Approved by the Regents
July 21, 2006

THE UNIVERSITY OF MICHIGAN
REGENTS COMMUNICATION

REQUEST FOR ACTION

<u>SUBJECT</u>: Michigan Health Corporation (MHC) Annual Business Plan

<u>ACTION REQUESTED</u>: Approve the MHC FY2007 Annual Business Plan and Budget

<u>BUSINESS PLAN</u>:

The Bylaws of MHC provide that MHC will annually submit a business plan to the Board of Regents for approval. MHC submitted its last business plan to the Board of Regents in July 2005. Since that time, MHC has focused on the operations of its existing subsidiaries.

In September 1996, the Regents approved the initial business plan and capitalization for MHC in the amount of $30 million. As of June 30, 2006, MHC has committed $21.8 million to existing projects. MHC will begin its eleventh year of operations in fiscal year 2007 and is budgeting net patient revenues of $22 million.

At the June Board meetings, the Board of MHC and the Sole Member Representative unanimously approved the FY2007 Business Plan for submission to the Board of Regents.

<u>APPROVAL REQUESTED</u>:

The Board of MHC recommends that the Board of Regents approve the MHC FY2007 Annual Business Plan and Budget.

Robert P. Kelch, M.D.
Executive Vice President for Medical Affairs
Chair, Chief Executive Officer & Sole Member Representative, MHC

July 2006

MICHIGAN HEALTH CORPORATION
FISCAL YEAR 2007 ANNUAL BUSINESS PLAN

June 2006

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I. MHC OVERVIEW

A. Introduction

The Fiscal Year 2007 (FY2007) Business Plan for Michigan Health Corporation (MHC) provides an overview of the direction for MHC and its subsidiary organizations, as MHC begins its eleventh year of operation.

The subsidiary organizations are grouped as to whether they are consolidated or unconsolidated on MHC's financial statements. Consolidated subsidiaries are organizations in which MHC maintains greater than fifty percent ownership. Unconsolidated subsidiaries are organizations in which MHC maintains ownership of fifty percent or less.

An overview of MHC, an operational and financial assessment, and the MHC Fiscal Year 2007 Budget are included in this business plan. In the Operational and Financial Assessment section, information is provided regarding capital allocation, management of MHC, future subsidiaries and capitalization, and subsidiary financial performance reviews. The MHC Fiscal Year 2007 Budget section highlights elements of the FY2007 budget and is followed by the FY2007 budget statements.

B. Structure and Governance

MHC is a non-profit, non-stock membership corporation solely owned and operated by the University. MHC, the University of Michigan Medical School (UMMS), the University of Michigan Hospitals and Health Centers (HHC), and M-CARE comprise the University of Michigan Health System (UMHS). The Executive Vice President for Medical Affairs is the Member Representative of MHC.

The MHC Board meets on a quarterly basis or as necessary to conduct business. The Board of Directors are: Robert Kelch, M.D., Executive Vice President for Medical Affairs (Chair and Chief Executive Officer); Douglas Strong, Interim Executive Director of the Hospitals and Health Centers (Vice Chair and Chief Operating Officer); Timothy Slottow, Chief Financial Officer of the University (Treasurer); John Billi, M.D., Associate Dean for Clinical Affairs of the Medical School and Associate Vice President for Medical Affairs (Secretary); and Glenna Schweitzer, Assistant Provost and Director of the Office of Budget and Planning of the University.

All proposed activities that are presented to the MHC Board for approval are first reviewed and endorsed by the MHC Management Committee. The Committee is chaired by Douglas Strong, the Interim Chief Operating Officer of MHC. Members of the Committee include an Associate Professor of Internal Medicine from the Medical School, the Interim Chief Financial Officer of the HHC, the Administrative Director for MHC and representatives from the University Tax Office and the Office of General Counsel. The performance of each MHC subsidiary organization is reviewed annually by the MHC Management Committee. In this process, the initial goals of each subsidiary and its overall performance are reviewed, and goals for the coming year are assessed.

MHC staff monitor the activities of the ventures on an ongoing basis. Financial statements from the ventures are reviewed monthly and various activities are tracked, including trend analyses. The

MHC Administrative Director also attends board meetings for most of the subsidiary companies; actively participates in finance and operations committees; and interfaces regularly with venture representatives to assist with problem solving and assuring that venture and MHC needs are being met.

C. Fiscal Year 2006 and 2007 Activities

During this past year, the MHC administrative staff focused on operational and financial reviews of the subsidiaries' performance; examined financial and cash flow relationships between MHC and UMHS and between MHC and its subsidiaries; and completed an MHC return on investment analysis. As a result of this focus and the needs of the subsidiaries, MHC accomplished the following during fiscal year 2006 (FY2006):

1. Invested $667,000 in Central Michigan Community Hospital Radiation Oncology (CMCHRO) which initiated operations in September 2005;

2. Earned an estimated $343,600 from Great Lakes Lithotripsy, LLC;

3. Received cash distributions of $405,000 from PMHC Cancer Center (PMHC) and $100,000 from North Eastern Michigan Cancer Center (NEMCC) and equity transfers of $600,000 from Michigan Health Management Corporation (MHMC);

4. Returned more funds to HHC than transferred from HHC and established the first loan agreement with a Medical School Department to fund a venture;

5. Completed a MHC return on investment analysis demonstrating positive returns to the Health System in the areas of increased research funding, net income on professional revenue associated with the ventures and increased throughput and downstream net income for the HHC totaling over $3 million;

6. Assisted with transition efforts to terminate the Kids Care contract with the State, including a procedures audit with PricewaterhouseCoopers, LLC, and transitioned accounting and corporate functions for Kids Care to MHC;

7. Worked closely with Renal Research Institute, LLC (RRI) and Michigan Dialysis Services, LLC (MDS) leadership to develop and monitor financial and operational performance of the venture;

8. Initiated Partnership Health close out process with termination of contract with Ford;

9. Worked with Michigan Visiting Nurse Corporation (MVNC) on various financial challenges and transitioned to a new controller for MVNC;

10. Completed the year with no management letter comments from the external auditors;

11. Participated in a review of MHC by the University of Michigan Health System Planning for MHC Task Group;

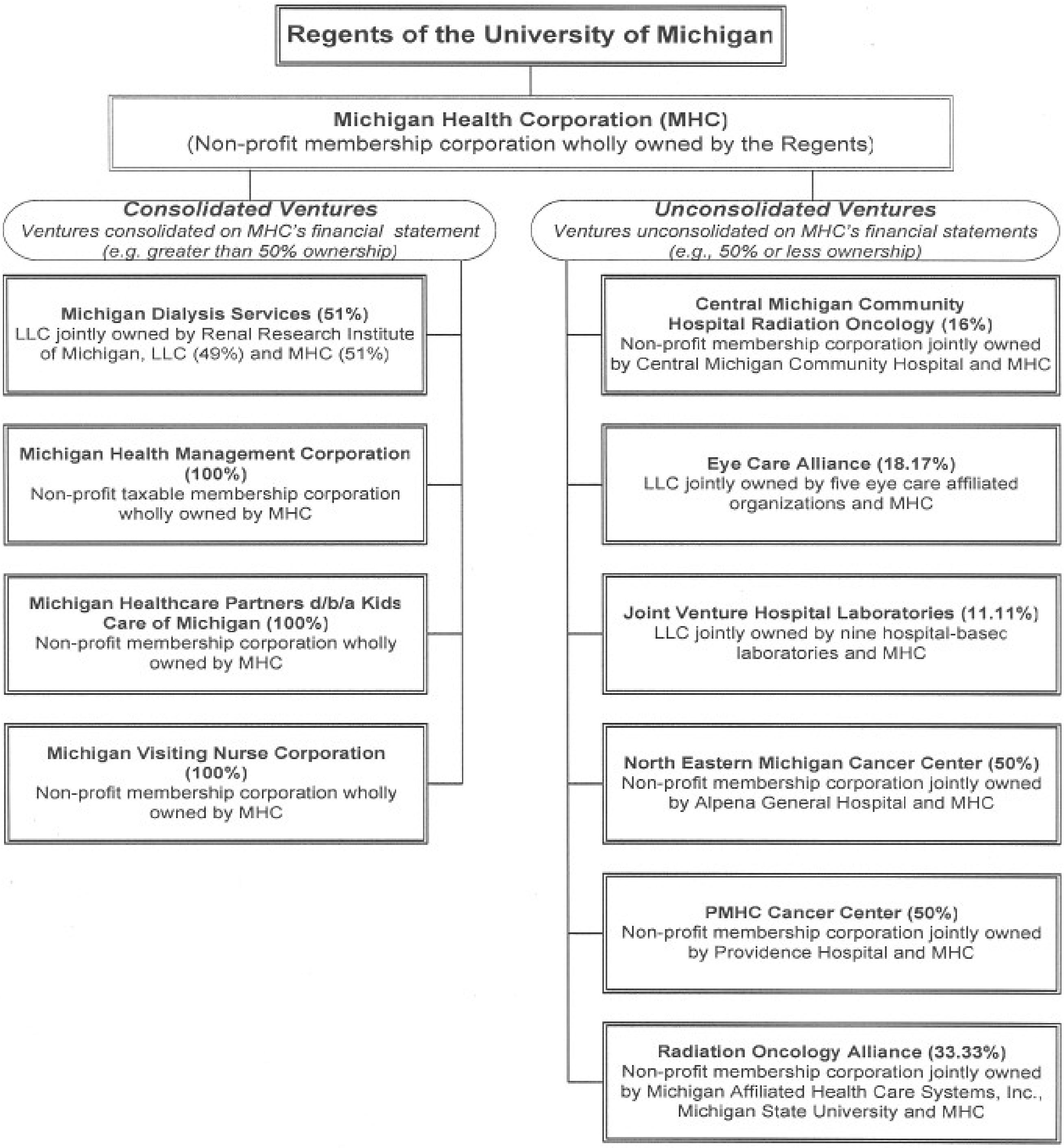
12. Made several presentations to the Regents Finance, Audit and Investment Committee.

For FY2007, MHC administrative staff will focus on the following activities:

1. Work with project representatives to improve the operational efficiency of the subsidiaries;
2. Evaluate potential for new projects relating to the advances in technology and new projects resulting from changes in the UMHS and health care environment in general;
3. Provide any follow-up necessary with internal and external units to close-out MHMC;
4. Develop a course of action for the future of Michigan Healthcare Partners, d/b/a Kids Care of Michigan;
5. Continue to work closely with MDS and RRI leadership to improve the financial reporting, operations and viability of MDS;
6. Work with MVNC to meet FY2007 Budget;
7. Determine status of Eye Care Alliance (ECA);
8. Work with project representatives to develop specific financial goals for each venture;
9. Work with the project representatives to reach individual venture and overall target margins for MHC in support of MHC's financial viability;
10. Establish routine for CMCHRO corporate activities;
11. Implement new University system changes in Human Resources and Financial Operations;
12. Renew the master loan agreement with HHC;
13. Review and implement UMHS Planning for MHC Task Group recommendations;
14. Provide follow-up information to the Regents Finance, Audit and Investment Committee.

D. MHC Subsidiary Organizations

As MHC completes its tenth year of operation, the MHC Board has approved a total of seventeen (17) subsidiary organizations since its activation in 1996. Seven subsidiaries, or proposed subsidiaries, have been terminated and ten subsidiaries are operational. The following chart shows each of the current subsidiary organizations under MHC. The subsidiaries are grouped as to whether they are consolidated or unconsolidated on MHC's financial statements. Consolidated subsidiaries are organizations where MHC maintains greater than a fifty percent ownership.



II. OPERATIONAL & FINANCIAL ASSESSMENT

A. Capital Allocation

Capitalization for MHC is provided predominantly by a loan under the Loan Agreement with the HHC or equity transfers from HHC and the clinical departments of the Medical School. Decisions to provide capitalization to MHC subsidiary organizations through a loan or through an equity transfer from the MHC are made based on an evaluation of the needs of the system as a whole. This evaluation includes the prospects for a return on investment to MHC as well as to the Hospitals and Health Centers and/or the Faculty Group Practice of the Medical School.

As of June 30, 2006, $21.8 million of the initial capitalization has been committed to MHC and its subsidiaries, of which $19.9 million has been invested (See Table 1 below).

Table 1. MHC Capital Allocation for Board Approved Subsidiaries

	MHC Approved Commitment	Net Changes	MHC Approved Commitment	MHC Investment	Net Changes	MHC Investment
	6/30/05		6/30/06	6/30/05		6/30/06
MHC Current Subsidiaries						
Central Michigan Community Hospital Radiation Oncology	$1,000,000	$0	$1,000,000	$0	$667,000	$667,000
Eye Care Alliance	$314,800	$19,000	$333,800	$285,800	$24,000	$309,800
Joint Venture Hospital Laboratories	$15,000		$15,000	$15,000		$15,000
Michigan Dialysis Services	$4,389,743		$4,389,743	$3,046,381		$3,046,381
Michigan Health Management Corporation	$1,550,000	($950,000)	$600,000	$1,200,000	($600,000)	$600,000
Michigan Visiting Nurse Corporation	$219,569		$219,569	$219,569		$219,569
North Eastern Michigan Cancer Center	$2,170,127	($100,000)	$2,070,127	$2,170,127	($100,000)	$2,070,127
PMHC Cancer Center	$7,602,685	($1,105,000)	$6,497,685	$6,902,685	($405,000)	$6,497,685
Radiation Oncology Alliance	$50,000		$50,000	$50,000		$50,000
Subtotal	**$17,311,924**	**($2,136,000)**	**$15,175,924**	**$13,889,562**	**($414,000)**	**$13,475,562**
Closed and Non-Active Ventures	$177,789		$177,789	$110,224		$110,224
MHC Administrative Operations*	$5,661,704	$800,000	$6,461,704	$5,567,825	$785,000	$6,352,825
Totals	**$23,151,417**	**($1,336,000)**	**$21,815,417**	**$19,567,611**	**$371,000**	**$19,938,611**

* Includes a $210,000 investment in mobile Lithotripsy.

B. Management

The operation and management of MHC is provided through a Management Agreement with the University. As a result, the business, administrative and management services are provided by employees of UMHS. MHC has 2.90 full time equivalents dedicated to the operations, management and financial reporting of MHC.

PricewaterhouseCoopers, LLP, MHC's auditors, performed an independent audit of MHC's activities for the fiscal year ending June 30, 2005, and issued an unqualified opinion.

C. Future Capitalization and Development

The sole member representative of MHC, together with the Board of MHC, will allocate any additional capitalization for MHC for development of new MHC projects and subsidiary organizations up to the initially approved capitalization of $30,000,000. The initial approval in September 1996 made financing available through a combination of equity transfers and loan agreements between MHC and the Regents. The HHC was identified as the primary source of financing. Future capitalization for MHC is considered as part of the UMHS capital planning and allocation process.

The Board of MHC will continue to meet as necessary to review the status of its current subsidiaries and develop and approve new projects, based on the needs of UMHS and the changing health care environment. MHC will also continue to perform the necessary legal and financial due diligence for every new project it considers. All projects approved by MHC will remain consistent with and supportive of the University's missions and the purpose and intent of MHC. Future projects that MHC participates in during the term of this business plan will be reported to the Board of Regents as necessary.

D. MHC Fiscal Year 2006 Financial Performance

Most MHC subsidiaries are past their development and start-up stages and are now ongoing operations. The exception to this is CMCHRO, which began operations in September 2005. In this next year, MHC will continue to focus on operational and financial performance reviews and address what management and funding actions to take if subsidiaries do not meet their activity and financial goals.

Although MHC operates with a July 1 to June 30 fiscal year, many of MHC's subsidiaries operate with a different fiscal year. This creates timing difficulties in developing and reporting budgets and projections to MHC and particularly in developing the MHC Annual Business Plan. Currently, the subsidiaries are held accountable for the annual budgets approved during the year by MHC, not necessarily the revenue and expense reflected in the July to June period of the MHC Annual Business Plan.

The Consolidated Statement of Operations on page ten summarizes the projected net gain or loss for MHC as a whole and by venture. It does not include the incremental benefits to the Health System in other areas such as increased grant funding, net income related to physician billings, or increased patient capacity in the HHC, which are estimated to exceed $3 million in FY2006.

In FY2006, MHC is projected to have a loss of ($93,618) that compares favorably to the ($362,177) loss in FY2005. This improvement in the overall performance is the result of each of the consolidated ventures, some of the unconsolidated ventures and MHC Administration performing better financially in FY2006 than in FY2005. Improvements were offset by the ($104,867) loss for CMCHRO, an unconsolidated venture, which just started operations in September 2005. However, the favorable performance enabled ventures to make cash distributions to MHC totaling $1,105,000. MHC in turn was able to use these funds to pay down the loan to HHC by the same amount, reducing interest expense in FY2006.

III. MHC FISCAL YEAR 2007 BUDGET

The MHC Fiscal Year 2007 Budget was developed from each subsidiary's financial plan, MHC's financial statements, projected results of the subsidiary's operations, and known/planned changes for the coming fiscal year.

MHC consolidated financial statements are displayed beginning on page nine. Highlights of those financial statements are identified below.

A. Schedule of Investments Summary

This Schedule of Investments displayed on page nine outlines the expected changes in approved capitalization for each subsidiary and MHC Administration from FY2006 to FY2007.

Currently, the MHC Board has approved commitments in the amount of $21.8 million, including $15.3 million to projects and $6.5 million to MHC Administration. Of this approved commitment, $13.6 million is approved to be transferred to the subsidiaries and $6.3 million to MHC Administration as of June 30, 2006. MHC will have secured $19.9 million for investment through $8.7 million as equity transfers and $11.2 million as loans. The $6.3 million for MHC Administration includes $4.7 million for interest costs.

Assuming the MHC Board approves all of the anticipated capital requests from its subsidiaries in FY2007, the total commitment level that the MHC Board will have approved for its subsidiaries and Administration will be $22.3 million. Of this approved amount, MHC is projecting to have transferred funds totaling $20.8 million as of June 30, 2007, with $1.5 million approved for future year transfers. With $22.3 million of the original $30 million capitalization designated for investment in current subsidiaries and MHC Administration, $7.7 million will be available for other projects or venture needs as of June 30, 2007.

B. Consolidated Statement of Operations Summary

The statement on page ten summarizes the FY2006 projected net gain or loss and the FY2007 budget for MHC as a whole and by venture. This summary identifies the direct results of operations of the subsidiaries, but does not reflect ancillary benefits to the Health System such as increased research funding and professional net income or expanded patient care service opportunities for the Hospitals and Health Centers and the Medical School Faculty Group Practice. It is estimated that the activities of MHC and its subsidiaries will again contribute several million dollars in net margin annually to other segments of the Health System in FY2007.

MHC is budgeting an overall gain of $9,940 for FY2007 compared to a projected loss of ($93,618) for FY2006. The primary reasons for this change is a $143,788 improvement in the MVNC net income due to increased patient referrals from HHC, partially offset by ($81,346) decline in MHMC's net income due to the end of Partnership Health and the winding down of operations. MHC is also budgeting $400,000 in investment income in FY2007 applicable to the Department of Urology's Lithotripsy investment and will be transferring these funds to the Department of Urology.

In FY2007, MHMC is budgeted to have a negative net income as it winds down operations. All unconsolidated ventures are expected to have a positive net income for FY2007, with the exception ECA and CMCHRO, which is in its start-up phase.

C. MHC Administrative Activity Summary

The FY2007 budget on page eleven reflects a budget increase for MHC Administration. Interest expense is expected to increase over the current year projection by $87,749 as a result of increasing interest rates and smaller cash distributions from the ventures. Increases in salary and wages and fringe benefits represent a $18,524 increase over the FY2006 projection. This is the result of adopting the HHC salary program of 3% and increased fringe benefit costs. Finally, the increase in investment income relates to budgeted proceeds from the MHC investment in lithotripsy that began in FY2006.

D. MHC Consolidated Financial Statements

MHC consolidated financial statements follow on pages nine through eleven.

Michigan Health Corporation
Schedule of Investments
Projected for June 30, 2007

	MHC Approved Commitment as of FY2006	Expected Changes in Commitment	MHC Expected Commitment as of FY2007	MHC Total Investment as of FY2006	Expected Changes in Investment	MHC Total Expected Investment as of FY2007
Consolidated Joint Ventures (A)						
Michigan Dialysis Services	$ 4,389,743	$ 0	$ 4,389,743	$ 3,046,381	$ 0	$ 3,046,381
Michigan Health Management Corporation	600,000	(30,000)	570,000	600,000	(30,000) (D)	570,000
Michigan Visiting Nurses - Consolidated	219,569	0	219,569	219,569	0	219,569
Total Consolidated Joint Ventures	$ 5,209,312	$ (30,000)	$ 5,179,312	$ 3,865,950	$ (30,000)	$ 3,835,950
Unconsolidated Joint Ventures (B)						
Central Michigan Community Hospital Radiation Oncology	$ 1,000,000	$ 0	$ 1,000,000	$ 667,000	$ 333,000 (E)	$ 1,000,000
Eye Care Alliance	333,800		333,800	309,800	24,000 (E)	333,800
Joint Venture Hospital Laboratories	15,000		15,000	15,000		15,000
North Eastern Michigan Cancer Center	2,070,127	(142,500)	1,927,627	2,070,127	(285,000) (D)	1,785,127
PMHC Cancer Center	6,497,685		6,497,685	6,497,685		6,497,685
Radiation Oncology Alliance	50,000	0	50,000	50,000	0	50,000
Total Unconsolidated Joint Ventures	$ 9,966,612	$ (142,500)	$ 9,824,112	$ 9,609,612	$ 72,000	$ 9,681,612
Closed and Non-Active Ventures	$ 177,789	$ 0	$ 177,789	$ 110,224	$ 0	$ 110,224
Subtotal for All Ventures	$ 15,353,713	$ (172,500)	$ 15,181,213	$ 13,585,786	$ 42,000	$ 13,627,786
Michigan Health Corporation - Administrative Activity	6,251,704	676,121 (C)	6,927,825	6,142,825	785,000 (E)	6,927,825
Mobile Lithotripsy	210,000		210,000	210,000		210,000
Funds Available to be Committed by the MHC Board	8,184,583	(503,621)	7,680,962			
Regental Approved Limit on Capital Investment	**$ 30,000,000**		**$ 30,000,000**			
Remaining Funds Not Currently Invested				$ 10,061,389	(827,000)	$ 9,234,389
Regental Approved Limit on Capital Investment				**$ 30,000,000**		**$ 30,000,000**

Notes:
(A) Consolidated joint ventures are entities where MHC has an ownership percentage greater than 50%.
(B) Unconsolidated joint ventures are entities where MHC has an ownership percentage up to 50%.
(C) Entities requiring additional commitment above current MHC approved amount. MHC Admin's additional $676,121 is approved with approval of the business plan.
(D) Ventures making repayments of a portion of their loan principal or making cash distributions to MHC in FY2007 include: MHMC-$30,000 and NEMCC-$285,000.
(All of these transactions will be used to decrease the loan between HHC and MHC.)
(E) Entities receiving additional investments in FY2007 include: CMCHRO $333,000, ECA $24,000 and MHC Admin $785,000.
CMCHRO funding for operations began in the fall 2005 and is provided by the Department of Radiation Oncology.

Michigan Health Corporation
Consolidated Statement of Operations
ProForma Summary of Net Gain / (Loss) by Joint Venture
as of June 30, 2007

	FY2005 Actual	FY2006 Projection	FY2007 Budget
Consolidated Joint Ventures			
Kids Care of Michigan	$ 2	$ 0	$ 0
Michigan Dialysis Services (51.00%)	(42,164)	83,891	56,996
Michigan Health Management Corporation	33,863	72,222	(9,124)
Michigan Visiting Nurses - Consolidated	(108,146)	(93,378)	50,410
Net Gain / (Loss) in Consolidated Joint Ventures	$ (116,445)	$ 62,735	$ 98,282
Unconsolidated Equity in Joint Ventures			
Central Michigan Community Hospital Radiation Oncology (16.00%)	$ 0	$ (104,867)	$ (87,173)
Eye Care Alliance (18.33%)	(26,096)	(26,996)	(31,726)
Joint Venture Hospital Laboratories (11.11%)	514	0	0
NEMCC (50.00%)	(63,301)	19,630	108,529
PMHC Cancer Center (50.00%)	524,023	241,951	254,629
Radiation Oncology Alliance (33.33%)	86,703	63,917	82,101
Equity in Net Gain / (Loss) in Unconsolidated Joint Ventures	$ 521,843	$ 193,635	$ 326,360
Michigan Health Corporation - Administrative Activity	(767,575)	(349,989)	(414,702)
Total Excess Revenue / (Expenses)	$ (362,177)	$ (93,618)	$ 9,940

Notes:

- MHC ownership interest shown in parenthesis after venture name, if less than 100%.
- Kids Care was terminated 9-30-04 and final transactions were processed in FY2006.
- MHMC's Partnership Health Program ended May 31, 2006; final expenses will be processed in FY2007. FY2006 and FY2007 fluctuations reflect closing the program.
- MVNC is looking to increase referrals from UM in FY2007 to help offset little or no payment increases from Medicare and other payors, while routine operating costs continue to increase.
- CMCHRO venture started operations in September 2005 and start-up activity is slower than anticipated.
- NEMCC is showing a positive net income for the first time in FY2006 and the trends are continuing into FY2007.
- MHC Administration changes are caused primarily by change in interest rate on loan from HHC.

Michigan Health Corporation
MHC Administration
FY2007 Operating Budget

	FY2005 Actual	FY2006 Projection	FY2007 Budget
Expenses			
Salaries and wages	$ 216,976	$ 235,772	$ 246,459
Staff benefits	65,383	63,636	71,473
Misc expense	41,695	24,617	32,548
Total administrative expenses before interest	324,054	324,025	350,480
Interest on notes payable to HHC	450,491	388,674	476,423
Total expenses	$ 774,545	$ 712,699	$ 826,902
Gain or (loss) from operations	$ (774,545)	$ (712,699)	$ (826,902)
Investment income / (loss) - Lithotripsy		343,600	400,000
Investment income / (loss) - Other	6,969	19,111	12,200
Excess revenues / (expenses)	$ (767,575)	$ (349,989)	$ (414,702)

Notes to the Administrative Financial Data and MHC Budget.

- Interest expense on notes payable is based on an interest rate of 3.787% in FY2005, 3.827% in FY2006 and 5.004% in FY2007 per the University of Michigan Treasurer's Office. Significant cash distribution from the ventures late in FY2005 decreased the balance of the note payable, therefore decreasing interest expense.
- Investment income of $343,600 applicable to mobile lithotripsy is projected for FY2006 and $400,000 is budgeted for FY2007. It is being transferred to the Department of Urology.