Presentation by William B. Kerr, Director, UCSF Medical Center, June 20, 1996

OPEN SESSION

Regent del Junco; members of the Committee:

At the last Regents' meeting, I presented an overview of the state of affairs of the UCSF Medical Center. Let me take a moment to highlight those concerns:

Over the past five years, UCSF has experienced a 28% decline in patient days, much of which is attributable to shortened length of stay and the transfer of clinical services to the outpatient setting.

During the same period, UCSF's operating gain declined from $9.5 million in 1990, which was an operating margin of 3.4%, to an operating gain of just over $1 million last year on a base of almost half a billion in revenues and expenses.

In order to remain economically viable and fulfill our clinical and academic mission, we need a much higher operating gain for investment in new and replacement technology and new program development.

We anticipate a current year end operating margin of less than 1% and this would not have been achieved were it not for the failure of Congress and the President to agree upon a budget.

Projected reductions to balance the federal budget and keep the Medicare trust fund solvent will target the $50 million in reimbursement which support our educational mission. We also anticipate substantial cuts in the MediCal program which constitutes one quarter of our patient population and already reimburses us $52 million less than our costs

Unreimbursed costs associated with care of the indigent and our educational mission can no longer be shifted to the private sector.

We have made substantial budget cuts over the past few years and cannot achieve a reasonable operating margin based on further expense reductions.

In the current decade, we have independently pursued a series of clinical strategies to improve our competitiveness. Despite the success of many of these initiatives, the Chancellor, the Dean, and I have concluded that the UCSF clinical enterprise must partner with others to assure its continuing competitiveness.

To meet our needs for a connection to a strong local primary care network, our campus is joining with California Pacific Medical Group to create a new managed care medical group to serve San Francisco. The combination of UCSF Medical Group and CPMG will provide additional local volume for teaching in primary care and secondary specialties. It will also allow the new group to reduce its average cost of managing "risk-based" contracts for primary and comprehensive care. The new medical group does not provide a solution to UCSF's needs to reduce its costs overall, to build regional referral volume, to create more cost effective ways to teach in a clinical environment, and to improve its operating margin to permit reinvestment in critical technology. The merger with Stanford meets those needs and would provide immediate benefits to UCSF.

The proposal to join with Stanford University in the creation of a merged clinical enterprise is a bold but necessary move. Consolidation of the clinical enterprises of Stanford, Lucille Packard Children's Hospital, and UCSF will enhance our ability to teach and do research. It will also allow the new entity to develop and maintain a viable market position as the system of choice for complex care and specialized expertise.

Senior clinical and management representatives from UCSF, Stanford University and Lucille Packard Children's Hospital along with representatives from the Office of the President and Ernst and Young consultants have been engaged in an intensive process over the last few months to determine the extent to which the proposed merger will increase patient care volume and reduce costs. This process allowed my senior management staff responsible for operations, finance, information systems and marketing and planning to engage with their counterparts from Stanford and Packard in an in-depth analysis of current clinical operations. As a consequence, they were able to jointly target opportunities for management action which would improve the financial performance of the newly merged entity.

The preliminary business analysis compared five year financial projections for each of the facilities operating in a stand alone financial model, versus the financial performance that could be expected as a result of the merger. The three facility stand alone projections are added together to form the combined base case financial estimates. Beyond this point, a detailed review was undertaken to determine the incremental improvements that could be achieved by the merged entity above and beyond what would have been achieved by the individual institutions if they remained independent.

The analysis concluded that various expense reduction opportunities could be achieved through consolidation. The preliminary business analysis projected administrative savings in three broad categories: elimination of duplicative resources, adoption of best practices, and capitalizing on the advantages of consolidated volume. Examples of administrative cost savings include a single senior management structure, centralization of accounting functions, and purchasing savings through product standardization.

What I would like to emphasize is the thoughtful, deliberate process that we followed in developing these options. Mr. Ted Magg, who worked with us from Ernst and Young, met with President Atkinson and his staff last week. During that meeting, he noted that ours was a much more detailed and vigorous analytical effort than that which is typically undertaken in hospital merger discussions. The senior executives from Stanford, Packard, and UCSF are confident that the expense reductions which have been identified are attainable, and they are prepared to be accountable for their achievement.

We believe that the net cost savings realized by the new enterprise will improve its ability to compete effectively for volume from managed care plans, integrated delivery systems, and capitated medical groups. This increase in patient volume would be achieved by:

- using overhead cost reductions to reduce prices;
- reducing clinical care costs through more effective clinical resource management; and
- by using combined volumes to develop better cost information and the financial models necessary to undertake risk sharing agreements.

Further, it is expected that the new enterprise would be able to:

- demonstrate superior outcomes;
- create more effective outreach to referring medical groups and health plans;
- create incentives for excellent service; and
- promote patient choice where insurance benefits allow.

A major target market for NEWCO is expected to be medical groups and integrated delivery systems that now accept financial risk for enrolled populations under capitation. These groups must not only deliver services, but must function as "mini-insurer" for their covered lives. A second target market is likely to be regional HMOs. Both the capitated medical groups and the regional HMOs are seeking to reduce the complexity and cost of their managed care operations by restricting outside referrals to a limited number of vendors and by contracting at predictable prices for complex care.

What options are available to UCSF other than the proposed action? If the proposed merger with Stanford does not proceed, UCSF is likely to attempt to create more fully integrated partnerships with Sutter/CHS, Kaiser Permanente, or Catholic Healthcare West. None of these have the potential of the Stanford relationship. The principle issues of governance, public accountability, and legality of asset transfer will characterize any potential merger. From a financial perspective, no partner, with the possible exception of Columbia HCA is likely to constitute a lesser financial risk. From the vantage point of assuring continued support of the academic mission, it is clear that no potential partner offers the shared values of Stanford University. Furthermore, no potential partner has the regional and national reputation for clinical excellence that SHS enjoys.

No one can predict the future of academic medicine with any certainty. Not only are we buffeted by the highly competitive California marketplace, but we suffer from the absence of public policy to support indigent health care delivery and medical education. But I am certain that the risks UCSF faces in the future are very real. UCSF's best case projections in a stand alone scenario yield an operating margin of one to two percent. We cannot maintain our clinical and academic excellence over the long run with such a modest operating gain. Further, this slim margin offers no financial cushion to protect against the major budget reductions being discussed in Washington. The improved financial performance achievable by the merged entity would allow us to face our uncertain future with a much higher degree of confidence.

UCSF is a strong medical center with a stable financial base. Together, we and Stanford University can develop a truly remarkable academic and clinical enterprise. We seek to preserve our preeminence, and I strongly believe that the proposed merger is the most immediate and predictable way to achieve that goal.