Southwestern Vermont HEALTH CARE
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August 29, 2017

Andy Pallito, Director of Health Systems Finance
Green Mountain Care Board
3rd Floor City Center
89 Main Street
Montpelier, Vermont 05260-3601

Dear Mr. Pallito,

Southwestern Vermont Medical Center (hereafter “SVMC” or “Medical Center” or “Hospital”) is submitting this document as requested by the Green Mountain Care Board on August 25, 2017. The request is to have SVMC reduce its budget submission to a 3.4% growth in Net Patient Service Revenues (hereafter “NPSR”) and explain how this change will affect key financial indicators.

On June 23, 2017 the Board of Trustee’s approved SVMC to submit to the GMCB a budget that included a 4.68% NPSR increase in the prior year’s budget, a positive cash flow and an operating margin that would create a foundation for SVMC to modernize its physical plant.

Simply reducing SVMC’s submitted NPSR budget to an increase of 3.4% is likely to create irreparable harm to SVMC’s ability to meet the healthcare needs of the Southwestern Vermont Region, Northern Berkshire County, Massachusetts and Eastern New York, especially now that a greater number out of state patients are seeking services at SVMC. In addition, the ability to modernize SVMC’s plant will be significantly hindered.

The impact of the proposed reduction is approximately $2 million. As presented at the August 17th meeting the patient volume assumptions management believes are conservative due to increasing out of state volumes. A significant portion of the increase in the SVMC budget is due to volume or $4.2 million, nearly 60% of the increase. Two million dollars of the volume increase is due to out of state volumes. Approximately, $1 million is directly related to Health Care Reform Initiatives, mainly improving primary care access. Additionally, bringing back Orthopedic services to Bennington that have out migrated to other Vermont, New York and Massachusetts hospitals and the continued growth in utilization of the Cancer Center service at SVMC have increased NPSR.

A reduction of nearly $2 million in NPSR will significantly adversely affect the financial position of SVMC. Below is the table of significant 2016 financial indicators presented at the August 17th meeting comparing SVMC to 2016 Avg. VT PPS Hospitals.

Benchmark/Ratio	*2016 SVMC*	*2016 Avg VT PPS Hospitals*	*Percent Favorable or Unfavorable*
Net Revenue per Adjusted Admission	$8,855	$10,174	13%
Cost per Adjusted Admission	$8,705	$10,349	16%
FTEs per 100 Adjusted Discharges	4.40	5.68	23%
Salary & Benefits per FTE (non-MD)	$75,319	$79,470	5%
Capital Cost per Adjusted Admission	$354	$559	37%
Days Cash on Hand ***(including parent)***	188	214	-12%

Source: Vermont Community Hospitals – Financial and Statistical Trends (PPS Hospitals excluding UVM)

Below is the second table that SVMC presented which includes FY 2018 SVMC indicators compared to Vermont System Averages as provided by GMCB staff via the SVMC's Budget Analysis, report date August 7, 2017.

Benchmark/Ratio	*2018 SVMC*	*2018 VT Hospitals 50th*	*Favorable or Unfavorable*
Cost per Adjusted Admission	$9,455	$10,994	Favorable
FTEs per 100 Adjusted Discharges	4.5	5.9	Favorable
Salary & Benefits per FTE (non-MD)	$82,331	$85,010 avg.	Favorable
Average Age of Plant	16.5 years	12.7 years	Unfavorable
Capital Expenditures to Depreciation	111%	123%	-----

Source: Southwestern VT Medical Center – Fiscal Year 2018 Budget Analysis Report date 8/7/2017

Key Indicators Review

There are many indicators that management could review. The indicators that management will comment on are:

1. Operating margin;
2. NPSR per adjusted admission;
3. Operating expense per adjusted admission;
4. Salary and benefit costs;
5. Days cash on hand;
6. Average age of plant / capital costs.

The following are management's comments on the impact on SVMC's indicators of a possible reduction of its budget submission.

1. Operating margin

The reduction of nearly $2 million in NPSR would affect the operating margin. If management made no change to operating expenses the operating margin would be reduced to 2.6% from 3.9%. The Hospital's cost structure combined with a 2.6% operating margin and a negative cash flow would ***not*** be acceptable to Financial Lenders and Rating Agencies as SVMC plans for a capital modernization improvement plan. See for further discussion operating expenses per adjusted admission, days cash on hand and average age of plant below.

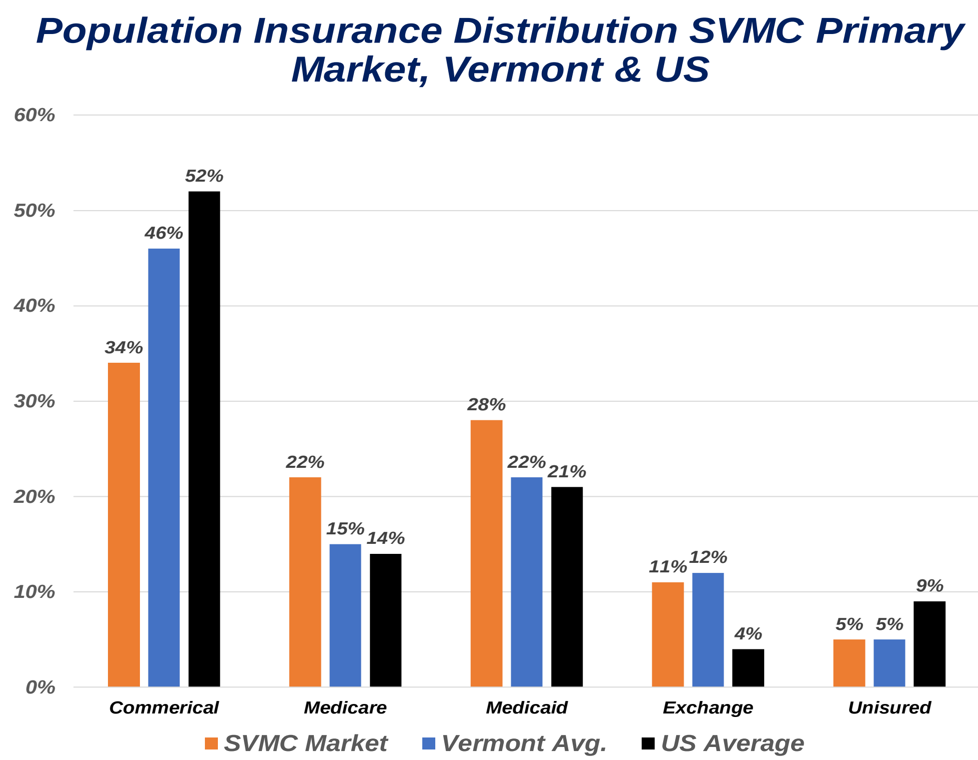
2. NPSR per adjusted admission

The report dated August 7, 2017 does not provide FY 2018 amounts for this indicator to compare to as the FY 2016 Vermont Community Hospitals – Financial and Statistical Trends report does. The FY 2016 data shows that SVMC receives 13% less per adjusted admission than the average VT PPS hospital. Data also shows that SVMC charges on average are lower than other VT hospitals.

The current system of holding each hospital to a 3.4% budget increase, via managing the amount a hospital can increase its charges rewards the higher charging hospitals and the higher NPSR per adjusted admission hospitals and disadvantages the lower charging hospitals. The lower charging hospitals continue to fall behind.

The reduction of nearly $2 million will reduce the NPSR per adjusted admission nearly back to the FY 2017 budget level.

Contributing factors to SVMC's lower NPSR per adjusted admission is the Hospital's payer mix and the region's demographics. Through our own data and management's evaluation of determining if SVMC will enter into the risk model the Hospital examined the "Population Insurance Distribution of SVMC's Primary Market" and compared it to Vermont and the US. Below is the information:



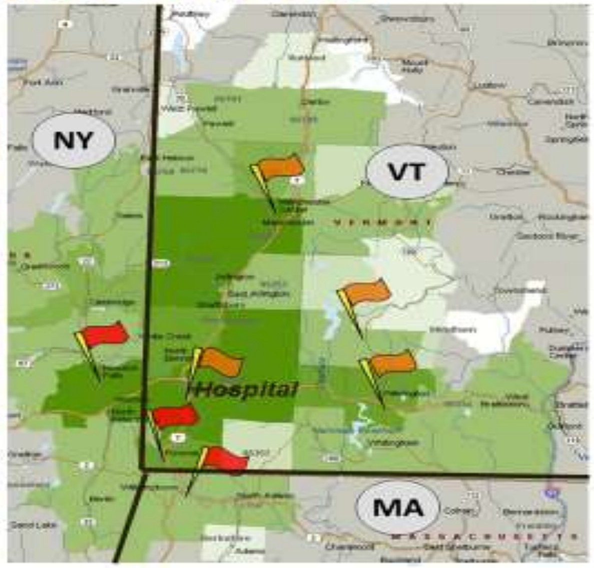
Source: DRG enrollment data, Kaiser, State Health Facts data, 2017

The population data shows that in SVMC's primary service area that 50% of the population is either enrolled in Medicare or Medicaid, compared to 37% in Vermont and 35% in the United States. Medicare and Medicaid pay less than the commercial payers. That is one of the reasons why SVMC's NPSR per adjusted admission is lower combined with SVMC's charge master are the two significant drivers in SVMC's lower NPSR per adjusted admission than average of comparative data of the PPS hospitals in VT.

The increase in out of state revenues is a benefit to SVMC and the region since the out of state payer mix is favorable. The Massachusetts and New York commercial payer mix are 59% and 54% based upon revenues, respectively, compared to 47% for Vermont. The image below is from SVMC's August 17th presentation.

Out of State -- NPSR

Payer Mix	Comm.& SP	M'care	M'caid (inc. DSH)
MA	59%	38%	3%
NY	54%	37%	9%
Other	82%	17%	1%
VT	47%	39%	14%
Total	**51%**	**37%**	**12%**



Higher out of state commercial volumes lowers the charge increases which SVMC has to request and lowers the cost of health care to Vermonters.

3. Operating expense per adjusted admission

The reduction of nearly $2 million in NPSR will not directly affect the cost per adjusted admission. In 2016, SVMC's operating expense per adjusted admission was favorable when compared to VT PPS hospital's average by 13% and is 14.3% below the FY 2018B Vermont Peers 50th.

The high cost of pharmaceuticals in the Cancer Center service is a significant revenue and expense driver in the budget. The budgeted revenues are expected to increase $2.3 million. The submitted budgeted cost of drugs sold are increasing $2.7 million or a $400,000 deficit.

In the FY 2018 budget SVMC's rate/price revenue increase is $2.9 million, from all sources. Management included in salaries and benefits an increase of nearly $2 million (see below). Included was approximately $2 million of costs related to Health Reform initiatives. The total increases in operating expenses exceeded the price/rate increase management included in the budget. To offset these increases over $1 million of expense reduction initiatives were budgeted.

4. Salary and benefit costs

The reduction of nearly $2 million in NPSR ***<u>may</u>*** have an impact on the Medical Centers salary and benefit costs since this is one of the largest expense categories.

SVMC salary and benefit expense per FTE – non MD was 5% *lower* in FY 2016 VT PPS hospital average and 8% below the Vermont System averages. The submitted FY 2018 budget which includes a 3% wage increase and a 1% provision for market update factor the average salary and benefit expense per FTE – non MD is *still* 3.2% *lower* than the Vermont System average. The increases will be evaluated if the reduction is approved.

Additionally, SVMC's FY 2018 FTE's per 100 Adj. Discharge is 4.5 *down* 4.2% from SVMC's FY 2017 budget, the FY 2018 Vermont Peer 50th is 5.9 and the 25th is 5.0. SVMC is 23% lower than the reported 50th and the 16% lower than the reported 25th.

These categories of expenses will most likely be adjusted if the reduction in NPSR is mandated by the GMCB.

5. Days cash on hand

SVMC's days cash on hand, including the cash and investments at the parent entity is budgeted at 172 days. This is assuming that the FY 2017 cash flows meet target. With two months left in the fiscal year the FY 2017 target will be missed by approximately 10 days.

Cash flow from operations

SVMC submitted its budget with a slight positive cash flow of $826,000 on a $158 million budget. Modifying the NPSR submitted budget to a 3.4% increase will reduce the NPSR by $2 million. If the NPSR is adjusted and no other adjustments are made to the budget this will create a negative cash flow from operations of over $1.2 million. The table on the following page shows the submitted FY 2018 budgeted cash flows vs. FY 2018 adjusted budget with the reduction.

	FY 2017 Budget	***FY 2018 Budget*** Submitted	***FY 2018 Budget*** With NPSR Reduction
INCOME (LOSS) FROM OPERATIONS	***$4,628,899***	***$6,328,377***	***$4,378,377***
*Add items included in operating results that are **non-cash items***			
Depreciation and Amortization	6,104,254	6,531,292	6,531,292
Defined Benefit Pension Plan credit (included in benefits)	(600,000)	(250,000)	(250,000)
Changes in working capital items and non operating activities (less then one year due)	2,264,879	123,279	123,279
Funding of Defined Benefit Pension Plan	(3,900,000)	(4,200,000)	(4,200,000)
Investing Activities			
FY 2018 Capital Budget and other capital related investments	(12,500,000)	(7,250,000)	(7,250,000)
Financing Actiivties			
Repayment of Debt	(441,552)	(456,000)	(456,000)
Excess cash from operations	***($4,443,520)***	***$826,948***	***($1,123,052)***

The negative cash flow would be SVMC's third year in a row with a negative budgeted cash flow, which is not sustainable.

During SVMC's budget presentation a question related to how much discretion is there in the pension funding. Currently, the unfunded pension plan liability is nearly $20 million. In 2018, the pension plan is projected to pay over $4.3 million of benefits to individuals. The plan was frozen September 30, 2009. The plan to minimize the future payments for liabilities accrued in FY 2009 and prior is to fund, at a minimum, the current years projected benefit payments to prevent the liability from growing. Simply, management is currently attempting to remain current with the liability and not to have it increase. If this strategy was not in effect the pension liability would be over $45 million as of September 30, 2017.

The reduction in NPSR and operating performance of approximately $2 million will reduce days cash on hand by approximately 4.5 days.

6. Average age of plant / capital costs

SVMC's average age of plant is 16.5 years after the investment of $7.250 million in FY 2018. SVMC's physical plant is the oldest in Vermont. If all of the NPSR reduction of $2 million reduction was taken from capital expenditures then SVMC's average age of plant would be 17.6 years at the end of the budget year FY 2018.

SVMC's average age of plant projected at the end of FY 2018 with the submitted budget is 16.5 years. The Vermont Peers 50th is 12.7 years and the 75th is 14.5 years. The Vermont System average is 12.9 years. SVMC's physical plant is 28% older than the Vermont average.

Theoretically, a one-time investment of over $35 million, in addition, to the annual routine capital investments of between $7 and $9 million would bring the average age of plant at SVMC close to the Vermont Average.

Interest and depreciation (capital costs) in FY 2018 are lower by $107 per adjusted admission to the closest VT PPS hospital. This has a positive effect of $1.7 million on the financial statements and SVMC's cost structure. As a result, the indicator Capital Expenditures to Depreciation of 111.0% compared to the Vermont System Average of 115.3% is misleading. The four percent change does not seem much but if SVMC's capital costs were at the Vermont State average this indicator would be only 88%. This would position SVMC significantly below the Vermont Peers 25th of 104%. This is an example of where the use of percentages can be misleading. This is very similar to the NPSR cross the board increase of 3.4% for each Hospital.

SVMC is planning on several capital projects estimated to be approximately $30 million. Management has been working with several organizations to determine the financial feasibility of the project. An overall reduction of $2.0 million NPSR will have a significant impact on the financial feasibility of this needed project. This project combined with annual routine capital investments would bring SVMC's average age of plant, capital costs per adjusted admission, as well as other indicators more in line with other Vermont PPS hospitals.

Summary

SVMC NPSR is nearly $2 million over the 3.4% budget guidelines of the GMCB. The largest significant driver is the over $2 million of additional out of state revenues over the FY 2017 budget. Other increases in the NPSR budget include approximately $1 million revenues related to increase primary care access, one of SVMC's and OneCare Vermont's "Health Care Reform" initiatives. The remaining significant increases are related to the Medical Center's Cancer Service, were additional expenses are exceeding the additional revenues, and Orthopedic services which are migrating back to Bennington.

If the reduction of nearly $2 million in NPSR is mandated it will have a negative effect on SVMC and the Communities we serve. The only variable which could be adjusted in the NPSR calculation could be the effective rate increase included in the budget of 2.85%.

Any reduction to the submitted budget will create further challenges for the Medical Center as demonstrated above when examining the Key indicators. SVMC is committed to be a low cost/high quality provider for the patients we serve and continuously look at ways to reduce operating expenses without jeopardizing quality. One of the organizations priorities is to modernize the physical plant. A reduction in NPSR will jeopardize SVMC's ability to efficiently do the modernization project which is needed. Additionally, it would create additional financial challenges which will hinder the ability to continue the journey of health reform both from a delivery of care model perspective and participation in risk models.

Mr. Dee and I are available to you or the Board to further clarify or discuss SVMC's FY 2018 budget, financial challenges, or any other matter you or the Board would like to discuss. I can be reached at 802.447.5011 or stephen.majetich@svhealthcare.org. Thank you for your time related to this matter.

Sincerely,

Stephen D. Majetich
Vice President, Finance-CFO

CC: Tom Dee, CEO
Jim Roy, Controller