National Audit Office

OFFICE OF THE THIRD SECTOR – IMPLEMENTATION OF FULL COST RECOVERY

A REVIEW BY THE NATIONAL AUDIT OFFICE

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SUMMARY

1 This review examines the progress government has made towards meeting its commitments to implement full cost recovery[1] across its contracts with third sector[2] providers, including charities, voluntary and community organisations and social enterprises. The commitments were originally made in HM Treasury's 2002 cross-cutting review *The Role of the Voluntary and Community Sector in Service Delivery.*[3] They were intended to address a concern among third sector groups that government funders' reluctance to pay for all attributable overhead costs was resulting in an effective subsidy of public service delivery out of the third sector's own charitable funds. Failure to pay for the full costs, where this is appropriate, can threaten value for money in the short and longer term: short term risks to the quality and effectiveness of a service if it is underfunded and reliant on charitable subsidy; in the longer term, possible erosion of third sector reserves, threatening continuity of service and even the supplier, and loss of competitiveness and choice if organisations collapse or withdraw from public service delivery.

2 While the extent of this perceived subsidy has never been estimated, research values central government's funding of the sector at over £3 billion per year. With even a one per cent shortfall capable of eroding over £30 million of charitable reserves each year, the financial risk to the sector could therefore be significant. Recognising this, government's commitments on full cost recovery were expected to be implemented by April 2006. The Office of the Third Sector – a part of the Cabinet Office – is responsible for overseeing the implementation of full cost recovery as well as the wider aspects of the 2002 Review agenda.

Main findings

3 The issue of full cost recovery has been kept high on the policy agenda since 2002 through guidance issued by government and a range of ad-hoc monitoring exercises. Despite this attention, anecdotal feedback through surveys of third sector organisations indicates a significant proportion of them do not consider they are receiving full cost recovery. The Office of the Third Sector's *Partnership in Public Services: an action plan for third sector involvement* published in December 2006 acknowledges that further progress must be made on full cost recovery.

4 The target was expressed in terms of service delivery through procurement and contracting, but the full scope of government's financial relations with the third sector is broader than this. There are useful distinctions to be made between procurement (mainly through contracts) and donor relations (through grants), as well as further distinctions within these categories. We found that full cost recovery does not necessarily apply in the same way across this variety of financial relationships. Crucially, these distinctions were missing from the language of the 2002 Review and 2006 target, much of the early guidance on the issue, and most of the subsequent debate and comment. This lack of early clarity risked an expectation gap between government and the sector.

5 Full cost recovery remains important to both government and the sector, but has proven difficult to pin down in any practical way: in many ways it is too blunt an instrument. The concept is useful as a code for fairer funding principles but not as an accounting treatment or process that public funders can implement or roll out in a mechanistic way. The term has the potential to mislead participants into thinking that all costs will be recovered in all situations. It also fails to reflect some third sector organisations' preparedness to share the costs and risks in joint ventures with public bodies.

6 There is no dispute from departments on the fairness of the financial principles underpinning full cost recovery. The problem for departments appears to be in turning the principle into specific practice which is meaningful across a variety of funding relationships. We found a very mixed picture of action taken by departments on full cost recovery, reflecting the diversity of relationships they have with the sector, with resultant scope for debate about whether the 2006 target has been met. With very few exceptions, departments in mature or longstanding relationships with the sector, whether procurement

1 Full Cost Recovery is the principle by which third sector organisations are paid not only for the direct costs they incur by providing a service – for example staff salaries – but also for the indirect or overhead costs associated with delivering the service such as office space, information technology support and other support costs.

2 'The third sector comprises organisations that: are non-governmental; are 'value-driven' – that is are primarily motivated by the desire to further social, environmental or cultural objectives rather than to make a profit per se; and principally reinvest surpluses to further their social, environmental or cultural objectives' (Partnership in Public Services, Cabinet Office (Office of the Third Sector), 2006).

3 Hereafter refered to as the 2002 Review.

or donor based, have seen little need for real change beyond quite limited updates to their internal guidance. Departments overseeing some new or transforming relationships with third sector providers have been more active in considering how best to adopt full cost recovery. No department has undertaken a systematic scrutiny of its programmes to see if funding practice needs to change.

7 Progress monitoring remains heavily reliant on anecdote from the sector and the front line. There is no systematic evidence base to demonstrate success or failure, or the nature and cause of any problems that exist. Departments in general, and the Office of the Third Sector, therefore have difficulty convincing the sector that they are closing the gap between the 2002 Review commitments and the sector's expectations.

Recommendations

8 We recommend that:

i The Office of the Third Sector and HM Treasury should expand on their commitment to the implementation of full cost recovery by developing more sophisticated statements that better reflect its underlying principles of fairer funding and sound risk management. Such complexity is unlikely to be capable of being reflected in any simple new target. Within these principles, departmental practice towards cost recovery will vary with the purpose of the funding and the environment it takes place in.

ii *Improving financial relationships with the third sector: guidance to funders and purchasers*, published in May 2006, added much needed clarification on the place of full cost recovery in procurement and donor-based relationships. Our work suggests, however, that departments find less clarity where full cost recovery runs up against other practicalities of procurement and grantmaking such as appropriate levels of scrutiny of third sector bids, and approaches to cost or price negotiations with third sector bidders. The initiative, announced in December 2006, to support the training of 2,000 public sector commissioners working with the third sector offers an opportunity to develop thinking around these practical concerns. The Office of the Third Sector and HM Treasury should use this opportunity to test whether commissioners are getting the practical guidance they need on full cost recovery issues from *Guidance to Funders and Purchasers*, and identify any additions or clarifications commissioners require. Part 2 of our review sets out a possible structure or starting point for how the commissioner training programme might explore full cost recovery.

iii Departments should review their major programmes, procurement opportunities and funding streams open to third sector organisations, and reach more explicit judgements on how full cost recovery should apply, and whether current practice needs to be revised. These results should be publicised and discussed with the sector, to arrive at agreed and mutual expectations. Departments should also require their main agencies and sponsored bodies to carry out similar reviews. **Figure 1** overleaf provides a framework based on our findings which should help departments with this task.

9 If the current expectation gap is to be closed, greater clarity and realism in government and departmental policy and guidance should be matched by corresponding articulation of full cost recovery issues by the sector. Problems will still arise, but third sector organisations can make a more positive contribution to learning and improvement if they too relate and express their concerns in such a way as to show where and why full cost recovery is breaking down across this diverse funding environment. The Commissioner for the Compact is well placed to develop a framework that can map problems as they arise and develop a consistent, evidence-based approach to learning from these experiences. More sophisticated feedback would contribute greatly to the Office of the Third Sector and Treasury's ability to target guidance, training and other efforts on helping departments and the sector to get full cost recovery right.

1

Shopping or purchasing relationships	Open and competitive market[1]: contract payment	Open and competitive market: tariff payment
Should FCR apply?	Yes	Yes
Aspects to consider in adopting full cost recovery for fairer funding	■ Purchasers should make clear their expectation that suppliers should bid on a sustainable, full cost recovery basis, including a profit or surplus margin if desired.[2] ■ Purchasers may need to undertake scrutiny of underlying cost details for assurance that the required service appears deliverable and sustainable at the quoted price. The requirements should be the same for all providers regardless of sector. The level of due diligence scrutiny required is likely to diminish where required service specifications are more straightforward or markets are more open and competitive.[3] ■ Purchasers should select the supplier offering the optimum combination of whole life costs and quality in meeting the required service specification – this will not necessarily be the cheapest.[4] ■ Purchasers' ability to negotiate price with a preferred provider restricted where EU procurement rules apply.[5]	■ Purchasers should make clear their expectation that the tariff is intended to allow suppliers to deliver on a sustainable, full cost recovery basis and will allow efficient providers to make a surplus or profit. ■ Purchasers should consult with potential providers on the design of tariffs and contracts which allow efficient providers to deliver the required outcomes on a sustainable basis with demand risk appropriately shared.
Giving or donor-based relationship	**Support for a specific project: funding an entire project**	**Support for a specific project: funding an agreed share of a project**
Should FCR apply?	Yes	Yes
Aspects to consider in adopting full cost recovery for fairer funding	■ Funders should make clear their expectation that applicants should prepare bids on a sustainable, full cost recovery basis.[6] ■ Funders will require transparency and scrutiny of underlying costs for assurance that the project scope appears deliverable at the level of funding bid for.[7] ■ Funders will need to confirm that no attributable costs are being met from other sources of public funding.[8] ■ Funders may manage costs by negotiating to reduce the scope of the fully funded project. Funders should not reduce costs by excluding particular attributable overhead costs or setting arbitrary percentage restrictions on overheads.	■ Some general considerations as when funding an entire project, though funder may also negotiate its contribution down by reducing the overall share of the full costs it is funding. Funders should not reduce costs by excluding particular attributable overhead costs or setting arbitrary percentage restrictions on overheads. ■ Funders will be additionally concerned with confirming remaining funding for full costs is in place from all sources to ensure the overall deliverability of the whole project.

NOTES

Sources of existing guidance and good practice

1 On the general assumption that procurement should be competitive see Government Accounting (GA) para 22.2

2 For Treasury expectation on full cost recovery bidding see *Guidance to Funders and Purchasers* (GFTP) para 5.7

3 On expectations for cost scrutiny in competitive procurement see GTFP para 5.13 and 5.30 or Office of Government Commerce's *Think Smart Think Voluntary Sector* (TSTVS) section 14

4 On warning that cheapest is not necessarily best value see GA annex 22.2

Less competitive or single supplier market: contract payment	**Less competitive or single supplier market: tariff payment**
Yes	Yes
■ Purchasers should make clear their expectation that suppliers should negotiate on a full cost recovery basis. ■ Purchaser will need greater transparency and scrutiny of bidders' underlying costs and profit margins due to lack of competitive pressures establishing a market price. The requirements should be the same for all providers regardless of sector. ■ Purchaser should negotiate on price to secure value for money in a non-competitive context.	■ Purchasers should make clear their expectation that the tariff is intended to allow suppliers to deliver on a sustainable, full cost recovery basis and will allow efficient providers to make a surplus or profit. ■ Purchaser and supplier should negotiate transparently on the design of tariffs and contracts which allow efficient providers to deliver the required outcomes on a sustainable basis with demand risk appropriately shared.
Support for a specific project: making a minor contribution	**Non project-specific support: a contribution to an organisation or programme's objectives**
No	No
■ Funder may offer a minor or specific contribution to a project. ■ Funder should have proportionate concern for the deliverability of the full project before committing funds.	■ Funder is not supporting specific projects with individual budgets. ■ Funder should be satisfied that the applicant's organisational or programme budgets and plans are capable of delivering the overall outcomes being supported.

5 On post tender negotiation see Office of Government Commerce briefing at http://www.ogc.gov.uk/briefings_post_tender_negotiation.asp

6 On the relevance of full cost recovery to grants see GTFP para 5.14

7 On need for cost scrutiny in grant funding see GTFP para 5.13

8 On risk of double funding in giving see GTFP para 5.20

PART ONE

GOVERNMENT IS COMMITTED TO FULL COST RECOVERY BUT CONCERNS PERSIST

In 2002 government committed to full cost recovery

1.1 In 2002 a government cross-cutting review of the role of the third sector in service delivery (the 2002 Review) set the strategic framework for the discussions in that year's spending review[4]. The 2002 Review's overall objective was to "explore how central and local government can work more effectively with the sector to deliver high quality services, so that where the sector wishes to engage in service delivery, it is able to do so effectively".

1.2 A major concern identified by the 2002 Review was the need to ensure that the price of contracts for services reflects the full cost of delivery – including any relevant part of the overhead costs. The 2002 Review concluded that there was no reason why this should not happen. It recognised that this may result in some indirect costs to some departments, but that all departments would meet these costs over time as contracts come up for renewal. The 2002 Review set some targets:

- In central government, all departments would by April 2006 incorporate the review's funding recommendations fully into their procurement policies by ensuring that the price for contracts reflects the full cost of the service, including the legitimate portion of overhead costs. The remainder of this Review is concerned with assessing progress against this target.
- For local government, the Office of the Deputy Prime Minister (ODPM), later to become the Department for Communities and Local Government (DCLG), working with other relevant bodies, would by October 2003 identify and incentivise best practice in full cost recovery and issue guidance on acceptable standards in procurement practice. DCLG's subsequent *National Procurement Strategy for Local Government* (October 2003) went some way towards meeting this by promoting and requiring Compact[5] compliance, but stopped short of guidance and standards. Subsequently, and announced in the Local Government White Paper, DCLG together with the Local Government Association, the Chartered Institute of Public Finance and Accounting and the Audit Commission have launched a review of third sector funding to identify best practice. This we understand will address issues associated with full cost recovery.

1.3 The 2002 Review also committed the Treasury to issuing clear and consistent guidance to public bodies on funding issues which it delivered in general in *Guidance to Funders* 2003 and more specifically on full cost recovery in its updated 2006 publication. The 2002 Review's acceptance of the principle of full cost recovery, and its recommendations and targets, were welcomed and supported by the sector.

1.4 Value for money is not about cheapness – the Treasury define it as 'the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user's requirement'. Failure to pay for the full costs, where this is appropriate, can threaten value for money in the short and longer term: short term risks to the quality and effectiveness of a service if it is underfunded and reliant on charitable subsidy; in the longer term, possible corrosion of charitable reserves, threatening continuity of service and even the supplier, and loss of competitiveness and choice if organisations collapse or withdraw from public service delivery. Unsustainable funding practices also threatened the 2002 Review's main policy agenda for increasing the third sector's role in the delivery of public services. While the extent of the full cost recovery shortfall has never been quantified, overall central government funding of third sector organisations was estimated at £2.03 billion at the time of the 2002 Review[6] (rising to £3.32 billion if funding to housing associations is included). The sums and services at risk, therefore, are significant.

Full cost recovery has remained high on the agenda

1.5 Since the 2002 Review, there have been a number of central initiatives within government, led by the Treasury and the Active Communities Directorate of the Home Office (now transferred to the Office of the Third Sector in the Cabinet Office), in which the principle of full cost recovery has been reiterated, expanded and enforced.

4 *The Role of the Voluntary and Community Sector in Service Delivery,* HM Treasury (2002).
5 The Compact is the agreement between government and the third sector setting out how they should work together. See www.thecompact.org.uk
6 These 2001-02 figures remain the most up to date data set for central government funding of the sector as published by the Home Office Active Communities Directorate (now the Office of the Third Sector).

Cross-governmental guidance notes relating to full cost recovery have been published by various sources since 2002 – a list of these is set out in Appendix 1.

1.6 In addition, various organisations have been monitoring progress. The Office of Government Commerce has monitored the issue on a six-monthly basis as part of its overall work with departments following the recommendations of Sir Peter Gershon's 2004 Efficiency Review. In February 2006 Cabinet Secretary Sir Gus O'Donnell also wrote to all departments inquiring about progress on full cost recovery amongst other third sector funding issues.

1.7 Our own work has brought further attention to the issue. The NAO first examined the issue of full cost recovery in a 2005 report which examined progress on the funding recommendations from the 2002 Review. We found that there had been little progress within departments, and that existing guidance focused on principles rather than practice, leaving practitioners unclear as to how to take full cost recovery forward. We recommended that the Office of the Third Sector along with HM Treasury should develop targeted practical guidance on how and when to apply the principle of full cost recovery.

1.8 The resulting Treasury guidance *Improving financial relationships with the third sector: guidance to funders and purchasers* was published in May 2006. This guidance went into much greater detail in its considerations of how full cost recovery should work in both procurement and grant funding regimes. At the same time, the NAO also produced a Decision Support Tool which sets out a step-wise approach to funding decisions, including guidance around the application of full cost recovery.

1.9 In parallel, sector leaders have developed and issued guidance to the sector on full cost recovery:

- The Association of Chief Executives of Voluntary Organisations (Acevo) responded to the recommendations of the 2002 Review (see paragraph 3) leading on the publication of *Full Cost Recovery – a guide and toolkit on cost allocation* (2004). This tool is aimed at helping third sector organisations to understand and allocate project costs and therefore to submit full cost recovery compliant bids.
- The National Council for Voluntary Organisations (NCVO) has also promoted this guidance, while keeping the issue on the policy agenda with publications such as *Shared Aspirations: the role of the voluntary and community sector in improving the funding relationship with government* (July 2005). The NCVO and Futurebuilders joint publication *Before signing on the dotted line…all you need to know about public sector contracts* (June 2006) further emphasised the issue.

The sector believes there are still problems

1.10 Despite the continued attention the issue has received, it is clear from ongoing campaigns that some organisations in the third sector have persistent doubts about the extent to which full cost recovery is being achieved in practice. This feedback has included:

- an Acevo survey of its members in early 2006 showing that 97 per cent of respondents believed the departments' April 2006 target would not be met;
- a survey of members by the Charity Finance Directors' Group (CFDG) in April 2006 showing over half of respondents reporting recovery of 85 per cent or less of the full costs of providing services for public funders;
- a Charity Commission survey from February 2007 which found that only 12 per cent of respondents delivering public services felt they achieved full cost recovery in all cases; and
- feedback from the Office of the Third Sector's State of the Sector Panel which shows 57 per cent of contracts containing a commitment to full cost recovery in 2004-05, up from 49 per cent in 2002-03.

The consistency and strength of message from these various surveys is diluted, however, because all asked simple questions without any qualification as to whether and how full cost recovery was applicable across different funding streams. Nonetheless, it is clear that there is considerable discontent over the issue and an ongoing feeling that the sector is still not being treated fairly.

1.11 Recent work of third sector representatives working closely with government departments also suggests continuing concern over the effectiveness with which this commitment has been translated into practice. The Department for Environment, Food and Rural Affairs (Defra) Compact Working Group, a body comprising both departmental and third sector representatives, has made this issue a priority. It has hosted a conference on the subject and commissioned a piece of external consultancy on the problems of implementation.[7] Similarly the Department of Health's Third Sector Task Force report of July 2006[8] made clear recommendations that the issue of full cost recovery still needed to be addressed in this sector also.

We therefore looked at latest practice in departments

1.12 With such a strong suggestion from the third sector that problems with full cost recovery and its associated value for money risks remained, we decided to return to the issue to explore in more depth how departments have interpreted the commitment to implementing full cost recovery and what they have achieved to date in their efforts to meet the April 2006 deadline. We worked with representatives from major central funding departments to establish their attitudes towards the issue and the extent to which they felt full cost recovery was appropriate to their funding relationships. We also built a picture of the practices, policies and initiatives departments have put in place as a result of their thinking on full cost recovery.

1.13 Based on this work we developed a framework of thinking on how full cost recovery can be applied across the range of funding environments, and we set this out in Part 2 of the review. In Part 3 we go on to discuss the extent to which attitudes and approaches to full cost recovery taken by departments appear legitimate or not compared to our framework.

1.14 We should explain here that our fieldwork was very much focused on how departments have approached these matters. We have not explored the sector's perspective on a detailed or case by case basis, reflecting our wish to give an overview of the extent of progress across all departments rather than sketch in fine detail. Nonetheless, our results, conclusions and recommendations were discussed with sector representatives including NCVO, Acevo, CFDG and other sector figures with an interest in these issues. We thank sector and Whitehall representatives for their time and contribution to our work.

7 *Improving financial relationships with the Third Sector: Defra Compact Group* report into the ability of Third Sector organisations to recover full and fair costs was published in November 2006 and endorsed by HMT and the Cabinet Office. See www.defra.gov.uk/rural/pdfs/compact/fcrreport.pdf
8 *No excuses. Embrace partnership now. Step towards change!* (July 2006) www.dh.gov.uk

THE PRINCIPLE OF "FULL COST RECOVERY" IS NOT EASY TO TRANSLATE INTO PRACTICE

There is a range of financial relationships which require different approaches

2.1 A problem for policy makers and practitioners alike is the great variety of different funding relationships between government bodies and third sector organisations. These range from large commercial-style competitive contracts through to small one-off grants, from essential "statutory public services" to discretionary "good causes" – and every possible variation in between. These taxonomies are not watertight – a difficulty compounded by the frequent use of the term "grant" to describe a wide range of circumstances including some which should more properly be described as procurement.

2.2 This confusion poses a particular difficulty in the application of full cost recovery – the 2002 Review's terminology and recommendations were directed at "service delivery", "contracts" and "procurement". In subsequent debates, however, it has not always been clear that participants recognise these boundaries established by the 2002 Review. In the rest of the Report, therefore, we address how departments are dealing with full cost recovery in procurement, but we also look at how it is being applied in other financial relationships with the Third Sector.

2.3 In our 2005 report *Working with the Third Sector*, we developed an existing idea of Julia Unwin's that there were three essential types of financial relationship between public sector bodies and third sector organisations. These relationships are:

- A "shopping" relationship – where a purchaser designs a specification for a service it requires or is statutorily obliged to provide, and seeks a supplier to provide that service;
- A "giving"[9] relationship – where the funder provides support towards a specific project or in support of the organisation's general objectives; and
- An "investing" relationship – where the funder provides support towards a specific internal organisational change, such as an enhancement in a third sector organisation's managerial capacity.

The Treasury's May 2006 guidance to funders and purchasers – *Improving Financial Relationships with the Third Sector: Guidance to Funders and Purchasers* – makes a similar distinction between "purchasing" (shopping) and "funding" (giving and investing).

2.4 Our 2005 report noted that the shopping relationship is likely to be best served by competitive procurement procedures, with the resulting service being governed by a contract. The more discretionary offer of support which typifies giving and investing arrangements, in contrast, were more likely to lend itself to conventional grant mechanisms. We suggested that greater clarity on the type of relationships would help reduce uncertainties about the basis on which they would be funded, including the approach towards full cost recovery.

2.5 In our report we identified that the different funding approaches led to different application of full cost recovery:

- in shopping, delivered through procurement and contracts, the main responsibility for ensuring the full costs of the specification are met falls on the provider (in this case, the third sector organisation) – **pricing** is the name of the game; but
- in giving and investing, typically delivered through grants, both the scope of the project and the costs of meeting it are a matter for dialogue between funder and recipient. In these situations, **costing** is the basis for funding decisions.

These ideas are set out in **Figure 2** overleaf, drawn from our 2005 report, and explored in more detail in the rest of this Part of our report.

9 Some pointed out that the term "giving" suggests donation for nothing in return – whereas in practice "giving" by public bodies is always done in expectation of some desired activity or outcome. We nevertheless stick with "giving" here, in faithfulness to the original schema set out first by Julia Unwin.

2 The relationship between the type of funding and the application of full cost recovery

Analysis of full costs

Informs price set by bidder | Informs price set by bidder

Intermediate forms of funding

Shopping (typically using contracts) ← Range of funding options → **Giving (typically using grants)**

Characteristics	Characteristics
Market contestable	Unique
Price-based	Cost-based
Defined output	Experimental
Certainty	Outcome uncertain
Enforceable	Unenforceable
Risk with service provider	Risk with funder
Provider keeps surplus	Surplus usually not included

Source: Department for Work and Pensions and NAO analysis of Department for Work and Pensions staff data

The onus in shopping is on the supplier or bidder to bid on full cost, but purchasers must consider due diligence

Purchasers will need to adapt how they fulfil their responsibilities towards full cost recovery

2.6 Whilst it is any bidder's responsibility to ensure that they know their full costs, including possible provision for surplus or profit, and bid on the basis of that knowledge, purchasing departments nonetheless need to consider both the realism of the price the supplier is offering to deliver at, and the supplier's financial capacity to bear any loss on delivering the funder's specification if things go wrong. Such procedures will help manage the risk of service failure in the event of a contractor collapsing, a risk that applies whether the bidder is from the private or third sector. These considerations also effectively provide a "due diligence" exercise through which a purchasing department's responsibilities towards full cost recovery are discharged.

2.7 Purchaser responsibilities towards full cost recovery through due diligence vary according to the nature of the market and the way in which the purchaser seeks to set prices:

- Straightforward service specifications in **mature and competitive markets** lend themselves to price based tendering, where bidders submit the price at which they believe they can deliver the specification with relatively limited transparency on underlying costs. This approach minimises the purchaser's obligation to assess cost in detail but competition should both drive suppliers' costs and margins to a deliverable minimum, while allowing purchasers to easily identify bids that vary significantly from the "market rate". In due diligence terms this allows purchasers to spot and reject bidders who may be taking risks which threaten successful delivery, as well as those whose costs may be too high to offer the best value for money for the services specified.
- In **less efficient or competitive markets** price based tendering is less appropriate. Without benefit of multiple providers establishing a market rate and competitive pressures keeping costs low, purchasers need a greater level of transparency on the cost and profit structures of the bid to provide assurance on value for money. This kind of cost-based bidding gives purchasers greater sight of the realism of cost estimates in the bid and as such more open assurance on any full cost recovery issues and delivery risks that may arise. It also gives the purchaser and bidder the opportunity to negotiate on profit margins and cost levels.

- The situation is complicated further because not all shopping relationships are established on a price-based tendering basis. Many contracts are based on **fixed unit fees or tariffs** which are set by the purchaser. The supplier then has to decide whether they are able to deliver a service at that price or not. In these instances due diligence responsibilities towards full cost recovery are discharged by the appropriate consultation and rigorous methodology required to set a reasonable tariff based on realistic estimates of cost and demand. In particular, full cost recovery will stand or fall according to how the risk of fluctuations in that demand is shared between purchaser and supplier.
- The previous options have been variants on a procurement model, but Treasury guidance recognises that departments may also use **grant arrangements to shop to obtain services**. In such circumstances, it suggests that "funders should assess in a simple, proportionate and equitable manner whether third sector organisations have allocated relevant overhead costs and ensure that costs are recovered only once".

Purchaser responsibilities to establish a fair price at the outset are accompanied by a continuing responsibility to assess whether agreed rates remain correct and fair – the contract should be clear as to what happens when costs turn out to be different from those assumed and agreed at the outset.

Third sector organisations may not seek full cost recovery, for legitimate reasons

2.8 In some instances, third sector organisations may make legitimate business decisions to recover less than full cost:

- A third sector provider may wish to **provide a quantity or quality of service in excess of the specification** the purchasing organisation requires. While it is legitimate for a third sector organisation to provide such additional services, full cost recovery will not relate to any such enhanced or additional provision. As such, the purchaser has no obligation to ensure that this additional service is funded.
- A third sector provider may wish to **improve its chances of securing a contract by bidding at a price that would incur a financial loss** and be subsidised from its charitable funds. Others may consider that the service or activity is one they wish to provide whether or not they receive taxpayer funding, and so welcome any taxpayer contribution. While the purchaser must ensure that such a position does not put the quality or sustainability of the service at threat, it is under no obligation to prevent the third sector organisation from running the service at a loss. The same considerations of risk apply to private sector "loss leaders".

2.9 Such stances mean that the principle of full cost recovery is not as straightforward as first appears, even in the world of contracting and procurement. If third sector organisations bid at less than full cost, this may reflect a genuine overlap of interest and objective between funder and provider – in effect a joint venture with shared objectives, funding and risk. This idea is at odds with the alternative thinking that a third sector organisation's activities using its own funds are quite distinct from the delivery of public services on behalf of the state, and that there should be no cross-subsidy between them. Full cost recovery is clearly more relevant to this strict portrayal than it is to the world of joint ventures, where negotiation over the share of costs and risk is central to business.

In giving or investing relationships, full cost recovery is not necessarily appropriate

2.10 Not all financial relationships with the sector are for the provision of services, achieved through shopping or purchasing. Some will be giving or investing – donor activity – to which funders may legitimately wish to **contribute** but not necessarily cover all the costs of some activity. Indeed, the Treasury target and guidance, expressed in terms of services, procurement and contracts, could be interpreted as not strictly applying here. Of course, these categorisations as shopping, giving or investing are not watertight – and can be emotive: what some may see as an essential service (which should be paid for in full) others may regard as a worthwhile activity (to which they wish to contribute). There may be genuine difficulty in defining or agreeing the nature of the funding relationship.

2.11 In the giving and investing circumstances which often characterise discretionary donor activity, it is hard to see that there can be an expectation of full cost recovery in every situation. Indeed, we note parallels with many other areas of public policy in which government contributes to but does not expect to meet all the costs of some enterprise such as a local regeneration scheme (where, for example, it may pay for transport infrastructure but not the cost of a new retail park). There are also parallels with joint ventures in which partners share the costs and the benefits. **Figure 3** below sets out the ways in which donors can choose to support the activities of a third sector organisation.

3 There is a range of ways public funders can support third sector organisations in donor relationships

Purpose	Mechanisms
Project-specific support	■ Support for a specific constituent aspect of a project such as accommodation or a particular supporting service or role. May be paid for or provided in kind by funder for duration of project. ■ A financial contribution to a project or a specific aspect of it capped at a particular value unrelated to the overall scope and cost of the project. ■ A financial contribution to project covering an agreed share of the full costs of project. ■ Financing the full costs of the project
Non project-specific support	■ Non-project related grant-in-aid relationships contributing to general organisational objectives often over a number of years. ■ Non-project related funding contributing towards the outcomes or objectives of a programme of activities. ■ Non-project related grant contributing to general organisational objectives on a one-off basis. ■ Support for a specific ongoing organisational cost such as accommodation or a particular supporting service. May be paid for or provided in kind by funder over a number of years.

Source: National Audit Office

2.12 Whilst there may be no expectation of full costs in all giving or investing situations it is useful to explore the risks involved for funders and the ways in which due diligence towards overall full cost recovery might apply:

- Most giving through grant programmes operates on a project basis, as do typical investing relationships. If the project concerned is not fully funded, including relevant overhead costs, its objectives and outcomes will be at risk, risking in turn the value of the public sector contribution. The more transparent scrutiny and cost negotiations typical of the grant application process therefore have a due diligence role in managing the risk to the funder of erroneous or unreasonable cost estimation on the part of the applicant. In cases where there is no single funder, public funders will also need to assess whether coverage of remaining costs from other sources is sufficient and secure. The grant recipient may be asked to demonstrate that they can meet all the project costs from a mix of own resources, grant funding and other sources (such as "match funding" from other donors).

- In other instances, public funders may make contributions towards the running costs of a third sector organisation because its objectives, programmes or activities are deemed to make a significant contribution towards the overall objectives of the funder. Often taking the form of grants-in-aid, "core funding" or "strategic funding", these sums do not relate to specific projects so there is no expectation to consider full cost recovery. Nevertheless the funder will wish to exercise due diligence to ensure that the nature and levels of funding sought are reasonable for the general activities of the organisation being supported, and that the organisation is financially viable, taking account of its income from all sources.

In conclusion, turning the principle into practice was never going to be simple

2.13 The previous sections in this Part have outlined a number of considerations which mean that the simple principle of full cost recovery was never going to be easy to translate into practice:

- The great variety in financial relationships between funders and third sector organisations – in size, purpose (shopping, giving, investing), form (procurement, grant or contract, and their variants) and the nature of the market (competitive, single supplier, third sector only or in competition with private and state providers);
- Room for discussion about the extent to which full cost recovery is relevant to all financial relationships with the sector – especially donor situations;
- Uncertainty about the scope of the 2002 Review, its recommendations and targetry – and whether "service delivery" refers to all third sector activity funded by government; and
- Different attitudes to full cost recovery amongst third sector organisations, in which negotiation over how costs of joint venture services are shared displaces full cost recovery as the dominant theme.

14 These complexities were compounded by the delay in providing practical information on how to make the principle work in different funding relationships. The Office of Government Commerce's 2004 publication *Think Smart Think Voluntary Sector* represented the first attempt to tackle how full cost recovery relates to shopping or purchasing but departments had to wait until Treasury guidance in 2006 for the first real articulation of the practical place of full cost recovery in giving and investing relationships.

TO DATE THERE HAS NOT BEEN WIDESPREAD CHANGE IN PRACTICE

Response to the target is mixed, though no department considers itself to have failed to meet it

Action on full cost recovery may look underwhelming, but not all departments feel it has been necessary

3.1 Part 2 explained how the application of full cost recovery depends on the nature of the particular financial relationship between government and the sector. It should not be surprising therefore if different departments have responded in different ways:

- some departments have not felt the need to make changes;
- some departments have recognised full cost recovery in their finance or procurement guidance;
- some departments have gone beyond guidance and sought to establish or build wider, practical understanding of the issue; and
- some departments have made real changes to the way they fund the sector.

Figure 4 shows how each of the 12 departments we examined, covering the majority of government's financial relations with the sector, match up. A more detailed summary of departmental action on full cost recovery is given in Appendix 2.

3.2 The picture Figure 4 shows is not one of dramatic change. Only the Department for Constitutional Affairs (DCA) could be said to have overseen a significant change in procurement practice with the Legal Services Commission's (LSC) new contracts for third sector providers of legal aid advice services. However, this change pre-dated the full cost recovery agenda and its associated target. On balance, though, we thought it fair to leave it in since it nonetheless represents real change, regardless of its origin.

3.3 More common were departments not feeling the need to take any action on full cost recovery. Generally there were two reasons behind this:

4 Departmental responses to full cost recovery have varied

Extent of action	Departments
No action felt necessary	■ Department for Communities and Local Government (Housing Corporation)? ■ Department for International Development ■ Department of Transport ■ Department for Work and Pensions (Jobcentre Plus)
Guidance	■ Department of Trade and Industry ■ Ministry of Defence (in progress) ■ Department for Education and Skills (in progress) ■ Department of Health
Guidance and wider promotion	■ Department for Environment, Food and Rural Affairs ■ Home Office: Drugs Directorate working with Drug Action Teams; National Offender Management Service commitments to full cost recovery in its service prospectus[1] ■ Department for Culture Media and Sport, in particular through Big Lottery Fund
Real change to funding methods	■ Department for Constitutional Affairs through the Legal Services Commission

Source: National Audit Office

NOTE

1 National Offender Management Service Improving Prison and Probation Services: public value partnerships (August 2006)

- Some giving departments have limited third sector funding activity beyond long standing grant-in-aid or other non-project specific relationships such as the Department for Transport's (DfT) funding of mobility centres and the Department for International Development's (DfID) Partnership Programme Agreements and other strategic relationships. The DCLG's oversight of social housing is also a long standing particular case based on competitive subsidy rather than project-based activity. With less emphasis on project-specific funding, these departments feel full cost recovery to be a less relevant funding concept.

- Some shopping departments, for example the Department for Work and Pensions' (DWP) agency Jobcentre Plus, feel that a sector-specific concept like full cost recovery sits uneasily in a procurement environment based on "sector-blind" competition between third sector and private providers.

3.4 The remaining departments have engaged with the target to the extent of acknowledging the legitimacy of full cost recovery in financial guidance, either through direct references or more commonly through links to the existing central government guidance. Internal departmental financial guidance does not extend to arm's length organisations such as agencies and non departmental public bodies, however, or to delivery partners such as local authorities and primary care trusts.

3.5 While some departments feel it is inappropriate to mandate the funding approaches of devolved arm's length organisations, the Department for Environment, Food and Rural Affairs (Defra) and the Department for Education and Skills (DfES) have involved these bodies on third sector policy working groups. DfES[10], the Department of Health (DH)[11] and the Home Office Drugs Directorate[12] have also addressed the concept in commissioning guidance aimed at local delivery partners. The Department of Trade and Industry have worked with their arm's length Regional Development Agencies to raise awareness of the guidance and expectations around full cost recovery are now incorporated in the London Development Agency's opportunities fund prospectus.

3.6 At the Department for Culture, Media and Sport, a department which is unusual in the extent to which it operates through a large number of arm's length organisations, a different approach has been taken. The Big Lottery Fund (BLF), one of these arm's length non-departmental public bodies, has taken the lead on developing thinking and guidance on full cost recovery. The full cost recovery target was already in existence when BLF was created, and drawing on the work of its predecessor bodies it was able to build the principle into its grant programmes and funding language from the start. It has rolled out training for staff and developed guidance tools and templates for applicants, particularly aimed at the smaller community sector where it perceives the need to be greatest. BLF is viewed by the department as the leader on full cost recovery in the lottery sector, and take-up of these principles by other existing lottery distributors is being encouraged.

3.7 Although departments have therefore varied in their engagement with and responses to the target, none of the departments we spoke to felt they had failed to meet the spirit of it. Nonetheless, no department had undertaken any kind of systematic review of funding which could demonstrate the systematic consideration or implementation of full cost recovery, or the identification of areas where practice might need to be revised. This has made practical demonstration of meeting the April 2006 target particularly difficult.

3.8 Those departments that have taken no action consider full cost recovery to be an irrelevant or in some cases potentially unhelpful concept to the way they work with third sector organisations. While the target has therefore had some success in keeping full cost recovery on the agenda in Whitehall, it appears to have been too blunt an instrument to engage all departments with the concept in an active and committed way. We examine the reasons why in the rest of this Part.

No department is planning significant further change

3.9 Our discussions with departments revealed no plans for future practical changes to funding methods in order to implement full cost recovery. In that sense, the landscape outlined in Figure 4 above is unlikely to change. Most departments that are actively exploring the full cost recovery issue characterise their ongoing effort as building understanding of what the concept means in practice for both sides in funding relationships. Defra has made progress towards this understanding through its Compact Working Group. **Figure 5 overleaf** summarises the outcomes of this work. The Department for Education and Skills has also signalled an intention to explore the issue through its Third Sector Strategic Board which aims to look at this issue as part of a wider review of Compact compliance.

10 DfES *Joint planning and commissioning framework for children, young people and maternity services* paragraph 6.8.
11 DH *Commissioning framework for Health and Wellbeing* paragraph 5.5.
12 Home Office and National Treatment Agency *Compact guidance on commissioning voluntary sector services* paragraph 8.

5 Defra is working with the sector to establish a better understanding of what full cost recovery means in practice

Defra Compact Working Group – a body comprising representatives of the department, its agencies and their third sector stakeholders – identified full cost recovery as a priority issue for relations between the Department and the third sector.

As an initial step the Working Group used its budget to host a conference on the subject. Having felt demand for greater understanding, the Group used its following year's budget to commission of a piece of consultancy on full cost recovery in Defra to build understanding on the issue and recommend a way forward.

Defra officials have welcomed the findings of the report which is seen as an important step in improving relations with the sector through developing shared awareness of practical realities of full cost recovery. Some of the key findings include:

- All participants value the concept of full cost recovery.
- Third sector organisations tend to split into two camps on full cost recovery – those organisations that are at ease with operating commercially and those that are more timid in their negotiation believing that their full costs won't be met anyway.
- Third sector organisations are able to articulate the principle of full cost recovery, but their thinking is not so developed on practical implications for them.
- Defra's motivation for funding third sector organisations (whether it is giving or shopping) is not always clear, leading to mixed messages and confusion.
- Changing the culture of a sector and its relations with government is a long term process.

Source: NAO summary of Defra Compact Working Group report by Transform Consultancy

3.10 The main lines of debate and doubt within departments dealing with the issue can best be viewed by looking at how full cost recovery has been applied in practice in the two different types of situation described in the previous Part: first, in procurement or purchasing scenarios; and second, in donor-type giving or investing situations.

Departments have mixed views on the appropriateness of full cost recovery in shopping or purchasing

Departments shopping in competitive markets accept the principle of full cost recovery but feel the practical responsibilities lie with the bidder

3.11 No department or agency we interviewed believed that it is beneficial to drive third sector suppliers into loss-making positions in order to secure the services they were commissioning at cheaper prices. In that sense, none is hostile to the concepts underlying full cost recovery. Nevertheless, departments involved in commercial procurement of services from third sector providers in competitive scenarios felt the term itself had limited meaning in practice and were unclear on where this left them in terms of active commitment to the April 2006 target.

3.12 DWP and its agency Jobcentre Plus were the strongest holders of this view. Jobcentre Plus buys labour market services worth over £1 billion per year from external providers, of which £200 million is estimated to be provided by third sector organisations[13]. The market is unusual at the central government level in both its size and its open, competitive nature. Third sector providers can bid for contracts but must do so in direct competition with private providers. All bidders are subject to the same, sector-blind procurement process.

3.13 Jobcentre Plus believes that the third sector organisations operating in this market have accepted the commercial foundation on which it operates and the assumption that bidders are responsible for managing their full costs within the tariff-based formula funding offered to all providers. By extension, it is also assumed that organisations sub-contracting with lead providers under these arrangements are also responsible for managing their costs within those contract negotiations. As a result, Jobcentre Plus does not consider this market to be one where third sector specific action on full cost recovery in the procurement process is required or indeed reasonable. The problem for Jobcentre Plus, however, is that they find this position difficult to align with the April 2006 target.

13 This estimate is from the most recent Office of the Third Sector central government funding data for 2003-04, but final figures are yet to be published. Since undertaking the fieldwork for this review the Jobcentre Plus central procurement team has been relocated into the Department for Work and Pensions. The views we heard from Jobcentre Plus are technically now the views of the Department.

3.14 Jobcentre Plus still thinks commercially about full cost recovery principles but it only does so in the context of what is best for **all** suppliers in the marketplace. **Figure 6** for example shows how it is addressing concerns about the threat demand risk and subcontracting pose to the ability of both private and third sector suppliers to recover their costs. This is a whole market approach, rather than a sector-specific one. Jobcentre Plus argues that special treatment of third sector providers beyond the usual due diligence reviews of all potential providers risks distorting the process by which the best suppliers would be selected on the best terms for the taxpayer. Commercial staff managing the centrally let contracts at the Department of Health expressed similar views.

6 Jobcentre Plus deals with full cost recovery issues only as they relate to all providers in the marketplace

Jobcentre Plus has piloted new funding mechanisms for its New Deal service lead providers which include third sector organisations.

These pilots are aimed at guaranteeing a greater proportion of the fixed costs of service providers under the existing fee-based contracting mechanisms, and therefore helping enable suppliers to meet the full costs of their service provision with less exposure to demand risk. The demand risk will never be removed completely as Jobcentre Plus feels it would be inappropriate to guarantee the full value of the contract. It is hoped, however, that a fairer balance may make the market more attractive to providers including smaller private and third sector organisations.

Jobcentre Plus has also introduced a new requirement for lead providers to produce signed evidence from all their sub-contractors, both third sector and private, that they are content with the funding arrangements for the supply of their services. Jobcentre Plus's expectation is that these deals should be viable and therefore negotiated on the basis of full costs.

While these initiatives should benefit third sector providers in full cost recovery terms they were not targeted at them specifically – they were responses to problems suppliers both private and third sector were having managing demand risk and sub-contracting sustainably under existing delivery arrangements.

Source: National Audit Office

Full cost recovery is easier to handle in newer or less competitive markets, but it may not stay that way

3.15 Few of the departments we met on this review operate open, competitive, established markets of the kind outlined above. The Ministry of Defence (MoD), for example, lets a significant proportion of its specialist overseas health and social care contracts through a non-competitive relationship with a long-standing third sector partner. In this kind of relationship prices can be negotiated without concerns for special treatment or distorting markets. Such relations are rare across central government though, and services under this particular relationship have been subject to increased competition recently. More commonly departments outsourcing services do so in markets where there is some competition but perhaps not the cross-sector breadth shown by Jobcentre Plus. In these instances the sector-specific nature of full cost recovery appears less of an issue.

3.16 One such department which is actively engaging with full cost recovery is the Home Office Drugs Directorate. It is overseeing a market in transition, having ended its giving relationships with the sector and moved funding instead to local Drug Action Teams (DATs) that commission services on a shopping-type basis. The drugs services market does not have a significant private sector presence, something which potentially frees purchasers from concerns about full cost recovery as a sector-specific concept. The Drugs Directorate has had no reservations in promoting the concept to DATs procuring services – to this end it has produced its own principles-based guidance and run regional roadshows to promote compact-compliant working and build a sustainable marketplace.

3.17 The transition from giving to shopping requires new approaches from both commissioners and suppliers as established cost-based negotiations give way to pricing. Providers now feel the market is reasonably mature but cultural issues around this change – in particular trust around pricing and overhead levels – have proven challenging and the Directorate hears frequent complaints from the sector that full costs are not being met. The Directorate believes there is sufficient funding in the pooled treatment budget to allow full cost recovery and that problems are generally due to a combination of commissioning capacity, a highly competitive sector and ongoing misunderstanding or mistrust around acceptable levels of overhead costs.

3.18 As **Figure 7** shows, DCA has also overseen the development of a new market in the Legal Services Commission's (LSC) funding of legal aid advice services. These advice services had previously been delivered through private law firms but LSC wanted to broaden its supplier base and to bring third sector advice providers (typically Law Centres) into the market. To bring them in and keep them in on a sustainable basis, LSC developed a sector-specific funding model which helped ensure the third sector providers met their full costs and remained protected from demand risk and price competition as they developed their new service delivery capacity. It has been running this segmented market for third sector and private providers since 2000.

3.19 While full cost recovery can therefore be promoted and also used to practical effect in new, third sector specific markets like these its place as an active concept may well diminish in future. The LSC, for example, is intending to remove the segmented funding structures and progress towards an open market based on competitive tendering for caseload. The market may therefore start to resemble that of Jobcentre Plus, with private and third sector providers treated the same way and bearing the same responsibilities for bidding on a full cost basis.

3.20 DfES also stresses its desire for a mixed economy of provision in children's services where suppliers delivering the best outcomes win contracts irrespective of the sector they are from. Much of the National Health Service system reform led by the Department of Health also points in this direction. The new commissioning framework for health and wellbeing prioritises outcomes and promotes a mixed market but is also essentially 'sector blind' on the procurement processes to secure the best outcomes. As the general policy direction continues to push towards greater contestability and choice in public sector markets, the sector-specific idea of full cost recovery in procurement could be expected to become less meaningful.

7 The Legal Services Commission used a sector-specific approach to build third sector presence in the legal aid advice market

The Legal Services Commission (LSC) wanted to develop the role of the third sector in the provision of legal aid advice services to the public. Aware of the unique challenges third sector providers faced, in particular the disadvantage they face in switching resources to other fee earning work if demand drops, LSC developed a sector-specific funding formula to help manage this risk and attract and retain third sector providers in the market. This was put in place in 2000.

Working in consultation with third sector advice service representatives, LSC developed a funding formula for legal aid advice which buys a planned number of hours of advice time each year along with the administrative support required to deliver that service. This contract gives a degree of certainty over funding and therefore capacity for the year. Targets are set for direct caseload time to incentivise efficient client throughput and use of the contracted hours, and contract payments will be reduced if underperformance against target cannot be satisfactorily explained.

The number of third sector providers has grown by 25 per cent since the introduction of the contract while payments under these contracts have increased from £20 million to over £75 million on civil legal aid advice.

LSC has consulted with the sector on setting a flat case-based tariff to cover providers' costs and reward those providers that work most efficiently. This tariff will apply equally to private providers, thus ending LSC's sector-specific approach and unifying the civil legal aid market. This tariff is also seen as stepping stone to full open market tendering with third sector providers and private firms bidding competitively for work when the market is more mature.

Concerns have nevertheless been raised by advice service suppliers who feel both the current formula and the proposed fixed tariff fail to cover full costs. These concerns highlight the importance of consultation and the risks to the market if tariffs are inappropriately set.

Source: National Audit Office

Practical problems remain with full cost recovery in procurement relationships

Cost scrutiny

3.21 In Part 2 we set out the distinction between cost-based and price-based procurement, and the relative levels of cost visibility presumed to follow from that. In practice, we found cost transparency to be commonplace in both types of procurement and the distinctions not so clearly drawn. Departments felt this visibility was helpful in providing assurance over sustainability of the service as well as overall value for money. Some also felt it provided a better understanding of how the service being offered would work. No procurement staff talked about scrutiny on a line by line basis to identify potentially irrelevant costs. The overall picture appears to be more important.

3.22 Where procurement relations with any provider are uncontested, high levels of cost visibility are legitimately required to give the purchaser the ability to negotiate on costs and profit margins and secure value for money outside of competition. The MoD's non-contested specialist contracts with third sector organisations, for example, are negotiated on the same basis of detailed cost visibility which it would apply to similar non-competitive private procurements. The MoD's relationships are long established, having grown out of historic grant funding arrangements. The Ministry reports no problems from the sector on either scrutiny or full cost recovery issues.

3.23 In contested contracts, having cost visibility for assurance on value for money is a less legitimate argument. Suppliers offering poor value, or those "trying it on" with excess overhead cost levels should be flushed out by more efficient market competitors. The Department of Health runs a number of central procurements which are competitive and therefore establish value for money through the market. The Department still requires a level of cost visibility however, in order to provide clarification and assurance that bidders have analysed and thought through the costs behind the bid and that they are not simply arbitrary estimates.

3.24 The Department of Health's procurement guidance recommends the use of pricing schedules for this kind of scrutiny and clarification. The Office of Government Commerce's (OGC) guidance *Think Smart Think Voluntary Sector* also endorses the use of detailed pricing schedules in competitive tendering. There remains a risk, however, that to the sector's eyes these demands on transparency and scrutiny conflict with the government commitment in the 2005 *Compact Funding and Procurement Code* not to seek information on management fees and overheads in public procurement.

3.25 Departments were keen to stress the intended parity between the way they scrutinised private and third sector bids, though it was also clear that in practice this parity may be difficult to achieve, particularly in the less established markets. Trust may still be low in some markets with a number of departments voicing concerns of third sector organisations "trying it on" with their overhead costs. Departments felt capacity was still an issue too, with some third sector organisations still approaching bidding with the line-by-line costing approach familiar from grant funding while others were unwilling or unable to explain underlying costings when requested.

Negotiation

3.26 Negotiation of cost and price is a fact of life in non-competitive procurement, as it is required to secure an acceptable price for the purchaser and acceptable profit margins for the supplier. The NAO would expect to see this kind of negotiation taking place with both private and third sector single tender applicants. Government's commitment to full cost recovery in no way diminishes departments' responsibilities on negotiation around value for money and bidders should expect to be pushed hard. As long as the purchaser considers the sustainability risks involved in pushing a price towards break-even point, purchaser responsibilities in respect of full cost recovery should be met. In addition, any provider has the right to walk away from negotiations where full costs or required returns will not be attained.

3.27 The ability of a purchaser to negotiate on price is more restricted in competitive procurement where the best price should theoretically be set by the market. The idea of bargaining down a price with a preferred bidder is ruled out where EU procurement directives apply.[14] A process known as Post Tender Negotiation allows for the purchaser to explore mutually acceptable improvements to submitted bids through negotiation around the specification and terms of payment amongst other things, but not specifically on price. Departments should undertake post tender negotiations with care and the OGC guidance[15] provides more detail on managing the process. The restrictions the regulations create on negotiating price limit the purchaser's ability to drive suppliers towards loss making positions, therefore considerations of full cost recovery risks are less meaningful here. Outside the scope of the regulations there is greater flexibility on negotiation therefore greater responsibility to consider the accompanying risks.

14 Regulations apply on central government procurements for services over £93,738 and local government procurements over £144,371.
15 http://www.ogc.gov.uk/briefings_post_tender_negotiation.asp

Full cost recovery is not considered applicable in all giving or investing relationships either

A number of grant-aiding departments see full cost recovery as marginal

3.28 There are a number of departments whose relations with the sector focus principally on general organisational support through giving arrangements based on grants-in-aid or similar strategic or programme funding mechanisms. These relationships are typically long-standing and often with a large or unique third sector organisation whose general objectives and work are felt to align with or support the objectives of the funder. While grant-in-aid is still reasonably common among central government funding organisations, no departments reported use of the other non-project mechanisms set out in Figure 3.

3.29 The DTI (with the National Association of Citizens Advice Bureaux) and the MoD (with the Royal British Legion and Combat Stress amongst others) operate largely non project specific grant in aid relationships, while the DfT supports mobility centres in England using similar non-project grants. **Figure 8** shows how DfID uses strategic Partnership Programme Agreements for its major third sector funding – another such structure where full cost recovery is deemed not to apply.

3.30 As these strategic or programme grants are generally in support of "baskets of outcomes" rather than a specific project or service, the cost identification and allocation process necessary for preparing bids in shopping relationships or applications for project grants does not apply. There is no recognisable full cost recovery process as a result, with considerations instead being about whether the organisation has sufficient resources from all sources to deliver its intended outcomes and is therefore a going concern. The full cost recovery agenda has had little impact on relations of this nature, which has left the departments who wholly or principally fund through this mechanism understandably disengaged from the Treasury target.

8 Significant elements of DfID's funding to the sector is considered outside the scope of full cost recovery

The Department for International Development (DfID) channels around £82 million each year to third sector organisations through donor-type relationships known as Partnership Programme Agreements. Typically running for three to six years, these funding agreements support programmes delivering broad "baskets of outcomes" rather that specific activities or projects. There is therefore no requirement for the department to request or assess details of overheads relating to particular projects. In this sense the relationship is more akin to grant-in-aid funding and is outside the scope of full cost recovery.

Additionally much of the £95 million conflict and humanitarian assistance funding is also strategic rather than project or activity-specific. Non-project funding given under these schemes is similar to that of PPAs and is outside the scope of full cost recovery. Where funding is project-specific, (e.g. the £14 million Civil society Challenge Fund), overhead costs can be included though DfID tends to apply percentage limits on these.

All these arrangements predate the full cost recovery agenda though DfID reports no related complaints on any of its funding streams, putting this down to the long standing nature of the relationship between the department and the sector and the relative lack of dependency of development TSOs on these funding streams. It has therefore not felt the need to update its practice in light of the full cost recovery agenda or make any changes to fulfil full cost recovery obligations.

Source: National Audit Office

Full cost recovery is more readily recognised and easily implemented in project-specific funding

3.31 Departments operating project-based giving relationships schemes seemed much more engaged with the full cost recovery agenda. Typically these relationships are through open grant programmes to which third sector organisations submit bids. The concept of full cost recovery makes more sense here as funders will have a due diligence interest in the specific project being fully and sustainably funded. In these schemes applicants typically submit transparent budgets for specific projects and services which departments can assess for full cost completeness before deciding whether to contribute towards the project and how much.

3.32 Departments have found the legitimacy of full cost recovery relatively easy to accept here. DfES admits it has moved from a rather sceptical attitude on funding core costs in grants to a position of expecting compliance with full cost recovery – for example this expectation is now clearly stated on application guidance for its Children's Young Persons and Families grant scheme for which it offers up to 100 per cent of full costs. The Department of Health's Section 64 grants offer the same terms, while the National Offender Management Service grant scheme and the Defra Environmental Action Fund offer funding to a maximum of 50 per cent of full costs.

3.33 There is less practical concern around scrutiny also, with budget transparency accepted as uncontroversial particularly in grant programmes where applications cannot be compared like with like. Overhead levels are scrutinised too but departments stress that they are looking for evidence of robustly calculated overhead costs rather than use of potentially risky arbitrary percentages. Scrutiny also allows funders to make sure the attributable costs submitted are not costs that are being funded by other public sector funders, thus helping to manage the risk "double funding" might pose to value for money.

3.34 Few departments have therefore felt the need to go beyond straightforward amendments to application guidance to communicate their expectation that applicants should prepare their bids on a full cost recovery basis, and no significant practical changes to the way funding decisions are made were reported.

Donor departments have concerns about reconciling full cost recovery with capped funding levels

3.35 The major practical challenge facing the implementation of full cost recovery in grant programmes in particular is that of making the idea work in the context of capped and over-subscribed grant programmes. This caused problems for the principal grant programme at the DfES, as **Figure 9** shows. For departments operating open grant programmes of this nature this means having to balance the requirement of funding sustainable projects on a full cost recovery basis with the desire to maximise the potential impact of the fund by supporting as many projects as possible. A degree of negotiation is therefore likely to apply.

9 DfES faced challenges managing full cost recovery on grant programmes in the face of high demand

In 2005-06 the DfES Children's Young Persons and Families grant scheme was oversubscribed by a factor of 10 applicants for every successful grant recipient. The desire to spread the impact of funding across this crowded field placed significant pressure on the Department's ability to meet its full cost recovery commitments.

DfES accepts that its attempts to negotiate applicants' requests downwards without scaling back on the volume of work in the bids put full cost recovery at risk. With funding due to shrink from £17 million to £3 million in 2006-07 these pressures are likely to intensify, though the Department is keen to avoid the "topslicing" of applicants' budgets in future. Instead it envisages more appropriate negotiations on the scope of projects and a higher hurdle at the first stage of application to limit the application burden of unsuccessful applicants.

Source: National Audit Office

3.36 Departments in such a position generally have three options for addressing full cost recovery:

- Fund all successful bids on a 100 per cent full cost recovery basis, but reducing the overall number of recipients;
- Negotiate to trim the scope of applicant projects, thus reducing their costs but maintaining or increasing the number of projects that can be funded on a 100 per cent full cost recovery basis; and
- Negotiate to fund a reduced proportion of the full cost of the project, inviting or requiring the third sector organisation to obtain other match funding to fill the gap.

3.37 No department reported any increase to the levels of funding in existing grant programmes in order to deliver full cost recovery, so these scenarios are likely to come into play in relationships of this nature. Given the discretionary nature of open grant programmes of this sort, all of these approaches are legitimate and do not necessarily undermine any commitment to full cost recovery.

APPENDIX ONE

GUIDANCE TO DEPARTMENTS ON FULL COST RECOVERY

Source	Title	Contribution
HM Treasury	Guidance to Funders (September 2003)	■ Acknowledged full cost recovery as a key concern requiring further action. ■ No specific guidance on FCR – seen as "wider funding context" and part of ACU's remit. ■ Repeated the stance and recommendations of the cross-cutting review with no further detail.
Sir Peter Gershon	Releasing resources to the front line (July 2004)	■ Reinforced the importance of making progress towards the acceptance of the principle of full cost recovery, to ensure that publicly funded services are not subsidised by charitable donations. ■ No specific guidance.
Office of Government Commerce	Think Smart Think Voluntary Sector (June 2004)	■ Sought to place the principle of full cost recovery within the processes of procurement. ■ Identified unwillingness to accept full cost recovery as a barrier to third sector service delivery. ■ Stressed the importance of allowing TSOs to submit prices in accordance with their own commercial judgement. ■ Acknowledged legitimacy of TSOs including surpluses in bids. Also acknowledged the right of TSOs to submit bids that would not recover full costs ("loss leaders"). ■ Recognised the legitimacy of funders to clarify prices and how they were calculated. Recommends the use of detailed pricing schedules to assist clarification.
Compact Working Group	Funding and Procurement: Compact code of good practice (2005)	■ Outlines government undertaking to recognise the legitimacy of TSOs including relevant overheads in their bids for services. ■ Also makes undertaking not to seek information about management fees and overheads in public procurement. ■ No specific practical guidance.
National Audit Office	Working with the Third Sector (June 2005)	■ Reported slow progress on full cost recovery implementation. ■ Highlighted the importance of funding objectives – giving, shopping and investing – for practical aspects of full cost recovery implementation. ■ Highlighted basic practical distinction between pricing-based procurement processes and costing-based grant making processes.
National Audit Office	Decision Support Tool (May 2006)	■ Reinforced practical distinctions of full cost recovery responsibilities and process between procurement and grant funding. ■ Highlighted practical distinctions between project-or service-based grant funding and unrestricted grant in aid.
HM Treasury	Improving financial relationships with the third sector: guidance to funders and purchasers (May 2006)	■ Developed the idea that full cost recovery is a consideration for both competitive procurement and grant funding regimes. ■ Developed the idea that grant-based regimes require proportionate cost transparency. ■ Developed the idea that procurement regimes require funders to ensure that bidders have a sustainable and realistic understanding of their cost structures.
HM Treasury	DAO Letter (July 2006)	■ Promoted Improving *Financial Relationships with the Third Sector and the Decision Support Tool* as sources of guidance and good practice on aspects of third sector funding including full cost recovery.

FULL COST RECOVERY IN MAJOR DEPARTMENTAL FUNDING STREAMS

Funding Area	Nature of the relationship	How full cost recovery was applied in 2005-06	Changes to the application of full cost recovery since 2002
Department for Education & Skills			
Children Young People & Families Grants (£17m)	Giving – Specific discretionary projects funded through competitive grant programme.	Applicants invited to submit bids on full cost basis. DfES may choose to fund up to 100 per cent of full costs. Budget costs including overheads scrutinised for reasonableness during appraisal.	Promotion of expectation of full cost recovery in application guidance.
Department of Health			
Section 64 Grants (£17.2m)	Giving – Specific discretionary projects funded through a competitive grant programme.	Applicants are invited/expected to submit bids on full cost basis. DH may choose to fund up to 100 per cent of full costs. Cost transparency (including overheads) required and scrutinised for reasonableness during appraisal.	Promotion of expectation of full cost recovery bids in application guidance.
Independent Complaints Advocacy Service Contract (£11.7m)	Shopping for a statutory service. Competition between third sector organisations for contracts. Tendering on price, quality of service and value for money.	Applicants have considered full cost recovery in making bid. DH requires cost transparency behind pricing including overheads and scrutinises cost assumptions for reasonableness and sustainability.	New five year contracts awarded with effect from 1 April 2006 on a full cost recovery basis. Total fixed price for the full five years, with scope for variation beyond +/- 5 per cent volume of activity.
Department forWork and Pensions			
Jobcentre Plus Labour Market Services (currently estimated at £200m)	Shopping for statutory services on range of schemes through open competition between TSOs and private providers. Payment is tariff based.	Applicants expected to be able to cover full costs within tariffs offered.	Pilot work with TSO and private contractors on better sharing of demand risk under tariff pricing through guaranteeing greater proportion of fixed costs.
Department for Communities & Local Government			
Special Grants Programme (£2.2m)	Giving – Specific discretionary projects and strategic funding through competitive grant programme.	Applicants invited to submit bids on full cost basis. DCLG funds up to 50 per cent of full costs.	None
Home Office			
National Offender Management Services Grants	Giving – Specific projects funded through competitive grant programme.	Applicants invited to submit bids on full cost basis. NOMS may choose to fund up to 50 per cent of full costs. Costs scrutinised for reasonableness during appraisal.	New scheme. Applicant guidance sets out expectations that applicants will consider full costs when bidding.
Drug Pooled Treatment Budget (Combined DH/ Home Office funds – £385m)	Predominantly shopping for largely discretionary services. Local Drug Action Teams (DATs) commission services from the third sector on the basis of local needs assessments. DATs are also responsible for ensuring appropriate standards.	To ensure fairness and equity, providers may have to take part in local competitive tendering procedures.	Promotion of concept of full cost recovery to DAT and commissioning partners.

Funding Area	Nature of the relationship	How full cost recovery was applied in 2005-06	Changes to the application of full cost recovery since 2002
Department for Environment Food and Rural Affairs			
Environmental Action Fund (£4m)	Discretionary giving through competitive grant programme.	Applicants invited to submit bids on full cost basis including reasonable attributable overheads. DEFRA may choose to fund up to 50 per cent of full costs. Costs scrutinised for reasonableness during appraisal.	None
Department of Constitutional Affairs			
Legal Services Commission – Civil Legal Aid Advice Providers (£75m)	Shopping for a statutory service. TSOs bid to provide service per a funding formula which pays an hourly rate to cover direct and indirect costs for target advice hours for year. Performance targets and contract reconciliation used to manage throughput.	Sector bodies were consulted on the setting of the funding formula and subsequent reviews. Applicants expected to be able to cover their full costs within formula.	Current scheme pre-dated cross-cutting review. From October 2007 TSOs will be paid fixed fees rather than hourly rates.
Department of Culture Media and Sport			
Big Lottery Fund	Giving – Specific discretionary projects funded through competitive grant programme.	Applicants invited to submit bids on full cost basis. BLF will fund a share of overheads in proportion to the share of direct project costs it is asked to fund. Cost transparency scrutinised for reasonableness. during appraisal.	Big Lottery Fund was launched in 2006 with training for grant staff covering full cost recovery.
Department for International Development			
Partnership Programme Agreements (£82m)	Giving – Competitive fund providing support for development programmes (not projects) based on business plans and outcomes.	No specific project based FCR considerations.	No as FCR not applied in PPA.
Civil Society Challenge Fund (£14m)	Giving – Specific projects funded through competitive grant programme.	Applicants invited to submit bids on full cost basis. DfID may choose to fund up to 100 per cent of full project costs. Cost transparency required. UK project overheads limited to 8 per cent project value.	None
Ministry of Defence			
Forces overseas health and social care (£17m)	Principally shopping – specialist health and social care services from long established TSO provider. Some elements contested but mostly single provider.	Would expect to pay full costs and market rate for specified healthcare services in shopping relationships. Cost transparency required in non-competitive contracts as is case with private providers.	None
Grant in aid relationships	Discretionary giving in long established, non-competitive grant-in-aid support towards running of organisation.	Grants are not project specific so FCR does not apply. Awards are reviewed regularly, and cost transparency is achieved through a number of ways ranging from formal attendance at the organisations quarterly planning meetings to receipt of annual accounts.	None

Funding Area	Nature of the relationship	How full cost recovery was applied in 2005-06	Changes to the application of full cost recovery since 2002
Department of Transport			
Community Transport Information Service £185,000	Long established relationship with single third sector provider. Uncontested grant supporting specific services.	Cost transparency in non-competitive funding negotiations with provider should allow FCR.	None
Mobility Centres in England and the Mobility Centres Forum £2.2m	Long established non-project giving relationship with mobility centres In support of a range of outcomes.	Grants are not project specific – support range of activities and outcomes so FCR does not apply.	None
Department of Trade and Industry			
Citizens Advice (£23.8m in 2005-06)	Long established ongoing relationship with single TSO national umbrella body. Majority of funding is on basis of discretionary giving – grant-in-aid contribution to organisation.	Majority of funding allocated in grant form and not project specific. However, a proportion of funding is allocated to help fund a number of specific activities and FCR principles are applied by DTI where appropriate. Cost transparency scrutinised for reasonableness during appraisal.	None