38th Board Meeting

2018 Operating Expenses Budget

GF/B38/04A- Revision 1 (for Decision)
14-15 November 2017, Geneva, Switzerland

Board Decision

Purpose of the paper: This document presents the 2018 Operating Expenses Budget, as recommended by the Audit and Finance Committee, for approval by the Board.

The Global Fund

Decision

<u>Decision Point: GF/B38/DP06: 2018 Corporate Work Plan and Budget Narrative and the 2018 Operating Expenses Budget</u>

Based on the recommendation of the Audit and Finance Committee, the Board approves the following:

1. 2018 Corporate Work Plan and Budget Narrative, as set forth in GF/B38/04B; and

2. 2018 Operating Expenses Budget in the amount of up to USD 312.0 million, as set forth in GF/B38/04A- Revision 1 (the "2018 OPEX Budget"), which includes USD 15.92 million for the Office of the Inspector General's 2018 operating expenses and up to USD 12.0 million as exceptional, one-off impact of the Global Health Campus infrastructure investment.

However, the Board reaffirms the agreement that the total operating expenses over the 2017-2019 period will remain within USD 900.0 million and requires that the Secretariat undertake a comprehensive review of both the operating expense budget for 2019 and the operating expenses required to meet the Global Fund's strategic objectives, in connection with the presentation of the 2019 operating expense budget.

A summary of relevant past decisions providing context to the proposed Decision Point can be found in Annex 3.

Executive Summary

Context

In line with its mandate, the Audit and Finance Committee ("AFC") reviews and recommends to the Board the Operating Expenses Budget ("OPEX Budget") for the next fiscal year. This paper provides the relevant background, and the AFC considerations and recommendation to the Board to approve the 2018 OPEX Budget, presented in Annex 1 to this paper (GF/B38/04A- Revision 1) and the 2018 Corporate Work Plan and Budget Narrative, presented in GF/B38/04B.

The 2018 Corporate Work Plan and Budget Narrative, and the 2018 OPEX Budget are designed to maintain the strict financial discipline seen since 2013, while continuing the direction set for 2017 as the Secretariat progresses into the second year of implementation for the 2017-2022 Strategy: Investing To End Epidemics (the "Strategy").

Since 2013, rigorous financial management has allowed actual annual OPEX spend to systematically be maintained below USD 300 million, despite significant investments in transformational initiatives (e.g., Step Up, AIM, wambo.org and HRIS), development of core expertise (e.g., CRG, Treasury and Supply Chain) and enhancements to compliance and assurance systems (e.g., ethics, risk and OIG) that have resulted in significant improvements in the maturity level of the organization. At the same time, and in spite of continuous efforts to drive efficiencies (incl. the zero-based budgeting process), these investments have resulted in increased budgetary pressure, with a growing portion of the cost base becoming either fixed or non-discretionary.

The 2018 OPEX Budget and key drivers

The 2018 budget is transitional and focused on compulsory changes and necessary adjustments compared to the 2017 F2 baseline, pending the appointment of a new Executive Director. Furthermore, as part of transition planning, the Secretariat is currently undertaking a review (i.e. the "Fit for the Future" initiative) to present options to the incoming ED to ensure optimal alignment of human and financial resources to maximize impact against the Strategic Objectives.

Budget details by nature and by function are presented in Annex 1, and detailed descriptions of 2018 OPEX Budget drivers are provided in the 2018 Corporate Work Plan and Budget Narrative.

The move to the Global Health Campus (GHC) planned in Q1 2018 will be a key achievement, realizing the most ambitious infrastructure project ever steered by the Secretariat. In terms of its vision, the GHC brings together global health partners based in the Geneva area to unlock the collective potential of their distinctive missions. The GHC is designed to foster collaboration and inspire innovation so as to deliver greater impact for the people all these organizations serve. From a financial perspective, the GHC represents a very positive business case, with a projected net return on investment of USD 29 million over the 10 year lease period, and an expected payback period[1] of less than five years. The GHC infrastructure investment will trigger an exceptional one off cost[2]. This mostly relates to the cost of the move itself and the dilapidation of the existing building. To prudently manage the GHC project, the Secretariat has included risks and contingencies assumptions in its cost estimate. The GHC one off OPEX impact on the 2018 Budget is up to USD 12 million. This amount is anticipated to correspond to a maximum cap, which will be refined in line with the project progress and related review of assumptions on risks and contingencies. At the request of the Audit and Finance Committee (AFC), five budgeting scenarios – each with their respective pros/cons - have been built by the Secretariat to describe potential OPEX trade-offs to absorb the USD 12 million exceptional one off impact in the Secretariat operating budget. These scenarios are described in Annex 2.

At the 5th AFC meeting in October 2017, the Secretariat outlined a rationale for the various scenarios and explained the risks associated with some of these. Key risks are around the potential negative impact on the ability to deliver upon the Mission and around work load and staff health.

AFC Considerations

The AFC evaluated the various options proposed by the Secretariat to balance the budget in spite of the one-off expenses, including scenarios in which the budget envelope for 2017-2019 would be exceptionally increased to accommodate the OPEX needs for the move to the GHC and one in which the one-off expenses would be absorbed over a six year period (see Annex 2 for an overview of the options presented to the AFC).

The AFC noted with concern a situation in which there is insufficient budgetary flexibility to absorb the expenses of the GHC move and recognized the apparent budget pressures related to priority initiatives for successfully implementing an ambitious strategy. However, the AFC considered it important, in the current political/donor environment, to do the utmost to stay within agreed budgetary expectations set for this cycle and to maximize the resources provided to countries.

Notwithstanding these considerations, the AFC also underscored the importance of the Global Fund being enabled to deliver impact, and for new leadership to have flexibility to make adjustments as required to successfully deliver the Strategy as well as prepare expediently towards the Sixth Replenishment. In this context, the AFC welcomed the "Fit for the Future" initiative and also recognized the need for a robust analysis of the operating expenses required to meet the strategic objectives in order to inform OPEX Budget discussion for 2019 and beyond. The AFC therefore recommends that the Board approve the proposed decision point which not only includes the 2018 OPEX Budget but also requires that the Secretariat under a

[1] The payback period corresponds to the period after which initial investment is anticipated to be completely repaid based on cumulated savings effectively realized.
[2] Refer to paragraph 43-45 of the Corporate Work Plan & Budget Narrative 2018 for more detailed considerations on one off costs and their usual budgetary treatment.

comprehensive review of both the operating expense budget for 2019 and the operating expenses required to meet the Global Fund's strategic objectives.

Conclusion and AFC recommendation to the Board

The AFC, after its deliberations, decided to recommend scenario 2, as detailed in Annex 2, with the following Decision Point (GF/AFC05/DP05):

1. The Audit and Finance Committee (the "AFC")

   a. Acknowledges its review and discussion of the 2018 Corporate Work Plan and Budget Narrative, as set forth in GF/AFC05/14 - Part A, and decides to recommend it to the Board for approval at its November 2017 meeting;

   b. Acknowledges the exceptional nature of the Global Health Campus infrastructure investment, takes note of the Secretariat's forecast on its return on investment which will yield significant savings over the investment lifecycle, and decides to recommend the inclusion of the one-off impact of this investment, in the amount of up to USD 12.0 million, in the 2018 Operating Expenses Budget, while remaining within the expected overall budget of USD 900.0 million for the period 2017-2019;

   c. Acknowledges the need for a comprehensive review of both the operating expenses budget for 2019 and the operating expenses required to meet the Global Fund's strategic objectives; and therefore recommends that the Board requires the Secretariat to undertake such comprehensive review prior to the presentation of the 2019 operating expenses budget;

   d. Notes its approval of including the Office of the Inspector General's 2018 budget, in the amount of USD 15.92 million, in the 2018 Operating Expenses Budget (GF/AFC05/DP04); and

   e. Decides to recommend the 2018 Operating Expenses Budget, in the amount of USD 312.0 million, as set forth in GF/AFC05/14 – Part B.

2. Accordingly, the AFC recommends the following decision point to the Board for approval at the November 2017 Board meeting:

Decision Point GF/B38/DP06: 2018 Corporate Work Plan and Budget Narrative and the 2018 Operating Expenses Budget

Based on the recommendation of the Audit and Finance Committee, the Board approves the following:

1. 2018 Corporate Work Plan and Budget Narrative, as set forth in GF/B38/04B; and

2. 2018 Operating Expenses Budget in the amount of up to USD 312.0 million, as set forth in GF/B38/04A – Revision 1 (the "2018 OPEX Budget"), which includes USD 15.92 million for

the Office of the Inspector General's 2018 operating expenses and up to USD 12.0 million as exceptional, one-off impact of the Global Health Campus infrastructure investment.

However, the Board reaffirms the agreement that the total operating expenses over the 2017-2019 period will remain within USD 900.0 million and requires that the Secretariat undertake a comprehensive review of both the operating expense budget for 2019 and the operating expenses required to meet the Global Fund's strategic objectives, in connection with the presentation of the 2019 operating expense budget.

Annexes

The following items can be found in Annex:

- Annex 1: 2018 Secretariat Operating Expenditures Budget by nature / by function
- Annex 2: Budgeting scenarios on potential OPEX tradeoffs to absorb GHC USD 12 million one off impact
- Annex 3: Summary of relevant past decisions providing context to the proposed Decision Point

Annex 1 – 2018 Secretariat Operating Expenditures Budget

2018 OPEX budget by nature

	F2 2017 @ 2018 Budget Rate	2018 Budget	Variances 2018 Budget vs F2 2017	
	kUSD	kUSD	kUSD	%
LFA costs	**50,800**	**48,300**	**(2,500)**	**(5%)**
CCM Costs	**10,558**	**9,500**	**(1,058)**	**(10%)**
Costs Secretariat	**232,941**	**235,361**	**2,420**	**1%**
Staff	146,223	152,092	5,869	4%
Professional fees	35,135	27,614	(7,521)	(21%)
Travel	16,165	16,792	626	4%
Meetings	2,360	3,048	687	29%
Communications	1,676	1,528	(147)	(9%)
Office Infrastructure	26,983	24,794	(2,189)	(8%)
Board Constituency	1,091	1,100	9	1%
Depreciation	5,389	9,612	4,223	78%
External Co-Funding	(2,082)	(1,219)	862	(41%)
Total Opex before non-recurring	**294,300**	**293,161**	**(1,139)**	**(0%)**
Non-recurring costs	**3,720**	**6,839**	**3,120**	**84%**
Total operating costs excl. GHC	**298,019**	**300,000**	**1,981**	**0.7%**
Health Campus - One-off Costs Impact	**1,980**	**12,023**	**10,043**	**507%**
Total operating costs incl. GHC	**299,999**	**312,023**	**12,024**	**4.0%**

2018 OPEX budget by function

Division	F2 2017 @ 2018 Budget Rate	2018 Budget	Variances 2018 Budget vs F2 2017	
	kUSD	kUSD	kUSD	%
General Management	**5,955**	**6,051**	**97**	**2%**
Office of ED/DED	5,955	6,051	97	2%
Operations	**170,605**	**170,304**	**(301)**	**(0%)**
External Relations and Partnerships	8,761	10,518	1,758	20%
Grant Management	**137,370**	**135,483**	**(1,886)**	**(1%)**
LFA	50,800	48,300	(2,500)	(5%)
CCM	10,558	9,500	(1,058)	(10%)
Opex	76,011	77,683	1,672	2%
Strategy Investment & Impact	**24,475**	**24,303**	(172)	(1%)
Support Functions	**95,593**	**95,293**	**(301)**	**(0%)**
Communications	7,025	6,284	(742)	(11%)
Human Resources	7,887	7,280	(607)	(8%)
Legal & Compliance	4,729	4,867	137	3%
Risk Management	3,484	3,917	433	12%
Finance, IT, Admin, Sourcing	72,468	72,946	479	1%
OIG	**16,132**	**15,889**	**(242)**	**(2%)**
Office of the Board Affairs	**6,015**	**5,623**	**(392)**	**(7%)**
Total Opex before non-recurring	**294,300**	**293,161**	**(1,139)**	**(0%)**
Non-recurring costs	**3,720**	**6,839**	**3,120**	**84%**
Total operating costs excl. GHC	**298,019**	**300,000**	**1,981**	**1%**
Health Campus - One-off Costs Impact	**1,980**	**12,023**	**10,043**	**507%**
Total operating costs incl. GHC	**299,999**	**312,023**	**12,024**	**4%**

Annex 2 – Budgeting scenarios on potential trade-offs to absorb GHC USD 12 million one off impact

At the AFC request, the Secretariat prepared five different budgeting scenarios describing potential OPEX tradeoffs to absorb the $ 12 M one off OPEX impact of the GHC.

GHC Impact on Budget – Scenarios

Scenario 1: Absorb one-off impact within 2018 budget ceiling	Scenario 2: Absorb one-off impact within the 2017-2019 period	Scenario 3: Absorb one-off impact over 2017-2022 funding periods	Scenario 4: Absorb one-off over 2014-2019 funding periods	Scenario 5: Exceptional increase of budget ceiling
• Identify $ 12 M of savings within the 2018 budget • Potential savings (examples): o cancellation of $ 8 M priorities for 2018 and proportional haircut on recurrent items such as travel, professional fees, meetings o CCM moved out of OPEX ($ 9.5 M) and proportional haircut on recurrent items, professional fees, meetings	• Identify $ 9.2 M savings in 2018 and 2019 i.e. maintain the $ 900 M over 3 years • Similar to 2018, this implies a significant stress on the fiscal space of the organization • Urgency to review the 2019 recurrent baseline including staff costs as no savings are expected from 2017 and 2018 • Trade offs may involve 2019 strategic priorities such as (Partnership Forum and prep work for 6th replenishment)	• Principle: exceptional projects / one-off items recovered in 2 allocation periods (forward) to avoid detrimental impact on the budgetary space. • Absorbing GHC one-off costs OPEX over two allocation periods is in line with project payback period • Achieve budgets below $300 M for the next 5 years will result in aggregated savings of $ 12 M **Averaging $300 M annually**	• Principle: exceptional projects / one-off items recovered in 2 allocation periods (backward) avoid detrimental impact on the budgetary space • $ 30 M OPEX funding not used in the 2014-2016 cycle. ***Integral part of 2017 ALM*** • Over 2 cycles, average OPEX envelope would remain below the $900 M envelope ($870 M for 2014-2016 and $912 for 2017-2019 periods). **Averaging $297 M annually**	• Principle: acknowledge the exceptional nature of the project, which should not have budgetary implication on "normal operations" • In line with standard (e.g. OECD) recommendations of 'isolating' exceptional one-off items • maintains the trajectory for "organizational maturity" and enhances overall excellence for impact • No impact on the next cycle (2020-2022)
$300 M ⊖ *Require to cut into priorities or core activities* ⊖ *This scenario will take time to implement*	***$900M*** ⊖ *Delays Fiscal stress to 2019* ⊖ *Impact worse than Option 1 due to planned strategic priorities in 2019 (partnership forum & replenishment)*	***$912M & $889M*** ⊕ *Avoid detrimental trade-offs on key activities* ⊖ *Follow project payback approach to aligning the one-off impact with the projected savings but reduce flexibility in 2019 budget*	***$870M & $912M*** ⊕ *Leverage savings already achieved in 2014-2016* ⊖ *Decoupling it with project timeline and payback*	***$912M*** ⊕ *Acceptable versus standard practice* ⊕ *Maintain the "organizational maturity" trajectory and enhance overall excellence to drive impact.*

IMPACT →

Scenario 1: <u>Absorbing the USD 12 million one off OPEX within a USD 300 million approved budget ceiling for 2018.</u>

As the Secretariat is at critical stage of transforming country allocations to grants for the 2017-19 period, achieving such level of savings in 2018 will be very challenging as discretionary expenses (travel, meetings, and professional fees) have already been carefully reviewed through the 2016 Zero-Based Budgeting (ZBB) exercise and there is limited scope for further savings without undermining the Secretariat's ability to deliver upon the Mission of the Organization. Additional efficiencies could only be achieved by scaling back on priorities or critical enablers to the delivery of strategic objectives, cutting functions or level of service currently performed by the Secretariat or the OIG, or shifting sources of funding for activities currently under OPEX (e.g., moving CCM funding out of OPEX would free up USD 9.5 million). The need for Board Committee recommendations and Board level approval, the lag time in the implementation of such decisions and the related one off transition costs will further delay the realization of savings beyond the considered one-year time horizon.

In all the subsequent scenarios a 2018 budget ceiling of USD 312 million is recommended for Board approval.

Scenario 2: ***Absorbing one off OPEX impact in the 2017-2019 allocation period i.e. within the three-year USD 900 million envelope***.

Scenario 2 allows to (i) reduce the one-off impact from USD 12 million to USD 9.2 million after integration of 2019 GHC expected savings for the year and (ii) delay the fiscal stress to 2019. However the same challenges outlined for scenario 1 still need to be addressed: as discretionary expenses (travel, meetings, and professional fees) have already been reviewed through the 2016 ZBB exercise, only structural changes on the OPEX cost base will allow to materialize an amount of savings of the considered magnitude. Additional efficiencies could only be achieved by scaling back on priorities or critical enablers to the delivery of strategic objectives, cutting functions and level of service currently performed by the Secretariat or the OIG, or shifting sources of funding for activities currently under OPEX (e.g., moving CCM funding out of OPEX would free up USD 9.5 million). As highlighted in scenario 1, the realization of those savings may only be gradual. Under Scenario 2, a USD 312 million budget ceiling is recommended to the Board for approval for 2018 and the Secretariat will have to remain within the USD 900 million envelope allocated for the 2017-2019 period. In line with the Scenario 1, Scenario 2 may require short term strategic OPEX trade-offs, a particularly challenging task as the mid-term review of the 2017-2022 Strategy as well as preparation work for the 6th replenishment, due in 2019, will have to be funded (including Partnership Forums and Replenishment)

Scenario 3: ***Absorbing one off OPEX impact over 2 allocation periods, 2017-2019 and 2020-2022***.

Scenario 3 allows the one off OPEX impact of USD 12 million to be absorbed through gradual materialization of savings generated by the GHC move as future rental charges will be lower than current ones. With an expected payback period of less than five years, the one off impact will be compensated by 2022 allowing the Secretariat to remain on average within the USD 300 million annual expenditure over two allocation periods. No detrimental trade off on key activities will be required. However the ring-fencing of savings to address the USD 12 million one off OPEX impact will limit the Secretariat's ability to invest additional funds in strategic priorities.

Scenario 4: ***Absorbing one off OPEX impact over 2 allocation periods, 2014-2016 and 2017-2019***.

Over the 2014-2016 allocation period, the Secretariat spent USD 870 million out of the USD 900 million OPEX envelope, effectively generating savings of USD 30 million. Even if the Secretariat manages to spend USD 912 million (USD 900 million + USD 12 million one off impact) OPEX over the 2017-2019 period, the average spend on OPEX will remain under the USD 900 million ceiling over two allocation periods. From an Asset and Liability Management (ALM) perspective, scenario 4 therefore does not reduce country allocation. Indeed, factoring the OPEX savings of USD 30 million, the net impact of funding the USD 12 million would still result in unused OPEX 'subsidizing' grants by ~USD 18 million.

Scenario 5: ***<u>Exceptional increase of budget ceiling to USD 312 million for 2018</u>***.
In this scenario, there is full acknowledgement of the exceptional nature of the GHC project, which therefore should not trigger budgetary implications on 'normal operations'. Such segregation would be in line with standard practice of isolating 'exceptional one-off items' (as per OECD recommendations[3]) and would allow the Secretariat to maintain its trajectory toward operational excellence. The additional USD 12 million (representing 1% of the overall OPEX envelope) for the 2017-19 period will be managed as part of the overall ALM.

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[3] Refer to paragraph 43-45 of the 2018 Corporate Work Plan and Budget Narrative for more detailed considerations on one off costs and their usual budgetary treatment. Reference is made to a document from 7th meeting of OECD Parliamentary Budget Officials and Independent Fiscal Institutions, Vienna 16-17 April 2015.

Annex 3 – Summary of past decisions

Relevant past Decision Point	Summary and Impact
GF/AFC05/DP05: 2018 Operating Expenses Budget (October 2017)	The Audit and Finance Committee: a. recommended to the Board, for approval at its November 2017 meeting, the 2018 Corporate Work Plan and Budget Narrative set forth in GF/AFC05/14 – Part A; b. recommended to the Board, for approval at its November 2017 meeting, inclusion of the one-off impact of an exceptional infrastructure investment in the Global Health Campus; c. recommended that the Board require the Secretariat to undertake a comprehensive review of both the operating expenses budget for 2019 and the operating expenses required to meet the Global Fund's strategic objectives prior to presenting the 2019 operating expenses budget; d. noted its decision to approve the Office of the Inspector General's budget as part of the 2018 Operating Expenses Budget (GF/AFC05/DP04); and e. recommends to the Board, for approval at its November 2017 meeting, the 2018 Operating Expenses Budget, in the amount of USD 312.0 million, as set forth in GF/AFC05/14 – Part B.