PAY FOR PERFORMANCE TOOLKIT

Life Cycle of Pay for Performance Contracts

The life-cycle of pay for performance contracts involves six key steps that are led by the buyer and involve the producer. As seen in Figure 1, these steps can be grouped into two distinct phases – Contracting, and Implementation and Payment.

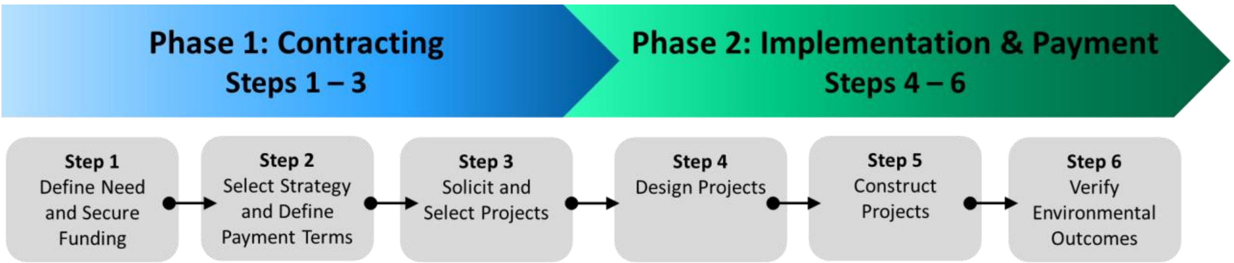

Figure 1: Project life-cycle of a pay for performance contract.

PHASE I: CONTRACTING

During the Contracting Phase, the buyer lays the groundwork not only for focusing the producer on the delivery of measurable environmental outcomes, but also to gain buy-in within its own organization for pay for performance contracting. This phase is essential in aligning the expectations of all parties involved within both the buyer's and producer's organizations on the mechanics and benefits of pay for performance contracting.

STEP 1: DEFINE NEED FOR PAY FOR PERFORMANCE AND SECURE FUNDING

Defining the need for pay for performance contracting in the context of the environmental goal of a program supports efforts to secure funding. Program managers should consider the environmental need and benefits that pay for performance offer in achieving the program's goals, particularly through cost-effective, outcomes-based contracting. In addition to defining the basics of the need, such as the geographic scope of the environmental issue, it is also important to consider the potential for pay for performance to influence the level of investment in the program through accountability for money spent. In many cases, the program's funding will already be secured, however, thoughtfully considering these components and others related to the specific needs and context of a program helps secure future funding. These efforts are essential in setting the stage as the program defines solicitation and contract terms and seeks applications from potential producers.

STEP 2: DEFINE PAYMENT TERMS

Prior to soliciting applications, the buyer works with its procurement department to define payment terms that work within the organization's finance and legal bounds and contribute to achievement of the goals of the program. Payment terms are tailorable in the degree to which they tie to project performance. Therefore, the buyer is able to balance its own risk of funding projects that do not produce intended environmental outcomes with the producer's reward for cost-effectively generating environmental outcomes to a degree that is desirable and agreeable by both parties. Specifically, the proportion of total payment that is contingent upon outcome-based milestones versus milestones linked to completion of actions can be adjusted to balance buyer risk and producer reward.

STEP 3: SOLICIT AND SELECT PROJECTS

Once payment terms are agreed upon within the buyer's organization, the buyer solicits applications using a request for proposals. The program manager selects a short list of project applications worth pursuing further based on the projected cost-effectiveness of credits to be generated, site characteristics, co-benefits, the applicant's experience and other criteria defined in the solicitation. The program manager then checks the producer's assumptions related to expected credits. If the program is taking on significant financial risk, a detailed site assessment and review of the proposed project should be required. If buyer risk is low and payments are primarily based on verified environmental outcomes, a quick screening assessment may satisfy the need for checking the producer's assumptions.

This approach to project selection has been demonstrated by the Nevada Conservation Credit System.

Nevada Conservation Credit System Selection Criteria

- **Current Habitat Quality** of the project site based on landscape and local-scale characteristics.
- Proportion of the project benefiting from **Habitat Improvement and Risk Reduction**.
- **Credit Generation Readiness and Probability** based on the project timeline and level of effort to generate credits.
- **Cost-Effectiveness** based on total cost of the project and estimated credits to be generated.
- **Other** meaningful project characteristics not captured in other selection criteria.

After the buyer selects projects for funding, contracts are executed between the buyer and producer. The final terms to be included in the contracts have been determined at this point in the process, as the buyer is required to align the contract with the payment terms defined in Step 2 of the pay for performance life-cycle. However, it is common in this step to hone those payment terms to the timing of each specific project and, for some pay for performance strategies, the upfront capital needs of the producer.

PHASE II: IMPLEMENTATION AND PAYMENT

During the Implementation and Payment Phase, the producer designs and constructs the project and the buyer makes payments based on the payment terms agreed upon in the Contracting Phase.

STEPS 4 & 5: DESIGN AND CONSTRUCT PROJECTS

Once contracts have been executed, the producer designs and constructs the project. Depending on the pay for performance strategy and the payment terms defined in Step 2 of the pay for performance life-cycle, the buyer either makes partial payments or no payments at all during Steps 4 and 5 (Design and Construct Projects). Payments made during this period are not typically contingent upon measurable environmental outcomes, but rather achievement of specific design and construction milestones.

STEP 5: VERIFY ENVIRONMENTAL OUTCOMES

After project design and construction is complete, the credits generated and maintained by the project are verified. A verifier determines the credits using a defined quantification tool and methodology, based on criteria that relate to the environmental issue and scientifically verified conditions. Payments are made to the producer upon verification of initial environmental outcomes generated and throughout the stewardship term based on ongoing verification that outcomes have been maintained. The verification payments are pro-rated to the proportion of outcomes generated initially and maintained throughout the stewardship term based on the amount specified in the pay for performance contract.

EXAMPLE PAYMENT STRUCTURE

The table below highlights the general payment terms that exemplify a partial pay for performance contract[1]. These terms can be tailored to adjust the proportion of total payment that is contingent upon reaching outcome-based milestones (as compared to the amount of the total payment that is based on reaching action-based milestones) to shift the producer's risk. This payment structure also serves as the basis for the Pay for Performance Contract Templates and Guidance document, which includes tailorable contract terms and solicitation components specifically related to a partial pay for performance contract.

The project phases in the table below apply to all pay for performance strategies. However, the proportion of total payment applied to each project phase varies across different pay for performance strategies. For example, in a full delivery pay for performance contract, there would be no payments made during the design and construction phases, and all payments would be made upon initial verification of environmental outcomes and throughout the stewardship term.

Table 1: Example Payment Structure for Partial Pay for Performance Contracts

PROJECT PHASE	MILESTONE	LINK TO ENVIRONMENTAL OUTCOMES	PROPORTION OF TOTAL PAYMENT
Project Design	Upon completion of project design plans	N/A	25%
Construction Phase 1	Upon breaking ground on the project	N/A	25%
Construction Phase 2	Upon completion of construction	N/A	25%
Verification	Upon initial verification of environmental outcomes after project is constructed, and periodically throughout the stewardship term	Based on credits generated and maintained	25%, pro-rated to the environmental outcomes achieved

Figure 2 illustrates how the payments would work in the payment structure outlined in Table 1. In this example payment structure, the buyer pays the producer upon completion of the project design and construction phases, upon initial verification of environmental outcomes, and periodically throughout the stewardship term as outcomes are verified. The payments made during verification would be equal to 25% of the total payment to the producer, but would be made in multiple, smaller payments, while payments made in the project design and construction phases are typically made in single, larger payments.

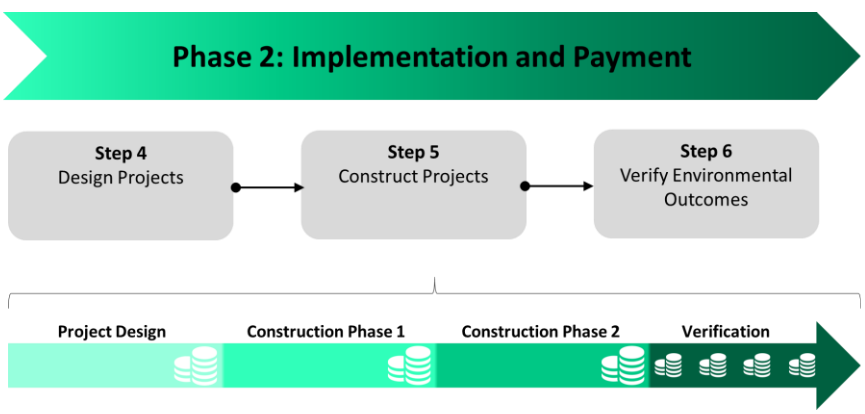

Figure 2: Example Payment Structure for Partial Pay for Performance Contract

[1] Partial Pay for Performance is one of several pay for performance strategies. To learn more about the full spectrum of pay for performance strategies, and when one is more appropriate than another, read [the Pay for Performance Strategies for Western States Technical Brief.]

Environmental Incentives
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