



*Industry Report Series*

**2006  
Medical Services Report**



*Presented by the Sonoma County Economic Development Board, in partnership with the Sonoma County Workforce Investment Board*





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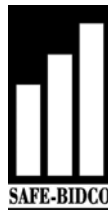


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# 2006 Medical Services Report

February 2006

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to bring you the 2006 Medical Services Report. Our research partner, Moody's Economy.com, produced this report for the EDB. It includes important information regarding the hospitals, health professionals, managed care organizations, and medical technology firms in Sonoma County.

Highlights from the 2006 Medical Services Report include:

- **The tide is turning from positive to neutral for the health services industry in Sonoma County.** After two years of improving financial positions, the outlook for the health services industry has moderated over the past year. Although some of this moderation has to do with the base effects of following a very strong 2004, it also reflects a broader national slowdown in the health-care industry.
- **Net income fell 40% in the second quarter for hospitals.** The slowdown was not merely in the second quarter either; for the year leading up to the second quarter of 2005, net income was down 38%.
- **Capital expenditure is up over 70% between the second quarters of 2004 and 2005.** For the year ending in the second quarter of 2005, hospital capital expenditures were up a whopping 90%, according to OSHPD data. Expansion of building space and new technologies will drive expenses in the coming year, especially as interest rates rise and make borrowing more expensive.
- **Job growth in healthcare has accelerated in the preceding two years.** Not surprisingly, nursing and healthcare-related degrees are the most sought after majors at local universities. That said, increased hiring has led to an acceleration in operating expenses for local hospitals.
- **Despite some downside risks on the horizon, the long-term outlook for the health service industry in Sonoma is positive.** The aging of the baby boomers, concurrent with a boom in healthcare technology and a growing life expectancy, will support consumer demand. Local hospitals should also continue to benefit from serving residents in neighboring counties, where the public caseload is significantly higher and healthcare facilities are less well-equipped.

Thank you for your continued interest in the Economic Development Board's research. As always, if you have any questions, please feel free to contact us at (707) 565 - 7170.

Sincerely,



Ben Stone  
Executive Director

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**Recent Performance.** The tide is turning from positive to neutral for the health services industry in Sonoma County. After two years of improving financial positions, the outlook for the health services industry has moderated over the past year. Although some of this moderation has to do with the base effects of following a very strong 2004, it also reflects a broader national slowdown in the healthcare industry.

Hospitals in the county are still posting healthy revenue growth. Total operating revenue for all hospitals in Sonoma County combined was up 14% in the second quarter of 2005, the latest data point available, according to the California Office of Statewide Health Planning and Development (OSHPD). However, over the same period, operating expenses have risen 18% for Sonoma County hospitals. As a result, net income fell 40% in the second quarter for hospitals. The slowdown was not merely in the second quarter either; for the year leading up to the second quarter of 2005, net income was down 38%.

Healthy revenue growth in the double digits suggests that hospitals are still enjoying healthy pricing in Sonoma County, even though it isn't enough to meet expenses. All of the revenue growth is coming from pricing, since utilization has been falling across the board. Total outpatient visits are down 4% for the year ending in the second quarter of 2005, and total patient days are flat over the same time last year. There is some evidence of an increase in the intensity of medical care, with the length of stay and staffed bed occupancy rate both rising on a year-ago basis in the second quarter, according to OSHPD data. Hospitals have lost some of their pricing power over the past year, even as expenses continue to grow at a steady clip.

On the medical technology front, Sonoma County lost out on the chance to attract device maker Sutter Instruments, which decided to stay in neighboring Marin after considering a move to Sonoma.

**Macro Drivers.** The broader U.S. economy is expected to post healthy but moderating growth through the remainder of 2005, with growth accelerating slightly in 2006. Fundamental macroeconomic and industry drivers will ensure that the health services industry maintains sturdy job and revenue growth. Steady income growth is crucial to driving overall medical care consumption trends, especially with increased cost shifting from employers to employees. Demographically, an aging population and ongoing improvements in medical technology are expected to support robust

consumer health spending over the longer term, particularly in outpatient centers, nursing homes and home-health settings.

In the medium term, an expected pickup in interest rates will weigh on demand for corporate and municipal bonds. This will adversely affect the health provider industry, as a majority of hospitals rely on this market for capital acquisition.

**Industry Drivers.** With economic conditions near as good as it gets for Sonoma County hospitals, most are re-investing their recent profits into physician and technological expansions. The most vaunted is the construction of the new 118-bed \$200 million hospital by Sutter Medical Center. The new hospital project has been mired in cost overruns however, mostly due to a dramatic expansion in construction costs and prices for steel and cement. Parts of the project have been scaled back as a result. With overall revenue growth starting to moderate and profits starting to wither, adding new hospital capacity might dampen price and revenue growth further.

Sonoma County physicians will be troubled by the recent denial of a proposed reimbursement rate hike by Medicare. Because Sonoma County is technically considered a "rural county" by Medicare, Sonoma County physicians get reimbursed at a lower rate than in neighboring Napa; yet house prices and living costs in Sonoma County are very much comparable to its "urban" neighbors. The proposal would have reclassified Sonoma as an urban county, and would have resulted in an 8% hike in Medicare reimbursement rates for physicians. Lacking support from the California Medical Association, the proposal was dropped by the Center for Medicare and Medicaid Services.

This will have a negative impact on physician bottomline and on public health in Sonoma County. An estimated 60% of physicians in Sonoma currently do not accept new Medicare patients due to low reimbursements. In addition, Sonoma County has had a difficult time attracting new physicians to the area to keep up with population growth and physician attrition.

The other big news affecting the healthcare industry nationally and regionally is the initiation of Medicare prescription drug coverage starting January 1, 2006. A number of insurance companies have already signed on to provide prescription drug coverage nationally and locally. In California alone, eight insurance plans have agreed to provide drug coverage to existing Medicare enrollees at no extra charge.

Medicare managed care's contribution to hospital revenues has been steadily declining

nationally and regionally. In Sonoma County, Medicare managed care plans contributed a mere 0.4% to total revenues in the second quarter of 2005, this was down sharply from 1.7% in the same time last year. This tide is set to turn with a number of retirees currently covered by private employer-based coverage likely to be shifted to the Medicare plan once coverage is initiated.

**Pricing.** Over 46% of hospital revenues in the county come from public sources, mostly Medicare. Despite growing fiscal deficits that pose a risk to long-term Medicare commitments, Medicare reimbursements are not threatened in the near term, and are expected to remain healthy. Medicare recently reaffirmed a 3.2% increase in reimbursement for inpatient hospital services for FY2006. Sonoma County hospitals received a healthy boost earlier this year due to their reclassification by Medicare from rural to urban, which garners a higher reimbursement rate. Physicians continue to be paid a lower wage, however, as they are still classified under rural designation. Legislation to raise reimbursements to physicians by paying them urban rates failed late this year; however, this is unlikely to be the last word, and local groups are likely to attempt to change this again in the future.

The outlook is less sanguine for the Medicaid portion of public reimbursements. Medi-Cal accounts for about 12% of total revenues for the county's hospitals, rising from just over 10% a year ago. Persistent budget deficits leave the Medi-Cal program open for serious cutbacks. The California health industry dodged a bullet last year when the governor's proposed 10% cutback in provider rates in Medi-Cal for FY2004-2005 was rescinded in May. Still, growth in Medi-Cal revenue for hospitals has been muted over the past year. In January 2005, Governor Schwarzenegger proposed an ambitious overhaul of the system, pushing for a shift from the current fee-for-service to a managed care system with new user fees for beneficiaries. Most providers are relieved that the proposal included no cuts in reimbursement rates, muting the direct impact of the proposed overhaul. Still, a shift to greater managed care participation could further limit pricing gains and hospital utilization in Medi-Cal.

Private insurers account for nearly 40% of local hospital revenues. The outlook calls for healthy but slower growth in reimbursements from private insurers in the coming year. Health insurance premiums rose an average of 9.2%

in 2005, according to the latest Kaiser/HRET survey, slower than last year's 10% gain and the previous year's 14%. Premium growth will remain high, but will slow into the high single digits in 2006 and 2007. Hospitals are coming off three years of steady accelerating private reimbursements. Increasing competition and public scrutiny will help temper premium growth. However, this also means a moderation in prices private insurers pay to local hospitals.

**Operating Expenses.** Labor and technology continue to be the biggest drivers of operating expenses for health service providers nationally, and Sonoma County is no different. Local hospitals suffer higher patient-adjusted operating expenses than the state average, according to OSHPD data. Whereas patient-adjusted operating expenses averaged \$2,005 for the state for the four quarters ending in the second quarter of 2005, Sonoma County hospitals averaged \$2,161, 7.8% higher. A year ago, Sonoma County operating expenses per patient adjusted day were only 4.5% above the state level.

Although local hospitals did a good job cutting expenses over the past two years, there are signs now that most efficiencies have been wrung out of the system; operating expenses rose over 18% between the second quarter of 2004 and 2005. This exemplifies some of the persistent labor and technology pressures that the county is facing. Although the national and regional nursing shortage has eased some over the past two years, hospitals remain pressured to pay higher wages to attract and retain trained staff. California's mandated minimum-nurse staffing ratio is also exacerbating the situation, although it is likely having a positive impact on outcomes.

Increased competition among local hospitals and an improvement in revenues have also led to the resurgence of technology competition between local hospitals. This is in turn putting upward pressure on technology expenses. Capital expenditure is up over 70% between the second quarters of 2004 and 2005. For the year ending in the second quarter of 2005, hospital capital expenditures were up a whopping 90%, according to OSHPD data. Expansion of building space and new technologies will drive expenses in the coming year, especially as interest rates rise and make borrowing more expensive.

Finally, bad debt remains a growing problem for hospitals, nationally and regionally. Despite the economic recovery, the number of uninsured remains notably high, and this has increased the pressure on hospitals that provide uncompensated care. Indigent care provided by Sonoma County hospitals rose from \$900,000

in the second quarter of 2004 to over \$2 million in the second quarter of 2005.

**Profitability.** Profit margins are now moderating after improving markedly in late 2003 and into early 2004. Healthy reimbursements have been unable to keep up with rising costs in providing healthcare in Sonoma County. In aggregate, Sonoma County hospitals remain in the black. Operating margins fell from 3.7% in the second quarter of 2004 to 0.5% in the second quarter of 2005.

Managed care companies are enjoying strong profit margins due to hikes in insurance premiums and reduced operating expenses. Successful attempts to bolster private industry participation in Medi-Cal will also further boost profitability in managed care plans. Further, the 10% increase in Medicare payments to health insurers in 2004 and 2005 have helped the industry immensely, and have spurred many companies to reenter Medicare markets that they had left in the past. That said, the best times have likely passed, and increasing competition and pressure from employers will lead to healthy but weaker profit margins in the coming year for the local health insurer industry.

**Long-Term Outlook.** Despite some downside risks on the horizon, the long-term outlook for the health service industry in Sonoma is positive. The county's demographics provide room for optimism for local healthcare demand. Sonoma residents are generally wealthier and older than the average Californian and the average American. Further, the public health caseload in Sonoma County is below average, with a lower share of the population eligible for the state's low-income Medi-Cal program than the state average. The aging of the baby boomers, concurrent with a boom in healthcare technology and a growing life expectancy, will support consumer demand. Local hospitals should also continue to benefit from serving residents in neighboring counties, where the public caseload is significantly higher and healthcare facilities are less well-equipped.

The outlook for managed care is less optimistic due to its decreasing efficacy in stemming rising healthcare costs. Continued growth in prescription drug spending will complement the ever-increasing costs of implementing new medical technologies. That said, new forms of managed care that take advantage of the internet to improve consumer ownership of healthcare could lead to renewed growth in the industry. Over the long term, hospitals and unionized physician groups with more negotiating clout on one side, and the

public and political forces demanding lower health costs on the other, will squeeze managed care profits.

**Upside Risks.** Technology creates the biggest upside potential for the health services industry. Greater use of the internet and budding wireless technologies could provide significant operational and cost efficiencies. More accurate, accessible, and standardized information would cut waste and increase consumer choices. Similarly, the continued rapid development of medical technologies offers significant potential for providing more efficient care to a larger population. Any unforeseen leap from the drawing board to the marketplace of even one of the many promising new technologies is a significant upside risk. Research done at the Buck Institute, as well as ongoing research and development at the many budding local biotech companies, bodes well for the nascent biotech cluster in Sonoma County.

**Downside Risks.** The greatest downside risk to providers nationwide is extremely high state deficits. Medi-Cal reimbursement cuts remain a real risk, even though they are off the table for now. Further, an imposition of Medi-Cal user fees could lead to a further increase in the rolls of the uninsured and put further pressure on hospitals through bad debt.

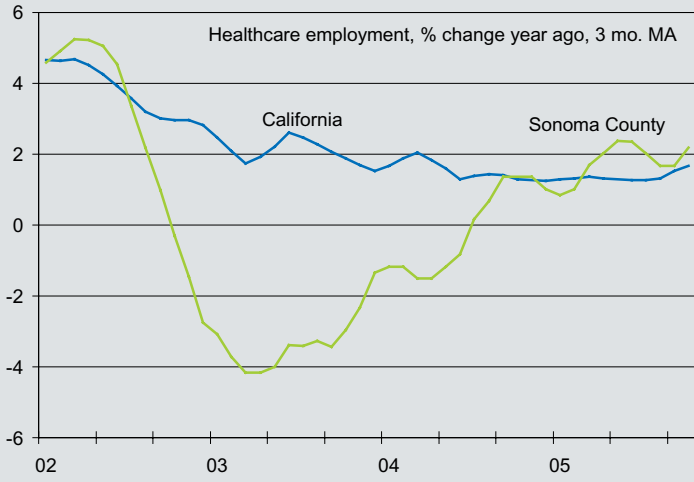
Demographic trends also bear watching. Healthcare providers in Sonoma County are building capacity anticipating a spurt in demand as baby boomers retire. However, with baby boomers living healthier lives, the demand for healthcare might not increase as much as expected, and might be focused on medical devices and drugs than on health services. Persistent physician woes are also a downside risk; anecdotal evidence suggests an ongoing physician shortage in the county, which could intensify and affect local health outcomes if it is not addressed.

The long-term future of Medicare remains a serious concern for the healthcare industry. The latest Medicare Trustees Report moved up the date for Medicare fund exhaustion by seven years to 2019, largely due to the addition of the prescription drug bill. The Hospital Insurance fund, which pays for inpatient hospital spending, is projected to start running cashflow deficits this year. The only ways to address this is through cutting benefits, raising premiums, raising taxes, or some combination of the three. Most of this will result in lower payments to hospitals.

*Rakesh Shankar*

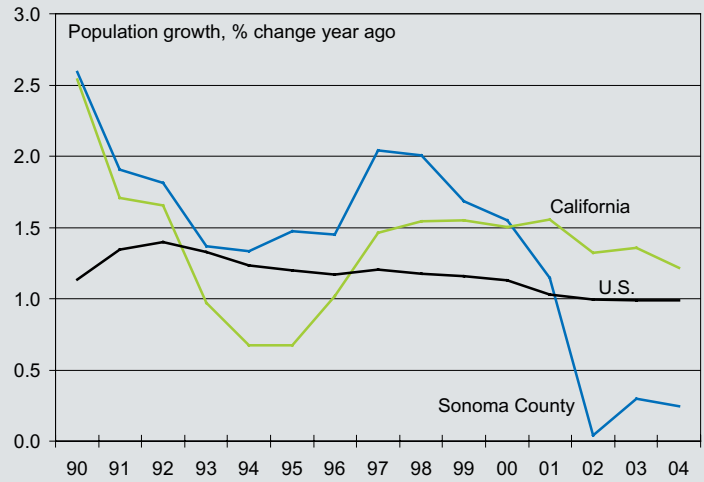
# Healthcare - Sonoma County

**Healthcare Employment Finally Recovers in Sonoma**



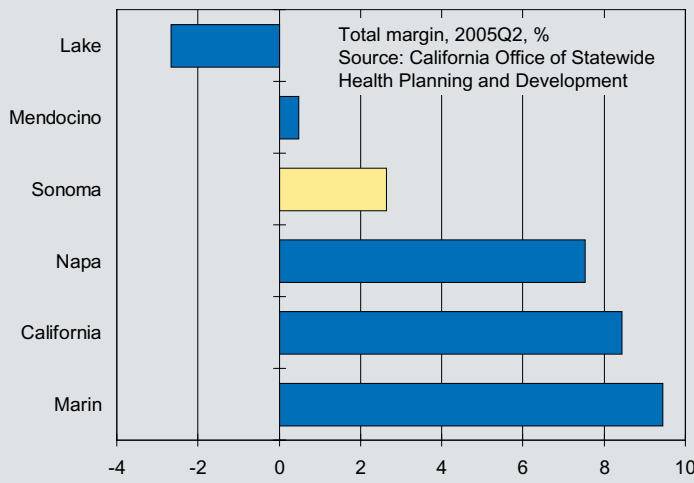
The improved standing of Sonoma County’s healthcare industry is demonstrated by its growing employment base. Local healthcare providers are now expanding payrolls on a year-ago basis at a pace faster than the state average. What’s more, job growth in healthcare has accelerated in Sonoma County over the past year, after posting weak growth in the preceding two years. Not surprisingly, nursing and healthcare-related degrees are the most sought after majors at local universities. That said, the increased hiring has led to an acceleration in operating expenses for local hospitals.

**Weaker Population Growth Persists**



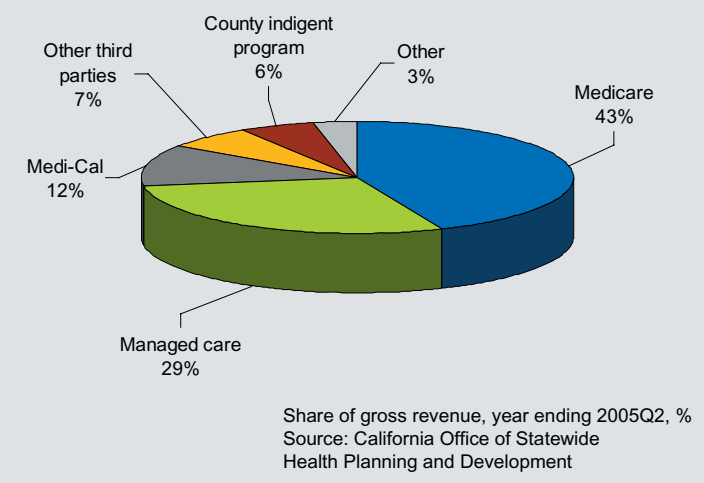
Sonoma County enjoyed healthy above average population growth through the 1990s. That trend reversed in the aftermath of the national and local recession. Population growth in Sonoma County has not recovered from its below average pace over the past four years. To some extent, this reflects weaker overall job growth in Sonoma County over the past four years, which has discouraged immigration. Moody’s Economy.com expects both job and population growth to rebound in the next year to above average pace, which will restore Sonoma County’s healthy demographic trends.

**The Laggard Along the Bay**



The healthcare industry has moderated nationally and regionally, with profit and revenue growth starting to flatten out. The same is true of Sonoma County hospitals as well, although the moderation locally has been far stronger than in the rest of the state. Operating and total margins for Sonoma County hospitals in aggregate are now lower than the state average. Sonoma County also lags behind its better-off neighbors to the South and the East. This largely reflects the higher burden of indigent care that Sonoma County hospitals bears. This is also evident for counties like Lake

**Source of Sonoma County Hospital Revenue**



Public sources account for the majority of Sonoma County hospitals’ revenue base. Over 55% of hospital revenues come from public sources. This is bound to change over the next year as both Medicare and Medi-Cal succeed in bringing more managed care programs into the fold. Higher reimbursement rates are enticing more insurance companies to get back into the fray; what this will likely mean is that hospitals will be more squeezed for price gains from Medicare and Medi-Cal going forward.