BRIEFING MEMO

Transfer Sponsorship of St. Joseph Healthcare Foundation and St. Joseph Hospital to Covenant Health Systems, Inc.

DATE: July 2, 2009

TO: Brenda M. Harvey, Commissioner, DHHS

THROUGH: Catherine Cobb, Director, Division of Licensing and Regulatory Services

FROM: Phyllis Powell, Manager, Certificate of Need Unit
Steven R. Keaten, Health Care Financial Analyst
Larry D. Carbonneau, Health Care Financial Analyst

SUBJECT: Transfer Sponsorship of St. Joseph Healthcare Foundation and St. Joseph Hospital to Covenant Health Systems, Inc.

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 325 et seq., as amended.

REGISTERED AFFECTED PARTIES: None

I. BACKGROUND:

- Covenant Health Systems ("Covenant") is a multi-state healthcare system that was organized in 1984 in Lexington, Massachusetts. Covenant currently consists of 28 organizations including non-profit acute care hospitals, assisted living and elderly housing facilities throughout New England and Northeastern Pennsylvania. The controlled organizations in Maine include St. Mary's Regional Medical Center and D'Youville Pavilion in Lewiston and St. Andre Health Care Facility in Biddeford.

- St. Joseph Healthcare Foundation (The Foundation) is a 501(c)(3) tax exempt, Maine nonprofit corporation. The Foundation and its subsidiaries are currently sponsored by the Congregation of the Sisters of St. Felix of Cantalice of the Third Order of St. Francis, Province of Our Lady of Angels (the "Felician Sisters"), a Roman Catholic Congregation of Religious women, with Provincial headquarters in Enfield, Connecticut. The leadership of Our Lady of Angels Province of the Felician Sisters currently serves as the corporate members of the Foundation. In turn, the Foundation is the sole corporate member of St. Joseph Hospital.

- St. Joseph Hospital (the Hospital) is a 501(c)(3) tax exempt, Maine nonprofit corporation. It is a fully licensed 112 bed community based acute care hospital in Bangor, Maine. It also holds accreditation from the Joint Commission. The Hospital has been in operation for more than 60 years under the sponsorship of the Felician Sisters. As a sponsored

ministry of the Felician Sisters, the Felician Sisters are responsible for both the civil corporate and the canonical requirements associated with the Hospital (and the Foundation and its other subsidiaries-collectively referred to as St. Joseph Healthcare) as works of the Catholic Church.

- In the preliminary analysis, CONU determined that the applicant satisfied review criteria and recommended that the Commissioner approve the application subject to the following conditions:

    1) Receipt of a letter from the Office of the Maine Attorney General advising their intention to take no action regarding any antitrust issues regarding this transfer;
    2) Modify the terms of the agreement to allow for the deferral or reduction of the management fee should excess revenue over expenditures be less than 1.2% of revenues;
    3) Report improvements in quality outcomes as a result of this merger annually for a period of three years from transfer date; and
    4) Identify and report savings that result from this project annually for the first three years from transfer date.

Preliminary Analysis Condition 1, stated above, has been deleted because the applicant has satisfied this condition.

II. PROJECT DESCRIPTION:

The parties have entered into an agreement that would transfer sponsorship of St. Joseph Healthcare Foundation and St. Joseph Hospital to Covenant Healthcare System. The proposed transfer of sponsorship transaction will include agreed upon amendments to the Articles of Incorporation and the Bylaws of the Foundation to identify Covenant as its sole corporate member. Acting in this capacity, Covenant will assume responsibility for: (a) appointing the Foundation's board of trustees; (b) approving long range strategic plans and budgets; and (c) working in conjunction with the local board to select and appoint the chief executive officer of the Foundation, among other duties. Copies of the proposed agreement are on file with CONU and are part of the record.

“The Foundation will pay a standard membership assessment to Covenant, which covers the provision of services to the Foundation and the Hospital, and supports the corporate structure necessary to maintain the Foundation’s and the Hospital’s Catholic identity. The services provided by Covenant will in some cases substitute for services that are currently provided by other parties (such as centralized risk management coordination) and also include new services (such as quality monitoring and leadership development activities). The annual membership assessment is equal to 1.2% of the consolidated operating expenses of the Foundation and its subsidiaries for the most recent year for which audited financial statements are available. The membership assessment will be phased-in, with the assessment for calendar year 2009 being 1/3 of the amount that would otherwise apply, and the assessment for calendar year 2010 being 2/3 of the amount that would otherwise apply.”

"At the closing of the transfer of sponsorship, Covenant will pledge to make a charitable contribution (from its own funds and not from the Foundation or the Hospital) to the Felician Sisters of $17,000,000 to support their continued religious and charitable works."

III. HIGHLIGHTS:

Letter of Intent filed:	December 21, 2007
Technical assistance meeting held:	January 24, 2008
CON application filed:	December 19, 2008
CON certified as complete:	December 19, 2008
Public Information Meeting Held:	January 28, 2009
Public comment period ended:	February 27, 2009
Preliminary Analysis Released:	May 22, 2009
Public comment period ended:	June 10, 2009

IV. PUBLIC COMMENTS RECEIVED (Condensed) IN RESPONSE TO THE PRELIMINARY ANALYSIS:

Following release of the Preliminary Analysis no public comments were received.

V. APPLICANT'S RESPONSE TO PRELIMINARY ANALYSIS WITH CONU COMMENTS:

The applicant submitted additional information on June 9, 2009.

Comments Addressing Conditions:

1) **Preliminary Analysis Condition 1: The applicants will be required to produce a letter from the Office of the Maine Attorney General advising their intention to take no action regarding any antitrust issues regarding this transfer.**

   Applicant's Response:
   The applicant provided the necessary documentation satisfying this recommended condition. The letter produce by the applicants from the Office of the Maine Attorney General dated May 7, 2009 acknowledges no antitrust enforcement action with respect to the proposed restructuring.

   CONU Comment:
   CONU recommends this proposed condition not be included since it has been satisfied. This condition has been deleted.

2) **Preliminary Analysis Condition 2: Modify the terms of the agreement to allow for the deferral or reduction of the management fee should excess revenue over expenditures be less than 1.2% of revenues.**

   Applicant's Response:
   The applicant offered two suggestions for alternative language "The applicants agree to modify the membership agreement as follows:

1. "For a three year period following implementation, Covenant Health Systems will allow for the deferral by St. Joseph Healthcare of a portion of the membership assessment where the payment of the full membership assessment would result in St. Joseph Healthcare's days cash on hand dropping below 40 days cash. The deferred portion will be required to be paid at such time as St. Joseph Healthcare may do so without causing its days cash on hand to drop below 40 days cash."

2. "For a three year period following implementation, Covenant Health Systems will allow for the deferral by St. Joseph Healthcare of a portion of the membership assessment if and to the extent that the excess of revenue over expenditures for the last year on which audited financial statements are available is less than the membership assessment which has been designated for that specific calendar year in which the membership assessment is owed. The deferred portion will be required to be paid in the following year in an amount equal to the lesser of the excess of revenue over expenditures for such year or the amount so deferred, and any deferred amount will continue to be deferred from year to year until paid in full."

CONU Comment:
The language of the CONU condition correlates to Covenant's management fee calculation (1.2% expenses). CONU acknowledges that Covenant has agreed to "phase in" a reduced management fee during the first three full years of implementation. There are presently no provisions in the management agreement for adjustments to the management fee beyond this three year "phase in". It was determined by CONU, in the Preliminary Analysis, that the Covenant membership assessment, lacking an adjustment mechanism, could have a negative impact on St. Joseph Healthcare. Limiting this condition to three years, as proposed by the Applicant, is counter to the purpose of this condition. It was further determined by CONU that 22 M.R.S.A. §332 does not limit the Department's ability to impose this condition. CONU recommends this condition remain with modified language that addresses the deferral of management fees. The modified condition is included in the RECOMMENDATION section of this memo.

3) Preliminary Analysis Condition 3: Report improvements in quality outcomes as a result of this merger annually for a period of three years from transfer date.

Applicant's Response:
"We accept this condition and will report to the CONU on an annual basis, summaries of currently publicly reported health outcomes/indicator data, such as the data provided to the Centers of Medicaid and Medicare Services (CMS) and those reported to the Maine Quality Forum for a period of three years following the finalization of the transfer of sponsorship and will note which of these areas have improved because of specific programs. However, we caution that quality outcomes which are only the result of participation in a Covenant program may be difficult to segregate out. Many of our initiative are iterative processes which incorporate the good work at our hospitals and other healthcare organizations, so to attribute only improvements to efforts of Covenant may prove limiting."

CONU Comments:
It order to meet this condition, reports on improvements in quality outcomes must be directly attributable to this application and result from this change in sponsorship. CONU recommends that this condition remain.

4) **Preliminary Analysis Condition 4: Identify and report savings that result from this project annually for the first three years from transfer date.**

Applicant's Response:
"We accept this condition and will prepare an annual summary of savings which have been achieved by St. Joseph Healthcare following the transaction, such as savings which result from SJH fully participating in Covenant's Supply Chain Initiative, savings which result from group purchasing of energy, and costs avoided by using internal Covenant resources, rather than having outside consultants provide services such as leadership development, strategic planning, etc. Covenant and St. Joseph Healthcare reiterates our willingness to cooperate to fulfill this condition, but once again, caution that specific savings which are only the result of a participation in a Covenant program may be difficult to segregate out, so to attribute only improvements to efforts of Covenant may prove limiting."

CONU Comments:
In order to meet this condition reports on savings must be directly attributable to this application and result from this change in sponsorship. CONU recommends that this condition remain.

Comments Addressing CONU Analysis:

Applicant's Response:
"After further negotiations with the Felician Sisters and in light of recent economic changes, the terms of the payment for the donation from Covenant to the Felician Sisters was changed from $1.7 million per year for ten years to $1.285 million per year for fifteen years, for a total of $19.275 million."

CONU Comments:
CONU acknowledges the change. This is not a material change that would effect CONU's recommendation for approval of this transaction with conditions.

Applicant's Response:
"Covenant recognized several other discrepancies with the document, specifically in the financial tables, which did not correlate to the internally generated Excel Model Financial Data Request's table "21" that we filed with CONU on February 25, 2009."

CONU Comments:
CONU acknowledges discrepancies between what was reported by the applicant in the Financial Forecast module. These discrepancies did not affect on the favorable opinion CONU gave the applicant under the financial section of the analysis.

Applicant's Response:

"Capital Expenditures & Financing (Section III, B ii) (page 10) references our use of the template provided by the CONU for financial projections and noted that we failed to quantify savings resulting from the increased efficiencies related to inter-company activities. As we pointed out to Mr. Carbonneau during our development of CONU's financial model, the model does not allow for changes in expenses over time, but rather uses 2009 numbers as a base upon which a growth or an inflation factor was applied, and therefore did not did permit us to reflect expense reductions that would lead to improvements contemplated by the transaction."

CONU Comments:
The Financial Module section of the CON Application allows an applicant to reflect expense reductions or increases over time. The CONU application also allows an applicant to demonstrate cost saving as a result of a proposed project. Covenant did not quantify any savings in this application.

Applicant's Response:
"On page 11, of the same section, the CONU references that a second St. Joseph Hospital, identified as a subsidiary of Covenant Health Systems, is located in Massachusetts. Please note that St. Joseph Hospital is located in Nashua, NH and is a sponsored/member institution."

CONU Comments:
CONU acknowledges this error.

Applicant's Response:
"Covenant Health Systems makes public quarterly financial disclosures in connection with the Systems' Obligated Groups' bond financings and as a matter of transparency. One of the financial ratios which Covenant regularly discloses to our bond holders and the general public is the number of consolidated Days Cash on Hand. Our formal calculation of Covenant Health Systems' consolidated Days Cash on Hand ratio as of the first quarter of 2009 is 116.40 days. Our Q 1 2009 Debt Service Coverage Ratio is 3.2. Covenant is not able to comment on the CONU's calculation of Days Cash on Hand and Debt Service Coverage Ratio calculations (other than noting that they are different than our reported results) as we do not know the methodology used by CONU to calculate these ratios."

CONU Comments:
Any discrepancies in the financial section of the application did not have an adverse impact on this section. Days Cash on Hand was calculated by CONU with the following equation as utilized in the Almanac of Hospital Financial and Operating Indicators (2009):

$$\left(\frac{\text{(Cash + Cash Equivalents + Short Term Investments + Marketable Securities + Board Designated Funds)}}{\text{Total expenses – (Depreciation + Amortization)}} \right) \times 365 = \text{Days Cash on Hand}$$

Applicant's Response:

"Within the Preliminary Analysis (page 24), the staff references the second alternative which has been considered by the Felician Sisters as linking with one of the two other Catholic hospitals in the state. The alternative which Covenant/SJH identified as #2 in its filing was "Linking with Another Maine Provider." This alternative #2 was rejected since the Felician Sisters has a goal of maintaining the Catholic identity of the Hospital and satisfying that goal therefore excluded all but two organizations, St. Mary's Regional Medical Center and Mercy Hospital, both of which are part of a larger Catholic health system. This necessitated the Sisters' looking to a transfer of sponsorship to another Catholic health system, in order to preserve the Catholic identity of St. Joseph Hospital. This alternative was stated in our Application as #3-Transfer Sponsorship to a Catholic Health System."

CONU Comments:
CONU acknowledges the applicant adequately considered several alternatives to their proposal including linking with other Catholic hospitals within the State.

Applicant's Response:
"Availability of State Funds (page 24), references the fact that the Membership Assessment was not considered by the Office of Audit, as a recognized, allowable cost as stated in the principles of Reimbursement Manual Part I. We are therefore confused when in the same section, there is a calculation related to a portion of the Membership Assessment which would be allocated to MaineCare identified as being a cost of $116,928."

CONU Comments:
The applicant is correct that the Principles of Reimbursement Manual I, §2150 does not consider the membership assessment fee to be a recognized, allowable cost; however, the parent organization's reasonable costs related to patient care are includable costs as long as they are disclosed properly. The applicant did not disclose what these reimbursable costs might be, therefore, CONU fairly assumed these costs would be close to the management fee for the purposes of identifying MaineCare cost related to this application.

VI. CONCLUSION:

The Preliminary Analysis by CONU staff dated May 22, 2009 concluded that this application, with conditions, satisfied CONU review criteria. For all the reasons set forth in the Preliminary Analysis, in the record, and considering the clarifying information provided by the applicant, CONU concludes that the review criteria have been satisfied and recommends the approval of a CON with conditions.

VII. RECOMMENDATION:

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

1) Modify the terms of the agreement to allow for the deferral or reduction of the management fee should excess revenue over expenditures be less than 1.2% of expenses in any given year. Payment of any cumulative deferral of the management fee from prior years will be allowed in a subsequent year only up to the excess of revenues over expenses in that year.
2) Report improvements in quality outcomes as a result of this merger annually for a period of three years from transfer date.
3) Identify and report savings that result from this project annually for the first three years from transfer date.

Capital Costs	
$ 59,481,656	Capital costs as Approved
$ 0	Contingency
$ 59,481,656	Total Approved Capital Costs
Incremental 3rd Year Costs	
$1,217,996	Approved Incremental Costs (Savings)
Capital Investment Fund	
$ 1,172,321	Approved CIF
$ 1,172,321	Total CIF Debits