

CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY

EXECUTIVE SUMMARY

<p>Applicant: Cottage Health System (“CHS”) Santa Barbara Cottage Hospital (“SBCH”) Pueblo at Bath Streets, Santa Barbara, CA 93105 Santa Barbara County</p> <p>Project Sites: same as above Facility Type: Acute Care Hospital</p>	<p>Amount Requested: \$125,000,000 Requested Loan Term: 30 years Date Requested: October 30, 2003 Resolution Number: F-301</p>																																				
<p>Use of Loan Proceeds: Loan proceeds will be used to finance costs associated with rebuilding the Santa Barbara Cottage Hospital facility including construction, equipment purchases, reimbursement, and land acquisition. In addition, the CHFFA Series 1985 revenue bonds will be refunded.</p>																																					
<p>Type of Issue: Negotiated public offering with fixed and variable rates as well as auction rate notes (ARNs). Credit Enhancement: Anticipated insurance w/FSA or MBIA Expected Credit Rating: AAA/AAA (S & P/Fitch) with insurance or A+/A+ without insurance Senior Underwriter: Morgan Stanley & Co. Incorporated Bond Counsel: O’Melveny & Myers</p>																																					
<p>Financial Overview: CHS is a well-managed, financially stable health system, with strong market share. Management anticipates increased demand for services due to the recent closure of a nearby hospital. The balance sheet is solid reflecting strong liquidity, minimal debt, and sizeable unrestricted net assets. CHS maintains very strong debt service coverage ratios with the pro forma ratio at 2.42x.</p>																																					
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<p>Staff Recommendation: Staff recommends the Authority approve a resolution in an amount not to exceed \$125 million for Cottage Health System subject to a bond rating of at least an “A” category by a nationally recognized rating agency.</p>																																					

STAFF SUMMARY AND RECOMMENDATION

Cottage Health System (“CHS”)

October 30, 2003

Resolution Number: F-301

I. PURPOSE OF FINANCING: CHS seeks funding to finance: construction costs to satisfy California Senate Bill 1953 seismic standards, equipment purchases, reimbursement of prior capital expenditures, and land acquisition costs. In addition, CHS plans to refund outstanding Authority bonds for its Santa Barbara Cottage Hospital (SBCH) facility.

Construction and renovations\$216,000,000

CHS intends to rebuild its SBCH in order to meet new stricter seismic safety standards. In addition, the multi-phase project will consolidate the design and enhance the efficiencies of the hospital built piecemeal throughout its 115-year history.

The rebuilding project involves six to seven years of construction through a phased improvement plan resulting in minimal disruptions to hospital operations. The plan calls for the demolition of approximately 283,000 square feet of the existing main medical facility and adjacent block and new medical facility construction totaling approximately 438,350 square feet. The new facility would include three 100-bed patient pavilions or “cottages”, a diagnostic and treatment wing with rooftop helipad, and a new central services plant. Two new parking structures will be built to accommodate visitors and staff, together with a combined and expanded pre-school and infant-toddler childcare program to replace the two programs that currently exist in the area to be demolished.

SBCH is currently working closely with the City of Santa Barbara on required permits and approvals with an environmental impact study in process. Final approvals for project plans along with contractor selection are anticipated in mid-late 2004. The multi-phase project includes 8 phases and is expected to be completed sometime in 2013.

In June 2002, SBCH Foundation Board approved support for the project with a promised donation of \$100 million. This commitment is consistent with this Foundation’s historical support of approximately 30% of the cost of past SBCH construction projects. The SBCH Foundation Board also committed to undertake a fundraising campaign (currently underway) in support of the project with a target goal of \$50 million.

Equipment82,700,000

Anticipated equipment purchases include equipment for clinical departments, furnishings and building amenities.

Current refund CHFFA Series 1985 bonds20,200,000

CHS plans to current refund its outstanding CHFFA Variable Rate Demand Bonds (Santa Barbara Cottage Hospital), 1985 Series A, B, and C with term bonds maturing in 2005 and 2015. These bonds were originally issued to finance the construction of a co-generation plant, new hospital wings, parking structure and remodeling. The original project has since been completed. The purpose of the refunding is to implement a new master trust indenture, and CHS anticipates that there will be no change in debt service requirements.

Reimbursement.....16,000,000

CHS anticipates reimbursement of approximately \$16 million, which includes land acquisition, planning, legal and architect expenses.

Real Estate (Land) Purchase 2,800,000

CHS is in the process of acquiring two properties (411 W. Pueblo Street and 417 W. Pueblo Street), that are currently in escrow and are located in between properties owned by SBCH. These properties are being purchased for the patient and visitor parking structure that will be built on land covering five parcels, two of which are the new properties.

Financing Cost	<u>27,500,000</u>
Bond Insurance	3,400,000
Underwriter's Discount.....	700,000
Debt Service Reserve.....	18,200,000
Other costs	<u>5,200,000</u>
Total	<u>\$365,200,000</u>

Financing structure:

- Up to 30-year loan term, fully amortized.
- Negotiated public offering.
- Expected Credit Rating: AAA/AAA (S & P/Fitch) - if insured, or A+/A+ if not insured.
- Bond insurance on fixed rate bonds and auction rate notes (anticipated FSA or MBIA).
- Letter of Credit on variable rate demand bonds.

II. FINANCIAL STATEMENTS AND ANALYSIS:

COTTAGE HEALTH SYSTEM

Consolidated Statements of Operations

(Unrestricted)

(in thousands)

	For the Year Ended December 31,			
	Eight months ended	2002	2001	2000
	Aug. 31, 2003 (Unaudited)			
Revenues:				
Net patient service revenue	\$ 167,955	\$ 226,729	\$ 214,834	\$ 194,283
Capitation revenue	-	-	-	4,060
Other operating revenue	3,994	6,334	5,950	4,664
Net assets released from restrictions	-	1,026	264	271
Total revenues	<u>171,949</u>	<u>234,089</u>	<u>221,048</u>	<u>203,278</u>
Expenses:				
Salaries and benefits	85,834	116,694	104,165	96,656
Supplies, services and insurance	57,617	76,302	71,975	66,072
Professional fees	11,647	15,157	13,949	9,859
Provision for bad debt	5,246	5,550	3,991	6,521
Depreciation and amortization	10,410	15,681	15,364	15,825
Interest	428	741	938	1,699
Total Expenses	<u>171,182</u>	<u>230,125</u>	<u>210,382</u>	<u>196,632</u>
Operating income	767	3,964	10,666	6,646
Other than temporary impairment of investments	-	(10,559)	-	-
Investment income	2,801	396	2,432	16,776
Change in net assets of the Foundation	16,668	(23,995)	-	-
(Deficiency) excess of revenues over expenses	<u>20,236</u>	<u>(30,194)</u>	<u>13,098</u>	<u>23,422</u>
Change in net unrealized losses	8,906	(1,138)	(3,288)	(15,400)
Contributions of long-lived assets from affiliates	66	377	198	314
Change in unrealized losses of the Foundation	-	(4,669)	(7,175)	(8,523)
Change in minimum pension liability	-	(16,494)	(303)	-
Cumulative effect of change in accounting principle	-	-	-	233,394
(Decrease) increase in unrestricted net assets	29,208	(52,118)	2,530	233,207
UNRESTRICTED NET ASSETS, BEGINNING OF YEAR	<u>410,414</u>	<u>462,532</u>	<u>\$ 460,002</u>	<u>226,795</u>
UNRESTRICTED NET ASSETS, END OF YEAR	<u>\$ 439,622</u>	<u>\$ 410,414</u>	<u>\$ 462,532</u>	<u>\$ 460,002</u>

COTTAGE HEALTH SYSTEM

(in thousands)

Consolidated Balance Sheets

	As of Aug. 31,	As of December 31,		
	2003 (Unaudited)	2002	2001	2000
Assets				
Cash and Cash Equivalents	\$ 39,210	\$ 55,857	\$ 48,110	\$ 16,784
Short-term investments	31,998	4,793	5,443	6,257
Patient accounts receivable, net	41,885	46,109	49,253	59,256
Current portion of assets limited as to use	1,026	1,006	1,027	750
Other receivables	6,120	999	1,383	1,286
Due from affiliates	4	88	68	28
Inventories	5,938	5,895	5,051	4,559
Prepaid expenses and other	4,134	5,079	2,453	1,747
Total current assets	130,315	119,826	112,788	90,667
Assets limited as to use:				
By board	83,183	74,475	86,023	88,586
Self-insurance trusts	2,906	2,896	4,179	4,984
Total assets limited to as use	86,089	77,371	90,202	93,570
Property, plant and equipment, net	101,870	111,699	109,724	108,339
Properties held for investment	13,412	10,953	3,603	2,934
Other assets	16,670	9,499	12,430	10,668
Interest in net assets of the Foundation	202,575	186,100	222,969	236,126
Total Assets	\$ 550,931	\$ 515,448	\$ 551,716	\$ 542,304
Liabilities and Net Assets				
Current liabilities:				
Accounts payable	\$ 8,695	\$ 9,090	\$ 9,331	\$ 9,067
Accrued expenses and other liabilities	15,010	10,664	9,859	9,743
Accrued self-insurance claims	8,009	7,479	5,063	3,227
Due to third-party payors	6,081	5,243	5,876	4,071
Current maturities of long-term debt and capital lease obligations	1,276	1,384	1,305	1,169
Total current liabilities	39,071	33,860	31,434	27,277
Other liabilities:				
Accrued self-insurance claims, net	7,756	6,381	6,078	5,852
Long-term debt and capital lease obligations, net	22,818	23,056	24,148	23,599
Minimum pension liability	15,850	16,839	1,297	-
Total Liabilities	85,495	80,136	62,957	56,728
Net Assets:				
Unrestricted Net Assets	439,622	410,414	462,532	460,002
Temporarily Restricted Net Assets	20,158	19,242	20,561	19,918
Permanently Restricted Net Assets	5,656	5,656	5,656	5,656
Total Net Assets	465,436	435,312	488,749	485,576
Total Liabilities and Net Assets	\$ 550,931	\$ 515,448	\$ 551,706	\$ 542,304

Financial Ratios:

	Proforma (a) FYE Dec. 2002			
Debt Service Coverage (x)	2.42 (b)	9.97 (b)	12.80 (b)	8.43 (b)
Debt/Unrestricted Net Assets (x)	0.36	0.06	0.06	0.06
Margin (%)		2%	5%	3%
Current Ratio (x)		3.54	3.59	3.32

(a) Recalculates December 2002 audited results to include the impact of this proposed financing.

(b) Based on operating results.

Financial Discussion:

CHS is a well-managed, financially stable health system, with strong market share. Management anticipates increased demand for services due to the recent closure of a nearby hospital.

From 2001 to 2002, net patient service revenue increased \$11.9 million, or 5.5%. These higher revenues are primarily attributed to a 5% price increase, a higher Medicare case mix, an increase of 2% in Medicare reimbursement, a 20% increase in negotiated non-government payer contract reimbursement, a 5% increase in Medi-Cal managed care reimbursement and a 7.5% growth in outpatient visits. However, these increases were partially offset by lower patient days. Government payers typically pay CHS lower amounts than other payers. Government payers comprised 48.5% of gross patient revenues in 2002 versus 46.8% in 2001.

Utilization statistics have remained relatively steady during the review period, while outpatient visits and emergency room visits increased. Currently, CHS has the highest market share at over 80% in its primary service area. Management expects that it will rise in 2003 due to the recent closing of St. Francis Medical Center. This 85-bed hospital, located less than two miles from SBCH, was owned and operated by Catholic Healthcare West. The SBCH Foundation purchased the property on June 30, 2003, with plans to develop it for future workforce housing to accommodate hospital staff.

Total operating expenses increased 9.4%, for 2002 compared to 2001, which included the following:

- Salary and benefit increases of \$12.5 million due to annual salary merit increases and market adjustments as well as higher group health, pension, and workers compensation costs.
- Professional fee increases due to registered nurse contracted labor in 2002.
- Supplies and services expense increases with the largest increases in surgical supplies, drugs, and information technology.
- Provision for uncollectible accounts increased 39% or \$1.6 million in 2002, as management decided to decrease the age of accounts that are written off as uncollectible.

Management at CHS routinely compares performance measures at all three of its hospitals (Santa Barbara Cottage Hospital, Goleta Valley Cottage Hospital, and Santa Ynez Valley Cottage Hospital), against information for ten community hospitals identified as peer hospitals in an annual peer group and local area hospital study. The report benchmarks key financial and operating indicators and helps guide management at the CHS Hospitals in decision-making regarding revenues and expenses by service.

Investment losses were recorded in 2002, including other-than-temporary impairment of investment assets of \$10.6 million. As a result, CHS went from an excess of revenues over expenses of \$13.1 million in 2001 to a deficiency of revenues over expenses of \$30.2 million in 2002.

The balance sheet is solid reflecting strong liquidity, minimal debt, and sizeable unrestricted net assets. CHS maintains very strong debt service coverage ratios with the pro forma ratio at 2.42x .

As indicated by a current ratio of 3.54x, CHS is liquid including \$55.9 million in cash and cash equivalents as well as \$4.8 million in short-term investments.

From 2001 to 2002, properties held for investment increased by \$7.3 million or 204% due to the acquisition of properties required for the building of the replacement facility for SBCH. From 2000 to 2001, accounts receivable decreased \$10 million due to the full implementation of the patient accounts receivable system installed in mid-2000. Furthermore, net days of revenue in patient accounts receivable decreased from 85 days in 2001 to 73 days in 2002 as a result of the improved collection activities.

Total net assets declined from 2001 to 2002, but remain substantial at over \$435 million. The majority of these net assets are unrestricted with over \$410 million in 2002.

CHS manages its operations with very minimal long-term debt. Existing debt includes primarily the CHFFA Series 1985 bonds, which will be refunded with this proposed financing. The pro forma debt-to-unrestricted net assets ratio remains low at .36x. Historically, debt service coverage has been strong averaging over 10x during the review period. The pro forma debt service coverage remains very good at 2.42x. CHS should be able to comfortably manage the new debt service payments.

III. UTILIZATION STATISTICS:

Cottage Health System

	Year Ending December 31,		
	2002	2001	2000
Licensed Beds	580	580	580
Available Beds	444	444	444
Discharges	19,759	20,104	19,784
Patient Days	92,629	94,790	97,408
Average Length of Stay	4.7	4.7	4.9
Average Occupancy Percentage based on Available Beds	57.2%	58.5%	60.1%
Emergency Room Visits	52,329	49,285	44,283
Outpatient Visits	213,612	199,954	198,931

IV. ORGANIZATION:

Background: Cottage Health System (CHS) was organized in 1996 as a not-for-profit California corporation to provide health care services through three acute care hospitals and related organizations in Santa Barbara, CA. CHS is affiliated with the following tax-exempt entities, each of which shares a common Board of Directors:

- **Santa Barbara Cottage Hospital (SBCH)** is a 436-bed acute-care teaching hospital and trauma center, the largest of its kind between Los Angeles and the San Francisco Bay Area. Founded in 1888 by 50 women determined to provide a healthcare facility for the growing community of Santa Barbara, it had annual discharges of 18,000 patients, 32,000 emergency department visits and 2,300 births in 2002.

SBCH is renowned for its comprehensive maternal-child and pediatric services, cardiac, neuro-surgical, and oncology programs, emergency and trauma services, modern operating rooms, advanced diagnostic radiology equipment, outpatient surgery, eye center and psychiatric and chemical dependency services. SBCH serves as a regional healthcare provider offering neonatal and pediatric intensive care, cardiac surgery, level II trauma services and a dedicated oncology unit.

As a teaching and research institution, SBCH sponsors residency programs in internal medicine (affiliated with the University of Southern California), general surgery and radiology, and provides education departments for its medical and nursing staffs. As of September 1, 2003, there are 25 internal medicine residents, 13 general surgery residents and 8 radiology residents. Approximately 157 physicians voluntarily participate in the training and education of these residents. More than 500 physicians make up the medical staff, including specialists in all major clinical areas.

In addition, SBCH offers a full range of health and wellness opportunities for the community, including smoking cessation and cardiopulmonary resuscitation classes, a weekly television program on health issues, annual flu shots and a regular series of low-cost health screenings.

- **Goleta Valley Cottage Hospital (GVCH)**, located seven miles west of SBCH, is a 122-bed acute-care facility, founded in 1966 to serve the growing community of Goleta Valley. The hospital affiliated with SBCH in 1996, and in 2002 discharged 1,400 inpatients, saw 14,000 emergency department visits and welcomed 300 newborns to its birthing center. Recognized for its comprehensive Breast Care Center, the hospital also operates a 30-bed sub-acute unit, an occupational health center and the Santa Barbara County's only hospital-based heliport.
- **Santa Ynez Valley Cottage Hospital (SYVCH)** has offered acute-care services to the residents and visitors of Santa Ynez Valley since 1964. The 22-bed acute-care hospital affiliated with SBCH in 1995, and today continues to provide inpatient and outpatient surgery and 24-hour emergency services. In addition to its 323 annual discharges for 2002, busy outpatient diagnostic programs and an active emergency department, provide important services to this rural community. SYVCH is located 35 miles from SBCH.
- **Goleta Valley Professional Building** – a medical office building adjacent to Goleta Valley Cottage Hospital. The Professional Building leases office space to medical providers and others.
- **Santa Barbara Cottage Hospital Foundation (the Foundation)** – a charitable foundation which solicits funds for the benefit of SBCH. The Foundation is not a member of the obligated group.

CHS is the sole corporate member of the above entities except the Foundation. CHS is also affiliated with the following non-profit entities, which are governed by separate Boards of Directors:

- **Santa Ynez Valley Hospital Foundation (Santa Ynez Foundation)**
- **Goleta Valley Community Hospital Foundation (Goleta Valley Foundation)**

CHS was established when the three hospitals and the Professional Building entered into affiliation agreements during 1995 and 1996 to form an integrated health care delivery system that provides coordination of patient care services and to reduce duplication of resources, increase efficiencies and decrease costs. The Foundation, Santa Ynez Foundation and Goleta Valley Foundation are parties to the agreements only for the purposes of providing financial support to the three hospitals. The affiliation agreement with SYVCH has an initial term of three years and renews automatically for additional three-year terms unless terminated at the sole discretion of SBCH.

Governance: CHS and the Obligated Group Members are each guided by a volunteer board of directors from the greater Santa Barbara community. The mission of CHS and each Obligated Group Member lies in providing the highest standard of healthcare services to its community through a commitment to continuous improvements in quality, safety, patient satisfaction, health education, research, efficiency and community health.

Members of the board are nominated by existing CHS board members to 1, 2, and 3-year terms, and are approved by the membership. No member can serve more than 3 consecutive 3-year terms.

CHS is the sole corporate member of SBCH, GVCH and Goleta Valley Professional Buildings, Inc. SBCH is the sole corporate member of SYVCH. SBCH is the sole beneficiary of SBCH Foundation. The Boards of Trustees of SBCH, GVCH, SYVCH, Goleta Valley Professional Buildings, Inc. and SBCH Foundation are composed of the same individuals that compose the CHS Board. This overlapping board composition is not required under the bylaws of the individual organizations.

Licenses: The CHS Hospitals are licensed by the State of California Department of Health Services as general acute care hospitals. In October 2000, each of the CHS Hospitals received a full three-year accreditation from the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). The next site visits from JCAHO are scheduled in late October, 2003.

Competition: Competition for outpatient service providers in the south coast of Santa Barbara County include two ambulatory surgical centers, diagnostic imaging services and clinical laboratory services. While there are no competitor inpatient acute-care facilities in the CHS Hospitals' primary service area, there are two inpatient acute-care facilities in the Hospitals' secondary service area in northern Santa Barbara County. They are Catholic Healthcare West-owned Marian Medical Center in Santa Maria and Lompoc District Hospital in Lompoc. Based on the most recent discharge information (2001), the hospitals serving patients from the CHS Hospitals' primary service area are as follows:

Hospital	Location	Licensed Acute Care Beds	Discharges	Percentage of Market Share
CHS Hospitals	Santa Barbara	580	13,442	80.1%
* St. Francis Medical Center	Santa Barbara	85	2,126	12.7%
Other, out of area		N/A	<u>1,184</u>	<u>7.2%</u>
Total discharges in CHS primary service area			16,752	100%

* Catholic Healthcare West closed this hospital June 30, 2003.

V. SECTION 15438.5 OF THE ACT (Savings Pass Through):

It is the intent of the Legislature in enacting this part to provide financing only to health facilities that can demonstrate the financial feasibility of their projects. It is further the intent of the Legislature that all or part of any savings experienced by a participating health institution, as a result of that tax-exempt revenue bond funding, be passed on to the consuming public through lower charges or containment of the rate of increase in hospital rates.

CHS has provided a description of its savings pass through in Attachment A.

VI. SECTION 15459.1 OF THE ACT (Community Service Requirement):

As a condition of the issuance of revenue bonds, whether by the Authority or any local agency, each borrower shall give reasonable assurance to the Authority that the services of the health facility will be made available to all persons residing or employed in the area served by the facility.

As part of this assurance, borrowers shall agree to a number of actions, including (a) To advise each person seeking services at the borrower's facility as to the person's potential eligibility for Medi-Cal and Medicare benefits or benefits from other governmental third-party payers, (b) To make available to the authority and to any interested person a list of physicians with staff privileges at the borrower's facility, and (c) To post notices in appropriate areas within the facility regarding services being available to all in the service area. This agreement is a standard "Certification and Agreement Regarding Community Service Obligation".

CHS has executed this certificate, included as Attachment B and submitted its current list of physicians, specialties, languages spoken, telephone numbers and whether Medi-Cal and Medicare patients are accepted.

VII. COMPLIANCE WITH SEISMIC REGULATIONS:

SB 1953 (Chapter 740, 1994) requires that all acute care hospitals in California meet specific seismic safety standards by 2008 and 2030.

CHS has provided a description of its seismic requirements. See Attachment C. A major portion of this financing will be used to satisfy seismic requirements.

VIII. OUTSTANDING DEBT:

<u>Description</u>	<u>Original Amount</u>	<u>Amount Outstanding As of 12/31/02 (a)</u>	<u>Estimated Amount Outstanding After Proposed Financing</u>
Existing Authority Debt:			
CHFFA Variable Rate Demand Revenue Bonds, Series 1985	\$30,000,000	\$21,100,000	\$0
Other Debt:			
Various notes payable (through Oct. 2011)		2,624,323	2,624,323
Proposed:			
CHFFA, Bonds 2003 – Series A,B, and C		N/A	125,000,000
TOTAL DEBT		<u>\$23,724,323</u>	<u>\$127,624,323</u>

(a) Includes current portion

IX. LEGAL REVIEW:

Staff has reviewed the Applicant’s responses to the questions contained in the Legal Status portion of the Application. No information was disclosed to question the financial viability or legal integrity of this applicant.

X. STAFF RECOMMENDATION:

Staff recommends the Authority approve a resolution in an amount not to exceed \$125 million for Cottage Health System subject to a bond rating of at least an “A” category rating by a nationally recognized rating agency.