

# Aligning Incentives with Service Level Agreements

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Service level agreements are one of the great ideas in outsourcing. In a service level agreement (SLA), a provider agrees to achieve defined performance levels and to reduce its charges if it fails to achieve those performance levels. An effective SLA balances the unfortunate incentive for a provider, in a fixed price arrangement, to increase its profits by cutting service quality.

An effective SLA fills a vital gap in contract law for the customer in a long-term contract for critical services. Contract law provides two primary performance incentives: a right to terminate for material breach and a right to collect damages. However, these incentives both address poor performance, and customers that rely on outsourcing providers for critical services frequently need to provide an incentive for good, or even world-class, performance. An effective SLA meets that need by linking the provider's profit margin to achieving performance standards.

SLAs are also a boon to providers. They replace general performance expectations (and the resultant disputes) with well-defined performance requirements. Providers can use service levels in the sales process to show genuine commitment to performance levels, and thus to make outsourcing as or more attractive than staying with known internal service levels. SLAs also help providers to simultaneously pursue their short-term interest in this month's margin and their long-term interest in being known as a provider of world-class services.

## Choosing Service Levels

Service levels can provide incentives for achieving desired quality, speed, availability, capacity, reliability, user-friendliness, timeliness, conformity, efficiency, and effectiveness. Of course, some service levels are more helpful than others. Such service levels are:

- *Controllable.* The provider must have the ability to control the outcome; otherwise, the service level doesn't provide an incentive.
- *Essential.* The best service levels go to the essence or heart of the contract. In a payroll outsourcing, timely payment of accurate wages goes to the heart of the contract, so this is where the service level incentives belong.
- *Measurable.* The parties must be able to agree on, and trust, a measurement process.

## Defining the Measurement Process

In SLAs, details matter. A network server can be measured as 100 percent functional while still being completely unavailable to the end user. For example, availability will be different when measured using software continuously running within that server, periodic polling by another server, user complaints about downtime, or a monthly user satisfaction survey asking about perceptions of downtime.

The measurement process must align with the intended incentive. Measuring call answer times by the percentage of calls answered within 30 seconds creates an adverse incentive to give priority to calls that have held for less than 30 seconds (ignoring those that have been on hold for longer). The provider might ignore this adverse incentive despite its own economic interests and the unmistakable signal sent by the service level, but it's a mistake to create the adverse incentive.

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A strong service level measurement process is critical to success. If the measurement process is not well-defined, the provider can report better results by gaming the system well instead of performing well. The problem is even worse if the customer lacks visibility

into the provider's actual measurement systems, allowing the provider to hide problems instead of fixing them. Thus, the customer's team must include people with a solid technical and operational understanding of how the performance will be measured and the contract must include well-defined measurement obligations and strong audit and access rights.

## Setting Required Performance Levels

The SLA must clearly define the performance levels that the provider is required to meet in order to achieve the customer's established service levels. These performance levels should be established during the period where the provider is bidding on the work and before the price has been set. At that point, the provider has an incentive to work with the customer to identify a value-maximizing price to committed performance level.

Providers often propose that the service levels be set after signing. There are two approaches for doing so, each of which creates poor incentives:

- *Use data from the provider's initial performance.* This approach is problematic, however, because, for example, the customer might set the minimum service level in line with what was the provider's worst performance during its first six months, thus inadvertently creating an incentive for the provider to have at least one terribly bad month in the first six months.

- *Agree to agree on service levels after a “burn-in” period.* The problem here is not a poor incentive but the lack of any incentive for the provider to arrive at an agreement. The incentive created is to make the topic of service levels sufficiently painful that the negotiation does not happen.

## Using Service Level Credits

A service level credit is a reduction in the provider’s compensation that occurs upon a specified level of service level failure. Because the credits reduce the provider’s profit margin, a large enough credit can provide a powerful incentive to meet service levels.

A well-crafted SLA can create incentives that target particular types of performance. For example, the SLA can:

- Define a minimum service level, with a credit payable upon each failure, to create an incentive to never miss that level of performance.
- Define a target service level, with a credit payable upon a series of failures, to create an incentive to keep generally good performance.
- Have credits increase for successive breaches to create an additional incentive to fix problems quickly.
- Have credits increase for larger breaches to create an incentive to minimize the scale of a service level failure.
- Give the customer the right to reallocate service credit exposure over the service levels to allow the customer to realign incentives as its business needs change.
- Have a failure to report actual service level performance be deemed a service level failure to create an incentive for prompt reporting.
- Create the opportunity to earn back service level credits based on annual performance to give an incentive both for monthly performance and annual overall performance.
- Create an opportunity for service level bonuses to create an incentive to meet service level objectives that would be unreasonable as contractual commitments.

If the SLA includes an incentive to exceed service level requirements, consider locking in the improvement by automatically resetting the performance requirement based on the provider’s performance. For example, for each year, the target performance could increase to the midpoint between the prior year’s actual performance and the prior year’s required performance. Note, though, that this dampens somewhat the provider’s incentive to exceed the required performance level.

## Credits are Not Liquidated Damages

Some providers argue that service level credits should be treated as liquidated damages. However, if service levels are used as described in this article, they should *not* be considered liquidated damages because, while they provide an incentive for good or excellent performance, they are not as effective as typical contract damages at preventing bad performance. Said another way, having credits for a breach of a 99 percent service level be liquidated damages would provide the same incentive to avoid 0 percent performance that it provides to avoid 98 percent performance. Also, if service level credits were to be liquidated damages, the customer would need to make them larger because they would need to reflect the potential harm to the customer instead of an adequate incentive to the provider.

## Deemed Material Breach

Service levels help to define the term “material breach.” Unfortunately, although material breach is commonly used as a threshold for termination of outsourcing contracts, it is not clearly defined by the law. For example, *23 Williston on Contracts* § 63:3 (4th ed.) explains that a material breach is a breach that “is so fundamental to a contract that the failure to perform . . . defeats the essential purpose of the contract;” “go[es] to the ‘root’ or ‘essence’ of the agreement,” or “touches the fundamental purpose of the contract and defeats the object of the parties in entering into the contract.” This allows a provider to argue that any service level breach, particularly in only one of many service levels, would not be a material breach.

The SLA can provide increased certainty by defining particular events that, without argument, allow the customer to terminate the contract for cause. For example, an SLA can set a “termination service level” that, when reached, allows the customer to terminate for cause. Additionally, the SLA could establish a defined amount of accumulated service level failures sufficient to permit the customer to terminate for cause, such as where the provider breaches a single, critical service level three times in succession, or the provider breaches enough service levels that the service level credits reach a percentage of the amount at risk over a period. The effect is to give the provider a powerful incentive to achieve service levels to avoid the risk of a termination for cause.

## Conclusion

Service level agreements, if used skillfully, can align the provider’s incentives with the customer’s business imperatives. They also benefit the provider, allowing it to maximize its short-term profits in ways that support its long-term interest in satisfying its customers. As a result, we expect that they will continue to be a critical component of successful outsourcing transactions. ♦