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Report on the current practice of determining specific cost-recovery rates and clear cost-recovery criteria*

Summary

The present report builds on three previous reports documenting the policy and implementation rationale of the current UNDP cost-recovery policy, which provides a degree of flexibility for country offices to determine specific general management support rates.

The need to achieve the proportional sharing of all indirect costs among ‘regular’ and ‘other’ resources at the individual unit level remains the overarching criteria informing the cost recovery policy of UNDP. Specific general management support rates to fit different project implementation scenarios are the result of managerial assessment of the nature and complexity of project requirements, as well as considerations such as: strategic investments to enhance operational capacity to deliver; size of the contribution; centrally negotiated donor agreements; continuation of specific donor legacy rates; and country-specific factors, including crisis conditions.

While no ultimate principle can be established to guide the determination of a specific GMS rate within the 5 to 7 per cent range, the overall flexibility offered by the current policy should be retained until 2007, when its effectiveness can be fully assessed.

*The compilation of data required to provide the Executive Board with the most current information has delayed submission of the present report.

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I. Background

1. The present report originates in decision 2005/18 of the Executive Board which requested UNDP to detail further the current practice of determining specific cost-recovery rates and clear cost-recovery criteria in different countries[1].

2. Three previous reports[2] elaborated on UNDP current cost recovery policy, which is based on the proportionality argument and on harmonized cost-recovery principles among member agencies of the United Nations Development Group (UNDG). The latest of these (DP/2005/CRP.5), in particular, detailed the process through which the rates for general management support fees from all trust fund and third-party cost-sharing projects are calculated.

3. Since the current policy was introduced, in 2004, UNDP has been engaged in a consistent effort to align all existing and new donor agreements to the new rates in order to achieve proportional funding of support costs from all resources. Following a transitional period (2004), the year 2005 represented the first year of full implementation of the new cost-recovery policy. UNDP will report in 2007 to the Executive Board on the overall progress towards achieving the proportionality goals.

4. While the purpose of this report is not to address the effectiveness of the current cost-recovery policy, it is nonetheless useful to contextualize the present discussion within the broader review of the UNDP financial and resource allocation model. That exercise seeks to analyse the distribution of regular and other resources within the UNDP infrastructure, and to define an integrated financial model that reflects the evolving business model of UNDP. The implications of the financial model review exercise will inform the report on the effectiveness of the current-cost recovery policy that UNDP will present to the Executive Board in September 2007. In the meantime, the Executive Board will be kept fully apprised of the financial model review progress and its implications on the overall service-delivery structure of UNDP and its resourcing.

5. As additional background to the present report, it should be noted that the gradual adjustment of GMS rates from 3-5 per cent to 5-7 per cent for third-party contributions and trust funds has not yet been fully met (see annex 1, table 1). At this point, approximately 50 per cent of offices have reached the average 5 per cent GMS, effectively the minimum policy target, whereas in the case of programme country cost sharing contributions the policy target has been fully met (3 per cent GMS). The following paragraphs will highlight some of the challenges faced by country offices in this regard. Corporately, however, UNDP continues to monitor policy compliance through monitoring tools such as select customized reports as well as the 'balanced scorecard'. These instruments are intended to help country offices and corporate units achieve the ultimate objective of policy – that is, the true attribution of all costs to their proper funding source – thus ensuring that there is no undue cross-subsidization among various funding sources.

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[1] See DP/2006/2

[2] The first (DP/2004/35) explored the classification of direct and indirect cost in the context of United Nations simplification and harmonization efforts. The second (DP/2005/CRP.4) provided details on the utilization of income generated from cost recovery, and suggested improvements in the way income is reported as part of the biennial support budget in order to increase transparency. The third (DP/2005/CRP.5) elaborated on project-level cost recovery in response to Board decision 2004/30 requesting clear criteria to determine general management support rates for a specific project.

6. It should also be noted that UNDP, UNFPA, the United Nations Children's Fund (UNICEF) and the World Food Programme (WFP) recently agreed, through the UNDG Management Group, to harmonize the cost-recovery rate for multi-donor trust funds, joint programmes, and joint offices. This important step towards a common cost-recovery approach within the United Nations family builds on cost-recovery principles and criteria that are already harmonized among Executive Committee agencies.

II. Principles informing the cost recovery policy of UNDP

7. In a multi-funded, decentralized environment, the key objective of a sound cost-recovery policy is to ensure the attribution of all costs to their proper funding sources so that there is no 'cross-subsidization' among various funding sources. In the case of UNDP, therefore, the resulting policy is informed by the need to ensure that regular resources do not subsidize the cost of managing programmes funded by other resources.

8. To achieve that objective, several principles of cost attribution and cost classification are applied:

(a) Each source of funding should be attributed all costs for the necessary management provided by the organization.

(b) All costs can be classified into 'direct costs', 'fixed indirect costs', and 'variable indirect costs'.

(c) Cost recovery would generally apply to variable indirect costs, which are indirect costs above what is known as the 'base structure' of the organization.[3]

9. The current policy requires that *indirect* costs be recovered in the form of general management support (GMS) from all trust fund and third-party cost-sharing projects in the range of 5 to 7 per cent of the individual contribution, and from programme country cost-sharing projects averaging 3 per cent for the country project portfolio.

10. This flexibility in establishing a GMS rate is leveraged in different ways by different offices. In addition to the general proportionality concern, a number of independent factors and considerations contribute to determining the choice of a specific GMS rate within the policy range of 5 to 7 per cent. What follows is an attempt to capture relevant criteria and variables that determine or combine to determine a specific GMS rate at the project level.

III. Criteria informing decisions to adopt specific cost recovery rates

11. The following considerations apply to projects funded through locally managed third-party cost-sharing contributions and trust funds, for which the current policy provides a degree of flexibility (in the 5 to 7 per cent range).

[3] Variable indirect costs are all costs incurred by the organization as a function and in support of its activities, projects and programmes, and which cannot be traced unequivocally to specific activities, projects or programmes. These costs typically include services and administrative units, as well as their related system and operating costs. For a more detailed elaboration of cost recovery principles, cost attribution and cost classification, see the report on UNDP strategic cost management and its implications for cost recovery (DP/2004/35).

12. Feedback from country offices points to criteria that can be roughly divided into two groups, namely, factors that drive the GMS rate up, and factors that drive it down. The two sets of criteria may coexist, and both affect the final GMS rate. For example, heavy reporting requirements might justify the negotiation of a higher GMS rate. Conversely, a large contribution would call for a lower GMS rate on the grounds of scale economies that set in. When both scenarios are present at the same time, managerial assessment of their collective impact at the project level will inform the choice of a rate. This makes it challenging to establish *a priori* criteria for determining specific GMS rates for individual projects.

13. The following paragraphs itemize the generic criteria that country offices identified as guiding their determination of a specific GMS rate.

Nature and complexity of project management requirements

14. In general, the more complex a project in terms of project design, oversight, reporting requirements and ICT systems reliance, the higher the applicable GMS rate. Although the assumption is that a complex project, if perceived to be so, will imply a rate closer to 7 per cent than to 5 per cent, there is no evidence that this translates into specific rates. It is difficult to gauge complexity from headquarters and, consequently, to legislate a rate accordingly. In this context, a relevant factor is the increasingly frequent role of UNDP as a provider of development assistance in crisis and post-crisis situations – including direct project execution – which calls for additional reliance on internal resources. In most crisis countries, where direct execution is common, UNDP will face increased support costs, particularly at the local level (country office service platforms), thus justifying a higher GMS.

Size of contribution

15. Donors generally expect that a large contribution would justify a GMS rate lower than the mandated 5 per cent. While some of the economies-of-scale justifications behind this line of argument are well founded, experience from other United Nations organizations (UNICEF in particular) shows that to manage a cost-recovery rate system based on a sliding scale is administratively cumbersome and does not necessarily capture the true management support requirements. Large trust funds, for example, require UNDP to set up a dedicated management unit, which in turn impacts heavily on general management support costs. Furthermore, while it might be expected that lower cost-recovery fees would be an incentive for donors to make larger contributions, this has not in fact been the case.

Centrally established rate

16. UNDP has concluded framework contribution agreements with most major bilateral donors and funds of the Organisation for Economic Co-operation and Development, thus standardizing many aspects of these relationships including the overall approach to management support cost recovery. These framework agreements are aligned to the new cost-recovery rates. Additional examples of such agreements are the European Commission Framework Agreement on Financial Administration and the Global Fund for AIDS, Tuberculosis and Malaria. They both establish a fixed GMS rate (7 and 5 per cent, respectively), thus avoiding local-level rate negotiations between implementing units and country offices.

Continuation of legacy rates established at lower levels than the approved rates

17. One factor that appeared to contribute to keeping the GMS rate below the mandated 5 to 7 per cent range was the legacy relationship with certain donors. Although the policy was introduced in 2004, and a one-year transition period

allowed for offices to renegotiate their GMS rates on existing projects in order to comply with the new policy, this was not always successful since few donors were willing to revisit previously stipulated management cost rates.

Exigencies of partnership building and donor negotiations

18. All of the foregoing reasons for determining a specific rate must be considered within the broader context of UNDP resource mobilization and partnership building efforts. Donors expect UNDP to remain a responsive, flexible partner. The ability to leverage a policy that offers some degree of flexibility remains a strategic tool that country offices employ effectively in securing new partnerships for development interventions as well as building on existing ones.

IV. Inter-agency harmonization objectives and GMS rate

19. Recent inter-agency discussions on the need to harmonize and simplify the common approach to the recovery of support costs are likely to have a profound effect on the rate flexibility identified above. Specifically, as recently as May 2006, the UNDG Executive Committee agencies (UNDP, UNFPA, WFP and UNICEF) agreed on charging 7 per cent to all multi-donor trust funds, joint programmes and joint offices.

20. The decision to align rates is grounded in the already harmonized cost-recovery principles identified in chapter II, as well as in the relevant experience of the Iraq Trust Fund, for which UNDP acts as administrative agent. For some organizations, the rate harmonization exercise sponsored by UNDG has meant that the applicable rate is somewhat higher than what would have been negotiated on a bilateral basis. For others, the rate is actually lower: in the case of UNICEF specifically – which has a similar resource structure to that of UNDP – the imperatives of harmonization and simplification have contributed to a fairly significant realignment of its internal policy. For UNDP, agreement on the harmonized rate means that for specific joint funds and programmes there is reduced flexibility during negotiations with donors.

V. Summary and conclusions

21. Several criteria and variables affect the specific GMS rate chosen by country offices. However, it has not been viable to single out specific formulas that would inform a country office’s determination of specific rates within the 5 to 7 per cent bracket to fit diverse project types and execution modalities. In a decentralized UNDP, and within the flexibility range contemplated by the policy, country offices decide on the final GMS rate.

22. Ultimately, the criteria for determining the GMS rate must be based on the actual operational environment of the project, and should take into account managerial assessment of the nature and complexity of projects, and differences in costs among offices. Some flexibility and discretion should remain, to allow country offices to negotiate successfully and/or adjust the GMS rate within the prescribed range based on the design and management decisions made on a project-by-project basis.

23. In conclusion, legislation of strict GMS cost recovery rates for specific execution modalities would not be in the interests of broad partnership building or in line with the basic objectives of simplification and harmonization. Furthermore, the determination of a specific rate based on project parameters would be administratively burdensome, and would run the risk of either grossly oversimplifying or inadequately capturing the cost of management arrangements for a specific project. It is imperative to keep the policy guidance simple, preserve a degree of flexibility, and continue to build on existing opportunities for inter-agency harmonization. By the end of 2007 UNDP will be in a position to report fully on the effectiveness of its cost recovery policy and propose adjustments as necessary, pending the outcome of the review of the corporate financial model.

Annex. GMS performance analysis for 2004 and 2005

Table 1. Increase on GMS rates
(Third Party Cost Sharing and Trust Funds contribution – country offices only)

	2004	2005
	(over total number of offices)	
Offices with average GMS < 3%	32%	12%
Offices with average GMS ≥ 3% and < 4%	24%	24%
Offices with average GMS ≥ 4% and < 5%	21%	26%
Offices with average GMS ≥ 5% and < 6%	12%	19%
Offices with average GMS ≥ 6% and < 7%	4%	9%
Offices with average GMS > 7%	7%	11%

Chart 1. Increase on GMS rates
(Third Party Cost Sharing and Trust Funds contribution – country offices only)

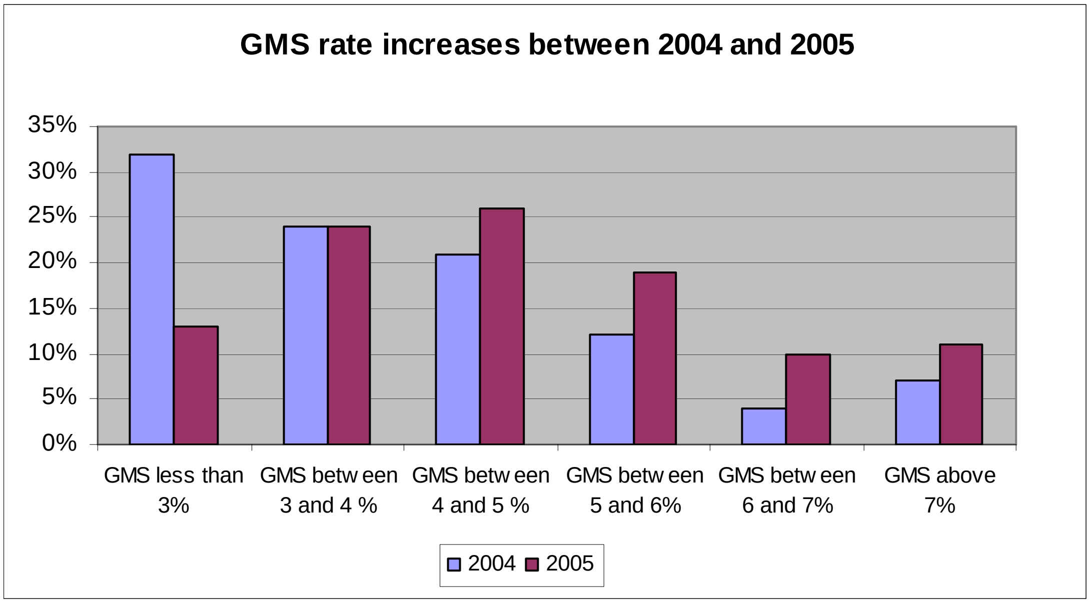

Table 2 – Other Resources programme expenditure and income (GMS)
for 2004-05 by source of funding
(in millions of United States dollars)

	2004			2005			2004-05	
	Total Expenses	GMS charged	Ave. GMS	Total Expenses	GMS charged	Ave. GMS	Total Expenses	Total GMS charged
Other Donor Resources	$1,183.0	$41.6	3.5%	$1,907.0	$77.5	4.1%	$3,090.0	$107.8
Other Local Resources	$1,111.0	$30.3	2.7%	$1,214.0	$40.8	3.4%	$2,325.0	$82.4
Total	$2,294.0	$71.9	3.1%	$3,121.0	$118.3	3.8%	$5,415.0	$190.2