COPLEY HOSPITAL, INC.
FY 2017 PROPOSED BUDGET
NARRATIVE

A. EXECUTIVE SUMMARY

Copley Hospital's proposed FY2017 budget reflects the challenges it has faced with respect to cost pressure, which includes increases in variable costs due to multiple years of increased utilization and challenges with recruitment, employee turnover and a very competitive labor market. As a result of these cost pressures, Copley's expenses are out-pacing the 3% cap on net patient revenue (NPR). This presents an on-going challenge in complying with the NPR cap without deteriorating Copley's financial position. For the proposed FY2017 budget, Copley respectfully requests to re-base its NPR based on actual historical trends to prevent deterioration of its financial position going into future payment reform initiatives such as the All Payer Model. While supportive of these initiatives, in order to assume greater risk under future health care reform, Copley must secure its financial health to sustain day-to-day operations, high quality patient care, and contribute to the success of such payment reform initiatives.

The following summarizes the key components of the proposed FY2017 budget:

- Operating Expenses to increase 8.3%, comprised of:
    - Fixed Labor Costs: 5.3% increase due to significant challenges with recruitment and retention of skilled staff and physicians, increased need for contracted labor and locum providers, and increases in the cost of health insurance
    - Variable Costs: 2.2% increase in variable costs, such as chargeable supplies and drugs, related to utilization and inflation. Inflation on drugs is more than double the 3% cap.
    - Other Fixed Costs: 0.8% increase in other fixed costs

- Cost saving opportunities to curb future growth of expenses are being explored, including a workforce efficiency assessment to be conducted by Quorum Health Resources beginning in July 2016.

- Net Patient Revenue is proposed to include the 3.4% increase allowed by the GMCB, plus an additional 4% increase to re-base NPR:
    - No rate increase is proposed, therefore, no impact on Commercial rates is proposed as a result of our request to re-base NPR.
    - Utilization assumptions are realistic and based on the actual three-year
    - Incorporates reduction in bad debts and charity care
    - Assumes flat reimbursement rates from Medicaid and Commercial/Other payers
    - Medicare cost-based reimbursement to increase due to expense growth and Critical Access Hospital designation

- Capital spending is proposed to be $10.4 million, including $6 million related to the approved CON for the replacement of our surgical suite. Capital spending is to be funded through a combination of proceeds on borrowing for the CON project, philanthropic community support secured for the CON project via a capital campaign, and working capital.
    - Average Age of Plant of 11.9 and Long-term Debt to Capitalization of 23.2% are in-line with our CAH peers

- Financial position:
    - Operating margin of only 0.4%, essentially break-even
    - Total surplus of $2.8 million due largely to philanthropic community support for the CON project
    - Days cash on hand of 93 days, under the CAH Median of 109 days budgeted in 2016
    - Copley may still need to request additional re-basing of NPR for FY2018, depending upon the impact on operations of the CON project and implementation time of any cost savings opportunities identified.

- Alternative NPR Scenarios Considered:
    - Copley evaluated three NPR scenarios while developing our FY2017 budget. Details of the alternative NPR scenarios are provided, beginning on page 8, so the GMCB can understand our rationale for proposing an NPR exception of 4%, which includes no rate increase and no impact on Commercial rates. These alternative NPR scenarios included:
        - NPR needed to generate a healthy 3% Operating Margin, which results in a 5.5% rate increase, a $2 million Operating Surplus, and 103 Days Cash on Hand
        - NPR in compliance with the GMCB cap, which results in a 6% rate reduction, a $2.3 million Operating Loss, and 80 Days Cash on Hand. This scenario would put at risk Copley's goals to sustain day-to-day operations, continue to provide high quality patient care, and contribute to the success of payment reform initiatives

In summary, Copley's request for an NPR exception of 4% includes no rate increase and no impact on Commercial rates, given the increased utilization we are experiencing, reduced bad debt and charity care, and cost-based reimbursement from Medicare. We believe it is a reasonable request given our NPR has not been rebased on actual trends since 2012 and our goal is to prevent deterioration of Copley's financial position. The financial health of Copley is of particular concern going into health care payment reform initiatives, such as the All Payer Model, that would put us at risk should our NPR base be inadequate to sustain the organization. Therefore, we respectfully request that the GMCB approve Copley's FY2017 budget as proposed.

B. EXPENSES

Copley Hospital proposes total expenses of $66,743,216 in FY2017, up $5,104,291, or 8.3% from the approved FY2016 budget of $61,638,925. Major cost pressures contributing to this expense growth relate to recruitment and retention of skilled staff and physicians, increased need for contracted labor and locum providers, increases in the cost of health insurance, and increases in chargeable supplies and drugs related to utilization and inflation. Copley did not previously anticipate this level of expense growth, but believes that the FY2017 proposed expenses are realistic given current circumstances. Copley is actively exploring opportunities for cost savings to curb future growth of expenses and has contracted with a consultant to guide us in an assessment of workforce efficiency.

Following is a summary of the composition of the proposed change in expenses and a more detail explanation of the cost pressures that Copley is facing:

Expenses, Budget 2016	$61,638,925		
Staff compensation	1,705,696	2.8%	Labor costs - Fixed: $3,259,190 = 5.3%
Contracted labor	820,411	1.3%	
Physician compensation	733,083	1.2%	
Supplies	1,035,906	1.7%	Other costs - Variable: $1,335,666 = 2.2%
Drugs	299,760	0.5%	
Coding support	152,000	0.2%	Other costs - Fixed: $509,435 = 0.8%
Recruitment	105,500	0.2%	
Interest on CON debt	52,688	0.1%	
Other	199,247	0.3%	
Expenses, Budget 2017	$66,743,216	8.3%	

Labor Costs

As can be seen in the table above, the majority of Copley's proposed expense increase relates to labor costs. Copley has experienced significant turnover throughout the organization in the last year and half, in part due to retirement. Our turnover rate was as high as 22% during FY2015 and included several key management and medical staff positions. In the last 18 months, 1 in every 5 positions at Copley experienced turnover. The cost of turnover can be significant. We often are competing for this talent nationally, especially in recruiting key management and medical staff positions. In order to compete in the labor market and recruit quality employees to Copley, we had to increase the compensation for several positions throughout the hospital. This included renegotiating the contract with the United Nurses and Allied Professionals union to increase wages in order to recruit and retain nurses.

Some of the key management and medical staff positions that we have experienced turnover in over the last year and half are as follows:

- Director of IT
- Director of Clinical Informatics
- Director of Food Service
- Director of Peri-Operative Services
- Director of Emergency Services
- Several Physician Assistants
- General Surgeon
- OB/GYN
- VP of Human Resources
- VP of Physician Practices
- Chief Nursing Officer
- Chief Executive Officer

In addition to market adjustments, there are other costs associated with turnover including recruitment, orienting and training new staff, and coverage for vacancies at premium wages or increased use of costly travelers, particularly when specific specialized skills in high demand or experience is needed. Contracted labor is proposed to increase $820 thousand, or 87%, from the approved FY2016 budget.

In addition to compensation pressures discussed above, the cost of health insurance for our employees is proposed to increase due to increase utilization and assumed inflation of 8% on medical claims and 13% on pharmacy claims.

Given that compensation and benefits are more than 60% of Copley's total expenses, we have contracted with Quorum Health Resources to guide us in an assessment of our workforce efficiency. This assessment will be performed in the summer of 2016 and will help us better understand our opportunities for improving efficiency and enable us to prioritize which transformative efforts we will pursue to achieve short-term goals and provide a foundation for long-term sustainability.

<u>Other Costs</u>
Another area where we have experienced cost pressure is in supplies and drugs. These costs increase along with the increase in our utilization, discussed further in Section C(c) below. In addition, inflation in drug prices, particularly oncology drugs, out-paces the 3% cap on NPR growth by more than double. The table below summarizes the utilization and inflation assumptions included in the proposed FY2017 budget for supply and drug costs.

	Utilization	Inflation
Supplies	21.1%	3.4%
Drugs	11.1%	7.7%

This inflationary pressure, combined with a few years of increased utilization, presents an on-going challenge in complying with the GMCB 3% NPR cap without deteriorating Copley's financial position.

C. <u>NET PATIENT REVENUE</u>

Copley Hospital proposes net patient revenue of $65,509,894 in FY2017, up $4,522,175 from the approved FY2016 budget of $60,987,719. This proposed increase includes the 3.4% allowed by the GMCB, plus an additional 4% increase to re-base net patient revenue in light of historical growth in utilization and expenses. This request for an exception of 4% includes <u>no rate increase and no impact on Commercial rates</u>, given the increased utilization we are experiencing, reduced bad debt and charity care, and cost-based reimbursement from Medicare. We believe it is a reasonable request given our NPR has not been rebased on actual trends since 2012 and our goal is to prevent deterioration of Copley's financial position. The financial health of Copley is of particular concern going into health care payment reform initiatives that would put us at risk should our NPR base be inadequate to sustain day-to-day operations and continue to provide our high quality patient care.

Following is a summary of the composition of the proposed increase in net patient revenue followed by an explanation of the factors influencing the proposed net patient revenue budget:

NPR, Budget 2016	$60,987,719	
Utilization	2,885,552	4.7%
Payer mix shift	-680,755	-1.1%
Bad debt and charity	733,762	1.2%
Reimbursement rates	1,098,252	1.8%
DSH	485,364	0.8%
NPR, Budget 2017	$65,509,894	7.4%

a. **Revenue Assumptions**

Major factors influencing the proposed increase in NPR include increased utilization, reduced bad debt and charity care, more favorable Medicare reimbursement based on the ratio of costs to charges, and an unfavorable payor mix shift to government payers from Commercial sources. Each of these factors is discussed further below.

Utilization of Services

FY2017 proposed utilization is based on the three-year average utilization of services from FY2014 thru projected FY2016, adjusted to account for filling an orthopedic surgeon position that has been vacant for over a year. The following table summarizes the proposed budget-to-budget change in key utilization statistics:

Utilization Statistics	ACT15	BUD16	PROJ16	BUD17	B-B Var	B-B %Var
Total Admissions	1,980	1,824	1,946	1,936	112	6.1%
Total Patient Days	5,222	4,731	5,372	5,273	542	11.5%
Total Average Length Of Stay	2.6	2.6	2.8	2.7	0.1	5.0%
Observation Units	462	550	476	514	-36	-6.5%
Operating Room Procedures	1,940	2,074	1,975	2,102	28	1.4%
Ambulatory Surg Procedures	1,542	1,580	1,480	1,577	-3	-0.2%
Physician Office Visits	27,011	27,819	27,496	27,988	169	0.6%
Emergency Room Visits	12,035	13,463	15,749	13,635	172	1.3%
Imaging Exams	30,916	30,585	32,239	31,167	582	1.9%
Rehab Units	55,880	52,945	56,465	53,152	207	0.4%
Laboratory Tests	313,733	317,823	324,988	317,565	-258	-0.1%
Pharmacy Doses	235,436	226,923	224,723	231,358	4,435	2.0%
All Outpatient Visits	99,183	99,292	103,797	101,586	2,294	2.3%

Based on historical actual utilization, Copley is proposing a 6% increase in inpatient admissions and an increase in the average length of stay to 2.7 days. Overall, surgical procedures are proposed to increase only 28 cases, or 1.4%; however, inpatient surgical procedures are increasing by 162 cases and outpatient procedures are decreasing 134 cases. The increase in inpatient cases is primarily due to the projected impact of filling an orthopedic surgeon position that has been vacant for over a year.

Total outpatient visits are proposed to increase 2.3%, which is primarily comprised of increases in ancillary diagnostic testing and emergency visits. Physician office visits are proposed to remain relatively flat.

Overall, changes in utilization of services account for $4.8 million in additional gross patient revenue, estimated to yield $2.9 million in net patient revenue.

Payer Mix: Utilization by Payer

In FY2016, Copley has seen a significant shift in the payer mix to government payers from Commercial and private pay sources. The table to the right summarizes the budgeted mix by payer, based on gross revenue, and the estimated impact on proposed FY2017 net patient revenue.

Payer	BUD16	BUD17	NPR Impact	%
Medicare	31.8%	33.3%	$ 801,052	5.0%
Medicaid	17.9%	18.3%	$ 137,733	2.2%
Commercial	47.4%	46.2%	$ (992,776)	-2.6%
Private pay	2.9%	2.1%	$ (626,764)	-85.5%
TOTALS	100.0%	100.0%	$ (680,755)	-1.1%

Bad Debt & Charity

Total bad debt and charity care write-offs are proposed to be 2.4% of gross patient revenue, based on Copley's current experience. This represents a significant decrease from 3.2% budgeted in FY2016, resulting in an increase in budgeted net patient revenue of $734 thousand. Copley believes the decrease in bad debt and charity care write-offs may be related to the decrease in the uninsured population, possibly due to the expansion of Medicaid, coverage under the health insurance exchange plans, and the increase in Medicare utilization.

Although there is a downward trend in the dollar amount of bad debt and charity care write-offs, the volume of cases of bad debt and charity care has increased 4.5%. Thus, the average write-off per case is significantly lower than in the past. In addition, Copley has expanded its charity care, which includes an increase in the discount from 25% to 50% for eligible applicants with a household income of up to 400% of the FPLG (that represents a household income of $97,200 for a family of 4).

Reimbursement Rates

Copley Hospital's FY2017 proposed budget includes a reimbursement rate of 59.8%, before Disproportionate Share (DSH) revenue, representing an increase over the approved FY2016 budgeted rate of 57.7%. The budget-to-budget impact on net patient revenue of changes in assumed reimbursement rates is approximately $1 million in total, summarized by payer in the table to the right.

Payer	NPR Impact	%
Medicare	$ 790,637	5.0%
Medicaid	$ 48,086	0.8%
Comm/Other	$ 259,529	0.7%
TOTALS	$1,098,252	6.4%

Medicare's cost-based reimbursement accounts for the majority of the increase in NPR due to reimbursement rate assumptions, with Medicaid, Commercial, and Other sources increasing less than 1% each. Following is a summary of the reimbursement assumptions for each of the major payer sources and the impact on the proposed FY2017 net patient revenue.

Medicare – Cost-based Reimbursement

Medicare net patient revenue is proposed to be $18,325,607, or 50.2% of Medicare gross patient revenue. Medicare reimbursement estimates utilize a CAH-specific reimbursement model based on the trend in the ratio of costs to charges. The estimates are calculated in accordance with legislated payment rules currently in effect and include the impact of cost report adjustments related to the disallowance of a portion of the VT provider tax. Copley estimates that the proposed increase in net patient revenue due to Medicare's cost-based reimbursement is $791 thousand.

Medicaid – Assumed Flat

Overall Medicaid net patient revenue (excluding DSH) is budgeted at $6,687,252, or 33.3% of Medicaid gross revenue. Medicaid reimbursement is proposed based on current year-to-date payment trends, reflecting an increase of $48 thousand, or 0.8%, in budgeted net patient revenue. As instructed by the GMCB, no payment rate increase was incorporated into the proposed budget, nor any changes related to the Governor's plan around the cost shift or other health reform payment incentives.

Commercial/Other – Assumed Flat

Net patient revenue from commercial and other payer sources is budgeted at $39,512,797 or 74.6% of gross revenue for commercial and other payers. The reimbursement rates proposed in the FY2017 budget are based on current actual reimbursement rates from commercial and other sources. The overall budget-to-budget increase in net patient revenue related to commercial/other reimbursement rate assumptions is approximately $260 thousand, or 0.7%. These payors primarily reimburse hospital services based on a percentage of charge, thus reimbursement from these sources are projected to remain relatively flat as we propose no rate increase for FY2017.

Disproportionate Share (DSH)

Copley Hospital's FY2017 proposed budget includes an increase of $485 thousand in disproportionate share payments, in accordance with the State's Notice of Disproportionate Share Payments for FY2017 dated May 20, 2016.

b. Actual Net Patient Revenue FY2015

Copley Hospital generated net patient revenue of $63,464,440 in FY2015, up $3,863,956, or 6.5% from the FY2015 budget of $59,600,484. Major factors contributing to this overage, as described further in the narrative previously filed for FY2015, were increased utilization, including chargeable supplies and drugs; favorable bad debt and charity care, and better than budgeted average reimbursement rates. The impact of each of these factors has been addressed in the development of the revenue assumptions described further above for the proposed net patient revenue in FY2017.

c. Projected Net Patient Revenue FY2016

Current projections for FY2016 indicate that net patient revenue may be $62.5 million for the year, 2.4% over the approved FY2016 budget due to increased utilization and favorable bad debt and charity care, partially offset by an unfavorable payor mix shift to government payers from Commercial sources. These factors contributing to the projected FY2016 NPR overage are incorporated into the assumptions used to develop the proposed FY2017 NPR budget.

d. Health Reform Investments

Copley's proposed net patient revenue includes a request for an allowance of $243,951, or 0.4%, to fund health reform investments related to:

- Participation in Accountable Care Organizations, including OneCare Vermont and Community Health Accountable Care LLC (CHAC)
- New Shared Decision Making program for Cardiology services
- Continuation of the Orthopedic Shared Decision Making program
- Participation in the Blueprint for Health program
- VT Program for Quality in Health Care (VPQHC) initiative to reduce readmissions

D. RATE REQUEST & ALTERNATIVES CONSIDERED

Copley's FY2017 budget proposes no rate increase and, therefore, no impact on commercial rates. Inherent in that proposal is a request that Copley's NPR exceed the GMCB's NPR cap by 4%. We have a sense of duty to submit a budget that is in compliance with the GMCB policies. We also have a fiduciary duty to safeguard the financial position of the hospital. This is of particular concern given that we are on the cusp of assuming new risks related to payment reform initiatives such as the All Payer Model. Copley will not be able to sustain its operations in the long-term under the NPR cap given that our utilization, capital needs, and costs are out-pacing the funding that 3% NPR cap allows. As such, we have evaluated multiple scenarios in determining Copley's NPR request and have summarized these scenarios below for the GMCB's consideration as well.

"Ideal" Scenario: 5.5% Rate Increase to yield 3% Operating Margin

Prior to the implementation of a cap on NPR growth, Copley determined the amount of rate request necessary to yield an adequate operating margin to sustain operations and fund capital investments. In general, we targeted a 3% operating margin, in-line with the system-wide average. If we were to take this approach with our proposed FY2017 budget, NPR would exceed the GMCB cap by 7%; we would propose a 5.5% rate increase, which would increase Commercial reimbursement by $2.3 million; the operating surplus would be $2 million; and Days Cash on Hand would be proposed at nearly 103 days, just below the CAH median of 109 days budgeted in 2016. While this scenario is ideal for Copley's financial health, we did not propose this scenario to the GMCB because Copley had a significant NPR overage in FY2015 that generated unbudgeted surplus of $2.4 million.

"Compliant" Scenario: 6% Rate Reduction yielding Operating Loss of $2.2M

In order to submit a budget in compliance with the GMCB NPR cap, Copley would need to implement a 6% rate reduction. This would yield an operating loss of $2.2 million, or -3.4%, and Days Cash on Hand of 80 days, nearly 30 days less than the CAH median budgeted in 2016. Taking this financial risk for FY2017 is of particular concern as we would be going into payment reform initiatives, such as the All Payer Model, with an inadequate NPR base. Our goals are to sustain day-to-day operations, continue to provide high quality patient care, and contribute to the success of payment reform initiatives. We believe that submitting the compliant NPR scenario would hinder our ability to accomplish these goals.

Proposed Scenario: 0% Rate Increase, Break-Even Operations

Copley's proposed NPR budget represents the moderate course of action, balanced between the ideal scenario of a 3% operating margin and the compliant scenario that would require a 6% rate reduction and deterioration of our financial position going into payment reform initiatives. It still assumes some financial risk as Copley would have no operating margin and would be operating with 93 Days Cash on Hand. However, it positions Copley in a reasonable financial situation going into payment reform and allows us some time to further evaluate and effectively implement cost savings opportunities. Even with this re-basing for FY2017, Copley may still need to request an additional re-basing for FY2018.

The following table summarizes the key components of each scenario described above that were considered by Copley in submitting its NPR request for FY2017:

Scenarios Considered	Compliant	Proposed	Ideal
Net patient revenue	$63,061,302	$65,509,894	$67,303,457
Operating surplus (loss)	($2,203,346)	$245,246	$2,038,809
Operating margin	-3.40%	0.40%	3.00%
Days Cash on Hand	80.3	93.1	102.6

We respectfully request that the GMCB approve this request to re-base Copley's NPR in FY2017 as we believe our request to be a reasonable option with no impact on commercial rates that will provide for sustaining moderate financial health going into payment reform.

E. CAPITAL BUDGET

Capital spending for FY2017, excluding Certificate of Need (CON) projects, is proposed at $4,406,202 and will be funded through operations. Additionally, Copley has received CON approval for the replacement of our surgical suite with total project costs of $12.5 million. The proposed budget for FY2017 includes $6 million in capital spending specific to this approved CON. The CON project will be funded through a combination of philanthropic community support, debt financing, and working capital. Copley's FY2017 budget proposes an Average Age of Plant of 11.9 and Long-term Debt to Capitalization of 23.2%, which are in-line with our CAH peers.

F. TECHNICAL DISCLOSURES

None.