PENSIONS PARTNERSHIP

BCPP Joint Committee

Date of Meeting: 6th June 2017

Report Title: Refinement of BCPP Corporate Entity and Transition Cost Sharing Principles (Version 3 - June 2017)

Report Sponsor: Chair Officer Operations Group – Fiona Miller

1.0 Executive Summary:

1.1 The report sets out the further refinement of the broad principles that are proposed to be applied in assigning the costs of operating the BCPP to the Partner Funds. It is intended to be a dynamic document that will be further enhanced and remitted back to this group for approval as and when key project implementation decisions are made and as such the detail of the type and quantum of all costs become fully known.

1.2 The overriding principle as outlined in the submission is to establish an equitable costs sharing framework. The aim has been to establish a process that recognises that each Partner Fund has an equal vote on all control and governance matters (regardless of size) whilst accounting for investment costs which are driven by assets being managed by BCPP ltd and complexity / underlying costs of the assets classes being chosen.

1.3 Therefore core to these principles has been to separate what are referred to in BCPP as "governance overhead costs" i.e. those costs required to operate an financial services company with the agreed FCA permissions (regardless of the assets under management or the types of investments offered) as opposed to those costs that are associated with the actual investing of client money.

1.4 The governance overheads are to be allocated and charged on an up-front annual fixed charge, split on an equal one twelfth basis. Whilst the investment costs and any associated income are to be allocated on a variable basis based on assets under management with the charging periods yet to be defined but probably incorporating a mixture of charging periods depending on the asset class.

1.5 An underlying objective has been to try to ensure that the company can succeed for the benefit of all Partner Funds, to do this it must remain cash flow positive at minimal cost. This means, that as would be expected in any commercial company, whilst BCPP Ltd can enter into overdraft and short term loan arrangements to cover operating purposes, as this would be at commercial interest rates, and therefore ultimately at the clients expense, it is to be avoided as it is not in the Partner Funds interests.

2.0 Recommendation:

2.1 Members are recommended to:-

2.1.1 note the further refinement of the BCPP cost sharing principles

2.1.2 approve the proposed further work to be undertaken by Officers required to complete the principles. Specifically in regards to allocation of transition costs and assets classes outside securitised markets.

2.1.2 approve the refined cost allocation principles as at June 2017 (Version 3) shown at Appendix 1.

3.0 Background:

Ongoing Development of Principles May 2017 (Appendix 1)

3.1 As was intended, following the continued progress of the build of the operating model (including external legal, tax and accountancy advice), the initial cost principles have been refined and expanded to further clarify cost allocation methodologies proposed.

3.2 None of the proposed additions alter the intent of the initial principles agreed. Rather, as was anticipated, as the development and greater understanding of the project build and required implementation decisions have become known, the cost sharing principles have been supplemented to add clarity to areas that were previously not fully formulated.

3.3 These principles are not intended to be a definitive list of costs to be charged to the Partner Funds by BCPP Ltd, but rather are the allocation principles to be used for determining how categories of costs will be allocated.

3.4 They do not cover associated governance costs outside the corporate BCPP Ltd entity e.g. the running of the Joint Committee which have been addressed previously.

3.5 It is intended the proposed cost allocation principles will be used to assign costs to categories and subsequently allocate them to the Partner Funds through the Annual Up-Front Fixed Operating Charge and the variable investment management charges.

3.6 Whilst substantially complete there remain areas that require further refinement (as outlined in the current document). It is proposed that the Officer Operations Group continues to consider and develop these in conjunction with the on-going project work to complete the target operating model design.

3.7 Whilst not yet fully formed Officers considered this to be of such significance to the Partner Funds that continual Member and Statutory Officer engagement and input throughout the process of their development is essential. The further development of the cost sharing principles will coincide with decisions taken throughout the project build of the target operating model and asset transition. Therefore they will be updated and further refined as the specific types and quantum of costs become better understood.

3.8 As such this is intended to be a dynamic document and will be updated with additions and clarifications throughout the project build and initial asset transition, as required. It is proposed that any further amendments will be formulated by OOG prior to being presented to the Joint Committee for the approval of both Members and representatives of the Statutory Officers.

3.9 The principles outlined below have been discussed in depth and agreed at the OOG (23rd May 2017).

4.0 Conclusion:

4.1 A great deal of work has been undertaken to develop the corporate entity cost sharing principles. Particular attention has been made to ensure actual procures put in place to allocate costs continue to adhere to the core beliefs that all Partner Funds initially signed up, that were then later reaffirmed and submitted to DCLG in July 2016 in the “BCPP proposal”.

4.2 While well-developed there is still work required to further develop these particularly in the areas of transition management and invest cost allocation outside of the securitised asset classes.

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6.0 Further Information and Background Documents:

Appendix 1 – BCPP Corporate Entity and Transition Cost Sharing Principles

Appendix 1

BCPP Corporate Entity and Transition Cost Sharing Principles

Version 3 - June 2017

1.0 Main Cost Allocation Categories

1.1 Fixed cost, split on an equal share basis.

a) project / initial build costs of creating BCPP Ltd, charged quarterly in arrears throughout the period of the project build.

b) on-going operational costs otherwise known as "governance overhead costs". These are the costs that will form the basis of the on-going annual operating charge. They are fixed costs, agreed annually by shareholders and charged to each Partner Fund in advance, allocated on an equal share basis. There will be a transitional period where some expenditures such as buildings costs which are not fully utilised will be allocated on a fixed cost basis, these will be reviewed each year and approved in the budget setting.

1.2 Variable costs, allocated based on assets under management (AUM), dependent on the cost driver these costs may either be charged in advance (e.g. on committed capital) or in arrears as appropriate.

c) transition costs on pooling and post initial transfer of assets and

d) on-going investment costs,

2.0 The above categories are then further sub-categorised as shown below:-

a) <u>Initial BCPP Ltd Project Build / Set-Up Costs</u>

2.1 ***Class A - £1 voting nominal share*** – each Authority to subscribe to a £1 share to secure voting / control rights. Only those parties named in the Shareholder Agreement and Inter Authority Agreement can subscribe.

2.2 ***Class B - Regulatory Capital Shares*** - each Authority to subscribe for an equal value of shares which sum to the expected level of regulatory capital (€10m maximum). As it has been determined this will be held in sterling further work on how currency fluctuations will be managed is ongoing through the OOG.

2.3 ***"Revenue" Set Up Costs****,* An equal split per Authority of the anticipated set up costs, broadly encompassing the following types of expenditure:- planning and due diligence, internal project resource (time, travel and expenses), procurement costs, consultancy services, property acquisition and fit out, ICT (hardware and software) and ancillary implementation expenses.

2.4 Project budget agreed up to £4.2m / £350k per Fund. Spend will be monitored and approved up to the allocated budgets through each of the sub-groups.

2.5 Members and Statutory Officers will be kept appraised of spend to date and anticipated outturn at each Joint Committee.

2.6 These costs are to be settled quarterly in arrears by invoice to / reimbursement from Tyne and Wear Pension Fund.

2.7 The total budget has now been split between the three sub-groups (Governance, People, Operating Model). If expenditure is anticipated to exceed an allocated budget, as per the agreed operating protocols of the sub-groups, this must be approved by the Joint Committee (each individual having received due approval from their individual Authority) prior to being committed.

2.8 ***BCPP Ltd Set-Up Potential Capital Requirements*** e.g. Computers etc. These costs are included in the £4.2m and therefore will be allocated on an equal, i.e. one twelfth split.

2.9 However, to ensure adherence to accountancy regulations and in the interest of securing the most economically advantageous tax treatment they may be categorised and charged differently to the bulk of the set up costs above. The deciding factor will be if the assets / services are to be acquired or leased and, furthermore, if leased the type of lease (i.e. finance or operating). The two allocation methods would then be either to charge as above to the previous set up budget or, if the assets are acquired, procured by BCPP Ltd and capitalised as assets of the company.

2.10 If they are to be capitalised and therefore required to be purchased by BCPP Ltd, this will be undertaken by securing a loan. This could be provided either from the market or from one or more of the Authorities. The associated capital and interest repayments would then be re-charged to each Partner Fund via the on-going annual operating charge. This option has the advantage that the costs can be off set against any tax liability that the company may generate, but only because it is at additional costs e.g. in the additional interest charge.

b) On Going BCPP Ltd - Governance Overhead Costs – "Annual Operator Charge"

2.11 Per the Shareholder Agreement (June 2017) this will form part of the Annual Business Plan and Budget and will therefore require an initial 100% approval with subsequent years requiring 75% approval.

2.12 To ensure the company remains cashflow solvent, payment will be required in full at the start of each year, as agreed in the shareholder agreement. These costs are to be allocated equally to each Partner Fund, as they are intended to cover Company Governance costs. Whilst not jeopardising BCPP Ltd remaining cash flow solvent, the core principle is to keep these costs to a minimum and to allocate costs directly by assets under management (AUM) wherever they can be accurately identified.

2.13 Whilst not an exhaustive list, from the work to date by Officers and advisors it is anticipated that these will include such cost items as –

- Executive & Non-Executive Director remuneration and expenses.
- Company corporate administrative expenses e.g. preparation, audit and registration of company accounts, shareholders meetings, non-investment related company legal fees, corporate bank charges, etc.
- Compliance and risk management costs not directly associated with an individual sub-fund e.g. costs of the risk / compliance officer, maintenance of FCA registration, etc.
- Premises, corporate technology costs, HR/ payroll services etc – in total these are to be collated and allocated on staff headcount. Therefore, a proportion of the total of such costs will be allocated to the individuals nominated as undertaking corporate governance and operational company roles (e.g. Executive, Non-Executive Directors, Risk Officer etc.) included in the governance overhead will be charged accordingly.

c) Transition Costs.

2.14 This is an area that continues to be developed so as to identify how the principles agreed can be applied in practice.

2.15 The key matters yet to be resolved are to ensure that the:-

- charging methodology adopted is not subject to challenge due to cross-Fund subsidisation issues.
- costs of transition attributable to either the externally managed or internally managed Funds are clearly identifiable, and therefore do not suffer cross-contamination.

2.16 ***Transition costs on initial inception of a sub-fund:-*** principle established is that these are to be shared based on the value of each of the Partner Funds' assets under management (AUM) transferring into each sub-fund (all costs of transitioning in will be allocated out by AUM within the sub-fund). This applies to both internally and externally managed sub-funds.

2.17 This cost-sharing will be in the sub-fund where the assets are moved into, not the asset class where they have come from. This has already been agreed by the Partner Funds as the most equitable basis as all will access future savings generated from reduced fee structures, and therefore it would be unequitable for a single Fund to benefit from the potential savings generated through future scale without sharing the costs required to access those savings.

2.18 ***Transitions after initial inception of a sub-fund. -*** Where a Partner Fund undertakes a future strategy review or asset reallocation resulting in movement of assets between sub-funds, the Partner Fund will bear the full costs of transition – there will be no sharing of costs.

2.19 It is assumed that all Funds will act in good faith. However, if there is evidence to suggest that a Fund undertakes not to enter a sub-fund at inception to avoid their allocation of initial costs, but requests to join at a future date then, through the Joint Committee, the Funds that entered at inception reserve the right to request that a proportionate “late joiners fee” is applied. Due to the sensitivity of this issue and as it is an Partner Fund matter not a BCPP Ltd issue, it is deemed appropriate that the OOG (rather than the project team) undertake the work required to devise the required guidance on how this will be monitored and enforced through the Joint Committee. Ultimately there are dispute resolution measures incorporated in the Shareholder Agreement that could be used to make final determinations where consensus cannot be achieved.

d) <u>On-Going BCPP Ltd – Investment Costs</u>

2.20 The basic principle is that “investment costs” and any associated income will, where it can be identified, be allocated to the lowest possible sub-fund level and charged on AUM.

2.21 Work continues on determining the timing of how these costs will be charged, (e.g. some will simply be adjustments through the valuation of the assets) but as above a core consideration will be ensuring BCPP Ltd remains solvent.

2.22 ***On Going Investment Costs – CIV Level*** – i.e. costs at the highest legal structuring level e.g. ACS; LP, etc. It is intended that costs will be allocated to the lowest sub-fund level and only allocated at a CIV level when they cannot be accurately attributed to a sub-fund. Some costs will be applicable to the structuring of the CIV regardless of the number, operational date or asset type of sub-funds that are housed within it e.g. ACS FCA registration costs. It may include an element of asset servicing, legal, tax, staff, buildings and technology etc. In addition, it may be more financially beneficial to procure investment research that can be used by the managers of several sub-funds and where this is the case these costs may also be allocated at this level.

2.23 ***On Going Investment Costs – Sub-Fund Level – General e.g. Securitised Markets*** - both costs and any associated income will be allocated based on AUM.

2.24 ***On-Going Investments Sub-Fund Level - Private Markets / Infrastructure / Global Property/ etc. –*** These types of investments often have up-front pre-investment internal and external due diligence and, potentially, abortive costs e.g. legal and professional expenses. The allocation of these costs is yet to be determined and will, to some extent, depend upon the asset sub-fund structuring solution and investment periods chosen. As a result, more research is required. The basic principles above will be applied, but additionally the issues of up-front and abortive costs and the impact of funds investing in a particular sub-fund at a date subsequent to the first close will need to be addressed.

N.B. - Part of the selection criteria for the chosen operating model / asset servicing provider will be associated with clearly being able to identify and separate investment costs and income to the levels above.

As At 6th June 2017