HCEO **Human Capital and Economic Opportunity Global Working Group**

Transcript for Pay for Success Social Impact Finance: Theory and Practice

Presenters

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Early Childhood Parternships

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Salt Lake City Pre-Kindergarten Project

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Transcript

Lindsay: Welcome, everyone, to the Pay for Success Social Impact Finance hosted by ReadyNation and the Human Capital and Economic Opportunity Global Working Group. After the speakers' remarks, there will be a question and answer session. Mr. Robert Dugger, you may begin your conference.

Robert Dugger: Thank you, Lindsay. Good afternoon, everybody. Thanks for joining the call. We've got a lot of territory to cover, so I'm going to be very, very brief. This call is, as you know, sponsored by the Human Capital and Economic Opportunity Global Working Group at the University of Chicago. I co-chair that working group with Jim Heckman at the University of Chicago and Steven Durlauf at the University of Wisconsin. I'm also co-chairman of the advisory board of ReadyNation. The two groups' work overlaps where the economic arguments are being developed for investing in kids prenatal to five. We have four speakers today. We'll begin with Stephen Bagnato, who will talk about the Heinz Foundation Pre-K Counts study. It's the most recent and largest of the pre-K studies and their effects.

In a few minutes Joe Waters from the Institute of Child Success in South Carolina will be available. He'll talk about the home visiting project there. That'll address interventions that involve kids prenatal to age three. Obviously Stephen's work is three year old, four year old.

Then we'll hear from Janis Dubno who will talk about the exciting effort in Salt Lake City, the Granite school district pre-K project there and an actual operating Pay for Success project. She'll review the Dubno-Dugger-Smith paper.

Last, we'll hear from George Overholser, who will talk about capital structures in Pay for Success arrangements and his interesting ideas about how the emergence of this approach to paying for early care and education will actually shape the evolution of interventions going forward.

Each of the speakers has about 10 minutes in order to leave time for questions. I'm going to step aside and ask Stephen to go ahead and begin his comments. I'll interrupt at the 10 minute mark and we'll move to the next. We'll hear from all four speakers, and then we'll turn it over to questions and answers.

Stephen...also, I'll beg you to take a look at the websites of these people for biographical information. No surprise, they're all famous, superbly educated, and deep thinkers with great resumes and wonderful successes in their background which I don't have time to recap. They're all noted in a variety of websites and so forth. I'll stop here and turn it over to Stephen! Stephen?

Stephen Bagnato: Thank you, Rob. It's a privilege to be on the call. Part of my job is to just give you a snapshot of the study that we were privileged to do in Pennsylvania from 2005 to 2009. It was called "Pre-K Counts in Pennsylvania for Youngsters—Early School Success." On the ReadyNation website, you have the executive summary and, I think, the full catalog of the study that we did, the manual.

I've had the privilege of being funded by the Heinz Endowments. Marge Petruska, the program officer there, who's the main driver behind the commitment to early childhood. The forerunner for Pre-K Counts was something called the Early Childhood Initiative, which was strictly in the Pittsburgh region, was a precursor to the state evaluation.

That one involved 2,000 children in about 25 programs in the Pittsburgh region, mostly in the inner city. It was from all the way from birth to five years of age. There were many lessons learned from that.

We applied that when we were once again tapped, winning the competition to be the evaluators for Pre-K Counts in Pennsylvania. This was a really unique chance to do a huge study.

I'm not an epidemiologist, but this comes closer to an epidemiologic study because it was 10,003 children in 21 school district-community partnerships.

This was a sample that was basically...all these programs, all comers were involved in the evaluation. That was one of the requirements.

We took it upon ourselves to really do a lot of work with many of these school districts. Most of them really good school districts but struggling with the high at-risk populations and even declining resources, in many cases.

I'll just give you a turbo version of some of the outcomes, because it was very intriguing. This was a three-year period of time where the Pre-K Counts model, I'll call it, was put in place. Which was more like a systems model, where every school district, in order to get funded, needed to write a proposal that attended to some overarching benchmarks.

All of them involving things like being involved in a coaching/mentoring process, where we mentored towards the use of best-practice standards by the...also, child development and early learning at the state level.

Parent engagement was a big part of it. Each district needed to show how they were going to do that. They had to braid the early-childhood system, so early intervention and early childhood and family support and Head Start and Early Head Start needed to be a part of it, and so forth.

There were about 8 to 10 overarching features. Everyone had to pay attention to a focus on the Pennsylvania Early Learning Standards as some of the outcome indicators and benchmarks.

With these children, the at-risk status for the children was enormous in the beginning. It was about 33 percent, when you put those who had major developmental delays versus at-risk status. Which was about twice what Fujiura and Yamaki found in the California studies, looking at the relationship between poverty and disability.

After a three-year period of time, that at-risk delay status went down to about 14 percent. For about 7,000 of the 10,000 children who reached the age to transition to kindergarten, these children were looked at as they transitioned into kindergarten, about 5 percent of them into first grade.

What we found is the historic special-education placement rate in those districts—by looking at the state data and the school district data—the median was 18 percent. For these 7,000 children that were going into kindergarten, it was 2.4 percent.

This was very similar to what we found in Pittsburgh, almost 10 years before that. The only difference was in the Pittsburgh region, grade-retention data was included. The grade-retention rates, historical, were about 21 percent. For those children transitioning into kindergarten and first grade, it was less than one percent.

Most people really focus on that as one of the major outcome indicators with economic implications, but there were plenty of other outcomes that related to decreases in social behavior problems in children, decreases in those children who met delayed status or disability status at one time and at a later time no longer do, in follow-up assessment.

Just to whet your appetite a little bit, about 18 percent of three-year-olds coming into both the Early Childhood Initiative and Pre-K Counts would qualify for a mental-health diagnosis in their counties. Their behavior problems were so significantly atypical and challenging.

Most of us who work in early-childhood programs and in Head Start realized the daunting task this presented in the last decade to 20 years with these kinds of data. For those children in Pre-K Counts, 21 percent of them would have qualified for a mental-health diagnosis in their county.

By transition to kindergarten, it was less than three and a half percent. That also has economic implications from my point of view not being an economist, not being a fiscal person.

It seems to me that in policy, we really need to think about grading the silos, grading the systems that support early-childhood programs and schools. Particularly when we talk about behavioral health support, when we talk about family-support services.

Even while we think about the new framework now of adverse childhood events in trying to blunt the recurrent crises that many children and families go through.

That's the turbo version of Pre-K Counts. I'll be happy to answer questions later on it.

Robert Dugger: Thank you, Stephen. I think for everyone on the call, the key comment that Stephen has made for pay-for-success finance is the observation that special-education placement rate declined from an 18 percent historical average to 2.4 percent. That reduction in special education placement represents a savings of about 10 to 12 thousand dollars a year per child, over the time in which a child usually would be in special education, that number running roughly 9, 10, 11 years. That's the octane for the application of pre-K pay-for-success finance.

Those are numbers from Pennsylvania. We'll now turn to Janis Dubno, who...I will say a little bit about her, because I'm such a fan of hers.

She was at Yale undergraduate, Wharton MBA. A bunch of years in investment banking. Long before the banking problems of the 2000s emerged, she had safely retired to go skiing in Utah in the late '90s.

Did some volunteer work for the Voices for Utah Children and then in that work came upon this anomaly, in which she could see right away that from her investment-banking background, that it was quite conceivable to invest in pre-K and capture the savings of special education. The savings would be likely large enough to create a sustainable expansion of pre-K services.

I'm getting ahead of you a little bit there, Janis, but I want to pat you...

Janis Dubno: No problem.

Robert Dugger: ...on the back before you get started. We started talking about this on a conference call much like this one, when she asked a question from way out in Salt Lake City. The rest of us realized, oh, this woman is on to something! That work began about three years ago. We've been working steadily on it, and she's brought this remarkable project to quite impressive maturity.

Janis, go ahead and take 10 minutes and talk about the work there. If you can squeeze in a few minutes to talk about the Dubno-Dugger-Smith paper, that'll be fine, too.

Janis Dubno: Yes, absolutely. Thank you, Rob. I do want to acknowledge Rob's role in facilitating this transaction. I believe it would not have happened without his participation. I'd also like to acknowledge the partnership we have with the United Way of Salt Lake and their role in both the development and the execution of the first social-impact loan for high-quality early education.

Goldman Sachs and JB Pritzker are investing. It's a five-year deal. The first year is the only year that's funded. That's about $1.2 million for the Granite School District's high-quality preschool program.

It is funding 600 children that are starting preschool right now. They will get paid back based on the cost avoidance that's achieved in special-education placement. They will receive 95 percent of the cost avoidance until they receive a five percent return on their investment—so they get their principal back and then a five percent return.

If that happens before the end of sixth grade, they will then be entitled to a success fee that's 40 percent of the savings. After sixth grade, all benefits accrue to the state. For each cohort that's funded, the investors will receive a percent of the cost avoidance through sixth grade.

We're very excited about this. Implementation has begun. We worked with Goldman for about two years on the data. As Rob mentioned, I'm a former investment banker and developed a financial model—at first initially and then with Goldman as they got serious about making the investment.

It's a senior-sub structure. Goldman is the senior lender, and it's up to $4.6 million. JB Pritzker is the subordinate lender and has $2.4 million. The repayment will be made for the first charge—this is a proof of concept.

We were narrowly defeated, with respect to legislation, last year. One of the issues was the fancy model was a little too abstract for people. All the partners determined that it would make sense for there to be a proof of concept so that we can demonstrate that this could work.

Again, I'm going to credit the United Way of Salt Lake for stepping up and contributing a million dollars into the repayment fund. Also the Salt Lake County council and the Salt Lake County mayor, who are contributing $350,000.

We were able to make the sell to the Salt Lake County based on a benefit-cost analysis that we did with their staff with respect to the savings, or the cost avoidance, that Salt Lake County could expect to achieve by these 600 kids—low-income children who are at risk, having access to high-quality preschool.

That benefit-cost, on the budget alone, that's only the county-funded items, was 3.67 to one. If you include economic development impact as well that is leveraged, the benefit-cost goes up to about 14 to 1.

That is the proof-of-concept social-impact loan for high-quality preschool, here in the Granite School District. I will say that we didn't....we had longitudinal data. We had been able to quantify actual cost avoidance through fifth grade, so there was a lot of work that went into that.

Now, we'd like to spend just a few minutes also on the paper that Rob, myself, and Michelle Smith co-authored. As you heard from Stephen and probably know from research, that others, including Doctor Heckman and Rob Grunewald have done, that high quality early education for at risk children produces cost savings and cost avoidance.

In special education, of course, but also in other parts of government. Health, criminal justice, youth services, welfare. It increases high school graduation. It increases earnings and tax revenue.

What we found, and as Rob and I looked at this, that the special education savings not only were significant, but they were more immediate, and as a result, were more appropriate for an investment vehicle where investors need to have a return of their principal and on principal within an acceptable timeframe.

We focused on special education, and we do speak in the paper that it makes sense for government generally to invest in this because there are savings across other government entities, and we hope to see more research about that in the future.

There are a few challenges to implementation of a Pay for Success project, and one is of course, sound statistical research that investors need to make an investment. The second is devising contracts between parties in a Pay for Success project.

I can say firsthand that it is not definitely, for lawyers, contracts have been...and for those of us who are not lawyers, something else. It's quite detail oriented, and we're very grateful for the work that ReadyNation is doing in trying to standardize some of these contracts.

The other is to monetize returns in an acceptable timeframe for investments. In the paper, we discuss the structure and sources of funding and returns, and we look at the returns to the investor, to state government, and to philanthropy.

There are three fundamental relationships that need to be examined to see if a Pay for Success could be feasible. One is the cost ratio. That is the cost of remediation to intervention. The second is the effect ratio, which is essentially the success ratio, and is what Stephen was talking about by a reduction in special education assignment of 18 percent to 2.4 percent.

You have to have a program that is effective in reducing the remediation that is under consideration for cost avoidance. The third is the investor ratio. What is the blend of the funding sources?

What percentage of the cost of pre-K is funded by the investor, is funded by the state, or funded by the federal government, either through Title one funds, or perhaps through President Obama's early childhood initiative. We looked at two benchmark programs.

One is the Bethlehem Area School District that Stephen referred to, and the other is the Granite School District preschool program in Salt Lake City.

We conducted a research project, again, in partnership with the United Way of Salt Lake and also the Granite School District, where we followed three cohorts of children who had access to high quality preschool during an early reading first grant. That grant was independently evaluated by Dr. Mark Innocenti at Utah State University.

What his data found is that 238 of the 737 children scored so low on a standardized norm assessment called a Peabody Picture Vocabulary test, they scored two to three standard deviations below the mean, that they were statistically likely to require special education services once they entered kindergarten up through 12th grade.

We followed those 238 children. The first cohort just finished fifth grade, are now in sixth grade, and what found is of the 238 who scored so low that they were likely headed towards special education, that only 11 had actually needed special education services. What we see is a consistency by...

Robert Dugger: Just repeat that again. How many students were on track to receive special education and how many students...

Janis Dubno: Two hundred and thirty eight, had they not received intervention. That was just regular education, Title 1 preschool, no IEPs, no special education services. The study did not include special education preschool children because that's not the population that we were addressing. Of the 238, 11 had been assigned over the last five years. What we see in these two studies are very comparable impact in terms of reduction of special education assignment. We used the Bethlehem Area School District as the example in our paper, and we've looked at two structures, two financial structures.

One is a fixed debt, where you have an interest paying instrument and a fixed principal prepay in years 9 and 10. The savings that occur after interest, that is achieved after interest is paid on the debt, goes into a reserve fund to pay the principal.

Any shortfall in that fund is covered by a PRI to guarantee, in effect, the payment of those interest and principal in the staff structure. We also looked at what's called a pass through. In a pass through, just a certain percent, about 80 percent, for instance, would accrue to the investor to achieve a benchmark return.

The remainder would accrue to the state, 20 percent in this example. In this example, payments will vary year to year. This is a variable cash flow instrument, and it is unsecured. There is no philanthropic support to back it up.

Of course, those two are priced accordingly, the fixed debt being priced at a more advantageous rate than the pass through, as it is a more secure and also a fixed duration instrument, as opposed to the pass through, which is a variable duration instrument.

We examined several combinations of investor state and federal funding. What we found is the most efficient, that produce the best results, was 50 percent investor funding, 25 percent state funding, and 25 percent federal funding to fund the cost of the preschool program.

In that scenario, we found positive returns, significantly positive returns, both to the investor and the state in both a fixed debt and pass through structure. We concluded our paper with areas that require future research.

One is standard error estimates of the distribution returns of PFS assets. PFS, project capital structures, risk, subordination, loss of absorption. Sensitivity analyses with respect to the returns to variations in the financial structures and also the parameter values.

We did some sensitivity analysis in our paper, and Rob did have to reign me in on occasion, but of course, we tried to limit that for ease of people to understand and absorb. We do think that there needs to be more work on that.

Also, we need more research on pre-, concurrent, and post-intervention data needed to evaluate near term financial trends and longer term all-in outcome improvements, such as the ones that we were able to quantify for Salt Lake County, and we're hoping here in Utah to be able to quantify at a state level.

We also need further research about research methodologies to use when data is limited. We were fortunate in that we were able, here in Utah, to look back and use historical data to validate the investment.

One thing that the early childhood field, I think, needs more of is not only more rigorous data analysis and research but also some thinking about what kind of methodologies we could use. Often times, randomized control trials are not only very expensive but considered unethical often in education circles.

Had you have a child who's the first on the list to sign up for preschool be randomly assigned to be in the control group. Those are some of the areas that we think need further work. With that I will hand it back to Rob.

Robert Dugger: Thanks, Janis. Great job. This has so far been a discussion about pre-kindergarten's implications for reducing cost in public schools and increasing student performance, three and fourth grade reading scores and that sort of thing. We'll turn next. I'm hoping that Joe Waters has been able to join us. Joe, are you...

Joe Waters: I'm here.

Robert Dugger: Oh, great. Excellent. Joe is taking the lead through the Institute of Early Child Success in South Carolina, focusing at home visiting. This is prenatal to three. Joe, go ahead and talk to us about your project there.

Joe Waters: Sure. Thank you, Rob, and thanks to ReadyNation for having this call and for including us. We're very happy to speak about our projects in South Carolina. I would like to start by acknowledging, first of all, the work of my colleague Megan Golden of New York University, who was the principal investigator on our feasibility study on user Pay for Success financing to improve outcomes for South Carolina's very youngest children.

I would also like to express our appreciation to the Duke Endowment and South Carolina's Department of Health and Human Services, which not only funded the feasibility study, but are also tremendous supporters of the Nurse Family Partnership program and tremendous coworkers with us on focusing on improving birth outcomes for South Carolina's Medicaid population.

We basically explored the feasibility of using Pay for Success financing to scale up, improving early childhood home visiting programs, like the Nurse Family Partnership, and in particular, we focused on NFP, which is the rigorously evaluated evidence based home visiting program that serves low income, first time mothers.

We looked at the other home visiting models. I like to say this just at the outset. We looked at the other home visiting models and determined that NFP was important for us to study for a couple of reasons.

First of all, the Duke Endowment has made an unprecedented multimillion dollar commitment in our state and in North Carolina to Nurse Family Partnership. That was a multiyear commitment, which is drawing to a close.

We were looking at sustainability of the Nurse Family Partnership program once the Duke Endowment's commitment begins to ramp down. Also, NFP was, as I mentioned, has a strong evidence base for improving birth outcomes and very early outcomes for children and moms and so it's consistent with Governor Haley's birth outcomes initiative within the Medicaid program here in South Carolina.

We wanted to look at an intervention that had very early health outcomes for both moms and kids and so that's how we settled on NFP. South Carolina has implemented the Nurse Family Partnership Program, but that implementation has not been sufficient to make a big impact in the state.

NFP serves 568 of 1,500 eligible high-risk moms a year in South Carolina. The government is very supportive of the Nurse Family Partnership Program. It recognizes the outcome, but has thus far not been able to come up with money to sustain through appropriation the Nurse Family Partnership Program.

We're very interested in how we can both scale the program and sustain the program in South Carolina. After six months of consulting with stakeholders, reviewing the research, observing the programs and analyzing data, the study concluded that it is indeed feasible to use Pay for Success financing to scale up the Nurse Family Partnership Program in South Carolina.

And on September 17th, the State of South Carolina released an RFI focused on how Pay for Success financing could be used to improve birth outcomes and control costs for participants in South Carolina's Medicaid program.

That RFI was not specific to the Nurse Family Partnership Program as they're interested in looking at a range of interventions that improve birth outcomes, but did include our feasibility study in full and further information on Nurse Family Partnership.

Our analysis found that using Pay for Success financing should fund a dramatic expansion of Nurse Family Partnership. It's feasible because the program model has an evidence based indicating that it's highly likely to produce positive outcomes, that those outcomes produce net savings to government and that's mostly to the Medicaid systems and that net benefit to the state far exceeds the cost.

We all know, those of you who are familiar with Nurse Family Partnership, that it is an expensive program but it is one that has a clear and very strong demonstrated return on investment. Also only a small fraction of population in need is currently being served and the program has the capacity to expand substantially with fidelity to its proven model.

We consulted widely with hospital systems, with the Department of Health and Environmental Control here in South Carolina to explore whether or not the state even had the capacity. Nurse capacity is an issue to look at as well.

Whether or not the state has the capacity to expand the program is, thanks in part to the investment of the sole profit partners. South Carolina has really developed strong capacities and wrap around supports to expand the program if a viable financing model was available.

We also determined that it is possible to come up with a viable financing model with reasonable timeframes and returns for a mix of commercial and sole profit investors, particularly if we look at reduction in rates of preterm births as the outcomes that would trigger the success payments if those are outcomes that are achieved in the very near term in this type of situation.

With that, I will say that South Carolina is continuing to look at this obviously through the RFI. What we recommend in terms of the contract structure—And again this is all to be determined. It's simply a recommendation that we made—with the NFP to serve 2,750 new families in South Carolina phased in over three years, that government pays for percentage reduction in one or two outcomes.

Our recommendation is reduction in preterm birth, secondary preterm birthrate and a secondary outcome being reduction in emergency department visits. For instance the outcomes measured compared to control group or match comparison group, that evaluation work of NFP is already ongoing in South Carolina and that the contract be for a four or six year term.

What we recommended was that this contract structure would require a $24 million investment from a combination of commercial and philanthropic investors and that amount covers the cost of providing up to two-and-a-half years of nurse and visiting services in fidelity to the Nurse Family Partnership model plus the cost of an intermediary and an evaluator.

And that this would be based on the government's willingness to pay up to $30 million for the agreed outcomes with the expectation that NFP serving this number of families over the course of this term would generate around $52 million in savings given the best studies on NFP available.

Rob I will stop there. If there's anything else you would like to for me to fill in with, that would be fine.

Robert Dugger: We'll then switch then to George Overholser. George are you available?

George Overholser: I am.

Robert Dugger: You're sort of bringing up the conclusion here. Go ahead and take ten minutes and talk about capital structures and what you see the longer term impact of these kinds of approaches to finance on intervention design and that sort of thing.

George Overholser: I would be very happy to do that. Good afternoon, everyone.

Robert Dugger: Let me say a few words about you, George. When we started the Invest in Kids working group in 2003, George was one of the people around the table. There were about fix or six people around the table. It was a group of about 18. In 18 months, we grew to over 800. George was one of the original members and he was on the advisory board of the Partnership for American Economic Success. He's still on the advisory board of ReadyNation. And in the minds of some of us, he is the most careful thinker on finance in nonprofit capital structures and one of the deepest thinkers in this whole area of Pay for Success early childhood finance. So George, go ahead.

George Overholser: Thank you very much. It's flattering. I thought I'd try to step back a little bit and take a longer view for people. One thing to be said is Pay for Success contracting and social innovation financing appears to be gaining traction. We're seeing formal efforts in Massachusetts, New York State, New York City, Connecticut, South Carolina, California, Santa Clara County in Utah we just heard about, Cuyahoga County in Cleveland. Los Angeles is now announced.

There is Michigan. There is the State of Ohio. There's the City of Chicago, Colorado. And then at the federal level, the Department of Labor of course just announced $20 million worth of grants. This is really something that is being tried out in this country.

We do not yet have the Early Childhood Project teed up, but it's absolutely inevitable and I would argue it's just very, very important that we get the Early Childhood Project up and running someplace in this country so that it can be proven and replicated.

I've found it helpful whenever talking about this topic to make a key distinction and that's the distinction between Pay for Success and social innovation financing. Quite simply Pay for Success is a contracting approach where government instead of reimbursing service providers for the work that they do with various population in their social work is instead paying for outcomes.

That's really procurement reform. It's a contracting approach. The great thing about Pay for Success is that by paying for outcomes instead of inputs, it makes it much more possible to try and do things and therefore it promotes innovation and it tends to unfreeze the system out there.

I think that's one of the great promises of Pay for Success contracting. It's that we put a feedback loop into that portion of the economy that previously had been somewhat frozen and then we prompt a reallocation of really what could be quite vast government resources away from the programs that are working not as well and towards the programs that are working better. Or by virtue of trying new innovations, are working much better.

Between for Pay for Success contracting and social innovation financing, I would say Pay for Success contracting is the most important innovation that we are talking about here. But then what is social innovation financing?

That's PFS's first cousin because in most Pay for Success contracting situations there are two things that come up. First is an inherent delay in when government would make these contingent payments for outcomes.

We're working on a project in Massachusetts that involves $26 plus million dollars of government payments, but it will be years before the first penny of payments is made and that's because it takes years to actually measure whether the impact has happened in a robust way.

That means that there is a need for financing and that's what social innovation financing is. It says, "We will pay for the program using private money during the let's say four years it takes before government is finally ready to pay."

The second thing that social innovation financing does is it absorbs the risk of failure. Suppose the project doesn't hit its goals. There is a big concern about putting our vital social institutions at risk. Social innovation financing says, "We will transfer the risk of failure into the hands of financiers rather than put the balance sheet of let's say an important homelessness provider at risk."

Of course in the end, we like everyone to have some as we say, "Skin in the game," but it is an important role of social innovation financing to do this.

Janis mentioned the senior sub approach and I thought it might be helpful to shed a little bit more light on what that is for those who aren't the financial world. The idea is that we suppose need to raise $20 million that will pay for a program during let's say those four years before government is ready to pay.

We could just raise $20 million all from one source or we could say, "Why don't we build a stack," or some people call it a wedding cake structure, "Why don't we have a senior partner," which would be commercial banks and they get paid back first. And then we would have a subordinate debt and they get paid back second. Then we could add another layer too which in these projects is typically being covered by philanthropists.

So perhaps in that $20 million you might have $5 million as senior debt, and $5 million of sub debt and then $10 of philanthropy. Philanthropy would be taking what some people call the "First loss position." It's a way to build a buffer that protects the other sources of funding.

Why would you do such a thing? The main reason you would do such a thing is that if you don't do it, the deal is too risky for those other providers of capital to participate. The second reason that you might do it is that from a philanthropic standpoint it's absolutely a great deal financially.

Think of it this way. Philanthropy typically would put in $10 million and there would be let's say 5,000 young people served. And then at the end, the money would be gone and they get a nice letter that said, "Thank you, but the money is gone now. Would you like to send another $5 million?"

In this setup, they put in the $10 million and the first thing that happens is the banks put in another $10 and that's another $20 million, so now twice as many young people are being served. The second thing that happens is at the end instead of getting a letter, what they get is the results of the randomized control trial.

The third thing that happens is the philanthropic money can be replenished. So instead of the letter saying, "Could you please send another $10 million check?" it says, "The $10 million has been replenished to the project. We're just going to recycle it."

That's just an absolutely fabulous deal for philanthropists compared to what they're used to. It is new however and it's going to take time for our field to really get everybody comfortable with participating in these rather complex structures.

I want to mention probably a more profound role for philanthropy and that is as transitional participants in what in the end will I believe look just like good old banking. I would hope that one day the social innovation financing is just going to be taken for granted.

That's because eventually we're going to have track records that banks can go by and we're going to have more scale to work with so that you can have whole portfolios of investments to go by for banks. And in the end, the social service providers are just going to be able to go to banks and be able to pay a market rate because the cost benefits they generate for government are so dependable based on that track record that you no longer need to have the philanthropists playing that shock absorber role or that first loss role.

But in the interim, we don't have track records. We don't have scale. These are unproven, unsecured investments and so the role of philanthropy is in a sense to pay for this transition in our industry. This has happened before. This is a little bit what the microfinance world looked like.

There were literally billions of dollars of philanthropic moneys put into microfinance in the early years but inexorably and over time as that world got its sea legs and built its track record, there were less and less philanthropy involved.

I'll stop there because I could talk for hours and hours. Thank you very much.

Robert Dugger: And George, we'd like to hear you for hours and hours. I think there's one question which is very important. Both in South Carolina the work was done on this and also in Salt Lake City. The question is how do you distinguish between near term financial gains and longer term social and economic gains? Joe and Janis if you would take a moment and just talk. Joe you go ahead first and talk about how you and Megan sorted out this question of near term gains and longer term gains that in essence the state would pay for and the near term gains that so to speak the investors would pay for.

Joe Waters: I think the most important thing to say there is, "Who was driving the ship at the state on this project?" And it was the Medicaid offices. They were very interested in improving birth outcomes and there's an additional benefit there. Not only were they interested in improving birth outcomes, but those are short term gains that we were looking at there. The other challenge of course is with a program like Nurse Family Partnership the benefits accrue to multiple systems. So unlike New York City's Social Impact Bond which is focused on the reduction recidivism and in that case most of the savings accrue to one system on one outcome, with Nurse Family Partnership there are multiple outcomes that accrue to multiple systems.

So at some point, we do have to make a decision based on what government in South Carolina was most interested in looking at and that was the improving of birth outcome. We also took a hard look at which of the Nurse Family Partnership outcomes were they most comfortable being held accountable for which were nearer term than their child abuse and neglect, child welfare system outcomes and those sorts of things.

It was a negotiation of sorts between the various partners who were involved in coming up with the project. I would just point to the critical role of the state in giving us the guidance that they were very interested in improving those birth outcomes and for the Nurse Family Partnership Program it was the outcome that they felt most comfortable being accountable for in the implementation of the program in South Carolina.

Robert Dugger: Janis can you recap how your discussion went?

Janis Dubno: In the proof concept which is funding the first cohort, we will need state legislation to continue this for the next four cohorts. The metric is special education reduction and the prime beneficiary of this cost savings is the state and that really is the sort and near term financial return and the benchmark for repayment and success payments to the investor. However in working with Salt Lake County, we effectively quantified and demonstrated that not only are there savings in special education, but there are savings that are longer term that will impact their budget in a positive way. Those were new services in health, in criminal justice, in affordable housing and behavioral health.

That of course is going to be dependent county by county on what counties fund. We didn't look at federal funding for programs, just what was specifically funded at the county. The argument that we made is that even though the metric was special education, the research showed that these benefits go hand in hand and that we didn't necessarily have to tie the measure of performance to these other areas in order for the council to justify the investment. They agreed with that. That even if the metric were special education, they were going to benefit in other ways that warranted a significant investment on their account.

We are also pursuing a similar study with an independent organization here in Utah to look at these other longer term savings to the state that we'll use in our advocacy effort in January to help pass social impact finance legislation that will allow us to continue this.

George Overholser: Rob, this is George, I might just have one comment.

Robert Dugger: Yes, George.

George Overholser: We're working on quite a few transactions around the country and we finally now are seeing the first of one that we've been expecting to see. That is a government official who says I already know how much I'm going to spend, I don't need a cost benefit to tell me I want to spend it. My cost benefit is about spending it better than I was going to otherwise. I think if you look at government money, these mandatory streams are vastly larger, and they already exist. It may be that the future of Pay for Success contracting, in fact I believe that the future of Pay for Success contracting, will begin more in this prevention space. But over time, the big dollars are going to be subjecting mandatory streams to outcomes-based mechanisms.

Robert Dugger: Marvelous. That would be, that's very important. Lindsay, anyone with questions?

Lindsay: Yes. Your first question comes from the line of Susan Ochshorn. Your line is now open.

Susan Ochshorn: Hi. I just want to say first that I am fully on the side of nurturing human capital, as I wrote this summer in an op-ed for the LA Times. I am thrilled with the work of ReadyNation and its predecessors and all the work that you are all doing. I am not a finance person, so I have to say my eyes glaze over a little bit, but I think I get the basic idea. Here are a couple of concerns which I expressed to Joe Waters when we had a lovely tea last week. Children are not commodities. Too many, as you know, of them are being left behind. Phil Peterson declared recently that nothing will ever replace public investment.

Here is my concern. If we adopt the position that Congress won't fund specifically Obama's universal preschool plan, I think that we risk, if not foreclosing the possibility entirely, but what I see is a dangerous movement away from a public commitment to supporting the nurturing of human capital. That is early childhood, early care and education.

Number two is children develop. They are not commodities. They are not iPhones. They are not machines. They develop at very different rates. Their development is really uneven. I'm concerned that in this structuring of these vehicles which sound very intriguing, I'm worried about the timeframe.

Because you're not, yes, you may see from your randomized, controlled trials, that certain children make it and they are not in special ed. But others take a little bit longer time. If the payback is contingent upon a particular timetable and the outcomes are not what we anticipate, which is often the case, where are the kids left?

Robert Dugger: Any of the panel care to comment? Hello? Go ahead.

Janis Dubno: No, go ahead, Rob, if you'd like to. That would be great.

Robert Dugger: No, I'll take the first one, is which we completely agree with your first point. [crosstalk]

Susan Ochshorn: I guess I want to be convinced, Rob. That this is the way to go. I'm just really worried about it.

Robert Dugger: Janis, go ahead. You were...

Janis Dubno: Sure. Thank you very much for your question and your concern. We do agree with Rob, this is not a substitute for public investment. Perhaps a complement, and in some places, like Utah, a bridge. Where we would like to see, we do not have state funded preschool here. What we're hoping, even, is that this vehicle will demonstrate over time to our state legislature that it makes sense to be making investments. I am a senior policy analyst for early childhood at Voices for Utah Children. I am a former investment banker. It's true—children are not commodities. I would agree with that 100 percent.

What's interesting is that there is a fiscal impact to children in closing the opportunity gap, in closing the achievement gap, and providing the opportunities for children who don't have them—who could statistically end up needing remediation but of course, when provided with early intervention, need them in smaller percentages.

The children are not commodities, but the fiscal impact is an asset. Does that make sense?

Susan Ochshorn: Oh, totally. Totally!

Janis Dubno: I think if you think about it that way, we're not monetizing children. We're monetizing the benefit that accrues to states when right things are done for kids. You're right about children developing differently. I think that that's often captured in the historical data, so the great thing about this vehicle...two things have always been a problem, particularly in education.

How do you shift funds from remediation to prevention when you still have the kid you have to remediate? Well, social-impact finance addresses that by having private investment fund the prevention. Then once there's cost avoidance, because the children either—depending upon your methodology—when it's determined that there is cost avoidance, that's when a shift of resources gets achieved by paying back the investor.

A child who develops more slowly, for instance, that child is always going to be served. The historical data takes that into account, so all the research that goes into statistically modeling the returns takes into account that variability in child development.

As I think we would all agree that by providing high-quality early education or a nurse-family partnership—and I would argue probably other policy interventions as well—we're able to allow a child to develop in their best possible scenario, essentially. Does that address any of your concerns?

Susan Ochshorn: I think that sounds like a wonderful, platonic explanation. I'd like to believe it. I just worry about the motives and expectations of those who are investing. I think it has to be clear that that point needs to be made up front so that in fact, it does become a social transaction. I don't know. I'm not sure what the answer is, but I don't know that that calms my fears.

George Overholser: This is George. I might comment too. I very much share your concerns and fears. I have a slightly different take on this. I think that what is really happening here is an inevitable and impossible-to-stop transition.

Susan Ochshorn: Inexorable.

George Overholser: Inexorable, inevitable. Thank you! That computers are now measuring stuff and that government has been doing contracting for a long time. They just couldn't do it in social services until computers measured stuff inexpensively. Now they do. For me, the question is...are we going to have civic-minded people with a seat at the table shaping what is, inevitably, inexorably, going to happen anyway? I have real concerns about a demagogue approach which says let's take this whole spending stream and subject it to the test.

Susan Ochshorn: Right.

George Overholser: Why don't we make the test one that we know they're going to fail. That way we can dismantle these vitally important parts of what makes the whole civic world work in the United States. My feeling is that we have a moral obligation to shape this inevitable world and to do so by using—I just love the idea of using evidence. Because I don't know what else to use that's better than that in the world of resource allocation.

Stephen Bagnato: This is Steve. I'd like to just chime in as a non-economist, non- [indecipherable 1:02:18] person on it. I think the question is really well taken. I'm going to frame it, not differently, but a different slant on thinking about what we all know and feel about early childhood education now is that it actually is underfunded. We're underestimating the amount that it really costs to maintain quality and to have really good teachers and providers there. Because one of the things is the cost of professionalism is underestimated. But it's a very low pay rate taskforce, which we all know. One of the things I like, frankly, about this approach is that it gives you a chance to really determine what is the real cost of high quality early care and education?

Almost taking advantage of the model in the IDEA regulations, I-D-E-A, of a response to instruction or response to intervention tier where you're looking at the fact that, at least in school settings, that people are applying this to systems now outside of schools.

When you use a tiered model, everybody benefits from it, from being universally screened, having your individual differences looked at, being nurtured in different ways, whether you need to work in a small group or whatever. Then what is the real cost of having what I would call graded services for kids at the highest tiers of your pyramid model.

Those may be kids who have very challenging behaviors or might have developmental disabilities or might have other events that serve as barriers to their learning. Because we're underestimating the cost of the system, in a sense. I think I mentioned before, from my point of view, it's the cost of interagency partnerships that [inaudible 1:04:43] costs for more seamless services.

Mental health, family support, quality, maintenance, professional development, all those non-educational services and supports need to be factored in. Because every child in the schools or in an early childhood program actually has access to at least one of those non-educational services.

They're part of the equation too. I don't even think we really know what the real cost is and that's my take-on point. I think what we're proposing now gives us an opportunity to actually look at a basic cost that is more realistic and then what are graduated increases in that cost for the highest need children.

Robert Dugger: Yes, I think those are great comments and they'll bring our session to a close. I'll just add my own thought that I'm reasonably certain, from my years of experience in finance and markets, that the result of this process will end up with a lot more capital being allocated to investing in kids, prenatal to five, than in the absence of either the evidence and research that we're doing or the financing methods that we're developing. I think that this will, in the end, be better for all kids and particularly kids socioeconomically at risk. With that, let me bring the call to a close and thank all of our panelists. Joe, Janis, Stephen, and George, thank you very much. Anyone who has questions is welcomed to contact me or any of the panelists by email and you can reach us via the various websites, the information or just our names.

Thanks for participating. This will be, as I said in the beginning, an information call. We hope to follow this call with future calls and spend about an hour on each one of these topics to delve into them in great detail. Thank you all, have a great rest of the day and a good conclusion to the week and we'll talk again about these topics next month. Thank you so much. Bye-bye.

Lindsay: This concludes today's conference call. You may now disconnect.