ADDENDUM TO THE
MUNICIPAL SERVICE REVIEW
AND SPHERE OF INFLUENCE STUDY
For the
PALM DRIVE HEALTH CARE DISTRICT
May 2019

SONOMA LOCAL AGENCY FORMATION COMMISSION

INTRODUCTION

Scope of Addendum Report

In October of 2016, the Sonoma Local Agency Formation Commission ("LAFCO"), adopted a Municipal Service Review and Sphere of Influence Study ("MSR" or "study") for the Palm Drive Health Care District ("PDHCD" or "District").

The study included a set of determinations regarding the condition of the District in the seven categories that, according to State law, must be evaluated in an MSR.

The MSR did not recommend amending the Sphere of Influence of the District. After the Commission determined that Russian River-area communities should be granted detachment from the District in early 2017, the Commission did reduce the District's sphere to remove the detached area.

The Commission has received an application, filed by petition, from residents seeking detachment of the Bodega Bay community from PDHCD.

In order to consider the merits of the proposal, LAFCO staff has prepared this addendum to the MSR, making further or otherwise updated determinations reflecting current conditions of the District. Because this is an addendum to the original report, not all factors required in an MSR are covered in this addendum.

In particular, the addendum addresses the following factors:

1. Capacity and Adequacy of Public Facilities and Services
2. Financial Ability to Provide Services
3. Accountability, Structure, and Efficiencies

This addendum also provides updated background information regarding the District, reflecting developments that have occurred since 2016.

DISTRICT PROFILE – UPDATES

HISTORY SINCE FORMATION – ADDENDA

Detachment of Russian River-area Communities

In 2016, LAFCO approved a proposal to detach Russian River-area communities from the District. These communities were defined as the territory located within the boundaries of the Forestville Union School District, Guerneville School District, and Monte Rio Union School District.

Subsequent to the detachment, District representatives met with the applicants and the Sonoma County Tax Collector, and agreed to a plan to continue collecting the voter-approved parcel tax levy of $155 per parcel in the detached areas.

Because residents in those areas are only responsible for payments directed towards debt that was incurred while they were a part of the District, collections in excess of those debt payments are being sequestered in the equivalent of an escrow account to pay debt obligations related to the District's current bankruptcy.

In simpler terms, rather than collecting a reduced parcel tax levy from detachment area landowners that would cover known, existing debt obligations, the District is collecting the entire authorized parcel tax, reserving "excess" payments that will be applied on the detached landowners' behalf against unknown existing debt obligations – the District's bankruptcy obligations.

Resolution of Bankruptcy

The District has filed a payment plan in bankruptcy court that will be presented to the creditor committees for consideration. If the plan is approved by the creditor committees and the court, the District will be obligated to pay on the order of $7 million to resolve the bankruptcy.

Previously, the District indicated that they would make payments to creditors of approximately $1 million annually for a multi-year period to settle claims. The District has accumulated about $1.1 million in reserves intended for bankruptcy settlement payments.

Closure of Sonoma West Medical Center

In October of 2018, the Sonoma West Medical Center, unable to meet financial commitments due to insufficient revenue, closed the hospital facility and filed for bankruptcy protection.

The MSR raised the concern that the District may not be suitably "insulated" from SWMC liabilities. Although there hasn't apparently been a broad challenge, the ownership of equipment at the hospital has come in to question by the SWMC bankruptcy trustee. The equipment could be declared an asset of SWMC rather than of PDHCD, and sold to repay SWMC creditors.

Facility Reopened as Sonoma Specialty Healthcare

The District entered into an agreement in October 2018 with the American Advanced Management Group ("AAMG") to take over operations of the District's facility, offering primarily long-term acute care services. AAMG has opened an urgent care center and may also operate an operating theater; however there are no plans to re-establish the facility as a hospital with emergency room capabilities.

The contract with AAMG included provision of $100,000 per month payments from PDHCD for management services; AAMG will book these payments as a debt obligation on behalf of the District. The District is also liable for any financial losses accrued by AAMG until such time as the facility is leased or sold to the management group. AAMG was granted the exclusive right to lease or purchase the facility.

District Secures Approval for Sale/Lease of Facility

In March 2019 the District sought and received voter support for the sale of the facility to AAMG, and election returns indicated broad support (over 75% of voters approved). The lease/purchase agreement with AAMG values the facility at between $5 and $6 million, less accrued management fees and financial loss coverage.

Under a lease, AAMG is expected to pay the District $275,000 annually; lease payments would end when and if AAMG exercised its right to purchase the facility. (The lease payments, per the agreement, will be used to fund facility maintenance and will therefore not accrue to the District.)

AAMG exercised their option to lease the facility in March 2019.

The District has authorized their bond counsel to seek refinancing of debt, with a target for completion of the end of May 2019.

DISTRICT BOUNDARIES

Subsequent to the detachment of Russian River-area communities, the District now serves the communities of Sebastopol, Graton, Bodega Bay, Carmet, Occidental, Freestone, and Bodega. A current map of District territory is shown in Figure 1.

AFFECTED AGENCIES

The Coastal Valleys EMS agency and the Sonoma County Fire District are additional Affected Agencies for this Addendum report.

These agencies are no longer Affected Agencies per Government Code Section 56014:

- Cazadero Community Services District
- Forestville Fire Protection District
- Monte Rio Fire Protection District
- Rincon Valley Fire Protection District (Dissolved and Annexed to Sonoma County Fire District)
- Russian River Fire Protection District
- Forestville Water District

MUNICIPAL SERVICE REVIEW FACTORS

State law requires LAFCOs to review and make determinations related to seven factors as part of a Municipal Service Review. For this Addendum, updates and/or new determinations have been made for three of the seven factors.

CAPACITY AND ADEQUACY OF PUBLIC FACILITIES AND SERVICES

Determinations

- The District's facility, now managed by the American Advanced Management Group, no longer provides emergency medical care services. While the District maintains that approximately ninety percent of former emergency room visits can be accommodated by AAMG's urgent care clinic, the clinic is not available 24-hours a day, and first responder agencies cannot deliver patients to an urgent care clinic.
- After the lease/sale of the facility, the District intends to continue operation, primarily to administer debt service, but also to provide community health services in West County.

Discussion

PDHCD was formed in 2000 with the intent of providing emergency care, acute care, and other medical services. With the cessation of emergency room services, the AAMG-managed facility will meet two of those criteria.

The District has leased the facility to AAMG; AAMG also has an exclusive right to purchase the facility. Upon the execution of the lease, the District will no longer provide subsidies (in the form of financial loss coverage and management fees) to AAMG.

The District is evidently planning to repurpose itself as a provider of public health services, funding community services, likely through grants to community organizations.

It has always been unclear whether the formation effort considered that all three areas of services must be provided by the District, or whether the District could focus more narrowly on one or two of the service categories.

Further, "other medical services" is a broad designation that certainly could include provision of community health services but also other activities. The MSR noted that the District could consider supporting urgent care clinics, community health clinics, and subsidies for first responder agencies within the broad category of "other medical services".

In October 2018, the Commission considered a broad array of options for potential reorganization of the District. Included in the discussion was whether it would be appropriate for the District to seek amendment of its "powers" (essentially proposing a new plan for services). The staff report that was provided to the Commission for that discussion is included as Attachment 1.

The District, the County, citizens within the District, and the Commission have the authority to seek a reorganization of the District, including authorizing a new service model, seeking detachments of territory from the District, joining the District to another Health Care District in the County, or dissolving the District and naming a successor agency to wind up District affairs.

FINANCIAL ABILITY TO PROVIDE SERVICES

Determinations

- The District has accumulated debt to AAMG in the form of accrued management fees and accrued AAMG losses. The District has accrued about $2.4 million in debt to AAMG.
- There appears to be a lack of clarity regarding whether an appropriate appraisal of the facility has been made. The District must, by law, seek a fair value for the sale of District facilities, based on an independent valuation, and should endeavor to fully meet this standard.
- The eventual sale of the facility to AAMG will likely result in less than $5 million in proceeds to the District. The District has indicated that these proceeds would be used to pay off or pay down existing debt obligations. The proceeds may be significantly reduced if the District uses a portion of them to pay accrued AAMG management fees or accrued AAMG financial losses.
- The District has reserves allocated to bankruptcy settlement payments the order of $1.1 million. Based on previous plans, the District might allocate about $1 million annually to bankruptcy settlement payments, for a multi-year period.
- The District's costs for securing legal, financial, and other services related to negotiating an agreement with AAMG, refinancing debt, bankruptcy proceedings, and other matters, represent a significant portion of District operating costs. These costs, and the costs of operating the District, are disproportionate to the amount of funds that could be used for community health programs. Near-term budget projections indicate that approximately three-quarters of District revenue not devoted to debt repayment will be devoted to "overhead" activities rather than funding health programs.

Discussion

Palm Drive Health Care District continues to address a complicated and intertwined set of transactions, including:

- Refinancing of Debt: District debt was issued in the form of non-taxable bonds, reflective of its former status as an agency directly operating a health care facility. With the transition to a facility managed by a contractor (first SWMC, and now AAMG), the bonds must be refinanced as taxable. Additionally, the District believes that it can secure what are historically low financing rates under current market conditions.

- Lease/Sale of the Facility: The District has secured voter approval to sell the facility, and has executed a lease of the facility to AAMG.
- District Bankruptcy: The District has filed a settlement proposal with the court and it is being sent to creditor committees for consideration.
- SWMC Bankruptcy: Although this is nominally a peripheral issue, the District may be drawn into the SWMC bankruptcy case if creditors or the court assert that the District's relationship with SWMC extended responsibility for debts from SWMC to the District.
- Transition to a New Service Model: The District has indicated that once it fully exits from providing emergency and acute medical care, including the sale of the hospital facility, it will shift to a service model of providing community health programs.

The District has indicated that it intends to use facility sale proceeds to pay off or pay down existing bond debt, although it is seeking bond restructuring prior to the sale of the facility. If the sale proceeds were devoted to bankruptcy creditor payments, the funds would represent perhaps a third of those liabilities.

There are two "escrow" accounts that the District has established that represent reserves held for bankruptcy settlement payments: one represents accruals from parcel tax payments made by landowners in the detached Russian River-area communities, the other is funded by remaining property owners in the District.

These reserves are on the order of $1.1 million, thereby representing perhaps 15% of anticipated bankruptcy creditor payments.

The District previously indicated that it would make bankruptcy settlement payments of about $1 million annually. Conceivably, the District could incur additional debt, separately or as part of the restructuring of existing debt, in order to fund these liabilities.

Key Determinants for Financial Outlook

There are three factors that will significantly affect the near- and long-term financial outlook for the District:

- The results of refinancing of existing debt: This includes whether debt can be restructured at higher or lower interest rates, longer maturities, and crucially, higher or lower annual payments.
- Resolution of bankruptcy: This includes whether the payment plan proposed by the District is accepted by creditor committees and the court, and how the District will structure payments and secure funding to pay the settlements.

- The sale of the facility to AAMG. Sale of the facility will result in some one-time income that can be devoted to a variety of purposes, including debt or bankruptcy settlement payments.

District Operational Outlook

The District has total revenues of about $4.2 million annually. Of this, about half is devoted to bond debt, and a portion of the tax received from the Russian River area is diverted to the aforementioned bankruptcy settlement “escrow” account.

If the District hews to previous plans, it will devote approximately $1 million per year, or almost one quarter of revenue, to pay bankruptcy settlement payments for a period of around a half-dozen years.

The District therefore has annual revenue for the near term of around $1 million that it can devote to administrative costs, contracted service costs, additional payments on existing debt, diversion to reserves for payment of bankruptcy debt, facility maintenance costs, and/or service program costs.

Direct District operational costs, which primarily constitute staff salaries and other office-related costs, are on the order of $250,000 annually.

Contracted service costs, including legal counsel, bond counsel, and bankruptcy counsel, are on the order of $500,000 per year. These costs should go down significantly after the sale of the facility is executed, bonds are refinanced, and the bankruptcy resolved.

It is unclear whether debt refinancing will result in lower costs for the District. Taxable bond financing has inherently higher interest rates that non-taxable bonds; bonds can be often be restructured at lower rates if the term is extended; prevailing market interest rates may be higher or lower than the original rates.

Prior to the sale of the facility, the refinancing of debt, and the resolution of the bankruptcy, the District has on the order of $250,000 of unallocated funding, after about $750,000 is allocated to operational and contracted services.

Although the District is likely to reduce operational and contracted service costs in time, and may see additional revenue from reduced debt service costs, the ratio of “overhead” costs to funding available for service provision is likely to remain alarmingly high for the next half-dozen years.

District leadership and constituents might carefully consider whether these circumstances represent the best interests of the community going forward.

ACCOUNTABILITY, STRUCTURE AND EFFICIENCIES

Determinations

- The District has not been providing minutes for meetings held this year, and should immediately rectify this situation.
- District directors and staff continue to be challenged by a thicket of transition activities, necessitating aggressive meeting schedules and agendas. There are continued reports from the public that transparency, reporting, and opportunities for engagement are not as forthcoming as they would hope.

Discussion

The District has not posted or otherwise distributed minutes of board and committee meetings in 2019. The District Secretary has acknowledged this in open session and is working to move the draft minutes through the review process and to the Board for consideration and approval.

The District continues to hold numerous monthly meetings of the board and board subcommittees to address transition issues, and to hold a series of public “town hall” meetings. These circumstances make it difficult for members of the public to engage with the District’s leadership. District staff and the board should be encouraged, despite the challenging workload, to continue to strive to provide suitable opportunities for engagement with the public.