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MARYLAND HEALTH CARE COMMISSION

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MEMORANDUM

TO: Commissioners

FROM: Kevin R. McDonald
Chief, Certificate of Need

DATE: June 17, 2021

SUBJECT: Sheppard Pratt at Elkridge
Docket No. 15-13-2367

STAFF REPORT
REQUEST FOR A SECOND PROJECT CHANGE
AFTER CERTIFICATE OF NEED APPROVAL

Commissioners will recall that, in March 2021, they approved a request for a change in an approved project filed by Sheppard Pratt Health System (Sheppard Pratt or “the applicant”) 1. The March 2021 modification authorized a $9,105,505 increase in the cost of Sheppard Pratt’s new 85-bed replacement special psychiatric hospital, resulting in a revised total project cost of $105,638,412. The applicant stated that the entire additional cost would be funded by philanthropic donations.

On June 8, 2021 the applicant filed a second modification request, this one not only requesting a further increase in the approved project budget, but also requesting authorization to change the way the project is being financed. Each of these changes require Commission action.[1]

[1]COMAR 10:24:01.17B:

> Commission Approval Required Before Project Changes**.** Any of the following changes that would place the project at variance with its Certificate of Need issued under these regulations … shall receive approval from the Commission: … (2) [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; .. (4) [b]efore changing the financing mechanisms of the project ….

The reasons for these changes put forward by the applicant and staff's recommendation will follow in this memorandum.

BACKGROUND

In September 2016, the Commission awarded a Certificate of Need (CON) to replace Sheppard Pratt's Ellicott City special psychiatric hospital and relocate it to Elkridge. The approved new facility is an 85-bed, three-level facility that was designed to serve adolescents, young adults, the general adult population, adults with co-occurring conditions, and adults with psychotic disorders. The project's original approved cost was $96,532,907. The stated funding sources for the original project were: $66.7 million in debt; $14.86 million in cash; $7.5 million in philanthropic gifts; and $7.5 million in State grant funding.

On March 18, 2021, the Maryland Health Care Commission (Commission) approved a the applicant's first requested modification to the project, specifically a $9,105,505[2] increase in project costs. At that time, Sheppard Pratt cited higher-than-anticipated construction bids resulting from increased costs for building materials and other cost increases attributable to the COVID pandemic. The applicant also cited some design changes and an associated increase in the cost of materials. Finally, it noted that the extension of the project timeline resulted in additional architectural and engineering fees. In its first modification request, Sheppard Pratt stated that the additional funds required for the project would be covered by an additional $9 million in philanthropy.

PROJECT CHANGE REQUESTS AND EXPLANATIONS

A. Project Cost Increase

As stated above, Sheppard Pratt seeks authorization to increase the approved project cost by $7,427,013, reflecting an increase in interest expense incurred during the construction period. Sheppard Pratt maintains that the increase in capitalized interest does not reflect an actual increase in the cost of constructing the project, but rather a correction related to accounting for the interest expense. The applicant explains that the

> increase [is] principally due to an oversight in the calculation of construction period interest …which was not discovered until recently [when] Sheppard Pratt engaged in discussions with the Health Services Cost Review Commission ("HSCRC") regarding a request for rate adjustment, which relates in part to this hospital project …. HSCRC staff noted that Sheppard Pratt did not reconcile the capitalized interest with the revised construction timeline for the project completion. The original project budget, as well as the budget submitted with the Initial Project Change Request, included capitalized interest for the initial estimated time period of construction. When the construction timeline was extended, Sheppard Pratt overlooked the need to update the interest expense. As a result, the capitalized interest was understated by approximately $7.4 million.

B. Changes to the Project's Financing

[2] The March 2021 modification included a calculation error of $540,999. The actual increase of the budget requested in March 2021 was $8,564,506.

The current modification request also contains significant changes to the funding of the project, replacing more than $25 million in cash and philanthropy with debt.

As shown in the table immediately below, both the approved CON and the March 2021 modification showed a cash contribution of $14.4 million and the March modification increased philanthropy as a funding source from $7.5 million to $16.5 million, covering the entire additional cost. The current request eliminates cash as a source of project funding and cuts the philanthropic contribution. This contribution was anticipated to cover 7.8% of project cost when the project was approved in 2016. The first modification request that the Commission acted on in March 2021 more than doubled the dollar value of philanthropy, to $16.5 million, accounting for 15.7% of the higher total project cost. Under this second modification request, philanthropy only contributes $5 million for this project, about 4.4% of project cost.

Table 1: Change in Source of Funds
Sheppard Pratt at Elkridge

Funding Source Classification	Sept. 2016 CON	March 2021 Project Change	June 2021 Project Change Request
Cash	$14,857,500	$14,422,006	$0
Philanthropy	$7,500,000	$16,500,000	$5,000,000
State Grants	$7,500,000	$7,500,000	$10,000,000
Authorized Bonds Proceeds*	$66,675,407	$66,675,407	$70,000,128
Working Capital Loan*[1]	$ 0	$ 0	$25,000,000
Interest from Bond Proceeds[1]	$0	$0	$2,524,298
Total Sources of Funds	$96,532,907	$105,097,413	$112,524,426

Source: Table G, Original CON, Request for modification March 2021 and June 2021
Notes: *For both debt "sources," the monies were raised through a single, multi-purpose bond sale.
[1]Previously unidentified "sources of funds."

The applicant's explanation for these changes is summarized below.

Shift from Cash to Working Capital Loan

Sheppard Pratt characterizes the elimination of the entire $14.4 million cash contribution as resulting from a "reclassification." Reviewing the new sources of funding classifications in the current request and the project funding source statements from earlier this year, there are higher levels of debt, including a "working capital loan" that was not previously identified as debt financing, as well as an assumption that additional money will be provided by the State in the form of grants, As stated by Sheppard Pratt, a "recent review by the HSCRC staff in connection with a rate adjustment request [has led to] … some reclassifications of sources and uses and some modifications to the projected expenses." What the applicant originally called "cash" was actually a portion of the proceeds of a larger bond issue by the Sheppard Pratt Health System. The applicant states that

> [a 2017] $178 million bond issuance … intended for routine capital for the organization unrelated to the new hospital facility [but for] … other projects [that] were being considered, [but never] … pursued for a variety of reasons. Because of cash constraints over the previous several years, and most recently as a result of the pandemic, a portion of

> these funds were used for the hospital construction …. The classification of these funds was subject to some deliberation in the course of discussions with the HSCRC staff. The options discussed were: Cash (line B.1), Authorized Bonds (line B.3), or Working Capital Loans (line B.6). As a result of the HSCRC discussions, it seemed most appropriate to classify the funds in the category of Working Capital Loans to distinguish the source from operating cash and the hospital bond proceeds fund.

<u>Reduced Philanthropy</u>

As noted above, the current request cuts the philanthropic contribution, and covers that reduction with the "working capital loan." The applicant explains:

> At the time of the grant of the CON until very recently (within the last 60 days), Sheppard Pratt expected there would be additional philanthropic funding related to the new hospital. While we have received more than $5 million in grants and philanthropic funds, to date, only $5 million has been expressly dedicated by funders for the new hospital, while other donated funds went to other system operating costs and capital items … [Although there may be more philanthropic funds dedicated to the project in the future] Sheppard Pratt … included only funds clearly earmarked for the hospital capital at this time.

STAFF ANALYSIS AND RECOMMENDATION

<u>**Viability**</u>

Staff notes that construction of this project is virtually complete. Sheppard Pratt has scheduled a ribbon-cutting for June 17. It is currently planning to open the facility on June 28. It has demonstrated its ability to implement the project. Turning to the project's sustainability, staff notes that the March 2021 modification showed a decreased but still positive bottom line compared to the original approval.

The current modification request increases the annual depreciation expense by $19,000 and increases in corporate overhead (mostly unexpected malpractice insurance increases) and "other" expenses added another $2.5 million. The most recent revenue estimate shown in Table 2 assumes higher rates that the applicant now expects to receive from HSCRC.[3] However, even without that assumed increment, the applicant's projections would result in a small but still positive bottom line.

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[3] Chief Financial Officer Kelly Savoca writes that "Sheppard Pratt has been in communication with HSCRC staff about rate relief to help manage some existing cost pressures as well as capital costs related to the new hospital," and that the most recent revenue estimate assumes an additional $1.7m or 5% above what was assumed in the March submission, which she characterizes as "conservative estimate based on the discussions with HSCRC staff." (Email to Kevin McDonald, June 11, 2021).

Table 2: Projected Utilization and Financial Statistics (Inflated) for the First Year of Operation

	Sept. 2016 CON	March 2021 Modification		June 2021 Modification Request
	Utilization Statistics			
Discharges	3,580	3,580	[redacted]	3,580
Patient Days	27,930	27,930	[redacted]	27,930
Average Length of Stay (Days)	7.8	7.8	[redacted]	7.8
	Projected Revenues, Expenses, and Income			
Net Operating Revenue	$42,762,026	$42,837,906	[redacted]	$44,699,587
Total Operating Expenses	$39,577,213	$40,005,422	[redacted]	$42,564,037
Net Income	$3,260,693	$2,832,484	[redacted]	$2,155,550

Source: Table H – Revenues and Expenses, Inflated–from the 2016 CON application, the March 2021, and June 2021 modification requests.

The HSCRC reviewed the financial projections provided in this modification request and states that it:

> is comfortable that the applicant has sufficient working capital to maintain the operation from its inception throughout at least five years after the completion and full occupancy of the project; that such use of its working capital does not put at risk the financial position of the applicant; and that the project can achieve a positive operating margin at least two to five years after project completion and full occupancy. We base the opinion on sufficient competent evidence as submitted by the applicant in the initial CON application and the ongoing discussions of the HSCRC with management. At this time, based upon review of all the submitted materials, staff is of the opinion that this project is financially feasible.
> (Attachment X.)

<u>Need and Impact on the Health System</u>

In its March 2021 approval, the Commission found that the applicant's initial request for a change in the approved project entailed no material changes to the nature of the project, its location, or its capacity, did not change the Commission's 2016 findings concerning the need for and the positive impact of relocating and replacing the Sheppard Pratt outdated Ellicott City facility. For these reasons, staff recommends that the Commission approve Sheppard Pratt's current modification request.

MEMORANDUM

TO: Kevin McDonald, Chief, CON, MHCC
Moira Lawson, Analyst, CON, MHCC

FROM: Katie Wunderlich, Executive Director, HSCRC
Jerry Schmith, Director, Revenue & Regulation Compliance, HSCRC
Bob Gallion, Associate Director III, Revenue & Regulation Compliance, HSCRC

DATE: June 15, 2021

RE: Sheppard Pratt
Sheppard Pratt at Elkridge Replacement Hospital
Docket No. 15-13-2367

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This memo is in response to your request dated June 10, 2021 regarding the financial feasibility of the above referenced replacement hospital project. On September 20, 2016, the Maryland Health Care Commission (MHCC) awarded a Certificate of Need (CON) to relocate and replace the Ellicott City special hospital to Elkridge (Howard County). The original approved project cost was $96,532,907 with four funding sources: $66.7 million in debt, $14.86 million in cash, $7.5 million in philanthropic gifts, and $7.5 million in state grant funding. On March 18, 2021, MHCC approved a $9,099,505 increase (+9.4%) in the approved cost of the project, bringing the total cost estimate for the project to $105,632,412. Sheppard Pratt stated that the additional funds required would be covered by an additional $9 million in philanthropy. On June 8, 2021, Sheppard Pratt filed with the MHCC a Second Request for Post-Approval Project Change seeking to increase the project budget by $7.4 million to account for previously understated capitalized interest for the new hospital construction, raising the total cost estimate to $112,524,426. Additionally, there are significant changes to the funding of the project, with $25 million of costs that were to be paid for by cash and philanthropy that will now be paid for by working capital loans. Other financing changes include a $3 million increase in bonds, a $2.5 million dollar increase in interest from bonds, and a $2.5 million increase in state grant funding.

Specifically, you have requested that the staff of HSCRC review the financial projections provided in the CON modification application and subsequent filings, and then also advise MHCC of our opinion on the general financial feasibility of the proposed project. Additionally, you have requested that HSCRC staff comment on any other aspects of this CON modification application that may be pertinent. MHCC staff has commented that the utilization projections presented in the CON modification application are reasonable, and has asked HSCRC staff to assume that the utilization volumes projected by Sheppard Pratt will be achieved.

BACKGROUND

As you have described it, the 85-bed special hospital would include 155,507 square feet (SF) of new construction on a 39-acre campus located at the intersection of Route 103 and Route 1 in Elkridge. The hospital will serve adolescents, young adults, the general adult population, adults with co-occurring conditions (i.e., adults with a primary psychiatric diagnosis and a secondary substance use disorder), and adults with psychotic disorders. The initial budget modification was due to increased costs for building materials and cost increases attributable to the COVID-19 pandemic. In addition, certain design changes added to the cost of materials and the associated design adjustments, and the extension of the project timeline resulted in additional costs for architectural and engineering fees. The second request for budget modification was due to the applicant having underestimated the capitalized interest for the new hospital. The actual capitalized interest is $9.7 million as compared to the original $2.3 million budgeted. The increase is related to the timing of debt issuance and delays in construction related to the COVID-19 pandemic.

THE PROJECT

As you have described it, the total cost of the project is currently estimated at $112.5 million, sourced as follows: $5.0 million from philanthropy, $70.0 million from bonds, $2.5 million from interest earned on bond proceeds, $25.0 million from working capital loans, and $10.0 million from state grants.

HSCRC REVIEW, DISCUSSION, and OPINION

HSCRC staff has reviewed the Request for Post-Approval Project Change dated March 4, 2021 and the related Report for Modification dated March 18, 2021. Additionally, HSCRC staff has reviewed the Second Request for Post-Approval Project Change dated June 8, 2021 and the related applicant's response dated June 10, 2021 to Additional Information Questions dated June 9, 2021. In addition to reviewing the aforementioned materials, HSCRC staff worked with executive management of the applicant to further explore the financial projections utilized in ongoing discussions between HSCRC and the applicant for purposes of researching potential amendments to its Approved Revenue. These projections were built upon those that the applicant previously submitted to MHCC. Upon review of these materials, observations were noted and conclusions were reached as follows:

The Table E - Project Budget as currently configured reflects the history of the project uses of funds and the current understanding of available information on project sources of funds. The Table E presentation has evolved since it was initially shared with the HSCRC as a result of inquiries and explorations inherent in discussions surrounding the potential for amendments to its Approved Revenue. It is our current understanding that the current presentation of Table E will not materially change going forward. Uses of project funds total $112,524,426 and are comprised of $111,474,865 for capital and $1,049,561 for financing. The material change from Table E as previously approved by MHCC was an addition of $7,427,014 for gross interest during the construction period. This change was needed to account for the extended construction period due to the effects of the COVID-19 pandemic and the capitalized interest during that extended period, which flows to the computation of annual depreciation upon completion and commencement of operations. Not all construction related invoices have been received and paid; however no material overruns are anticipated.

Sources of project funds total $112,524,426 and are comprised of $5.0 million from philanthropy, $70.0 million from the project specific portion of the MHHEFA bonds dated December 2017, $2.5 million from interest earned on such bonds, $25.0 million from the working capital portion of the MHHEFA bonds, and $10.0 million from state grants appropriations. The total value of sources changed from that as previously approved by the MHCC by the same $7.4 million increase in capitalized interest discussed above. Certain reclassifications of the components of those sources have been made so as to present Table E sources consistent with the current understanding of fund availability, not all of which was known with any degree of certainty at the time of the presentation, and was still in process to become realizable cash. The philanthropy was supported by donor documentation; the state grant was supported by appropriations; and the residual draw on the working capital portion of the MHHEFA bond essentially serves as the plug to balance out the sources. Both the philanthropy and the grant were nearly fully collected this month; at the time of this writing, just $1.5 million is outstanding and is documented by the donor. The interest earned on the bond proceeds was discovered through the same discussions that yielded the capital interest. It is the opinion of the HSCRC staff that the classifications of the sources were dynamic until such time as they were confirmed; at present, virtually all is cash collected.

The Table H – P&L Inflated Entire Facility or Service (inclusive of regulated and unregulated operations) as used in discussions with HSCRC was built upon that previously referenced by MHCC, and was amended by the applicant to reflect forward looking operating challenges and cost pressures inclusive of payroll and professional liability insurance. The HSCRC staff has further amended the 5-year Table H projections to account for: a reasonable estimate of the annual growth in rates/prices for regulated services; a reasonable/conservative estimate for any Approved Revenue award that may result from discussions still in progress; a reasonable estimate of contra-revenues;

provisions for interest and depreciation related to debt incurred and assets acquired from the project; and the results of discussions with the applicant's executive management team related to all operating items reflected in the projections. The assumptions incorporated in the current status of Table H projections include: that the applicant shall achieve the volumes projected in the CON as advised by MHCC and upon which the projected revenues are based; a 2.57% increase in unit prices for FY 2022 based upon the most recently approved update factor analysis; a 2.89% increase in service rates going forward based upon review of the average of such increase over the most recent 5-year history of the rate file; a placeholder estimate of a $1,080,000 increase to permanent Approved Revenue for FY 2022 based upon review of current methodology models for capital and operational provisions for all of regulated operations and the share of such revenues related to the Ellicott City/Elkridge project; an 18.6% contra-revenue assumption based upon a review of most recent 3-year-history; an estimate of $25.99 million for FY 2022 payroll and benefits expense which ties to Table L and which is subjected to a 21% increase over 3 years in an attempt to get back to market rates of compensation and to reduce excessive employee turnover; an annual interest expense which ties back to an amortization of the 2017 MHHEFA bond inclusive of funding for project construction and working capital components; and annual depreciation of acquired assets based upon capitalized interest over the construction period and estimated useful lives by asset category. The P&L projections reflect a positive operating margin in four (4) of the five (5) years presented, and a cumulative operating margin of $3.1 million over the 5-year projection (averaging 1.4% of operating revenues). The fifth and final year presented (FY 2026) reflects a $357,723 positive margin (0.7% of operating revenues). Applicant's management believes that the bottom line margin is expected to grow as a positive measure beyond the period presented as no further cost escalations for payroll are anticipated. Please note that the projections are prepared under the accrual basis of accounting. The cash projected to be generated annually by the project is $3.7 million more that the accrual based margin, due to depreciation not being a cash-based expense but rather an allocation of historical cost previously spent.

Staff has reviewed the two most recently published audited financial statements of the applicant and has reconciled the operating performance of the Ellicott City operation to the consolidating presentation. A review of the most recent internally prepared quarterly consolidating financial statements (March 31, 2021) reflects the Obligated Group, inclusive of Sheppard Pratt Health System, Inc., which in turn includes the present operations at Ellicott City, scheduled to move to the Elkridge location this month (June 2021). The balance sheet reflects cash balances of $42.0 million, current assets of $76.3 million, and total assets of $600.7 million with net assets (equity) of $339.6 million. The number of day's cash on hand to fund cash basis operating expenses calculates to 382 days, as compared to its debt covenant of 100 days. The ratio of debt to assets is 28%, and the ratio of debt to equity is 49%, both reflecting relatively healthy measures. The debt service coverage ratio is calculated at 2.61 as compared to the covenant of 1.1. The debt financing this Elkridge project is the 2017 MHHEFA bonds that are included in the above measures. Thus, in general terms, the balance sheet resources are not excessively burdened with debt, and the cash resources are more than sufficient to fund all present operations.

You have requested that HSCRC staff opine on the financial feasibility of the 85-bed psychiatric hospital project proposed by Sheppard Pratt. Based upon review of the history of audited financial statements, and the most recent internally prepared financial statements, staff is comfortable that the applicant has sufficient working capital to maintain the operation from its inception throughout at least five years after the completion and full occupancy of the project; that such use of its working capital does not put at risk the financial position of the applicant ; and that the project can achieve a positive operating margin at least two to five years after project completion and full occupancy. We base the opinion on sufficient competent evidence as submitted by the applicant in the initial CON application and the ongoing discussions of the HSCRC with management. At this time, based upon review of all the submitted materials, staff is of the opinion that this project is financially feasible.