

# Services and service levels

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## 1. Introduction

The services schedule and service levels schedule form two parts of what is often referred to as the 'Holy Trinity' in any outsourcing arrangement (the third limb being the charges schedule); they are crucial to the engagement between customer and service provider in that they are the basis for determining what will be provided, and to what level of ongoing quality/service delivery.

However, legal advisers often overlook or neglect the services description in particular as being not legal in nature or not as important as the front-end terms and conditions. As such, the schedule can frequently be left to the business or commercial teams to complete, even though these teams may have had limited experience of contract preparation and drafting. The result can all too often amount to little more than a collection of bullet points, with hardly any context or underlying detail. While the customer and service provider representatives who noted all of this down at the time will no doubt have had this understanding in their heads and may have presumed that it was obvious, they may well move on and no longer be available to help with interpretation in future (and, in any event, may turn out to have different recollections, once disputes as to scope arise in future and money and/or sanctions for alleged non-performance are at stake).

Accordingly, any negotiator and drafter of an outsourcing contract should be at pains both to understand the scope and nature of the services that are to be captured in the services schedule and to be heavily involved in the drafting of it, and likewise to ensure that the service level schedule maps closely against it. The remainder of this chapter seeks to highlight the specific drafting issues to be considered in so doing.

## 2. The services schedule

### 2.1 Capturing the service requirements

It may be tempting to think that the process of describing the services to be outsourced would be easy. After all, surely the customer knows what services it wants to acquire, and the service provider knows what it is going to provide? The reality, however, is that the process is far more complex than might appear at first. Indeed, it is probably fair to say that the perfect outsourced service schedule has never yet been written, and probably never will be.

Let us illustrate the issue with a simple example whereby the outsourced service

is “to make a cup of tea”. This sounds straightforward enough – but is it really? Strictly speaking, to make a cup of tea all that is needed is to dip a tea bag for long enough into a cup of boiling water. However, most people might also expect the task of making/offering a cup of tea to include enquiring as to whether the recipient takes milk (and adding it if he does) and sugar (and again adding it – and stirring the spoon thereafter – if sugar is indeed required). To add a further level of complexity, does the recipient expect:

- full-fat, skimmed or semi-skimmed milk?
- sugar or artificial sweetener?
- Earl Grey tea or some other form (eg, peppermint)?

This does not even take into account cultural difference in interpretation (eg, in parts of the United States, tea would be expected to be served in iced form), how long the tea bag should be left to brew, or the vexed issue of whether the cup of tea should be accompanied by an offer of biscuits.

If such a simple task can involve so much complexity, imagine the potential for confusion or debate in the context of a major outsourcing engagement. Equally, the example above amply demonstrates how the potential differences of opinion can have an impact upon both time and cost (eg, in the fuller interpretation of scope in the tea example above, the service provider would also have been obliged to procure various different forms of both milk and sugar/sweeteners, all at its own additional cost).

It is essential, therefore, to take the time to set out the service descriptions as fully as possible. If external legal or sourcing advisory services have been engaged, it is possible or even likely that they will have detailed precedent service descriptions available for most of the standard forms of outsourced services (eg, regarding the operation of a service desk, the provision of application development and/or maintenance services, or the operation and maintenance of local/wide area networks), but it would be unwise to conclude that a precedent will ever be a perfect fit for an organisation's requirements. A lot of work will accordingly be required to adjust any such templates to fit with the particular circumstances and requirements of the individual project and client. This will inevitably be time consuming and can accordingly be a considerable drain on the subject-matter experts within the customer organisation, who will frequently have to juggle this with their day jobs. However, it will pay dividends not just during the negotiation of the contract, but also over the lifetime of the contract itself.

## 2.2 Prescriptive or descriptive?

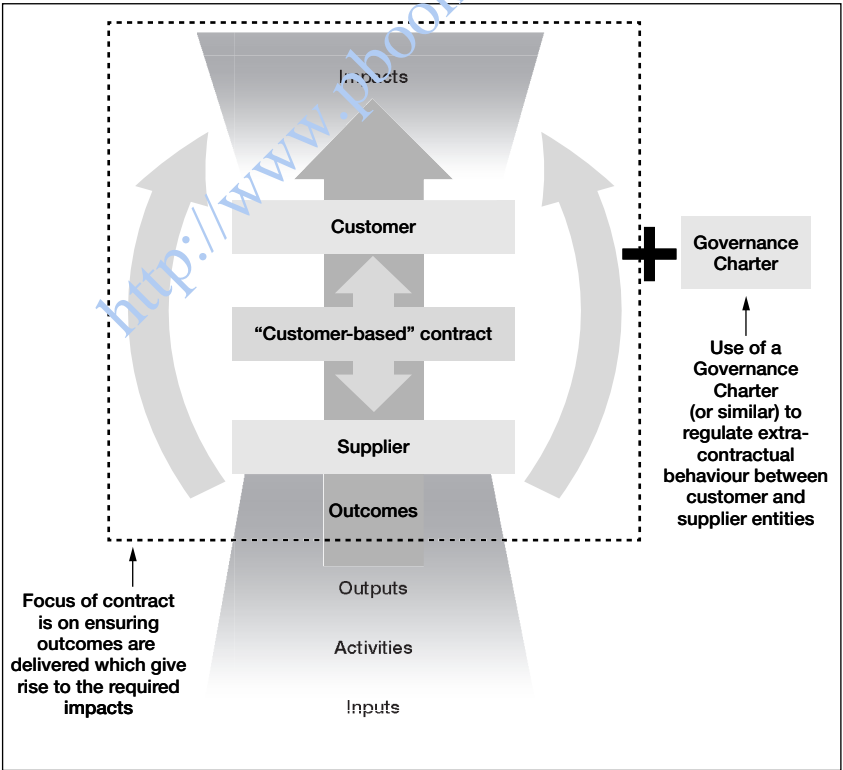
Initially, the description of services typically adopted high levels of prescription, mirroring the status quo of tasks and activities and reflecting a ‘command and control’ approach to outsourcing by customers. This is unsurprising, as early service providers confronted the need to establish the necessary levels of assurance as to their ability to perform at the required level, while customers naturally sought to minimise the impacts of outsourcing on the organisation.

The challenges in this approach are largely twofold. First, if one of the expected benefits of engaging an external service provider is to benefit from that service

provider's experience, knowledge and processes, the stipulation that the service provider mimics the existing organisation – or largely does so – defeats that purpose. Expected productivity gains will not follow and efficiency dividends may not arise as the service provider will charge for a tailored solution rather than apply the pricing of its standard service delivery model.

Second, the effort required to translate existing behaviours to contractual commitments is significant and rarely results in complete alignment, meaning either service overlaps (where the retained organisation and the external service provider consider that each is responsible for a particular task) or service gaps (where the retained organisation believes that the external service is responsible for a particular task, a belief with which the service provider disagrees).

One of the responses to these challenges was to adopt what is known as an 'outcomes-based' approach, focusing on what the customer's business outcomes are rather than the service inputs for which the service provider is responsible. Another way to look at this is not to prescript the 'how' but to describe the 'what'. This approach is reflected not only in terms of service descriptions, but also more broadly including service levels (eg, a service level based on end-user experience rather than a service level based on, say, the time within which documentation is required to be updated following changes in process) and the broader contractual commitments and governance regimes. Diagrammatically, an outcomes-based contract can be represented as:



However, an outcomes-based approach is not without its challenges: developing clear, cohesive and cogent outcomes is difficult. There is an inherent ambiguity in describing outcomes and attempts to do so often revert to high-level descriptions of outcomes that are then cloaked in what is perceived to be the safety and security of more detailed service inputs. In this case, all things in moderation is not necessarily a recipe for enduring success.

Further, where a true outcomes approach is ultimately implemented, the risk of interpretative differences in terms of outcome definition demands strong governance and relationship management, recognising the interdependence between customer and service provider.

There are also issues in determining whether outcomes have been achieved and, if so, the extent to which the achievement was a result of the service provider and/or other externalities.

The reality is that the precise approach to service definition will depend on the customer (including its retained organisation and internal corporate governance), the industry, the extent of regulatory oversight and direction, the services outsourced and the delivery model of the selected service provider. There is no 'one size fits all' solution in outsourced service description.

## 2.3 Example of a service description

Below is a description for a service agnostic document management service (ie, a necessary service but one that is complementary to a core service such as applications development or infrastructure management).

It adopts an outcomes-based approach, setting out a number of higher-level requirements and allowing the service provider, within these parameters and subject to other quality assurance requirements such as service levels and general quality warranties and commitments, to determine itself how to undertake the required task.

Annotations provide further explanation.

### 1.1. Description

The service provider is required to perform the Document Management Service. All the tasks, activities and processes set out in this Service Description must be performed as part of the Document Management Service.

Document Management means the tasks, activities and processes required to coordinate and control the flow of electronic and paper Documentation in a secure and efficient manner, and to ensure that the Documentation is accessible only to persons authorised by the customer as and when required. Without limitation, Document Management includes the following tasks, activities and processes: [This definition is intentionally not exclusive to minimise any arguments that the specific service requirements are strictly based on the following. This inclusive approach is a recurring theme throughout this clause as it applies to the tasks, activities and processes that the service provider is required to undertake. Further, the following could also be subject to greater definition; however, as this services description is prepared within the context of an

outcomes-based arrangement, it is intentionally not prescriptive in terms of all tasks, activities and processes]

- (a) Document storage;
- (b) Document retrieval;
- (c) Document processing;
- (d) Document printing;
- (e) Document routing and distribution;
- (f) release management;
- (g) version control; and
- (h) access control.

### 1.2. Outcomes

The service provider must achieve the following Outcomes for this Service: [The outcomes are intentionally broad in scope, though with specific details on key issues (eg, version control)]

- (a) Document Management is planned, communicated to customer and performance is measurable.
- (b) a centralised online library is implemented in accordance with the requirements of the agreement.
- (c) all Documentation may be quickly and efficiently retrieved as and when required.
- (d) the Document Management System in place enables effective collaboration between dispersed groups of users.
- (e) only personnel authorised by the customer are able to view, access, modify or destroy Documentation.
- (f) effective disaster recovery strategies are in place with respect to all Documentation.
- (g) Incidents of lost and damaged Documentation are minimised (and the service provider must take all reasonable steps to minimise such loss or damage).
- (h) only the latest version of a particular Document is available through the Document Management System by default, however superseded versions of Document are also readily available.
- (i) Documentation that is up to date, current and accurate.
- (j) the Document Management System ensures that customer's confidential material is at all times held in a manner that is confidential.

### 1.3. Supplier Responsibilities

The service provider responsibilities for this Service, which must be performed in accordance with the prevailing policies, standards and procedures of the customer in connection with document management [There is also an obligation to ensure that the customer's own policies, standards and procedures are observed. However, this raises a legitimate issue for the service provider – in the event of any change in customer's requirements, how is this communicated, and how is the

impact in terms of cost, service levels etc regulated? In the context of this agreement, a separate overriding clause exists to provide for the impacts of policy compliance requirements], include the following:

1.3.1. Document management system [Not only are specific requirements outlined, but also the underlying process for providing assurance that such requirements will be undertaken, in this case through a requirement to implement a system and, below, a requirement to implement a specific plan]

(a) implementing and operating a Document Management System that:

- (i) satisfies the requirements of the agreement with respect to data protection and confidentiality;
  - (ii) stores all Documentation in a secure and fail-safe environment;
  - (iii) organises and indexes Documentation to assist retrieval via indexes or other tools;
  - (iv) enables Document browsing and searching to facilitate Document retrieval via search tools;
  - (v) only enables access to Documentation by persons authorised by the customer; and
  - (vi) ensures Documentation is secure and unauthorised persons are prevented from viewing, modifying and destroying Documentation;
- (b) providing disaster recovery services for Documentation stored in the Document Management System to minimise disruption to delivery of any Outcomes or to the customer's business operations;
- (c) identifying which Documentation must be:
- (i) returned to the customer and any other supplier nominated by the customer after the agreement terminates or expires;
  - (ii) held confidential after the agreement terminates or expires; and
  - (iii) retained by the service provider after the agreement terminates or expires;
- (d) archiving Documentation to maximise performance or reduce cost by taking Documentation offline or through any other method after a defined period signed-off by the customer;
- (e) managing and enforcing version control, release control and Document traceability to ensure only current versions of Documentation are in use (other than where superseded versions of a Document are specifically requested or required);
- (f) tracking modification date and users of Documentation to provide transparency with respect to any changes to a Document; and
- (g) ensuring Documentation is managed under the guiding principles defined by the Knowledge Management Service.

1.3.2. Document Management Plan the service provider's personnel [There is a separate obligation that the plan is subject to a customer review and approval process (see below). There is, however, a balance to be struck – namely, the extent to which a customer acts as an approval body (with the potential absorption of risk as a result) and the confidence in the service

provider being able to regulate its own performance]

- (a) developing and accordingly documenting a Document Management Plan that:
  - (i) documents a Document Management System, including by detailing the process, tools and methods required by that Document Management System;
  - (ii) allocates to the service provider's personnel roles and responsibilities with respect to Document Management; and
  - (iii) sets out the manner and methodology by which the service provider's performance of Document Management Services may be measured; and
- (b) ensuring that all the service provider's personnel comply with the Document Management Plan; and

#### 1.3.3. Manage Documentation

- (a) developing and maintaining the Documentation contemplated by or specified in this Service Description and amended in accordance with the customer's requirements as contemplated by or set out in this Service Description;
- (b) providing access to and or copies of the Documentation as specified by the customer;
- (c) regularly reviewing and updating the Documentation as specified in this Service Description and the agreement;
- (d) amending the Documentation as reasonably requested by the customer;
- (e) conducting periodic audits (no less than monthly) to determine whether or not the Documentation under management is complete and current; and
- (f) returning, retaining and holding confidential Documentation in accordance with the Document Management Plan.

### 1.4. Customer Tasks

The customer's tasks are as follows for this Service: [A separate process exists where the service provider is able, subject to certain notification and mitigation obligations, to obtain relief in the event that the customer does not undertake a particular task that affects a service provider commitment]

#### 1.4.1. Document Management System

Signing-off on the Document Management System or otherwise providing feedback on the Document Management System to the service provider.

#### 1.4.2. Document Management Plan

Signing-off on the Document Management Plan and other Documentation related to Document Management Services or otherwise providing feedback on the Document Management Plan and such Documentation to the service provider.

#### 1.4.3. Manage Documentation

Signing-off on Documentation or otherwise providing feedback on such Documentation to the service provider.

### 1.5. Supplier Document Deliverables

In addition to any other requirements to provide Deliverables under a Contract, the service provider must deliver the following Document Deliverables for this Service:

#### 1.5.1. Supplier Document Deliverables

- (a) Document Management Plan which is substantially in the form set out in the relevant customer policy or standard (where available) or as agreed with the customer and which otherwise meets the requirements for this Document Deliverable contemplated by or set out in this Service Description.
- (b) A report which lists all current versions of all Documentation under Document Management. The report must contain the following fields:
  - (i) Document Identifier (if available);
  - (ii) Document Name;
  - (iii) Document Version;
  - (iv) Document Revision Date; and
  - (v) Document Author,and otherwise meet the requirements for this Document Deliverable contemplated by or set out in this Service Description.

## 2.4 Request for proposal documentation

Assuming that – as is usually the case – the customer will run a bidding process involving some form of request for proposal to potential service providers (see the chapter on the overview of the procurement, negotiation and delivery process), one of the immediate pay-offs of the work done in preparing the service description will be the inclusion of part or all of its content in the bidding instructions sent out as the basis for the proposals to be submitted by the service providers. The service providers should then be able to assess the nature of the customer's business operations and requirements, and assess whether they have the capability to provide the envisaged outsourced services in future.

This leads on to an important consideration: what relevance/use (if any) should any such request-for-proposal document have when the contract comes to be signed?

One view has it that the request-for-proposal documentation should be of no significance, and that the parties should have exhaustively negotiated the contract documents themselves so as to include in the relevant schedules all of the service requirements, porting across as necessary such parts of the original request for proposal as may be relevant. Proponents of this view point to the advantage of having 'a single view of the truth' in the form of the finally signed contract, without risk of ambiguity or conflict in looking back to try to interpret previous documents. It is also said (with some validity) that while a customer may have originally stated a set of service requirements in a request for proposal, these requirements may have been set out only at a relatively high level (perhaps even at the 'make a cup of tea' level as referred to above in section 2.1) and have been subject thereafter to elucidation and clarification during the subsequent bid and contract negotiation



process; there may then have been elements of the original request for proposal that the customer has dropped or changed, or that the service provider has indicated it could not provide or would need to provide in a manner that is different to that envisaged in the original request-for-proposal documentation, all of which could more accurately be covered in the final contract schedules. Service providers will also be aware that customer's request for proposals are often stating 'aspirational' requirements (eg, for 'best in class' service provision) that may be risky to give contractual effect to.

By contrast, a customer might argue that it has put a lot of time into creating the service requirements as stated in the request for proposal, and that these requirements consequently form the best description of what the customer wants. Accordingly, it can be said that – at least in the absence of a specific statement from a service provider that it cannot deliver part of the required services – the request for proposal should form a part of the contract or even take precedence over any other document (ie, on the basis that this is the document against which the service provider has based its promises and pricing in the contract).

What then about the possibility of looking instead to incorporate the service provider's response to the request for proposal, either on its own or by way of an amendment or addition to the proposal itself? This may have some merits; it would help to resolve the issue of the service provider stating what it could not do or would do differently, and would potentially also help to contractualise another level of the service provider's commitments so as to capture not only what it would be doing for the customer, but also how it would do it – for example, in relation to technology and processes to be employed, service locations and internal governance structures. The service provider might argue that its own proposal document is also an even better reflection of its detailed pricing and contract commitments than the customer's request for proposal as it will set out in more detail what the service provider's solution and services will consist of.

However, simply incorporating the service provider's proposal document is also not without risk or downside, for both customer and service provider alike. A customer may be concerned about potential omissions from its detailed requirements; if the service provider's response is silent on a particular requirement, would this mean that it is accepted/included, or not part of the services being offered? Equally, the customer may want to insist on some aspects of its original requirements being provided (eg, something that the service provider could do, but might have preferred not to or failed to price for); if these are then picked up in the subsequent negotiations, the customer would have to take great care in ensuring that they were expressly stated in the contract service schedule itself, or risk them being lost. From a service provider perspective, the contract negotiators will be wary that much of the response to any customer request for proposal will have been created by the service provider's sales/business development team, all of whom will have been keen to win the project work and to have put the best possible spin on the service provider's delivery capabilities. There is a risk, therefore, that some marketing speak may have been used, which could be quite onerous if given express contractual effect.

In relation to both the request for proposal and the service provider's response documents, there is the additional challenge of how best to capture any further clarifications or negotiations of these documents during the bid and negotiation phase; for example, there may have been any number of PowerPoint presentations, workshops, subject matter experts' meetings, emails and conference calls to discuss and refine the requirements and service offers further, which may in turn have changed the nature of either the requirements or the proposed solution, potentially to a material degree. If the original documents are to be given express contractual effect, then these subsequent discussions and documents would presumably need to be as well.

The traditional approach to these challenges has tended to exclude both the customer's request for proposal and any service provider responses, both by avoiding any express contract provision to incorporate them into the contract (whether by attachment to the contract or by incorporation by cross reference) and by including in the contract a 'whole agreement' clause to state expressly that the provisions in the contract constitute the entire agreement between the parties as to its subject matter, to the express exclusion of any other pre-contractual documentation, discussions or representations. This has the not-inconsiderable benefit of creating a clean and certain entry point for the contractual relationship between the parties, and hence tends still to be the default option in most outsourcing engagements. However, another option that can be used and that seeks to strike a compromise between this approach and those referred to above is to allow for reference to the pre-contractual documentation (eg, both the customer's request for proposal and the service provider's response(s) to it), but expressly only in the circumstances where there is ambiguity in the contract drafting/description of the services, and then only to the extent necessary to resolve such ambiguity.

## 2.5 The service description

Whatever approach may be taken to the inclusion or non-inclusion of pre-contract documentation, there is no substitute for taking time to record the service description in as much detail as possible. Hopefully, the customer will already have done much of the legwork in this regard in the course of ascertaining the service requirements as described in section 2.1 above, but the process of negotiating with the service provider will undoubtedly have resulted in clarifications and further detail, and also additions from the service provider as to how it will go about service delivery, all of which will need to be catered for and captured. A debate as to whether to take a descriptive or perspective approach will also need to be had and concluded (see section 2.2 above).

The service descriptions will obviously vary depending on the nature of the outsourced services themselves, and as a general rule of thumb should be defined to such a level of detail that someone reasonably skilled/experienced in the relevant subject matter would be able to understand not just what is to be done, but also the general scope/size of the task involved. By way of example only (and building upon the lengthier example already set out in section 2.3 above), below is a form of words dealing with a particular element of a desktop IT and hosting services outsource deal concerning batch management.

### 1.1 Batch Management

The Supplier's responsibilities will include:

- 1.1.1 manage and control a secure batch scheduling environment on a 24x7 basis;
- 1.1.2 implement change to planned and current schedules;
- 1.1.3 manage yearly diaries and calendars as defined by the batch owners;
- 1.1.4 provide support for application development teams on how to best exploit the environment;
- 1.1.5 optimise batch to ensure that there are no unnecessary linkages or dependencies;
- 1.1.6 clearly instrument the batch to make external dependencies clear;
- 1.1.7 provide Centre of Competence (CoC) for all batch scheduling for the Customer and third party service providers;
- 1.1.8 publish and enforce Customer standards for all batch runs scheduled;
- 1.1.9 automate all batch activities to include critical batch alerting ensuring all critical deadlines are adequately signposted;
- 1.1.10 manage and support all operations applications that support the processing of batch and the broader operations environment.

In this example, the service provider's responsibilities in respect of batch management include those listed out in the clause, which of course raises the prospect of the customer arguing that other tasks that may be associated with the general duty of batch management would also still be within the overall scope of the services and, therefore, fall to be performed by the service provider. This reflects the reality that – for most outsource projects at least – the nature and scope of the outsourced services will be so multifaceted as to be impossible to define down to the last potential detail so as to be truly incapable of debate as to precise scope.

There are therefore residual risks for both customer and service provider. For the customer, the concern will be that once the contract has been signed (and when the customer will be fully committed to the project and its bargaining leverage will be correspondingly diminished), the service provider will seek to exploit any ambiguities as to the service descriptions so as to allege that aspects of the customer's requirements on a day-to-day basis are out of scope and therefore subject to change control (and by implication, agreement as to additional fees to be paid to the service provider) – a process only half-humorously referred to as 'death by change control'. Suspicious customers may even form the view that service providers may allow poorly crafted service descriptions to pass through the negotiation process and into the final contract knowing that they will be well placed to exploit any uncertainties thereafter.

Service providers may, however, have a different perspective. Far from feeling that they have the whip hand in discussions about change control post-contract signature, service providers may feel beholden to the customer in agreeing that the 'new' activity is, in fact, a change at all, and in the absence of such agreement may find themselves facing the prospect of being compelled to perform an enlarged role (or at least one beyond what they had planned and costed for) without additional payment – a phenomenon usually referred to as 'scope creep'.

There is unfortunately no magic wand or silver bullet solution for this issue. Effort and attention in detailing the services will clearly mitigate the risk, but will not avoid it altogether. Outsourcing agreements have therefore developed to seek to further close the gap between the parties by means of a series of implied services, usually contained in what is sometimes known as the 'sweeper clause'.

## 2.6 The sweeper clause

As the name suggests, the sweeper clause seeks to sweep up additional obligations or aspects of service provision that might not have been explicitly stated in the contract, but which the customer expects the service provider to perform. Although somewhat contentious when first introduced into outsourcing contracts, such provisions are now very common and – from a customer perspective at least – probably part of best practice in contract drafting.

The clause breaks down into several component parts.

The first part is the least contentious, and relates to the additional tasks that are a 'reasonable and inherent part' of the overall outsourced services (the idea being to capture the kind of thing that a reasonable bystander with knowledge of the kind of outsourced services in question would ordinarily have expected to see detailed as being part of the service provider's responsibilities). A typical form of words in this regard would be as follows: "[The Service Provider shall also undertake and perform] any services, functions and responsibilities (including any incidental services, functions and responsibilities) not expressly specified in this Agreement as being within the scope of the Supplier's responsibilities but which are reasonably and necessarily required for, and related to, the proper performance and provision of the Services."

From a service provider perspective, one might accept the logic of the approach (recognising the difficulties of creating a perfect services schedule, as discussed in this chapter), but seek to negotiate some kind of boundaries for it. Examples include a time limitation within which the customer must have identified and notified any such 'additional' service requirements to the service provider (so as to try to get to a point when a line can be drawn under the scope of the services, and using the logic that any discrepancies should come to light reasonably quickly after commencement of the services, even though the customer may argue that the full annual business cycle would need to be completed for it to be able to say with any certainty that this would be the case), and/or a limitation on the additional cost to be borne by/effort to be undertaken by the service provider in supplying the 'implied' services, before it is able to raise a change control note to recover any additional amounts (on the basis of an argument that the clause is intended to pick up more minor or incidental matters only, and that if more significant costs are being incurred, one might surmise that the service description itself was flawed/inadequate and therefore in need of re-negotiation).

The second part looks at the individuals undertaking the services immediately prior to the commencement of the outsourced services, who may then transfer across to the service provider's employment (whether by agreement or by operation of the Acquired Rights Directive – see the chapter on human resources and the Acquired

Rights Directive) or be replaced by the service provider's own personnel or those of its subcontractors. The form of words that one might then see utilised could read as follows: "[The Service Provider shall also undertake] any services, functions and responsibilities that the Customer can reasonably demonstrate were ordinarily provided by the Employees and/or any individuals employed and/or engaged by an incumbent supplier in the twelve (12) months prior to the Service Commencement Date."

The customer's argument here is that it is outsourcing the function that those employees were previously undertaking. It follows that the customer is intending to continue to receive at least the same scope as was being provided before (if not more/to a better standard), and that therefore the service provider should be obliged to continue to undertake such services, even if not explicitly stated in the services schedule.

There is considerable logic to this approach, especially for those deals modelled on a service provider taking on the customer's existing function on pretty much a like-for-like basis, and then looking to run it more efficiently/cost effectively thereafter so as to reduce the cost to the customer (and possibly also improve or commit to service levels). If the individuals in question have transferred across to the service provider, it is likely that they will continue to perform pretty much the same tasks as they did prior to the transfer of their contracts of employment, and so the customer's expectation as embodied in this form of words should be fulfilled.

Service providers may however raise concerns as to the way in which such a clause could operate. For example, the services may be intended to change/transform, and in order to do that and to provide the agreed pricing to the customer, the service provider has specifically modelled its envisaged set of tasks/activities on a set number of people being available to undertake them (be they from the service provider's existing pool of employees or those previously employed by the customer). If 'new' tasks are then found for the transferring employees to undertake, the service provider may then have to allocate additional staff to fill the gaps.

The bigger service provider concern, however, is the relative inability of the service provider to understand/find out what these additional tasks might be. To give two real examples:

- In an outsource transaction we were involved with in Scandinavia, it transpired that one of the transferring personnel used to drive in to the office via the local post office, and so would drop in to pick up a mail sack each day. He was made redundant shortly after the outsource agreement was signed (on the basis that his role would be undertaken in future by India-based staff), but the service provider was told that it had to keep on picking up the mail and delivering it to the client's offices (which it had to do by way of paying ongoing courier fees).
- In an IT outsourcing project in the United Kingdom, a team of three administrators transferred across with the core IT services. It subsequently came to light that they had habitually undertaken procurement activities not just for the IT department (which was the subject of the outsource deal), but

also for other parts of the business (eg, office supplies, furniture etc), and the customer required that these procurement activities be continued.

The acceptability of such a clause will accordingly be heavily influenced by the extent of the service provider's familiarity with the customer's operations and its plans concerning the retention of the transferring workforce.

The third potential element of the sweeper clause relates to third-party contracts that are to be novated or assigned to the service provider. A form of words to cover this issue might read as follows: "[The Service Provider will provide] any Services within the scope of any contracts assigned and/or novated to the Service Provider directly in connection with the provision of the Services."

For the customer, the attraction of such a clause is clear; it had previously been receiving a set scope of services from a particular supplier, and now that those contracts have passed across to the outsource service provider instead, it will not expect to see any diminution in them. Again, there is undeniable logic in such an argument, but not to the point that it will necessarily apply on a blanket basis to every deal. For example, the parties may have discussed and agreed that a third-party supplier will be retained for only a short period of time, with the service provider then being understood to be changing to a new mode or location of service delivery. In such circumstances, it might be always understood and agreed that there would be a change in the scope of services from those described in the transferring contracts, which would then need to be accounted for.

For both the second and third elements of the potential sweeper clause, one might again find service providers arguing for time limitation periods and/or cost caps regarding the identification of additional tasks to be undertaken, over and above what is expressly stated in the contract. These tend to be hotly contested and negotiated between the parties.

## **2.7 Customer responsibilities and relief notices**

It should not be forgotten that in order for the service provider to perform the services, it is likely that the customer will have to do a few things as well.

Such customer responsibilities can be seen in contracts at a very high/broad brush level – for example, by way of a statement to the effect that the customer will provide the service provider with all such information or assistance as it may reasonably require in connection with the provision of the services. However, whether such a catch-all provision exists, it is likely to be in the interests of both parties to have included in the contract a more explicit/detailed list of any particular obligations or duties that the service provider will need the customer to fulfil. Although the customer might at first question why it might be best advised to accept additional contractual obligations in this manner, it is worth taking a moment to reflect upon what the customer really wants from an outsourcing agreement; in our view, its objective is not to get sanctions or remedies against the service provider simply for the sake of having them (although clearly such remedies need to exist). Instead, the better-advised customer will be aiming to have a contract that best supports the prospects for the outsourcing being a success, and this will mean one

that reminds the customer that it must do certain things as well (even if this is by way of a pointed reminder that the service provider will be relieved from liability and may be able to claim additional costs if the customer fails to do so). See also the chapter on the role of the client in this regard.

Accordingly, having a relatively detailed list of customer responsibilities can be a good thing from a customer perspective (usually as set out in a separate ‘customer responsibilities’ schedule in the relevant contract). As with the service descriptions themselves, care must however be taken to ensure that the responsibilities are carefully crafted and scoped, can be readily understood, and are linked to ‘relief notice’ provisions.

‘Relief notices’ are a relatively recent innovation in outsourcing agreements in the sense of only becoming truly common in the course of the past five or six years. They were borne out of experiences with many failed or failing outsourcing engagements, in circumstances where the project appeared to be proceeding on track with no major issues being flagged, and then all of a sudden when the service provider seemed to be on the point of failing to meet a date or to deliver on some other obligation, it would allege that the ‘true’ cause of the problem was not its non-performance, but something that the customer either had or had not done some time previously (and sometimes some period of months previously). Although this would be a point of fact to be determined, the practical reality is that records and documents needed to ascertain the true picture might not have been retained or might be difficult to gather, memories may have faded or people with relevant knowledge may have moved on to new employment, all leading to increased uncertainty as to the outcome of any dispute between customer and service provider. All too often, what would happen would be a forced agreement between the parties on terms that could be equally unsatisfactory for both, and with lasting damage to the relationship between them.

This is clearly an unsatisfactory state of affairs. The outsourcing market has accordingly borrowed from a long-standing approach used in the construction industry, whereby if a supplier wishes to allege that its performance of its obligations has been effectively prevented by reason of the non-performance of the part of its contract counter-party, it must serve a written notice to that effect upon becoming aware of such non-performance.

In the outsourcing context, a clause to embody this approach might read as follows:

1.1 The Supplier shall only be entitled to relief in respect of any failure to meet any obligation imposed by the Agreement if and to the extent:

- (i) the Supplier's non-performance results directly from a Relief Event;
- (ii) the Supplier uses all reasonable endeavours to mitigate the Relief Event and to perform the Services notwithstanding the Relief Event; and
- (iii) the Supplier notifies the Customer's Contract Manager as soon as reasonably possible (and in any event within 7 calendar days) after the Supplier becomes aware of the Relief Event via a notice in the format specified in Schedule XX (Pro Forma Relief Event Notice) (a “Relief Notice”).

Although this clause may at first appear to be relatively advantageous to the service provider in that it is providing it with an express right of relief vis-à-vis its contract non-performance, closer examination shows that it is an obligation placed upon the service provider itself and a limitation of its rights. If the service provider were to fail to notify the customer of the alleged relief event (which would usually be defined as a failure by the customer to perform any of its express obligations under the outsourcing contract), then it would be denied the ability to raise the customer's acts or omissions as a shield or defence against any corresponding failure on its own part to perform in accordance with the contract requirements (eg, if it incurred liquidated damages for failing to hit a contractual milestone, or incurred service credits vis-à-vis resulting failures to meet service levels).

This may seem harsh, but in reality there is good reason for it. If the service provider did not face such consequences, there would be serious doubts as to whether it would be sufficiently incentivised to serve any such notices upon the customer. After all, there is a risk that the issue of a relief notice might prompt a debate or argument with the customer that the service provider might prefer to avoid from the point of view of maintaining good client relations, and if the service provider knows that it can still claim a defence by reason of the customer's original non-performance of its obligations, whether it serves a relief notice or not, it will likely err in favour of keeping things sweet on the customer relationship front. The customer, however, will want to know if there are failings on its side that are preventing the aims of the outsourcing agreement being met (which takes us back to the point that the customer ultimately wants a working service, not a contractual sanction against the service provider).

A number of points will remain to be negotiated in respect of such a clause. In particular:

- will the notice be required to be given in a prescribed format (as is the case in the example cited above) or will email or some other format suffice (eg, by noting the issues in the minutes of a weekly progress meeting)?
- will the service provider be able to recover any additional costs, either as a result of its mitigating actions or by reason of the relief event itself?
- what is the time period within which the relief notice must be served?
- is the provision of relief under the clause the sole and exclusive remedy of the service provider, or can it also claim damages (or even potentially seek to terminate the contract if it has a contractual right or means to do so – see the chapter on termination and step-in rights)?

## 2.8 Other services obligations

The contract may include various service obligations that sit outside the services description (and aside from the entry and exit relation tasks associated with transition and termination assistance, as are dealt with in the chapters on due diligence and transition, and renegotiations, retenders and termination assistance). Some non-exhaustive examples may include:

- an obligation to comply with the customer's policies and processes;
- obligations to comply with applicable laws and regulations (and potentially



with any post-signature changes to them, which will usually be a vexed topic for negotiation vis-à-vis the charging arrangements for this – see the chapter on charges and charging models);

- provisions to require the service provider to improve the services continuously (usually without being too specific as to how this is to be done); and
- an obligation to replace elements of the customer's infrastructure with more up-to-date versions/releases of the applicable software or hardware (usually referred to as 'tech refresh' obligations).

The service provider in particular will need to consider such provisions carefully so as to ensure that it is capable of performing them and caters for them in its financial model.

### **3. Service levels**

#### **3.1 Introduction**

An integral part of any outsourcing agreement is the service level regime implemented to measure performance at a quantitative and, in contemporary contracts, increasingly a qualitative level. The service level regime forms one of the four pillars of an outsourcing agreement along with the service description, pricing details and governance requirements.

There is also, however, often confusion as to how best to develop and subsequently manage service levels to drive the correct service provider behaviour, and a tendency to seek set-and-forget positions that do not respond to the one constant in any long-term contract of interdependence – namely, change. Equally, customers sometimes fall into the trap of seeking to specify too many service levels or to require measurement and reporting on rather peripheral or unimportant aspects of the service, thus running the risk of making the whole regime cumbersome, uncommercial and sometimes even unworkable.

What, then, is a service level regime? At its most basic, service levels are pre-determined and usually measurable performance requirements that the service provider must meet in its performance of the service and where any failure to meet such performance requirements typically generates a credit (or rebate) in favour of the customer – usually by way of a deduction from the service provider's ongoing charges for the outsourced services – and, increasingly commonly, providing a bonus payment where other performance thresholds are exceeded (see in this regard section 3.7 below).

An effective service level regime therefore creates disincentives (and, increasingly, incentives) for the service provider to ensure that the services performed meet the customer's requirements, and reflect the quality of services promised by the service provider during the initial procurement and negotiation process.

A simple example is a service level aligned to problem resolution for critical problems, as shown below.

Service level	Definition	Required metric	Service level credit
Problem resolution – Severity 1	Permanent resolution of a Severity 1 problem or customer-approved workaround to a Severity 1 problem.	95% of problems resolved within 4 hours of the problem notified to service provider or otherwise identified by service provider and 100% of problems resolved within 8 hours of the problem notified to service provider or otherwise identified by service provider	2% of monthly charges

Unsurprisingly, service levels rely on defined terms in the outsourcing agreement itself – in the above example, terms such as ‘problem’, ‘resolved’ and ‘Severity 1’.

### 3.2 History

The use of commercial drivers to encourage certain behaviour is not a new phenomenon. To return to the example given earlier in this book of the British government using private contractors for the transportation of convicts, reformers raised concerns with the high mortality rates of those being transported (which significantly exceeded already high rates of mortality for transcontinental travel). One hypothesis suggests that a key reason for this was the fact that if a person died in transit, an equal weight of rum could be acquired and then on-sold to the colonies on arrival, providing a windfall gain for the ship owner. To counter this, the government introduced a bonus payment that was paid following the verification of the health and wellbeing of the persons transported in addition to prosecuting the worst cases of ill-treatment – the commercial carrot and the penal stick, as it were (though prosecutions were rare and no such prosecution was ultimately successful).

More contemporary approaches exist in the telecommunications services contracts from the 1980s onwards where the concept of service levels as currently understood were initially implemented, or were probably initially implemented (although these were not necessarily accompanied with a rebate or credit arising where there was non-performance).

From here, given the criticality that service level regimes play in outsourcing relationships, an industry now exists around the development, implementation and management of service level frameworks, either as part of the outsourcing advisory business or as specific standalone assistance and training. Organisations have also developed internal supporting capabilities. However, developing an effective service level regime remains a delicate balancing exercise between the legitimate interests of the customer and those of the service provider.

### 3.3 Broader context

“Not everything that counts can be counted and not everything that is counted counts”. This quote, commonly attributed to Albert Einstein, shows that even in a world increasingly geared towards data analytics, quantitative analysis has limitations – intangibles continue to exist, qualitative considerations continue to arise and an over-reliance on multiple service level metrics can result in analysis paralysis.

While an incredibly useful tool to drive preferred service provider behaviour, service levels remain just that: a tool as part of a bigger toolbox of contract commitments and broader relationship governance. Any service level regime is part of the outsourcing agreement generally and should not be divorced from a relationship with other terms, especially those of a liability-related nature.

For example, what is the relationship between service levels and:

- termination rights? Should a certain number of service level failures, the impact of each of which in isolation is manageable but in aggregation may represent a more systemic problem, give rise to a right to terminate the agreement? If so, and given that not all service levels necessarily represent the same level of importance, how should any such termination right be defined?
- remedial obligations? Rather than, or perhaps in addition to, a specific termination right, should specific service levels or aggregated service level failures result in a requirement for the service provider to develop a draft remedial plan that is subject to the customer’s approval and sets out the specific steps that the service provider will take to correct the underlying cause of service level failure(s)? If so, what is the remedy if the remedial plan itself is either not complied with or does not ultimately result in rectification of the underlying issue?
- reporting? How and when is the service provider to report on service level performance? What is the format of reports? Should raw performance data be provided or otherwise made available? What verification rights should the customer have?
- benchmarking? What consequences arise if a benchmarking exercise indicates that the service level metrics are less than market?
- relief events? Should *force majeure* events result in a suspension of any service level liability? Similarly, if a customer fails to perform certain obligations, what is the impact on service level liability? How is the causal nexus between any prescribed relief event and a service level failure to be determined? Or has the likelihood of such relief events arising already been factored in to the setting of service level metrics?
- liability? What is the relationship, if any, between service credits that may arise and the service provider’s overall liability limit? Should service credits paid reduce the available cap or exist separately, as a form purely of adjusting the amount of the charges?

### 3.4 Setting service levels

#### (a) *Who should do the setting?*

The setting of service levels has powered many debates between customer and service provider, and even between different business units within the customer. In the information and communication technology context, the debate was often between the IT department and 'the business' as to which unit was better placed to determine the required service levels. It is probably fair to say that this debate has been settled largely in favour of the latter.

Given that the intention of any outsourcing is ultimately to provide some benefit to the business organisation, and the increasingly common view that internal support departments such as information technology exist to support the commercial operations of an enterprise, it is unsurprising that the personnel who will be most affected by any decision to outsource certain services should be fully engaged (although often facilitated by external, specialist consultants) in setting the performance parameters of the incoming service provider.

Of course, with the aim of service levels being to define measurable service targets, this process sounds easy. But in certain service areas, in particular those requiring significant human interactions and relying on personnel making qualitative decisions (eg, human resources), agreeing quantitative measures is not necessarily simple.

#### (b) *An example*

Even in what might be seen as comparatively simple services, the process can give rise to different considerations. Imagine that you have been tasked with setting meaningful service levels that can be quantitatively evaluated for call centre outsourced services. Now assume – not unreasonably – that your own key performance indicators are in part driven by customer satisfaction results.

The starting point might be to align your own internal key performance indicators with what you require the service provider to meet. However, the service provider might respond with the (not unreasonable) view that your own indicators are not quantitative, that they fail to take into account adequately other aspects of the organisation's performance (apart from the specific call centre experience) that might affect customer satisfaction, or that the service provider has its own tried and tested customer satisfaction measures.

You might therefore instead start to think about the sorts of things that drive good customer experiences and which therefore might reasonably be anticipated to be likely to affect overall customer satisfaction. In a call centre context, this might lead you to think about the following:

- How fast are calls answered? Or, to put the same issue another way, what is the maximum time a customer should be expected to wait until the call is picked up?
- Your customers are also busy people who do not want to spend ages on the telephone. So you might consider including a measure of the period of time that it takes to complete a call. But not all calls are the same and different

issues are experienced. What to do? Maybe some form of averaged time is the solution.

- However, your own customers are presumably calling about an issue that they want resolved without the need to call back. So you might think about a call resolution rate to measure the extent to which a customer calls back within a period of time after the initial call (this itself can raise other issues of course. What if the end customer simply had another unrelated issue? Often this might be managed through setting a target that allows for such variability).
- There is a tension, however, between a resolution requirement on the first call (which might take time) compared to a service level based on a required handling time. What is more important? Do you need to weigh the requirements? Do you impose different credit amounts if the service level is not met? Do you impose a credit only on the service level that you consider to be the most important?
- Of course, the end customer's resolution might occur only if the call centre representative then logs the required action in your own organisation's systems. So you might include another service level requiring relevant inputs to your own customer systems within a period of a call being completed.

And so on.

Then you have to consider the required performance targets, and whether these apply on a 24/7 basis (which will relate in turn to the call centre's required hours of operation). You might then return to the issue of customer satisfaction and require this to be included, although you may have to look at the methodology used or consider an alternative path to the imposition of credits if performance falls below a certain level.

A simplified version of the output of this hypothetical exercise could therefore be similar to the version below.

Service level	Service credit weighting	Measure
Call acceptance	25%	85% of calls answered within 10 seconds, 95% of calls answered within 15 seconds.
Average handling time	10%	The average time that it takes a consultant to answer and handle a call to be less than or equal to 2 minutes.

*continued on next page*

Service level	Service credit weighting	Measure
First call resolution	50%	The percentage of all issues resolved on the first call must meet or exceed 75%. An issue is deemed to have been resolved on the first call where there are no repeat calls from the same customer within 48 hours as measured by the relevant system.
Escalation	20%	Where tickets are required to be logged to the customer's CRM system as a result of a call, 95% of such tickets are logged within 1 hour of the relevant call being completed and 100% of such tickets are logged within 2 hours of the relevant call being completed.
Customer satisfaction	N/A – see measure	<p>The customer will commission an external market research company to gauge end-customer satisfaction in accordance with the details set out in Annexure X.</p> <p>The service provider will provide the research company with a random list of 50 end customers who have dealt with the service provider in the last month. The results of the interviews are collated monthly, and a report is provided to the customer by the 10th business day of the following month.</p> <p>The survey will measure end-customer satisfaction based on the manner in which the service provider delivers the services, and not end customers' satisfaction with the customer's products or services specifically.</p> <p>The supplier must meet or exceed the customer satisfaction service level based on responses by customers to the following question, which will be scored out of 10, where 1 is the lowest score and 10 is the highest: "Thinking about all</p>

*continued on next page*

Service level	Service credit weighting	Measure
		<p>aspects of your most recent call centre experience, how would you rate the service provider's handling of your call?"</p> <p>The service provider's service level is that the average mean score from end customers is equal to or greater than 7. If the service provider does not meet this service level, it must provide to the customer a rectification plan that sets out the processes and steps that the service provider will take to remedy the non-performance. Any failure to comply with the rectification plan is deemed to be a material breach of this agreement, and if the service provider fails to meet this service level in 3 consecutive months or 5 months in any 12-month period, the customer may terminate this agreement for cause and the provisions of Clause XX will apply.</p>

Where applicable, service credits will be determined by the following formula:

$$SC = MC \times W \times Lim$$

where:

- SC = the amount of the service credit to be credited to customer;
- MC = the amount of the charges payable by customer;
- W = the weighting that applies to the relevant key performance measure, expressed as a decimal (eg, 50% would be expressed as 0.50); and
- Lim = 0.10, being a percentage limit on the allocation of monthly charges in respect of a service Level failure, expressed as a decimal.

All of the above has a direct impact on the underlying commercial model. Put simply, the service provider will find it easier to commit to more testing service levels if it is able to apply more resources/people to the underlying services, but all of this needs to be paid for. The customer may accordingly have to balance out the service levels that it might ideally want against what it is prepared (or able) to pay for.

(c) **Baselining and service level holidays**

One of the issues that commonly arises in the transition phase of any outsourcing relationship is determining what the service level target should be.

Accurate historical customer data, where it exists, can be useful – although it is

rarely determinative; after all, a skilled provider of services is usually expected to be able to perform services at a level higher than that of the existing internal personnel of the organisation, or possibly its legacy service providers/suppliers. Even where such personnel may be transferring to the employment of the service provider, the service provider's tools, processes and supervision may be expected to result in better and more efficient performance.

So, the view might be that the service provider's own historical performance with its wider customer base becomes the appropriate litmus test for setting targets. In some circumstances, where the service provider is deploying its standard service delivery model into an organisation that has sufficiently comparable systems, facilities and infrastructure as those of its other customers, this might well be appropriate. Or where effective market intelligence exists in the form of performance benchmarking, this also could provide an effective litmus test to guide the setting of service level targets.

However, there may be an aspect of transformation as part of the outsourcing initiative where systems and/or processes will be changed. What confidence exists in historical performance information in this case? Further, certain services may not have clear comparable environments – for example, where an application management service is being provided in a specific environment or over niche applications. Alternatively, the outsourcing arrangement may be fundamentally based on continual use of the customer's existing infrastructure or facilities, such that the service provider may not be able to effect improvements in historic levels of performance very quickly (if at all). In such circumstances, a 'baselining' process may be required as part of transition and where the service provider undertakes the services for a defined period, measures its own performance and then the resulting performance data is used to determine the service level targets. There are, though, a couple of key issues to consider in any baselining process:

- Given that the performance data will be used (at least in part) to set future service level targets, there is a perverse incentive for the service provider to underperform during the baselining period. Adequate contract protection and post-execution management can mitigate this risk, however.
- Once the baselining process is completed and the data provided, how will the targets be set? Should the data themselves automatically set the targets – for example, through averaging the relevant months of data or perhaps averaging but with highest and lowest performance months excluded to remove outliers (the latter being the service level equivalent of ice skating scoring)? Or should the data trigger a further negotiation between the customer and service provider? If so, what occurs if there is no resolution? Should an independent expert be used? If so, who?

Related to the transitional issue of the setting of targets is the question of when performance against those targets should be measured and from when any negative consequences of failing to meet those targets (eg, service level credits) should commence. Many outsourcing initiatives allow the service provider a period to 'bed down' its delivery model, tools and personnel before any negative consequence



arises from any failure to meet service levels – often referred to as a ‘service credit holiday’ or similar.

There is nothing necessarily objectionable about holidays where a genuine need exists to bed down complex services or manage the results of a transformation programme (ie, on the basis that the service provider’s focus will be on that rather than hitting service levels, which may well be a stretch target in any event). There is less justification for such holidays, or at least certainly ones of any significant length, where the services being performed are essentially generic and where no or limited transformation activities have been undertaken. As in all aspects of outsourcing, there is not a right or a wrong answer.

**(d) *Dealing with change***

Unfortunately, ‘set and forget’ service level positions in long-term outsourcing contracts are questionable for at least two key reasons. First, what if the customer’s requirements change over the duration of the term of the contract? Second, what if the market moves such that the service provider’s competitors are providing better service at comparable prices (and, where those competitors are providing services to the customer’s own competitors, the impact of this is not a palatable one)? This may, for example, result from improvements in the underlying technology being used to deliver the services, as opposed to the service provider having to work harder. Service levels therefore ideally need to be dynamic.

The tension here is obvious. The service provider has entered into the contract based on the agreed terms and conditions (and, indeed, it will have priced its services based on a certain risk allocation). If the customer requires flexibility around service levels, how is this risk of change to be priced? What should be the parameters of change? In a microcosm, this issue as it applies to service levels shows one of the most significant challenges in implementing effective outsourcing contracts and relationships: effective measures for dealing with change.

One approach to managing customer-required changes is to implement an ability to change the service credit allocation over time, allowing the customer to weigh service levels differently. This approach can be effective where the service provider may have been performing very well against certain service levels, but perhaps not as well in respect of others. This approach is often referred to as the ‘pool allocation percentage’ model.

The diagram below is an example of an adjustable pool where, in year 1, 20% of the potential amount of service credits payable has been spread across Service Levels A to J. Initially, this would suggest that the customer considered that Critical Service Levels A and E were particularly important, and so a greater proportion of the available service credits were allocated to those particular service levels.

Now, let us assume that in reality the service provider’s performance against Critical Service Levels A and E turned out to be particularly strong, while performance against Critical Service Levels B and C was poor and required a greater level of focus. Under the pool allocation percentage model, the customer could address this by reallocating some of the potential service credits away from Service Levels A and E, so as to increase those for B and C.

As indicated in the diagram below, a key issue in any such adjustable pool is the timing of change – how regularly can the customer alter the allocation of service credits (once per year in the example below, which is common in the market although quarterly or biannual adjustments also occur). A further issue is whether the extent of change is entirely discretionary (as it is below), or whether there should be limits placed on the extent of change (eg, in the following diagram, the service provider may require a limit that the allocation of service credits can change only by a single percentage point. So, if this rule applied, the change in Service Level C from 2% to 5% would not arise and it could only be raised to a maximum of 3%).

	Allocation of potential service credit – Year 1 (% of monthly charge)	Allocation of potential service credit – Year 2 (% of monthly charge)
Critical service level A	5%	3%
Critical service level B	2%	4%
Critical service level C	2%	5%
Critical service level D	–	1%
Critical service level E	4%	1%
Critical service level F	2%	1%
Critical service level G	1%	–
Critical service level H	1%	–
Critical service level I	–	2%
Critical service level J	3%	3%
<b>Total</b>	<b>20%</b>	<b>20%</b>

What about the relevant service level targets themselves (ie, the actual levels of performance that the service provider is to achieve)? Should a customer be entitled to vary these and if so how? Again, this may depend on the leverage positions of the customer and the service provider, the requirements of the customer and the representations made by the service provider in any request for proposal or similar competitive offer process. However, mandated changes in targets – for instance, moving an application availability target from 99.5% to 99.6%, 99.7%, 99.75% etc each year – is not without precedent (and may arise because the project involves

specific transformational obligations that should in due course improve service quality, or simply because the service provider is confident of its ability to improve upon the level of performance inherited from a previously in-house function. However, the customer will of course pay for the change through the pricing model developed by the service provider, so a key question should be whether a move from 99.5% to 99.75% over a four-year term reflects genuine value.

The ability of a customer to change the required targets unilaterally, without any form of limit, is understandably rare. Likewise, the ability of a customer to introduce new service levels and targets without consent is also rare. It may even give rise to considerations with respect to unconscionable conduct or similar concepts in certain jurisdictions. This is not to say that provisions cannot be included at least to frame a discussion with respect to such changes – for example, as part of an annual or quarterly review process where both parties are required to act reasonably, however typically the potential impact of such changes on the service provider's delivery model will result in a requirement of negotiation and formal amendment.

Similarly, general obligations on the service provider to ensure continuous improvement in its performance against service level targets are common, though the ability to rely upon such commitments from a legal, rather than commercial or relationship perspective is often questionable given the 'motherhood' nature of many such provisions. In any event, customers often fail to manage the service provider's performance adequately in light of such broader considerations (where the immediate focus is on the strict service levels imposed, not such wider, and more difficult to manage, concepts).

However, certain outsourcing models now seek to give such soft commitments some real teeth by adopting a mechanism where the service provider's actual average performance against the service levels over a year is measured and if it turns out to have been in excess of the required service level targets, the service provider's performance in the subsequent year will be reset to its immediate past performance level (or at least adjusted by some percentage of the delta between the original service level and the actual level of performance achieved). To go back to the application availability service, if this is set at 99.5% without any automatic adjustment, this model would hold that if the service provider's performance over a year averaged to 99.6%, 99.6% would be reset as the new service level target. There are, however, some important limits to this model that should be carefully considered:

- A rational service provider would be encouraged to do all it could to ensure that performance meets but does not exceed the existing service level target (and might argue in negotiations that it would be unfair for it to be penalised for better performance, by having its service levels increased). Improvements would then be unlikely to accrue. Attempts to remove this disincentive could be introduced, however, through a payment of a bonus for over-performance in the previous year. This raises complex financial modelling questions, however, and if the amount of the bonus is insufficient, the same prisoners' dilemma arises. Further, as noted elsewhere, where a primary driver of many outsourcing relationships is to reduce costs, the payment of bonuses could be seen as being anathema to that objective, even leaving aside the often

difficult issue of internal budgeting for potential bonus payment.

- Even if the relevant incentives were adequately determined, the price impact of the service provider being subject to increased levels of performance might well see upward adjustments to the service provider's pricing model. So, if increased performance is not achieved, the service provider may not receive a bonus, but the customer may still be paying an increased amount for the potential increased performance (on the basis that the service provider will have factored this in to its pricing model at the point the contract was signed). Further, if increased performance is achieved and a bonus is paid, does the increase in the service level target reflect any genuine business value? If the business has agreed to a service level target of, say, 99.5% for application availability, that may simply indicate that a move to 99.6%, 99.7% or higher will lead to limited improved productivity and, therefore, no added value for the customer – in which event the payment of a bonus may make little business sense.
- Lastly, difficult discussions on the impact of externalities also commonly arise. In other words, to what extent should the service provider be able to rely upon improvements in service level performance that have occurred for reasons not of their making?

In terms of broader moves in the market, where other service providers are offering comparable pricing but better performance, benchmarking can provide an effective mechanism to ensure that comparability is maintained (see the chapter on charges and charging models).

### 3.5 A word on service credits

Service credits can easily be confused with liquidated damages. In many jurisdictions, parties to contracts are entitled to agree the amount of damages that will be paid in the event that a certain event does not arise. One of the better-known examples of liquidated damages is in the construction industry where liquidated damages are often paid for late completion.

However, there is also often a legal requirement in many jurisdictions that the amount of damages agreed by the parties be a “genuine and reasonable pre-estimate” of the loss that would arise from the relevant event. If the amount is more than that, the amount could be deemed a penalty with the consequence that the amount is unenforceable.

To use the building example, if a landlord had a completion date of January 1 and had lessees ready and available to take premises from that date, if there was any delay a genuine and reasonable pre-estimate of the landlord's losses might be determined by considering the expected rental income. If the specific amount of liquidated damages was more than that, in some jurisdictions the landlord would be unable to claim those liquidated damages. In short, liquidated damages are a measure of loss.

Should service credits be seen in the same light? Given that the intention of a service credit is not to compensate the customer for losses suffered as a result of a

failure to meet the corresponding service level, but rather to reflect the decreased value of the services provided, an alternative is to view service credits as nothing more than a price adjustment. In other words, if you agreed to pay \$100 for a service and if that service was performed late, \$5 difference if reducing the price to \$95 is no attempt to compensate the customer for the impact of the late service; it is a mere reflection of the diminution in value of the service provided.

There is danger, therefore, in assuming that liquidated damages, penalties and service credits are interchangeable terms. This needs to be assessed jurisdiction by jurisdiction in order to consider the potential impact upon the legal enforceability of the service credit regime.

The accrual of service credits can be calculated in many different ways. Below are a few examples.

**Simple monetary amount:** For instance, if Service Level A is not met, the service provider will pay the customer \$X.

**Percentage of fees/charges:** As with simple monetary amount, but instead of \$X, the amount then incurred as a service credit is expressed as a percentage of the relevant charges (usually calculated on a monthly basis) – for instance, 0.5% of the monthly charges per individual service level breach.

**Pool allocation percentage model:** This is alluded to in section 3.4 (d) above. Under this model, the total amount of potential service credits (again, usually expressed as an overall percentage of the service provider's monthly charges) is spread/allocated across the total number of service levels. From a customer perspective, the size of the pool to be allocated in this regard should ideally be more than the 'at risk' percentage, as otherwise the full 'at risk' amount will never be incurred by the service provider unless it fails to achieve all of the relevant service levels. Having an allocatable pool of between 150% to 250% of the 'at risk' amount is accordingly common (although the service provider will never have to pay/deduct more than 100% of the 'at risk' amount, even if more than 100% is notionally accrued); from a service provider's perspective, it will equally be important for the pool not to be too large, as this would materially increase the risk of the full 'at risk' amount having to be paid out in a given month.

One of the advantages of this model from a customer perspective is that it will often be set up on the basis that the customer can change the allocation of the overall pool across the various service levels so long as the maximum size of the pool itself does not increase. See again the example in section 2.4 above.

**Service credit point model:** This model starts with the assessment of the amount placed at risk to service credits in a given month (or other measurement period), but then divides that monetary amount by a denominator so as to create the value of a single service credit point. Knowing then the value of each such point, the customer and service provider will agree for each service level how many points should accrue if the service level is missed (often on the basis of more points accruing, the further

below the required service level the service provider may fall). Thus, if a service level required a workaround for an incident to be provided within eight hours, a service credit point-based scheme might then state that five service credit points per hour would accrue for the eight to 16-hour period after the incident was logged, then 10 service credit points per hour for the 16 to 24-hour period, and then 15 per hour for each hour thereafter until the workaround is provided.

### 3.6 Service bonuses?

It is certainly not uncommon for service providers to position their response on service levels as one that includes statements similar to the following:

*While appreciating that there needs to be an effective regime for ensuring service assurance and performance, where we are subject to a model which imposes a financial impact on certain levels of performance, there should be an equivalent opportunity for us to receive a financial benefit where levels of performance are exceeded. As a result, we propose a service bonus regime which mirrors the service credit regime.*

There is certainly no issue with any service level regime that includes bonuses where there is actual value derived from the payment of a bonus (ie, the payment of a bonus provides an incentive for a level of service performance or other outcome that the customer organisation considers is more valuable than the amount of the bonus) and the budgeting impact of a potential bonus payment has been factored in. This is ultimately a business call.

However, if no value arises from performance in excess of a service level target, should the service provider be entitled to an additional amount? Has the customer not already determined the level of performance that it requires and paid for that through service charges? Perhaps cynically, has the service provider not already included a risk buffer in its service pricing in the event that any service credits are not achieved so, in fact, there is no need for such mutuality? To give an example, if a service level requires that a call to a service desk be answered within an average of 30 seconds and the actual average time for answer is 27 seconds, the customer may well be pleased with how the service provider is performing, but will it have derived any additional financial benefit?

It is arguably more effective to divorce service bonuses from the detailed service level credit regime and apply such bonuses to less quantitative and more outcome-based measures such as customer or executive satisfaction.

Ultimately, however, the payment or not of bonuses is part of the customer's outsourcing philosophy – some organisations take a very firm view that in no event will bonuses be paid (perhaps linked to the primary rationale for outsourcing being cost savings). Other organisations may take a different approach. The customer should make its position clear, whatever its approach.

### 3.7 Linkages to termination rights

One of the other advantages of a detailed service level regime is that it can be used to pre-define the points at which poor performance will trigger a termination right (and so as to avoid a potentially difficult debate as to whether a failure to meet the service levels is a breach of contract and if so, whether it constitutes a material breach

so as to justify contract termination). Detailed service level regimes may accordingly set minimum levels/thresholds of performance for truly critical service levels – and usually at a level some way below the point where service credits will start to accrue – on the basis that if such threshold is breached, a termination right will arise.

Aside from debating which critical service levels this kind of threshold should be attached to and the setting of the threshold itself, service providers can be expected to challenge whether a one-off failure should trigger termination, or whether it should be required to be repetitive (eg, a breach of a minimum service level two or more times in a rolling six-month period).

Other service level-related termination rights commonly seen are those relating to a repetitive breach of the same service level, or where the aggregate accrual of service credits over multiple measurement periods exceeds a set amount (eg, if more than 75% of potentially accruable service credits are in fact accrued across a six-month period).

For more in this regard, see the chapter on termination and step-in rights.

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