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COMMITTEE OF REPRESENTATIVES OF GOVERNMENTS AND ADMINISTRATIONS
(Noumea, New Caledonia, 28–30 June 2016)

AGENDA ITEM 6.2: SUSTAINABLE FINANCING OF SPC

(Paper presented by the secretariat)

Summary

1. Given the passage of time since the initial paper on sustainable financing was presented to CRGA 43 in 2013, the finalisation of SPC's Strategic Plan for 2016–2020, and the impacts of the volatile global economy in which SPC operates, this paper presents (i) a stocktake of progress since 2013 on implementing the Sustainable Financing Plan, and (ii) the priority actions that will be implemented by the secretariat over the next 3 years.

2. The delay in progress towards implementing the actions proposed in 2013 to improve SPC's financial sustainability is partially the cause of the constraints that SPC is facing now. The secretariat also recognises that with global economic conditions continuing to be volatile, it is critical to implement structural reforms that increase SPC's ability to adapt to external shocks beyond its control.

Recommendations

3. CRGA is invited to:

   i. approve the principle that assessed contributions be subject to annual indexation adjustments to maintain the real value of such contributions over time;

   ii. endorse the proposal that, starting with the 2017 budget, draft budgets be presented for information to CRGA in June each year, but that revised budgets be submitted to the Audit and Risk Committee for review and approval in November before being submitted to the CRGA Subcommittee for Implementation of the Strategic Plan for adoption on behalf of CRGA;

   iii. encourage all members to consider adopting a multi-year restricted programme funding modality, similar to that negotiated with Australia and New Zealand;

   iv. endorse the secretariat's intention to review the established project management fee with the intention of implementing a single rate set initially at the forecast 2016 rate of 15%;

v. note the secretariat's plans to fully implement full cost recovery and to encourage all funders to support these important changes when new project proposals are being negotiated;

vi. authorise the secretariat to analyse and make recommendations on the most appropriate operating currency for SPC.

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SUSTAINABLE FINANCING OF SPC

Background

4. The secretariat presented a detailed paper to CRGA 43 in November 2013, which set out its plans for '*exploring an adapted sustainable financing business model to support the implementation of the plan (SPC's corporate strategic plan) – a model which includes full cost recovery of programmes supplemented by targeted increases in income from host country grants and members' assessed contributions*'.

5. In response to the recommendations of the 2012 Independent External Review (IER), the secretariat committed to the following five main actions:

   i. ***Aim for a higher level of our long-term funding to be under the unrestricted category.*** *Within five years, SPC would like to ensure that all key services are covered by a mix of core financing and programme income, so these services are not reliant predominantly on project funding.*

   ii. ***Establish and implement a cost recovery policy.*** *The full costs of doing business effectively, such as monitoring, evaluation, communication, indirect costs and overheads, will be budgeted and financed in the following ways:*
   - *Full cost recovery – apportion these costs across all projects and programmes.*
   - *Identify sources of funding for some of these costs.*
   - *Use unrestricted income to cover a small portion of these costs.*
   - *Keep these costs at a competitive level (including benchmarking against other organisations).*

   iii. ***Ensure unrestricted funds achieve maximum benefit,*** *including through:*
   - *regularly reviewing spending to identify areas where savings can be made to help release unrestricted funds;*
   - *regularly reviewing the allocation of unrestricted funding to programmes and projects that are not fully funded to ensure these are used only for SPC priorities.*

   iv. ***Adopt best practice principles in setting and achieving reserve levels.*** *In line with best practice principles, the general reserves will be built up and maintained at a level sufficient to fund 60 to 90 days of operations (at the discretion of CRGA). This includes maximising the use of restricted funds to release unrestricted funds.*

   V ***Review SPC's finance policy*** *to ensure flexibility and security in terms of possible loans to assist the transition, investments, etc.*

   Anticipated results

   This approach has two objectives. The first is an improvement (almost doubling in five years) in the proportion of long-term and flexible funding available to SPC to enable a high-quality response to members' requirements. The second is an increase in the amount and quality of SPC's investment in the cost of doing business (an additional 7% of programme income by end 2017). This will be achieved through building these costs into programmes using full cost recovery, which will assist SPC to ensure high quality and sustainability in its future work.

6. Given the passage of time since the initial paper was presented to CRGA 43, the finalisation of SPC's Strategic Plan (2016–2020) and the impacts of the volatile global economy in which SPC operates, this paper presents (i) a stocktake of progress against the actions agreed in 2013, and (ii) an update of the Sustainable Financing Plan to reflect the priority actions that will be implemented by the secretariat over the next 3 years.

Funding overview: 2013–2016

7. After reaching a peak of 114 million CFP units in 2012, total funding for SPC has been variable. It declined significantly in 2013 (108 million) and 2014 (84 million), only increasing again in 2015 (91 million), with a further increase forecast for 2016 (101 million). It should, be noted, however, that 2016 funding is still more than 11% below the 2012 level of activity.

8. The main causes of these differences have been changes in the level of project funding received, combined with internal bottlenecks that have delayed project execution. This volatility has been problematic for SPC as it has occurred while the secretariat has been in the process of adapting its management structures to respond to the findings of the IER. The secretariat draws members' attention to the fact that those findings were based on a long historical trend of continued growth, not decline.

9. SPC's donor base has not diversified to any material degree, resulting in the fact that the 80:20 rule continues to apply, where 20% of donors provide more than 85% of total funding. The narrow donor base is even more evident when the revised 2016 budget forecasts that two donors alone will provide approximately 60% of total funding. We also note that funding from non-members consistently exceeds 50% of the total budget, leading to a question as to the degree of control that members can exercise over SPC's activities and strategic direction.

10. Core funding has remained relatively constant at around 25–26 million CFP units since 2013. At 25.47 million CFP units for the revised 2016 budget, core funding remains well short of the 35 million CFP units that the IER recommended should be achieved by 2015.

11. Assessed contributions received from members increased by approximately 400,000 CFP units (primarily derived from material increases in the assessed contributions for New Caledonia and Papua New Guinea) following the triennial adjustment that was agreed on at CRGA 43 and implemented in 2014. We note that another triennial review is due to be undertaken in 2016 with any adjustment to be implemented in 2017 and future years.

12. Programme (voluntary) contributions remain an important component of the total core budget and have remained relatively constant at around 9–9.5 million CFP units, although adverse currency movements will impact the aggregate amount of this funding in 2017 and future years. The majority of this funding is based on a multi-year funding commitment by Australia and is a critical component of SPC's funding structure.

13. An increase in host country grants to a total amount of 3 million CFP units was submitted to CRGA 43. The increase has been partially implemented: for the 2016 revised budget, total host country grants amount to 540,000 CFP units, with the increase for 2016 arising from an additional contribution of 190,000 CFP units by New Caledonia and an indicative first time contribution of 200,000 CFP units from Federated States of Micronesia (FSM). Despite these increases, the 2016 forecast remains substantially below the 2013 target. Meeting the target of 3 million CFP units would require a significant effort on behalf of host countries. While the secretariat realises that this may not be practical in the current global and regional financial context, it is pursuing discussions

on an increased level of host country grant with Fiji in particular, and seeking confirmation of the indicative contribution from FSM.

14. General income has declined due to a reduction in interest income and currency fluctuations, but the main impact has been a decrease in project management fees resulting from variations in both the amount and timing of receipt of project funding. The IER recommended increasing the level of income earned through selling SPC's services, but this has not occurred.

15. Full cost recovery (FCR) is a work in progress. As a consequence, available core funding continues to be primarily allocated to institutional costs rather than being available for priority programmatic activities. The secretariat commissioned an external study on FCR options in 2014 and has taken the first substantial step to implement improved cost recovery in the revised 2016 budget through shifting ICT costs from being completely core funded to a recovery mechanism based on a fixed annual charge to all users of ICT support services.

16. Reserves increased in 2014 as the result of a write back of a prior year provision. However, due to the financial constraints experienced in 2015 and projected for 2016, the secretariat has not been able to implement a plan to increase the reserves to a level that is both sustainable and effective.

REVISED SUSTAINABLE FINANCING MODEL

17. Sustainable financing of SPC remains a challenging issue in the prevailing economic environment. SPC has yet to secure the consistent long-term flexible funding required to ensure its ability to develop, deliver and sustain world-class programmes responsive to members' development priorities. Continued reliance on project funding, which is often short term in nature, leads to volatility in the level of programmatic activity that SPC can maintain. Project funding cycles do not follow consistent patterns and gaps arise when a cycle ends and there are delays in replacement funding being confirmed. As a result, programme delivery is disrupted, staff are lost and institutional risk increases due to interim or transition costs being shifted to core funding.

18. Since the 2013 paper was presented, the secretariat has implemented numerous organisational changes to ensure that a solid institutional platform is in place to support the proposed 2013 actions. The further financial actions necessary to improve SPC's financial sustainability will now be implemented over three budget cycles to address the financial constraints that SPC is facing. The secretariat also recognises that as global economic conditions continue to be highly volatile, it must implement structural reforms that increase SPC's flexibility in adapting to external shocks beyond its control.

19. The secretariat implemented a series of short-term measures that balanced the 2016 budget (after recognising an initial deficit of 2.15 million CFP units), but notes that these do not address many of the long-term structural challenges that SPC faces, particularly those that underpin the significant budget deficits forecast for 2017 (5.6 million) and 2018 (9.2 million).

20. The secretariat therefore proposes the following actions.

Core funding

21. The triennial review of assessed contributions and host country grants is due to be undertaken during 2016 for implementation in 2017. This will be completed during the second half of 2016.

- While the secretariat does not anticipate requesting a substantive increase in assessed contributions, we do request that CRGA approves the principle that contributions will be subject to annual inflation adjustments to maintain the real value of such contributions in the face of inflation.
- Given the secretariat's limited success in achieving the 2013 target for increasing the level of host country grants to 3 million CFP units by 2015/16, further consultation will be undertaken with the relevant host countries and a revised proposal will be submitted to CRGA for consideration. These consultations will aim to increase the current level of host country grants from 540,000 to 990,000 CFP units as soon as possible, and to develop a plan for reaching a more realistic level within the next three budget cycles.
- It is proposed that the outcomes of the review of assessed contributions and host country grants be submitted, together with the revised 2017 budget, for review and approval by (a) the Audit and Risk Committee, and (b) the CRGA Subcommittee on Implementation of the Strategic Plan before the end of this year.

22. The secretariat is working closely with the CRGA subcommittee and will gradually introduce improved priority-setting mechanisms to ensure that available core funding is directed to the highest priority activities. Given that shifts in core allocations will have to be accompanied by organisational change and restructuring, it is anticipated that such changes will be undertaken within the next three budget cycles.

23. The ongoing voluntary contributions received from Australia and France are particularly important and the secretariat will continue to work with other members to explore opportunities to increase this source of flexible funding.

Restricted funding

24. The secretariat acknowledges the efforts made by Australia and New Zealand towards increasing the levels of their restricted programme funding, which supports SPC's divisional plans through multi-year funding arrangements rather than project-specific funding. The nature and amount of funding provided (7.8 million CFP units in the revised 2016 budget) is evolving and the secretariat will continue to engage in regular high-level consultations to ensure that this funding evolves on a sustainable basis to meet the needs of all parties.

25. The secretariat encourages other members to consider similar funding arrangements.

Project funding

26. The significant variations in annual project income since 2012 have caused difficulties across the organisation. To remain at 2016 levels, the secretariat is required to raise more than 68 million CFP units of new project funding every year. Recognising the challenge this represents, the secretariat has committed resources in the 2016 revised budget (initially 200,000 CFP units, but increasing in future years) to develop its resource mobilisation capacity and processes with the aim of maintaining project funding at a minimum of the 2016 revised budget levels.

27. To ensure that new projects address SPC's priority activities as identified in the strategic plan, revised internal prioritisation processes are being developed and will be applied to all existing activities as well as new project proposals.

Indirect costs/Project management fees

28. SPC has a long-standing practice of applying project management fees (PMF) to all projects that it executes in an attempt to recover part of the total indirect costs that are incurred in maintaining the organisation. Despite the Tahiti Nui Declaration stating that a PMF rate of 7% is to be applied to member-financed projects and 15% to non-member funded projects, the reality is that very few non-member projects contribute 15%. As a result, actual recoveries have historically not exceeded an average level of 5%.

29. This is an area of concern to management, particularly when the officially endorsed rates of 7%/15% do not bear any relationship to actual indirect cost rates, which have varied between 22% and 10% over the last decade. We attach a table of 2015 actual, and 2016 forecast indirect costs which indicate that, even after shifting ICT to full cost recovery, and forecasting a significant increase in our direct cost base, SPC's indirect cost rate for 2016 will remain in excess of 15% (Annex 1).

30. The secretariat recommends that the dual PMF rate be reviewed and that a single indirect cost rate be applied to all projects undertaken, irrespective of the funding source. While the proposed changes to full cost recovery outlined below will lead to a reduction in SPC's calculated indirect cost rate, this will take time. It is therefore proposed that a minimum PMF of 15% be adopted for all new project proposals.

Full cost recovery (FCR)

31. The 2016 revised budget incorporates SPC's first serious attempt to implement FCR practices and processes. A significant part of the costs of ICT services (initially budgeted at 1.56 million CFP units) has been moved from core funding to a direct cost basis linked to all internal users of ICT services.

32. The next major step will be the implementation of FCR for our facilities. The cost of maintaining SPC's offices and physical support infrastructure is budgeted at approximately 2.1 million CFP units in 2016 and is the largest component of our current indirect costs. Due to the real differences in operating conditions that exist between Suva and Noumea, it is a complex process to implement a sustainable facilities cost recovery process, but this will be incorporated into the revised 2017 budget.

33. In addition to the above 'big bang' changes to FCR, Finance will develop a standardised proposal costing template that will be applied to all new project proposals. This template will be designed to ensure an improved level of recovery for project-related costs for services such as communications, publications and translation and interpretation, which account for approximately 2.8 million CFP units of core funding in the 2016 revised budget. It is essential that a reasonable level of the costs for these services is recovered from the projects that require them. We expect to achieve an incremental improvement in FCR across all these functional support units as current projects are replaced with new, fully costed, projects.

34. Monitoring, evaluation and learning (MEL) is currently funded through a mix of core funding to SEPPF, core resources at the divisional level and a limited amount of project-specific funding. The 2017 revised budget will move a significant component of MEL costs to direct costs through the introduction of a sustainable FCR process.

35. It must be noted that the move of ICT to FCR is still being 'bedded down' and that a longer process of education and learning on the methodologies and implications of the shift to FCR is required to ensure that such changes are achieving their intended results and are not counterproductive.

36. We also note that the success of FCR is often determined by the willingness of funders (particularly project funders) to accept direct FCR charges on projects that are being negotiated with them. To this end, the secretariat recognises that there will be a need for extensive external communication with donors and that project negotiation may initially be somewhat lengthier than at present.

Reporting currency

37. SPC's operating currency is the Pacific franc (XPF), alternatively known as the CFP (Comptoirs Français du Pacifique). For reporting purposes, this currency is reported in 'CFP units' where each unit represents 100 CFP.

38. While CFP represents the currency of our New Caledonia headquarters and has been our traditional reporting currency, the secretariat requests authorisation from CRGA to analyse whether there is a reasonable cause to formally adopt an alternative, international currency as our reporting currency. The main factors driving such a review are:
- difficulties experienced by stakeholders in understanding reports based in CFP units;
- potential efficiency gains arising from aligning our reporting currency with the main funding currencies that we receive and are required to report against. Our primary funding currencies remain the Euro (>30%), AUD (>28%) and USD (>12%);
- the need to address some of the currency exchange issues arising from SPC's Suva-based operations, which are subject to a three- or four- way currency conversion;
- provision of options to simplify our current international staff salary structures, which are currently based in SDR and should be brought in line with SPC's global operating currency.

39. Significant currency fluctuation has been experienced by SPC over the last 3 years and is expected to continue. The secretariat is obligated to implement improved strategies and processes of currency management to mitigate the risk that increasing currency volatility may drive material future forex losses.

Recommendations

40. CRGA is invited to:

i. approve the principle that assessed contributions be subject to annual indexation adjustments to maintain the real value of such contributions over time;

ii. endorse the proposal that, starting with the 2017 budget, draft budgets be presented for information to CRGA in June each year, but that revised budgets be submitted to the Audit and Risk Committee for review and approval in November before being submitted to the CRGA Subcommittee for Implementation of the Strategic Plan for adoption on behalf of CRGA;

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v. note the secretariat's plans to fully implement full cost recovery and to encourage all funders to support these important changes when new project proposals are being negotiated;

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Annex 1

Table 1: Indirect costs

Indirect costs	2015 Draft financial statements	2016 Revised budget	
DG's Office	1,273	1,507	1. 71%
DDG (Noumea)	676	426	0.48%
DDG (Suva)	287	278	0.31%
SEPPF	1,240	1,289	1.46%
Communications	450	478	0.54%
Nth Pacific Office	537	588	0.67%
Melanesia Office	237	245	0.28%
Administration	1,391	1,212	1.37%
Finance	1,159	1,317	1.49%
HR	1,446	1,085	1.22%
ICT	1,636	202	0.22%
Library	307	406	0.46%
Publications	1,102	1,007	1.14%
Translation & Interpretation	1,451	1,377	1.56%
Facilities/Common Charges	1,815	2,114	2.40%
Total indirect costs	**15,007**	**13,531**	**15.3%**
Total direct costs	**79,488**	**88,303**	
Indirect cost rate	**18.9%**	**15.3%**	