11 August 2011

Attorney-General Martha Coakley
Commonwealth of Massachusetts
One Ashburton Place
Boston, MA 02108 -1518

Dear Attorney-General Coakley:

It is reasonable to ask at least four questions about the proposed sale of six Caritas hospitals to Cerberus Capital:

Will this sale bolster delivery of needed hospital care to Massachusetts citizens?
Will it help to slow increases in costs paid by citizens, employers, and taxpayers?
Will it proceed in ways that avoid harm to other hospitals?
Will it protect and sustain the six Caritas hospitals themselves?

I'd like to focus today on the last of these questions, but will give some attention to the others.

Throughout, I write individually only, and not on behalf of any organization or any other party.

It's helpful to appreciate two related background realities. First, Massachusetts has long had the costliest hospitals in the world, now about 55 percent above the U.S. average cost per person. (Alan Sager and Deborah Socolar, *Massachusetts Hospital Spending Reached 55.4% per Person above the U.S. Average in 2007: Most of Excess Is Unjustified and State's Health Reform Law Is Negligible Factor*, Boston: Health Reform Program, Boston University School of Public Health, 15 March 2010, 211 pages, www.healthreformprogram.org.)

These high costs, combined with the ongoing national and state economic and fiscal crises, make it very likely that growth in Massachusetts hospitals' revenues from both public and private payers will be tightly constrained in the years ahead.

Second, neither a vigorous and freely competitive market nor competent government regulation shapes hospital payments and profitability. One consequence is that hospital profitability registers neither efficiency nor satisfaction of patients' genuine health care needs or wants. Another consequence is that the $22 billion or so that will be spent on hospital care statewide in 2010 will not be divided up either fairly or in ways that stabilize all needed hospitals.

Turning now to the question of protecting and sustaining Caritas hospitals, I'd like to offer these thoughts:

Cerberus has declared its intention to invest about $800 in today's dollars over the next few years if its proposed purchase of Caritas goes through. What sort of a return on its venture capital does it expect? Is that rate of return attainable? Under what circumstances? What combination of price and volume projections will make this a profitable investment for Cerberus?

Overall, I think that the many generally glowing press reports and public testimonials about Caritas's plans closely parallel the uncritical enthusiasm greeting the Partners merger late in 1993. Money will be saved, someone promised then.

Caritas will be the low-cost provider, someone promises now. (I'd like that if it were possible. After all, retaining more care in lower-cost hospitals has for about two decades been one of the Health Reform Program's core proposals for containing hospital costs in Massachusetts.)

State government settled for bland, vague, and unsubstantiated assurances from Partners in 1993-1994. Should it not demand concrete and relevant evidence from Cerberus in 2010?

Cerberus would like to make a lot of money for its investors. But can it do that without raising prices substantially? Or without boosting volumes of hospital care in our state still higher above U.S. averages than they are already? Or without closing some of their money-losing hospitals, even though those might actually be needed (despite losing money) by people who live nearby? Or without hurting other needed hospitals?

Again, without a functioning free market—or competent government action—there is, unsurprisingly, no correlation between efficiency and profitability among hospitals—and also no correlation between hospital efficiency and risk of closing.

It's helpful to consider some of the apparent numbers facing Cerberus.

Suppose that Cerberus seeks to earn 10 percent annually on its $800 million Caritas investment, or $80 million annually.

Patient revenue at the six Caritas hospitals was $1,076 million in 2008. Make that about $1,150 million-plus this year. Other revenue—parking, cafeteria, gift shop—is trivial.

$80 million would be over 7.4 percent of patient revenue—substantially more than even Partners has been able to extract in good years.

Operating margins in excess of 7.4 percent are unimaginable in the looming economic and hospital cost climate.

If some Caritas hospitals lose money, Cerberus would have to earn operating margins higher than 7.4 percent at the others. (Something similar would be true if Cerberus closed some Caritas hospitals; the return on revenue for the survivors would have to be higher than 7.4 percent to generate the 10 percent return on equity that Cerberus is supposed to seek.)

And Cerberus would have to clear that 7.4 percent after paying sales, property taxes (I've seen estimates of $20 million annually for property tax payments alone) and state/federal income taxes—all payments Caritas does not now need to make.

In light of these apparent realities, it's worth asking at least six questions:

a. Does Cerberus have a credible financial plan? Does Cerberus offer credible and detailed revenue (price and volume) and cost numbers publicly to explain how it will make money and therefore be willing and able to keep open the six Caritas hospitals? Does Cerberus explain how it will be able to make money on the deal in ways that advance health care goals of low-cost care, access, and quality? What prices and volumes do they expect to see for various types of care?

The public needs and deserves to see Cerberus's numbers, its business plan. Hospitals must routinely file and substantiate their projected annual revenues and expenses when they apply to the Department of Public for determinations of need for large new capital projects. The same numbers should be filed by a party seeking to buy six important hospitals.

Moreover, some have said that Cerberus hopes to build up its operating margins mainly by boosting volumes by attracting patients from other hospitals. If so, which hospitals will lose volume? What harm would those hospitals and their patients suffer? (This assumes that current total volumes of ER visits, other outpatient visits, surgery, hospital admissions, and the like are reasonable and appropriate—or, at least, hard to change.)

If Cerberus hopes to build Caritas hospitals' volumes, how would they accomplish that? Capital investments might help, but most patient volume is steered by physicians. How would Cerberus work to change physicians' decisions about where to admit patients?

If Cerberus hopes and plans to build up its operating margins by boosting volumes without taking patients from other hospitals, statewide volumes would rise, probably substantially. That would probably mean still higher insurance premiums. Is that a good idea? (Our state's rates of inpatient hospital admissions are already 11 percent above national levels, hospital surgery rates are 18 percent above, ER visits are 23 percent above, and non-emergency outpatient visits are 58 percent above.)

Generally, if for-profits aren't more efficient, how do they make more money (when they do)? I think it's likely to be a combination of higher prices, lower quality, and attracting patients insured by higher-priced payers and patients whose medical problems are more profitable to treat. It's tough to do those things in eastern Massachusetts.

Further, yesterday's short report from Thomson Reuters found that Catholic and other church-affiliated hospital systems did much better than for-profit hospital chains in providing "higher quality performance and efficiency to the communities served. . . ." (David Foster, "Differences in Health System Quality Performance by Ownership," Thomson Reuters, 9 August 2010, http://100tophospitals.com/assets/100TOPSystemOwnership.pdf.)

b. You may be wondering, Does any of this matter? Should anyone care? After all, isn't Cerberus just spending its own money? Shouldn't the market simply allowed to work—by rewarding good decisions and punishing bad ones?

If we had anything close to a functioning competitive free market for hospital care, that might be arguable. But not one of the six requirements for a functioning free, competitive market is satisfied in hospital care.

(The six are smallness of buyers and sellers, so the market makes prices; absence of artificial influences on supply, demand, and price; easy entry and exit; good information about price and quality for both producers and consumers; prices that track costs; and the usefulness of mistrust/caveat emptor.)

Therefore, it would be reckless to imagine that if Cerebus seeks to advance its own financial interests, the public automatically benefits, owing to the working of the competitive free market whose invisible hand converts private greed into the public good. It would be equally reckless to imagine that only Cerberus's investors will be harmed if its purchase of Caritas sours.

Absent a functioning market, our state's surviving hospitals should be seen as public utilities. Each survivor should be considered needed unless proven otherwise. This burden of proof is entirely reasonable in a state that has lost fully one-half of the 140 hospitals open in 1960, when Pres. Kennedy was elected. Further, our state's bed/population ratio is below the (low) national average.

Caritas hospitals number almost one-tenth of the surviving acute care hospitals statewide, and provide an even greater share of our often-endangered non-teaching/community hospitals' capacity.

c. Would the sale be a financial life preserver for Caritas hospitals or a political/public relations smokescreen for closing one or more of them? The sale of Caritas to Cerberus is usually described as a way to keep the six hospitals open. But what if it actually has the effect of facilitating the closing of one or more of the hospitals.

(Indeed, although some parties sought to close the Carney Hospital not long ago, I'd argue emphatically that a hospital that's lost patients or is losing money may well still be needed, especially if it can provide high-quality and low-cost community hospital services.)

If the Carney and other Caritas hospitals lost money—or seemed to be losing money—a few years from now, would Cerberus not find it much easier to close them than Caritas did?

And a few years later, if Cerberus were unable to realize expected returns on its $800 million investment, and if Cerberus were unable to find a buyer, might it simply walk away and close all of the remaining Caritas hospitals? Who would force Cerberus to operate hospitals at a loss?

If this seems unimaginable today, please consider whether, a decade or so ago, any reasonable observer could have imagined New York City without a single Catholic acute care hospital. And please consider the rash rush to close the last hospital, St. Vincent's. (Alan Sager, "Why Stabilizing St. Vincent's Is Essential," *The Villager*, 10 March 2010, http://www.thevillager.com/villager_358/talkingpoint.html.)

d. Given the importance of sustaining all remaining Massachusetts hospitals—unless they are proven not to be needed—and given the uncertainties about Cerberus's willingness and ability to keep open all Caritas hospitals, what binding legal and financial assurances (performance bonds, other?) does Cerberus provide regarding their financial capacity and—just as important—their unbreakable commitment to invest and run the hospitals successfully?

It is wrong-headed, I think, to allow for-profit firms' transient or spasmodic financial needs to determine which Massachusetts hospitals survive. What are the back-up arrangements allowing or requiring reversion of each of the hospitals to Caritas—as going concerns—should Cerberus discover they've made another big, Chrysler-size mistake?

If Cerberus claims, "we don't need to make money off annual operations; rather, we just need to turn the hospitals around so someone else will buy them," that claim wouldn't hold water, since the prospective buyer would demand evidence that they would earn substantial returns on investment—off of annual operations.

Otherwise, no one would buy. So everything comes back to the challenge of generating a very substantial and steady stream of after-tax profits.

e. Is it fair to claim that some or many of the Caritas hospitals are doomed if all six are not quickly sold to Cerberus? I don't think so.

First, it is important to assure the preservation of each of the 70 or so surviving Massachusetts hospitals, except those proven not to be needed.

Second, 2010 statewide hospital revenues of about $22 billion are absolutely sufficient to finance the efficient operation of all needed hospitals.

Third, those revenues are not fairly apportioned among hospitals, not in ways not justified by anything close to a competitive free market, and not commensurate with financing the costs of efficient provision of needed services.

Fourth, because when so much money is already available to pay for hospital care in Massachusetts, it is both foolish and unnecessary to rely on a promised investment by an inexperienced firm, Cerberus, to protect almost one-tenth of our state's surviving hospitals

Fifth, investment by venture capitalists is certainly not the only potential source of capital. And it is certainly not the least expensive source of capital. Caritas has moved back into the black. If Caritas can demonstrate its ability to repay bonds, investors will buy those bonds. And the interest on tax-exempt HEFA bonds is substantially lower than the rate of return Cerberus seeks.

Consequently, the state can and should seek options to Caritas's sale to Cerberus. An interim measure would be for the legislature to establish a hospital receivership law in combination with a trust fund to provide interim financing to needed but endangered hospitals, as Senators Jehlen and Tarr have proposed. (S. 899, filed 14 January 2010.)

Another option, requiring more time, work, and federal waivers, would be for the legislature to return to all-payer regulation of hospital prices and revenue. Crucially, this would guarantee each needed hospital revenue sufficient to cover the cost of efficient operation.

If the all-payer plan established flexible budgets, as Maryland's does, hospitals would no longer have financial incentives to boost volumes of care. And they would not be rewarded financially for cutting volumes either. This financial neutrality is easier to achieve than the more complex, untested, radical, and potentially dangerous step of

bundling payments. Financial neutrality is also makes hospital behavior more trustworthy.

Incidentally, all-payer payments quickly overthrow the discredited method of secret hospital – insurer negotiations that have resulted in different payers paying radically different prices for the same care to the same hospital, and also in radically different prices for the same care to different hospitals. Ironically, only this form of regulated payment does what a free market would do, were one attainable. That is, it sets one price for all payers and an end to inter-payer or inter-patient cross-subsidization.

f. Do Caritas or Cerberus yet estimate the value of the charitable remainder that would be placed in a new foundation, or be made available in other ways, if the sale were to go forward? Is this valuation fair and credible? (When Worcester's St. Vincent Hospital was sold to a for-profit some years ago, only about $4 million was identified as the charitable remainder, a sum so small that it raises questions about conservation, dissipation, or other treatment of charitable assets.)

I hope these thoughts are useful.

Cordially,

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