maryland
health services
cost review commission

Memorandum

To: Wynee Hawk, Director, Facilities Planning & Development, MHCC
Jeanne-Marie Gawel, Acting Chief, CON, MHCC
Moira Lawson, 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: July 14, 2023

Re: University of Maryland Shore Regional Health, Inc. (SRH)
University of Maryland Shore Health System, Inc. (SHS)
University of Maryland Shore Medical Center at Easton (SMCE)
Certificate of Need – Relocation and Construction of Replacement Hospital

This memo is in response to your communication dated May 9, 2023, requesting our review of financial projections as provided in the Certificate of Need (CON) application dated January 6, 2023, and our opinion on the financial feasibility of the proposed project.

BACKGROUND

SRH is a subsidiary of the University of Maryland Medical System (UMMS). SRH is the parent corporation of SHS, Chester River Hospital Center, Shore Medical Group, and other non-hospital entities. SHS operates SMCE, Shore Emergency Center at Cambridge (SECC), and Shore Emergency Center at Queenstown (SECQ). In addition, SHS operates several unregulated facilities in Easton, Denton, Cambridge, and Centreville.

SHS has submitted a CON application proposing to construct a 407,872 square feet (SF) 110-bed replacement hospital in Easton. SHS explained that the existing hospital, which dates in part to the early 1900's, is obsolete and located in a residential neighborhood, which limits any hospital expansion and makes accessing the hospital inconvenient for patients and staff.

The applicant filed a CON application for a similar project on the same site in 2012, but it was withdrawn in 2018 due to significant changes post docketing. The applicant again filed a CON application in 2018 for a similar project on the same site, but review was deferred at the applicant's request pre docketing.

THE PROJECT

SHS is proposing a capital expenditure of approximately $540 million to construct a six-story hospital with 110 acute care beds and 12 special hospital rehabilitation beds, as well as 25 observation beds. The hospital will also include a surgery suite with 7 operating rooms, an emergency department (ED) containing 27 treatment spaces, and 3 behavioral health holding spaces, regulated outpatient clinics, a full-service laboratory, and space for administrative and education functions.

The project's budget was assembled in November 2022 and is based upon cost estimates collected mid-2022. At this time there are no firm bids or contracts, such are to be solicited closer to the completion of the CON process. The applicant is to complete the proposed project in 36 months after signing the construction contract. The total cost of the project is approximately $540 million, with approximately $471 million for the hospital building and $69 million for the central utility plant. The hospital component budget consists of $2.5 million for the land purchase; $261.5 million for construction; $85.1 million for movable equipment, $17.0 million contingency allowance, $44.2 million for gross interest during construction; $24.6 million for other capital costs, $25.4 million for inflation allowance; and $10.7 million for financing costs. SHS plans to finance the project with $38.6 million in cash; $50 million in philanthropic gifts; $333.3 million in authorized bonds; $17.7 million on interest income from bond proceeds; and $100 million in state funds. MHCC staff notes that, to date, the state has authorized $30 million towards the project.

MHCC has stated that the utilization projections included in the CON are reasonable, and that HSCRC staff may assume that the new hospital will achieve its projected utilization volumes.

HSCRC STAFF REVIEW, DISCUSSION, and OPINION

HSCRC staff (Staff) reviewed the following materials: the SHS CON dated January 6, 2023; SHS Responses to Completeness Questions dated February 22, 2023; SHS Responses to Additional Questions dated March 21, 2023; SHS Responses to Additional Questions dated March 22, 2023; SHS Responses to Additional Questions dated April 28, 2023; UMMS presentation dated July 13, 2023, and the Independent Audit Report for UMMS for fiscal years ended June 30, 2022, and June 30, 2021.

Staff noted that the CON application (page 21) referred to the existing hospital campus and SRH's plans for convening a special study group focused on the disposition of the existing hospital site in downtown Easton. The Staff understands that the proceeds of any liquidation, should it follow the new construction, may well be material in value and would effectively lower the net cost of this project. The Table E Project Budget, as it stands currently, does not provide a credit provision against the usage cost for such value, nor does it include this potential windfall among the sources of financing. Any liquidation value realized will lower the cash drain of this project.

Staff noted that the CON application (page 56) also referred to the applicant's intent to seek an increase in rates for 50% of the incremental regulated capital costs (plus markup) associated with the proposed project. The applicant's request for rate relief is to be filed as a Full Rate Application (FRA) in the first quarter of fiscal 2024 (after July 1, 2023). The P&L projections as provided in the initial CON tables are representative of SHS and include SMCE, SECC, and SECQ. The P&L projections include an estimate for a requested GBR award of $24 million to result from a planned FRA, which as per Responses dated March 21st, is to be made on behalf of SMCE to be effective fiscal 2029. Staff prepared a high-level test for the reasonableness of measured incremental depreciation and interest. Acquired depreciable assets valued at $526.0 million divided by 19 years average useful life as per stated assumptions yields $27.9 million in average annual depreciation. Assumed $333.3 million in debt financing over 30-year bond life at 5% as per stated assumptions, yields $10.6 million in average annual interest. Together, interest and depreciation tally $38.5 million. A 50% request plus markup would approximate an ask of $19.25 million. A preliminary review of the capital model implies that no material capital award would result, due to the relative inefficiency of the hospital's service cost as compared to its peer group hospitals. The formula for a full rate application differs from these high-level tests. However, the projected award as included in the initial CON and the Responses may be quite optimistic, and likely overstated.

Staff noted that the CON application (page 99) referred to the format of Tables F, G and H (representing Entire Facility Statistics, P&L Uninflated and P&L Inflated, respectively) as being representative of SHS (inclusive of health care facilities in Easton, Cambridge, and Queenstown). Such a contention is based on the premise that Cambridge and Queenstown are outpatient extensions of the Easton facility. Given that each of the three (3) health care facilities that comprise SHS file separate annual reports and have separate Medicare identification numbers, and only one of the three is expected to file an FRA seeking award to fund incremental capital related operating costs, Staff requested stand-alone P&L projections for SMCE, in addition to the consolidated projections for SHS.

Staff noted that the P&Ls for SHS labeled as "Actual" for FY 2021 and FY 2022 and as reflected in the initial CON Tables G and H (with operating income of $25,090,000 and $30,787,000, respectively) did not tie to the P&Ls for those same periods as reflected in the audited consolidating financial statements (with operating income of $47,657,000 and $55,157,000, respectively). The Tables were corrected and resubmitted as part of the February 22nd responses. In addition, the February 22nd Responses note (page 26) that SHS is composed of SMCE, SECC and SECQ, while SRH is composed of SHS, Chester River Hospital Center in Chestertown, Shore Medical Group, and other non-hospital entities. Additionally, and consistent with the Responses dated March 21st, it should be noted that SHS's operating performance as presented in the audit report is inclusive of allocations of the operating results of the Shore Medical Group. Allocations of the losses incurred by the physician group are not included in the projections.

Staff has noted recently reported project cost escalations on other hospitals' capital projects related to delayed and extended construction schedules owing to the global supply chain interruptions, employment issues, and economic price inflation related to the continuing impacts of the COVID-19 pandemic. Staff recently assisted in studying a request for a post approval project change related to a 38% project budget cost increase and a year-long construction delay on the Shady Grove patient tower project, and Staff has been requested to assist on a post approval project change related to a 37% project budget cost increase on the UMMC Greenebaum Cancer Center. Staff notes that such cost escalations make budget provisions

for contingencies and inflation very important, and potentially result in changes to any Marshall Valuation Service (MVS) exclusion measure. As per the March 21st Responses, the construction phase on this project is estimated to conclude in the summer of 2028. And the project budget is based upon cost estimates received in mid-2022, not bids or contracts. That implies a 6-year span of exposure. As per the February 22nd Responses, the budget provision for contingencies is 7% of construction costs, and the provision for inflation is 5.75% of capital costs. Together, these provisions provide approximately $48.2 million in cushion for budget cost overruns.

The Table E Project Budget included in the initial CON reflects sources of funds to include $100 million from state grants. Such value was based upon former Governor Hogan's budget proposal. Currently the commitment from the state stands at $30 million. As per the February 22nd Responses, if the shortage were to be covered by increases in bond financing, it would imply a $4.70 increase in annual interest and a $0.60 increase in annual depreciation for every $100 increase in borrowing. Accordingly, it follows that $70 million in added borrowing would push approximately $3.29 million in annual interest and $0.42 million in annual depreciation. As per the April 28th Responses, SRH expects to work with the current administration, Governor Moore, to lobby for more funding.

The Table E Project Budget included in the initial CON reflects sources of funds to include $50 million from philanthropy. As per the February 22nd Responses, approximately $7 million to $10 million sits with the Memorial Hospital Foundation (MHF) as restricted funds. As per the March 21st Responses, the timeline for securing pledges is the end of the construction phase of the project (summer 2028). Should pledges fall short of the goal, then SRH plans to tap into MHF unrestricted funds and additional borrowing.

Staff tested the reasonableness of the P&L implications of the project budget components. The high-level tests of average annual depreciation expense ($27,961,000), capitalized interest during construction ($49,999,000), interest expense by year following construction ($15,694,000 in 2029), and interest income on bond proceeds ($17,646,000) resulted in immaterial variances, and therefore such are judged to be reasonable.

Staff noted cumulative projected "performance improvements" of $15.3 million are spread between 2024 and 2027. As per the March 21st Responses, these performance improvements are related to efficiencies to be achieved in payroll expense ($8 million due to agency normalization and staffing demand in patient care centers); supplies expense ($7 million due to 340B drug savings and inventory management); and purchased services expense ($0.3 million due to repairs and maintenance savings). Staff has noted that such performance improvements are anticipated to be achieved at the existing facility now that the pandemic has concluded and prior to the planned opening of the new facility in 2029. Staff takes caution that to the extent that such performance improvements are not realized, such may represent negative cushion in the projections.

Staff prepared a pro forma presentation of Table G - P&L Uninflated for entire facilities of applicant SHS, with revenues reflective of review of the 2023 rate file, adjustments (-$610,012) for All Payer Reduction for TCOC Medicare Compliance, a $0 award in 2029 for incremental capital expense, 0.05% annual rate increases as per Table G assumptions; and expenses reflective of $15.3 million performance

improvements as submitted per the March 21st Responses. Average annual operating loss for the four (4) years ended 2032 was -$17.0 million. The average annual net loss for that 4-year post opening period was -$1.8 million. And average annual cash flow from operations for the 4 years was a positive $26.1 million.

Staff prepared a pro forma presentation of Table H – P&L Inflated for entire facilities of applicant SHS, with revenues reflective of review of the 2023 rate file, adjustments (-$610,012) for All Payer Reduction for TCOC Medicare Compliance, a $0 award in 2029 for incremental capital expense, 2.55% annual rate increases as per Table H assumptions; and expenses reflective of $15.3 million performance improvements as submitted per the March 21st Responses. Average annual operating loss for the four (4) years ended 2032 was -$14.3 million. The average annual net income for that 4-year post opening period was +$3.3 million. And average annual cash flow from operations for the 4 years was a positive $28.8 million.

Staff prepared a pro forma presentation of Table J (or Alternate Table G) – P&L Uninflated for new facility SMCE, with revenues reflective of review of the 2023 rate file, adjustments (-$558,978) for All Payer Reduction for TCOC Medicare Compliance, a $0 award in 2029 for incremental capital expense, 0.05% annual rate increases as per Table G assumptions; and expenses reflective of $15.3 million performance improvements as submitted per the March 21st Responses. Average annual operating loss for the four (4) years ended 2032 was -$10.8 million. The average annual net income for that 4-year post opening period was +$4.4 million. And average annual cash flow from operations for the 4 years was a positive $30.8 million.

Staff prepared a pro forma presentation of Table K (or alternate Table H) – P&L Inflated for new facility SMCE, with revenues reflective of review of the 2023 rate file, adjustments (-$558,978) for All Payer Reduction for TCOC Medicare Compliance, a $0 award in 2029 for incremental capital expense, 2.55% annual rate increases as per Table H assumptions; and expenses reflective of $15.3 million performance improvements as submitted per the March 21st Responses. Average annual operating loss for the four (4) years ended 2032 was -$6.6 million. The average annual net income for that 4-year post opening period was +$10.3 million. And the average annual cash flow from operations for the 4 years was a positive $35.1 million.

Staff requested, but did not receive, projected balance sheets for SHS and SMCE for the periods beyond 2022. Thus, 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 2032. However, given that the projected cash flow for SHS and SMCE is positive throughout the periods projected, cash is not expected to be depleted during the periods projected. Also, given that accrual basis losses are reflected in all four of the pro forma tables discussed above, there may be times when the debt service coverage ratios for SHS and SMCE may become uncomfortably modest.

As per the March 21st Responses, the obligated group for debt service for any bonds issued (anticipating $333.3 million MHHEFA bonds expected to be issued around October 2025) to finance the project is UMMS, inclusive of all thirteen (13) obligated group members. As per review of the audit report for 2022, UMMS had $1.7 billion in cash, equivalents, and unrestricted investments at June 30, 2022. Cash

basis operating expenses per day were $12.7 million, and that implies days' cash on hand to fund cash basis expenses of 132 days. The cash planned to fund this project is $38.6 million which equals three (3) days' cash supply. At June 30, 2022, the Debt Service Coverage Ratio (DSCR) for UMMS was approximately 1.92:1 (EBITDA of $307,507,000 / Debt Service of $159,544,000). If the planned debt for this project were assumed at June 30, 2022, then the pro forma DSCR for UMMS would have been approximately 1.70:1 (based on a debt service increase of $21,683,205).

Based upon review of the materials submitted, it is the opinion of Staff that launching this project *may* be financially feasible, and that this project *may* be viable on an ongoing basis. The financial feasibility of this project is dependent on a number of factors described in this report. Specifically, the applicant's management will need to work towards realizing the potential of several challenges presented here: to maximize the potential liquidation value of the current campus; to realize greater efficiencies in operating the hospital services as compared to its peer hospitals; to realize the performance improvements assumed in the projections; to minimize potential cost overruns on the project budget; and to maximize fund raising both philanthropic and governmental.