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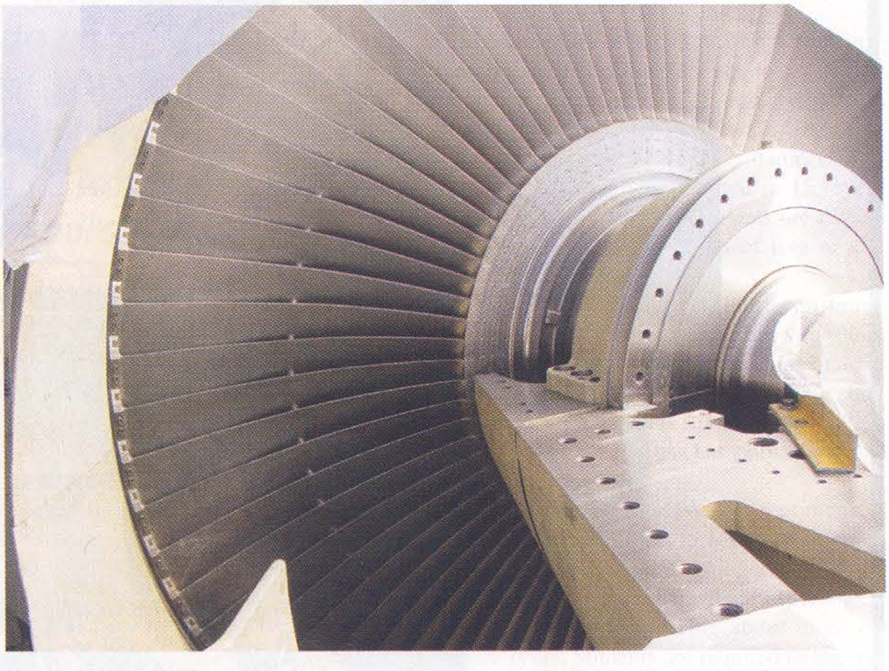
How to negotiate LTSAs like a pro

There's no way around the math: Risk equals dollars. To finance a new plant, risks must be identified, allocated, and paid for. The contractor assumes completion risk, but once you purchase the turbomachinery, its operating and performance risk must be quantified. One way to help do that is to negotiate a long-term service agreement (LTSA) with the original equipment manufacturer—but at what price and with what conditions? Navigate the minefield like a pro with these "Top 20" negotiating points.

By Dr. Robert Peltier, PE

Remember the last time you bought a new car? It may have taken a couple of hours, including that ritual between the salesman and sales manager, but you held your ground and got your price. Then came the pressure to buy options like undercoating. But you did your homework, knew that such options have an inflated markup, and declined the opportunity. Finally came the pitch for an extended warranty, which you also declined while wondering, "Isn't the carmaker confident about the long-term reliability of its product?"

Purchasing major equipment, like a gas or steam turbine, is more like forming a partnership with the original equipment manufacturer (OEM). With a car negotiation, if you couldn't come to terms, you could just go down the street and start over with a different dealer, confident that eventually you'll get the deal you want. Not so with that gas turbine purchase, which marries you to the OEM for the rest of your career, for better or for worse. And because you can't trade a turbine in when styles or tastes change, you had better get the purchase right the first time.



1. Predictability. Long-term service agreements (LTSAs) offer many advantages to turbine owners, including the predictability of long-term maintenance costs and contractually guaranteed or incentivized original equipment manufacturer (OEM) support. Negotiate your LTSA as part of the OEM purchase to maximize your purchasing leverage. *Source: Platts*

Unlike automobile warranties, long-term service agreements (LTSAs) for turbines are essential to properly allocating risk between the owner and OEM. After all, the owner just wants the prime mover to operate as advertised. The OEM has faith in its equipment but doesn't operate the plant. Risk has to be allocated, and any time operating risk is involved the dollars at stake add up quickly.

LTSAs typically commit OEMs to maintain—on a relatively "fixed-priced" basis—the equipment they manufacture. In terms of risk, LTSAs offer many advantages to turbine owners, including the predictability of long-term maintenance costs and contractually guaranteed or incentivized OEM support. However, because these agreements are complex and often full of complex conditions spelled out in legalese, they may end up forcing an owner to bear an inordinate amount of risk or necessitating costly and time-consuming disputes with the OEM. Here it's important to realize that you're negotiating with a disadvantage: The OEM has probably negotiated dozens of these agreements and understands what's good and not so good about the equipment you've just purchased.

Proper preparation for negotiations is the key to creating a well-structured LTSA that works in practice.

LTSAs expiring

The dash for gas plants in the late 1990s will soon see a large number of early LTSAs expire in the coming few years. After recovering from sticker shock at the costs of current LTSAs, owners will find themselves scrambling to find ways to negotiate lower costs without increasing

Two issues that many LTSAs fail to address

Here are 2 of the 20 tips for negotiating your next long-term service agreement (LTSA) that you'll find at www.powermag.platts.com.

Avoid illiquidity of parts. Typically, an LTSA for a turbine provides that the warranty for parts provided begins when the parts are installed into the "covered unit" with a specific serial number included in the contract. It is also typical for an LTSA to provide that an owner cannot assign the LTSA, "or any portion thereof" (that is, including the warranty portion), without the OEM's prior written consent.

Thus, if an owner has one or more like-kind turbines in its fleet that are not covered by the subject LTSA and would like to share its parts among these turbines, then such LTSA provisions will present serious problems. Specifically, such an owner runs the risk of voiding the warranty on a part if it is not installed in the turbine to which the LTSA applies. In addition, such owner may likely be hamstrung from assigning the part's warranty for want of the OEM's prior consent. In this way, the owner's parts become "illiquid." The solution to this potential problem: Draft warranty language that is not "covered-unit-specific" and allows for the free assignment of warranties to affiliates without prior OEM consent.

Consider state tax law ramifications. When entering into an LTSA, an owner must seriously consider the impacts of state law on the parties' activities under the contract. How are the various parts and services provided under the LTSA taxed or exempted from tax under the applicable state laws? What will be the taxes on the sale of parts? Is turbine maintenance considered an improvement to personal property? Will there be taxes on the "use" of parts? Will there be taxes on services?

One of the most dangerous mistakes an owner can make is failing at the outset to understand completely and plan for state-level tax treatment issues. Smart owners can avoid doing so simply by seeking qualified tax counsel on the subject. Even smarter owners can take their efforts to the next level by pursuing various planning strategies to minimize tax impacts on the contract. Depending on the taxes of the state in which the project is located, possible minimization strategies include: (1) bifurcating the LTSA into two separate contracts—one for parts and one for services; (2) arranging for separate invoices from the OEM—one for parts and one for services (but still under the same LTSA); or (3) taking a position that the provision of a refurbished part should be taxed as a service event (the refurbishment) and not as a sale of personal property.

performance risk. This is especially true for asset managers that inherited the LTSA as part of a plant acquisition.

Do you feel strangled by an LTSA signed years ago that doesn't reflect how the plant is actually operated now? That's not that unusual. Perhaps the plant was designed for baseload operation but is now operated as a summer peaker. Yes, the plant operates significantly fewer hours a year, but those peaking hours require cycling the plant much more often than the original LTSA envisioned. The wise turbomachinery owner will ask: Are the equipment's costs and risks now properly allocated by the LTSA?

The language of LTSAs, even inherited ones, is not etched in stone. In fact, for every contract condition you find onerous, there is likely another one that the OEM would like an opportunity to renegotiate in its favor. Renegotiation is common, and it certainly should be, given that LTSAs must serve the long-term interests and relationships of the partners to be successful.

Navigating the minefield

To level the playing field for turbine purchasers, POWER asked Richard E. Thompson II and Jason B. Yost to prepare a list of negotiating "speed bumps" that owners often face when negotiating an LTSA. Thompson and Yost are attorneys with Atlanta-based Troutman Sanders LLP and members of the

2. Expanded coverage. Some OEMs have expanded their LTSA programs to cover the steam turbine as well as the gas turbine. *Source: Platts*

law firm's LTSA Team. Collectively, they have negotiated and advised on LTSAs for more than 140 gas turbines and 70 steam turbines, so they know the business.

The full table (available at www.powermag.platts.com) that Thompson and Yost have prepared lists 20 issues that any purchaser of turbomachinery should consider before beginning an LTSA negotiation. Two examples are detailed in the box.

Not all of the issues will apply to every owner and/or OEM, so there isn't a rational way to prioritize the list. But Thompson and Yost emphasize that, based on their experience, proper preparation for negotiations is the key to creating a well-structured LTSA that works in practice. They also advise prospective LTSA signers to:

- Carefully consider each of the negotiating points listed in the table both individually and as part of the total package. Note how many of the negotiating points are interdependent.
- Prioritize your list and work with your legal counsel to develop a negotiating strategy that reflects which points are very important to you and which ones you can afford to give a little on.
- Collect historic cost and performance data to improve your understanding of your O&M costs and the risk/cost consequences of each negotiating point. Rely heavily on your own years of operating experience when developing your negotiation strategy.
- Join a turbine users' group to find out about your new unit's track record in the field. Such information is not only free but also unbiased.
- Take steps to better understand your current risk/cost profile and refine your vision of how the LTSA will help meet your risk goals. A caveat here: If you don't know where you are going, then any path will do.
- Stay focused on the results, not the process. You aren't going to get everything you want, but even one seemingly small change in the LTSA often can save you big bucks.
- Remember that an LTSA also must be a good deal for the OEM, but if you don't squeeze the last penny out of the OEM during the negotiations, you'll pay for it during the entire term of the contract.

Whether you're negotiating your first LTSA or renegotiating an existing one, the advice here and on our Web site represents a free legal session. It's also important to realize that although LTSA agreements tend to be complex, their underlying concepts are not. So prioritize the full list to fit your circumstances by collecting hard data and attaching costs and risks to each item; then take the results to your corporate counsel. And don't discount the possibility that the LTSA may have to be renegotiated or amended in the future to satisfy either or both parties. After all, ongoing cooperation is a key to any successful long-term relationship. ■