



STATE OF WASHINGTON
DEPARTMENT OF HEALTH

December 8, 2011

CERTIFIED MAIL # 7008 1300 0000 7202 9690

D. Andrew Slusser, SVP
Acquisitions and Development
Capella Healthcare
501 Corporate Centre Drive, #200
Franklin, Tennessee 37067

Re: CN12-07

Dear Mr. Slusser:

We have completed review of the Certificate of Need application submitted on behalf of Valley Regional Hospital, LLC proposing to lease real estate from Snohomish County Public Hospital District, #1 Valley General Hospital, in Monroe. For the reasons stated in this evaluation, the application submitted is consistent with applicable criteria of the Certificate of Need Program, provided Valley Regional Hospital, LLC agrees to the following in its entirety.

Project Description:

This project approves the 40-year lease of Valley General Hospital in Monroe. At project completion, the allocation of Valley General Hospital's 72 beds is as follows:

Bed Type	# of Licensed Beds
General Medical/Surgical	32
Dedicated Chemical Dependency	26
Dedicated Geropsychiatric	14
Total Number of Licensed Beds	72

Conditions:

1. Valley Regional Hospital, LLC agrees with the project description stated above.
2. Before issuance of a Certificate of Need, Valley Regional Hospital, LLC must provide documentation to demonstrate creation of the LLC.
3. Valley Regional Hospital will provide charity care in compliance with the charity care policies provided in this Certificate of Need application, or any subsequent policies reviewed and approved by the Department of Health. Valley General Hospital will use reasonable efforts to provide charity care in an amount comparable to or exceeding the average amount of charity care provided by hospitals in the Puget



Sound Region. Currently, this amount is 4.41% for adjusted revenue. Valley General Hospital will maintain records documenting the amount of charity care it provides and demonstrating its compliance with its charity care policies.

4. Within 20 days of finalizing the lease of Valley General Hospital, Valley Regional Hospital, LLC will submit to the Certificate of Need Program for review and approval a final, executed Lease Agreement, including all finalized exhibits attached to the agreement. The executed Lease Agreement must be consistent with the draft agreement provided in the application.
5. Within 30 days of appointment of the Applicant Board, Board of Trustees, Chief of Staff, and Chief Executive Officer, Valley Regional Hospital, LLC will submit to the Certificate of Need Program the names and professional license number (if applicable) for each individual.

Approved Costs:

The approved capital expenditure for this project is \$33,250,000.

You have two options, either accept or reject the above in its entirety. If you accept the above in its entirety, your application will be approved and a Certificate of Need sent to you. If you reject any provision of the above, you must identify that provision, and your application will be denied because approval would not be consistent with applicable Certificate of Need review criteria. Please notify the Department of Health within 20 days of the date of this letter whether you accept the above in its entirety. Your written response should be sent to the Certificate of Need Program, at one of the following addresses.

Mailing Address:

Department of Health
Certificate of Need Program
Mail Stop 47852
Olympia, WA 98504-7852

Other Than By Mail:

Department of Health
Certificate of Need Program
310 Israel Road SE
Tumwater, WA 98501

If you have any questions, or would like to arrange for a meeting to discuss our decision, please contact Janis Sigman with the Certificate of Need Program at (360) 236-2955.

Sincerely,



Steven M. Saxe, FACHE
Director, Health Professions and Facilities

Enclosure

cc: Jody Carona, Health Facilities Planning and Development

**EVALUATION OF THE CERTIFICATE OF NEED APPLICATION SUBMITTED BY
VALLEY REGIONAL HOSPITAL, LLC PROPOSING TO LEASE SNOHOMISH
COUNTY PUBLIC HOSPITAL DISTRICT #1 – VALLEY GENERAL HOSPITAL**

LESSEE DESCRIPTION

Valley Regional Hospital, LLC is a ‘to-be formed’ Washington limited liability company, whose ultimate members will be CMCH Holdings, LLC, a Delaware limited liability company, and Snohomish County Public Hospital District (PHD) #1, a Washington municipal corporation. CMCH Holdings LLC is a wholly owned subsidiary of Capella Healthcare, Inc. Once formed, Valley Regional Hospital, LLC will be 90% owned by CMCH Holdings and 10% owned by Snohomish County PHD #1. [source: October 12, 2011, supplemental information, p1; and October 27, 2011, cover letter, p1]

Capella Healthcare owns or operates hospitals, home health agencies, and ambulatory surgery centers in seven states, including Capital Medical Center in Washington State. [source: Application, p2 and October 12, 2011, supplemental information, p2]

Snohomish County PHD #1 operates Valley General Hospital in Monroe, a 40-bed residential treatment facility known as Recovery Center at Valley General Hospital, and the Sky River Medical Group. [source: Application, p3]

For this project, Valley Regional Hospital, LLC (VRH, LLC) is the lessee and the applicant. The applicant’s address is:

501 Corporate Centre Drive, #200
Franklin, Tennessee 37067

LESSOR DESCRIPTION

Snohomish County Public Hospital District #1 (hospital district) is a not-for profit health district governed by a three member board of commissioners. The hospital district operates the following three healthcare facilities. [source: Application, p3, and VGH website]

- Valley General Hospital (VGH)
VGH is a 72-bed acute care hospital located at 14701 – 179th Avenue Southeast in Monroe, within Snohomish County. Of the 72 licensed beds, 26 are dedicated to chemical dependency services, 32 are general medical surgical, and the remaining 14 are dedicated to geropsychiatric services.

- Recovery Center at Valley General Hospital (Recovery Center)
The Recovery Center is a licensed residential treatment facility located on the VGH campus at 17889 – 147th Street Southeast in Monroe and provides chemical dependency support services in its 40 beds. The facility offers a 21-day treatment program for chemical dependency, which includes substance abuse, drug addiction, or alcoholism.

- Sky River Medical Group

Located on the southwest corner of the VGH campus, the medical group's address is 14841 – 179th Street Southeast, #210 in Monroe. The medical group's website shows only two physicians associated with Sky River Medical Group—Diane Doerner, MD and John Okemah, MD.

For this project, the hospital district is the lessor. The lessor's address is VGH's address as listed above.

PROJECT DESCRIPTION

On August 12, 2011, Capella Healthcare, Inc. reserved the name of 'Valley Regional Hospital, LLC' with the Washington State Secretary of State. Formal registration of Valley Regional Hospital, LLC will occur at or before closing this transaction. The project proposes a long-term [40 year] lease of VGH and the Recovery Center by VRH, LLC.¹ Since lease of the Recovery Center, which is a licensed residential treatment facility, does not require prior CN review, this evaluation will focus on the lease of VGH. If this project is approved, the department would attach a condition to the approval requiring the establishment of Valley Regional Hospital, LLC before a Certificate of Need is issued.

On October 27, 2011, VRH, LLC provided a copy of the draft lease agreement. Under the draft agreement, VGH will continue operations at its current site, maintain participation in both the Medicare and Medicaid programs, and maintain all services currently offered by the hospital. Services currently provided at VGH include general medical surgical, emergent care, critical care, diagnostic and imaging services, inpatient and outpatient mental health, and obstetrical. [source: Application, p7]

VRH, LLC identified an estimated capital expenditure for the lease of VGH of \$33,250,000. Of this amount, CMCH Holdings, LLC is responsible for 90% or \$29,925,000 and the remaining 10% or \$3,325,000 is the responsibility of the hospital district. CMCH Holdings, LLC intends to finance its 90% portion through cash or cash equivalents of Capella Healthcare. The hospital district will contribute its 10% through equipment and assets of the hospital. [source: Application, p23, and October 27, 2011, supplemental information, cover letter and draft lease p2]

APPLICABILITY OF CERTIFICATE OF NEED LAW

This project is subject to Certificate of Need (CN) review because it is the lease of all or part of an existing hospital under Revised Code of Washington (RCW) 70.38.105(4)(b) and Washington Administrative Code (WAC) 246-310-020(1)(b).

¹ The application does not indicate that the Sky River Medical Group is part of the lease transaction. Lease of the medical group does not require prior Certificate of Need review and approval.

CRITERIA EVALUATION

WAC 246-310-200(1)(a)-(d) identifies the four determinations that the department must make for each application. WAC 246-310-200(2) provides additional direction in how the department is to make its determinations. It states:

"Criteria contained in this section and in WAC 246-310-210, 246-310-220, 246-310-230, and 246-310-240 shall be used by the department in making the required determinations.

(a) In the use of criteria for making the required determinations, the department shall consider:

- (i) The consistency of the proposed project with service or facility standards contained in this chapter;*
- (ii) In the event the standards contained in this chapter do not address in sufficient detail for a required determination the services or facilities for health services proposed, the department may consider standards not in conflict with those standards in accordance with subsection (2)(b) of this section; and*
- (iii) The relationship of the proposed project to the long-range plan (if any) of the person proposing the project."*

In the event the WAC 246-310 does not contain service or facility standards in sufficient detail to make the required determinations, WAC 246-310-200(2)(b) identifies the types of standards the department may consider in making its required determinations. Specifically WAC 246-310-200(2)(b) states:

"The department may consider any of the following in its use of criteria for making the required determinations:

- (i) Nationally recognized standards from professional organizations;*
- (ii) Standards developed by professional organizations in Washington state;*
- (iii) Federal Medicare and Medicaid certification requirements;*
- (iv) State licensing requirements;*
- (v) Applicable standards developed by other individuals, groups, or organizations with recognized expertise related to a proposed undertaking; and*
- (vi) The written findings and recommendations of individuals, groups, or organizations with recognized expertise related to a proposed undertaking, with whom the department consults during the review of an application."*

To obtain Certificate of Need approval, VRH, LLC must demonstrate compliance with the applicable criteria found in WAC 246-310-210 (need); 246-310-220 (financial feasibility); 246-310-230 (structure and process of care); and 246-310-240 (cost containment).²

² Each criterion contains certain sub-criteria. The following sub-criteria are not discussed in this evaluation because they are not relevant to this project: WAC 246-310-210(1), (3), (4), (5), (6) and WAC 246-310-240(2) and (3).

APPLICATION CHRONOLOGY

Below is a chronologic summary of this project.

Action	VRH, LLC
Letter of Intent Submitted	August 15, 2011
Application Submitted	September 6, 2011
Department holds the application until the remainder of the 30-day Letter of Intent period	September 7, 2011 through September 14, 2011
Department's pre-review activities including screening and responses	September 15, 2011, through October 17, 2011
Beginning of Review <ul style="list-style-type: none">• public comments accepted throughout review;• no public hearing conducted under expedited review rules	October 18, 2011
End of Public Comment	November 7, 2011
Rebuttal Comments Received	November 22, 2011
Department's Anticipated Decision Date	December 13, 2011
Department's Actual Decision Date	December 8, 2011

AFFECTED PERSONS

Washington Administrative Code 246-310-010(2) defines "affected person" as:

"...an "interested person" who:

- (a) *Is located or resides in the applicant's health service area;*
- (b) *Testified at a public hearing or submitted written evidence; and*
- (c) *Requested in writing to be informed of the department's decision."*

Throughout the review of this project, one entity sought and received affected person status under WAC 246-310-010(2).

- Providence Regional Medical Center Everett is an acute care hospital located at 1321 Colby Avenue in Everett, within Snohomish County. The hospital provides Medicare and Medicaid services to the residents of Snohomish County and surrounding areas.

SOURCE INFORMATION REVIEWED

- Valley Regional Hospital, LLC Certificate of Need Application received September 6, 2011
- Valley Regional Hospital, LLC supplemental information received October 12, 2011 and October 27, 2011
- Public comments received at the Certificate of Need Program office by November 7, 2011
- Rebuttal comments submitted by Valley Regional Healthcare, LLC on November 22, 2011
- Comprehensive Hospital Abstract Reporting System (CHARS) data obtained from the Department of Health's Hospital and Patient Data Systems

- Historical charity care data obtained from the Department of Health's Hospital and Patient Data Systems (2007, 2008, and 2009 summaries)
- Financial feasibility and cost containment evaluation prepared by the Department of Health's Hospital and Patient Data Systems received December 2, 2011
- Licensing and/or survey data provided by the Department of Health's Investigations and Inspections Office
- Data obtained from the internet regarding Capella Healthcare (www.capellahealth.com)
- Data obtained from the internet regarding Snohomish County PHD #1-Valley General Hospital (www.valleygeneral.com)
- Historical Certificate of Need and Investigations and Inspections files

CONCLUSION

For the reasons stated in this evaluation, the application submitted by Valley Regional Hospital, LLC proposing a 40-year lease of Valley General Hospital is consistent with applicable criteria of the Certificate of Need Program, and a Certificate of Need should be issued provided Valley Regional Hospital, LLC agrees to the following in its entirety.

Project Description:

This project approves the 40-year lease of Valley General Hospital in Monroe. At project completion, the allocation of Valley General Hospital’s 72 beds is as follows:

Bed Type	# of Licensed Beds
General Medical/Surgical	32
Dedicated Chemical Dependency	26
Dedicated Geropsychiatric	14
Total Number of Licensed Beds	72

Conditions:

1. Valley Regional Hospital, LLC agrees with the project description stated above.
2. Before issuance of a Certificate of Need, Valley Regional Hospital, LLC must provide documentation to demonstrate creation of the LLC.
3. Valley Regional Hospital will provide charity care in compliance with the charity care policies provided in this Certificate of Need application, or any subsequent policies reviewed and approved by the Department of Health. Valley General Hospital will use reasonable efforts to provide charity care in an amount comparable to or exceeding the average amount of charity care provided by hospitals in the Puget Sound Region. Currently, this amount is 4.41% for adjusted revenue. Valley General Hospital will maintain records documenting the amount of charity care it provides and demonstrating its compliance with its charity care policies.
4. Within 20 days of finalizing the lease of Valley General Hospital, Valley Regional Hospital, LLC will submit to the Certificate of Need Program for review and approval a final, executed Lease Agreement, including all finalized exhibits attached to the agreement. The executed Lease Agreement must be consistent with the draft agreement provided in the application.

5. Within 30 days of appointment of the Applicant Board, Board of Trustees, Chief of Staff, and Chief Executive Officer, Valley Regional Hospital, LLC will submit to the Certificate of Need Program the names and professional license number (if applicable) for each individual.

Approved Costs:

The approved capital expenditure for this project is \$33,250,000.

A. Need (WAC 246-310-210)

Based on the source information reviewed and the applicant's agreement to the conditions identified in the "Conclusion" section of this evaluation, the department determines that the applicant has met the need criteria in WAC 246-310-210(2).

(2) All residents of the service area, including low-income persons, racial and ethnic minorities, women, handicapped persons, and other underserved groups and the elderly are likely to have adequate access to the proposed health service or services.

VGH is currently a provider of health care services to residents of Washington State, including low-income, racial and ethnic minorities, handicapped and other underserved groups. As an acute care hospital, VGH also currently participates in the Medicare and Medicaid programs. To determine whether all residents of the service area would continue to have access to a hospital's proposed services, the department requires applicants to provide a copy of its current or proposed admission policy. The admission policy provides the overall guiding principles of the facility as to the types of patients that are appropriate candidates to use the facility and any assurances regarding access to treatment.

To demonstrate compliance with this sub-criterion, VRH, LLC provided copies of the following admission policies to be used at VGH once the lease agreement is in effect:

- Admission of Patients to the ED [emergency department]
- Patient Admission from ED to Nursing Unit
- Pediatric Patient Admission Process and Admission Form Guidelines
- Nursing Admission Procedures

The existing policies outline the process/criteria that VGH currently uses to admit patients for treatment or care at the hospital. [source: October 12, 2011, supplemental information, Attachment 3] All policies provide the following non-discrimination statement:

"Valley General Hospital does not exclude, deny benefits to, or otherwise discriminate against any person on the basis of age, race, creed, gender, national origin, religious preference, or disability in admission to participate in, or receipt of the services and benefits under any of its admissions, programs, activities and services."

To determine whether low-income residents would have access to the proposed services, the department uses the facility's Medicaid eligibility or contracting with Medicaid as the measure to make that determination.

To demonstrate compliance with this sub-criterion, VRH, LLC stated that VGH currently contracts with Medicaid and the applicant intends to maintain this status. Further, financial data provided in the application includes Medicaid revenues. [source: Application, pp19-21]

To determine whether the elderly would have access or continue to have access to the proposed services, the department uses Medicare certification as the measure to make that determination.

To demonstrate compliance with this sub-criterion, VRH, LLC stated that the hospital currently contracts with Medicare and this transaction would not affect this status. Hospital-wide financial data provided in the application includes Medicare revenues. [source: Application, pp19-21]

A facility’s charity care policy should confirm that all residents of the service area including low-income, racial and ethnic minorities, handicapped and other underserved groups have, or would have, access to healthcare services of the applicant. The policy should also include the process one must use to access charity care at the facility.

To demonstrate compliance with this sub-criterion, VRH, LLC provided a copy of VGH’s current, Department of Health approved, charity care policy. [source: October 12, 2011, supplemental information, Attachment 4] The policy outlines the process/criteria that patients would use to access this service from VGH. The applicant states that the policy would not change as a result of this transaction. Further, VRH, LLC included a ‘charity care’ line item as a deduction from revenue within the pro forma financial documents for VGH. [source: October 12, 2011, supplemental information, Attachment 5]

For charity care reporting purposes, the Department of Health’s Hospital and Patient Data Systems program (HPDS), divides Washington State into five regions: King County, Puget Sound (less King County), Southwest, Central, and Eastern. VGH is located in Snohomish County within the Puget Sound Region. Currently there are 18 hospitals located within the region, including VGH. According to 2007-2009³ charity care data obtained from HPDS, VGH has historically provided more than the average charity care provided in the region.

The pro forma revenue and expense statements submitted by VRH, LLC indicate that the hospital will provide charity care at approximately 3.65% of gross revenue and 6.65% of adjusted revenue. RCW 70.38.115(2)(j) requires hospitals to meet or exceed the regional average level of charity care.

Table 1 below shows a comparison of VGH’s most recent three-year (2007 - 2009) average percentage of charity care for gross and adjusted revenues, the Puget Sound Regional averages, and VGH’s projected averages. [source: HPDS 2007-2009 charity care summaries and October 12, 2011, supplemental information, Attachment 4]

**Table 1
Valley General Hospital Charity Care Comparison (2007-2009)**

	3-Year Average Puget Sound Region	VGH 3-Year Average	VGH 3-Year Projected
Percentage of Gross Revenue	2.02%	5.81%	3.65%
Percentage of Adjusted Revenue	4.41%	9.63%	6.65%

The department acknowledges that VGH’s three-year historical average is above that for the region and VRH, LLC projects to continue providing charity care above the regional average.

³ Year 2010 charity care data is not available as of the writing of this evaluation.

Because VRH, LLC is a new entity and to ensure that the charity care averages will remain consistent with the regional averages under the lease agreement, the department concludes that a condition related to the percentage of charity care to be provided at VGH is necessary if this project is approved.

Providence Regional Medical Center-Everett (PRMC-E) provided comments on VRH, LLC's application related to this sub-criterion. Specifically, PRMC-E noted that VRH, LLC's application projected a decline in charity care from year 2013 to 2014. [source: October 26, 2011, public comments, pp1-2]

VRH, LLC provided rebuttal comments related to PRMC-E's charity care statements. The responses are restated below. [source: November 22, 2011, rebuttal documents, p2]

"Providence's Table 2 notes that Valley Regional Hospital, LLC's charity care is projected to decline in 2014 over 2013 levels. This is correct. The decline in 2014 is related to an expected reduction of currently underinsured individuals due to the full implementation of the federal health care reform legislation. As the department is aware, the national health care reform legislation envisions that on January 1, 2014, 32 million Americans will gain access to insurance. The widely accepted assumption is that bad debt and charity care will decline within hospitals because of the insurance expansion. However, as noted on page 17 [of the application] we have assumed charity care at well above the 2007-2009 regional average-even after the 2014 reduction associated with health care reform implementation."

Department's Review

RCW 70.38.115(2)(j) provides the following guidance regarding charity care for hospital projects.

"In the case of hospital certificate of need applications, whether the hospital meets or exceeds the regional average level of charity care..."

The department noted the decline in charity care for projected year 2014 when compared to projected year 2013. VRH, LLC provided a valid explanation for the decline and noted that the projected percentages of charity care continue to be above the most recent 3-year average as shown in Table 1. With agreement to the condition regarding the charity care percentages, the department concludes that all residents, including low income, racial and ethnic minorities, handicapped, and other under-served groups would continue to have access to the services provided by Valley General Hospital. **This sub-criterion is met.**

B. Financial Feasibility (WAC 246-310-220)

Based on the source information reviewed and the applicant's agreement to the terms and conditions identified in the "Conclusion" section of this evaluation, the department determines that the applicant has met the financial feasibility criteria in WAC 246-310-220.

(1) The immediate and long-range capital and operating costs of the project can be met.

WAC 246-310 does not contain specific WAC 246-310-220(1) financial feasibility criteria as identified in WAC 246-310-200(2)(a)(i). There are also no known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b) that directs what the operating revenues and

expenses should be for a project of this type and size. Therefore, using its experience and expertise the department evaluates if the applicant's pro forma income statements reasonably project the proposed project is meeting its immediate and long-range capital and operating costs by the end of the third complete year of operation.

VRH, LLC identified an estimated capital expenditure for the lease of Valley General Hospital to be \$33,250,000; of that amount, \$29,925,000 would be funded by CMCH Holdings, LLC. This amount would be paid on or before the 'commencement date' of the Lease Agreement. The amount represents fixed, prepaid rent for the premises for the entire term of the lease (40 years). [source: Application, p23 and October 27, 2011, Draft Lease Agreement, p2] The remaining \$3,325,000 would be contributed by the hospital district through equipment and assets of the hospital. [source: Application, p23]

To demonstrate that the hospital's revenues would cover its expenses, VRH, LLC provided the following three separate pro forma financial statements for projected year 2012 through year 2014:

- 72 bed hospital only;
- 40 bed residential treatment center only; and
- Combined statement for the 72 bed hospital and 40 bed residential treatment center.

Table 2 below shows the 72-bed hospital only. [source: October 12, 2011, supplemental information, Attachment 4, p35]

Table 2
Valley General Hospital
Projected Revenue and Expenses for Years 2012 through 2014

	2012	2013	2014
# Inpatient Admissions	1,909	1,928	1,948
# Inpatient Days	5,346	5,399	5,454
% Occupancy	46%	46%	47%
Total Net Revenue	\$ 49,220,000	\$ 53,749,000	\$ 56,894,000
Minus Expenses	\$ 49,145,000	\$ 51,421,000	\$ 53,729,000
Net Profit or (Loss)	\$ 75,000	\$ 2,328,000	\$ 3,165,000
Minus Depreciation	\$ 1,405,000	\$ 2,048,000	\$ 2,691,000
Net Profit or (Loss) w/ depreciation	(\$ 1,330,000)	\$ 280,000	\$ 474,000

Table 2 reflects a gradual increase in admissions and patient days and includes all acute care services currently provided at VGH. The occupancy percentages are expected to remain at approximately 46% in the next three years.

The 'Total Net Patient Revenue' line item in Table 2 is the result of gross patient revenue minus any deductions for contractual allowances, bad debt, and charity care. It also includes non-patient care revenue from property. The 'Minus Expenses' line item includes staff salaries/wages and all expenses to operate the hospital. The expense line item also includes allocated costs for administrative services provided by Capella Healthcare, Inc. or one of its subsidiaries.

VRH, LLC based its projections shown in Table 2 on the assumptions summarized below. [source: Application, pp7 and 13-14; October 12, 2011, supplemental information, p 4 and pp7-8]

- The number of set up, licensed beds remains at 72;
- The breakdown of beds remains at 32 medical surgical beds, 26 dedicated chemical dependency beds; and 14 dedicated geropsychiatric beds;
- The number of admissions and patient days excludes normal newborns;
- The hospital provided obstetric services until mid year 2011. OB services (normal newborn only) would again be provided by end of year 2013, however, these services are not reflected in the admissions shown in Table 2.
- The hospital also provided geropsychiatric services until mid year 2011. These services would again be provided by end of year 2013, however, these services are not reflected in the admissions shown in Table 2.
- ‘Other Operating Revenue’ includes \$3,000,000 for years 2012 and 2013 from the creation of a \$6,000,000 indigent care fund created to help bridge the gap to health care reform in year 2014. It also includes line items such as cafeteria and pharmacy sales in all three years.
- ‘Other Operating Expenses’ is based on historical expenses and includes non-assignable medical supplies, pharmacy supplies, and physician recruitment costs.
- The expense line item also includes federal and state taxes. As a for-profit entity in years 2012 through 2014, VRH, LLC will be subject to federal income tax, state and county property or lease tax, sales tax, etc. These are taxes from which the district is currently exempt.

With the assumptions above, Table 2 shows the hospital would operate at a loss in year 2012, and a slight profit in years 2013 and 2014.

As previously stated, this transaction also includes the long-term lease of the 40-bed residential treatment facility (RTF) known as Recovery Center at Valley General Hospital. VRH, LLC also provided a combined Revenue and Expense Statement showing operations of both VGH and the RTF. [source: October 12, 2011, supplemental information, Attachment 4] Table 3 below is a summary of that statement.

Table 3
Valley General Hospital and Recovery Center at Valley General Hospital
Combined Projected Revenue and Expenses for Years 2012 through 2014

	2012	2013	2014
Total Net Revenue	\$ 52,424,000	\$ 57,173,000	\$ 60,616,000
Minus Expenses	\$ 52,443,000	\$ 54,838,000	\$ 57,272,000
Net Profit or (Loss)	(\$ 19,000)	\$ 2,335,000	\$ 3,344,000
Minus Depreciation	\$ 1,410,000	\$ 2,053,000	\$ 2,696,000
Net Profit or (Loss) w/ depreciation	(\$ 1,429,000)	\$ 282,000	\$ 648,000

The ‘Total Net Patient Revenue’ line item in Table 3 is the result of gross patient revenue minus any deductions for contractual allowances, bad debt, and charity care. It also includes non-patient care revenue from property. The ‘Minus Expenses’ line item includes staff salaries/wages and all expenses to operate the hospital and the RTF. The expense line item

also includes allocated costs for administrative services provided by Capella Healthcare, Inc. or one of its subsidiaries.

For the RTF alone, VRH, LLC projects occupancy percentages to increase slightly from year 2010 (54%) to years 2012, 2013, and 2014 (59%, 59%, and 60%, respectively). [source: October 12, 2011, supplemental information, p4] Comparing the 'Net Profit or (Loss)' line items in Table 2 and Table 3, it is clear that the RTF is also expected to operate at a loss in year 2012.

PRMC-E provided comments on VRH, LLC's application related to this sub-criterion. Specifically, PRMC-E compared historical payer mix data with projected payer mix data, and provided comments on the comparison. [source: October 26, 2011, public comments, pp1-2]

- 2008 through 2011 historical or estimated discharges by payer mix were compared with the projected 2012 through 2014 discharges by payer mix. The comparison shows a significant decrease in Medicare, Medicaid, and self-pay patients for estimated year 2011 and projected year 2012. Minimal changes are shown from year 2012 through 2014.
- The applicant also assumes a 26% and 45% increase for commercially insured patients for years 2011 to 2012.

VRH, LLC provided rebuttal comments related to PRMC-E's statements. The responses are summarized below. [source: November 22, 2011, rebuttal documents, pp1-2]

Related to PRMC-E's concern regarding Medicare rates at 50% below estimated 2011 levels and Medicaid rates at 59% below estimated 2011 levels, as stated in footnote #4 on page 10 of the application, the district closed both behavioral health and OB services in mid-year 2011. These closures changed the hospital's payer mix. Historically, the behavioral health unit was 80% Medicare and the OB service was 70% Medicaid. While VRH, LLC anticipates reinstating both of these services by January 2013, in an effort to be conservative, volume and payer mix estimates do not rely on reinstatement of these two services and assume very little growth. In year 2012, Medicare and Medicaid discharges are expected to grow at 2% through year 2014.

Department's Review

Historical information obtained by the department confirms VGH's recent closure of behavioral health and OB services. Given the revenue percentages stated above for both of these services, a change in payer mix is expected when the services were discontinued. While VRH, LLC anticipates reinstatement of both of these services, VRH, LLC is not required to provide either of the services at VGH.

The department also reviewed 2010 Medicare and Medicaid patient admission data for both VGH and PRMC-E. [source: 2010 hospital reported data] A summary of the data is shown in Table 4 on the following page.

**Table 4
2010 Medicare and Medicaid Patient Admission Data Comparison**

2010 Medicare Admission Data			
	# of Admission	Total Admissions	% of Medicare Patients
VGH	765	2,061	37.1%
PRMC-E	6,244	25,234	27.7%

2010 Medicaid Admission Data			
	# of Admission	Total Admissions	% of Medicaid Patients
VGH	639	2,061	31.0%
PRMC-E	1,841	25,234	7.3%

While the percentages of both Medicare and Medicaid decreased from 2010 to 2011 because of the closure of both behavioral health and OB services, Table 4 above confirms that VGH is an essential provider of both Medicare and Medicaid services to the residents of east Snohomish County. In anticipation of reinstatement of both services, VRH, LLC appropriately assumed a small percentage of growth in its pro forma statements. VRH, LLC provided a valid explanation for the Medicare and Medicaid percentages shown in the projected years and the pro forma statements substantiate its intent to continue providing those services.

To analyze short- and long-term financial feasibility of hospital projects and to assess the financial impact of a project on overall facility operations, the department uses financial ratio analysis. The analysis provided by the Department of Health's Hospital and Patient Data Systems office (HPDS) assesses the financial position of an applicant both historically and prospectively. The financial ratios utilized are **1)** long-term debt to equity ratio; **2)** current assets to current liabilities ratio; **3)** assets financed by liabilities ratio; **4)** total operating expense to total operating revenue ratio; and **5)** debt service coverage ratio. If a project's ratios are within the expected value range, the project can be expected to be financially feasible.

For Certificate of Need applications, HPDS compares the projected ratios with the most recent year's financial ratio guidelines for hospital operations. For this project, HPDS uses 2009 data for comparison. The ratio comparisons shown below include VGH in 2010, and projected ratios for the hospital operated under the lease agreement by VRH, LLC. [HPDS analysis, p3] The ratio review is shown on the following page.

Table 5
Current HPDS Debt Ratios for Valley General Hospital
Projected HPDS Debt Ratios for Valley General Hospital operated under VRH, LLC

Category	Trend*	State 2009	VGH 2010 Current	VGH 2012 Projected	VGH 2013 Projected	VGH 2014 Projected
Long Term Debt to Equity	B	0.551	1.709	N/A	N/A	N/A
Current Assets/Current Liabilities	A	2.221	1.455	1.166	1.048	0.981
Assets Funded by Liabilities	B	0.433	0.701	0.215	0.228	0.238
Operating Exp. to Operating Rev.	B	0.942	1.064	1.027	0.995	0.992
Debt Service Coverage	A	5.928	0.663	N/A	N/A	N/A
Definitions:	Formula					
Long Term Debt to Equity	Long Term Debt/Equity					
Current Assets/Current Liabilities	Current Assets/Current Liabilities					
Assets Funded by Liabilities	Current Liabilities + Long term Debt/Assets					
Operating Exp/Operating Rev	Operating Expenses/Operating Revenue					
Debt Service Coverage	Net Profit+Depr and Interest Exp/Current Mat. LTD and Interest Exp					

*A is better if above the ratio, and B is better if below the ratio.

After reviewing the current ratios for VGH and the projected ratios under the management and operation of VRH, LLC, staff from HPDS provided the following analysis. [source: HPDS analysis, pp2-3]

"The 2010 audited [financial data for] Valley General Hospital shows high long term debt as compared to equity. The reports also show the equity is shrinking each year due to operating losses. These losses could make the near future continued current level of operation difficult. ...There is no debt assigned to [the hospital] since it is an operating entity. The debt will remain with the [LLC]. Because of this, Long Term Debt to Equity and Debt Service Coverage are not applicable and Assets funded by liabilities is a healthy ratio. Current Assets/Current Liabilities are out of range due to low profit margin in the early years of VR [Valley Regional, LLC]. CH has the assets to deal with this. [Valley General Hospital] will be at or above break-even (operating expense/operating revenue) by the end on the third year as required by CON rules. Capella Holding's financial health overall is fair compared to hospitals in Washington State."

Based on the information above, the department concludes that the immediate and long-range operating costs of the project can be met and **this sub-criterion is met.**

(2) The costs of the project, including any construction costs, will probably not result in an unreasonable impact on the costs and charges for health services.

WAC 246-310 does not contain specific WAC 246-310-220(2) financial feasibility criteria as identified in WAC 246-310-200(2)(a)(i). There are also no known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b) that directs what an unreasonable impact on costs and charges would be for a project of this type and size. Therefore, using its experience and expertise the department compared the proposed project's costs with those previously considered by the department.

As stated in the project description section of this evaluation, VRH, LLC intends to maintain all current services at VGH during its lease, plus reinstate both obstetric services (normal newborn) and geropsychiatric services. [source: Application, pp7 and 13-14; October 12, 2011, supplemental information, p 4 and pp7-8]

Staff from HPDS compared the proposed costs for services after this transaction to the costs for services of existing hospitals. HPDS determined the costs and charges are reasonable and comparable. [source: HPDS analysis, p4]

Based on the information provided above, the department concludes that the cost of the project will not result in an unreasonable impact on the costs and charges for health services within the service area. **This sub-criterion is met.**

(3) The project can be appropriately financed.

WAC 246-310 does not contain specific source of financing criteria as identified in WAC 246-310-200(2)(a)(i). There are also no known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b) that directs how a project of this type and size should be financed. Therefore, using its experience and expertise the department compared the proposed project's source of financing to those previously considered by the department.

VRH, LLC identified an estimated capital expenditure for the lease of Valley General Hospital to be \$33,250,000. A breakdown of the funding sources is shown below. [source: October 27, 2011, supplemental information, cover sheet]

**Table 6
Funding Source Breakdown**

Funding Source	Amount	% of Total
CMCH Holdings, LLC portion	\$ 29,925,000	90 %
Hospital District portion	\$ 3,325,000	10%
Total Capital Costs	\$ 2,898,000	100%

As shown in Table 6 above, \$29,925,000 would be funded by CMCH Holdings, LLC. This amount would be paid on or before the 'commencement date' of the Lease Agreement. This amount represents fixed, prepaid rent for the premises for the entire term of the lease (40 years). [source: Application, p23 and October 27, 2011, Draft Lease Agreement, p2]

The remaining \$3,325,000 would be contributed by the hospital district through equipment and assets of the hospital. [source: Application, p23]

After reviewing Capella Healthcare's (CH) fiscal year 2010 balance sheet, staff from HPDS provided the following analysis. [source: HPDS analysis, pp2 & 4]

"CH audited 2010 report shows negative stockholder equity in the firm. Total liabilities are more than assets. Negative shareholder equity most often comes from the accounting methods used to deal with accumulated losses from prior years. These losses generally are viewed as liabilities carried forward until future cancellation. Oftentimes, the losses exist on paper only, which makes it possible for a company to maintain operations, despite the continued posting of substantial losses.

Capella [Healthcare's] capital expenditure for Valley Regional Hospital is projected to be \$29,925,000 in cash. [The public hospital district] is expecting to contribute \$3,325,000 in assets. According to the 2010 audited report of Capella Holding, \$48 million in cash is available. While [Capella Healthcare] is committing a small amount of the corporations' assets on this purchase, it is committing a large percentage of its available cash. [The public hospital district] is contributing assets, which is a neutral transaction."

Based on the information provided above, the department concludes that the project can be appropriately funded. **This sub-criterion is met.**

C. Structure and Process (Quality) of Care (WAC 246-310-230)

Based on the source information reviewed and the applicant's agreement to the terms and conditions identified in the "Conclusion" section of this evaluation, the department determines that the applicant has met the structure and process of care criteria in WAC 246-310-230.

(1) A sufficient supply of qualified staff for the project, including both health personnel and management personnel, are available or can be recruited.

WAC 246-310 does not contain specific WAC 246-310-230(1) criteria as identified in WAC 246-310-200(2)(a)(i). There are also no known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b) that directs what specific staffing patterns or numbers of FTEs that should be employed for projects of this type or size. Therefore, using its experience and expertise the department concludes that the planning would allow for the required coverage.

VRH, LLC states that it plans to continue to employ all employees of the hospital and RTF that are in good standing, and adopt the hospital's existing medical staff bylaws, rights, and privileges. Current pay scales and staff seniority will also be maintained. [source: Application, p26]

VRH, LLC also states that it intends to 'grow' VGH so that it can better meet community need. To this end, additional staff is expected to be hired, especially additional physician staff. In consultation with the Board of Trustees and VGH Medical Staff, VRH, LLC expects additional recruitment of staff at some point in the next five years. [source: Application, p26]

VRH, LLC intends to establish an eight-member Applicant Board. Four of the members will be appointed by CMCH Holding, LLC. These four are expected to be Capella executives. The remaining four members will be appointed by the hospital district, and are expected to be current members of the district's Board of Commissioners. The Applicant Board is expected to be established on or before closing the transaction and completion of all necessary agreements between the hospital district and Capella Healthcare, Inc. Additionally a Chief of Staff position is expected to be established to serve as a non-voting member of the Applicant Board. [source: Application, p9; October 12, 2011, supplemental information, p3]

VRH, LLC also intends to establish a hospital governing board, known as the Board of Trustees. This board will consist of 50% medical staff representation and 50% community representation, plus the Chief Executive Officer of the hospital. The Board of Trustees will be responsible for development of strategic plans, monitoring/advising on quality of services provided, development of operating and capital budgets, and act as charitable contributions advisors. [source: Application, p9; October 12, 2011, supplemental information, p4]

The names of the individuals that would fill the Applicant Board, Board of Trustees, Chief of Staff, and Chief Executive Officer positions have not yet been identified. If this project is approved, the department would attach a condition to the approval requiring VRH, LLC to provide the names and professional license number (if applicable) for each individual.

With the condition regarding the Applicant Board, Board of Trustees, Chief of Staff, and Chief Executive Officer positions, the department concludes that **this sub-criterion is met.**

- (2) The proposed service(s) will have an appropriate relationship, including organizational relationship, to ancillary and support services, and ancillary and support services will be sufficient to support any health services included in the proposed project.

WAC 246-310 does not contain specific WAC 246-310-230(3) criteria as identified in WAC 246-310-200(2)(a)(i). There are known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b) that a facility must meet when it is to be Medicare certified and Medicaid eligible. Therefore, using its experience and expertise the department assessed the applicant's history in meeting these standards at other facilities owned or operated by the applicant.

VGH has been operating as an acute care hospital since 1960; and the district began its management of the hospital in approximately 1964. [source: VGH website] While no other hospitals operate in the district, several health care providers, including nursing homes, adult family homes, home health and/or hospice agencies, and primary care clinics currently operate in east Snohomish County. Over the years, VGH has worked closely with these providers, and VRH, LLC intends to continue these collaborative relationships. [source: Application, p26; October 12, 2011, supplemental information, p9]

Documentation provided in the application demonstrates that both VGH and district intend to continue working closely with existing providers to the betterment of the community. VRH, LLC does not anticipate any new working relationships, but will consider additional relationships as opportunities arise.

The department concludes that there is reasonable assurance that VRH, LLC will continue to maintain the necessary relationships with ancillary and support services to provide healthcare in the communities. Approval of this project would not negatively affect these relationships. **This sub-criterion is met.**

(3) There is reasonable assurance that the project will be in conformance with applicable state licensing requirements and, if the applicant is or plans to be certified under the Medicaid or Medicare program, with the applicable conditions of participation related to those programs. WAC 246-310 does not contain specific WAC 246-310-230(3) criteria as identified in WAC 246-310-200(2)(a)(i). There are known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b) that a facility must meet when it is to be Medicare certified and Medicaid eligible. Therefore, using its experience and expertise the department assessed the applicant's history in meeting these standards at other facilities owned or operated by the applicant.

VGH will continue to provide Medicare and Medicaid services to the residents of Snohomish County and surrounding communities. Currently, VGH contracts with the Joint Commission to survey and accredit the quality of service provided. The Joint Commission lists VGH in full compliance with all applicable standards following the most recent on-site survey in August 2010.⁴

The Department of Health's Investigations and Inspections Office (IIO) has completed two surveys at VGH since 2007.⁵ There was no adverse licensing action as a result of these surveys. [source: facility survey data provided by the IIO]

While the applicant, VRH, LLC, does not currently own or operate any healthcare facilities in Washington State or any other states, one of its members—CMCH Holdings, LLC—is a subsidiary of Capella Healthcare, Inc. Capella Healthcare owns or operates hospitals, home health agencies and ambulatory surgery centers in seven states, including Washington State. For Washington State, Capella Healthcare operates Capital Medical Center, an acute care hospital located in Olympia, within Thurston County. IIO has completed two surveys at Capital Medical Center since 2007.⁶ There was no adverse licensing action as a result of these surveys. [source: Application, p2; October 12, 2011, supplemental information, p2; and facility survey data provided by the IIO]

To assure that VGH would continue to provide quality healthcare services under the Capella Healthcare ownership, the department requested quality of care histories from the states where Capella Healthcare, or any of its subsidiaries, owns or operates healthcare facilities-- which represents a total of 14 health care facilities in six states. Through either return of the quality of care survey or by accessing The Joint Commission website, the department was able to obtain information representing all six states. A review of data from the six states revealed that none reported substantial non-compliance issues.

Based on the compliance histories of Capella Healthcare, Capital Medical Center, and VGH, there is reasonable assurance that the VRH, LLC would operate VGH in conformance with applicable state and federal licensing and certification requirements. **This sub-criterion is met.**

⁴ <http://www.qualitycheck.org>

⁵ Surveys were completed in years 2007 and 2009. Fire and life safety compliance reported in 2009.

⁶ Surveys were completed in years 2008 and 2010. Fire and life safety compliance reported in 2010.

- (4) The proposed project will promote continuity in the provision of health care, not result in an unwarranted fragmentation of services, and have an appropriate relationship to the service area's existing health care system.

WAC 246-310 does not contain specific WAC 246-310-230(4) criteria as identified in WAC 246-310-200(2)(a)(i). There are also no known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b) that directs how to measure unwarranted fragmentation of services or what types of relationships with a services area's existing health care system should be for a project of this type and size. Therefore, using its experience and expertise the department assessed the materials in the application.

Currently VGH has formal and informal working relationships with area healthcare providers. Further, VGH has referral relationships for home health and hospice services with providers in Snohomish County. VRH, LLC states that continuity in the provision of health care will be accomplished with the long-term lease agreement because it allows the facility to continue operating as a hospital in the community. [source: Application, p27; and October 12, 2011, supplemental information, p9]

VGH has been a provider of health care services in Snohomish County for many years. VRH, LLC has committed to continue to provide the following services currently available at the hospital. [source: Application, p7]

- Obstetrical services, excluding cesarean section and LDRP
- Critical care
- Emergency care
- Diagnostic services, including endoscopy, imaging, laboratory
- Therapeutic services, including endoscopy
- Medical services, including wound care
- Surgical services, including both inpatient and outpatient
- Chemical dependency, including both inpatient and outpatient

In mid year 2011, VGH discontinued providing geropsychiatric services and cesarean section and LDRP obstetrical services. By end of year 2013, VRH, LLC intends to reinstate these services at VGH.⁷

Based on VRH, LLC's focus on maintaining current services and its intent to reinstate additional services, the department concludes that VRH, LLC will continue to promote continuity in the provision of health care services in the community for VGH. **This sub-criterion is met.**

- (5) There is reasonable assurance that the services to be provided through the proposed project will be provided in a manner that ensures safe and adequate care to the public to be served and in accord with applicable federal and state laws, rules, and regulations.

This sub-criterion is addressed in sub-section (3) above and **is met.**

⁷ Reinstatement of geropsychiatric services may require prior Certificate of Need review and approval.

D. Cost Containment (WAC 246-310-240)

Based on the source information reviewed and the applicant's agreement to the terms and conditions identified in the "Conclusion" section of this evaluation, the department determines that the applicant has met the cost containment criteria in WAC 246-310-240(1).

(1) Superior alternatives, in terms of cost, efficiency, or effectiveness, are not available or practicable.

To determine if a proposed project is the best alternative, the department takes a multi-step approach. Step one determines if the application has met the other criteria of WAC 246-310-210 through 230. If it has failed to meet one or more of these criteria then the project is determined not to be the best alternative, and would fail this sub-criterion.

If the project met WAC 246-310-210 through 230 criteria, the department would move to step two in the process and assess the other options the applicant or applicants considered prior to submitting the application under review. If the department determines the proposed project is better or equal to other options the applicant considered before submitting their application, the determination is either made that this criterion is met (regular or expedited reviews), or in the case of projects under concurrent review, move on to step three.

Step three of this assessment is to apply any service or facility specific criteria (tie-breaker) contained in WAC 246-310. The tiebreaker criteria are objective measures used to compare competing projects and make the determination between two or more approvable projects which is the best alternative. If WAC 246-310 does not contain any service or facility criteria as directed by WAC 246-310-200(2)(a)(i), then the department would look to WAC 246-310-240(2)(a)(ii) and (b) for criteria to make the assessment of the competing proposals. If there are no known recognized standards as identified in WAC 246-310-200(2)(a)(ii) and (b), then using its experience and expertise, the department would assess the competing projects and determine which project should be approved.

Step One

For this project, VRH, LLC's project met the applicable review criteria under WAC 246-310-210, 220, and 230. Therefore, the department moves to step two below.

Step Two

In identifying the two options considered before submitting this application, VRH, LLC also provided background information related to VGH. Specifically, VGH has been operating as an acute care hospital since 1960. Since that time, it has not grown significantly. The main reason for the lack of growth is VGH's lack of capital that would be used to add needed services and recruit / retain physicians and staff. As a result, VGH has struggled to maintain status quo with its services. Ultimately VGH has been unable to generate a net income from operations, which has recently resulted in a discontinuation of obstetric and geropsychiatric services. The hospital district recognized the vulnerability of the hospital, and determine that a partnership with another entity could benefit both VGH and the community it serves.

Ultimately, the hospital district considered and rejected two separate options.

- Do Nothing or Status Quo
With consistent loss of patient volume resulting in consistent financial losses since 2007, VGH would have to continue to reduce its services, which would result in further losses in volume and revenue. The option of do nothing was quickly rejected if the hospital was to remain in operation. [source: Application, p30]
- The Sale of VGH to Another Entity
The only option that remained was the sale of VGH. This option was considered for some time, however no interest in purchasing VGH was generated. This option was also rejected. [source: Application, p30]

VRH, LLC states that in early 2011, the district issued a 'Request for Proposal' to eight non-profit organizations. Within the RFP, the district solicited interest in an affiliation. Three non-profit organizations responded, and only one of those offered a significant capital investment. Discussions between the two entities ensued, which ultimately were discontinued for a variety of reasons. In response, the district approached several entities--both for- and non-profit--and Capella Healthcare responded with an affiliation model. The district considered the affiliation plan to be attractive for many reasons.

- It provides much needed capital for program and facility development.
- It offers the expertise of Capella Health for day-to-day management and operations.
- It offers Capella Healthcare's guidance and expertise in preparing for healthcare reform in 2014.
- It allows the hospital district to continue active involvement of the healthcare decision-making and delivery.
- It allows continued operation of VGH, and future reinstatement of recently discontinued services.

[source: Application, p29]

One option not considered is the option of closing VGH. The hospital became operational in the city of Monroe in 1960 and, since that time, has been a provider of essential services in the community. Since Monroe is the largest city in east Snohomish County, VGH has become one of the largest employers in its hospital district and east Snohomish County. Closure of the hospital would impact the residents of the hospital district and surrounding areas. As a result, closure of VGH is also not considered a viable option.

After reviewing the extensive process undertaken by the district and Capella Healthcare to determine the best alternative for Valley General Hospital, the department concurs that the long term lease of VGH is the best alternative for the community. This sub-criterion is met.

Step Three

For this project, only VRH, LLC's application was submitted. As a result, step three is not evaluated under this sub-criterion.