, this standard mobility device, the whole thing, that's a hundred." The motor assembly relative to the hundred is, say, 30. The battery might be five. That is 1/20th of the whole complete deal, and so on. You do this for each of the products within the category.

The sum of those things -- they aren't constrained to sum to 100. They would sum to much more than 100, right, because it's more costly to provide the individual parts. But the point is you, as a bidder, get to specify the relative price for each of those products within the complementary category. And that is really nice because what the auction is going to do is determine the price for the lead product, which might be the standard mobility device, the whole thing.

(30:31) Then the price for all the other products is determined instantly from the relative price index. How do we get the relative price index? We simply average what you reported as the relative prices, okay, and what average do we use? We weight by capacity. So it's a weighted average. It's the industry's consensus, properly weighted. The 20 percent guy in the industry is given more weight than somebody that's got 1 percent -- perfectly natural.

And the incentives are actually excellent for truthfully reporting your correct relative prices. And what you really care about is the absolute price which is determined in the auction. So that actually is a very simple trick. It gets around -- we had -- you remember with the individual, there's this thing -- the bid skewing that Brett initially pointed out in a very nice paper about nine years ago or even more -- when the first draft. And this bid skewing, which basically makes you want to put in bids of plus infinity and minus infinity on the individual products based on the scoring rule and so on, it's all quite complicated and messy.

(31:54) And that's why we got into the floor and ceiling business, to tighten things down, to keep people from bidding at huge extremes. But the end result is we can eliminate all that and actually capture all of the complementarities much more effectively in a much simpler process. So this is a very, very important simplifying step, and I strongly recommend it.

Okay. The products and the categories and the regions, all those need to be thought of some more. There's been a lot of status quo for a very long time, and the world's a changing place. And so the products, the product categories and the regions need to be re-thought. And I'm not going to say more on that. It's a topic for afternoon discussion. But that is actually very important.

(32:49) One of the last things I want to say and then we're going to take a break is the -- and this is very important -- is the staging of the auction. Do you do the whole country all at once? Do you do parts of the country in sequence? How long are the contracts and so on? All those are very important.

So here's version one where we're going to auction 100 percent of the country, but rather than do it all at once -- we don't want to put all our eggs in one basket -- we want to auction it in stages. So one thing we could do is have three-year contracts and auction a third of the country each year.

(33:35) So we do the West Coast, then we do the mid-West, then we do the East. Now that would work just fine. The one problem with it, however, is that you're going to be excluding a lot of suppliers because basically if you haven't won in a region for the particular product, you can't supply it. You're not eligible to receive reimbursement. So that's going to limit the Medicare beneficiary choice.

Some of that exclusion is necessary in order to get the auction to work; otherwise, you would just exit right away and then supply anyway, right? Exiting right away keeps the price up, and then you supply anyway. So that doesn't work.

(34:27) But here's an alternative that does work, and I know it works because we've used it in other countries. So this is my preferred variation, and I know it's the preferred variation of many in the provider community. And that is to auction just 10 percent, a representative 10 percent, each year. And when I say representative, I mean each year we auction 10 percent of the regions, and the regions are selected to be representative. Some are urban. Some are rural. Some are halfway in between and so on. Some are in the West. Some are in the East. Some are in the mid-West. Some are in the South.

Why would you do that? So under this proposal -- and this is just an example of the proposal -- we have the 10 percent representative region and actually product region, two-year contracts. And so what that would mean is that any particular time there's 20 percent of the country that's under contract.

(35:43) In that 20 percent of the country, only the winners for those regions and those products are eligible to supply; however, in 80 percent of the country, it's any willing supplier at what price? We don't have a contract price. The price is determined from the auction prices in the 20 percent representative areas.

Okay. So you have a simple econometric model that makes the adjustment. Let's say I've got a price in New York under contract, I've got a price in Washington under contract, and I'm trying to figure out what the price is in Boston. Well, econometricians are actually great at doing that. We know that Boston actually shares a lot of properties with Washington and New York. It's got a slightly different cost of living, let's say, a slightly different mean transit time for this particular product or whatever, and we make a slight adjustment.

(36:47) So let's say you know it's $95 in Washington, it's $105 in New York, and then we figure out, oh, actually, that the price is going to be $99. And any supplier that's qualified, any Medicare qualified supplier for that product and that region, can then supply.

Okay. And then we move around the country, the 10 percent, and what that does is it leads to a lot more beneficiary choice. It leads to much less turmoil in the market structure, and it still does lead to competitive equilibrium prices. And in fact, it fosters, in some sense, greater competition in the auction because you're enabling a larger set of competitive suppliers.

(37:38) One of the problems with auctions -- I mean, one thing we could do is just auction the whole thing to one bidder, just "Here, you get the whole country" and I just have one supplier. And the problem with that is, of course, then after the auction I'm left with one supplier. I've just destroyed the market, and we'd have a monopoly situation which we don't want. So this actually, I think, better addresses competitive issues as well.

We use that exact process very well for timber in British Columbia, and in fact, we use the 80/20. Twenty percent is auctioned. Eighty percent is in the long-term tenure. The long-term tenures are priced based upon the competitive auction contracts. It works beautifully. They adopted the proposal that Susan Athey and I made 10 years ago, and it's going great.

(38:34) The auction is very easy for bidders. That's what this demonstration is all about, okay, to actually show you that this is a piece of cake, you can do it, it's not a problem, and CMS can do it. My God, we did it in less than a month -- less than a month we customized this -- you'll see the software. It's amazing. It's incredibly intricate, and we did it in less than a month, and it works on all the major browsers. It doesn't work quite as well on Internet Explorer because Internet Explorer actually is a nightmare to program for, which is why I recommend that you use Chrome or Firefox. It'll be faster, and you'll get a better experience. But it works better. It definitely works better than the United website, and United Airlines has been working on that for a long time and spending a lot more money on it too.

(39:29) Okay. Highly transparent. You'll see exactly how transparent this is, and that is -- it's just a huge thing. It's night and day from what you've experienced so far. And I won't say more because you'll actually see it. What we're going to do is run the auction, and you will actually see just the information with our standard information policy that we would recommend for this environment.

Yes, there's lots of bells and whistles that we could turn on and off, but we'll talk about that after break. You're going to see what we think at this time is likely the best information policy in terms of what information you get when.

(40:16) The auction design is based on proven methods. These are methods that have developed over the last 20 years. They build on methods that have been used for thousands of years. They are extremely effective based on rock solid basic economics. In contrast, the CMS method is not, and I don't think I need to say anything more about that.

And it is true that especially these methods -- actually, my colleague, Larry Ausubel, is going to say more about it after break, but he'll give you some idea of the wide range of applications it's been used in in many industries across the world and with great success.

(41:04) Okay. So that's all for now. We'll break until 10:15. So we have a half-hour break until 10:15.

[APPLAUSE} [CONCLUSION OF FILE 0545]

TRANSCRIPT:

<u>MEDICARE AUCTION CONFERENCE</u>

<u>UNIVERSITY OF MARYLAND</u>

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MEDICARE AUCTION CONFERENCE

SEGMENT 3

[File 0546: MAC-Segment3.doc] [Tape begins after morning break.]

Peter Cramton: Thank you very much… Thank you. Thank you very much. Please finish your conversations and sit down. I wish my students would show as much enthusiasm. Good. Thank you very much.

So. Now we're going to do something very exciting, which is actually do an auction. And it's nearly a full-scale simulation… each of you has rules and a team member… some of you may not have a team member because somebody had to step out, in which case you'll be on your own, that's not a problem; and of course throughout this if there's any questions, you just raise your hand and I'm sure that there's going to be lots of people that can help you.

The… what we're going to do is actually have about a half an hour of discussion, or presentation of how this is going to work; my good colleague Larry Ausubel is going to begin. Larry and I have been working together since 1980 when we were starting our PhDs at Stanford. And we both ended up here at Maryland and have been here for now nearly 20 years. And in any event, for the last 18 of those years we've been engaged pretty much full time designing auction markets, and have done this around the world.

Larry is going to talk to you about some of that experience, and then how it relates to this immediate application; and then I will pick up with some of the details needed to get you going. Okay. Take it away Larry.

[File 0546: MAC Segment 3]

<u>Larry Ausubel</u>: Thank you Peter for organizing this, thank you everybody for participating; so my role right here is going to be to introduce you to the actual method of auction that we'll be using in today's exercise, and also… which is also the auction format that is proposed.

So, what I'm going to be referring to throughout is what we call "clock auctions," so let me basically begin by saying what me mean by a clock auction.

So the notion is that all items are auctioned simultaneously; prices are going to be descending. If this were Sotheby's and were auctioning off paintings… selling something, prices would be ascending; but since the government is buying, prices are descending.

Now… you may think about an electronic auction as being something like eBay, where bidders successively submit prices, but that is particularly badly suited for this environment. Two reasons: one is we want there to be transparency -- if you've watched an eBay auction, then five seconds before it's over you don't know what's going to happen; and at the same time, there are going to be multiple winners, because there are multiple suppliers in every region and every product.

So the way it goes instead, is in each round the auctioneer announces the price -- bidders don't announce prices, and in fact the auctioneer does -- and then bidders simply respond whether they're in or whether they're out.

Exit is irrevocable. So you can't say you're out at a high price, and then later change your mind and say you're in at a low price -- all that is, is an invitation for deception. As Peter was describing before, bidders prequalify for a specified number of blocks -- where a block is one percent of the overall; there's a lot of transparency, so after every round the aggregate supply remaining in is disclosed to everybody, and then the prices successively decrease and decrease, until aggregate supply is less than or equal to demand… that is until things clear.

Now this may seem a little bit unfamiliar, particularly in the medical area, so let me mention a few areas where these are more prevalent.

So first of all, clock auctions are quite prevalent in the electricity sector… for example, I'll just mention a couple of things here: in France, six gigawatts of electricity… gigawatts, that is, have been auctioned by this procedure for the last decade. If you happen to live in the New England region, the six-state New England region of the U.S., a hundred percent of the generating capacity for electricity where you live is procured via a clock auction; and one thing just to say -- you may have the attitude: well this is energy, it's something very generic; medical supplies are different, the medical supplies have to be there and it has to work.

But that's equally an issue with electricity… the lights have to go on, and in particular, the power for the medical equipment needs to be there, and clock auctions are used quite prevalently.

Just to say very briefly, they're also quite prevalent in the natural gas sector, and then in lots of other non-energy sectors of the economy.

So for example, clock auctions are used for spectrum licenses for mobile telephones; the FCC doesn't use clock auctions, but they use a very close cousin to it and have used it for over 15 years; and literally clock auctions have been used in a number of other countries…

They were used for the world's first auction of greenhouse gas emission reductions; they're used for Canadian diamonds; they're proposed for generic top-level domains on the Internet; they're used all over the place, and they're quite suitable, as you'll see, for this application.

So let me get away from the abstract, let's see how a clock auction works. So as I said, it begins with the auctioneer naming the price -- I'll call that P-1; if you're a bidder, you then decide you're in or out -- that bidder was in; but all the bidders are making this decision, so we aggregate all the bidders who said they're in, and that's the aggregate supply after the first round. So aggregate supply is greater than demand, which means that price can go down.

Okay, so we go to Round 2… a lower price, I'll call it P-2, the bidders submit their bids… you can see there one bidder dropped out, still very excess supply… we go on to Round 3.

Another bidder has dropped out, we still have excess supply, we go to Round 4; things are tightening up, two bidders have dropped out… and finally we go to Round 5, and you see in Round 5 it's now cleared. And so that is what we call the closing price, or the clearing price for that region, that product.

That's really the basics of the clock auction… they'll be some niceties to it that I'll describe and that Peter will describe, but a lot of it's really this picture for each and every product.

Okay, so some details. The first thing is, what was sort of simplistic about my last picture is that it looked like the pricing was very coarse. So it looked like we started at $25, then we go $24, then we go $23, and that's pretty coarse. So I mean, you can see right there. There is very little gradation; so in fact, the way that we implement this, is we allow the bidders not just to say they're in or out, but to choose an exit price, which can be any intermediate price, as to where they exit.

So for example, the auctioneer might announce in Round 1, the start of round price is 25, the end of round price is 24; what a bidder can do is either say "I'm in, all the way down to 24," or they can say they're out; and they don't have to say they're out at 25, they don't have to say they're out at 24, they can say they're out at $24.17. So you get much finer gradations than in that last picture.

[File 0546: MAC Segment 3]

So the advantages of that… there's finer expression of bidder's costs; and furthermore, you know, to go back to the picture, it looks like there's the potential for ties… having the bidders name these prices gives you a way of breaking ties, and a way of breaking it that's consistent with selecting the most efficient firms as the suppliers.

Okay, the next thing, multiple products. What I just described was just for a single product in a single region. So in fact, in the mock auction there will 6 products, 9 regions, and in the real world there could very easily be a lot more than that.

So in each round the bidder will place bids for each product region pair that the bidder prequalified for… these will all be going on simultaneously; the software you'll see is kind of slick, and it has an interface that will enable you to place as many as 54 bids really quickly and easily…

The advantages of having these multiple products going simultaneously, is that the bidding can reflect synergies. So, for example, you're a provider who wants to provide multiple products, or all the products in a given region; or you're a supplier who wants to focus on a single product, but to provide it over a lot of regions, this enables you to do that.

And by contrast, think of the nightmare if this is done entirely by independent sealed-bid auctions… you can think of the 6 products in the 9 regions as being a board or a table, and you're very likely to get stuck winning some kind of checkerboard pattern as opposed to something rational.

Okay? The next thing just to focus on is pricing. So as I said, there will be a separate price clock for each product region pair, so each one has its own start-of-round price, end-of-round price…

they may be dramatically different, because we're talking about different products; and so each price descends independently until aggregate supply is less than or equal to demand…

And then of course we have the question: What's the pricing rule? So we'll use the natural pricing rule, which is, we just take the average of all the remaining winners -- just checking if you're paying attention, April Fools -- [Laughter] everybody is paid the closing price.

The advantages of this, first: you can prepare the bid all the way down to your cost, but generally if you're a winner you don't have to… you'll probably be paid more -- and that goes back to the notion of cancellation or renunciation of bids that Peter was referring to; if you're a winner, you're someone below the closing price, so you want to deliver.

A second thing to note is confidentiality. Suppose you happen to be a really low-cost provider, lower than the rest of the pack… you'll never have to reveal this information because the auction will stop sooner.

So let me conclude with a summary of the advantages of the clock auction. So you'll see there's a great deal of transparency… there's transparency both in that after every round you get to learn the aggregate quantity being demand for your product and for your region; and furthermore, the moment the auction's finished, you know whether you won or lost, and you know why.

Second thing is efficiency: it selects the most efficient providers, and it determines a sustainable price.

Third is information price discovery. So as you'll see, you learn a lot of information in real time as the auction is going, and you can incorporate that into your bidding strategy, and you can use that information to come up with rational… a rational pattern of what products and regions you offer, and which ones you don't.

There's a simple activity rule, this rule of irrevocable exit -- once you leave you can't return, and that is what makes the aggregate information provided after each round meaningful. If you're an eBay person, it removes the possibility of what's called bid sniping there. Just hanging out until the last minute and then pouncing.

And then finally, there's privacy preservation; which as I said, if you're a winner, you don't actually have to disclose your bottom line to the software, to the government, to anybody.

Okay, so now Peter is going to pick up.

Peter Cramton: Okay. Now we actually get to see the software. So hopefully every team has a laptop, at least one laptop… if you have two, that's great, but definitely good to have one… the first screen you see here is actually not the first thing we want to do with your laptop, the first thing you would do with your laptop would be to log onto the hotel Wi-Fi system.

There was a single piece of paper, or maybe a couple pieces of paper, Ulrich's holding it up right now, that on one side it's got the program, on the back side it's got the wee-fee instru- I'm sorry, the Wi-Fi instructions -- the French say wee-fee and I think it's so cute that I like to slip into that. The Wi-Fi instructions are very easy, you just open up your… turn on your wireless and then open up your browser, and a modern browser will self-detect that the hotel wants a login and password.

The login and password… first you'll get some screen that says something about security, blah-blah-blah, do you want to bypass it, and then just yeah, you want to go right on in, please come in; and then you'll the university screen and the Inn and Conference Center screen, and your login is

Medicare with a capital M, your password is Medicare with a capital M. So everybody has the same login and password. So that gets you… now you're online.

Okay, the next screen, which isn't enabled yet, is the one that we have right here. But as soon as we open it to the public -- that is you, it's not really the public -- all the participants, you'll be able to click here to log in.

But of course you would have to go to the right URL, the web address is www.medicareauction.com, all one word. Medicareauction.com. Hopefully that will become a valuable URL. [Laughter] It was unused when we got it last week. [Laughter]

So. Then, once you click on the login, then you'll get the login page, where you answer your username…

Participant remark: Peter, I think that login's been compromised…

Peter Cramton: Yeah, it's been compromised, right… which actually is your actual first name, last name, all lower case, no space. Okay? So you are actual people, and we've customized this whole thing just for you.

Now. And that's why… the reason we have the assigned seats, which is pretty unusual for a conference, but the reason I did that was so that you would be seated next to your team member, and we wouldn't have to do some elaborate movement around in order to get all organized. Because as you can see, that would be a bit of a juggle.

So we should be all set, you should be seated next to your team mate, and you can decide whether one or both wants to log in. You would need to use different accounts, and you each have an individual account; to keep the load on the Wi-Fi down, you might want to just at least initially, just log on the one account. But if you want to do both, then probably we won't have any problems, and all will work well.

I have to say that typically when we do-- this isn't the first demonstration that we've ever done, we've done this lots of times with lots of industries around the world. So our number one problem in all this is the Wi-Fi connection. Number one.

So hopefully -- now at the same time that the software, which is incredibly elaborate, was done at record speed, and so it is possible that there'll be a glitch or two, but we're actually pretty confident and we did a lot of testing, the team -- we had, you know, multiple dozens of people testing the last few days. So it should work just fine, as long as the Wi-Fi connection holds out.

I believe both the username and the password, everything is lower case. At least that's the ones that I've seen. So definitely make sure your caps-lock key is not on, because it is case sensitive, so if you've got caps-lock on it will not enter properly.

Okay, then we're into the system. Now this is very hard for you to read, especially those in the back of the room, and I understand that. Hopefully you'll be able to see it on your screen in just a moment. But the important thing to look at first is this top row of blue buttons. Each of these is- clicks to the particular screen. So right now this one's highlighted -- that's the bidding screen. So we're actually looking at the bidding screen, which is the most important screen. Because that's where you place your bids.

Now we're doing something that's quite… I know we wouldn't have too many opportunities to do this, so I wanted to do something that was fairly close to full scale right off the bat. So normally what we would do, is we would do a little exercise with, you know, maybe 10 products and regions so you get a feel for it, and then we'd build up to 54, but we're just jumping right in with 54 right from the get-go.

And if you think about it, in a real auction, if we were doing 10 percent of the country, this is actually not wildly different from what you did in November of 2009. The part that's wildly different is the auction rules. And the interface on which you're doing it. That certainly is wildly different.

So each of these buttons are buttons that you will want to pass at various times. Your best friend is going to be the Bidding button, the Profit Summary, and the Round Results, and the Auction Schedule. Auction Info is going to tell you about the various products -- you actually don't need to know that, it's just a bunch of details; there's a messaging system built in so that if you have a question, something's not working the way you think it should be, then click on Messages and send a message to the auction manager.

We actually have a team of four of us here that are playing the auction manager role, and we will respond to your question. So the other way -- and we'll actually know who you are, we'll know where you're seated, so we'll actually be able to find you if we think face-to-face is going to be required for the resolution.

When you send a message you're sending it to the auction team, you're not sending it to everybody. That's good. Only the auction team can send messages to everybody. Which we will occasionally do.

The Auction Schedule is very important, that's going to show when a round ends, and when the next round starts.

Now the auction system works like clockwork. That's why you call it a clock auction. So if the round ends at 11, you've got to get your bids in by 11. If you do, then you're all set. If you don't, then you may be a loser in a market there where you want to win.

The other thing about your bids is, you might enter some bids, and your brand-new to the system, you have no practice whatsoever, you might make a mistake. Not to worry. You can fix any of your mistakes as long as you fix them before the round ends.

So you can go back, you can place a bid and then change the bid, change it again, redo it six times -- no problem; but once the clock strikes 11, if the round happens to end at 11, boom, whatever is your current bids is what's accepted. And then it's of course a binding commitment.

And nobody is going to see your bids until after the round is closed and the results are posted. And then you'll see -- they don't see actually your individual bids, they see: oh, Abraham Lincoln and Co. is… we won't say that you're in on this product in Cincinnati, no, it'll just say: this is the excess supply. But if you happen to be Abraham Lincoln and Co., then you actually see all your individual bids, as well as the prices in the individual… in the excess supply, aggregate supply for each of the markets.

This system actually has one feature which is totally state of the art. And that feature -- it's got many features like that -- but the feature that really is at the very forefront is actually the ability to input elements of your business plan that help you, as a bidder, make sure you're doing the right thing.

And the particular element that it has here -- notice this column right here. Though you can't read it, that says Cost. Cost. That actually -- what that is, is we did- each of you have got a sheet of paper with your private information. Your private information is your costs for each product and region that you're eligible to bid on. That's what you're having to pay, in terms of all your costs -- you know, both from the manufacturer, the service component, everything -- that's your bottom line. That's your cost per unit. And you've got that for every product region you're eligible to bid in.

Now the neat thing here, is the auction system has it, too. How did that happen. We entered it for you, okay, since we knew your costs; but in a real auction, you would have to enter it yourself.

Now what sort of crazy person is going to enter their cost information into the CMS Auction System. You know, nobody. Right? Why-- that's you're very secret information. You're not going to do it. And I don't blame you.

But the reason that you can, is modern technology. So Larry mentioned the EDF auctions in France for electricity, where we would auction 10 percent of the electricity supply in France every year. We've done that since 2001. We do that with an-- we know more information than EDF does. So there's lots of things that auction team can know, that even EDF -- we're doing it on behalf of EDF, but in a regulated environment for the government. And so we see it, but we don't communicate that to EDF.

So this would be the same thing: the auction system could see this, but that information could be made never available to anybody, ever. And in fact, the modern technology is such that we can have information which only the bidder can see, that nobody on the auction team can see. Not even Ulrich the lead developer can see. You know, and that's pretty impressive. But there are computer science methods that enable that.

Now how can you trust such a system. You can trust such a system because actually with computer science methods, we can prove that the auction rules are followed. Okay? It's a ___ [indecipherable] code and you can run the code through a prover, which establishes that all the auction rules have been followed, including the information policy, of no disclosure to any human life form. So that can be done. And that sort of thing would be done if you were entering very sensitive business plan information.

The advantage of entering it -- now even then you might not trust it. So even then what you would do -- like let's say you're bottom line on something was 10 bucks, then rather than entering 10 bucks, enter 12 bucks for now. And you'll see that- you know, the price right now is at 16 bucks. So if I enter a cost of 12 bucks, it's sort of a rough gauge, and I know I can beat it by 20 percent later. And then I can always change it. It would be an editable field.

Now here, you're not able to edit cost; in a real auction you'd be able to edit that particular piece of information. But that cost is just for your information purposes.

What it enables, is it enables the software to calculate your profit. Because you're profit's going to be price minus cost times quantity. Summed over the product regions in which you win. Okay, that's a very simple business model.

I'm quite aware, and I’m sure you're quite aware, that your real business plans are much more complicated than that. In particular, what you have in practice is all kinds of what economists call "complementarities." And I talked about the complementarities earlier. Now one would be a regional complementarity. Such as a referral. Having referral advantages, because you have the ability to support a wide range of products in a region.

Another complementarity would be: you are outstanding at mobility devices across the country. Okay, that's a product complementarity. Another complementarity is simply economies of scale. Okay, you basically have a minimum efficient scale of such-and-such. If your quantity falls below this much, then you can't make any money. So that might be another complementarity, which introduces: all these complementarities make the problem much more complicated. They are all practical realities that you deal with all the time.

Another one is fixed cost. Any businesses out there that don't have any fixed costs? I don't see any hands… No, everybody's got fixed costs. Right? And so that relates to the minimum efficient scale, too.

So in particular, you might find that: well, you're happy in Charlotte if you get a wide range of products; but if you don't, then you can't pay the lighting, the heating, the employees to staff, which are largely fixed costs. Yet if you grow and are huge, then you're going to be hiring additional employees and so on, larger space, but you've sort of a minimum size. You can't have half a person. You've got to hire a whole person. So there's that lumpiness. All the complementarities involve these lumpy issues. And you've faced them all.

In this… the auction is much simpler when we don't have these lumpy issues. However… and in fact, we could run a simulation, and I would if I was doing this training say a bidder, I would actually first do a simulation where we just had the marginal costs. Everybody just had a marginal cost for each product region, and it was very simple. That's pure substitutes, there's no complementarities. And we'd see how that works.

And what we'd find is: Wow. This thing works really well. We get full efficiency all the time, and you've got very strong incentives to bid your cost.

Now. To make it a little bit more interesting this time around, what we're going to do is throw in a single complementarity. So in this, there's only going to be a single complementarity. And that complementarity is going to be based upon something I've heard from many of you, which is the referral bonus that one can get from being a one-stop-shop.

Okay, so a particular region -- you're going to get more calls from hospitals, from doctors, because that doctor or hospital knows that you supply all the products in that region. And they're just too lazy to make separate referrals for oxygen and walkers. They want to make one referral, so they go with the one-stop-shop. So that's going to be worth to you -- everybody in room, actually the same -- $25,000. 25K. So if there is a region in which you win all 6 products, you get the 25K. But as soon as you go down to 5, you don’t get the 25K bonus.

Now the 25K, it turns out, is not going to be- it's not a huge number yet. It might sound like a lot to you, but, you know, 70-trillioin is a big number, 25K is not. And so you don't let it totally dominate you, but it is something that's going to make it more interesting for everybody, I think. To sort of recognize that there's that there. But I urge you not to, you know, just like seek to maximize the number of times you get 25K. Which would be 9 times 6, if you happen to have eligibility across all 54 products, which no one does. You actually are going to be limited eligibility in some products in some regions. So. That's going to be an important detail, and I'll come back to that in a moment.

But anyway, this column is fixed. This is the Your Bid column, that's the most important, I mean, you can see this is all obvious, right? The Regions, the Products… here's the aggregated supply. Very important. So you can see what's going on. Where we're closed. See here at 145. We're far from clearing in diabetes test strips. We are at 158. Far from clearing. But look at walkers. Look at the feeding kit. It's practically closed. Okay, so that's- it gives you a sense of how close we are to clearing the market. And so this price actually has a bit more validity. It's sort of closer… it's likely closer to the eventual clearing price.

[File 0546: MAC Segment 3]

Now here's Your Bid column. Absolutely the most important. And this is what you'll click on to place a bid. There's three ways… at least three ways to place a bid. Let me tell you my favorite.

To do so, I need to look at these other things. So as Larry described, we do a clock auction in a very effective way. And that is, in each round there's going to be a start price and an end price, and the end price is lower than the start price because this is a descending auction.

And essentially what we're doing is we're asking: are you in for all prices between the start price and the end price. If the answer is "yes," then you'll be given an opportunity to bid next round. If the answer is "no," and you actually want to get out, the price is just too low, then what you'll want to do is put in a bid which is somewhere between these two numbers. And that would be your exit price. The price at which you're leaving that particular product category.

Now. One thing I can do, if I want to, let's say, make sure I stay in the entire round, is I can just click on the end price and then it will put the end price in as my bid. Which guarantees that I will be able to bid the next round, and this will be highlighted in green, which means that everything's working well.

Another thing I could do -- as I said, you have very strong incentives to bid your costs, and you can reason through that why you would want to, but remember that your bid is not going to set the price. The price is going to be -- unlike the CMS auction, so get CMS out of your head, this is not at all like the CMS auction, has nothing to do with it. So just throw out all that information. Expunge it.

The way this works is the clearing price will always be at or above your bid if you're going to be a winner. Okay, which means if you bid your cost, you will be guaranteed to be making money. Because the price is going to be set by the last rejected bid. The guy that's above you.

[File 0546: MAC Segment 3]

If you bid below your costs, you run the risk of being a winner at a price that's below your cost. So keep that in mind. Okay, and this is exactly- and remember, bids are binding commitments. So if you win at a price that's below your cost, you have lost money, and you're going to have to pay me before you leave the room. So… actually not. But… I wish it were true. But, you know, treat it as if this was for-real money. In fact, there will be a prize for the winning team, where the winning team -- it's a little complicated to explain -- is going to be the team that has the highest profits relative to the theoretical profits.

Okay, so what we do is look at the actual outcome and how much money you made; we have a theoretical model that says how much money you *should* be making, given the hand that you were dealt; and the team that has the highest difference.

So basically what you should be thinking of is: I want to maximize profits. That's your goal. Maximize profits. As much as money as you can, then you will do the best with respect to that particular objective that I presented. And that will maximize the probability that you get the winning prize.

Okay, so, if you like the- and the prize is something positive. It's definitely something good. [Laughter] I'll tell you later. But given it's an efficient auction, it's actually going to be an efficient prize.

So. If you wanted to bid your cost you could just actually click it, and your cost would appear right there. So colors are going to be used in a number of ways, and it's very intuitive, I think. You know, green tends to be good, red tends to be bad, you know, things like that. It's very logical. And easy to use. It's a nice interface. Much nicer than United Airlines. I shouldn't keep picking on them, but I fly them a lot.

[File 0546: MAC Segment 3]

So. Let's go on. Oh, and actually, you can sort- you can do all kinds of fancy stuff, you probably -- I'm not going to play with it, you can play with it if you want, and that's great; and that's so- because your business plan in real life, it'd actually be a lot more useful, because you're probably specialized in, I don't know, mobility devices. And so you want to put mobility devices at the top. Or you specialize in the East Coast. So you put all the regions on the East Coast at the top. So it enables you to do that. In this case, we don't have- your business plans aren't quite focused like that, and so you're probably going to want to look at all the ones that you're eligible to bid on.

Okay. So here I am entering a bid, and I just click on it and then I type it, and then click "save bid" when I'm done. So that's the third way, just by direct entry. But I think you'll find that you can actually do a lot of your bidding just by clicking without entering much of anything.

Now. The other thing, the feature that is very useful in this that is state of the art, is the idea of proxy bidding. Which basically enables you to put in a bid that's well advanced from where the clock is. So let's say the clock is at $16, you've got a cost of $10, and you say: hey, well, you know, I'm just- I know I'm staying in for at least- until at least $10, so I just want to put in a bid of $10 right now, and then I'll just watch the clock and see what happens. And that's fine, and then you'll actually have to do a lot less clicking. And a lot less entry.

So you're allowed to do that, it will remember you're at $10, and then of course you can improve that; or let's say, you know, that this particular round is between $16 and $14, is the start and end price, you put in $10, the next round is $14 to $12 dollars… well then you could actually change your $10 to $11.50. That's just fine.

[File 0546: MAC Segment 3]

Okay, but once I get passed $10 -- like now it's between $9 and $7 -- I can't go back and say… if I had the $10 and it threw me out, I can't then say: oh, I want to do $8 after all. Too late. It's gone, you're out, you're history. The software will indicate that to you, as you'll see in a second.

This is your bid confirmation, which is very much like your bidding screen… it just tells you your activity; it shows you in a reddish-pink color the markets in which you're dropping out; and the green staying in, is in green.

Profit Summary. Extremely useful, especially with respect to the referral bonus complementarity. The one-stop-shop. 25K. Okay, we'll see that in a second. I know this is very small, there's lots of information here.

But what it is, is each of the regions, and then all the products within that region, and it's showing me a whole bunch of information. Now there's a button right here called Show Graphs. And I love that button… I actually- the first thing I do, is I press that button. When I press the button, then it introduces colors that facilitate my decision-making.

Some people think those colors are a little busy, but actually I like it. So that's why you get two choices. It's up to you. If you like the colors you get the colors; if you don't, you don't have to have it. You just click Hide Graph if you don't like that.

But what I like about it, is it's actually showing me quite clearly -- first, I actually get a visual of where we stand in terms of price, I'll come back to that in a second. So here it's actually calculating my profit for each product region. So we're in Charlotte, this is Charlotte; this is the cap device; and I've got the winning price; I've got my costs times the quantity; and here where I'm winning 3 blocks, there is an adjustment what a block is -- it depends upon the particular product region; and this basically scales how many units are associated with a particular block in this Charlotte region for cap devices.

Now. There is my cost in blue -- you can see cost is always in blue here, and profits always in green. Unless profit turns negative, in which case it's in red. And here I am actually losing money.

Let me show you the bigger picture, hopefully this is a little bit easier to see, and I'm sure it's a lot easier to see on your screen. Again, lots of information all presented at once; but here are two regions. Here's the first region, here's the second region. Actually, in both of these, notice I am still eligible for this- the six for six. The one-stop-shop. Great. So I'm getting, right now -- if the auction ended right now, I would get the 25K in both of those. That's another 50K of profit, and that's great. I like profit.

But, it's actually costing me some money. Right? So I've extended myself here… this $9.52 is actually below my cost. So the price is $9.52, my cost is $10.08. I'm losing money on every item I sell. And that's why I get a loss here.

But actually, it's worthwhile. Because I'm only losing 7K. And I'm getting 25K for the bonus. So I'm still coming out ahead. So basically, I’m taking a little hit -- and I know many of you in the Round 1 Rebid are kind of in that experience. You know, you're taking a hit, you're losing money on every unit you sell… but you're making up for it in volume. No, you're… [Laughter] you're not making it up with your volume, what you're doing could be various things. You're keeping your foot in the door… okay, you're not having to fire your employees, and you're optimistic that this is going to go away. At some point… hopefully soon. So… we make these decisions in business.

And here's another one. Where I'm hanging out too long for the feeding kit, but I'm only losing 11K and I pick up 25. So that's the calculus that you need to go at, and it's basically guess work.

[File 0546: MAC Segment 3]

Because you don't know -- you might get stuck with this. So you might get stuck winning, and then the prices on some of these others drop enormously. You're stuck. You can't get out. That one's cleared, and it cleared at a loss for you.

Okay, so this addresses complementarities, but it doesn't address complementarities perfectly. There are very fancy auctions called "package auctions," or "combinatorial auctions," that address complementaries perfectly. But they are wildly more complicated than this. And it was our judgment that this was better. In terms of the tradeoff. And here you can see what a loss looks like; here's my little bit of profit right there on that; but this is a case where, gosh, I'm bidding low on one region -- I'm sorry, on one for these test strips in this one region, and I'm getting the 25K bonus, but that's a really bad idea. That was stupid.

Okay. We're almost done… Round Results: once the round-- there's a sequencing. Okay, first, the auction hasn't started yet. Okay, then you get to log in; then, once the auction starts, it will be-Round 1 will be announced. And you'll get a message that says: Round 1 has started. At that point, you can start submitting bids.

Then, and there'll be a timer that says when Round 1 ends. All right, you've got to get your bids in before the round ends. Then when the round ends, then there's a brief period before we post the results. Okay, so the next step in on the auction team to post the results for the round. The round gets posted, and it'll say on your screen: the results have not yet been posted. You actually don't get to see anything until the results are posted. Once they're posted, then you get to see what the excess supply is and so on.

[File 0546: MAC Segment 3]

Then we'll announce the next round. And then once the next round starts, you can bid in the next round. And we repeat this process until we find the market clearing price for each of the 54 product regions. So it's that simple, it'll take a little while to get used to.

What we're going to do is, actually before lunch we're going to try to do as many rounds as possible, but that as many rounds as possible we're going to have to start slow, so it'll probably be two rounds. But it's possible we might be able to get a third round in before lunch, we'll have to see.

The whole auction's likely to take somewhere between six and eight rounds, depending upon how you bid, and so we will finish up the mock auction after our lunch break.

When we take a lunch break, you'll just leave everything here, the room- the doors will be shut and the doors will be guarded, so nothing's going to go away and nobody's going to reformat your hard drive [short laughter]; you might want to- if you're concerned then close it and put it to sleep or whatever; but then we'll come back -- and we're having lunch just right next door -- and then we'll come back and finish up.

And then we'll have -- all afternoon is going to be the panels where we discuss a lot of the critical issues.

But here on this chart is your round results. And this graph right here is especially useful, because the whole length of this bar is actually the entire supply that we started with; and then as the price goes down, what's going to happen is people are going to be dropping out. These yellows are the guys that are dropping out. This round. The gray is the guys that dropped out in prior rounds.

[File 0546: MAC Segment 3]

We clear when we fall below the demand, which is the red dashed line. So here, this one's over. This Charlotte cap device is closed, that one we know about. I won three blocks as Franklin Roosevelt and Co. Actually Larry won as Franklin Roosevelt.

You can see there's a pattern to the names… I apologize to the women, it's historical U.S. political figures which is dominated by men, but the next hundred years I'm sure will be dominated by women, and the world will be a much better place.

Last is the Auction Schedule. So here if you want to know -- like let's say you've got to race to the bathroom -- you want to know what the schedule is, you know, how many minutes do I have to race to the bathroom -- this will tell you. Together with looking up here at the counter.

Okay. I think we're all set, it's 11:14… or 11:15, question, Nancy.

Nancy Johnson: Don't you need to know where your company is located?

Peter Cramton: Your company is located… basically, you've been assigned various products and regions that you're interested in. And your costs are dependent upon where your location is, and you won't actually have to know, you just have to know what your costs are. So it's already been determined in the model.

But in real life, your business plan would certainly be a function of where you were located.

Attendee: So these blank spaces are where you're ineligible.

Peter Cramton: Yes. If you got a blank, yeah. There's no cost information. You're not eligible to bid… that one's-- you can just cross that off. So just forget about the 25K bonus in those regions. Yes.

[File 0546: MAC Segment 3]

Attendee: How long is the bid period for.

Peter Cramton: So the bid period for -- let me tell you what we would do normally… normally we would probably have a half hour for a round, and then…

Attendee: How many years duration.

Peter Cramton: Oh, duration. Oh.

Attendee: Can I adjust it for a loss for six months and get back in later.

Peter Cramton: No-no. It's a two-year contract. So this is going to be a two-year contract that we're…

Attendee: Can I have business outside these markets that might subsidize it?

Peter Cramton: It's not in your model, no. Your model… you are an agent for the CEO -- if you're not the CEO… many of you are the CEO already. But you're an agent for your company, and you've been given instructions to maximize profit; these are your costs per unit; and in addition, you get the 25K for the one-stop-shop bonus. That is all… that is your directive. And that is what you need to act on today.

I know in real life it's much more complicated than that. And so but absolutely. None of you have the incentive of: well, I'm staying in to zero because I think that six months from now CMS is going to take the prices from the auction and multiply by four, and it'll all be profitable again.

No, you can't have any kind of stories like that. That's all just… you know, that's just make believe.

Attendee: Do I have other avenues to sell the product that I don't get in at this market.

[File 0546: MAC Segment 3]

Peter Cramton: Yes. So that goes with respect to fixed costs and so on. So how much of my fixed cost has been allocated in that marginal cost, and the like. And the answer is: don't worry about that for the purpose of this exercise.

I completely recognize that there are other complementarities that you guys face. I have one in there which is just an example: referral bonus. But there are other fixed costs, and we can go on… and in fact, that will be I'm sure mentioned in the panels, about just how complicated your business is. Yes.

Attendee: So the price that we bid ultimately becomes the price set across the nation, and will be anyone to provide it. So we won't be able to subsidize. So the price won't be higher if we're bidding on the West Coast, it won't be higher in our location on the East Coast.

Peter Cramton: Right. So just do not think about the nationwide aspect at all today… we're going to bid on nine regions, six products, and that's the entire universe for today. Okay? So no nationwide issues.

Attendee: Just for clarification, I think one of the things that permeates a lot of the private [ph] thinking, was this concept of suicide bidding.

Peter Cramton: Yes. Absolutely.

Attendee: …like winning [ph] and cost get a contract. I think what you're saying is suspend that…

Peter Cramton: That's right.

[File 0546: MAC Segment 3]

Attendee: …for the purposes of running the auction and demonstrating it, don't be ____ [inaudible] in hidden costs… your task is to bid and maximize profit in respect to this demonstration.

Peter Cramton: Exactly. And so yes. So I really would like you to take to heart that objective; and in fact, I am… keenly aware that there's lots of other stuff going on in your lives; and in particular, you know, many of you, perhaps the majority of you, would like to see the enabling legislation repealed. I am aware of that. You'd like to see auctions go away.

I do not want you to bid strategically in a way that you think is going to mess this up, so that it will make it more likely that repeal will occur. You should basically throw that out of your mind… and I am also very aware that in the CMS rules you have extremely strong incentives for low-ball bidding, and in fact, suicide bidding has been a name used as well; but it's not suicide bidding, it's actually rational bidding given crazy rules.

But we're not using the crazy rules. We're using sensible rules here, and I really want you to just take that very simple business plan to heart today. Even though it's quite limiting. Yes. And then I'll come to you.

Attendee: [first part inaudible] What's the penalty if I can't provide the service.

Peter Cramton: Okay. So in this exercise we actually have gone through a rigorous qualification. And if you've got a cost number in a product region, you are fully qualified in our very rigorous process, and you have put up a bid bond or a deposit that is sufficiently large, that none of you would even consider defaulting on your obligation.

So there is no possibility of default in this, because everything's been done perfectly. Yes.

[File 0546: MAC Segment 3]

Attendee: [inaudible] …everything's in here, go for it.

Peter Cramton: That's right. It's all in. Yep, yeah. That single marginal cost number has embedded fixed and variable perfectly. Which is, yeah, simplification, but you've got to start somewhere.

All right. Now. It's 11:21, we're just a few minutes behind schedule but that's no problem, I think we're fine; we will start, we're going to do two rounds at least, and we'll pause after the first round and take additional questions just for a minute or two. So everybody should try to log in. Yes.

Attendee: [inaudible]

Peter Cramton: Ah, no. Actually a good question, we have a very good question; so everybody -- just one moment -- everybody that is in the… so the organizer team, that has the ability to answer questions like how to connect a Wi-Fi and how to use the auction system, raise your hand so people can see who you are. Raise your hand. Ulrich, raise your hand. Larry, raise your hand. That's it. Come on, everybody. Okay, good.

So those are the people… so just reach out to any of those, send a message to the auction manager.

The password for Wi-Fi is Medicare/Medicare. And then in the auction… it's on your presentation sheet. [Crowd talking.]

[End audio for File 0546] [Missing Files 0547 & 0548]

[Begin File 0549]

Peter Cramton: And you can see it says in the upper right corner: Round 1 results will be posted shortly. That actually is the case. So we'll find out how shortly is…

[File # 0549, 0550, 0553: MAC Segment 3]

<u>Attendee</u>: Now, then?

<u>Peter Cramton</u>: Now. Yes. (pause) Now they're posting. And so now you can actually see the round results, if you click on Round Results…

Okay. At this point, so the round results have been posted, you can click on Round Results and see them, and you can see the excess supply…

If anybody has any questions, now would be a good time, and then we will actually start -- as soon as we finish the questions we will change the auction schedule so it actually starts right up into Round 2, so we don't have to wait for ten minutes. Because I know that everybody wants to get to lunch as quickly as possible and accomplish as much as possible before lunch.

So questions. Now you can either walk to the microphone, or you can say your question and then I'll repeat your question. Yes.

[Question asked, to be repeated.]

<u>Peter Cramton</u>: Yes. So the question is: what is the cost referring to, and how does that relate to the blocks in the units.

And the answer is that the cost is your per-unit cost, which is going to be -- so you all know how the- remember the SPA, the Single [audience remark] Purchase Amount, yes. I don't remember it, but… Single Payment Amount. Right. Okay. Thank you. I hate acronyms. So that's what the cost is related to. How much you get reimbursed per unit; so your actual profit's going to be based upon when you click the Profit Summary screen, then you'll see that it's going to be Price Minus Cost, Times Blocks, Times Units Per Block. So that's why it comes out into just dollars in the end, once we multiply it by quantity. Yes.

[File # 0549, 0550, 0553: MAC Segment 3]

[Question, inaudible.]

__Peter Cramton__: No. So as bidders fall out -- because what happens is, we've got excess supply. So for a particular product, diabetes test strip, we have 150 let's say in the excess, so there's 50 excess, and so they're dropping out. So you're going to still be at 100.

Now there's one little wrinkle here which I didn't mention yet. And that is, these quantities, those are -- they're a perfectly objective number based upon your historic supply. Okay, everybody's got that. Now what you actually are going to supply in practice is going to depend upon whether the beneficiaries choose you or choose somebody else. So, that's going to be a different number. And that number we don't actually have right now. You have to estimate that in your real life; but in this mock auction, you're just going to assume that it is whatever capacity you're assigned.

Now one thing is -- this is a technical detail, but I want to mention it since you raised this issue about: does the capacity change. And it actually does change in one circumstance.

Let's say we have excess supply of three blocks, so we're at 103. Excess supply of three blocks. And a bidder with capacity of 5 drops out. They say at $9 I'm out of here. I can't do this. I can't take it anymore. So they drop out at $9. That sets the price, the quantity falls from 103 down to 98. Less than 100. What do we do about that.

Well what we do, is we scale up each of the winnings of the 98. So everything gets scaled up by 100 over 98. So rather than -- if you were a 2-block guy, you're now a 2 times 100 over 98. So that's a very simple way of addressing the lumpiness problem. Yes.

__Evan Kwerel__: You're obligated to supply at least the number that you're committed. I mean, you're saying that the actual number depends upon ___ [?] how many people show up. So what if

I've, in order to get my 25K bonus, then when people show up for the test strip, that this one had to stop. Because I've taken a loss in every one I've ___ [?]. I'm not allowed to do that.

<u>Peter Cramton</u>: Right. So that's right. The performance obligation is something that's going to be talked about in the afternoon panels. So the question was about the performance obligation and what you're exactly obligated to, and it's coming from Evan Kwerel which makes perfect sense, because he knows how important this is.

You know, what's the obligation, and -- because the bindingness of the bid is all about that, too. What am I actually locking myself into.

What you're locking yourself into intuitively, details need to be worked out. But essentially what you're locking yourself into. So let's say I win 5-percent test strips. Okay, so I'm 5-percent market of the test strips. Then, what that means is, I actually have an obligation, when people call me up and say, "I want test strips," I have an obligation to deliver test strips to them at the clearing price, up until the point where I've reached my 5-percent.

Now if I've satisfied my 5-percent, and people -- and I do such a wonderful job that everybody keeps calling me -- I am then allowed to say: "I'm sorry, I don't want to do it anymore."

Now probably I wouldn't. Probably I'd say: I'm making money on this, and yeah, the more the better. Great. Well I'd like to have you as a customer. So I can certainly supply more; I can actually supply less. So I could supply 1-percent. Now how does the 1-percent work… I'm a 5-percent winner, why do I end up doing 1-percent… because no one calls me. If they don't call me, I haven't done anything wrong.

[Inaudible remark from audience.]

[File # 0549, 0550, 0553: MAC Segment 3]

__Peter Cramton__: That's right, no-no-no, and that's the performance obligation. So yes. You have to be… you know, you have to have your Internet, or the phone, or you have to make yourself available. You can't say, you know: actually, we shut that phone off a long time ago. [Laughter] Or it's a collect call, $99-hundred a minute. Can't do that.

Okay. So. Now, it looks like we're getting ready to begin Round 2, unless there's further questions.

[Remark: We're ready to play.]

__Who__: Okay, ready to play! Round 2… is going to start in just a moment… can we speed up Round 2? Okay, so the auction manager is going to initiate the start of Round 2 in probably 7 seconds. Depending on how fast he is. Well perhaps one minute. We'll see. Okay, it'll be one minute from now. (pause with background noise) Round 2 has begun.

[End File 0549]

[Begin File 0550]

__Peter Cramton__: [in progress] …the 25K, that you get the one-stop-shop bonus in each region… that actually is not included in the computer system. It doesn't know about that. It has a very simple generic business plan, which is just your marginal cost. That's what's in the system. So it's calculating profits. So that 25K is going to be additional to whatever you see there. And that is by design.

The second thing is, those of you that are using Internet Explorer, at the beginning of rounds we'll have some performance issues because of Wi-Fi and the demands of Internet Explorer. Those of you that are using Chrome and Firefox will have less, uh, connectivity issues. Thank you.

[File # 0549, 0550, 0553: MAC Segment 3]

[End File 0550] [Missing Files 0551 & 0552]

[Begin File 0553]

Peter Cramton: [in progress] …has arise… has arisen. The Wi-Fi network is down. So it has nothing to do with our software, as you can see, it's all network connections seem to be bad right now. So what we're going to do is break for lunch, fix the Wi-Fi, and it'll all be ready to go when you get back.

So you can either close your laptop, or log out, whatever you want to do… just leave it plugged in, leave everything here, take your purse if you want, but it will be locked up here. And then we'll start promptly at… well, let's start at the same time, 1:15. So continue on schedule, 1:15 back here.

The lunch is right next door, it's all set up, if you just sit down -- it's not a buffet -- you will be served. And it'll take a little bit of time, and so some of you may want to use the restroom down this way first… others may want to go right in and get served first. It's up to you.

Thank you very much.

[End File 0553]

[Begin File 0554]

Peter Cramton: I wanted to make one very important announcement, and that is, for those of you that are using Internet Explorer… there's actually a few announcements. But the issue that we're having with the Wi-Fi is the fact that we're all trying to do the same thing at the same time, and we're lots of people and we're all coming into some little Wi-Fi hub; and so one thing I'm going to do is not tell you when a round is starting, you're going to figure that out on your own, and then you'll jump in at different times. That'll relieve some of the load.

Another thing is that Internet Explorer is much more Wi-Fi intensive than Chrome and Firefox, that are much more efficient. Now my understanding is Microsoft and Internet Explorer 9 has improved things, but I'm sure none of you are using Internet Explorer 9. You're using Internet Explorer 8 or worse. And so what we have here is a USB key that has Firefox on it. And so you can just plug this in and install Firefox, and then log in again with Firefox.

A number of people have these, those that are using Internet Explorer, and that will reduce the load and give you a better user experience. Because you'll find the system is about two or three times faster, perhaps even more.

So Karen Wrege has a whole bunch of them, so just raise your hand if you're an Internet Explorer user and would like to give Firefox a try. Anybody? Here's one… Okay.

Good. So we'll just see how the Wi-Fi works out. Hopefully it'll be fine with this new method. So I'm actually not-- I'm going to turn off this display so you won't be able to see the clock here, you'll just be using your laptops; and when a new round starts, don't even… there'll be plenty of time, so just give it a few minutes perhaps and then we're less apt to crash the system. The Wi-Fi system.

[Pause; background noise, etc.]

[End File 0554]

[Missing Files 0555, 0556, 0557]

[Begin File 0558]

[File # 0558: MAC Segment 3]

Peter Cramton: Two quick announcements…

The first announcement is that we are having Wi-Fi challenges. The Wi-Fi challenges are very much computer specific; so Tom Bradley had a card that his computer for some reason just didn't work very well, but my computer works fine… even though it's the exact same location; and so one thing is, those that have a 3G card in your computer, then you can actually use your Verizon 3G network or whatever, and that takes the load off the Wi-Fi. All that works-- all you need is an Internet connection. You don't have to have the-- and if you've got some access to some other Internet Wi-Fi, then that's fine, too. So anything that works.

The other thing is that with respect -- I want to make one thing very clear. And that is, you are going to get paid -- for what you win, you are going to get paid the clearing price. The clearing price is almost always above your bid. Okay? So it's going to be a number-- if I've got a cost of $8, and let's say I've bid $8, I know that if I'm a winner, the clearing price is above $8. The only exception is if I'm right at that intersection of supply and demand, in which case I actually-- it's not enough for me to set the price. Because the price setter actually is the last rejected bid.

So the only time that can happen, is if I bid $8, and that's right at the clearing price, and somebody else bids exactly $8 as their exit bid. In all other ca-- and then there's an elaborate tie-breaking rule, and there's a neat little knapsack problem that's solved, and it's all extremely technical and you do not need to know it… what you need to know is, don't worry.

If you, for example, were to bid cost, you will be making money on every product for which you win.

One other things in terms of the schedule... we will speed up, I think we're moving to 5-minute rounds? If you can't get in, you have try to reinitiate your Wi-Fi connection.

[File # 0558: MAC Segment 3]

[Continues with background noise; crowd talking.]

[End File 0558]

[Missing File 0559]

[Begin File 0560]

<u>Peter Cramton</u>: Yea. [Applause] Now there'll be a brief pause, and in approximately -- sometime in less than one year we'll have the results, just a moment. [Laughter]

[Inaudible background remark.]

<u>Peter Cramton</u>: Yeah, you're Round Results 3, and I think it's actually already available to you. There you go. So you see everything… and what we're doing up here, Pat, who's an expert in these matters, is bringing in the analysis of every team, and incorporating it in an analysis that is actually quite sophisticated, and I'm going to show you just a hint of it, and then I'm going to post it on my website, and then all of you can look at it at your leisure over the weekend or whenever, but it actually -- I'll present things that look very confusing unless you're an economist, and if you're an economist they look like: oh, this is simple supply and demand, this makes a lot of sense, and I see what's going on.

But it's the kind of detailed analysis that we would do when we're running a scientific experiment and then we want to look at all the data to see how the- what the bidding behavior is like and how the auction performed… that's exactly what we're doing; and of course computers are powerful, so we actually prepared to do the analysis. Even though we have no idea what you guys did, we are able to prepare in advance the software to do the analysis. That goes beyond what the auction system provides instantaneously to you. So we're almost there.

[File # 0560: MAC Segment 3]

And as you can see, if you were a real bidder in a real auction, what you would have -- and I've advised lots of real bidders in lots of real auctions -- what you would have is what we call an Auction War Room. Where you have your bidding team, and in that you would have all your computer equipment, you would have a dedicated wired line to the Internet, you would have a laptop with an excellent Verizon or AT&T 3G card or 4G card if you live in such a city that would provide redundancy with respect to Internet, and you might even actually have a third Internet system. So you would guarantee that you would have connectivity.

Now our system is also set up in the event that everything fails… then you can get on the phone to the Auction War Room with the Auction Administrator and explain your situation; and depending upon the rules, the Auction Administrator can take and accept a bid via the phone line, which is a recorded line, and enter it on your behalf. And the auction system actually… this auction system right now can do that, and that's what's done in commercial auctions that are used around the world.

So the results are here, let me just pull… let's see… I just have to figure out how to get to the screen… [pause] Okay. So here's the first of the many confusing… actually, let me first jump to the auction system itself. Because the auction system… I'm logged in as Auctioneer, Peter Cramton, and so I actually get to see lots of things that you didn't get to see as bidders.

For example, I can click on, if I'm feeling lucky, Supply Curves. And boom… notice, nearly instantaneously, it shows me for each product -- so this is the… oh actually, let's look at diabetes test strip… so here's diabetes test strip, here's our demand curve, and here's our supply curve in each of the nine regions. So each color is a different region.

[File # 0560: MAC Segment 3]

Now in fact, if I want to see this larger, I can just click on the diabetes there, and I've got to scroll down a little bit, and I get a bigger picture.

So you can see… and in fact, the Auction Manager, according to the information policy of this auction, gets to see this throughout the auction. So we actually get to see a lot of detailed information that you don't get to see. So it looks confusing, but for an economist, we just- this is great stuff for us. We love it. Supply and demand… it's wonderful.

And we get to see all those clearing prices, where the supply curves cross the vertical demand curve at 100 blocks.

Now. And this actually is helpful… actually some of you asked me: well, how do you set the price decrement. And the answer to that is -- and actually, how did you set the prices? You know, there's lots of details here. What did we do? First of all, we used very simple straight-forward rules that are consistent with best practice.

First of all, descending clock auction, you want to make sure you start at sufficiently high prices. So you want to have lots of excess supply initially. So what I did, was I took the Medicare price… there's a Medicare price, right? that many of you are paid, hopefully… and I multiplied by 20-percent. So it's 120-percent of the Medicare price. So I'm starting 20-percent above.

Now that might make CBO feel a little bit nervous. That we're starting way above, but it's okay, it works itself out. That's a competitive auction. And we've done this a lot. And so the price will come down, and it will end at the competitive equilibrium price typically, if it's a competitive auction. The market clearing price.

[File # 0560: MAC Segment 3]

Now the reason that we start so high is, as CMS or as somebody advising CMS, I don't know what the market clearing price is. You do, the bidders, collectively. And that's what the auction's all about. Auctions do a tremendous job of asking the question: Who should supply the goods and at what prices. And that's why we're doing an auction, rather than administrative pricing. If I knew what the price is, I would just say: the price is $12.

Okay. So. That's some information, and you can see there's lots of other information which I won't go through, but one of the things that was here is downloads. And you can see as the Auction Administrator actually I've got lots of downloads, and these are available every single round… it just downloads us a very teeny CSV file, which is a text file that's got all the data, and then I can take that and import it into my analysis tool. Which is exactly what I did.

Now in fact, in a real auction, if we had more time to do development, you'd actually have a portfolio of downloadable files for you, that's consistent with the information policy, and you'd be able to download them with each round. And then you, in your War Room, can use Excel or more powerful analytical tools to analyze the circumstances that you're in, and use your own highly-customized tools in order to further develop your bidding strategy throughout the auction process. So that's all available to you, and that's actually a very nice feature of a modern auction system.

So. Let's go to our data visualization tool… and this -- I apologize, it's intended not to be seen on a low-resolution screen from the back of a big room. It's meant to be seen on a high-resolution desktop or laptop in your War Room where you're looking right at it. And so if you were a big bidder, you want to actually have a big screen so you could actually look at very fine information… so I recognize it's going to be hard to look at, but I promise I will make it online very soon, probably later today. In fact I'm quite confident, later today.

[File # 0560: MAC Segment 3]

So what this shows is… it's showing price difference here. Payment difference, social cost difference. What are these things.

First of all, price difference. So what it's doing is it's, it-- based upon the cost that I gave you -- many of you asked: where did those costs come from -- those were actually randomly drawn from a normal probability distribution… the model is a little bit complicated because it had regional factors and product factors, and it's… you don't need to know about it, but you all had different costs. And for various reasons. And some of you were dealt good hands, and some of you were dealt bad hands.

Okay, so some of you… it was really easy to make lots of money; some of you, it was very difficult to make lots of money. And in fact, if you had a sensible bidding strategy, there was no way that you could lose money. Because the auction gives you the ability to avoid any loss of money when you know what your costs are.

Now the price difference is the difference between the theoretical clearing price… which is based upon the assumption that everyone bids costs… and what actually happened, which is your actual behavior.

Okay, so what I do, is I calculate what the price actually was -- which is what we saw, those intersections of supply and demand in the prior figure -- those are the actually prices that you determined collectively through your bidding behavior… I subtract out the theoretical price, and what this is showing is how you differed from the theory.

So in particular, when we see green… taxpayers eyes should light up, because that actually means that's good for taxpayers; that means that the auction was even more competitive than the theory would predict.

When we see red, that means in that particular product region it was a little bit less competitive than what the theory would predict.

And you can see that actually the theory is doing pretty well. Notice these bounds are plus or minus 5 percent. So in all cases, we're within 5 percent of the theoretical clearing price.

My guess is that the CMS Round 1 Rebid, those prices are probably not within 5 percent of the competitive market price. I'm just guessing.

Payment difference… now this is figuring out, okay, price times quantity. Right? Is the payment that Medicare is making to the providers. And again, green is good for taxpayers, bad for providers, and so all this green means is that the payment is typically less than the theory would predict. But again, it's between minus 10 and 5 percent.

Now let me say one thing about the theory. The theory is a little bit simplistic. In that if we ignore the 25K… just set the 25K pool to zero… then the theory is actually 100 percent right, which is bid your cost.

If we had that 25K, we took the complementary and we threw it out, everyone would have the incentive -- if you're maximizing profit -- to bid your cost. That is the best strategy that you could come up with. No matter who you are, no matter how smart you are, that is the best strategy. That is what we call a dominant strategy, it's the best strategy you can have, regardless of what all the other guys are doing. So it's actually stronger than your typical equilibrium, it's a really wonderful strategy. No matter what the other guys are doing, it's the best that you can do.

Now. With the complementarity, that throws things off a little bit. And so what I did for the theory, is I used a simple theory. It's actually quite difficult to work out the theory with these complementarities. So what I did was just-- the theory is, everybody bids their cost, and then in the theory, if you happen to win all six when you bid you costs, you get the 25K. And that's it. So it's a very simple theory, but the 25K is actually not that big a deal compared to the grand scheme of things in this particular exercise. So it's a pretty good theory, but it is simplistic. As all theories are. That's the nature of theory, is you make assumptions that are simplified.

Social cost difference is actually looking at the welfare of society. So that there's cost to the taxpayers, and there's cost to the providers and profits to the providers. And it's basically, social cost is saying: well we have to recognize that, in fact, there is some value in the providers making money. Okay, if nothing else, we can always tax their profits… but that's a good thing.

So in this case the social cost is, as you can see, it's generally positive, and that's because we did not achieve full efficiency. And you'll see there'll be some deviations, because many of you did not bid you cost. You deviated from bidding you cost. And I know that for a fact, because if you all bid you costs, these things would all be… they wouldn't be red there anymore.

But notice still that the inefficiency is actually still quite small. It's always between 0 and 5 percent -- well actually, there's one teeny little thing… these walkers in Charlotte, it was above 5 percent. But everything else is less than 5 percent in efficiency.

Now. Let me look at a few others, and the rest of these you can look at at your leisure, so one is efficiency. So here he is, all the 56 products, green means we got -- you're an efficient winner. You were supposed to win, because you had low cost, and you won. You can see we have a lot of green and not much red. The red is somebody that inefficiently won.

There was somebody that had lower cost that was a loser who you displaced. And you're a winner. And that happened because either that person dropped out too early, or you stayed in longer. So if they bid their cost, in particular -- which they at least should have bid down to the cost, and the complementarity you had an incentive to bid a little bit lower -- they would have had to have bid below their cost in order to be an inefficient winner.

Okay. Product Region. Now, this is a particular product, Okay, so let's go… actually, let's do diabetes test strips… I mean, here's just -- and what this is showing right up here, is the supply and demand. Okay, and there's the clearing price, but it's showing two ways.

The actual is the orange line; the theoretical is the blue line. Okay, so here's the theory, and here is the actual. So we had a few guys that dropped out early, but notice -- see how close that is? That's pretty good. So the theory is actually doing pretty well.

And that's one thing about auctions, is actually auctions -- if you do anything that's, you know, a reasonably intelligent design, it actually performs quite well. So it tends to be very robust. To fairly minor mistakes. Now if you do something that's wildly problematic, then that's when you start having some serious differences.

Now down here, I'm actually showing your bidding behavior. And this is a very nice data visualization, because it's showing -- notice when I hover over it, and you'll be able to do this too on your machines at home, it actually is giving me the detailed information of each data point.

The size of the circle represents the size of the bidder. Very intuitive. The color of the dot represents whether you're a winner or a loser. Red, you're a loser; green, you're a winner.

These lines here -- again, orange is actual, blue is theory -- so the theory is everybody should bid their cost -- and this is just the 45-degree line… notice these scales aren't the same, so that doesn't look like it's 45-degree, but that actually is the 45-degree line -- and many of you did bid your cost, and you can actually see them lie right on the blue line. But there's certainly some outliers that did not. And so here's some big outliers… you know, here's a very bid bidder that dropped out early. And then there's some guys that hung in longer than they should have. When I say "should have," maybe they were going for the 25K. So if they got it, then good for you, and then you'll be a winner at the end.

Now here, this is actually just showing -- this is what, in electricity, what we call the "merit order, just ranking the bids from lowest to highest, so the high-merit guys are down here, and the low-merit guys or the high-cost guys here -- and so basically the theory says that all the- this should be all the winners, these should be the losers. That's the theoretical outcome.

But in fact what happens is we have mostly that -- so that's why we have mostly green here -- but there's some red there, too. Some red down here. So this guy inefficiently lost, inefficiently lost, inefficiently lost; and displaced by this guy, this guy, and this guy. So you see there are some behavior that was different than bidding cost, but it didn't dramatically upset the efficiency of the market.

Nancy.

Nancy Johnson: [inaudible] …chart with what, units or numbers. [inaudible]

Peter Cramton: Yes. Yes. So absolutely, I can. So in fact, it tells us both of these give us that information visually. So here, it's the size of the circle that indicates the size, and here it's the length of the bar that's capacity.

And so basically you can look at that, and you can see how many people dropped out -- it's all the guys in red. How many should have efficiently dropped out? It's everybody above this line. How large was the inefficiency? It's all these greens here that should be reds, and it's all these red here that should be greens.

So what happened, which is quite predictable given the 25K bonus, is we have distortions away from the perfect merit order, from the perfect theory, where everyone bids costs; in instances where you're actually a very small bidder in that market, and so you actually hang in longer in order to get the 25K bonus for all six, which is worth the 25K to you because you're such a teeny guy in that market.

Now you might be concerned: well, aren't you biasing the price downward; and yes, it does bias the price downward; but since it's really teeny guys, the bias is very teeny. Which is why we distorted the price hardly at all.

So you can see, this is hopefully, to me, it's a dramatic revelation. I would be more surprised if I haven't seen it so many times before; but these efficient auctions are actually extremely powerful. We ask you, we put you, the bidder, in a complicated environment. It was complicated -- you know, 54 products, you've never seen this, you've never seen the software… extremely complicated because of the complementarities, the 25K business… quite frankly, we have some very sophisticated people in the room -- mathematicians and so on, powerful computers; we've got John Rust here, who's computational economics… I could give John Rust a month to compute the equilibrium for that problem with complementarities and he'd struggle to get it.

But you, through your bidding behavior, got to within 99 percent of the optimal, probably, just through your own thought. So it's actually a- you know, it's a very good example, I think, of the power of basic, simple, auction design.

[File # 0560: MAC Segment 3]

And of course, and the way that -- well you can see, I'm not hiding anything, there's all-- if you want to see walkers, click on walkers; if you want to see… and again, look at the difference between theory and prediction.

Now even though this one -- we had actually the bidding behavior all distorted. So here we- with walkers we had lots of distortion. Why? Because walkers is small potatoes in terms of the dollars involved. It's fine for you to mess around with things that are small potatoes. But you couldn't- if it was a big ticket item, like diabetes test strips, you wouldn't be able to mess around.

Okay. So let's go on to profit -- actually, let me skip profit for a second.

Okay, and this actually is not profit, it's the profit difference. So what it's showing is the -- this is actually just the top ten -- and actually, let me click on Harry Truman. Okay, so this is Harry Truman, who actually did make 290-thousand more than the theoretical profits. Okay, so the theoretical profits were substantial, but Harry Truman's strategy was so effective, given what the other people were doing in the markets that Harry Truman was operating in, that Harry Truman gets the prize.

So… yes. So who is Harry Truman. Please raise your hand. Harry Truman. Seth. Seth and your partner? Oh! Man-oh-man. So we've got a combined team, we actually had- this is very funny. So this is -- and I have no- you know, I had no idea. As I said, all these cost numbers are random, the teams I did actually do a little juggling so that I would put a provider with a government person, and in this case I put a provider with a journalist. [Laughter] So…

So sometimes people make comments about the "dumb press" and so on… [Laughter] well apparently, we should take those back. The press did just fine, thank you very much. [Applause]

[File # 0560: MAC Segment 3]

Also… so the prize, what is the prize… we have a very nice outcome, because it does not involve a government employee, because the government employees would be limited in what they could accept. So the prize is -- and I promised an efficient gift -- it's a $100 gift certificate at Amazon for each of you. So you each got a $100 gift certificate which I will email to you -- I've got your email address -- I will email it to you later tonight.

So congratulations… [Applause]
And so, yeah, how'd they do it. So let me tell you how they did it.

So one thing… basically what happened was, in order to win here you need two things. You need good strategy, and you need to be lucky. Because the problem is, lots of people used good strategy here. So at the end of the day, I have to confess that it's not just good strategy, there also is just some luck about it; and in particular, if you happen to be -- so what happened was, they probably had a number of regions where they were able to grab the 25K, in which the theory would not predict that they could get it, because the theory was just bidding cost. So they bid more sophisticatedly than the theory; and they were lucky that they were dealt a hand that enabled them to win all six in a number of regions. And actually you can see they did win all six in a number of regions… there's one region there, there's another region, and another region… and so they had three regions, right, where you win all six. And so that's how -- and they weren't supposed to win those. So that's why they… but that's what it takes.

Now it's- you might think that, well, you know, this was just luck, but in fact it wasn't. So if you had a bad strategy, it doesn't matter how lucky you are, you would be a loser in this.

So anyway, my point is, don't go home feeling bad if you happen to be a loser; there's lots of people that were dealt bad hands, they played a good strategy, and it just didn't work out; and there certainly were some that played a not-so-good strategy and actually lost money, and so I'll let you figure out why that happened.

Now in terms of the decrement -- the last thing I'll say, and then we'll turn to the panels -- is the auction is the auction… the nice thing about this clock auction is the auctioneer actually has a great ability to optimize the duration of the auction. And the duration of the auction will depend upon the circumstance.

So for example, if we're doing highly-traded electricity products, it's absolutely essential that we complete the auction within the day. And that's because we don't want to have people locked into positions overnight.

If we're doing a spectrum auction, which is a long-term investment auction, the auction can last many days and typically does. But with modern tools it lasts more like a week, rather than the old days when it would actually last several months. We've improved on that.

Now here, we optimized the auction to last somewhere between 6 and 8 rounds, because I knew exactly -- I wanted to fit it into the program. And hopefully did, except I've probably spoken too long already. But we're pretty close. I think I was supposed to finish at 2:45, and I'm only a few minutes over that.

But it shows you the price discovery when the rounds close, and you can see that even though I just used -- for price decrement I just used a very simple rule. I had an upper bound for the decrement of 8 percent, which is what we started with. It would fall down to 3 percent if we- as we lose the excess supply. Okay, so as excess supply goes down to zero, the decrement falls to 3 percent. So I use smaller and smaller decrements as we hone in on the clearing price.

[File # 0560: MAC Segment 3]

And that is a very simple rule, I used the same rule, it was programmed in, I didn't do anything fancy, and I programmed that rule in independent of the cost model that was actually derived. It's a very simple rule that's consistent with best practice. So that's what we did.

But now we're going to do something that's very exciting, which is do the panel discussions; we're going to start with Lance moderating the first panel, so if Lance could come up as well as all of the first panel. Then, after -- I know you guys want to take a break -- we will take a break. A half-hour break, or actually a 23-minute break, after the first panel. Okay, so hang in there just a little bit longer.

So the first panel please come forward. Lance will be sitting right here, right next to me, and then if you could arrange yourself in alphabetical order by last name. By last name. Alphabetical order by last name with the A all the way on the far wall. Okay, so A on the far wall -- Lance, could you double-check that people are…

The reason I'm doing the order, is to help the cameraman. We agreed on this. And we'll do the same thing for the moderators for the second panel and the final panel.

[End File 0560; End Segment 3]

MEDICARE AUCTION CONFERENCE

INN AND CONFERENCE CENTER

UNIVERSITY OF MARYLAND

FRIDAY, APRIL 1, 2011

SEGMENT 4

FILE 0560 (PARTIAL) AND FILE O561

FIRST PANEL:

SUSTAINABILITY, MARKET STRUCTURE AND BENEFICIARY CHOICE

Transcribed for: Bart Woodward

Transcribed by: Aleva (Lee) Schneider-Pollard, TranscriptionBiz

Date: April 7, 2011

File Name: 0560 (Partial) and File 0561

P R O C E E D I N G S

[ENDING OF FILE 0560] SEGMENT 4

MR. CRAMTON: So the first panel, please come forward. Lance will be sitting right here, right next to me. And then if you could arrange yourself in alphabetical order by last name. By last name -- alphabetical order by last name with the A all the way on the far wall, okay? So A on the far wall. Lance, can you double-check that people are -- the reason I'm doing the order is to help the cameraman. We agreed on this. And we'll do the same thing for the moderators for the second panel and the final panel.

[BEGINNING OF FILE 0561]

MR. LEGGITT: [IN PROGRESS] -- because it's very much appreciated, and I'd ask everybody to give Peter a round of applause.

[APPLAUSE]

MR. LEGGITT: The second thing I would say is that I actually had the privilege of having a senior economist from the FCC on my team, and I made enough money that I think I'll retire after today.

(00:23) So by way of background, I work for Baker Donelson, which is a D.C. law firm and lobbying firm. Prior to joining Baker Donelson, I spent a substantial amount of time in the

Federal Government working on healthcare issues.

I was the Counsel to the Deputy Secretary within the Department of Health and Human Services for a number of years with oversight over CMS, FDA, NIH, and basically all the agencies within HHS.

(00:51) In the second term of the Bush Administration, I was fortunate enough to be hired to be the President's Senior Health Policy Advisor in the White House. So I spent a lot of time focusing on what you saw early on which is this issue about the cost curve and the unfunded liability in the tens of trillions.

What's interesting was in the 2000s, that unfunded liability was at $20-30 trillion, and now we're moving six-seven years later and we're talking about $70 trillion.

So the issue is extremely important, and getting costs under control with Medicare is extremely important. But what I fear is as we grapple with this issue and how to control prices, that we go at it in a way in the short term that destroys our ability to contain costs in the long term.

(01:43) And DME is a perfect example of that. The DME community in terms of cost to Medicare is not, you know, the big cost. As that graph showed that Peter put up, hospitalization is a big driver of costs.

What DME does do, though, is the DME community serves a chronically ill population that does drive costs, and in my mind, the problem we get into is as we're squeezing the DME community -- and it's clearly appropriate, and I think everybody here would agree, it's appropriate to push for quality and a competitive price.

(02:19) But as we're squeezing the DME community which, quite frankly, spends a lot of time supplying beneficiaries with stuff that keeps them out of the hospital and keep costs down, if we go about this in a way that's reckless and drives prices down and fundamentally alters the market structure, in the long run it's going to increase costs substantially.

And so that's -- from my view, that's a big problem, and so I was appreciative of Peter putting me on this panel today because what we're doing is we're talking about that issue. We're talking about sustainability, talking about market structure, and beneficiary choice. All of those factors are very important as the Government plans on how they're going to do this prospectively.

(03:00) And so what I'm going to do -- and I think that Peter put this in the program -- I'm going to ask each of the panelists to give a short introduction and then give about five minutes of discussion on their thoughts on these three issues, both in the sense of what's now in place with CMS and kind of the thoughts of what they've seen today.

And then what we'll do is I'll work in some questions, and we'll work some questions into the audience.

So with that, what I'm going to do is turn it over to Zach, and take it away.

(03:31) **MR. SCHIFFMAN:** Sure. Thank you, Lance. Zachary Schiffman. I'm the owner of United States Medical Supply and U.S. Med. I like to go by the name U.S. Med now. It's our rebranding.

We've lost all the regions in the diabetic space that we're in. That's our main product category. We are a Top 5 Provider in that space. We have over 100,000 patients that we service on an every 90 day basis.

(03:54) In CPAP, we won all nine regions, and so that puts us in a little of an interesting dichotomy there.

Of course, I'd like to, of course, thank Peter Cramton and the community of auction experts that he put together for us to create a real issue out of our plight rather than just seem like a bunch of whining business owners not making enough money; that this is a real issue. It's something that needs to be fixed.

(04:22) And I think we can all agree, like we said, that saving the country money is a good thing. Even though it might cause some short term pain, as along as there's long term sustainability, that's what we're looking for.

As far as sustainability, as a certified public accountant, I wanted to get into the details with you of how a company that bids lower than their net income margin is effectively saying that they want to go bankrupt, but Tom Milam, who's also a CPA, he advised me -- he's also one person that you can actually thank for the genesis of Peter Cramton. It was his idea to find experts in the field -- as well, of course, Nancy Johnson. Her feet get in the door very easily with her pedigree. But he vetoed me going into the details on that, so if anyone wants, I do have a little flyer to explain why, if you bid lower than your net income margin, you're somehow losing money.

(05:16) But for a simple back of the napkin reasonableness test on how that works, if you look at Liberty Medical and Diabetic Supplies' space -- and I know they are represented here, so I don't want to speak out of turn necessarily -- but they have a 30 percent market share, so they're arguably, like I said, the 800 pound gorilla.

They have the lowest costs by far because of their volume, and their net income margin in their last public filing was 8 percent. So, theoretically, if they bid a discount more than 8 percent, they'd be losing money or they'd have to fire a lot of people, including Wilford Brimley, et cetera.

(05:53) CCS Medical is the second largest company, and they're also -- I don't know if they're represented, but somebody that used to be there is here -- but they're just coming out of bankruptcy, and that's with the current fee schedule.

So just as a reasonable test, you can look and say, "Okay. A 36 percent cut in overall, but 56 percent cut in revenue without doing, you know, too much with your expenses is definitely an unreasonable hurdle to overcome." And Peter Cramton showed that his model is much more efficient than what's being done.

(6:24) So one of the things I need to respectfully ask in that and what we've asked for is what were the financial standards that were actually used other than "Show me you've got an invoice for a low cost product. Okay, that's good enough."

The next topic, I guess, that we're supposed to discuss is market structure, and you have to believe that, at least in diabetic supplies, that something's wrong when 99 percent of beneficiaries have to go find another provider. And the reason for that is because 95 percent of the bid winners were new entrants or only serviced a few thousand patients.

(07:02) And now these companies are supposed to grow a thousand percent overnight while making no money at the same time. And you know, I can tell you that it takes time and money to grow infrastructure, especially infrastructure that is compliant. So if we can get Medicare to give us the data for Medicare, I think what we're going to find is -- or I know that what we're going to find is that patients have basically gone to retail, and Medicare is going to be paying full bore on -- full fee schedule on those prices.

And I think we're a little early and it's only been three months, so patients still have their 90-day supply. But a lot of companies are holding their billing because they wait for deductibles to get met, so I think we actually have to look more towards six to nine months from now. Unfortunately, I'd like to get rid of this thing sooner than that, but that's the reality of it; that the data is not going to be terribly reliable until around then when people really start falling off the ranks.

(07:57) And then a final travesty that I have in thinking about a national program is that I've heard rumors that there could be as little as two bid winners in a national program or they're looking at doing a handful. And you know, you can only look at OPEC to see that an (indiscernible) does not bid well -- bode well for future rounds of bidding and have real competition.

And then the final topic is, of course, the beneficiary choice. The fact that 99 percent of patients are going to have to switch -- on the diabetic supply side -- switch to other providers obviously speaks for itself. But in addition, I mean, my company is one of the largest, so we're able to beat up manufacturers and get the best prices we can.

(09:41) My product costs alone on the national brands is more than the competitive bid rate. So even if I could stay in business, which I couldn't, I can tell you that patients would have basically three choices of product: bad, more bad and really bad. So, I mean, that's how I see it on that.

As far as Cramton's model, I know that we're going -- or Dr. Cramton's model -- I think we're going to talk further on that maybe in some other rounds. I just wanted to put out my two cents while I have a microphone in front of me; that I'm terribly skeptical about the bid bond to ensure that it actually has teeth in it and you've really got to put substantial money up for it because currently the surety bond requirement, the $50,000 surety bond, sounds like a big number, but the premium for that is about $500 a year. So that really isn't too much of a poison pill to swallow if you want to do that.

(09:36) So the bid bond really -- you're putting a lot of faith in the bid bond. So, you know, if you want to a buy a million dollars worth of volume, you either got to put a million dollars in an escrow account or pay a $150,000 premium or something substantial; otherwise, you're still going to get the bad actors.

The other issue is Peter had us suspend disbelief in the system and not bid below cost unless you think you're going to get those synergies. But I'd like to see what happens when people gain the system, and you have the typical DME industry, which is typically Mom and Pops, that don't really know their cost structure.

(10:14) I mean, they know what the cost thing is here. They know what it costs them for the product, but, you know, "Oh, I took this home after taxes, and you know, maybe I won't do this. Maybe I'll cut this person's staff." They just don't really know their costs other than what they paid for the goods and just have a ballpark idea.

So what happens when somebody doesn't have perfect knowledge of their costs? A lot of his model was basically "Okay, we met theory because everyone just knew exactly what their cost was, so we just stayed at our cost." Some people screwed that up, but still most people stayed at their costs. So when you really don't know your costs, that's a big assumption or when you're not terribly sophisticated at it, that's a big assumption. So that I would be scared about, to see how people can gain the system because that's what happened this last time is people had gained the system, and so people started bidding zero dollars or just saying, "I'm just going to stay in it and wait until Liberty sets the price." So things like that...

(11:03) And then also finally -- I'm sorry if I went over time -- but the new entrants taking up the number of units. Is it 100? Each new entrant takes one unit -- can take -- have one unit or each new entrant can have two -- can take half a unit. Even that seems too small for me. When you have 50,000 supplier numbers out there, you could have 50,000 new entrants if it's just another hunting license, and it's even -- I mean, at least this time it was hard to submit a bid. You had to do all this paperwork, and go into every single product.

If it was just a couple of clicks, I think we're going to get a lot more people just saying, "Oh, screw it. I'll click and do" -- we'll get 20,000 more suppliers trying to click in and do it. So there you go; there's my two cents.

(11:49) **MR. MARX:** Good afternoon, everyone. I'm Joel Marx. I'm with Medical Service Company. We're a provider based in Cleveland, Ohio. We won contracts for many items, most of the items in the Cleveland, Cincinnati and Pittsburgh markets.

My comments will be in three parts -- my thoughts on the program right now, some comments on what Mr. Blum said earlier this morning, and my thoughts on the revised bidding process that we all enjoyed today.

(12:30) So I won five product lines in the Cleveland market. I won them in Pittsburgh and Cincinnati. At the time we bid, we did not have locations in those markets. At the time we bid, we did not provide consumer power wheelchairs which we won in those markets. So we won contracts for products that we didn't sell for markets that we didn't serve. And these are the people that the beneficiaries are supposed to have confidence in.

I'm doing what the rules said. They said I could bid anywhere. They asked how many power -- consumer power chairs we had provided last year, and I said zero. They asked what's your closest office to Pittsburgh, and I said about a hundred miles away. And they said, "Good, you got a bid because your price was there." So it sounds a little silly to me.

(13:39) This morning Mr. Blum talked about the program addressing fraud and abuse, and I still haven't gotten my arms around that, how the program makes any difference in fraud and abuse. It seems like there's a lot of things in place now.

Between 2008 and 2009, the actual cost of the program for respiratory -- for oxygen services was less in real dollars. They put in constraints -- the surety bonds, the accreditation, the 36-month cap. They spent less money in 2009 than 2008. So it seems like there are some restrictions being put in. Most of the providers know that those are real.

(14:28) Mr. Blum also talked about how the bidding or auctions will improve quality, and I just don't get that. We will pay people a lot less, limit the number of competitors they have to compete with, and therefore, everybody's going to step up and give higher levels of service. It seems that that just leads to the opposite.

And the third issue is that somehow competitive bidding would address utilization, and in his words, over-utilization, and I don't understand that. Utilization is not bad. Utilization is why providers are in business, because people need the services ordered by a physician and paid for with their premiums that are paid to Medicare.

(15:29) We're keeping people out of hospitals and long-term care. There's a cost-shifting. It's less going to the hospitals and more to home care. But utilization is a good thing. That's why the benefit is there, so it can be utilized. And just because utilization goes up doesn't mean it's wrong.

There are far more knee implants done today than there were 30 years ago. Does that mean it's bad to have an artificial knee? Again, that just doesn't make sense to me. So I'll get that off my chest.

(16:03) My third issue is the process we went through today. I mean, this was like a really great Monopoly game. I enjoyed it. I love the theory. I was an economics major. I love the curves and all that stuff. But you talked about the term complementarities, and you spoke of one complementarity that we had in this, the $25,000.

Every one of our businesses has 50 complementarities, and we're going to bid below cost because the same rep that serves that area does the V.A., and I really need it so he can keep calling on the V.A. Or I just brought my son-in-law in the business, and I want to make sure he still has a market because we're partly in the competitive bid area and partly out of the competitive bid area.

(16:52) Half the people in the industry don't know what their costs are. And how do we take into account changes -- the risk factor for gasoline prices next year? There have to be 50 different complementarities. I'm only in one market and it's being bid, and if I don't get the bid, I go out of business.

Now on a macro level, that's fine; you shouldn't have been in business. On a micro level, it's a two generation or three generation business with 15 employees. And dammit, I just want to get through the two-year period. I'll lose money during that period, and then I'll bid it again and try to get it.

(17:34) There's also the inaccuracy that our capacity can be provided to another market segment, and with Medicare being a monopolistic buyer, that pricing -- without Medicare, most of us can't stay in business.

What wasn't addressed at all, what were the service aspects. This is not a homogeneous product that can be easily transferred, electricity over the lines. You send them to Belgium instead of France if you had that excess and you low bid in Belgium because you didn't get the bid in France.

(18:14) In this case, if we don't get the Medicare contract for concentrators, we can't provide it to the healthy 22-year-olds. It's sort of like saying to a doc who bids, "We'll let you keep taking care of patients, but they have to be under 65 years old."

And the way the bidding process went is the heart surgeon who wins the contract for the heart surgery, "Well, you're a doctor; you can bid on brain surgery too." I mean, that's what they did in our case. They felt we were qualified to do something we've never done before. Is this wacky?

(28:55) Other than that, I really like the bidding program, so I'll turn it over.

[LAUGHTER]

MS. LUTZ: So unlike everybody else on this panel, I am not an expert in DME, and I suspect that's why Peter put me on this panel, in fact. What I am is an economist, and I'm with the National Science Foundation. And I do need to start by saying that the National Science Foundation does not endorse what I say.

These are my opinions and not the opinions of the Foundation.

(19:25) There's a reason for that. The Government employees who are all here know that otherwise multiple layers of lawyers would have had to look through the most innocuous things that I would be saying.

NSF is about -- we're a Federal agency, but what we're about is funding the best new ideas, the best new research. In general, we leave health-related issues to the National Institutes of Health.

(19:50) But one of the things that happens is that in doing other kinds of science, we develop -- our research communities develop ideas that are important for issues with healthcare provision or healthcare evaluation, healthcare management.

Here it's important to remember that why am I -- why we were sponsoring this? Well, as you know, we have an award to Peter and Larry for their academic research. We look at everything on two criteria. One is intellectual merit, how good a -- how innovative and how new are the ideas, and the second one is broader impact. Do the ideas have the potential to improve society in a fundamental way?

(20:35) So this is an example of how academic research can end up producing broader impact. Auctions are an area broadly where we know that this has happened. I could ask you all, say, who's got a cell phone with them today, and most of the hands would go up. And I could say, "Do you know that the U.S. Treasury" -- Evan will know the numbers for sure, I suspect, but the last one I got from Peter was on the order of a hundred-billion in the States. And that's not some economist estimate of the net benefit to society; that's actual money in the U.S. Treasury. The net benefit to society is way huger.

(21:13) What do we know about how to make auctions work? Well, it turns out that over time a process that has been pretty robust in the sense that it's been tried in a number of different areas is, in fact, the one that Peter laid out this morning.

You start with economic theory because it -- among other things, it keeps you from flailing around to randomly trying things, hoping you will find one that sticks. When you have some ideas from your theory for a form of auction that would work well, you take them to the decision-making lab, and you all were, in my terms, subjects in such a lab experiment, except that we would have actually taken the money home or a fraction of the money home and not just a prize for being best.

(21:57) And then we take a look, analyze that data, and then we take it out into the real world, and in a good process, like the one that the Federal Communications uses, you watch what happens in the field and you adjust the way that the auction runs to identify any weaknesses you've found, to find new methods. The way that you auction something off in 10 years may not be the way that you did it at the beginning.

What do we learn from that process? That it's important; that things that fail theoretically do not suddenly figure out -- do not suddenly sprout wings and work well in reality. Things that don't work well in the lab also do not work well in reality. It's one of the big advantages of the lab; you can even figure out what interfaces are easy or hard for people to understand on the fly.

(22:47) We also know something about the kinds of outcomes you can reach through auctions. And I could use fairly technical language from economics, but what it boils down in many ways is common sense. There are a few things that we know that we'd like to have as a society in the outcome of any procurement process.

One is that we'd like to minimize the cost that we're paying for what we're buying. Minimizing doesn't mean making it zero; it just means not paying more for it as a society than we need to.

(23:16) Another one is that we want to make sure that winning sellers who are operating efficiently and fairly earn enough money to stay in the business. There's a phrase from antitrust that "We're not about preserving competitors, but we are about preserving competition," and that applies here too.

Market structure -- I can't tell you when I wear my professional economist hat if there should be 10,000 providers in this market or two. It depends on the size of the market; it depends on the cost structure. I can tell you that competition is the only force over the long term that keeps prices down. Regulated pricing does not have a great track record. Administrative pricing just doesn't globally.

(23:58) And we want an outcome that's what economists would call Pareto efficient. That's a big term that basically means we're not leaving anything on the table. Everybody -- when we leave the room, everybody -- there's nothing that we could do to make somebody happier without making somebody else less happy.

Those are pretty common sense things. Auctions are a pretty good way of getting there. They are, as Peter noticed, in practice actually quite robust. They're a lot more robust than some other ways of running a market as we have discovered.

(24:33) But getting the rules right is really important, and that's the kind of place where I like to see my principal investigators, the people that we're funding, thinking about real world problems. So I'm glad to be here.

(24:48) **MS. LAW:** Hi. I'm Amy Law. I'm with the -- Hi. I'm Amy. Thank you, Dr. Cramton. Thank you for your passion. I really appreciate what you're doing, all of you.

So we were in Round 1, the original Round 1 before the rebid, with one product called negative pressure wound therapy, which I hope you are not familiar with. It is a therapy used on severe and chronic wounds in a highly comprised Medicare patient population that is younger, more likely to be disabled.

(25:22) We treat in the hospital and the home, but about 60 percent are now in the home, transitioning out of the hospital, which we appreciate. Our therapy helps prevent readmission, emergent care, amputations, reduces length of hospital stay. So we are very passionate about what you're doing for us. So thank you.

So I do have approved comments, but I'm not going to read. So they're my own just in case -- in case I deviate and say the wrong thing.

(25:51) We are supportive of competitive bidding. I raised my hand and agreed this morning. One thing I would say, we bid this product all the time to hospital systems, GPOs regularly. We have 500 contracted payors.

One difference that we didn't talk about this morning or that CMS has not included is in the market today they typically include a clinical panel of experts to help define what is being bid, both the product specifications, the service levels, the training and the access to support.

(26:22) And I think you all talked about understanding cost structure. We're not a category where if it alarms at 9:00 on Friday, you can worry about that on Monday. You need to worry about that that night, similar to like maybe a home dialysis.

So obviously we're very, very concerned that you take into account your costs and you understand those before you bid. And I think you kind of alluded to that today with accrediting a bidder before the process just to make sure there's quality for what you actually have to deliver.

(26:54) So we are in support of having clinicians on the panel and help define what the product and the service levels should be as we see in the market.

We also believe, to your point this morning, that the system should not interfere with the choices of the physician in this case, particularly just because wound healing is still an art and not a science, and you really need to understand the patient, the product, the outcomes that you're dealing with the products. I heal very differently from an 80-year-old or a disabled. And so you need to really look at what are the -- what is the nutritional status, what is the caregiver status, what's the comorbidities of that patient. And you have to realize that in evolving categories, you want to have some choice of the physician when they're looking at a patient and evaluating.

(27:41) That's how they decide what's the best outcomes. That's how they decide what to use. That's how they decide how long to keep it on and what kind of support they're going to get.

Our brief experience in Round 1, which was, I believe, two years, before I was with KCI -- we were -- I believe we won two categories, and we learned from discharge planners that our therapy was not available for the two weeks that the program was open in Cleveland, Ohio -- and Cincinnati -- excuse me -- because, as we talked about, suppliers were awarded contracts who were not familiar with the costs, and they decided not to bid.

(28:18) So, again, it goes down to the non-binding bid and inexperienced suppliers. Once they realized what they'd won, as I did today, they opted out, and so we did have a severe access issue. So we were lucky it only lasted two weeks. We were told by the hospital Administrators that they were keeping patients in the hospital which you alluded to will likely happen. That's what we saw happen.

I mean, when you have a complex therapy, you can't really risk putting somebody out there on something else that's not going to do that. And you're absolutely right -- the cost of our therapy at -- 30 days in the home is nothing like three days in the hospital. So you really have to work on trying to figure out what is the way to keep them and let them go home.

(28:58) Anybody's who been in the hospital knows you're going to prefer to heal in the home care setting, and that's where it's going to be more efficient. So I think it's important from the beneficiary standpoint that we get that right as we design our model.

One other point I just wanted to make, the FDA and the stakeholders in our community agree that NPWT improves outcomes. It can be used safely and effectively in the home; however, we are asking that, due to the risk of the patients in the category or complex category, that there is that pre-accreditation, that people are familiar and have the capability, the service levels that you spoke to to be able to provide that.

(29:37) And I know in other categories, such as respiratory, that they do accredit suppliers in that category prior to allowing them to bid. So it will ensure that you can actually deliver on therapy or the 24/7 support, which is what the entire category is asking a supplier is able to do.

Again, we want to be able to treat these patients in the home. We just want to be able to ensure that you don't take out the safety net because you can't afford to deliver the safety net.

(30:02) And the last thing which is really my point about --

you asked the question this morning, option one or preferred option, three years or two, about how many years should a contract be. I think if you have a medical advice category that's still on a high degree of innovation, you know, you're still on that innovation curve and you're on your fourth or fifth generation product and therapy within a couple of years, it's not really fair to the patient to restrict a supplier for a three-year window.

I think you sort of limit access sometimes to the best technology if you try and lock suppliers out. And it's really, as I said, to the patients who need the best therapy the most that can be at harm if you have a three-year duration.

(30:41) So that is my view. Again, thank you for having us. I really appreciate it.

MR. GABOS: Good afternoon. I'm Paul Gabos. I am the Chief Financial Officer of Lincare Holdings. We are probably the largest provider in most of these product categories in the country, with a particular focus on oxygen and CPAP and respiratory disease.

(31:05) By most measures, we are, I think, the singly most profitable company in this space in terms of aggregate dollars as well as margin. So in some respects, you might expect, as the most efficient provider in these markets, theory would indicate that we would have been a significant winner of contracts.

Of the 73 contracts that we bid on, we won two. Needless to say, we were shocked when we saw the results of the auction. Prices down 25 to 40 percent in some of these categories.

(31:41) Now we fashion ourselves pretty smart guys. You know, when we went into the bidding process, our bid strategy was to essentially bid at a price that we felt would clear the market. We know from publicly trade company information, we know having been an acquirer of hundreds of businesses over the years, we have a very good sense of what profit and margins in the industry look like.

We felt that bidding down 15 to 18 percent would clear the market, ensure contract wins in the markets that we desire and allow us to gain substantial share in those markets.

(32:17) You know, when we see prices down 25 to 40 percent and then understanding that those prices are based on median prices so that half of the winning bidders actually bid less than that, you really start to question the integrity of the bid process.

Now we were told there were protections that had been developed since the first round that would ensure that bids were bona fide. Well, let's examine some of those protections. All right. Providers or bidders were asked to submit cost data, invoice cost data. Okay. So I can tell you that in most of these product categories, the cost of the product itself represents roughly 20 to 25 percent of the total cost picture. Payroll is 50 percent of my costs. Vehicles and facilities, another 10 to 15 percent of my costs.

(33:03) None of those costs were evaluated. And so the opportunity for a bidder to submit a price at substantially below the cost he could operate at and make profit was not prevented.

Furthermore, we were asked to submit financial data. We were asked to submit our 2008 tax returns. Well, the bidding occurred in late 2009. The economics in our business in late 2009 looked nothing like they looked like in 2008.

(33:32) In 2009, we had a nine-and-a-half percent across the board price cut. In the oxygen space, there was an additional 2.3 percent cut for what's called the budget neutrality adjustment. There was an implementation of a 36-month rental cap which, by our estimates, was somewhere between an 18 to 24 percent price reduction off the 2008 levels.

And so the data that was presumably used by CMS to evaluate whether bidders were bona fide and could make money at the prices submitted was clearly outdated and irrelevant at the time that it was submitted. That's highly concerning.

(34:10) Was there any attempt to do a pro forma analysis? In other words, even looking at the 2008 data, could that company make money at the prices that it was submitting with the bid process? I suspect that none of that evaluation occurred.

(34:24) And so these are very concerning, but I think enough has been said about the flaws in the design of the auction process. I think this concept of suicide or low-ball bidding became the prevailing bid strategy, and we see tremendous dislocation in these markets.

What are we seeing in these markets today? I think it's very early, and I think that some may be gaining a very false sense of comfort about how these markets are actually operating. I think the real cash flow impact to companies in these markets is just now being felt because, you know, in January and February, you're working down your 2010 receivables. So, you know, while your profit and loss statement shows the full impact in January and February, your cash flow is still benefitting by older receivables.

(35:14) I can tell you that, you know, by luck or by design, there is a national provider in every market in every product category, and I can tell you that the nationals are willing to subsidize these markets with their significant out-of-market operations.

What that tells you -- and that was, you know -- if it was by design, great. And we saw Peter's example of how the pricing could be set very arbitrarily in each of these markets because of the lack of a defined quantity.

(35:44) And so CMS had the discretion to look and say, "At this price, I guarantee myself a national provider in this market, and that will prevent dislocation." So I think that we are getting a very false sense in these markets because companies like ours in the two markets that we're competing in where we are losing money by providing those product categories, those markets are immaterial to me in the aggregate.

And so in the interest of patient care, we're also a grandfathered provider. We continue to provide products to our existing patients. We do that in the interest of continuity of care and preservation of our patients.

(36:22) We have been inundated with requests by winning contract providers to purchase their companies. You know, it's very well known that Lincare, a very well capitalized company, did not win a significant number of contracts. I can tell you that we have confidential information from over 30 companies that have won bids, and we've been contacted by at least twice as many as that.

I can tell you that these companies are broke, okay. They were broke before January 1st, and they're even more broke now. Some of these companies are not able to take new patients until an existing patient comes off service because they can't buy a new piece of equipment.

(37:04) What are the long term implications of that? That the fleet of equipment that is being provided to these patients is going to be old and outdated within six to twelve months, with no investment in new technology or equipment.

What does it tell you when, you know, winning a contract which, according to efficient theory, should have been a good thing, it should have been at a price that you should have made money; now everybody is looking to get out of those businesses?

(37:29) We know that CMS said that, I think, 28 percent of the contracts were won by out-of-market providers or providers who had no experience in those marketplaces. You know, Joel, perfect example. Do you have any intention of setting up a physical location in those markets where you won contracts and don't have one today?

MR. MARX: We are intending to, yes.

MR. GABOS: You are intending, but you haven't yet?

MR. MARX: One we have; one we haven't.

MR. GABOS: One we have; one we haven't. We're not seeing a lot of that. I can tell you that there is some subcontracting going on. I don't think there's meaningful volumes that are occurring under these subcontracts, but, really, you know, those out-of-market bidders really only serve to drag the price down, and certainly you're not doing anything to enhance access to care in those markets.

(38:14) You know, we're seeing in the companies that have contacted us in terms of acquisition inquiry -- these same companies contacted us early -- late last year, October, November, when the bidding had been announced. Their staffs have been significantly reduced since then as these companies are laying off to try to sustain themselves.

I think I'll end my comments there. I think we want to have some discussion. But, you know, I think, my biggest concern is that there's going to be an evaluative process here. Hopefully there will be hearings on the Hill shortly.

(38:49) I don't know that we have enough information to know how bad the outcome of this bidding process was and what the long-range impact is going to be on these markets and on these patients. And I really caution any comments to the effect that "Well, we haven't received many complaints from beneficiaries."

Many of these beneficiaries don't know what to expect, particularly patients that are being prescribed these therapies for the first time. They don't know what the expectation of proper care should be in many of these markets. And I'm concerned that, you know, a lack of complaints by beneficiaries and measuring them against some control group is somehow some indication that this market didn't fail and that everything is okay.

(39:34) I can tell you that everything is not okay, and it's going to get worse with each month that passes in these nine markets.

MR. LEGGITT: Thank you, Paul.

So we've got a little bit of time for questions, and we've got a lot of very bright people in this room. And so what I wanted to do was we have some mics up there and I would open the floor up for a couple questions from folks in the audience.

[PAUSE]

(40:00) **MR. LEGGITT:** Okay. So I'll ask a question. Paul and the rest of the panelists, let me ask you this question. In terms of sustainability, if CMS forges ahead in Round 2 the same way they've done with the Round One Rebid, what do you think the impact will be on the supplier community and sustainability?

PANEL PARTICIPANT: I'll address that. I mean, I think, for one, as the size and scope of the program grows, the national company subsidy will go away because now that is a bigger component of our business, and so this ability to provide service to customers at a loss with a subsidy will disappear.

(40:38) **MR. LEGGITT:** So I take it if CMS had come to you in Round 2 and said, "Look, you didn't win bids, but we want you to compete in all 91 cities at the price that you have today" that would probably not be a very positive conversation?

PANEL PARTICIPANT: It would not be.

MR. LEGGITT: Zach, do you -- what about in terms of the diabetes industry? You know, I know, or at least it's my understanding, statistically that most of the mail order diabetic supply companies are heavily reliant upon Medicare for reimbursement. And so if you're getting squeezed at a 50 percent reduction and it expands to 91 cities, what do you think that does to the market?

(41:20) **MR. SCHIFFMAN:** Well, I mean, I can say that we definitely, on the diabetic side, win the bid, but I know the companies that have, and they're subsidizing. They're subsidizing because it's around eight percent of your patients -- seven to nine percent of your patients are in the competitive bidding areas. So it's not an inconsequential -- it's not a terribly material amount that you can just subsidize.

(41:43) And some people are even pulling loopholes and actually delivering to the home themselves, which they're trying to get rid of in the next round, saying that you can't; you have to actually pick up testing supplies at a brick and mortar store. You can't just drive it in a delivery van to someone's house and get paid full reimbursement.

But, yeah, I mean it's logical that when it rolls out to 90-plus regions, that it's not going to be something that you can subsidize, and you really have to put rubber to the road.

But at the same time, a lot of the diabetic supply companies don't have the scale or anything to get into the managed care business, so they are 90 percent Medicare, 80 percent Medicare, with the other 20 percent just being supplements. So really you're a hundred percent Medicare.

(42:31) So they're going to be bidding as if their kids won't be able to eat if they don't bid low.

PANEL PARTICIPANT: I had one other -- this is obviously a little bit longer term and hypothetical, but if the larger companies -- in theory, we like to think we've achieved our economies of scale, but we know we're always trying to take costs out, I think, longer term.

If you want to be, especially with the private payors, and you need to treat Medicare to also have your private payor business, I mean, we have to look very seriously at how we cut further costs, whether it's service, whether it's R&D, whether it's moving locations outside of the United States. I mean there is a longer industry play here as well.

(43:11) **MR. CRAMTON:** Thank you very much. Lance, panelists, you guys are wonderful. Your comments are wonderful.

We are running a few minutes behind, so I know we could go on for hours. But we have two Panels remaining which are going to be very important, and so what I'd like to do is cut the break short to 15 minutes rather than a half-an-hour -- so a 15-minute break from right now. That takes us to 5 minutes to 4.

And so get your coffee, get your sugar, and come back 5 minutes to 4 ready for Panel 2. Thank you.

[APPLAUSE]

[CONCLUSION OF FILE 0561]

MEDICARE AUCTION CONFERENCE

INN AND CONFERENCE CENTER

UNIVERSITY OF MARYLAND

FRIDAY, APRIL 1, 2011

SEGMENT 5

FILE 0562 (PARTIAL)

SECOND PANEL:

PRODUCT DESIGN AND ENSURING PERFORMANCE

Transcribed for: Bart Woodward

Transcribed by: Aleva (Lee) Schneider-Pollard, TranscriptionBiz

Date: April 8, 2011

File Name: 0562 (Partial)

P R O C E E D I N G S

[FILE 05620] SEGMENT 5

MR. MILAM: Okay. Thank you. As everyone is coming in, hi, there. I'm Tom Milam from Nashville, and for seven years had the great pleasure of operating and building a little company I'd run into on a small turnaround assignment back on '02 into one of the top three or four companies in the diabetes supply and pharmacy space following the death of a very, very close friend whose kidneys failed as a result of his diabetes, and I actually saw him die of a massive cardiac arrest on dialysis.

So I know what the disease can do, care a lot about it and still care a great deal about it.

(04:52) I'm also a member of the Program Advisory and Oversight Committee on Competitive Bidding along with -- and Walt Gorski is here; also the co-chair here, along with Jon Blum, who you saw earlier. The Industry co-chair here is Tom Jeffers of Hill-Rom. He's also here. We'll be back over at CMS Tuesday.

So our group here is going to be talking about product design and ensuring performance, if you will, the categories of the products, are they right, are they structured right, and also, how can we ensure performance.

And we've already given a round of applause, and I'm sure we will at the end, to Peter. It's not just Peter, but also Larry Ausubel, the great team of the dozens of people who have maybe slept a couple of hours a night this week making this possible. Just thank you again.

(05:43) Just a couple of quick remarks from me, and then we'll move to my right, your left, with Cara Bachenheimer, et cetera. Each person will introduce themselves and give you just two or three minutes of comments so we can have some questions.

One thing I want to say about today, this is not the end all, be all. This is not it in terms of walking out of here, "Okay, it's done." It's meant to show, I think, how the auction can be conducted, and then with the right structure, the right prerequisites for qualification, et cetera, that something could happen.

(06:16) That's a positive for the industry, positive for the Government, positive for beneficiaries. As I went on record at a PAOC meeting and said, I'm not opposed to competitive bidding at all. I'm all for competition. I am opposed to what is being conducted or forced on the marketplace, another form of administrative pricing as it is.

(06:37) And what I've been most frequently reminded of is the definition of insanity that's attributed to Albert Einstein which is, you know, doing the same thing over and over again and expecting a different outcome.

And certainly I would say that about the current bidding program, but also I would say for myself and the rest of you in the industry in here, we've got to hold the mirror and say, "If we're going to go flail ourselves or throw ourselves against the wall, you know, looking for the same thing again and again and again, and we haven't had that outcome before, it's not likely to be that outcome in the future."

(07:16) The group that you have here, I think they're going to have some good things to say about the product categories, HCPC codes within those categories, how products are classified to categories. I'm going to leave that to them.

I will say a quick thing about ensuring performance. I had actually submitted as a recommendation in the spring of 2010 to CMS that there needed to be performance bonds, and it was waved off. And I've studied more about that.

(07:45) A performance bond is a form of a surety bond. There are issues with surety bonds. The surety bonds that Congress, with its good intentions, required and that CMS wants are probably not worth the paper they're written on in terms of -- I mean, I wonder if anybody has collected on one yet. A lot of issues there.

But the performance bond that they're talking to experts in the bonding industry, if you will, can be -- it follows the contract. It's whatever the obligations of the contract are, and the more detailed, the more precise those obligations are, the more enforceable that bond is.

(08:19) The bond is probably a couple of percentage points of whatever the face amount is. That's probably the requirement, and it's all based on financial wherewithal. I know Mr. Marx earlier was talking about, you know, "We have two generation this, whatever. I'll bid whatever I have to bid." But then you've got to go back and say, "Okay, I've got the bid. Now I've got to submit the performance bond. Can I secure that performance bond?"

And they're going to look at the financial wherewithal to perform the obligation. If you can't perform the obligation in the bonding company's eyes, you're not going to be able to get that performance bond. So there can be, I think, some attributes that can be added which will make these -- will which help ensure that bidders are going to bid true costs, if you will, or bid rationally in a sustainable way.

(09:08) And a lot has to be fleshed-out on that, and I think that's what we're seeing today. There's a lot of details to be fleshed-out, but I've been impressed with what I've seen for the day.

But without further ado, let's go down the line.

(09:20) **MS. BACHENHEIMER:** All right. Thanks, Tom. I'm Cara Bachenheimer, and I'm with Invacare, the Senior Vice President for Government Relations. We're probably the largest manufacturer of home medical equipment, world-wide company, based on Ohio.

My job in D.C. is on the lobbying front, so a couple of my comments will be on topic, and we were allowed to go off topic, but I will only be a couple minutes with all of those.

(09:42) A couple things. First of all, this is a great program. I just wish every member of Congress was sitting here and their health staff because what I think this points out is, first of all, the complexity of a bidding program regardless of the direction you go, and that is so critical.

And what I'm sitting here all day thinking is how can we translate this into a message to Congress that they really need to step in and stop this program. And I think we need to put our collective brains together to figure that out because whether it's the incredibly flawed way that CMS is doing it or whether there are better ways, is there a way that we can do it, whatever it is? We have to stop the program this year in Congress before it gets rolled out to an additional 91. So I put that challenge out to everybody because I think -- my guess is a lot of us in this room feel that way.

(10:32) A couple comments just on topic related to that and sort of related to the thoughts of the process moving forward today. This exercise -- I'm not a provider; our company is not a provider, so it was kind of fun to sort of try and step into those shoes.

Observations on the whole cost issue -- obviously we've got thousands of customers across the country. The real question, regardless of the program you have, is how well do people really know their costs, how well can they know their costs, because that is such a critical information component to ensure rational bidding.

(11:07) And I'm not an economist or anything like that, but it seems to me that is so fundamental to any bidding program. If you don't have good numbers, if you don't know what your costs are, you're never going to have a rational bidding program. So there's a gap, I think, in my estimation in this industry given the types of players we have, the diversity of players in the marketplaces across the country.

The other issue that sort of raises as going through it is the assumption -- and I know Dr. Cramton emphasized "Be rational. Don't bid below your costs" -- and I understand that's how it needs to work, but is that how it would work in the real world because our conversations with customers, bidders across the country is irrational behavior that results in the suicide bidding prevailed because of that desperation to stay alive.

(11:55) And I don't know how you establish a program that prevents irrational behavior, but you have to know your costs and you need to ensure rational behavior. How you build that into the structure I don't know, but those seem to be the two pillars upon a foundation for a program that is actually going to result in prices that are sustainable.

On the sustainability front -- and this relates to the process that CMS used -- we've been highly critical of the -- well, we don't even know what financial standards CMS used, but we do know looking at the results of the 359 contract winners, we did an analysis as a manufacturer, since we know virtually everybody across the country, and we found that one in five of the winners were financially unsustainable.

(12:39) They were either -- they couldn't have bought one product from us if they wanted to. We were actively in credit collections with them where they were on credit hold. One in five when -- I think it was Paul in the previous panel -- he's absolutely right. There are companies out there who, one, who cannot buy a product. How do you service them?

There were an additional 14 percent that were new companies. In our estimation -- brand new entrants to the field. And that's neither good nor bad, but it's indication that I think their financial sustainability has got to be questioned a lot more rigorously at the front end. So that comes from our analysis. We broadcast that on Capitol Hill and across the airwaves a couple months ago, but I think that speaks to such a critical component before you even get to that bidding process.

(13:22) And I will stop there and keep my promise -- hopefully just a couple minutes.

MR. ISKRA: Great. Thank you. My name is Mike Iskra. I'm the Chief Operating Officer of Simplex Healthcare based in Nashville. We're the third largest provider of diabetes test strips to the Medicare beneficiaries through mail order.

(13:42) Prior to working at Simplex, I was head of the Diabetes Business Unit at CCS Medical, which was the number two mail order provider. So from the diabetes point of view, I've seen the inner workings of a few companies.

With that, I'd like to provide some comments on the areas for this panel. I don't have to go too far off topic on anything because I think there's enough here within the topic.

(14:06) But I'll first agree pretty much with everything that Cara said. One of my points to take away today was a real big concern about the importance of understanding your true cost basis to have rational bidding. And I think that was said well enough.

As far as product design, I think the groupings in the diabetes product may be one thing that actually was done right.

It makes a lot of sense. I don't see any need to make any changes there.

(14:34) However, when I look at another area that our company is in, CPAP supplies, I think that we've got a challenge there in that it's all wrapping around the CPAP device; yet, many companies provide the device, but not the supplies. Some provide the supplies and not the device. And some provide both. But it would make bidding very difficult if that remains the way that it is.

(14:56) With regard to product design, going forward and in through today's exercise, great exercise. But from the diabetes test strip point of view, there's a major, major flaw that has to be fixed before you can go the next step with any bidding program. And that's the fact that we have a bifurcated market.

We have a retail market that has not been impacted by competitive bidding with one price. That price, on average, across the United States, is over $37.00. In the CBAs, the average price -- winning price was $14.62. For some reason, it seemed to be a good decision to pay some people two-and-a-half times the price for the same product that we are trying so hard to bring the cost down on. So that has got to be fixed.

(15:39) And with that, you know, if it's not, we're going to see a few impacts. One, it's going to undermine this program completely because as a bidder, you know that there's always an exit for that beneficiary. So what am I really bidding on? What is my gain to make any sort of financial commitment to this process?

Secondly, it's going to lead to less than expected savings, and we're seeing that today. What we're seeing are three things happening in the market that are starting to prove this. One is -- and it was brought up by some of the other panelists in some of the other comments throughout the day -- winning mail order companies, their capacity and capability is being questioned.

(16:16) In fact, we've called 20 of the winners. There was 20 winners for diabetes testing supplies. We have three that didn't answer the phone. That's a problem; that's a concern.

Zach talked about the gap with the number of new providers in this space and how many beneficiaries are being displaced. When there was a challenge and hassle, in our particular category you can still walk into CVS and Walgreens and pay two-and-a-half times the price.

(16:41) The other challenge that we see is the OIG recently released a study on the market shares in the diabetes testing area. The top seven products made up over 51 percent of the products. Every single one of those products, if I were to buy it through a wholesaler, every single one of those products except for one is above the price of the winning rate. My cost would be above the winning rate. So I find it very difficult that anybody that's out there is providing those products.

So we looked -- when we called the 20 different providers that won, we looked at the number one products. It's the LifeScan One-Touch Ultra. It has about 14.7 percent of the market in mail. Not one -- I'm sorry. Let me rephrase that. Of that 14, 14 providers said they do not offer this product. The number one market share product that beneficiaries are on is not being offered.

(17:35) We had three that did offer the product. One said they're losing their contract and they won't be offering it much longer, and two others said, "Yes, you can have it, but there's a copay for that product." Whereas, if you went with their generic or preferred product, the copay would be waived. I'm not so sure that that is something that we expected to see performance-wise from the winning bidders. I'm not so sure it's actually within compliance standards for the Medicare program.

(18:00) So we're seeing the challenges with capacity and capability. We're seeing the branded products not being offered, and that's causing patients to go to retail where it's a safe haven.

We're also seeing the emergence of a lot of direct marketing and advertising by the retailers to the Medicare beneficiaries specifically to let them know that they can find those products, the same products they've been using, in retail.

(18:23) The result is, just frankly, we're just not going to see the savings that we've been expecting to with this program if it stays with this structure regardless of the nice competitive bidding tool that was shown today.

Another area that we were asked to comment on was partitioning of the country, and there were a couple scenarios provided. I think they're both headed in the right direction; however, the second scenario with 10 areas seems like a better idea to me.

(18:49) The biggest challenge I have is that the pricing that was awarded in the first session be held as or used as a gauge to set pricing in the other areas. That doesn't make sense to me because if I lost an area because I couldn't bid that price, it doesn't make sense that I could provide that price in 80 percent of the market after that. And I'm not so sure -- although I'd love to see rational bidding, I'm not so sure I can trust the outcome based on what we've seen in the last two rounds, Round 1 and then Round One Rebid. And so I'd be hesitant to agree that.

(19:22) I think this should be rolled out in a controlled manner and over time. And what we all know will happen is if people win and they prove that it can be served at that price, they're smarter than I am right now. But I will figure out how to mimic what they're doing and be competitive in the next round.

If they were not smarter than I am right now, they made a mistake, it will show itself, and we can all correct for that in the next round.

(19:44) So we have to be careful about going from nine to 90, and so I'd suggest that we back that down and take it maybe one at a time.

The last thing is around ensuring performance. Before we start talking about adding other things and standards -- and I completely support and the bonds make sense relative to what you plan on bidding. The fact of the matter is there are standards in place today that are not being enforced, okay.

(20:10) As a large company that produces a high volume of claims, we are audited on a regular basis. And you know what? I don't have a problem with that. That's what should happen. But we have many providers that have won and been awarded contracts that have not been audited to the same level. And so as we go forward, I think it's important that we have some pre-bidding performance insurances, such as a performance bond.

I think prior to award there should be site visits and reviews of the business practices. The current situation with being accredited is not tight enough. The variability between accrediting agencies is too broad and lets too many people in. CMS will have to come in and inspect people prior to contracting, and I think that they should mandate that every winning contractor will have a focused audit on-site within three months.

(21:02) I know from many people that are not investing in compliance and finding the right way to do things, they would start to factor that cost in before they started the bid if they knew that people were going to show up and take a look.

So those are my comments. I appreciate the opportunity. Thank you very much.

(21:19) **MR. LLOYD:** My name is Scott Lloyd. I'm with Extrakare. We're a respiratory-focused DME supplier in Atlanta. We did not participate in Round 1.

I believe that the product categories as defined in Round 1 of competitive bidding will lead to beneficiary access issues, quality of service issues, and non-compliance by contacted suppliers.

(21:40) Many DME suppliers develop specialties within categories as you referenced, Mike, just as a general surgeon may choose to specialize in bariatric surgery. The definition of the product category appears logical -- oxygen, beds walkers, et cetera. But really it's a little more complicated.

Many CPAP suppliers, for example, choose to supply CPAP devices exclusively for the treatment of sleep apnea and don't choose to supply them for the treatment of severe COPD, restrictive thoracic disorders and other health conditions.

(22:15) In the absence of competitive bidding, these suppliers would not be required to supply certain items in the CPAP category; for example, what is known as a HCPC EO471, a BiPAP S/T device. I think most clinicians would agree that a beneficiary suffering from a restrictive thoracic disorder is much better off receiving their device and ongoing support and care from a supplier that specializes in treating patients with that health condition.

A CPAP supplier that specializes in CPAP therapy for the treatment of OSA should no more be required to supply a BiPAP for a patient with a restrictive thoracic disorder than a general surgeon who specializes in bariatric surgery should be required to remove a gall bladder.

(22:57) Product categories bid in Round 1 include many clinically complex diagnoses. Most DME suppliers are not experts in all of these complex situations. Contracted suppliers that do not have expertise to handle clinically complex beneficiaries must choose between doing the beneficiary a disservice in dispensing the prescribed DME or violating their contract and refusing to dispense the DME. It's a classic double bind.

Bidding rules should be changed to allow suppliers to bid on categories without having to supply each item in the category or the items included in the category should be pared down to include, for example, the top 10 most frequently prescribed HCPCS.

(23:44) The current rules require DME suppliers to dispense branded prescriptions. Auction rules should include significant changes to the rules that require contracted suppliers to fill branded -- to change the current rules that require contracted suppliers to fill branded prescriptions and to accept assignment on all claims. The combination of those two rules reduce beneficiary access to prescribed DME under the current competitive bidding program.

It's simply not practical for every contracted supplier to be able to maintain vendor relationships for every produced coded by the PDAC. Examples from a recent search on the PDAC website: Group Two power wheelchairs, HCPC KO823, the PDAC currently lists 22 manufacturers -- not products, but manufacturers that are coded that manufacture KO823s.

(24:39) Oxygen concentrators, the PDAC currently lists 17 manufacturers, and for rolling walkers, they currently list -- any guesses? 55 manufacturers.

The point should be clear it's not reasonable to require contracted suppliers to be required to fill branded prescriptions. There's going to be circumstances where beneficiaries simply cannot get the product or cannot get a certain product, and when they call 1-800-Medicare, they're only going to be more frustrated because the customer service person on the phone is going to tell them that any contracted supplier is required to supply them with the branded product.

(25:15) A sustainable program must be one where suppliers have a reasonable idea of what costs they may incur, and the only way a supplier can know what costs they're going to incur is if they know what products they're agreeing to supply.

The HCPC Coding System today is not sufficiently detailed to allow suppliers to effectively bid by HCPC. The two largest manufacturers of CPAP devices, each making a number of CPAP devices which are approved by PDAC and meet the data collection requirements established by Medicare, but the most expensive models cost two-and-a-half times the least expensive models, and they all have the same HCPC.

(25:55) Products have predictable costs; HCPCS do not. Suppliers can bid on products; they cannot bid on HCPCS. Bidding on a HCPC is a lot like bidding on paving a mile of road if you don't know how many lanes are in the road.

Hopefully we can all admit there are products included in Round 1 categories that will simply not be available by any contracted supplier. If a beneficiary happens to live in CBA, they may -- happen to live in CBA, they may acquire any coded item from any supplier they choose -- I'm sorry. If they don't live in a CBA, they can acquire any coded item from any supplier they choose using an unassigned claim and still access the benefits of their health insurance.

(26:42) Beneficiaries that happen to reside in a CBA who need a "hard to find item" are precluded from accessing their insurance benefit. Contracted suppliers must accept assignment, so they simply will not supply the product, and non-contract suppliers must execute an ABN which precludes them from accessing their benefits.

A more sustainable system would require suppliers to include the manufacturer and model number for each product they plan to supply for each HCPC. Rules could require each prospective bidder to include at least one primary product and perhaps one or two additional products.

(27:18) Contracted suppliers would then be required to supply only the specific items they agreed to furnish when they submitted their bid application. It would effectively work just like the pharmaceutical formularies that exist currently under the Part D Program.

Contracted suppliers should also be able to process unassigned claims for items different than those included in their bid. So if a beneficiary presents a branded prescription for a very expensive or hard to access product, they can access their benefits, and the supplier can get the beneficiary the prescribed product without violating their contract.

(27:53) **MR. PFISTER:** All right. Thank you, Scott. My name is Mike Pfister, and I'm the Vice President of Government Relations for The SCOOTER Store, and I want to make it clear that I've already got an exclusive arrangement with Seth and John on bidding for Round 2.

[LAUGHTER]

MR. PFISTER: So as I mentioned, I'm with The SCOOTER Store. Professor Cramton, thanks for your efforts today and for having a wide view of people up here with different perspectives.

(28:16) Let me provide some context around our company's experience in the competitive bidding Round 1, and maybe that'll help share some of our insights. And then I want to also talk about the product design and kind of the regional roll-out and then a few other considerations that I think we may not have touched yet on in any of the panels, and maybe we can reserve those for questions this afternoon.

On the product issues, ironically that was the area where we had -- frankly had the least concern. As we were developing our bids not only in power mobility, but also in complex space, where we were a winner in all nine cities, and hospital beds, where we were winners in -- winners at loose. I guess that's the inappropriate word. We accepted contracts in all nine cities for the hospital beds and then four for oxygen. The product codes -- it seems obvious that CMS has hundreds of millions of claims to draw upon to kind of appreciate how those codes are prescribed, how those products are prescribed and supplied and referred by people across the country. So we kind of anticipated that that would have been the area that they did the best job, and from our perspective, that seems to be the case.

(29:25) There were a couple of errors or glaring errors in the single price for all the modalities of oxygen which I think everybody here appreciates. And then there was -- you had to cover a couple of products that aren't even reimbursed by CMS, and so that was -- there were some illogical exceptions, but in general, we felt a lot better and thought that if we were going to change the program, we needed to focus on a lot of different places instead of the actual product design.

(29:49) As far as the regional staging concept that you introduced today with your preferred 10 percent or your 33 percent, our preference was to have the famous fewer, slower method. And I don't know what university to attribute that to, but, frankly, our hope was that CMS would implement a program that they would pick a dozen or so cities, and then that we'd run the process and we'd learn something from it, and we would then improve the program a year or two later when the next round comes in.

I'm not sure that CMS doesn't feel they're, to some extent, hamstrung by some of the legislation that's in place that says they have to make certain progress by a certain period of time. But, frankly, I think we'd all be better off if this was done at a slower pace and at a much smaller volume of areas each year.

(30:38) A couple of comments about the definitions of the CBAs. Again, our research felt that that -- and maybe we're skewed because we're a national provider that delivers across the entire lower 48. But we really didn't have any issues with those definitions. Somewhat ambivalent about it, and again, CMS has got so many million claims that they -- I'm assuming that they developed some objectives that they wanted to accomplished, and then they poured the data and they built boundaries around that. Maybe that's giving a little more credit, but that would be the logical thing for them to do.

(31:11) We will note that there's some complex environments, like Cincinnati, you know, where, when you start crossing state lines, you start creating a little bit more of a problem in terms of company licensure, your clinical licensures, and then whether or not you do Medicaid in those particular states. So we may want to re-think whether or not a CBA should cross a state boundary.

Really, regarding the bid bonds and the performance guarantees, the suggestions you made this morning were actually much better than the things that we came up with as a company from that perspective. And I guess we weren't -- but we would be in favor of any of the barriers that keep the guys that we all worry about that aren't doing the accreditation and some of the other controls that have been put in place. So we would be in favor of that.

(32:00) It seems that the bid bond should be forfeited if the old program continues; that the bid bond should be forfeited if you don't accept the contract offer. And then from a performance perspective, that if companies are allowed to continue to have a capacity that is much larger than what they've historically performed, then their performance guarantee should be a little bit larger so that it matches the risk associated with them being allocated such a large percentage of volume.

(32:28) From a performance management, rather than talk about how CMS might manage it, I wanted to just introduce one quick idea that I talked with Peter about last fall, which is somewhat coming from my -- I spent my first 25 years in kind of a business-to-business environment in the energy sector.

And when we either rewarded contracts to people or we won contracts, if you're on the service side, not only did you get their business, but there also was an implied or an assumed effort by both sides to make it easier and cheaper to do business with each other. And I don't see anywhere in any of the regulations or any of the definitions of competitive bidding where it's actually going to be easier for the winners to do business, which would then lend itself to having lower cost structures going forward and allow us to bid even lower prices.

(33:15) So now whether that's fewer audits or that's portals that allow us to maybe to have a head start on the IT initiatives that we hope HHS is making some progress on or different ways that documentation is collected, there's got to be some advantages that are offered to the winners that benefit both CMS, from an administrative perspective, as well as help us to lower our cost structure.

(33:39) I'll close with a couple of comments. From our perspective, the issues that you've addressed earlier in the morning that touch upon the price that's set far outweigh product design, geographic design, from our perspective.

The big gaping hole in this whole picture that you've highlighted is the fact that without transparency, CMS is allowed to pick a price with their capacity that they assign to winners. And so that part to me -- seems to me needs to be reconciled and repaired before any of the other changes to the program are done.

(34:16) And then to kind of parrot some of the comments you've heard from the other panels, there are 25,000 DME providers that billed a claim into Medicare in 2009, and I just don't know how the system that we've been talking about today is applied.

We've probably mentioned too much the unsophistication, but in addition to the unsophistication, several of these product categories have broad differences between the top three and four and the next thousand. For instance, if you combine (indiscernible) company and ours, we make up almost 50 percent of the market share, and so then you've got another couple of thousand. So I just don't know that these auction systems work when you have that type of range of providers.

(35:01) And so I think that we, just like everyone else, we're anxious for CMS to figure out a way to help the country lower healthcare costs, but it's going to have to be in a way that's sustainable for all of us here today. And I appreciate the opportunity to address everyone.

(35:21) **MR. SHIRVINSKY:** Good afternoon. My name's John Shirvinsky. I'm the Executive Director of the Pennsylvania Association of Medical Suppliers. We represent the DME industry in Pennsylvania, and we have our Pittsburgh MSA which incorporated the city of Pittsburgh, seven surrounding counties, bits and pieces of another seven counties, for a total of about 5700 square miles of the Round 1 MSA.

When Round 2 hits, all of eastern Pennsylvania is going to be thrown into the mix, from the northeast in the Scranton/Wilkes-Barre area and a county immediately adjacent to the -- a very rural county immediately adjacent to Scranton/Wilkes_Barre that's going to be thrown in with New York City for God's sakes.

(36:08) You come down to the Allentown, Bethlehem, Easton area, and then down into the Philadelphia MSA, which is going to be a real monster, incorporating Philadelphia, the five bedroom counties in Pennsylvania around Philadelphia, all of southern Jersey, all of the populated part -- portion of Delaware -- northern Delaware, and the far eastern part of Maryland. So that's going to be a real bear.

(36:36) I understand bidding. In a previous life, I worked for an industry that competed in the bidding process. So my friend, Brett Katzman, back there from Kennesaw State University, had written a paper on the early programs that CMS did, the demonstration projects, and one of his cautions in that study was that CMS needs to understand that you're not going to get the same type of efficiencies from a multi-unit auction that you do from the single unit auctions. And the industry that I worked in dealt with the single unit auctions, and it worked -- it worked.

(37:23) I have a hard time believing that this will. I love the idea of competition. We are, in fact, a very competitive industry. But price competition does not exist in healthcare in the United States anywhere; not just for DME. Prices are set by CMS. Prices are set by Medicaid. Prices are set by insurance companies.

Individual healthcare setting prices is virtually unheard of. It happens, but for the most part, managed care providers are taking care of the pricing for us.

(38:09) Economists have long referred to competition as the consumer's best friend. And in a perfect market -- one of our tasks with this panel is to talk about effective market. So if you want an effective market, yes, competition will yield optimal pricing. Competition will help to establish standards for product quality and service. And as a result of those types of things happening, the consumer wins. But consumer needs have been deemed virtually irrelevant in the way CMS has designed its program. I've literally spoken with hundreds of DME patients over the last few years, and every time I have a chance to speak to them I ask them one question. I say, "What's the most important thing to you when you select a DME provider?" and without variance, they say two things.

(39:13) One, they say they want good quality both in terms of service and in terms of products that they need, and secondly, proximity. They want somebody who's located nearby, you know, because, again, if you rely on oxygen to breathe, if you rely on a wheelchair to get around for your daily tasks, if something goes wrong with either piece of equipment, you want to know that someone is nearby to take care of that problem. So the concept of the local provider makes a whole lot of sense.

(39:55) Now these are -- again, they're perfectly logical consumer preferences. They're the kind of preferences that I use in selecting my dry-cleaner. You know, good service; you know, nearby.

So it's a lot more important. I mean, we serve the elderly. We served the disabled. We serve the infirmed. These preferences, proximity and quality, you know, they're so much more important for our customer base. Yet CMS -- the CMS bidding program obliterates both of these consumer preferences.

(40:35) When you are talking about eliminating 80 to 90 percent of providers from the program -- and that's what the CMS program does, eliminates 80 to 90 percent of providers -- we have to assume that CMS had absolutely no qualms about eliminating these consumer preferences.

And some of the stuff that I've read when Congress adopted the CMS mandate, one of the things that was talked -- one, the idea of competition, injecting price competition into the healthcare marketplace -- great idea.

(41:13) And the other was that CMS had to start thinking of itself as a consumer. Well, CMS is not the consumer. The consumer is the consumer. CMS is the payor. And yeah, we need to disabuse ourselves -- if anyone is still thinking in those terms, we need to disabuse ourself of the notion that CMS is a consumer of these products; they're not.

Now we also have to assume that CMS had no qualms in eliminating the consumer's --

MR. MILAM: John, I've got to do this. You've got about one minute, and we're going to have to -- because we've got to get to this final panel.

MR. SHIRVINSKY: All right. All right. Look, the

CMS folks who may still be in the audience, you know, I really don't expect everybody in CMS to understand how our markets work. But when revenues are reduced as the revenues have been reduced here to the tune of 32 percent -- there's a 32 percent reduction in revenues against an industry that, on average, earns a five percent net profit, okay, that's a disconnect that somehow, somewhere along the line needs to be addressed.

(42:27) Obviously the financial analysis that CMS did didn't take that into account. But when revenues are reduced by a third, expenses have to be reduced as well. And there are only so many places that a provider can go to reduce those expenses.

You can go to product quality. You can buy cheaper products. You can go to employment expenses, which means layoffs. And you can go to service. You can ration care.

(42:58) So I'll stop there in the interest of time, Tom.

MR. MILAM: I think, Peter, we really need to have your panel up here. So don't hesitate to engage any one of these fine people at the end of the session, but why don't we bring your panel up. Is that okay with everybody, I think?

[APPLAUSE]

[CONCLUSION OF SEGMENT 5]

MEDICARE AUCTION CONFERENCE
INN AND CONFERENCE CENTER
UNIVERSITY OF MARYLAND
FRIDAY, APRIL 1, 2011

SEGMENT 6
FILE 0562
FINAL PANEL
"WHAT HAVE WE LEARNED?"

Transcribed for: Bart Woodward

Transcribed by: Aleva (Lee) Schneider-Pollard, TranscriptionBiz

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File Name: 0562 (Partial)

P R O C E E D I N G S

(0:43:20 - FILE 0562) FINAL PANEL: WHAT HAVE WE LEARNED?

MR. CRAMTON: Thank you, Tom. Thank you, panel members. That was wonderful. Your remarks are extremely helpful. It's so wonderful to get all the perspective from people all over the country and from Government and as providers and those working closely with beneficiaries.

Now, as we bring up our final panel -- and again, if you could arrange yourself in alphabetical order and hopefully brought your name cards, but if you haven't, that's fine.

So actually, Tom Bradley, why don't you sit right here. I think you're first, and then Walt, then Nancy, then Tom, then Evan, and finally Wayne. Good. Excellent.

(0:44:17) Good. Well, I know it's been a very long day, and we are in the home stretch now. We've covered a lot of ground, and I think actually it's been very illuminating. Certainly has for me and I hope for everyone.

This final panel, the goal is to reflect on what we've learned today, what we've learned in the last few years, what we've learned in the last decade, and what we've learned in the last 200 years. So whatever -- you have a lot of discretion in what you can speak on, but hopefully it's going to be related to the Competitive Bidding Program.

And our first is Tom Bradley, who needs no introduction. Tom.

(0:45:10) **MR. BRADLEY:** I'm Tom Bradley. I'm the Chief of the Medicare Cost Estimates Unit at the Congressional Budget Office.

I see a number of familiar faces in this audience, and I expect many of you are fired up to go visit my clients on the authorizing committees and then looking forward to coming to visit with me and my colleagues. So I'm here largely out of self-defense.

I want, when you come to see us, for you to have a better understanding of how we think about DME in the baseline, how we think about estimating changes in legislation for DME, and I want you to come prepared with data to help us understand how to analyze your proposal.

(0:45:57) Let me start with our baseline projection. Under current law, we project that Medicare is going to pay in the neighborhood of $125 billion to DME providers over the next decade. That is about $15 or $20 billion less than we would project if Medicare continued to pay on the fee schedule to that decade.

So, clearly, we are assuming that DME -- that the competitive bidding mechanism will generate substantial savings for the Medicare Program.

(0:46:34) We do take into account the results of the demos and of the Round 1 bidding. We assume -- the 32 percent figure has been thrown around a lot. We assume considerable slippage from that and considerable slippage over time; nevertheless, we assume that the DME Competitive Bidding Program will generate considerable savings for Medicare, compared to the alternative of going back to the fee schedule.

Let me start by recapping in my own terminology some of the high points of what I took away from today's session and how we think about how CMS operated the first round of the Competitive Bidding Program.

(0:47:24) One of the things we learned is that the purpose of an auction that's intended to be repeated -- and I think that's an important part of what we've been discussing today -- is that it reveals the sustainable marking -- market clearing price; that is, the price at which the seller and the buyer are willing to contract to exchange something and then are expecting to be willing to come back to the auction on the next round.

The auction mechanism that CMS used in the first round was poorly suited to the task of revealing that sustainable market price. That auction mechanism creates very strong incentives for bidders to submit bids that are below the amount at which they're willing and able to commit to deliver, and CMS's price setting mechanism, once they got those bids in, was -- I'll describe it as an interesting method of attempting to compensate for that incentive to bid low.

(0:48:26) Why did it create an incentive to bid low? Because the bidders were not actually bidding for the price at which transactions would occur; they were bidding for an invitation to the next round. They were bidding to the invitation to the "any willing supplier" round or "any willing vendor" round.

And once they got there, then we have to deal with the mechanism that CMS used to set the price. CMS had this median price mechanism. I think the median -- the focus on the median price is actually kind of misleading. I think they selected the median price because they realized that they had all these crazy low bids, and they needed to get them out of the calculation.

(0:49:13) What they did was they selected bidders up to the quantity well over the amount needed to clear -- to serve the given market, and then from that vastly expanded pool, they selected the median.

Fundamentally, that's an arbitrary number. It's a number that bears no relationship to the market clearing price other -- otherwise -- other perhaps than when they went up the scale of all the bidders, they were, in their judgment, going high enough so that the median of that distribution was what, in their judgment, was a reasonable approximation of that market clearing price.

(0:49:56) If, in their judgment, they guessed well, then the Program would work, at least for the first round. The danger in that mechanism is that now having established that -- I don't know what the numbers are, but say they went up to 150 percent of expected quantity in a given product. They now have a bureaucratically approved value for how high they go up.

And that makes it far more difficult in the next round to do a similar compensation that will substitute somebody's judgment of the sustainable market clearing price for -- to calculate that price out of the bids they got because the incentive for the vendors to bid low exists. And more and more of them are going to bid low because they realize that this is only bidding for an invitation to the next round.

(0:50:51) So we fast-forward to December, and we find that vendors agreed to the prices that CMS offered. And we fast-forward to March, and as we heard, there's good reason to discount this, but so far we haven't had a whole lot of complaints.

So at this stage of the process, CMS is looking back on its first round, and it is, in their terms, largely a success. So I think a lot of people here are expecting to hear CMS breastbeating about how they screwed up the first round.

(0:51:34) I think, in their view, it's a reasonable success. The issue is they're going now into a next round, a procurement. John was up here this morning, and he said a couple things; he didn't say some things.

One of the things he said, essentially, is they're going into a round of procurement, and they're in the listening phase. I think CMS is aware that they need to make changes. I don't know what changes they will be able to make, and I don't know how quickly they'll make those changes, but I think there is awareness they need to make those changes.

(0:52:23) So let me bring this back to our baseline projecting, projecting that there is considerable savings from the Competitive Bidding Program.

Let me remind you first that I said that the bidding mechanism they used in the first round doesn't provide bids that -- doesn't reveal the same old market clearing prices.

(0:52:46) And the next point is, I think, the probability of failure in a subsequent round of bidding is very high because mechanisms they use aren't actually designed to reveal those prices.

Excuse me. What John didn't say is that they're going to change the bidding price because they are in a procurement round. There are strict rules about doing a procurement, and there are strict -- there are severe penalties for violating those. I suspect he doesn't want to break any rules that might lead to cancellation of the next round of procurement. I suspect he wants to hold on to his job. I suspect he wants to stay out of jail. So this is not the venue, and so far we have not had the venue at which he is going to make statements about how they're changing.

(0:53:45) Starting next week at PAOC, I think we should be listening very carefully to what he does say as they move into the listening mode and as they move into the potential revision of regulations mode.

If they don't change the mechanism they use, I think there is a high probability of failure in the near future. There is near certainty of failure sometime down the road. I think that's what Peter wants to hear; I suspect a lot of you want to hear that.

(0:54:20) I think there's also a very high probability that CMS is going to make moves in the direction of structuring an auction that actually reveals sustainable market prices. They may do that in time to avoid any of those failures. They may have to get whacked up side the head by having an auction failure.

What happens when -- if they act preemptively, then we have the savings that we're anticipating. If they fail to act preemptively and they have to get whacked up side the head, what happens? Well, in the next round, we're going to have to close to a thousand different auctions essentially. Today we had 56.

(0:55:04) If there are failures in there -- and I think there's a high possibility there would be failures in there -- in that set of auctions -- it's not likely to be across the board. It's likely to be a subset, and therefore, the amount at risk as they learn the hard way is actually a relatively modest amount, a relatively modest share of DME spending, a relatively modest share of the difference between spending that we're anticipating under competitive bidding and spending that we would see if we were back on the fee schedule.

(0:55:37) And so the budgetary impact of legislation that forces CMS to wise up before they otherwise would is actually going to be quite modest, and so I think you should have that in mind before you go visit my friends on the authorizing committees. And I think you should have that in mind when you bring me data to help us analyze your proposal. And let me stop there.

MR. CRAMTON: Thank you very much, Tom. That was illuminating.

Next up is Walt Gorski from AA Homecare, who will provide a provider perspective.

(0:56:13) **MR. GORSKI:** Okay. Thank you very much. My Walt Gorski. I am Vice President of Government Affairs of the American Association for Homecare. We represent about 500 members with about 3000 locations across the country.

I want to align myself with the issues raised by the economists and the auction experts here today. And thank you, Dr. Cramton and your colleagues and your students who have worked so hard giving people a different perspective on auctions.

(0:56:44) So what I wanted to do here today is focus on what -- based on my experience, what I see are key variables that may make auctions hard to apply to home medical equipment and services.

And what we saw here today in a very controlled environment is a system that seems modestly to work, and however, I think if we have to expand that to the full nation with 25,000 different suppliers, I think we're going to have an entirely different result because there are so many different variables.

(0:57:24) And you know, going last kind of has its benefits and its perils. You know, a lot of things that I wanted to say have already been said, so I'm trying to keep this panel moving.

You know, I also question the ability of suppliers to accurately calculate costs. I think some of the larger suppliers have the bandwidth and the staffing to do that. I think a lot of people -- a lot of smaller suppliers don't have that capacity. So that is actually a very, very critical aspect.

(0:57:56) Also, Scott from Extrakare, identified that the HCPC codes are not discrete enough to bill. And when you have a code, a HCPC code, a billing code, that the price of that code is set by the median, which means half the products are less expensive than the reimbursement rate, half the products are more expensive than the reimbursement rate, what we have set up with the competitive bidding model or -- and an auction model, if you can't calculate your costs right and you're trying to win this contract, you are, in essence, going to have to be able to provide the least expensive product that meets that HCPC code description.

(0:58:40) So beneficiaries are going to get the cheapest equipment, and providers, the only real fungible thing that they have aside from buying the least expensive equipment is to reduce services. And that is how any auction or any bidding program is going to have to function in the real world.

Another issue is I still don't really understand how you can apply -- if you bid 10 percent of the country at any given time and then you apply and so you've reduced the marketplace in that 10 percent in that area, how you then apply those prices nationwide because, quite frankly, people who lost in those areas, as Mike pointed out earlier, lost because they couldn't compete on price.

(0:59:24) Well, you're now going to apply that price nationwide, and those providers are not -- there is going to be no diminution of suppliers in those areas. So you -- at least under bidding, you may have the possibility of increasing the number of items that you provide at a lesser cost. That's not going to happen in the 90 percent of the other areas.

Again, I also think a race -- we're going to see a race to the bottom just like I mentioned with the HCPC codes, but it's going to stifle innovation. Why would anybody want to invest in home medical equipment when the cheapest product is the product that people have to go with? There's no incentive to invest R&D in this sector if we're racing to the bottom.

(1:00:15) And finally, I think that there are input variables that we just cannot account for, and this has been one of my major concerns, and I've raised this as a PAOC member many times with CMS.

We have 76 million baby boomers coming on-line. We're basing capacity on Medicare -- our historic Medicare volume when we know Medicare is going to -- the beneficiaries are going to increase expedientially over the next couple years.

(1:00:45) We also don't talk about what other payors are going to do. Nor can we anticipate what other payors are going to do. You know, right now Medicaids across the country set their price based on Medicare. We're going to see Medicaid prices 40 to 50 percent below the Medicare price.

(1:01:04) So if you think the Medicare price is bad, wait till you see the Medicaid price. And then there's the private payors. Private payors are going to mimic and probably even go worse than what -- or go lower than what Medicare and Medicaid do. And I mean, going to Tom's point, I mean this just goes to the sustainability of the Program. It crashes and burns, and it crashes and burns quickly.

(1:01:38) Finally, you know some other people talked about gas prices. I mean, a year ago we were at $2.50 a gallon; today we're at $3.50 or $4.00 a gallon. Now a supplier who's traveling in his given supplier area is traveling somewhere between 150-200 miles a day. If you calculated your bid at $2.00 a gallon and it's now $4.00 a gallon, clearly you have a disconnect.

(1:01:54) So I come away from this session with a lot of my questions answered. At the same time, I think a lot more questions were raised, and bottom line is we have to stop this Program now before we tear at the fabric of the home care safety net and leave it in tatters. Thank you.

MR. CRAMTON: Thank you, Walt.

So our next speaker is Nancy Johnson, who is largely responsible for this event. Nancy has served the United States public and especially the citizens of Connecticut for 24 years as a congresswoman, and now she continues her effort in efforts to improve healthcare. Nancy.

(1:02:41) **MS. JOHNSON:** Thank you very much, Peter.

First, let me thank Peter for all his volunteer hours to do this. When we first went to visit the Hill and people saw that actually there was logic behind what he was saying and some science and a body of experience that clearly had not been a part of the process in HHS, not unusual nor surprising, their first comment was "But, you know, we can't change course because two of you think that it's an important thing to do." So -- and the other one was Brett Katzman. Brett, where are you? You're back there -- because he wrote the first -- he did his Ph.D. thesis on the first pilot in Florida.

(1:03:30) So we had really solid thinkers raising issues. So their comment was "But, you know, two of you are great, but this is the nation, and this is a Program that's going to -- that's been through a lot of work" and so on and so forth. So he said -- they said, "Well, do you think anyone else agrees with you?"

Well, that led to the letter that Peter developed that most of you are familiar with that was signed by 167, including

Larry, of his colleagues throughout the country. And if you look at that letter, they're from every major university in America, two Nobel Peace price winners.

(1:04:10) I mean, clearly there's a body of knowledge that has developed since the time, which is now quite a ways back, that the first pilot was put in the field. And as in every university, as in every walk of life, information tends to stay in its silo. So it isn't surprising that this body of knowledge about how to auction or set prices for products that Government wants to buy, you know, didn't get in to the health sector. It wasn't getting in to the health sector anywhere.

(1:04:47) When we first passed legislation authorizing competitive bidding, we didn't know how to do it. Nobody knew how to do it. And that's important to remember. But we and CMS and MedPAC and sort of everybody involved knew that the administered pricing system was failing us and shorting out.

(1:05:09) What's happening in the pricing structure in Medicare is profoundly the outcome of what is costing -- what is driving costs in healthcare. I mean, it's all of the piece. You know, healthcare no longer provides what Americans need in health. We don't need just illness treatment. We've gotten so good at illness treatment that we're keeping a lot of ill people alive.

(1:05:39) And we need now a health system that supports chronic -

- people living with chronic illnesses. And because that's so expensive, we need a health system that looks early at prevention and early intervention.

(1:05:54) So, in fact, America is at a point where what we need in healthcare is literally different than it was when we founded Medicare. When we founded Medicare, we just needed to take care of sick elderly. Frankly, it wasn't so costly then. You didn't have MRIs. You didn't have orthopedic surgery. You didn't have the cardiology intervention.

(1:06:18) So we're here for the right reasons. We're here because of advances in medicine. But it means that we can't keep doing things the old way. Medicine isn't doing things the old way. So the old pricing systems don't work.

(1:06:34) So what I learned when I was in Congress, because I worked a lot with very smart people in CMS, right down the line, often way down at the people who do the real work and who never testified before a Congress, and I knew that oftentimes they didn't have a way to get at the information in a new field.

(1:06:57) And so I often -- a couple of times I brought in from across the country experts, not to talk with me, not for me to pressure CMS, but to bring together the minds that were trying to figure out how do you fund clinical trials, for instance, in oncology.

(1:07:15) And when you have new things happening in the private sector, you have to give everybody a chance to absorb what does it mean, how does it fit in the old system. So one thing I've learned here today -- and I really thank Peter for running this -- first for sitting there and having to make decisions about which baby you're going to throw away, you know, and how you're going to reshape your business, as crude and simplistic as it was, was, I think, good for all of us to understand a little more tangibly what an auction is actually meaning and what its strengths are because there definitely are some strengths and what its weaknesses are.

(1:07:53) And one of the things that I'm struck by, both to the panelists and during the discussion, was that you see -- and I know this from other -- I mean, there's plenty of evidence of this in other areas -- our old coding system has shorted out. I mean, we're going to from ICD9 to ICD10 for a good reason, but that doesn't mean that will work.

So, you know, we really have to think what would be the products, how would we define them, and you can't do that -- if you listen to Amy, you cannot do that without clinical input. And it has to be very mutual.

(1:08:25) The mutuality is missing, and we've never had mutuality much at the national policymaking because we're such a big country, it's hard to be mutual with 250 million people, but it's not impossible. And actually, you can't do this job anymore without much greater clinical input.

(1:09:45) So competitive bidding was put in the law. If you read the law, you won't disagree with anything in there. It just wasn't enough because we didn't want to tell them how to do it because we didn't know how to do it.

So when we first went to the Hill, I'll tell you my Democrat colleagues (indiscernible) competitive bidding. Peter (indiscernible) gave me a really hard time -- "Well, you put this in there." Well, it's not unlike their putting ACOs in. We don't know how to do accountable care organizations. We do know you have to integrate care. You have to reintegrate care so that we can start early, identify early, blah, blah, blah.

(1:09:19) So what do we know now? Well, two things we know really, really well now that haven't been part of the process in the past. It must be transparent because too many lives are going to be affected. Too many people in our great nation who put their lives and capital behind building their business are going to arbitrarily lose it all.

(1:09:43) And those of us who have talked to some of those people -- I talked to another one just this morning. It was, you know -- you feel that. You've got to feel that. That's not fair.

So we have to have a transparent process, and as crude as the auction experience was today, you could see "I can't do it for that. So these guys can do it for that." Now there are ways that we can help small business. We have small business offices in every state. We have business -- we have small business centers for women-owned businesses. We have lots of -- we have continuing education that we fund with Federal money in every community college.

(1:10:24) We can teach small businesses to identify their costs, but that clearly is something that we're going to have to do because if you don't have an understanding of your costs, you can't bid honestly.

Then we have to figure out what is that -- that objective process by which we make sure that people do bid their costs. We just haven't thought about this much because we thought they might. Well, they don't, particularly when the categories are so screwy.

(1:10:51) So we need to take away what does it take to build a transparent process in which everybody will have the greatest opportunity to defend what they've created and invested in. That's important.

Then the second thing is it has to be sustainable. If 99 percent of your people who have done diabetes mail orders are going to be out of business, this is not a good sign about sustainability.

(1:11:18) So it has to be transparent; it has to be sustainable. But you know what? It has to do three other things that are really profoundly important that haven't -- we haven't been thinking about.

But if this is going to work in DME -- remember, this isn't just going to work in DME; if we do this right, it will help us out in some other areas of medicine too. What is any greater failure than the way we set the physician reimbursements -- the greatest failure in the Federal Code in any area. And we are losing doctors' services to Medicare patients because of that.

(1:11:53) So we need to learn all there is to learn from this. So the three other things I want to mention is a good auction process has to respect the fact that what is unique about America's economy, different from Europe, the one thing that enables us to recover more rapidly from downturns is our small business sector.

If we do competitive bidding in a way that only the big guys survive, a, this won't work in rural areas because home care -- remember, if you're going to keep people out of hospitals, you need home care. This -- that's what this is about.

(1:12:29) And little old ladies -- I can remember walking into -- going on rounds with one of my home care agencies, and this little old lady says to me -- she said, "You know, she used to play here when she was little with my daughter." Now, that's what's wonderful about small rural communities. People do know each other. They do care about each other. And why can't we help that small business be efficient? We can if we help it identify costs and so on. So small business is the strength of our economy, and we threaten it through sort of blunt instruments at our own peril.

(1:13:04) Secondly, innovation. Innovation is what keeps us a strong economy. It's the only thing that keeps us competitive in the global economy, and we need it in every single corner of our lives. And if we have one segment, we turn one segment into a segment that doesn't invent when, after all, innovation and invention has gotten us to where we live longer in much better health.

So -- but those underlying principles of our profound reliance as a society on small business and innovation and rural -- strong rural service networks, all of those three things are at risk if we do the competitive bidding wrong.

(1:13:46) So I think from here, if we can work together in a more transparent process that includes everyone, we keep in mind, as

Tom said, sustainability, then we will have served the American people as individuals, as public servants which those who work in our Government are, and their longevity and experience is an extraordinary asset to us, and in our intellectual institutions, then we will all be proud; more importantly, we'll succeed. Thank you -- and also, we'll set the stage for ACOs. You know, if we don't do this right, then we won't do bundling right, you know. **(1:14:26)** So the process has implications, and change is in the air. And some of it will never happen, but with that that does happen, we want to be sure happens right for all of us. Thank you.

MR. CRAMTON: Thank you very much, Nancy. That was excellent.

Our next speaker is Tom Kruse, the CEO of Hoveround, who provides us the perspective of a nationwide provider.

(1:14:49) **MR. KRUSE:** Thank you very much, Dr. Cramton. Thank you, Dr. Ausubel; for everybody else here at University of Maryland for putting this together. This industry really, really needed this and needed you to step into it at this time.

You know, I'm going to mostly speak about the mobility sector that I'm in, but, you know, we're all well aware that the baby boomers -- and I'm a part of the baby boomer -- we're not really a healthy group. I mean, we all look back -- go back 10 years, we're saying, "Oh, we knew this hockey stick was coming and all the people were coming," but the fact of the matter is is that we're finding in our industry -- I think we all know this -- that obesity, diabetes, everything is on the rise. Whether it's food supply or whatever else, there's going to be a need for all of us and for everything we do.

(1:15:30) And the efficacy of home care we all know. Sometimes it feels like CMS doesn't understand that, and sometimes you hear about balancing the buckets in Part A and Part B; that if people don't get their oxygen, they wind up in the hospital, and you wonder whether someone really is kind of weighing those two things out on a daily basis or looking at that.

But a little bit about the bid that I was in and the bids that I've bid in here -- there have been two. In this last round, there's 129 discrete winners in our section -- sector, and 103 have no data whatsoever in the FOIA data. I mean, 103 -- only 103 have data in the FOIA information. Of the 129 winners, 85 have sold one unit or more, and there are 34 that are nowhere to be found in any FOIA data going back to 2006. And this data goes all the way up through September of 2010.

(1:16:28) In sum, of all the nine CVA areas, one large provider holding 35.8 percent of the market in those nine areas as of September of last year was a winner, and the rest of the winners combined only comprise 19.7 percent of the market.

What does that mean? By law, the way this was put together, is no one could have more than 20 percent of the market going in. That means that the 19.7 percent left were supposed to do or grow by 400 percent or do 80 percent of the business. **(1:17:02)** And this goes to Paul Gabos's comment that it seems that CMS has put in one supplier as a safety net that can fill the void. That's a huge void when, again, 19.7 is supposed to grow to 80 percent at least on day one.

As a bidder in all nine regions, I won four on the first round. Now since that time, as you all know, we took a nine-and-a-half percent cut. I go into the second round and I bid about the same as I did the first time. And I said, you know, I won half; I should be in the money. I lost nine for nine. **(1:17:41)** You know, I come from a perspective here when I'm looking at this thing that if you -- since I'm in Florida and I was very familiar with Poke County and San Antone and all of that, where there was about a 20 percent reduction in those demonstrations. And then we came out of the last one where there was about a 23 percent reduction.

How could it be that from earlier in this century, in the late '90s when there was a 20 percent reduction -- and by the way, since that time we've really gotten very few, if any, cost of living increases, and we've taken a 23 percent cut in the meantime, a nine-and-a-half percent cut in the meantime, and all of a sudden it's 30 or 30-something percent off. Something is wrong.

(1:18:26) Lawrence Wilson himself said, you know, of the winners, you know, he was uncomfortable with 30 percent of them. That's a scary notion. The fact of the matter is is that the bidders that did win the contracts -- and however this was done. There was a lot of ways to gain in this thing, and it appears to have been gained through capacity.

And a lot of people, you know, aren't talking about that, but there's also the fact of the matter there's been no transparency. Typically when there's no transparency, there's a reason for no transparency. Most of the time people are very proud of their work and what they do. And I'm, one, as an American, as a provider, I'm concerned, and I think we all should be.

(1:19:08) I'm also a provider that believes in competitive bidding. So for what it's worth, it doesn't make a lot of people, AA Homecare, happy and other folks around the country. I'm just saying blow it up. I'm saying let's just do it right.

And I don't understand why -- if I were to run a bid, the first thing I would do is run out and get an expert to help me. When I enter this as a bidder next time, I will certainly have a Ph.D. next to me, maybe two. Going through that last exercise -- I'm a business -- we're a decent size company. We understand our costs. And when I look around and I experienced kind of the same things as Lincare has with suppliers calling me wanting us to buy them, us finding/looking to do subcontract deals in the nine areas we lost, and quite frankly, the people that were calling us had no clue -- I mean, not a clue. They just wanted to know how much they could buy a chair for and whether they could use our name or "Would you buy us? That would make it easier." And there was nothing -- nothing to buy.

(1:20:16) The fact of the matter is is nobody has talked about the train wreck that's coming, and I think this is probably, as far as I'm concerned, the biggest point relative to sustainability. If, in fact, there's going to be a 30 percent cut and in my business, somewhere between -- in our standard mobility business, about 15-16 percent of the people are either in Medicaid carve-out states where you don't get the 20 percent or, in fact, they're indigent and justifiably indigent, and they can't play the 20 percent.

We go to the bariatric business; that number doubles, 30-32 percent that are indigent or in states -- and everybody understands the dilemma -- that the Medicaids are in. And the fact of the matter is they're all going to be carve-outs based on the -- what's going on with the states and unless they get waivers or something.

(1:21:08) But the fact of the matter is if you take that into account, you'd say that you're taking a 30 percent discount and then writing off 20 percent, and then in our business, then you're going to wait 13 months to get paid.

The reality of that whole situation is that if you're poor, you're not going to get a wheelchair. If you're poor -- I don't know -- I guess you're going to get oxygen in the hospital. If you're rural, no one is driving a hundred miles to bring you those products. If you're poor and rural, you're screwed, and that's the train wreck.

(1:21:42) And when I'm on the Hill, that's what I talk about. It's not here and now. It's CMS saying, "We're not hearing anything from anyone." We're hearing it, and I don't understand how this lack of communication -- but a couple of other points.

You know, the non-transparent financial qualification system, I just don't understand why that would not be transparent. The accreditation without real operational surveys, as we all know, they're three year deals, and if you buy an accreditation package up front, you really aren't expected to have it implemented, et cetera. So these new dealers are kind of on a different playing field.

(1:22:19) When we've gone into places like Orlando and Miami looking for a provider for our products, we found that it was very difficult to find, as I'd said before, providers that have been in the business. There's people that actually went and got supplier numbers that we found that were never ever in the business. And I think we've talked about that enough.

The flow over the three-year contracts relative to the sustainability, I will tell you now the price of lead has doubled since everyone bid. I'm a manufacturer, so I understand the cost of batteries and other commodities. We look at petroleum and fuel that drives the cost of plastics and whatnot. These things are on the way to doubling.

(1:23:03) And those that are buying products from -- and sub-assemblies, et cetera -- from China or other places in the world, that drives the cost, logistics cost and everything else. Never mind the fact that the lack of sophistication of some of the smaller dealers; how do you -- did they factor in a cost of living? If, in fact, they just squeaked by today, where are they going to be three years from now?

We're already seeing that people -- we're not allowed to put batteries on our own chairs anymore in these areas. But the problem is we can't find a dealer that wants to do that or that will do that. And maybe they're going to get in trouble with CMS or something for not doing it, but the fact of the matter, when I sold them the chair so many years ago, I expected that the profit that I made by selling the higher ticket item put me in the front seat of taking care of them for the length of need of product. And I do want to do it.

(1:23:57) I'm not going to do it as any willing provider, though, because I'm not a willing provider at those prices given the fact that those prices are underwater.

The service issues will continue, I believe. I think some of the stuff that I heard here today, quite frankly, you know, I was a little, you know -- I tried really hard on this bid thing, but as the clock was clicking down really fast, it was a little difficult.

(1:24:21) But the fact of the matter is I have faith in our system. I have faith in America. I think we look to our universities for knowledge. I, for the life of me, will never understand -- this is not a session on trashing CMS or anything -- I just would not -- do not understand why -- just like the Department of Energy or Interior or anyone else that's running an auction -- wouldn't go to auction experts.

I, for one, am in for a fair auction designed by people that know what they're doing, and I'm always in for a good fight.

So I appreciate everything you did. Thank you very much. Thank you.

MR. CRAMTON: Thank you very much, Tom.

So our next -- we're sort of alternating Government, non-Government, Government, non-Government. We're back to Government, and actually I've got a little -- Evan Kwerel is our next speaker, who's a Senior Economist at the FCC. And he's actually somebody I've worked with for nearly a couple decades. And he thought that at this time of day we are probably a little sleepy and we need a little cartoon.

(1:25:28) So there's the cartoon, and let me just say Evan is -- he's been the intellectual force at the FCC with respect to spectrum matters for nearly 20 years, right, or maybe over 20 years. He can appreciate, as this cartoon illustrates, that sometimes it takes more than a month, maybe even more than a year to get to the right market solution. And in fact, he knows how long it took in the case of Spectrum to get auctions done, and he'll tell you that.

And he also has a lot of experience throughout Government bringing market solutions. So with that, Evan Kwerel.

(1:26:20) **MR. KWEREL:** Well, thank you, and I hope we're not going to leave anybody at the Emergency Room door while we're trying to figure out how to do this.

So first let me start with a disclaimer. You know, these are my opinions. If you've got a problem, come to me, not my boss.

One of the points that I'd like to make, which has been made in many ways, and sort of vaguely related to that cartoon, is that details really matter in economics as well as medical care. Now in medical care, you know, you want somebody who's an expert. This is a point that Peter made earlier. Just like in medical care, in economics, it's not that anybody can figure out how to design an auction. It's not like everybody thinks "Well, gee, I know how to do this. You know, just it's common sense." Well, look what common sense brought us. It didn't make any sense at all. So paying attention to details and getting experts who have actually studied these things in many cases can help.

(1:27:28) The third point that I really want to make, and it just -- so many of the panelists, I mean, I just felt like jumping up and saying -- when I heard various concerns -- my thought was compared to what. You know, there's a problem here. You know, all these concerns about competitive bidding and this and that. Well, that's fine. But, you know, give me your alternative, and what is the alternative.

Well, nobody really says, but it's like implicitly it's administrative pricing. Well, that's a great system. You know, tell me how administrative pricing is going to work really well when people don't know their costs. This is not an auction problem. You've got people that don't know their costs and they're out there, you know, providing a market. It's not an auction problem. It's -- like administrative costs, that's going to help?

(1:28:22) Let me ask you -- how many of you think that administrative pricing provides great incentives for innovation and providing quality service? I mean, that's its real strong point, you know, getting people to innovate. You know, that's what I always thought.

And then the question with administrative pricing. Well, that's going to solve our problem about how to define products? I mean, all those issues about we haven't defined the product price. You know, you're lumping all things together; they're not the same. I mean, this is a problem -- this is not an auction problem. This is an inherent problem with any kind of Government program to subsidize a service.

(1:29:09) When you can do a head-on comparison of your alternative, like administrative pricing with this, then I'll be able to make a judgment. Has administrative pricing ensured performance? I don't see it. So the issue of what if gas prices go up -- administrative pricing is going to solve that problem? I mean, any of these issues, I don't see most of these issues as an auction problem. I think you really need to separate out what's an auction problem from what's a general problem, regardless of what you do, and then when you're finished complaining about all these things, tell me your alternative and how it's going to work.

I'm not denying that how you define the product affects the auction design, that there aren't interactions between these things. But all the issues that were raised here are issues regardless of whether you have an auction or whether you have some man from Mars come down and tell you what the prices are. **(1:30:13)** So now that I've got that off my chest, you know, I just want to then just tick off, you know, what we did at the FCC that I thought, you know, would be valuable lessons learned, you know, how to do these things right.

And the first point is that collaboration is really important. It's really important to listen to industry people, to listen to academia, Government. All three have to work together, and of course, there's ultimately the public. **(1:39:56)** It's not like just, you know, the Government can do it alone. But you're not going to have a successful program without all those elements working in a truly collaborative way.

The second point, you know, a pitch for the economics profession which at least on some things -- you know, some things like auctions, they actually know what they're doing and that that is important for the designer of these things to hire, you know, experts and consultants, including game theorists and experimental economists to figure it out.

(1:31:38) Another thing that helped our process work well was that potential bidders also in the part of the rule-making process hired leading academics to develop auction design proposals. They didn't just sort of make this stuff out of thin air; they hired experts who came in with ideas that were better than ideas that we in Government had originally, and we were smart enough to listen.

And finally, the FCC didn't try to do it all itself. We contracted out part of the implementation. Now, I mean, there were other ways that we could have done this, but if we were going to do it ourselves and without hiring any experts, I think, you know, we would have had a box where, you know, a lock maybe made out of metal where people put in their bids and we would look for each license at a time to pick out the lowest bid. And that probably was sort of the limits of our capability without getting in outside design experts and people for implementation.

(1:32:44) So, you know, one lesson for Government is don't think you can do it all yourself. Those are my remarks.

MR. CRAMTON: Thank you very much, Evan. Very wise, indeed.

Our final panelist before we open it up for discussion is Wayne Sale, who's the Chairman of NAIMES and the President and CEO of Health First. Wayne.

(1:33:07) **MR. SALE:** Thank you, sir. Appreciate it. Like everyone else here on the panel, I appreciate your work. And Ms. Johnson, I certainly appreciate your initiation of this process and appreciation for the challenges we have before us.

I've spoken to a room full of people as the last speaker. I've never had this many to talk to, though. Thank you for staying.

(1:33:35) I am the Chairman of the Board of the National Association of Independent Medical Equipment Suppliers. They're mostly small business people from around our nation. They are community providers. They are active in their community, and a lot of them go to church with their patients and make sure they have the oxygen they need whether they get paid for it or not.

They are committed, and as I've heard many times, maybe not the best business people because they don't know all their costs, but they are caring individuals who do a good job at keeping people out of the hospital.

(1:34:16) I am a respiratory practitioner. I started my career in healthcare in a hospital. I saw patients every three months come in for pulmonary toilet. They would spend between $20,000 and $30,000 for four days in the hospital. They'd go home and they'd do absolutely nothing for the next three months until their mucus built up and then pneumonia set in, and then they were back for another week's stay in the hospital.

I could see very easily how a chronic disease moves regularly and methodically through someone's life, Stage 1, Stage 2, Stage 3, COPD. It's predictable. You can watch it happen. You can watch it get worse. And if it's predictable, you can intercept it. And that's what I plan to do with my company, intercept the progress of chronic disease. In my case, it was chronic lung disease. Now it's turned out to be congestive heart failure, obstructive sleep apnea, and let's throw diabetes in there. Not that I do it, but because the results of unchecked diabetes is so expensive. Not only does it cost a lot of money, but it costs people their sight. It costs people their legs. **(1:35:44)** We're here talking a lot about budgets, but what we're really talking about is the means to an end. We're really talking about disease. Disease is what costs our country money; not DME suppliers across the United States. And disease is what we're going to have to manage in order to bring healthcare costs under control.

That's my effort and the effort of the independent suppliers, the publicly traded suppliers, all of us have a mission to curb the cost of healthcare as it rises from a home care setting to an Emergency Room setting to hospital admission to an intensive care unit. It gets worse and worse and worse. **(1:36:36)** So there were a couple of things that I hoped to leave here with and one or two things that I hoped to leave with you. The first certainly is to say that the bidding process, I think, clearly has problems that need to be addressed.

I would say two things. Back in the old days, if you don't have time to do it right, how are you going to find time to do it over? And I used to do a little woodcutting, and there was an old saying among carpenters, "Measure twice, cut once." **(1:37:12)** I think we need to be there. This is an important time in our nation's history, but we don't have time left to solve this problem, to think about it. We've got to do something. We're on the threshold of a serious threat. We all know that.

And if we look at the numbers and see that most of the numbers are in chronic disease categories, that $70 trillion that we're looking at, chronic disease costs us money. Prevention, methods of prevention, early detection can save spending now. **(1:37:54)** I know in a business survey that was done that every dollar a business spends in preventive medicine for its employees has a return on investment of three to four dollars. That's in a business setting. In a healthcare setting, for every dollar spent in DME, if it prevents Emergency Room visits, hospitalizations, falls, physician visits, then we know that that's a multiple of three to four times ROI.

I can't say what the multiple is. My study is not complete yet. I hope it'll be out within the next couple of months. But I would daresay with the cost of healthcare rising and the cost of DME falling, that that ROI gets bigger every year. We are worth -- the DME industry is worth something to our healthcare system. It's the only segment of the healthcare system that brings more to the table than they take away.

(1:39:00) So I'd like to leave here with a new perception of what the DME market brings to our country, and there's a reason for that too. I'm a taxpayer along with a business owner, and I want to see my tax dollars spent intelligently. I'm a father. I've got two kids who are going to be stuck paying the bill when I'm gone. I've got an 83-year-old mother who's in a nursing home right now, and I want her to have the best, but will she? I feel like she's threatened right now.

Suppose I'm not in a current Round 1; I'm in a Round 2, so it's coming up. Entirely possible -- Round 2 bids I would not win the oxygen that my mother needs, and someone else would have to take care of her. We can do better than that. We can build a better healthcare system than that.

(1:40:04) I think it's clear we can't do it the way we're doing it. It needs renovation, and I think what I have seen today brings us an option that has heretofore not been mentioned. Before today we didn't know what the options were. When I went to my congressman and said, "Competitive bidding is strangling us. Ask CMS to take their foot off of our throat; let us breathe," they said, "Okay. Well, what are your alternatives?"

We've got 32 percent savings here. You've got to show me where your 32 percent is. We can't just walk away from that. Our fiduciary responsibility to our citizens and our District says we can't throw this away. I think this is certainly a viable option to consider.

(1:41:01) What I like about it that the other system does not have is it has potential sustainability, and I love the transparency that I saw today. That's certainly an improvement.

I have bid bond concerns which I'm sure we can work through. But -- oh, there's one other thing I wanted to point out. Durable medical equipment lumped together is seen as beds and wheelchairs and oxygen and CPAP machines. I want to make a clear distinction between oxygen, CPAP and a bed and a wheelchair.

(1:41:42) A bed and a wheelchair are simply aids to daily living that help people get along better with their disease process. Oxygen therapy and CPAP are both treatments, much like insulin would be to a diabetic, and has a positive effect on the progress of a disease process called COPD, CHF and OSA.

So there are differences in the categories that we're looking at, and I ask that you recognize those. And thank you again for the opportunity to speak here today and be a part of this process.

(1:42:19) **MR. CRAMTON:** Thank you, Wayne. Very helpful.

Well, I apologize. We have run over. It is 5:35, and we started at 8:00. It's been an extremely long day.

I think what -- and I really am sorry about this, but I think we should end now, and then what we can do is hopefully you've written down your questions, and you can email me your questions. And we can have some Q&A off-line. But I think it's just too much right now. We've all worked so hard.

I'd like to thank this entire panel and your other panels --

[APPLAUSE]

MR. CRAMTON: -- and I would especially like to thank you, the audience. Thank you very much.

(Whereupon, the Conference was concluded.)

[CONCLUSION OF SEGMENT 6, FILE 0562]