

THE BOND BUYER

THE DAILY AUTHORITY ON PUBLIC FINANCE **O N L I N E**

The Bond Buyer, December 6, 2007

Berger Commission's Cost

by Ted Phillips & Dakin Campbell

In Orange County, N.Y., plans are moving forward to build a new \$255 million hospital for the Orange Regional Medical Center. The facility, one of the few new hospitals planned in the state in the last few years, is designed to bring greater efficiency to health care services in the region.

However, it is not entirely clear how the construction will be paid for. New York has provided some initial funding, but far less than the more than \$200 million that it will cost. Though details remain scarce, it looks like the hospital itself will turn to the bond market for at least a portion of its capital financing.

The medical center is just one of the institutions singled out last year by the Commission on Health Care Facilities in the 21st Century, more commonly known as the Berger Commission. Named after Stephen Berger, who led the effort, it was created by former Gov. George Pataki and the Legislature in 2005 to restructure the state's hospital and nursing home system to address what a report called a "system in crisis."

The report, released in November 2006, recommended the closure, merger, downsizing, or reconfiguring of operations at 80 hospitals and nursing homes across the state. The recommendations became law on Jan. 1 and gave the facilities until June 2008 to comply.

The changes were intended to create greater efficiency in a system that the commission said had overcapacity and needed to focus more on primary care. Although the majority of the institutions are taking steps to comply with the recommendations, 18

filed legal challenges. Courts have so far rejected the three cases in which there have been rulings.

Berger, who is chairman of Odyssey Investment Partners LLC, a private equity investment firm, said that the process has been moving along. Creating a more efficient system was in part meant to help institutions better access the debt market.

"We were very concerned with creating an environment which over the next decade would improve the capital-raising capacity of health care institutions in this state," Berger said. "We believe that to do that you've got to go through several steps of consolidation and rationalization to create stronger institutions with better cash flow."

The commission's work was never meant to be an end in itself, he noted.

"The goal of the commission was to make the first set of the consolidating moves, and to layout a template which could be followed by the industry without the necessity of a commission, although under the imprimatur of the Department of Health," Berger said. "I know the first step was done, and I've had conversations with people who have begun to think about the second step."

Berger declined to identify which institutions he meant.

The commission assumed that implementing the recommendations would cost about \$1.2 billion, but argued that a more efficient system would save payors and providers \$1.5 billion annually. In an effort to fund the recommendations, the state promised \$1 billion in funds under the Health Care Efficiency and Affordability Law for New Yorkers, or HEAL-NY, while the federal government pledged \$1.5 billion from the Federal-State Health Reform Partnership, or F-SHRP, matching fund program.

The first three rounds of the state's portion have already been allocated by the Department of Health, which has awarded \$362.3 million to 23 hospitals and seven nursing homes, with another round of awards set to be announced. The money will come from the proceeds of personal income tax bonds issued by the Dormitory Authority of the State of New York, which plans to sell about \$700 million of bonds over several years for this purpose.

As the funding is dispersed, many questions remain over how it will be used. In some cases it has been slated for new construction or commission recommendations, while in others, such as Kaleida Health's Millard Fillmore Hospital-Gates Circle, which is slated to close, state funds may be used to retire old outstanding bonds.

"Do we retire old debt?" said Michael Hughes, vice president for public relations and government affairs at Kaleida Health in western New York. "Or do we assume the obligation of some of the debt we owe for a facility like Millard Gates, and they help build our new infrastructure? So it is going to be a question of what the state wants to invest in."

However, institutions are finding that the pledged funds are inadequate to cover the full cost of the mandated changes. The commission's report was clear on this point, as were hospital advocacy organizations, like the Healthcare Association of New York State, as they huddled with client hospitals and nursing homes in the run-up to the report's release last year.

Regardless, it is now apparent that the changes, in effect forcing modernization among New York's nonprofit health care institutions, could mean a new era of municipal bond issuance. Some of the debt may come through DASNY, while other debt may come through local industrial development agencies or commercial loans.

"I would expect that at some point we will see the next generation of institutional capacity being built on new issuance of debt," said HANYS president Daniel Sisto.

Nowhere is that more apparent than at Orange Regional. The hospital center is the largest recipient of state funding so far, with more than \$48 million secured through two rounds. Yet chief financial officer Mitchell Amado, while grateful for the state funds he has already received, realizes that it will fall

to his institution to make up the difference between the project's cost and the state funding. If all goes as planned, and the necessary regulatory approval is secured, this will mean coming to market with a deal sometime next spring.

It is unclear how much debt is outstanding for the 80 institutions. DASNY previously has sold debt for 13 facilities named in the report, of which \$1.14 billion was outstanding in September. In addition, the Health Department compiled debt information for the commission but it may not have been complete and has not been updated, said department spokeswoman Claudia Hutton. The department would not release the information without a Freedom of Information Law request.

Of the institutions with DASNY debt, 11 are either in compliance with the commission's recommendations or working on it, while two hospitals slated for closure are fighting to stay open.

The authority is working with its clients to deal with the commission's recommendations, but much of the work is still preliminary, said DASNY spokesman Marc Violette.

"We have a twofold job - on the one hand, the Dormitory Authority is playing an important role to roll out the state's health care policy. At the same time, we know that we have a fiduciary duty to protect bondholders," he said.

This week, DASNY filed a material event notice of possible defeasance to holders of about \$37.4 million of bonds issued on behalf of St. Vincent's Midtown in Manhattan. The hospital has already closed in accordance with the report, and is now in contract to sell its property in an amount "well in excess" of the outstanding bonds, said Tracy Raleigh, assistant director of DASNY's portfolio monitoring unit. The authority is gearing up for a potential redemption as soon as next week, she said.

Other facilities in the report with DASNY debt are:

- Victory Memorial Hospital in Brooklyn, which has about \$24.1 million of DASNY bonds, was slated for closure and is in bankruptcy, but Rep. Vito Fossella, R-Brooklyn, and other lawmakers filed a lawsuit to keep the hospital open. Barring a legal lifeline, it will shutter its doors early next year. The state has awarded it a \$25 million HEAL grant to defease its bonds.

- St. Joseph's of Cheektowaga in the Buffalo area is part of an obligated group, the Catholic Health System WNY, which has about \$67.2 million outstanding. St. Joseph's portion of that is about \$8 million. The hospital has been fighting a closure recommendation and has submitted an alternate plan to the Health Department that is now under review.
- St. John's Episcopal South Shore in Far Rockaway, Queens, which has about \$9.2 million outstanding, has completed a financial feasibility study for a merger with Peninsula Hospital Center, which borrowed \$5.7 million through the New York City Industrial Development Agency in 1998 and was approved in October for an additional \$20 million IDA issuance.
- New York Downtown hospital in Manhattan has about \$44.2 million outstanding and has begun the process of downsizing by 74 beds.
- The 403-bed Long Beach Medical Center in Long Island has about \$20.5 million of FHA-insured bonds outstanding and has begun to downsize to 145 beds. Long Beach was awarded a \$12 million HEAL grant.
- The Manhattan Eye, Ear and Throat Hospital, which was not a DASNY client, merged with Lenox Hill Hospital, which has about \$136 million of DASNY bonds outstanding. Lenox Hill was awarded \$25 million to reduce MEETH's debt and DASNY views the merger as positive to the credit, Raleigh said.
- North General Hospital in Manhattan has \$133.1 million outstanding and is in talks with Mount Sinai Medical Center about entering into a passive parent corporate relationship.
- Ellis Hospital in Schenectady, which has about \$50.8 million outstanding, is working with the Health Department to join with St. Clare's Hospital under a single governance structure and downsize to between 300 and 400 beds from 568 beds. Ellis absorbed Bellevue Women's Hospital's facilities, which closed under commission recommendations.
- St. Charles Hospital in Long Island, which has \$61.8 million of DASNY debt outstanding, and J.T. Mather Memorial Hospital, which has about

\$24.3 million outstanding, were both to downsize and reorganize their acute and mental health care. But that was contingent on approval from the state Office of Alcoholism and Substance Abuse and Office of Mental Health, which did not approve the change.

In Nassau County, the Nassau Health Care Corp. has moved forward in responding to two separate recommendations, one for the Nassau University Medical Center and the other for the A. Holly Patterson nursing home.

The NHCC has closed the nursing home in preparation for building a smaller, \$115 million facility. According to Arthur Gianelli, the chief executive officer and president of the corporation, he is in the process of selecting the financing team and completing the environmental impact studies. He expects to sell bonds in the spring, though he's still unclear about the exact amount.

"It's unclear if all of it will be in bonds. The question at issue is the nature of the equity contribution," Gianelli said. "We may finance our equity contribution, we just aren't sure, and it may be the case that all \$115 million will be financed."

Of the \$41 million that NHCC received in HEAL funding, \$14 million was used to retire debt associated with the nursing home, and an additional \$6 million linked to the medical center. Roughly \$50 million of bonds is still outstanding for Patterson, as well as \$215 million outstanding for the medical center, Gianelli said.

In the western part of the state, in a region the commission listed as the number two priority for health care reform, Kaleida Health is looking to make good on the recommended changes. With \$234.4 million of DASNY bonds outstanding as of Sept. 30, the system has applied for an additional \$121 million to close Millard Fillmore Hospital-Gates Circle and \$1 million to complete a strategic plan to downsize DeGraff Memorial Hospital, which could cost as much as \$36 million.

The closure of Millard Fillmore could require some bonds to be redeemed under IRS rules, DASNY's Raleigh said.

Kaleida Health is also asking for \$2.5 million to do the due diligence and strategic planning effort in looking into a joint unified governance structure with Erie County Medical Center.

The institution thinks the \$123.5 million is a small price to pay for overhauling that region's health care infrastructure.

"We've had a very extensive dialogue with the Department of Health and they have been very good about working through our plan with us," Hughes said. "The money we are looking for will be matched, if not doubled, with private sector development in terms of medical office space and new building development, so from a taxpayer standpoint it is a good investment for the state."

The potential consolidation of the two medical institutions presents a unique problem – the county facility, which is a public benefit corporation, would be privatized to join a 501(c)(3) nonprofit. ECMC used to be a department of Erie County before it became a public benefit corporation, but it still receives subsidies from the county, which is the guarantor of its \$101 million of outstanding debt. Employee benefits could become an issue in trying to retain workers since county workers at ECMC get better benefits than those at Kaleida do, said medical center CFO Susan McCarthy. The fiscal weakness of the two institutions is a potential hurdle as well.

"When you look at all the hospitals in this town, there's historical capital under-investment because of a lack of available resources," she said. "Usually when there's a consolidation between organizations, one party is looking to the other to increase their access to capital, they want to get something out of it, and in this circumstance, there's not a real strong partner on either side of the table here."

In central New York's Ulster County, HEAL funds have been used to retire the existing \$22 million of debt at Benedictine Hospital and \$20 million at Kingston Hospital, as the two hospitals began actions to merge under one parent corporation, which, when finalized, will be responsible for issuing any future debt.

Orange Regional Medical Center has used roughly half of its HEAL grants, just under \$25 million, to retire most of the outstanding debt at the two facilities it is set to close, the Horton campus and the Arden Hill campus.

"It obviously puts our total cost on the amount of borrowing down, so we are very excited," Amado said.

More difficult to quantify, but just as relevant, are those bonds issued by local industrial development agencies. For example, Brookhaven Hospital currently has \$20 million outstanding through the Brookhaven Industrial Development Agency in Long Island, the most it can have.

Yet hospital officials have proposed an ambitious project to address the Berger Commission's report, laying the foundation for a psychiatric outreach program, which will need financing. The hospital has received a preliminary award of \$9 million, but will need another \$7 million or \$8 million.

"We are appealing for additional funds in order to be able to do the program we are mandated to do," said Ronald A. Giraulo, senior vice president and CFO. "We are stretched beyond our debt capacity."

In choosing to fund the retirement of outstanding debt or provide monies to hospitals or nursing homes with constrained debt ceilings, the Health Department and DASNY indicate that they understand the importance that the bond market will play in reshaping and modernizing health care throughout the state.

"The state government and the provider community have had a great deal of sensitivity on the need to protect bondholders throughout this implementation process because of the natural dependency, if you will, for capital acquisition," HANYS' Sisto said.

From a ratings perspective, the commission recommendations haven't had any direct impact, and none of the three rating agencies have changed a rating based on them. Analysts said that's largely because most of the facilities in the report are unrated and not investment grade.

Standard & Poor's health care analyst Liz Sweeney said for the hospitals that remain open, the end result could be stronger balance sheets.

"It should be a positive for the hospitals," Sweeney said. "Certainly the closure recommendations are going to be very modest, but any incremental [patient] volume helps."

Sweeney said that the big picture change is not the number of beds lost but how the system operates.

"The bigger thing that could ultimately come out of the commission's work is some kind of different methodology for how hospitals are paid, to

change the incentives from episodic care to treating chronic care to avoiding acute episodes, things like that, which is really what's lacking in the system," she said. "What they've done so far doesn't represent a dramatic change in the way care is delivered and in the way hospitals and physicians are incentivized and all those things that would really dramatically change cost."

However the health care system is ultimately changed remains to be seen, while policy experts and

others admit that the true impact of the commission's report will not be seen for some time.

"I think there is common acceptance that the Berger Commission was a first step in a long process of reconfiguring the way health care is provided in the state," said Courtney Burke of the Rockefeller Institute of Government, a New York-focused policy think tank. "Financing tends to drive form, so if you want to shape the system you have to go where the money is."