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Malcolm Baldrige National Quality Award 2007 Award Recipient

Office of the President

June 3, 2011

Via Federal Express

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HEALTH FACILITIES & SERVICES REVIEW BOARD

Mr. Dale Gallasie
Chairman
Illinois Health Facilities Services and Review Board
525 West Jefferson Street
Second Floor
Springfield, Illinois 62761

Re: Centegra Hospital - Huntley (Project Number 10-090) (the **"Centegra Project"**).

Dear Mr. Gallasie:

I have been the President and Chief Executive Officer of Mercy Health System (**"Mercy"**) for over 21 years. Mercy has a keen understanding of the central objectives and purposes of the Illinois Health Facilities Planning Act and regulations (collectively, the **"Act"**), and when planning any development project, including its current hospital project in Crystal Lake, Mercy does its best to plan the project in a manner that fulfills as many of the Act's purposes and objectives as possible.

As you are aware, the central purposes of the Act include, among other things, developing a procedure that (i) establishes an orderly and comprehensive health care delivery system which will guarantee the availability of quality health care to the general public; (ii) considers the projected impact on health care costs by evaluating financial and economic feasibility of proposed projects; and (iii) increases the accessibility of essential health care services to the medically underserved and indigent. When considering these and the other purposes and objectives of the Act in light of the application submitted by Centegra Health System, it is clear that the Centegra Project fails to fulfill many of the Act's fundamental purposes and objectives. As such, I am writing to express Mercy's firm opposition to Centregra's application for the Centegra Project.

1. **An applicant seeking to establish a health care facility must have the financial resources to adequately provide a proper service. Approval of the Centegra Project does not meet this objective and would put Centegra Health System at considerable financial risk.**

It is vital that an organization have the financial wherewithal to absorb projects the magnitude of the Centegra Project without jeopardizing the financial stability of the organization and maintain future access to capital from the municipal bond markets. Centegra Health System currently has an A minus rating from Standard & Poors, which is weaker than Mercy's A2 stable rating from Moody's Investor's Service (see Financial Analysis attached as Exhibit A). Centegra Health System has significantly less cash reserves available for a project the magnitude of the Centegra Hospital – Huntley Project than Mercy. The Centegra Project, at $233 Million, is $33 Million more than Mercy's proposed hospital in Crystal Lake. To fund its project, Centegra Health System plans to use $48 Million of its own cash and take on an additional $185 Million in debt. Mercy plans to use $30 Million of its own cash and fund the

BBB+ rating). If that happens, Centegra Health System will be at significant risk of not being able to finance a new hospital in Huntley and will also put itself at considerable financial risk due to overly high debt-to-equity levels.

2. The Centegra Project does not help to fulfill the Act's purpose of guaranteeing the availability of quality health care to the general public.

In 2008, Centegra Health System filed an application with the Board to approve a $58 Million renovation of its Woodstock, Illinois hospital facility. In justifying its Centegra Hospital – Woodstock application, Centegra Health System certified to the Board that "doing nothing" was not an acceptable alternative to the proposed Woodstock project. "Doing nothing" would not address the access and quality of care issues that were impacting the Centegra Hospital – Woodstock facility. "Doing nothing" would not help the labor patients being held in the postpartum area of the Woodstock facility due to lack of available space, or help reduce the number of inductions Centegra Hospital – Woodstock was suspending because the units are at capacity. "Doing nothing" would not address the Woodstock facility's labor delivery recovery department operating 20 percent above capacity, which regularly result in patients being housed in recovery rooms. Finally, "doing nothing" would not help the women who Centegra Health System argued have to leave the community and travel great distances to receive care.

Yet, unfortunately for the resident of McHenry County, "doing nothing" is exactly what Centegra Health System did in Woodstock. Citing the "global financial market crisis," "changing market conditions," "uncertain financial situation"and"health care reform," less than 2 years after passionately arguing in support of the need for the Woodstock project, Centegra Health System abandoned the project (and the patients of Centegra Hospital – Woodstock in the process). One needs only to read the headlines to know that the "global financial market crisis" is not over and "market conditions" continue to be volatile. The battle over health care reform continues to rage on. In short, not much has changed since Centegra Health System abandoned the Centegra Hospital – Woodstock project. As stated above, if the Centegra Project is approved, Centegra Health System will be at significant risk of not being able to fund a new hospital in Huntley and will also put itself at considerable financial risk due to overly high debt-to-equity levels. If Centegra Health System could not afford a $58 Million project in this climate, it is highly suspect that they can afford a $233 Million project in the same or similar climate. "Doing nothing" was not an acceptable alternative in Woodstock, and the residents of McHenry County cannot run the risk of Centegra Health System "doing nothing" once again in Huntley. The residents of McHenry County need a hospital now, and the hospital project proposed by Mercy is better positioned to guarantee the availability of quality health care to the residents of southern McHenry County.

3. The Centegra Project does not help fulfill the Act's purpose of improving the financial ability of the public to obtain necessary health care services.

Although the decision to approve the Centegra Project will not be decided in an antitrust proceeding or by a competition authority, the effect of a project, including the Centegra Project, on competition is relevant to project review pursuant to the Act. In addition to the purpose of the Act stated above, among the different criteria applied to the review of a given certificate of need (**"CON"**) application is the project's expected impact on the total health care expenditures in the facility and community. As Dr. David E. Eisenstadt, Ph.D, an antitrust economist and former employee of the United States Department of Justice, Antitrust Division, concluded, "greater competition usually benefits consumers and the economy." (see Eisenstadt Testimony attached as Exhibit B). Dr. Eisenstadt also concluded that more competition normally fosters at least three beneficial effects: expanded consumer choice, the provision of higher quality goods and services, and lower costs and prices. With the exception of certain sophisticated inpatient hospital services for which there is some statistical evidence that medical outcomes are superior when that service is provided by a single entity within a locale, competition among hospitals yields benefits similar to competition in other sectors of the economy.

After extensive analysis, Dr. Eisenstadt's bottom line is simple: the Centegra Project, if approved, will result in a virtual monopoly for Centegra Health System (giving them 436 out of 461total beds in McHenry County, or 94.6%) , which, in turn will lead to increased health care costs for the residents of McHenry County. Conversely, the additional competition in McHenry County created by Mercy's proposed project (if approved) would result in price declines of up to 9 percent – thus improving the financial ability of the residents of McHenry County to obtain necessary health care services.

Further, the Centegra Project, with a total cost of $233 Million, is not the least costly alternative available to the residents of McHenry County. Mercy's proposed project, which has the same bed complement, has a total cost of $200 Million. Simply put, the 128-bed Centegra Hospital – Huntley Project in McHenry County costs $33 Million more than the 128-bed proposed Mercy project also proposed for McHenry County. Construction for the Centegra Project is not expected to commence until 2015, whereas construction for Mercy's proposed project is expected to commence in 2011. When you factor in the inflationary costs associated with the Centegra Project's significantly later start date, the $33 Million difference in project costs will likely further increase. The increased project costs of the Centegra Project will lead to higher health care costs for residents of McHenry County – thus also negatively impacting the financial ability of residents of McHenry County to obtain necessary health care services.

4. **The Centegra Project does not help to fulfill the Act's purpose of ensuring that health care services are appropriately located to best meet the needs of the population.**

The Illinois Department of Public Health (**"IDPH"**) has determined for Planning Area A-10 (McHenry County) that there is a bed need for 83 Medical-Surgical-Pediatric beds, 8 Intensive Care beds, and 27 Obstetric beds, for a total of 118 beds. If McHenry County is divided into four sub-areas, Southeast, Southwest, Central and North, nearly 93% of the inpatient beds in McHenry County are located in the Central sub-area, with a population of 113,196 or 32.2% of the total county population (see Exhibit C). As reflected on the map attached as Exhibit D, the most densely populated area of McHenry County is in Southeast McHenry County. Specifically, Huntley had an estimated population of 25,824 in 2010 while Crystal Lake had an estimated population of 62,365. Mercy's Crystal Lake Hospital and Medical Center location is in the center of the six Southeast McHenry County communities representing over 46% of the county's population; a dense but rapidly growing sub-area of close to 164,000 people (depicted on Exhibit D) which has no full-service emergency room, no hospital-based outpatient services, and no hospital beds. In contrast to Huntley, Illinois, where the rapid population growth of the last decade resulted disproportionately from the Del Webb Sun City Huntley community (an estimated 9,800 new residents between 2000 and 2010, with only 50 remaining home sites) and single family and multi-family residential construction permits have dropped from a high of 1,210 in 2003 to 107 in 2010, the Centegra Project is dependent upon ambitious and optimistic population projections, Mercy's Crystal Lake project is supported by a large, growing and dense population where there is an immediate need for a hospital.

The Mercy facility's Crystal Lake location, not the Centegra Project location, is appropriately located to best meet the needs of the existing McHenry County population, and will provide McHenry County's largest sub-area of residents in Southeast McHenry County with access to much needed hospital care.

5. **The Centegra Project does not help fulfill the Act's purpose of increasing the accessibility of essential health care services to the medically underserved and indigent.**

The Huntley area population is a more affluent patient population. Whereas, the Mercy Crystal Lake service area includes the most diverse population as well as sheer numbers of indigent residents in need of hospital access. This area also includes the largest concentration of Medicaid and Self Pay patients. Mercy's proven track record of serving the poor in Harvard is indicative of the organization's commitment to these population groups. Finally, the addition of 45 new physicians in the Crystal Lake service area will improve accessibility to health care services. This is not proposed in the Centegra application.

* * * *

Echoing the purposes and objectives of the Act, Mercy has always focused on serving the community by providing quality, affordable healthcare where it is most needed within the community. In contrast, the Centegra Project fails to further the purposes and objectives of the Act, and for this and other reasons I would respectfully urge the Board to deny the Centegra Hospital - Huntley project (Project Number 10-090). Thank you for your time and consideration.

Sincerely,

Jayon R. Bea
President and CEO
Mercy Health System

c: Courtney Avery, Administrator

EXHIBIT A
FINANCIAL ANALYSIS

Ziegler

EXHIBIT A

May 31, 2011

Financial Consultant Report Prepared For Mercy Alliance, Inc.

As it relates to the Certificate of Need Application filed by Centegra Health System (Project No. 10-090) on December 29, 2010

ZIEGLER HEALTHCARE FINANCE/INVESTMENT BANKING

I. Executive Summary

Ziegler Capital Markets has been engaged by Mercy Health Alliance (MHA) in connection with its appeal to the Certificate of Need (CON) application filed on December 29, 2010 by Centegra Hospital - Huntley and (the "Hospital") and Centegra Health System (CHS) for construction of a new hospital facility (Project No. 10-090) (the "Project"). Ziegler Capital Markets has reviewed the proposed Project as described in the CON application and assessed potential implications of the Project to CHS's financial position.

The key issues discussed in the following report and the main observations are as follows:

- **New hospital projects carry substantial short-term and long-term risks, which can materially affect the outcome of a project, and are more appropriate for providers with stronger profitability and liquidity than CHS.** Standard & Poor's (S&P) published a study on replacement hospitals titled: *U.S. Not-for-Profit Replacement Hospitals Offer Great Opportunity, But Risks Abound* discussing the risk associated with constructing a replacement hospital which is significantly similar to that of building a new hospital. In their study, the hospitals and health systems that undertook a replacement hospital project faced several key challenges associated with a constructing a new facility. The hospitals rated by S&P demonstrated strong financial performance prior to the replacement hospital project. At the time of financing, average operating margin for these hospitals was 6.9%, and the average days cash on hand was 260 days.

- **CHS will nearly double its long term debt burden likely resulting in a multi-notch downgrade of its S&P rating and a substantial increase in current and future capital costs.** The proposed $183M of new debt represents significant additional leverage for CHS. At the end of FY10, CHS's debt-to-capitalization ratio was 52%, above the A- median of 45%. Factoring in the proposed new debt, CHS will increase its leverage to a pro forma FYE 2010 debt-to-capitalization ratio of 68% which is more consistent with a non-investment grade rated provider. In fact, all but one of Centegra's seven key financial ratios on a pro forma basis will be below the respective investment grade medians.

- **Additional operating expense associated with the Project further pressures CHS's financial position.** The incremental interest and depreciation expense associated with the Project after its completion are estimated at $16.8M, assuming fixed rate debt issuance at current market rates with an overall level aggregate debt service. This amount represents approximately 4.2% of CHS's FY10 operating expense. CHS pro forma projected loss in profitability of $13.6M adversely impacts the organization's financial position and exacerbates concerns associated with a materially weaker pro forma balance sheet.

- **The physician strategy to support the project further pressures the organization's financial position.** CHS has embarked upon a strategy to increase the number of employed physicians through Centegra Primary Care, LLC (CPC) to create a larger presence in its market with particular focus in Huntley. This strategy has led to significant increase in loses at CPC which were $13.7M in FY10 and $14.8M in FY09 up from FY08 loss of $8.1M with moderate increase in utilization.

- **The approval of the CHS CON application will grant the organization a dominant market position and likely lead to higher costs for healthcare consumers.** Given a materially weaker pro forma balance sheet and a substantial increase in depreciation and interest expense associated with the Project, CHS will be pressured to leverage its dominant share and increase insured reimbursement rates pushing consumer healthcare costs materially higher.

- **Given a market characterized by higher interest rates, extremely wide credit spreads, and a dearth of viable credit enhancement, borrowing costs for CHS will increase significantly constraining the organization's ability to fund capital.** A rating downgrade and weakening balance sheet that is associated with the Project will impair CHS's ability to fund future capital improvements that are necessary to optimize the quality of care for healthcare consumers.

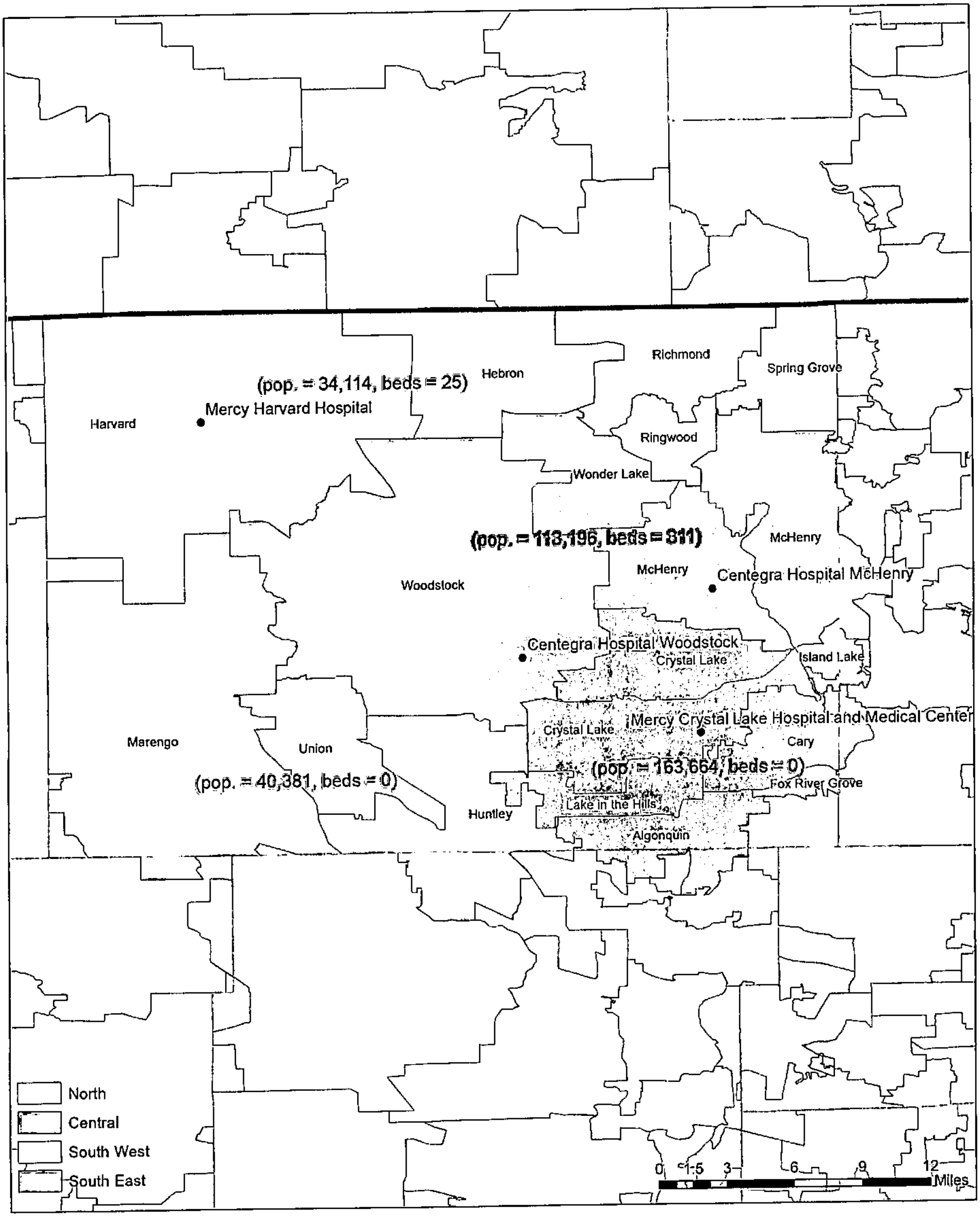
EXHIBIT B

EISENSTADT TESTIMONY
EXPECTED CENTEGRA PRICE DECLINE GIVEN
MERCY-CRYSTAL LAKE'S EXPECTED SHARE

GEOGRAPHIC AREA	EXPECTED CENTEGRA PRICE DECLINE
CENTEGRA-WOODSTOCK PSA	9 PERCENT
CENTEGRA-WOODSTOCK PSA+SSA	6 PERCENT
CENTEGRA-MCHENRY PSA	8 PERCENT
CENTEGRA-MCHENRY PSA+SSA	4 PERCENT

EXHIBIT C
MCHENRY COUNTY MAP

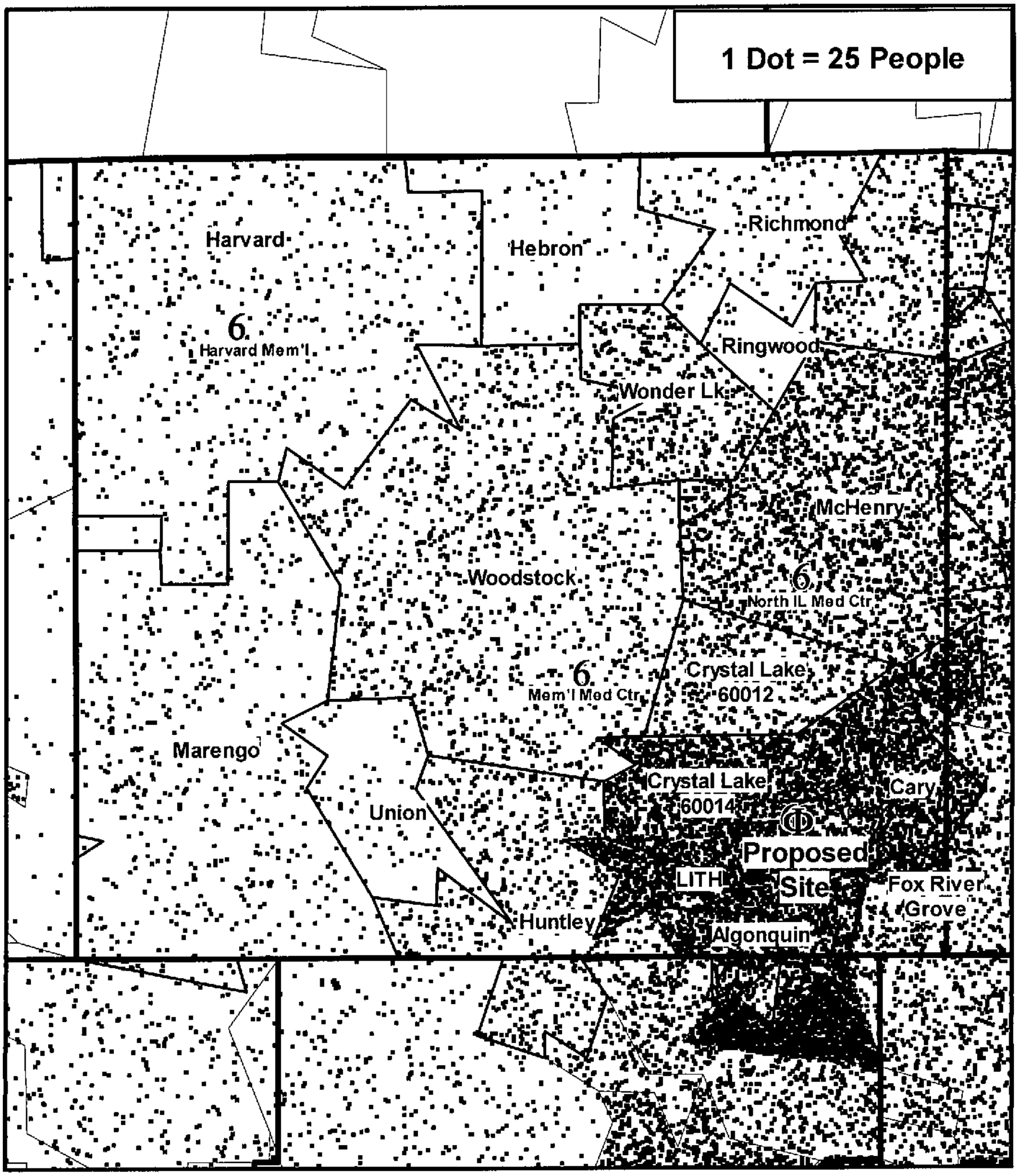
Residents and Hospital Beds in McHenry County



Sources: 2010 population figures from Claritas Nielsen, 2010 hospital bed counts from IDPH Inventory of Healthcare Facilities and Services and Need Determinations

EXHIBIT D
MCHENRY POPULATION DENSITY MAP

Population Density in McHenry County
2010 Population Estimate



Source: Nielsen Claritas, Inc., New York, NY; U.S. Census 2000