PROVIDER REIMBURSEMENT REVIEW BOARD
HEARING DECISION

98-D17

PROVIDER -Robert Packer Hospital Sayre, Pennsylvania	**DATE OF HEARING-** October 24, 1995
Provider No. 39-0079	Cost Reporting Periods Ended - June 30, 1986 and 1987
vs.	
INTERMEDIARY - Blue Cross and Blue Shield Association/ Blue Cross of Western Pennsylvania	**CASE NO.** 89-0303

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ISSUE:

Were the Intermediary's adjustments to the Provider's interest expense to account for the hospital's 1983 advance refunding of debt proper?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Robert Packer Hospital ("Provider") is a short-term, acute care hospital located in Sayre, Pennsylvania. As an affiliate of the Guthrie Medical Center, the Provider is a major teaching center and is recognized as a regional referral center by the Medicare program. In 1983, the Provider initiated a major construction and renovation project to upgrade and expand its services at an estimated cost of $28,000,000. At that time, the Provider had over $24 million of serial and revenue bonds outstanding (collectively referred to as "1977 Bonds"), which had been issued to finance earlier capital projects. Pursuant to the 1977 Bond Indenture and Sublease,[1] the Provider had the option of extinguishing its obligations under a defeasance provision which permitted the transfer of sufficient funds to a trust established for the bondholders to fully repay all obligations.

In an effort to obtain the least expensive financing alternative to fund the new project, the Provider sought the opinion of an investment banking firm and was advised that the interest granted pursuant to the 1977 Bond Indenture and Sublease was controlling on the Provider's ability to issue future debt.[2] In light of a subordination requirement to the interest of the 1977 bondholders, it was determined that a new series of bonds could be issued for the new project at a substantially lower interest rate if the new bonds were not subordinate to the 1977 Bonds. Since the Provider could achieve a net project savings if the 1977 Bonds were extinguished as part of the overall borrowing for the new project, the Provider chose to defease the 1977 Bond debt as part of the proposed financing of the new project.[3]

In February of 1983, effective January 1, 1983, the Provider obtained financing in the amount of $46,920,000 through the Sayre Borough Hospital Authority, the funding for which was derived from the sale of Hospital Revenue Bonds - Series of 1983 ("1983 Bonds"). The 1983 Bonds were issued at a discount of $1,173,000 yielding net proceeds of $45,747,000 prior to issuance expenses. Of the net proceeds obtained, the Provider utilized $17,390,100 from the 1983 Bonds to defease the 1977 Bonds. At the time of their defeasance, the carrying value of the 1977 Bonds was approximately $23.6 million. However, based on the prevailing interest rates at the time, the sum required to defease the 1977 Bond indebtedness was $21,101,901.

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[1] Provider Exhibit 2.

[2] Provider Exhibit 3.

[3] The Provider estimated a net savings of approximately $6.3 million - See Provider Exhibit 6.

In addition to the proceeds obtained from the 1983 Bonds, the Provider used $3.7 million of its own funds obtained from two escrow accounts that existed under the 1977 Bonds. One of the escrow accounts was the 1977 Debt Service Reserve Fund ("DSRF"), which was required under the 1977 Bonds and was funded with proceeds from the 1977 Bonds. The other escrow account utilized was the 1977 Bond Redemption and Improvement Fund ("BRIF"), which was deemed available by the Provider upon the defeasance of the 1977 Bond debt.

Pursuant to the advance refunding transaction, the 1977 Bonds were defeased by depositing funds into a trustee account to pay the interest and principal on the refunded 1977 Bonds. To satisfy this requirement, $17,390,100 of the proceeds from the 1983 Bonds (approximately 37 percent) were transferred to the 83-77 Revenue Bond Redemption Fund ("RBRF"). In addition, $1,965,792 was also transferred from the Provider's DSRF to the RBRF for payment of principal and interest to the 1977 bondholders. The balance of the advance refunding transaction in the amount of $1,746,009 was transferred from the Provider's BRIF to a separate trust account identified as the 1977 Demand Payment Term Bond Escrow Account ("1977 DPTBEA"). Upon transfer of the above amounts to the trustee in February of 1983, all obligations of the Provider under the 1977 Bonds were terminated.

In reporting the defeasance of the 1977 Bonds on its financial statements and Medicare cost reports, the Provider treated the advance refunding transaction in accordance with generally accepted accounting principles ("GAAP") as set forth in Accounting Principles Board ("APB") Opinion No. 26 - Early Extinguishment of Debt.[4] Under GAAP, the Provider no longer incurred any interest expense or amortizable discount and issuance costs on the 1977 Bonds after the defeasance, and a gain or loss on the early extinguishment of the debt was computed. The gain or loss was determined by comparing the difference between the reacquisition price and the net carrying amount of the extinguished debt. Pursuant to GAAP, this difference is recognized in the year in which the advance refunding takes place and should not be amortized to future periods. Accordingly, the Provider claimed only the actual interest and amortization expenses incurred on the new 1983 Bonds subsequent to the advance refunding transaction in its 1983 cost reporting period and all future periods. The interest and amortization expense on the portion of the 1983 Bonds used to defease the 1977 Bonds was $696,308 in the 1983 cost reporting period, $1,757,046 in the 1986 cost reporting period, and $1,748,046 in the 1987 cost reporting period. No interest expense relating to the 1977 Bonds was claimed after the defeasance date, and the remaining unamortized discount and issuance costs in the amount of $804,359 was offset in the computation of the gain or loss. In 1983, the actual cost incurred and claimed on the 1977 Bonds for the seven-month period prior to the advance refunding was $900,637 for interest expense, $11,484 for amortized bond discount, and $8,990 for amortized financing costs. In determining the costs

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[4] Provider Exhibit 11.

incident to the early extinguishment of the 1977 Bonds pursuant to APB Opinion No. 26, the Provider computed a gain of $2,517,489 determined as follows:[5]

Costs Incident to Early
Extinguishment of 1977 Bonds[6]

1977 Bonds

Amount Due at Maturity	$24,423,749	
Unamortized Financing Costs	(353,217)	
Unamortized Discount	(451,142)	
Net Carrying Value - 1977 Bonds		$23,619,390

Funds Transferred to Trustee

83 Bond Proceeds to RBRF	$17,390,100	
DSRF to RBRF	1,965,792	
BRIF to 1977 DPTBEA	1,746,009	
Total Reacquisition Price		21,101,901
Total Advance Refunding Costs/(Gain)		($ 2,517,489)

Since the carrying value of the 1977 Bonds exceeded the reacquisition price, the negative advance refunding costs represent a gain on the early extinguishment of debt which is treated as an extraordinary item of income from operations to be recognized in the period that the debt is extinguished. Relying on the applications of GAAP and §§ 215 and 215.1 of the Provider Reimbursement Manual (HCFA Pub. 15-1), the Provider did not offset the gain against its allowable interest expense because the gain was considered extraordinary income from operations and not investment income.

Based on its examination of the Provider's advance refunding transaction, Blue Cross and Blue Shield Association/Blue Cross of Western Pennsylvania ("Intermediary") adjusted the Provider's treatment of the gain based on its interpretation and application of Medicare law, regulations and program instructions. The Intermediary analyzed the components of the refinancing transaction and followed the guidance offered by Blue Cross Association

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5 The Provider originally reported a gain of $5,792,265 on its financial statements as of June 30, 1983. This misreported amount was corrected by the Provider's independent auditors for discrepancies later discovered. See Provider Exhibits 7 and 8.

6 See Provider Exhibit 18. (The Intermediary has stipulated that $2,517,489 is the correct calculation of the gain under GAAP.)

Administrative Bulletin ("AB") 1158, 78.01.[7] Applying the instructions set forth in AB 1178, 78.01, the Intermediary reduced the amount of interest expense claimed by the Provider for the fiscal years in dispute.[8] The Intermediary estimates the amount of Medicare reimbursement in controversy to be approximately $149,000 and $238,000 for the fiscal years ended June 30, 1986 and 1987, respectively.

The Provider appealed the Intermediary's adjustments to the Provider Reimbursement Review Board ("Board") and has met the jurisdictional requirements of 42 C.F.R. § 405.1835-.1841. The Provider was represented by David H. Eisenstat, Esquire, David B. Palmer, Esquire, and Cy Walker, Esquire, of Akin, Gump, Strauss, Hauer & Feld, L.L.P. The Intermediary's representative was Michael F. Berkey, Esquire, of the Blue Cross and Blue Shield Association.

PROVIDER'S CONTENTIONS:

The Provider contends that its treatment of the 1983 advance refunding transaction fully complied with Medicare law, regulations and program instructions which were in effect at the time the 1977 Bonds were extinguished. The law at 42 U.S.C. § 1395x(v)(1)(A) states that:

> The reasonable cost of any services shall be the cost actually incurred . . . and shall be determined in accordance with regulations establishing the method or methods to be used, and items to be included, in determining such costs . . . .

42 U.S.C. § 1395x(v)(1)(A).

With respect to the controlling regulations in the instant case, the Provider cites three regulations which are germane to the proper resolution of the advance refunding issue presented in this appeal. The first regulation concerns the provisions of 42 C.F.R. § 413.153 which govern the reasonable cost of interest expense. Under this regulation, necessary and proper interest on capital indebtedness is an allowable cost if the following criteria are met:

> Necessary requires that the interest be-
>
> (i) Incurred on a loan made to satisfy a financial need of the provider . . .;
>
> (ii) Incurred on a loan made for a purpose reasonably related to patient care; and

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[7] Intermediary Exhibit I-14.

[8] Intermediary Exhibits I-4, I-5, I-6 and I-9.

> (iii) Reduced by investment income except if such income is from gifts and grants, . . . funded depreciation or a provider's qualified pension fund . . .

42 C.F.R. § 413.153(b)(2).

> Proper requires that interest be-
>
> (i) Incurred at a rate not in excess of what a prudent borrower would have to pay in the money market existing at the time the loan was made; and
>
> (ii) Paid to a lender not related through control or ownership, or personal relationship to the borrowing organization.

42 C.F.R. § 413.153(b)(3).

Another controlling regulation cited by the Provider involves the financial data and reporting requirements established under 42 C.F.R. § 413.20 which provides in pertinent part the following:

> The principles of cost reimbursement require that providers maintain sufficient financial records and statistical data for proper determination of costs payable under the program. Standardized definitions, accounting, statistics, and reporting practices that are widely accepted in the hospital and related fields are followed. Changes in these practices and systems will not be required in order to determine costs payable under the principles of reimbursement.

42 C.F.R. § 413.20(a).

The provisions of the above-stated regulation are complemented by 42 C.F.R. § 413.24 which provides that:

> . . . cost data must be based on a approved method of cost finding and on the accrual basis of accounting.

42 C.F.R. § 413.24(a).

This regulation goes on to explain that:

> Under the accrual basis of accounting, revenue is reported in the period when it is earned, regardless of when it is collected, and expenses are reported in the period in which they are incurred regardless of when they are paid.

42 C.F.R. § 413.24(b)(2).

In addition to the statutory and regulatory provisions, interpretive guidelines are published in the Provider Reimbursement Manual (HCFA Pub. 15-1), which assist providers in preparing their cost reports and are relied upon for business planning purposes. The Provider notes that the Foreward to this manual includes the following directive relating to cost determinations:

> For any cost situation that is not covered by the manual's guidelines and policies, generally accepted accounting principles should be applied.

Foreward - HCFA Pub. 15-1.

The Provider notes that there were no provisions directly addressing the reimbursement of costs associated with an advance refunding of debt when the manual was originally published. The first manual provision specifically addressing situations where providers recall bonds prior to their scheduled maturities was in February, 1977 when the provisions of §§ 215 and 215.1 were issued. The original version of these manual provisions that was in effect at the time of the advance refunding transaction under appeal was entitled "Recall of Bonds Before Maturity," and provided the following:

> Costs incident to recall of bonds before their date of maturity are considered debt cancellation costs and are allowable to the extent they are reasonable. Debt cancellation costs include bond recall penalties, unamortized discounts and expenses, legal and accounting fees, etc. These costs are reduced by any unamortized bond premiums . . . .
>
> In determining the reasonableness of the costs of recalling bonds before their maturity, consideration must be given to the overall financial implications of the recall. Financial considerations include not only the fact that more favorable terms can be secured by the provider, particularly with regard to interest rates, but also the cost of debt cancellation. The reasonableness of any refinancing costs incurred in connection with the recall of bonds before maturity must take into account such approvals as may be required by authorized planning agencies.

HCFA Pub. 15-1 § 215.

In turn, HCFA Pub. 15-1 § 215.1, entitled "Treatment of Debt Cancellation Costs" provides:

> When costs incident to debt cancellation plus the actual cost incurred on the debt during the provider's reporting period are <u>less</u> than the amount of interest cost and amortization expense that would have been allowable in that period

> had the indebtedness not been canceled, then the cost of debt cancellation, to the extent reasonable, is allowable in the year incurred.
>
> However, when reasonable costs incident to debt cancellation plus the actual cost incurred on the debt during the provider's reporting period exceed the amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been canceled, the maximum allowable cost in that period is the total amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been canceled. The excess is allowed as a cost in the subsequent period (again, to the extent that the amount does not exceed the interest cost and amortization expense that would have been incurred in that subsequent period, and so on, until fully absorbed).
>
> An exception to this limitation is permitted when the debt cancellation costs are less than 50 percent of the amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been canceled, in which case, the full amount will be allowable in the period incurred . . . .
>
> . . .
>
> Debt cancellation costs are not interest payments and, therefore, should not be reduced by investment income either in the period of cancellation or in subsequent periods.

HCFA Pub. 15-1 § 215.1.

The Provider notes that the manual was revised in May, 1983, to add the provisions of §§ 233-233.5, which specifically relate to costs associated only with refinancing existing debts through the issuance of new debt ("advance refunding of debt"). Concurrent with this revision, § 215 was amended to limit its application to costs associated only with the recall of debt prior to its scheduled maturity without the issuance of new debt. In light of the new provisions of §§ 233- 233.5, the Provider avers that it was necessary to change the original version of § 215 because it was clearly intended to apply to costs incurred in connection with any recall of debt prior to its maturity, including advance refundings. The Provider notes that the changes set forth in §§ 233-233.5 are expressly effective, if at all, only for advance refundings initiated on or after July 1, 1983. Accordingly, the method of treating costs associated with advance refunding under § 233 should not be applicable to the Provider's February, 1983 advance refunding transaction at issue in this case.

The Provider asserts that the interest expense and other costs incurred on the 1983 Bonds fully met the necessary and proper requirements of the interest regulations at 42 C.F.R. §

413.153.[9] However, since this regulation makes no reference to advance refunding transactions or how to account for such transactions in determining the interest costs payable under the Medicare program, the Provider submits that the general regulations governing financial data and cost finding are dispositive. The regulation at 42 C.F.R. § 413.20 implicitly states that standardized definitions, accounting, statistics and reporting practices are followed by the Medicare program in determining a provider's reimbursable costs. In this regard, the Provider points out that GAAP is the only standardized system of accounting that is widely accepted in the hospital and related fields. The Medicare program's commitment to GAAP is also confirmed by the regulation at 42 C.F.R. § 413.24 which provides that cost data must be based on the accrual basis of accounting.

The Provider submits that GAAP has issued standardized definitions and accounting practices specifically dictating the treatment of debt extinguished early under APB Opinion No. 26. Under GAAP, the gain or loss on early extinguishment of debt such as an advance refunding transaction is the difference between the reacquisition price and the net carrying amount of the extinguished debt. GAAP further instructs that this difference should be recognized currently in income of the period of the extinguishment as losses or gains, and should not be amortized to future periods. In the instant case, the net carrying amount of the 1977 Bonds at the time of the advance refunding transaction was $23,619,390, and the reacquisition cost of the debt was $21,101,901. In accordance with the pertinent Medicare regulations, the determination of reimbursable costs under the Medicare program requires the application of GAAP which results in the recognition of a gain of $2,517,489 in the cost reporting period ended June 30, 1983.

Even assuming arguendo that the pertinent regulations at 42 C.F.R. § 413.20 and § 413.24 do not require the application of GAAP, the proper application of the manual provisions under HCFA Pub. 15-1 §§ 215 and 215.1 would still require the reimbursement of the debt cancellation costs to the extent that they are reasonable. These manual provisions became effective for cost reporting periods beginning after December 31, 1976, and were still in effect at the time of the 1983 defeasance transaction. The Provider contends that the preliminary version of HCFA Pub. 15-1 § 215 was specifically issued to address the recall of bonds prior to their scheduled maturity. Further, since refinancing is expressly contemplated as a means of debt cancellation, the provisions of this manual section were clearly intended to govern the treatment of a gain or loss on advance refunding transactions.

The Provider contends that, at the time of its 1983 defeasance transaction, HCFA Pub. 15-1 §§ 215 and 215.1 governed the treatment of a gain or loss on advance refunding. Pursuant to the manual provisions, debt cancellation costs are reimbursable to the extent they are reasonable under the totality of the circumstances. Where a gain results from such transactions, the gain eliminates any remaining otherwise allowable unamortized bond

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[9] The Intermediary stipulated that the advance refunding of the 1977 Bonds was a prudent financial transaction which achieved overall savings. Tr. at 24-25.

discount and issuance expenses on the defeased debt, but are not further offset against costs. It is the Provider's position that HCFA Pub. 15-1 §§ 215 and 215.1 essentially follow GAAP except when the debt cancellation costs exceed the limit set forth in § 215.1, which did not occur in this transaction due to the gain. Accordingly, the Provider followed both the applicable manual provisions and GAAP in reporting the 1983 defeasance transaction in its Medicare cost reports.

It is the Provider's position that the Intermediary's treatment of the advance refunding transaction improperly included the following additional elements in its determination of the actual cost incurred on the 1977 Bonds:

(1) The interest expense accruing on the defeased 1977 Bonds after the indebtedness was extinguished;

(2) The interest and amortization expense incurred on the portion of the 1983 Bond proceeds used to advance refund the 1977 Bonds; and

(3) The interest income of the funds placed in trust for the benefit of the holders of the 1977 Bonds.

The Provider argues that, under GAAP, where a debt is defeased it is no longer reflected on the debtor's financial statements because the debt is completely satisfied and no longer a legal obligation of the former debtor. The amount deposited within an advance refunding trust to retire outstanding debt is invested, and the trust earnings and principal are payable to the bondholders by the trust as the defeased bonds mature. The Provider points out that the gain which it realized results from the fact that it was able to deposit an amount with the trustee which was less than the net carrying amount of the 1977 Bonds. In an advance refunding, the monies paid into trust are payable to the holders of the defeased debt. The trust earnings are under the exclusive control of the trustee and are not available to the former debtor. The Intermediary's investment income offset adjustments ignored the actual use of the funds and continued to treat both the interest expense on the defeased debt and the trust income as expense and income to the Provider as though the advance refunding never occurred. In effect, the Intermediary is using the advance refunding gain to directly reduce otherwise allowable costs, which is inconsistent with both Medicare rules and generally accepted accounting principles. Such gains on operations are not investment income and, therefore, are not offsettable against interest expense.

The Provider contends that the advance refunding methodology applied by the Intermediary pursuant to AB 1158, 78.01 is essentially the "componentization methodology" set forth in HCFA Pub. 15-1 § 233.3(D). Since this manual provision was issued in May of 1983 and the application of that methodology is expressly limited to advance refundings initiated on or after July 1, 1983, the Intermediary has improperly applied the provisions of HCFA Pub. 15-1 § 233 retroactively. The Provider asserts that both the federal courts and the Board have ruled in numerous cases that it is inequitable and illegal to retroactively apply a new policy which was not applicable to the cost reporting period in dispute. Providers act in reliance upon the manual provision in effect at the time. While the Intermediary in this case purported to follow HCFA Pub. 15-1 § 215, in reality it essentially followed the new policies set forth in HCFA Pub. 15-1 § 233.

In response to the Intermediary's reliance on the Supreme Court's decision in Shalala v. Guernsey Memorial Hospital, 115 S.Ct. 1232 (1995) ("Guernsey"), the Provider notes that the Court in that case was clearly reviewing the validity of the application of HCFA Pub. 15-1 § 233 to a loss on advance refunding. Whereas the Guernsey decision reviewed the treatment of a loss on advance refunding that occurred in 1985, after the expressed effective date for § 233, this case involves a gain for advance refunding that occurred prior to the effective date of the manual provision. Guernsey simply does not address the Medicare rule governing this advance refunding under HCFA Pub. 15-1 § 215.

The Provider maintains that it is the Intermediary's treatment of the gain as an offset to otherwise allowable interest expense that is inconsistent with general principles of Medicare reimbursement. Under the Intermediary's audit adjustments, interest expense on the refunding debt is allowed as though the bonds were not defeased, and interest income on the advance refunded trust is treated as income to the Provider as though it belonged to the Provider. This disregards the fact that the trust income must be used by the trustee of the escrow account to pay the bondholders when the refunded bonds become due. The Provider asserts that the intent of the investment income offset required by 42 C.F.R. § 413.153(b)(2)(iii) is for the Medicare Program to reimburse the net interest expense incurred by the Provider. Contrary to the Intermediary's determination, the investment earnings in an advance refunding are not available to help the Provider satisfy its obligation to pay interest expense on the newly issued refunding debt. Nor do those earnings satisfy any financial obligation of the Provider with respect to the defeased bonds; all the obligations having been defeased before the trust earns any income.

The Provider notes that the only Medicare regulation providing for offsets against interest expense is 42 C.F.R. § 413.153(b)(2)(iii). This regulation requires that allowable interest expense be reduced by investment income except if such income is from gifts or grants, funded depreciation accounts, or pension funds. In interpreting the rule set forth in the regulation, the provisions of HCFA Pub. 15-1 § 202.2 plainly limit investment income to gains and losses on investments. The Provider asserts that the loss or gain realized on an advance refunding of debt is not investment income under the Medicare program and, thus, is not subject to offset. This conclusion is further demonstrated by the Medicare program's longstanding practice of reimbursing for losses on advance refundings. If such losses constituted losses on investments, they would not be reimbursable because HCFA Pub. 15-1 § 202.2 unambiguously states that net losses on investment are not allowable. Therefore, since the gain or loss on an advance refunding is not a gain or loss on investment, and since 42 C.F.R. § 413.153 provides for a reduction in otherwise allowable interest expense only for investment income, the Provider concludes that the gain recognized on its 1983 advance refunding of the 1977 Bonds is not investment income subject to offset against interest expense. In further support of this provision, the Provider refers to the Board's decision in Geisinger Wyoming Valley Medical Center v. Blue Cross and Blue Shield Association/Blue Cross of Northeastern Pennsylvania, PRRB Decision No. 94-D23, April 8, 1994, Medicare & Medicaid Guide (CCH) ¶ 42,249. In that case, the Board found that gains on advance refunding should not be offset against interest expense because such gains are clearly not investment income under 42 C.F.R. § 405.419(b)(2)(iii) [Redesignated as 413.153(b)(2)(iii)].

At the hearing, the Intermediary raised subsidiary issues concerning the funded depreciation status of the DSRF and BRIF used in the advance refunding transaction. With respect to the DSRF, the Provider acknowledges that the monies in that fund had been borrowed in the 1977 Bond offering. Prior to the 1983 advance refunding, the Provider notes that the Intermediary did not offset the interest income on this account because it had not treated the interest expense on the borrowed funds as allowable. When the 1983 advance refunding occurred, the money in the DSRF was freed from the trust restriction under the 1977 Bonds, and the then unrestricted funds were expended in trust in the advance refunding. After the 1983 advance refunding, the Intermediary began offsetting the interest income derived from these funds. The Provider believes the Intermediary's historical treatment of the DSRF supports its handling of the fund as a funded depreciation account. Regardless of the prior treatment of this account, the Provider insists that the DSRF became unrestricted, nonborrowed funds when the 1977 Bonds were defeased in the 1983 advance refunding.

Regarding the BRIF, the Provider argues that these funds were available for the advance refunding, or for any other purpose, when the 1977 Bonds were defeased. The monies in the BRIF were transferred to the 1977 DPTBEA for the purpose of meeting demand payments on the 1977 Bonds at the option of the bondholders. Historically, the Intermediary determined that the BRIF was funded depreciation and did not offset interest income on this account against interest expense. Similarly, the Intermediary continued to treat these funds as funded depreciation after their transfer to the advance refunding trust in 1983. Since the Intermediary is now challenging its own treatment of these funds, the Provider states that it was not prepared at the hearing to address all the historical facts surrounding the creation of the BRIF. While the Provider believes the Board should reject any attempt by the Intermediary to seize upon this small degree of inconclusiveness in the record for this area, the Provider did address this matter in its post-hearing submission.[10]

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[10] In its post-hearing submission on this matter, the Provider included additional documentation which was identified as Exhibit P-25. In response to the Intermediary's November 25, 1995 motion to strike certain post-hearing submissions by the Provider, the Board granted the Intermediary's motion with respect to Exhibit P-25 only. It should be noted that the Provider submitted a corrected Exhibit P-22 which it also identified as Exhibit P-25. This corrected exhibit continues to be part of the record in this case.

The Provider points out that the Intermediary did not offset the interest income derived from the 1977 DPTBEA against allowable interest expense. Accordingly, the monies in that account have been consistently treated as funded depreciation by the Intermediary throughout its existence. Given the fact that the Provider did not know that the treatment of this account as funded depreciation would become an issue in this case, the Provider's witness was not prepared to address questions concerning the origin of the account or whether it included borrowed monies. The Provider's witness did testify, however, that both the original establishment of the BRIF account in 1977 and its reestablishment as the 1977 DPTBEA account in 1983 were approved by the Provider's Board, and that the Intermediary in its audits had historically reviewed the facts surrounding the original account. Further, the Intermediary had discussed its review with Provider officials and had determined that the account's income was not subject to offset.[11]

The Provider asserts that the monies in the BRIF and 1977 DPTBEA have the same character and meet the requirements of HCFA Pub. 15-1 § 226 in that:

1. the establishment of accounts were approved by the Provider's Board;

2. The funds were segregated and maintained in a separate account; and

3. The funds were available to meet a capital need related to patient care.

The Provider acknowledges that the perception of the account is clouded by the fact that the account was subject to contingencies as to its ultimate disposition. One possibility is that these funds might be returned to the Provider or a related party. However, under other contingencies, the funds would be used for payments to the holders of the 1977 Bonds. The Provider submits that the funds should continue to be recognized as funded depreciation until, and unless, they are ultimately expended from the 1977 DPTBEA account for a nonqualified purpose. The Provider asserts that none of the contingencies leading to further transfers from the fund had occurred in the years at issue or any other year back to the date of the 1983 transaction. In further support of this position, the Provider cites the Board decision in Valley Hospital and Medical Center v. Ætna Life Insurance Company, PRRB Decision No. 95-D5, October 17, 1994, Medicare & Medicaid Guide (CCH) ¶ 42,917 wherein the Board stated the following:

> As long as the funded depreciation is ultimately used for the acquisition of depreciable assets used in rendering patient care or for other capital purposes, (such as a non-borrowed bond reserve fund), these monies retain their identity as funded depreciation and the interest income earned on such account will not be used to offset interest expense. Only if the funded depreciation is actually used for some other purpose unrelated to acquisition of depreciable assets or

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11 Tr. at 120-123.

> other capital purpose, would there be an adjustment to offset the interest income on such fund against interest expense.

Id.

The Provider emphasizes that its lead position is that the funds in the 1977 DPTBEA account were expended in the advance refunding transaction, and that none of the income earned by advance refunding trusts is offsettable against interest expense. However, if this position is incorrect, the Provider alternatively argues that neither the income on the 1977 DPTBEA account nor the DSRF should be subject to offset because both accounts would now qualify as funded depreciation.

INTERMEDIARY'S CONTENTIONS:

The Intermediary contends that its adjustments to the Provider's advance refunding transaction are not an offset of a gain, but an offset of interest income which is required by the regulation at 42 C.F.R. § 413.153(b)(2)(iii). At issue in this appeal is whether interest income resulting from the bond defeasance may be used to reduce the Provider's interest expense. The Intermediary maintains that it is this interest income which results in a gain to the Provider. While the regulation at 42 C.F.R. § 413.153 does not specifically address the proper treatment of costs incurred when one bond issue is replaced with another, the manual provisions set forth under HCFA Pub. 15-1 § 215.1 state the following:

> When costs incident to debt cancellation plus the actual cost incurred on the debt during the provider's reporting period are less than the amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been canceled, then the cost of debt cancellation, to the extent reasonable, is allowable in the year incurred.
>
> However, when reasonable costs incident to debt cancellation plus the actual cost incurred on the debt during the provider's reporting period exceed the amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been canceled, the maximum allowable cost in that period is the total amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been canceled. The excess is allowed as a cost in the subsequent period (again, to the extent that the amount does not exceed the interest cost and amortization expense that would have been incurred in that subsequent period, and so on, until fully absorbed). . . .

HCFA Pub. 15-1 § 215.1.

In this case, a gain resulted from the refinancing transaction with no corresponding cost reporting presentation. Accordingly, the Intermediary analyzed the components of the transaction which resulted in the gain in accordance with the guidance offered by AB 1158, 78.01.[12] This AB instructs intermediaries to analyze the difference between principal amounts of the refunded bonds and the refunding bonds, and lists the following items which would account for the gain or loss on a refinancing transaction:

1) Call premium
2) Unamortized discounts/premiums
3) Unamortized issue costs
4) Redemption expenses related to the defeased bonds (legal fees, trustee fees, authority fees, feasibility study, etc.)
5) Interest expense on defeased bonds until call date
6) Discounts/premiums on the new refunding bonds
7) Issue costs of the refunding bonds
8) Interest expense on the new refunding bonds
9) Interest expense on the special obligation bonds
10) Investment income on the escrow funds
11) Gain or loss on early extinguishment of debts
12) Annual miscellaneous expense (annual trustee/authority fees)

It is the Intermediary's position that the Provider's gain on refinancing is due to the "interest differential", which is the excess of the interest earned on the escrow fund established from the proceeds of the new 1983 Bonds over the interest expense to be paid on the original 1977 Bonds. Under the AB's instructions, the interest expense incurred on the defeased bonds until the call date (Item 5) is not debt cancellation cost. It is to be allowed annually when paid by the trustee to the bondholders subject to HCFA Pub. 15-1 § 215.1. With respect to investment income earned on the escrow fund (Item 10), this income should be offset against interest expense of the old bonds and the new special obligation bonds.

The Intermediary contends that the Provider did not account for this "interest differential" on its Medicare cost report. While the Provider claimed interest expense on the new refunding bonds, it did not include interest expense on the refunded bonds after the defeasance date, and did not offset any interest income earned on the escrow fund established from the proceeds of the new bond issue. The Intermediary argues that the twelve items listed in the AB comprise the difference between the principal amounts of the new refunding bonds and old refunded bonds and, thus, includes the gain or loss on the early extinguishment of debt. The AB's instruction as to the treatment of this item for Medicare cost reporting purposes is as follows:

> Item 11 (gain or loss on early extinguishment of debt) is already componentized by the above listed 10 items, therefore, no specific treatment is necessary for Medicare purposes. In rare cases where a gain results from defeasance, such gains should be offset against previously allowed issue costs

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[12] Intermediary Exhibit I-14.

> and discounts. Any excess gain would not be further offset against interest expense.

AB 1158, 78.01 at page 16. (Intermediary Exhibit I-14).

The Intermediary believes that the Provider has interpreted this instruction to govern the treatment of the entire refinancing transaction for Medicare cost reporting purposes. The Intermediary's position is that the Provider has misinterpreted the instruction. The AB is discussing a situation where, upon componentizing a refinancing transaction, a net gain results, i.e., the interest income earned on the escrow fund exceeds the interest expense on both of the bond issues. When this occurs, the net gain should not be offset against other interest expense reflected in the provider's cost report. The Intermediary observes that it would be a "rare" occasion for the escrow fund earnings to be so high, especially considering the arbitrage regulations included in the United States Tax Code which limit the amount of interest earnings on the proceeds of tax-exempt debt. This Provider's situation in the instant case is not rare and is not the kind of gain to which that portion of the AB refers.

The Intermediary maintains that the gain in this appeal results from the interest differential inherent in this specific refunding transaction. Therefore, the regulations at 42 C.F.R. § 413.153, as interpreted by sections 202.2 and 215 of HCFA Pub. 15-1, and AB 1158, 78.01, should control. The investment income earned on the escrow fund established from the proceeds of the 1983 Bonds should be offset against the reported interest expense of both the old refunded and new refunding issues. The Intermediary notes that section 233 of HCFA Pub. 15-1, which was effective for all advance refundings initiated on after July 1, 1983, recommends an analysis of bond refinancing transactions which is significantly similar to that recommended by AB 1158, 78.01.

In further support of its position, the Intermediary cites the Board's decision in Walter O. Boswell Memorial Hospital, Inc. v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Arizona, Inc., PRRB Decision No. 86-D79, April 3, 1986, Medicare & Medicaid Guide (CCH)
¶ 35,555 ("Walter O. Boswell").[13] In that case, a refunding (1981) bond issue was intended to defease two older issues (1980 and 1976) and fund construction on another project. The provider argued that the trust income earned on the refunded bonds could not be used to reduce interest expense on the refunded debt since the provider could not claim interest expense on the defeased issues. The intermediary in that case had allowed interest expense related to the defeased issues and treated the interest income earned on the resulting escrow fund as investments requiring offset against allowable interest expense. In its decision, the Board applied 42 C.F.R. § 405.419 [Redesignated as 413.153] stating that the income earned by the trusteed proceeds of those bonds which relate to the portion of the defeased bonds applicable to patient care should be offset against allowable interest expense. The

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[13] Intermediary Exhibit I-16.

Intermediary believes the same result should be obtained in this case which involves an identical adjustment.

The Intermediary refers to another Board decision which also involved a gain realized on an advance refunding transaction - Geisinger Wyoming Valley Medical Center v. Blue Cross and Blue Shield Association/Blue Cross of Northeastern Pennsylvania, PRRB Decision No. 94-D23, April 8, 1994, Medicare and Medicaid Guide (CCH) ¶ 42,249, rev'd by HCFA Admin. Dec., June 7, 1994, Medicare and Medicaid Guide (CCH) ¶ 42,555 ("Geisinger").[14] In that case, the Board held that 42 C.F.R. § 405.419 [Redesignated as 413.153] allows the offsetting of interest expense by investment income only. In the Board's view, a gain realized from the advance refunding of debt was not investment income and should not be used to reduce interest expense. The HCFA Administrator reversed the Board's decision holding that the refunding gain resulted from interest earned on the funds placed with, and invested by, the trustee. The Administrator further found that a gain met the definition of investment income contained in HCFA Pub. 15-1 § 202.2.

The Intermediary believes that the Medicare program should share in the benefit of the reduced borrowing necessary in the 1983 Bond issue to cover the principal and interest payments on the old 1977 Bonds. This gain results from the escrowed funds on the new issue earning interest at a higher rate than the interest expense on the 1977 Bonds. To ignore all components of the refinancing transaction and the economic gain that has occurred would be contrary to Medicare reimbursement principles. No reduction has been made to the costs of the fixed assets acquired with debt that has been significantly reduced through financial market forces. However, the Medicare program is being forced to pay higher annual interest costs on a current basis than would have transpired had the refinancing not occurred.

The Intermediary rejects the Provider's contention that GAAP must be applied because there was no specific Medicare reimbursement principle addressing advance refunding at the time of the defeasance transaction. The Intermediary notes that HCFA Pub. 15-1 § 233.3D states that ". . . interest income derived from the investment of the proceeds of the refunding debt must be used to offset interest expense in accordance with section 202.2, whether this interest income is earned by the provider directly or through a trust." Although the provisions of HCFA Pub. 15-1 § 233ff are effective for advance refunding initiated on or after July 1, 1983, the Intermediary points out that the regulatory basis for its adjustments was 42 C.F.R. § 413.153 which applies to the fiscal years at issue in this appeal. Moreover, the Board's decision in Walter O. Boswell and the HCFA Administrator's ruling in Geisinger both acknowledged that the regulation was controlling for the refunding transactions. Accordingly, the Provider's reliance on GAAP as a basis for overturning the Intermediary's adjustments is incorrect, and should be rejected.

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[14] Intermediary Exhibit I-17.

In response to the Provider's argument that the investment earnings in the escrow fund must be used by the trustee to satisfy the legal obligation to the bondholders, the Intermediary contends that the availability of the investment income to the Provider is immaterial to a finding that 42 C.F.R. § 413.153 was properly applied. The Intermediary points out that, both the courts and the Board have rendered decisions which address this argument. In Research Medical Center v. Schweiker, 684 F.2d 599 (8th Cir. 1982),[15] the circuit court ruled that income earned by accounts that could be used only for paying the principal or interest on bonds, or for covering the costs of unusual repairs or replacements, was required to be offset against allowable interest expense. A similar ruling was made in Cheshire Hospital v. New Hampshire - Vermont Hospitalization Service, Inc., d/b/a Blue Cross/Blue Shield of New Hampshire - Vermont, 689 F.2d 1112 (1st Cir. 1982).[16] In that case, the provider deposited a portion of the proceeds into a debt service reserve fund pursuant to a bond issuance agreement. The court ruled that the income earned by the debt service reserve fund constituted investment income within the scope of 42 C.F.R. § 405.419(b)(2)(iii) [Redesignated as 413.153(b)(2)(iii)]. The court held that the investment income would be used to discharge the hospital's financial obligation, thereby conferring a substantial benefit on the provider. The Intermediary also cites the Board's decision in Harris Hospital - Methodist v. Blue Cross/Blue Shield Association - Group Hospital Service, PRRB Decision No. 88-D12, January 12, 1988, Medicare and Medicaid Guide (CCH) ¶ 36,837,[17] in which the Board ruled that investment income earned by a debt service reserve fund using the proceeds of a bond issue was required to be offset against the provider's interest expense.

During its presentation at the hearing, the Intermediary raised the subissues of whether the DSRF and BRIF should have been treated as funded depreciation accounts, and whether the accounts may have been established with borrowed funds. The Intermediary's witness testified that no adjustments were made with respect to the BRIF prior to 1983 because the account was treated as funded depreciation. However, if the funds deposited into the BRIF were borrowed, it would be a mistake to continue to treat the fund as a funded depreciation account.[18] Further, if the BRIF did not qualify as a funded depreciation account, then an interest income offset adjustment should have been made subsequent to the 1983 advance refunding transaction. The Intermediary's witness testified that he did not have enough information to determine whether the BRIF qualified as a funded depreciation account.[19]

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15 Intermediary Exhibit I-20.

16 Intermediary Exhibit I-21.

17 Intermediary Exhibit I-22.

18 Tr. at 176-177.

19 Tr. at 192-193.

Regarding the DSRF, the Intermediary's witness testified that an interest income offset would be the appropriate adjustment under existing Medicare policy if the fund was established with borrowed monies. While he did not know how the Intermediary treated the DSRF in the prior years, he acknowledged that the disallowance of interest expense incurred on the funds deposited into the account was an acceptable practice under the Medicare program in earlier years if borrowing was the source of the funds.[20] With respect to the treatment of the DSRF subsequent to the 1983 advance refunding, the Intermediary's witness testified that it was proper for the Intermediary to offset the interest income as part of the escrow earnings, rather than a disallowance of the interest expense on the borrowing.[21]

CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS:

1. Law - 42 U.S.C.:

§ 1395x(v)(1)(A)	-	Reasonable Cost

2. Regulations - 42 C.F.R.:

§ 405.1835-.1841	-	Board Jurisdiction
§ 413.20	-	Financial Data and Reports
§ 413.24	-	Adequate Cost Data and Cost Finding
§ 413.153	-	Interest Expense

3. Program Instructions - Provider Reimbursement Manual, Part I (HCFA Pub. 15-1):

Foreward

§ 202.2	-	Necessary Interest Expense
§ 215	-	Recall of Debt Before Maturity
§ 226	-	Funded Depreciation
§ 233	-	Advance Refunding of Debt

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[20] Tr. at 188-189.

[21] Tr. at 194-195.

4. Case Law:

Shalala v. Guernsey Memorial Hospital, 115 S.Ct. 1232 (1995).

Cheshire Hospital v. New Hampshire - Vermont Hospitalization Service, Inc., d/b/a Blue Cross/Blue Shield of New Hampshire - Vermont, 689 F.2d 1112 (1st Cir. 1982).

Research Medical Center v. Schweiker, 684 F.2d 599 (8th Cir. 1982).

Walter O. Boswell Memorial Hospital, Inc. v. Blue Cross and Blue Shield Association/ Blue Cross and Blue Shield of Arizona, Inc., PRRB Decision No. 86-D79, April 3, 1986, Medicare and Medicaid Guide (CCH) ¶ 35,555.

Harris Hospital - Methodist v. Blue Cross/Blue Shield Association - Group Hospital Service, PRRB Decision No. 88-D12, January 12, 1988, Medicare and Medicaid Guide (CCH) ¶ 36,837.

Geisinger Wyoming Valley Medical Center v. Blue Cross and Blue Shield Association/ Blue Cross of Northeastern Pennsylvania, PRRB Decision No. 94-D23, April 8, 1994, Medicare and Medicaid Guide (CCH) ¶ 42,249, rev'd by HCFA Admin. Dec., June 7, 1994, Medicare and Medicaid Guide (CCH) ¶ 42,555.

Valley Hospital and Medical Center v. Ætna Life Insurance Company, PRRB Decision No. 95-D5, October 17, 1994, Medicare and Medicaid Guide (CCH) ¶ 42,917.

5. Other:

Accounting Principles Board Opinion No. 26 - Early Extinguishment of Debt.

Blue Cross Association Administrative Bulletin - AB 1158, 78.01 - Advance Refunding of Bonds (Bond Defeasance), March 30, 1978.

FINDINGS OF FACTS, CONCLUSIONS OF LAW AND DISCUSSION:

The majority of the Board, after consideration of the controlling law, regulations, and manual provisions, the facts of the case, parties' contentions, and evidence in the record, finds and concludes that the Intermediary's adjustments to the Provider's interest expense based on the application of AB 1158, 78.01 was not proper. The Intermediary's treatment of the gain resulting from the Provider's advance refunding transaction, effected on January 1, 1983, is not supportable under the financial record keeping requirements of 42 C.F.R. §§ 413.20 and 413.24, and the governing interest expense regulation at 42 C.F.R. § 413.153.

The statutory provisions of 42 U.S.C. § 1395x(v)(1)(A) require that, for reimbursement purposes, the actual reasonable costs incurred by a provider "shall be determined in accordance with regulations establishing the method or methods to be used . . . in determining such costs." The statute further states that "[i]n prescribing the regulations . . ., the Secretary shall consider, among other things, the principles generally applied by national organizations . . . ." Consistent with the statutory provisions, the regulation at 42 C.F.R. § 413.20(a) states the following:

> The principles of cost reimbursement require that providers maintain sufficient financial records and statistical data for proper determination of costs payable under the program. Standardized definitions, accounting, statistics, and reporting practices that are widely accepted in the hospital and related fields are followed. Changes in these practices and systems will not be required in order to determine costs payable under the principles of reimbursement.

42 C.F.R. § 413.20(a).

In explaining adequate cost data and cost finding, the regulation at 42 C.F.R. § 413.24 provides that the cost data must be based on the accrual basis of accounting, pursuant to which "revenue is reported in the period when it is earned, regardless of when it is collected, and expenses are reported in the period in which they are incurred, regardless of when they are paid." In addition to the financial recordkeeping regulations, the issue before the Board in this case is directly impacted by the application of the interest expense regulation at 42 C.F.R. § 413.153 which sets forth the governing provisions for the reimbursement of necessary and proper interest expense under the Medicare program. In defining necessary interest expense, the regulation at 42 C.F.R.
§ 413.153(b)(2)(iii) requires that interest be "reduced by investment income except if such income is from gifts and grants, . . . funded depreciation or a provider's qualified pension fund. . . "

The Board majority finds that the Provider properly relied upon the above-stated regulations in applying GAAP to its advance refunding transaction in accordance with APB Opinion No. 26. In the absence of any specific regulatory policy for the treatment and reporting of advance refunding transactions under the Medicare program, the Board majority concludes that the application of GAAP was required under 42 C.F.R. §§ 413.20 and 413.24, and that the Provider correctly determined and recognized a gain of $2,517,489 in its cost reporting period ended June 30, 1983. The Board finds this accounting treatment under GAAP conforms to the regulatory requirements under which providers are to follow standardized accounting practices, and to furnish adequate cost data based on the accrual method of accounting.

The majority of the Board recognizes that the manual instructions and guidelines established under HCFA Pub. 15-1 may serve an important role in the Medicare reimbursement process by setting forth specific procedures of how a particular regulation should be applied. However, in the instant case, there was no specific manual provision which addressed advance refunding transactions at the time of the Provider's bond defeasance on January 1, 1983. While the provisions of HCFA Pub. 15-1 §§ 215 and 215.1 do address situations where providers recall bonds prior to their scheduled maturities, this manual provision only deals with the treatment of debt cancellation costs associated with recalled debt. It was not until the promulgation of HCFA Pub. 15-1 § 233, effective July 1, 1983, that the Medicare program established definitive reimbursement policy for advance refunding transactions. Since neither of these manual instructions are applicable to the advance refunding which occurred in the instant case, the Board is compelled under the regulations to apply GAAP in accordance with APB Opinion No. 26.

Consistent with the application of APB Opinion No. 26, the majority of the Board finds that the Provider correctly reported the gain on advance refunding as extraordinary income from operations to be recognized currently in the period the debt is extinguished. The Board majority finds no justification under Medicare reimbursement policy for treating the gain on advance refunding of bonds as an offset against allowable interest expense. The majority notes that the only regulatory provision which requires a reduction to allowable interest expense is found in 42 C.F.R. § 413.153(b)(2)(iii) . This regulation states that in order to be necessary, interest expense must be reduced by investment income ("except if the investment income is from gifts and grants
. . . funded depreciation or a provider's qualified pension funds. . . .") The Board majority is aware of the provisions in HCFA Pub. 15-1 § 202.2 which includes the term "gains and losses" in its definition of investment income. However, since the manual provision does not specify the types of gains and losses to be included in the terminology, the majority concludes that the term is limited to gains and losses derived from investments. A gain on defeasance is not investment income, and should not be used to reduce interest expense.

Although the Board is bound by the Medicare policies set forth in the law and regulations, it may also rely on the instructions and procedures set forth in manual publications which are consistent with the intent and application of a specific regulation. However, the Board is not bound by instructions that an intermediary implements based on its interpretation of how a specific reimbursement procedure should be applied. In the instant case, the Intermediary's treatment of the advance refunding transaction was based solely on the application of AB 1158, 78.01, which was published by the Blue Cross Association in response to inquiries received from local intermediaries. Since the bulletin was not published by the Health Care Financing Administration, the Board majority gives little weight to its application as legitimate reimbursement policy under the Medicare program. The creditable nature of AB 1158, 78.01 is further diminished by the fact that there was no basis for its application under the existing regulations or manual instructions at the time of the advance refunding.

In response to the Intermediary's citation of various Board and Court decisions that upheld an offset of investment income earned on debt funds established by providers, the Board majority finds that the cited decisions are not on point because the providers in those cases controlled the established funds. In the instant case, the funds established to defease the refunded debt were deposited into trustee accounts which are under the exclusive control of the trustee pursuant to the requirements of the advance refunding transaction. The principal and earnings of the trustee accounts are payable to the bondholders by the trust as the defeased bonds mature, and are no longer available to the former debtor who has been completely relieved of legal obligations relating to the payment of the debt. Further, the Board majority finds that the establishment of the separate trust accounts is equally applicable to the subissues raised by the Intermediary as to the funded depreciation status of the DSRF and the BRIF. Since the monies in the DSRF and BRIF were also deposited into trustee accounts together with a portion of the proceeds from the 1983 Bonds, the character of these funds changed with the 1983 advance refunding transaction. As separate funds under the control of an independent trustee, the question of whether the DSRF or BRIF qualify as funded depreciation accounts is a moot issue.

DECISION AND ORDER:

The Intermediary's adjustments to the Provider's interest expense to account for the hospital's 1983 advance refunding of debt was not proper. The Intermediary's determination is reversed.

Board Members Participating:

Irvin W. Kues
James G. Sleep
Teresa B. Devine
Henry C. Wessman, Esquire (Dissenting Opinion)

FOR THE BOARD:

Irvin W. Kues
Chairman

Dissenting Opinion of Henry C. Wessman

I respectfully dissent. My dissent is based on the two-pronged Rose Test: "What's in a name? That which we call a rose, by any other name would smell as sweet". To paraphrase: That which we call interest income, by any other name, is still interest income.

While I commend Robert Packer Hospital ("Provider") for the business astuteness of the 1983 bond float, the good fortune of that astuteness must be shared with the general tax-paying public via "fair share" with the federal Medicare program. 42 U.S.C. § 1395x(v)(1)(A)(i) . To that extent, I would uphold the Intermediary's adjustment to the Provider's interest expense costs via set-off of the investment income realized by the Provider via the fortuitous 1983 advanced refunding and defeasance of the 1977 debt.

The calculation here is specific to Medicare - to return "fair share" to the federal program via interest income resulting from defeasance; in this case, debt cancellation and gain realized by a more favorable interest rate - but income due to interest, nonetheless.

The logic of 42 C.F.R. § 405.419 (now § 413.153) is controlling in this case. In Cheshire Hospital v. New Hampshire - Vermont Hospitalization Services, Inc., d/b/a Blue Cross/Blue Shield of New Hampshire - Vermont, 689 F.2d 1112 (1st Cir. 1982), a hospital, pursuant to an agreement under which bonds were issued, deposited a portion of the proceeds in a debt service reserve fund. The court held that the Provider was required to offset the income earned by the debt service reserve fund against allowable interest expense, inasmuch as such income constituted investment income within the scope of 42 C.F.R. § 405.419. The Provider's assertion that the interest was not subject to its control and conferred no benefit to the Provider was rejected. The court held that the investment income, in that case, would be used to discharge the financial obligations of the Provider, thereby conferring a substantial benefit on the hospital. Intermediary's Position Paper at 19. That same logic is persuasive here.

Further, in Geisinger Wyoming Valley Medical Center v. Blue Cross and Blue Shield, et al, PRRB Dec. No. 94-D23, rev'd, HCFA Administrator Decision, June 7, 1994, the Administrator ruled that the refinancing did, indeed, result in investment income, and therefore, was properly offset under 42 C.F.R. § 405.419.

For the above reasons, I would hold that the Intermediary's adjustment to the Provider's interest expense to account for the Provider's gain via the 1983 advanced refunding of the 1977 debt was proper.

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Henry C. Wessman, Esquire
Board Member