



## **Final report of joint UKRO/UUK/JCPSG project on full economic costing and EU cost models**

### **Introduction**

1. With the full introduction of the Transparent Approach to Costing (TRAC) methodology in the UK HEI sector, universities will be in the position to identify the Full Economic Cost (fEC) of their activities at research project level. From this, universities will have a clearer understanding of any shortfalls in funding from sponsors, and will be required to take measures to balance their activities to ensure the sustainability of activities across each institution (since February 2004 this has been a requirement of the Financial Memorandum between HEFCE and HE institutions in England).
2. Close working between the Office of Science and Technology, UK Research Councils, and HE institutions on the TRAC project has meant that institutions are generally clear on the implications of implementing fEC for Research Council funded activities. Further work has been done, through case studies, to adapt the TRAC methodology for use with European Social and Regional Development Funding (ESF and ERDF).
3. However, the implications of the use of the TRAC methodology for European research funding, primarily from the Sixth European Framework Programme for Research and Technological Development (FP6), are still unclear.
4. Therefore, the UK Research Office (UKRO), Universities UK (UUK) and the Joint Costing and Pricing Steering Group (JCPSG) undertook a joint exercise to develop a clearer understanding of the implications of using the TRAC methodology with FP6 projects. In particular, the work focused on two issues:
  - Cost recovery using TRAC with the Additional Cost (AC) 'versus' the Full Cost (FC) model.
  - The possibility of future use of the Additional Cost (AC) model.

5. The prime purpose of the exercise was to start to bridge the evidence gap in this area and identify issues for institutions, as well as EU and national policy makers.

## Overview of TRAC

6. TRAC is now the standard method used for costing in higher education in the UK. TRAC was introduced in 1999 after the Transparency Review– a government policy study overseen by the Science and Engineering Base Co-ordinating Committee. After a successful first five years of implementation (finishing in 2004), TRAC is now being consolidated and extended to cover full economic costing at project level.
7. The new fEC requirements are set out in Volume III of the TRAC Guidance Manual. They are an addition to the original TRAC requirements, but they build on the same methods and principles (and consolidate them in some places). HE institutions have training on Volume III and implementation support is in place.
8. The development of TRAC has been the responsibility of the JCPSG – an HE sector body supported by J M Consulting Ltd. Further information is available on the JCPSG website <http://www.jcpsg.ac.uk>.

## Overview of FP6 Costs

9. The 6<sup>th</sup> Framework Programme operates three cost models:
  - Full Cost (FC): this involves reimbursement of a proportion of **all** eligible costs, both direct and indirect.
  - Full Cost Flat Rate (FCF): this involves reimbursement of a proportion of **all direct** eligible costs, plus a flat-rate of 20% of these costs to cover indirect costs.
  - Additional Cost Flat Rate (ACF; generally referred to as AC): this involves reimbursement of 100% of **additional direct** costs, plus a flat-rate of 20% of these costs to cover indirect costs.
10. The proportion of costs reimbursed under the FC and FCF models is determined by the activity that the costs relate to: research and technological development are reimbursed at 50%; demonstration activity is reimbursed at 35%; training, management (up to a ceiling of 7% of the Community contribution to the project) and other activities are reimbursed at 100%. These reimbursement rates are not applied to AC participants, who always receive 100% of their additional costs relating directly to the project. AC participants make their contribution to the project through provision of their own resources, such as staff, the costs of which are already paid from another

source. Reimbursement is subject to the Community Framework for State Aid for Research and Development.

11. In FP6, most UK universities and other HEIs use the AC model. This is considered to be equivalent to the FC model, and can be used by public bodies that are not in a position to fully identify and calculate direct and indirect costs at project level. AC is also available to the Joint Research Centre and to international organisations, and is mandatory for physical persons participating in FP6.
12. Unlike previous Framework Programmes, FP6 does not have any pre-defined eligible costs. Any cost could be eligible, providing it is actual, economic and necessary, and providing it is incurred in the lifetime of the project. A key feature of FP6 is that costs should be determined according to each organisation's usual accounting principles. Although there are no eligible cost categories, there is a clear list of costs that are *not* eligible under FP6. This includes identifiable indirect taxes, including VAT or duties, interest owed, provisions for future losses or charges, exchange losses, cost of return on capital, current costs, notional costs and opportunity costs.
13. The Framework Programme operates on a shared-cost basis. This means that all participating organisations are required to make a contribution to the project. For FC and FCF partners the shared-cost element is explicit, since only a proportion of costs are reimbursed. For AC partners their contribution is not as straightforward, and it is not usually possible to quantify precisely. In FP6, AC partners are required to provide, in their financial reports, a global estimate of their resources, including their own contribution, in order to indicate that there is cost sharing.

## **Implications of Moving to a Full Cost Model**

14. Once UK HEIs are in a position to fully identify and calculate both direct and indirect costs at project level they will no longer be in a position to use the Additional Cost model. At this point, they will need to adopt one of the Full Cost models.
15. The European Commission has indicated that a move to FC (or FCF) will not affect FP6 contracts already signed. In other words, it will not be necessary to re-cost an ongoing project. However, it may be necessary to use FC (or FCF) for new contracts. For many institutions, it is not possible at this point to identify and calculate costs in the way required by the European Commission, for participation on a full-cost basis, since TRAC is not yet robust for the purposes of the Framework Programme. Consequently, for many institutions changes may only come into full effect in the next Framework Programme.
16. It is recognised that the current cost system may not apply in FP7, and that there may be changes to the cost models – and also to reimbursement rates, given the revision to the Community Framework for State Aid for Research and Development.

## Methodology

17. In order to assess the implications for UK HEIs of a move from AC to FC within the current FP rules, since those for the next FP are not yet known, five UK universities were each asked to take one or two current FP6 projects that they are co-ordinating, costed on an AC basis, and to re-cost these on an FC basis using the new fEC methodology. Institutions were selected so as to provide a cross-section of institutional type (e.g. Russell Group, 94 Group & Campaign for Modern Universities) and funding instrument, as well as a spread by country within the UK.
18. A reporting event was also held on 18 March 2005 to keep key practitioners within the sector updated on developments, and to provide an opportunity for them to share their experiences and inform the on-going work. Feedback from this session was extremely valuable and has helped inform and shape the final report.
19. Each institution was asked a set of supplementary questions, and the majority received follow-up visits to discuss these in detail. The intention was to see if there was a significant difference in the level of reimbursement between the two models, and to identify if there were any particular issues or problems arising.

## Findings of Cost Model Case Studies

20. Integrated Projects (IP) and Specific Targeted Research Projects (STReP) are both funded on the basis of a grant to the budget, which comprises a number of elements, each reimbursed for FC participants at different rates. The case studies indicated that the overall level of reimbursement was very similar under the AC and FC models; this is as expected, since AC and FC are intended to be equivalent models.
21. However, there are significant differences depending on the balance of activities in the project; for example, a project weighted towards demonstration activity is going to be reimbursed a lower amount overall under the FC model. All institutions participating in the case studies recognised that had they been putting the project together under FC at the outset they may have altered the balance of activities that they had taken on. For example, they may have taken on fewer Demonstration components (reimbursed at 35% under FC), but more Training components (reimbursed at 100% under FC). They also recognised that they would have considered the staffing of the project differently, had they been able to include more core-funded staff as an eligible cost.
22. Had institutions been applying the FCF model, reimbursement would have been lower than either AC or FC, since all case study organisations had indirect cost rates considerably in excess of the 20% provided under FCF; indeed, this is perceived by UK HEIs to be the least advantageous model.

23. Networks of Excellence (NoEs) are funded on the basis of a grant for integration. Here there are no different reimbursement rates, and costs are potentially reimbursed at 100%, subject to certain conditions. Case study participants anticipated that they would be able to claim slightly more under FC than under AC, since it would not only be their additional costs that would be eligible; for example, core-funded staffing would be an eligible cost.
24. Co-ordination Actions (CA) and most Specific Support Actions (SSA) are funded on the basis of grants to the budget. Both cover 100% of eligible costs, plus a flat-rate of 20% to cover indirect costs. Like NoEs, participants could potentially claim for more under FC than under AC, as non-additional resources are eligible for FC partners, as well as additional costs.
25. For all instruments a number of potentially problematic issues were raised. These include:
- **Apportioning funding within a university:** at present, each institution has a different practice regarding distributing the Community funding within the university. Many, however, use a model where direct costs are used by the department/research centre carrying out the work, whereas all, or some, of the 20% indirect costs are retained centrally. In an IP or STReP, universities may well receive a similar amount overall under FC when compared to AC, but this is likely to comprise lower direct costs (since only a proportion may be recovered) but higher indirect costs (since a real indirect cost rate will be used in place of the 20% flat rate). This means that institutions may have to consider how the funding is handled internally, to ensure that the project can be carried out.
  - **University departments/research centres with only externally funded staff:** some departments/research centres run on predominantly external funding, and do not have core-funded staff resources. This means that there are potentially problems as to how they make up the shared-cost element in an FP6 STReP or IP, in addition to the fact that they would receive less money under FC than under AC.
  - **Contribution to a NoE:** in a NoE, participants are obliged to ensure that the cost of the project is greater than the Community contribution; consequently, there is still an element of institutional contribution to be taken into account.
  - **Time accounting:** under FC, universities will need a mechanism for estimating and recording all staff time, both additional and core-funded. This could be by way of time sheets. This applies to all project types.
  - **Balance of activities:** institutions will need to look at the balance of activities across the portfolio of projects that they have, in order to ensure sustainability.

## **Issues Relating to Indirect Costs**

26. Some of the major issues arising from the case studies surrounded indirect costs. It is essential, for the purposes of the Framework Programme, that the indirect cost rate used for a project is made up of elements that are related to the project, albeit indirectly. The TRAC methodology provides a costing framework, but institutions can choose their own cost drivers. Indirect cost rates that are acceptable to UK funders may well include elements that are non-eligible under FP6 rules. Examples of these that were found in the case studies carried out includes: excessive teaching-related costs; student services; and irrecoverable VAT. Other elements may be included that may be questioned by an auditor, and where the institution may need to provide justification of their relevance to the project. Examples of these include: the infrastructure adjustment; sports and recreation services; Corporate Development; non-project-related travel and subsistence; professional fees; Registry; International Relations; principal investigator thinking time; and catering and residences.
27. Institutions may have to 'strip out' various non-eligible elements. In order to be able to do this, they will need to be able to break the indirect costs down into individual items, and to calculate the value of any non-eligible items(s). There are some questions at present as to whether or not the UK HEIs are in a position to be able to do this, using TRAC. There are also some questions around the fact that TRAC bases indirect cost rates on estimated expenditure- although this is the basis of many costing systems.
28. If participants are able to strip out the non-eligible elements, this means that they will have more than one indirect cost rate. Where this is the case, these rates will need to be applied consistently; there should be as little divergence as possible between them, and areas of divergence should be clear to an auditor. The institution will need to have a system to manage two (or more) rates in parallel. There is precedence for using a number of indirect cost rates amongst current FC participants in the Framework Programme.

## **Auditing of Project Costs**

29. In FP6, there is increased autonomy and responsibility for contractors, in relation to previous Framework Programmes. Participants should manage their funding by consistently applying their own accounting principles; indeed, they should not employ separate practices for FP funding. Cost eligibility issues are checked by the institution's auditor (either internal or external) on a periodic basis. The use of an appropriate cost model is also ratified by the institution's auditor. Therefore, it is essential that institutions have good dialogue with their auditors on these issues.

30. The European Commission may also audit a project; this may identify non-eligible costs. It may also recommend a change of cost model, although it will not over-rule the choice of cost model being used.

## **Broader issues**

31. During visits to participating case study institutions, and through feedback at the reporting session, concern was raised that as the full costs of EU funded activities come into focus, through the application of TRAC, it would be revealed that this activity is not financially sustainable for institutions in the medium to long term. Whilst recognising the principle of co-funding, it was suggested that the funding climate in the UK might not be sufficient to secure current, let alone increased, levels of activity in a sustainable way. Ultimately, as institutions start to think more strategically about taking on European funded projects, the overall volume of Framework Programme research projects undertaken in UK universities could reduce.
32. Concern was raised over the impact this would have on institutions, for example, the break up of some research teams across Europe and the erosion of long standing European partnerships, including the loss of experienced high quality academic staff from the UK. This would ultimately impact on the sector's ability to play its part in delivering the aspirations for economic growth, underpinned by R&D, as set out in the government's 10 year science and innovation framework.
33. It was, however, also recognised that there is currently little firm evidence on what the likely impacts of this scenario might be for HEIs and the UK as a whole. It was agreed that further work in this area is needed. Universities UK are currently working with stakeholders to explore the evidence requirements in this area. This will in turn inform the government's 2006 Spending Review and ongoing policy discussions around the sustainability of UK HE.

## **Next Steps**

34. UK HEIs participating in FP6 will need to determine whether or not they are in a position to move to a full-cost model for new contracts signed. This should be done in consultation with the institution's auditors, taking into account the above issues. It should be noted that once an institution has moved from AC to FC (or FCF) it is not possible to then move back to AC.
35. In terms of future developments, the first draft of the FP7 Rules of Participation is expected in September 2005. This document will set out the proposed legal and financial framework for FP7. In April 2006 the Commission adopted a working document on 'Simplification in the 7<sup>th</sup> Framework Programme'; this sets out ten proposed measures to simplify and streamline the programme, including several relating to costs.

36. The aim of this work was to shed light on the potential implications of TRAC for research funded through the Framework Programme to assist institutions in understanding this issue. It is not, however, intended to be a definitive document, and may raise a number of further questions. We would therefore invite feedback on the issues raised and usefulness of the document. It is hoped that with feedback from the sector this document can be periodically modified to provide a useful and up-to-date resource for the sector.

37. If you have any comments or feedback please contact one of the following:

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