PROVIDER REIMBURSEMENT REVIEW BOARD
DECISION

ON THE RECORD
2003-D43

PROVIDER –
Helen Ellis Memorial Hospital
Tarpon Springs, Florida

Provider No. 10-0055

vs.

INTERMEDIARY – Blue Cross Blue Shield Association/First Coast Service Options, Incorporated

DATE OF HEARING -
May 21, 2003

Cost Reporting Period Ended
September 30, 1995

CASE NO. 97-3008

INDEX

	Page No.
Issue	**2**
Statement of the Case and Procedural History	**2**
Provider's Contentions	**4**
Intermediary's Contentions	**6**
Findings of Fact, Conclusions of Law and Discussion	**7**
Decision and Order	**8**

ISSUE:

Was the Intermediary's determination of obligated capital proper?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Effective October 1, 1991, Medicare changed the method by which it reimburses hospitals for certain capital expenditures. The Medicare program replaced its prior reasonable cost-based payment methodology for inpatient capital-related costs with a prospective payment methodology, phased in over a ten year period. Under the phase-in, the classification of certain capital expenditures as "old" or "new" can have significant Medicare reimbursement consequences. The regulation recognized there may be a time lag between the time a hospital obligates capital and when that asset is put into operation and thus, provides treatment for obligated capital as old capital. 42 C.F.R. §412.304(c).

The regulations recognize several methods of qualifying for obligated capital status. When an asset is put in use after December 31, 1990, it must be in use before October 1, 1994, and the hospital must so notify the intermediary. 42 C.F.R. § 412.302(c)(i). Where there is no binding agreement to obligate the capital before December 31, 1990, the regulation still allows hospitals to meet the construction in process (CIP) criteria to qualify as obligated capital provided the following six criteria are met.

(A) The hospital received any required certificate of need approval on or before December 31, 1990.
(B) The hospital's Board of Directors formally authorized the project wit ha detailed description of its scope and costs on or before December 31, 1990.
(C) The estimated cost of the project as of December 31, 1990 exceeds 5 percent of the hospital's total patient revenues during its base year.
(D) The capitalized cost that had been incurred for the project as of December 31, 1990 exceed the lesser of $750,000 or 10 percent of the estimated project cost.
(E) The hospital began actual construction or renovation ("groundbreaking") on or before March 31, 1991.
(F) The project is completed before October 1, 1994.

42 C.F.R. §412.302(c)(3).

On January 28, 1988, the Board of Directors of Helen Ellis Memorial Hospital (Provider) adopted a strategic plan to add three additional floors to the patient Tower. The plans were to add floors as follows:

Fifth Level – 40-Bed Med/Surg Unit
Sixth Level – 40-Bed Med/Surg Unit
Seventh Level – 16-Bed OB/GYN Unit and Surgical Suite

The following is a chronological sequence of significant dates leading to the actual construction of the additional floors of the patient tower:

01/28/88	Hospital Board of Directors adopted a plan to add three additional floors to tower.
08/15/89	Hospital Board of Directors passed a resolution authorizing expenditures for construction of the three floors.
08/24/89	Hospital filed a letter of intent, which is necessary to file for a Certificate of Need (CON), with the state of Florida for the three additional floors.
02/22/90	The hospital filed CON application number 6153. Estimated project cost was $15,068,000.
05/22/90	The state of Florida denied CON number 6153.
09/11/90	The hospital signed an architectural/construction management agreement with Harvard, Jolly, Marcet & Associates (Harvard, Jolley). The agreement was to plan, design and manage the construction of the addition of forty Med/Surg beds to the fifth and sixth floors and sixteen OB/GYN beds to the seventh floor.
10/01/90	Hospital applied for CON exemption for the addition of the one story for the OB/GYN unit.
10/16/90	The state approved the exemption.
03/20/91	Hospital applied for CON exemption for the addition of the one-story outpatient surgery unit (OSU). (The OSU was not in the original plans.)
03/28/91	The State approved the exemption for the OSU.
06/05/91	Hospital filed CON application number 6736 with the State to construct a two-story addition atop the north tower to accommodate two thirty-one bed Med/Surg units. Total project cost estimated at $6,821,760.
8/27/91	State approved CON number 6736 for two thirty-one bed Med/Surg Units and a fifteen-bed OB/GYN unit.
12/20/91	Provider notified Intermediary of existence of obligated capital.
01/07/92	City of Tarpon Springs Health Facility Authority issued bonds for construction.

05/04/92 Hospital signed construction contract with Biltmore Construction Co. Inc./Central-Allied Enterprises, Inc. for $9,496,782.

02/01/94 Construction completed at a cost of $15,826,841.

First Coast Service Options, Inc. (Intermediary) reviewed the notice of obligated capital information and determined that the additions did not qualify as obligated capital. It reclassified $246,639 of movable equipment costs, $744,631 of building and fixture costs, and $1,110,450 of other building and fixture costs from "old" capital-related costs to "new" capital-related costs.

The Provider appealed the Intermediary's determination to the Provider Reimbursement Review Board (Board). The Provider's filing met the jurisdictional requirements of 42 C.F.R. §§ 405.1835-.1841. The Provider was represented by Ms. Yvette H. Cummings, Principal, KPMG. The Intermediary was represented by Bernard M. Talbert, Esquire, of Blue Cross Blue Shield Association.

PROVIDER'S CONTENTIONS:

The Provider contends that it entered into a legal binding contract with Harvard, Jolly on September 11, 1990. Article 11 of the contract addressed the basis of compensation for the architects as follows:

(1) A fixed fee of $450,000
or,
(2) A percentage of the Construction Cost based upon a fee of 5.5% of the project costs after the Contract for Construction has been executed. The actual fee shall be based on the lesser of these two methods.

The Provider contends that the architectural contract entered into was not for preliminary drawings or schematic designs, but rather, the complete architectural involvement throughout every phase of the entire Patient Tower Project. Section 11.2.2 of the contract discusses progress payments. The progress payments also indicate a much greater involvement in the project than just schematic or preliminary designs. Sixty-five percent of the architect's fees are to be paid after the design phase.

The Provider observes that the $450,000 payment for the architectural fees involved every phase of the entire Patient Tower project. Although the contract allows the Provider to back out of the contract at any phase of the construction contract, the Provider was contractually obligated to compensate the architect for the percentage of completion of its work for the phases in process or completed as of the termination date. By December 30, 1990, Harvard, Jolly had completed 100% of the schematic design phase and had started the preliminary construction phase.[1] Project costs incurred as of December 31, 1990, for the schematic

[1] See Provider Position Paper at pg. 13.

design phase were $67,500 (plus related expenses of $1,275) and $90,000 (20% x $450,000) for the preliminary construction phase started prior to December 31, 1990.[2]

The Provider observes that the Intermediary's position was that the Medicare Program's intent for allowing obligated capital as "old" capital was to reimburse providers that had committed to capital projects before December 31, 1990, when terminating the contract and project was not feasible without a financial loss. The Harvard, Jolly contract is clearly: 1) a contractual obligation in the form of a binding written agreement executed on or before December 31, 1990 that obligates the Provider on or before December 31, 1990, and 2) terminating the contract and project was not feasible without a financial loss. The Provider had committed to this capital project before December 31, 1990, and should the Provider have terminated the contract and/or project, the financial loss related to the Harvard, Jolly Contract would have been $157,500. Therefore, the Harvard, Jolly contract clearly meets the Medicare program's requirements and intent for allowing obligated capital as "old" capital.

The Provider notes that it was required under State law to obtain the CONs prior to starting the construction and obtaining financing of the project. The initial CON process delayed the Patient Tower project financing and construction process and the related expenses.

The Provider notes that 42 C.F.R. § 412.302(c)(2) relates to requirements of a "Lengthy Certificate of Need Process." Under 42 C.F.R. § 412.302(c)(2)(B), the hospital is required to file the initial Patient Tower project CON on or before December 31, 1989. The Provider notes that it had to re-file the initial Patient Tower project CON separately for each Patient Tower project component. The Provider received the denial for CON number 6153 on May 22, 1990. Approval of the CON exemption for the addition of one new story to the existing building to accommodate the conversion of sixteen medical/surgical beds to OB/GYN beds was obtained from the state of Florida on October 16, 1990. Therefore, the Provider asserts that it meets the requirements of 42 C.F.R. § 412.302(c)(2)(B).

The Provider states that incurred and contractually obligated expenses ($633,683) as of December 31, 1990, exceeded 10% of the OB/GYN CON estimated costs of $3,318,000, which was the first Patient Tower project CON approved by the State. The total expenses incurred and contractually obligated reflect management's effort to contain costs as required by the State and the Provider's Board of Directors. In addition, at the time these expenses were incurred and contractually obligated, neither the proposed nor final PPS capital regulations had been issued. Although the PPS capital regulations were applied retroactively once issued, there were no specific regulatory requirements or guidelines available to the Provider regarding obligated capital and the required expense thresholds. As of December 31, 1990, the expenses incurred and contractually obligated exceeded the 10% threshold of the first approved Patient Tower project CON; therefore, the Provider met the requirement of 42 C.F.R. § 412.302 (c)(3)(ii)(C). Further, the Provider contends that construction of the four-story Patient Tower project was completed, and the addition was placed in use prior to September 30, 1996. Therefore, the Provider contends it met the requirement of 42 C.F.R. § 412.302(c)(2)(i)(D).

The Provider observes that § 412.302(c)(1)(vi) addresses cost limitations on obligated capital. The amount of the Patient Tower project financed by debt in the initial CON was estimated to be

[2] See Provider Position Paper at pg. 14.

$14,918,000. On July 1, 1990, financing could not be obtained for the Patient Tower project until CON approvals were obtained from the State. The final CON approval for the Patient Tower project was obtained on August 27, 1991. The Provider notified the Intermediary on December 20, 1991, of the existence of obligated capital. On January 7, 1997, the Provider notified the Intermediary of the anticipated bond issuance of $14,695,000 and the CON delays. As planned, financing was subsequently obtained on January 7, 1992. The Patient Tower project was completed on February 1, 1994 at a total cost of $15,826,841. The Provider asserts that these activities support the Provider's Board of Directors and management's commitment to containing the costs of the Patient Tower project.

INTERMEDIARY'S CONTENTIONS:

The Intermediary contends that a project can qualify for obligated capital based on three specific rules. First, 42 C.F.R. § 412.302(c)(1) is the General Rule for obligated capital costs for binding agreements that obligated hospitals on or before December 31, 1990. Second, if a provider's capital project does not meet the General Rule to qualify as obligated capital, the project may qualify as obligated capital if the project requires a Lengthy Certificate of Need Process. See 42 C.F.R. § 412.30(c)(2). Third, the Construction in Process exception is addressed in 42 C.F.R. § 412.302(c)(3).

The Intermediary contends that, of the four provisions stated in the General Rule at 42 C.F.R. § 412.302(c)(1)(i), the Provider did not meet one of the provisions to qualify the project as obligated capital; i.e., the binding agreement that obligated the facility to complete the project was not executed before December 31, 1990. In reviewing the Architectural/Construction Agreement executed on September 11, 1990 with Harvard, Jolly,[3] the following statements were noted in Article 12, number 10:

> (B) Owner may terminate this Agreement at any time without cause for Owner's own convenience upon three (3) days written notice to Architect; and
>
> (C) . . . Architect agrees that the compensation to be paid as set forth hereinabove in this Article 12.10 (C) shall be accepted in complete and total satisfaction of all obligations of Owner to Architect hereunder, in the event of Owner's termination without cause for Owner's convenience and Owner shall be relieved of all further obligations to pay Architect for services rendered under this Agreement.

In reviewing the Federal Register Vol. 56 No. 169[4] and the Architectural Agreement, it is very clear that this project does not qualify as obligated capital. The hospital could simply back out of the contract at any phase of the construction process without penalty until 1992 when the bond agreement and construction agreement were signed. The compensation arrangement was to pay the lower of $450,000 or 5.5% of project cost. If no project costs were incurred, nothing is owed to the architectural firm. The contract was under the control of the owner.

The Intermediary argues that the Provider did not qualify for the "Lengthy Certificate of Need Process" exception because two of the four criteria of 42 C.F.R. § 412.302(c)(2)(i)(B) were not met. First, the

[3] See Intermediary Exhibit I-2
[4] See Intermediary Exhibit I-1.

original CON was denied on May 22, 1990. On June 5, 1991, the Provider reapplied for a different CON. Approval was received on August 27, 1991. The latter CON was for two thirty-one bed units rather than the original two forty bed units. Second, 42 C.F.R. § 412.302(c)(2)(i)(C) states:

> [t]he hospital expended the lesser of $750,000 or 10 percent of the estimated cost of the project on or before December 31, 1990; and . . .

The Intermediary observes that the Provider had spent no material funds on the project before December 31, 1990. The debt was not financed until January 7, 1992, and the construction contract was not signed until May 4, 1992.

The Intermediary contends that since the Provider did not qualify for obligated capital based on the General Rule or the Lengthy Certificate of Need Process, the Provider could have qualified under Construction in Process exception rules under 42 C.F.R. § 412.302 (c)(3). However, this project does not qualify as obligated capital, as the Provider did not have CON approval by December 31, 1990; expenditures did not exceed the lesser of $750,000 or 10% of the estimated project cost as of December 31, 1990; and the hospital did not begin actual construction or renovation ("groundbreaking") on or before March 31, 1991.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

The Board, after considering the Medicare law, program instructions, facts, and parties' contentions, finds and concludes that the Intermediary properly treated the Provider's capital project as "new" capital under Medicare regulation at 42 C.F.R. § 412.302(a). The Provider's treatment of its architectural contract as obligated capital under 42 C.F.R. § 412.302(c), with resulting treatment of the facility construction as "old" capital costs, is incorrect. For fixed assets to be considered obligated capital, the above regulation requires that four conditions be met. See 42 C.F.R. § 412.302(c)(i)(A)-(D).

42 C.F.R. § 412.302 (c)(i)(A) states:

> The obligation must arise from a binding written agreement that was executed on or before December 31, 1990 and that obligates the hospital on or before December 31, 1990.

Further 42 C.F.R. § 412.302(c)(1)(iii) states:

> Agreements Not Recognized. Agreements for planning, design or feasibility that do not commit the hospital to undertake a project are not recognized as obligating capital expenditures for purposes of this subsection.

Clearly, the Provider does not meet these requirements. Its September 11, 1990 contract with Harvard, Jolley was for architectural planning only and not construction. The latter

regulation specifically disallows this type of contract from being considered a commitment to obligate capital.

The Board notes that the Provider could have complied with two types of exceptions in order to treat the costs of its project as obligated capital under 42 C.F.R. § 412.302. Those regulations are 42 C.F.R. § 412.302(c)(2) - Lengthy Certificate of Need Process and 42 C.F.R. § 412.302(c)(3) - Construction in Process. Regarding the Lengthy CON Process, the regulation requires that four conditions must be met. Subsection B requires a provider to file its initial application for a CON on or before December 31, 1989. Based on the record, the Provider filed its original CON on February 22, 1990. Clearly, this regulation section has not been met. Regarding the Construction In Process section, it has six requirements that must be met in order for obligated capital to be recognized as "old" capital. Comparing the regulation requirements with the Provider's factual situation, the Board finds that the Provider does not meet the requirement of 42 C.F.R. § 412.302(c)(3)(A) in that the hospital did not receive the required Certificate of Need approval on or before December 31, 1990. The Board's review of the record indicates that the CON approval for its Med/Surg units and its OB/GYN unit were received on August 27,1991. Thus, the Provider clearly does not meet this exception.

The Board does note that all dates used in its application of the various regulations are undisputed. Thus, based on the above analysis, the Board concludes that the Intermediary properly denied the Provider's attempt to treat its post - December 31, 1990 construction costs as obligated capital that would have resulted in "old" capital costs.

DECISION AND ORDER:

The Provider's architectural contract does not qualify as a binding written agreement capital under 42 C.F.R. § 412.302 (c). The Intermediary's adjustments are affirmed.

BOARD MEMBERS PARTICIPATING:

Suzanne Cochran, Esquire
Henry C. Wessman, Esquire
Gary B. Blodgett, D.D.S.
Martin W. Hoover, Jr., Esquire
Elaine Crews Powell, CPA

DATE: August 7, 2003

FOR THE BOARD:

Suzanne Cochran
Chairman