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Local Economic Report Series

Medical Services Industry

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Presented By
Sonoma County Economic Development Board
in partnership with
Sonoma County Workforce Investment Board

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The Economic Development Board (EDB), in partnership with the Workforce Investment Board, is pleased to bring you another issue of the *Sonoma County Local Economic Report Series*.

The health services industry in Sonoma County is facing a positive outlook in the long-term despite the fact that the industry is currently wrestling with many financial challenges. Highlights from the report include:

- Patient revenues continue to steadily increase.
- Decline in hospital's net income is generally due to climbing operational expenses.
- Insurance costs are showing their vulnerability after the collapse of Health Plan of the Redwoods.
- Unemployment among hospital workers remains low.

Economy.com has provided an updated analysis on Sonoma County's strengths and weaknesses, sector performance, and other key economic indicators for the medical services industry.

As always, please feel free to offer feedback on ways to improve the reports released under this series. If you would like to view this, and other reports from the Local Economic Report series online they can be found at www.sonoma-county.org/edb/Reports.htm. You can contact Nikhi Raj at (707) 565-7589 or nraj@sonoma-county.org with any feedback or questions.

Thank you for your interest in Sonoma County's economy and the Economic Development Board's research efforts.

Yours sincerely,

Ben Stone

Kaiser already dominates the local market with an estimated 60% market share, according to the California Healthcare Foundation. Kaiser and other smaller players like Health Net and PacifiCare who have stepped into HPR's stead have raised insurance premiums for the area's employers. Some of these costs are also being transferred to consumers through a combination of higher monthly payments, higher co-payments and fewer covered services. This is expected to continue in the near term.

More physicians continue to move into SON, although the physician per capita ratio has fallen as growth in physicians has not kept up with the population growth rate. The Sonoma County Medical Association notes that nearly 35% of the current practicing physicians in the county arrived over the past seven years, indicative of significant churn in the marketplace. Physicians are of particular importance in California under its physician-led managed care system, which is currently emerging from a crisis of low reimbursements, high costs and increased consumer demands. SON physician woes reflect this statewide trend.

Pricing. Over 50% of hospital revenues in SON come from public sources, mostly Medicare. Federal budget deficits and spending constraints pose minimal downside risks to the outlook, and Medicare payments are expected to rise. That said, Medicare reimbursements for inpatient procedures are still insufficient, and this year's hike, to be implemented this month, will also be disappointing. Low Medicare prices especially hurt physicians; payments fell 5.4% this year and are slated to drop a further 12% over the next three years unless Congress enacts new legislation. Further, designation as a "rural agricultural" county by the Medicare programs ensures lower reimbursement to SON hospitals. On the positive end, Medicare payment for outpatient procedures is set to rise over 3.5%.

With enrollment largely flat, most of the growth for health insurance companies is coming from price increases. Despite rising premiums and weak corporate earnings, most businesses indicate no willingness to reduce coverage for employees; hence a drop in demand for insurance products is unlikely.

Operating Expenses. Labor and technology continue to be the biggest drivers of operating expenses for health service providers. Although hospitals nationwide suffer from a persistent national nursing shortage that has driven wages up significantly, SON hospitals' have been successful in maintaining modest operating expenses. By the OSHPD's reckoning, operating expenses rose a manageable 5% in the first quarter of 2002 from the same period one year ago. SON hospitals will also benefit from a recent $500,000 state grant to help train and recruit nurses.

Managed care companies will increasingly resort to emerging disease management techniques to reduce medical costs. Furthermore, health plans have resorted to tiered options, where access to hospitals and drugs is limited according to price. Managed care companies are betting that these tiered plans will transfer more of the burden of expensive care to consumers; hospitals have usually opposed these efforts.

A significant expense for healthcare providers and insurance companies is imminent compliance with the Health Insurance Portability and Accountability Act (HIPAA). Health providers have to be in compliance with HIPAA's strengthened health data transmission privacy laws by October 2004, which will require considerable hospital investment in compatible IT systems in the near term.

Profitability. Profit margins have worsened on a year-over-year basis in the SON healthcare industry. Nationally, for-profit hospitals are reporting across-the-board gains, while not-for-profit hospitals remain on shakier ground with narrow margins. Weak private and government reimbursement is the main culprit behind weak health service profitability.

Managed care companies are enjoying improved profit margins due to successful hikes in insurance premiums and reduced operating expenses. Over the long term, hospitals and unionized physician groups with more negotiating clout on one side, and the public and political machinery demanding lower health costs on the other, will squeeze managed care profits.

One factor eating into SON hospitals' profit will be continued investment in retrofitting hospitals for possible earthquakes, as required by California law. The move, required to be complete by 2008, is expected to cost SON hospitals around $200 million, although there is talk of state government aid and a possible extension of the deadline.

Long-Term Outlook. Despite near-term difficulties, the long-term outlook for the health service industry in SON is positive. The county's demographics provide much room for optimism for the local health services industry. In general SON residents are wealthier and older than the average Californian, and even the average American. Further, the public health caseload in SON is below average, with only 8% of the population eligible for the state's low-income Medi-CAL program in 1999-2000, well below the state average of 14%. The aging of the baby boomers, concurrent with a boom in healthcare technology and growing life expectancy, will support consumer demand. SON hospitals should also continue to benefit from serving residents in neighboring counties, where the public caseload is significantly higher and healthcare facilities are less well equipped.

The outlook for managed care is less optimistic due to its decreasing efficacy in stemming rising healthcare costs. Continued growth in prescription drug spending will complement the ever-increasing costs of implementing new medical technologies. That said, new forms of managed care that take advantage of the Internet to improve consumer ownership of healthcare could lead to renewed growth in the industry.

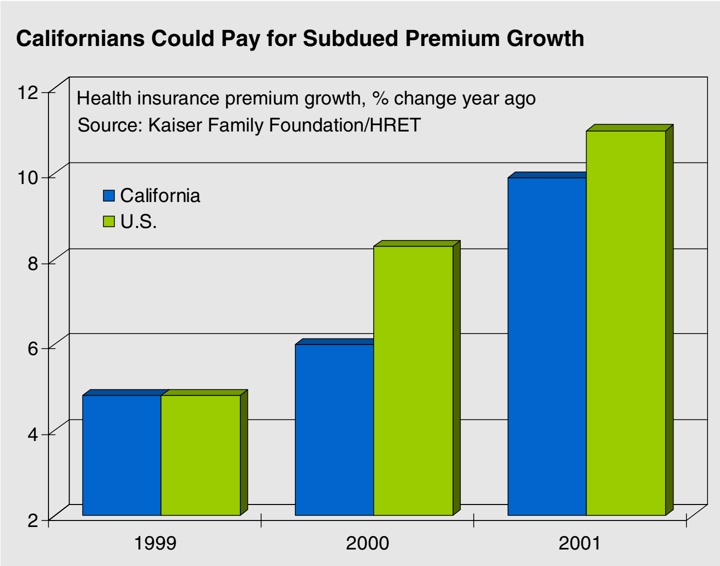
Upside Risks. Technology provides the greatest upside potential for the health services industry. Greater use of the Internet and budding wireless technology would provide significant operational and cost efficiencies. Similarly, the continued rapid development of medical technologies offers significant potential for providing more effective care to a larger population.

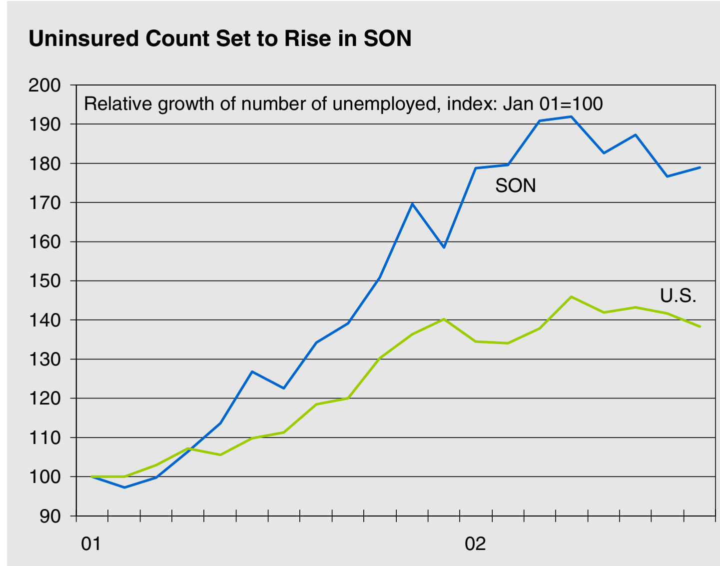
The industry would also benefit from federal legislation that increases healthcare coverage for the uninsured, which would boost utilization in hospitals and improve chances of government reimbursement for managed care companies, although this is fairly low on the legislative agenda currently.

Downside Risks. The greatest downside risk to providers is presented by looming cuts in public health spending. With budget surpluses turning to deficits, protracted revenue slowdowns, particularly at the state level, will lead to cuts in healthcare programs, which are among the largest and fastest-growing segments of expenditures at both levels of government.

Rising insurance premiums and medical costs in general also risk pushing more SON residents into the ranks of the uninsured in the near term, which could in turn lead to further medical cost increases.

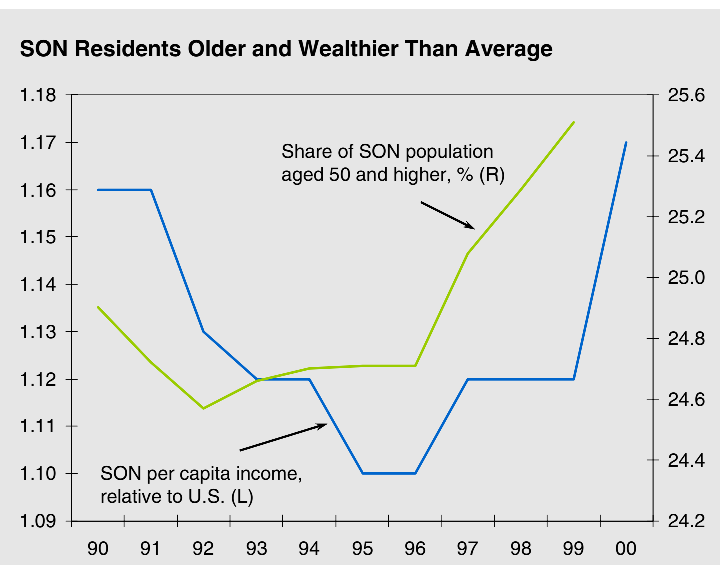
Rakesh Shankar
October 2002

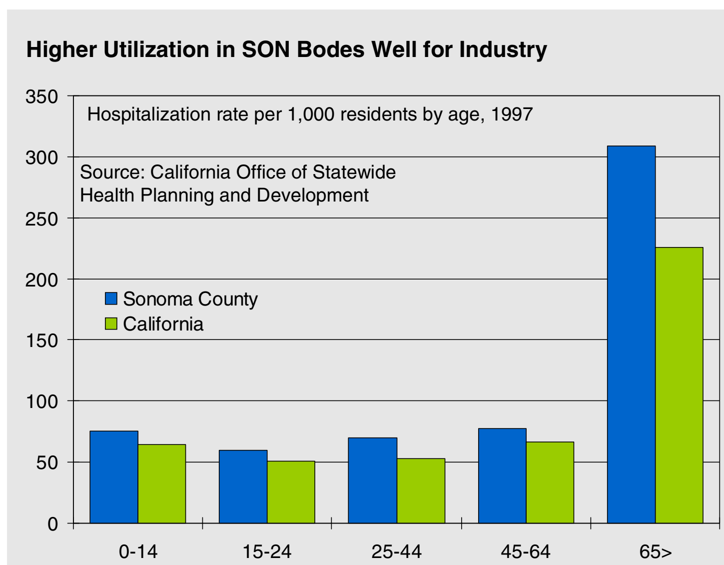




California has been insulated from the dramatic gains in insurance premiums in the rest of the nation. The high prevalence of managed care in the state, coupled with the power wielded by large purchaser groups like CalPERs (which negotiates benefits for the state's employees) and the Pacific Business Group on Health (PBGH), have helped stymie premium growth. This is set to change, as signaled by the 25% insurance premium hike announced for 2002 for CalPERS members. If a group with the clout of over 1 million members is forced to pay the higher premium, the effect of insurance premiums on smaller businesses with less clout can be inferred.

With the majority of healthcare consumers obtaining health insurance through employer-based programs, the rise in the number of the unemployed in SON means more households without insurance. Nationally, the number of uninsured increased by over 4% in 2001, following two years of steady declines. With the number of unemployed workers in the county growing at nearly twice the national average, the county's uninsured population is sure to have grown significantly over the past two years. This adds some stress on the local health system by increasing demand for uncompensated care on the health provider system.





The fundamental drivers for healthcare demand in SON are sound, and look promising for the local health services industry. Local residents, on average, are wealthier than the national average: the latest census figures show that median household income in SON is $10,000 above the state and national average. Further, the county has an above average share of elderly residents, who are the largest consumers of healthcare services, and its share of residents 50 and older has grown over the past decade. SON also has a below average poverty rate. All of this bodes well for healthy demand going forward.

Not only does SON have a healthy base of higher income elderly residents, but it also has a demonstrably high healthcare utilization rate. Across all age groups, but especially among residents aged 65 and older, county residents have a higher hospitalization rate than the average Californian. This may reflect, in part, the county's managed care penetration rate, which is the highest in the state and one of the highest in the nation. High managed care penetration could contribute to higher utilization. This high utilization rate ironically leads to higher medical costs for the county, which in turn pushes up managed care premiums.