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SLAs: GUARDING AGAINST SURPRISES

The importance of SLAs

Please spell «Breakdown»

This is how the employee of an Indian call centre, responsible for the IT-maintenance of a German car manufacturer's production plant, replied when the person in charge urgently called for help after the plant had broken down.

It is therefore not surprising that bad experiences related to outsourcing of IT operations sometimes cause emotions to boil over. Offshoring, as in this case in India, can especially cause a lot of problems, but also in domestic outsourcing worst-case scenarios must be taken into account. Despite potential problems it is worth taking a closer look at the advantages and disadvantages of outsourcing projects. Most failed projects can be explained by a limited view on wage costs. There is a reason why a Business Case takes an integrated view on costs, benefits, and risks. This is often not carried out in outsourcing projects. Priority therefore must be set on a meticulous preparation of Service Level Agreements (SLAs). This can be illustrated in a Business Case for Norsk Hydro ASA, the third largest aluminium producer in the world, who wanted to outsource their IT service management.

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The promise of cost savings of outsourcing projects had obviously led to much enthusiasm, but had also created a situation in which the services provided by the present help desk or in-house IT department were not taken into account. By focusing only on cost the level of services provided was unimportant. It was not until services were no longer provided that their importance moved back into focus.

Outsourcing of IT operations can be successful when the focus lies not only on cost, but rather on the relationship between cost and the level of services provided. Although this seems obvious, it is often neglected as the implementation requires a lot of work. At worst the assessment was based only on hourly wages, and costs such as for the existing infrastructure were not taken into account. Several projects were cancelled after significant investment because the required service levels had not been sufficiently accounted for in relation to costs.

«Manage my mess for less» aptly sums up the motivation of many companies to outsource their IT operations to external service providers. This statement, however, requires knowledge of the current costs for IT operations. Since cost structures are often very tangled within companies, the effort is not made to also quantify the cost and services provided within in the current solution. Accounting often has difficulty in providing these figures due to accrual and source related assignment issues. Necessarily cost savings can only be calculated by comparing the new with the current cost situation.

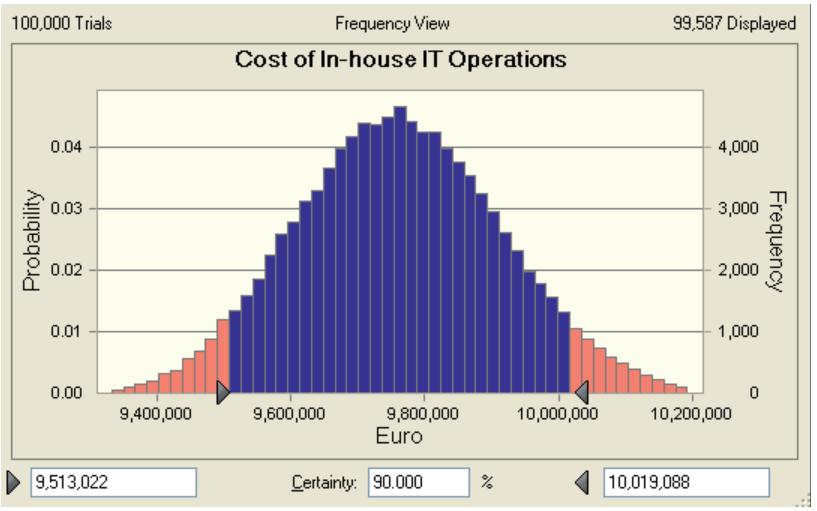

Figure 1: Cost of in-house IT operations – Monte Carlo-Simulation includes 100,000 trials and generates a range of possible results. The x-axis displays the cost of IT operations when delivered by the own IT department.

SLAs act as a link

The link between costs and services are Service Level Agreements. The failure to define reliable SLAs is a pitfall for each outsourcing project. Without a clear definition of service levels, costs cannot be calculated accurately. The specifications could be formulated as follows: repair of production plant IT-system within four hours. Weekly updates of employees' laptops. 98% company server availability. Etc. For each application, such as e-mail, security or SAP, it is necessary to specify how quickly all errors must be corrected in case of a breakdown.

This includes making a decision on the priority and value associated with certain issues. A production plant for example must have top priority and the desired service time and quality must both be agreed upon. In this case 24 hour service availability is necessary. For the repair of employees' notebooks however, service availability during working hours from 8 a.m. to 5 p.m. is fully sufficient.

Optimally the SLA also defines whether only actual breakdowns are included or whether also performance or productivity decline are taken into account. Then it is necessary to define at which level of decline it must be repaired within which timeframe. A server for example can still be working, but at a very slow speed, which then can lead to similar operating losses as a complete breakdown. In this case it is necessary to specify that the server's download speed must be at least 54 MB/s and a drop of 20% counts as a breakdown, which must be fixed within 12 hours otherwise a penalty is due.

Missing or inadequate Service Level Agreements can have several negative effects:

- **no balanced relation between costs and services provided**

This is essential in order to make informed economic decisions either in favour of or against an outsourcing project. This is also why many outsourcing projects fail. A Business Case must quantify costs, benefits, and risks in equal measure otherwise it is hardly worth more than the paper it was written on. This connection between costs and benefits is exactly where Service Level Agreements make all the difference.

- **dissatisfaction with service provider since expectations are not met**

Just because Service Level Agreements have not been specified, it does not mean that the company has no expectations regarding service levels. More likely they have just not been defined accurately. Therefore a clear and concise formulation is essential.

- **increasing costs**

If not clearly specified the provider may apply the most expensive solution, such as 24 hour service availability for services which can sufficiently be provided during the day on weekdays.

Example

In the Business Case for Norsk Hydro ASA, the cost of the current scenario is compared with the outsourcing scenario. To set up a financial model, various cost items need to be gathered over a minimum period of three years. Individual cost items are collected in the form of interval estimates with a minimum, a most likely, and a maximum value. Total costs are accordingly calculated in three columns in the financial model. This includes costs for missed Service Level Agreements, hardware maintenance, operating systems, desktop applications, network, hosting, email, security, and infrastructure.

In the in-house scenario, where IT services are covered by the own IT department, total costs for IT service management for three years are € 9.75 million. For the outsourcing project the costs are only € 8.38 million. These figures represent the most likely values within the estimated interval. For the in-house solution the financial model shows a minimum value of € 8.87 million and a maximum value of € 10.97 million. Using Monte Carlo simulation 100,000 trial values are extracted from the interval, which enables a statistical evaluation of the results: with a probability of 90% the costs of the in-house solution will be between € 9.52 million and € 10.02 million (Figure 1).

In the case of the outsourcing solution the values derived from the financial model are as follows: the outsourcing solution will cost at least € 7.62 million, in the most likely case € 8.38 million, and no more than € 9.25 million. Again, Monte Carlo simulation can be used for statistical validation: With a 90% probability the costs of the outsourcing solution will be between € 8.19 million and € 8.62 million (Figure 2).

So, is it only the costs which make the decision after all? The outsourcing project costs € 1.37 million less than the in-house solution and is therefore superior. Yes, in the end the decision is again down to the costs. The main difference with the total costs calculated here, however, is that the level

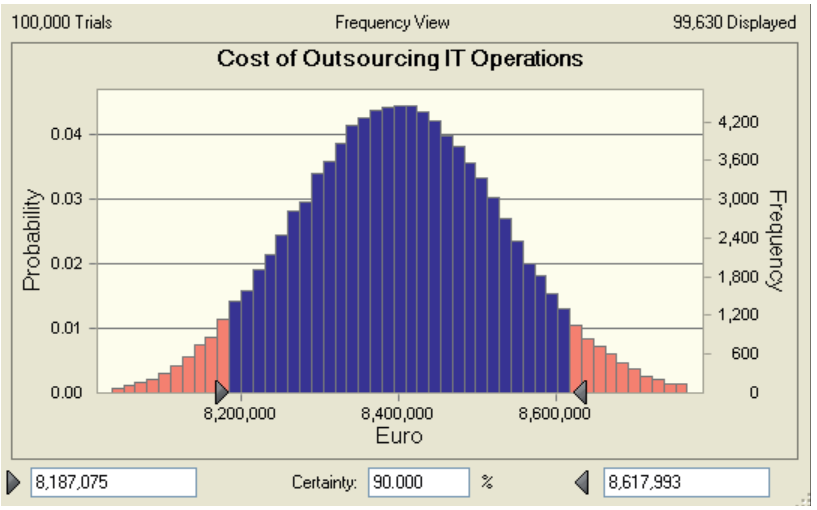

Figure 2: Cost of outsourcing IT operations – the blue bars indicate the range of values which will occur with a probability of 90%. Together with the red bars the complete (100 %-) range of all possible outcomes is displayed.

«Most failed projects can be explained by a limited view on wage costs. There is a reason why a Business Case takes an integrated view on costs, benefits, and risks.»

Johannes Ritter
Business Case Expert
Solution Matrix

of service is accounted for thanks to Service Level Agreements. Individual cost items were always evaluated with respect to the level of service provided. Many incomplete outsourcing Business Cases only compare costs such as infrastructure, wage and rental cost without linking these to the service level of the IT operations they provide.

Requirements

So what are the requirements for a successful outsourcing project? An informed economic decision is only possible on the basis of a balanced cost and benefit analysis. What differentiates a good Business Case is that costs are evaluated based on the level of service provided. This is possible with SLAs, which provide a solid structure for a well balanced Business Case including all costs, benefits, and risks of a project. On this basis the Business Case ensures that the outsourcing project is indeed worthwhile (or not). Also the Business Case not only quantifies costs, benefits, and risks of the outsourcing project alone, but always in comparison to the current in-house solution. As this Business Case concept makes concrete SLAs a prerequisite instead of delaying their specification, the SLAs become an important critical factor to the project's success. The precise definition of Service Level Agreements is what ensures the necessary environment for required IT operations. In outsourcing projects it is not unusual that the middle management or the project managers do a better job than the top management. While the top management likes to be associated with the potential cost savings, the middle management is usually held responsible for decreasing productivity levels or increasing costs.

« The link between costs and services are Service Level Agreements. The failure to define reliable SLAs is a pitfall to each outsourcing project. »

Christine Marburger
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