An Assessment of the Consistency and Alignment of the Cost Recovery Methodology used by the New York-based Funds and Programmes Agencies with General Assembly Resolution 67-226

A report prepared in response to UNDP/UNFPA Executive Board decision 2013/9, UNICEF Executive Board Decision 2013/5 and UN Women Executive Board Decision 2013/2

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Executive Summary

The executive boards of UNDP, UNFPA, UNICEF and UN Women in 2013 requested that an independent and external assessment on the consistency and alignment of the then-new harmonized cost recovery methodology with UNGA resolution 67-226 be carried out in 2016. Section II of that resolution (1) reaffirmed full cost recovery as the " guiding principle governing the financing of non-programme costs", (2) stressed the importance of core resources as the "bedrock of the operational activities for development of the United Nations system.." and (3) called for a "simple, transparent and harmonized methodology" for cost recovery. This assessment reviews the methodology approved by the boards and employed by the four agencies as well as the cost recovery rates that have been employed with the methodology. The desired 8% rate of recovery of indirect costs has not been achieved, nor could it have been achieved, in large part because (1) the set of rates approved by the board includes some that are below 8% and (2) some donors, including some participating in umbrella agreements, have not been willing to accept the 8% rate.

The assessment also describes challenges faced by the agencies in recovering costs and proposes a number of steps the agencies should review and adopt, if appropriate, to enhance their recovery of direct and indirect costs. From the outset, it is imperative to continue efforts to work with their executive boards and funding partners to increase the levels of core contributions to the agencies.. Based on this foundation of core, agencies should consider with the boards reviewing and adopting, if appropriate, specific steps to enhance their recovery of costs. These include:

- building better understanding with donors regarding direct costs to assure that all such costs are included in programmes and projects so they do not draw on core and non-core segments of the institutional budgets;

- working with donors to reduce exceptions to the 8% rate for contributions that should be paying that rate;

- looking at the possibilities of introducing volume discounts for large contributions with relatively small management costs and, conversely, premium rates for small contributions.

- examining the feasibility of building security risk reserves into programmes; and,

- carefully reviewing the rationale for reduced rates currently given to certain types of programmes, including private sector programmes, government cost sharing activities and pooled or blended funds within the United Nations system.

In summation, given progress to date, the possibilities available through the recommendations described in the assessment, and the fact that the agencies will have new strategic plans, integrated budgets, continuously evolving funding streams and the likelihood of new partners and programme approaches, the agencies will continue to move toward harmonized full cost recovery.

Introduction

General Assembly Resolution 67/226 took note "of the current work being undertaken by the four organization on a conceptual framework and calculation methodology for cost recovery rates," reaffirmed "that the guiding principle governing the financing of all non-programme costs should be based on full cost recovery, proportionally, from core and non-core funding sources," and requested "the Executive Boards of the United Nations funds and programmes..........to adopt cost recovery frameworks by 2013, with a view to full implementation in 2014, based on the guiding principle of full cost recovery, proportionally, from core and non-core resources, and a simple, transparent and harmonized methodology..."

In 2013, the four New York based funds and programmes agencies (UNDP, UNFPA, UNICEF and UN Women) presented to their executive boards a document, "The road map to an integrated budget; joint review of the impact of cost definitions and classifications of activities on the harmonized cost recovery rates" (DP-FPA/2013/1, E/ICEF/2013/8) which proposed a harmonized approach to determining which direct and indirect costs should be subject to cost recovery and a harmonized cost recovery rate of 8%, with different rates proposed for certain types of contributions.

Also in 2013, the boards, *inter alia*, (1) accepted the methodology and the general, harmonized 8% rate, with the rate to be reviewed in 2016 "with the possibility of increasing the rate if it is not consistent with the principle of full cost recovery, proportionally, from core and non-core funding sources..." (2) approved some but not all of the different rates proposed by the agencies; (3) decided that existing agreements would retain their previous rates until renewed; (4) stipulated that waivers to the rates could be granted by agency heads, (5) requested the agencies to recommend adjustments to the approved cost recovery rates, as required, in 2016 and (6) requested that "an independent and external assessment be performed in 2016 on the consistency and alignment of the new cost-recovery methodology with General Assembly resolution 67-226" (UNDP/UNDPA Executive Board decision 2013/9; UNICEF Executive Board decision 2013/5; UN Women Executive Board decision 2013/2).

This document responds to request 6, above, by providing an independent and external assessment of the methodology approved by the boards, a review of progress with regard to the attainment of the approved rates and a number of recommendations designed to permit the agencies to increase their recovery of direct and indirect costs. A summary of the methodology employed is at Attachment 1.

Background

UN agencies must recover the costs they expend in carrying out their mandates or they cannot continue to operate. This is done in two ways: (1) all direct costs of each project or programme should be financed as part of that activity and (2) indirect costs must be recovered either through a fee charged to each project or from an agency's core management budget.

Historically the New York based funds and programmes agencies received most contributions as core funding; as the proportions of non-core funding rose, it became necessary to recover a portion of indirect costs from non-core funds. Initially, however, recovery rates were established that forced agencies to continue to finance a disproportionate amount of indirect costs from core contributions so that, in effect, core funding was subsidizing the indirect costs of programmes financed by non-core contributions. As the proportion of core in the agencies' total available sources has continued to decline in recent years, it has been necessary to recover higher levels of such costs from the non-core funds that now constitute a majority of funds for all agencies. The following table shows the declining percentages of core in total funds contributed to the four agencies over the past three years.

Table 1. Contribution Levels for Funds and Programmes Agencies, 2013-2016

$ millions

		UNDP	UNFPA	UNICEF	UN Women
2013					
	Core	889	460	1,176	156
	Non-Core	4,247	504	3,588	118
	Total	5,136	964	4,764	274
	Core %	**17%**	**47%**	**25%**	**58%**
2014					
	Core	834	477	1,232	163
	Non-Core	4,191	529	3,843	159
	Total	5,026	1,007	5,075	322
	Core %	**17%**	**47%**	**24%**	**51%**
2015					
	Core	714	398	1,074	135
	Non-Core	4,258	581	3,838	171
	Total	4,971	979	4,912	306
	Core %	**14%**	**41%**	**22%**	**44%**

As can be seen, not only the proportions but the absolute levels of core contributions declined, especially between 2014 and 2015. The decline can be attributed in part to the negative exchange rate movement of the currencies of some major donors against the U.S. dollar but it continues a trend begun over a decade ago.

The approach taken by the agencies in developing their harmonized methodology for cost recovery is that, with certain exceptions, sufficient funds are to be recovered from non-core programmes to cover the portion of management (indirect) costs in each agency's institutional budget that non-core funding represents as a proportion of each agency's overall operations (expenditures). Exceptions are: functions that are not harmonized, such as agency-specific United Nations coordination and unique programme operations; development effectiveness functions; and a limited number of critical, cross cutting management functions without which each agency could not operate. In implementing the new methodology, a number of eligible costs previously considered indirect have been included in direct programme costs.

The harmonized cost recovery rate of 8% approved by the boards and adopted in 2013 represented a commonly agreed level by the four agencies of the amounts of non-core funding needed to provide the proportional share of the portion of the their institutional budgets subject to cost recovery under the harmonized methodology. A separate rate was retained for thematic contributions (7%, with UN Women maintaining the 8% rate as a temporary arrangement) and the existing preferential rates for programme country government cost-sharing, South-South contributions and private-sector contributions were also retained. Also maintained were existing rates for approved, ongoing activities and the ability for agency heads to grant waivers to the standard rates "on an exceptional basis and when the urgency of the circumstances requires.....taking into account specific priorities, modalities that incur lower management costs, and harmonization goals".

Harmonization takes into consideration the different business models and approaches undertaken by the four agencies. Some major differences include the following:

- While all four agencies continue to experience reductions in core funding as a proportion of total actual expenditures, core constitutes only 14-20% of UNDP and UNICEF operations while proportions of core for UNFPA and UN Women remain above 40%.

Table 2. Core as percentage of total expenditures, 2013-2015

	UNDP	UNFPA	UNICEF	UN Women
2013	17%	52%	22%	52%
2014	17%	46%	21%	52%
2015	14%	47%	20%	44%

- While all the cost recovery rates currently in use have been approved by the boards, the 8% rate and the 7% rate for thematic trusts are harmonized among the four agencies while other rates are not. Programme country government cost sharing rates, for example, vary from about 3% to 5%, and UNICEF has set lower rates for private sector contributions than have the other agencies.

- The multi-year institutional budgets of UNDP and UN Women are appropriated on a "net" basis; that is, the appropriations consist of core funds only and do not include expected cost recovery funds. The budgets of UNICEF and UNFPA are appropriated on a "gross" basis whereby the total institutional budgets include expected cost recovery funds as well as core. For the latter two agencies, therefore, the expected cost recovery amount is fixed for multiple years in advance and, if not achieved, would need to draw on additional core funds if the budget levels are to be maintained.

- UNDP and UN Women have agency-specific UN coordination responsibilities, UNDP for development generally and UN Women for gender issues. Agencies also manage unique programmes not found in other agencies, as described below. Such functions are therefore not comparable among agencies and are excluded.

- The agencies place some posts that appear to be similar in different cost categories, as laid out in the Annex to Part B of the Joint informal note "The road map to an integrated budget: cost classification and results based budgeting" submitted to the boards at their first regular session in 2011. Differences include the classification of programme development and implementation and programme policy advisory services at country level and deputy regional directors located in regional offices. These differences occur because of the different business models employed by the agencies and the nature of their work.

The benefits of a common, harmonized methodology for determining cost recovery requirements and of harmonized rates based on that methodology are significant. First, the methodology is clear and transparent, so that agencies and donors can have a common understanding in advance of what costs will be, so that negotiations are simplified. Second, it reduces transaction costs, especially with regard to multi-donor trust funds with agencies that could otherwise have different rates. Third, it eliminates undue competition between and among agencies wherein donors may be "shopping" for lower rates without regard to agencies' capacities and mandates. Finally, it promotes UN coherence in the delivery of development resources and programmes.

Assessment of cost recovery methodology and current rates

The consistency and alignment of the new cost recovery methodology with General Assembly resolution 67/226 should be considered in the context of Section II of that resolution, titled "Funding of operational activities of the United Nations for development." In addition to reaffirming full cost recovery as the guiding principle governing the financing of all non-programme costs, the Section also *inter alia*, stresses the importance of core resources as the "bedrock of the operational activities for development of the United Nations system..." and calls for a "simple, transparent and harmonized methodology" for cost recovery. The centrality of core in the operations of these agencies strongly implies that there can and should be a small base of functions, essential to the existence of the agencies, to be funded from core contributions. This would cover the critical cross cutting management functions in the methodology as well as development effectiveness functions that support development outcomes but cannot be considered programme. A further discussion of core appears in the final section of this paper. The other category of exceptions relates to harmonization; these are functions unique to individual agencies, including agency-specific coordination functions, which should, therefore, be excluded from a harmonized system. In that context, the methodology is consistent with and aligned with the General Assembly resolution.

Methodology

As indicated above, the methodology calculates the amount of funding needed to achieve harmonized full cost recovery by first subtracting from the total institutional budget the exceptions listed, which produces a total amount of residual harmonized management costs subject to cost recovery. To that total is then applied the proportion of total planned expenditures for the agency that comes from non-core funds, producing the amount that needs to be recovered from non-core to achieve full cost recovery under the methodology. Each of the exceptions has been reviewed with regard to its appropriateness.

The cost classification system in use by the agencies splits activities into development and management. Development is further divided into programme and development effectiveness. As such, development effectiveness activities contribute to the achievement of development results. Activities and associated costs such as longer-term strategic planning, programme design and quality assurance which precede or operate outside existing programmes are classified and will remain as development effectiveness. Such activities will be considered as a basic agency functions. In addition, UNDP has traditionally classified as development effectiveness those activities that are directly supportive of specific core and non-core programmes (the transition of such activities to programme is still underway). Other agencies have traditionally classified such costs as programme.

Critical cross-cutting management functions constitute a much narrower concept of what was called a "base structure" prior to the 2013 cost recovery decisions by the boards. The methodology "takes into account that certain functions that are integral to the existence and the advancement of the mandate of the organizations must be carried out, irrespective of the volume of Programme implementation and therefore, their funding must be assured from the regular resources. The main difference between cross-cutting critical functions in the present model, as opposed to fixed indirect costs or base structure in previous ones, is in their scope, as the notion of critical cross cutting functions is more limited than similar notions in previous models." (DP/FPA/2013/1-E/ICEF/2013/8.

UN Coordination functions that are unique to the agencies involved (mainly UNDP and UN Women, as mentioned above) are appropriately placed outside the harmonized framework. Coordination activities common to all four agencies such as contributions to the UN Resident Coordination system are within the harmonized framework and subject to cost recovery.

Similarly, programmes unique to individual agencies, such as the UN Capital Development Fund, the UN Volunteers programme and reimbursable programmes in UNDP and certain private sector related activities in UNICEF, are appropriately placed outside the harmonized set of functions.

The methodology is generally sound. As noted above, the transition of a portion of development effectiveness costs to programmes is continuing for UNDP. It is noted that, under the methodology, about half of each agency's institutional budget (less in the case of UN Women because of the large proportion of their institutional budget employed in their UN coordination function) is considered residual indirect costs to be funded by cost recovery.

Cost Recovery Rates

As indicated above, the rates approved by the boards include a basic 8% amount as well as lower rates, principally for minimally earmarked thematic trusts (7%) and programme country cost-sharing agreements (ranging from 3% to 5%) as well as the ability to provide waivers to these rates. Using these rates, it would not be possible to achieve the aggregate 8% of CR that agencies have determined would be necessary to achieve harmonized full cost recovery. However, a number of additional actions, described in the final section of this paper, may significantly increase the agencies' abilities to comply with the principle of harmonized full cost recovery. It should be noted that, with regard to programme county cost sharing, in some cases programme countries make in-kind contribution such as office space to the country offices of the agencies which, while not considered a part of CR, nonetheless help to offset the costs of operations for the agencies.

Agencies have made good progress in applying the new rates:

Table 3. Agencies' Effective Cost Recovery Rates

(percentages)

	UNDP	UNFPA	UNICEF	UN Women
2013	5.9	6.7	5.5	6.5
2014	6.1	7.0	6.3	7.1
2015	6.3	7.0	6.5	7.0

The section on challenges facing the agencies in recovering costs, below, discusses a number of reasons for the shortfalls.

Agencies will continue efforts to minimize exceptions but some changes in approaches will be needed if harmonized full cost recovery is to be achieved.

Practices in other multilateral agencies that may be relevant in recovering costs

Other multilateral agencies have adopted a variety of practices for recovering costs. The approaches employed by three organizations - the IBRD, the World Food Programme and UNOPS - are briefly described below and summarized in the matrix provided in Attachment 2.

- The World Bank (IBRD and IDA) operates two types of trust funds; Bank Executed Trust Funds , or BETFs, for which the Bank has spending authority and which support the Bank's work programme, and Recipient Executed Trust Funds, or RETFs, which the Bank passes on to a third party and for which the Bank plays an operational role. The Bank normally appraises and supervises activities financed by these funds. For the former, the Bank charges a service fee and for the latter, the fee is determined based on a scale relating to the size of the trust fund. The current rates for both types of funds were adopted in 2016.

- The World Food Programme (WFP) decided in 2014 to retain the previous 7% standard cost recovery charge rather than adopting the 8% fee now charged by the four New York based agencies. Most of its funds are earmarked for specific country programmes but somewhat less than 10% of total contributions to WFP annually are designated as "multilateral", which means they can be used in a variety of programmes around the world and, in some cases, to provide administrative support at the agency's Rome headquarters. WFP charges separate fees for private sector contributions and for programme country contributions, as shown in the matrix.

- UNOPS is a sister agency to the funds and programmes agencies in New York but receives no contributions, *per se,* and covers its costs by charging fees on the projects it manages. It does not have a standard fee or set of fees, but negotiates a management fee for each activity based on the nature and characteristics of the project.

Challenges faced by the agencies in recovering costs

- Declining core contributions are faced by all agencies, as shown in Table 1, above. Despite constant requests from the agencies and annual messages from the boards, the proportions and actual levels of core funding continue to decline. As noted above, under the approved methodology, roughly half of the institutional budget of each agency consists of management functions that need to be funded from cost recovery, proportionally from core and non-core funding. The balance of those budgets are funded fully from core. While the institutional budgets of the agencies have remained level or declined over the past several years, the amounts of core funding that must go to those budgets are limiting the ability of the agencies to use core as the basis for their country, regional and central programmes.

- The ability to finance all direct costs within programmes and projects is at times inhibited by donors insisting that some types of costs considered direct by the agencies are indirect and should be financed by cost recovery rather than as direct costs.

- Some agencies have found it difficult to convince certain donors, including private sector and other non-government actors, to accept the standard rates. A number of such donors have insisted on lower rates or fees, in some cases because their own mandates prohibit paying overhead rates at the standard levels or because they exclude from their definitions of overhead some of the costs for which the agencies charge management fees. As an example, the European Commission, a major donor to some of the agencies, has insisted on retaining the 7% fee in its multi-year agreements with the agencies. In addition, funds pooled with those of other UN agencies usually receive a lower rate, wherein the administering agency will receive a 1% fee for managing the money and the implementing agencies will receive the balance of the fee charged, often 7% but sometimes lower

- The phasing out of legacy rates for ongoing activities for individual programmes has proceeded over the past three years, but some longer-term institutional arrangements have maintained the earlier, lower rates despite the provision of new funding to the agencies.

- Lower rates for certain types of programmes, such as thematic trust funds, have also been maintained, in part on the assumption that such trust funds are consistent with broad agency strategic priorities and are therefore minimally, or softly, earmarked . Their consistency with agency strategies is important but may bear little relationship to the indirect costs associated with their implementation and oversight.

The following section offers a number of recommendations that could be considered to meet these challenges and permit the agencies to increase their recovery of direct and indirect costs.

Conclusions and Recommendations - a way forward

As stated at the outset, UN agencies need to recover the direct and indirect costs of their operations if they are to function. The methodology currently employed to achieve harmonized full cost recovery of indirect costs is appropriate but the way the rates are structured makes achievement of the required recovery amounts problematic, as does the unwillingness of some donors to accept the rates and to pay some direct programme costs. To increase the recovery of costs to achieve the required funding levels, a number of steps could be taken.

-The agencies attach great importance to maintaining levels of core funding that will provide the "bedrock" referred to in General Assembly resolution 67-226 to cover not only a share of management costs but, more important, to provide a funding base for each of its programmes, thematic and geographic. That base is intended to finance basic programmes in individual countries, regionally and centrally, and also to attract additional, non-core resources to support and facilitate carrying out the mandates of the agencies and achieving their strategic objectives. Agencies, their executive boards and other funding partners will need to work to end the decline in the volume of core funding. Unless a core of flexible funding can be maintained into the future, they could move toward becoming implementers of programmes rather than premier development agencies that attract funding from donors who support their core-funded goals and objectives. It is thus in the interest of agency stakeholders, covering both programme countries and donor countries, that core be a solid basis that can leverage programmes financed from both core and non-core resources.

A number of revisions to the approaches for recovering costs should be considered. Among them are the following:

-Efforts should be continued to assure that all direct costs are built into projects and charged directly. Start-up costs, donor-imposed reporting requirements that exceed agency standards and other activities that increase programme costs need to be paid for in the funding for those programmes and projects. Agencies have already made progress in this area but additional work will be needed to convince donors that projects they finance must include all direct costs. Donors used to dealing with private sector firms and non-governmental organizations may not fully understand the specific terminology on costs used in UN system operations. Once given a clear understanding of such costs, they may be willing to permit additional direct costs in the programmes they finance. In light of the different business models, each agency should enhance instruments that describe direct costs, which would give the agencies more coherence and transparency when dealing with donors; it would also help to minimize different agencies granting different rates to the same donors or types of donors.

- While the granting of waivers has affected only a small proportion of the programmes of each of the agencies, a strong enforcement of the 8% basic recovery rate requires that the number of exceptions granted to donors through waivers or longer term agreements be carefully managed to assure that they comply with the boards' admonition that they be used only "on an exceptional basis and when the urgency of the situation requires" and will be granted "on a case-by-case basis, taking into account specific priorities, modalities that incur lower management costs, and harmonization goals..." Agencies express concern that donors will look elsewhere if they do not agree to the reduced rates requested by donors but there should be ways of working around such rates, in part by assuring that all direct costs are charged to the programmes(see preceding recommendation). In the case of certain multilateral funding sources, lower cost recovery rates are accompanied by broader definitions on what can be included as direct costs.

- As the World Bank does, setting rates based on volume tiers may be a useful tool, especially for the larger agencies. Scales could be established which would reward large contributions with somewhat lower cost recovery rates; such scales could also set rates for very small contributions above the 8% standard because of the higher level of management and oversight costs that such programmes entail.

- As part of the costs to be recovered, agencies should factor security risk into their operations, as UNOPS has done. In many cases security costs are already build in as direct programme costs when projects in high-risk areas are to be undertaken. This could be done in different ways, but should be limited to specific programme risks rather than being used as a funding source for broader risk mitigation functions, such as audit. A risk reserve could be established either by increasing the general cost recovery rates for all programmes or as a separate fee or contingency amount to be incorporated into those programmes that will be carried out in environments of the highest security risk. Either of these approaches would help the agencies recover their costs. Agencies could be asked to review both approaches and recommend to the boards which they consider to be more appropriate. While neither option would revise the basic methodology, the first option would, if adopted, require a rate adjustment to incorporate risk.

- A closer look should also be taken at some of the reduced rates currently being charged to certain programmes and donors. As indicated earlier, these rates often require subsidization from core funds or from CR proceeds from those donors paying the full 8% rate. WFP, as indicated above, now charges a rate of 10% for private sector donors, in part because of additional reporting requirements levied by private sector organizations, whereas some private sector donors receive reduced rates from the funds and programmes agencies.

- Agencies should also determine whether costs are being met when they participate in pooled or blended programmes or other UN system operations. While such programmes often include UN organizations beyond the four New York based agencies, if each agency has to absorb or subsidize some of the costs of participating, it may be appropriate to revisit the cost and fee structures to assure that sufficient costs can be recovered by all agencies participating in such programmes.

Summation

It is likely that the environment within which the agencies operate will continue to evolve. Levels and proportions of different funding streams - core and within non-core - will vary from year to year and over time. Such changes will affect the percentages and amounts needed to recover costs. Each agency will, in addition, have new strategic plans and integrated budgets starting in 2018, and perhaps new types of partnerships and types of programmes, as they work toward achievement of the Sustainable Development Goals. These, too, will affect cost recovery requirements.

The executive boards and the agencies might consider integrating a number of the recommendations above into their ongoing dialogues on funding, with a view to arriving at concrete proposals or options to be considered in the context of their future budgets and plans, with the clear goal of recovering the funds needed to finance their indirect costs without disproportionate subsidies from core funding.

Attachment 1.

Methodology Employed in Cost Recovery Assessment

1. Held initial meeting with the technical working group from the four agencies, followed by individual sessions with each agency, to learn what progress has been made, what technical and political factors are at play and what individual agency viewpoints are on moving forward with a harmonized cost recovery approach.

2. Reviewed available documentation from the General Assembly, executive boards and agencies to learn the history of the harmonized cost recovery system adopted in 2013.

3. Met with controllers from the four agencies to determine broader agency perspectives on cost recovery issues.

4. Reviewed recent financial information from each of the agencies to determine contribution and expenditure levels as well as progress being made in increasing the recovery of costs.

5. Held additional meetings with the technical working group and with other officials from the agencies to gain their views on cost recovery generally, as well as specific ideas on improvements that could be made to increase the recovery of costs. In addition, discussed broader issues such as the difficulties faced with regard to declining core and the importance some attach to the current reduced rates for some donors.

6. Held second meeting with controllers to report findings to date and obtain their views.

7. Continued discussions with technical working group and review of agency financial and narrative information.

8. Prepared draft report; held a third meeting with controllers and technical staff to obtain feedback to assure that report was factually correct and that agency views were accurately represented. Obtained additional feedback from technical working group.

9. Prepared and submitted final report.

Attachment 2

Cost Recovery Approaches and Rates for Multilateral Agencies

Organization/Programme	Rates	Explanation
World Bank Trust Funds		Rates approved in 2016
Bank Executed	17%	Fee on staff salaries, consultant fees and benefits
Recipient executed	Tiered (volume)	5% rate on first $50 million
		4% on next $450 million
		3% on next $500 million
		2% all amounts above $1 billion
World Food Programme		Rates approved in 2014
Regular Programme	7%	
Private Sector contributions	10%	
Programme country contributions	4%	
UNOPS	No fixed rates	Project fees negotiated individually based on engagement and start up costs, staff and non-staff resources and risk factors; include indirect costs for country, regional and headquarters offices.