The Regents of the University of California

COMMITTEE ON HEALTH SERVICES
November 18, 1998

The Committee on Health Services met on the above date at Covel Commons, Los Angeles campus.

Members present: Regents Atkinson, Clark, Davies, Khachigian, Leach, Preuss, and Sayles; Advisory member Vining

In attendance: Regents Chandler, Espinoza, Gould, Hotchkis, Johnson, Kozberg, Lee, Miura, Montoya, Nakashima, and Ochoa, Regent-designate Taylor, Faculty Representative Coleman, Secretary Trivette, General Counsel Holst, Assistant Treasurer Young representing Treasurer Small, Senior Vice President Kennedy, Vice Presidents Broome, Gurtner, Hershman, and Hopper, Chancellors Bishop, Carnesale, Cicerone, Orbach, and Vanderhoef, and Recording Secretary Bryan

The meeting convened at 3:30 p.m. with Committee Chair Khachigian presiding.

1. **SUPPLEMENTAL REPORT ON WESTERN HEALTH ADVANTAGE, MEDICAL CENTER, DAVIS CAMPUS**

It was recalled that at the September 1998 meeting of The Regents, the Committee on Health Services received a status report on Western Health Advantage (WHA), a nonprofit public benefit corporation formed by the UC Davis Health System (UCDHS), Mercy Healthcare, and the NorthBay Health System for the purpose of developing and operating a provider-sponsored health plan. The following update was presented.

Financial Projections

Projected Revenue and Expense: Updated projections for 1999 and 2000 anticipate that WHA will lose an additional $1.85 million before it breaks even in the year 2000, when commercial enrollment is projected to reach approximately 35,000 lives. These losses will be split equally among the three member organizations. The financial projections presented at the September Regents meeting have been updated to reflect two significant decisions made by the WHA Board at its most recent meeting:

- The budget for the quality data information system (QDIS) has been reduced by approximately $1.2 million and $1 million in 1999 and 2000, respectively. This change reflects an agreement to expand the use of the QDIS system to monitor the quality of care for all capitated patients served by WHA member organizations and an agreement by UCDHS, Mercy, and NorthBay Health

System to pay for QDIS-related costs that are not directly associated with WHA enrollees. The cost-sharing agreement between WHA partners regarding the acquisition of QDIS is an example of how UCDHS has been able to reduce planned expenditures by spreading the cost of a sophisticated, capital-intensive information system among several parties.

- The cost of marketing to Medicare beneficiaries has been reduced by approximately $610,000 and $520,000 in 1999 and 2000, respectively. This estimate reflects the WHA Board's decision to limit efforts to broadly market its Medicare Risk product to individuals.

Capital Contributions: The WHA discussion item presented at the September Regents' meeting indicated that UCDHS would invest approximately $10.2 million in WHA before it reached the break-even point. This estimate included approximately $6 million in management fees retained by WHA to help pay for administrative costs associated with UCDHS patients. Excluding these fees, which are similar to the premium retained by an HMO for administrative services, the total direct investment in WHA is expected to be $3,869,180 before the organization breaks even in the spring of 2000.

UCDHS contributions and loans to WHA totaled approximately $2.9 million as of June 30, 1998. This includes the $1 million loan provided by UCDHS to meet the tangible net equity requirement of the Department of Corporations and contributions to offset operating losses. Current projections indicate that UC Davis Health System will invest an additional $973,000 by the time it breaks even in 2000. This investment will provide funds to offset the UCDHS share of projected operating losses in 1999 (approximately $616,000) and additional capital (approximately $354,000) to enhance WHA net equity, thereby increasing its financial stability.

Marketing Plan/Business Strategy

Updated financial projections for WHA indicate that approximately 35,000 commercial lives will be needed before the plan breaks even. This assumes that Medi-Cal enrollment will remain constant at approximately 14,700 enrollees. As of August 31, 1998, there were approximately 13,700 commercial patients signed up with WHA. Several strategies are actively being pursued to increase the number of commercial patients enrolled in WHA:

Expanded Service Area: Efforts are in progress to expand the WHA service area to include Colusa, El Dorado, and San Joaquin counties. If approved, this expansion would add over 750,000 people to the WHA service area.

Advertising and Marketing: WHA has launched an aggressive marketing campaign that includes television, radio, print, outdoor advertising, and direct mail. This $1 million campaign targets small and large employers and consumers throughout the WHA service area. This initiative will be complemented by the individual efforts by WHA

member organizations to increase local awareness and appreciation of WHA. While WHA will continue to market aggressively to small and medium employers, a major emphasis will be made during the current "open enrollment" period to sign up federal employees, as approximately 30,000 federal employees who live in the WHA service area now have the option of choosing WHA.

New Products: WHA expects to receive authorization to offer an HMO product to Medicare beneficiaries in the first quarter of 1999. While WHA does not plan to promote its Medicare Risk product to individuals, by having it as part of its "portfolio" WHA will have access to several large employers that want insurance products that can meet the needs of retirees eligible for Medicare.

Expanded Physician Panel: Approximately 305 specialists and 105 primary care physicians were added to the WHA's physician panel through an agreement with Golden State Physicians Medical Group.

Additional Partners: Other healthcare organizations have expressed an interest in joining WHA. The management and the board of directors are weighing the potential financial and strategic consequences of adding partners to WHA. Consideration is being given to developing a structure and approach that facilitates broader participation and financial support, but not necessarily at the same level as the three founding organizations.

As noted above, Medi-Cal enrollment is projected to remain about the same during the next three years. The decision to limit the future growth of capitated Medi-Cal patients has been influenced by capacity constraints at the UC Davis Medical Center and limits on how many additional Medi-Cal patients other WHA-affiliated physicians are willing to accept at this time. During the past year, there have been several occasions when it has been difficult to accommodate specialty referrals that are important for teaching and research programs. Inpatient admissions at the Medical Center and total outpatient visits have grown by 31.5 percent and 54.3 percent, respectively, in the past three years. For the first quarter of FY 1998-99, the Medical Center average daily inpatient census increased by 8 percent from last year, and the overall occupancy rate in September 1998 climbed to approximately 84 percent. While UC Davis has been, and will continue to be, the region's largest provider of care to indigent and Medi-Cal patients, it does not have the capacity to accommodate substantial growth in the volume of Medi-Cal patients it serves.

Major Benefits of WHA

The most significant contribution of WHA to date has been to foster improved working relationships with Mercy Healthcare, part of Catholic Healthcare West (CHW), and several other organizations. More referrals and educational activities have resulted as a by-product of these other relationships rather than as a direct result of WHA. These

relationships could be affected adversely if UCDHS withdrew its support of WHA. Some of the specific benefits of WHA are:

- WHA has helped increase the number of patients who rely on primary care physicians of the UC Davis Medical Group. Approximately 18,600 UCDHS capitated patients are enrolled in WHA.

- WHA has helped increase specialty referrals to UCDHS.

- WHA has provided a vehicle to share the costs of information systems that are an important tool in monitoring the quality of care provided to capitated patients.

- WHA has enabled UCDHS to retain a sufficient number of Medi-Cal patients to meet the training programs of the School of Medicine.

WHA has helped strengthen its relationship with Mercy/CHW, an important academic and strategic partner that is currently involved in several important initiatives, including:

- Residency training programs at several Mercy-affiliated hospitals that involve family practice, obstetrics, pediatrics, surgery, and neurology.

- Joint clinical programs involving trauma and emergency medicine, cancer, and pediatrics. WHA has also opened the door to discussions regarding several other joint programs that involve Mercy Sacramento and other Mercy affiliated hospitals in Sacramento.

- Joint business ventures and collaborative programs, like the Merced Cancer Center approved by The Regents in September.

- Strategic initiatives related to the UC Davis Community Hospital Network which includes Mercy affiliated hospitals in Stockton, Merced, and Grass Valley.

Another important contribution of WHA is in the contracting arena. The existence of WHA provides UCDHS and other member organizations an alternative product to offer to employers if existing HMOs in the region are unwilling to negotiate fair and equitable contracts with UCDHS and other providers. As HMOs struggle to maintain their profit margin, they have become increasingly aggressive in their attempts to reduce or delay payments to provider organizations. WHA is an important strategic asset in bargaining with other payor organizations.

Monitoring

WHA management and its member organizations continue to believe that WHA is a sound financial and strategic investment. Management anticipates that WHA will break even within the next 18 months. To address concerns raised at the September Regents meeting, the UC Davis management team proposes the following:

- Annually to provide The Regents with a brief written status report on WHA.

- To report financial results of WHA quarterly to the Office of the President. If results vary substantially from the budget, the Regents will be notified.

If WHA's financial performance falls materially below projected levels, UCDHS will re-evaluate its continued participation in the organization.

This reporting structure is proposed to allow for the development of remedial actions to adjust to unforseen circumstances and changing market conditions while maintaining fiscal control. It would also communicate to other WHA member organizations that UC Davis does not intend to withdraw its support in the near term.

Regent Clark asked how WHA can minimize losses by the sale of assets. Mr. Chason explained that WHA, like most HMOs, has an intrinsic value. Individuals may look to purchase interest in WHA. The patients who have selected UC Davis, Mercy, or North Bay as their provider and thus have selected WHA as their HMO have a value that may be sold. That value is above and beyond the University's capital investment.

Committee Chair Davies noted that it has been agreed previously that for this type of transaction there will be annual status reports to the Board. He suggested reporting to The Regents more often concerning this particular enterprise. He asked also that the annual report contain a comparison of the actual financial outcome to what the Regents were originally told the outcome would be, in addition to providing new projections.

Regent Gould asked about the status of the geographic managed care plan for Sacramento County. He was concerned that local providers will be vying for the same market share. It was explained that there were originally eight provider organizations included in the geographic managed care plan, only five of which were HMOs. Subsequently, when it was decided that only licensed HMOs would be able to participate, it became imperative for UCD to maintain the lives owned by WHA. Blue Cross, Kaiser, and Foundation compete directly with WHA for those lives. The University's patient growth in commercial lives has been about the level necessary to maintain its training programs; however, it is not known how the geographic managed care plan will be constructed. It is possible that a two-county model will be developed. Vice President Gurtner noted that he expected there would be ongoing discussions about developing geographic managed care plans across the system.

Regent Lee asked how the economy affects hospital profits. Mr. Gurtner responded that the economics of the situation are not driven by the individual. In the past decade

the growth in the premium dollar both at HMO and commercial levels has been relatively flat. The University needs to decide how best to have access to the increasing number of patients who are opting for managed care. Currently, only two of the University's medical centers are making money from operations. They continue to benefit from the allocation of at-risk funds received for teaching and indigent care. Those dollars are not directly operationally linked, but they allow the University to do well relative to the rest of the market. At the same time, the University continues to be at risk of losing those funds. The administration must continue to assess its relationships with groups such as WHA to make sure they are good investments that attract the patients necessary to maintain the University's teaching, research, and patient care missions.

2. **UCSF STANFORD HEALTH CARE: UPDATE ON THE MERGER**

Mr. Peter Van Etten, chief executive of UCSF Stanford Health Care, provided a programmatic overview of the organization. Mr. Van Etten recalled that UCSF Stanford Health Care has four hospitals, UCSF, Mount Zion, Stanford, and Packard's Children's, with a combined occupancy rate of 75 percent. The organization has one million clinic visits a year, employs 13,000 people, and has $1.5 billion in revenue and $1.4 billion in assets. The corporate purpose is to support, benefit, and further the charitable, scientific, and educational purposes of the Schools of Medicine at UCSF and at Stanford University. The role of the clinical enterprise is to support the educational enterprise of the two schools that sponsor UCSF Stanford Health Care. Its mission statement is, "To Care, To Educate, To Discover." The administration is working with staff to develop a set of values that will guide management decisions and inform strategic decision making. Those values include commitment to service, compassion, integrity, respect, and leadership through excellence.

Mr. Van Etten emphasized that the merger is one of the clinical enterprises and not of the two medical schools. The success of the enterprise should be judged not by the extent to which programs are combined but by the extent to which strong programs are built at each school. He noted that faculty recruitment appears to have been enhanced by the merger. Another measurement of success is the reduction of costs. The infrastructures of the two sites are being merged and integrated aggressively. Increased profitability, increased philanthropy, and improved outcomes are additional ways of measuring the success of the merged entity.

Mr. Van Etten commented on the challenges faced by academic medical centers. One of these is the fact that HMO payments barely cover variable costs. The profitability of UCSF Stanford Health Care broken out by payor classes reveals that the total margin of 2.8 percent in operations was achieved because of positive margins in Medicare and private and other payor categories. Medicare funds are at risk, however. Of the $300 million that UCSF Stanford Health Care is paid by Medicare, about $100 million comes from additional payments related to its teaching programs. The strategic position of UCSF Stanford Health Care is not to purchase large numbers of primary

care practices and community hospitals but rather is to emphasize its role as a referral institution. Another challenge is Medicare's conversion to capitation. Mr. Van Etten noted that for every 1,000 Medicare enrollees in the Bay Area who convert from traditional Medicare to Medicare HMOs, UCSF Stanford Health Care loses $2 million. The strategy that UCSF Stanford Health Care has adopted, and the principal reason for the merger in addition to reducing infrastructure costs, was to position itself as the provider of choice in northern California for complex care. He recalled that UCSF and Stanford have a market share of complex care within the Bay Area of about 11 percent. An increase of that share to 13 percent would bring in $100 million in additional revenue.

Mr. Van Etten noted that health services researchers at both campuses have been working to develop evidence that shows the benefits of sending patients who have complex illnesses to institutions such as UCSF Stanford Health Care. A review of 88 published studies led to the conclusion that over 1,300 deaths per year could be avoided throughout the state by treating high-risk patients at high-volume settings such as the University's medical centers. UCSF Stanford Health Care is working with the business community to gain an understanding of the importance of this issue. UCSF Stanford Health Care's strategy concerning primary care has been to extend the partnership that was established previously with California Pacific Medical Group to include Brown and Toland Medical Group. He recalled that it was a merger with a competitive medical group with the condition that there would be open referrals throughout the merged group. UCSF contributed 35,000 lives; California Pacific Medical Group contributed 120,000 lives. The merged group now has over 200,000 lives, and the number of patients who went to UCSF exceeded expectations, enabling UCSF to gain an increased market share. Brown and Toland is being extended to Stanford, whose 45,000 lives are being added to it. The effect is to outsource primary care management to Brown and Toland, in which UCSF Stanford Health Care has a minority position but which, because of open referrals, offers significant benefits to the medical center without the risk of purchasing practices or getting involved directly in the provision of insurance.

Mr. Van Etten discussed some accomplishments of the first year of the merged entity. He noted that a 17-member board of directors was formed that includes two Regents. The board meets every six weeks. A leadership group and five subcommittees headed by faculty were established. The principal policy-making group within the organization includes 22 people, 14 of whom are faculty members, who meet weekly to guide the organization toward reaching its academic objectives. The management structure was integrated, and administrative costs were reduced. A strong senior management team was recruited, including a chief financial officer and a chief information officer. The pediatric programs at each site were integrated under a common surgical and medical leadership. In the first year, costs were reduced by $38 million, $20 million of which were attributed directly to the merger, as projected in the business plan. Of the $20 million reduction, about $12 million resulted from reduced supply costs. The balance represents reduced administrative costs, including reductions in managerial

staffs achieved through attrition. Contracts were consolidated without suffering price reductions, and significant increases were negotiated from Blue Cross and United Healthcare. A major advertising campaign was initiated to enhance the recognition and reputation of UCSF Stanford Health Care. A $300 million bond offering was completed. Major planning was initiated for an information technology initiative. The board approved a $95 million spending plan over the next two years to replace many of the information systems at both campuses, some of which are necessary to meet Y2K requirements. A 6.5 percent increase in activity was achieved, which is far greater than either institution had experienced previously. The principal goal of increasing market share was achieved. Preliminary reports indicate that the merged entity will exceed its $20 million budgeted operating gain for the year. The non-operating income will be approximately $20 million from investments, making the total gain about $40 million. In addition, that operating gain is expected to double in the coming year, resulting in an approved budget that will enable a $44 million bottom line. Included in that is a $16 million increase in funding to the two schools.

Mr. Van Etten reported on some major projects for the coming year. These include pilot service lines in eight areas, including cardiac, neurosurgical, oncology, and other adult and pediatric areas. The development of service lines entails bringing together physicians from each site in a multidisciplinary way and organizing them in new ways in order to effect superior patient care. The goal is to move away from the traditional structure of an academic medical center based on departments and to move toward services organized around specific service lines. There is a concern that expense increases from inflation and salaries may be greater than the amount of possible revenue increases. Continued pressure from HMOs and continued Medicare reductions threaten. Every effort will be made to reduce costs further than was envisioned in the business plan.

UCSF Stanford Health Care must continue to address the challenges of the marketplace by growing patient activity in a shrinking patient market with excess capacity and marginal cost-pricing, hindered by structural costs and service problems. Mr. Van Etten was confident that this objective will be met.

Regent Leach commented that much more was accomplished in UCSF Stanford Health Care's first year than could have been expected. He commended Mr. Van Etten's leadership capabilities and those of Executive Vice President Bill Kerr. He believed that the accomplishments listed were made possible by dedication in the management and professional areas. The financial goals for the merged entity were surpassed. He observed that the hospital management team that was formed was outstanding. The faculties of the two schools have been cooperative in putting programs together and thinking of ways in which to improve patient care. Chancellor Bishop was also pleased with the progress of UCSF Stanford Health Care in its first year. Its success is vital to the teaching mission. Regent Davies noted that Regent Leach, in his role as Chair of the Executive Committee of the UCSF Stanford Health Care Board, had exhibited tremendous dedication to his task.

Regent Preuss found the report of UCSF Stanford Health Care's first year exciting. He wondered whether anything happened that went against expectations. Mr. Van Etten noted that merging different institutions and managements was much harder than anyone expected. Changing the payroll system was a major challenge. He was disappointed that more headway was not made in integrating programs such as organ transplant. He acknowledged that more time will be needed to achieve true integration of the two entities.

Regent Lee asked where Mr. Van Etten spends the bulk of his time, whether patients registered at the north campus may get their care also at the south campus, and whether Y2K poses any problems. Mr. Van Etten responded that he has an office at each campus and one near the airport, where he holds faculty meetings. He noted that patients may visit either site. He reported that the Y2K issue does not appear to pose problems.

Regent Montoya asked for more detail about Stanford's outsourcing 45,000 lives to Brown and Toland. Mr. Van Etten explained that Brown and Toland is not controlled by UCSF Stanford Health Care. The Brown and Toland joint venture between UC and California Pacific Medical Group now includes Stanford. UCSF Stanford is not at risk for those capitation payments.

Regent Clark noted that the August 31, 1998 data for UCSF Stanford Health Care have not been forwarded. He asked why no interim figures were available. Mr. Van Etten responded that the final audited numbers would not be available until December. He did not believe it would be appropriate to provide unaudited interim figures. Regent Leach added that the UCSF Stanford Health Care Board has seen the interim unaudited figures and that they are very favorable.

3. **ACTIVITY AND FINANCIAL STATUS REPORT ON HOSPITALS AND CLINICS**

Vice President Gurtner continued to be concerned about changes in Medicare reimbursement, including payment of those funds as an annual federal distribution. Regent Miura asked for an explanation of who is an HMO capitated patient, who is not, and why Brown and Toland does not fall into that category whereas WHA does. Mr. Gurtner suggested providing an overview at a future time of the capitated risk and delivery systems in which the University is involved.

The meeting adjourned at 4:45 p.m.

Attest:

Secretary