# Service levels and service credit schemes in outsourcing

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This practice note analyses how service levels may be set and used in outsourcing transactions and the service credit schemes that may be employed to encourage good performance under an outsourcing contract.

## At a glance

- Service levels and key performance indicators measure a supplier's performance against the standard set in the services description.
- Service credits penalise the supplier for failing to meet pre-agreed performance standards.
- While they can stand alone, service levels and service credits typically work together to manage the standard of a supplier's performance.
- Creative outsourcing models are moving away from dependence on service levels to consider the success of the arrangement as a whole.

## Introduction

Service levels and service credits are popular mechanisms in outsourcing contracts that ensure the supplier performs services to the required standard.

Both service levels and services credits can stand alone, although they are frequently used as a dual mechanism to prevent or rectify poor service delivery. There are many ways to implement them, and most practitioners will have favoured approaches. With no single right answer but plenty of potential pitfalls, this note focuses on the options available to customers and suppliers when drafting service levels and service credits and the market practice that has evolved in this area.

The terminology used to describe service level regimes can vary from contract to contract. Throughout this note, we have used the following terms which we consider to be the most commonplace:

- **Service levels** define how well the supplier needs to perform certain services as described in the services description. Service levels are generally tied to a service credit mechanism.
- **Key performance indicators (KPIs)** are also metrics by which service performance is assessed and reported. These do not generally attach a service credit. Where a contract contains both KPIs and service levels, it is common practice to include a mechanism in the contract which allows the customer to swap KPIs for service levels on giving reasonable notice.
- **Service credits** are the sums deducted from the amounts to be paid under the contract to the supplier if its actual performance fails to meet the service levels.

## Service levels and KPIs

Service levels in most negotiated outsourcing contracts are not intended to cover all aspects of the services, and do not measure all things that can be measured. Instead they are used to focus on the services that are of most importance and value to the customer.

The appropriate number of service levels and KPIs to include in an outsourcing contract will vary depending on the breadth and value of the services. However, less is generally considered to be better than more, and ten to fifteen service levels (with additional KPIs sitting behind this figure) is a good rule of thumb. Having a larger number of service levels can be disadvantageous because (i) it dilutes the impact of service credits meaning they have less impact; and (ii) it can overwhelm the supplier in terms of administration and reporting thus taking their focus away from the delivery of the actual services.

Each service level should be:

- Contractually binding (ie, service levels are contractual obligations, rather than goals or targets).
- Capable of objective and reliable measurement.
- Important to the customer's business objectives and focused on those parts of the service that directly impact the customer.

They should also, to the extent possible, cover the end-to-end service and be constructed to drive the right behaviour from the supplier. For example, in an agreement for business process outsourcing, it would not be a good idea to have service levels measuring only the speed of response/process without also looking at the accuracy and completeness of such responses/processes.

The current trend is towards service levels that measure the customer's or the end user's experience of the service performance, eg, through uptime and response times, as opposed to technical standards, eg, the connection bandwidth that must be provided. This reflects the importance to the customer of the outsourcing arrangement providing a better service than is possible to perform in-house.

### Types of service levels

Service levels can measure a variety of elements of a service. These may include: a target for the number of invoices/complaints/calls/shipments processed in a certain timeframe; the time window for responding to an incident/complaint/inquiry; or the required length of uptime/permitted downtime of a service. Service levels measure the supplier's performance over a given measurement window, eg, monthly.

The nature of the service being measured will determine the type of service level that should be drafted into the contract. At a high level, service levels can be broken down into three categories, each of which have different characteristics that need to be defined (see box below):

- **Continuous service levels.** These measure whether a steady state has been maintained over the given period, eg, the availability of an IT component or service. Service levels of this type are measured on a continuous basis (albeit within certain service windows) and do not measure the completion of an event.

- **Event service levels.** These measure the extent to which a series of separate events are successfully completed on time during the performance period, eg, calls answered on time or equipment installed within the relevant timeframe.
- **Sample service levels.** These measure whether a sample of items meet the standard in the contract, eg, accuracy of entries in an asset registry. Sample service levels are useful where it is not practically possible for every item to be measured in the given period.

| **Examples of factors to be considered** | |
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| Continuous service levels, eg, availability: | • How is "availability" defined?<br>• What is the service window (during which availability is measured)?<br>• Are there different service windows with different levels of service?<br>• Are there maintenance windows, during which unavailability is excused?<br>• What tool is used to measure availability?<br>    • What is the availability of the tool itself (is it less than the availability being measured)?<br>    • If the tool samples availability, how regularly does it sample (is it less than the periods of unavailability which need to be measured)?<br>    • Can the tool measure the availability of the full system (is it "end to end")?<br>• What is the performance standard during the service window? (eg, 99.9% availability)? |
| Event service levels: | • What is the event that is being measured?<br>• When does each event start to be measured?<br>• What is successful completion?<br>• What tool is used to measure the time taken to complete the event? Can the tool measure both the start and the end points for the event?<br>• What is the performance standard (eg, 95% of events in month successfully completed on time)?<br>• Is there a minimum number of events which need to be completed by the supplier or a maximum number of events to which the performance standard shall apply?<br>• Are there different performance standards depending on the priority of the event? |

 

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| Sample service levels: | • What is the pool from which the sample is taken?<br>• How will the sample be selected?<br>• How big is the sample?<br>• What is the required standard for each sampled item?<br>• What is the performance standard (eg, 95% of assets in sample have accurate associated records in the asset database)? |

## Defining service levels

### Single performance standard

Service levels can specify a single performance standard, eg, the computer system is available for use by the customer 99.9% of the time (see box below). While this approach appears simple, it is important to ensure that all terms used in describing such service levels (eg, in relation to availability service levels, terms such as "system", "unavailable" and "service hours") are accurately and adequately defined. How the service level is to be measured must also be addressed in the contract (see *Measuring service levels*).

### Compounding service levels

Instead of a single performance standard, service levels may be compounded such that they are only passed by the supplier if both condition A and condition B are met. This formulation is a useful way of helping reduce the number of multiple service levels for the same topic and can be a legitimate method to create a single, multi-tiered service level that captures what success looks like for a particular service category. The supplier should, however, be cautious of this where the multiple conditions decrease its chances of meeting the whole service level, as that may trigger service credits more frequently than under single performance standards.

The compounding formulation can be particularly useful in addressing "long tails" in service levels. For example, if a service level states that 80% of calls to a call centre are answered within 20 seconds, without including anything else in the agreement, there would be no requirement on the supplier ever to answer the remaining 20% of calls. To address this, best practice is to specify a further requirement to cover the remaining calls: for example, 80% of calls answered within 20 seconds and 100% of calls answered within 60 seconds (see box below).

**Continuous service level example: service availability of an Application**

The Service Level is stated as a percentage and is calculated as follows:

**Service Level % = ((A – B) / A) *100**

Where:

 

**A**= the number of minutes during the month less scheduled downtime for maintenance purposes that the relevant Application is required to be available.

**B** = the number of minutes during the month when the Application is unavailable (other than during scheduled downtime for maintenance purposes).

For the purpose of this Service Level, "unavailable" means [non-agreed downtime; and/or more than [10]% of Users cannot fully access the Application; and/or response times in relation to the Application are [25]% worse than expected response times; and/or the services required to perform the end-to-end process fail].

Supplier shall measure the Service Level using [tagged outages; and/or ticket based non-availability statistics].

The performance standard that shall be achieved by Supplier in the relevant [month] for the Service Level to be achieved shall be greater than, or equal to, [99.8]%.

**Event service level example: answering of calls to a Helpdesk**

The Service Level is stated as a percentage and is calculated as follows:

**Service Level % = (B / A) *100**

Where:

A= the actual number of Calls that are made to the Helpdesk by Users in the relevant month.

B = the number of Calls that fall within "A" above that are answered by the Helpdesk in accordance with the agreement within the relevant timeframe. Supplier shall measure the Service Level using [its ticketing system].

The performance standards that shall be achieved by Supplier in the relevant month for the Service Level to be achieved are both of the following:

[80]% of all Calls answered within [20 seconds].

[100]% of all Calls answered within [60 seconds].

[Note that under this example, Customer may also require monitoring of the time taken to resolve incidents reported to the Helpdesk.]

**Sample service level example: accuracy of asset management database**

The Service Level is stated as a percentage and is calculated as follows:

**Service Level % = (B / A) *100**

Where:

A= the number of asset entries audited during the Measurement Window (each audit to cover at least [10]% of the overall number of asset entries in Supplier's asset management database).

B = the number of missing, or incomplete, or orphaned asset entries discovered in any such audit during the Measurement Window.

Supplier shall not exceed the following performance standards for the Service Level:

Expected standard: [1]% each [quarter].

Minimum standard: [2]% each [quarter].

**Multiple performance standards**

An alternative approach uses two (or more) performance standards to measure the same service element. There are two primary ways of using dual performance levels:

- Target/Minimum. This approach requires the supplier to meet the minimum service level but also provides it with a target level to try to achieve. Generally, service credits apply if the minimum is failed and possible incentives/rewards are given to supplier where the target is frequently achieved.
- Expected/Critical. The "expected service level" sets the required standard which the supplier is required to meet in a measurement period, i.e. service credits will apply if it is not met. The critical service levels is the standard below which services cannot fall without causing significant harm to the customer and, accordingly, the critical level brings additional remedies for the customer.

While there may be some circumstances where these models are appropriate, they do both come with certain drawbacks which should be considered prior to implementation.

- Models driving greater performance from the supplier may measure the supplier against the target service level and offer earn-back or some other form of reward if that target is met for a prolonged period of time. However, before offering incentives for reaching a target service level, it is important to look at whether achieving that target brings any significant benefit to your organisation. If it doesn't, is paying the supplier a reward for meeting it simply a wasted cost? And if it does bring significant benefits, should that actually be your minimum standard?
- Some service credit mechanisms state that a service credit is only applicable if the expected level is missed multiple times, but the use of a critical service level can result in a single failure leading to a service credit. While the multiple performance standards approach does not immediately penalise the supplier if it misses the higher service level standard, reducing the supplier's risk by including both a higher standard and a minimum standard may increase the likelihood of the supplier accepting a higher standard than it might otherwise agree to.

 

- If there is disagreement as to whether service credits should be the sole remedy for service level failures, one solution is to state that within the range of expected performance up to the expected service level, service credits are the sole remedy; but below the critical service level, damages may also be recovered by the customer.
- The agreement may specify examples of material breach if there is a right to terminate for material breach by reference to particularly poor service level performance. If this approach is followed, such breaches may be defined by reference to critical service levels. The downside to this approach is that a lesser breach of the service levels, even multiple lesser breaches, do not qualify as a material breach of the purposes of termination; and to avoid disputes over this the parties should carefully define the meaning of material breach. The linking of service levels to a material breach termination right may also result in the supplier insisting on a high threshold for failure.

### Scaled service credits

A further alternative approach is to combine service levels with service credits using a sliding scale, so that the amount payable as a credit increases depending on how poor the performance is.

## Setting service levels

There are a number of ways to determine the performance standards that the supplier must meet for each service level:

- **Pre-contract performance.** In an agreement where the functions being outsourced are currently being performed by, or on behalf of, the customer, the existing standards are the most valuable source of service level data.

  For these reasons, one of the first tasks to perform when outsourcing is to collect service level data for the current operation. Three to six months' worth of sound measurements are often a reasonable baseline of service level performance. It is therefore important for the customer to include the right in outsourcing contracts to be able to pass on data to successor suppliers regarding the service level performance under the existing contract.

  It is important to note however that, particularly in a first generation outsourcing, it may not be appropriate to take these standards "as is". The objective of an outsourcing is generally to improve service performance so taking current in-house performance without further diligence and building in improvement will probably not deliver that objective. Therefore it is necessary to take that data and couple it with additional data points.
- **Market standards.** Many areas of service, especially at the more commoditised ends of the market, have well understood and industry-standard service levels. External advisors will be able to advise on market standards and, in particular, benchmarking organisations have data on what levels of service should be expected at different price points.
- **Post-handover verification.** If the supplier is taking over an existing customer function, but there is insufficient existing data to prove the pre-contract performance of that function, the supplier may ask for post-handover verification or measurement of performance. Often this would take the form of setting the performance standard based on actual performance over a measurement period post-signature. This is of particular attraction to the supplier as it significantly de-risks the transaction by ensuring that it is not held to a higher standard than it knows it can meet in practice.

 

Conversely, from the customer's perspective post-handover measurements are very unattractive and should be avoided for a number of reasons: (i) the customer takes a significant risk entering an agreement not knowing the level of service it will receive going forward; (ii) the supplier is not incentivised to perform at its best during the measurement period thus meaning service levels may be set at unacceptably low standards; and (iii) there is no measure against which services will be assessed immediately following signature which is the time when the deal will likely be under the most scrutiny from the broader business.

- **Transformed service levels.** One issue which can be tricky in transformative outsourcing agreements is identifying what the service levels should be following completion of the supplier's transformation activity. There are no historic data points to rely on and the parties will have very clear conflicting views: (i) the customer will be looking for significant improvement on existing measures; and (ii) the supplier will be wary of over-committing to standards before reaching the end-state. Where these issues cannot be resolved pre-contract, the parties may agree to a post-contract improvement scale where performance standards get better gradually following transformation.

  Most importantly, service levels should be set using realistic targets which the supplier should be able to achieve. If service levels are set too high, the supplier may build in a buffer to its charges if it considers service credits to be highly likely and frequent. This negates the point of the mechanism and does not drive the desired behaviour.

### Measuring service levels

All service levels must be capable of accurate and objective measurement. Including service levels that are open to ambiguity in assessing whether or not they have been met is fertile ground for disputes later down the line. It is therefore important for the parties to focus, prior to contract signature, on how the service levels will be measured and the tools to be used.

Issues to be considered when specifying the tools and methods include:

- Subjective standards such as "reasonable efforts" should be avoided.
- Proposed tools should be able to measure to a sufficient granularity to identify whether the service level is being achieved. For example, a tool that measures availability of a system by sampling must measure sufficiently regularly to identify short, but service-impacting, outages.
- For availability service levels, it is also important that the availability of the measuring tool is itself high enough to be able to consistently measure the performance of the system being measured.

### Protecting the supplier

The supplier can reasonably expect not to be penalised for service level failures that are outside its control. The supplier should, in particular, ensure that:

- Either it has control over all aspects of the service level performance or, alternatively, where parts of a process are retained by the customer, that such periods are carved out of the measurement.
- Specific acts or omissions by the customer that cause a service level failure to occur are excluded from the service level calculations.
- Events of force majeure are excluded from the service level calculations.

That said, a customer should be wary of the introduction of terms such as "supplier caused issue" or "supplier caused outage" in the agreement and should encourage provisions which place overall responsibility with the supplier. The above issues would therefore be dealt with by way of exception with the rule being that the supplier is responsible.

Other areas that the supplier should address with caution are:

- Such small sample sizes that the actual performance standard in practice is perfection. For example, with only 19 or fewer events being measured in a month, a performance standard of 95% is actually 100% as any failure will lead to a missed service level. Anomalies of this nature can be rectified with contractual mechanisms, such as quarterly conformance reviews (where the service level is recalculated over a three month period and averaged), to ensure the supplier has not been penalised in any month where the number of events being measured did not reach the required threshold.
- Subjective measurement that is left to the customer's discretion. The one exception to this principle is customer satisfaction surveys, which, if measured independently against a pre-agreed baseline, can be a reasonable and useful measure of overall performance under the contract.
- Survey responses will typically be sent to a sample of end users (eg, recent users of the services) and may also be sent to key customer representatives in the business and/or executives. Typically surveys will require a minimum response rate to generate valid results. The supplier should understand in advance what templates will be used for any such surveys (ideally it should approve the template), and it should be alert to the risk of frustrations unrelated to the quality of the service creeping into the survey results, eg, employees' disagreement with the decision to outsource at all.
- Services performed by automated processes, as there may be an inherent risk of a service level failure being repeated multiple times at high speed.
- Responsibility in multi-vendor outsourcing arrangements, especially "tower" structures in which each supplier provides a different aspect of the overall service. The supplier should resist any responsibility that depends upon performance by another vendor, and avoid any direct liability arrangement with the other vendors given that those vendors have been selected by the customer and may well be competitors.

### Reporting

The supplier will normally be responsible for measuring the service levels and will be required to report regularly (typically monthly) on actual performance against the service levels. The contract may specify how the service levels are to be reported upon and require the supplier to carry out trend analysis on problems that are occurring

Failure to provide a service level report on time or at all, may legitimately result in a service credit as, without a service level report, the customer does not have the necessary means to assess whether or not the relevant service levels have been met.

### Changing performance standards over time

Like many other aspects of outsourcing transactions, specifying how things will work at one point in time is not sufficient and the service levels need to be flexible as the services evolve. It is therefore desirable for the parties to include rules about how the performance standards will improve over time, whether on a pre-set basis or depending on actual performance by the supplier.

 

Ongoing improvement provisions can range from a statement that there will be an annual review with the parties "expecting" that improvements to the service levels will occur, but without specifying what these are, through to an automatic ratcheting drafted into the agreement. The ratcheting approach operates automatically, per service level, whenever actual performance in the previous year exceeds the contracted standard. The latter approach should be treated by the customer with care. Unless there are other incentives for improved performance, this may actually encourage the supplier only to perform at or just above the contracted standard.

### Adding and removing service levels

In addition to change control, the customer may sometimes reserve the right in the contract to add new service levels and remove service levels that are no longer required. This may take the form of promoting KPIs to service levels (so that service credits start to apply) or the introduction of completely new service levels.

If the customer's right to introduce new service levels is unilateral, it is reasonable for the supplier to expect to see, in advance, an objective process for ascertaining the level at which such new service levels are to be set. Typically new performance standards are introduced based on actual supplier performance over a reasonably long sample period.

### Failure to meet service levels

When drafting service levels the customer should pay close attention to how a supplier might fail to meet them, and the potential consequences of doing so. One common consequence for failure is the imposition of a service credit, as discussed below. The contract will also often specify additional activities that the supplier will be required to perform following a service level failure, including:

- Performing a root-cause analysis.
- Creating and implementing a remediation plan.
- Escalation plans to senior stakeholders.
- Updating the customer of the cause and the steps being taken to remedy the fault.

There is a trend in certain industries towards more creative approaches to outsourcing that focus on the base drivers that led the parties into signing the outsourcing arrangement in the first place. For example, under the vested outsourcing model, there is a shift from a customer-results orientated approach towards an alignment of the parties' incentives that seeks to measure the success of the whole outsourced arrangement, with less of a focus on the actual performance of the supplier. Service levels in vested outsourcings remain important but are not the last word in measurement of the supplier's performance; instead of penalising failure to perform, the parties work towards a win-win arrangement that is mutually beneficial. This type of outsourcing can see the supplier held liable (eg, by a portion of its profit margin being placed at risk) for a failure that it might not be directly to blame for, or that might be independent of the service levels.

## Service credits

### Purpose of service credits

It is now standard in outsourcing agreements to include a service credit mechanism alongside service levels, where the customer receives a credit if actual supplier performance does not meet the contracted performance standard set out in a service level. The purpose of this mechanism is not to reduce the charges as a matter of course, or generate profit for the customer, but instead to focus the supplier's attention on those parts of the service that are most important to the customer and to drive good performance. The application of service credits can attract the attention of senior management within a supplier organisation if the profitability of the account is affected; and it is not uncommon for the personal bonuses of supplier account personnel to be directly affected by service credits.

The threshold trigger for a service credit should be at a level of performance at the bottom end of the range of acceptable supplier performance, so that service credits will apply only in situations where all agree that performance was inadequate.

Suppliers will want to ensure that service credits are reasonable and proportionate to the particular failure. Service credit caps and weightings and multipliers are used as methods of ensuring this. Suppliers may also seek to localise service credits in global deals so that a failure in one location warrants a relatively small service credit in comparison to a single failure that affects the global provision of the services.

### Sole and exclusive remedy

The contract should state expressly whether service credits are an exclusive or non-exclusive remedy for any given performance failure. From the customer's perspective, service credits are rarely sufficient as a sole and exclusive remedy as the amounts paid out are generally capped at a relatively low sum and would not be sufficient to reimburse the customer's losses. It is therefore important to ensure that the contract states that other remedies will also be available where a service level is breached; if the drafting is silent, service credits drafted as liquidated damages are likely to be interpreted as an exclusive remedy.

This is often a fiercely negotiated point. Typically the outcome of these issues in the agreement falls between the following extremes:

- To treat the credit as a price adjustment reflecting the reduced value of the services received, with the customer also entitled to seek damages for breach.
- To treat the service credits as liquidated damages and the sole financial remedy available to the customer (although the customer might also have the right to terminate for breach if the failure is severe enough).

These positions are often qualified by adopting one of the following approaches:

- The service credit is treated as a price adjustment, but if damages are also sought, the service credit will be deducted from the damages.
- The customer has a period to choose whether it will either seek damages or accept the service credit.
- The service credit is treated as the sole financial remedy provided that the performance is no worse than a specified minimum threshold, but if performance goes below the minimum threshold, then damages may also be sought.
- •The service credit is treated as the sole financial remedy but if the customer terminates for breach, then damages may also be sought.

See *Practice note, Contracts: agreed remedies* for a review of whether a clause operates as liquidated damages or a penalty.

 

### Service credit mechanisms

At its simplest, failure to meet a service level will result in a service credit. However, other mechanisms may also be used, such as scaled service credits (25%, 50%, 75%) which increase depending on the severity of the failure and service credits which only apply where a minimum level of service is reached (see *Multiple performance standards*).

### "Service credit holidays"

Suppliers will often resist the imposition of service credits immediately following the effective date. This may be because they are unable to meaningfully quantify the risks associated with taking over an unknown existing operation (see *Setting service levels*) or it may that they just want a "settling in" period during which they can ramp up the services without fear of service credits. So called "service credit holidays" are periods immediately following service commencement during which the supplier is required to measure service levels but shielded from service credits even where service level standards are not met. From the customer's perspective, service credit holidays are not particularly attractive as it is during this period that the project's reputation is made or lost and high performance during this period by the supplier is of particular importance.

### Service credit caps

Typically the agreement will include an overall cap on the amount of service credits that may apply in any month or year. There are evolving market standards for the level of this cap (5% to 20% of fees payable in the relevant period is the typical range), but the actual level likely to be agreed will depend on many factors, including, ultimately, the supplier's appetite for risk. Other relevant factors include the aggressiveness of the performance standards, whether any failure will automatically lead to a credit and whether the supplier will have the possibility of earn-back.

In extreme cases a customer may believe that it has obtained an above-market standard and exceptionally strong contract position, while in reality it may be paying a premium in the charges which will counterbalance any service credits that might apply. This could actually reduce the supplier's incentive to perform while increasing the cost of the deal for the customer.

### Weightings and multipliers

Given that the purpose of service credits is to focus the supplier's attention on the aspects of the service that are of most importance to the customer, service credit mechanisms often contain a weighting mechanism apportioning larger credits to some service levels than others. The customer's priorities are likely to change over the term (whether because of a change in business focus or in order to respond to poor performance by the supplier in particular areas) so the more sophisticated mechanisms will include a method by which the customer can elect to reallocate the weightings between service levels on giving reasonable notice.

It is also common to see the use of "multipliers" in service credit mechanisms. The effect of these is that the service credits potentially applicable to the individual service levels will in total exceed the cap (although the cap will still apply). The effect is that the cap is reached when only a proportion of the service levels are failed in a particular month, rather than all of the service levels. This significantly increases the risk to the supplier of the cap being reached and consequently the multiplier will be as heavily negotiated as the cap itself. Typical outcomes range from a multiplier of 1.5 to 3.5 (eg, if the multiplier is 2 then on average only half the service levels will need to be missed for the cap to be reached).

 

**Example wording**

As of the handover date, the percentage of the monthly charges that will apply as a service credit for the failure to achieve a Service Level (the "**Weighting Factor**") is as follows:

| Service Level | Percentage |
|---|---|
| [Insert relevant service level] | [ ] |

The Customer may from time to time, by giving not less than [three] months' notice, change the Weighting Factors that apply to one or more Service Levels (or change any Service Level to a Key Performance Indicator or change any Key Performance Indicator to a Service Level); provided that at no time will the aggregate Weighting Factors applicable for all of the Service Levels exceed [•]%.

If a Service Level is not achieved in any month and the failure is not excused, then the service credit that will apply will be calculated by multiplying the Weighting Factor that applies in the relevant time to such Service Level, by the total charges payable in respect of the relevant month; provided that in no event will the total service credits applicable in respect of any month exceed [•]% of the total charges for that month.

**Earn-back**

Some approaches to service credits include an "earn-back" concept which gives the supplier the opportunity to earn-back any service credits that might otherwise be payable for poor performance. Typically these mechanisms look at overall performance over a reasonably long period such as a year and come with stringent conditions such as all or some of the following:

- The average performance over the year must exceed the performance standard for the service level.
- For every missed service level, there must be a specified multiple of months in which the service level was exceeded.
- The service level is not missed by more than a specified amount.
- There were no more than a specified number of months in which the service level was missed in the year.

The advantage of the earn-back approach is that it encourages the supplier to overachieve the service levels in order to have the opportunity to remedy any missed months (or counterbalance any service credits incurred later in the year). The disadvantage is that it downplays the importance of hitting the service levels each and every month and may not match the business expectations of sustained and consistent high quality service. Accounting for earn-backs can also be complicated as a customer cannot recognise service credits received until the ability for the supplier to earn them back has passed.

 

A similar mechanism to earn-back that gives the supplier some protection by not making service credits such an immediate remedy is to include the concept of "free-misses", whereby the first missed service level in a period (eg, a year) is excused.

### Performance bonuses or incentive schemes

The supplier will often want to raise the possibility of service bonuses applying if the service level is exceeded in the same way that a credit applies if the service level is not met. Such bonuses are sometimes referred to as service incentive schemes or service debits. From the supplier's perspective, it is reasonable to ask for the inclusion of incentives as well as penalties; but from the customer's perspective the situation is not really symmetrical, and it is rare that bonuses are an attractive option to the customer. The customer will not be able to predict what the charges will be as it will not know whether a bonus will apply; and more importantly, the customer may not receive a commensurate business benefit from the improvement to the service that carries a higher charge.

However, there are two areas where bonuses or incentive schemes may be appropriate and helpful to both parties. First, where the customer could receive significant benefit from the supplier meeting a performance deadline or other target that will be difficult to achieve and which cannot be guaranteed by the supplier. By offering an incentive to meet the target, it may lead to a more successful outcome. Second, in business transformation outsourcings where there are not detailed service descriptions and service levels, bonuses can have an important role as part of the overall risk-reward incentivisation mechanisms.

Sometimes a service credit/debit bank is established where an account is set up into which service credits and debits are paid. This may take the form of an actual bank account or only a notional account and the mechanism and timing of the set-off of service credits and debits in the account will need to be addressed in the contract.

### Milestones

Most of this note has focused on service levels and service credit approaches for the "business as usual" services. Liquidated damages are also often used for the transition and transformational aspects of the outsourcing arrangements and other major projects to help ensure that deliverables are provided against the required milestone dates. Liquidated damages can be used not only for delivery of transformation or transition itself, but also for other accompanying deliverables that can otherwise become nagging issues if not addressed. Sometimes contracts are constructed on the basis that even if individual milestones are not met, the deductions for delay will not apply if the project or element of the project is finally delivered on time. The contract may also provide that additional damages may be sought by the customer if the delay exceeds a particular timeframe.

### Balanced score cards

Balanced score cards are a method used to roll-up a number of service level measurements to produce an overall outcome that measures the status of the relationship as a whole, sometimes classifying the overall status as "red", "amber" or "green". The scorecard is "balanced" because the different measures are weighted depending on their relative importance to the overall relationship. Service credits may be applicable if the relationship is "red" or "amber".

A scorecard can provide a simple and helpful high-level summary report of the state of the relationship, but beyond being used as simply a reporting tool in practice a balanced scored card mechanism is quite rare. Primarily this is because from the customer's perspective there is a significant problem caused by the lack of granularity implicit in the approach, which means that good results in some areas can outweigh significant problems in other areas meaning that service credits rarely apply in practice. The implication is that service credits only apply where the relationship is poor overall, leading to a blunting of the leverage offered by the service credit tools.

### Penalties and service credits

Customers have previously been concerned to ensure that service credit mechanisms are carefully framed so as to avoid being construed as penalties, and therefore unenforceable under English contract law. Service credits framed as liquidated damages and ramped service credits were particularly at risk of failing the 'genuine pre-estimate of loss' test. Some of this concern has been allayed by the decision of the UK Supreme Court in the joined cases *Cavendish Square Holding BV v Makdessi and Parking Eye Limited v Beavis [2015] UKSC 79*. The Supreme Court took a pragmatic approach to the interpretation of remedies, and considered that the ultimate question to be answered is whether the clause in question is extravagant, exorbitant or unconscionable by imposing a detriment for breach that is out of all proportion to the legitimate interest of the non-breaching party.

The Supreme Court acknowledged that a non-breaching party may have a legitimate interest in a remedy that goes beyond financial compensation of the type available under a damages claim. Simply punishing the party in breach would not amount to a legitimate interest, but it could be permissible to require performance by the party in breach or even an appropriate alternative to performance. The Supreme Court noted that the extent to which the parties were negotiating at arm's length on the basis of legal advice was a relevant factor in making this assessment. This may protect ramped service credits (ie, where the service credit increases the longer the breach continues), where the customer can argue a legitimate interest in ensuring consistently good performance and avoiding multiple minor failures in delivery of the services by the supplier.

The consequence for service credit schemes is that they are likely to be enforceable if they do not impose an extravagant, exorbitant or unconscionable detriment on the supplier.

## Practical drafting tips

### Interplay with other contract terms

Agreements employing service levels and service credits mechanisms can be complex, and the parties should take care to ensure the mechanisms work in harmony with termination rights, variation provisions and other terms so as to accurately reflect their intentions. This is particularly important where clients draft the majority of the detail around service levels and service credits. In *BT Cornwall Ltd v Cornwall Council and others [2015] EWHC 3755* Knowles J identified the following points that made the agreement in question difficult to work with, which may be useful to bear in mind:

- There was disagreement as to whether the parties' executive forum set up to govern performance under the contract had the authority to validly amend the agreement, outside the contract's detailed amendment provision.
- Imprecision in the waiver provision lead to disagreement over whether a waiver had in fact occurred.
- The right of one party to unilaterally amend service levels led to confusion as to whether a KPI had been met.

The contract under consideration in this case also contained an unusual right of the customer to terminate the whole agreement immediately on occurrence of a material breach, where a material breach included an accrual of service credits. A supplier should be cautious to grant termination rights to the customer that do not allow for a cure period, particularly in the case of an accrual of several small failures to meet KPIs or service levels.

**Industry-specific considerations**

This note is intended to give an overview of service levels and service credits for bespoke business-to-business agreements, and does not take account of industry-specific considerations. Most clients will be aware of guidance from their regulators regarding outsourcing arrangements and the content of service levels (eg, for regulated financial services firms) and any industry standards that have been issued (eg, for cloud computing providers). The payment of liquidated damages and service credits can also give rise to specific concerns under Shari'ah-compliant outsourcing arrangements.

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