BRIEFING MEMO

Kittery Commons – Restructure Operations and Update Costs for Actual Expenditures (Subsequent Review)

DATE: January 5, 2009

TO: Brenda M. Harvey, Commissioner, DHHS

THROUGH: Catherine M. Cobb, Director, DLRS

FROM: Phyllis Powell, CONU Manager
Larry Carbonneau, HCFA

SUBJECT: Proposal by Kittery Commons, LLC; Modify Operating Structure and ownership interests and to finalize expenditures and operating costs for construction of new Nursing Facility named Durgin Pines, located in Kittery, Maine.

ISSUE ACTIVATED BY: The referenced proposal requires Certificate of Need (CON) approval as defined in "The Maine Certificate of Need Act of 2002," 22 MRSA Section 326 et seq., as amended. This is a subsequent review of a CON approved December 1, 2005.

I. BACKGROUND:

- The facility, operated by Sentry Commons, LLC opened May 5, 2008 doing business as Durgin Pines. The real estate is held and operated by Kittery Commons, LLC. The CON was approved December 1, 2005. At the time of the approval, Kittery Commons LLC was owned by William Gillis, Ward Hand and Joseph Hogan.

- The project was proposed to cost $7,317,867 and approved for $7,011,579. The difference of $306,288 was in two categories:

  a) The applicant had included a budget for 81 beds that was 38% over the allowable costs. According to the Certificate of Need Rules for Nursing Facilities 71.05, (N), (4)(F) "Movable equipment, excluding computers, printers, and networking, shall not exceed five thousand dollars ($5,000) per licensed bed."

  b) The second excluded amount was $150,000 for working capital; this was disallowed in the original application based on the principles of reimbursement for nursing facilities (44.5.3).

  These two items were not allowed as capital expenditures. Total allowable costs were determined to be $5,172,984. MaineCare reimbursement was projected at $3,387,822. Total Nursing Facility MaineCare revenue available for the project was $3,448,308. The project was considered MaineCare neutral with projected savings of $60,316.

- A letter dated May 12, 2006 from Catherine Cobb, approved the relocation of the project from York, Maine to Kittery, Maine. Information provided by the applicant and noted in the letter projected the relocation to save $12,500 in costs to the project. This savings is attributable to the land located in Kittery costing less than the amount originally estimated for the land located in York. The applicant reported $514,800 in actual land improvement costs would not be included as allowable costs.

- On March 11, 2008, a prior subsequent review of this project was approved allowing change of ownership of the facility and entities to a partnership between Joe Hogan and Bill Gillis, each partner owning 50%.

- The present CON application is considered a subsequent review of the original project for two reasons: first, because of the change in the organization and structure involving the separation of the operating company (Sentry Commons, LLC) and the company that owns the real estate (Kittery Commons, LLC) and second, because of cost overruns on the original project.

II. PROJECT DESCRIPTION:

The preliminary analysis of the Kittery Commons application recommended that a CON be approved because it was deemed to meet all the criteria for a determination. The Certificate of Need was issued December 1, 2005. This proposal would clarify the name of the operating company as Sentry Commons, LLC and allow for a lease arrangement between Sentry Commons, LLC and Kittery Commons, LLC. Additionally, it would allow for cost overruns from the project to be approved to the extent that they were MaineCare neutral.

III. HIGHLIGHTS:

Original CON Approved December 1, 2005
Modifications to CON approved May 12, 2006
Subsequent Review Approved March 11, 2008

IV. CLARIFYING INFORMATION RECEIVED FROM APPLICANT (condensed):

<u>Change in Operating Entity</u>

The applicant reports that the CON was approved under the sole name of Kittery. The CON indicates that the assets, debt and operations would be transferred from Sentry Commons, LLC to Kittery Commons, LLC. Both companies are owned by Joe Hogan and Bill Gillis, with each partner owning 50%. Currently, the fixed assets and related debt are on the balance sheets of Kittery Commons, LLC. Operations are being maintained by Sentry, LLC. The applicant proposes amending the CON to reflect the reality of the current situation. The applicant supplied a proposed lease for Sentry Commons, LLC to lease the facility from Kittery Commons, LLC. The lease is in conformity with other operating leases and was modified by the applicant with CON input to include provisions found in leases deemed acceptable by CON in the past two years.

Change in Capital Cost Expenditures and Expected Costs to MaineCare

The applicant provided the following schedule of expenses incurred in developing Durgin Pines:

	2005 Estimate as Filed	**Revisions**	**As Revised**
Land	$275,000	-$12,500	$262,500
Land Improvements		$514,800	$514,800
Building and improvements	$5,460,939	$757,604	$6,218,543
		$214,000	$214,000
Equipment	$561,288	$0	$561,288
Commitment fees	$423,300	-$14,000	$409,300
Carrying charges and finance costs	$389,840	$209,633	$599,473
Legal, organization, audit	$57,500	$0	$57,500
Total	**$7,167,867**	**$1,669,537**	**$8,837,404**

Revisions

Land attributable to the project is $12,500 less than the original estimate.

The $514,800 cost to improve the replacement land property, as agreed to by the applicant, is not included in the reimbursable basis for the improved property. The $514,000 was approved as a non-reimbursable expense in the May 12, 2006 letter.

Construction costs have increased by $757,604. The applicant has filed timely implementation reports with the department and attributed these overruns to increased costs due to time delays caused by location change of the facility.

The $214,000 cost includes construction bond costs, service impact fees and water main installation, which the applicant says was not anticipated and therefore not included in the original estimate.

The $14,000 decrease in commitment fees is attributable to the applicant increasing the amount of capital they provided for this project.

Carrying costs increased by $209,633 due to increased construction costs, increased construction time and by the interest rate on the loan from 7% in the estimate to an actual rate of 7.5%.

Additional Allowable Costs

1) The applicant estimates that additional allowable depreciation expense would be $29,182.

2) The applicant states that the increase for the change in interest expense would be $27,175 for the changes attributable to both the decrease in loan amount and the increase in the interest rate.

3) The applicant estimates that the additional expenditures will increase projected allowable costs by $56,357 annually.

4) There was a contingency of $200,000 in the original approved CON but no provision for the annual expenses attributable to those capital costs were included in the original analysis.

5) The applicant also updated a schedule that compares the 2005 determination of resources with 2007 estimated expenditures. The schedule indicates a MaineCare Savings of $60,317. Adjusting the savings for known inflation adjustments for 2006 and 2007 would increase this savings to $73,880. Available resources for MaineCare funding for this project are now $3,461,601.

This is the end of additional comments by applicant (condensed).

V. CONU ANALYSIS:

Change in Operating Entity

The original application indicates that one entity would own the real estate and the operating company. It was assumed by CONU in reviewing the file that the only activities and liabilities of the entity would be the new facility. Upon receiving and approving the lease agreement, CONU recommends this change to the CON. However, Sentry, LLC is an existing operating entity with an operating history. CONU cannot state that the operating entity is financially able to support the project without complete financial statements. This is because it is unknown whether there are any existing liabilities from the pre-existing Sentry Commons, LLC that impact operations of this new facility. Expenses related to pre-Durgin Pines activities are not allowable costs under this CON. These concerns are mitigated because the applicant has significant assets and other interests that would be available to assist this entity. Therefore the CONU will recommend approval with several conditions.

Change in Capital Cost Expenditures and Expected Costs to MaineCare

The proposed changes, when compared to the original costs included and approved in the CON, will be an increase of $112,579 in allowable expenses.

	As Revised	Unallowed Amounts	Recommended for Approval
Land	$262,500	$0	$262,500
Land Improvements	$514,800	$514,800	0
Building and improvements	$6,218,543	$0	$6,218,543
	$214,000	$0	$214,000
Equipment	$561,288	$156,288	$405,000
Commitment fees	$409,300	$0	$409,300
Carrying charges and finance costs	$599,473	$0	$599,473
Legal, organization, audit	$57,500	$0	$57,500
Total	$8,837,404	$671,088	$8,166,316

The adjusted proforma indicate expenses to MaineCare will be $3,461,601. This is based on 17,972 MaineCare days out of 27,400 days occupancy. Capital costs in the proforma are $8,837,404. However, by agreement, the fixed costs allowable for reimbursement will be $8,166,316.

Fixed costs (expenses) recommended for approval are $1,345,635. This is the amount shown in allowable costs claimed on Schedule F of the original analysis for fixed costs ($1,233,056) plus an additional $83,398 in interest expense (limited by MaineCare reimbursement neutrality, Chapter 101 Sec. 67-44.4) and $29,182 in depreciation and amortization expense. The Division of Audit will conduct its regular audit procedures at the appropriate time to determine actual allowable costs. The Division of Audit should note that no additional expenses are recommended for approval.

Allowable interest expense has been calculated in a manner consistent with the original analysis. Approved interest expense on long-term debt was $461,071. Recalculating the allowable interest amount for MaineCare neutrality calculation purposes indicates a potential cost of $579,658. Long-term debt interest on allowable interest expenses is reduced to $544,469 due to MaineCare neutrality.

Total allowable costs will increase from $5,172,984 to $5,285,563. The reasonableness of the added expenditures can be analyzed by looking at allowed capital expenditures per bed. This project has allowable capital costs per bed of $102,748 and total capital costs per bed of $109,104. In the preliminary analysis this was compared to the Inn at St. Andrews Village project with capital costs per bed of $100,853. Considering that the St. Andrews Village was a 2004 project this represents an increase in costs of 2.5% annually.

MaineCare revenues available for this project were projected to be $3,387,722. Because of the changes outlined above, MaineCare revenues due to this project are now expected to be $3,461,601. This is equal to the estimated amount of MaineCare expenses estimated for this project.

The additional costs do not affect MaineCare neutrality because the projected adjusted approved costs of operating the beds for MaineCare at the new facility are no more than the revenues expended by MaineCare at the previous facilities.

The CONU recommends that the additional expense be approved.

VI. CONCLUSION:

For all the reasons contained in the record, the Preliminary Analysis, modification letter dated May 12, 2006, the initial Subsequent Review and considering the information provided by the applicant, we now conclude that the review criteria has been satisfied and recommend the Approval of a modification to the Certificate of Need.

VII. RECOMMENDATION:

The CONU recommends this proposal be **approved** with the following conditions**:**

1) Review of actual costs of the project, and a copy of the signed lease agreement to conform to the CON as amended.

2) Receipt of financial statements and tax returns of Sentry Commons, LLC and Kittery Commons, LLC for a period of three years from project implementation.