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Item 9 of the provisional agenda
Financial, budgetary and administrative matters

United Nations Children's Fund
Executive Board
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Item 10 of the provisional agenda
Resource, financial and budgetary matters

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

Summary

As part of the joint Roadmap to the Integrated Budget, UNDP, UNFPA and UNICEF were requested to review their harmonized cost recovery rate and propose a transparent methodology for its calculation, aligned with the new harmonized cost classifications. The agencies submitted the requested report in September 2012 (reference DP-FPA/2012/1 and E/ICEF/2012/AB/L.6). The Executive Boards requested the agencies in decision 2012/27 (UNDP/UNFPA) and 2012/20 (UNICEF) to provide additional information so that the Executive Boards could decide on a final cost recovery rate(s) to apply within the context of the Agencies' respective integrated budgets beginning in 2014. At its November 2012 session, the Executive Board of UN Women requested the agency in decision 2012/7 to join in the harmonized work of UNDP, UNFPA and UNICEF. As a result, the present paper is submitted as a joint work of the four agencies.

On 14th December 2012, the Second Committee of the 67th session of the General Assembly adopted the resolution on the Quadrennial Comprehensive Policy Review of operational activities for development (A/RES/67/226). The cost recovery methodology proposed by the agencies, while initiated in parallel with the QCPR negotiations, is in line with the guidance in the QCPR, specifically regarding the full recovery principle, the importance of increased core resources, and incentives for improved complementarity between core and non-core resources.

Based on the additional analysis provided in the present report, the Agencies recommend the adoption of a harmonized cost recovery rate of 8% beginning in 2014. Additional differentiated rates are also proposed.

Background

1. As part of the joint Roadmap to the Integrated Budget, UNDP, UNFPA and UNICEF were requested to review their cost recovery rates and determine a transparent methodology for its calculation, aligned with the new harmonized cost classifications. Per the Roadmap, such review and methodology was to be tabled at the 2012 Second Regular Session Executive Boards together with steps taken towards the integrated budget and integrated budget mock-up.

2. The agencies submitted the requested report in September 2012. The report included a proposed methodology for the calculation of cost recovery rates, based on the harmonized cost classification, but stopped short of proposing a new rate. The Executive Boards requested the agencies in decision 2012/27 (UNDP/UNFPA) and 2012/20 (UNICEF) to provide details on the proposed methodology. The present paper responds to decision 2012/27 (UNDP/UNFPA) and 2012/20 (UNICEF). In particular, it focuses on the proposed methodology and the new rate (Section I), as well as in addressing specific areas on which elaboration was requested by the Executive Board (Section II).

3. At its November 2012 session, the Executive Board of UN Women requested the agency in decision 2012/7 to join in the harmonized work of UNDP, UNFPA and UNICEF. As a result, the present paper is submitted as a joint work of the four agencies.

4. On 14th December 2012, the Second Committee of the 67th session of the General Assembly adopted the resolution on the Quadrennial Comprehensive Policy Review of operational activities for development of the United Nations systems (A/RES/67/226). The cost recovery methodology proposed by the agencies, while prepared in parallel with the QCPR negotiations, is nevertheless, in line with the guidance in the QCPR resolution that relate to the funding of operational activities of the UN development in terms of promoting core and non-core resource complementarity and other principles of cost recovery.

Section I: Overview of proposed methodology and proposed new rate

5. The methodology presented in September 2012 moves in the direction of more equitable funding of organizational costs and is based on the fundamental principle that organizational costs that are eligible for cost recovery should be proportionally funded from Regular Resources (RR) and Other Resources (OR).

6. Costs are considered eligible for cost recovery only if they are indirectly linked to the delivery of development results. Costs directly linked to the delivery of development results will be directly funded from Regular Resources or Other Resources, depending on where the cost originates.

7. Due to differences in funding streams, each of the four agencies have a different relative proportion of RR and OR expenditure, as reflected in Table 1 below. As per the proposed methodology, the ratios shown in Table 1 are used by each agency to split costs eligible for cost recovery between RR and OR in order to apply the “proportionality” principle for cost recovery:

Table 1:

Proportion of expenditure between RR and OR, based on 2012-2013 budget estimates
In USD million

	UNDP		UNFPA		UNICEF		UN Women	
RR	2,081.0	23%	1,065.40	61%	2,222.0	32%	347.4	47%
OR	6,882.0	77%	686.40	39%	4,802.0	68%	390.4	53%
Total	**8,963.0**		**1,751.80**		**7,024.00**		**737.8**	

Source: 2012-2013 Institutional Budget document of each Organization

8. While all costs eligible for cost recovery are to be proportionally funded by Regular Resources and Other Resources based on each agency's relative proportions of RR and OR, other organizational costs are excluded (not eligible) from the cost recovery calculation, as follows:

    - According to the new cost classification, costs classified as Development Effectiveness are an integral part of Development activities and therefore directly contribute to the achievement of Development Results. As such, they are directly funded from RR and OR. A limited level of costs relate to critical, cross-cutting functions that are funded from regular resources, and therefore not subject to the proportionality principle;

    - Costs classified as UN Development Coordination and non-comparable Special Purpose costs (e.g. UNV and UNCDF support from UNDP) are largely agency-specific, not-harmonized amongst the four agencies, and therefore excluded from the cost recovery calculation. However, should future budget proposals contain elements of the UN Development Coordination costs that are comparable, i.e. common to all four agencies, then it may be warranted to include such comparable costs in the cost recovery calculation.

9. Table 2 shows the harmonized cost classification categories, and shows which categories are funded from cost recovery and which ones are not in the newly proposed cost recovery methodology, and a comparison with the current cost recovery methodology. Costs related to cross-cutting, critical functions will be discussed in more detail in Section II of the present paper.

Table 2: Impact of New Cost Classification Categories on Cost Recovery Methodology and Rate.

Harmonized Cost Classification Categories	Current Cost Recovery Model	Proposed Cost Recovery Model	Impact on Cost Recovery Rate
Development Activities*			
Programmes	No*	No*	No Change
Development Effectiveness	Yes	No*	Decrease
Management Activities			
Management Recurring	Yes	Yes	No Change
Management non-recurring	Yes	Yes	No Change
United Nations Development Coordination	Agency Specific	Agency Specific	Agency Specific
Special Purpose			
Special Purpose comparable (Capital Investments)	Agency Specific	Yes	Agency Specific
Special Purpose non-comparable	Agency Specific	Agency Specific	Agency Specific
*As noted under para 8, development activities encompassing programme and development effectiveness directly contribute to development results and as such are funded directly from RR and OR.			

10. As per the methodology submitted by the agencies to the Executive Board in September 2012, the calculation of the cost recovery rate is as follows:

(i) Calculate the sum of management and comparable Special Purpose costs [and remove costs related to critical, cross-cutting functions[1]]
(ii) Take the amount calculated in step (i) and split it proportionally according to the levels of total planned core and non-core expenditures;
(iii) Take the amount calculated in step (ii) to be recovered from non-core resources and calculate it as a percent of total planned non-core development expenditures
(iv) The amount in step (iii) equals the notional cost-recovery rate on non-core resources.

11. Table 3 below shows the step-by-step calculations for each agency, based on the 2012-2013 financial estimates already provided in Table 1.

[1] The September 2012 paper states "[…] factor in an assured level of core resources that would be available to each agency to ensure the funding of those critical, cross-cutting functions […]". The present paper paraphrases this notion as "remove costs related to critical, cross-cutting functions" for simplicity purposes.

Table 3:

Cost Recovery Based on Harmonized Conceptual Framework - analysis on 2012-2013 budgets				
	UNDP	**UNICEF**	**UNFPA**	**UNW**
2012-2013 institutional budget	**1,315.5**	**966.0**	**292.2**	**140.8**
Less - Development effectiveness activities	(203.2)	(256.0)	(57.5)	(24.6)
Less - Non-comparable special purpose activities	(109.0)			
Less - UN development coordination activities	(192.1)	(3.5)	-	(20.9)
Less - Attribution of centrally managed costs to programmes/projects	(86.0)	(98.0)	(18.0)	
Less - Critical cross-cutting functions	(81.3)	(90.0)	(67.0)	(40.0)
Total - 2012-2013 institutional budget cost subject to cost recovery	**643.9**	**518.5**	**149.7**	**55.3**
Regular resources proportional share	*149.5*	*165.9*	*93.6*	*26.0*
Other resources proportional share (A)	*494.5*	*352.6*	*56.1*	*29.3*
2012-2013 planned use of other donor resources (B)	6,387.5	4,449.4	630.3	364.2
Cost recovery rate (C)= (A)/(B)	**7.74%**	**7.92%**	**8.90%**	**8.05%**

Note: Attribution of centrally managed costs are those costs which can be directly identified to the programs and projects and hence, funded directly instead of through cost recovery. Accordingly, cost recovery rate should not be looked at in isolation; it should be recognized that there are elements of costs previously funded centrally, that will in the future be embedded in programmes and projects.

12. The above analysis shows that agency-specific rates range from about 8% to about 9%. Several factors impact the differences in rates, including business models, economies of scale and overall funding streams. For example, UN Women classifies a higher portion of its costs as UN Development Coordination in order to fulfill its specific mandate, which are excluded from the cost recovery calculation, driving the agency-specific rate down. On the other hand, UNFPA has a similar worldwide presence as UNDP or UNICEF, but a much smaller funding base, driving the agency-specific rate up.

13. Differing stages of development can also have a direct impact on the funding requirements of the agencies. UN Women for example is still in the process of finalizing its base capacity and absorbing the implications of the recently approved Regional Architecture implementation. As such, it is likely to require a higher proportion of critical functions to be directly funded from Regular Resources whilst it develops its funding base. As noted in the QCPR A/RES/67/226 it is important to determine a minimum critical mass of core resources and as a new Organisation, UN Women needs to ensure that this is achieved and maintained. Similarly the use of the 2012 – 2013 budgets to estimate cost recovery percentages is likely to differ quite significantly from the actual percentages within the 2014-15 budgets as cost classifications are refined, and the split of income develops between Regular and Other resources.

14. Overall, there seems to be reasonable scope for harmonization among the agencies, as the benefits from continued harmonization far outweigh the differences in rates (more on harmonization in the Section II of the present paper). A harmonized rate is an integral dimension to UN coherence, particularly at the country level, and to providing the right incentives for Delivering as One and joint programming. As a result, based on the above analysis and the responses to the Board decision provided in Section II, the agencies are proposing a harmonized cost recovery rate of 8% for Other Resources. As is customary, agencies will update the Executive Board on the implementation of the new rate on a regular basis.

Section II: Response to Executive Board Decision 2012/27:

Executive Board decision 2012/27 requested agencies to provide *“[…] further information, including organization-specific information, on the following:*

(a) *Critical cross-cutting functions, their funding, and the implications for cost-recovery rates;*

15. The concept of critical cross-cutting functions is akin to the concepts of “fixed indirect costs” and “base structure” used in previous models of cost recovery. Specifically, a level of core resources would be available to ensure a provision of resources to support the mandate, integrity and resource mobilization platform. In other words, the cost recovery 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.

16. 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 much more limited than similar notions in previous models. In addition, while the previous model included in its fixed indirect cost a portion of costs now classified as development effectiveness, the newly proposed model excludes development effectiveness from the calculation of the cost recovery rate.

17. Cross cutting critical functions, have been conceived as part of a harmonized model, and estimated in the range of $40mm to $90m for each of the agencies.

18. The implication of the critical function concept on the cost recovery rate should be looked from two perspectives:

a) Compared to the previously determined fixed indirect costs / base structure, the critical functions are significantly smaller in absolute terms. That means that overall a higher amount of costs is subject to cost recovery, resulting in a higher cost recovery rate than in the previous model

b) Compared to the full proportionality principle, given that the limited amount of cross-cutting critical functions costs would be funded from core resources, the resulting rate is slightly lower than would otherwise be the case

19. In assessing financial estimates for cross-cutting critical functions it is important to bear in mind that, because these functions are not volume-driven, no direct correlation should be expected between the size of a given agency and the nominal value of its cross-cutting functions. Thus, cross-cutting functions are expressed as a nominal amount, and not as a percentage of the budget of an agency.

20. While costing these functions to a degree of certainty would be a complex undertaking, it has not precluded agencies from arriving at high level estimates. As an illustration of the scope of these functions, for UNDP, UNICEF and UNFPA the estimates of critical cross cutting functions provided represent key leadership functions and include the cost of all heads of office in Headquarters and the Field. As such, the notion is limited only to key, leadership functions, and not extended to wider areas of work which are essentially volume-driven. Whilst UN Women has currently followed a similar approach its ongoing review of cost classifications for 2014-2015 could result in some refining of those elements included.

(b) The way development effectiveness will be directly funded from core and non-core resources and the consequences for cost-recovery rates;

21. The current cost recovery model with the 7% rate was developed based on the former cost categories in the Biennial Support Budget (BSB). Since budgets are now based on the harmonized cost classification, the Executive Board requested a revision of the methodology for calculating the cost recovery rate, and not only the rate itself. According to the new cost classification framework, Development Effectiveness costs are part of Development activities, relate to Development results, similar to Programme activities. As a result, Development Effectiveness activities should be directly funded from RR and OR, in the same way that Programme activities are funded from RR and OR. Compared to the previous methodology, this results in a lower cost recovery rate.

22. To enable for appropriate adjustments transitional measures for its application will be necessary, as discussed below.

(c) The comparable and non-comparable special-purpose activities and associated costs, their funding, and the consequences for cost-recovery rates;

23. The distinction between “comparable” and “non-comparable” special purpose activities refers to the fact that some Special Purpose costs are common to all four agencies, while other Special Purpose costs are agency-specific. Specifically, while all agencies may at some point have costs related to capital investments (i.e. comparable Special Purpose), only UNDP has costs related to UNV and UNCDF (i.e. non-comparable Special Purpose).

24. The former (capital investments) is part of the cost recovery calculation, as shown on Table 2. By including these costs in the cost recovery calculation, the recovery rate increases.

25. The latter (UNV and UNCDF) are UNDP specific costs, and not subject to cost recovery. These costs will be addressed separately by UNDP in the context of the preparations of the 2014-2017 Integrated Budget.

(d) The advantages and disadvantages of including or excluding United Nations development coordination activities in the cost-recovery calculation methodology and the consequences for cost-recovery rates;

26. Since costs classified as UN Development Coordination are primarily unique to UNDP for the Resident Coordinator system and to UN Women for gender advocacy and mainstreaming, these costs are not part of the harmonized cost recovery methodology. These will be addressed separately in the context of the agencies' Integrated Budgets 2014-2017.

27. The main advantage of excluding these costs from cost recovery is that it allows agencies to better address areas that are specific to them, without attempting to build a one-size-fits-all model that may not be reflective of the realities of each. The disadvantage is that it leaves certain elements separate from the model, thus reducing the cost recovery rate. All in all, however, it is reasonable to argue that, given the specific nature of these costs, they should not be part of the proportionality argument that is central to cost recovery.

28. However, should future budget proposals contain elements of the UN Development Coordination costs that are comparable, i.e. common to all four agencies, then it may be warranted to include such comparable costs in the cost recovery calculation. This would be in line with the treatment of Special Purpose costs, and would increase the cost recovery rate.

(e) The transitional arrangements after the new cost-recovery rates are adopted;

29. The new methodology requires that some transitional measures be developed, in particular regarding the funding of Development Effectiveness costs and the implementation of a new rate.

30. In terms of the funding for Development Effectiveness, policies, guidance and resource mobilization strategies will need to be developed to include in funding proposals costs that were originally funded from cost recovery. Donors will also need to understand the significance of including such direct charges to projects whenever warranted.

31. The new methodology is a major change in business and therefore may need time to implement fully. Specifically, cost recovery income may still be needed to fund some Development Effectiveness costs until such time as the Development Effectiveness costs can be effectively charged as direct costs to the portfolio of regular resources and other resources. .

32. In terms of the implementation of the new rate, it is understood that legacy rates will need to coexist with the newly revised rates for those projects that have already been signed. This will have an impact on certain administrative and management processes, as well as on the overall estimates for the planning period, which will need to take into account the distinction between current projects and new ones.

(f) The way the new cost-recovery policy will help to achieve improved cost efficiency"

33. The cost recovery methodology proposed is just one element of the agencies' collective efforts to improve the complementary roles of core and non-core resources. By better aligning costs and

funding sources, the revised cost recovery policy will enable a more robust allocation of resources across different activities. In particular, the direct attribution of centrally managed costs (ref: Table 3 in the present paper) will enable budget owners and donors to be better informed regarding the costs of projects, thus facilitating decision-making that is more conducive to generating efficiencies.

34. Cost recovery policy is not a means in itself to achieve cost efficiencies and should not be seen in isolation from all other initiatives that have strengthened transparency, harmonization and cost efficiencies in the Organizations. These initiatives are highlighted in the budget submissions of each Organization and will continue to be included in future Integrated Budget documents to complement the cost-recovery policy and to improve efficiency. Independent of the cost recovery rate, such initiatives contribute in lowering the overall costs charged either directly or indirectly.

Executive Board decision 2012/27 further requested agencies to provide:

(a) Different scenarios of harmonized versus organization-specific cost-recovery rates and their possible consequences and risks;

35. Table 4 below shows a comparative analysis of harmonized versus organization-specific cost recovery rates, including opportunities, challenges and risks:

Table 4: Harmonized versus organization-specific rates

	Organization-specific rates	Harmonized rates
Opportunities	Allows agencies flexibility to properly charge all organizational costs to projects according to organization-specific cost basis	Simplifies negotiation. Reduces transaction costs. Eliminates undue competition for funds. Promotes UN coherence.
Challenges	Results in undue competition among agencies, and could result in higher transaction costs, particularly for multi-partner trust funds	Determining a harmonized cost recovery rate for four agencies is a demanding exercise due to different business models.
Risks	Potentially results in inadequate allocation of resources across agencies, as donors could choose agencies based on rate rather than based on capacity/mandate. Potentially undermines joint programming initiatives.	Results in varying levels of core contributions to organizational costs per agency – due to different scopes, different levels of economies of scale, and different business models. At the margin, may result in under- or over-recovery.

36. While acknowledging the opportunities, challenges and risks noted above for both organization-specific rates and harmonized rates, the agencies are strongly recommending the continuation of the harmonized rate option for other resources cost recovery, which has been in effect for the past several biennia. Harmonized rates are an integral dimension of UN coherence, particularly at the country level, and to providing the right incentives for Delivering as One and joint programming.

(b) The effects of differentiated rates – those taking into account different volumes of funds and the different nature of funds, including, inter alia, complex development situations with attendant increased risks, programme-country contributions and the degree of earmarking – on mobilizing core as well as non-core contributions and the kinds of non-core contributions

37. While the present model is harmonized with a 7% rate, limited differentiated rates currently exist, as shown in Table 5 below:

Table 5: Current differentiated rates, within the harmonized 7% model

Type of contribution	UNFPA	UNDP	UNICEF	UN Women
Donor contributions lower than $40m	7%	7%	7%	7%
Donor contributions larger than $40m	7%	7%	6%	7%
Government cost-sharing	5%	minimum of 3%	n.a.	n.a.
Thematic trust funds	7%	7%	5%	7%
Multi-partner trust funds	7% + 1% administrative agent fee	7% + 1% administrative agent fee	7% + 1% administrative agent fee	7% + 1% administrative agent fee

38. As detailed in previous paragraphs, the Agencies strongly recommend the continuation of a harmonized cost recovery rate for other resource contributions at the newly proposed level of 8%. In addition, the agencies are proposing that the following differentiated cost recovery rate structure apply:

i) a harmonized 1% reduction for non-core agreements greater than $40 million (8%-1% = 7%)
ii) a harmonized 2% reduction for thematic funds for UNDP, UNICEF and UNFPA (8% - 2% = 6%) (UNWOMEN will maintain the 8% subject to its discretion) [subject to UNWOMEN finalization]
iii) maintain the existing preferential rates for Government cost-sharing contributions. Additionally, the same preferential rates will apply for south-south contributions.
iv) maintain cost recovery rates contained in existing inter-institutional formal agreements which apply UN system-wide with funding partners (ie: the cost recovery rate would be maintained at the rate previously established in any formal existing inter-institutional agreements)
v) a 0.5% surcharge is proposed to manage and address the higher risks associated with activities in crisis and complex development situations (8% + 0.5% = 8.5%). This will be managed as a reserve and used when exceptional risk situations arise.

39. With respect to the mock Integrated Budget proposal, Executive Board in decision 2012/27 (UNDP/UNFPA) and 2012/20 (UNICEF) " *requested to receive, at the first regular session 2013, the mock-up of the integrated resource plan with a harmonized presentation of the cost-recovery amount and information on its use;"*

40. In response to the above, the Integrated Resource Plan table has been modified to clearly identify how funds from cost recovery will be allocated in respect to the approved cost classification categories, applying the approved cost recovery methodology.

Table 6: Mock-up of Integrated Resource Plan

1. Resources available	201x - 2013 Regular Resource	Other Resources Prog.	Cost Reocvery	Total Resources	% of total	2014-2017 Regular Resource	Other Resources Prog.	Cost Reocvery	Total Resources	% of total
Opening Balance										
Income										
Contribution										
Other										
Total										
Total available										
2. Use of resources										
A. Development activities										
A.1. Programmes										
A.2. Development Effectiveness										
B. Management										
B.1. Recurrent costs										
B.2. Non-recurrent costs										
C. United Nations Development Coordination										
D. Special Purpose										
D.1. Capital Investments										
D.2. Non-agency specific operations										
Total use of resources (A+B+C+D)										
3. Balance of resources (1-2)										

III. Draft decision:

The Executive Board may wish to:

1. Recall decision 2012/27 (UNDP/UNFPA) and 2012/20 (UNICEF) requesting further development of the harmonized conceptual framework and calculation methodology for cost-recovery rates.

2. Approve the harmonized methodology for the calculation of cost-recovery rates presented in document DP-FPA/2012/1 - E/ICEF/2012/AB/L.6 and further developed in the present paper.

3. Endorse the harmonized cost recovery rate of 8% for non-core contributions.

4. Endorse the following differentiated cost recovery rate structure:

   i) a harmonized 1% reduction for non-core agreements greater than $40 million (8%-1% = 7%)
   ii) a harmonized 2% reduction for thematic funds for UNDP, UNICEF and UNFPA (8% - 2% = 6%) (UNWOMEN will maintain the 8% subject to its discretion) [subject to UNWOMEN finalization]
   iii) maintain the existing preferential rates for Government cost-sharing contributions. Additionally, the same preferential rates will apply for south-south contributions.
   iv) maintain cost recovery rates contained in existing inter-institutional formal agreements which apply UN system-wide with funding partners (ie: the cost recovery rate would be maintained at the rate previously established in any formal existing inter-institutional agreements)
   v) a 0.5% surcharge is proposed to manage and address the higher risks associated with activities in crisis and complex development situations (8% + 0.5% = 8.5%). This will be managed as a reserve and used when exceptional risk situations arise.

5. Decide that the new cost recovery rates will be applicable as of 1 January 2014;

6. Note the guiding principles of the integrated budget contained in the joint note of UNDP, UNFPA and UNICEF on steps taken towards the integrated budget and integrated budget mock-up submitted at the second regular session 2012, and the mock-up of the integrated resource plan with a harmonized presentation of the cost recovery amount contained in Table 6 of the present paper;

7. Request UNDP, UNFPA, UNICEF and UN Women to prepare the integrated budget proposal for each organization respectively, based on the above approved cost recovery rates and the integrated budget conceptual framework.