Managing Provider Performance in IT Services Transactions

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In any services contract, one of the buyer's critical concerns is that the vendor perform at the level of quality promised.

To this end, contracts for technology services should include clear performance requirements, procedures for accurately measuring the vendor's performance, and mechanisms to encourage compliance. The specific incentive structure will vary based on the services, but in each case it should be focused on the output (rather than the input) expected from the vendor.

Many services occur only once during the life of the contract, such as completion of transition or implementation of a new software product. The final output is timely, accurate and complete transition or implementation.

To motivate vendors to perform on time, buyers have a number of options. One is to make payment contingent on the vendor's completion of the project or certain interim milestones.

Buyers can provide additional motivation by insisting on credits if the vendor does not meet a milestone, and these credits can be structured to increase progressively based on the length of time the vendor remains delinquent. Over time, we have found that insisting on credits for late delivery does a better job of forcing vendors to be more realistic in establishing or agreeing to transition milestones.

Finally, buyers can also reserve the right to terminate the contract if the vendor fails to meet certain milestones within a specified time. This provides buyers with certainty regarding their termination rights, as it relieves them of the obligation to prove material breach, which is a high standard in a long-term agreement.

Other services, such as website hosting or call center support, are provided over the life of a contract. Buyers can encourage vendors to meet the performance requirements for these recurring services by including "service levels" in the contract.

Unlike warranties, such as a vendor will perform the services "on time and in a professional manner," service levels provide quantifiable measures of vendor performance. For example, if a retailer outsources hosting and management of its customer-facing e-commerce site, it will lose sales when the site is down. This makes it imperative that the site is "available" to potential customers on a 24/7 basis. To address this performance need, the retailer could include a service level specifying that the solution be available 99.8 percent of the time.

When establishing service levels, buyers should keep certain guidelines in mind. Service levels should focus on the vendor's output, rather than the effort or resources used in providing the services. Additionally, buyers should limit the number of service levels to those governing critical performance requirements; a large number of service levels dilutes the effectiveness of each service level. Finally, avoid double-dipping—using multiple service levels to cover the interim steps necessary to produce the final output.

Determining individual service levels involves a different set of considerations. As a rule of thumb, the buyer should not accept a level of service lower than its own performance. If the buyer does not know its current level of performance, the buyer should try to measure it to create a baseline for negotiation.

If this is not feasible, then there is a wealth of information available for free online and from various trade associations, and consultants can also be quite helpful. Also, buyers should generally avoid using a vendor's form service levels, as vendors usually propose service levels that are easy to meet.

Finally, if a vendor is meeting the specified service levels, and the buyer is still unhappy with the vendor's performance, then this is evidence that the service levels are measuring the wrong things, set too low, or being measured improperly.

When reviewing or preparing service levels, pay attention to the details. Seemingly unimportant content can affect a service level's effectiveness. For example, consider the impact of these various definitions of "unavailable":

- the period of time during an outage, beginning when the buyer reports the outage or at a specified time after the outage commences (instead of measuring the full time of the outage), or
- the period of time during which all material functionality of a solution is down (instead of the period when any material functionality of the solution is down).

When a vendor misses a service level, the buyer should receive a credit against the fees, along with a root cause analysis describing the reason for the failure and the actions to be taken by the vendor to demonstrate that the problem will not reoccur. The service level credits induce better behavior and allow buyers to collect for poor service without having to bring litigation or prove damages.

Buyers should usually avoid describing these credits as liquidated damages and never describe them as penalties, as some case law holds that liquidated damages are a party's sole remedy for a breach, while contractual penalties are unenforceable. Rather, service level credits are often framed as reductions in price reflecting the decreased value of the services due to the vendor's poor performance.

Service level credits should be large enough to motivate the agreed-upon performance. Buyers can also employ several other mechanisms to enhance the value of the service levels.

Buyers can structure the service level credits to increase each consecutive month that the vendor misses the same service level. The monthly service level credit can increase based on the degree by which the vendor misses the targeted level of performance.

Buyers can also obtain the right to reallocate credits among the various service levels periodically. For example, if the buyer is satisfied with the solution's availability, but the vendor is consistently missing a service level regarding call center performance, the buyer could reallocate a portion of the "availability" credit to the call center credit, thus increasing the vendor's incentive to improve the performance of its call center.

In order to enforce compliance with the service levels, buyers must be able to monitor the vendor's performance. Thus, buyers should require that vendors provide periodic reports showing the vendor's performance against the service levels and should require the vendor to provide raw performance data. To provide further oversight, contracts should include broad rights for buyers to audit vendor compliance.

Each of the topics addressed above has many nuances, and the general discussion in this article only scratches the surface of the issues involved and the options available in structuring service levels.

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