

Indirect Costs: a Primer

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Introduction

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In early May, 2003, Interim Provost Randhawa constituted a group to review the University's practices and policies regarding indirect cost recovery.

The members of the group include Sherm Bloomer, Science (Chair); Mark Abbott, College of Oceanic and Atmospheric Sciences; Joe Beckman, Environmental Health Science Center; George Boehlert, Hatfield Marine Science Center; Barbara Bond, Forest Science; Stella Coakley, Botany and Plant Pathology; Faculty Senate President-Elect; Dan Edge, Fisheries and Wildlife; Rich Holdren, Research Office; Walt Loveland, Chemistry; Faculty Senate Budget and Fiscal Planning Committee; Karty Mayaram, Electrical and Computer Engineering; Roger Nielsen, Geosciences; Faculty Senate Research Council; Rosita Rodriguez, Pharmacy

The charge from the Provost states:

'The ICR Task Force will advise University leadership on the principles of ICR allocation and the distribution policy that would lead to long-term growth of OSU's research enterprise. Specific issues that merit careful assessment include: 1) re-examination of the historical university policy of returning 26% of ICR to units, in the context of the new budget model and OSU Strategic Plan, and 2) consistency in returned overhead policies for units, centers, and institutes, including issues related to historical agreements with colleges and programs, and funding issues related to facilities. ICR Task Force members will be expected to represent the very best interests of the University. The advisory nature of the group means that the Task Force makes recommendations, but does not serve in a decision-making capacity. Members are asked to commit to active participation.'

To begin the conversation, I offer a short description of what indirect costs are, how we have dealt with them in the past, and what our constraints are in dealing with them in the future. This primer may be a starting point for something that would be useful to members of the faculty as background.

What are *Indirect Costs*?

Indirect costs are costs paid by agencies that enter into grants or contracts with the University for research work. They are also called overhead charges, but formally should be called Facilities and Administrative Costs (which is how the Federal

Government refers to them). I will generally call them F&A Costs in this document. The most important thing to note about F&A Costs is that they are provided to the University as a reimbursement for real costs incurred in maintaining the infrastructure for research. I'll take an example from my science experience. I had a laboratory in Wilkinson Hall for doing research work on the geochemistry of volcanic rocks, largely from the sea floor. OSU committed to providing the lab and an environment in which I could compete for NSF grants, train graduate students, and hopefully do meaningful research. Some of the costs of providing that commitment that come to mind are: building the lab (and depreciating the costs); providing lights, water, gas, vacuum and distilled water; emptying the trash; keeping a hazardous waste office and disposing of dangerous waste; stocking the library with essential journals for the work; paying the librarian to take care of the journals; providing repairs in the lab; keeping the library working; paying professionals to do accounting, payroll, ordering, travel for the grant activities; providing compliance officers to make sure the work is line with Federal and State Regulations, and so on. You get the idea.

Maintaining a research infrastructure is a very expensive enterprise. If the faculty did nothing but teach classes for undergraduates, much of the infrastructure we have on campus would not be necessary. When we are paid F&A Costs as part of a project, it is important to remember we are being reimbursed for costs. We don't run out and build a lab when we get the grant (usually). We've already invested in the lab, the library, the support personnel, and have already incurred those costs. F & A Funds are not "extra" money. They are paid to us for very specific functions. One of the myths of indirect costs is that high return programs (Biochemistry let's say) subsidize low return programs (English let's say). It is true that the F & A Rates are an institutional average but it is much more expensive to do research in Biochemistry than in English. The high return programs generally produce much more F & A because they are in fact much more expensive to maintain.

How are *Facilities and Administrative Costs* determined?

The F & A Cost rates are determined in negotiation with a lead Federal Agency. In OSU's case, the agency is the U.S. Department of Health and Human Services. The last negotiated agreement was June, 2001, and runs until June 2004. OSU negotiates with representatives of HHS. In that negotiation OSU documents the costs it has incurred for supporting research over the period since the last negotiation. One of the most important steps in that process is documenting what we spent for research support and where we spent it. This is one of the steps that costs many institutions percentage points in their negotiations. If the plumbing in my lab needs to be repaired and the department pays for it on an account that is in the instructional side of the ledger, no record of that repair and that cost ever gets into the F & A negotiation. Add those up and it can become a significant issue. A 1% point change in the rate for an organization that does more than \$100M of research is a lot of money. This is the reason the institution worries so much about classifying space as for research, instruction, or administration. Space use is one of the most important elements of the negotiation. The costs are reviewed in two broad categories, Facilities Components and General and Administrative Components. Facilities Components include (% is the contribution of this component to the total rate, based on FY00) Building Use Allowances (1.79%),

Equipment Use Allowance (3.03%), Interest Cost (0.33%), Operation and Maintenance Cost (9.36%), Utility Cost Adjustment (1.3%), and Library Cost (0.72%). General and Administrative Components include General Admin and Expense Cost (6.45%), Departmental Admin Cost (15.66%), Sponsored Projects Admin Cost (1.54%), Student Services Admin Cost (0.13%), and Faculty Department Admin Cost (3.60%). The General and Administrative components total 27.38%, but the rate is capped by the Federal Government at 26.00%. The total for OSU that year was therefore 42.53%.

An aside, since I've asked this question before. What's in General Admin?—all those functions that support the entire University—the President's Office, Chancellor's Office, Academic Affairs, VP for Finance, VP for Information Services and so on.

Departmental Admin Costs include a depreciation allowance for unit admin space, an operations and maintenance allowance, and all the general admin costs (chairs, classified staff, student works, local IS staff) at the unit and college level.

HHS reviews the documentation and negotiates with OSU's representatives. Not all of the costs we incur are necessarily reimbursable. The Federal Government capped administrative costs at 26% of direct costs some time ago. Most of us (as faculty members) have at one time or another rolled our eyes at how much money is spent on "administration." However, if we consider the increasing regulatory requirements of any research that involves human subjects, animal subjects, environmental impacts, waster disposal, etc. it is clear that there are real and substantial costs in complying with regulations, once we have accepted certain kinds of grants. We do not, in general, recover the full cost of providing those oversight services---most institutions don't. The negotiations produce a set of rates to be charged for reimbursement in the next few years. These rates are usually subdivided for broad categories of work such as on-campus, off-campus, and ship operations. Once agreed upon, these rates are operative for grants and contracts with all Federal Agencies, the State of Oregon, and private entities. The rates document costs that HHS is satisfied represent real costs incurred for doing research work on the campus.

There is an interesting chicken and egg issue here. I sometimes hear (or say) "well, OSU collects indirect costs to support research facilities so they ought to be paying for X (let's say a technician to support a large expensive instrument)." However, since the F&A rates are negotiated on the previous few years actual expenditures, if we are not paying for that technician, it is in fact not a reimbursable cost, and we do not get money back to cover it. If we want the F&A Rate to include those costs, we need to be able to pay for them initially and then document them in the next negotiation. Hence the problem. We can't get reimbursed for it until we make the expenditure but we haven't got enough cash to pay for it until we get reimbursed.

Why do I get charged if my research doesn't cost much?

There are indeed differences in what it costs to maintain different kinds of research. These differences are driven most by the kind of space required to do the work. In fact, any research on campus has an overhead cost. Most of OSU's faculty members are expected to do research as part of their appointment. Even if that research requires only a small office, a computer to write on, and a lot of thought, there are still overhead costs involved. The parts of utilities, space maintenance, the library, etc. that go to support that part of a faculty member's time are costs to support research. That overhead is

indeed probably lower than it is for programs that need large and complex labs. It is also true, however, that many of those lower cost programs do not have the same opportunities for external support that the higher cost programs do. Most Universities probably do not recover the costs of maintaining those research programs, but it is recognized that the research is important. All large research institutions commit some part of their base budget (from state support and tuition) to funding the part of the research enterprise that does not recover its F & A costs.

Before those of us in disciplines that do have access to lots of grant money become too smug, it is also extremely rare that we recover the full costs of our research programs. If we include the actual costs of our lab space, the portion of our base salary that covers time spent in research, and the cost of all the support facilities, it is the very rare individual on any campus that actually recovers the whole overhead costs attributable to his or her particular research operation.

The F & A negotiations are designed to be done at an institutional level, and average over the institution. This approach is manageable and provides consistency over time.

What about waivers of indirect costs?

As pointed out in the paragraphs above, even when a grant pays the full F & A cost rates, OSU still does not recover all of its costs for supporting research. Any time that we accept a grant that pays less than the full F & A rate, for whatever reason, we forgo the reimbursement of costs we have incurred. We must pay those costs somehow, and in general they are made up out of the state and tuition portion of the E&G budget (the Statewide Public Services do include in their budget allocations approximately \$2.5M of reimbursements to the E&G budget for facilities costs).

Does this mean that we should not accept grants that do not carry full F & A costs? Not at all. There are many grants and contracts that do not support full F & A costs, but that support projects that directly further the mission of OSU. The expenditure of the direct costs from those projects support students, research faculty, support personnel, and have an impact on the economy of the community, the benefits from the research itself aside. We do need to recognize that we are subsidizing projects to a greater degree when we do not recover full F&A costs. We need to be aware of the mix of our grant and contract activity and that we need to maximize our return from agencies that do support full F&A reimbursement. Every additional dollar we recover in F&A costs is one less tuition or state dollar that we need to spend supporting the research infrastructure.

When do we waive some part of the F & A costs? Some agencies cap the rate of reimbursement that they honor. In those cases, if the accepted rates are clearly stated in the agency's published policies, we accept the grant under those conditions.

Private entities that wish to enter into a contract with the University not uncommonly wish to reduce the reimbursement rate. Most research universities, OSU included, expect that for-profit private entities will honor the full-negotiated F&A costs.

Principal investigators will sometimes argue to accept a reduced rate to make a particular grant appear more competitive (i.e. of a lower cost). It is very rare that this is in the University's best interest. If a Federal Agency agrees to a certain indirect cost rate, it is to our advantage in the long term to pursue the maximum rate we can.

The point to remember, again---F&A costs are a reimbursement for costs incurred.

When we don't recover the F&A funds, we still incur the costs—we just need to pay

them from a different source.

How are F&A Costs treated in the budget?

The F&A costs are paid to the University as reimbursement for the costs of providing research infrastructure. As such, they are simply put into the general operating fund of the university and are allocated like any other part of the budget. With only a couple of exceptions, these funds are not "earmarked" for special research purposes. They are to defray legitimate costs of supporting the research enterprise.

The two exceptions are for Building Use Credits (BUC) and Research Equipment Reserve Funds (RERF). The Federal guidelines governing Facilities and Equipment Costs (OMB Circular A21 for those of you tempted by daunting documents) requires that 4% of the F&A Costs be spent on improvements to research space (BUC) and that 8% be spent on improvements in research equipment (RERF).

The balance of the F&A funds have been put into the general fund budget and distributed. Prior to FY02, the F&A funds were distributed to units (the Library, Facilities, Research Accounting, etc.) in roughly the proportion that was negotiated. The balance of the base budget for those units was then made up from the tuition and state dollars.

The Budget Allocation Model that was used first in FY02 does not differentiate the F&A funds from other sources of general fund income. The intent was to identify a reasonable share of the total operating budget for essential support functions like the library. With the exception of the BUC, RERF, and the overhead returned to units (see the next section) the F&A funds are not tracked separately.

If we returned to allocating the F&A funds in proportion to the negotiated rate, it would not increase the funding to any particular unit . . . the library for example. Such a change would mean that the budget allocation model was used to allocate only state and tuition dollars rather than the total general fund. The library's share of that state and tuition pool would be less in a modified model, as the library would be getting funds from the F&A pool. The difference is not in the overall allocation but in how the funds are tracked and distributed.

What about *Returned Overhead*?

There is probably no part of the budget that is less understood than what is called Returned Overhead (ROH). This is an amount of money that is distributed to units based upon their overall recovery of F&A costs. The percentage returned varies from 26% to 42%.

There is nothing in the negotiations with HHS or in OMB 21A that mandate that some part of the F&A Costs be returned to units for research. Quite the opposite. Those costs are reimbursement for indirect support costs, not for direct costs related to grants. What we term ROH is not in fact some mandated share of the F&A dollars. The ROH is an internal budget mechanism to provide incentives to pursue grants and contracts that recover F&A costs for the University.

Put another way, OSU has chosen to provide a budget allocation to units over and above the base budget allocation. That additional budget allocation is calculated using the unit's F&A cost recovery as a yardstick. This budget allocation is an incentive to pursue

work that generates F&A. It might be better termed a Research Incentive Allocation. Most research institutions do something similar, all with the same purpose---to stimulate the pursuit of grants and contracts that produce F&A costs.

Almost any proposal to "use" indirect costs to support some research enterprise has the same issue. It is really just proposing to use part of the General Fund (since F&A is part of the General Fund) to support a research cost. As pointed out in an earlier section, until we make those research expenditures, they can't be used in negotiating our rate and we can't get reimbursed for them. The pool of F&A funds is not there to support new research initiatives. The funds are to pay real costs and whenever we try to move funds to some new purpose, we need to be aware that those funds have to be made up some place else in the budget.

Where do we generate F& A Recovery?

OSU's Colleges have a wide range of missions and diverse portfolios of teaching, research and instruction. That is reflected in the patterns of grant funding and indirect cost recovery. The table below shows the five-year average grant expenditures and the associated indirect cost recovery for some of the major research units on campus. There are two reasons that the "effective" rate is so much lower than the "full" F&A rate. First, indirect costs are not calculated on the total direct costs of a project, but on the modified direct costs. Student tuition, capital equipment, and subcontracts over \$25,000 are all excluded. COAS receives nearly all of its funding from agencies that pay "full" F&A, and their return of 21-23% indirect costs is therefore a good measure of the upper end of F&A recovery.

Fiscal Years 1997 - 2001	Grant Funding	ICR	Effective % ICR	ROH Rate %	ROH Funds	Net OSU ICR
COAS	22,083,546	4,898,528	22.2%	42%	2,057,382	2,841,146
Ag Science	23,639,138	2,970,650	12.6%	26%	772,369	2,198,281
Science	15,400,254	2,489,471	16.2%	26%	647,262	1,842,208
Forestry	18,825,411	1,079,332	5.7%	26%	280,626	798,705
Research	5,273,566	1,018,970	19.3%	26%	264,932	754,038
TOTAL	97,830,783	14,718,839	15.0%		4,610,663	10,108,177

**grant funding here is direct cost expenditures; the effective ICR rate is simply the ICR divided by the total expenditures*

The percentages less than 22% reflect the diversity of funding sources for grant activity in different units. Forestry and Agricultural Sciences, for example, receive significant funding from USDA, PNNL, USFS and other agencies that do not pay full F&A. The table above also notes how much of the F&A funds are returned to the unit and how much is left centrally for OSU to distribute. A more detailed look at the "net" F&A produced by each unit is shown below. This table includes the FY02 distributions of BUC and RERF to units as well as the indirect cost and returned overhead.

2001-2002 Distribution of Indirect Cost Recovery (ICR) by Major College or Unit

College/Unit	ICR Generated	ROH	BUC	RERF	Net Retained by OSU
COAS	\$ 5,194,351	\$2,181,628	\$176,700	\$91,059	\$2,744,965
Ag Science	\$4,078,302	\$1,060,358	\$77,900	\$505,235	\$2,434,808
Engineering	\$3,088,422	\$802,990	\$95,300	\$319,495	\$1,870,637
Science	\$2,855,843	\$742,519	\$91,100	\$286,401	\$1,735,823
Research Centers	\$2,290,918	\$595,639	\$49,300	\$361,474	\$1,284,505
Forestry	\$1,336,378	\$347,458	\$16,500	\$46,321	\$926,099
Home Ec	\$570,413	\$148,307	\$6,200	\$42,130	\$373,776
Pharmacy	\$495,258	\$128,767	\$11,400	\$28,782	\$326,309
Health/HP	\$355,154	\$92,340	\$6,000	\$15,600	\$241,214
Liberal Arts	\$124,825	\$32,454	\$2,200	\$ -	\$90,170
Vet Med	\$41,180	\$10,707	\$700	\$55,194	\$(25,421)
TOTAL	\$20,431,044	\$6,143,168	\$533,300	\$1,751,691	\$12,002,886

I hope that this document is useful as background. Errors in interpretation or representation are entirely mine and I'd appreciate it if you could bring them to my attention. Any corrections, questions, or differing interpretations are welcome.

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