Healthcare Association of Hawaii

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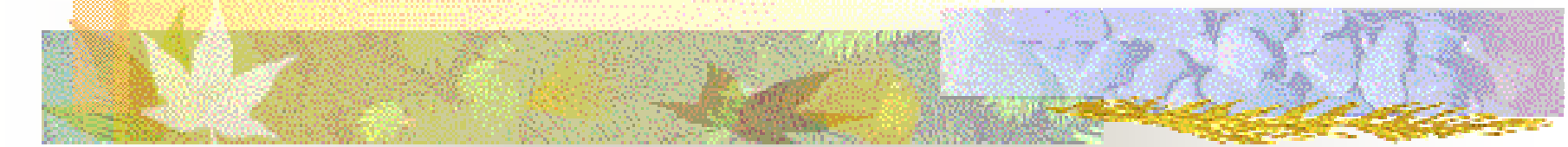


Financial Trends of Hawaii's Hospitals and Nursing Facilities

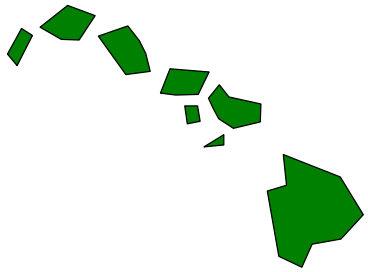
November 2005

Prepared by

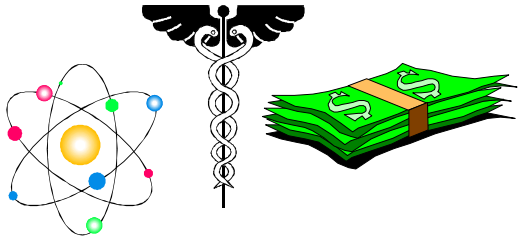
Ernst & Young

Quality In Everything We Do

Healthcare Industry in Hawaii

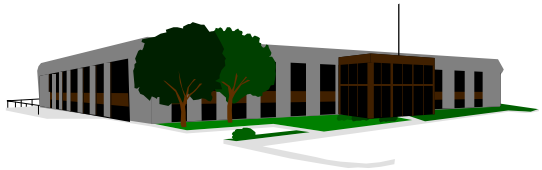


Hawaii



Healthcare Industry

Health Services Sector



Hospitals and Nursing Facilities

- Hawaii's economy is made up of several key industries
- Healthcare industry in Hawaii includes all aspects of healthcare - providers, pharmaceuticals, research, insurance plans, etc.
- A major part of the healthcare industry is the health services sector, which includes providers such as physicians, clinics, hospitals and nursing facilities

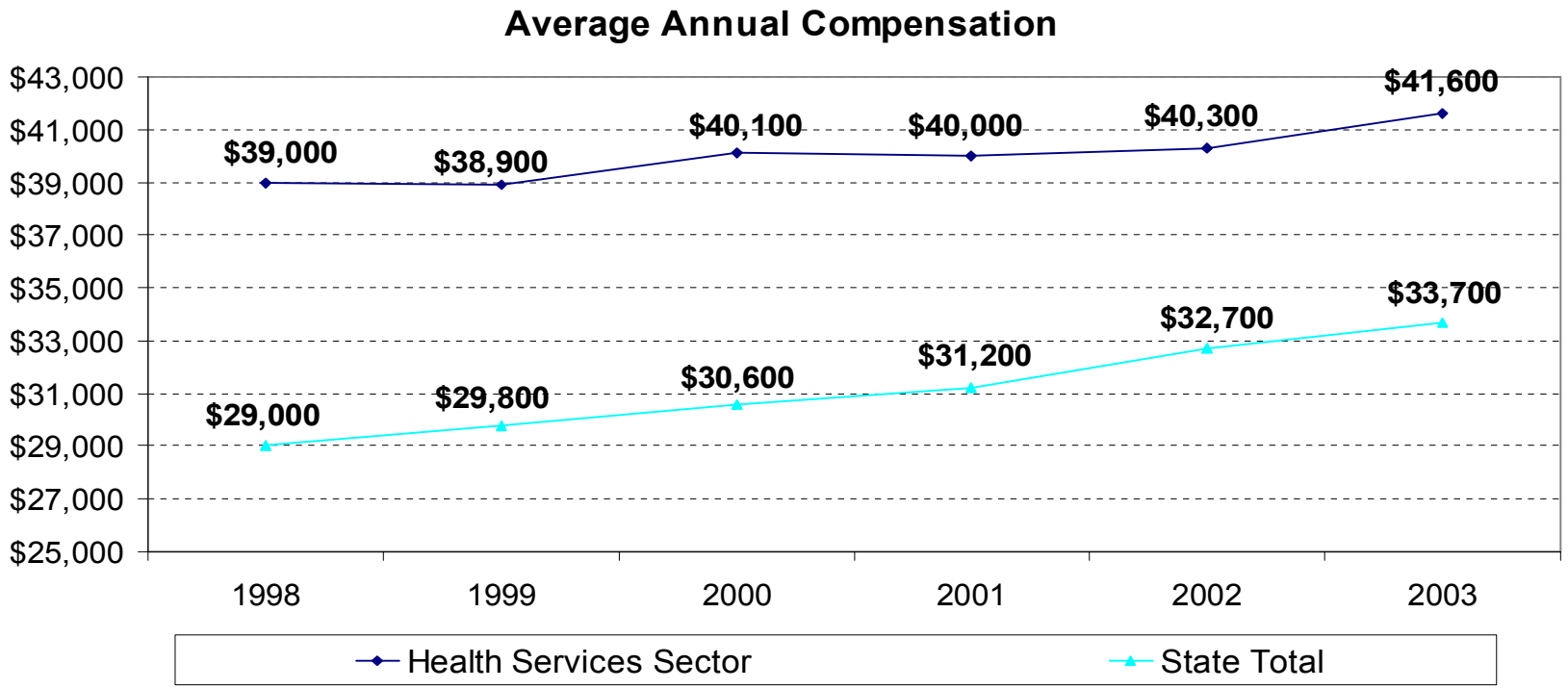
Health Services in Hawaii

- Healthcare industry is the second largest private industry in Hawaii
- Health services sector provided $3,216,000,000 ($3 billion) toward the state gross product in 2003
- Health services sector is one of the larger employers of the healthcare industry and Hawaii's economy
  - Health services sector employed more than 40,000 individuals in 2003
  - Health services sector paid out more than $1,600,000,000 ($1.6 billion) in wages in 2003

Source: State of Hawaii Data Book

Health Services in Hawaii

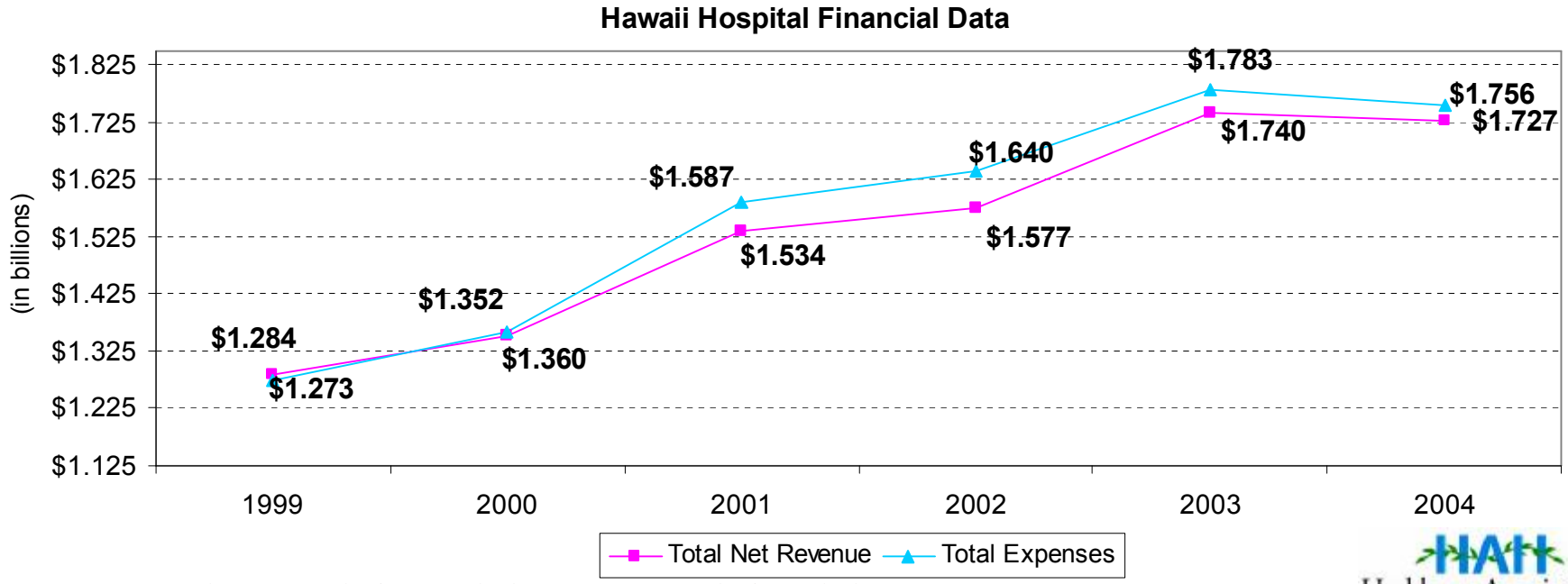
- Health services sector provides its employees with a higher annual average compensation than the average for the State
- Health services sector pays on average almost 23% more than the State average



Source: State of Hawaii Data Book

Hawaii Hospital Financial Data

- Hawaii hospital financial data shows that expenses exceeded revenues beginning in 2000 with the losses continuing
- Hawaii hospitals in total experienced net losses since 2000
- Other operating (cafeteria, parking, etc.) and nonoperating revenues (interest and investment income, etc.) are needed in addition to net patient revenues to help cover expenses
- Personnel expenses comprise approximately 50% of hospital expenses and benefits are approximately 18% of payroll costs



Source: American Hospital Association, 2006 Hospital Statistics

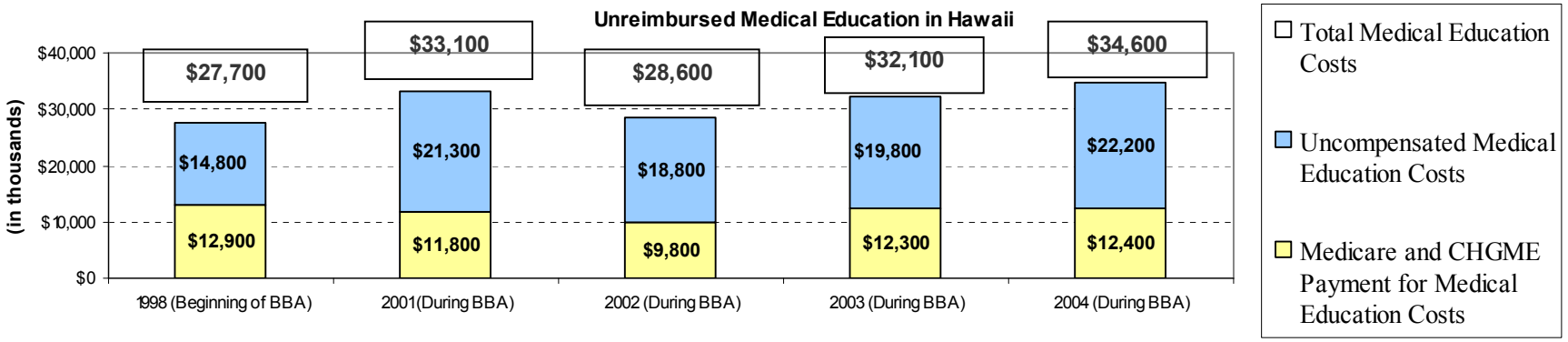
Healthcare Association of Hawaii

Contributions to Community

- In addition to providing medical care, Hawaii's hospitals and nursing facilities provide a significant service to the community through support of:
  - Medical education
  - Community programs
  - Provision of services regardless of ability to pay
- Hospitals and nursing facilities provide these programs because of their benefit to the community, even though they result in additional costs

Medical Education

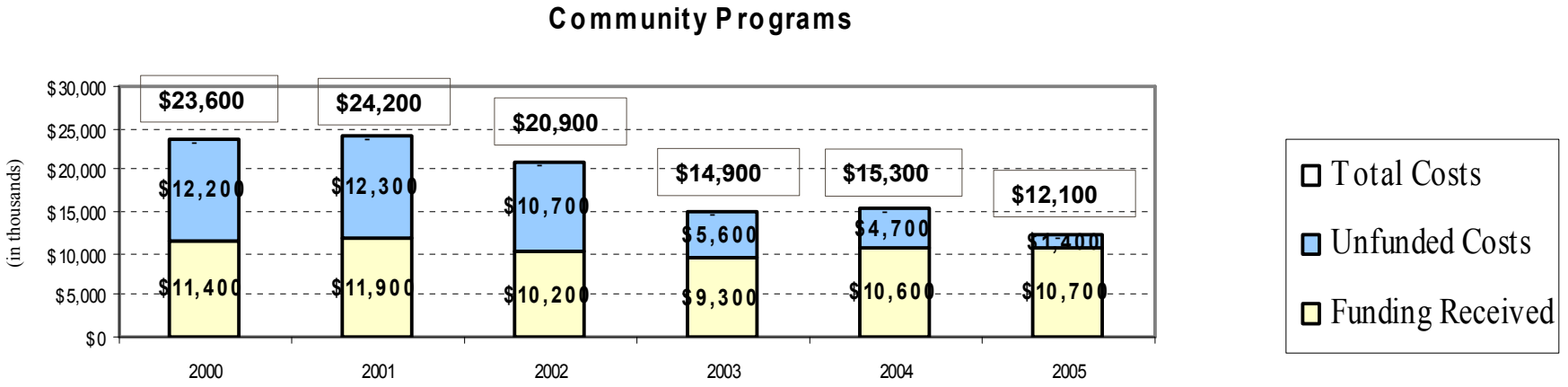
- Seven hospitals have teaching programs (interns and residents)
- Teaching programs support the School of Medicine and medical research
- Payment is received mainly from Medicare but has decreased due to the Balanced Budget Act (BBA)
- A federal program was established to provide additional payment to children's hospitals for medical education (CHGME program)



Source: Hawaii Residency Program study, information from teaching hospitals as-filed cost reports

Community Programs

- Medicare and Medicaid do not pay for these programs
- State and federal funds received through appropriations and grants are minimal
- Six year total program costs is $111,000,000 with only $64,100,000 received in funding for total unfunded (net) costs of $46,900,000
- Average annual unfunded cost from 2000 to 2005 is $7,800,000
- Examples include alcohol and drug treatment, services for the elderly, programs on Hawaiian nutrition, programs for adolescents, school health programs, family planning programs, counseling services and outpatient clinics for the underserved and uninsured



Source: Information provided by *five* hospitals and *two* nursing facilities

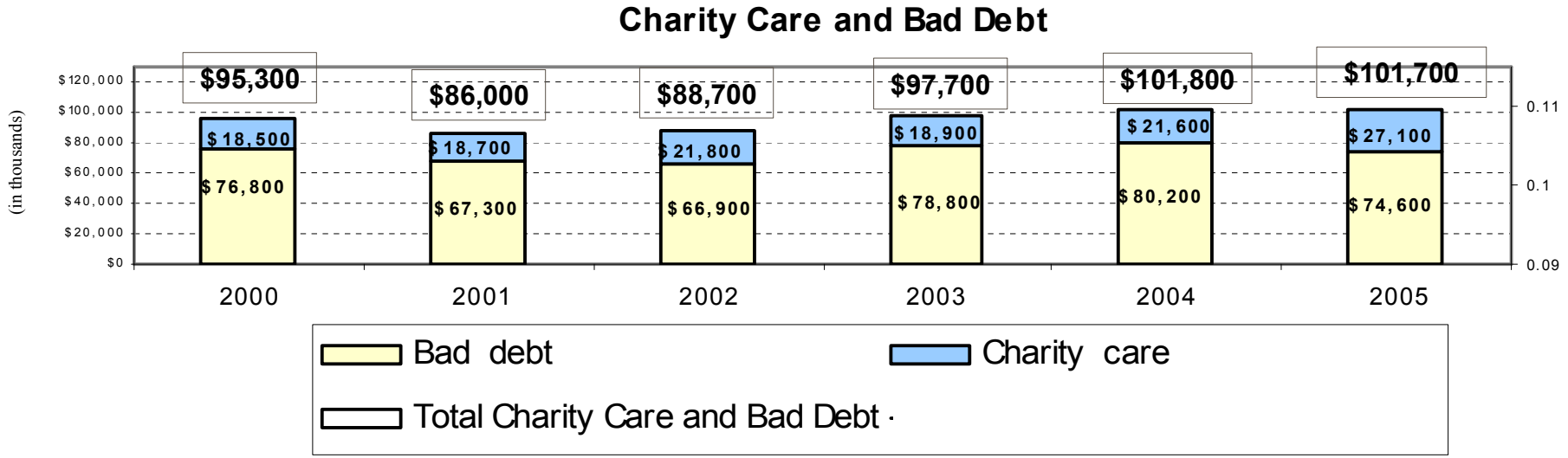
Charity Care and Bad Debt

- Hawaii's hospitals and nursing facilities provide services regardless of ability to pay. Services provided to those without the ability to pay result in bad debt or charity care
  - Bad debt is when the hospital cannot collect the amount due from a patient (services are provided with partial or no payments received)
  - Charity care is when the hospital never expected to collect payment from the patient (services are provided at no charge to patient)
- Generally, as the percentage of uninsured in Hawaii increases, bad debt and charity care increases
- Generally, as the percentage of unemployed in Hawaii increases, the percentage of uninsured increased
- Not all that are employed are insured even with employer-based insurance

Source: The State of Hawaii Data Book

Charity Care and Bad Debt

- Bad debt and charity care represent the amounts not collected as payment for services rendered
- Average annual charity care and bad debt from 2000 to 2005 is $95,200,000
- Six year total is $444,600,000 in bad debt and $126,600,000 in charity care for total of $571,200,000



Source: Bad Debt and Charity Care information provided by 27 hospitals and 7 nursing facilities.

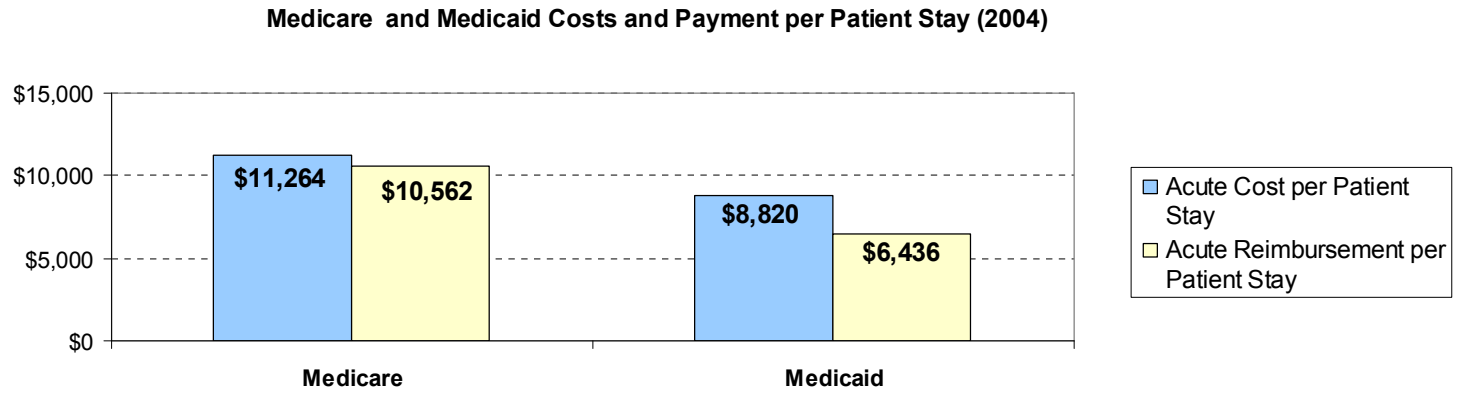
Negative Payment Impact Due to BBA

- Medicare is a significant source of payment for hospital, outpatient and nursing facility services
- Impact of the Balanced Budget Act (BBA) on Hawaii's facilities has been significant
- Average annual BBA impact from 1998 to 2003 (years impact was estimated) was a reduction of $29,639,000 for Hawaii which is about 2% of total net patient revenues
- Payment reduction averaged 10% per year for the six years based on the anticipated Medicare payment before BBA
- BBA is still in effect, payment reductions are still in place

Amounts reflect the impact on 17 hospitals including the hospital-based skilled nursing units (approximately 90% of the total hospital beds) and 5 freestanding nursing facilities

Federal Payments in Hawaii

- Medicare and Medicaid do not pay for the full cost of hospital services provided to beneficiaries in Hawaii
- Burden of the unpaid costs can no longer be shared with the private sector as insurers are also looking to reduce payments to providers

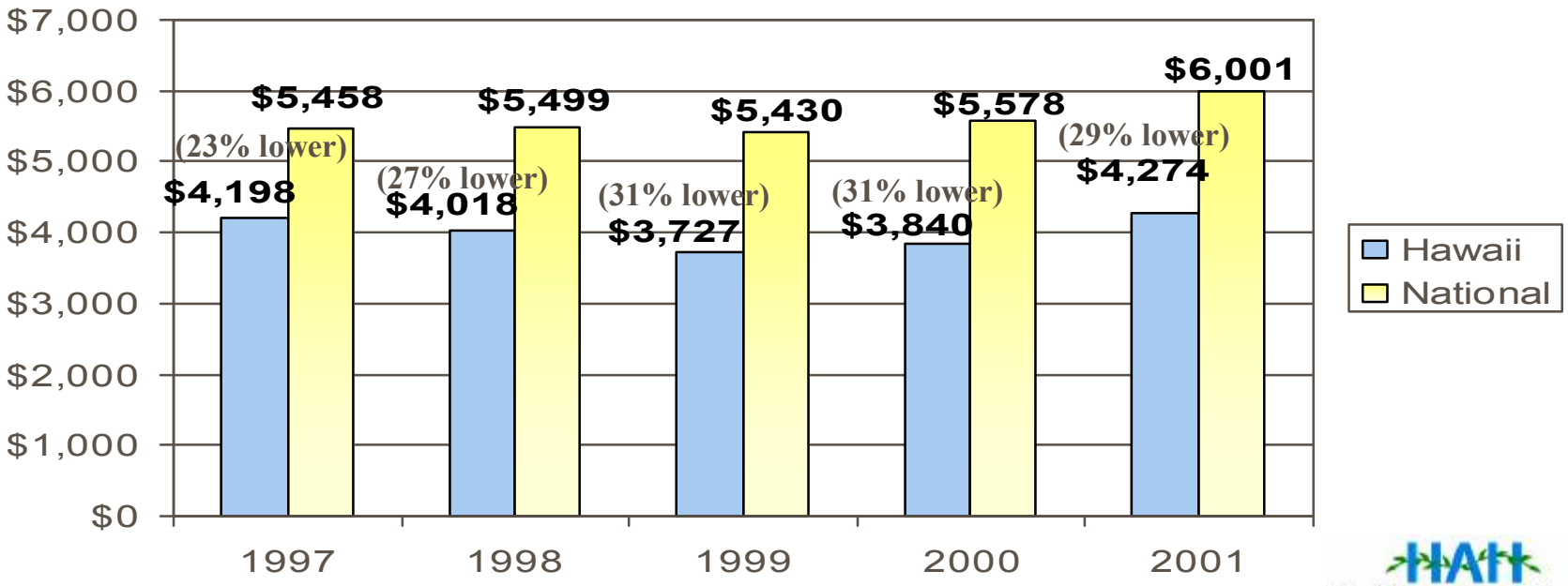


- Total difference between Medicare cost and payment is $18,495,000 ($702/patient stay X 26,346 patient stays)
- Total difference between Medicaid cost and payment is $21,888,000 ($2,384/patient stay X 9,181 patient stays)

Source: Facility as-filed cost report data

Medicare Payments in Hawaii

- Hawaii has one of the lowest per enrollee Medicare payments
- Medicare benefit payments in 2001 totaled $718,000,000
- Hawaii's average payment per enrollee in 2001 is 29% lower than the national Medicare payment
- Differential may be due to many factors including utilization of services
- With 168,000 enrollees in Hawaii in 2001, the differential is approximately $290,100,000



Source: The Universal Healthcare Almanac, updated information not available

Medicaid Impact

There are five major components or programs that could impact providers

- Act 294
- Medicaid DSH
- Medicaid federal medical assistance percentage (FMAP)
- QUEST Expansion
- State Children's Health Insurance Program (SCHIP)

Act 294

- Nursing facilities received payments based on the historical costs of the facility, subject to limits (different limits for hospital-based and freestanding facilities)
- Act 294, SLH 1998 required the payment be based on the acuity of the resident as opposed to hospital-based and freestanding
- Financial impact has generally been a reduction in payment for the hospital-based nursing facilities and certain freestanding nursing facilities and an increase in payment to the majority of the freestanding facilities.

Medicaid Impact

Act 294 (continued)

- To minimize the impact, a phase-in plan was developed with full implementation scheduled by 2008
- Total impact of implementing Act 294 to the Medicaid budget is to be neutral
- Reimbursement rates established as a result of Act 294 need to be considered in the implementation of QUEST Expansion
- Impact of Act 294 on the number of already limited nursing facility beds in Hawaii has not been determined
  - Number of hospital-based nursing facility beds could be reduced due to lower payments
  - Higher freestanding payment could encourage the addition of freestanding beds which has been limited due to lower payments

Medicaid Impact

Medicaid DSH

- Prior to the implementation of QUEST, Hawaii received disproportionate share hospital (DSH) payments from Medicaid, which provided additional payments to the hospitals
- Current DSH allotment for Hawaii is $0
- Hawaii and Tennessee are the only states that do not receive any additional payments
- Medicaid DSH allotments would increase the funds available to pay for Medicaid and QUEST services
- The hospital providers in Hawaii are continuing their work to once again have a Medicaid DSH allotment for Hawaii
- DSH allotments for Hawaii averaged $34 million prior to QUEST

Source: Federal Register

Medicaid Impact

Medicaid Federal Medical Assistance Percentages (FMAP)

- Federal government pays for a portion of the State's Medicaid costs
- Portion paid by the Federal government is based on the FMAP
- If the FMAP is 58.81%, for every dollar spent by the State on Medicaid, the State receives 58.81 cents from the Federal government
- At one time, FMAP for Hawaii was 50%, which is the lowest percentage
- FMAP has been increasing:

	2002	2003	2004	2005	2006
Hawaii FMAP	56.34%	58.77%	58.90%	58.47%	58.81%

- If approximately $750,000,000 is spent on Medicaid (federal and state funds), the amount paid by the federal government is $441,000,000
- If State spending remains constant, for every 1% increase in the FMAP, the State receives an additional $7,500,000 in Federal funding
- The additional funding should allow the State to provide better payments to the providers of service

Source: Federal Register

Medicaid Impact

SCHIP

- Program provides health benefits to uninsured children
- In 2004, there were 13,719 children enrolled in SCHIP in Hawaii
- Federal matching percentage for SCHIP is currently 71.17% thus, for every dollar spent by the State, the Federal government pays for approximately 71 cents
- In 2003, there were 25,180 uninsured children (18 years and younger)
- Each child enrolled in SCHIP reduces the uninsured population
- Uninsured tend to use expensive emergency room services, wait longer to obtain care which may result in bad debt and charity care

Source: State Health Facts, Kaiser Family Foundation

Medicaid Impact

QUEST Expansion

- The QUEST Program was implemented in 1994 for certain Medicaid beneficiaries
- The aged, blind and disabled (ABD) remained in the traditional fee-for-service (FFS) Medicaid program
- Medicaid plans to implement QUEST for the ABD
- Under QUEST, health plans provide the services to beneficiaries, manage their care and pay the providers
- Medicaid has submitted its request to expand the QUEST Program for the ABD
- The providers would negotiate payment for services with the health plans just as is currently done for QUEST

Medicaid Impact

QUEST Expansion (continued)

- The impact on the providers has not been determined as it will depend on the negotiated payment with the health plans
- Questions that have been raised include:
  - What will be the financial impact to the providers?
  - What will be the impact to the ABD recipients who are more vulnerable and frail?
  - Will QUEST be able to control the Medicaid cost of services for the ABD?
  - Will there be proper coordination of care?
  - Does Hawaii have sufficient home and community based services to care for those not placed in a nursing facility?

Who Pays

- Those who provide health insurance (businesses or private payors) are paying for the unfunded costs
- Health insurance premiums have generally continued to increase

Percentage Increase in Premiums

	2002-2003	2003-2004	2004-2005 *
HMSA	11%	8%	3.4%
HMAA	7%	9%	6.0%
UHA	12%	-4%	5.0%
Kaiser	10%	12%	3.0%

- Average annual increase in family health insurance premiums in the US from 1996 to 2004 was 9%
- Plans must now file with the Insurance Division for approval of premium increases.

* Rate increases for 2004-2005 are proposed rate increases.

Source: October 14, 2005, Pacific Business News

Who Pays

- Both Employees and Employers are paying for health insurance

Portion of Health Insurance Premiums Paid by Employee and Employer (2003)

	National		Hawaii	
	$	%	$	%
Employee Portion				
Single Coverage	$42	16%	$21	8.0%
Family Coverage	$201	27%	$171	26%
Employer Portion				
Single Coverage	$221	84%	$231	92.7%
Family Coverage	$543	73%	$487	74%

- Increases in health insurance premiums have outpaced inflation and wage increases in Hawaii and nationally

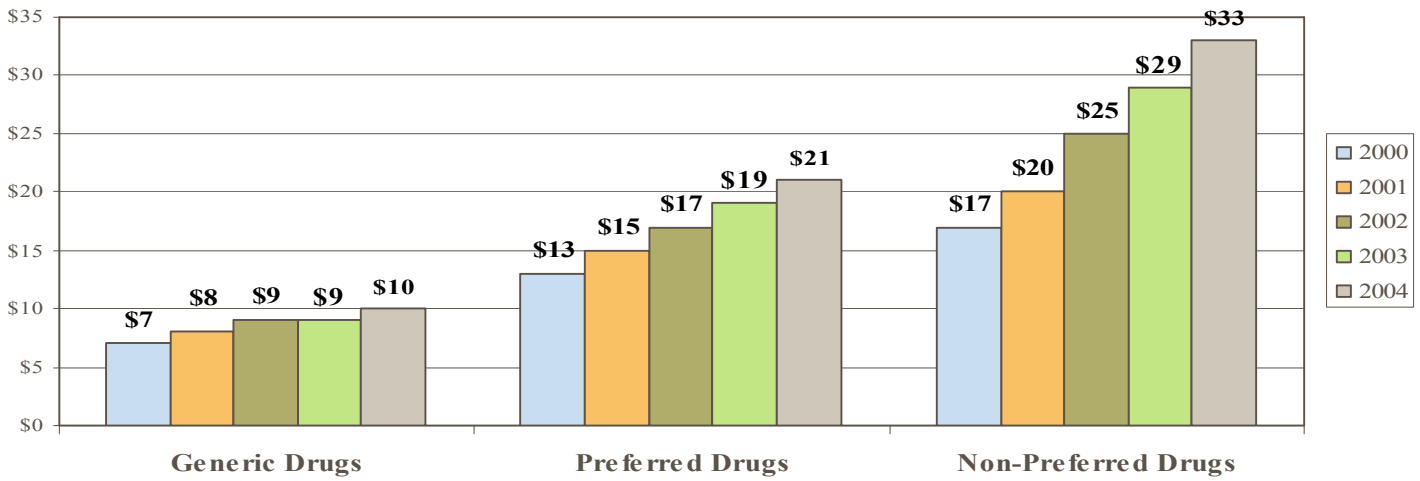
Inflation and Wage Increases (2003)

	National	Hawaii
Inflation	2.2%	2.3%
Wage Increases	3.0%	3.0%

Source: State of Hawaii Data Book, US Dept of Labor and Kaiser Family Foundation

Prescriptions - Costs

- Increasing drug costs have contributed to the higher medical costs and insurance premiums
  - Retail prescription drug costs have increased an average of 7.4% each year from 1993-2003
- Co-payments for drugs, particularly brand name drugs have increased



Note: Preferred Drugs are on the "preferred list" or formulary for third party payors. They may be brand or generic. Non-Preferred Drugs are any drugs not on the "preferred list" or formulary and also may be brand or generic.

Source: Kaiser Family Foundation / Health Research and Educational Trust, *Employer Health Benefits, 2004 Annual Survey*, September 2004, Exhibit 9.2 and P*rescription Drug Trends,* October 2004

Prescriptions - Taxes

- Hawaii is one of two states that has a sales or use tax on prescription drugs
  - Illinois generally taxes sales of prescription and non-prescription drugs at a reduced rate
  - States such as Georgia, Michigan and Pennsylvania specifically exempt prescription drugs
- Hawaii does not directly tax the drug purchaser
  - Tax is imposed on the seller and
  - Seller typically passes on the tax to the buyer

Financial Trends of Hawaii's Hospitals and Nursing Facilities

- Unfunded amounts incurred by the hospitals and nursing facilities for community support average $122,900,000 each year
- Hospitals and nursing facilities also incur significant amounts to comply with the Health Insurance Portability and Accountability Act (HIPAA), Patient Safety requirements and other regulatory matters and increases in salaries

Unfunded Costs	2000	2001	2002	2003	2004	2005 ^	Total
Medical Education	$ 14,800,000	$ 21,300,000	$ 18,800,000	$ 19,800,000	$ 22,200,000	$ 22,200,000	$ 119,100,000
Community Programs	12,200,000	12,300,000	10,700,000	5,600,000	4,700,000	1,400,000	46,900,000
Bad Debt/Charity Care	95,300,000	86,000,000	88,700,000	97,700,000	101,800,000	101,700,000	571,200,000
Total	**$ 122,300,000**	**$ 119,600,000**	**$ 118,200,000**	**$ 123,100,000**	**$ 128,700,000**	**$ 125,300,000**	**$ 737,200,000**

- Changes in Medicaid and QUEST will also impact the hospitals and nursing facilities including the phase-in of Act 294 and expansion of QUEST to the ABD

^ - Assumed the same costs for Medical Education for 2005 as reported in the cost reports for 2004.

Factors Impacting Hawaii's Hospitals and Nursing Facilities

- Increases in premiums charged by health insurers do not necessarily translate into increased payments to providers
- Increases in rates charged by the facilities do not necessarily translate into increased patient revenues
- Although the hospitals and nursing facilities have taken steps to control costs, certain cost increases are not within the facility's control:
  - Increases in personnel costs due to contract negotiations and shortages
  - Increases in the cost of pharmaceuticals and medical supplies
  - Increases in insurance premiums (especially after September 11)
  - Increases in costs due to corporate compliance programs, HIPAA and other regulations

Factors Impacting Hawaii's Hospitals and Nursing Facilities

- Medicare is the main payor of hospital and outpatient services for the elderly
- Medicaid is the main payor of nursing facility services for the elderly
- Elderly population is growing and will be a larger percentage of the population
- As the elderly population grows, more inpatient, outpatient and nursing facility services will be paid for by Medicare and Medicaid
- Medicare and Medicaid payment typically does not cover costs and both programs continue to look for ways to control payment amounts
- As costs increase, payments may not keep up resulting in lower payments and higher costs
- Payment amounts are fixed per day, discharge or visit. Provision of more services does not result in increased payment
- As the elderly utilize more services, payments may not keep pace with the utilization levels required to maintain quality care
- Providers are also not able to obtain increased payments from other payors that are also looking to reduce their costs to minimize increases in insurance premiums

Impact on Community and Industry

Financial losses may result in the following:

- Reduced access to quality care
- Reductions in full-time equivalents and salaries
- Decreased bond ratings due to the poorer financial results which results in higher interest payments
- Reductions or delays in capital expenditures (i.e., technology)
- Reductions or limits in the amount provided for medical research