

# Your LTSA Is Ending: What Should You Do?

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**I**magine this: The expiration date or other contractual “off ramp” for your long term service agreement (LTSA) is approaching and your company has decided to make an exit, or at least to attempt a renegotiation with the original equipment manufacturer. Many alternatives are available as you try to determine the best path forward for your turbines. Sound familiar? If so, there are many issues to consider as you plan your next move.

## The “True-Up” Clause

If your LTSA contains an early termination option, it will be important to consider any “true-up” clause that may apply. Such a clause is typically intended to balance the parties’ accounts, retrospectively, at the time of termination. For example, if the owner has pre-paid for parts or services that have not yet been received, those pre-payments would be refunded. Given the dollar-per-operating-hour structure of many LTSAs, pre-payments of this nature are common. Consequently, upon an early termination the owner may have paid for parts and services that are not scheduled to be provided until later in the LTSA’s term. Similarly, if the original equipment manufacturer (OEM) has provided parts or services under the LTSA and the owner has not made the required payments for them, then the OEM should of course receive such payments. Thus, a “true-up” clause can ensure that the parties “get what they pay for and pay for what they get” at the time of termination.

As simple as the true-up concept seems, the devil can be in the details or, in many cases, the lack of details. From the owner’s perspective, a clause that simply dictates a rebate for pre-paid amounts in excess of the value of parts and services that have already been received raises the issue of how to value those parts and services. Only by knowing this value can one start the necessary calculations for any rebate.

However, what defines that value? While the “cost” for such items is undoubtedly buried in the LTSA’s dollar-per-operating-hour pricing mechanism, attempting to unbundle that cost from the other pricing components (for example, risk premiums, allocations for overhead, profit) can be a daunting task, especially given the presumed reluctance of the OEM to open its books.

From the OEM’s perspective, a true-up clause that mandates payment to it for parts or services raises the issue of what payments are considered “required?” Certainly, this would include invoices remaining unpaid at the time of termination. However, should the clause also require payment for parts that were provided early in the term of the LTSA and for which full “payment” has yet to occur via the dollar-per-operating hour payments? Consider as well how such a clause would apply to other situations where the OEM has provided parts and services to the owner without additional charge.

For example, imagine an OEM who—valuing the long-term relationship with its customer—elected to replace a defective row of blades with a new set, despite the lapsing of the blades’ warranty. Should a true-up clause require payment for those parts after all?

Another example might involve the OEM having agreed to bear certain monetary risks for downstream damages resulting from defective parts. If those risks materialized, the OEM may have spent thousands of dollars to install replacement parts at no cost to the owner. Should a true-up clause require repayment for those amounts? What if the agreement’s pricing presumably contained a premium for the OEM having taken that risk in the first place? Yet another question is whether the value of any discounts on parts might retrospectively be considered payments “not made” by the owner for parts. Should the true-up clause require disgorgement of discounts? These are the types of complicated issues that can arise in the true-up context and impact the steps an owner might take in exiting its LTSA.

## Measuring Better “Market” Pricing?

Long-term agreements of any type will often allow the purchaser to exit if, after a stated period, it can demonstrate that the market pricing for the same goods and services is lower than the contract pricing. If an owner’s LTSA contains such a provision, it will need to consider the extent to which the wording requires a true “apples to apples” comparison as between the OEM LTSA and non-OEM alternatives. It is one thing to compare the pricing of OEM-provided parts and repair services to those of a non-OEM. It is quite another to analyze the comparative value of the ancillary scope components that have become commonplace in OEM LTSAs, such as remote monitoring and tuning and on-site technical advisors.

Beyond these items, analysis may also require comparing the risks taken by the OEM against those that non-OEMs are willing to take. Such risks may include, for example, length and breadth of warranty coverage, extent of collateral damage coverage and implementation of OEM-recommended maintenance advisories. Depending on the wording of the contract provision, an owner should be aware these types of factors may need to be included in any consideration of whether the overall pricing for a non-OEM LTSA alternative is lower than that of the original agreement.

## Strategies for Going to Market

Whether driven by a “market comparison” clause or not, the approach that many owners will take to select the provider of their next tranche of LTSA coverage will be through a request for proposal (RFP) process. While such a process can certainly serve to gather general information about the LTSA market, a practical owner will put significant thought into developing a proactive RFP strategy that can increase the value of that information.

For example, an owner will want its RFP to define the desired level of LTSA coverage, both in terms of work scope and risk allocation. As regards work scope, beyond detailing the parts and repairs to be provided, an owner will want to specify any ancillary services that are or may be desired. In order to facilitate evaluations, an owner may structure its RFP to require segmented pricing of these components.

When it comes to risk allocation, while many LTSAs of the late 1990’s provided only standard “planned maintenance” coverage,

the risk coverage available more recently can be much more robust. Expanded coverage can include the contractor's taking on pre-mature wear and tear and early fallout risks, committing to perform unplanned preventive maintenance without additional charge and even bearing certain costs of collateral damage. As another example, an owner may want the contractor to bear risks of outage duration or other performance metrics. Thus, an RFP should outline how the owner expects each of these types of risk to be allocated.

Of course, risk shifting always comes with a cost. Thus, an ideal RFP will elicit incremental risk pricing information to facilitate the owner's cost/benefit analysis. Beyond pricing, the owner will want to seek information that will help it evaluate the ability of each bidder to manage and mitigate such risks.

Finally, an owner will want to consider whether its RFP should include form terms and conditions, so that each responding bidder is truly on the "same page." A full-blown form contract accompanying the RFP can be a valuable means of bringing to light key differences between bidders. However, if time does not allow for such details, a well developed term sheet can often serve the same purpose.

### Non-OEM Vendor Issues

The maturing parts and services market for large-frame gas turbines has resulted in an increased number of non-OEMs who offer competing products. While this opens new cost savings opportunities for owners, several unique issues must be considered when contracting with a non-OEM vendor. Among them are the following:

*Parts Issues:* One key issue is whether the non-OEM manufactures its own parts or only offers repair services for OEM-manufactured parts. If the non-OEM manufactures its own parts, an owner will want to consider the long-term reliability and viability of such operations and ensure it has a "Plan B" should the non-OEM's business model change.

A related issue involves parts pooling. Over the years, the large "parts pools" of the OEMs have incentivized many owners to move to an "open pool" arrangement. In this arrangement, the OEM taps its worldwide pool of parts to supply parts, providing new or refurbished parts as needed. Although the owner has parts title while the parts are installed, it otherwise never owns any specific, identifiable set of parts. This can provide owners with expanded parts availability and lower cash flow outlays. An owner will want to assess the availability and viability of such an arrangement with a non-OEM. It may be that the "closed-pool" model will work best, where the owner buys and always owns the requisite parts. However, this model may drive different cash flows and influence risk allocation decisions on such issues as early fallout and availability of parts for unplanned maintenance.

*Intellectual Property Issues:* Another issue is whether the parts manufactured and/or services performed by the non-OEM could violate any patent or other intellectual property rights of the OEM. This is a risk that any new market entrant, like the non-OEMs, will regularly bear. Nonetheless, the question becomes the extent to which they are willing to insulate owners from such risks. Patent rights allow the patent holder to enjoin anyone from using the patented product without permission. This would include the ability to stop an owner from using infringing turbine parts installed in its operating units. Thus, an owner must have very well structured clauses that protect its interests in light of

these issues and must realize that any chink in its armor on this point could create untenable risks to its operations.

*End of Term Parts:* This issue involves the capital parts remaining in an owner's units at the end of the original LTSA term. If an owner elects to extend its existing LTSA with the OEM, it is quite possible that such capital parts (assuming remaining life on them) will be "picked up and wrapped" by warranty provisions of the extended contract. Such continuous and extended coverage is typically not difficult for the OEM to provide. However, this may not be the case with a non-OEM and an owner should be careful to discuss the treatment of such parts with any such non-OEM provider.

For example, to the extent those parts are subject to warranty coverage under the prior LTSA, the owner may risk voiding that warranty by allowing the non-OEM to handle those parts. Thus, an important question will be whether the non-OEM will agree to pick up and wrap those parts, even though it did not manufacture, repair or install them. By addressing these issues head on, an owner can work toward a seamless transition of coverage for these parts as it moves from one contract to the next.

### Eyes on the Horizon

OEM LTSAs are complicated arrangements in their own right. The rise of the non-OEM market only adds to these complications. The issues raised here are but a few of the many an owner must consider in transitioning to a new LTSA. Against this backdrop, owners must also realize that the process of assessing market conditions, addressing these issues and negotiating new LTSAs (especially if negotiating with both OEM and non-OEM) can take many months. Further, the adage of "haste makes waste" has never been more valid than in this context. Thus, a prudent owner will allow ample time for all of these efforts. In doing so, it will have increased its chances of attaining the ultimate goal: a win-win contract that achieves cost efficiencies and reliable operations for years to come. ■■

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