

Memorandum

To: Wynee Hawk, Chief, CON, MHCC
Jeanne Marie Gawel, 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 19, 2022

Re: Laurel Freestanding Medical Facility – Project Change
Request for Comments on Application for Post Approval Project Change

This memo is in response to your request dated May 10, 2022, regarding an Amended Request for Post-Approval Project Change in the matter of the conversion of University of Maryland Laurel Regional Hospital to a Free-Standing Medical Facility. The review and analysis of this request were delayed due to incomplete applicant information, which was not made fully complete and received in total by the HSCRC staff until July 15, 2022.

BACKGROUND

As stated in the above noted request, on September 20, 2018, the Maryland Health Care Commission (MHCC) granted an exemption from Certificate of Need (CON) authorizing University of Maryland Capital Region Health (UMCRH) to convert University of Maryland Laurel Regional Hospital (UMLRH) to a freestanding medical facility (FMF) operating as The University of Maryland Laurel Medical Center (UMLMC). On April 21, 2022, UMCRH filed an Amended Request for Post-Approval Project Change (Amended Request) to the CON exemption that was first issued September 20, 2018. MHCC has requested HSCRC's staff to comment on the following statement on page 7 of the Project Change: "The presentations of projected revenue in Tables H and K reflect the approved GBR for UMCRH in total and UMLMC specifically. The GBR is projected to increase with the HSCRC annual update factors, shared savings, demographic adjustments, and other adjustments consistent with the HSCRC payment policies." Additionally, MHCC has requested HSCRC to review and comment on any other aspects of this application pertinent to this Amended Request.

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THE PROJECT

As stated in the above noted letter, this project was of two phases. The FMF was originally to be located in the hospital building (Phase 1), and then moved to a new building on the southwestern side of the campus (Phase 2). When the new building was complete, the existing hospital building was to be repurposed or demolished. The FMF was approved for a host of outpatient services including, emergency, observation, diagnostic, imaging, outpatient surgery, behavioral health, primary care, and wound care. Phase 1 was completed in January 2019; Phase 2 remains under construction. The approved Phase 2 building was to have two floors totaling 75,855 square feet (S.F.). The total approved cost of the project was \$53.1 million.

UMCRH now requests that the MHCC approve an \$18,152,814 increase (35%) in the project, bringing the total capital cost estimate from \$52,222,000 to \$70,500,669. UMCRH is also requesting to make changes to the physical plant design of the Phase 2 building by increasing the square footage by 7,888 S.F. in order to house a community room, more outpatient services (Wound Care Center), more physician specialty clinic space, and shell space for additional clinics in future expansions.

In addition, UMCRH states that although the new FMF building is expected to bolster utilization of the emergency department as an emergency department with ancillary services, the new FMF is projected to have operational losses that will be absorbed through the profits of UMCRH in order for the FMF to be cost-effective. UMCRH included Table H showing it is projected (through 2027) to have a positive operating income after adding back in depreciation (a non-cash expenditure).

HSCRC STAFF REVIEW, DISCUSSION, AND OPINION

HSCRC Staff (Staff) reviewed the Amended Request for Post-Approval Project Change. The Amended Request included Table E Project Budget, which reflected the as-approved budget for the hospital building of \$53.1M and the as-amended budget of \$71.58M for an increase of \$18.48M or 34.8%. The as-approved budget for an interim location was dropped from the Amended Request. The increased budget was due to the increase in size of the proposed facility (\$2.4M), inflated construction cost (\$5.2M), site preparation and professional fees (\$3.7M), moveable equipment (\$5.2M), interest during construction (\$3.3M), and a reduction in the inflation allowance (-\$1.3M). The Amended Request also included Exhibit 3, a review of the physical plant design. The as-approved project was to consist of two (2) stories with 75,855 S.F., the as-amended project will remain two (2) stories but with 83,743 S.F., an increase of 7,888 S.F. or 10.4%. The project is expected to be completed and operational by January 1, 2023.

Staff also reviewed Tables I, J, K, and L included in the Amended Request, which are presented as being reflective of UMLMC. Table I Statistical Projections shows that total outpatient visits (OPVs) are projected to grow from 17,988 visits in 2021, to 21,324 visits in 2023 (first year of new operations), and to further grow to 23,227 visits in 2027 (two years after reaching full occupancy). Note that volumes reported to HSCRC for 2019 (pre-pandemic) were 27,307 visits (that is emergency plus same day surgery plus clinic), 23,103 visits in 2020, 18,038 visits in 2021, and 20,166 visits in 2022 (that is annualized FYTD May). The computed compounded average annual growth rate on projected OPVs between 2022 and 2027 is 2.4%, which Staff judges to be a reasonable assumption.

Table L Workforce reflects FTEs for UMLMC: 2023 is projected to be 169.6 FTEs, and 2027 is projected to be 172.6 FTEs. The annual report filed with HSCRC for 2021 reflects 173.1 FTEs. These projections appear to be reasonable relative to recent reporting.

Table J P&L Uninflated reflects projected negative operating margins for UMLMC averaging -\$4.5M or -14.3% of net operating revenues. This is reported to be inclusive of allocating 10% of UMCRRH's projected operating expense performance improvements that are posted to Contractual Services – this would equate to approximately \$1M per year in 2024 through 2027, or an average savings of \$0.8M per year over the five years projected.

Table K P&L Inflated for UMLMC reflects projected negative operating margins averaging -\$4.3M over the five years projected, or -12.7% of net operating revenues. Again, this is presented net of planned performance improvements. Cash basis operating margin is projected to be negative, averaging -\$1.5M over the five years projected, or -4.5% of net operating revenues. The UMLMC is projected to lose \$7.7M in cash over the five years projected. Staff compared the top line revenue projections included in Table K with in-house staff prepared projections based upon research of the UMLMC rate file and HSCRC policy methodologies. The initially prepared Table K revenue projections average \$41.65M per year. On July 15th, Staff received a revised Table K, coupled with revised assumptions from representatives of UMCRRH, which reflected an average top line patient service revenue of \$41.867M per year over the five years projected. Staff is satisfied that the revised Table K (attached) is consistent with HSCRC policies. The revised operating margin is projected to be an average loss of -\$4.17M, and an average cash basis operating margin of -\$1.372M. Given that operating expenses may be understated by an average of \$0.8M per year (counting performance improvements before they have been realized), the bottom-line operating margin for the UMLMC may be close (within \$0.8M per year) to being projected fairly. The revised Table K projects that in 2027, four and a half years after its planned opening, and two years after reaching full occupancy, UMLMC will lose \$3.3M on its operation, with a cash burn of \$0.2M.

Staff also reviewed the Tables F, G, and H included in the Amended Request, which are presented as being reflective of UMCRRH. UMCRRH is inclusive of UMCRRMC, UMLMC, UM ED at Bowie, and UMCRRH Medical Group. Table F Statistical Projections reflects Inpatient days (IPDs) projected to grow from 55,505 IPDs in 2021 to 57,133 IPDs in 2023 (first year of new operations) and to further grow to 64,304 IPDs in 2027 (two years after reaching full occupancy). Staff compared the IPDs on Table F to prior period annual filings and found the reported IPDs within 1.4% of that filed. The computed compounded average growth rate for IPDs between 2022 and 2027 is 1.5%. Staff judges this assumption to be reasonable. Also, Table F reflects Outpatient Visits (OPVs) projected to grow from 77,500 visits in 2021, to 90,583 visits in 2023, and to further grow to 98,050 visits in 2027. The OPVs reported in annual filings to HSCRC for UMCRRH (inclusive of IP ED visits at UMCRRMC) is 98,353 visits for 2020, 77,909 visits for 2021, and 82,650 visits for 2022 (note 2022 is annualized FYTD May). The first-year projection for 2023 of 90,583 visits represents an increase of 9.6% over the prior year actual. The computed compound average annual growth rate for OPVs between 2022 actual and 2027 projected is 3.5%, which staff judges to be an optimistic but reasonable assumption to return to pre-pandemic volumes.

Table G P&L Uninflated for UMCRRH reflects projected negative operating margin of an average -\$8.5M per year over the five years projected, or -2.2% of net operating revenues. Again, this is presented net of planned performance improvements, which are posted to Contractual Services on the P&L. As per the reported assumptions for the Table G, performance improvements totaling \$40.2M are planned for the four years ending 2027 (or an average of \$8M per year over the 5-year projection), with 2024 having the greatest savings of \$18.2M, and 2027 having the least savings of \$4.5M. Ten percent of the savings are presented as attributed to UMLMC. According to Table 3 of the responses dated June 29, 2022, performance improvements are composed of \$8.5M in denials improvements, \$6M in agency staffing improvements, \$5M in market share revenues adjustments, \$3M in CRH Medical Group performance improvements, \$2M in productivity improvements, \$1M in School of Medicine contract improvements, and \$0.8M in Reduction in Force, to subtotal to \$26.3M in targeted improvements, with an additional \$13.9M in as yet undefined actions to total \$40.2M. Staff is concerned that performance improvements of this magnitude are netted in this presentation given the newness of various facilities and operations: UMCRRM, the Cancer Center, and UMLMC are new. It may be an aggressive assumption that \$40.2M can be saved over the projected five-year term - counting savings before realized.

Table H P&L Inflated for UMCRRH reflects projected negative operating margins averaging -\$2.4M over the five years projected, or -0.6% of net operating revenues. Again, this is presented as net of planned operating performance improvements. Cash basis operating margin is presented as positive, averaging \$38.3M over the five years projected. Given planned performance improvements total \$40.2M of which \$13.9M is yet undefined, Staff is concerned that there is the potential that both operating margins and cash flow operating margins may be overly optimistic or even materially overstated. Staff compared the top line revenue projections included in Table H with in-house staff prepared projections based upon research of the UMCRRH related rate files and HSCRC policy methodologies. The initially prepared Table H revenue projections average \$518.2M per year. On July 15th, Staff received a revised Table H coupled with revised assumptions from representatives of UMCRRH, which reflected average top line patient service revenues of \$518.37M over the 5 years projected, which is the result of rolling up the UMLMC changes reflected on the revised Table K. Staff is satisfied that the revised Table H (attached) is consistent with HSCRC policies. The as-revised operating margin is projected to be an average loss of -\$2.2M per year over the five years projected. The cash basis margin is projected to be an average of \$39M. Given that operating expenses may be understated by an average of \$8M per year (counting performance improvements before they have been realized), the bottom-line operating margin for the UMCRRH P&L projections as reflected in Table H may be overstated by \$8M on average over the 5-year projection. Therefore, the annual cash basis margin projected in Table H may also be \$8M overstated over each of the five years projected. The revised Table H projects that in 2027 UMCRRH will earn \$9.7M on its combined operations and create \$48M in cash.

In conclusion and in response to your specific request that Staff comment on the statement made on page 7 of the Project Change, Staff believes that projected top line revenues for UMCRRH over the five years projected ending with 2027 are fairly stated as presented in the revised Table H, and that top line revenues for UMLMC over the five years projected ending with 2027 are fairly stated as presented in revised Table K. Staff notes, however, the caution detailed above, that the performance improvement plan presented by the applicant may be optimistic or overstated, thereby places additional financial strain on low or negative projected operating margins.

Table H – Key Financial Projection Assumptions for UM Capital Region Health (Includes HSCRC Annual Update Factors & Expense Inflation)	
Projection is based on the Capital Region Health (CRH) FY2022 budgeted financial performance with assumptions identified below	
Projection period reflects FY2023 – FY2027	
Volumes	— See Table F of the application for volume projections
Patient Revenue <ul style="list-style-type: none"> ● FY2023 Adjustments to Permanent Revenue <ul style="list-style-type: none"> ○ Inflation — 2.53% ○ Shared Savings — -0.25% included in financial projection for UM CRMC ○ Demographic Adjustment — 0.02% ○ Other Rates — -1.92% — Total 0.38% ○ UM LMC expects to charge up to its approved GBR in FY2023 which includes \$4.6M not charged in FY2022 ● FY2024+ Adjustments to Permanent Revenue <ul style="list-style-type: none"> ○ Inflation — 2.58% ○ Shared Savings — -0.26% ○ Demographic Adjustment — 0.02% — Total 2.34% ● Revenue Deductions — 23.9% of gross revenue per year 	
Other Revenue <ul style="list-style-type: none"> ● Grants <ul style="list-style-type: none"> ○ State — \$10M in annual support from FY2022 - FY2027 ● Other Operating Revenue — 2% annual growth 	
Expenses <ul style="list-style-type: none"> ● Inflation <ul style="list-style-type: none"> ○ Salaries & Benefits — 2.0% ○ Professional Fees — 3.0% ○ Supplies - Drugs — 4.0% ○ Supplies - Medical & Other — 3.0% ○ Purchased Services — 2.0% ○ Insurance & Other — 2.0% Operating Expenses 	
<ul style="list-style-type: none"> ● Expense variability with volume changes <ul style="list-style-type: none"> ○ Salaries & Benefits — 20% ○ Professional Fees — 50% ○ Supplies - Drugs — 30% ○ Supplies - Medical & Other — 20% ○ Purchased Services — 0% ○ Insurance & Other — 0% Operating Expenses ● Interest Expense <ul style="list-style-type: none"> ○ Existing Debt — UM CRH has existing debt of \$275.9M in FY2022 that is amortized ○ Project Debt — In mid-FY2023, the new Laurel FMF will open and interest expense on \$55.5M of tax-exempt debt associated with these facilities will be recorded at an interest rate of 4.5% ● Depreciation and Amortization <ul style="list-style-type: none"> ○ Existing Depreciation — Reflects the depreciation of existing assets with useful lives ranging from 5 to 30 years ○ Project Depreciation — Reflects a half-year of depreciation in FY2023 associated with the opening of the Laurel FMF, with a project budget of \$71.6M and a useful life of 25 years ● Performance Improvements <ul style="list-style-type: none"> ○ FY2023 — \$0 ○ FY2024 — \$18.2M ○ FY2025 — \$28.9M ○ FY2026 — \$35.7M ○ FY2027 — \$40.2M ○ Identified Improvements by FY2027 <ul style="list-style-type: none"> — \$10M - Denials improvement — \$5M - Reduction in force — \$3M - Medical Group improvement — \$6M - Agency improvement — \$2M - Productivity — \$5M - Market share revenue adjustments — \$1M - School of Medicine contract improvement — \$8.2M - Undefined Actions 	

Table K – Key Financial Projection Assumptions for UM Laurel Medical Center (Includes HSCRC Annual Update Factors & Expense Inflation)

Projection is based on the UM Laurel Medical Center FY2023 budgeted revenues and FY2022 budgeted expenses with assumptions identified below

Projection period reflects FY2023 – FY2027

Volumes	— See Table I of the application for volume projections
Patient Revenue <ul style="list-style-type: none"> ● FY2023 Adjustments to Permanent Revenue <ul style="list-style-type: none"> ○ Inflation — 3.76% ○ Demographic Adjustment — 0.01% ○ Market Shift — -3.50% ○ Change in Markup — 1.18% — Total <u>1.45%</u> ○ UM LMC expects to charge up to its approved GBR in FY2023 which includes \$4.6M not charged in FY2022 ● FY2024+ Adjustments to Permanent Revenue <ul style="list-style-type: none"> ○ Inflation — 2.58% ○ Demographic Adjustment — 0.02% — Total <u>2.60%</u> ● Revenue Deductions — 20% of gross revenue per year 	
Other Revenue <ul style="list-style-type: none"> ● Grants <ul style="list-style-type: none"> ○ State — \$1M state grant each year ● Other Operating Revenue — 2% annual growth 	
Expenses <ul style="list-style-type: none"> ● Inflation <ul style="list-style-type: none"> ○ Salaries & Benefits — 2.25% ○ Professional Fees — 3.0% ○ Supplies - Drugs — 4.0% ○ Supplies - Medical & Other — 3.0% ○ Purchased Services — 2.0% ○ Insurance & Other — 2.0% Operating Expenses ● Expense variability with volume changes <ul style="list-style-type: none"> ○ Salaries & Benefits — 20% ○ Professional Fees — 50% ○ Supplies - Drugs — 75% ○ Supplies - Medical & Other — 75% ○ Purchased Services — 0% ○ Insurance & Other — 50% Operating Expenses ● Interest Expense <ul style="list-style-type: none"> ○ Existing Debt — Laurel has little existing debt and related interest expense ○ Project Debt — In mid-FY2023, the new Laurel FMF will open and interest expense on \$55.5M of tax-exempt debt associated with these facilities will be recorded at an interest rate of 4.5% ● Depreciation and Amortization — Reflects a half-year of depreciation in FY2023 associated with the opening of the Laurel FMF, with a project budget of \$71.6M and a useful life of 25 years ● Performance Improvements — 10% of UM CRH annual performance improvements are allocated to Laurel FMF 	