Pay for Success and the Forest Service

Frequently Asked Questions

How does Pay for Success work?

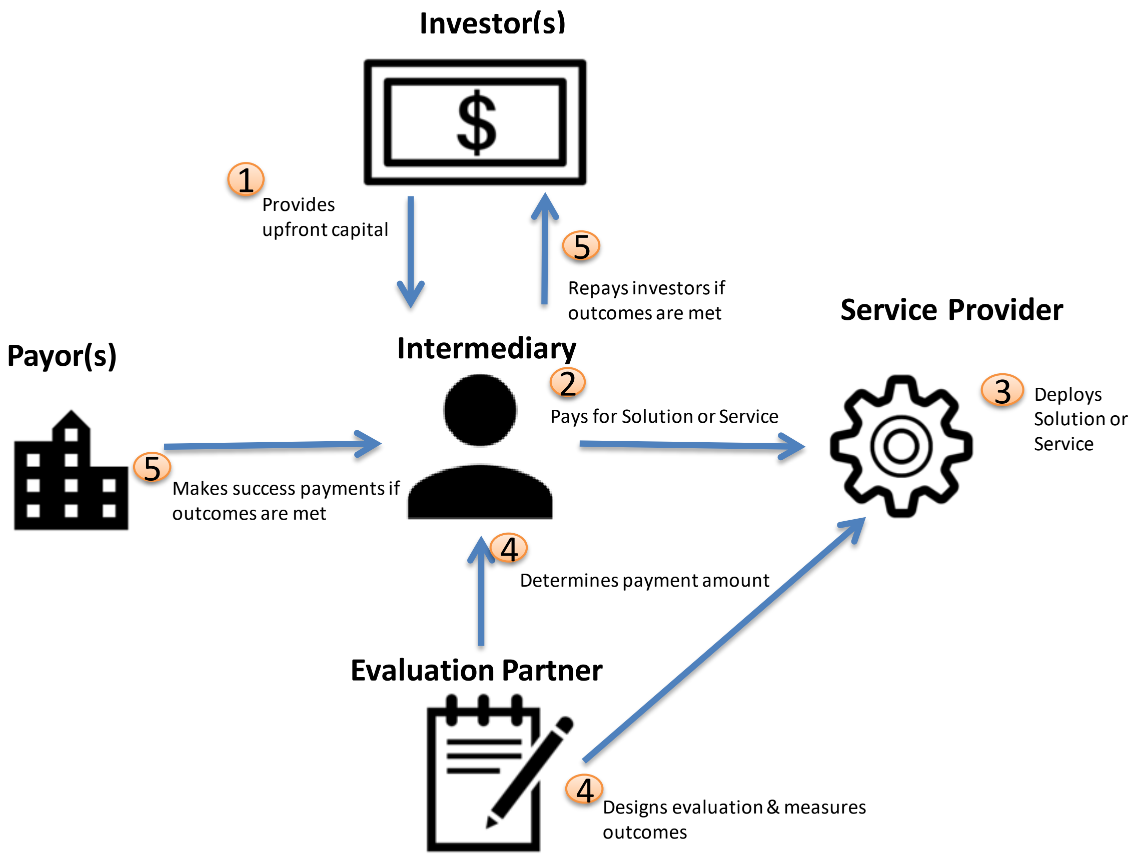
Pay for Success (PFS) is an innovative approach to contracting that links a meaningful portion of payment for services to measurable outcomes. It is a tool to align incentives to service providers, shift performance risk to the private sector, and integrate multiple stakeholders. [1] Pay for Success (PFS) is an innovative approach to contracting that 1) identifies a critical issue and the activities or programs that can address the issue, 2) identifies service providers to implement the activities, 3) obtains investors to fund the activity, and 4) sets a pre-determined rate of return on the investment for the investor to earn a profit if the activity performs as expected or exceeds expectations, thus shifting performance risk to the private sector.

Each transaction is different, but most involve the following roles (one party can play multiple roles):

- One or multiple investors provide the up-front capital to fund the service provider to implement the activities that will deliver the desired outcomes and enable program scaling. If the project outcomes are successful, the investor receives a return on their investment.
- Payors are the entities that realize cost savings, revenue increases, or positive outcomes from the scaled program and activities. They agree to repay the investors if outcomes are achieved.
- Service Providers (nonprofit or for-profit) deliver the selected service or solution to the target population and geography, with the goal of achieving both improved social, health, or environmental outcomes to the target population and the projected financial benefits to the payor.
- Evaluators are third-party independent entities that measure the impact of the program against the agreed-upon outcomes as well as the financial impact to the payor.
- Intermediaries can play several roles in a PFS transaction, including feasibility assessments, transaction structuring, fundraising, contracting, project management and financial processing.

[1] http://www.payforsuccess.org/learn/basics/#what-is-pay-for-success

Figure 1: How Pay for Success Works (Quantified Ventures March 30, 2017)



How has Pay for Success been helpful for addressing environmental challenges?[2]

Since 2010, over 50 PFS transactions have been executed across six continents, including 13 in the United States, with a further 50 in the U.S. under development[3].

In partnership with DC Water, Quantified Ventures closed the nation's first Environmental Impact Bond (EIB), a Pay For Success (PFS) transaction, on September 2016. This new, highly-replicable financing mechanism allowed DC Water to shift the performance risk of their green infrastructure project to impact investors, thus enabling them to choose 'innovation' over 'business as usual.' As a result, DC Water will pay for outcomes versus paying for a project and hope the desired outcomes follow.

https://static1.squarespace.com/static/558071a0e4b00a2971965f06/t/58d90f7a86e6c087a943a51b/1490620284529/DC+Water+EIB+Overview.pdf

Are Pay for Success models and Environmental Impact Bonds the same thing?

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2 http://www.quantifiedventures.com/new-page-1
3 http://www.payforsuccess.org/learn/basics/#

Environmental Impact Bonds are one example of a way to finance a PFS deal. EIB are one financial approach investors can use to provide upfront capital for service providers to implement projects that 1) deliver ecological uplift 2) provide a profitable return on the investment..

Despite the terminology, most PFS deals thus far have not involved actual bond financing, with the potential for securitization and secondary-market trading. The exceptions are the $25M tax-exempt EIB issued by DC Water for its green infrastructure PFS program (for which Quantified Ventures was the Transaction Coordinator), and the 'Forestry Resilience Bond' now under development in a project in California through grant funding from USDA and various Foundations.

What are the benefits of the PFS or EIB model?

PFS/ EIB can achieve the following benefits:

- Deploy the fast-growing pool of impact capital, now sized at $17.7B[4], into worthy programs across the country;
- Reallocate some or all of the funding risk to impact investors, enabling payors to buy measurable outcomes;
- Prioritize spending for evidence-based social, health, and environmental services, and;
- Increase funding for rigorous evaluations to grow the evidence-base on what works;
- Use lessons learned from PFS outcomes to re-design programs to become more effective
- Bring together multiple payors to improve the viability and scale of outcomes

What types of projects work well for the PFS or EIB model?

PFS/ EIB work especially well for projects that have the following characteristics

- Defined and measurable social, ecological outcomes that are in demand
- Potential for financial returns from activities that deliver the socio-ecological outcomes
- Resource constraints and rising demands for services/ performance
- Existing solutions to scale or promising solutions to test
- Defined geographic boundaries
- One or many beneficiaries with a defined need
- At least $3-5M of private investment in service provider activities/ programs

Is the Forest Service using Pay for Success already?

Yes. The Forest Service, through the Ecosystem Services & Markets Team, is establishing a portfolio of conservation finance partnerships to illustrate strategies and tools to increase the total amount of funding available for Forest Service all-lands restoration, stewardship and conservation objectives. Two of these partnerships are using different variations of the Pay for Success model. An example is below:

<u>Blue Forest Conservation Forest Resilience Bond:</u> The Forest Resilience Bond (FRB) is a model developed by Blue Forest Conservation in partnership with the World Resources Institute, Encourage Capital, and the American Forest Foundation with support from a 2016 Conservation Innovation Grant from the National Resources Conservation Service. The FRB deploys private capital to fund forest

[4] In 2015, Impact Investors committed $15B to over 7000 'impact' deals, with plans to increase capital spend by 16% to $17.7B in 2016 (Global Impact Investor Network, 2016 Annual Survey).

restoration treatments. In this pay-for-success approach, beneficiaries (such as private landowners, public agencies, utilities), repay private investors over time for forest treatments that yield desired benefits such as water quality protection, increased water yield, regulated water flow, and reduced risk of catastrophic wildfire.

Working with BFC, the U.S. Forest Service is exploring use of the Forest Resilience Bond model for restoration on public and private forest lands.

- In this partnership, BFC will raise private capital, through debt and equity investments, into a special purpose financial vehicle. The vehicle funds implementation partners to contract with crews for thinning treatments on National Forest System land (R5) at a cost savings to the Forest Service or, if applicable, on private lands at a discount to landowners.
- BFC will work with the Forest Service and other stakeholders to prioritize treatments in critical areas to the agency with projects for which National Environmental Policy Act review has already been completed.
- Partners—including but not limited to the Forest Service, academia, NGOs, and state experts—will help design a methodology for monitoring and quantifying watershed benefits and impacts on catastrophic fire risk/occurrence.
- BFC will work with downstream beneficiaries (such as water and electric utilities, water dependent private companies and state agencies) to cost-share the quantified benefits and deliver investor returns.

The benefits to the Forest Service of this partnership and the broader portfolio of conservation finance partnerships include, but are not limited to:

- Achieve social, ecological, and financial outcomes at a cost savings in priority areas through shared investments in shared risks and benefits from sustainable management
- Lead out on utilizing innovative private sector conservation financing models
- Build capacity for economic analysis and for identifying, quantifying and valuing benefits to people from forests
- Increase FS capacity by working with a primary cooperator that consolidates contractors, partners, beneficiaries, and investors
- Build relationships with non-traditional stakeholders that extend beyond simple cost sharing to promote shared stewardship
- Contribute to job creation by developing local markets and accelerating treatments

What is the Forest Service role in Pay for Success?

The Forest Service can have multiple roles depending on how the transaction is structured. We could occupy one or many of these roles in a single PFS engagement.

- We could be a service provider, completing activities or scaling programs that deliver social and ecological outcomes
- We could be a connector helping to map out the target geography, population, beneficiary
    - Define problem
    - Define target landscape
    - Help map out stakeholders
    - Frame solutions to be provided by FS or service provider
    - Utilize our R&D knowledge to understand link between services and outcomes
- We could be an evaluation partner – defining outcomes through collaboration with R&D and measuring the outcomes through boots on the ground
- Working with an intermediary, we could be a payor or investor

  - FS does not have authority to 'invest' money – but we can be reimbursed. In that way, we could provide 0% interest up-front investment to a service provider working through a non-profit partner
  - FS does not have authority to dedicate out year funds we have not been obligated – so we cannot promise payment for future outcomes. However, we can dedicate funds to a non-profit congressionally chartered partner to hold in an endowment or escrow fund to then pay for outcomes at a defined rate and timescale.
- We can explore if the Forest Service could function as an intermediary

How can the Forest Service utilize large impact investments on the ground?

The Forest Service can work closely with private investor partners to design a beneficial project and do the necessary environmental planning, project design, and contract prep work ahead of receiving the funding for implementation. Funding could also be phased over several years depending on what works best for a given project. Also working with intermediary non-profits (e.g. NFF, NFWF, NWTF, TNC, etc.) can help line up contractors in advance to help expedite a project. An intermediary can help conduct NEPA analysis as well. When working with an intermediary partner, the FS primary role could be simply making final decisions pursuant to NEPA on project locations & design.

Can the Forest Service "pay back" investors?

The Forest Service role in a PFS project cannot include providing payments to for-profits for already completed activities. FS can use appropriated funds to contribute to actual costs of a given project in a given fiscal year or over multiple-years during the implementation phase by obligating funds through an agreement or contract. This can reduce the cost of up-front investments to private partners and provide a consistent cash flow to support project activities, without serving as "pay back".

Are PFS models implemented for one or multiple resource challenges and geographies?

PFS transactions must occur within a defined geography. If that transaction is addressing a challenge that occurs in other geographies, the model can be scaled, but it is still best applied within a specific boundary. The scale of the landscape or geography is not as important. PFS transactions can support activities that address challenges and deliver outcomes in one resource area (i.e. recreation, timber restoration, urban wood utilization). It is also possible for PFS transactions to support activities that address challenges and deliver outcomes in multiple resource areas within the same geography.

Are there other places within USDA that are exploring Pay for Success?

The USDA Natural Resource Conservation Service included pay for success as one of the funding categories in their 2017 Conservation Innovation Grant program. They are funding projects that use pay for success models to promote conservation practices on private farms and forestlands.

Are there other federal agencies exploring Pay for Success?

<u>Energy Savings Performance Contracts for Federal Agencies:</u> An energy savings performance contract (ESPC) is a partnership between a Federal agency and an energy service company (ESCO). ESCOs conduct facility audits and identify opportunities for agency energy savings. The ESCO designs a project, and arranges for project financing. The ESCO, "guarantees that the improvements will generate sufficient

energy cost savings to pay for the project over the term of the contract."[5] Any utility bill savings from the contract accrue to the agency. The Department of Energy provides agencies with training, template contracts, and guidance to achieve high quality energy use reductions through ESPCs. Agencies use EPSCs to reduce energy costs while contributing toward Federal sustainability goals. The Bureau of Land Management (BLM) used an ESPC to implement a $3.6 million project across 6 western states.

World Bank Pilot Auction Facility: The World Bank Pilot Auction Facility stimulates private investment in projects to reduce Green House Gases (GHGs) while maximizing the impact of public funds. The Facility sets a minimum price guarantee for tons of future carbon credits to private investors. The minimum price guarantee is allocated through a competitive auction where project developers bid on a put option giving them the right, but not the obligation to sell their future credits at the guaranteed price. The facility is backed by philanthropic donors. The Pilot Auction Facility utilizes auctions to allocate public finance for climate action efficiently. The competitive nature of the auction reveals the minimum price required by the private sector to invest in climate mitigation projects, maximizing the impact of public funds to support the highest volume of climate benefits per dollar. [6]

[5] http://energy.gov/eere/femp/about-federal-energy-savings-performance-contracts
[6] http://www.pilotauctionfacility.org/content/paf-fact-sheet-1-overview