Evaluation of "Small Hospital Option"
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This report includes information from the previous "25-bed Acute Hospital Option-Summary of Findings" and revises that report to include information regarding the estimated project costs.

Evaluation Process

HFS' evaluation was performed by:

- Developing estimations of future financial performance under the conditions of this option
- Developing estimation of land and project costs for the option
- Comparing these financial estimates with those of other options
- Using pre-defined evaluation criteria to evaluate the options

The financial forecasts and project cost estimates were based upon the "Business Plan Model" (BPM) that was provided by management of Sonoma Valley Hospital and that was reviewed and verified by HFS. HFS conducted extensive evaluation of the BPM assumptions and calculations and is satisfied that they provide a reasonable frame of reference for evaluating options.

Description of the Option

- There are two sub-options:
    - 25 total beds, with 4 being ICU and 4 OB
    - 25 total beds, with 4 being ICU and with no OB
- No Skilled Nursing Facility beds for either option

Key assumptions

- Demand for services is consistent with that used in the BPM and with the analysis conducted by J. M. Watt.
- The average length of stay for Medicare patients is increased by 1.25 days due to the lack of the SNF to which discharges would otherwise be directed.
- Two sub-options were analyzed:
    - 25 total beds, with 4 OB beds --- OB demand and utilization remain at current levels
    - With no OB service --- all 25 beds are acute/ICU.
        - All OB/Gyn services, including outpatient procedures, are eliminated.
        - The hospital loses its Medicare "Disproportionate Share" revenue in the amount of $450,000.
- Bed capacity limits cause admissions to be "diverted" --- based upon historic census fluctuations
    - With OB using 4 beds, we estimate that admissions to the acute/ICU service would decrease by 21.9% from current forecasts.

  - Without OB, we estimate that admissions to the acute/ICU service would decrease by 11.4%.
- Outpatient volume and revenues are reduced as follows:
  - In the option with 4 OB beds, a 6% reduction in the base year OP revenues due to reductions in emergency and surgical procedures.
  - In the option with no OB services, all OB/Gyn outpatient services are eliminated --- with net revenues estimated at $650,000.
- Reimbursement rates are consistent with those used in recent hospital budgeting and forecasting unless calculation corrections were needed. No changes were made to these rates because the current assumptions are considered to be very conservative.
- Cost assumptions are consistent with those used in recent hospital budgeting and forecasting except for certain departments. These departments are those which are clearly impacted by the service change and for which there are comparable industry cost statistics. These include Nutritional Services, Pharmacy, and Environmental Services.
- Depreciation and interest expense remain the same. The capital costs of a new facility will be financed with a GO bond issue. Although depreciation would increase significantly and therefore decrease the operating margin further, this is a non-cash expense.
- Non-operating revenues and expenses remained as in the BPM:
  - Parcel tax sunsets in 2012-13
  - Donations remain at BPM levels
  - Expenditures to recruit physicians remain at BPM levels
- Regarding the new building project:
  - No separate MOB or OSHPD III Ambulatory Services buildings were included for either option.
  - Facility square footage was spread between an "I Occupancy" hospital building with a non- escalated construction cost of $575 per square foot and a "Utility" building with a non-escalated construction cost of $235 per square foot.
  - The distribution of square footage was based upon the Broadway space program. In essence, the ambulatory service program is folded into the hospital building and the MOB is not built.
  - The calculation of total project cost was based upon the same formula used in the Broadway Option.

Findings

Although the Small Hospital Options appear to have the benefit of reducing project costs, they result in several extremely adverse results:

- Very large losses and negative cash flows that would cause financial failure
- To ensure continuation of services SVHD would need to consider significant reductions of services and/or an increase and extension of the parcel tax to cover the operating losses
- Probable loss of critical services: SNF and OB

- Frequent diversions of admissions due to capacity constraints

The following table summarizes some critical financial performance measures for these options:

| Estimated Impact of "Small Hospital Option" in 2012-13 | | |
|---|---|---|
| **Measure** | **4 OB bed option** | **No OB option** |
| ADC | 15.9 | 16.5 |
| Cash flow | ($3.4) million | ($5.8) million |
| Operating margin | ($5.8) million | ($3,4) million |
| Net Revenues | $46  million | $45.4 million |
| Operating expenses | $51.9 million | $48.8 million |
| Net income (loss) | ($6 ) million | ($3.7) million |
| Square feet constructed | 112,000 | 108,000 |
| Project costs | $125 million | $122 million |

The primary reason that eliminating OB services improves the operating margin with the 25 bed model is that eliminating the OB beds would lessen the diversion/reduction in acute admissions and related outpatient revenues. The payer mix for these admissions is over 20% commercial insurance and over 60% Medicare. In addition, eliminating OB services significantly reduces fixed labor costs.

We consider these estimates to be "best case". Several factors could cause additional erosion of financial performance:

- Increased difficulty in recruiting and retaining physicians. At particular risk are the surgical services and OB/Gyn, although all services are likely to be affected.
- Additional decline in OP revenues due to the preceding problem.

The impact of having no SNF is significant, and we recommend evaluating the Small Hospital option under the assumption that the SNF remains in operation at its current location. In essence, this would combine the Small Hospital Option with the In-Town Option.