Contract Performance and Service Level Agreements (SLAs)

Recommended Practices for Maximizing the Value of Outsourced Services

Definitions and Background

Incentives and penalties are contractual statements of performance measurement. They reward service providers for exceptional performance or penalize them for inferior performance.

Incentives and penalty clauses are vital elements of outsourcing contracts and relationship management. They are contract tools that that the state can use to manage its outsourcing relationships. They have a single purpose – to drive the desired behavior of the supplier.

Used properly, incentives and penalties can be effective and can produce a positive relationship between the state and the supplier. Used incorrectly, incentives and penalties can cause meaningful relationship problems, including monetary loss, diminished confidence and trust and the demise of the relationship.

Standard Contract Types

Contract Type	Vendor Risk	State Risk	Contract Metrics	Contract Pricing
Cost Plus	Low	Medium	Deliverables and service level agreements	Actual cost + fees
Time and Materials	Low	Medium	Deliverables	Fixed Rate per hour/day/month
Fee for Service	Medium	Medium	Service Level Agreements	Rate per Transaction
Fixed Price	High	Low	Deliverables and Time	Fixed Rate
Gain Share	Medium	Medium	Service Level Agreements or Deliverables and Time	Fixed Rate + Percent of $ Gain
Business Benefit Based	High	Medium	Business Metrics	Percent of Profit or Revenue
Shared Risk/ Reward	High	High	Service Level Agreements and Business Benefits	Fixed Rate + Percent of $ Gain

Open Market Leading Principles for SLAs and Performance Contracting

1. **SLAs are clear, unambiguous and easy to follow**. A simplified template helps support SLA monitoring.

2. **The contract type dictates the types of incentives and penalties that are applicable and appropriate**. The incentives and penalties appropriate to a fee for service or fixed price contract differ significantly from those best applied in a gain share or shared risk/reward type of contractual relationship. The contract author should explore the pros and cons of all the contract types and apply the SLA measures that work for the contract type.

3. **Ensure the SLAs or incentives and penalties are appropriately tailored to the type of project or service** being put out for bid. RAGU' makes great spaghetti sauce but "bits and pieces of everything in one jar" doesn't work regarding the construction of contract SLA's. Tailor contract SLA metrics to fit the contract type and needs of the investment to drive behavior and outcomes. Avoid boilerplate SLAs.

   Projects (or investments) are neither exclusively IT or business projects and, only when they are viewed and handled as both, are the investments positioned for success. The relationship that people, process and technology (P.P.T.) has on transformation investment and a more even distribution of SLA measures across those domains is appropriate.

   Also consider the level of penalties and whether they will be impactful. Consider setting penalties between 10% and 20% of the payment schedule. Successful application of penalty could involve a gradual penalty charge such as first failure would be at the discretion, second failure could be 10% and third could be 20%.

4. **Use incentives to drive business value**, but ensure the value is greater than or equal to the incentive payout. This helps ensure that the state does not "lose money" on the incentives payout. Organizations that don't provide earn-back opportunities for service-level failures often create dissatisfaction and distrust in the relationship from both parties.

   Additionally, one sided contract SLA's are only half a strategy. A "earn-back" process is also required in a leading practice SLA program. Contract authors may need to work with the supply chain or a focus group to develop viable "earn-back" buy-in and develop a SLA model that is mutually agreeable, actionable and understood by all parties.

5. **Use standard state terms and conditions, including limitation of liability, whenever possible**. Limitation of Liability contract language is another form of penalty. This is often converted into a risk and cost item by bidders. As a result,

contract authors must apply consistency and judgement regarding limit of liability matters. Prior to adjusting state term limit of liability clauses, contract authors should benchmark limit of liability standards in use at other state and, whenever possible, use the standard State of Ohio clause. Limit of liability should not be handled as a negotiable or variable item.

6. **Specify phase-based delivery requirements and incorporate project deliverables, related payments and holdbacks to drive the right service delivery behaviors from service providers.** Many "project-based services contracts" are typically based on delivery of products according to schedule and specific requirements for the deliverables, fixed-price time and materials with performance-based terms and the responsibility for risk of outcomes is shared between the organization and provider

7. **Distribute SLA measures relatively evenly over the major phases[1] of the contract vs. based on the milestones contained and defined within the contract.** The use of formalized "Show Us" gate reviews can be used to ensure compliance to contract methodology can help ensure the product being delivered aligns with expectations of quality and scope (unlike reliance on paper deliverables, which may not fully reveal the product under development). Projects (investments) are a cumulative nature whereby the outcomes accumulate over the lifecycle phases of the project. If using an agile or agile/hybrid methodology, determine what percentage of deferred features is acceptable and incorporate language into the contract or SLAs.

8. **Develop supply chain "buy in" to SLAs and performance-based contracts**. Supply chain collaboration/"buy-in" should be considered as part of routine relationship development and continuous improvement efforts in the states contracting maturation. A Voice of the Supplier (VOS) session should be incorporated into each contracting cycle so that the suppliers understand the spirit of the program and takes some ownership of the program benefit and mutual success.

9. **Create alignment around service and personnel issues.** Service providers are sometimes engaged on a staff-augmentation basis with no penalties for nonperformance, leaving them unaligned to the outcomes sought. Often, "outsourcing contracts" are staff augmentation contracts in disguise. This mistake can cost the state if it fails to enact the appropriate risk mitigation, contract management practices, and performance metrics for the type of contract it really has. Additionally, don't try to force one-sided accountability in the contract when if the supplier is unable to manage with true accountability because of the contractual relationship. Last, ensure that the contract adequately addresses key personnel commitment expectations of the state by the contractor as part of the statement of work.

[1] Within standard contracts, discovery, design, build testing and deploy are generally in use

Types of Performance Contracts, Incentives, Payment and Factors in Selecting

Cost Plus Time

Cost-plus-time bidding, more commonly referred to as the A+B method, involves time, with an associated cost, to determine the low bidder. Cost-plus-time bidding is used when time overruns have a significant business impact whereas early completion has a significant business benefit. The associated incentives and penalties should not exceed the business benefit of early or late completion.

A+B Bidding is used to motivate the supplier by minimizing project completion time on high priority and high usage projects. This encourages supplier to finish early by (1) offering bonuses for early completion and (2) assessing disincentives for late completion. A + B Bidding allows the state to have a project “schedule bid” so that the duration or time to completion takes on more importance. The supplier’s estimate for the completion of critical work can be an effective technique to significantly reduce project impacts.

Under the A+B method, each bid submitted consists of two components:

- The “A” component is the traditional bid for the contract items and is the dollar amount for all work to be performed under the contract.
- The “B” component is a “bid” of the total number of calendar days required to complete the project, as estimated by the bidder, multiplied by a factor set by the contract “owner” or project sponsor prior to the bid. (Calendar days are used to avoid any potential for controversy with work days.)

The bid for award consideration is based on a combination of the bid for the contract items and the associated cost of time, according to the formula: (A) + (B x Disincentive/Day) This formula is used to determine the lowest bid for award and is not used to determine payment to the Contractor.

Sample Language

The number of calendar days to complete the work to be performed under this contract for [project output/outcome] will be that specified by the supplier in the Proposal for the bid item of “Calendar Days of Contract Time for [project output/outcome]” which days, including any days based on an approved extension of contract time, shall be the end of opening to [project outcome]. The final project completion will be an additional [___] days. The date for the beginning of the contract time will be the date [appropriate

benchmark for start of project] but no later than [___]. The calendar days for [project outcome] shall NOT be longer than [___] days. No adjustment of the contract time date will be allowed for delays in execution of the contract caused by the supplier.

Because of the [reason for use of cost-plus-time contracting], it is essential that this work be completed as quickly as possible once work begins. The state has determined that this [reason/impact] will result in a disincentive of [$___] per calendar day which the supplier's established contract [project outcome] has been used as a basis for comparison of bids and award of contract. Should the supplier fail to [project outcome] in the time stipulated by the supplier in the proposal or within such time granted by an approved extension of time, the supplier shall be assessed a disincentive of [$___] per calendar day which will continue to be assessed until all [project outcome – define in detail] is completed. All work inclusive of critical and high defect resolution shall be completed before [project outcome] as defined above.

The supplier will be paid an incentive of [$ ___] for each calendar day the project is [outcome] before the published completion date as per this contract, not to exceed an amount equal to [$ _____]. If the supplier fails to complete the project by final project completion, liquidated damages will be assessed in accordance with [state terms and conditions]. However, if a disincentive period extends beyond final project completion, the supplier will be assessed either the disincentive amount or the liquidated damages, whichever is greater, but shall not be assessed the sum of both.

In the event the supplier must impede use of the system by the state or by its users after going live, the supplier shall be assessed the daily disincentive amount for each day traffic is restricted.

Innovative methods for Incentive / Disincentive payments:

Incentive/Disincentive Contract: Establishes an incentive payment to the Contractor for each day that critical work is completed ahead of the completion date and a disincentive for each day / hour or smaller interval that critical work is completed after the completion requirements. The incentive and disincentive amounts do not have to be the same amount.

Lump Sum Minus Contract: Establishes a large lump sum incentive for the Contractor that is paid if a specific completion date is met. If the completion date is not made, the incentive is reduced by a fixed amount for each time period until the Lump Sum incentive reaches zero. This method, like Incentive/ Disincentive, would typically be used on projects where the emphasis is on the Contractor to provide innovative solutions to minimize construction time to meet a challenging completion date.

A+B Contract: Establishes an “A” portion of the contract to be bid as normal bid items, and a “B” portion to be bid as the number of days the Contractor proposes complete the project. The “B” number is multiplied by the daily user cost given in the contract and added to the “A” portion to determine the low bid. A+B Contracts allows the Contractor top control the completion date.

Factors in Selecting Contract Types:

There are many factors that the contracting officer should consider in selecting and negotiating the contract type. They include the following:

1. Price competition. Normally, effective price competition results in realistic pricing, and a fixed-price contract is ordinarily in the Government’s interest.

2. Price analysis. Price analysis, with or without competition, may provide a basis for selecting the contract type. The degree to which price analysis can provide a realistic pricing standard should be carefully considered.

3. Cost analysis. In the absence of effective price competition and if price analysis is not sufficient, the cost estimates of the offeror and the Government provide the bases for negotiating contract pricing arrangements. It is essential that the uncertainties involved in performance and their possible impact upon costs be identified and evaluated, so that a contract type that places a reasonable degree of cost responsibility upon the contractor can be negotiated.

4. Type and complexity of the requirement. Complex requirements, particularly those unique to the Government, usually result in greater risk assumption by the Government. This is especially true for complex research and development contracts, when performance uncertainties or the likelihood of changes makes it difficult to estimate performance costs in advance. As a requirement recurs or as quantity production begins, the cost risk should shift to the contractor, and a fixed-price contract should be considered.

5. Combining contract types. If the entire contract cannot be firm-fixed-price, the contracting officer shall consider if a portion of the contract can be established on a firm-fixed-price basis.

6. Urgency of the requirement. If urgency is a primary factor, the Government may choose to assume a greater proportion of risk or it may offer incentives tailored to performance outcomes to ensure timely contract performance.

7. Period of performance or length of production run. In times of economic uncertainty, contracts extending over a relatively lengthy period may require economic price adjustment or price redetermination clauses.

8. Contractor's technical capability and fiscal responsibility

    a. Adequacy of the contractor's accounting system. Before agreeing on a contract type other than firm-fixed-price, the contracting officer shall ensure that the contractor's accounting system will permit timely development of all necessary cost data in the form required by the proposed contract type. This factor may be critical

        i. When the contract type requires price revision while performance is in progress;
        ii. When a cost- reimbursement contract is being considered and all current or past experience with the contractor has been on a fixed-price basis.

9. Concurrent contracts. If performance under the proposed contract involves concurrent operations under other contracts, the impact of those contracts, including their pricing arrangements, should be considered.

10. Extent and nature of proposed subcontracting. If the contractor proposes extensive subcontracting, a contract type reflecting the actual risks to the prime contractor should be selected.

11. Acquisition history. Contractor risk usually decreases as the requirement is repetitively acquired. Also, product descriptions or descriptions of services to be performed can be defined more clearly.