
The Impact of Competitive Bidding on the Market for DME – An Update¹

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The gold standard for market structure has always been competition. Many companies striving to outwork and out-service other firms in an industry lead, both in theory and in practice, to lower prices and greater availability for consumers. Economists and policy makers are so certain of this that competition has been codified as a goal.³

Markets of course are not infallible. In the course of time, some markets appear to yield outcomes that are suboptimal. Put another way, some markets, when left to their own devices, result in too much or too little of a good being produced from society's perspective. Alternatively, a market might determine a price that is subjectively either too high or too low. When markets fail in this way, government has stepped in to fix the perceived failure.

At the heart of the debate over CMS's bidding plan for durable medical equipment (DME) is whether a failure has occurred. This question has been answered to no one's satisfaction. In fact, the implementation of a so-called "competitive" bidding program has all the makings of destroying the only component of the DME market that is competitive. In essence, CMS has already dealt with the concern over what they see as unsatisfactory prices. Since CMS sets the reimbursement rates for Medicare patients, the price issue should be off the table. Firms therefore are left to compete on a basis of service. A continuation of the bidding plan will prevent this from being possible, and is likely to lead to a decrease in social welfare – a typical goal of public policy that seems to be ignored by CMS.

This brief analysis will establish that the CMS bidding program will make patients worse off, and may even lead to more inadequate price containment in the future. While markets sometimes fail from the perspective of policy makers and the general public, governments can also fail by making outcomes inferior to those before intervention.

³ The Department of Justice touts the protection of competition on its website www.justice.gov in a number of places.

THIS IS A FRANCHISE BID

The notion of competitive bidding needs to be addressed in a more forthright manner.

Firms are acting in a competitive fashion to acquire the governmentally protected right to provide medical equipment to a given geographical area. Thus firms are competing for a franchise.

Franchise bidding was originally thought to provide the advantages of competition while reducing the burdens of regulation in an industry.⁴ By getting firms to reveal the price at which they could profitably exist while competing against each other for the privilege of exclusively providing a good in the market was thought to be a win-win situation for government.

The necessary feature for such a bidding system to achieve its ends is that firms engaged in the bidding process must be part of an industry that possesses economies of scale. Such firms are sometimes referred to as being natural monopolies. In such a setting a firm can increase output and reduce operating costs due to the scale of their operations. Thus, a single firm could provide a product – typically utility services – at a lower cost, and presumably at a lower price, than multiple smaller firms. Left to their own devices, these firms would charge a monopoly price. The tradeoff with regulators is that, in exchange for driving out their competition, the surviving firm agrees to have their prices controlled.⁵

DOWNSIDES OF FRANCHISE BIDDING

DME is not a natural monopoly

⁴ The work of Tullock (1965) and Demsetz (1968) explains franchise bidding as a way to achieve optimal social welfare without the inherent costs of regulation.

⁵ Most intermediate micro theory books, managerial economics textbooks, and regulatory theory books, provide analysis of the natural monopoly situation. This is merely a summary of the content of such books.

The concept of competitive bidding sounds great on its surface, but as with so much in the policy arena, taking an idea from theory to application changes things. The first and most obvious problem with the current DME bidding plan is that the market for DME is not one in which natural monopoly characteristics are evident. All research on competitive bidding agrees that it is relevant only when a single large firm can serve a geographic area at lower cost than multiple small firms. Market *competition* “would likely prove a more efficient cost-price tracking system than the system enshrined by politically-involved bilateral bargaining between regulators and regulatees.”⁶ The most telling failure of the DME plan is that it is being applied in the wrong kind of market.

Problems with long-term contracts

Another concern for this governmentally awarded franchise is the reliance upon long-term contracts. The support for franchise bids assumes low transaction costs of changing the contract. This is not realistic in the long run as future uncertainties can exacerbate a poorly conceived bid. Uncertainty raises the specter that the contract will lead to flexibility problems including the concern that “technology, demand, local factor supply conditions, inflation, and the like, [cause] price-cost divergences and/or indeterminacies” to develop.⁷

A bidding plan needs to provide an incentive for firms to bid low, and a long-term contract can help incentivize low bids by preventing the losing firm from reentering the market in the near future. However, if the re-bidding opportunities are too far apart you drive the competition permanently out of business. Setting the correct contract price should be done over shorter intervals. Even if you wanted to average the first few rounds of bidding, a three-year interval will leave you with far fewer firms bidding in later rounds.

⁶ See Ekelund and Saba (1981).

⁷ See Williamson (1976), page 82.

Reduction in quality and service

A natural consequence is that bidding on price necessarily leads to a diminution of quality. A cheaper is better attitude must be paid for somehow. It is assumed that a lower price will lead to an increase in the value of the program. This may be true for the bureaucrat, but it most assuredly is not for the consumer. "Although franchise awards can be reduced to a lowest bid price criterion, this is apt to be artificial if the future is uncertain and the service in question is at all complex. Such awards are apt to be arbitrary and/or pose the hazard that "adventurous" bids will be tendered."⁸ This appears to be the case based on the first round of bids where in the Dallas-Fort Worth-Arlington area, for example, six of thirteen winners for liquid oxygen or enteral nutrition turned down the referrals flat-out. Three of these firms reported they did not have the products available. One winner said they could not provide service across the metro area as required by the program. Two of these firms were from out of state and reported that they could only provide enteral nutrition via mail service, prolonging a patient's hospital stay.

Service concerns are further exacerbated by heterogeneity. If service is not the same, or if expectations of service are not consistent then the race to the bottom in price yields a less than optimal social outcome. Since quality is more difficult to measure than price, the results of the bidding process may be worse than the initial state of the world as the only options for consumers are low price, low quality. This may cause the need for increased regulation to monitor quality.⁹

Opportunistic behavior

⁸ See Williamson (1975), page 81.

⁹ See Viscusi, et al. (2005), and Katzman and McGeary (2008).

It has also been shown that franchise bidding needs to be characterized by frequent opportunities to re-bid. Competition must be prevalent every time there is a bidding stage otherwise price will not be reduced and the winning firms become prone to entrenchment and opportunistic behavior.¹⁰ Regulators and firms both realize that costs exist to replacing the original winners, so these firms are likely to become institutionalized. This is exacerbated by a long contract as it prohibits losing firms from hanging around until the next bid. Firms who rely on Medicare patients, in many cases for 50% or more of their business, cannot hold out for three years and wait until the next chance to bid. Thus, there will necessarily be fewer bids in future rounds.

When the next round of bidding occurs it is likely that prices will rise to be sure, but there is also the possibility of opportunistic hold-up. The firms who stay in the market are at a distinct advantage over those who would like to enter. They understand the way things work, not to mention, they already have the facilities in place that are necessary to run the business. The key is to be the winning firm from the outset in order to be around in the future. If price has to be raised, as so much in the literature shows, regulators have little incentive to say no. DME is an inelastic good. People will pay higher prices if need be as they need testing supplies and oxygen. If the franchise owner has made an effort to establish their firm through capital investment, the regulator will almost always approve an increase in price, especially if the alternative is television coverage of people who cannot access their medical supplies.

The flip side of opportunistic behavior poses the question for the winning bidders. How far is CMS willing to go to drive down prices? Put another way, what happens if CMS, knowing how vital being a winning bidder is, imposes other conditions on winners to keep their franchise?

¹⁰ See Viscusi, et al. (2005).

Barriers to future entry

This gives rise to another significant concern. Once you are entrenched as a supplier, you gain advantages that can prevent the future bidders from entering the market. This is an effective barrier to entry that prevents competitive market forces from checking the advancing price hikes that are bound to come. Learning by doing, familiarity with the franchising process, investment in resources, and information about market demand allow the incumbent firm to stay that way. Thus, firms should and will do whatever it takes to acquire the coveted position of bid winner, even if this means understating a bid. Once the winners are determined, they can merely petition for a price increase based on underestimation of cost or an overestimation of demand. Regulators, not wanting to appear with egg on their face for choosing an unsustainable firm will likely comply.¹¹

WHAT IS THE MEANING?

What is the purpose of this? Basic economic reasoning tells us that decreasing competition leads to a concentration of an industry and higher prices. Research shows us that regulated industries are not immune to increases in prices, some of which occur at a rate faster than inflation. The observed failure or flat out refusal to provide a good in a category by some winners in the first round of bidding confirms that bidding was conducted with – at best – imperfect information. At worst, however, bids were submitted under the pretense of getting one's foot in the door with no intention of fulfilling the contract. After the franchise was awarded, winners could simply push for price hikes

So what is the purpose of this plan? Cost savings is most often touted, but surely the regulator has a responsibility to the public beyond the bottom line. This is known as the

¹¹ See Viscusi, et al. (2005).

public interest theory of regulation. We are, after all, told repeatedly that private firms have such a role to play in society. In the case of DME, savings might indeed accrue, but at what cost and for how long? Theories of regulation seek to explain why regulatory action would yield a better outcome than a market. Other than the potential for making it easier to monitor the regulated firms by reducing their number, there appears to be no honorable explanation for why this bidding process is being used.

Some suggest that many of the problems pointed out by critics of competitive bidding could be overcome if the bidding was applicable to local firms.¹² Services such as garbage pickup and electricity provision tend to be provided by local firms. This keeps the interests of the public more focused and the propensity for political deal making in check.¹³ However, in a case like DME where the regulation pertains to a much broader geographic area, and where the regulator resides in Washington rather than being locally available, this does not apply.

In theory, value for society is created by an auction for a franchise. The monopoly income that could be earned by the firm is transferred to the government, which it is assumed, uses such revenue to improve societal welfare. When no money changes hands for the awarding of the franchise, as in the case with DME, prices are reduced which also should benefit consumers. Yet, when the product being provided is coupled with a significant service component we should take pause. The outcome of this bidding plan will be to reduce price for a time, but also to reduce the quality of service provided to patients to whom service matters a great deal. In some cases, the service itself becomes a life or death issue. DME is not an industry characterized by natural monopoly features. It is not like

¹² See Ekelund and Saba (1981.)

¹³ This is supported by Prager's (1989) analysis of the Massachusetts cable television bidding.

cable television. If your cable service goes out in the middle of the night you have alternatives. If your oxygen supply does the same, service is of paramount importance.

Congress mandated the implementation of the competitive bidding program and as such CMS is merely doing its job, however, alternatives must be considered. Yet, from the outset predictions by CMS about the impact on the market have been incorrect. For instance, the distribution of winning firms in the initial phase of bidding did not yield the predicted breakdown between large and small firms. If economies of scale existed, large firms should have won the majority of bids. However, 64% of bid winners were small providers. This raises the question of whether economies of scale in this industry are as prevalent as initially believed.

If the regulators do not understand the market a bidding plan will not provide the proper incentives. More problematic is when a competitive bid plan is put in place for an industry that is already competitive. This would, it seems, defeat the purpose of the bidding.

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