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Getting the Most Out of Your SLAs

(Part II in a Series)

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This is the second installment of a two-part *Executive Update* series on structuring service-level agreements (SLAs). Part I (Vol. 4, No. 9) discussed service-level components; here I examine the penalties and bonuses associated with service levels and how to use different methods to structure them based on the type of SLA in place. I also discuss the "at-risk" amounts for service levels that should be defined in the service provider contract.

AT-RISK AMOUNT

All contracts include an at-risk penalty amount for the service provider. This limits the overall penalty that the provider might be required to pay if it does not meet the service-level targets specified in the SLA. This amount is usually based on a percentage of the provider's monthly charges (15%, for example). After you and the service provider define your SLAs, you must assign dollar-amount penalties to each, using either an exact dollar amount or a percentage. But the total dollars that you allocate among all your SLAs should be larger than your at-risk amount, otherwise you won't have enough at-risk dollars for the SLAs. For example, if your total monthly at-risk amount is $1 million and you have 20 SLAs, dividing this amount among the SLAs would give you only $50,000 per SLA (with dollars split evenly). In most cases, that amount wouldn't be enough. So you should structure penalty pool amounts to be at least 200% of the at-risk dollars. Using the previous example, therefore, you would have $3 million available penalty dollars; if you split this amount evenly among SLAs, each SLA would have $150,000. This would ensure that you have enough at-risk dollars for each SLA while still limiting the total at-risk payout to X% of monthly charges. While it is unusual for a service provider to fail multiple SLAs at the same time, you must ensure that when a provider does fail, you have an appropriate penalty in place. Of course, if the service provider falls short on many SLAs, you must incorporate language into your contract that allows you to terminate the contract with the service provider "for cause."

In my experience, the best way to allocate the dollars among the various SLAs is first to divide chunks of the penalty pool among different metric categories (e.g., cost, quality, customer satisfaction) based on their business impact and the type of behavior you are trying to foster from the service provider. After you split this pool, divide the percentage amount in each category among the individual SLAs that fall within that category. For example, if you assign 30% of the overall penalty pool to quality, you must split the 30% among those parts of the SLAs that address quality issues (e.g., defects and availability). If you then assign 40% to cost, you would split the 40% among portions of the SLAs that address cost (e.g., development and maintenance costs). Then you can put the remaining 30% toward customer satisfaction activities.

PENALTY STRUCTURE

There are many ways to structure penalties. The following are several methods that I have found useful.

Exact Dollar Amount

This is a good method to use when an SLA has only one component and can be evaluated as one entity (e.g., on-time delivery of enhancements or customer satisfaction).

"Feathered-Penalty" Amount

This is a good method to use when an SLA has no other components and where missing target service levels by various percentages causes different levels of business impact. For example, we (At&T) have used this method for system availability and assembled a penalty structure much like that illustrated in Table 1, based on an agreed-upon target with the service provider.

So if the provider's service-level results were off by 5% from the specified target, the provider would be penalized 17% of $150,000 (using the penalty amounts detailed above in the at-risk amount paragraph).

"One Service-Level Miss, Two Service-Level Miss" Concept

This is a good method to use when you have an SLA with many components for which you don't want to assign specific dollar amounts. This concept is sometimes referred to as the "nested SLA." For example, we have used this for assessing deliverables (such as data files that must be sent from one system to another or an external source for processing). We have one SLA category of critical deliverables, which may include 10 different deliverables (e.g., provisioning or bill payment files sent on time), with each deliverable having a service-level target. As illustrated in Table 2, this method can, for example, assesses a penalty for one service-level miss (35%), a higher penalty for two service-level misses (65%), and 100% of the established SLA penalty for three service-level misses. Of course, you can define a structure with as many misses as appropriate for the category.

"One Service-Level Miss, Two Service-Level Miss" Concept and Feathered-Penalty Amount

This is a combination category in which you have multiple components of an SLA, but the impact of each differs by the extent to which the provider has missed the target. For example, if you have two items in a category in which each has a separate target, you can establish a feathered-penalty amount if one target is missed by X% or if two targets are missed by X% (see Table 3).

Table 1 — Dollar-Amount Penalty Structure

Deviation from Target	Penalty Assessed
2% or less	8%
5% or less	17%
10% or less	25%
20% or less	50%
30% or less	75%
30% or more	100%

Table 2 — Feathered-Penalty Amount Structure

Service-Level Miss	Penalty Assessed
One miss	35%
Two misses	65%
Three or more misses	100%

Table 3 — Combination Penalty Structure

Service-Level Miss	Deviation from Target	Penalty Assessed
One miss	10% or less	12.5%
One miss	20% or less	25%
One miss	20% or more	50%
Two misses	10% or less	25%
Two misses	20% or less	50%
Two misses	20% or more	100%

In this method, if one service-level result was off by 20% from the target, the provider would be penalized 25% of $150,000. If two service-level results were 10% off, the provider would be penalized 25% of $150,000.

BONUSES

Not every contract includes a bonus. Having a bonus depends on the nature of the contract. Many business process outsourcing (BPO) contracts contain them, while most strictly IT contracts do not. (Why? BPO contracts are usually tied to business results, such as increased sales, and bonuses are established for increased business results. Meanwhile, IT contracts have been established mainly for cost and process control and are not as closely coupled with business results.) Before you award a bonus, ensure that you can validate the data the supplier gives you in its effort to seek the bonus. Also, ensure that you establish bonuses only for items from which you will achieve business benefit, not just for routine activities that you expect the service provider to perform. And provide a bonus only if the service provider exceeds the target. Your established targets also should be aggressive and not easily attainable. You also might want to join several service levels together here, and provide a bonus only if all metric targets are exceeded. Additionally, you can structure a bonus so that you pay a certain percentage based on the amount that exceeds the target that the supplier achieves. So the higher an amount exceeds a target, the higher the bonus.

SUMMARY

There are many ways to structure penalties with your suppliers. With certain types of service levels, some methods are more beneficial because they allow you to assign a higher penalty amount if a service level is missed. Others give you flexibility in feathering your penalties if the service level is missed by only a small amount. Be creative in your approach and maximize the use of penalty dollars across your SLAs. I have used all the above methods with providers and have chosen the appropriate method according to the type and number of SLAs.

ABOUT THE AUTHOR

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