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July 28, 2016

**VIA EMAIL AND U.S. MAIL**

Alexandra Hicks, Coordinator  
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Division of Health Care Services  
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Re: Diagnostic Health Center of Anchorage, LLC's Request for Reconsideration of  
Department of Health and Social Services' June 28, 2016 Certificate of Need  
Determination

Dear Ms. Hicks:

My firm is counsel to Chugach Imaging, JV LLC and Diagnostic Health Alaska (collectively, "DHA") in this matter. Pursuant to 7 AAC 07.033, DHA requests reconsideration of the June 28, 2016 determination that DHA must obtain a certificate of need (CON) for its imaging and radiology clinic located at 1751 E. Gardner Way in Wasilla, Alaska ("Determination").<sup>1</sup> As explained in detail below and shown in the enclosed affidavit and exhibits, the Determination is factually and legally in error.

First, the Determination is factually wrong concerning the equipment installed at the Wasilla facility. Upon learning that x-ray, C-arm and ultrasound equipment had to be included in the CON threshold, DHA sold the expensive state-of-the art equipment it had purchased and replaced it with less expensive equipment.

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<sup>1</sup> In the event that the Department determines that this Request for Reconsideration should be treated as a new Request for Determination because it includes additional expenses not mentioned in DHA's April 25, 2016 Request for Determination, DHA has no objection to treating this submission as a Request for Determination under 7 AAC 07.031 that incorporates by reference the invoices and construction contract submitted with DHA's April 25, 2016 Request for Determination.



Second, the Department incorrectly included the cost of DHA's signage. The signage is a purely aesthetic improvement that CON regulations exclude from the threshold calculation under 7 AAC 07.0900(16)(B). Also, upon further review, additional purely aesthetic improvements that were part of the tenant improvements by KC Corporation should also be deducted from the CON threshold, as described below.

Third, the Department's disallowance of DHA's reduction in the "net present value" of its lease for the 1751 Gardner Way space based on the rent received from subleases of portions of the space is contrary to the plain language of the relevant statute and regulations, as well as the policy goal underlying CON requirements. 7 AAC 07.010(8) requires inclusion of only the "net present value" of the lease of space "occupied by the facility," not space utilized by sublessors or for other purposes. Moreover, because the purpose of CON requirements is to limit expenditures that will be passed on to State payors, the concern of the statute is the *net* cost of a facility. Sublease rent reduces the net lease cost to the facility that will ultimately be recouped from payors. Thus, consistent with the underlying CON policy, the CON statutes and regulations, the legislative history, and prior decisions of the Department, the sublease revenue should be subtracted from the *net* present value of the lease for space "occupied by the facility."

Fourth and finally, the non-decorative equipment and furnishings that DHA inadvertently omitted from the CON calculation do not raise the total cost of the facility above the \$1.5 million threshold. These items include some of the items that the Department identified from DHA's document production in the *Imaging Associates* litigation, as well as the cost of power injectors for the MRI and CT machines that GE invoiced separately from the machines themselves and which DHA inadvertently failed to include in its initial requests. Even when these items are added to the calculation, the cost of the facility is below the \$1.5 million statutory threshold.

Taking all of these deductions and additions into account, the appropriate CON threshold calculation under 7 AAC 07.010 for the Wasilla facility should be \$1,493,503.47. A detailed listing of each item comprising that figure is listed in Appendix A to this Request for Reconsideration, and supporting documentation is attached to the accompanying Affidavit of David Joslin ("Joslin Affidavit"). DHA accordingly requests that the Department reverse its determination that DHA requires a CON for the Wasilla facility.

## **I. Background**

Chugach Imaging, JV LLC ("Chugach") is an Alaska LLC jointly owned by Diagnostic Health Alaska and Turnagain Radiology Associates. Diagnostic Health Alaska also owns and operates a diagnostic imaging facility located at 4100 Lake Otis Parkway in Anchorage. Diagnostic Health Alaska is wholly owned by Alliance Healthcare Services, Inc. ("Alliance"), a nationwide company that owns and operates medical facilities around the United States. Chugach entered into the lease for the space for the Wasilla facility, contracted for improvements



to the space, and purchased and owns the imaging and other equipment used in the Wasilla facility.

DHA submitted its original request for determination on July 27, 2015. At that time, DHA erroneously believed that CON regulations did not require inclusion of diagnostic imaging equipment other than MRI equipment, CT equipment, and PET-CT equipment in calculation of the CON threshold under AS 18.07.031. DHA's understanding was based on the fact that DHSS has only included CON review standards and methodologies in its 2005 *Alaska Certificate of Need Review Standards and Methodologies* for these three diagnostic imaging modalities – not for x-ray or ultrasound. DHA had not retained outside counsel to assist with the request for determination process at that time.

Based on this understanding, DHA did not include the cost of x-ray, ultrasound, and C-arm diagnostic imaging equipment in its original July 27, 2015 request for determination. After retaining outside counsel in connection with the litigation commenced by Imaging Associates, however, DHA determined that the CON regulations and statute require the inclusion of the x-ray, ultrasound and C-arm equipment in the CON threshold calculation. DHA submitted a new request for determination, dated April 25, 2016, which included these costs in the threshold calculation.

DHA's April 25, 2016 request for determination also provided a new calculation of the total cost to Chugach for the lease of space for the Wasilla facility, which reduced the total lease amount by rent that DHA received from subleases of portions of the Gardner Way space not occupied by the imaging and radiology facility. Part of the subleased space was subleased to DHA's ultimate parent company, Alliance, to use as office space for management and transcription services. Another portion of the subleased space was leased to an unrelated healthcare provider, Cottonwood Creek Clinic.

The employees occupying Alliance's subleased office space at 1751 East Gardner Way are involved in a number of activities for Alliance. These include managing the DHA's Anchorage imaging facility, providing management services for the DHA Wasilla location, working to open additional Alaska facilities, and providing medical record transcription services for both Diagnostic Health Alaska locations. Approximately 80% of the management and transcription services provided by Alliance from their subleased offices are for DHA's Anchorage facility.

Prior to Chugach's lease and remodeling of the 1751 East Gardner Way location, Alliance's Alaska offices were located at 4100 Lake Otis Parkway, Suite 309, in Anchorage. Alliance moved its Alaska offices to the Gardner Way location due to the lower per-square-foot



rent. The Alliance office occupies 1,019 square feet of the total facility.<sup>2</sup> The 267 square feet of the facility dedicated to an office for the radiologists and imaging technicians working at the Wasilla facility are still included in the lease amount included in the CON threshold calculation.

## **II. DHA's Sale and Replacement of Initially Purchased Equipment**

Because inclusion in the CON calculation of the x-ray, Ultrasound and C-arm equipment originally purchased by DHA would have exceeded the \$1.5 million CON threshold, Chugach uninstalled the equipment it had initially purchased, including the US Gold Seal Logiq E9 Ultrasound Unit, the Gold Seal 9900 Elite C-Arm, and the Gold Seal Delfinium 9000 Digital X-Ray. Chugach sold this equipment to affiliated companies Diagnostic Health Alaska and Alliance Healthcare Services for use at Diagnostic Health Alaska's Anchorage facility and other imaging facilities. Chugach also removed the Falcon ProV4 (reflected in DHA000032-33) it had initially purchased for the Wasilla facility and sold it to Diagnostic Health Alaska. The bills of sale reflecting Chugach's sales this equipment are attached as Exhibit 3 to the accompanying Affidavit of David Joslin ("Joslin Affidavit").

DHA replaced this equipment with an Americorps Summit AM2 X-Ray machine purchased from Integrity Medical Systems, Inc. for \$57,840, a Siemens Sequoia 512 ultrasound machine purchased from Diagnostic Health Alaska for \$1,500, a GE Stenoscope 2 C-Arm purchased from Diagnostic Health Alaska for \$2,000. DHA also purchased an ABI machine from Diagnostic Health Alaska, but that ABI machine has since been removed from the Wasilla facility and returned to Diagnostic Health Alaska's Anchorage facility. The relevant invoices and bills of sale for this equipment are attached as Exhibit 4 to the Joslin Affidavit. DHA obtained professional valuations the equipment purchased from an affiliated entity. These valuations are attached as Exhibit 5 to the Joslin Affidavit.

The amounts DHA paid for the original ultrasound, x-ray, C-arm and ABI machines that it subsequently replaced or removed should accordingly be excluded from the CON threshold calculation. DHSS observed in its May 3, 2016 request for additional information from DHA that it was treating DHA's April 25, 2016 request for determination as a brand new request. Accordingly, in making a determination on the April 25 request, DHSS should consider the

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<sup>2</sup> Notably, DHA has not at this time subtracted the construction expenses for building out Alliance's office space from the tenant improvement construction costs included in the CON threshold calculation. These expenses should, however, be excluded because they were not incurred for the imaging and radiology facility at issue here.



expenses to be included under 7 AAC 07.010 for the equipment to be used in the facility as of the time the request was made.<sup>3</sup>

### **III. Purely Decorative Improvements, Including DHA's Signage, Should Be Excluded Under 7 AAC 07.900(16)(B).**

DHSS erred in including the \$8,928 that DHA paid for the signage at the Wasilla facility in the CON threshold calculation. An additional \$6,948.87 in purely aesthetic upgrades of worn cabinets, paint and carpeting should also be excluded. 7 AAC 07.900(16) defines the term "equipment" for the purposes of determining what equipment and furnishings must be included under 7 AAC 07.010. 7 AAC 07.900(16)(B) excludes from this definition "optional design features, furnishings, or décor choices that do not add to the minimum necessary for the safe, functional, and medically appropriate operation of the facility."

The custom-made signage purchased by DHA is a purely decorative improvement to the facility that is not necessary for the safe, functional and medically appropriate operation of the facility. *See* Joslin Affidavit, ¶ 12. It should therefore be excluded from the threshold calculation. *See In the Matter of Providence Health & Services Alaska*, OAH No. 11-0045-DHS, at 23-24 (Dec. 27, 2011) (excluding optional lighting and wall surface expenditures from CON calculation under 7 AAC 07.900(16)(B)).

In addition to the exterior sign, portions of the expenses for the tenant improvement work done by KC Corporation should also be excluded from the CON calculation as purely decorative improvements. As indicated in the letter from KC Corporation attached as Exhibit 6 to the Joslin Affidavit, KC Corporation broke out from their total tenant improvement invoice \$6,948.87 in expenses that were purely decorative upgrades. These expenses included the cost of materials and limited labor, overhead and profit expenses associated with repainting of some pre-existing interior walls, new carpet, and new cabinet and surface facings in the radiologist reading room and reception area. KC Corporation's detailed breakdown of these expenses is attached as Exhibit 6 to the Joslin Affidavit. These minor décor improvements did not add to the safe, functional and medically appropriate operation of the facility. *See* Joslin Affidavit ¶ 13.

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<sup>3</sup> A request for determination under 7 AAC 07.031 is not required before a provider may open a healthcare facility involving expenditures under the \$1.5 million threshold. The regulation phrases the submission of a request for determination in permissive, not mandatory terms. *See* 7 AAC 07.031. Thus, neither the Department nor the facility owner are bound by an earlier determination on a request for determination in the event the actual costs for the facility increase or decrease. *See In the Matter of Providence Health & Services Alaska*, OAH No. 11-0045-DHS, at 9. (Dec. 27, 2011) (finding erroneous administrative determination irrelevant where actual facility expenses were below CON threshold).



#### IV. The Failure to Subtract Sublease Revenue from the Net Present Value of the Lease for the Space Was Error.

DHSS's determination that Chugach's subleases of portions of the Gardener Way space should not be deducted from the "net present value" of the lease under 7 AAC 07.010 is erroneous as a matter of law, policy and fairness. The determination is contrary to the plain language of the regulation, which requires inclusion of only the "*net* present value of lease payments" and only for "space occupied by the facility." The determination is also contrary to DHSS's prior interpretation in an analogous case, and to the policy and legislative history underlying the CON statute.

DHSS's interpretation of 7 AAC 07.010(a)(8) as not allowing deductions for sublease revenue is contrary to the State policy and legislative history underlying CON requirements. The CON program is premised on the principle that healthcare providers will recoup the cost of building new healthcare facilities through charges to patients and payors (such as Medicare and Medicaid) for healthcare services. To the extent that there is not a sufficient need for these services, the provider building the new facility will be required to increase prices for healthcare services in order to recover these costs. *See generally* 1999 Alaska Laws Ch. 55 (H.B. 187), Finding 7(B) (finding that as to nursing home facilities, the CON statute "enhances access to the appropriate level of care . . . and does not foster reliance on the state general fund to finance the operating and capital costs"); DHSS Certificate of Need Program Summary (2016), available at <http://dhss.alaska.gov/dhcs/Pages/CertificateOfNeed/default.aspx> (noting that half of Medicaid dollars spent on care subject to CON requirements came from the State's general fund); *In the Matters of Alaska Medical Development-Fairbanks LLC, Kobuk Ventures, LLC, and Fairbanks Memorial Hospital*, OAH Nos. 06-0744-DHS through 06-0746-DHS (2007) (citations omitted) (discussing legislative history and policy purpose of CON laws to in part control health care costs).

In implementing this policy, the Alaska legislature determined that expenditures below the \$1.5 million threshold are sufficiently small that their recoupment by providers will not meaningfully affect the price of the related healthcare services. Thus, the statute and regulations implementing the cost threshold seek to determine the capital outlay by a provider that will have to be recouped through patient fees. Because costs offset by other revenue are not passed on to patients, the regulations sensibly seek to determine the *net* cost of a new facility. It is contrary to the purpose of the statute to include the *gross* costs to the provider that will be recovered in ways other than through patient billing.

This policy goal is reflected in the plain language of both AS 18.07.031(e) and 7 AAC 07.010(a)(8), concerning the inclusion in the CON threshold of expenses for leases of space or equipment. This statute and the related regulation require inclusion of only the "*net* present value" of the lease for "space *occupied* by the facility." *Id.* (emphasis added). By requiring only the "net" expenditures for the facility, the statute and regulation appropriately exclude aspects of



expenditures that will be offset by cost savings rather than passed on to patients and payors. Similarly, by requiring inclusion of the cost only for space “occupied by the facility,” the statute and regulation exclude the cost of space that will not be used by the facility, such as space subleased to other users.

Both DHSS and an administrative hearings officer have previously interpreted the language in an analogous regulation to allow a healthcare provider to exclude the cost of any square footage not “occupied” by the facility. *See In the Matter of Providence Health & Services Alaska*, OAH No. 11-0045-DHS, at p.18. (Dec. 27, 2011). In that case, Alaska Regional Hospital installed a new PET/CT imaging suite in office space it owned. In calculating the market lease value for the space under 7 AAC 07.010(a)(7), DHSS interpreted the regulation to allow Alaska Regional to exclude from the calculation the square footage of the suite that would not be part of the clinical operations of the PET/CT facility. In effect, the Department allowed Alaska Regional to reduce the cost of the “lease” by carving out portions of the suite for other non-clinical purposes. The hearings officer affirmed the Department’s interpretation. *Id.*

Applying the foregoing analysis to the present facts, the Department’s earlier determination in connection with the Alaska Regional PET/CT, the plain language of 18.07.031(e) and 7 AAC 07.010(a)(8), and the policy goal of the CON statute all support a determination allowing DHA to exclude sublease revenue from the CON threshold calculation. Here, the portions of the space subleased to Alliance Healthcare Services and Cottonwood Creek Clinic are not “occupied by the facility,” as required for inclusion under 7 AAC 07.010(a)(8). The Alliance Healthcare Services space is used by DHA’s parent company to conduct management and transcription services for all DHA facilities (mostly the Anchorage location). The Cottonwood Clinic portions of the space are used entirely by a provider unrelated to DHA.

Furthermore, because the revenue received by Chugach for the sublease of these spaces offsets the total cost to Chugach of the space leased for the Wasilla imaging facility, it should be deducted from the “*net* present value” of Chugach’s lease. The amount that Chugach and DHA will have to bill to patients and payors to recover the lease cost is directly reduced by this sublease income. It should therefore be excluded from the CON threshold calculation.

Indeed, to disallow reduction for the sublease revenue ignores the real economic effects of the transaction and effectively favors certain lease structures over others. For instance, if Alliance Healthcare Services had entered into the master lease with the landlord, and then subleased the space actually occupied by the imaging facility to Chugach, there would be no question that only the portion subleased to Chugach should be included in the CON threshold calculation under 7 AAC 07.010(a)(8). Merely because the lease is structured with Chugach as the master tenant that subleases the non-facility space for non-clinical purposes to Alliance should not change the outcome. Both arrangements have the exact same economic effect – they reduce the total lease cost for the imaging facility, and in turn reduce the expenses passed on to patients and payors. Similarly, Chugach should not be disadvantaged compared to providers like





Alaska Regional that own their own medical office building, who are able to carefully configure that owned space to minimize the cost that must be counted against the CON threshold.

In summary, DHSS should reconsider and reverse its determination that the total lease cost for the Wasilla facility should not be reduced by the sublease revenue received from Alliance and Cottonwood over the lease term. A reduction of the total lease amount to account for the subleases is most consistent with the language of the regulation, the Department's earlier interpretation, the purpose of CON requirements, and the real economic effects of the sublease on the total cost of the facility.

**V. Additional Equipment Inadvertently Omitted from Request for Determination.**

As a final note, DHA does not object to the inclusion in the CON calculation of additional equipment used by the Wasilla facility that was inadvertently omitted from DHA's July 27, 2015 and April 25, 2016 requests for determination. This equipment includes items identified in the Department's June 28, 2016 determination that are still in use at the facility, as well as power injectors for the MRI and CT machines that were invoiced separately from the costs of the machines and inadvertently omitted from DHA's earlier request for determination. These items are broken out in the calculation in Appendix A.

**VI. Conclusion**

For the foregoing reasons, the Department should reconsider and reverse its determination that DHA requires a CON for the Wasilla facility. In particular, the Department should deduct from the CON threshold calculation: (1) the cost of the original x-ray, C-arm, ultrasound, and ABI equipment that Chugach sold and replaced, (2) the cost of the signage and portions of the construction contract that represent purely decorative or aesthetic improvements, and (3) the sublease rent amounts that Chugach will receive over the two-year lease of the Gardner Way space. Even after the costs of the replacement equipment and other items are added back into the calculation, the total cost of the facility as defined by 7 AAC 07.010 is \$1,493,503.47, below the \$1.5 million statutory threshold, as set forth in the detailed calculation in Appendix A.





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Alexandra Hicks,  
Coordinator  
July 28, 2016  
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Please do not hesitate to contact me with questions or if the Department requires further information or documentation.

Sincerely,

GARVEY SCHUBERT BARER

By



John C. Rothermich

JCR:lkb

Enclosures

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