REPLACEMENT REVENUES FOR HOSPITALS WHEN DEVELOPING FREESTANDING AMBULATORY BUSINESSES

BY

Robert J. Zasa, MSHHA, FACMPE
Principal, Woodrum/Ambulatory Systems Development, LLC

One of the most common issues to address when implementing hospital and physician joint ventures is the need for the hospital to replace the revenues that it will lose when forming a joint venture with the physicians. This occurs when moving ambulatory surgery or the ambulatory care business out of the hospital into the new, jointly owned venture. Having worked with multiple hospitals over the last twelve years, there are successful ways to coordinate the succession of revenues for the hospital. It is important that the hospital has a thoroughly planned the replacement strategies prior to the opening of the new ambulatory center. It is also imperative that the hospital has the political will to reduce its expenses for the services that are leaving the hospital and reorganizes the hospital to generate new revenues. These new sources of revenue should generate as much if not more profit for the organization.

The successful steps to implement in developing replacement revenues are as follows:

1. Identify the financial impact - A mini-profit and loss statement reflecting the financial impact on the hospital should be developed for the services that will be moving to the new entity. It is important to identify the net revenues (net of contractual allowance for Medicare, HMO's and PPO's and other third party payors) and the expenses related to

delivering those services, including all allocations within the hospital toward that service. In short, a mini profit and loss statement should be developed to identify the actual lost profit that will be experienced when that ambulatory care service leaves the hospital.

2. Utilize the Organization's Strategic Plan – Every healthcare organization has a long-term strategic plan. That plan typically identifies new, inpatient services that the hospital would like to develop. Those services that relate to the operating rooms or that would need space equivalent to an operating room should be considered when developing a replacement strategy. It is recommended that the top three strategies within this strategic plan that may fit into the operating room be considered. Mini profit and loss statements should be developed for each of those strategies to find the most profitable one to consider for the replacement strategy.

3. Review of best DRG's – The CFO of the hospital should review the DRG's germane to that hospital and find which of the services are most profitable for that organization. This will vary by state and it will also vary by hospital given the market share and services that that hospital offers. The top two services (identified by DRGs) should be reviewed as potential replacement strategies. Both services should be considered from the viewpoint of profitability, and from the standpoint of the practical use of the space vacated by the services leaving the hospital.

4. Compare the Replacement Plan Strategies- the various replacement strategies should be compared. The criteria of selection should be profitability, contribution to the growth of the organization, suitability of space, and how well the strategy fits into the hospital's

strategic plan. The CEO and CFO need to select the new replacement service that best meets the financial and strategic objectives of the hospital.

5. Developed an Architectural Space Program- an architectural space program needs to be developed to validate the cost of renovation. This is imperative in that the strategy may be a very good one from a profit and loss standpoint, but the cost of reconstruction or modification of the institution may be prohibitive. It is imperative that these costs be worked into the final financial projections for the potential strategic replacement strategies in order to select the proper one. An architect with significant experience in renovating hospitals and working with ambulatory care types of activities should be selected. It is imperative that the services be designed in a cost-effective way in order to maximize the profit to the organization.

6. Development of a Business Plan – Once the replacement strategy is identified, a business plan should be put together for that strategy to be presented to the Board. The business plan should be used as a guideline in developing and managing the development process of the replacement strategy. A business plan should include the description of the services, a review of competition, a review of reimbursement and regulatory factors, identification of key critical success factors that will have to be implemented for the program to be successful and financial projections. The financial projections should include a use and source of proceeds. This will tell the hospital how much money it will need to raise, and for what items the money will be used. It will also outline the debt required to implement the new service. In addition, cash flows for at least two years should be developed along with the profit and loss statements, staffing models and

expectation of net revenues and cost per visit for the replacement strategy. These all should be attached to the financial section of the business plan. It is important to highlight all the key indicators that need to be implemented to make the replacement strategy successful. In addition to these items, the business plan should include a projected equipment list, outlining all the equipment and the cost of that equipment necessary to implement the program, including contingency, taxes, and delivery and installation charges. Finally, a detailed space program and cost estimates from the architect or design build firm should be included in the business plan to outline not only space requirements but also the cost associated with implementing the replacement strategy. These costs should be reflected in financial projections as stated above.

7. Select a Person to be Accountable for Implementation - There should be one person designated in the organization to make sure the implementation of the replacement program is executed according to the business plan. It is important that there is somebody accountable for the proper implementation and the coordination of the timing of other people and activities necessary to successfully implement a replacement strategy.

There are several common replacement strategies that our firm has experienced working with hospitals. Some of the most common replacement strategies have been to expand the existing heart, orthopedic and eye programs. These are all programs that have heavy inpatient ramifications in terms of ancillaries, over-night beds and better reimbursement in a hospital than on an outpatient basis. Other uses of vacated operating rooms are for MRI,

P.E.T. and other large diagnostic services that require large space and support services surrounding them. Cath labs are very good replacement strategy in most states where the reimbursement is positive for such services. Cath labs are invasive procedures. This service needs approximately the same space as the operating rooms and needs having recovering and pre-op areas surrounding the service.

In summary, it is imperative that a hospital properly plans the replacement strategies for revenues (and ultimately profit) when considering a joint venture with physicians for ambulatory services such as an ambulatory surgery center. It is important that these strategies be coordinated and the timing of these strategies be implemented concurrently with the development with the new ambulatory service in order to maximize the revenues for the hospital and minimize any disruption of service.