Outsourcing Incentive and Penalty Best Practices

The popularity of using external service providers has led to a wide variety of outsourcing deal types and numerous types of service-level agreements. These agreements are enforced through incentives and penalties. This report describes the best ways to use such contractual elements.

Management Summary

Incentives and penalties have been used, misused and even abused as a tool to manage IT outsourcing contracts — regardless of the type of outsourcing arrangement. This Strategic Analysis Report answers the most frequently asked questions about incentives and penalties, debunks myths surrounding them and provides a road map for their successful use.
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1.0 Introduction

The appropriate use of incentives and penalties in outsourcing contracts is a critical success factor in outsourcing deals. But these important contract elements are often misunderstood by enterprises — that is, service recipients (SRs) — as well as external service providers (ESPs). SRs and ESPs frequently ask:

- "What are incentives and penalties?"
- "How should they work?"
- "Are they effective?"
- "How do I build a business case for them?"
- "What contract clauses should I use, and how should I use them?"
- "What are the risks?"
- "How do I measure them?"
- "What effect will they have on the relationship?"

This Strategic Analysis Report answers these questions and provides a framework for successfully using incentives and penalties to assist enterprises in managing their outsourcing relationships.

2.0 The Service-Level Agreement

The foundation of incentives and penalties lies within the service-level agreement (SLA) portion of the outsourcing contract. Service-levels should be set to the minimum acceptable level of performance required to meet the enterprise business objectives. For the service levels to qualify as an SLA and, therefore, an effective foundational tool for managing the outsourcing relationship, the service levels — when not met by the ESP — must be subject to contractual penalties.

IT management best practices dictate that service levels must meet the criteria of a five-step process to qualify as a valid and usable measurement tool. That five-step process is:

- Define the required service levels to ensure maximum effectiveness and meet minimum business objectives.
- Measure service activity results against the defined service levels.
- Examine the results for problem determination and root cause analysis.
- Take appropriate corrective action.
- Continuously guide service activities to hold the gains achieved by the corrective action taken.


Gartner has developed a list of the 100 most common service levels used by enterprises. The following is a sample.

- **Category:** Customer satisfaction — ongoing
- **Explanation:** Measures performance of a specific function, such as help desk call resolution or desktop problem resolution. Used to identify end user's opinion of service performance. The results
are used to identify and resolve any issues and problems. The resulting actions should improve end-user/management satisfaction and service performance.

- **Service level:** Establish that 92 percent are very satisfied or satisfied. It is important to note that the customer satisfaction process will not start until six months after contract initiation and project/activity initiation.

- **Responsibilities:** Measure customer satisfaction on a daily basis by taking less than 5 percent of daily activities and completing a customer satisfaction record per documented processes and procedures. The sampling should be spread over the various functional areas.

- **Assumptions:** Survey will be completed via direct voice contact or via e-mail. End users will take part on a volunteer basis.

- **Measure formula:** The following formula is valid for the daily and monthly reporting periods: The number of responses with a "very satisfied" or "satisfied" rating divided by the total number of responses equals the percentage service level attained.

- **Data sources:** An ESP-provided tool that provides documentation capabilities will be used to meet the reporting requirements.

- **Incentive or penalty formula:** Variable

### 3.0 What Are Incentives and Penalties?

Incentive and penalty clauses are vital foundational elements of all outsourcing contracts and, ultimately, critical in managing the relationship. They are tools that are specified in the contract and used by the SR and ESP. They drive the desired behavior of the ESP and allow the SR and ESP to manage the relationship effectively. Without them, the likelihood of a deal's success is significantly minimized.

#### 3.1 Definitions

Incentives and penalties are contractual statements of performance measurements that will either reward an ESP for exceptional performance or penalize the ESP for subpar performance. Incentives and penalties are normally financial. For example, exceptional performance is rewarded by a share of the cost savings above the targeted savings or by a bonus for early completion of a project. Penalties are normally imposed by issuance of a credit against future service fees.

**Incentives:** To be of value, incentives must provide the SR with a measurable way to realize a greater business value than the incentive pays out. Incentives generally take the form of fee increases, additional business or other positive reinforcement forms.

**Penalties:** Penalties generally take the form of a fee reduction and are necessary to reinforce the ESP's commitment to the service level and to ensure compliance. ESPs are more driven to meet service levels that are tied to performance penalties than to meet those that are not tied to penalties. The best case for an enterprise is when penalties are established in the contract but go unenforced because the ESP meets the required service levels.

It is important to note that the word "penalty" may be the most common and recognized term used by SRs and ESPs, but it is not a term accepted by the legal systems. Therefore, the word penalty should replaced by the phrase "fee reduction," which is more acceptable term from a legal perspective.
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Some level of error is implicit in human activities, so a certain amount of faults, errors or accidents are acceptable for a service or project. Thus, a limited amount of service problems can be accepted, but the problems must and can be minimized through the use of incentives and penalties.

3.1.1 What Incentives and Penalties Are Not Intended to Do

Incentives should not be designed to provide the ESP extra money for overachieving against metrics in the baseline contractual agreement when doing so provides no additional business value to the SR. Penalties should not be designed with the goal of reducing the payments made by the SR.

3.2 Cultural Aspects

Enterprises negotiating an outsourcing contract often ask about how best to handle the subject of incentives and penalties. Although incentives are an easy topic to discuss with the ESP, the SRs — especially the technically oriented personnel — are often reluctant to raise the penalty topic. Lawyers, on the other hand, are accustomed to addressing penalties in general; normally, however, they determine the contractual language and do not participate in the development of the service levels and their related management processes — nor in the determination of the common incentive and penalty amounts used in the IT outsourcing business.

Senior managers, who are scarcely or not at all involved in the day-to-day negotiation, sometimes assume that technical personnel and lawyers will establish the contractual details. Often, no one from the SR is focused on the overall "penalties" negotiation strategy.

ESPs, on the other hand, are accustomed to negotiating outsourcing contracts, and their penalty strategy is straightforward: They attempt to reduce their risk by avoiding penalties, particularly when no incentives are available to offset them.

4.0 How Should Incentives and Penalties Work?

SRs and ESPs will succeed in securing a mutually beneficial contract if both parties are frank about their objectives and constraints, reasonable in their expectations and flexible in their negotiating positions. Using incentives and penalties to develop a shared-risk approach to the relationship will help lead to a positive deal outcome.

4.1 Incentive Key Factors

Incentives can be good for the SR and ESP, but certain rules must be followed. What should SRs and ESPs know and do about incentives?

The SR should:

- Gain acceptance and unconditional support from the top to the bottom of the enterprise for the payment of incentives.
- Define, understand and communicate the values of exceeding the service levels contracted.
- Implement incentives that provide a higher value received by the SR than value paid to the ESP.
- Obtain the ability to influence how the ESP utilizes the incentive payments by influencing the incentive distribution.
- Ensure that the contract permits service levels to be adjusted over time as business requirements dictate.
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The ESP should:

- Acknowledge that additional value must be recognized by the SR and delivered by the ESP for the incentive program to be successful in the eyes of the SR.
- Take a portion of the incentives earned and pay bonuses to the operational personnel associated with exceeding the SR’s service levels, thereby significantly enhancing, if not ensuring, the day-to-day service delivery.

From an SR perspective, following these best practices increases the likelihood of the incentives being accepted within the SR organization. However, challenges to incentive payments may cause the SR political and business unrest and may cause the SR to lose focus on the business goals.

Implementing an incentive program based on the above-described best practices should produce an ESP delivery team striving to exceed the contracted service levels. In addition, the ESP senior management team will recognize the incentives' direct impact on the bottom line, providing a clear and compelling motivation to aggressively work toward exceeding the contracted service levels. At the same time, the SR will be happy to pay the incentives because it knows that, by doing so, it is realizing extra business benefits.

4.1.1 Common Types

To drive the behavior of the ESP toward performance enhancement or cost reduction, the SR should use incentives. Performance enhancement is defined as the ESP providing greater than required service, thereby allowing the SR to perform its business functions at a higher level. Cost reduction is defined as the ESP reducing the cost of service delivery through continuous-improvement processes, with the two parties sharing the resulting savings. This type of performance enhancement is often referred to as "gain sharing."

4.1.2 Common Mentality

SRs look at incentives, more often than not, as a way to appease ESPs that balk at the notion of being penalized without being able to seek a like reward. In addition, ESPs look at incentives as a way of receiving "equal treatment" based on the logic that, "If the SR wants to penalize me for not meeting service levels, then it should also reward me for exceeding these levels."

Unfortunately, both approaches are wrong. As stated earlier, incentives should be used to by SRs to drive ESP behavior in a business atmosphere where the SR seeks to gain a competitive advantage or improve business productivity. ESPs should execute contracts with service levels that they have pledged to meet with full knowledge of the requirements.

SRs risk seeing the costs for the contract exceed the predicted budget when incentives are paid. Therefore, SRs are advised that incentives should be paid only on those items that can be determined to provide more value than the incentive paid. In addition, SRs that follow best practices will include clauses in their outsourcing contracts that permit service levels to be adjusted over time as their business requirements dictate. This will have the impact of raising or lowering the objectives for the ESP and, thus, may affect the incentive payments and keep the SR business objectives and service levels aligned.

The key to incentives is that an ESP’s team will be highly motivated by even a modest additional profit. Therefore, an incentive payment will be a strong motivation for the ESP to deliver results above the required service levels.
4.1.3 Incentive Examples

Examples of service level incentives in various industries include:

- **Manufacturing**
  - A production line is supported by IT, and one of the service levels requires availability of the hardware and software running the line to be at 99 percent.
  - The cost of the service provided is $500 per month.
  - To meet business expectations, the manufacturing line needs to produce 500 widgets. If this goal is met (but not exceeded), the IT services provided will cost $1 per widget produced.
  - The ESP is penalized 10 percent for not achieving the 99 percent availability.
  - The ESP wants an incentive payment equal to 10 percent ($50) for exceeding the availability service level for the month.
  - Scenario 1: If the line is able to produce at least 51 more widgets with an availability greater than 99 percent, it creates a lower cost per widget; therefore, the incentive payment is justified.
  - Scenario 2: If the ability to produce more widgets is 50 or less, then the incentive causes the cost of widget production to remain the same or increase; therefore, the incentive is not justified.

- **Financial**
  - A financial-processing function is supported by IT, and one of the service levels requires the availability of the hardware and software running the system to be at 99 percent.
  - The cost of the service provided is $50,000 per month.
  - To meet business expectations, the financial-processing function must process 25,000 transactions per month. At this level, the cost of the IT services provided works out to $2 per transaction.
  - The ESP wants an incentive payment equal to 10 percent, or $5,000, for exceeding the availability service level.
  - Scenario 1: If the financial-processing function is able to process at least 2,501 more transactions with an availability greater than 99 percent, this will create a cost per transaction of less than $2; therefore, the incentive payment is justified.
  - Scenario 2: If the number of additional transactions enabled by the higher availability amounts to 2,500 or fewer, the incentive causes the cost per transaction to equal or exceed $2; therefore, the incentive is not justified.

4.2 Penalty Key Factors

Although penalties are not a popular portion of any contract, they are required for the contract to be an effective tool for the SR to manage the relationship.

Knowledgeable SRs know that ESPs have reduced their margins on outsourcing contracts during the past five years due to increased competition, a user base that better understands the intricacies of outsourcing.
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deals, and the maturity of technical capabilities and business processes. The result is lower profit margins on recent outsourcing contracts, making ESPs sensitive to losing money through penalties.

Therefore, SRs should:

- Utilize penalties judiciously by not always invoking them on the first occurrence of failure to meet the contracted service level. Instead, some penalties may be invoked only after working with the ESP and examining the ESP's corrective actions to determine that no progress has been made toward ensuring the problem is corrected and that the service levels will be met or exceeded.

- Set penalties at the right level to drive the behavior of the ESP without harming the relationship with the ESP beyond repair.

- Include penalties in the contract in a form that is a financial subtraction from the scheduled payment to the ESP.

- Not allow penalties to be in the form of additional service credits, which are defined as credits toward receiving more services.

At the same time, ESPs should:

- Accept reasonable penalties.

- Reject penalties that exceed profit and deter the ESP from working toward meeting or exceeding the contracted service levels.

Implementing a penalty program based on the above-described best practices should provide incentives to the ESP to meet the contracted service levels to maintain its profit margin and, hopefully, earn extra business as well as a renewal to the established contract. The ESP delivery team will strive to meet or exceed the contracted service levels to avoid the penalties. The ESP senior management will recognize the penalty's impact on the bottom line, which is a clear and compelling reason to aggressively seek to meet or exceed the contracted service levels. In addition, SRs will be happy to make a full payment with no fee reductions incurred due to penalties, because they know the service provided will allow them to meet their minimum business objectives.

4.2.1 Common Types

SRs should consider using two forms of penalties, each designed to drive a distinctive behavior. First, there are penalties invoked that provide for a fee reduction in scheduled payments when service levels are not met. Second, there are penalties that provide for a payment by the ESP to be invoked when failure by the ESP causes actual financial losses to the user's business. It is important to note that the fee reduction penalty takes the form of a reduction in the amount paid for the service in the measurement period during which the service level was not met.

- The first type of penalty — where the ESP does not meet a service level — is varied in its delivery, but the key characteristic is that it must act as a powerful behavioral motivator for the ESP to meet its service delivery requirements.

- The latter case is usually referred to as "contingent liability." Because contingent liability is used in many contracts — IT-related and non-IT-related — the penalty type, amount and the associated language is generally consistent. This is usually addressed in the "limits of liability" clause within the contract and the amount is driven by the business impact on the SR. The SR and ESP legal counsel normally negotiates this type of penalty.
As for the more typical service penalty, knowledgeable SRs know that many ESPs have reduced their margins on outsourcing contracts during the past five years due to increased competition and better-informed enterprises. This means that the ESPs are experiencing lower profit margins, making them sensitive to losing money through penalties.

Therefore, if the penalty is set too low, it may not act as a motivator. If it is too high, the possibility exists that the ESP will lose its profit, and it will cut into its fixed cost to deliver the service. Hence, the ESP will have little motivation to invest in the current deal. Therefore, penalties must be set to impact only a portion of the ESP’s profit. This amount is typically 10 percent to 20 percent of the charge associated with the under-performed service for the measurement period.

4.2.2 Common Mentality

SR IT personnel frequently have a strong business relationship with ESP relationship management staff. Because of this strong relationship, the SR is often reluctant to raise the penalty topic. This reluctance by the SR often leads to insignificant penalties or — worse — no penalties.

ESPs, on the other hand, have a simple, straightforward strategy. They attempt to reduce their risk by avoiding penalties, particularly when no incentives are available to offset them. This approach is not meant to slight the SR requirements. ESPs look at penalty avoidance as a way to enhance their position in the relationship and protect their bottom line. Unfortunately, the lack of penalties quite frequently does just the opposite: it puts the ESP in an adversarial position with the SR and — in the long term — frequently causes more problems than it solves.

The fact is, penalties play an important role in ensuring a successful relationship for both SRs and ESPs. When they are well-designed, penalties protect the SR from under-performance and help drive ESP behavior toward meeting the contracted service levels.

4.2.3 Penalty Examples

Examples of penalties in various industries include:

- **Financial**
  - A financial-processing function is supported by IT, and one of the service levels requires the availability of the hardware and software running the system to be at 99 percent.
  - The cost of the service provided is $50,000 per month.
  - To meet business expectations, the financial-processing function must process 25,000 transactions, which works out to a cost of $2 per transaction for the IT services provided.
  - The ESP is penalized 10 percent or $5,000 for not achieving the 99 percent availability.

- **Help desk**
  - Three key factors measure the help desk: average speed of answer at 30 seconds, first call resolution at 75 percent and call abandonment rate of less than 3 percent.
  - The SR has 3,500 help desk users.
  - Each user is charged $25 per month for a total monthly charge of $87,500.
  - If any of the service levels is not met, a penalty in the form of a fee reduction of $13,125 (15 percent of the monthly charge) is invoked.
4.3 Other Penalty Considerations

Occasionally, SRs and their ESPs set additional contractual factors related to penalties. They include "earn-back" opportunities and incremental penalties.

Either or both approaches are fine to use in a contractual relationship, as they achieve the desired result of driving the behavior of the ESP to perform at or above the required level of service. However, it is important to remember that no amount of penalty will compensate for an unsatisfactory level of service.

4.3.1 Earn-Back Definition

Sometimes, SRs will allow ESPs to regain or "earn back" previously invoked penalty amounts. If the ESP improves and meets the service delivery requirements for several consecutive months, some or the entire penalty amount can be restored. This generally occurs during the next several measurement periods.

4.3.2 Earn-Back Example

An example of earn-back is:

- For critical desktop systems, the break/fix resolution service level is set to four hours with a 95-percent-of-the-time achievement rate. It is set to eight hours, with an achievement rate of 92 percent, for other desktop systems.
- The measurement period is monthly.
- The SR has 3,500 desktops.
- Each user is charged $15 per month for a total monthly charge of $52,500 per month.
- The service level is not met, and a penalty in the form of a fee reduction of $5,250 or 10 percent of the monthly charge is invoked.
- During the subsequent three months, the service levels are met.
- Then, during the next three months, the original penalty amount of $5,250 is paid to the service provider at $1,750 per month.

4.3.3 Incremental-Penalty Definition

If the ESP does not improve and continues to fail to meet service targets, the SR will charge incrementally higher penalties or be able to terminate the contract and seek another ESP, with the current ESP paying the transition costs for the multiple failures.

4.3.4 Incremental-Penalty Example

The following provides an example of the application of an incremental penalty:

- Priority 1 — mission-critical impact — multiple users down
- The service level is set at two-hour resolution 96 percent of the time.
- The measurement period is monthly.
- The SR has 400 servers and 100 desktops covered under the mission-critical service level.
- Each server is charged $500 per month, and each desktop is charged $30 per month for a total monthly charge of $203,000 per month.
In the first month that the service level is not met, a penalty in the form of a fee reduction of $20,300 (10 percent of the monthly charge) is invoked.

In the second month that the service level is not met, a penalty in the form of a fee reduction of $30,450 (15 percent of the monthly charge) is invoked.

In the third month that the service level is not met, a penalty in the form of a fee reduction of $40,600 (20 percent of the monthly charge) is invoked.

After any failure month, if the service level is met the following month, the next time the service level is not met it reverts back to the first penalty or 10 percent.

4.4 Are Incentives and Penalties Effective?

An outsourcing contract without penalties is an outsourcing contract with no effective way of driving the ESP’s behavior and enforcing the service delivery requirements. Such contracts have no way of ensuring the deal’s success.

Used properly, incentives and penalties are very effective, and the outcome of their use produces a positive relationship between the SR and its ESP. Used incorrectly, however, incentives and penalties can cause significant relationship problems, including financial loss, diminished confidence and trust, and, ultimately, the demise of the relationship.

5.0 How Do Enterprises Build a Business Case?

The evidence used in support of the business case depends on the type of relationship the organization intends to have with the ESP (see Figure 1).

That relationship type then leads, at least in part, to the required service levels and corresponding incentives or penalties (see Figure 2).
Table 1: Contract Clauses

<table>
<thead>
<tr>
<th>Contract</th>
<th>Vendor risk</th>
<th>User risk</th>
<th>Metrics</th>
<th>Metrics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost plus</td>
<td>Low</td>
<td>Medium</td>
<td>Deliverables and service-level agreements</td>
<td>Actual cost + fees</td>
</tr>
<tr>
<td>Time and materials</td>
<td>Low</td>
<td>Medium</td>
<td>Deliverables</td>
<td>Fixed rate per day/hour/month</td>
</tr>
<tr>
<td>Fee for service</td>
<td>Medium</td>
<td>Medium</td>
<td>Service-level agreements</td>
<td>Rate per transaction</td>
</tr>
<tr>
<td>Fixed price</td>
<td>High</td>
<td>Low</td>
<td>Deliverables and time</td>
<td>Fixed rate</td>
</tr>
<tr>
<td>Gain share</td>
<td>Medium</td>
<td>Medium</td>
<td>Service-level agreements or deliverables and time</td>
<td>Fixed rate + percent of $ gain</td>
</tr>
<tr>
<td>Shared risk/reward</td>
<td>High</td>
<td>High</td>
<td>Service-level agreements and business benefits</td>
<td>Fixed rate + percent of $ gain</td>
</tr>
<tr>
<td>Business-benefit-based</td>
<td>High</td>
<td>Medium</td>
<td>Business metrics</td>
<td>Percent of profit or revenue</td>
</tr>
</tbody>
</table>

Source: Gartner Research

Figure 2: Defining the Deal Type

Because the overall relationship will, in part, be governed by the contract, Gartner advises enterprises to insert the business case incentive-and-penalty scenarios into the contract as clauses and link them to the management processes. Utilizing this methodology — wherein the contracted service levels include penalties or incentives, which are linked to relationship management governance — will result in a more productive deal for both the SR and ESP.

6.0 Determining What Contract Clauses Enterprises Should Use and How to Use Them

Incentives and penalties form an integral part of the critical terms and conditions that underpin the success of an outsourcing relationship. Large-scale outsourcing agreements are structured with specified performance measurement, incentive and penalty mechanisms. The ESP is given an incentive to meet critical transition and capability milestones. The contract clauses must include the scope of work, service-level performance, price and associated incentive fees.

6.1 Penalties as a Contingent Liability

When service exceptions become a threat to an enterprise’s business, penalties must take on another characteristic. They must go beyond the failure to deliver a penalty and must be of a substantial nature to quickly get the ESP's attention. The amount is often a factor of "X" times the amount of harm done. This strongly reinforces, to the ESP, the urgency to fix the problem. The depth or time limit factors do not apply to this type of penalty, as the need to fix the problem is immediate. Failure to fix this type of problem immediately is often followed by contract termination, including the transition costs to the new service.

6.2 Contract Clauses

As discussed previously, penalty clauses are required elements of the successful outsourcing contract. Financial penalties are necessary to reinforce the ESP’s commitment to meeting the contracted service levels. ESPs have a greater incentive to respond in a timely manner to services that are tied to performance penalties than to those without such penalties.

For enterprises to enforce penalties or damage clauses, all the rules, processes and procedures must be defined in the contract, and the SR and ESP must follow the defined service levels and associated penalties or incentives (see Figure 3). To get the ESP to pay a penalty for a service exception:
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- The problem must be detected and properly communicated.
- The problem management and escalation procedures need to be activated in a timely manner.
- The root-cause analysis process must be completed, demonstrating that the enterprise is not responsible.
- The application of exception clauses must be excluded.
- Formal communication must be issued and accepted.

When negotiating penalty or incentive clauses, SRs and ESPs need to focus on:

- The definition and the measurement of service faults that can trigger penalties
- How the penalty must be computed, communicated and paid
- The overall process that starts with one or more service violation and ends with a penalty accepted by the provider (that is, service level, service management process and contract)
- The overall processes that span multiple violations and penalties until a contract breach and, if appropriate, a damage request results

Source: Gartner Research

Figure 3. Master Terms and Conditions
6.3 Definitions

Language varies from contract to contract. Therefore, several key factors need to be identified and defined to maintain a consistent methodology from deal to deal. The following definitions apply to incentives and penalties.

- **Consideration amount**: This term refers to the dollar amount of the estimated service charge for the measurement interval.

- **Service underperformance**: This occurs when the service provider fails to meet any of the stated service levels or critical milestones defined in the contract. This would apply to penalties only.

- **Service overperformance**: A occurs when the service provider exceeds any of the stated service levels or critical milestones defined in the contract. This would apply to incentives only.

- **Calculation number**: This is the factor used for the purposes of calculating a fee result. The calculation number is the number of months in the applicable contract year within which the ESP has committed to complete its performance obligations with respect to a specific service level.

- **Measurement interval**: This is the period in which a given service level is measured (for example, one month or one year). The measurement interval for each service level commences on the SLA compliance date.

- **Weighting factor**: For any service level, this factor is applied to the consideration amount for the purposes of calculating the fee result during a given measurement interval. The total of the weighting factors for a period should equal 100 percent.

- **Fee result**: The fee reduction for any service underperformance or overperformance is calculated using a specific formula (see Figure 4). It is important to note that these fee results are intended to reflect the increased or diminished value of the service provided. Fee results do not constitute incentives or penalties but, rather, are intended to equate the fee for services to that level of service provided.

\[
\frac{\text{Consideration Amount} \times \text{Weighting Factor}}{\text{No. of Service Underperformance/Overperformance Months}} = \text{Fee Result}
\]

Source: Gartner Research

**Figure 4. Fee Result Formula**

7.0 Risk Scenarios

There are certain risks that can easily lead to disharmony in any outsourcing relationship. Gartner presents eight key risk scenarios and the actions to mitigate those risks.

**Scenario 1: The transition phase.** The ESP seeks leniency during the transition phase with the result that, 12 months into the contract, the enterprise has invoked no penalty clauses. To mitigate the risk, enterprises should provide for a gradual implementation of service levels and the associated penalties during the first three to six months of the contract. This gradual implementation schedule must be a part of the contract. The result is a fair and balanced approach to the implementation and, at the same time, provides for early successes that will be communicated to all employees for both parties and thereby provide momentum to the deal.
Scenario 2: Service-level average masks underperformance. The ESP underperforms for half the month but overperforms for the rest, thus meeting the SLA. To mitigate this risk, enterprises should understand their business requirements and set SLAs to fit them. Averages must never be used in the calculation and measurement of service levels. Enterprises must remember that a service level should be set at a certain level to be met for each activity or transaction. The example below amplifies the "no-average" approach:

- Desktop break/fix resolution is set at four hours.
- The achievement of the service level is 95 percent of the time.
- This results in 95 out of every 100 activities being completed within four hours.
- 100 activities take place in the measurement period.
- 90 are completed in two hours, and 10 are completed in 10 hours.
- This would result in a 90 percent achievement against the four hours.
- However, if an enterprise uses averages, the result would be: (90 x 2 = 180) + (10 x 10 = 100) = 280 hours, or an average of 2.8 hours per transaction. This would then meet the service level of four hours per transaction.
- In addition, if an incentive was in place for overachievement, the incentive would be paid — further exacerbating the issue.

Scenario 3: Component service levels. The enterprise sets separate service levels and penalties for the server, network, LAN and associated desktops. Measuring each individual component availability at 99.5 percent could result in a 98 percent or less availability of the key applications without penalty. To mitigate the risk, wherever possible, enterprises should use end-to-end service levels and corresponding penalties. Enterprises must recognize that SLAs must be enforceable if they are to have meaning.

Scenario 4: Avoiding damaging the relationship. The ESP admits that it has not met some service levels but seeks leniency because it has faced skill shortages and bad luck, while the enterprise has suffered no real cost increases or performance underruns. To mitigate this risk, enterprises must write SLAs that adjust fees for actual performance and employ an approach of "working toward the common good" by allowing for a stepped implementation of the penalties.

Scenario 5: Penalties are less expensive for ESP. The ESP finds that meeting the SLA requires additional resources but declines to do so, opting to pay the penalty instead. Mitigating this risk requires that enterprises ensure that the cost of the penalties to the ESP reflects the business costs to the enterprise from the ESP’s nonperformance. Enterprises should escalate penalties for repeated underperformance in consecutive months and have the right to terminate the agreement for nonperformance.

Scenario 6: Fixed or capped penalties. Poor performance in the first week of a month-long measurement period results in the ESP reaching the maximum penalty payable for that service level. Therefore, the ESP now has no incentive to perform for the balance of the month. To mitigate this risk, enterprises should write penalty clauses that provide for increased penalties commensurate with the performance or lack thereof.

Scenario 7: Incentives higher than value received. The ESP discovers that it can easily exceed service levels in one area, thereby picking up credits that offset the penalty in another area where it
underperforms. To mitigate this risk, enterprises should use incentives only when they are clearly tied to business value, and the value received exceeds the incentive paid.

**Scenario 8: No service levels during implementation.** The SR and ESP enter into an agreement and decide service levels are "to be determined" (TBD) during the implementation phase of the deal — leaving the ESP with no performance incentives during this period. To mitigate this risk, service levels should be set for the implementation phase and changed as required. A contract should not be signed with service levels that are TBD.

### 8.0 Measuring ESP Performance

There are two keys to successfully measuring the performance of an ESP. First, enterprises must have a baseline statement of work (SOW), including the requisite service levels, and know all the costs associated with performing the SOW at the requisite service levels. Second, enterprises must have effective SLAs established at the commencement of the contract. Highly effective SLAs have the following six key characteristics:

- Meet minimum user business requirements and expectations
- Are defined by function, service type and locale
- Use benchmarks at the beginning of the deal as the starting point, and at regular intervals during the deal
- Specify penalties and incentives in the contract
- Are monitored by reports and tracking tools
- Can be adjusted as required to meet the SR's business requirements

It is important for SRs and ESPs to understand the appropriate roles and responsibilities involved in measuring an outsourcing deal:

- SRs should be responsible for defining the service levels and auditing the reported results.
- ESPs should be responsible for measuring, reporting and improving any deficiencies.

### 9.0 Conclusion

Successful ongoing relationships are based on open and consistent communication of the enterprise requirements throughout the life of the contract. To accomplish this, an effective outsourcing agreement must clearly define the scope of the services that the ESP will deliver and the associated service levels.

A balanced outsourcing contract implies that the level of service received will help determine the fees actually paid to the outsourcer. Nevertheless, many enterprises find it difficult to define the right penalty or service credit formula to apply to the service level. To develop SLAs that include effective penalties and incentives, an enterprise should remember the fundamental purpose of the SLAs — to further the enterprise's business goals.

As an integral part of the outsourcing contract, an SLA specifies the precise levels of service required. However, many enterprises entering outsourcing agreements have never developed internal service-level standards and gauge the ESP's performance based on whether it seems to have given the outsourcing agreement its best effort.
To begin with, in outsourcing contracts, enterprises should turn implicit SLAs into explicit SLAs. In most cases, penalties or service credits provide a required safeguard to drive the appropriate ESP behavior and ensure that the SLAs are met. However, poor SLAs and ill-considered penalty clauses can drive the wrong behaviors.

A myriad of circumstances can arise in operating environments. Ultimately, SLAs that seem adequate, even strict, when written may not support the enterprise’s business needs. In applying penalties to SLAs, enterprises often stumble into one of several pitfalls.

Consequently, SRs must focus on business value keys, achieve enterprisewide recognition of incentives and penalties, measure only those items that provide value to the assessment and management process, and implement service levels over time. These steps will ensure that SLAs are enforceable through penalties and provide incentives for performance beyond the required level of service where a value greater than the incentive is verifiable. Ultimately, this significantly enhances the deal and ensures a successful relationship.
Appendix A: Acronym Key

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
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<tbody>
<tr>
<td>ESP</td>
<td>external service provider</td>
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<tr>
<td>IT</td>
<td>information technology</td>
</tr>
<tr>
<td>LAN</td>
<td>local-area network</td>
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<tr>
<td>SLA</td>
<td>service-level agreement</td>
</tr>
<tr>
<td>SOW</td>
<td>statement of work</td>
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<tr>
<td>SR</td>
<td>service recipient</td>
</tr>
<tr>
<td>TBD</td>
<td>to be determined</td>
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