THE CASE FOR PRIVATIZING THE KANE REGIONAL CENTERS

by
Dr. Jake Haulk, Research Director
Allegheny Institute For Public Policy

Allegheny Institute Report #97-02
March 1997

Table of Contents

Key Findings of the Study

1. Over the past decade, more than a dozen counties in Pennsylvania have privatized their nursing homes. Providing medical care is not a "core function" of government. Nursing home services ought to be provided by the private sector, either as a proprietary or non-profit function. Most recent privatizations of county homes in Pennsylvania have been through the creation of a non-profit organization to take over the homes.

2. The Kane Regional Centers are an expensive and inefficient county nursing home system, with per patient day costs well in excess of other urban nursing homes in Pennsylvania. Likewise, the Kane system is far more costly than nursing homes that have been privatized. Thus the Kanes represent an unnecessarily large burden to federal, state and local taxpayers.

3. The Kanes are currently being reimbursed from federal and state sources at a rate in excess of $150 per patient day. This level of reimbursement is $20 to $30 higher than the Kanes' peer group of large, urban facilities and $40 to $50 more than many privatized facilities in Pennsylvania. In view of the budget tightening environment in Washington, especially the need to curb runaway health care expenditures, it is unreasonable to expect that the Kanes can continue to receive reimbursement payments that are so far out of line with what other providers require to deliver nursing care to the indigent.

4. The Kanes' cost per patient is very high compared to Pennsylvania benchmark facilities across most large expense categories, especially housekeeping, food, administration, and debt service. The Kanes are more expensive than private, for-profit operations despite the advantage of not having to pay real estate and other taxes.

5. In the five-year period from 1991 to 1995, Allegheny County taxpayers provided $68.3 million in support for the Kanes over and above the amounts received from state and federal programs. The County is also responsible for some $90 million in general obligation bonds related to the Kane construction and various refinancings.

6. Based on conservative estimates of 1997 occupancy, operating costs per patient day, and using a representative operating cost per patient day for Pennsylvania nursing home facilities, the potential yearly operating cost savings from a privatized Kane system is in the range of $12 million per year.

7. The enormous debt service expense associated with the Kanes creates a major problem for any privatization effort since it is not a reimbursable expense. Therefore, any privatization must be structured so as to reduce or eliminate the County's debt service subsidy.

8. Current rules governing reimbursement will permit a privatized Kane system to receive payment for imputed lease value. That payment creates the possibility of a privatization entity earning an operating surplus, some of which could be contractually turned over to the County to defray some or all of the $11.5 million in annual debt service which is now being covered almost entirely by a transfer from the general fund.

9. Of the five privatization approaches available, the most promising approach would be a controlled sale or lease to a private non-profit entity created for the purpose of providing care to the indigent.

A Summary Background of the Kane Regional Centers

Allegheny County's first involvement in care for the indigent began in 1852 with the construction of an almshouse "...as a shelter for widows, orphans, displaced families and the elderly." It is interesting to note that while this was created as a government facility supported by the taxpayers, the 19th century definition of an almshouse was: "A privately endowed home for the poor."

In 1900, the Allegheny County Almshouse was replaced by the Woodville and Mayview facilities that continued to function as both shelters and medical facilities. These two buildings served the County until 1958 when they were sold and replaced by the new John J. Kane Hospital in Scott Township. An enormous amount of taxpayer money was lavished on the construction of this "hospital". The word is in quotes because it never was a licensed hospital; it was simply the most expensive nursing home imaginable. In a sad parallel to the many government housing projects that blight the land, the John J. Kane "Hospital" went from showplace to slum in just two decades, becoming famous nationwide as the subject of a Pulitzer Prize-winning newspaper series entitled "A Place to Die".

ALLEGHENY COUNTY'S FIRST INVOLVEMENT IN CARE FOR THE INDIGENT BEGAN IN 1852 WITH THE CONSTRUCTION OF AN ALMSHOUSE... WHILE THIS WAS CREATED AS A GOVERNMENT FACILITY SUPPORTED BY THE TAXPAYERS, THE 19TH CENTURY DEFINITION OF AN ALMSHOUSE WAS: "A PRIVATELY ENDOWED HOME FOR THE POOR."

What was the cause of this fiscal disaster joined to a human tragedy? Many people have blamed the patronage system, corruption and even simple stupidity. All those elements probably played a part.

In the 1980s, the County embarked on an ambitious program of nursing home construction, replacing the old 1500-bed Kane hospital in Scott Township with four 360-bed regional centers; Scott, Ross, McKeesport, and Glen-Hazel. These facilities have been in operation since 1984, when the old hospital closed.

The Kanes are owned and operated by the Allegheny County Institution District, which has the responsibility of providing long-term care and other public health services. The District is a recognized corporate entity, and a component of the County that falls within the legislative and executive purview of the County Commissioners.

A Financial Overview of the Kane Regional Centers

Background on Debt

Construction of the regional Kanes required a large general obligation debt issue. In 1985, the Allegheny County Institution District issued $103 million in bonds to refund the earlier Kane related debt along with other obligations. An additional $94.5 million in bonds were authorized in 1990 to fund capital projects, to reimburse the Allegheny County Institution District for certain capital outlays and to retire the 1985 bond issue. That transaction was completed in 1995, when the remaining $86 million of original outstanding bonded indebtedness was retired. The County still has approximately $90 million in Kane related bonds (maturing in 2012) to service. The annual debt service over the next several years will be in excess of $11 million.

Recent History of Operations

A five year history of Kane system revenues and expenditures covering the 1991-1995 period are shown in the table below.

Kane Regional Health Centers Audited Financial Statements *	1991	1992	1993	1994	1995	Total
Operating revenues	$60,356,692	$56,353,544	$63,521,972	$69,384,100	$74,822,594	
Expenditures	$61,311,536	$64,575,822	$66,117,602	$68,182,040	$70,657,874	
Operating Gain (Loss)	($954,844)	($8,222,278)	($2,595,630)	$1,202,060	$4,164,720	($6,405,972)
Financial transactions **	($31,000)	($31,000)	($31,000)	($31,000)	($2,087,535)	($2,211,535)
Normal Debt Service	$11,256,811	$10,716,578	$10,695,610	$10,677,645	$11,592,776	$54,939,420
Debt Service plus losses	$12,242,654	$18,969,856	$13,322,240	$9,506,585	$9,515,591	$63,556,926
County Funds Transfer	$7,500,000	$23,000,000	$7,500,000	$15,000,000	$15,280,000	$68,280,000

* Arthur Andersen & CO SC

** Reflects Series 18 Refund Anticipation Bonds

These data show a generally rising trend in revenues and expenditures with slightly faster growth in revenues through 1995 because of rising occupancy and higher per patient reimbursement. That trend may well have ended in 1996 as occupancy fell and revenues failed to increase.

According to audited financial records, the Kane system required some $64 million in County support over the 5 year period. Early figures for 1996 indicate that another $9 million or was needed to make up for losses at the Kanes. In addition to the audited figures shown above, the Allegheny County Institution District has spent another $3.2 million on capital projects at the Kane facilities and there have been $14.8 million in general fund expenditures across various departments representing services provided to the Kanes that are not captured in the Kane budget. The latter expense reflects the so-called Griffiths report that attempted to assign all costs to user departments. Adding all the expenditures would put the total Kane operating losses at roughly $26.5 million.

ADDING ALL THE EXPENDITURES WOULD PUT THE TOTAL KANE OPERATING LOSSES AT ROUGHLY $26.5 MILLION...THE COUNTY HAD TO MAKE UP OR SUBSIDIZE THE KANES TO THE TUNE OF ABOUT $20 PER PATIENT DAY PROVIDED.

Kane revenues consist almost entirely of reimbursements from the Federal and state governments. Reimbursement is based on formulas which take into account the number of patient days provided by the facilities, the amount of acute care service, therapeutic services, etc.. The average reimbursement for all Kane Centers in 1995 was around $148 per patient day and about $152 in 1996– based on unaudited figures.

Kane operating expenditures per patient day had climbed to the neighborhood of $148 in 1996. Meanwhile, debt service expense in 1996 was nearly $24 per patient day, bringing the total cost to $172 per patient day of service provided. That means the County had to make up or subsidize the Kanes to the tune of about $20 per patient day provided. That figure will almost surely rise over time if the occupancy level is not increased or stringent cost cutting is not put into place.

Expenditures by Category

For the Kanes as a whole, actual expenditures totaled $85 million in 1995. Of that total, $53 million (62 percent) is spent on personnel and fringe benefits. $14.7 million (17 percent) went toward debt service and the remaining $17.6 million (20.7 percent) is accounted for by spending for supplies, materials, services, repairs and equipment. These proportions have held fairly steady over time.

Looked at by functional area, the largest budget items for the Kanes and indeed, most nursing homes are the following: dietary and food, housekeeping, plant operations and maintenance, nursing care, and general administration. These six items account for about 75 percent of operating outlays. The remainder is spread over medical services and supplies, pharmacy, laundry, patient activities, therapy, etc.

THE COSTS OF DELIVERY AT GLEN-HAZEL ARE SO MUCH WORSE THAN THE OTHER CENTERS THAT REMEDIAL ACTION OUGHT TO BE TAKEN IMMEDIATELY.

Differences Among the Kane Regional Centers

Despite having the same number of beds, being of virtual identical construction and the same age, there are important differences among the Kane Regional Centers. The primary difference is, and has been, in occupancy levels which cause per patient day costs to vary widely. For example, over the last 6 years the Glen-Hazel center has averaged 83.8 percent occupancy, while occupancy at the Scott and McKeesport centers has averaged 95 percent. Ross averaged 92.6 percent over the same period. Since staffing levels and overhead costs are very nearly the same at the various facilities, differences in occupancy will cause significant variation in per patient expenditures.

The full costs per patient day-- excluding depreciation-- in 1994 for the four centers are shown in the table:

	1993 Per Patient Day Costs*
Glen-Hazel	$166.67
Ross	$146.61
Scott	$150.54
McKeesport	$160.90

**Department of Public Welfare, Commonwealth of Pennsylvania*
Bureau of long-term Care Programs, Profile of Allowable Costs Reports

Actual budgeted operational expenditures for the individual Kanes vary much less than the per patient day cost, ranging from $16 million at Ross to $16.9 million at the Glen-Hazel Center. Unfortunately, the occupancy level at Glen-Hazel has declined sharply since 1994, which means that the variance in patient day costs among Kane facilities is more pronounced than it was in 1993. Moreover, the drop in overall occupancy since 1994 is pushing the overall Kane system delivery costs higher. The costs of delivery at Glen-Hazel are so much worse than the other Centers that remedial action ought to be taken immediately.

Comparison of the Kane System Costs to Other Nursing Homes

Kane system costs have been compared to large urban nursing homes in Pennsylvania, to a benchmark of 159 facilities in Western Pennsylvania, and to three Pennsylvania nursing homes that have privatized their operations in recent years.

...THE NON-PROFIT BENCHMARK FACILITIES ARE OPERATING AT A MUCH LOWER COST THAN ARE THE KANES...OVERALL, THE KANES-- EXCLUDING INTEREST EXPENSES-- COST SOME $27 MORE PER PATIENT DAY THAN THE BENCHMARK NURSING HOMES.

PANPHA vs. the Kanes

The table below shows the per patient day costs for PANPHA (Pennsylvania Association of Non-Profit Homes For The Aging) benchmark nursing facilities and for the four Kane Regional Centers. The PANPHA benchmark includes 159 homes in Erie, Warren, McKean, Potter, Crawford, Venango, Forest, Elk, Cameron, Mercer, Clarion, Jefferson, Lawrence, Butler, Armstrong, Beaver, Allegheny, Westmoreland, Washington, and Fayette Counties. Of the 159 facilities in the benchmark sample, 83 are proprietary and 62 are non-profits. Costs for several major expense items are shown separately along with the total per day cost. PANPHA facilities are privately operated and pay real estate taxes; proprietary homes also pay other state or federal taxes. Therefore, a line is included to indicate the costs with taxes removed to make the comparisons fair. As a general comment, the proprietary homes have a much lower cost level than the non-profits in the region.

	Cost per Patient Day				
	PANPHA Benchmark**				
	1994 W. PA	Kane Regional Centers: 1993			
Selected Categories	159 facilities	Glen Hazel	McKeesport	Ross Twp.	Scott Twp.
Dietary and Food	11.53	19.56	19.17	16.65	17.38
Laundry	2.69	4.22	3.86	4.24	4.91
Housekeeping	4.35	12.10	11.51	11.45	11.84
Plant Op. & Mtnce.	6.65	12.96	12.41	11.73	12.13
Materials Management	1.71	2.18	2.19	2.12	1.53
Nursing	40.62	51.34	53.14	48.14	54.22
General Administration	11.9	16.14	13.71	12.20	11.81
Depreciation	4.51	8.26	.6.00	5.69	6.17
Interest on Capital Indebtedness	6.97	18.89	14.88	14.27	14.30
Totals	131.35	174.93	166.9	152.3	156.71
Excluding taxes	127.36	174.93	166.9	152.3	156.71

*** PANPHA Cost Benchmark Report: MA-11 Schedule C Costs, Western Pennsylvania Region*

From these data it is obvious that the non-profit benchmark facilities are operating at a much lower cost than are the Kanes. Even the lowest cost Kane comes has a total per patient day outlay of $25 more than the non-tax expenditures of the private facilities. On average, the Kanes have a per patient day expenditure that is $35 higher than the PANPHA benchmark facilities.

Since the Kanes have an exceptionally high debt service cost, it is of some interest to compare the benchmark facilities' costs with the Kanes excluding the debt service payments. Even excluding the interest on debt costs, Ross, the best performing Kane--

operating at 97.5 percent occupancy-- still costs almost $20 per day more than the benchmark average. Overall, the Kanes-- excluding interest expenses-- cost some $27 more per patient day than the benchmark nursing homes.

The reason? In almost every major expense category, the Kanes are higher than the nursing homes benchmark. Housekeeping and plant operations are particularly egregious categories, not because of the absolute amount spent but because of the ratio to the private home expenditures. Housekeeping per patient day at the Kanes costs almost 3 times the level at the benchmark homes. At the same time, Kane plant operations and maintenance costs are nearly double those for the PANPHA benchmark homes. Interest costs are also much higher, suggesting that the underlying capital expenditures for the Kanes were far higher than they needed to be.

HOUSEKEEPING PER PATIENT DAY AT THE KANES COSTS ALMOST 3 TIMES THE LEVEL AT THE BENCHMARK HOMES. AT THE SAME TIME, KANE PLANT OPERATIONS AND MAINTENANCE COSTS ARE NEARLY DOUBLE THOSE FOR THE PANPHA BENCHMARK HOMES.

To be fair, it should be noted that the Kanes do outperform the benchmark in a few expense categories and are comparable in others. For example, expenditures for pharmacy, therapy and clinics are similar. Unfortunately, these items are not substantial portions of total outlays and therefore cannot offset the large gap favoring the benchmark homes in the major expense items.

All told, this comparison of the Kanes with the PANPHA benchmark shows an enormous cost advantage for the private sector operations. At current patient levels in the Kanes, the $35 per day cost differential represents a $17 million in potential expense reductions. Using the conservative $25 per day differential with the best performing Kane places the potential savings at $12 million per year.

Large, Urban Peer Group Nursing Facilities vs. the Kanes

Some would argue that it is unfair to contrast the Kanes with privatized nursing home operations where size of facility, urban environment and percentage of acute care patients are not taken into account. In the table below, the Kanes' per patient day costs are compared to those of large urban nursing homes--the Kanes' 20 facility peer group-- with an adjustment for the number of acute care patients; the so-called "acuity factor".

Kane Costs Per Patient Day Compared to Median of Pennsylvania's Large Urban Nursing Facilities

	Peer Group CMI Neutralized Cost Per Patient Day	Glen Hazel CMI Neutralized Cost Per Patient Day	Glen Hazel Vs. Peer Group Median	McKeesport CMI Neutralized Cost Per Patient Day	McKeesport Vs. Peer Group Median	Ross CMI Neutralized Cost Per Patient Day	Ross Vs. Peer Group Median	Scott CMI Neutralized Cost Per Patient Day	Scott Vs. Peer Group Median	All Kanes Average CMI Neutralized Cost Per Patient Day	All Kanes Pct of Peer Group Median
Resident Care	71.76	72.37	101%	67.54	94%	63.78	89%	63.65	89%	66.84	93%
Other Resident Related	33.74	58.66	174%	50.76	150%	51.6	153%	47.66	141%	52.17	155%
Administrative	11.95	17.88	150%	15.47	129%	17.48	146%	15.92	133%	16.69	140%
Total	117.45	148.91	127%	133.77	114%	132.86	113%	127.23	108%	135.69	116%

Note: Peer group include twenty facilities (including the Kanes) that are urban and larger than 270 beds.

Cost per day adjusted for acuity CMI index to enable comparability.
(Depending on the facility, Kane's actual cost per day for resident care is 12 % to 14 % higher than presented above)

Even though the cost figures in the preceding table do not attempt to take into account depreciation or debt service, it is apparent that the Kane facilities are significantly more expensive on a per patient day basis than their "large, urban" peer group. Kane

nursing care expense adjusted for "acuity" (Cost Mix Index) is well in line with its peer group. At the same time, however, other operating expenses are dreadfully out of line, running 40 to 50 percent higher at the Kanes. This finding is consistent with the PANPHA benchmark results above which show a great disparity in many of the major expenditure areas other than nursing care compared to privately operated facilities.

Thus, compared to their peers, i.e., large, urban nursing facilities, the Kanes do not measure up well. They are very expensive to operate.

THESE FIGURES SHOW THE KANES TO BE FAR MORE EXPENSIVE TO OPERATE ON A PER PATIENT DAY BASIS... THE KANES COST FROM $45 TO $66 PER PATIENT DAY MORE THAN THE THREE PRIVATIZED FACILITIES.

Select Regional Privatized Homes vs. the Kanes

The final performance comparison is between the Kanes and three privatized facilities in western Pennsylvania. Detailed cost data was obtained from administrative officials at Jefferson Manor in Jefferson County, DuBois Nursing Home, and Valley View Center. Using information on occupancy rates, per patient day costs for the several major functional areas and expenditure categories were calculated. The table below shows the relevant cost comparisons.

COMPARISON: KANE AND PRIVATIZED NURSING HOMES

Expenditure Item	1365 Patients **Kane Regional Centers– 1994** Expenditure	Per Patient Day	207 Patients **Valley View Center** Per Patient Day	199 Patients **Jefferson Manor** Per Patient Day	175 patients **DuBois Nursing Home** Per Patient Day
Nursing Personnel	$ 28,827,011	$57.86	$46.30	$39.75	$34.54
Inservice	$ 1,136,966	$2.28	$0.17	$0.22	$0.32
Busi/Pers./Comm.	$ 967,089	$1.94	$22.92	$20.80	$21.22
Pharmacy/Radiology	$ 2,643,162	$5.31	$3.00	$1.89	$1.68
Recr./Social/Voltrs.	$ 2,050,172	$4.12	$2.33	$2.66	$2.58
Administration	$ 5,128,726	$10.29	$3.27	$2.50	$3.39
Therapy: Oc/Spe/etc.	$ 2,805,619	$5.63	$5.70	$11.78	$10.85
Food Service	$ 8,933,260	$17.93	$13.48	$9.87	$9.10
Housekeeping	$ 8,038,777	$16.13	$7.58	$6.27	$5.70
Mntce./Security/etc.	$ 7,674,533	$15.40	$2.19	$2.69	$1.91
Debt Service	$ 10,677,645	$21.43	$6.93	$4.27	$0.57
Total Revenues	$ 69,384,100	$139.26	$124.40	$112.36	$99.68
Total Expenditures	$ 78,882,960	$158.33	$113.87	$102.71	$91.86
Net Income/(Loss)	($9,498,860)	($19.07)	$10.53	$9.65	$7.82

These figures show the Kanes to be far more expensive to operate on a per patient day basis than the other facilities, which is not surprising in view of the results obtained in the first two comparisons. For example, with all expenses except depreciation included, the Kanes cost from $45 to $66 per patient day more than the three privatized facilities. Occupancy levels at DuBois and Valley View were 97 percent while Jefferson Manor occupancy stood at 88 percent.

If debt service is excluded, the comparisons with the three privately run facilities improve somewhat. However, the per day cost differences are still very large, ranging from $30 to $45 per patient day. Again, the extraordinarily high debt service cost at

the Kanes compared to other facilities points to very poor oversight of the cost of building and subsequent capital expenditures at the Kane Centers.

Again, in the areas of housekeeping, food service and plant operations the Kanes are simply atrocious in comparison to the three privately operated facilities. Some of the comparisons are not quite apples to apples because of differences in reporting categories. But where there are precise matches like the ones mentioned earlier, the Kanes are outperformed by substantial margins.

THE KANE COST STRUCTURE IS SO OUT OF LINE WITH OTHER NURSING HOME OPERATIONS IN PENNSYLVANIA THAT SERIOUS AND IMMEDIATE CORRECTIONS NEED TO BE INITIATED. ONE WAY TO ADDRESS THE PROBLEM WOULD BE TO PRIVATIZE THE KANES...

Summary of Kane Cost Comparisons

The information presented in the three cost comparisons leaves little doubt that the Kanes are a truly horrendous operation in terms of cost per patient day. This is true whether or not debt service expenditures are included but is worse with the interest charges included because they are so high relative to other nursing homes both private and non-private.

The Kane cost structure is so out of line with other nursing home operations in Pennsylvania that serious and immediate corrections need to be initiated. One way to address the problem would be to privatize the Kanes-- the subject of the next section.

The Case for Privatization

Provision of medical and nursing care is not a "core" or "primary" function of government. While the government may concern itself with making sure the indigent have access to care and provide funding for that purpose, there is no reason that the care itself should not be delivered by the private sector. The private sector has every incentive to keep costs under control while providing quality care for the patients. Government bureaucracies are not rewarded for being cost conscious.

The private sector has a much greater ability to be flexible in its employment and other management decisions and is better suited to adjusting to changing market and regulatory conditions than government bureaucracies. In light of the almost certain unfavorable changes that are likely to occur in terms of funding and the competitive environment, it is taken as axiomatic that the County should explore privatizing the Kanes as expeditiously as possible.

In considering a move to privatization, the County must keep three things in mind.

(1) The quality of care must be maintained or improved.

(2) The County taxpayers should see both near term and long term relief in terms of the amount of subsidy required from the general fund.

(3) State and federal taxpayers should realize savings in the form of lower cost operations at the Kanes.

The first and third items are very easily achieved by a privatization. Any cost savings will benefit federal and state taxpayers because reimbursements from Medical Assistance and Medicare make up about 97 percent of all Kane revenues. Moreover, since there are hundreds of private nursing facilities providing quality care to patients and residents in Pennsylvania and regulations are enforced regardless of whether privately or publicly managed, it is clear that quality of care should not be a deterrent in the decision to privatize. Obviously, those opposed to privatization will use the argument that quality of care will suffer if the Kanes are privatized because the private entity will care more about money and/or profit than about the patients entrusted to them. However, it is extremely unlikely that the state would allow incompetence or poor quality of care without taking action. Then too, private sector owners and managers have every incentive to deliver a quality product. Otherwise they do not survive. County government does not face that problem.

THE TRANSACTION MUST BE STRUCTURED APPROPRIATELY, BUT THERE ARE PRIVATIZATION OPTIONS THAT WILL CLEARLY BE OF SHORT AND LONG TERM BENEFIT TO THE COUNTY'S TAXPAYERS.

Meeting the objective of saving the County taxpayers money is not quite as straightforward, especially in Allegheny County because of the large debt service obligation related to the Kanes. The transaction must be structured appropriately, but there are privatization options that will clearly be of short and long term benefit to the County's taxpayers.

A confounding element in a privatization effort is that normal market rules do not apply. The revenue for indigent care facilities is almost entirely dependent on government reimbursement for costs. Since reimbursement will decline if costs are reduced, the privatizing entity is severely limited in its ability to increase its profits or reduce losses by simply cutting costs of patient care. Thus, the ability of a privatized operation to return money to the County will be marginal at best even though taxpayers at the state and federal level could achieve substantial savings.

In Allegheny County, this complication is particularly acute because the current reimbursement regime for the Kanes' is fully covering the operating expenditures, although it falls well short of covering debt service. Any privatization of the Kanes-- if it is to save the taxpayers money in the short run-- must reduce the debt service subsidy. For that to happen the Kanes must have a positive value. In a market context, the Kanes as indigent nursing facilities can have very little value and in fact may well have a negative value if tested by a Request for Proposals. They produce no profit and they have over $90 million in related outstanding debt.

In the context of government program with taxpayer funding as the primary revenue source, a privatized Kane has a positive value in terms of reimbursable lease expenses. Using the state's formula, the Kanes' fair rental value is placed at $3.3 million per year, which has a capitalized value of $43 million--using the state's allowable 1996 financial yield of 7.84 percent. This provides an opportunity for a properly structured privatization transaction to ease the burden on the County's taxpayers by having a private entity borrow against its future lease reimbursement and transfer some of the loan proceeds to the County.

In view of the possibility of reducing the burden of costs to County taxpayers, the County ought to move quickly to develop a privatization program. Consider the following arguments.

One of the most important developments in government at all levels in recent years has been the recognition of the need to get a handle on runaway spending on social services. This is reflected in the massive change in the federal government's approach to welfare. A shift which, to a large extent, follows equally monumental changes in approach at the state level, with Wisconsin, Michigan and Virginia for example taking the lead. In addition, Pennsylvania has begun a process of mandating a managed care approach to the delivery of mental health services. A principal aim is to get the cost down while maintaining adequate service. In view of these developments at the state and national level, can there be any doubt that the government will begin to turn its attention to reimbursement level for nursing homes? This eventuality will have serious implications for Allegheny County and the Kanes. How long can the reimbursement levels for the Kanes, which are currently running at $155 per patient day, be expected to continue when the peer group homes cost $20 to $30 less? In short, given the Kanes' cost structure, the County has a severe exposure in terms of a rapidly rising operating subsidy if and when there is a significant reimbursement reduction.

MOREOVER, A PROPERLY STRUCTURED PRIVATIZATION, IN ADDITION TO TAKING THE RESPONSIBILITY FOR THE OPERATING EXPENSE REDUCTIONS, COULD PROVIDE FUNDING TO REDUCE THE COUNTY'S DEBT SERVICE SUBSIDY.

Clearly, the County needs to begin a serious effort to get costs down in anticipation of this high probability event. This might be accomplished through a stringent belt-tightening effort or it could be done through privatization. Given the government's track record in getting costs under control, and the virulent stance taken by the unions regarding major cutbacks, it is not possible to be sanguine about the County's prospects in achieving the required savings. Thus, it behooves the County to move quickly to shift the Kanes to a private operation who would then have the responsibility and accountability for getting costs under control.

Some have pointed to the fact that in recent years the Kanes have received more than enough reimbursement to cover operations expenditures and therefore provide some of the funds required for debt service. From this they conclude there is no need to privatize the Kanes. If the Kane surplus of revenue over expenditure were expected to rise and the County subsidy to continue shrinking that position might have merit. The more likely scenario as described above is that the surplus will go away and be replaced by a rapidly expanding deficit. As a result, the County's subsidy would move sharply higher than the debt service it is now required to cover.

Moreover, a properly structured privatization, in addition to taking the responsibility for the operating expense reductions, could provide funding to reduce the County's debt service subsidy. By taking advantage of the lease reimbursement value in a private operation and the savings the privatization entity will be able to generate, a sufficient operations surplus can be produced that will help the County defray its debt service.

So, it is clearly possible for a privatization to meet all three of the objectives outlined above. And in view of the current extraordinarily high level of operating costs, the large associated debt service, and the exposure the County faces in an era of increasingly tighter federal and state control over social services spending, the County should explore and develop its options for privatization.

Methods of Nursing Home Privatization

The following briefly describes generally accepted **privatization alternatives** for nursing homes.

CONTRACT MANAGEMENT IS DESIGNED TO IMPROVE BOTH PROGRAM SERVICES AND BUDGETARY PERFORMANCE WHILE CONCURRENTLY REDUCING THE DAY-TO-DAY TIME COMMITMENT OF GOVERNMENT OFFICIALS.

Privatization Through Contract Management

Contract management of county nursing homes has helped local governments cope more effectively with the maze of regulatory and operating issues such facilities face. Under such a plan, the county government contracts with an established professional management firm, which typically provides the county home's chief administrator, director of nursing and chief financial officer. The on-site management team receives support and direction from the firm's specialists in quality assurance, reimbursement, operations, and other fields. The overall team is responsible for establishing goals and policies and ensuring that these directives are carried out.

Contract management is designed to improve both program services and budgetary performance while concurrently reducing the day-to-day time commitment of government officials. It creates a more efficient management structure by which the responsible government is kept informed of both requirements and results in order to set policy, while the private management team has the authority to carry out that policy and deal with day-to-day operating requirements.

Under a management contract, the county retains ownership and licensure of the nursing home, which is in most cases staffed by county personnel. Such contracts are usually no longer than five years, and county officials should take care to explore other outsourcing possibilities at regular intervals. While management contracts are not guaranteed successes, counties which select firms with successful histories are well-positioned for good results.

Privatization Through Outsourcing Operations

This is essentially a variant on the traditional management contract. All employees are on the contractor's payroll with goods and services being purchased directly by the contractor. However, the government continues to receive all program revenue since it remains the "provider" of service, as well as the owner of the facility. Note that, as owner, the governmental entity remains responsible for capital improvements and property insurance.

Typically the goal of this method is to make the facility more viable when employment costs are significantly higher for a government employer than in the competitive marketplace. This option presents the opportunity for government to maximize the utilization of the resources available through the management firm while maintaining the service through continued ownership of the facility, licensure and provider status.

Privatization Through Operating Leases

This method is essentially a sale of the nursing home's "business entity" to a private for-profit or a private not-for-profit, while the County retains ownership of the facility and real estate. Under an operating lease, the government transfers use of its land to the lessee/provider for consideration. Such consideration generally includes rental payments, as well as a requirement that the lessee carry out mandated program goals and policies. The lessee/provider operates the facility in accordance with the conditions set forth in the lease, employs all facility staff and purchases goods and services in its own name. The terms of the lease spell out the division of responsibility between the county and the provider on matters like capital improvements and property insurance. The lessee/provider will bill and collect program revenues in its own name.

IN THE "CONTROLLED SALE" APPROACH...THE GOVERNMENT CREATES A NON-PROFIT CORPORATION, SELLS ITS NURSING HOME TO THE NEWLY CREATED ENTITY, AND THEN CONTROLS FUTURE OPERATIONS TO ENSURE THAT ITS PROGRAM GOALS ARE ACHIEVED.

The county should use the same standards in evaluating potential lessees as it would in choosing a contract management firm. Specifically, the lessee must have the capability to maintain quality of care and smoothly complete the transition from public to private facility operation, must use financial assumptions which are plausible and also support program goals, and must have access to sufficient funds to ensure that the effectiveness of the operation will not compromised in the event that financial projections are not met.

The goal of this sort of privatization is to remove the responsibility for day-to-day operations of a nursing home from government officials and to shrink the county government's total payroll. As with outsourcing operations, careful forethought must be given to the impact of staff moving from county to private employment. In addition to continuity of bargaining agreements and the potential overall reaction of staff, the government should estimate the cash impact on its pension fund which will result from a large number of employees leaving the program at once.

Privatization Through Controlled Sale to Non-Profit

An increasingly popular privatization option, especially in Pennsylvania, is the "controlled sale" approach. In such a transaction, the government creates a non-profit corporation, sells its nursing home to the newly created entity, and then controls future operations to ensure that its program goals are achieved. The new entity can be one of several types of "501" non-profit corporations which can be treated as "county homes" under the existing reimbursement system, assuming that "full financial control" rests with the county. The membership of the new non-profit's board can include the county commissioners or other government officials. Board membership can provide a control mechanism to ensure that the original objectives of the new entity are met.

The main goal of this form of privatization is to relieve the county of the necessary payroll, subsidy outlay and general aggravation of running nursing homes, while ensuring that the mission to assist the indigent continues.

NOTE: Despite the potential savings, significant changes in employee compensation and other operational areas are difficult to achieve in a public program. That is why governments must carefully plan and continue to control program performance. Operating results, capital projects, and cash flows can continue to present significant demands on the local taxpayers if the facility fails to meet projections and the "parent" government has guaranteed debt.

Privatization Through Outright Sale to Non-Profit or For-Profit

Although less common, it is possible in some situations to sell a county nursing home in a true, arms-length transaction with no future commitments from either seller or buyer. This type of transaction is most likely in an area with a significant "bed need", a structurally and financially "healthy" facility, and the potential for operation within the reimbursement rates. Note that a true arms-length sale represents abandonment of the county's traditional role in providing access to care for the indigent. Whether this has been a state, not a county responsibility, historic expectations alone can make it difficult for a government to adjust the level of service downward. No matter which option is chosen, nor how well-intentioned or well-designed it may be, care for the aged is an emotional issue fraught with potentially negative political consequences.

While each of these methods of privatization offers its own set of advantages and disadvantages, the controlled sale or lease to a non-profit seems to offer the quickest and most viable approach from the standpoint of political salability and the ability of the Commissioners to maintain a level of control and input into the operations of the privatized facility.

..THE COUNTY SHOULD MOVE WITH ALL DELIBERATE SPEED TO STRUCTURE A PRIVATIZATION TRANSACTION THAT ENSURES QUALITY CARE FOR THE KANE PATIENTS AND IS ABLE TO REDUCE THE COUNTY'S GENERAL FUND SUBSIDY FOR THE KANES.

Conclusions and Recommendations

Notwithstanding the unique characteristics associated with indigent care facilities, especially the Kanes, the County should move with all deliberate speed to structure a privatization transaction that ensures quality care for the Kane patients and is able to reduce the County's general fund subsidy for the Kanes.

Furthermore, based on the privatization options available, the approach that is most feasible-- in terms of being carried out in the short term and in being able to meet regulatory hurdles--would be a controlled sale or lease to a County created non-profit organization.