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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

TO: Mental Health Oversight Committee and Joint Fiscal Committee

FROM: State Treasurer's Office and Joint Fiscal Office

RE: Report Describing the Financing Arrangement for a New Psychiatric Wing at the Rutland Regional Medical Center

DATE: October 1, 2009

The State Treasurer's Office and Joint Fiscal Office are presenting the following Report in accordance with Act No. 43, Sec. 32, "Vermont State Hospital; Replacement of Acute Care Functions." Specifically, the legislation states that "No later than October 1, 2009, the treasurer's office and joint fiscal office shall provide a report to the mental health oversight committee and the joint fiscal committee describing the financing arrangement for a new psychiatric wing at RRMC and the results of the accounting and financial analysis, including their conclusions as to whether the financing arrangement is reasonably feasible."

The accounting and financial analysis (the PFM Analysis) is included as an attachment to this Report. The Report describes the financing arrangement for the new psychiatric wing, reviews the conditions under which the financing arrangement would not be expected to place debt capacity burden on the State, summarizes the results of the PFM Analysis, and then provides the joint conclusions of the Treasurer's Office and the Joint Fiscal Office as to the feasibility of the financing arrangement.

In summary, we believe that the financing arrangement is reasonably feasible. We conclude that the Department of Mental Health (DMH), in conjunction with other State entities and RRMC, should continue working to develop an executable financing arrangement. However, we do not believe that a financing arrangement of this type could be executed today given current financial market conditions, the uncertainty created by Federal health care reform legislation, and without addressing several business considerations and risk factors that have been identified by the financial community (and are discussed in greater detail below). Further, any such financial arrangement may require modifications that are generally consistent with the original objectives of this proposal, to improve ultimate marketability and likelihood of success.

In addition, one regional bank, that maintains extensive business relationships with both the State of Vermont (State) and Rutland Regional Medical Center (RRMC), has expressed interest in working on the financing arrangement with the State and RRMC, and may be a willing partner subject to the resolution of these considerations and concerns. We further conclude that DMH, working in conjunction with other State entities and RRMC, should continue working with the

interested bank (or other prospective financial institutions) to address business considerations and risk factors.

The Joint Fiscal Office recognizes that this financing effort is part of a broader initiative (master plan) to address the State's mental health care needs, and that these needs will not be addressed by this project alone. The department needs to pursue this as part of a broader mental health master plan to be developed consistent with statutory requirements with legislative review.

Proposed Financing Arrangement

Over the past year, DMH has convened several dozen meetings with a working group of staff drawn from the Agency of Administration, Treasurer's Office, Joint Fiscal Office, Vermont Educational and Health Buildings Financing Authority (VEHBFA), Attorney General's Office, and RRMC. This working group discussed and formulated the legal and business framework, operating parameters (i.e., revenues and expenses) and prospective capitalization and financing alternatives for a new psychiatric wing at RRMC.

The financial construct envisions an arrangement to prevent debt associated with the new psychiatric wing from burdening either the State's or RRMC's debt capacity. To accomplish this, the working group determined that the new wing would need to be incorporated as a separate 501(c)3 non-profit organization, which would be responsible for (1) entering into a ground lease with RRMC for a building site located adjacent to RRMC's existing facilities, (2) designing, constructing and owning the new facility, (3) structuring and marketing a bond issue to pay for the capital costs of construction of the facility, and (4) entering into an operating lease of the facility to RRMC, collecting lease payments from RRMC, and disbursing the lease payments to pay principal and interest on the bonds. For working purposes, this new 501(c)3 entity was referred to as "Rutland Regional Psychiatric Services" or simply "RRPS." A more detailed description of the financing arrangement can be found on Pages 2 through 4 of the PFM Analysis.

Determination Regarding the State's Debt Capacity Burden

Government Finance Associates (GFA), a financial advisory firm based in New York City, was retained to determine whether debt incurred by RRPS would be considered as part of the State's net tax-supported debt. GFA has served as the State's financial advisor since the early 1990s, and is very experienced with municipal debt issuance, specifically with regard to debt issued both by the State of Vermont, and numerous Vermont-related entities. GFA also advises the Vermont Municipal Bond Bank, Vermont Telecommunications Authority, Vermont Student Assistance Corporation, Vermont Economic Development Authority, and numerous other state and local governments.

As part of its analysis, GFA relied upon previous determinations by the three primary municipal debt rating agencies, Standard & Poor's, Moody's and Fitch, in regard to a previous financing completed for mental health designated agencies that provide services to the State. The rating agencies' determination that designated agency debt was not part of the State's net tax-supported debt rested upon two findings: first, that although State payments to the designated agencies comprised more than 50% of their revenue, well over 50% of the State's contribution was Federal funding over which the State had no discretion. Second, under Vermont State Law, the State has no authority to take over an independently-operated 501(c)3 organization.

Several years ago, Mr. Chester Johnson, GFA's President, and senior members of the Administration at the time and the State Treasurer's Office had significant communications with the rating agencies on the impact of mental health provider debt on Vermont's net tax-supported debt statement. Based on the precedents established at that time, as explained in this paragraph, Mr. Johnson has indicated to the working group that there is no discernible reason to alter the State's understanding of the manner in which this debt would be handled with respect to its effect on the State's debt load. To this end, the financing structure has been tailored to reduce the likelihood of the debt becoming part of the State's indebtedness, as computed by the rating agencies. Notwithstanding this point, Mr. Johnson has stated that two salient points need to be monitored closely with respect to the financing structure. One, if the State's direct revenue support (net of Federal participation) begins to reach into the 50% range and beyond, it is very possible that the rating agencies would, at that point in the future, include such debt on the State's net tax-supported debt statement. Two, if the services rendered by the new entity are less effective than planned or inferior to comparable facilities, such that the State decides to step into the facility and operate it, there is also a high probability that the rating agencies would, also at that point, decide to include the debt on the State's debt load. It should be stated that credit evaluation is not an absolute science; therefore, it is conceivable that, over time, the rating agencies will alter their approach to the handling of this type of debt (market practitioners have seen this happen more than once), and in that case, the conclusions set forth in this section may no longer be relevant.

GFA did not provide any analysis on behalf of RRMC; rather, it was agreed that RRMC and its financial advisors would be responsible for determining RRMC's independence from debt incurred by RRPS.

Overview of the Analysis

Public Financial Management, Inc. (PFM), a financial advisory firm headquartered in Philadelphia, was engaged to provide an accounting and financial analysis of potential bonding structures. PFM is the largest financial advisory firm to state and local governments nationally, advising on the pricing and sale of approximately 600 municipal bond issues and $43 billion par amount of bonds each year. PFM's Boston office, which provided the professionals for this engagement, specializes in health-care related financings, and serves as financial advisor to VEHBFA and numerous hospitals and health care agencies throughout New England and the United States.

To conduct its analysis, PFM first identified three bond financing structures that are currently used to finance projects similar in structure to that proposed for RRPS. These structures are:

1. Variable Rate Demand Bonds (VRDOs) supported by a direct-pay Letter of Credit (LOC);
2. Variable Rate Privately-Placed Bonds; and
3. Publicly-Issued Natural Fixed Rate Bonds.

A more detailed description of these financing arrangements can be found on Pages 5 through 10 of the PFM Analysis. In general, structures 1 and 2 above were seen as the most likely to be able to be executed, in part because they would not require credit ratings on the underlying

obligations of RRPS. In structure #1, the credit rating is derived from the rating of the LOC-providing bank, and in structure #2, no ratings are required because the bank with which bonds would be privately placed would conduct its own credit due diligence. Structure #3, fixed rate bonds, would almost certainly require ratings from one or more rating agencies on the underlying RRPS structure, which, if rated poorly, would have negative consequences for the marketability of bonds.

PFM then approached approximately 20 banking organizations, including investment banks and national and regional commercial banks that provide financial and underwriting services to municipal governments and health care organizations, to determine their appetite for the RRPS structure. Of these banks, 15 expressed no interest in discussing health care or mental health financings generally, or the RRPS structure specifically. Five banks did provide specific feedback, which is described in the Appendix to the PFM Analysis. However, only one of the banks expressed interest in pursuing the RRPS financing structure, and contingent upon favorable resolution of several business considerations and risk factors.

Numerous risk factors identified by the banking organizations, such as current market conditions, the length of time between now and potential groundbreaking, lack of appetite or capacity for health industry financings generally and mental health facilities in particular, and concerns regarding Federal health care reform or other Federal legislation, are beyond the State's or RRMC's control.

However, a number of the identified risk factors and business considerations potentially are within the State's or RRMC's control. Several of the most important factors, and possible resolutions or mitigations, are:

1. **Lack of RRPS track record or assets.** This could be addressed by the inclusion of a reserve fund, by strong covenants regarding the State's and RRMC's intent to utilize the facility, or by demonstration of the financial benefit to the State of the arrangement; for example, DMH has provided a preliminary estimate of over $1.7 million of annual savings to the State. Finally, this concern could be mitigated by some form of direct or indirect guarantee by either or both the State or RRMC; however, such an arrangement is beyond the scope of this Report, and could result in a problematic debt capacity burden to either the State or RRMC.

2. **Risk of non-performance by the State or RRMC.** This could be addressed by covenants by the State and/or RRMC to utilize the RRPS facilities during the term of the financing arrangement. However, explicit or implicit support could impact either the State's or RRMC's debt capacity.

3. **Length of Operating Agreement between RRMC and DMH.** The current plan was for the operating agreement to be renewed annually; however it could be possible for DMH to designate a much longer term, e.g., 10 years, or an indefinite term as long as the facility operated satisfactorily within State guidelines.

4. **Length of Operating Lease between RRMC and RRPS.** The financing arrangement as reviewed contemplated a one-year lease. To the extent that a longer-term lease could be

developed consistent with generally accepted accounting principles, the financing arrangement would have increased marketability, and would result in an increased comfort level with potential financial partners.

5. **Substitution of lower-cost facility.** Several banks expressed concern that the State could discontinue utilizing the RRPS facility if cheaper service were offered by competing facilities in the future. This concern could be mitigated if the State covenanted that during the term of the financing arrangement it would maintain a certain number of beds at RRPS, regardless of cost of alternative facilities.

6. **Restrictions on use of facility.** RRMC stated a requirement that RRPS remain a psychiatric care facility during the term of the financing arrangement, regardless of whether the State or RRMC terminated use of the facility. This was of concern to banks, in that they would want to allow a broader range of potential revenue-generating activities at the facility in order to pay interest and principal on outstanding bonds. Two possible mitigations are: (1) for RRMC to explore acceptable alternative uses, such as an elder care or substance abuse treatment facility, and (2) for RRMC and/or DMH to provide a list of prospective operators, other than RRMC, of the RRPS facility, and/or examples where such an arrangement (that is, a different service provider operating a facility on or adjacent to RRMC's campus) has worked previously.

These risk factors and business considerations are discussed in greater detail on Pages 4 and 5 of the PFM Analysis.

Conclusions

As indicated above, the Treasurer's Office and Joint Fiscal Office recommend:

1. First, that the Legislative Committees approve continued expenditure authority to allow that the Department of Mental Health (DMH), in conjunction with other State entities and RRMC, to continue working to develop an executable financing arrangement with the interested bank (or other prospective financial institutions); and

2. Second, that the Legislative Committees and the parties be aware that the final financing arrangement might require some modifications of the terms and the specific requirements that the State and the RRMC desire.

In addition, the Joint Fiscal Office, recognizes that this financing effort is part of a broader initiative (master plan) to address the State's mental health care needs. All parties should understand that these needs will not be addressed by this project alone. The department needs to pursue this as part of a broader mental health service master plan to be developed consistent with statutory requirements and with legislative review.

Should you have any questions regarding the contents of this Report, in the Treasurer's Office please contact Beth Pearce at 828-5195 or Steve Wisloski at 828-5197, and in the Joint Fiscal Office contact Steve Klein or Stephanie Barrett at 828-2295.

Attachment: PFM Analysis

Statutory Language included in Act 43 of 2009 Capital Construction Bill

Sec. 30. VERMONT STATE HOSPITAL; REPLACEMENT

(a) It is the intent of the general assembly that expenditures for planning for replacement of the functions of the Vermont state hospital shall be directed toward meeting the conditions and requirements of the conceptual certificate of need issued by the department of banking, insurance, securities, and health care administration on April 12, 2007, and extended for 12 months, to expire on April 12, 2010.

(b) Prior to the submission of an application for a phase II certificate of need for construction of a facility to house a secure residential recovery program provided for in Sec. 31 of this act, the department of mental health shall develop a master plan to replace the functions now provided in the Vermont state hospital and to close the Vermont state hospital. The master plan shall include an adequate long-range perspective of the funding needs and sources such that the phase II review process for a secure residential recovery program will be able to:

(1) consider whether there will be an appropriate balance between the fiscal and other needs of current and future inpatient facilities and the fiscal and other needs of the community mental health system; and

(2) consider the state's financial ability to complete the master plan.

(c) While pursuing the secure residential facility as described in Sec. 31 of this act and the planning for acute mental health care in several hospitals geographically distributed throughout the state as provided for in Sec. 32 of this act, the department of mental health shall enter into discussions with general and specialty hospitals to explore options for hospital-level care for the remaining placements needed to close the Vermont state hospital.

(d) As part of its master plan to replace the Vermont state hospital, the department of mental health shall conduct a financial analysis and an analysis of the impact on care of the temporary return to inpatient care at staff-secure facilities.

Sec. 31. VERMONT STATE HOSPITAL; SECURE RESIDENTIAL RECOVERY PROGRAM

(a) It is the intent of the general assembly that the commissioner of mental health shall provide for a secure residential recovery program for individuals who are in the care and custody of the commissioner of mental health with a mental health disability for whom inpatient hospital treatment would be inappropriate and for whom other appropriate less-restrictive alternatives are not available. It is further the intent of the general assembly that the facility housing the program shall be designed to afford the greatest future flexibility for any potential residential health care program and shall be consistent with the goal of creating a facility with a residential character. In addition, both the site and design shall foster the ability to provide outdoor recreation, safety of residents and program participants, and appropriate programming to meet the needs of each of the several diagnostic groups to be served.

(b) Prior to further design development, the commissioner of mental health and the commissioner of buildings and general services shall fully investigate and analyze site options for locating the secure residential facility on the Waterbury campus and, in the discretion of the commissioner of buildings and general services, at other sites in Waterbury. The facility shall not be located next to the A-building. The facility design shall incorporate the necessary components to function as a freestanding program that does not rely on support space currently serving patient needs in the existing Vermont state hospital.

(c) It is the intent of the general assembly that the secure residential recovery program shall

have a governance structure which is as separate and independent from the governance structure of the Vermont state hospital as is legally feasible and would be operated under a license to be issued by the department of disabilities, aging, and independent living (DAIL).

(d) DAIL shall amend by rule pursuant to chapter 25 of Title 3 the licensing requirements for therapeutic community residences to provide for the operation of secure residential recovery programs.

(e) At the time of filing a certificate of need (CON) letter of intent with the department of banking, insurance, securities, and health care administration, the agency of human services shall notify the Centers for Medicare and Medicaid Services (CMS) in writing that it is planning and developing a 15-bed residential program, with a description of its size, program, intended patient population, physical location relative to the existing state hospital, anticipated licensing, and anticipated governance structure. In addition, the agency shall request CMS to review the final plan to determine if federal financial participation under Titles XVIII (Medicare) and XIX (Medicaid) of the Social Security Act would be available for the facility.

(f)(1) The agency of human services shall submit the response of CMS, if any, or the fact that CMS has not responded to the request, to the senate committee on institutions and the house committee on corrections and institutions, the senate and house committees on appropriations, the senate committee on health and welfare, the house committee on human services, the joint fiscal committee, and the mental health oversight committee.

(2) During the legislative session, the department of mental health shall provide quarterly updates to the senate committee on institutions, the house committee on corrections and institutions, the senate committee on health and welfare, and the house committee on human services on the progress toward completing the facility and developing the residential recovery program.

(3) Outside the legislative session, the department of mental health shall provide quarterly updates to the joint fiscal committee and the mental health oversight committee on the progress toward completing the facility and developing the residential recovery program.

(g) Within 30 days of beginning to accept patients in the secure residential recovery program, the department of health shall reduce the licensed bed capacity at the Vermont state hospital by 15.

Sec. 32. VERMONT STATE HOSPITAL; REPLACEMENT OF ACUTE CARE FUNCTIONS

(a) The general assembly recognizes that the Vermont state hospital provides both specialized and intensive acute inpatient mental health care. It is the intent of the general assembly that the plan for replacement of the functions of the Vermont state hospital shall provide geographic access such that patients requiring specialized acute mental health care or intensive acute mental health care or both can be appropriately treated as near to their respective homes as possible by providing replacement specialized and intensive inpatient levels of care in more than one hospital staffed with appropriately trained and experienced staff. Therefore, the commissioner of mental health shall work with general and specialty hospitals to explore options for replacement of these functions. Acute care facilities may be operated under one or more licenses issued to the department or to the hospitals, as appropriate.

(b) The commissioner of mental health shall design a special designation program for hospitals that operate an intensive acute or specialized acute inpatient program or both which will serve as a successor program to the Vermont state hospital and submit proposed enabling legislation for consideration in the 2010 legislative session. A special designation will be similar

to the designation of community agencies to provide mental health and developmental disability services provided for in 18 V.S.A. chapter 207. The designation process shall, at a minimum:

(1) Provide for an ongoing, consistent, and predictable relationship between the specially designated hospital and the state.

(2) Allow the commissioner to establish a reasonable schedule of cost per service unit and a uniform and reasonable schedule of fees for services provided by the specially designated hospitals. Any grant of funds to any specially designated hospital shall be based on a program plan and program budget and a balanced plan of anticipated fees and receipts developed by the hospital and submitted to and approved by the commissioner.

(3) Establish minimum program standards and other regulations as may be necessary to ensure a quality program and care that is consumer-directed, trauma-informed, and recovery-oriented.

(c)(1) The department of mental health, in collaboration with the joint fiscal office, the treasurer's office, and the Vermont educational and health buildings finance agency, shall obtain an accounting and financial analysis of any proposed bonding structure, including costs of capitalization, to determine whether a financing arrangement that places no debt capacity burden on either the state or on Rutland Regional Medical Center (RRMC) is reasonably feasible for a new psychiatric wing at RRMC to replace and expand the existing psychiatric unit.

(2) The joint fiscal office may contract with an independent consultant to provide additional analysis, if needed, for the analysis required under subdivision (1) of this subsection. Upon request of the joint fiscal office, the commissioner of the department of buildings and general services shall transfer up to $25,000 of unexpended funds appropriated to the department of buildings and general services in prior capital construction acts for Vermont state hospital planning to the joint fiscal office for this purpose.

(3) No later than October 1, 2009, the treasurer's office and the joint fiscal office shall provide a report to the mental health oversight committee and the joint fiscal committee describing the financing arrangement for a new psychiatric wing at RRMC and the results of the accounting and financial analysis, including their conclusions as to whether the financing arrangement is reasonably feasible.

(4) After receipt of the report and no later than November 1, 2009, the mental health oversight committee and the joint fiscal committee may object at a joint meeting of the two committees to the financing arrangement proposed by the department for a new psychiatric wing at RRMC. A quorum shall be a majority of the combined membership of the committees and, for voting purposes, a majority of those present shall be authorized to act. If the committees object, the department shall discontinue planning for a new psychiatric wing at RRMC.

(d) Simultaneously with any planning for expansion of psychiatric services at RRMC, including conducting the financial analysis under subdivision (c)(1) of this section and whether or not planning for the RRMC option is discontinued as provided for in subdivision (c)(4) of this section, the department shall continue to assess the feasibility, including the cost, of providing acute care services at general or appropriate specialized hospitals in other locations. As part of the planning process described in this subsection, the department shall obtain an independent labor analysis as necessary to demonstrate that a sufficient number of professional staff and other trained staff will be available to support adequately and appropriately any Vermont state hospital successor program at RRMC and at general or appropriate specialized hospitals in other locations being considered for provision of specialized acute or intensive acute care functions, or both, with respect to recruiting and maintaining staffing for any staff-intensive specialized psychiatric services required. The department of labor may provide the labor analysis provided

for in this subsection. The commissioner of the department of buildings and general services shall transfer funds necessary for this study from unexpended funds appropriated to the department of buildings and general services in prior capital construction acts for Vermont state hospital planning to the department of mental health for this purpose.

(e) By January 15, 2010, the department shall propose any statutory changes it believes may be necessary for implementation of its master plan.

Sec. 33. Sec. 124d(e) of No. 65 of the Acts of 2007 is amended to read:

(e) For purposes of this section, the council shall cease to exist ~~on~~ when the development of the alternatives to the Vermont state hospital is completed, but no later than July 1, ~~2009~~ 2012.