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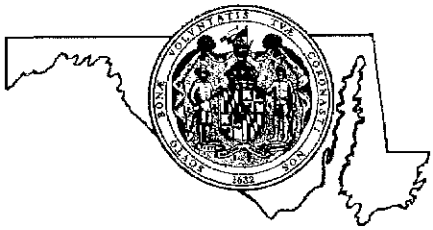
CHAIR

STATE OF MARYLAND



Ben Steffen
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MARYLAND HEALTH CARE COMMISSION

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MEMORANDUM

TO: Commissioners

FROM: Joel Riklin JR
Program Manager, Certificate of Need

DATE: May 15, 2014

SUBJECT: Mercy Medical Center
Docket No. 12-12-2332

Enclosed is the staff report and recommendation on the request by Mercy Medical Center for a Project Change after CON Approval ("modification request") for the above-referenced project approved by the Commission in December of 2012. The project will relocate four operating rooms and add four additional operating rooms.

The originally approved project cost was $23,529,589. A combination of the need to add an additional air handling unit and other design changes to enhance the flexibility of the operating rooms and associated increases in architectural and engineering fees, and an increase in the amount budgeted for future inflation have increased the estimated project cost by approximately $1.8 million (7.5%), bringing the total anticipated cost to $25,381,424. This increase exceeds the permissible inflation allowance under the Commission's regulations. Therefore, Commission action on a request for a modification of the CON is required.

Staff has reviewed the request and determined that the requested modification does not change the Commission's earlier findings regarding need, cost effectiveness, viability, or impact on other providers, and thus recommends **APPROVAL** of the request.

IN THE MATTER OF	*	**BEFORE THE**
	*	
MERCY MEDICAL CENTER	*	**MARYLAND HEALTH**
	*	
DOCKET NO. 12-12-2324	*	**CARE COMMISSION**
	*	

* * * *

II. STAFF REVIEW AND ANALYSIS: PROPOSED MODIFICATION

Requirements for Project Modification

Commission regulations at COMAR 10.24.01.17 require Commission approval of changes to projects approved through the Certificate of Need program. Specifically, Commission approval is required if any of five specified changes to a project is proposed before project implementation. These changes are:

(1) Significant changes in physical plant design;

(2) Capital cost increases that exceed the approved capital cost inflated by an amount determined by applying the Building Cost Index published in *Health Care Cost Review* from the application submission date to the date of the filing of a request for approval of a project change;

(3) Total expense or revenue increases that exceed the approved expenses or revenues inflated by 10 percent per year;

(4) Changes in the financing mechanisms of the project; and/or

(5) A change in location or address of the project.

COMAR 10.24.01.17C describes three types of changes to a project that are impermissible, and would require Commission review and approval as a new CON project:

(1) A change in the fundamental nature of facilities or services to be provided in the facility from those that were approved by the Commission;

(2) An increase in the total licensed bed capacity or medical service categories from those approved; and

(3) Changes requiring extensions of time to meet the applicable performance requirements specified under Regulation .12, except as permitted under Regulation .12E of this chapter.

The proposed changes will not increase operating room capacity beyond what has already been approved. While the redesign of the project requires an extension of time to meet the performance requirement for the obligation of funds, the extension of time requested is permitted under subpart 12E. Therefore, the proposed changes are not of sufficient scope to warrant complete review in accordance with the Certificate of Need review process.

While Mercy has requested approval of changes in the originally-approved physical plant design, Commission staff does not consider such changes to be significant enough on their own to require Commission approval.

Mercy is also requesting a change in the approved capital cost that exceeds the allowable amount – i.e., the approved capital cost inflated by an amount determined by applying the

Building Cost Index published in *Health Care Cost Review* from the application submission date to the date of the filing of a request for approval of a project change. This index would allow a capital cost increase of slightly above $607,000 against the projected increase of $1,164,333 in the total current capital cost. Therefore, the Hospital is required to seek Commission approval of the capital cost increase. The changes in project costs are detailed in Table 1 below.

Table 1: Requested Changes in the Approved Project Costs
Mercy Medical Center Operating Room Project (Docket No. 12-24-2332)

USES OF FUNDS	As Approved Dec. 20, 2012	Requested Modification	Change	Percent Change
	Dollar Amount	Dollar Amount		
Building (Fit Out Shell Space)	$8,446,000	$9,244,380	$798,380	9.5%
Site preparation	385,000	396,550	11,550	3.0%
Architect/engineering fees	981,000	1,452,150	471,150	48.0%
Permits (buildings/utilities)	109,880	25,000	-84,880	-77.2%
SUBTOTAL-CONSTRUCTION	**$9,921,880**	**$11,118,080**	**$1,196,200**	**12.1%**
Equipment	10,151,979	10,005,815	-146,164	-1.4%
Contingencies	2,094,350	2,158,837	64,487	3.1%
TOTAL CURRENT CAPITAL COSTS	**$23,171,239**	**$24,335,572**	**$1,164,333**	**5.0%**
Inflation Allowance	358,620	960,853	602,233	167.9%
TOTAL CAPITAL COSTS	$23,529,859	**$25,296,425**	$1,766,566	7.5%
Legal Fees	35,000	45,000	10,000	28.6%
Consulting Fees	35,000	40,000	5,000	14.3%
SUBTOTAL-FINANCING/OTHER	**$70,000**	**$85,000**	**$15,000**	**21.4%**
TOTAL USES OF FUNDS	**$23,599,859**	**$25,381,425**	**$1,781,566**	**7.5%**

Source: Project Budget in Staff Report dated July 15, 2010 for original CON; Project Budget in Submission dated November 2, 2012

Explanation of Cost Increases

Following approval of the Project, Mercy's consultants and contractors determined that the existing air handling unit ("AHU") is inadequate to provide sufficient relative humidity and low-temperature air for all of the new operating rooms similar to the operating rooms on the sixth floor of the Bunting Center. The need to redesign the space to place an additional AHU prompted Mercy to examine and assess other design features of the project, such as the size and location of the operating rooms and whether an adjacent driveway for a patient pick-up point would be functional or whether it should be put to better use as additional space for the eight operating rooms.

Mercy determined that the new AHU should be placed on the second floor in space that is currently part of the two-story driveway portion of the building and does not currently have structural support for a second floor. The modified project will include the construction of 1,540 square feet of floor space on the second floor to house the new AHU. At the same time, in order to support the infrastructure required in the operating rooms below, Mercy intends to construct the structural support for flooring for the remaining second floor portion of the driveway space, consisting of approximately 3,120 square feet. The infrastructure will include the supports for the operating room lights and equipment booms as well as all the HVAC distribution.

Under the design of the approved Project, the operating rooms are approximately 587 square feet each. From experience with the operating rooms on the sixth floor of the Bunting Center, Mercy has determined that operating rooms of this size would not be suitable for certain surgical procedures, such as cardiovascular, neurosurgery, and orthopedic procedures. Mercy has found that operating rooms that are at least 700 square feet are more efficient and flexible than 600 square foot operating rooms. In order to enlarge the operating rooms, the rooms had to be moved to the east side of the building where the column spacing allowed a larger room. This move east also reinforced the need to eliminate the patient pick-up area and use the space more efficiently for larger, uniformly-sized general operating rooms. Under the proposed modified design, the operating rooms will be 700 square feet each.

Most of the increase in the Building line item of the revised Project Budget ($798,380) is attributable to the cost of the new AHU ($300,000) construction of the space for the AHU and the adjacent infrastructure for the structural support of the operating rooms below ($245,000). The $471,150 increase in Architecture and Engineering fees is related to the redesign, mechanical, electrical, and plumbing system testing, and a change in the architectural firm.

The project will be financed entirely with cash as originally proposed. Therefore there is no change in the project financing mechanism. Regarding total revenue and expense increases, there will be no revenue increases as a result of the design changes and increased cost and annual depreciation will increase by $28,588, which is .05% of total expenses as projected in Table 3 of the 2012 CON application. Therefore, the change in capital cost is the only change in the project requiring Commission approval. No impermissible changes are proposed.

Construction Costs

At the time of the CON approval, Commission Staff analyzed the original proposed construction costs compared to building cost benchmarks derived from Marshall Valuation Service (MVS) guidelines, as required by COMAR 10.24.10. These comparisons indicated that the proposed cost per square foot for the construction, as appropriately adjusted for certain characteristics of the project, were above the MVS benchmark for a project of this type by $25.77 per square foot.

Commission Staff compared the modified costs to current costs for comparable new construction in the applicable region of Maryland according to MVS. Only costs associated with the design and construction of the buildings are used in calculating project costs for MVS purposes and adjustments are allowed for extraordinary costs. This analysis indicates that the new estimated cost per square foot for the construction, as appropriately adjusted for certain characteristics of the project, is now below the MVS benchmark for a hospital project of this type, by $88.81. Therefore, the condition should be removed from the modified order. Removal of this condition, that would have limited increases in future rate increases or revenue caps, should have no impact on future hospital rates because the Hospital is not likely to seek an increase in rates or its revenue cap for the capital cost of this project and HSCRC is not likely to approve such an adjustment, if it were requested.

III. SUMMARY AND STAFF RECOMMENDATION

While the increase in project cost is greater than the allowable inflation and is attributable to factors that could have been identified by the Applicant during the original CON review period, the increase would not have had a material effect on the findings made by the Commission with respect to the cost and effectiveness of alternatives. Because no material changes are occurring in the location, capacity, or nature of the project, the increased project cost has no effect on previous conclusions regarding the need for the project or its impact on existing providers.

The Staff Recommendation on this project, endorsed by the Commission, found that Mercy had demonstrated a need for the proposed increase in operating rooms from 19 to 23. The Staff Recommendation also found that the consolidation of the additional operating rooms with four operating rooms to be relocated on the Mercy campus is more cost effective than other alternatives primarily due to the anticipated $900,000 annual savings in personnel costs. The proposed increase in project costs will have a relatively small impact on the depreciation attributable to this project and Mercy's operating expenses. Therefore, the proposed increase would not fundamentally alter the finding of cost effectiveness. However, Mercy should carefully consider the HSCRC staff concern with the use of limited resources to add four operating rooms given the recent transition to the Global Budget Revenue model.

With respect to financial feasibility and project viability, consultation with HSCRC staff has documented that Mercy has sufficient cash to fund this project at the increased cost level without fund raising. HSCRC staff review concluded that the increased costs do not adversely impact the financial feasibility of the project because the projected days of cash after funding the project (149 days) is more than adequate relative to the bond covenants. Regarding any increase in operating revenues associated with this project and the requested cost increase, HSCRC staff stated that any future volume growth will have to be funded from the market share adjustment.

Staff concludes that the requested modifications are permissible under COMAR 10.24.01.17 and recommends that the Commission **APPROVE** the proposed modifications

STATE OF MARYLAND
DEPARTMENT OF HEALTH AND MENTAL HYGIENE

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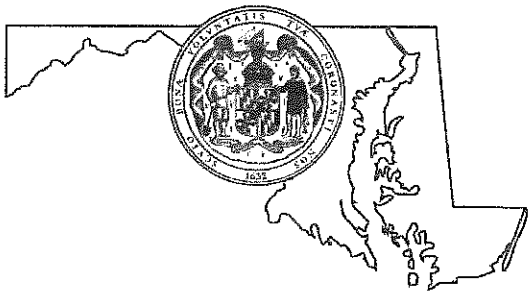

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To: Joel Riklin, MHCC

From: Gerard J. Schmith, HSCRC

Date: May 1, 2014

Subject: Mercy Medical Center ("Hospital," or "Mercy")
Consolidation of Surgical Services
Docket No. 12-24-2332

In response to your request of April 10, 2014, the HSCRC staff has reviewed and determined the financial feasibility of Mercy Medical Center's request for modification of the Certificate of Need ("CON") issued on December 20, 2012. The CON approved the relocation of four mixed-use general purpose operating rooms (currently in the Weinberg Center), the construction of four additional mixed-use general purpose operating rooms, and the construction of surgical preparation, recovery, and storage areas within the first floor of the Mary Catherine Bunting Center. HSCRC staff deemed the initial CON request as financially feasible.

The previously approved project cost was $23,529,859. Mercy has determined that physical plant design changes are necessary, and therefore, the new capital cost of the project is $25,381,424. This increase of 7.5% is not allowable without obtaining MHCC approval. The design changes are as follows:

1) Install additional air handling unit to serve the operating rooms.
2) Reposition and universally size all of the operating rooms.
3) Relocate sterile core area adjacent to the sterile elevator.
4) Build our existing patient pick-up space as additional surgical space.

On April 16, 2014, the Hospital provided a copy of the Audited Financial Statements for Mercy Health Services, Inc. ("System"), the parent company of Mercy Medical Center. Additionally, the Hospital provided an analysis of Days of Cash on Hand ("DCH") for the System's Obligated

Group, before and after the cash outlay for the Project as revised in the request (Attachment 1.) The Obligated Group is made up of the entities within the System, which are responsible for servicing the debt associated with the Hospital's outstanding bonds. These entities include Mercy Medical Center, Mercy Health Services and Mercy Foundation. The Obligated Group had 172 DCH as of June 30, 2013 and would have 149 DCH after the financing of this Project. The Maryland Health and Higher Educational Facilities Authority's rate covenant calls for no less than 60 DCH, and PNC Bank's rate covenant calls for no less than 75 DCH.

Since the Days of Cash on Hand of the Obligated Group are more than adequate relative to the bond covenants included in the Hospital's borrowing documents, HSCRC Staff believes that the revised financial projections do not adversely impact the financially feasibility of the project. Notwithstanding, HSCRC staff does question the utilization of limited resources to expand operating room capacity, particularly given the already existing excess capacity in the downtown area, as well as the recent transition to the GBR model. Any future volume growth will have to be funded from the market share adjustment, as there will be no additional adjustments to fund increased volumes associated with this project.

Please contact me with any additional questions or concerns.

Mercy Medical Center
CON- Surgical Services
Cash Availability for Project Cost
(in $000)

Per Audited Consolidated Financial Statements, June 30, 2013

	Mercy Medical Center	Mercy Health Services	Mercy Health Foundation	Total Mercy Obligated Group	less Project Cost Funded	Adjusted Mercy Obligated Group
Cash Available:						
Cash and short term investments	$ 69,876	$ 120	$ 2,153	$ 72,149		
Long term investments	9,207	6,769	-	15,976		
Board designated and donor restricted funds	94,250	9,579	10,670	114,499	(25,381)	
less donor restricted funds	(14,646)	-		(14,646)		
	$ 158,687	$ 16,468	$ 12,823	$ 187,978	$ (25,381)	$ 162,597
Operating expenses	$ 428,455	$ 1,316	$ 1,812	$ 431,583		
less depreciation	(33,087)	-	-	(33,087)		
Net Cash operating expenses	395,368	1,316	1,812	398,496		
days	365			365		
Daily operating expense	$ 1,083			$ 1,092		$ 1,092
Days Cash on Hand				**172**		**149**
Debt Covenants:						
PNC Target Day's Cash on Hand				75		75