PREVIEW

# Hospital Financial Analysis 2006

## Statewide Total Margin Increases for Fourth Consecutive Year, Driven by Growth in both Operating and Non-operating Income

The Pennsylvania Health Care Cost Containment Council (PHC4) is an independent state agency charged with addressing the cost and quality of health care in Pennsylvania.

In order to maintain a high quality, cost-effective health care delivery system, hospitals and freestanding surgery centers must be financially viable and effectively managed. PHC4 produces a series of annual reports that measure the financial health of the Commonwealth's hospitals and surgery centers and the utilization of their services.

In response to the high level of interest in the financial condition of Pennsylvania's general acute care (GAC) hospitals, PHC4 is releasing this *Preview* in advance of its forthcoming *Financial Analysis 2006, Volume One* to be released in Spring 2007.

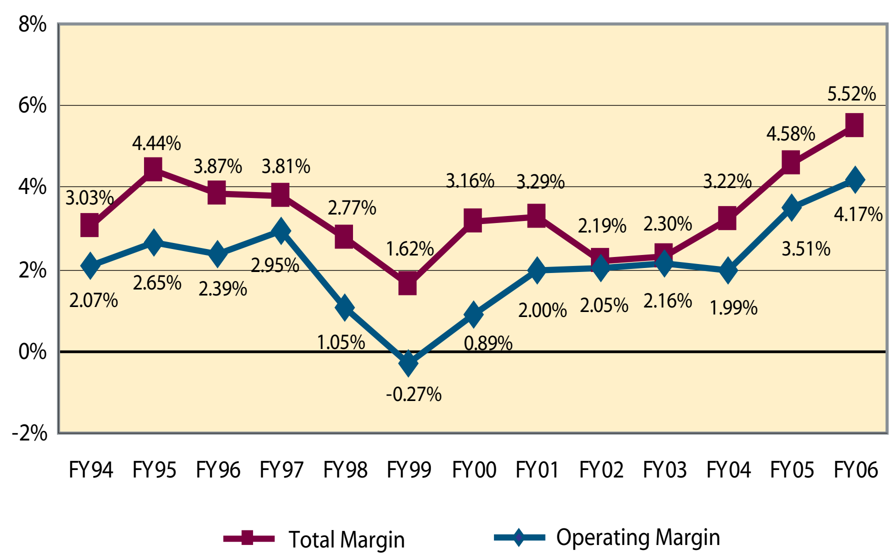
Information in this *Preview* is derived from the hospitals' audited financial statements and additional data filed directly by the hospitals. PHC4 wishes to thank the hospitals for their cooperation and timely submissions.

The overall net income or total margin realized by Pennsylvania's 174 general acute care (GAC) hospitals grew by almost a full point (0.94), rising from 4.58% in fiscal year 2005 (FY05) to 5.52% in fiscal year 2006 (FY06). This is the fouth consecutive year of growth in statewide hospital income. Over the last three years, the average total margin increased 3.2 points from the 2.30% total margin posted for FY03. The total margin reflects the net income hospitals realized from all sources, including operations, investment gains and contributions.

Unlike FY04 and FY05, the improvement in the FY06 total margin resulted from the combination of a 27.3% ($262 million) improvement in operating income and a 36.4% ($111 million) increase in non-operating income. In FY04, the 0.9-point improvement in the total margin was almost exclusively driven by a $291 million increase in non-operating income while operating income remained relatively constant. During FY05, non-operating income actually fell, and the 1.4-point climb in the statewide total margin was the result of a $454 million increase in operating income.

With these increases in operating and non-operating income, GAC

**Statewide Average Total and Operating Margins**



hospitals received about 75% of the $1.6 billion FY06 total income from operations with the remaining 25% coming from non-operating sources. Non-operating income is primarily the result of investments and contributions.

## Despite Statewide Gains, 22% of GAC Hospitals Lose Money in FY06

While the statewide average total margin grew nearly a full point to 5.52%, 38 or 22% of the 170 reporting GAC hospitals[1] posted a negative total margin in FY06.

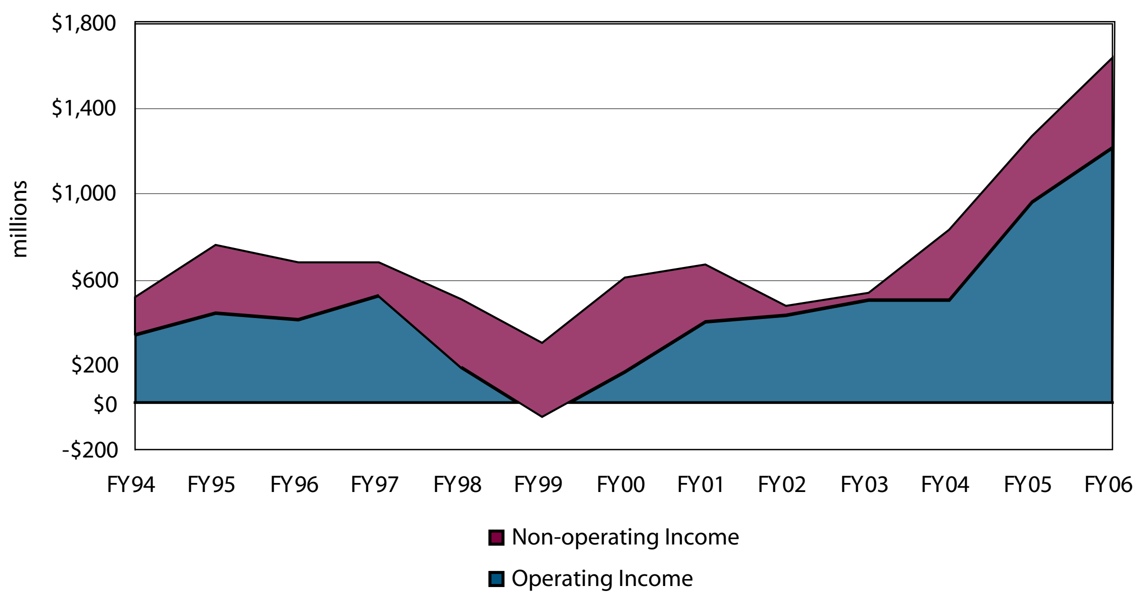
Nearly one-third (32%) or 55 hospitals reported a negative operating margin. For these hospitals, revenue from patient care and other operations was not sufficient to cover operating expenses.

The hospitals with an operating loss were more likely to be smaller community hospitals. Only 11% (6 out of 55) of the hospitals with negative operating margins had annual net patient revenues above $150 million. These 55 hospitals had an average FY06 net patient revenue of about $73 million. In contrast, 43% (49 out of 115) of the hospitals reporting positive operating margins had net patient revenues above $150 million, and the average net patient revenue for the group was about $206 million.

Since extraordinary or short-term events can have a significant impact on a hospital's annual total margin, a three-year average total margin can provide some perspective on a hospital's medium-term financial health.

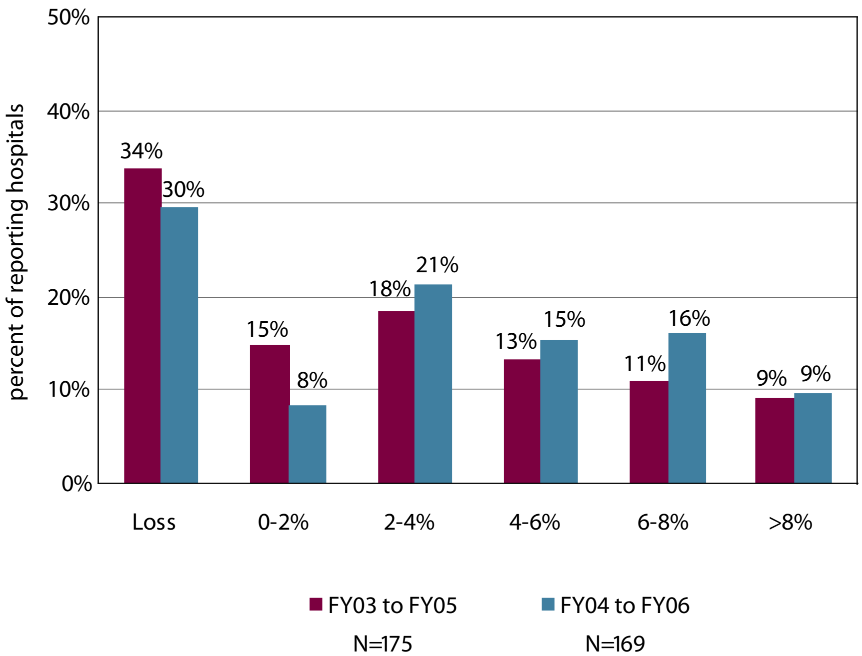
There was a decline in the number of hospitals that had either negative or small positive three-year average total margins. Nine fewer hospitals realized average losses over the three-year period ending in FY06. There were 50

**Statewide Operating and Non-operating Income**




[1]There were 174 individually-licensed hospitals that operated for some period of time during FY06. Three hospitals closed during the year and did not submit financial data to PHC4. One hospital was purchased during the year, and the former owner did not submit financial data for FY06. As a result, 170 hospitals reported FY06 financial data to PHC4.

## Statewide Distribution of Three-Year Average Total Margin




| 3-yr Average Total Margin | Hospitals | |
|---|---|---|
| | FY03-FY05 | FY04-FY06 |
| Loss | 59 | 50 |
| 0-2% | 26 | 14 |
| 2-4% | 32 | 36 |
| 4-6% | 23 | 26 |
| 6-8% | 19 | 27 |
| >8% | 16 | 16 |
| Total | 175 | 169 |

hospitals with a negative three-year average total margin at the end of FY06, compared to 59 at the end of FY05. Similarly, there were 12 fewer hospitals with three-year average total margins in the 0%-2% range.

Counterbalancing the decline in the number of hospitals at the lower end of the scale, there were 15 more hospitals with three-year average total margins between 2%-8%. Between FY04 and FY06, 52% of the 169 hospitals that were in operation for the entire three-year period were in the 2% to 8% range.

The number of hospitals with three-year average total margins above 8% between FY04 and FY06 remained the same as the FY03 to FY05 level at 16 hospitals.

## GAC Hospital Care Represents a Growing Portion of Pennsylvania's Resources

Net patient revenue (NPR), the revenue hospitals receive for patient care, grew about $1.9 billion or 7.2% during FY06. In contrast, Pennsylvania's economy, measured by the Commonwealth's gross domestic product (GDP)[2], grew 5.4% during 2005. Since the majority of FY06 GAC hospital care was rendered during 2005, the growth in the Pennsylvania GDP during 2005 was used for the comparison.

Over the past five years between FY01 and FY06, hospital NPR grew 48.3% or an average of 9.7% per year. Over a comparable period between

[2]U.S. Department of Commerce, Bureau of Economic Analysis, www.bea.gov. February 2007.

2000 and 2005, Pennsylvania's GDP grew at nearly half that rate (25.5% or an average of 5.1% per year). The $27.8 billion in FY06 statewide NPR and the $29.3 billion in statewide operating revenue reported by GAC hospitals is equivalent to 5.7% and 6.0% of Pennsylvania's 2005 GDP of $489.0 billion.

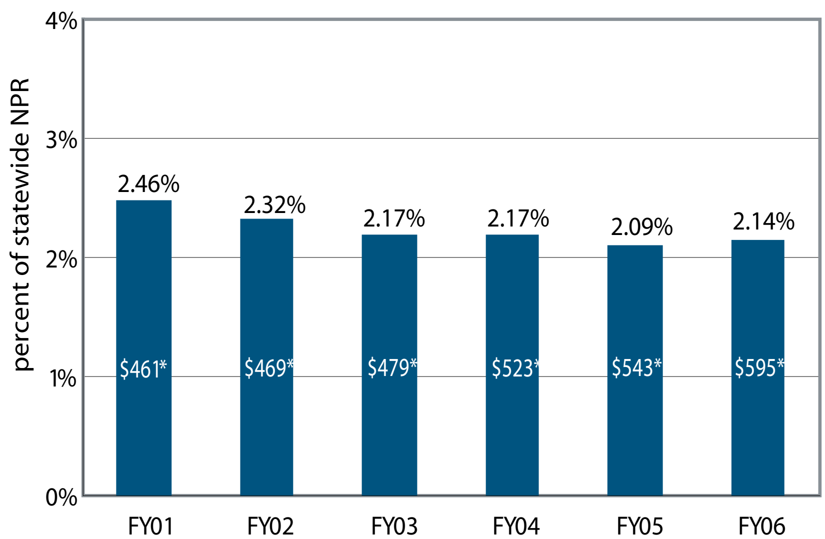
The dynamics of the growth in FY06 patient revenue will be addressed in the forthcoming *Financial Analysis 2006, Volume One*. In the past few years, increases in reimbursements from commercial insurers, particularly managed care plans funded by employers and government programs, have been a major factor in the growth of hospital revenue.

## Uncompensated Care Rates Rise

The dollar value of uncompensated care grew by 9.7% or $53 million from $543 million during FY05 to $595 million during FY06. However, since statewide net patient revenue grew by 7.2%, uncompensated care as a percentage of net patient revenue rose only from 2.09% in FY05 to 2.14% in FY06.

Uncompensated care revenue provides an estimate of the amount of revenue hospitals lost due to bad debt and charity care. This foregone revenue reflects what hospitals would have received if they had been reimbursed for uncompensated care. The estimate of foregone revenue is based on the average overall reimbursement hospitals received from all payors, including commercial health insurers, Medicare, Medical Assistance and patients.

### Statewide Uncompensated Care Revenue




* Statewide Uncompensated Care Revenue in millions.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