## Constantino, Mike

**From:** Ourth, Joe [JOurth@arnstein.com]
**Sent:** Thursday, June 02, 2011 10:41 AM
**To:** Constantino, Mike
**Subject:** Safety Net Impact Statement Response - Centegra Hospital - Huntley (Project No. 10-089)
**Attachments:** 0641_001.pdf

Mike,

We wish to file the attached Safety Net Impact Statement Response in connection with the above referenced hospital. Hard copy will follow.


## Joe Ourth

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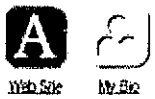


Offices in Illinois, Florida, and Wisconsin< P>


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Joe Ourth
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June 2, 2011

VIA Electronic Mail
and Federal Express

Mr. Dale Galassie
Chair
Illinois Health Facilities and Services
Review Board
525 W. Jefferson
Springfield, IL 62761

Re: Safety Net Impact Statement Response
Mercy Crystal Lake Hospital
Project No. 10-089

Dear Chairman Galassie:

Sherman Hospital, St. Alexius Medical Center, and Advocate Good Shepherd Hospital wish to submit the enclosed Safety Net Impact Response Statement to the project referenced above. By separate cover we will also be submitting a detailed Market Assessment and Impact Study of the proposed Mercy Crystal Lake Hospital project. As you know, the new provisions of the Planning Act invite response to Safety Net Impact Statement submitted by an Applicant. We believe the information contained in this report shows the significant and serious impact the proposed hospital will have on existing hospitals and their ability to provide Safety Net Services.

Very truly yours,

Joe Ourth

JRO:eka
Enclosures

# Safety Net Impact Statement Response

## MERCY CRYSTAL LAKE HOSPITAL AND MEDICAL CENTER PROJECT NO. 10-089

Thursday, June 2, 2011

ShermanHealth
Every life, every moment, every day

Advocate
Good Shepherd Hospital
Inspiring medicine. Changing lives.

St. Alexius Medical Center
A Healthy Community Begins with Alexian Brothers.

# Safety Net Impact Statement Response
# Mercy Crystal Lake Hospital and Medical Center
# (Project No. 10-089)

## TABLE OF CONTENTS

# Safety Net Impact Statement Response

# Safety Net Impact Statement Response
# Mercy Crystal Lake Hospital (Project No. 10-089)

Pursuant to Section 5.4(f) of the Illinois Health Facilities Planning Act, Sherman Hospital, St. Alexius Medical Center, and Advocate Good Shepherd Hospital (collectively, the "Concerned Hospitals") submit the following Safety Net Impact Statement Response to Mercy Crystal Lake Hospital and Medical Center, Inc. and Mercy Alliance, Inc. (collectively, "Mercy" or the "Applicants") proposal to establish a 128-bed acute care hospital to be located in Crystal Lake, Illinois. As discussed in greater detail below, the proposed hospital will negatively impact safety net services and existing safety net service providers in the area.

## Public Act 96-0031 – Safety Net Requirements

In 2009, the Illinois General Assembly substantively amended the Illinois Health Facilities Planning Act (the "Amended Planning Act") (Public Act 96-0031). One key change of the Amended Planning Act is the requirement that an applicant for a permit submit a Safety Net Impact Statement detailing the impact its project will have on Safety Net Services. Additionally, the Amended Planning Act invites any person, community organization, provider, health system or entity to respond to the applicant's submission.

In accordance with Section 5.4(f) of the Amended Planning Act, we hereby submit our Safety Net Impact Statement Response for the Health Facilities and Services Review Board's ("Review Board's") consideration.

## Requirement of Safety Net Impact Statement

To ensure the impact on any Safety Net Services would be considered as part of any application for a permit, the General Assembly included a requirement in the Amended Planning Act that an applicant evaluate the impact its new project would have on other providers' ability to cross-subsidize safety net services to the community. Specifically, an applicant must address the following criteria:

> (1) The project's material impact, if any, on essential safety net services in the community, to the extent that it is feasible for an applicant to have such knowledge.
>
> (2) The project's impact on the ability of another provider or health care system to cross-subsidize safety net services, if reasonably known to the applicant.

2009 Ill. Health Facilities Planning Act Amendments, Pub. Act 096-0031 (codified as amended at 20 Ill. Comp. Stat. 3960/5.4).

In their permit application for Mercy Crystal Lake Hospital, the Applicants include a Safety Net Impact Statement;[1] however, the Safety Net Impact Statement is skeletal at best. More importantly, Mercy did not even attempt to address section (c)(2) above (impact on other providers), despite the fact that their application makes clear that the new hospitals takes thousands of patients from existing hospitals.

In an attempt to show that its proposed hospital could reach target utilization, Mercy provided numerous letters from its affiliated physicians to show the number of referrals that the physicians would make to the proposed Crystal Lake hospital. In those letters the physicians quantified the number of referrals that would be taken from existing providers. According to their own application, Mercy states that it will take almost 4,000 discharges from existing hospitals. Clearly there is significant, and serious, impact to existing providers. More importantly, the number of discharges referenced in the letters would be far short of the number of patients necessary to meet target utilization for a new hospital. Either the proposed hospital will not achieve required utilization or the impact on other providers will be far worse than even the Applicant admits.

Given that the Applicants provided no indication as to how other providers would be impacted by the project, the Concerned Hospitals commissioned Krentz Consulting to quantify the impact of a new Crystal Lake hospital and the Concerned Hospitals' ability to provide safety net services to their communities. The result, as discussed further below, is that net revenue for existing area hospitals would decrease by $144.4 million annually and combined contribution margin by $51.5 million.[2] These losses severely impact the ability of Concerned Hospitals to continue to provide needed Safety Net Services.

Krentz Consulting performed an extensive analysis of the health care delivery in the market area proposed for the Mercy Crystal Lake Hospital – Mercy Crystal Lake market area. The analysis is submitted to the Review Board in the report Market Assessment and Impact Study, Proposed Mercy – Crystal Lake Hospital (Project 10-089) (May 24, 2011) concurrently with this Safety Net Impact Response Statement. As part of that report, Krentz Consulting further analyzed the fiscal impact of the proposed Crystal Lake hospital in its Financial Impact Study and quantified the serious negative impact that the proposed hospital would have on existing providers as shown below:[3]

[1] Mercy Crystal Lake Hospital, Project No. 10-089, application for Permit, Attachment 43.

[2] Financial Impact Study, proposed Mercy-Crystal Lake Hospital (Project 10-089) (May 25, 2011).

[3] Id.

| | Concerned Hospitals (Advocate Good Shepherd Hospital, Sherman Health, St. Alexius Medical Center) | Other Area Hospitals (Centegra Hospital-Woodstock, Centegra Hospital-McHenry, Provena St. Joseph Hospital) | GRAND TOTAL |
|---|---|---|---|
| **Annual Inpatient Loss:** | | | |
| Lost Inpatient Discharges | 5,279 | 4,462 | 9,741 |
| Lost Net Revenue | $42.8M | $36.3M | $79.1M |
| Lost Contribution Margin | $15.5M | $12.4M | $27.9M |
| **Annual Inpatient + Outpatient Loss (adjusted by outpatient factor):** | | | |
| Lost Net Revenue | $78.2M | $66.2M | $144.4M |
| Lost Contribution Margin | $28.6M | $22.9 M | $51.5M |
| FTEs at Risk | 464 | 392 | 856 |

As the analysis from Krentz Consulting shows, the proposed new hospital clearly reduces hospital volumes at existing hospitals and results in excessive beds. Professor Thomas Miller had prepared an analysis of the impact of duplication of services and his report is included as part of this Safety Net Impact Response Statement. Importantly, Professor Miller notes:

> *I am pleased to provide this letter summarizing some of the economic issues related to the development and entry of a new hospital in a market currently served by existing hospitals and health systems. From a societal perspective, the primary concerns include the cost of excess bed capacity, duplication of services, and the potential responses by hospitals to cut back on subsidized or less profitable, but needed services. Simply put, because there are both fixed and variable components of costs in the production of hospital services, entry of a hospital into an existing market can result in:*
>
> - *A net increase in the total costs of production in the local health care system which may lead to increases in premium costs and costs to taxpayers, and*
> - *A diminished ability of existing providers to leverage economies of scale from higher volumes, which would adversely impact cash flows available to cross subsidize safety net and community benefit services.*[4]

[4] Letter to Chairman Galassie from Thomas R. Miller, (Page 1) (May 11, 2011).

**Impact on Safety Net Services**

Safety Net Services are defined as "services provided by health care providers or organizations that deliver health care services to persons with barriers to mainstream health care due to lack of insurance, inability to pay, special needs, ethnic or cultural characteristics, or geographic isolation."[5] The Applicants fail to address the impact of the proposed project on Safety Net Services, fail to provide any information on the payor mix to show it provides health services to underserved populations in its geographic service area and fail to identify the needs not being met by existing providers or how their proposal will better service those groups than existing providers

**Impact of New Hospital Would Exacerbate Hospital Fiscal Environment**

A new hospital in the proposed area would compound the already challenging economic environment for hospitals. In a recent *Moody's Investors Services Report* entitled "Negative Outlooks for U.S. Not-For-Profit Healthcare Sectors Continues" analyzed the economic environment for not-for-profit healthcare and summarized its findings as follows:

> *Summary*
>
> *Moody's maintains a negative outlook for the U.S. not-for-profit healthcare industry. The leading factors driving this outlook are large federal and state budget deficits, ongoing high unemployment, and substantial uncertainty surrounding healthcare reform. For 2011, the preponderance of credit factors facing the industries is negative, and will remain so for the next several years, at least. Pressures on hospital reimbursements will remain heightened and the transition to different payment schemes will continue to stress operating revenues and net income, creating an unremitting need to reduce expense growth. The sluggish economy recovery, continuing high unemployment and thinning ranks of well-insured patients remain as unambiguous drivers of weaker financial results, manifested in softer volumes, weaker payer mix, and stress operating revenues. While the last year has seen a number of positive developments, including the improvement of balance sheets and operating results, much of this improvement resulted from comparatively easy reductions in expenses, rather than from strong revenue growth. These conditions will challenge hospital boards and management teams to revisit their model of healthcare delivery.*[6]

**Demographics of McHenry County**

McHenry County is disproportionately white, wealthy (median income of $77,314), and insured (92% adults with health care coverage); however, vulnerable populations do reside in

[5] 20 Ill. Comp. Stat. 3960/5.4(b).

[6] Moody's Investors Services, Negative Outlook for U.S. Not-for-Profit Healthcare Sectors Continues for 2011, February 3, 2011 (page 1).

McHenry County.[7] According to the 2010 McHenry County Health Community Study, 4.5% of elderly adults live in poverty, 11% of the population is Hispanic, and 8% of residents are uninsured.[8] Moreover, access to health care for Medicaid recipients and the uninsured have been cited by McHenry County health officials as issues that need to be addressed by the County.[9] The need for affordable and accessible health care is particularly pronounced among the low-income senior, Hispanic, and low income populations who often face socio-economic barriers to health care. However, the Applicants put forth no strategic plan to maintain and enhance the provision of health care services targeted toward these vulnerable populations nor identify unmet needs not addressed by existing providers.

**Applicants Argument for Safety Net Services**

While the Applicants briefly touched on some points relating to indigent care during the March 18, 2011 public hearing, the testimony submitted only marginally addressed the proposal's impact on the safety net or the continued ability of existing providers to cross-subsidize safety net services. As evidence of the Applicants' provision of safety net services to the community, Mr. Javon Bea, President and CEO of Mercy Health System, pointed to Mercy Harvard Hospital.[10] While Harvard is one of the poorer areas in McHenry County, Harvard is not within the proposed hospital's geographic service area.[11] Moreover, the amount of Medicaid and charity care provided at Mercy Harvard Hospital is insignificant compared to the charity care provided by other existing providers within the proposed hospital's geographic service area.

Additionally, Mr. Dan Colby, Vice President, Mercy Health System, testified that the proposed hospital will be located at the epicenter of Planning Area A-10, where the greatest number of safety net patients in the county resides.[12] Importantly, the greatest percentages of low income, Hispanic, and African-American populations in the proposed hospital's geographic service area do not reside near the proposed hospital, but rather in Carpentersville and Elgin in Kane County.[13] The Concerned Hospitals are as close, or much closer to the areas with the highest number of low income, Hispanic and African-American populations in the proposed hospital's service area.

Moreover, these areas where a disproportionately larger number of vulnerable populations reside are better served by the existing hospitals in the geographic service area.

---

[7] KRISTEN HARRISON, M.P.H., 2010 MCHENRY COUNTY HEALTHY COMMUNITY STUDY, COMMUNITY ANALYSIS 19, 82, 180 (2011); HEALTH SYS. RESEARCH, UNIV. OF ILL., COLL. OF MED. AT ROCKFORD, 2010 MCHENRY COUNTY HEALTHY COMMUNITY STUDY, EXECUTIVE SUMMARY PRIORITIES AND REPORT OF KEY FINDINGS 33 (2011).

[8] Id. at 19, 83, 180.

[9] HEALTH SYS. RESEARCH, UNIV. OF ILL., COLL. OF MED. AT ROCKFORD, 2010 MCHENRY COUNTY HEALTHY COMMUNITY STUDY FOCUS GROUPS 6 (2011).

[10] Transcript of Project #10-089, Mercy Crystal Lake Hospital & Medical Center, Inc. at 9.

[11] Mercy Crystal Lake Hospital & Medical Center, Inc., Application for Permit at 96.

[12] Transcript of Project #10-089, Mercy Crystal Lake Hospital & Medical Center, Inc. at 19.

[13] Harvard, the area with the highest percentage of low-income (19.7%) and Hispanic (35.2%) residents is not in Mercy Crystal Lake Hospital and Medical Center's proposed geographic service area.

Residents in the proposed hospital's geographic service area already have access to hospitals and need access to outpatient services, wellness care, and community services. According to the 2010 McHenry County Health Community Study, residents found availability of health care services to be one of the positive characteristics of living in McHenry County;[14] however, access to health care services for Medicaid recipients and the uninsured was identified as a significant problem. Increased access to affordable medical, dental, vision and prescription services for Medicaid recipients, uninsured individuals and senior citizens were also cited as issues that need to be addressed by several focus groups.[15]

Increasing access to affordable outpatient services is a more appropriate use of scarce health care resources rather than establishing a new hospital. In fact, due to the rising cost of health care, many residents do not receive preventative care and present to hospital emergency departments when they have serious illnesses or conditions.[16] Successful primary care programs, such as Family Health Partnership Clinic and Greater Elgin Family Care Center, are critical in lowering the rate of costly hospitalizations. Timely and effective outpatient care is integral to reducing hospitalizations and improving overall health status associated with ambulatory care sensitive conditions like hypertension, diabetes complications, bacterial pneumonia, COPD, and congestive heart failure. Primary care programs are integral in cost-effective treatment of these conditions as they take the underserved out of emergency departments, ameliorating these conditions before they become life threatening and require hospitalization. Approval of the proposed hospital will impair the ability of existing safety net providers to serve vulnerable populations by increasing the cost of services provided by safety net providers without adding safety net services that aren't already available or serving populations that do not have access to health care.

Advocate Health System serves as a safety net for many who are medically indigent. Within the Advocate System, Good Shepherd is one of the hospitals that provides resources for Advocate to fulfill its mission and provide care to those in need. Many of these services are provided in areas of much higher need for indigent care than the service area proposed in Huntley such as Advocate Trinity in Chicago (37% of inpatients are Medicaid or charity care) or Advocate-Illinois Masonic in Chicago (32% of inpatients are Medicaid or charity care). To put it simply, the revenues earned in a community like Barrington assist Advocate in maintaining its inner city services.

St. Alexius Medical Center in Hoffman Estates is a Disproportionate Share hospital that serves a large number of medically uninsured or underinsured residents. Overall, more than 20% of St. Alexius patients are Medicaid recipients, more than 50% of all Obstetrics patients are on Medicaid. The new patient tower recently approved by the Illinois Health Facilities and Services Review Board will be dedicated to pediatrics. Our estimates are that more than 60% of those

[14] HEALTH SYS. RESEARCH, UNIV. OF ILL., COLL. OF MED. AT ROCKFORD, 2010 MCHENRY COUNTY HEALTHY COMMUNITY STUDY, EXECUTIVE SUMMARY PRIORITIES AND REPORT OF KEY FINDINGS 30 (2011).

[15] HEALTH SYS. RESEARCH, UNIV. OF ILL., COLL. OF MED. AT ROCKFORD, 2010 MCHENRY COUNTY HEALTHY COMMUNITY STUDY FOCUS GROUPS 16 (2011).

[16] Id. at 26.

patients will be Medicaid recipients. Our ability to serve these patients depends on our ability maintain our patient volumes as were expected in the initial application.

**Impact on Safety Net Providers**

Establishing a new hospital in an area well-served by existing providers will not improve access to safety net services, rather it will draw patient volumes away from existing providers, weakening the safety net. As detailed in the report from Krentz Consulting, if the Mercy Crystal Lake hospital goes forward, annual discharges of all existing hospitals in the geographic service area would fall by 9,700 when cases are shifted to the new hospital. As a result, total net revenue of all existing hospitals would decrease by $144 million and the combined contribution margins would fall by $51 million.[17] With shrinking margins, it will become more difficult to maintain, much less expand, vital safety net health services in the community. In fact, many programs may be curtailed or eliminated altogether.

**Impact on Sherman**

As set forth in its 2010 Community Benefit Report, Sherman provided approximately $3 million in charity care; $41.5 million in unreimbursed care to Medicare, Medicaid, and other government-sponsored health care program beneficiaries; $500,000 in subsidized health care services; and $400,000 in language assistance services. Additionally, Sherman is actively involved in health initiatives in the community, such as the Women's Organization for Wellness ("WOW"), Activate Elgin, Community Crisis Center, and SafeKids. Importantly, providers, like Sherman, receive little to no reimbursement for these vital safety net services; funding for these programs comes from hospitals' contribution margins, i.e., profit from operations.

If the proposed hospital is approved, Sherman projects its annual discharges would decrease by over 2,000. Total net revenue (inpatient and outpatient) is projected to fall by approximately $26.8 million and Sherman's contribution margin would be down by $4.7 million.

With specific regard to obstetrics services, a new hospital will adversely impact Sherman's ability to provide obstetrics services to the underserved. Approximately 60% of Sherman's patients in its obstetrics service line are Medicaid recipients. Total payments received from Medicaid for obstetrics and normal newborn cases is approximately $4 million annually, total operating expenses attributed to these cases is approximately $6.2 million annually, for an annual contribution margin loss on Medicaid cases of $2.2 million or a contribution margin loss per Medicaid case of $1,268. If the proposed hospital is approved, Sherman would lose 16% of its commercial obstetrics cases, or approximately $1.2 million in net revenue, which is vital to subsidizing the obstetrics service line. As a result, Sherman may have to curtail obstetrics services or scale back or eliminate other services to the community to subsidize the obstetrics service line.

[17] Financial Impact Study, Proposed Mercy-Crystal Lake Hospital (Project 10-089) (May 25, 2011).

**Impact on Good Shepherd**

Advocate Good Shepherd Hospital is part of the Advocate Health Care system which provided over $450 million dollars in community benefit contributions in 2009, according to Advocate's most recently published Community Benefit report. Of the total $450 million dollars, $360 million dollars was for charity care and other uncompensated costs, $26 million dollars was for subsidized health services and $2.5 million dollars was for language assistance services. It is often revenues from a community like Barrington that allow Advocate to provide Safety Net Services in other communities where there is great need for indigent care.

Advocate is actively involved in the community and offers free or subsidized services for key vulnerable populations. Examples include: school-based health centers for students from low income neighborhoods, primary care services for uninsured and underinsured patients, Ronald McDonald Care Mobile which offers physicals and vaccinations and services at community health fairs, HIV screening services, diabetes health fair for Hispanic residents, flu shots for seniors, dental van, diabetes lifestyle program, teen suicide prevention, fall prevention program for seniors and many free screening programs for diseases such as asthma and diabetes. Advocate is the largest provider of trauma care in the state and provides 20% of the trauma care in the metropolitan Chicago area.

Advocate Good Shepherd provides free screening programs to the community including: skin cancer screening, prostate screening and cardiac screening. Other free community programs offered through Advocate-Good Shepherd include childhood obesity in area schools, Care Track to monitor dementia and Alzheimer's patients who tend to wander, and heart screening for high school students.

**Impact on St. Alexius**

St. Alexius Medical Center is part of the Alexian Brothers Hospital Network. As detailed in the Alexian Brothers Hospital Network 2009 Community Benefits Plan Report, the Network provided over $7 million (at cost) in charity care to the community. Approximately 50% ($7,026,412) of this charity care was provided directly by St. Alexius. The Network provided just under $65 million in unreimbursed care to Medicare and Medicaid, with St. Alexius providing approximately 23% of these services to the community.

In 2009, St. Alexius alone provided over $1.3 million in subsidized health services (equaling approximately 69% of the Network's total expenditures for subsidized health services), $767,000 in education services and just over $700,000 in other community benefits, including cancer outreach and support programs, senior citizen support services, health life publications, diagnostic testing, community health assessment programs, emergency medical services, interfaith parish support services and transportation services.

In 2007, St. Alexius Medical Center recommended the hiring of a Community Outreach Program Director, a full time position that assists uninsured and underinsured persons to find a medical home, serve as a community resource for referral to other healthcare services and to respond to the healthcare concerns of the community as they develop. The program was

launched in 2008 and has been a great success. Hundreds of persons have been connected with primary care providers, community mental health centers and other social service agencies. These are the kinds of services that truly help the community and would be in danger if cutbacks had to occur.

St. Alexius provides a significant amount of the Network's charity care and other subsidized services to the community. The approval of the proposed hospital would significantly and negatively impact St. Alexius' revenue, which in turn, would have the unfortunate effect of reducing the level of safety net services St. Alexian would be able to provide to the community.

**Conclusion**

Importantly, the proposed hospital will not enhance safety net services in the geographic service area. In fact, the proposed hospital will significantly impact the Applicants' own ability to fund safety net services. The increased debt will reduce the Applicants' ability to fund safety net services in the community as they must commit more financial resources to debt service for the new hospital. Moreover, the Applicants failed to provide a strategic plan to maintain and enhance safety net services in the geographic service area. Accordingly, there is no evidence that the proposed hospital will improve access to safety net services. To the contrary, the proposed hospital will impair existing providers' ability to provide safety net services.

The proposed Mercy Crystal Lake hospital will significantly affect the ability of existing hospitals to provide safety net services. Most importantly, it will seriously affect the patients who rely on the existing hospitals to receive safety net services.

Respectfully,

Sherman Hospital
St. Alexius Medical Center
Advocate Good Shepherd Hospital

9614213.4

# Financial Impact Study

# Financial Impact Study

## Proposed Mercy-Crystal Lake Hospital (Project 10-089)

May 25, 2011

KRENTZ
CONSULTING

KRENTZ
CONSULTING

Krentz Consulting LLC is pleased to provide this independent *Financial Impact Study* in response to Mercy Health System's request for Certificate of Need approval (Project 10-089) to build a new hospital in Crystal Lake in Illinois Health Planning Area A-10 (McHenry County).

Krentz Consulting LLC
Krentz Consulting LLC

25 May 2011
Date

**About Krentz Consulting LLC**

Krentz Consulting LLC is a management consulting firm providing strategic planning services to the health care industry, including community hospitals, health systems, academic medical centers and medical schools, children's hospitals, and industry and professional associations. Krentz Consulting is nationally recognized for its strategic planning expertise, frequently serving as faculty at educational programs and writing articles for national publications.

**Susanna E. Krentz**, President of Krentz Consulting, has over twenty-nine years experience as a health care consultant and oversaw the process and reviewed all analyses for this project. As a recognized leader in strategy development for health care organizations, she has worked with numerous hospitals and health care systems across the country in the development of strategic plans, physician strategy, growth plans, resource allocation, and competitive strategy. She has a Master of Business Administration from the Booth School of Business, University of Chicago and a Bachelor of Arts from Yale University.

**Tracey L. Camp**, Senior Consultant, has 25 years of experience in health care planning and strategy and provided the analytical support for this project. Her areas of expertise include strategic planning, service line planning and demand modeling, medical staff development studies, and market research. She is expert at converting data into meaningful information to support decision making. She has a Bachelor of Arts from Northwestern University.

# Financial Impact Study
# Proposed Mercy-Crystal Lake Hospital (Project 10-089)

## Table of Contents

# I. Executive Summary

## Executive Summary

1. The proposed new Mercy-Crystal Lake Hospital is estimated to result in annual lost net revenue of $78.2 million and annual lost contribution margin of $28.6 million for Advocate Good Shepherd Hospital, Sherman Hospital, and St. Alexius Medical Center combined (the Concerned Hospitals).

    - Including an estimate of the financial impact on three additional area hospitals, Centegra Hospital-Woodstock, Centegra Hospital-McHenry, and Provena St. Joseph Hospital, increases the estimated annual lost net revenue to $144.4 million and the estimated annual lost contribution margin to $51.5 million.

2. The estimated loss of inpatient and outpatient volume at the three Concerned Hospitals is estimated to place the jobs of 464 FTEs at risk.

    - Including an estimate of the jobs at risk at three additional area hospitals, Centegra Hospital-Woodstock, Centegra Hospital-McHenry, and Provena St. Joseph Hospital, brings the total FTEs at risk to 856.

3. The volume lost by the three Concerned Hospitals will be disproportionately commercially insured compared to the overall patients served by these Hospitals, resulting in an increase in the proportion of their patients covered by Medicaid or no insurance.

4. The estimated loss of revenue and contribution margin resulting from the addition of the proposed new Mercy-Crystal Lake Hospital will challenge the capacity of the Concerned Hospitals to:

    - Cross-subsidize safety net and other community benefit services
    - Continue to offer services with poor financial performance
    - Meet debt obligations
    - Support expanded access, e.g., evening or weekend hours or off-site locations

# I. Estimated Financial Impact

## Background

Krentz Consulting was commissioned by Advocate Good Shepherd Hospital, Sherman Health, and St. Alexius Medical Center (the "Concerned Hospitals") to provide an independent assessment of the financial impact of a new Mercy-Crystal Lake Hospital (Project 10-089) in Planning Area A-10. The proposed project is seeking approval to add 128 beds including 100 medical/surgical, 20 obstetric, and 8 intensive care beds. This *Financial Impact Study* estimates the financial impact on the Concerned Hospitals as well as on three additional hospitals serving the Planning Area including Centegra Hospital-Woodstock, Centegra Hospital-McHenry, and Provena St. Joseph Hospital in Elgin (the "Other Area Hospitals").

## Estimated Financial Impact

Using the methodology described in Section III, we estimate that a new Mercy-Crystal Lake Hospital would result in a reduction of over 5,000 inpatient discharges at the Concerned Hospitals and an annual inpatient and outpatient loss of over $78 million in net revenue and over $28 million in lost contribution margin. The estimated loss of inpatient and outpatient volume at the Concerned Hospitals would also place the jobs of over 460 FTEs at risk.

Adding in the estimated utilization impact of the Other Area Hospitals increased the estimated lost inpatient discharges to over 9,700 with an estimated annual inpatient and outpatient loss of over $144 million in net revenue and over $51 million in contribution margin. The FTEs at risk for Other Area Hospitals was estimated to be 392, bringing the total FTEs at risk for all area hospitals to over 850.

| | **Concerned Hospitals** (Advocate Good Shepherd Hospital, Sherman Health, St. Alexius Medical Center) | **Other Area Hospitals** (Centegra Hospital-Woodstock, Centegra Hospital-McHenry, Provena St. Joseph Hospital) | **GRAND TOTAL** |
|---|---|---|---|
| **Annual Inpatient Loss:** | | | |
| Lost Inpatient Discharges | 5,279 | 4,462 | 9,741 |
| Lost Net Revenue | $42.8M | $36.3M | $79.1M |
| Lost Contribution Margin | $15.5M | $12.4M | $27.9M |
| **Annual Inpatient + Outpatient Loss (adjusted by outpatient factor):** | | | |
| Lost Net Revenue | $78.2M | $66.2M | $144.4M |
| Lost Contribution Margin | $28.6M | $22.9M | $51.5M |
| FTEs at Risk | 464 | 392 | 856 |

Because Mercy-Crystal Lake will be geographically more proximate to the economically most attractive areas of the region, the volume that the Concerned Hospitals are estimated to lose from those markets would have an adverse effect on the Concerned Hospitals' overall payer mix. A new Mercy-Crystal Lake hospital would capture a high percentage of commercial patients, reducing the Concerned Hospitals' percentage of volume that is commercially insured and increasing their proportion of Medicaid/self-pay patients. This loss of commercially-insured patients is particularly problematic for obstetric services, where the Concerned Hospitals' proportion of discharges that are Medicaid/self-pay would increase by eight percent.

**Impact of Losing Volume to Mercy-Crystal Lake on Payer Mix of Concerned Hospitals**

| Payer | Concerned Hospitals 2010 Total Actual Payer Mix of Discharges | Mercy-Crystal Lake's Payer Mix of Estimated Volume Shifted from Concerned Hospitals |
|---|---|---|
| **Medical/Surgical Discharges** | | |
| Commercial/HMO | 38.6% | 46.8% |
| Medicare | 47.8% | 43.0% |
| Medicaid/Self-Pay/Other | 13.6% | 10.2% |
| **TOTAL** | **100.0%** | **100.0%** |
| | | |
| **Obstetric Discharges** | | |
| Commercial/HMO | 57.5% | 80.6% |
| Medicare | 0.3% | 0.3% |
| Medicaid/Self-Pay/Other | 42.2% | 19.1% |
| **TOTAL** | **100.0%** | **100.0%** |

Source: COMPdata, 9 months calendar year 2010 data for all inpatient discharges excluding all neonatal, psychiatry/substance abuse, and rehabilitation patients. Assumptions of lost volume were applied consistently across all payers for the patients currently treated at each of the Concerned Hospitals.

# III. Overview of Methodology

## Overview of Methodology

Krentz Consulting first modeled the impact that the proposed Mercy-Crystal Lake Hospital would have on the utilization of existing hospitals. We completed a detailed impact analysis for the three Concerned Hospitals by service line, level of acuity, and payer class using the methodology described below. We also modeled the overall utilization impact on Other Area Hospitals. Once the utilization impact on the Concerned and Other Area Hospitals was quantified, we estimated the financial impact of that lost volume.

### Impact on Utilization

The volume impact was quantified using actual inpatient discharges being treated at existing hospitals in 2010 for patients residing in Mercy-Crystal Lake Hospital's proposed service area. Mercy-Crystal Lake Hospital's proposed service area was segmented into sub-geographies with which to judge current and expected patient migration patterns. Discharges for inpatients residing in the sub-geographies were grouped into service lines, levels of acuity, and payer class using publicly available information obtained by COMPdata for the first nine months of calendar 2010[1]. The service line definitions and levels of acuity were defined by Krentz Consulting using the Centers for Medicare and Medicaid Services' MS-DRGs which distinguish cases by their level of severity. For each sub-geography, assumptions of volume loss were made by service line and level of acuity for each of the Concerned Hospitals. It was assumed that the Concerned Hospitals would lose a higher proportion of their lower acuity cases but a lower proportion of their highest acuity cases originating from Mercy-Crystal Lake Hospital's proposed service area. The utilization impact was also modeled for the Other Area Hospitals by applying overall assumptions of volume loss by sub-geography for medical, surgical, OB, and neonatal services.

[1] Based on analysis of inpatient data from Illinois COMPdata. Excludes normal newborn, psychiatry, substance abuse, and rehabilitation inpatients (psychiatry, substance abuse, and rehabilitation are not included in Applicant's proposed bed complement).

## Financial Impact on Existing Hospitals

Once the potential lost inpatient volume for 2010 was calculated for each of the Concerned Hospitals, the financial impact on net revenue and contribution margin[1] was estimated by multiplying each hospital's current inpatient net revenue and contribution margin per case (by service line, level of acuity, and payer category) by the potential lost volume. Contribution margin is an appropriate measure to judge the financial impact of lost volume because it quantifies the amount of money available to cover the fixed costs of an enterprise that can't be eliminated (like buildings and fixed staffing) when volume declines. Any loss of volume-driven contribution margin means that the fixed costs of an enterprise will have to be spread across a smaller patient base and may compromise a hospital's financial health or require an increase in prices.

A new Mercy-Crystal Lake Hospital will shift both inpatient and outpatient volume. To estimate the impact of potential lost outpatient volume at the Concerned Hospitals, we increased the potential lost inpatient net revenue and contribution margin by each hospital's current outpatient factor [the outpatient factor reflects each hospital's proportion of outpatient activity and is determined by dividing a hospital's total gross revenue by its inpatient gross revenue]. Since we did not have proprietary financial information for the Other Area Hospitals, we estimated their financial impact by applying the average lost net revenue and contribution margin per case estimated for the Concerned Hospitals to the Other Area Hospitals' estimated lost volume. Lastly, we estimated the potential full-time equivalent (FTE) employees that would be at risk at each of the Concerned Hospitals by multiplying the potential lost inpatient average daily census (adjusted to reflect their proportion of outpatient activity) by their current staffing ratio (FTEs per adjusted patient day). The FTEs at risk for Other Area Hospitals was estimated by applying their potential lost inpatient discharges by the same ratio of FTEs at risk per lost discharge to be experienced by the Concerned Hospitals.

[1] Contribution margin represents the amount of revenue gained after covering the variable operating expenses of care delivery. A positive contribution margin in a service helps offset the fixed infrastructure costs of an enterprise (such as buildings) as well as under- or uncompensated care. Different hospitals have different approaches for defining contribution margin: two of the Concerned Hospitals defined contribution margin as Net Revenue minus Total Direct Expenses (both Fixed and Variable) while the third Concerned Hospital defined contribution margin as Net Revenue minus Total Variable Costs (both Direct and Indirect).

# Economic Analyses Letter

TRM
PRETIUM

May 11, 2011

Mr. Dale Galassie
Chair
Illinois Health Facilities and Services Review Board
525 W. Jefferson, 2nd Floor
Springfield, IL 62761

Dear Mr. Galassie:

Advocate Good Shepherd Hospital, Sherman Health, and St. Alexius Medical Center are currently assessing the impact of two McHenry County proposals for new hospitals; one in Huntley, Illinois which is proposed by Centegra Health System (HFSRB Project 10-090) and one in Crystal Lake, Illinois proposed by Mercy Health System (HSFRB Project 10-089). I am pleased to provide this letter summarizing some of the economic issues related to the development and entry of a new hospital in a market currently served by existing hospitals and health systems. From a societal perspective, the primary concerns include the cost of excess bed capacity, duplication of services, and the potential responses by hospitals to cut back on subsidized or less profitable, but needed services. Simply put, because there are both fixed and variable components of costs in the production of hospital services, entry of a hospital into an existing market can result in:

- A net increase in the total costs of production in the local health care system which may lead to increases in premium costs and costs to taxpayers, and
- A diminished ability of existing providers to leverage economies of scale from higher volumes, which would adversely impact cash flows available to cross subsidize safety net and community benefit services.

**Cost of Excess Bed Capacity**

Economists have analyzed the costs of excess bed capacity for more than 20 years; and estimates have ranged from $4,400 to $92,000 (in 1987 dollars). The differences in the estimates reflected differences in time periods covered, hospital samples, cost estimation methods, and local market conditions.[1] Gaynor and Anderson's annual cost estimate of $36,443 per empty bed is cited most often because of the rigor of the statistical analysis and the sample size.[2] This figure reflects 1987 dollars. Based on changes in the consumer price index for *hospital and related services* between 1987 and 2010, the $36,443 estimate equates to $168,280 in 2010.[3] Of course, some level of available bed capacity is required to ensure patient access during periods of peak demand for inpatient services. The cost of an empty bed, therefore, also reflects the level of benefit required of hospital reservation capacity (e.g., the value of not turning away patients).

**Economies of Scale**

The cost of excess bed capacity results, in part, from the fixed costs of having bed capacity paired with the inability to take advantage of scale economies. Economies of scale exist if the average cost of producing a product or service declines as the volume of production increases. Therefore, excess capacity and duplication of services are problematic from a cost perspective if they preclude established organizations from taking advantages of economies of scale. ***Empirical evidence suggests that hospital mergers of all sizes benefited from economies of scale, primarily involving technology relying on expensive capital equipment.[4-5] Therefore, transferring business out of a hospital diminishes that hospital's ability to leverage high volumes and economies of scale to drive lower average costs.***

**Manpower Implications**

Economies of scale, as discussed above, are possible because, as with many industries, hospitals' cost structures reflect fixed and variable components. This fixed and variable behavior is especially true for labor-related costs in hospitals. The actual impact on area employment depends on these cost characteristics. For example, if staffing were 100% variable, the net manpower effect of a new market entry would be minimal, simply reflecting the transaction costs associated with hiring and firing employees. There would be essentially a transfer of employees from one hospital or hospitals to the new hospital, assuming similar rates of productivity and compensation. On the other hand, if staffing were 100% fixed, the result would be a substantial increase in costs and staffing. Hospital costs are of course somewhere in-between, but they tend to be more fixed than variable.[6-8]

Therefore, typical estimates of increases in the workforce resulting from a new hospital may overstate the amount of net new employees in the area. Some duplication of fixed staffing and costs will occur; while variable labor will be, in effect, shifted from one organization to another based on volume. The ability of existing hospitals to operationally leverage their fixed staffing also will be reduced, resulting in higher average costs.

**Duplication of Services**

Excess bed capacity and the availability of more beds in an area may induce excess demand or result in the provision of unnecessary services.[9] ***A similar concern surrounds the duplication of services which can result from a new hospital entering a market. Often, competition among hospitals takes the form of non-price competition for community-based physicians through the acquisition of expensive clinical technology and facilities.[10]*** This in turn results in equipment and facilities being operated at less than optimal volume levels, mitigating the provider's ability to reduce costs through potential economies of scale. Furthermore, a "medical arms race"[11-13] and oversupply of physicians in a defined service area also raise concerns of physician-induced demand[14] and the provision of unnecessary services along with the associated costs.

**Hospital Responses to Higher Average Costs**

Excess capacity and unwarranted duplication of services, therefore, result in additional aggregate costs. These additional costs negatively impact hospital margins and typically engender an operating response by hospital management. Responses may include cost shifting[15] to place the burden on non-governmental payers (e.g., self-insured employers). Those payers that base even a portion of their payments on a provider's costs would necessarily see an increase in the amounts they pay.

Of course, hospitals have some ability to reduce staffing, variable costs, and potentially some fixed costs as their volume declines due to the new market entry. ***However, as noted previously, this strategy has limits as average costs cannot be reduced or reduced commensurate with declines in volume. More likely, hospital responses may include cutting back on discretionary services that are least profitable and substantially subsidized, even though they represent safety net services or serve a community need. In addition, with less available funds, providers may directly or indirectly reduce the amount of uncompensated care provided.***[16]

**Economic Impact Analyses**

Throughout the country, states and local governments have developed economic impact analyses that show tremendous gains to local area economies that would accrue from building a new hospital. These analyses include the impact of new construction and the jobs created, the impact of the additional employees estimated using economic impact multipliers, and the impact of incremental state income and sales taxes.[a]

Although impressive economic gains can be reported, there are two primary limitations of these analyses. First, most do not consider whether the employment represents net new employees to the area or simply a transfer among area hospitals. Second, there is typically no consideration of who bears the cost of the new hospital. If the new hospital services are not "needed," then the excess capital costs and labor costs, in long run, will be borne by private and public entities.

Suppose the state or federal government hired 500 persons to dig a giant hole and refill it, numerous times. A typical economic impact analysis would show tremendous economic gains to the region because there would be more employment and more money to the community via the multiplier effects and taxes. Although this example is hyperbole, it illustrates that the validity of an economic impact analysis, from a societal perspective, depends in part on whether the additional hospital and services are, in fact, "needed." ***Therefore, the determination of need and who ultimately bears the cost are important criteria in evaluating the merits of a new hospital in an established service area.***

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[a] For example, see impact factors available through https://www.bea.gov/regional/rims/ and http://implan.com/V4/Index.php; and a typical tax benefit analysis in the Iowa Hospital Association *Economic Impact of the Health Sector*, January 2010.

**Conclusion**

*Cost*, *quality*, and *access* are known as the Iron Triangle of health care and health policy.[17] The goal of this letter was to provide some insight regarding relevant cost implications of building a new hospital in a service area which may result in excess bed capacity and duplication of resources. Although access may be enhanced for some patients, from a policy perspective, it is necessary to balance the needs of competition and accessibility against the substantial savings from preventing excess capacity.

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I appreciate the opportunity to provide this information and my perspectives. Please do not hesitate to contact me if you have any questions or require additional information. I can be reached at (979) 458.0831, trmiller@tamhsc.edu, or at the phone and email listed on the first page.

Sincerely,

Thomas R. Miller, PhD, MBA
President, TRM Pretium

Assistant Professor
Department of Health Policy and Management
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# Exhibit

*HuntleyPatch*:
Hospital Debate Focuses
on Charitable Care

*HuntleyPatch*
http://huntley.patch.com/articles/hospital-debate-focuses-on-charitable-care

# Hospital Debate Focuses on Charitable Care

*Sherman Hospital says a new Centegra hospital in Huntley would affect how it helps the poor and uninsured.*

By Gloria Casas
March 15, 2011

The rhetoric from all the hospitals embroiled in Centegra Health System's and Mercy Health System's battle to build a hospital is confusing, but there's a key issue that could affect a final decision: how a new hospital would affect services to the uninsured and the poor.

Centegra filed an application in December with the Illinois Health Facilities and Services Review Board for a Certificate of Need to build a 128-bed hospital on its Huntley campus on Haligus Road. Mercy filed an application days later to build a similar hospital at Route 31 and Three Oaks Road in Crystal Lake.

This week, Mercy has a public hearing in Crystal Lake before representatives with the review board.

Last month, Centegra presented hours of testimony at a public hearing on its plan that drew opposition from Mercy, Sherman Hospital in Elgin, Advocate Good Shepherd Hospital in Barrington, St. Alexius Medical Center in Hoffman Estates and Provena Saint Joseph Hospital.

What Sherman, in particular, argued is the proposed Centegra-Huntley hospital would have a negative affect on safety net services.

**The safety net impact**
The term safety net refers to health care services provided to "persons with barriers to mainstream health care due to lack of insurance, inability to pay, special needs, ethnic or cultural characteristics or geographical isolation," according to Illinois statute.

A way hospitals, which in this area are all nonprofits, generate revenues to provide safety net services is through populations that have insurance, hospital officials said.

Hospitals get paid 30 cents per dollar from insured patients for inpatient care but get only 21 cents per dollar for Medicare and Medicaid patients for the same care, said Sherman Hospital CEO Rick Floyd, who recently spoke at a Kane County board meeting.

According to a recent Moody's Investors report, Medicare makes up about 43 percent of a given hospital's gross revenues but that source "is highly vulnerable to changes in Medicare reimbursements." For example, this year Medicare payment rates to hospitals were decreased from 3.5 percent to 2.1 percent and are expected to decrease next year, the company said.

"There are many residents in Kane County who don't have access to health care," Floyd said.

But Huntley and surrounding towns are more "affluent communities that makes it very attractive for health care" because there are more people who are likely to have insurance, Floyd told county board members. So, hospitals would generate more funds to help provide for charitable care.

Sherman and Provena currently provide 18 to 20 percent in public aid charity for inpatient services compared to Centegra's 9 to 12 percent, Floyd said. Sherman officials said the Elgin hospital provided $3 million in charity care and $41 million in unreimbursed Medicare and Medicaid care.

**Finding funds for charitable services**

What is being argued is that a new hospital in southern McHenry County would affect neighboring hospitals' ability to provide services to this population and thus affect the "safety net."

"If you have more competition for few paying customers, that may reduce the capability of Provena and Sherman to offer charity cases," Kane County Public Health Executive Director Paul Kuehnert said. Providing charitable assistance is the "heart of the health care system," he said. Centegra, however, maintains the safety net won't be affected by a new hospital.

"A hospital in Huntley would predominantly serve new patients, rather than taking existing patients from Sherman Hospital or Centegra's hospitals in Woodstock and McHenry," said Susan Milford, Centegra senior vice president via an e-mail interview.

"This is a unique situation," Milford said. "We are proposing our new hospital based on population growth, rather than solely the existing population. The population of the Huntley community itself grew a staggering 166 percent from 2000-2010. The community continued to grow even during the recession."

Huntley's projected growth from Claritas is 12 percent between 2010 and 2015, she said. Similar population growths, about 10 percent, are expected in Lake in the Hills and Algonquin, she said.

"Because a new Huntley hospital would not take many patients away from existing hospitals, it would not impact the safety net services those hospitals provide," Milford said.

Part of the review board's CON application includes a Safety Net Impact Statement from hospitals and can be an arguing point for hospitals opposing a CON, said Christine Priester, Sherman Hospital spokeswoman.

**A policy issue?**

The hot potato issue is landing right on Kuehnert's lap. Kane County was poised to oppose Centegra's plan and had a resolution drawn up to send to the review board.

However, board members last week tabled the motion to explore the issue within the county's Public Health committee. Kuehnert will help lead the discussion at the committee's April 12 meeting. The county board and public health committee are faced with supporting two local hospitals while trying to keep the welfare of Sun City Huntley residents in mind.

Kane County's top health care priority is providing access, Kuehnert said. A concern would be that a new McHenry County hospital would cut into the charitable services and led to decreased access for county residents, he said.

"The (Kane County) board does have to carefully consider," the issue and "may have to look at it as a policy issue," Kuehnert said.