HOSPITAL CONSOLIDATION:  
OPTIMAL STRATEGY FOR A TWO-HOSPITAL TOWN (A)

John Tortini and the rest of the consulting team sat around the large conference table and reviewed the outline of their final report, which was due in two weeks. The consultants had been asked by the boards of directors of the only two hospitals in Gorsich, Wyoming to study the best possible ways in which the hospitals might work together to meet the health care needs of the community, and Mr. Tortini wanted to be sure everyone was in agreement before the team made its recommendations.

From past experience, Mr. Tortini knew that collaboration between two competing hospitals is never easy, and that the team's report was likely to be attacked by those who opposed the conclusions. Consequently, he wanted to be sure they had covered all of the relevant issues and considered the potential sources of opposition prior to submitting the report.

At the beginning of the meeting, Mr. Tortini asked the various team members to review the findings of the previous eight weeks of on-site work in Gorsich. Bill Dean began the discussion with a review of the financial situation and environment within which the hospitals operate.

Environment and Financial Factors

Holy Family Hospital and Gorsich General Hospital are the only two acute care hospitals in a county of 80,000 people. They also serve as regional referral hospitals for a much larger secondary service area that includes another 90,000 people and 14 small hospitals. Because of the predominantly rural nature of the state, patients often travel great distances to receive care.
The total service area for the hospitals covers an area approximately five times the size of the state of New Jersey.

The hospitals are located three miles apart in the city of Gorsich, and they are both full-service acute care hospitals, offering nearly a full range of secondary services and some tertiary services. While some services, such as open-heart surgery, are provided only at one hospital, the majority of services are duplicated at the two facilities. Historical market share analysis shows that Gorsich General had an overall 60 percent market share in the county, with Holy Family holding steady at an approximately 40 percent market share. Generally, the community has been very loyal to the two hospitals, which together account for nearly 97 percent of the inpatient volume of the county.

Both hospitals have a long history in the region. Holy Family Hospital was founded by the Sisters of Health Care in the late 1800s and is currently part of I Healthcare Services, a loosely affiliated system that includes 14 Catholic hospitals throughout the region. Gorsich General has been in the community for nearly as long as Holy Family, although it is no longer affiliated with its Lutheran founders and now serves as an independent, not-for-profit institution.

The region surrounding Gorsich has generally seen a slowly declining population, especially after the closure of one of the largest employers - a mining smelter - in the middle 1980s. Although unemployment has declined in recent years, many local business leaders are concerned about the long-term economy. The largest employer in the region is Zebra Air Force Base, which is in danger of being downsized or closed due to reductions in defense spending. Many other local employers have also experienced layoffs or downsizing, whereas the hospitals are two of the largest and most stable employers in the region, together accounting for nearly 1,800 full-time equivalent employees.

On the positive side, educational attainment in the region is higher than the national average, although local officials are frustrated that the available jobs often do not take advantage of the well-educated workforce. Many local jobs pay only slightly over minimum wage; many families struggle to get by from paycheck to paycheck. A review of the census data indicates that over 60 percent of the population have an annual household income of less than $30,000 per year, compared to 50 percent of the national population. The weak economy also manifests itself in the health care arena: 15 percent of the population is without health insurance, although 85 percent of the adults in this group are employed in low-wage jobs. While access to emergency care is available from the hospitals and local physicians without regard to ability to pay, lack of insurance is a major barrier to needed preventive and general health care services.

Public health officials are concerned about a number of other local health issues. These include higher-than-average rates of heart disease and cancer, high rates of death and disability from work-related injuries, high adolescent suicide rates, higher out-of-wedlock birthrates than other similar communities in the state, and high rates of alcohol and smokeless tobacco use among the
youth of the region. Many of these concerns are not only local issues, but also occur throughout the state, due in part to the weak state-level support for public health efforts.

Mr. Dean proceeded with his review of the environment by detailing some hospital operating statistics the team had compiled during their study. As in nearly all communities around the country, Gorsich has seen a dramatic decrease in the inpatient utilization of hospitals in recent years. As lengths of stay have declined and many services have switched to outpatient settings, the combined acute care average daily census (ADC) of the two hospitals has dropped from nearly 300 in 1983 to just over 150 in 1993. Moreover, these changes occurred in the absence of managed care, which is still nearly nonexistent in the region. The consulting team has estimated that an additional 25 percent decline in the ADC could result when managed care pressures do arrive.

The substantial overcapacity resulting from these changes was one of the key drivers behind the hospitals exploring collaborative activities after decades of competition; the decline in patient volumes made it difficult for both hospitals to maintain staff proficiency and efficient staffing levels in many areas. For example, both hospitals have pediatric units, with reported ADC levels of six patients at one hospital and three patients at the other. Despite these low volumes, physicians working at both hospitals expect nursing and ancillary staff to be fully proficient in nearly all areas.

While inpatient hospital volumes have been decreasing, hospital costs have been increasing substantially. Over the ten-year period ending in 1993, the combined hospital operating costs in Gorsich increased by 115 percent (versus 45 percent for the general inflation level and 100 percent for the national health care inflation level). Indeed, over the previous four years, average price increases by the hospitals were between 8 percent and 9 percent, while per capita income for the state grew by only 4 percent to 5 percent per year. Business leaders interviewed during the project indicated their ability to absorb additional health care cost increases was nearly exhausted, and that some way of controlling local health care costs needed to be found.

Mr. Dean also covered the historical and anticipated future financial results for the hospitals. Both hospitals are currently financially healthy and profitable, although they have both had to resort to staff layoffs and salary freezes during the past two years to avoid operating losses. Neither hospital has a tremendous amount of debt outstanding, and neither is planning a large debt-financed project in the near future. Although neither hospital is an A-rated credit risk in all areas, both are in generally good financial shape at the present time.

A look into the future provided by the consulting team, however, indicates things may get much more difficult financially for the hospitals. As commercial payers begin demanding discounts on hospital charges, patient lengths of stay continue to decline, and government payers continue to cut back, the hospitals are likely to face significant financial losses within the next five years. In essence, they will be fighting over a shrinking patient population, while not being able to make significant reductions in their expenses. While some individuals and physicians at the hospital do
not agree with this assessment, the majority of management personnel at both institutions see these trends occurring throughout the country and feel the trends will likely come to Gorsich within the next few years.

Bill Dean concluded his presentation to his colleagues with a discussion of the estimates of cost savings associated with collaborative efforts. For purposes of making estimates, the team developed four alternative scenarios:

- The first alternative is to do nothing and maintain the status quo, which of course would not yield any cost savings.

- The second alternative is to develop a series of joint ventures for some services, such as selected administrative or clinical services, in order to reduce costs through economies of scale. The team had estimated this alternative would save approximately $1.2 million per year in operating costs, which is roughly 1 percent of the annual combined operating budget. In addition, this alternative would allow the hospitals to avoid $3.5 million in duplicated capital spending over the next five years.

- The third alternative is to consolidate the hospitals into a single organization, but maintain selected inpatient services at both facilities. This would likely save approximately $5.8 million per year in operating costs, and $11.5 million over the next five years in capital costs.

- The fourth alternative is to consolidate the hospitals and concentrate all inpatient services at one campus and put many nonacute and ambulatory services at the alternative location. Because of the concentration of acute care services and the resulting economies of scale, this alternative yields the greatest savings - $8 million per year in operating costs, and $14.5 million over the next five years in capital costs.

After Mr. Dean had completed his presentation, Mr. Tortini asked Dustin Robb to review what the team had found during the interview phase of the project. Mr. Robb began with an overview of the process the team had used for its interviews.

**Interview Findings**

The team spent the first few weeks of the project conducting over 200 interviews with local physicians, hospital personnel, community leaders, public health officials, and payers. The interviews lasted approximately one hour each, and the consultants used a confidential questionnaire to ensure the consistency of the questions being asked.

The team generally found a high degree of support for hospital collaboration from those in Gorsich, although there was dissension within some groups with regard to the desirability of collaboration. One question asked respondents what degree of collaboration they would favor,
ranging from 1 being "no collaboration" to 10 being "complete consolidation." The results of this question are shown in Table 1.

**Table 1. What Degree of Collaboration Would You Support?**

(U = Status Quo, 10 = Complete Consolidation)

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As Dustin Robb reviewed these findings with the consulting team, he explained the differences in opinion between the independent physicians and the clinic physicians. The medical community in Gorsich is split fairly evenly between one large multispecialty clinic of about 60 physicians - Gorsich Clinic - and the remaining physicians, organized as independent solo practices and small groups. Gorsich Clinic recently moved into a new building adjacent to Gorsich General and has been fairly aggressively adding new physicians and recruiting existing independent physicians. The remaining independent physicians are largely clustered in hospital-owned medical office buildings around Holy Family Hospital, whose administrator sees part of the hospital's role as a haven for independent physicians who do not want to join Gorsich Clinic.

As the interview results indicate, the Gorsich Clinic physicians are generally supportive of a consolidation of the hospitals. The independent physicians are much less enthusiastic, with a small core group strongly opposed to any collaboration. Mr. Robb speculated that the reluctance of the independent physicians comes from several sources. First, the rural, frontier nature of the region attracts very independent physicians who strongly believe in competition and the survival of the fittest and are opposed to anything they perceive to be reducing competition. Second, a small group of independent physicians are very strongly opposed to either state or national health reform, and these physicians may believe anything that changes the status quo is undesirable. Finally, Mr. Robb felt the independent physicians are fearful that any collaboration between the hospitals would result in a stronger role for Gorsich Clinic within the medical community, possibly to the detriment of the independent physicians.
Apart from the physicians, there appears to be fairly strong support in the community for collaboration or even consolidation. Many local leaders expressed frustration during the interviews at the competition between the Hospitals and felt it had only led to unnecessary duplication and additional expense for the community. Many cited the presence of a magnetic resonance imaging unit at each hospital in Gorsich, both of which units are substantially underutilized, as an example of this. Community leaders wondered aloud during the interviews why the hospitals couldn't work together to prevent the unnecessary and expensive duplication.

Finally, Mr. Robb reviewed some of the issues that had surfaced in the interviews that might be barriers to collaboration. A number of people affiliated with both hospitals cited a difference in organizational culture as a potential barrier. The general perception was that Holy Family Hospital is the smaller, more caring, more mission-oriented hospital, while Gorsich General is more "high-tech" and operated more "like a business." Some employees felt it would be difficult to integrate these two cultures in collaborative ventures. In addition, some Holy Family physicians and employees were very concerned that collaborative efforts would lead to a reduction in the Catholic presence or an abandonment of Catholic standards for women's health, which was for some a very strong reason for their affiliation with Holy Family.

After listening to these presentations, John Tortini decided to spend a few minutes reviewing for the team what he had learned about the personalities of the key players involved in the decision-making process. As team leader, Mr. Tortini had spent a lot of time with the CEOs and the board chairs for both hospitals, and his years of experience had given him some insight into players' possible reactions to various recommendations. While it was important to consider the various constituencies, ultimately it would be the boards who would make the final decision.

**Key Decision Makers**

Mr. Tortini began his review with Scott McDougal and Terry Conrad, who chaired the boards of Gorsich General and Holy Family Hospitals, respectively. Mr. McDougal is the president of the chamber of commerce and is very well known and well respected around the town. Mr. Conrad is the manager of a large construction company and has been active in community affairs for many years. The two men have had a long-standing relationship. Mr. McDougal also had the distinction of being the first lay chair of the Holy Family board, which now draws a majority of its members from the laity. Both Mr. McDougal and Mr. Conrad seem very committed to the process, and Mr. Tortini felt they would seriously consider any recommendation, including a recommendation to consolidate the two organizations into a single entity.

Mr. Tortini then discussed the two CEOs with the team. Jeff Williams, the CEO of Gorsich General, is the younger and more aggressive of the two. Although the exact origin of the idea of a collaboration study was somewhat unclear, it was Mr. Williams who took the initiative to contact John Tortini, and it was clear that Mr. Williams saw himself as the CEO of the new organization if a consolidation did occur. Mr. Williams is in his middle forties and has been
CEO of Gorsich General for approximately six years. In an earlier phase of his career, he had been on the administrative staff at Holy Family Hospital, and thus had a greater degree of familiarity with the workings of the rival hospital than would ordinarily be the case. Mr. Williams is seen by many at both hospitals as being very bright, but possessing a tendency to change things without considering all of the implications of his decisions.

Bob Grambinski, the CEO of Holy Family Hospital, is nearly the complete opposite of Jeff Williams. Mr. Grambinski is 63 and is planning to retire within the next couple of years. He has been at Holy Family for approximately ten years and is seen as a traditional administrator who views himself as the spokesperson for the hospital and the protector of the employees. He leaves the details of running the hospital to his group of three vice presidents, who are each given a great deal of autonomy. Mr. Grambinski is not felt by the employees or the board members to be a strong innovator, but he is universally liked and respected.

John Tortini then discussed the nature of the relationship between the two CEOs. Because of their very different personalities and management styles, they do not work well together. Mr. Grambinski gets frustrated very quickly with Mr. William's "micro-managing" and does not like to be in long meetings with him. Although Mr. Grambinski has not come right out and said so, he does not seem entirely comfortable with Mr. Williams being the CEO if a consolidation occurs. In fact, while Mr. Grambinski is generally in favor of collaboration, he has expressed reservations about moving too quickly toward that goal. He has suggested it may make sense for the hospitals to spend some time "getting to know each other," in collaborative ventures, before undertaking a consolidation.

Mr. Tortini finished his review by discussing Miranda Maddern, the CEO of Healthcare Services, and the parent organization of Holy Family Hospital. Healthcare Services is a fairly loose affiliation of the local Sisters of Health Care Catholic hospitals in the region, with Ms. Maddern and a few others being the only employees of the corporate office. Ms. Maddern has been CEO of Healthcare Services for only one year, having formerly been one of the founders of a small health care consulting firm. She is a dynamic and, at times, opinionated manager who understands the problems of overcapacity and other issues, and generally looks favorably upon collaborative efforts. She seems to see her role as both ensuring that Holy Hospital actively participates in the process, and positioning Healthcare Services to have some role in whatever entity evolves from the discussions. She will also serve as liaison with the Sisters of Health Care, who will ultimately have to approve any changes at Holy Family Hospital.

Other Issues

After a short break for lunch, John Tortini reconvened the meeting and opened the floor for discussion. Bill Dean began by saying that, while he generally supported a consolidation of the organizations based on the data, he felt the opportunity to be constrained by the physical facilities of each hospital. Gorsich General is the larger of the two hospitals, although it is still slightly too small to accommodate the entire current inpatient and outpatient volumes of both
hospitals. It is also nearly 30 years old and in need of some substantial renovations, including asbestos removal. Unfortunately, renovations alone may not be enough. The floor plan is not particularly efficient and, due to the presence of many hallways and small rooms, the hospital has the feel of a "rabbit warren," as one of the other team members described it.

Holy Family Hospital, on the other hand, was constructed on a new location in the 1970s and has recently added a new emergency room and rehabilitation wing. The facility is in good shape but is significantly too small to accommodate the entire volume of both hospitals. To locate all services on the Holy Family campus would require a major capital campaign involving tens of millions of dollars, which does not seem likely in the near future. While data from other communities would indicate that the greatest savings come from a consolidation onto one campus, this does not seem possible in this situation. And, while the savings from collaborative efforts may be substantial, they will not be as great as those under full consolidation.

Dustin Robb then brought up the likely objections to any recommendation for collaboration or consolidation. First, the independent, more conservative physicians were likely to object on the grounds that any reduction in competition is undesirable. From the physicians' standpoint, many of them have been able to exploit the two hospitals for equipment and other favors, and a consolidation would eliminate this opportunity.

In addition to the independent physicians, some opposition to collaboration would be likely from employees of the two hospitals. While everyone is in favor of reducing health care costs, cost reductions ultimately translate into reductions in jobs and possibly layoffs. There are not many opportunities in Gorsich for other good jobs, so employees concerned about losing their jobs may find it difficult to support collaborative efforts. Finally, Mr. Robb continued, religious issues may surface and create opposition to collaboration. Anti-abortion forces had picketed Gorsich General in the past, and they could create problems throughout the discussions by focusing attention on the abortion and sterilization issues.

John Tortini wrapped up the discussion with a review of the antitrust issues. If the hospitals did decide to collaborate to the point of consolidating operations, the move would require approval from either the Justice Department or the Federal Trade Commission. Both of these organizations have gone on record recently opposing consolidations in situations similar to that in Gorsich. Their position is that consolidations that create monopolies result in higher prices and lower quality than would otherwise be the case. While this is not necessarily the position of many experts with regard to the market for health care services, a consolidation would nonetheless likely involve a fight with the federal antitrust agencies. If very strong community support for a consolidation were forthcoming, then the fight might be won without going to court, but this is considered an unknown at this point.

With the afternoon drawing to a close, and the pros and cons having been presented, Mr. Tortini decided it was time for a decision. He began by going around the room asking each member of the team for a recommendation.
Questions for Discussion

1. What would your recommendation be? Why?

2. If you would recommend a consolidation, how would you recommend the hospitals proceed?

3. How would you propose the consultants communicate their recommendations (e.g., closed meetings versus public meetings, press coverage versus no press coverage)?

4. What strategy should the hospitals and their consultants adopt with regard to potential opposition groups?