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MARYLAND HEALTH CARE COMMISSION

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MEMORANDUM

TO: Commissioners

FROM: Kevin R. McDonald
Chief, Certificate of Need 

DATE: February 21, 2019

SUBJECT: Anne Arundel Mental Health Hospital, Inc.
Docket No. 16-02- 2375

Attached is a Staff Report and Recommendation in the review of the request for a Project Change after Certificate of Need Approval (“modification”) of a Certificate of Need (“CON”) issued in April 2018 to Anne Arundel Medical Center, Inc. (“AAMC”) to build a 16-bed special hospital-psychiatric on a site approximately two miles from its general hospital in Annapolis and adjacent to Pathways, its addiction treatment facility.

Under our regulations the Commission needs to approve this modification request because the increased estimated expenditure exceeds the inflation allowance, and thus requires Commission action (COMAR 10.24.01.17B(2)).

The modification requested is a \$3,300,763 increase (slightly more than 13%) in the authorized capital expenditure, raising the total estimated project cost to \$28,285,558. AAMC attributes the cost increase to two factors: (a) the project cost estimate was 20 months old at the time the CON was approved; (b) significant increases in material costs due to a combination of catastrophic weather events (Hurricanes Irma and Harvey) and changes in U.S. governmental trade agreements and tariffs. The additional capital cost will be funded with cash, so the amount of debt to be incurred for this project (and related interest expense) will not change from what was approved in the CON.

Staff has reviewed this request for a project change to a CON in the context of the Commission’s conclusions in its April 2018 decision, and concludes that the proposed project change would not have a material effect on the findings made by the Commission at that time, and thus recommends **APPROVAL**.

IN THE MATTER OF

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BEFORE THE

ANNE ARUNDEL

MARYLAND

MEDICAL CENTER, INC.

HEALTH CARE

Docket No. 16-02-2375

COMMISSION

REQUEST FOR PROJECT CHANGE AFTER CERTIFICATE OF NEED APPROVAL

I. INTRODUCTION

Brief Summary of the Requested Project Change

Anne Arundel Medical Center, Inc. (“AAMC”), a wholly owned subsidiary of Anne Arundel Health System, Inc., seeks a change to its April 19, 2018 Certificate of Need (“CON”) to establish a 16-bed special psychiatric hospital to be located at the intersection of Riva Road and Harry S. Truman Parkway in Annapolis (Anne Arundel County), Maryland. It seeks approval of an increase in the authorized cost of the project to \$28,285,558, an additional \$3,300,763 above the project cost approved ten months ago (or an increase of slightly more than 13%). This increase exceeds the inflation allowance provided in COMAR 10.24.01.17B(2), and thus requires Commission approval.

Because the additional capital cost will be funded with cash, the amount of debt to be incurred for this project (and related interest expense) will not change from that approved in the CON. The applicant cites two bases for the increased cost of the project. First, the project cost estimate was 20 months old at the time the CON was awarded. Secondly, AAMC states that cost estimates for some needed building materials have increased due to “several market and other external factors” such as “significant increases in material costs due to a combination of catastrophic weather events (Hurricanes Irma and Harvey) and changes in U.S. governmental trade agreements and tariffs.”

Through this request, AAMC also informed the Commission of a change in the legal name of the entity designated to be the licensee of the approved special psychiatric hospital. During the CON review process, AAMC designated a to-be-formed entity named “Anne Arundel Mental Health Services, Inc.” as the intended licensee of the project under COMAR 10.24.01.07D(1). AAMC is changing the name of this entity (which has not yet been formed) to “Anne Arundel Mental Health Hospital, Inc.” As required by COMAR 10.24.01.07D(1), the entity “Anne Arundel Mental Health Hospital, Inc.” will be formed as a wholly owned subsidiary of AAMC, just as the entity “Anne Arundel Mental Health Services, Inc.” would have been formed.

Background

On April 19, 2018, the Maryland Health Care Commission awarded AAMC a CON, with a condition, approving its application to establish a special psychiatric hospital in a new building to be constructed on a site approximately two miles from the AAMC campus. The acute psychiatric hospital will be constructed adjacent to Pathways, an alcoholism and drug abuse treatment intermediate care facility that provides inpatient and outpatient addictions treatment. In addition to the 16-bed acute psychiatric hospital for adults, the project would also include an outpatient mental health clinic and a partial hospitalization program for both adults and adolescents. The approved capital cost of the project was \$24,984,795, to be funded with \$14,984,795 in cash and \$10 million in borrowing.

II. APPLICABLE REGULATIONS

Commission regulations, at COMAR 10.24.01.17C, identify certain circumstances where a modification to an approved project is not permitted¹ and a new CON application is required. AAMC's project change request does not involve an impermissible modification. However, COMAR 10.24.01.17B provides that certain listed "changes that would place the project at variance with its Certificate of Need ... shall receive approval from the Commission" AAMC is required to obtain MHCC approval

[b]efore incurring 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

COMAR 10.24.01.17B(2). As previously noted, AAMC's request involves a capital cost increase that is in excess of the inflation allowance, and thus requires Commission action. Under COMAR 10.24.01.17D(3), the Commission may: approve the requested change; approve it in part or with conditions; decide not to approve the change for stated reasons; or require a complete CON review because of the scope of the requested change.

III. COST INCREASE AND FINANCIAL IMPACT OF THE REQUESTED PROJECT CHANGE

Projected Costs Exceed Inflation Allowance

CON regulations provide for an inflation allowance, but require increases that exceed that allowance to obtain Commission approval. The allowance is calculated using the building cost

¹ Impermissible modifications include:

- (1) Changes in the fundamental nature of a facility or the services to be provided in the facility from those that were approved by the Commission;
- (2) Increases in the total licensed bed capacity of medical service categories from those approved; and
- (3) Any change that requires an extension of time to meet the applicable performance requirements specified under Regulation .12 of this chapter, except as permitted under Regulation .12E of this chapter.

indices published on a quarterly basis by IHS Global Insight in *Healthcare Cost Review*.² The allowable inflation adjustment is determined from the CON application's submission date (March 29, 2016 or the 1st quarter of CY 2016) to the date of the filing of a request for CON modification (December 13, 2018, or the fourth quarter of CY 2018). The applicant is seeking an increase of \$3,812,255 in current capital costs,³ which exceeds the inflation allowance of \$920,441,⁴ and thus requires the Commission's review and approval.

CON-Approved Cost Compared to Project Change Request Costs

Table 1 below compares the projected costs and funding sources as originally approved by the Commission with those in AAMC's request for project change. Table 1 shows that current capital costs increased by just over \$3.8 million. The increase in the project cost estimate breaks down across principal cost elements as follows: building construction, approximately \$3.5 million; site development and infrastructure costs, \$400,000; and movable equipment, \$550,000.

Table 1: PROJECT BUDGET Cost Comparison, Approved Project Budget and Proposed Change

	APPROVED CAPITAL COST	CURRENT CAPITAL COST ESTIMATE	CHANGE
A. USE OF FUNDS			
1. CAPITAL COSTS			
a. Land purchase	\$0	\$0	\$0
b. New construction			
(1) Building	\$16,080,433	\$19,617,688	\$3,537,255
(2) Fixed equipment	0	0	0
(3) Site and infrastructure	2,770,763	3,170,763	400,000
(4) Architect/engineering fees	1,373,350	1,373,350	0
(5) Permits (building, utilities, etc.)	23,757	23,757	0
SUBTOTAL	\$20,248,303	\$24,185,558	\$3,937,255
c. Renovations			
(1) Building			
(2) Fixed equipment (not included in construction)			
(3) Architect/engineering fees			
(4) Permits (building, utilities, etc.)			
SUBTOTAL			
d. Other Capital Costs			
(1) Movable equipment	\$900,000	\$1,450,000	\$550,000
(2) Contingency allowance	\$1,600,000	\$925,000*	(\$675,000)
(3) Gross interest during construction period			
(4) Other (<i>minor equipment</i>)			
Commissioning/testing	\$375,000	\$375,000	\$0
IT/integration	\$700,000	\$700,000	\$0

² As described at

http://mhcc.maryland.gov/mhcc/pages/hcfs/hcfs_con/documents/con_capital_threshold_update_20170317.pdf.

³ The net increase in total project costs is a lower figure because of a smaller inflation allowance. See Table 1.

⁴ Fourth Quarter 2017 edition of the Building Cost Index published in *Healthcare Cost Review*, as required by COMAR 10.24.01.17B(2).

Exterior courtyard/hardscaping	\$500,000	\$500,000	\$0
SUBTOTAL	\$4,225,000	\$4,100,000	(\$125,000)
TOTAL CURRENT CAPITAL COSTS	\$24,473,303	\$28,135,558	\$3,812,255
e. Inflation Allowance	\$511,492	\$0	(\$511,492)
TOTAL CAPITAL COSTS	\$24,984,795	\$28,135,558	\$3,300,763
2. FINANCING COST AND OTHER CASH REQUIREMENTS			
g. Financing Transaction Costs	\$150,000	\$150,000	\$0
SUBTOTAL	\$0	\$0	\$0
TOTAL USES OF FUNDS	\$24,984,795	\$28,285,558	\$3,300,763

Source: CON application and Request for Project Change after CON Approval

* Part of the original contingency allowance has been allocated to budget line item(s).

The increases in costs are offset to an extent by a \$675,000 reduction in the inflation allowance and in the contingency allowance, due to the fact that some of the original contingency has been drawn down now that the project is underway.

AAMC details the cost increases as follows.

Rough grading (\$150,000): AAMC discovered unsuitable soils that needed to be remediated. In addition, a mis-located County water line generated additional grading expenses.

Utilities (\$250,000): BGE changed its design for the incoming gas and power services after the projections in the CON application were prepared, resulting in additional expense to bring power to the site.

Building (\$3,537,255): AAMC cited significant increases in materials costs due to a combination of catastrophic weather events (Hurricanes Irma and Harvey) and changes in U.S. trade agreements and tariffs, primarily related to products made from steel. There have been increases in mechanical equipment and building material with the increased demand from areas that are still rebuilding following storm events (including roofing, air handlers, generators, general building products, etc.).

Movable Equipment (\$550,000): AAMC also cited changes in federal trade agreements and tariffs as a principal factor in this cost increase. The majority of the furniture for the project is sourced by way of affected countries, in particular, Canada.

Projected Financial Impact of Proposed Modification

AAMC states that it expects to fund the increased project costs by increasing its cash contribution from \$14,984,795 to \$18,285,558. AAMC's operating budget will be affected by an increase in annual depreciation expense of about \$83,000, an amount that also comes off the project's projected bottom line. AAMC projects no changes to rates or other operational expenses.

Table 2: Projected Financial Performance of AAMC Mental Health Hospital, Year 1 of Project Operation and at Full Capacity Use (FY 2023)

Original CON Application and as Modified

	Projected First Year of Operation		FY 2023	
	Original CON	As modified	Original CON	As modified
Net Operating Revenue	\$5,840,989	\$5,840,989	\$8,002,757	\$8,002,757
Total Operating Expenses	\$6,558,083	\$6,640,603	\$7,401,900	\$7,484,420
Net Income	(\$717,094)	(\$799,614)	\$600,857	\$518,337

Source: CON application and Project Change Request, Table K: Revenues and Expenses, Inflated

IV. RECOMMENDATION

Staff has reviewed this request for a project change in the context of the Commission’s conclusions in its April 2018 decision, and concludes that the proposed project change would not affect the findings made by the Commission at that time. Staff arrived at this conclusion because the requested modification makes no changes in the location, capacity, or nature of the project, and thus would not alter the findings made by the Commission less than a year ago with respect to the need for the project or its likely impact on existing providers and on costs and charges. There is also no projected impact on rate-payers, as AAMC does not propose an increase in revenue related to this project.

And despite the 13.2% increase in project cost, staff concludes that the Commission’s earlier findings regarding cost and effectiveness of alternatives or project viability still apply. AAMC has the resources to cover the increase, and while the projected operating margin will be smaller, it is still positive and reasonably healthy, at about 7% of expenses.

For the reasons stated, staff recommends that the Commission **APPROVE** the requested project change and issue a Modified Certificate of Need, retaining the original condition, which is:

Anne Arundel Medical Center shall not increase its bed capacity without obtaining required approval from the Maryland Health Care Commission.

The modified CON will be issued to and the condition will be modified to reflect that the legal name of the hospital licensee will be Anne Arundel Mental Health Hospital, Inc., a wholly-owned subsidiary of Anne Arundel Medical Center.

IN THE MATTER OF * BEFORE THE
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ANNE ARUNDEL * MARYLAND
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MEDICAL CENTER, INC. * HEALTH CARE
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Docket No. 16-02-2375 * COMMISSION
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FINAL ORDER

Based on the analysis and recommendations in the staff report and the record in this review, it is, this 21st day of February, 2019, **ORDERED**:

That the request of Anne Arundel Medical Center, Inc. for an increase in the authorized cost of its April 19, 2018 CON to establish a 16-bed special psychiatric hospital in Annapolis from \$24,984,795 to \$28,285,558 and to issue the modified CON in the name of Anne Arundel Mental Health Hospital, Inc. is hereby **APPROVED**, retaining the original condition, which, as modified, is:

Anne Arundel Mental Health Hospital, Inc. shall not increase its bed capacity without obtaining required approval from the Maryland Health Care Commission.

MARYLAND HEALTH CARE COMMISSION