maryland
health services
cost review commission

Memo

To: Wynee Hawk, Chief, CON, MHCC
William Chan, Program Manager, 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: May 4, 2023

Re: Adventist HealthCare, Inc., Shady Grove Medical Center – Patient Tower
Request for Opinion on Financial Viability – Post Approval Project Change

This memo is in response to your letter dated April 3, 2023, as amended April 10, 2023, requesting our opinion on the financial viability of the proposed project taking into consideration cost escalations and the potential for rate adjustments.

BACKGROUND

On April 15, 2021, Adventist HealthCare (AHC) Shady Grove Medical Center (SGMC or the Hospital) received an approved Certificate of Need (CON) from the Maryland Health Care Commission (MHCC) to construct a six-floor patient care tower with 150,352 square feet (SF) of inpatient service space, and renovation of 25,696 SF of existing hospital building space at a then estimated project cost of $180,011,359. The approval was subject to the condition that "any future change to the financing of this project involving adjustments in rates set by the Health Services Cost Review Commission (HSCRC or Commission) must exclude $21,226,090, which includes the estimated new construction costs that exceed the Marshall Valuation Service (MVS) guideline cost and portions of the contingency allowance and inflation allowance that are based on the excess construction cost."

On September 15, 2022, SGMC submitted a written request notifying the MHCC that while the design of the proposed patient tower had not changed, the cost of the proposed project had increased primarily due to inflationary pressures and volatile market conditions which were exacerbated by the COVID-19 pandemic and its impact on the labor market and the global supply chain. SGMC further stated that the project cost also increased because of the need to implement extensive upgrades to the central utility plant (CUP). As a result, SGMC stated

that the cost for the patient tower had increased significantly to $247,657,497, an increase of $67,646,138 (or approximately 37.6 percent) above that approved.

On April 3, 2023, the MHCC advised the HSCRC that any future change to the financing of this project involving adjustments in rates set by the HSCRC must exclude $52,410,234, which included the estimated new construction costs that exceeded the MVS guideline cost and portions of the contingency allowance and inflation allowance that were based on the excess construction cost. The MVS cost exclusion was approximately 21.2 percent of the revised project cost. On April 10, 2023, the MHCC advised the HSCRC that they had revised the MVS exclusion to $49,968,605.

On November 23, 2022, the HSCRC received a request from SGMC to withdraw its Partial Rate Application (PRA) dated March 11, 2022, and to submit a revised PRA for capital reflective of the increased cost of the patient tower project. The Hospital requested gross capital funding in the amount of $10,077,575 as part of the Commission's capital funding policy, to be effective August 1, 2026, an approximate 2 percent increase to SGMC's permanent revenue. The rate increase of $10,077,575 requested by SGMC for capital was represented to be entirely related to regulated services and eligible for financing.

THE PROJECT

As per the initial CON application, the project was to consist of approximately 150,352 SF of new construction and about 25,696 SF of renovation. The applicant was to complete the proposed project in 60 months, in two phases after signing the construction contract. Phase one included constructing the new patient tower and was to require an extended period of 36 months for completion. Phase two included renovating the current ED space and the areas on each floor that are to connect to the new patient tower, such renovations were to be completed over a 24-month period. The key features of the project include:

- Vertical stacking of clinical units to maximize clinical efficiency.
- Adding forty-eight private medical/surgical rooms and converting the remaining inpatient semi-private rooms to all private medical/surgical rooms
- Relocating and replacing the emergency department
- Replacing the existing 18-bed semi-private Clinical Decision Unit (CDU) (a.k.a. observation) with a new 20-bed private room CDU
- Replacing the 26 ICU beds/rooms with a new, appropriately sized unit
- Relocating of the Cardiovascular and Interventional Radiology (CVIR) unit to space adjacent to the perioperative services
- Relocating the helipad to the roof of the new addition

The total cost of the project was initially to be approximately $180,011,359, with about $168,214,984 for the new construction and renovations for the patient tower and about $11,796,375 for an upgrade to the CUP. Costs were distributed as follows: $113,036,937 for construction and renovations; $42,893,526 for movable equipment, contingency allowance, and gross interest during construction; $14,682,334 for inflation allowance; and $9,398,562 for financing costs and debt service reserve fund. SGMC planned to finance the project with $9,996,359 in cash; $16,000,000 in philanthropic gifts; and $154,015,000 in authorized bonds.

The total cost of the project as amended is to be approximately $247,657,497, with about $217,486,631 for new construction and renovations for the patient tower and about $30,170,865 for an upgrade to the CUP. The amended costs, as approximated, are distributed as follows: $201,361,521 for construction and renovations; $38,526,262 for movable equipment, contingency allowance, and gross interest during construction; $6,523,187 for inflation allowance; and $1,246,527 for financing costs and debt service reserve fund. SGMC plans to finance the amended project budget with $77,642,497 in cash from operations; $16,000,000 in philanthropic gifts; and $154,015,000 in authorized bonds.

Upon review of the planning information included in the initial CON application, it was noted that the tower construction was to begin around September 2021 and was to conclude around August 2024, while the renovation of existing space was to begin immediately following the construction period and to conclude around August of 2026. Review of SGMC's recent March responses to questions indicates that the latest schedule planning reflects tower construction to have begun November 2022 and is to conclude around December 2025, while the renovation of existing space is to begin January 2026 and to conclude September 2027.

HSCRC STAFF REVIEW, DISCUSSION, AND OPINION

HSCRC staff (Staff) reviewed the audit reports of Adventist HealthCare and SGMC as of December 31, 2022, 2021, 2020, 2019, and 2018. Additionally, Staff reviewed the following: the request for project change dated September 15, 2022; the partial rate application dated November 28, 2022; SGMC's responses to questions dated March 3, 2023; and CON tables as resubmitted March 29, 2023.

As per review of the exploded view of the substantially amended project budget, as provided in the March responses, approximately $165,794,286 has been contracted with not to exceed / guaranteed maximum price (NTE/GMP) limits – that being the Tower Core Shell construction and the CUP upgrade, and approximately $81,863,210 has yet to be contracted – that being $69,856,214 for the fit out of the new hospital space and $12,006,996 for the renovation of the existing hospital space. Thus, 67% of the budget has been contracted; with 33% yet to be determined until NTE/GMP contracts are executed. Additionally, it was noted that there were no financing costs attributed to the budget value for the scope yet to be contracted, while 0.75% of the budget value contracted was attributed to financing costs.

As per review of the CON tables resubmitted in March, several observations are noteworthy. The P&L projections for 2021 through 2026 on Table G (uninflated) and Table H (inflated) are the same as they were submitted back in October 2020, save for project depreciation expense. The P&L projections for 2027 and 2028 are as they were when added to the submission back in March 2021, again save for project depreciation expense. Comparing the P&Ls for 2018 through 2022 as presented in the tables to those as presented in the audit reports, material variances were noted in line-item values, operating income, and presentation classification format. As a reasonableness check on gross patient service revenues as presented in the tables for those periods that have passed (2018 through 2022), such were compared to the rate files, and material variances were noted. The projections as submitted extend through 2028. However, the project is expected to conclude, and full operations are expected to commence around September 2027. As per instructions to the CON tables, the P&L projections were to be presented to conclude at least two

years after project completion and full occupancy. Therefore, to be compliant with the instructions, the P&L projections should run through fiscal 2029.

Table H (P&L projections inflated) as most recently submitted, reflects average annual operating income for the 6 years ended 2028 of $15.6 million (or 3.0% of operating revenues), and average cash flows from operations for the 6 years ended 2028 of $46.6 million (or 8.9% of operating revenues). The final year presented (2028) reflects operating income of $15.5 million (or 2.8% of operating revenues), and cash flow from operations of $49.3 million (or 8.9% of operating revenues).

Given the age of the SGMC projections, Staff prepared a pro forma P&L projection reflective of the values as presented in the audit reports and the rate files through 2022. The purpose of the pro forma model is not to predict operating performance by period, but rather to assist in evaluating on a macro level the impact of this project upon operating performance of the Hospital. The patient service revenues were projected beyond 2022 and were inflated at an annual rate of 2.3% consistent with SGMC's assumption, such rate was deemed reasonable. A provision for the All-Payer Reduction for TCOC Medicare Compliance was applied for a one-time adjustment of -$1,029,000 in 2023. Contra revenues were projected at 14% based upon review of the 5-year audit history. Other operating revenues were projected to remain flat, equal to the 5-year audit history average measure. Projected operating expenses were classified consistent with the audit presentation, and values reflect growth beyond 2022 at the rates equal to those reflected by line item in the SGMC Table H. Interest on project debt is a function of the MHHEFA bond amortization schedule (bonds were issued September 2021) and such is expensed on the projections following the period of construction capitalization. Projected project depreciation is expensed as the asset components are scheduled to come online, with an average project asset useful life of 27.3 years. Gross revenue projections for 2026, 2027 and 2028 reflect the potential for an award to permanent GBR for incremental capital associated with the patient tower project of $9.2 million, as anticipated to come online August 2026 in proportion to the completion and operation of the patient service spaces. The maximum award assumed was the product of the capital funding policy model and an MSV exclusion value of $49,968,605. The $9.2 million award for capital is pending review and discretionary approval by the HSCRC Commissioners at their next scheduled public meeting, May 10, 2023. The pro forma P&L projection reflects average annual operating profit for the 6 years ended 2028 of $68,000 (or 0.0% of operating revenues), which is essentially breakeven; and average cash flows from operations for the 6 years ended 2028 of $32.5 million (or 6.5% of operating revenues). The final year presented (2028) reflects operating income of $7.1 million (or 1.3% of operating revenues) and cash flow from operations of $45.2 million (or 8.6% of operating revenues).

Staff requested, but did not receive, projected balance sheets for the periods beyond 2022. Accordingly, Staff is not able to comment on projected days cash on hand to fund cash basis operating expenses, nor debt service coverage ratios for the projected operating periods through 2028.

On a high-level basis, the project budget as amended reflects cash draws of approximately $77.6 million to finance the construction. The audit report for 2022 reflects daily cash basis operating expenses for SGMC of $1.199 million, and cash and investments (net of advances) of $269.4 million. Therefore, days cash on hand in December 2022 was 225 days, and the days cash draw needed for the project was approximately

65 days. In theory, SGMC would have been left with 160 days cash after financing the project if such were to have occurred in December 2022.

Repeating the same high-level review for Adventist HealthCare while referencing the same 2022 audit report, yields daily cash basis operating expenses of $2.979 million, and cash and investments (net of advances) of $312.1 million. Therefore, days cash on hand in December 2022 was 105 days. Financing the cash draw for the project would take 26 days. In theory, AHC would have been left with 79 days cash after financing the project if such were to have occurred in December 2022.

Also given that the projected cash flow for SGMC is positive throughout the periods projected, cash is not expected to be depleted during the periods projected. However, there may very well be occasions during the periods projected when cash levels may become uncomfortably low.

Given that accrual basis losses are reflected in the pro forma P&L projections in two of the six years ended 2028, there may be times when the debt service coverage ratio may become uncomfortably modest.

Based upon the information reviewed, it appears that the project may be financially feasible at its initial launch, and it may be financially viable throughout the periods projected. However, the pro forma projections imply that operating performance may at times be uncomfortably stressed, if and when unexpected circumstances may arise to increase the challenge. There appears to be little cushion in the pro forma projections, should project costs continue to rise, and if hospital operations are negatively impacted by market forces. Also, it will be particularly important for SGMC to adapt quickly to changes as they occur.