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## FINANCE COMMITTEE

**Hundred and Fortieth Session**

**Rome, 10 - 14 October 2011**

**Measures to improve Implementation of the Organization's Support Cost Policy**

Queries on the substantive content of this document may be addressed to :

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### EXECUTIVE SUMMARY

- The Conference in July 2011 was concerned about the persistent under-recovery of administrative and operational support costs for extrabudgetary activities, which amounted to USD 37.2 million in 2008-09, and reaffirmed the policy of full cost recovery.
- As requested by the 138th Session of the Finance Committee and urged by the Conference, the Secretariat has identified measures to reduce the cost recovery gap of variable indirect costs within the current scope and ceiling rates of the FAO Support Cost Policy, including for categories of costs that have been previously excluded from recovery by FAO but are recovered by other UN Organizations. These measures could yield incremental recoveries of about USD 9 million in 2012-13.
- Measures to improve the recovery of the variable indirect costs are proposed in relation to projects where the PSC rate approved within the policy is lower than the ceiling rate, focusing on recovery of costs incurred in the recruitment and management of project personnel.
- Measures to improve cost recovery are proposed for categories of variable indirect costs that have been largely excluded from the FAO Support Cost Policy, particularly costs related to information technology, office occupancy and headquarters security.
- The improved cost recovery measures would be implemented through use of a transparent and simple uplift of standard project staff costs and project consultant costs without changing the current PSC ceiling rates and categories.

### GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- The Committee is requested to review and approve the measures identified to reduce the cost recovery gap of variable indirect costs within the current scope and ceiling rates of the FAO Support Cost Policy, and to improve the cost recovery of categories of costs that have been previously excluded from recovery by FAO, but are normally recovered by other UN Organizations, in particular in the area of information technology and headquarters security.

#### Draft Advice

- **The Committee reviewed the measures being taken to reduce the cost recovery gap of variable indirect costs within the current scope and ceiling rates of the FAO Support Cost Policy, and those proposed to improve the cost recovery of categories of costs that have previously been excluded from the policy. It welcomed the proposals to improve administrative and operational support cost recovery from extra-budgetary activities, as urged by the Conference.**
- **In considering the proposals, the Committee:**
  - **noted that the measures would not change the current PSC ceiling rates by project category;**
  - **approved the use of an uplift of project staff costs and project consultant costs to recover the indirect variable costs of services provided in connection with recruiting and managing project personnel where PSC rates are applied below the ceiling rates; and**
  - **approved the use of an uplift of standard project staff costs and project consultant costs to improve cost recovery for categories of variable indirect costs that have been largely excluded from the FAO Support Cost Policy, but are normally recovered by other UN Organizations, specifically: information technology-related costs, office occupancy related charges and headquarters security.**

## Background

1. The voluntary contributions managed by the Organization in Trust Funds have increased significantly in recent years. During the 2008-09 biennium, Trust Fund expenditures amounted to more than USD 1 billion, and for the first time exceeded Regular Programme expenditures. There are a number of emerging issues and risks in the context of increasing Trust Fund activity, in particular concerning cost recovery of administrative and operational support services provided in the delivery of the activities funded by voluntary contributions.

2. Financial Regulation 6.7 of the Basic Texts of the Organization sets out the boundaries for the acceptance of any voluntary contribution, in particular stating that there should be no additional financial obligations for Member Nations.

*“The acceptance of any such [voluntary] contributions and moneys which directly or indirectly involves additional financial obligations for Member Nations and Associate Members shall require the consent of the Conference.”*

3. The FAO policy for setting project servicing cost (PSC) rates, including for voluntary contributions held in Trust Funds, was endorsed by the Council in November 2000.<sup>1</sup> The policy is based on the principle that there should be a reasonable alignment of charges to the actual costs of providing administrative and operational support (AOS) to projects, taking due regard of existing arrangements, and the need for a simple and transparent approach.

4. The Organization reports regularly on the level of support costs and recoveries, and keeps implementation of the support cost policy under close review.<sup>2</sup> At its 138th Session in March 2011, the Committee welcomed and encouraged measures being taken by the Secretariat to reduce the cost recovery gap of variable indirect costs within the scope of the FAO Support Cost Policy. The Committee also looked forward to reviewing in further detail at its session in October 2011 proposals for cost recovery measures of categories previously excluded from recovery by FAO, but that are normally recovered by other UN Organizations, under the in-principle enlarged scope of the support cost policy endorsed by the Finance Committee in July 2009.<sup>3</sup>

5. The Conference at its 37th Session in June-July 2011<sup>4</sup> reaffirmed the policy of full cost recovery and was concerned about the persistent under-recovery of administrative and operational support costs for extra-budgetary activities, as regularly reported in the biennial Programme Implementation Reports.<sup>5</sup> The gap for the 2008-09 biennium was some USD 37.2 million. The Conference urged the Director-General to:

- a) vigorously pursue improving administrative and operational support cost recovery from extra-budgetary activities, including in areas such as country-level costs, security, and information systems and technology, as previously proposed to the Finance Committee in July 2009;<sup>6</sup>
- b) develop new mechanisms, as appropriate, building on the experience of other UN agencies, notably an uplift on project employee costs to recover those costs most closely associated with the level of staffing of programme and projects; and
- c) present the means for improved cost recovery for consideration by the Finance Committee at its session in October 2011 and endorsement by the Council before the end of 2011.

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<sup>1</sup> CL 119/13 Annex II and subsequent refinements in CL 112/4 paragraphs 21-23; CL 128/4 paragraphs 20-25; CL131/7 paragraphs 49-52.

<sup>2</sup> FC 140/7

<sup>3</sup> FC 138/7 and CL 141/9 paragraphs 28-29

<sup>4</sup> C 2011/REP, paragraph 100

<sup>5</sup> C 2011/8 PIR 2008-09, paragraphs 310-314 and table 18

<sup>6</sup> FC 128/13

6. Therefore, the Secretariat has further reviewed implementation of the support cost policy and has identified new mechanisms to improve project support cost recoveries within the existing PSC ceiling rates, relating to:

- a) variable indirect costs that are not recovered in projects where the PSC rate approved within the policy is lower than the ceiling rate; and
- b) variable indirect costs within the scope of the policy but not currently recovered.

7. These measures could yield incremental recoveries of about USD 9 million in 2012-13, taking into account the trend of project approvals and mix of project types.

### **Recovery of costs for projects with PSC rates below the ceiling**

8. The scope of the FAO support cost policy is to recover all variable indirect costs associated with projects funded by voluntary contributions. These are defined as incremental administrative and operational services that are necessary for project execution, but where the cost of such services cannot be readily traced for charging directly to each individual project. The FAO support cost policy and the definition of variable indirect support costs are provided in Annexes I and II.

9. Variable indirect costs are recovered through the levy of a percentage rate applied to project expenditures, the Project Support Cost (PSC) rate, with an established ceiling of 13 percent for technical cooperation projects, 12 percent for Associate Expert projects, and 10 percent for emergency assistance projects. The policy allows for a lower PSC rate to be charged provided that costs of a PSC nature are identified, budgeted for and charged directly to the project to offset the lower PSC rate.

10. The annual cost measurement studies indicate that if all extra-budgetary financed projects were to be assessed at the ceiling PSC rates, the resulting PSC charges could cover FAO's variable indirect costs as currently defined. However, an increasing number of projects are assessed lower PSC rates within the FAO policy to accommodate the requirements of the financing partners. Tracing and directly charging the balance of administrative and operational services, as foreseen by the policy, is administratively cumbersome. It would require high transaction costs with sophisticated cost accounting techniques to identify, trace and charge each such service to individual projects, which is not presently done. This has contributed to the gap between costs incurred by FAO for project support costs and the amount recovered from PSC charges.

11. There has been ongoing consideration of harmonized and streamlined methods to directly recover PSC-type costs for projects that are assessed PSC rates below their ceiling rates. Initially, based upon discussions with the High Level Committee on Management (HLCM) Finance and Budget Network (FBN) Working Group on Support Costs, it had been suggested that the PSC rate for these projects be assumed to cover headquarters-based costs and that a direct cost mechanism be used to recover variable indirect costs incurred in country offices.<sup>7</sup> However, due to significant differences in the way in which field projects are delivered by the specialized agencies and UN funds and programmes, comparable PSC rates would have been difficult to construct. In addition, the utilization of such an approach would have been complex and labour intensive to administer.

12. Building on the methodology applied by the World Health Organization since 2010, it is proposed to use a standard direct cost mechanism in the form of a project personnel charge for projects with PSC rates below the ceiling rate. This project personnel charge, in the form of an uplift of standard project staff costs and consultant costs, would recover the indirect variable costs of services provided in connection with the project personnel that are not captured due to application of PSC rates below the ceiling. The cost covered would include recruitment services, contracting, entitlement calculation, travel arrangements, payment, briefing and debriefing and related support.

13. Such a charge would be transparent, relatively easy to administer and would not involve substantial additional costs to implement. The project personnel charge for projects with PSC rates that are below the ceiling rates would be developed in such a way that there is no duplication of costs recoverable through the PSC rates charged. Therefore, the project personnel charge would be

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<sup>7</sup> FC 138/7, paragraphs 9-10

calculated as a percentage of project personnel costs including staff compensation and entitlements, consultant fees and staff/consultant travel and charged to all active projects with a PSC rate of seven percent or less. FAO's annual work measurement survey and the independent annual computation the costs of project support services to extra-budgetary financed activities would ensure that there is no duplication of charges.

14. The proposed charging methodology is summarized in *Annex III*.

### **Recovery of costs not included in the established PSC ceiling rates**

15. The PSC ceiling rate for technical cooperation projects was calculated as part of UN system wide support costs studies conducted in the early 1980s and updated in 1991-1993 using a methodology that had been agreed by a multi-agency working group under the sponsorship of UNDP. FAO has continued to utilize the same methodology in its annual cost measurement study to ensure year on year comparability to monitor improvements in the efficiency of delivering administrative and operational services and to compare results to other UN agencies that have updated their support cost calculations.

16. When these studies were conducted, technical cooperation projects financed from extra-budgetary projects represented only a small portion of the total expenses of FAO and the other specialized agencies of the UN system. For that reason, decisions were made by the CCAQ (predecessor to the HLCM) to treat as fixed indirect costs, and thus exclude from the calculation of project support costs, each organization's basic infrastructure, including costs of, information technology (IT), as well as headquarters and regional office space and security.

17. At the time the studies were conducted more than two decades ago, IT services were far different than those in place today and consisted primarily of centralized data processed and produced through mainframe computer systems. The cost study methodology has since treated these costs as fixed indirect costs, because at the time mainframe computer IT costs incurred were not impacted by the level of extra-budgetary activity. Current support such as e-mail and internet access did not exist, nor did most of the software now available on the personal computers utilized by FAO project staff, and the IT support to PCs and the provision of ICT infrastructure to run email, internet and PC software. Since these costs now vary in accordance with the number of the staff and consultants financed from extra-budgetary resources as well as from the Regular Programme, they should no longer be treated as fixed indirect costs financed solely by FAO's assessed contributions.

18. With the large increase in extra-budgetary funding that has taken place at FAO in the past decade, the exclusion of security, and office space costs from PSC recoveries is also no longer sustainable. There was general agreement among the UN agencies participating in recent FBN working group discussions that these costs should be considered as variable indirect cost and be recovered using a system of direct charges. In line with the in-principle enlarged scope of the support cost policy endorsed by the Finance Committee in July 2009, it is proposed to recover these variable indirect costs beginning in 2012, as follows:

- a) IT support services provided to extra-budgetary financed staff located at headquarters including the costs of e-mail, intranet access, internet access, help desk, use of corporate systems, software licenses, band-width, hardware replacement management and telephone infrastructure. In 2012-13 implementation of these recoveries will focus on costs incurred in relation to headquarters project staff costs only, while for 2014-15 its application will be expanded to consultants at headquarters.
- b) Headquarters security services (costs of badge issuance and management, maintenance of security equipment, security guard services, UN security service charges attributable to staff and consultants) available to extra-budgetary financed staff located at headquarters. Such recoveries would be implemented from 2012-13.
- c) IT support services to extra-budgetary financed staff located in subregional, country and project offices including the costs of e-mail, intranet access, use of corporate systems, software licenses, band-width, hardware replacement management. A single global rate would be computed for all such offices. The application of these charges to project staff

and consultants in these offices would take effect only from 2014-15, as detailed research on types of local IT services and quantification of such services must first be conducted.

- d) Space, security, acquisition of related equipment, IT costs as defined under c) above and telephone infrastructure provided to extra-budgetary financed staff located at regional offices. Individual rates would be computed based upon the costs incurred by each regional office. It is foreseen that in 2012-13 recoveries would focus on costs of servicing project staff, while in 2014-15 recoveries would also apply to costs related to project consultants.

19. The costs would be collected through a project personnel charge for staff on extra-budgetary projects computed as a percentage based on the total costs incurred by FAO in providing the services at each location divided by the total compensation of staff and consultants receiving the service at each location<sup>8</sup>. The percentage-based charges would follow the practice of the World Health Organization and would be levied against all actual staff and consultant costs charged to extra-budgetary financed projects at each location. Alternative methodologies such as unit charges per work month assigned to projects were examined, however, such costs are more complex to administer than percentage rates and tend to involve significantly higher levels of manual input and verification.

20. The proposed charging methodology is summarized in *Annex III*.

21. As noted by the Committee at its 138th Session in March 2011, the Secretariat is taking measures to improve cost recovery by updating project budgeting guidelines, providing training, and streamlining procedures. Further measures to improve the allocation of recovered costs, particularly in decentralized offices, are presented in the document on *Actions Arising from the Vision for the Structure and Functioning of FAO's Decentralized Offices*, to be considered jointly with the Programme Committee at this session.<sup>9</sup> Furthermore, information notes will be prepared and guidance provided to help FAO staff, member countries and present and emerging donors to better appreciate the FAO support cost policy and its flexible application, the administrative and operations support costs covered and the recovery measures.

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<sup>8</sup> Space utilized by extra-budgetary financed staff and consultants located at headquarters is already recovered on the basis of average square metres of space occupied by headquarters based project personnel. This is labour intensive to administer and would be replaced by the percentage uplift on project personnel as described here.

<sup>9</sup> JM 2011.2/3 paragraphs 24-25

## ANNEX 1

### Current FAO Support Costs Policy

1. The scope of the current FAO support cost policy is to recover all variable indirect support costs associated with projects funded by voluntary contributions. These are mostly defined as administrative and operational services which are a necessary and inherent part of any project which the Organization agrees to execute, but which, because of their nature, cannot be readily or directly singled out for charging to the project itself.

2. More specifically, FAO has defined variable indirect support costs in MS 250 as follows:

*Administrative services may include such items as:*

- recruitment, briefing and servicing of project personnel;
- servicing of fellowships;
- procuring supplies and equipment, formalizing contracts;
- preparation of budgets and control of project expenditures;
- receipt, custody and disbursement of funds, maintenance of project accounts, financial reporting, external and internal audits, etc.;
- security monitoring.

*Operational services may include such items as:*

- assembling and submitting proposals to donors;
- negotiating agreements and plans of operation with project-sponsoring bodies and recipient governments;
- location and recommendation of qualified personnel;
- guidance and supervision of the implementation of projects;
- preparing, monitoring and revising work plans and budgets;
- reporting periodically on projects;
- fellowships placement and formulation of study plans;
- technical selection of equipment and technical preparation of contracts.

3. It is noted that all of these costs fall under the definition of variable indirect project support costs.

### Summary

**Table 1: Matrix of Activities by Funding Source and Type**

Funding Source	Technical Assistance (TA)		Emergency Assistance	Normative Programmes and Other RP Activities	
	National Funding	Donor Contributions	Donor Contributions	FAO RP Normative Activities inc. Commissions	Jointly Funded Activities
Extra-budgetary	13% ceiling (see text below for exceptions)	13% ceiling (see text below for exceptions)	10% ceiling	13% (see text below for exceptions)	As per MoU
Regular Programme	TCP and SPFS: ceiling of 7%		TCP 7% ceiling	FAO Regular Programme	FAO Regular Programme

4. The following notes apply these principles to each of the categories of programme defined in Table 1.

## **EXTRA-BUDGETARY PROGRAMMES**

### *Technical Assistance - Government Cost Sharing*

5. These are defined as technical assistance projects in the field which are funded by the Government of the recipient country, including those which are funded through loans from international financing institutions.

6. In principle, such projects should reimburse the variable indirect support costs associated with the project. Standard rates are not to exceed a ceiling rate (currently 13 percent) but can be lowered where appropriate for special circumstances:

- high proportions of contracts, supplies and equipment requiring minimal AOS costs (current Manual Section 250 provisions to continue to apply);
- national execution in whole or in part;
- inclusion of project support costs in the project budget as direct project costs;
- other cost sharing or complementary support arrangements; and
- exceptionally large projects when economies of scale apply.

### *Technical Assistance – Donor Contributions*

7. These are defined as technical assistance projects in the field which are funded by a third party other than FAO or the recipient Government.

8. In principle, such projects should reimburse the variable indirect support costs associated with the project. Standard rates are not to exceed a ceiling rate (currently 13 percent) but may be lowered where appropriate for special circumstances:

- rates established by inter-governmental bodies of the UN system organizations (including the international financial institutions);
- high proportions of contracts, supplies and equipment requiring minimal AOS costs (current Manual Section 250 provisions to continue to apply);
- Associate Professional Officers (APOs) which are charged a fixed rate of 12 percent;
- inclusion of project support costs in the project budget as direct project costs; and
- exceptionally large projects when economies of scale apply.

### *Emergency Assistance*

9. FAO emergency assistance is defined as a situation where an urgent and exceptional external response is needed in the agriculture sector to address the impact of a particular disaster, natural or man-made. If a project is characterized as an emergency, the request follows the "fast track" and is operationally treated as such. Generally, "prevention" and "preparedness" are not within the meaning of "emergency" for project operational purposes.

10. The ceiling rate for emergency assistance projects is 10 percent. Rates for emergency assistance are to be determined on a case-by-case basis to recover the full variable indirect support cost of the project. When Emergency Operations and Rehabilitation Division (TCE) operates technical assistance projects because of special situations, the reimbursement rates for technical assistance shall apply.

### *Regular Programme Normative Activities*

11. These are defined as voluntary contributions which directly support the implementation of Regular Programme activities. Such activities will generally be normative in nature and be implemented at Headquarters or at a Regional Office rather than directly in the field.

12. A standard PSC rate of 13 percent will apply.

13. Such rates can be lowered to reflect the impact of certain special circumstances:
- contributions to cover the travel cost of participants from developing countries to conferences and consultations on matters within FAO's mandate will be exempted from indirect support cost charges;
  - sponsorship funds in support of awareness raising and/or promotional events will be used to cover the identifiable direct costs of these activities and as such, are not subject to project servicing costs;
  - contributions to FAO for the refurbishment and improvement of FAO premises (both at Headquarters and in Regional and Subregional Offices) are exempt from PSC charges;
  - Associate Professional Officers (APOs) which are charged a fixed rate of 12 percent; and
  - long-term trust fund accounts (e.g. Commissions established under the auspices of FAO) will be subject to a case by case estimate of the actual level of variable indirect support costs and charged accordingly.

#### *Jointly Funded Activities*

14. These arrangements cover activities which are part of the Regular Programme and are usually normative in nature. They are defined as partnership arrangements between FAO and other inter-governmental organizations including, in particular, UN system organizations.

15. The special nature of these partnership arrangements will be recognized and translated into an agreement to share direct costs in a manner appropriate to the joint activity's contribution to the Strategic Objectives of the Organization. Variable indirect costs are generally to be funded by the host organization although recognition of this fact should generally be given in the Memorandum of Understanding and related cost sharing formulae.

16. It is noted that the FAO-GEF Agreement foresees a flat reimbursement fee of 10 percent for full size projects for support and supervisory costs. This arrangement is still being evaluated by FAO. GEF-funded PDF Block B projects that have become operational have been granted Project Support Servicing of 6 percent, which seems sufficient to fully recover variable indirect support costs.

### **REGULAR PROGRAMME**

#### *TCP and SPFS*

17. Regular Programme funded technical assistance (including emergencies) should, in principle, reimburse the variable indirect support costs incurred by "operating units" or their equivalent associated with the project (i.e. for operational services). This should be based on an average rate (currently 7 percent).

## ANNEX II

**General Categories of Cost<sup>10</sup>***Definition*

The following table defines the terms used in the current FAO Support Cost policy. This terminology is in line with the harmonized concepts approved by the HLCM, while the application varies widely among UN System organizations.

**Table 2: Definition of Cost Accounting Terms**

Cost Accounting Term	General Definitions	Term used in this paper	Original application
Direct Costs	Items of cost that are directly traceable to the product or output.	Direct project costs	Project inputs that are directly traceable to the project and charged to it
Indirect Costs (also referred to as "overhead"): a) Variable Indirect Costs	Items of cost that are associated with the production of several outputs but which are not traceable to individual outputs. They will tend to vary indirectly with the volume produced	Indirect project support costs	Administrative and operational support costs and some technical services to projects involving staff time which cannot be discretely identified
b) Fixed Indirect Costs	Items of cost that are not easily traceable to the production of a single output and which do not vary with the volume of output	Fixed overhead costs	Costs of general management (e.g. ADGs and D2s; ODG), general financial accounting; central HR function, auditing, messenger service, central records and procurement for Regular Programme, etc.

<sup>10</sup> See FC 93/4 table 1 and paragraph 29.

## ANNEX III

## Measures to improve recovery of Project Servicing Costs

Service	Calculation of Charge	Charging methodology
<b>Charges for costs included in FAO Cost Measurement Study but not recovered in PSC rates below ceiling rate</b>		
<b>Project Personnel (staff and consultants)</b> support services provided by CSH, SSC, technical departments, Regional and FAOR offices including recruitment, entitlements, contracting, staff travel authorizations, travel arrangements	Costs are determined based upon the annual work measurement survey. Actual annual costs of providing support will be divided by the annual total amount incurred for project personnel delivery to determine a percentage rate.	Percent uplift on project personnel costs (staff compensation and travel plus consultant fees and travel) for projects charged 7% or less compared with the ceiling rate established by FAO policy (- 13% for technical cooperation projects, 12% for APO projects and 10% for emergency assistance projects); total recovery for a given project would not exceed the applicable ceiling rate for that project.
<b>Charges for costs not included in the FAO Cost Measurement Study</b>		
<b>Headquarters IT Services</b> - services provided to project staff and consultants - e-mail connection, intranet and internet connection, mobile and desk phone services, corporate desktop software, website design and development, server hosting management, data centre equipment life cycle management, system security, network connectivity	Global budgeted CIO costs for 2012-13 of providing services divided by global budgeted compensation of users (staff and consultants) from all funding sources = percent	Percent uplift on project personnel costs (staff compensation plus consultant fees), charged to all projects
<b>IT Services in Field Offices</b> - same as headquarters, excluding services related to mobile and desk phone services and IT support not provided to field locations	Global budgeted costs of providing specified field office support services divided by global cost (total compensation) of global users (staff and consultants) from all funding sources = percent	Percent uplift on project personnel costs (staff compensation plus consultant fees) located in FAO regional offices, FAOR offices and project offices; charged to all projects
<b>Headquarters Security</b> - costs of badge issuance and management, maintenance of security equipment, headquarters security guard services, UN security service charges attributable to staff and consultants at headquarters	Budgeted 2012-13 headquarters cost of security services divided by cost (total budgeted compensation) of headquarters based staff and consultants from all funding	Percent uplift on cost of project personnel located at FAO headquarters (staff compensation plus consultant fees); charged to all projects

Service	Calculation of Charge	Charging methodology
	sources = percent	
<b>Regional Office</b> - space occupancy charges for project personnel located in Regional Offices	Annual budgeted RO cost of space, telephone, IT support and internet access divided by total compensation of staff and consultants located at each RO. Separate rates would be computed for each regional office	Percent uplift on cost of project personnel located at each regional office (staff compensation plus consultant fees); charged to all projects
<b>Headquarters Space</b> - costs of building maintenance and repairs, cleaning, utilities and related costs for space occupied at headquarters by staff and consultants.	Annual budgeted headquarters cost of building services divided by costs (total compensation) divided by costs of headquarters based staff and consultants from all funding sources = percent	Percent uplift on cost of project personnel located at FAO headquarters (staff compensation plus consultant fees); charged to all projects, replacing current cumbersome methodology which is based on average square metres of space occupied