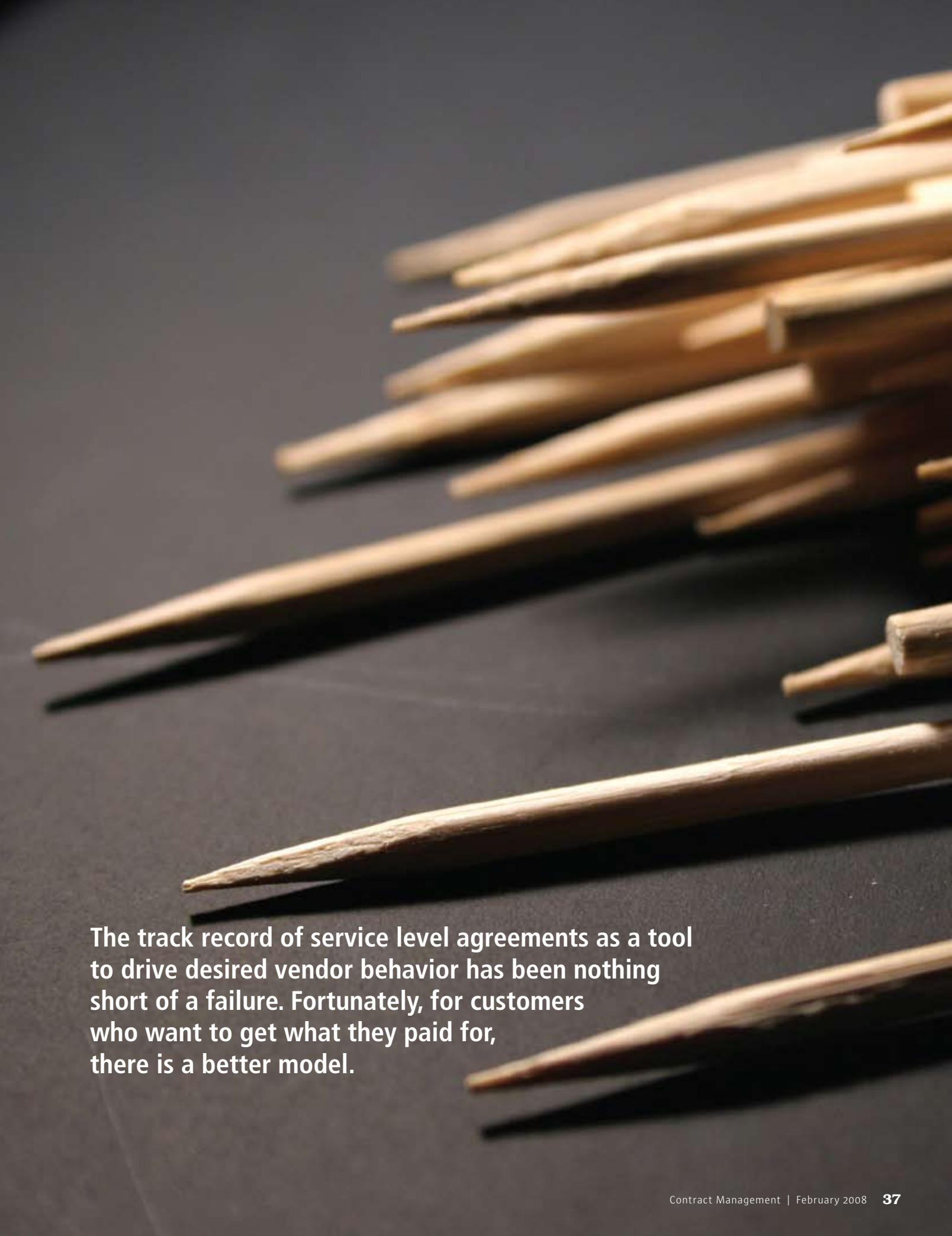



Service Levels: The Carrot, the Stick, or Neither?



BY STEPHEN R. GUTH



The track record of service level agreements as a tool to drive desired vendor behavior has been nothing short of a failure. Fortunately, for customers who want to get what they paid for, there is a better model.



Over the past 20 years, particularly in IT outsourcing engagements, service level agreements (SLAs) have come into vogue. The concept of SLAs attempts to fill two major customer needs: measuring performance and driving desired vendor behavior.

When it comes to measuring performance, SLAs do an adequate job of giving customers an evaluative picture of a vendor, provided that the underlying data is objective and quantitative.

As a means to drive vendor behavior, SLAs typically include the payment of penalties by the vendor in the form of liquidated damages for not achieving service levels (the “stick”) or less frequently, the payment of rewards by the customer when the vendor exceeds service levels (the “carrot”).

While SLAs have been a relative success in terms of measuring vendor performance, the track record of SLAs as a tool to drive desired vendor behavior has been nothing short of a dismal failure. Ultimately, neither the SLA stick or carrot models work. Fortunately, for customers who want to get what they paid for, there is a better model.

The Stick Model

There are two reasons why customers request service level penalties: (1) to recover business costs associated with a missed service level or (2) to induce the vendor to achieve service levels through negative reinforcement through penalties. Generally, business costs resulting from missed service levels are difficult to calculate and are not a common motivation

behind requests for service levels with penalties.

On the other hand, customers frequently request SLAs with penalties because they believe that penalties induce vendors to achieve service levels in order to avoid a penalty. Sometimes customers believe that they are due a financial “discount,” in the form of a penalty, if the customer is not receiving the level of service for which they contracted.

In reality, the stick model of service levels with penalties has limited or no effect on vendors. In fact, it may have a negative effect on the customer in terms of pricing. Even where vendors are generally capable of achieving a service level with an associated penalty, vendors commonly increase prices to mitigate any possible penalties.

This incremental increase in price converts into an accrual on the vendor’s books for the potential liability of a penalty.

At this point, the performance-oriented behavior the customer was attempting to drive has been diminished—whatever “hammer” or stick the customer thought they had as leverage is now a simple accounting transaction.

The Carrot Model

The carrot model assumes that financial rewards will induce the vendor to achieve higher levels of customer satisfaction. In this model, the vendor receives rewards from the customer for consistently sustaining or exceeding service levels.

Companies sometimes combine the carrot and stick models to incorporate a theoretical balancing factor—penalties for under-performance and rewards for over-performance.

This service level model is relatively rare—companies just do not want to have to pay a premium for a heightened level of service they do not really need. They simply want vendors to hit the SLA targets. Another reason against the carrot model is that companies do not want the uncertainty of future payments (in the form of rewards) that may be committed to the vendor.

For example, if a customer did not accurately define a particular service level in contract negotiations, the customer may have unwittingly committed itself to the continuous payment of rewards for a service level that the vendor will routinely exceed.



Wrath of the Customer Model

An alternative model that can drive the desired effect is the “wrath of the customer,” or worded in a more formal construct, SLAs with escalations. Rather than a simple accounting transaction hidden in a vendor’s financial system, escalation paths ensure visibility of nonperformance to increasing levels of management within customer and vendor organizations.

In other words, each level of a vendor must answer to the next level of management when the vendor did not achieve a service level. The effects on a vendor’s human and company behavior in this type of service level model can have a significant and far-reaching impact, with resultant tangible benefits to the customer.

The last thing the vendor’s operational manager wants is his or her vice president being woken up in the middle of the night due to some missed service level.

The primary objective of the service level with escalations model is to ensure that the vendor understands that its relationship with the customer centers on achieving required service levels.

The construct of this model should focus on and encompass:

- **Detailed peer-to-peer escalation procedures**, to include escalation “triggers” and timeframes for escalation to the next level;
- **A predetermined set of actions** to occur when performance measurement points below minimum targets (the escalation trigger);
- **Clear identification of escalation levels** by name, title, and responsibility;
- **Methodology** for a joint problem resolution process;

- **Post-mortem procedures** defined for root cause analyses;
- **Acting on the intent of the contract**, rather than solely the exact content; and
- **An operating principle of fairness**, not exploitation of any contract inefficiencies.

SLAs cannot be the sole basis for how the vendor–customer relationship is managed and should not be used as an inflexible construct; rather, SLAs merely represent the parameters of expected performance. Of all vendor–customer expectations, vendor commitment is the most critical to sustain an ongoing successful business relationship between vendor and customer.

The escalations model not only enhances a customer’s leverage in driving the desired vendor behavior, it also engages the vendor in such a way that an ancillary benefit is increased vendor commitment. To develop workable SLAs with escalations models, customers will need to invest some time in determining the right metrics and the right escalations. The pay-off is ultimately getting what the customer paid for. **CM**

ABOUT THE AUTHOR

STEPHEN R. GUTH, ESQ., C.P.M. CTPE, CCCM, is the executive director of the Vendor Management Office at the National Rural Electric Cooperative Association in Arlington, Virginia. He is the author of *The Contract Negotiation Handbook: An Indispensable Guide for Contract Professionals* (available at www.lulu.com/content/1718685 for \$44.95) and *The Vendor Management Office: Unleashing the Power of Strategic Sourcing* (available at www.lulu.com/content/1346743 for \$25).

Send comments about this article to cm@ncmahq.org.



Janell Bursac,
Contract Management
Certificate

- Earn a minor or certificate in 17 months or less from top-ranked university
- Fulfills NCMA educational requirements for professional certifications
- Accelerated schedule of five, nine-week terms a year



SAINT LOUIS
UNIVERSITY

Saint Louis University offers
Online Contract Management Program



NCMA
Education
PARTNER

Apply online at professionalstudies.slu.edu or call **800.734.6736**