Programme Board

Cost-Sharing Principles Proposal

1. Recommendations (subject to the on-going review of the Pool's tax position e.g. Corporation Tax and VAT, for both ACS and non-ACS):

a) <u>Set-up costs</u> – shared equally amongst participating funds, i.e. one eighth per fund;

b) <u>Investment management and monitoring costs</u> – by assets under management (AUM), on a sub-fund by sub-fund basis, subject to a pricing schedule being agreed for different asset classes e.g. active vs. passive and the differing activities of managing and monitoring assets;

c) <u>Corporate governance costs</u> – shared equally amongst participating funds, i.e. one eighth per fund;

d) <u>Operator costs</u> – charged by total AUM (from day one);

e) <u>Transition costs</u> - charged by AUM within sub-funds with a condition that if a fund(s) 'throws into the pot' a mix of assets that suffers from liquidity constraints or much larger transition costs than the rest of the assets, then that fund(s) is charged the additional cost;

f) <u>Working capital</u> - provided in the form of an interest-free working capital advance loan.

g) <u>Cost-sharing principles review</u> – recommendations 'a' through to 'f' above are recommended to be agreed subject to review by 1st April 2020, following the transition of assets to the pool.

2. Introduction

2.1. This report provides recommendations for sharing the costs of establishing and running LGPS Central between the participating funds

2.2. The report covers the following types of cost:

a) The costs of setting up LGPS Central;
b) The ongoing running costs of LGPS Central, including the costs of investment management and monitoring;
c) Transition costs on the set-up of LGPS Central.

3. Cross-subsidisation

3.1. Based on legal advice obtained by the Brunel Pensions Partnership the sharing of costs on an equitable basis should not involve any element of illegal "subsidy". Cost sharing should be on a fair and equitable basis, so that a reasonable and commercially responsible public authority would enter into it.

4. Set-up Costs

4.1. The draft pooling submission to Government included an estimated budget of £3.3 million for set-up costs from July onwards. Following this, tenders were received for the financial and legal advisors, with the successful tenders totalling £400,000 higher than the original estimate (approved by Programme Board on 10th August 2016). The following table provides a breakdown of the revised estimate of £3.7 million:

Heading	Estimated Set-up Costs £000
Staff	1,918
Legal / Tax / Advisers	1,100
Procurement Support	200
Technology	250
FCA Fees	5
Shared Services	50
Miscellaneous	200
Total	**3,723**

4.2. The staffing cost shown in the table above breaks down as follows:

Staff Cost	Estimated Set-up Costs £000
Interim Management Team	317
CEO (from April 2017)	264
COO (from April 2017)	264
Head of IT (from July 2017)	149
CIO (from October 2017)	132
CRO (from October 2017)	132
Compliance (from October 2017)	79
Core Staff (from February 2018)	350
Recruitment Advisor Costs	231
Total	**1,918**

4.3. In addition to the above, the Programme Board has approved additional programme administration officer support.

4.4. In accordance with LGPS Central's core principle of 'one fund, one vote', and as previously agreed, set-up costs will be divided equally between the participating funds, i.e. one eighth of the actual cost will be met by each fund, estimated at £465,000 based on the revised budget.

4.5. This cost-sharing basis is the same approach as included in the Base Case Long Term Cost Savings Model used for the July 2016 draft pooling submission to Government.

5. Ongoing Running Costs of LPGS Central

5.1. The financial modelling included an estimated budget of £5.1 million for running costs (rising to £5.4 million from the fourth year onwards). This was made up as follows:

Heading	Annual Budget 2018/19 to 2020/21 £000	Annual Budget 2021/22 Onwards £000
Staff	3,317	3,634
Premises	200	200
Legal / Tax / Advisers	250	250
External Audit	50	50
Travel & Subsistence	50	50
Facilities	50	50
Insurance	250	250
Technology	500	500
FCA Fees	50	50
Internal Audit	60	60
Shared Services	100	100
Miscellaneous	100	100
Corporate Tax	100	100
Total	**5,077**	**5,394**

5.2. In addition to this, a further £1.4 million of staffing costs was included in the model for the costs of internal Investments staff allocated directly to sub-funds.

5.3. The cost-sharing basis included in the Base Case Long Term Cost Savings Model, used for the July 2016 draft pooling submission to Government, was that ongoing running costs of LGPS Central would be split into equal eighths for the period 1st April 2018 through to 31st March 2021, and then split based on total AUM from 1st April 2021 onwards in order to prevent those transferring assets into the Pool first suffering a heavy burden of costs.

5.4. It is now proposed that for the purposes of cost-sharing, the ongoing running costs of LGPS Central will be split three ways:

a) Those costs that can be directly attributed to a sub-fund (or pooled vehicle), which will be referred to as investment management and monitoring costs;
b) The costs of the company's core governance arrangements, which will be referred to as corporate governance costs;
c) Costs that do not fall into either of the above categories, which will be referred to as operator costs.

5.5. Investment management and monitoring costs are expected to include:
a) External investment manager fees, including performance fees/carried interest and other costs;
b) Transaction costs;
c) Fees for the audit of sub-funds;
d) The portion of the total pay cost of the in-house investment management teams that is attributable to direct investment management (pre and post the launch of the Pool's solution);
e) The portion of the total pay cost of LGPS Central staff that is attributable to the direct monitoring of external investment managers/funds (pre and post launch of the Pool's solution);
f) Expenses incurred by the above-mentioned staff in the course of investment management/monitoring;
g) Other costs which are incurred directly as a result of managing the assets in that sub-fund according to the strategy of that sub-fund (for example, licence fees);
h) An apportionment of office overheads (for example, premises costs) in respect of staff included in the other points in this paragraph.

5.6. Corporate governance costs are expected to include:
a) The total pay costs of executive officers, excluding the CIO;
b) The cost of remuneration of the chair of the board and non-executive directors;
c) Other costs associated with the operation of the Board, Shareholder's Forum, clerking and company representation at Joint Committee/Practitioners' Advisory Forum;
d) The total pay costs of relationship managers;
e) The cost of internal audit;
f) The costs of preparing statutory accounts and external audit;
g) Certain aspects of external legal and financial advice;
h) An apportionment of office overheads (for example, premises costs) in respect of staff included in the other points in this paragraph.

5.7. Operator costs are expected to include:

a) The portion of the total pay cost of the in-house investment management team that is not attributed to investment management and monitoring (i.e. charged through 5.5 (d), (e) and (f));
b) The total pay costs of the CIO;
c) The cost of operations, administration and finance staff;
d) The costs of compliance and risk management;
e) Shared services;
f) The costs of performance management;
g) Responsible investment;
h) An apportionment of office overheads (for example, premises costs) in respect of staff included in the other points in this paragraph.

5.8. It is proposed that these costs be shared between participating funds according to the following principles:

a) Investment management and monitoring costs – by assets under management, on a sub-fund by sub-fund basis. The pool will need to agree a pricing schedule that reflects the differing costs of managing different asset classes, active versus passive management and the differing activities of managing and monitoring assets;

b) Corporate governance costs – shared equally amongst participating funds, i.e. one eighth per fund;

c) Operator costs – by total assets under management, including Alternatives and Life Policies. This will mean that all funds must transfer management of assets to the pool from day one to spread costs, and accordingly all assets will be monitored or managed by the operator from then on. For the avoidance of doubt, if the management of assets can't be transferred to the pool from day one, for what-ever-reason, they will deemed to have been effectively transferred into the Pool for the purposes of charging out Operator Costs.

5.9. It should be noted that under the sharing principles set out in the above paragraph, the ITA fund would attract no corporate governance cost (although it would incur costs in the two other categories). This would be consistent with the principle of 'one fund, one vote'.

5.10. There is no change from the previous model in the proposed approach to the allocation of staffing costs of internal Investments staff, which is that the element of their work attributable to management or monitoring will be allocated directly to sub-funds (the model assumed this to be 80%).

6. Transition Costs

6.1. Transition Costs (on initial transition of assets into LGPS Central) represent both the largest and difficult to estimate set-up costs. In the Base Case Long Term Cost Savings Model, these were estimated at £40.6 million, and were apportioned according to assets under management, at a ‘sub-fund’ level.

6.2. It is proposed that transition costs will be charged by AUM within sub-funds with a condition that if a Fund(s) ‘throws into the pot’ a mix of assets that suffers from liquidity constraints or much larger transition costs than the rest of the assets then that Fund(s) is charged the additional cost. The transition manager will be able to identify each Funds' actual transition costs and therefore will be able to identify such charges and allocate accordingly. It is anticipated that transition costs will be charged directly to Pension Funds in the pool to allow VAT to be recovered.

7. Charging and Invoicing Mechanisms

7.1. In order for LGPS Central to have a reasonable level of working balances at all time, and in particular to avoid it having to resort to lending/overdraft facilities for short-term cash flow purposes, consideration needs to be given to the timing of charges being issued to and paid by participating funds.

7.2. It is proposed that working capital will be provided, possibly in the form of an interest-free working capital advance loan, rather than LGPS Central invoicing for services in advance.

8. Reporting

8.1. Since some elements of the charges for the running costs of LGPS Central will be variable, the company will need to report on its costs to the participating funds on a regular basis, in order to allow those funds to budget for and forecast their costs on a timely and accurate basis.

8.2. It is noted that the annual budget, which should include the basis on which costs will be recovered, will be approved with the full visibility of funds, and consultation with them.

8.3. LGPS Central should provide the participating funds with forecast annual expenditure, and the resulting forecast charges on a regular basis throughout the financial year.