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Turbines in focus

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Many turbine owners view 'Long Term Service Agreements' (LTSA) as fundamental components of their generation asset management programs. LTSA typically commit the original equipment manufacturers (OEMs) to provide maintenance services for the power turbine that they have manufactured.

Commercially speaking, LTSA can offer many advantages to owners, including the predictability of relatively fixed long term maintenance costs and contractually incentivised OEM support. However, these very complex agreements often contain pitfalls for the unwary equipment owner - pitfalls that can cause an owner to bear an inordinate amount of risk, or that may result in costly disputes with the OEM.

This article examines five of the key contractual pitfalls most commonly found in LTSA, and suggests appropriate means for avoiding them. Since no two LTSA are alike, this article posits for the sake of discussion an LTSA whereby the OEM's work scope is to perform:

- all regularly 'scheduled' maintenance on the unit, including providing parts and labour, at pricing that is relatively fixed over the life of the LTSA
- all 'unscheduled' maintenance on the equipment, at pricing that is unit-based, fixed, or a combination of both
- certain 'Extra Work' as may be requested by the owner and priced based upon an agreed schedule of rates.

Wear and tear

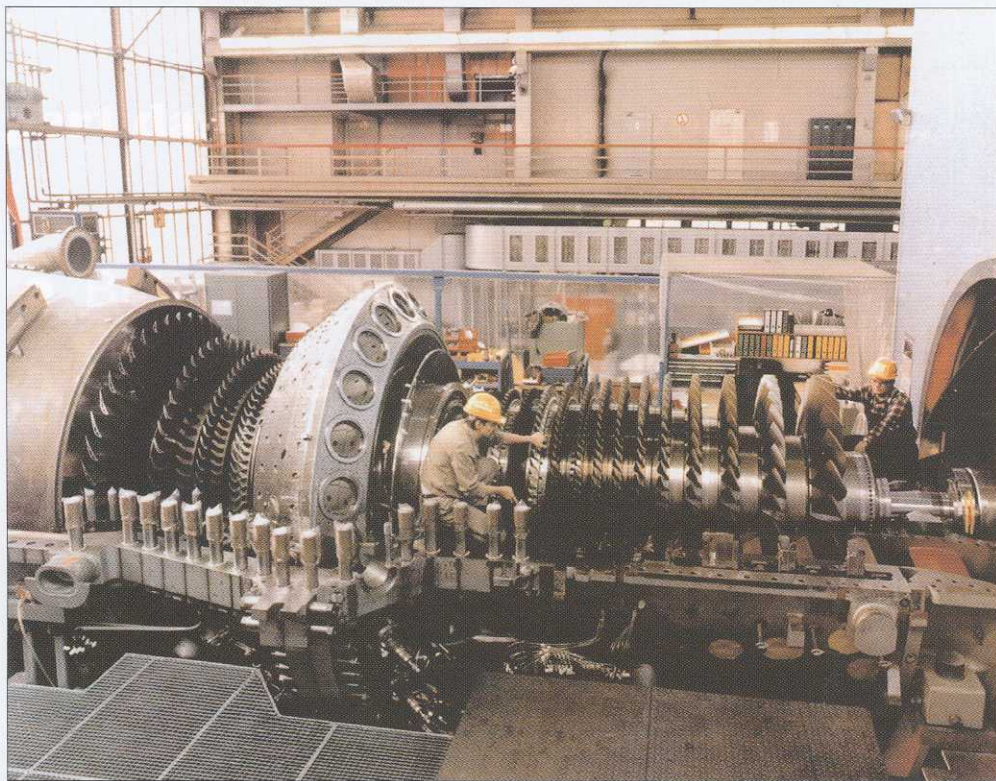
In many cases, LTSA will require the OEM to perform 'scheduled maintenance' to address the effects of 'wear and tear' on the turbine. The problem with this approach arises when the parties fail to step beyond an extremely vague reference to 'wear and tear.'

This failure can leave a gaping hole in the contract in certain situations. For example, imagine the scenario where a part must be removed and replaced one thousand operating hours prior to the time when replacement of such part was (at the outset of the LTSA) expected to occur. From one perspective, such maintenance might arguably have been required to address so-called 'normal' wear and tear.

Thus, it would be considered within the scheduled maintenance scope of the OEM, already included in the LTSA pricing. However, from another perspective the 'early' nature of the fallout of the part arguably categorises its replacement as 'unscheduled maintenance,' putting the cost of the maintenance on the owner.

This analysis can become even more convoluted if the 'premature' wear and tear itself resulted from a defective design of the part, possibly implicating repair obligations under the parts' warranties.

Avoiding costly pitfalls



Richard E. Thompson II & Jason B. Yost,
from US law firm Troutman Sanders,
outline how turbine owners can avoid key
contractual pitfalls when deciding upon
long term service agreements.

As they say, 'the devil is in the details,' and it is exactly these types of detailed distinctions that can result in major cost differences for the owner and the OEM. Thus, it is essential to be clear on this important matter, by clearly defining the parties' intentions as to what constitutes 'wear and tear.'

Extra work

Many LTSA commission the OEM to be the exclusive provider of all parts and services related to 'unscheduled maintenance' and 'extra work' on the turbine over the term of the LTSA. Many LTSA fail, however, to establish clear pricing for such work, opting instead to allow the OEM to perform this work at then-current time and materials rates.

The pitfall raised by this approach is that the owner immediately takes the risk of future price increases; a risk that

is arguably inconsistent with a long-term and exclusive mandate for work by the OEM.

Thus, a prudent owner can avoid this pitfall by locking in unit pricing for all future parts and services that may become required as a matter of unscheduled maintenance and/or extra work. Of course, the parties can then protect themselves from inflation or deflation via an indexation mechanism.

No clear owner rights

As part of their business, OEMs continuously work to develop longer lasting turbine parts. These efforts constantly increase the likelihood of eliminating a given scheduled maintenance outage event (e.g., a combustion inspection) in a turbine's original scheduled outage program. This raises particular issues in the context of LTSA that are priced based upon an assumed long term scheduled outage program.

Some LTSA will remain completely silent on this eventuality. Such silence today can lead to disputes tomorrow. Other LTSA will address this possibility by implication only, with provisions that allow the OEM to use 'new technology,' without the requirement of owner approval and broad OEM scope language that does not enumerate the exact number and types of planned maintenance

Above: The clear definition of what turbine 'wear and tear' is can create problems when service agreements are agreed (picture courtesy Siemens PG).

nance outages covered under the term of the contract. In these LTSAs, the pitfall for the owner is that the fixed LTSA pricing will mean that the owner pays for an outage that it did not receive. While arguably an inequitable result, any owner will also undoubtedly agree that the OEM should be incentivised to develop longer-life parts, because the elimination of outages will certainly benefit the owner with more generating revenues. Thus, the solution to this pitfall lies in creating a balance between these perspectives.

Tax ramifications

When entering into an LTSA, an owner must seriously consider the impacts of applicable tax laws on the parties' activities under the contract. A failure to do so can result in major unplanned expenses for the owner. Smart owners will not only seek tax counselling on the tax law impacts upon their LTSA, but will also pursue various contract structuring strategies aimed at minimising such impacts.

For example, in a jurisdiction that taxes the sale of parts but not the sale of services, an owner may be able to reduce its tax burden by splitting the LTSA into two separate contracts – one for parts and one for services.

As another example, depending upon the applicable laws, the LTSA may be drafted in such a way that the provision of a refurbished part will be viewed as a

non-taxable service event (the service being the refurbishment) and not as a taxable sale of goods.

Limitations on warranties

A 'standard' clause in the warranty section of many LTSAs will provide that the owner's 'exclusive' remedy, with respect to a defective part and/or service, is for the OEM to either replace the defective part or re-perform the defective service. While this concept is not necessarily unacceptable, there are some provisions of the contract which must be excluded from this provision.

For example, it is entirely possible that a defective part could cause collateral damage to owner property. Thus, to the extent that the OEM has agreed to take liability for damage to the owner's property, such liability should not be contractually trumped by the 'sole and exclusive' remedy language.

Similarly, a defective part could injure someone. In this regard, if the owner has indemnities from the OEM for personal injury to third parties, then the owner should not be limited in its ability to seek remedy under such indemnities.

Thus, the solution to this pitfall is to 'carve-out' exceptions to the exclusive remedies clause that will enable the owner to take advantage of other rights in the contract as may arise in connection with same set of facts that happened to result in a warranty breach. By their very

Below: The updating of turbine parts can affect some service agreements (picture courtesy GEPS).

nature, long term service agreements are going to be a significant part of owners' businesses for years to come.

Owners who are entering into LTSAs for the first time must realise, as a matter of ensuring the long term success of these maintenance programs, the importance of avoiding the many pitfalls that these complex documents can present (and these pitfalls number well past the five described in this article).

The same holds true for those owners who are currently implementing LTSAs signed and shelved years ago when their turbine was originally purchased. These owners should be mindful of the symbiotic relationship struck between owners and OEMs under most LTSA arrangements. Indeed, many pitfalls can be just as detrimental to the OEM as to the owner.

Consequently, such owners should not discount the possibility of renegotiating their LTSA for the sake of improving it for all parties involved. After all, joint cooperation is a key to any successful long-term relationship. Thus, the important thing to remember is to avoid these pitfalls if you can, but if you find yourself at the bottom of one, all is not lost. You can always climb your way out. **IPG**

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