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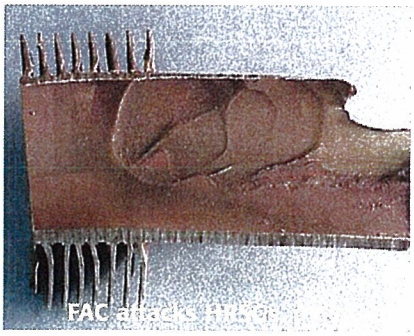
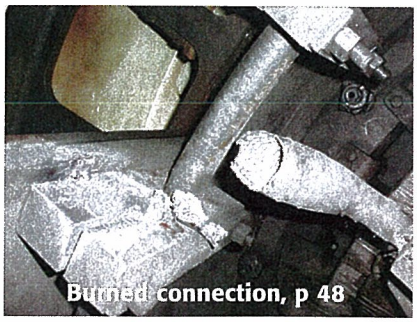

FAC attacks HRSG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What you need to know about non-OEM LTSAs

By Jason B Yost, Mercer Thompson LLC

It took a while for non-original equipment manufacturers (OEMs) to break into the long-term service agreement (LTSA) market for gas turbines, but now they are here to stay. In many cases, the parts and maintenance services offered by non-OEMs are comparable to the OEM's.

This is good for owner/operators: It adds competition to the market. But it also complicates many decisions about the LTSA, most notably in the areas of originally installed parts, manufacturing versus repair services only, parts pools, financial guarantees, OEM advisory alerts and upgrades, insurance, and intellectual property (IP).

Parts issues

Most LTSAs, not surprisingly, only offer coverage for parts that are provided under the LTSA. For a new unit, this typically means that the originally installed parts are not covered. If an owner enters into an LTSA with the OEM, it may be able to negotiate coverage under the LTSA for originally installed parts once the warranty under the new-unit turbine supply agreement expires.

Similarly, if an owner already has an LTSA with the OEM that is set to expire, and the owner is considering extending that agreement (or entering into a new agreement with the OEM that will pick up where the current LTSA ends), then the owner may be able to negotiate extended coverage under its new LTSA for the parts that are in the unit at the end of the term of its current LTSA.

OEMs can offer this coverage because they are familiar with the parts and how they have been maintained. Non-OEMs may be more hesitant to take this risk since the parts are not theirs, and they have not been providing repair services for these parts during the current maintenance cycle. The owner needs to address how to mitigate the risk of these parts should they fail.

Further, what happens if the owner enters into an LTSA with a non-OEM and the non-OEM performs work on parts *while they are still under the OEM's warranty*? Most likely, this would immediately void the OEM's warranty. All of these factors must be addressed to protect the owner's interests.

Is the non-OEM manufacturing its own parts, or merely offering repair services for OEM parts? The answer has major implications on how to proceed. For example, if all of an owner's capital parts are reaching (or have reached) their end of useful life, then the owner is going to need to procure new parts.

If the non-OEM is manufacturing its own parts, then the owner will likely plan to rely on the non-OEM to provide parts the owner needs going forward. Of course, the owner will want to consider the reliability and operating data regarding these parts before deciding to rely solely on the non-OEM.

On the other hand, if the non-OEM is only providing repair services for OEM parts, then the owner must determine where to get replacement parts as it proceeds through the next maintenance cycle.

Parts pools. As OEMs have developed larger and larger parts pools over the years, many owners who enter into an LTSA with the OEM have the option of relying on an "open pool" arrangement. Here, the owner only has title to parts while they are in the owner's possession. Once the OEM replaces these parts and removes them from the site, the OEM takes title to such parts, and is free to utilize them at any other facility where the OEM provides similar services.

Contrast this to a "closed pool," where the owner maintains title to its parts at all times—as they come out of the unit, go to the repair shop, and are returned to the owner's site.

The advantages of an open pool are two-fold: (1) Because the OEM is free to utilize parts from its entire fleet in order to meet the owner's maintenance needs (and not rely solely on the owner's parts), it achieves economies of scale to reduce the overall cost of the LTSA to the owner; and (2) the owner does not have to keep a complete set of spare parts in its inventory because the OEM is obligated to provide the necessary parts in the event of an unplanned outage.

Of course, many owners will still opt to keep certain spare parts in inventory for emergency situations, but this list can be narrowed considerably from what the owner would otherwise have to keep if it was relying solely on its own inventory of parts.

Certain non-OEMs have built up their own inventory of parts over the last several years and offer their own open-pooling arrangement, or a variation of pooling including both OEM and non-OEM parts.

If a non-OEM offers an open pool using only its own parts, an owner should carefully consider whether the non-OEM has a big enough pool to satisfy all of its LTSA customers. For instance, if there is a run on a certain part, an owner who is relying exclusively on a non-OEM parts pool may have difficulty obtaining that part when it is needed. Of course, as any owner will tell you, they occasionally have issues getting parts from OEMs as well, so don't think accessibility of parts is purely a non-OEM issue.

Deep pockets

Many owners are not concerned (or at least have the perception that there is little need for concern) about the financial wherewithal of the OEM to fulfill its obligations under the LTSA, and are not inclined to demand a parent guarantee or other form of security from the OEM. This may not necessarily be the case with a non-OEM.

Some non-OEMs also have strong balance sheets, or can rely on a parent with a strong balance sheet to backstop their obligations. But there also are many who cannot withstand excessive unexpected liabilities. Owners should carefully consider the financial capability of any non-OEM to fulfill its obligations under the LTSA (including its maintenance, warranty, and indemnification obligations, to name a few), as well as how many other contracts are held with other parties.

One relatively straightforward issue with a non-OEM part could quickly turn into a major risk across the non-OEM's entire fleet of parts for its LTSAs, causing major heartburn for the non-OEM, and leaving individual owners with little or no recourse. Sufficient security to backstop the non-OEM's obligations should be evaluated carefully.

Advisory alerts, upgrades

OEMs periodically publish advisories regarding parts that they manufacture. Owners often end up negotiating with OEMs for coverage in their LTSA of the performance of certain replacement parts or repairs as recommended by these advisories.

Non-OEMs may be hesitant to take this risk. They have no control over how the OEM's parts were designed or manufactured, or what kind of fixes the OEM will recommend in an advisory. Most non-OEMs will probably avoid bearing any responsibility to inspect, repair, or replace parts manufactured by the OEM to satisfy advisories.

However, when a particular issue is found throughout the OEM's fleet, non-OEMs will often come up with their own fixes. As a result, an owner may be able to get coverage in a non-OEM LTSA for any non-OEM-developed fixes that, while not exact, address OEM issues.

In addition, as OEMs continue to improve performance and extend parts life, LTSA customers can often obtain these upgrades at a discount under the terms of the original LTSA. However, this privilege will likely be reserved for OEM LTSA customers. But this does not necessarily mean that the owner is out of luck.

Many non-OEMs are similarly advancing parts and repair services beyond the bounds of what the OEMs do. While a non-OEM may not offer the same part upgrades offered by the OEM, they may offer their own upgrades at discounted pricing.

Insurance

As non-OEMs manufacture more of their own parts, owners need to carefully assess the reaction of their insurance provider. Insurance companies, which typically condition coverage on the owner following OEM guidelines (which the insurance company uses to determine prudent industry practices), initially may not be comfortable having non-OEM manufactured parts installed in the owner's unit.

Owners may have to show their insurance companies (remember, insurance is a competitive business, too) that the non-OEM parts demonstrate sufficient safety and reliability to warrant coverage. Many non-OEMs have already dealt with this issue

with other customers and can offer assistance in answering an owner's insurance company's questions.

Intellectual property

Many engineers and technicians have left OEMs to work for non-OEMs. This raises the prospects that OEMs will claim that certain non-OEM part designs and/or repair services infringe upon the OEM's intellectual property (IP) rights—for example, patent infringement and infringement of trade secrets.

OEMs take protecting their IP very seriously. No owner wishes to be in violation of an OEM's IP rights. In such an instance, the owner may not only be liable to the equipment manufacturer for monetary damages, but may also be enjoined from operating the unit.

Owners should have similar concerns when negotiating an OEM LTSA (as OEMs can be just as susceptible to IP infringement claims), but paying special attention to these clauses in a non-OEM agreement is even more important than in the manufacturer's. One critical issue: negotiating what indemnification rights an owner will be entitled to from the non-OEM, including requiring the non-OEM to replace an infringing part with an OEM part, if necessary.

Is the OEM out?

Should an owner decide to pursue an LTSA with a non-OEM, the question arises: "Am I done with the OEM for good?" The answer is, probably not. In addition to the parts and services coverage provided by the non-OEM, an owner will also likely need some coverage for those parts that are not otherwise covered, such as inspect-only parts and auxiliaries, under its non-OEM LTSA.

Chances are, at some point, an owner will probably need a part from the OEM, and may want to consider a standby agreement with pre-negotiated terms and conditions (for example, warranty, delivery, and payment) for such parts.

This avoids having to negotiate a parts deal precisely at the time when the owner has the least amount of leverage.

Non-OEMs are here to stay, and are making inroads into the LTSA market. Knowing what issues to be aware of, and how to address them before entering into a non-OEM LTSA, can ensure continued success for both the owner and the non-OEM. CCJ