
The State of Hospitals' Financial Health

"Although growth is generally viewed as a positive factor, many hospitals have really struggled to translate growing patient volumes into increased cash flow due to expense pressures."

**-- Standard & Poor's
Jan. 2002 Market Analysis**

"... continued market forces such as increased labor, pharmaceutical, and supply expenses, and growing liability insurance costs present obstacles to sustained advancement."

**-- Fitch
Jan. 2002 Hospital Outlook**

"We caution ...that the depth and breadth of the current economic recession could upset this stable industry outlook, particularly if a shrinking

federal surplus were to result in a material cutback in Medicare reimbursement."

**-- Moody's Investor Service
Jan. 2002 Industry outlook**

"Access to capital markets for most hospitals remains very expensive, and spending for capital improvements is a fraction of what it was before 1997 ... hospital balance sheets remain weak ... they will need sustained profitability before access to capital can return to 1997 levels. In order to achieve sustained profitability, more of the cuts should be restored and Medicare payment updates should at least account for inflation."

**-- MBIA Insurance Corporation
Jan. 2002 letter to MedPAC**

For America's hospitals, the bottom line supports our top priority: providing patients the right care, at the right time, in the right place, and doing it on demand, 24 hours a day, seven days a week. But that bottom line is threatened.

As Wall Street experts have recognized, many of America's hospitals are sitting on the edge of financial viability. Severe cuts in Medicare payments to hospitals in the Balanced Budget Act of 1997 continue to be felt, even after legislation that restored some of those cuts in recent years. In fact, without congressional action, hospitals face an additional five-year cut of \$21 billion scheduled for implementation in October 2002. And hospitals are bearing the cumulative impact of a series of forces that are beginning to erode the foundation of the essential public service they provide.

This paper demonstrates the forces that are eroding hospitals' ability to provide the care their patients and communities need. It then shows, with graphs and charts, that their financial status has not improved. And, finally, the paper warns that things could get worse unless Congress and the administration take positive action soon.

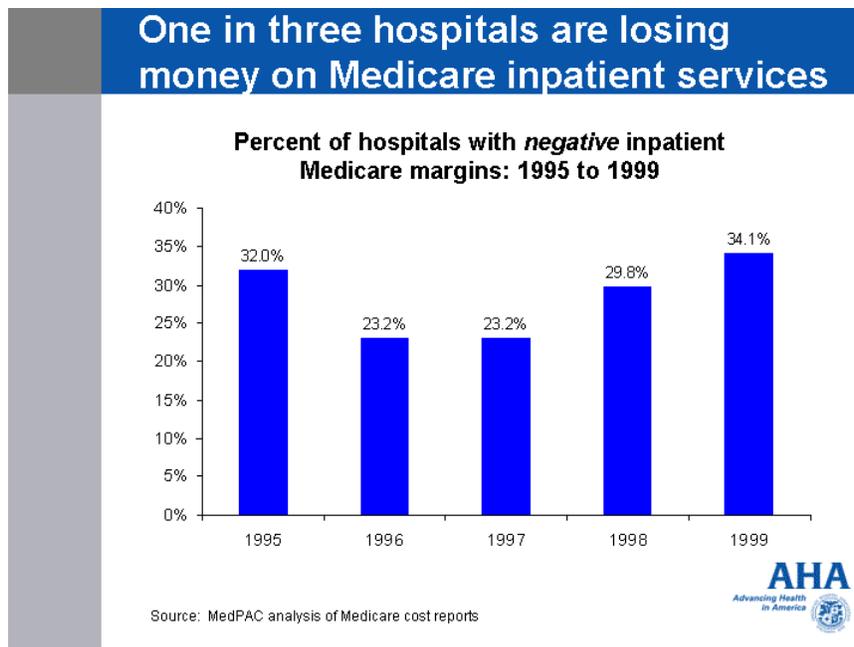
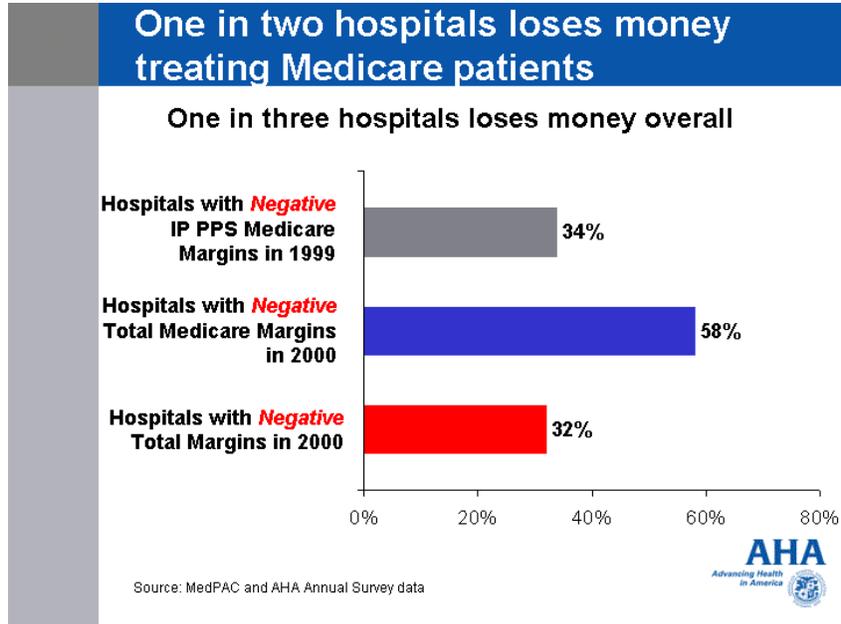
Cracks in the Foundation of Care

- Hospitals are experiencing severe workforce shortages. There are more than 168,000 unfilled positions, of which 75 percent are for registered nurses. Partly as a result of these shortages, full-time nurse salaries rose by as much as 10 percent across the country from 2000 to 2001; pharmacist salaries rose by as much as 13 percent. It is estimated that hospitals will have spent \$71 million in 2001 using agency and traveling nurses to fill slots left vacant by the shortage of staff nurses.
- As front-line responders in the event of disasters, hospitals are working to upgrade their readiness to respond to nuclear, biological and chemical emergencies. This requires an investment of more than \$11 billion to meet public expectations.
- New federal regulatory mandates will impose additional administrative and paperwork burdens. Compliance with the Health Insurance Portability and Accountability Act's privacy regulations alone are expected to cost hospitals between \$4 billion and \$22 billion.
- Providing the highest quality services on the cutting-edge of scientific development, including the introduction of new patient safety technologies, requires substantial resources. For example, the traditional X-ray machine, which typically costs \$175,000, is rapidly being replaced by more contemporary CAT scan machines that can cost \$1 million ... and the next round of technology, PET imaging machines, cost well over \$2 million.
- The cost of pharmaceuticals continues to skyrocket. Prescription drug costs rose 17.3 percent in 2000 alone, the sixth consecutive year of double-digit increases. In addition, the cost of a pint of blood increased an average of 31 percent last year; in some states, blood costs increased by 100 percent.
- A crisis is rapidly developing in the area of professional liability insurance, where hospitals and physicians are finding it difficult to purchase coverage and premiums. Some of the biggest insurers are raising rates more than 30 percent in many states.
- Millions of Americans have no health insurance coverage. Hospitals – by their own mission and under federal law – serve as America's health care safety net, and provided \$21.6 billion of uncompensated care in 2000 alone.
- In 2000 Medicare paid hospitals one percent *less* than the cost of treating Medicare patients.

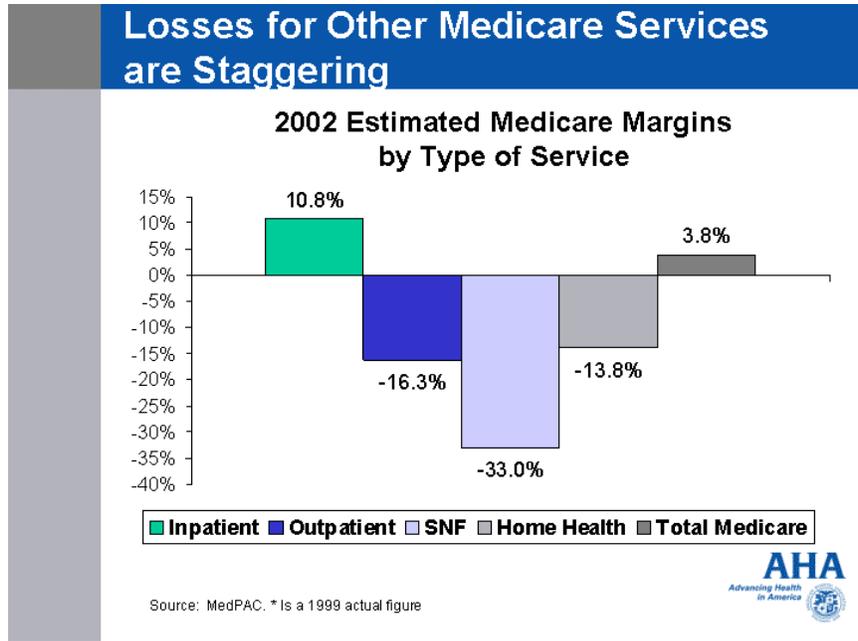
Evidence of an Eroding Bottom Line

For America's hospitals, the unrelenting cost pressures resulting from the above factors mean an erosion of their financial viability. As these graphs demonstrate:

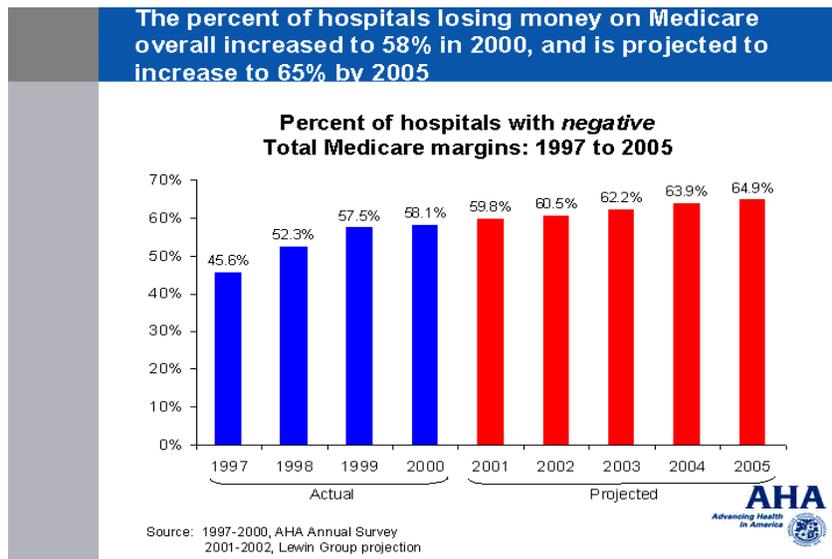
- 58% of hospitals *lose money* treating Medicare patients.
- 34% of hospitals *lose money* meeting just the inpatient hospital care needs of Medicare patients.
- 32% of hospitals - one in three - have *negative* total margins; overall, they are paid less than the cost of delivering care.



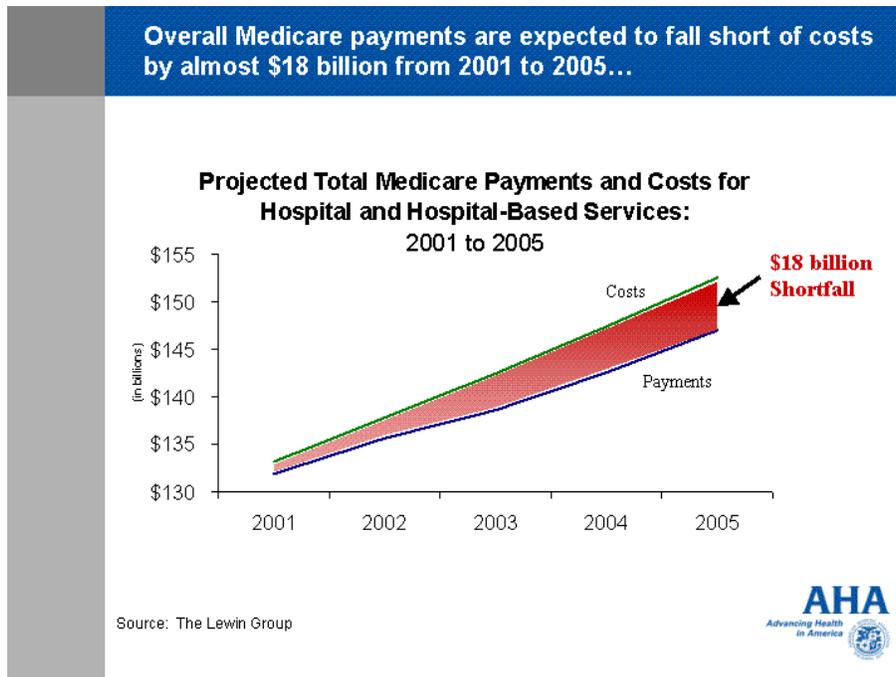
While some measure hospitals' overall financial viability by focusing on indicators of inpatient financial performance, the reality is that these measures are now too narrow – more and more hospital services are being delivered beyond the inpatient ward. As medical technology and training progress, more and more health care can be, and is, delivered in the outpatient setting. And, as America's population grows older, demand for home health and skilled nursing facility services continues to increase. A severe underfunding of payments for these services is contributing to a weakened bottom line for many hospitals ... and in many areas, is curtailing access to these important services.



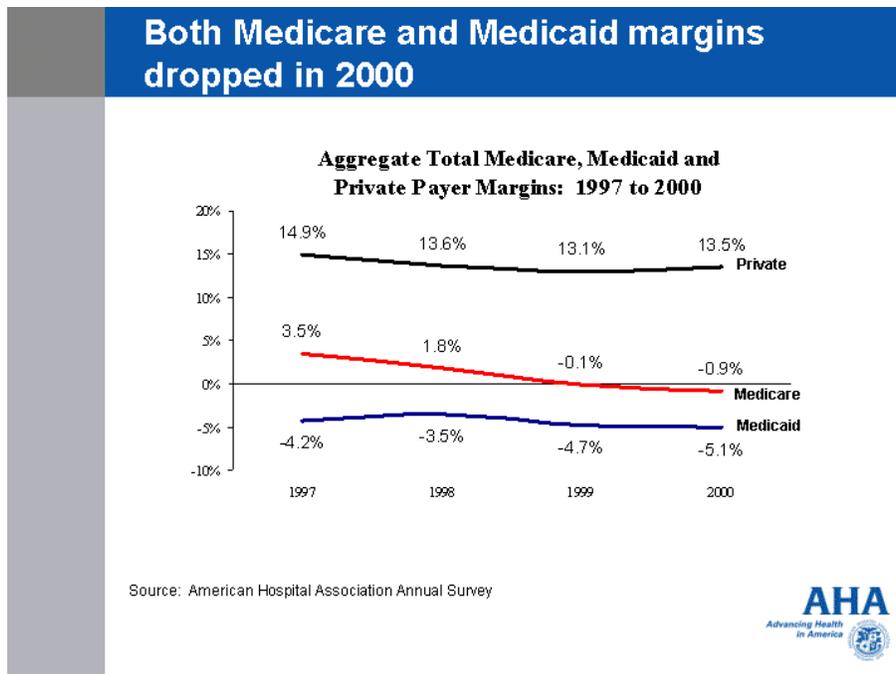
Overall, government reimbursement to hospitals is simply not keeping up with the cost of care. Medicare and Medicaid reimbursements continue to fall below the costs of caring for America's seniors and needy families ...



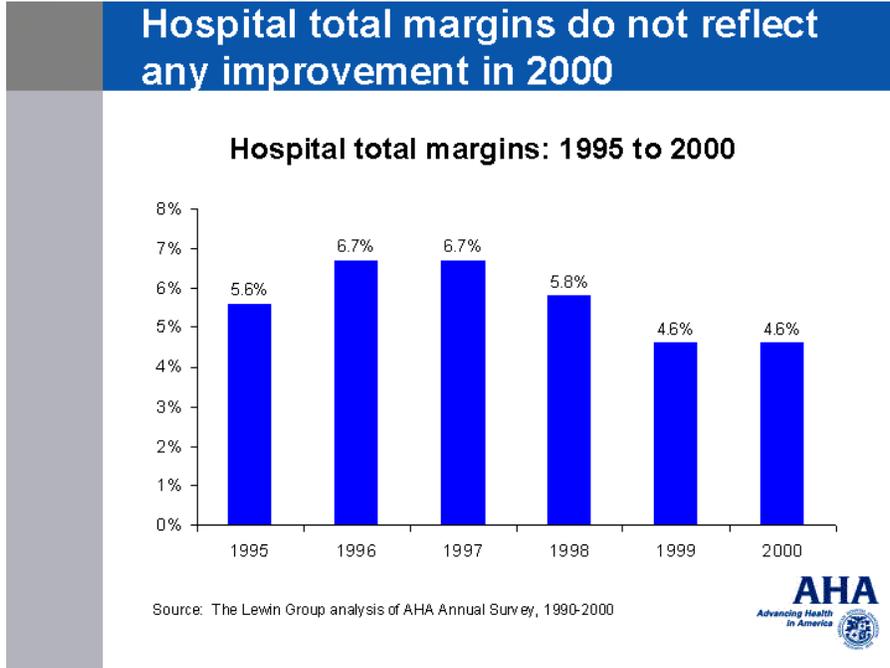
... and the situation is expected to get worse instead of better unless improvements are made soon ...



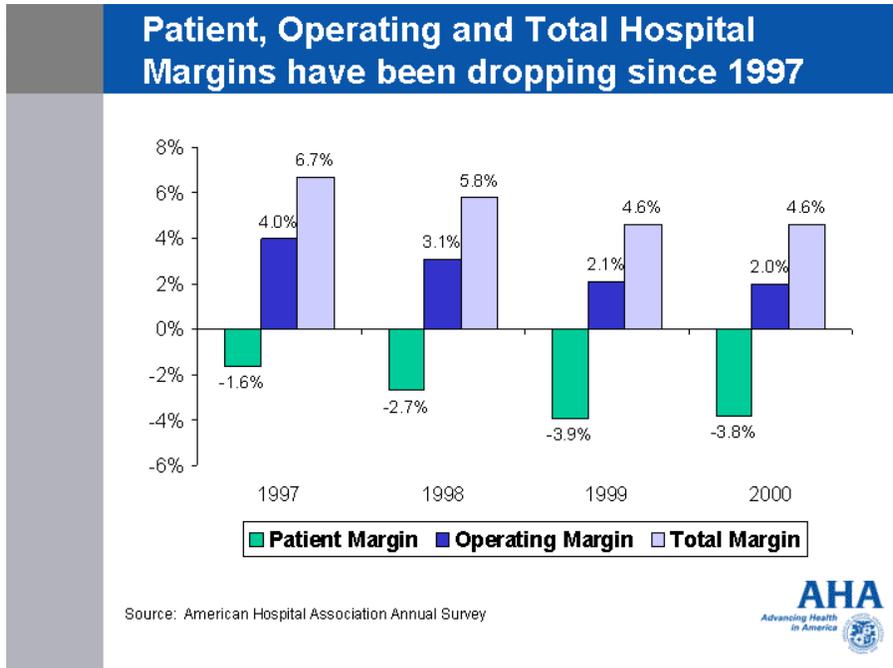
Medicare payments are not the only category in which hospitals are underpaid ... Medicaid payments are also well below the cost of providing care to the nation's neediest families ...



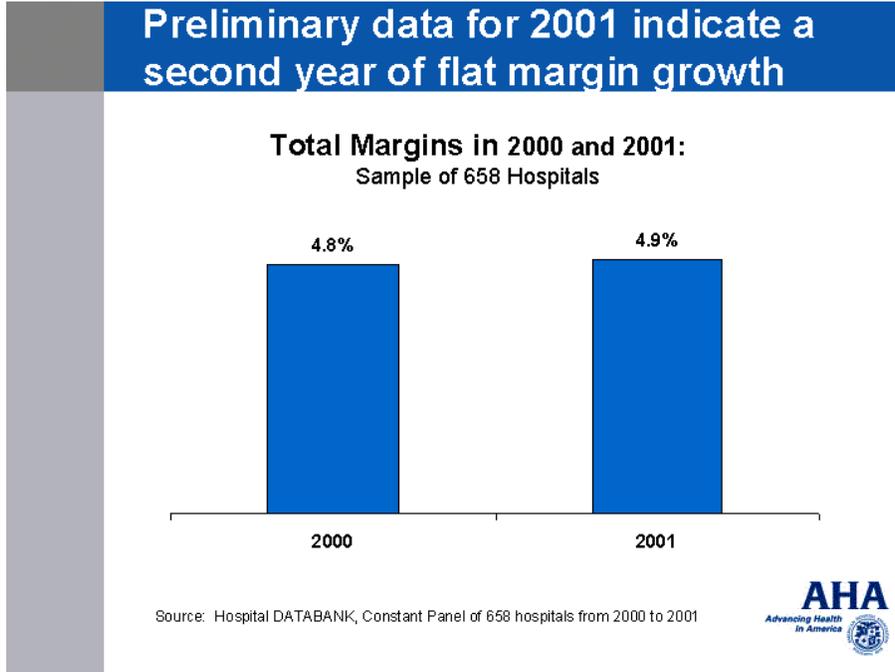
The overall impact of these underpayments has been felt since the late-1990s ...



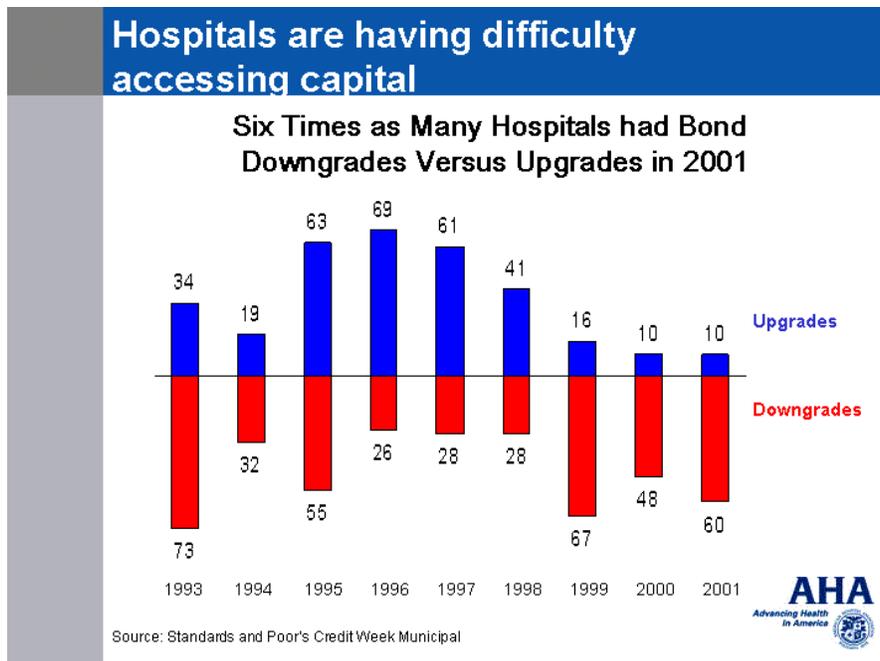
And hospitals cannot break even delivering patient care ...



This impact continued into 2001 ...



The dramatic increase in demand for hospital services is requiring new capability even as hospitals are having difficulty accessing the funding needed to invest in capital projects like replacing aging facilities and adding expensive information systems. The average age of hospitals' physical facilities has increased 18 percent since 1990. But Wall Street sees hospitals as riskier investments, leading to higher interest rates for the funding necessary to maintain and improve their facilities.



The importance of a hospital's credit worthiness can be the difference between a go or a no-go decision on improving physical facilities or upgrading information systems. According to Merrill Lynch & Co. and Bloomberg, the average size of a bond issue in 2001 was \$49 million. For a hospital seeking that bond, the difference between a rating of "BBB-" and a rating of "AAA" translates into an additional \$850,000 in interest paid on the bond. Wall Street generally demands margins of 7 percent or higher for an entity to achieve a AA rating or higher. But, with average overall hospital margins hovering far below that, many hospitals are paying much higher interest rates to attain the financing they need to upgrade aging facilities, further draining their resources. Most hospitals are simply unable to afford the higher cost of financing, or are unable to attain it at all, thus delaying much-needed upgrades or replacement of facilities that continue to bear the pressure of rising demand. In fact, only 25-30 percent of hospitals have secured financing in the public market, according to Merrill Lynch.

Hospital Access to Capital

Nonprofit Health Care Medians* by Rating, 2001

Rating	Profit Margin %
AA+	7.0%
AA	6.6
AA-	3.6
A+	5.3
A	4.7
A-	3.6
BBB+	2.8
BBB	3.0
BBB-	1.5
NIG	(1.8)

Source: Standard & Poor's Ratings Direct
2001 nonprofit median health care ratios
*Medians for 2001 are based on 2000 audited financial data

Spreads to "AAA" G.O. Bonds By Rating Category

AAA → AA = 50 basis points

AAA → A = 95 basis points

AAA → BBB = 160 basis points

Source: Morgan Stanley Dean Witter, June 2001
100 basis points = 1% increase to a hospital's interest rate



Improvements needed – now

"We have no compelling evidence that there is a problem with the overall adequacy of provider payments."

-- March 2002 letter from HHS Secretary Tommy Thompson and White House Office of Management and Budget Director Mitch Daniels to House Ways & Means Committee Chairman Bill Thomas (R-CA) and health subcommittee chair Nancy Johnson (R-CT).

The Medicare Payment Advisory Commission, which advises Congress on Medicare payment issues, as well as House and Senate budget leaders, have indicated their support for additional hospital funding. They understand that the cornerstone of care for our nation's seniors, and for all those we serve, is in jeopardy. Yet, the administration suggests that there is no compelling problem with the overall adequacy of Medicare provider payments to hospitals, and suggests further that, as a result, hospitals could absorb further reductions. The administration has stated that hospital margins have stabilized and suggest that limits on hospital market basket updates "would appear to provide adequate reimbursement for hospitals."

This view ignores today's economic reality as well as published opinions from Wall Street. There is a compelling problem, and the problem is that inadequate Medicare and Medicaid payments are contributing to the overall weakened financial condition of the nation's hospitals.

The Medicare hospital payment update – the foundation of the financial strength of most American hospitals – compensates hospitals for price increases, due only to inflation, of the bandages, sponges, scalpels, gloves, nurse wages and other expenses needed to provide care. Without this update, the government is simply devaluing the Medicare dollar. Even apparently small-sounding reductions in the update amount translate into billions of dollars either paid to or withheld from America's hospitals. Within the over \$2 trillion federal budget of the United States, there must be room, through the update and other payment adjustments, to ensure that America's hospitals can regain their financial footing, and thereby keep the promise this nation has made to its seniors and poor people: that their local hospital will be there to provide the right care, at the right time, in the right place.