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Height Commentary

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Dialysis

DaVita's Exposure to California Third-Party Premium Assistance Bill

THE TAKEAWAY

DaVita (DVA) will face operating income losses of up to $95.5 million per year, or 5.3% of 2017 operating income, if legislation before the California Assembly is signed into law. The legislation, SB 1156, would limit commercial reimbursement rates to the Medicare rate for services provided by operators that have a financial relationship with a third-party charitable contributor to the patient's insurance premiums. The bill is a high priority for its proponents and we expect it will reach a vote by the full Assembly. We assign 45% odds that the Assembly will pass it and 25% odds that Governor Jerry Brown will sign it into law.

This month, the California Assembly is considering SB 1156, legislation to remove financial incentives for financially interested third parties to make premium payments on behalf of patients. If passed into law, the legislation would materially reduce commercial insurance revenue for outpatient dialysis providers including DaVita (**DVA**) and Fresenius (**FMS**).

The bill is the subject of intense lobbying in Sacramento, with the Service Employees International Union (SEIU) and Blue Shield of California supporting the legislation and the California Dialysis Council, DaVita, and California Medical Association opposing it. The bill faces three more hurdles before becoming law:

- consideration by the Appropriations Committee (by August 17);
- consideration by the full Assembly (by August 31); and
- the Governor's signature (by September 30).

Based on the current legislation (acknowledging that lawmakers will likely further amend it), we assign:

- 90% odds that the Appropriations Committee will approve the bill;
- 45% odds that the full Assembly will approve the bill; and
- 25% odds that the Governor would sign the legislation.

A risk to our current projection is that further amendments to the bill could make it more palatable to its opponents, and opponents may seek to cut a deal on a less impactful version of the legislation in hopes of avoiding more

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harmful legislation next year under the administration of the more union-friendly presumptive Governor Gavin Newsom.

SB 1156 would require disclosure of third-party premium assistance and limit commercial reimbursement rates

SB 1156 would implement several policies that would require third-party premium assistance organizations, such as the American Kidney Foundation (AKF), to disclose to health plans and insurers which patients are supported by third-party premium assistance. The bill would also reduce commercial reimbursement rates for services provided to patients supported by third-party premium assistance. Specifically, SB 1156:

1. Requires third-party charitable premium assistance organizations to disclose the name of an enrollee to the enrollee's health plan prior to making the initial payment;

2. Requires health plans and insurers to report third-party payment information to the California Department of Managed Health Care or the California Department of Insurance;

3. Limits commercial reimbursement rates to providers that have a financial relationship with the third-party charitable contributor to the Medicare rate or a lower negotiated rate; and

4. Imposes a fine equal to the overpayment plus 20% in instances where a third-party entity fails to disclose required information to the health plan.

In June, the Assembly Health Committee added the rate-setting policy (#3 above) and the fines (#4 above) to the legislation. The legislation in its current form would have a material impact on the operations of AKF in California. At this point, it is unclear whether AKF would comply with the new regulations, resulting in the commercial reimbursement rate of thousands of AKF-supported patients dropping to the Medicare rate, or whether AKF would discontinue operations in California, which would shift insurance coverage for many (but not all) dialysis patients from commercial coverage to Medicare or Medicaid.

High Hurdles to Clear: SB 1156 Needs to Clear the Assembly Appropriations Committee, the full Assembly, and the Governor's Desk

- **Appropriations Committee Must Vote by August 17** - The Assembly Appropriations Committee placed SB 1156 on the Committee's Suspense File, meaning it will vote on the bill on August 16 or 17. In order for the legislation to qualify for consideration by the full Assembly, the Appropriations Committee must pass it by August 17. Given the strong momentum behind SB 1156 and its support by insurers and a key labor union, we assign 90% odds that the Appropriations Committee will pass the bill by August 17.
- **Assembly Must Vote by August 31** - Following passage by the Assembly Appropriations Committee, the full Assembly must vote on SB 1156. We anticipate intense lobbying on the bill with strong resistance from the California Medical Association on the grounds that the bill authorizes rate setting for certain dialysis

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services. While another union-backed dialysis bill, SB 349, was withdrawn by its sponsor at this point in the legislative calendar last year, we believe SB 1156 will have more momentum than SB 349 because it is also supported by Blue Shield of California and because it is the end of the legislative session. Legislators will not have another opportunity to advocate for their priorities; therefore, they will be less willing to withdraw their sponsored legislation. That said, the California Medical Association is an impactful lobby, and we expect other groups such as the California Hospital Association will more vocally oppose the legislation as the deadline for Assembly passage (August 31) nears. The legislation could also face an economic impact analysis that would show increased expenditure on Medicaid because patients may shift from commercial insurance and Medicare to Medicaid if AKF were to exit California. We expect this will be an "eleventh hour" vote and assign 45% odds to the Assembly passing it.

- **Governor Must Sign by September 30** - Should the Assembly pass SB 1156, Governor Jerry Brown (D) is required to sign it by September 30 in order for it to become law. In our view, Governor Brown would be more likely to leave major healthcare legislation to his successor, so he may veto the bill, especially if it would add to Medicaid expenditures. He has previously opposed legislation sponsored by SEIU. Therefore, we assign 25% odds that he would sign SB 1156 if the Assembly sends it to his desk. If the bill were amended to make it more amenable to the dialysis industry and California Medicare Association, we would increase our odds of the governor signing the legislation.

American Kidney Foundation's Reaction to SB 1156 is Uncertain, but up to 5.3% of DVA's Total Operating Income is at Risk

SB 1156 presents a significant financial threat to outpatient dialysis providers in California. In this analysis, we estimate the "worst-case scenario" for DVA. Two possible outcomes of passage of SB 1156 include:

1. AKF will discontinue operations in California if it loses funding from DVA and FMS. Commercial insurance patients currently supported by AKF would (1) stay in their employer-sponsored plans, (2) shift from COBRA plans to Medicare and Medicaid, (3) shift from individual commercial plans to Medicare, and (4) shift from Medicare to Medicaid. We do not estimate the financial impact of this scenario to DVA.

2. Commercial reimbursement for AKF-supported patients would drop to Medicare levels. We estimate this would reduce DVA's annual operating income by up to $95.5 million, or 5.3% of total annual operating income. We caution that this estimate may be slightly high because the dollar figures are based on national average commercial reimbursement rates, and DVA shared with us that California's commercial reimbursement rates are slightly lower than the national average.

Our Methodology:

To arrive at our estimate, we estimated the number of AKF-supported DVA patients in California enrolled in employer-sponsored and individual commercial insurance. Then, we multiplied each patient by the amount of annual operating income each one contributes based on national figures disclosed by DVA.

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1. The AKF provided third-party premium payments to 3,867 dialysis patients in California in 2017.

- Approximately 45% (1,740 individuals) were enrolled in Medicare;
- 35% (1,353 individuals) were on employer paid plans, including COBRA;
- 20% (773 individuals) we enrolled in private non-group commercial coverage.

2. DVA operates 50% of the clinics in California, from which we can assume DVA serves 50% of California's 80,000 annual dialysis patients and at least 50% of AKF-supported patients, including:

- 870 AKF-supported patients enrolled in Medicare;
- 677 AKF-supported patients enrolled in employer paid plans, including COBRA;
- 387 AKF-supported patients enrolled in private non-group commercial coverage.

3. In October 2017, DaVita disclosed that nationwide:

- 4,000 AKF-supported patients were enrolled in commercial employer-sponsored coverage and COBRA, accounting for approximately $450 million of DaVita's expected annual operating income (from this, we calculate operating income of $112,500 per patient);
- 1,800 AKF-supported patients were enrolled in ACA and non-ACA individual coverage, which if lost would cost DVA between $45 million and $90 million in annual operating income ($25,000-$50,000 per patient).

4. From here, we calculate that in California:

- 677 AKF-supported patients enrolled in employer paid plans at $112,500 per year contribute $76.16 million in annual operating income.
- 387 AKF-supported patients enrolled in private non-group commercial coverage at $25,000-$50,000 per year contribute $9.68 million - $19.35 million in annual operating income.
- Together, these AKF-supported patients account for somewhere between $85.8 million and $95.5 million of operating income per year, or 4.7% to 5.3% of total 2017 operating income of $1.813 billion.

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COMPANIES MENTIONED IN THIS REPORT

DaVita HealthCare Partners Inc (DVA), Fresenius Medical C Shs Sponsored American Deposit Receipt Repr 1/2 Sh (FMS)

RISKS

The legislative and regulatory agendas are subject to change at the discretion of leadership. Unprecedented economic conditions could instigate unanticipated and/or sweeping shifts in policy. Predicting the future is a hazardous endeavor and economic / market forecasting is an imprecise science. Actual outcomes may differ substantially from our forecasts. The predictions and opinions expressed herein are subject to change at any time.

ANALYST CERTIFICATION

I, Andrea Harris, certify with respect to each security or issuer covered in this research report that (i) the views expressed in this research report accurately reflect my personal views about those subject securities or issuers and (ii) no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by me in this research report.

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