

**Response to the State of Michigan
Request for Information:
Social Impact Bonds – Pay for Success Based Financing
Project Number: #0071141113B0000535**

October 24, 2013

Third Sector Capital Partners
200 Clarendon Street, 9th Floor
Boston, MA 02116
(617) 912-8957

Contact:
Caroline Whistler
Co-Founder & Partner, Advisory Services
(401) 258-1109
cwhistler@thirdsectorcap.org

Table of Contents

I. Executive Summary	2
II. Background Information	3
About Third Sector Capital Partners.....	3
Third Sector’s Track Record	4
Pay for Success and Social Innovation Financing Overview	5
III. Potential Projects in Michigan	6
Potential Initiatives and Program Areas in Michigan.....	7
IV. Additional Information	11
Funding Considerations	11
Governance Structure Considerations	11
V. Appendix	13
The Third Sector Leadership Team	13
Case Study: Massachusetts Juvenile Justice Pilot	14



I. Executive Summary

Pay for Success (“PFS”) contracts and **Social Innovation Financing** (“SIF”), such as Social Impact Bonds (“SIBs”), provide governments the opportunity to invest in proven social programs while maintaining fiscal balance and only paying for proven outcomes. Because PFS projects involve complex public-private partnerships, they require the support of experienced advisors like Third Sector Capital Partners (“Third Sector”) to provide the expertise necessary to develop and implement successful PFS projects.

Third Sector, a nonprofit advisory firm, provides a range of PFS and SIF specific services including landscape and feasibility analysis, deal construction, and financial arranging. As the nation’s leading practitioner in the emerging PFS and SIF fields, Third Sector has experience working with multiple states, including Massachusetts, New York, Michigan, Illinois and Ohio, as well as multiple local governments, including Cuyahoga County, OH and Santa Clara County, CA. Third Sector is currently in the final stages of structuring the PFS deal for the Massachusetts Juvenile Justice Pilot. With success payments as high as \$38M, it will be the largest PFS deal in the world to date.

In order to help the State of Michigan (the “State”) develop the most effective PFS project possible, Third Sector assessed the Michigan social services landscape. Through our discussions with Michigan service providers, funders, research organizations and other stakeholders, we have developed an early assessment of promising program areas and interventions within the state that have the qualities necessary to function and succeed in a PFS model. While further research is necessary to assess whether a PFS model would prove feasible, we have summarized in this response our research on interventions’ evidence, scalability and target populations, as well as the state and local environment that would support the necessary data collection and analysis for a PFS project. Third Sector is pleased to submit the following response outlining key considerations, recommendations, and potential project areas for the State’s review. Please feel free to contact us with further information or questions.

II. Background Information

Overview of Third Sector Capital Partners

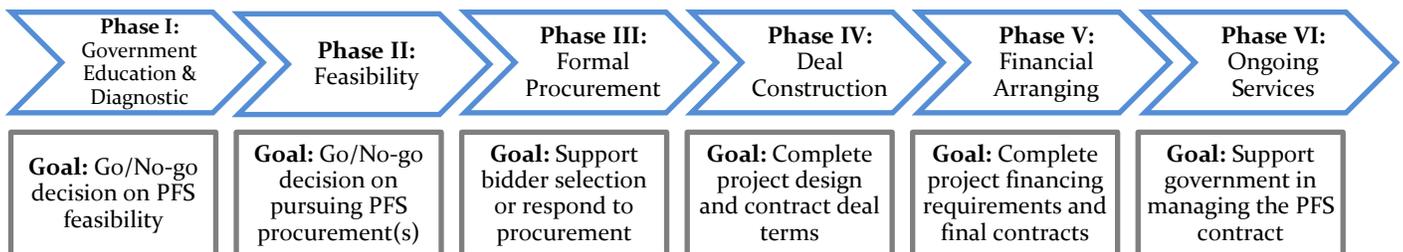
Third Sector Capital Partners (“Third Sector”) is a nonprofit advisory services firm whose mission is to accelerate America’s transition to a performance-driven social sector. We work with government, funders and service providers to bring powerful and innovative public-private partnerships to bear on many of society’s most pressing social issues. Third Sector has worked on multiple projects with federal, state, and local partners and brings an experienced perspective and customized approach to each of our engagements, recognizing that each PFS or SIF project has particular objectives and requires unique services. The range of services we offer is detailed in *Figure 1*.

Figure 1: Third Sector’s Services

Transaction Feasibility	Deal Construction and Financing
<p>Goal: Work with government, providers, and investors to assess the feasibility of PFS pilots and procurements around the country. <i>Includes procurement technical assistance, program feasibility and provider assessment, risk evaluation, economic modeling, and partnership formation.</i></p>	<p>Goal: Help our clients create strong, lasting collaborations that benefit all stakeholders. <i>Includes financial structuring, multi-party contract formation, fundraising from philanthropic and commercial sources, and vetting of partnership stakeholders.</i></p>
Post-Closing Intermediary	Education and Advocacy
<p>Goal: Track and support the successful implementation of social innovation financing contracts. <i>Includes project management, fiscal agency, investor relations, and evaluation support.</i></p>	<p>Goal: Share insights learned, broaden understanding of social innovation financing, and move the nonprofit and government sectors towards higher levels of performance impact. <i>Includes case studies and publications, federal policy support, and speaking engagements.</i></p>

Our PFS advisory services can be broken down into six key phases as illustrated in *Figure 2*. Third Sector can support any and all phases of the process, either working with government or responding to government procurements.

Figure 2: PFS Advisory Process Phases and Goals



Third Sector's Track Record

As a proactive leader in the domestic PFS market, Third Sector has developed and implemented several state-level, county-level, and federally-funded PFS projects in the United States. From helping to launch the world's largest SIB in Massachusetts to advising key PFS stakeholders, Third Sector has partnered with government, philanthropic and commercial funders, as well as service providers to bolster the growth of the promising PFS market (*Table 1*).

Table 1: Third Sector's Past and Existing PFS Engagements

Project Level	Engagement Details
Federal	<ul style="list-style-type: none"> ▪ Third Sector developed the first and largest federally-funded PFS projects in the country. We were successful in helping our clients receive the following federal resources: <ul style="list-style-type: none"> ▪ Cuyahoga County (Cleveland, Ohio) earned a Second Chance Act Grant from the Department of Justice in 2012, and ▪ The Massachusetts Juvenile Justice Pilot was awarded a \$11.67 million grant from the Department of Labor in 2013 ▪ Third Sector has advised numerous federal partners including the White House Office of Management and Budget and the White House Office of Social Innovation. ▪ Third Sector has presented at numerous convenings on PFS including the White House and has written articles published in a journal by the Federal Reserve Bank of San Francisco.
State	<ul style="list-style-type: none"> ▪ Third Sector was selected as the lead intermediary for the \$38 million Massachusetts Juvenile Justice Pilot, the first state-level PFS project in the country. Working with Roca Inc. as the main service provider and the Harvard SIB Lab as lead government advisor, Third Sector led project negotiations, finalized contracts, and has raised more than \$18 million of private financing for the project. ▪ Massachusetts also selected Third Sector to advise the Commonwealth's chronic homelessness PFS initiative, in partnership with the Corporation for Supportive Housing, United Way of Massachusetts Bay and Merrimack Valley, and the Massachusetts Housing and Shelter Alliance. ▪ Third Sector partners with service providers across the country to promote education and understanding on developing PFS projects. Third Sector has provided educational services in New York, Illinois, Ohio, and South Carolina and serves on the California advisory working group for Social Innovation Finance.
Local	<ul style="list-style-type: none"> ▪ Third Sector is currently developing and implementing the first two county-level PFS projects in the country in Cuyahoga County, Ohio and Santa Clara County, California. Under formal county mandates with funding from local philanthropies and both Counties, Third Sector: <ul style="list-style-type: none"> ▪ Convened and educated government, funders, providers and other community stakeholders; ▪ Performed landscape analyses to identify target populations and program areas ▪ Co-designed PFS procurement processes; and ▪ Performed due diligence and economic modeling. ▪ Projects are expected to launch in both Cuyahoga County and Santa Clara County in 2014.

In addition to these formal government engagements, Third Sector is regarded as a national thought leader in the field, involved in presentations and publications by the Harvard Business School, Social Capital Markets Conference, Bloomberg Philanthropies, *The New York Times*, *The Economist*, *Stanford Social Innovation Review*, and many more. Our wide range of advisory services is supported by our partners, including the Rockefeller Foundation, The William and Flora Hewlett Foundation, and the Laura and John Arnold Foundation.

Pay for Success and Social Innovation Financing Overview



PFS

Pay for Success (PFS) is a general term for performance-based contracting between government and social service providers, where government only pays providers if target outcomes are achieved, e.g. reduced recidivism or improved health outcomes, as opposed to providing cost reimbursement payments.



SIF

Social Innovation Financing (SIF) is a financing approach that bridges the timing gap between government success payments and upfront working capital needed for service providers to run PFS programs. Financing capital can be raised from philanthropic or commercial sources. Depending on the terms of the financial deal, these investors will be either repaid from government success payments or will reinvest payments into future projects. *Social Impact Bonds* (SIBs) are a form of SIF.

A basic PFS project includes five key partners:

- **The State of Michigan** must determine which outcomes in a given area it wants to invest in, and agree on how much it will pay for successful outcomes.
- **Service Provider(s)**, in agreeing to implement projects, need to determine which outcome targets they are willing to be held accountable for and the cost of achieving those targets, as well as subject themselves to rigorous evaluation.
- **Independent Evaluator(s)** assess providers' intervention outcomes and determine the success of the project. The independent evaluator can either hold the contract with the State or the limited liability corporation created by the project.
- **Funders** provide the upfront working capital necessary to implement the project that can come from multiple sources including traditional grants, mission related/project related investments, credit enhancements, loan guarantees, and commercial loans.
- **Intermediaries** like Third Sector can provide vital PFS services in two categories: *short-term, pre-contract functions* move a PFS project from procurement through launch and can include negotiations, data analysis, deal construction, and fundraising. *Ongoing functions* include day-to-day project oversight and management, and are best performed by organizations with programmatic expertise and local knowledge.

In the Massachusetts Juvenile Justice Pilot, Third Sector performs both functions (see the case study included in the Appendix for further information). However, in many cases, organizations with expertise for on-going implementation do not have the requisite skills to perform economic modeling, negotiation of terms and conditions, and fundraising PFS contract development requires. Similarly, organizations with expertise in PFS pre-contract development and design frequently do not have local knowledge or programmatic implementation expertise to manage a contract to outcomes.

For this reason, government should consider designing procurements to allow two different intermediary organizations to support the project, one pre-contract and one to execute the contract, to ensure the appropriate skills are brought to bear at relevant moments of the process.

An intermediary organization(s) can potentially be compensated at four different points of the PFS process:

- **Pre-Contract:** A fee to cover the feasibility assessment, formal procurement and deal construction phases
- **Contract Closing:** A fee when the PFS contract is successfully put together
- **Ongoing Management:** An ongoing management fee during the PFS contract
- **Contract Completion:** A fee at the end of the PFS contract depending on if and the extent to which target outcomes are met

The size and role of an intermediary organization can vary significantly depending upon the specific circumstances of a PFS/SIF project. For example, if a single social service provider is chosen to enter into a PFS arrangement, it may be possible to embed the intermediary function within the provider. If multiple service providers are chosen, a separate standalone intermediary entity may be more appropriate. In all cases, it is wise to ensure that *ongoing* intermediary functions be performed by an organization with strong programmatic experience, while *short-term* intermediary functions such as deal construction and financial arranging are performed in consultation with firms such as Third Sector that offer strong transaction support experience.

III. Potential Pay for Success Projects in Michigan

PFS is not a panacea, and not every service in the social sector lends itself to the features of PFS contracts, particularly at this nascent stage of the field's development. As the State recognized in its request for information, several criteria (outlined below) are helpful in guiding the selection of potential PFS project areas.

Table 2: Criteria for Choosing a PFS Project

Criteria	Considerations
Defined Target Populations	To achieve optimal PFS interventions, the population served must be clearly identified, and enough individuals must be served to ensure that evaluations are statistically significant.
Available Data	In addition to data collected by the provider, is there existing data from government or another organization that will provide independent evaluators with the necessary tools to conduct rigorous evaluations? High quality, low cost evaluations require the use of existing data rather than the collection of new data or creation of new data systems. By harnessing existing administrative data from governments and service providers, experts are able to construct inexpensive but effective evaluations necessary for PFS projects.
Proven Interventions	Are there evidence-based service providers or providers with data-driven records of success within a given issue area to merit PFS consideration? PFS is not currently a tool for testing new interventions, but instead offers the opportunity to invest in and expand services that have a track record of achieving certain outcomes.
Ability to Scale	Do these providers have the ability to scale in a given community or area, and to a specific size while maintaining the efficacy and quality of the intervention?
Evaluation Methodology	Are there providers willing to subject themselves to rigorous, on-going evaluation that are likely to succeed in a given project?
Safeguards for the Target Population	What ethical concerns are associated with a proposed project, and how will those concerns be addressed?
Cashable Savings and/or Priority Outcomes	What is the cost-benefit analysis for government, and what specific cashable savings and/or priority outcomes will be achieved for the government organizations of interest?

It is important to note that *the ultimate success of any PFS project is directly related to the strength of a given service provider and the potential of the intervention model to meet pre-determined outcomes.*

Potential Initiatives and Program Areas in Michigan

Through our research, we have determined that multiple program areas in Michigan provide a promising combination of the factors discussed on the previous page. While an in-depth landscape analysis of these areas still needs to be conducted, we have found the following interventions to be initially promising PFS project candidates. Please note that all savings estimates are preliminary and are based on available data.

Juvenile Justice: Juvenile Care Justice Model and Residential Treatment Diversion

The juvenile justice (“JJ”) landscape in Michigan is well positioned for a PFS project that reduces residential treatment through increased use of community-based alternatives. While there is no state system for tracking JJ data, it is estimated that anywhere from 2,000 to 3,400 youth in Michigan are placed in residential treatment annually, a quarter of all youth in the JJ system statewide.¹

Residential treatment is a costly option to all levels of government and service providers, counties and judicial systems have started to consider alternative approaches to improve outcomes and reduce costs. Michigan’s JJ system currently operates with little to no coordination across counties or at the State level on the use of data systems, definitions and risk assessments. An estimated 30% of counties do not employ a risk assessment in their JJ detention and placement processes.² Faced with limited funding, JJ systems are treating youth with increasingly complex problems and who require more rigorous and individualized treatment approaches. A survey conducted in 2011 of JJ professionals identified “programming and treatment services” as the highest priority for Michigan’s JJ system, including expanding community-based programs.³

The State and several counties have recently started a shift to data coordination, performance-based contracting and alternatives to residential treatment programs for juvenile offenders, making the JJ system a promising environment for a PFS project. This shift is evidenced by many factors, including a recent state grant for the development of rural community-based programs and the creation of **Juvenile Justice Vision 20/20** (“JJV2020”), a group working to create common data definitions and risk assessment tools that will build a comprehensive JJ data repository across the state. JJV2020’s members include court coordinators from numerous counties across the state as well as stakeholders from the State’s Bureau of Juvenile Justice, Michigan Department of Education, various service providers, Grand Valley State University and Michigan State Police and Sheriff’s Association. JJV2020’s stakeholders and coordination can provide a strong foundation of cross-county data collection necessary for a JJ PFS project.

In Michigan, JJ offenders are typically referred to residential treatment programs operated by counties or contracted out to private service providers. Community-based and home care alternatives provide a less costly and more effective approach to treatment, resulting in savings to counties and to the Department of Human Services’ County Childcare Fund. Service providers throughout the state have started to expand community-based programming, including organizations such as Starr Commonwealth and Highfields.

The **Juvenile Care Justice** (“JCJ”) model currently employed in Ottawa County serves as an existing example of a residential treatment diversion intervention. Through the JCJ model, the County contracted with nonprofit agencies to provide individualized wraparound services to juvenile offenders. Utilizing risk assessment tools, the County

¹ Staley, K. & Weemhoff, M. (2013). There’s no place like home: Making the case for wise investment in juvenile justice. Lansing, MI: Michigan Council on Crime and Delinquency.

² Juvenile Justice Vision 20/20, “Michigan Juvenile Offender Risk Assessment Survey Report.”

³ JJV2020 Strategic Plan

determined which youth could be safely diverted from residential treatment. Within the first year of operation, the JCJ model reduced residential placements in the County from 62 placements to 11. The County currently averages only 5 residential placements per year. The model is supported by a Resource Team within the county, which meets weekly to brief on difficult cases and jointly decide on placement with input from law enforcement, DHS, treatment managers and the local Community Mental Health department.

Ottawa County pays an average of \$220 per diem to residential treatment providers as opposed to a sliding cost structure for community-based treatment providers that ranges from \$50 to \$105 per diem. The statewide average per diem cost for residential treatment is \$202 per juvenile; community-based alternatives cost, on the high end, \$65 per diem, resulting in the potential for as much as \$137 in savings per diem for each diverted youth assuming the above estimates are marginal costs.⁴ Ottawa County also has experienced shorter duration of stay in community-based treatments (an average of six months) than in residential placements (often 9-12 months); shorter stays could result in further cost savings per youth.

In addition to reducing treatment costs and offering individualized treatment for juvenile offenders, the community-based aspect of the JCJ model allows for families to remain actively involved in juveniles' treatment programs. A PFS project could expand the JCJ model to other counties, beginning with those already participating in the JJV2020 initiative. Outcome measures might include a reduction in days in residential treatment as well as a reduction in recidivism post-treatment.

JJV2020 is focusing its initial county-level efforts in Ottawa, Kent, Kalamazoo and Ionia. Given JJV2020's data collection and standardization efforts, a PFS project would ideally begin in these four counties. The target population within the four counties would be youth offenders at-risk of residential treatment. Pilot counties will utilize one of the four risk assessment tools that JJV2020 recommend for all youth that enter the Michigan JJ system.⁵ These risk assessments identify common individual, family and community risk factors that can identify high-risk youth that can be diverted from residential treatment and would benefit from community-based wraparound services. True randomization may be difficult due to judicial discretion with sentencing guidelines, but narrowing the target population to those youths who are at high risk of residential treatment can produce a strong counterfactual and treatment group. Given Ottawa County alone diverted approximately 50 youth into community-based programming annually, the four counties should be able to serve a target population of at least 200 youths a year.

Juvenile Justice: Multisystemic Therapy ("MST")

Multisystemic Therapy is a JJ diversion model focused on delivering intensive family-focused therapy. MST has demonstrated through 22 randomized trials, including one with two long-term follow-up studies, to reduce short- and long-term recidivism by an average of 39% and out-of-home placements by 54%. The MST model is currently operating in eight Michigan counties. **The Guidance Center**, a Southeast Michigan non-profit agency focused on child welfare services, proposes scaling MST services in Southeast Michigan. In a PFS project, the Guidance Center would divert 200 juvenile offenders in Wayne County from residential treatment to MST services. Measured outcomes could include diversion from residential treatment and reduction in recidivism, both evidenced outcomes of MST. For more information, please refer to the Guidance Center's submitted response.

⁴ "A Comparison of Michigan's Residential Placement Options for Juvenile Delinquency Cases." Francis Carley, Senate Fiscal Agency; published May 2012. \$202/\$65 per diem estimates provided by Kristen Staley, Michigan Council on Crime and Delinquency.

⁵ The recommended four risk assessment tools are MJJAS, YASI, YLS/CMI 2 and SAVRY. For further information see JJV2020's "Michigan Juvenile Offender Risk Assessment Survey Report."

Juvenile Justice/Child Welfare: Therapy Services

The **PLL Performance Group**, a group of partner organizations including VisionQuest National Ltd., Northern American Family Institute (NAFI) and Parenting with Love and Limits (PLL), has strong potential to manage a collective action PFS project in Michigan. The PLL Performance Group plans to provide three evidence-based interventions: PLL, Functional Family Therapy (FFT), and Aggression Replacement Therapy (ART) to at-risk youth. The interventions serve populations including reentry service to youth in residential placement as well as an alternative or diversion to placement service to crossover youth and youth on probation. In 2010 the total population of juvenile delinquents was approximately 13,000.

The PLL Performance Group proposes a PFS project to serve youth in Wayne, Oakland, and Macomb counties, with the potential of scaling up to other counties in the southeastern part of the state. The three programs would serve a total of approximately 1,026 youth annually through FFT, ART, PLL Reentry and PLL Alternative to Residential Placement. These evidence-based programs have been proven to reduce recidivism, as well as reduce time in residential treatment through diversion or the PLL Re-Entry transition program. Outcomes measured through a PFS project could include the length of stay in residential treatment, avoided days in residential treatment, and reduction in recidivism. Based on currently available data, the PLL Performance Group estimates that it could save up to \$72,000 per youth diverted to these programs. For more information, please refer to the PLL Performance Group's submitted response.

Foster Care: Safe Families Program

In 2012, approximately 90,000 children referred to Child Protective Services were categorized as at risk of neglect. Children are then placed into foster care, with the State incurring high expenses and long stays without remediating family issues that can solve the root causes of neglect. On average, Michigan pays a base daily rate of \$17.24 - \$20.59 for foster care.⁶ Factoring in supplemental payments to agencies and additional costs for special needs, Michigan on average spent \$55 daily per each child in the foster care system.⁷ **Safe Families** is a foster care initiative that utilizes faith-based networks to recruit volunteer host families that provide foster care, with a strong track record of expediting reunification and improving outcomes for children and their families. Safe Families provides a *diversion from the State's traditional foster care model* that works with children's families to provide long-term supports and resources. Safe Families reports a cost of \$10/day for foster children, with an average length of stay of 40-45 days. In Chicago, where SFFC was founded, The State of Illinois' Department of Child and Family Services has recognized a multi-million dollar reduction in child welfare/foster care expenses due to the SFFC initiative. Ultimately, 93% of children are returned to their families and 80% maintain a long-term relationship with their host families.

Over the past decade, Safe Families has provided over 8,500 hosting arrangements and currently provides services in 54 active sites in 25 states. Through **Bethany Christian Services**, Safe Families has been operating in Michigan since 2011 with current operations in Holland, Grand Rapids, Traverse City and Kalamazoo. Expansion is planned for next year in Flint and Detroit. In 2013 year-to-date, Safe Families has served 130 Michigan youth. Factoring in the previously mentioned expansion plans in Southeast Michigan, Safe Families would be able to serve approximately 550 families annually in a PFS project. Child Protective Services would divert children to Safe

⁶ DeVooght, Trends and Blazey. "Family Foster Care Reimbursement Rates in the U.S." Child Trends; published April 9, 2013. <http://childtrends.org/wp-content/uploads/2013/04/Foster-Care-Payment-Rate-Report.pdf>

⁷ Based on Bethany Christian Services' internal cost data.

Families if they fall into two risk categories of neglect, and the outcomes of family reunification and avoided re-referral to foster care would be tracked over the PFS project term.

By serving 550 children, Bethany estimates it could generate up to \$13 million in governmental cost savings. This assumes, based on past data, that 3% of Safe Families participants are re-referred to foster care, an average reduction from 450 days in traditional foster care to 45 average days with Safe Families and an average reduction in costs from \$55 per day in traditional foster care to \$10 per day with Safe Families. With an annual program cost of \$1.5 million, state and local governments could realize a net cost savings in foster care expenditures of \$11.5 million for every 550 children served annually. For more information, please refer to Bethany Christian Services' submitted response.

Asthma: Green and Healthy Homes Initiative

In 2010, an estimated 39,700 children on Medicaid in Michigan had persistent asthma.⁸ Substandard housing conditions can exacerbate asthma, causing high rates of emergency medical care services that are entirely preventable. **The Green and Healthy Homes Initiative** ("GHHI") utilizes a combination of in-home patient education, housing assessments and asthma trigger mitigation services to reduce allergy-related emergency room visits and hospitalizations of Medicaid patients. GHHI interventions have demonstrated a 50% reduction in emergency room visits and 65% reduction in asthma-related hospitalizations. A GHHI PFS project in Michigan would serve four pilot counties: Genesee, Ingham, Muskegon and Saginaw.

GHHI will work with Medicaid managed care organizations and the State's data tracking systems to track and analyze pre-post cost information. This same database can provide information on patients with similar characteristics who were not referred to GHHI, providing cost information on the counterfactual group, as well as track those who were referred to GHHI but were not enrolled successfully, potentially supporting an intent-to-treat evaluation design as well. The collaborative and community-based nature of GHHI's intervention can easily be leveraged to scale the program across Michigan. If proven successful in its first years of operation, GHHI has identified the opportunity to scale its intervention to 11 more counties in the state.

The preventative nature of the intervention has been proved in a variety of studies to generate significant savings through averted medical costs. For more information, please refer to the GHHI's submitted response.

Diabetes Prevention: Omada Health

Omada Health targets the 69,300 Michigan residents with prediabetes on Medicaid through *Prevent*, a 16-week online version of a proven diabetes prevention program study. Through online support and weekly lessons led by professional health coaches, participants are encouraged to improve their diet and increase physical activity to achieve a 5-7% weight loss goal that reduces the risk of developing diabetes. The *Prevent* intervention is easily scalable due to its online delivery, and can recognize savings by serving Michigan state government employees or Michigan Medicaid recipients. An estimated 69,300 Michigan adults on Medicaid are currently diagnosed with prediabetes, a critically large target population to serve. The diabetes prevention program generates an estimated \$2,277 in savings per successful program completion that results in a lower body fat percentage through reduced medical costs.⁹ At a program cost of \$430 per participant, and by serving 6,000 residents over a PFS project period,

⁸ Garcia, Lyon-Callo. "Epidemiology of Asthma in Michigan; Asthma Burden for Children in Medicaid." Michigan Department of Community Health. http://www.getastmahelp.org/documents/Asthma_for_Children_in_Medicaid_2012.pdf

⁹ Cost of a Group Translation of the Diabetes Prevention Program Healthy Living Partnerships to Prevent Diabetes. Lawlor et al.

Omada estimates the program has the potential to generate as much as \$8.5 million in cost savings to the government annually. For more information, please refer to Omada Health's submitted response.

IV. Additional Information

Funding Considerations

Engaging potential funders early is critical to the successful execution of a PFS project. Through our development work and work as lead intermediary for the Massachusetts Juvenile Justice PFS Pilot, Third Sector has developed close relationships with a wide variety of potential PFS investors, including commercial banks, national and regional philanthropic foundations, and high net worth individual impact investors. We have had preliminary discussions with interested funders in Michigan, including the Council on Michigan Foundations and the Kellogg Foundation, on the funding and development of a PFS project in the state. If the State proceeds with PFS project development, we would seek to continue those discussions.

Governance Structure Considerations

While there is no one size fits all model for PFS projects, a few key questions must be addressed when considering the governance structure:

1. Should the project use one or multiple service providers?

Two types of models are emerging in the PFS marketplace: collective action (multiple providers orchestrating service delivery with common outcome goals), and single provider (one organization delivers all services). Both approaches are valuable and pose different challenges. In the collective action model, it may be more difficult to evaluate which providers are driving impact if they are serving the same population. In the single provider model, evaluation is less complicated but placing too much responsibility on one organization can be risky. As a practical matter, the single provider model is easier to implement. Third Sector is able to work with both types of projects and prefers whichever model is most appropriate for the target population and that can be rigorously evaluated to determine outcomes.

2. Can for-profit service providers be included in a PFS contract?

Since the central goal of a PFS contract should be payment for outcomes, it is certainly possible for for-profit firms to be used as service providers. At this early stage of PFS industry development, however, it is helpful to use a nonprofit intermediary as the primary PFS contracting organization, so that philanthropic funding is more easily obtained, the possibility of personal enrichment is removed, and purely social motives are clearly in place.

3. Where should project funding be held?

Once a service provider has been selected and the project partners have been established, it is critical to create a non-governmental repository for the upfront working capital raised from funders. This will alleviate funder concerns about the money being 'swept' and allow all partners to limit their levels of liability. In Massachusetts, Third Sector established a limited liability special purpose vehicle for this reason.

4. How should project partnerships be governed?

Projects are best governed via multi-party contracts and committees. For example, even though the Massachusetts Juvenile Justice Pilot funds will be housed within a new non-governmental limited liability nonprofit entity, all of the transactions that flow in and out of that entity will be governed by a collection of

contracts and committees developed among the project partners, rather than any one board or leadership team. The contracts spell out specific standards of performance for all parties, along with available remedies should those standards not be met. They also clarify the decision rights afforded to each party.

5. **How will government guarantee future funding?**

We have learned that a government's unbackstopped promise to pay for outcomes in future years is not enough to reassure investors and service providers that government will meet its commitments. In order to bring partners to the table, government should strongly consider offering some form of 'political' budget protection. In Massachusetts, the legislature passed a bill placing the full faith and credit of the state behind the contracts. Elsewhere, certain contractual penalty arrangements have been put into place to bolster investor confidence that government payments will be forthcoming.

In order for broader systemic change to take place, PFS innovations need to move beyond the early pilot projects that are currently being developed with new budget allocations. Ultimately, PFS innovations will bring about significant shifts in the long-term allocations of many billions of dollars of already-existing government funding streams. PFS needs initial private capital to catalyze performance-based contracting, but it will require long-term government investment and reallocation of resources to bring about systemic change.

6. **Should private investors absorb all the risk?**

PFS projects do not necessarily require that financial investors bear 100% of performance risk. Indeed spreading the 'skin in the game' to include governments and service providers may appeal to private investors who would otherwise shy away and can bring greater alignment and transparency among project parties. In some rare cases, providers may possess balance sheets or lines of credit large enough to finance a PFS project independent of outside investors.

7. **When should potential investors be engaged?**

Commercial lenders tend to prefer responding to specific projects and financing opportunities, while philanthropies tend to prefer helping inform project development. All funders require some form of an iterative process before agreeing to fund any project. However, no funder will guarantee project funding without understanding the details of a proposed deal. We believe the best way to engage a diverse pool of interested funders is to establish an "Investor Council" early in a deal's development. This allows funders to express interest and potential commitments early, project partners to incorporate funder feedback in initial deal construction, and all parties to avoid significant time delays in negotiation and contracting late in the project's development.

In conclusion, The State of Michigan's focus on innovation and efficiency is well-suited to implementing a PFS project and supporting the replication of efficient and impactful service models. Based on our discussions, we believe that the State has the necessary environment of interested funders, government support and innovative and data-driven service providers to implement a PFS project. Our initial analysis has identified several program areas and promising interventions that could be scaled in Michigan through performance-based financing, especially in human services. Further research and utilization of government data can determine the specific level of savings these interventions could deliver. Third Sector looks forward to working with Michigan stakeholders and the State to move forward in this process.

V. Appendix

The Third Sector Leadership Team

PFS contracts require multi-sector skills, and Third Sector's national team consists of experienced professionals from the fields of finance, fundraising, government management, policy analysis, nonprofit leadership, partnership development, budgeting, and economic analysis. In addition to a diverse team of analysts, associates and advisors, Third Sector's leadership team is comprised of the following experts:

- **George Overholser, CEO & Co-Founder** introduced the concepts of PFS and SIF at New Profit's *Gathering of Leaders* in 2007 and has been a longtime advocate for "smarter" social investing. He was on the founding management team of Capital One Financial Corporation and was Co-Founder of North Hill Ventures. George also co-founded and led Nonprofit Finance Fund's Capital Partners division, which helped high-performing nonprofits raise over \$320M in growth capital.
goverholser@thirdsectorcap.org
- **Rick Edwards, Partner, Capital Markets** brings extensive experience in structuring public-private partnerships from his time as Global Head of Project Finance and Advisory for JP Morgan Chase, where he built #1 market share for the division. He also previously worked as CEO of an insurance brokerage firm and as an entrepreneur in the communications technology industry.
redwards@thirdsectorcap.org
- **John Grossman, Partner & General Counsel** was Undersecretary of Public Safety for the Commonwealth of Massachusetts until April 2011, before attending MIT's Sloan School of Management. He brings deep experience in public sector performance management and government affairs.
jgrossman@thirdsectorcap.org
- **Caroline Whistler, Co-Founder & Partner, Advisory Services** previously worked at Nonprofit Finance Fund Capital Partners and brings five years of experience in innovative social financing for high-performing nonprofits. Prior to NFF, Caroline conducted nonprofit analysis, market research and sustainability studies for Community Wealth Ventures, a social enterprise consulting firm.
cwhistler@thirdsectorcap.org

Case Study: Massachusetts Juvenile Justice Pilot

The Commonwealth of Massachusetts, Third Sector Capital Partners, and Roca Inc. are in the process of launching the Massachusetts Juvenile Justice Pay for Success Pilot, the world's largest PFS deal to date. Expected to launch in late 2013, the project will provide up to \$38M in success payments to Roca for reducing recidivism and increasing employment among high-risk young men aging out of the juvenile justice system.

Interested in piloting the country's first state-level PFS project, Massachusetts issued a Request for Information (RFI) in May 2011 with the goal of helping the Commonwealth determine "the areas of government activity where success-based-contracting strategies have the potential to improve outcomes and/or reduce cost." Through this information gathering process, Massachusetts determined that reducing youth incarceration would be one project focus area for the Commonwealth given the variety of established providers offering preventive services likely to result in improved outcomes and reduced costs.

Every year approximately 4,000 high-risk young men age out of the juvenile justice system or are released from probation in Massachusetts. 65% of these young men are incarcerated at least once within the next 5 years for an average of 2.3 years. With an annual cost of incarceration of \$47,500 per person, each cohort of 4,000 young men costs the Commonwealth over \$280 million in incarceration expenses in the five years after they leave the juvenile justice system. With barely any government services provided to these young men and no new resources available to serve them, Massachusetts determined PFS provided the opportunity to invest in evidence-based, cost-effective services, reducing juvenile recidivism while saving taxpayer dollars.

Following the RFI process and initial development work conducted in partnership with the Harvard Social Impact Bond Technical Assistance Lab (SIB Lab), the Commonwealth issued a Request for Responses (RFR, also known as an RFP or RFQ in other jurisdictions) in February 2012 to select project partners for the juvenile justice pilot project. Following a joint, in-depth RFR proposal development process, Roca and Third Sector submitted responses to the Commonwealth and in August 2012 were selected as the project's service provider and intermediary. During this process Roca was evaluated against several key criteria and determined to be well positioned to provide services in a PFS arrangement. Specific Roca strengths include dedication to performance-based management and use of data, demonstrated experience scaling-up and replicating their services, an established record of success, and an unwavering commitment to improving results for the population served.

With partners selected, Third Sector began developing the project with Roca, the Commonwealth, and the Harvard SIB Lab: negotiating contracts, conducting in-depth data and economic analyses, structuring project terms, and raising project capital. Through this process, project partners negotiated various aspects of the deal including evaluation design, project timelines, and project financing, including government success payments. Third Sector established a nonprofit special purpose vehicle, Youth Services Incorporated, to serve as the project's financial clearinghouse, and the Commonwealth passed legislation providing full faith and credit to the government's commitment.

Through this iterative process, partners initially agreed to the following key project parameters:

- Roca will serve an additional 900 young men over 6 years through the pilot project, with a target reduction in recidivism of 45%
- Beginning in project year five, Massachusetts will pay a success reward for every cumulative foregone bed-day of incarceration and every quarter of increased employment, compared to counterfactual levels; potential financial returns for the Commonwealth range from break-even to over to \$15M in net savings, depending on outcomes
- Financing will consist of various financial instruments ranging from "impact debt" to philanthropy

To date, Third Sector has raised more than \$18M for the project and helped secure an additional \$11M in success fees from the US Department of Labor through a competitive grant awarded in September 2013. Roca has been preparing to expand its operations, and the Commonwealth expects the project to officially launch in late 2013.