

# Managing the value chain

**LONG TERM SERVICE AGREEMENTS ARE A NECESSARY PART OF NEW PRODUCT SALE**



**T**here was a time when we used to call it the spare parts business and all the product development was done in the lab. Now we talk about the value chain and much of the development activity is done through simulation, with actual testing done in the field as a condition of contract.

Let's face it. In the machinery business, no one makes much money, if at all, on the sale of new equipment. We all make the money on the backend through the sale of parts and service, and maintaining control of what used to be called the "after-market." That is what this whole "value chain" thing is about.

Companies are willing to live with 15% gross margin on the complete machine sale and/or installation because they recognize that they can make it up on the back with parts and service which can generate gross margins of 30% and 60%. I think that's why we coined the term "value chain" and why these business activities that have gained new respectability are now a principal focus of most machinery companies today.

The product development cycle has also been affected. The sheer physical size, cost and complexity of today's advanced turbomachinery development dictates incremental development, with advanced component testing done in the lab and system integration done on the job. Certain customers will accept the inherent risk associated with this for the promise of lower long term operating costs and greater return on investment. And...other folks just like to be on the leading edge.

In the old days, we had some spare capacity and the units were not as large. But more importantly, the utility rate-payers were available to bear the risk. With the emergence of the highly leveraged Independent Power Producers (IPPs), these risks must now be assumed by the commercial risk carriers. These are numbers guys who don't care about long term relationships and are also insuring the added dimensions of contingent liability and lost production.

Predictably, this has resulted in the

requirement for long term maintenance contracts (see page 24). These agreements are really guarantees on availability and maximum maintenance cost by the OEMs, as today's way of selling the hardware and funding field testing.

Interestingly enough, when the actual reliability and maintenance cost reaches the guaranteed values, the users begin to shift their focus to using non-genuine or, dare I say, "pirate" parts as a way to drive the costs lower and to put pressure on the value chain objectives of the OEMs.

In my former life we actually had a utility request we perform an engineering analysis of a non-genuine part, looking for a validation of its use. I may be a little goofy at times, but I am no idiot, and I insisted that the evaluation stick strictly to the engineering analysis and stop short of making any judgment as to the part's suitability.

The other trend is to control costs through condition-based monitoring systems. Obviously, the techniques that allow for both planned intervention and maximizing the useful life of the components will be sought out. The OEMs are developing this capability, not so much to control the costs, but rather to be the "first responders" and in control of the parts and service value, as they compete with third party service organizations offering independent platforms and equipment-neutral monitoring systems.

OEM objectives are quite clear, but as a prospective user, I would prefer the independent platforms and the equipment-neutral solutions myself, because a single system can be used to monitor all the equipment, not just that of a particular OEM.

On a personal note, I use Quicken rather than any one particular brand of electronic banking software, and I buy genuine parts for the M3. 

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