**The Pacific Oil Company**

“Look, you asked for my advice, and I gave it to you,” Frank Kelsey said. “If I were you,

I wouldn’t make any more concessions! I really don’t think you ought to agree to their

last demand! But you’re the one who has to live with the contract, not me!”

Static on the transatlantic telephone connection obscured Jean Fontaine’s reply.

Kelsey asked him to repeat what he had said.

“OK, OK, calm down, Jean. I can see your point of view. I appreciate the pressures

you’re under. But I sure don’t like the looks of it from this end. Keep in touch—I’ll talk

to you early next week. In the meantime, I will see what others at the office think about

this turn of events.”

Frank Kelsey hung up the phone. He sat pensively, staring out at the rain pounding

on the window. “Poor Fontaine,” he muttered to himself. “He’s so anxious to please the

customer, he’d feel compelled to give them the whole pie without getting his fair share

of the dessert!”

Kelsey cleaned and lit his pipe as he mentally reviewed the history of the negotiations.

“My word,” he thought to himself, “we are getting completely taken in with this

Reliant deal! And I can’t make Fontaine see it!”

**Background**

Pacific Oil Company was founded in 1902 as the Sweetwater Oil Company of Oklahoma

City, Oklahoma. The founder of Sweetwater Oil, E.M. Hutchinson, pioneered a major

oil strike in north central Oklahoma that touched off the Oklahoma “black gold” rush

*Source:* Case prepared by Roy J. Lewicki.

Although this case is over 20 years old, the editors of this volume believe that it presents valuable

lessons about the negotiation process.

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of the early 1900s. Through growth and acquisition in the 1920s and 1930s, Hutchinson

expanded the company rapidly and renamed it Pacific Oil in 1932. After a period of

consolidation in the 1940s and 1950s, Pacific expanded again. It developed extensive

oil holdings in North Africa and the Middle East, as well as significant coal beds in

the western United States. Much of Pacific’s oil production is sold under its own name

as gasoline through service stations in the United States and Europe, but it is also

distributed through several chains of independent gasoline stations. In addition,

Pacific is also one of the largest and best-known worldwide producers of industrial

petrochemicals.

One of Pacific’s major industrial chemical lines is the production of vinyl

chloride monomer (VCM). The basic components of VCM are ethylene and

chlorine. Ethylene is a colorless, flammable, gaseous hydrocarbon with a disagreeable

odor; it is generally obtained from natural or coal gas, or by “cracking”

petroleum into smaller molecular components. As a further step in the petroleum

cracking process, ethylene is combined with chlorine to produce VCM, also a colorless

gas.

VCM is the primary component of a family of plastics known as the vinyl chlorides.

VCM is subjected to the process of polymerization, in which smaller molecules

of vinyl chloride are chemically bonded together to form larger molecular

chains and networks. As the bonding occurs, polyvinyl chloride (PVC) is produced;

coloring pigments may be added, as well as “plasticizer” compounds that determine

the relative flexibility or hardness of the finished material. Through various forms of

calendering (pressing between heavy rollers), extruding, and injection molding, the

plasticized polyvinyl chloride is converted to an enormous array of consumer and

industrial applications: flooring, wire insulation, electrical transformers, home furnishings,

piping, toys, bottles and containers, rainwear, light roofing, and a variety of

protective coatings. (See Exhibit 1 for a breakdown of common PVC-based products.)

In 1979, Pacific Oil established the first major contract with the Reliant Corporation

for the purchase of vinyl chloride monomer. The Reliant Corporation was a

major industrial manufacturer of wood and petrochemical products for the construction

industry. Reliant was expanding its manufacturing operations in the production

of plastic pipe and pipe fittings, particularly in Europe. The use of plastic as a substitute

for iron or copper pipe was gaining rapid acceptance in the construction

trades, and the European markets were significantly more progressive in adopting the

plastic pipe. Reliant already had developed a small polyvinyl chloride production facility

at Abbeville, France, and Pacific constructed a pipeline from its petrochemical

plant at Antwerp to Abbeville.

The 1979 contract between Pacific Oil and Reliant was a fairly standard one for the

industry and due to expire in December of 1982. The contract was negotiated by

Reliant’s purchasing managers in Europe, headquartered in Brussels, and the senior

marketing managers of Pacific Oil’s European offices, located in Paris. Each of these

individuals reported to the vice presidents in charge of their companies’ European

offices, who in turn reported back to their respective corporate headquarters in the

States. (See Exhibits 2 and 3 on pages 592 and 593 for partial organization charts.)

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**EXHIBIT 1** | Polyvinyl Chloride Major Markets, 1982 (units represented in

MM pounds)

**Market MM Pounds Percentage of Market Share**

Apparel

Baby pants 22 0.6

Footwear 128 3.2

Miscellaneous 60 1.5

210 5.3

Building and construction

Extruded foam moldings 46 1.2

Flooring 428 10.8

Lighting 10 0.3

Panels and siding 64 1.6

Pipe and conduit 720 18.5

Pipe fittings 78 2.0

Rainwater systems 28 0.7

Swimming pool liners 40 1.0

Weather stripping 36 0.9

Miscellaneous 50 1.2

1,500 38.2

Electrical

Wire and cable 390 9.9

Home furnishings

Appliances 32 0.8

Miscellaneous 286 9.8

318 10.6

Housewares 94 2.4

Packaging

Blow molded bottles 64 1.6

Closure liners and gaskets 16 0.4

Coatings 16 0.4

Film 124 3.2

Miscellaneous 80 2.0

300 7.6

Recreation

Records 136 3.4

Sporting goods 46 1.2

Miscellaneous 68 1.7

250 6.3

Transportation

Auto mats 36 0.9

Auto tops 32 0.8

Miscellaneous 164 4.2

232 5.9

(*continued*)

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**The 1982 Contract Renewal**

In February 1982, negotiations began to extend the four-year contract beyond the

December 31, 1982, expiration date. Jean Fontaine, Pacific Oil’s marketing vice president

for Europe, discussed the Reliant account with his VCM marketing manager, Paul

Gaudin. Fontaine had been promoted to the European vice presidency approximately

16 months earlier after having served as Pacific’s ethylene marketing manager.

Fontaine had been with Pacific Oil for 11 years and had a reputation as a strong

up-and-comer in Pacific’s European operations. Gaudin had been appointed as VCM

marketing manager eight months earlier; this was his first job with Pacific Oil,

although he had five years of previous experience in European computer sales with a

large American computer manufacturing company. Fontaine and Gaudin had worked

well in their short time together, establishing a strong professional and personal relationship.

Fontaine and Gaudin agreed that the Reliant account had been an extremely

profitable and beneficial one for Pacific and believed that Reliant had, overall, been satisfied

with the quality and service under the agreement as well. They clearly wanted to

work hard to obtain a favorable renegotiation of the existing agreement. Fontaine and

Gaudin also reviewed the latest projections of worldwide VCM supply, which they had

just received from corporate headquarters (see Exhibit 4, p. 593). The data confirmed

what they already knew—that there was a worldwide shortage of VCM and that demand

was continuing to rise. Pacific envisioned that the current demand–supply situation

would remain this way for a number of years. As a result, Pacific believed that it

could justify a high favorable formula price for VCM.

Fontaine and Gaudin decided that they would approach Reliant with an offer to

renegotiate the current agreement. Their basic strategy would be to ask Reliant for their

five-year demand projections on VCM and polyvinyl chloride products. Once these projections

were received, Fontaine and Gaudin would frame the basic formula price that

**Market MM Pounds Percentage of Market Share**

Miscellaneous

Agriculture (including pipe) 106 2.6

Credit cards 24 0.4

Garden hose 40 1.0

Laminates 44 1.1

Medical tubing 42 1.1

Novelties 12 0.3

Stationery supplies 32 0.8

Miscellaneous 12 0.3

312 7.6

Export 146 3.7

Miscellaneous 98 2.5

244 6.2

Total 3,850 100.0

**EXHIBIT 1** | (*concluded*)

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Stockholders

Board of directors

President and chief executive officer

Vice president

for marketing

(Warren Meredith)

Other product groups VCM Marketing

(Jean Fontaine)

VCM

manager

(Paul Gaudin)

European

operations

(Stan Saunders)

Strategic

planning

(Frank Kelsey)

**EXHIBIT 2** | Partial Organization Chart—Pacific Oil Company

they would offer. (It would be expected that there would be no significant changes or

variations in other elements of the contract, such as delivery and contract language.)

In their negotiations, their strategy would be as follows:

**1.** To dwell on the successful long-term relationship that had already been built

between Reliant and Pacific Oil, and to emphasize the value of that relationship

for the success of both companies.

**2.** To emphasize all of the projections that predicted the worldwide shortage of

VCM and the desirability for Reliant to ensure that they would have a guaranteed

supplier.

**3.** To point out all of the ways that Pacific had gone out of its way in the past to

ensure delivery and service.

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Stockholders

Board of directors

President and chief executive officer

Vice president

for Europe

(Egon Zinnser)

Purchasing

(Frederich Hauptmann)

**EXHIBIT 3** | Partial Organization Chart—Reliant Chemical Company

TO: All VCM Marketing Managers

FROM: F. Kelsey, Strategic Planning Division

RE: Worldwide VCM Supply–Demand Projections

DATE: January 17, 1982

*CONFIDENTIAL—FOR YOUR EYES ONLY*

Here are the data from 1980 and 1981, and the five-year projections that I promised you at

our last meeting. As you can see, the market is tight, and is projected to get tighter. I hope

you will find this useful in your marketing efforts—let me know if I can supply more detailed

information.

**Total Projected Demand Supply Plant Operating Rates to Meet**

**Year (in MM pounds) Capacities Demand (percent)**

1980 4,040 5,390 75%

1981 4,336 5,390 80

1982 5,100 6,600 77

1983 5,350 6,600 81

1984 5,550 6,600 83

1985 5,650 7,300 75

1986 5,750 7,300 78

**EXHIBIT 4** | Memorandum, January 17, 1982

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**4.** To use both the past and future quality of the relationship to justify what might

appear to be a high formula price.

**5.** To point out the ways that Pacific’s competitors could not offer the same kind of

service.

Over the next six months, Gaudin and Fontaine, independently and together, made

a number of trips to Brussels to visit Reliant executives. In addition, several members of

Pacific’s senior management visited Brussels and paid courtesy calls on Reliant management.

The net result was a very favorable contract for Pacific Oil, signed by both

parties on October 24, 1982. The basic contract, to extend from January 1983 to

December 1987, is represented as Exhibit 5 on page 595.

**A Changed Perspective**

In December of 1984, Fontaine and Gaudin sat down to their traditional end-of-year

review of all existing chemical contracts. As a matter of course, the Reliant VCM contract

came under review. Although everything had been proceeding very smoothly, the

prospects for the near and long-term future were obviously less clear, for the following

reasons:

**1.** Both men reviewed the data that they had been receiving from corporate headquarters,

as well as published projections of the supply situation for various chemicals

over the next 10 years. It was clear that the basic supply–demand situation

on VCM was changing (see Exhibit 6 p. 599). While the market was currently

tight—the favorable supply situation that had existed for Pacific when the Reliant

contract was first negotiated—the supply of VCM was expected to expand rapidly

over the next few years. Several of Pacific’s competitors had announced plans for

the construction of VCM manufacturing facilities that were expected to come on

line in 20–30 months.

**2.** Fontaine and Gaudin knew that Reliant was probably aware of this situation as

well. As a result, they would probably anticipate the change in the supply–demand

situation as an opportunity to pursue a more favorable price, with the possible

threat that they would be willing to change suppliers if the terms were not

favorable enough. (Although rebuilding a pipeline is no simple matter, it clearly

could be done, and had been, when the terms were sufficiently favorable to

justify it.)

**3.** Fontaine was aware that in a situation where the market turned from one of

high demand to excess supply, it was necessary to make extra efforts to maintain

and re-sign all major current customers. A few large customers (100 million

pounds a year and over) dominated the marketplace, and a single customer

defection in an oversupplied market could cause major headaches for everyone.

It would simply be impossible to find another customer with demands of that

magnitude; a number of smaller customers would have to be found, while

Pacific would also have to compete with spot market prices that would cut

profits to the bone.

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**EXHIBIT 5** | Agreement of Sale

This Agreement, entered into this *24th* day of *October, 1982,* between *Pacific Oil Company,*

hereinafter called Seller, and *Reliant Chemical Company of Europe,* hereinafter called Buyer.

WITNESSETH:

Seller agrees to sell and deliver and Buyer agrees to purchase and receive commodity

(hereinafter called “product”) under the terms and conditions set forth below.

1. Product: Vinyl Chloride Monomer

2. Quality: ASTM requirements for polymer-grade product

3. Quantity: 1983: 150 million pounds

1984: 160 million pounds

1985: 170 million pounds

1986: 185 million pounds

1987: 200 million pounds

4. Period: Contract shall extend from January 1, 1983, until December 31, 1987, and every

year thereafter, unless terminated with 180 days’ prior notification at the end of each

calendar year, but not before December 31, 1987.

5. Price: See Contract formula price.

6. Payment Terms:

*a.* Net 30 days.

*b.* All payments shall be made in United States dollars without discount or deduction,

unless otherwise noted, by wire transfer at Seller’s option, to a bank account designated

by Seller. Invoices not paid on due date will be subject to a delinquency finance

charge of 1 percent per month.

*c.* If at any time the financial responsibility of Buyer shall become impaired or unsatisfactory

to Seller, cash payment on delivery or satisfactory security may be required.Afailure to

pay any amount may, at the option of the Seller, terminate this contract as to further deliveries.

No forbearance, course of dealing, or prior payment shall affect this right of Seller.

7. Price Change:

The price specified in this Agreement may be changed by Seller on the first day of any

calendar *half-year* by written notice sent to the Buyer not less than thirty (30) days prior to the

effective date of change. Buyer gives Seller written notice of objection to such change at

least ten (10) days prior to the effective date of change. Buyer’s failure to serve Seller with

written notice of objection thereto prior to the effective date thereof shall be considered

acceptance of such change. If Buyer gives such notice of objection and Buyer and Seller

fail to agree on such change prior to the effective date thereof, this Agreement and the

obligations of Seller and Buyer hereunder shall terminate with respect to the unshipped portion

of the Product governed by it. Seller has the option immediately to cancel this contract

upon written notice to Buyer, to continue to sell hereunder at the same price and terms which

were in effect at the time Seller gave notice of change, or to suspend performance under this

contract while pricing is being resolved. If Seller desires to revise the price, freight allowance,

or terms of payment pursuant to this agreement, but is restricted to any extent against doing

so by reason of any law, governmental decree, order, or regulation, or if the price, freight

allowance, or terms of payment then in effect under this contract are nullified or reduced by

reason of any law, governmental decree, order, or regulation, Seller shall have the right to

cancel this contract upon fifteen (15) days’ written notice to purchaser.

8. Measurements:

Seller’s determinations, unless proven to be erroneous, shall be accepted as conclusive evidence

of the quantity of Product delivered hereunder. Credit will not be allowed for shortages of

(*continued* )

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1/2 of 1 percent or less of the quantity, and overages of 1/2 of 1 percent or less of the quantity

will be waived. The total amount of shortages or overages will be credited or billed when quantities

are greater and such differences are substantiated. Measurements of weight and volume

shall be according to procedures and criteria standard for such determinations.

9. Shipments and Delivery:

Buyer shall give Seller annual or quarterly forecasts of its expected requirements as

Seller may from time to time request. Buyer shall give Seller reasonably advanced notice for

each shipment which shall include date of delivery and shipping instructions. Buyer shall

agree to take deliveries in approximately equal monthly quantities, except as may be otherwise

provided herein. In the event that Buyer fails to take the quantity specified or the pro

rata quantity in any month, Seller may, at its option, in addition to other rights and remedies,

cancel such shipments or parts thereof.

10. Purchase Requirements:

a. If during any consecutive three-month period, Buyer for any reason (but not for reasons

of force majeure as set forth in Section 12) takes less than 90 percent of the average

monthly quantity specified, or the prorated minimum monthly quantity then applicable

to such period under Section 12, Seller may elect to charge Buyer a penalty charge for

failure to take the average monthly quantity or prorated minimum monthly quantity.

*b.* If, during any consecutive three-month period, Buyer, for any reason (but not, however,

for reasons of force majeure as set forth in Section 12) takes Product in quantities

less than that equal to at least one-half of the average monthly quantity specified

or the prorated minimum monthly quantity originally applicable to such period under

Section 12, Seller may elect to terminate this agreement.

*c.* It is the Seller’s intent not to unreasonably exercise its right under (*a*) or (*b*) in the

event of adverse economic and business conditions in general.

d. Notice of election by Seller under (*a*) or (*b*) shall be given within 30 days after the end

of the applicable three-month period, and the effective date of termination shall be

30 days after the date of said notice.

11. Detention Policy:

Seller may, from time to time, specify free unloading time allowances for its transportation

equipment. Buyer shall be liable to the Transportation Company for all demurrage charges

made by the Transportation Company, for railcars, trucks, tanks, or barges held by Buyer beyond

the free unloading time.

12. Force Majeure:

Neither party shall be liable to the other for failure or delay in performance hereunder to

the extent that such failure or delay is due to war, fire, flood, strike, lockout, or other labor

trouble, accident, breakdown of equipment or machinery, riot, act, request, or suggestion of

governmental authority, act of God, or other contingencies beyond the control of the affected

party which interfere with the production or transportation of the material covered by this

Agreement or with the supply of any raw material (whether or not the source of supply was in

existence or contemplated at the time of this Agreement) or energy source used in connection

therewith, or interfere with Buyer’s consumption of such material, provided that in no

event shall Buyer be relieved of the obligation to pay in full for material delivered hereunder.

Without limitation on the foregoing, neither party shall be required to remove any cause listed

above or replace the affected source of supply or facility if it shall involve additional expense

or departure from its normal practices. If any of the events specified in this paragraph shall

have occurred, Seller shall have the right to allocate in a fair and reasonable manner among

its customers and Seller’s own requirements any supplies of material Seller has available for

delivery at the time or for the duration of the event.

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**EXHIBIT 5** | (*continued* )

(*continued* )

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13. Materials and Energy Supply:

If, for reasons beyond reasonable commercial control, Seller’s supply of product to be

delivered hereunder shall be limited due to continued availability of necessary raw materials

and energy supplies, Seller shall have the right (without liability) to allocate to the Buyer

a portion of such product on such basis as Seller deems equitable. Such allocation shall

normally be that percentage of Seller’s total internal and external commitments which are

committed to Buyer as related to the total quantity available from Seller’s manufacturing

facilities.

14. Disclaimer:

Seller makes no warranty, express or implied, concerning the product furnished hereunder

other than it shall be of the quality and specifications stated herein. Any implied warranty

of FITNESS is expressly excluded and to the extent that it is contrary to the foregoing sentence;

any implied warranty of MERCHANTABILITY is expressly excluded. Any recommendation

made by Seller makes no warranty of results to be obtained. Buyer assumes all

responsibility and liability for loss or damage resulting from the handling or use of said product.

In no event shall Seller be liable for any special, indirect, or consequential damages,

irrespective of whether caused or allegedly caused by negligence.

15. Taxes:

Any tax, excise fee, or other charge or increase thereof upon the production, storage,

withdrawal, sale, or transportation of the product sold hereunder, or entering into the cost of

such product, imposed by any proper authority becoming effective after the date hereof, shall

be added to the price herein provided and shall be paid by the Buyer.

16. Assignment and Resale:

This contract is not transferable or assignable by Buyer without the written consent of

Seller. The product described hereunder, in the form and manner provided by the Seller, may

not be assigned or resold without prior written consent of the Seller.

17. Acceptance:

Acceptance hereof must be without qualification, and Seller will not be bound by any different

terms and conditions contained in any other communication.

18. Waiver of Breach:

No waiver by Seller or Buyer of any breach of any of the terms and conditions contained

in this Agreement shall be construed as a waiver or any subsequent breach of the same or

any other term or condition.

19. Termination:

If any provision of this agreement is or becomes violate of any law, or any rule, order, or

regulation issued thereunder, Seller shall have the right, upon notice to Buyer, to terminate

the Agreement in its entirety.

20. Governing Law:

The construction of this Agreement and the rights and obligations of the parties hereunder

shall be governed by the laws of the State of New York.

21. Special Provisions:

BUYER: SELLER:

PACIFIC OIL CORPORATION

(firm)

By: By:

Title: Senior Purchasing Manager Title: Marketing Vice President

Date: Date:

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**EXHIBIT 5** | (*concluded*)

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**4.** In a national product development meeting back in the States several weeks prior,

Fontaine had learned of plans by Pacific to expand and diversify its own product

line into VCM derivatives. There was serious talk of Pacific’s manufacturing its

own PVC for distribution under the Pacific name, as well as the manufacture and

distribution of various PVC products. Should Pacific decide to enter these businesses,

not only would they require a significant amount of the VCM now being

sold on the external market, but Pacific would probably decide that, as a matter of

principle, it would not want to be in the position of supplying a product competitor

with the raw materials to manufacture the product line, unless the formula

price were extremely favorable.

As they reviewed these factors, Gaudin and Fontaine realized that they needed to

take action. They pondered the alternatives.

**A New Contract Is Proposed**

As a result of their evaluation of the situation in December 1984, Fontaine and

Gaudin decided to proceed on two fronts. First, they would approach Reliant with the

intent of reopening negotiation on the current VCM contract. They would propose to

renegotiate the current agreement, with an interest toward extending the contract five

years from the point of agreement on contract terms. Second, they would contact

those people at corporate headquarters in New York who were evaluating Pacific’s

alternatives for new product development, and inform them of the nature of the situation.

The sooner a determination could be made on the product development strategies,

the sooner the Pacific office would know how to proceed on the Reliant

contract.

Gaudin contacted Frederich Hauptmann, the senior purchasing manager for Reliant

Chemicals in Europe. Hauptmann had assumed the position as purchasing manager

approximately four weeks earlier, after having served in a purchasing capacity for a

large German steel company. Gaudin arranged a meeting for early January in Hauptmann’s

office. After getting acquainted over lunch, Gaudin briefed Hauptmann on the history of

Reliant’s contractual relationships with Pacific Oil. Gaudin made clear that Pacific had

been very pleased with the relationship that had been maintained. He said that Pacific

was concerned about the future and about maintaining the relationship with Reliant for

a long time to come. Hauptmann stated that he understood that the relationship had been

a very productive one, too, and also hoped that the two companies could continue to

work together in the future. Buoyed by Hauptmann’s apparent enthusiasm and relative

pleasure with the current agreement, Gaudin said that he and Jean Fontaine, his boss,

had recently been reviewing all contracts. Even though the existing Pacific–Reliant

VCM agreement had three years to run, Pacific felt that it was never too soon to begin

thinking about the long-term future. In order to ensure that Reliant would be assured of

a continued supply of VCM, under the favorable terms and working relationship that

was already well established, Pacific hoped that Reliant might be willing to begin talks

now for contract extension past December 31, 1987. Hauptmann said that he would be

willing to consider it but needed to consult other people in the Brussels office, as well as

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senior executives at corporate headquarters in Chicago. Hauptmann promised to contact

Gaudin when he had the answer.

By mid-February, Hauptmann cabled Gaudin that Reliant was indeed willing to

begin renegotiation of the current agreement, with interest in extending it for the future.

He suggested that Gaudin and Fontaine come to Brussels for a preliminary meeting in

early March. Hauptmann also planned to invite Egon Zinnser, the regional vice president

of Reliant’s European operations and Hauptmann’s immediate superior.

**March 10**

Light snow drifted onto the runway of the Brussels airport as the plane landed. Fontaine

and Gaudin had talked about the Reliant contract, and the upcoming negotiations, for

most of the trip. They had decided that while they did not expect the negotiations to be a

complete pushover, they expected no significant problems or stumbling points in the deliberations.

They thought Reliant negotiators would routinely question some of the coefficients

that were used to compute the formula price as well as to renegotiate some of the minimum

quantity commitments. They felt that the other elements of the contract would be routinely

discussed but that no dramatic changes should be expected.

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**EXHIBIT 6** | Memorandum, December 9, 1984

TO: All VCM Marketing Managers

FROM: F. Kelsey, Strategic Planning Division

RE: Worldwide VCM–Supply–Demand Projections

DATE: December 9, 1984

*CONFIDENTIAL—FOR YOUR EYES ONLY*

This will confirm and summarize data that we discussed at the national marketing meeting

last month in Atlanta. At that time, I indicated to you that the market projections we made several

years ago have changed drastically. In early 1983, a number of our competitors announced

their intentions to enter the VCM business over the next five years. Several facilities

are now under construction, and are expected to come on line in late 1986 and early 1987.

As a result, we expect a fairly significant shift in the supply–demand relationship over the

next few years.

I hope you will give this appropriate consideration in your long-range planning effort.

Please contact me if I can be helpful.

**Total Projected Demand Operating Rates to**

**Year (in MM pounds) Supply Plant Capacities Meet Demand (percent)**

1982 5,127 (actual) 6,600 78%

1983 5,321 (actual) 6,600 81

1984 5,572 (rev. 11/84) 6,600 84

1985 5,700 7,300 78

1986 5,900 8,450 70

1987 6,200 9,250 64

1988 6,500 9,650 67

1989 7,000 11,000 63

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After a pleasant lunch with Hauptmann and Zinnser, the four men sat down to review

the current VCM contract. They reviewed and restated much of what Gaudin and

Hauptmann had done at their January meeting. Fontaine stated that Pacific Oil was looking

toward the future and hoping that it could maintain Reliant as a customer. Zinnser

responded that Reliant had indeed been pleased by the contract as well but that it was

also concerned about the future. They felt that Pacific’s basic formula price on VCM,

while fair, might not remain competitive in the long-run future. Zinnser said that he had

already had discussions with two other major chemical firms that were planning new

VCM manufacturing facilities and that one or both of these firms were due to come on

line in the next 24–30 months. Zinnser wanted to make sure that Pacific could remain

competitive with other firms in the marketplace. Fontaine responded that it was Pacific’s

full intention to remain completely competitive, whether it be in market price or in the

formula price.

Zinnser said he was pleased by this reply and took this as an indication that Pacific

would be willing to evaluate and perhaps adjust some of the factors that were now being

used to determine the VCM formula price. He then presented a rather elaborate proposal

for adjusting the respective coefficients of these factors. The net result of these adjustments

would be to reduce the effective price of VCM by approximately 2 cents per

pound. It did not take long for Fontaine and Gaudin to calculate that this would be a net

reduction of approximately $4 million per year. Fontaine stated that they would have to

take the proposal back to Paris for intensive study and analysis. The men shook hands,

and Fontaine and Gaudin headed back to the airport.

Throughout the spring, Gaudin and Hauptmann exchanged several letters and telephone

calls. They met once at the Paris airport when Hauptmann stopped over on a trip

to the States and once in Zurich when both men discovered that they were going to be

there on business the same day. By May 15, they had agreed on a revision of the formula

price that would adjust the price downward by almost one cent per pound. Gaudin,

relieved that the price had finally been established, reported back to Fontaine that

significant progress was being made. Gaudin expected that the remaining issues could

be closed up in a few weeks and a new contract signed.

**May 27**

Hauptmann contacted Gaudin to tell him that Reliant was now willing to talk about the

remaining issues in the contract. The two men met in early June. Gaudin opened the

discussion by saying that now that the formula price had been agreed upon, he hoped

that Reliant would be willing to agree to extend the contract five years from the point of

signing. Hauptmann replied that Reliant had serious reservations about committing the

company to a five-year contract extension. He cited the rapid fluctuations in the demand,

pricing structure, and competition of Reliant’s various product lines, particularly in the

construction industry, as well as what appeared to be a changing perspective in the

overall supply of VCM. Quite frankly, Hauptmann said, Reliant didn’t want to be caught

in a long-term commitment to Pacific if the market price of VCM was likely to drop in

the foreseeable future. As a result, Reliant wanted to make a commitment for only a

two-year contract renewal.

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Gaudin tried to give Hauptmann a number of assurances about the continued

integrity of the market. He also said that if changing market prices were a concern for

Reliant, Pacific Oil would be happy to attempt to make adjustments in other parts of the

contract to ensure protection against dramatic changes in either the market price or the

demand for Reliant’s product lines. But Hauptmann was adamant. Gaudin said he would

have to talk to Fontaine and others in Paris before he could agree to only a two-year

contract.

The two men talked several times on the telephone over the next two months and

met once in Paris to discuss contract length. On August 17, in a quick 45-minute meeting

in Orly Airport, Gaudin and Hauptmann agreed to a three-year contract renewal.

They also agreed to meet in early September to discuss remaining contract issues.

**September 10**

Hauptmann met Gaudin and Fontaine in Pacific’s Paris office. Hauptmann stressed that

he and Zinnser were very pleased by the formula price and three-year contract duration

that had been agreed to thus far. Fontaine echoed a similar satisfaction on behalf of

Pacific and stated that they expected a long and productive relationship with Reliant.

Fontaine stressed, however, that Pacific felt it was most important to them to complete

the contract negotiations as quickly as possible, in order to adequately plan for product

and market development in the future. Hauptmann agreed, saying that this was in

Reliant’s best interest as well. He felt that there were only a few minor issues that

remained to be discussed before the contract could be signed.

Fontaine inquired as to what those issues were. Hauptmann said that the most

important one to Reliant was the minimum quantity requirements, stipulating the minimum

amount that Reliant had to purchase each year. Gaudin said that based on the

projections for the growth of the PVC and fabricated PVC products over the next few

years, and patterns established by past contracts, it was Pacific’s assumption that Reliant

would want to increase their quantity commitments by a minimum of 10 percent each

year. Based on minimums stipulated in the current contract, Gaudin expected that

Reliant would want to purchase at least 220 million pounds in year 1, 240 million

pounds in year 2, and 265 million pounds in year 3. Hauptmann responded that Reliant’s

projections were very different. The same kind of uncertainty that had led to Reliant’s

concern about the term of the contract also contributed to a caution about significantly

overextending themselves on a minimum quantity commitment. In fact, Reliant’s own

predictions were that they were likely to take less than the minimum in the current year

(*underlifting,* in the parlance of the industry) and that, if they did so, they would incur

almost a $1 million debt to Pacific. Conservative projections for the following year

(1987) projected a similar deficit, but Reliant hoped that business would pick up and that

the minimum quantities would be lifted. As a result, Hauptmann and Zinnser felt that it

would be in Reliant’s best interest to freeze minimum quantity requirements for the next

two years—at 200 million pounds—and increase the minimum to 210 million pounds

for the third year. Of course, Reliant *expected* that, most likely, they would be continuing

to purchase much more than the specified minimums. But given the uncertainty of the

future, Reliant did not want to get caught if the economy and the market truly turned sour.

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Fontaine and Gaudin were astonished at the conservative projections Hauptmann

was making. They tried in numerous ways to convince Hauptmann that his minimums

were ridiculously low and that the PVC products were bound to prosper far more than

Hauptmann seemed willing to admit. But Hauptmann was adamant and left Paris saying

he needed to consult Zinnser and others in Brussels and the States before he could revise

his minimum quantity estimates upward. Due to the pressure of other activities and

vacation schedules, Gaudin and Hauptmann did not talk again until late October.

Finally, on November 19, the two men agreed to a minimum quantity purchase schedule

of 205 million pounds in the first year of the contract, 210 million pounds in the second

year, and 220 million pounds in the third year. Moreover, Pacific agreed to waive any

previous underlifting charges that might be incurred under the current contract when the

new contract was signed.

**October 24**

Jean Fontaine returned to Paris from meetings in New York and a major market development

meeting held by senior Pacific executives at Hilton Head. After a number of

delays due to conflicting market research and changes in senior management, as well as

the general uncertainty in the petroleum and chemical markets, Pacific had decided not

to develop its own product lines for either PVC or fabricated products. The decision was

largely based on the conclusion—more gut feel than hard fact—that entry into these new

markets was unwise at a time when much greater problems faced Pacific and the petrochemicals

industry in general. Fontaine had argued strenuously that the VCM market

was rapidly going soft, and that failure to create its own product lines would leave

Pacific Oil in an extremely poor position to market one of its basic products. Fontaine

was told that his position was appreciated but that he and other chemical marketing

people would simply have to develop new markets and customers for the product.

Privately, Fontaine churned on the fact that it had taken senior executives almost a year

to make the decision, while valuable time was being lost in developing the markets; but

he wisely decided to bite his tongue and vent his frustration on 36 holes of golf. On the

return flight to Paris, he read about Pacific’s decision in the October 23 issue of *The Wall*

*Street Journal* and ordered a double martini to soothe his nerves.

**December 14**

Fontaine and Gaudin went to Brussels to meet with Hauptmann and Zinnser. The Pacific

executives stressed that it was of the utmost importance for Pacific Oil to try to wrap up

the contract as quickly as possible—almost a year had passed in deliberations, and

although Pacific was not trying to place the “blame” on anyone, it was most concerned

that the negotiations be settled as soon as possible.

Zinnser emphasized that he, too, was concerned about completing the negotiations

quickly. Both he and Hauptmann were extremely pleased by the agreements that had

been reached so far and felt that there was no question that a final contract signing was

imminent. The major issues of price, minimum quantities, and contract duration had

been solved. In their minds, what remained were only a few minor technical items in

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contract language. Some minor discussion of each of these should wrap things up in a

few weeks.

Fontaine asked what the issues were. Zinnser began by stating that Reliant had

become concerned by the way that the delivery pipeline was being metered. As currently

set up, the pipeline fed from Pacific’s production facility in Antwerp, Belgium, to Reliant’s

refinery. Pacific had built the line and was in charge of maintaining it. Meters had been installed

at the exit flange of the pipeline, and Reliant was paying the metered amount to

Pacific. Zinnser said that some spot-checking by Reliant at the manufacturing facility

seemed to indicate that they may not be receiving all they were being billed for. They were

not questioning the integrity of the meters or the meter readers, but felt that since the pipe

was a number of years old, it may have developed leaks. Zinnser felt that it was inappropriate

for Reliant to absorb the cost ofVCM that was not reaching its facility. They therefore

proposed that Pacific install meters directly outside of the entry flange of Reliant’s manufacturing

facility and that Reliant only be required to pay the meter directly outside the plant.

Fontaine was astonished. In the first place, he said, this was the first time he had

heard any complaint about the pipeline or the need to recalibrate the meters. Second, if

the pipeline was leaking, Pacific would want to repair it, but it would be impossible to

do so until spring. Finally, while the meters themselves were not prohibitively expensive,

moving them would mean some interruption of service and definitely be costly to

Pacific. Fontaine said he wanted to check with the maintenance personnel at Antwerp to

find out whether they could corroborate such leaks.

Fontaine was unable to contact the operating manager at Antwerp or anyone else

who could confirm that leaks may have been detected. Routine inspection of the pipeline

had been subcontracted to a firm that had sophisticated equipment for monitoring such

things, and executives of the firm could not be reached for several days. Fontaine tried

to raise other contract issues with Zinnser, but Zinnser said that this was his most

important concern, and this issue needed to be resolved before the others could be

finalized. Fontaine agreed to find out more about the situation and to bring the information

to the next meeting. With the Christmas and New Year holidays approaching, the

four men could not schedule another meeting until January 9.

**January Meetings**

The January 9 meeting was postponed until January 20, due to the death of Hauptmann’s

mother. The meeting was rescheduled for a time when Hauptmann needed to be in

Geneva, and Gaudin agreed to meet him there.

Gaudin stated that the investigation of the pipeline had discovered no evidence of

significant discharge. There were traces of *minor* leaks in the line, but they did not

appear to be serious, and it was currently impossible to determine what percentage

of the product may be escaping. The most generous estimate given to Gaudin had been

0.1 percent of the daily consumption. Hauptmann stated that their own spot monitoring

showed it was considerably more and that Reliant would feel infinitely more comfortable

if the new metering system could be installed.

Gaudin had obtained estimates for the cost of remetering before he left Paris. It

was estimated that the new meters could be installed for approximately $20,000.

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Tracing and fixing the leaks (if they existed) could not be done until April or May

and might run as much as $50,000 if leaks turned out to be located at some extremely

difficult access points. After four hours of debating with Hauptmann in a small conference

room off the lobby of the Geneva Hilton, Gaudin agreed that Pacific would

remeter the pipeline.

Hauptmann said that as far as he was concerned, all of his issues had been settled;

however, he thought Zinnser might have one or two other issues to raise. Hauptmann

said that he would report back to Zinnser and contact Gaudin as soon as possible if

another meeting was necessary. Gaudin, believing that Pacific was finally beginning to

see the light at the end of the tunnel, left for Paris.

**January 23**

Hauptmann called Gaudin and said that he and Zinnser had thoroughly reviewed the

contract and that there were a few small issues of contract language which Zinnser

wanted to clarify. He said that he would prefer not to discuss them over the telephone

and suggested that since he was going to be in Paris on February 3, they meet at the

Pacific offices. Gaudin agreed.

Fontaine and Gaudin met Hauptmann on February 3. Hauptmann informed them

that he felt Reliant had been an outstanding customer for Pacific in the past and that it

probably was one of Pacific’s biggest customers for VCM. Fontaine and Gaudin agreed,

affirming the important role that Reliant was playing in Pacific’s VCM market.

Hauptmann said that he and Zinnser had been reviewing the contract and were concerned

that the changing nature of the VCM market might significantly affect Reliant’s

overall position in the marketplace as a purchaser. More specifically, Reliant was concerned

that the decline in market and price for VCM in the future might endanger its

own position in the market, since Pacific might sign contracts with other purchasers for

lower formula prices than were currently being awarded to Reliant. Since Reliant was

such an outstanding customer of Pacific—and Fontaine and Gaudin had agreed to that—

it seemed to Reliant that Pacific Oil had an obligation to write two additional clauses

into the contract that would protect Reliant in the event of further slippage in the VCM

market. The first was a “favored nations” clause, stipulating that if Pacific negotiated

with another purchaser a more favorable price for VCM than Reliant was receiving now,

Pacific would guarantee that Reliant would receive that price as well. The second was a

“meet competition” clause, guaranteeing that Pacific would willingly meet any lower price

on VCM offered by a competitor, in order to maintain the Reliant relationship. Hauptmann

argued that the “favored nations” clause was protection for Reliant, since it stipulated that

Pacific valued the relationship enough to offer the best possible terms to Reliant. The

“meet competition” clause, he argued, was clearly advantageous for Pacific since it

ensured that Reliant would have no incentive to shift suppliers as the market changed.

Fontaine and Gaudin debated the terms at length with Hauptmann, stressing the potential

costliness of these agreements for Pacific. Hauptmann responded by referring to

the costliness that the absence of the terms could have for Reliant and suggesting that

perhaps the Pacific people were truly *not* as interested in a successful long-term relationship

as they had been advocating. Fontaine said that he needed to get clearance from

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senior management in New York before he could agree to these terms and that he would

get back to Hauptmann within a few days when the information was available.

**Frank Kelsey’s View**

Frank Kelsey was strategic planning manager, a staff role in the New York offices of the

Pacific Oil Corporation. Kelsey had performed a number of roles for the company in his

12 years of work experience. Using the chemistry background he had achieved in

college, Kelsey worked for six years in the research and development department of

Pacific’s Chemical Division before deciding to enter the management ranks. He transferred

to the marketing area, spent three years in chemical marketing, and then assumed

responsibilities in marketing planning and development. He moved to the strategic

planning department four years ago.

In late 1985, Kelsey was working in a staff capacity as an adviser to the executive

product vice president of Pacific Oil Company. Pacific had developed a matrix organization.

Reporting relationships were determined by business areas and by regional

operating divisions within Pacific Oil. Warren Meredith, the executive vice president,

had responsibility for monitoring the worldwide sale and distribution of VCM. Jean

Fontaine reported to Meredith on all issues regarding the overall sale and marketing of

VCM and reported to the president of Pacific Oil in Europe, Stan Saunders, on major

issues regarding the management of the regional chemicals business in Europe. In

general, Fontaine’s primary working relationship was with Meredith; Saunders became

involved in day-to-day decisions only as an arbiter of disputes or interpreter of major

policy decisions.

As the negotiations with Reliant evolved, Meredith became distressed by the

apparent turn that they were taking. He called in Frank Kelsey to review the situation.

Kelsey knew that the VCM marketing effort for Pacific was going to face significant

problems. Moreover, his dominant experience with Pacific in recent years had been in

the purchasing and marketing operations, and he knew how difficult it would be for the

company to maintain a strong negotiation in VCM contracts.

Meredith asked Kelsey to meet with Fontaine and Gaudin in Paris and review the

current status of negotiations on the Reliant contract. While Kelsey could act only in an

advisory capacity—Fontaine and Gaudin were free to accept or reject any advice that

was offered, since they were the ones who had to live with the contract—Meredith told

Kelsey to offer whatever services the men would accept.

Kelsey flew to Paris shortly after New Year’s Day 1986. He met with Fontaine and

Gaudin, and they reviewed in detail what had happened in the Reliant contract negotiations

over the past year. Kelsey listened, asked a lot of questions, and didn’t say much.

He felt that offering advice to the men was premature and perhaps even unwise;

Fontaine and Gaudin seemed very anxious about the negotiations and felt that the new

contract would be sealed within a month. Moreover, they seemed to resent Kelsey’s visit

and clearly didn’t want to share more than the minimum amount of information. Kelsey

returned to New York and briefed Meredith on the state of affairs.

When Fontaine called Meredith for clearance to give Reliant both “favored

nations” and “meet competition” clauses in the new contract, Meredith immediately

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called Kelsey. The two of them went back through the history of events in the negotiation

and realized the major advantages that Reliant had gained by its negotiation

tactics.

Meredith called Fontaine back and advised against granting the clauses in the

contract. Fontaine said that Hauptmann was adamant and that he was afraid the entire

negotiation was going to collapse over a minor point in contract language.

Meredith said he still thought it was a bad idea to make the concession. Fontaine said

he thought he needed to consult Saunders, the European president of Pacific Oil, just

to make sure.

Two days later, Saunders called Meredith and said that he had complete faith in

Fontaine and Fontaine’s ability to determine what was necessary to make a contract

work. If Fontaine felt that “favored nations” and “meet competition” clauses were

necessary, he trusted Fontaine’s judgment that the clauses could not cause significant

adverse harm to Pacific Oil over the next few years. As a result, he had given Fontaine

the go-ahead to agree to these clauses in the new contract.

**March 11**

It was a dark and stormy night, March 11, 1986. Frank Kelsey was about to go to bed

when the telephone rang. It was Jean Fontaine. Kelsey had not heard from Fontaine since

their meeting in Paris. Meredith had told Kelsey about the discussion with Saunders, and

he had assumed that Fontaine had gone ahead and conceded on the two contract clauses

that had been discussed. He thought the contract was about to be wrapped up, but he

hadn’t heard for sure.

The violent rainstorm outside disrupted the telephone transmission, and Kelsey had

trouble hearing Fontaine. Fontaine said that he had appreciated Kelsey’s visit in January.

Fontaine was calling to ask Kelsey’s advice. They had just come from a meeting with

Hauptmann. Hauptmann and Zinnser had reported that recent news from Reliant’s corporate

headquarters in Chicago projected significant downturns in the sale of a number

of Reliant’s PVC products in the European market. While Reliant thought it could ride

out the downturn, they were very concerned about their future obligations under the

Pacific contract. Since Reliant and Pacific had already settled on minimum quantity

amounts, Reliant wanted the contractual right to resell the product if it could not use the

minimum amount.

Kelsey tried to control his emotions as he thought about this negative turn of events

in the Reliant negotiations. He strongly advised against agreeing to the clause, saying

that it could put Pacific in an extremely poor position. Fontaine debated the point,

saying he really thought Reliant might default on the whole contract if they didn’t get

resale rights. “I can’t see where agreeing to the right to resale is a big thing, Frank,

particularly given the size of this contract and its value to me and Pacific.”

KELSEY: Look, you asked for my advice, and I gave it to you. If I were you,

I wouldn’t make any more concessions. Agreeing to a resale clause could create

a whole lot of unforeseen problems. At this point I think it’s also the principle of

the thing!

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FONTAINE: Who cares about principles at a time like this! It’s my neck that’s on

the line if this Reliant contract goes under! I’ll have over 200 million pounds of

VCM a year to eat in an oversupplied market! It’s my neck that’s on the line, not

yours! How in the world can you talk to me about “principle” at this point?

KELSEY: Calm down, Jean! I can see your point of view! I appreciate the pressures

on you, but I really don’t like the looks of it from this end. Keep in

touch—let me ask others down at the office what they think, and I’ll call you

next week.

Kelsey hung up the telephone, and stared out of the windows at the rain. He could

certainly empathize with Fontaine’s position—the man’s neck was on the block. As he

mentally reviewed the two-year history of the Reliant negotiations, Kelsey wondered

how they had gotten to this point and whether anyone could have done things differently.

He also wondered what to do about the resale clause, which appeared to be the final

sticking point in the deliberations. Would acquiescing to a resale clause for Reliant be a

problem to Pacific Oil? Kelsey knew he had to take action soon.

***APPENDIX Petrochemical Supply Contracts:***

***A Technical Note***

Supply contracts between chemical manufacturing/refining companies and purchasing

companies are fairly standard in the industry trade. They are negotiated between supplier

and purchaser in order to protect both parties against major fluctuations in supply and demand.

Any purchaser wishing to obtain a limited amount of a particular product could always

approach any one of a number of chemical manufacturing firms and obtain the

product at *market price.* The market price is controlled by the competitive supply and demand

for the particular product on any given day. But purchasers want to be assured of a

long-term supply and do not want to be subject to the vagaries of price fluctuation; similarly,

manufacturers want to be assured of product outlets in order to adequately plan manufacturing

schedules. Long-term contracts protect both parties against these fluctuations.

A supply contract is usually a relatively standard document, often condensed to one

page. The major *negotiable* elements of the contract, on the *front side* of the document,

include the price, quantity, product quality, contract duration, delivery point, and credit

terms (see Exhibit 1A for a sample blank contract). The remainder (*back side*) of the

contract is filled with traditionally fixed legal terminology that governs the conditions

under which the contract will be maintained. While the items are seldom changed, they

may be altered or waived as part of the negotiated agreement.

The primary component of a long-term contract is the price. In the early years of the

petrochemical industry, the raw product was metered by the supplier (either in liquid or

gaseous form) and sold to the purchaser. As the industry became more competitive, as

prices rose rapidly, and as the products developed from petrochemical supplies (called

*feedstocks*) became more sophisticated, pricing became a significantly more complex

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**EXHIBIT 1A** | Agreement of Sale

This Agreement, entered into this \_\_\_\_\_\_\_\_\_\_ day of \_\_\_\_\_\_\_\_\_\_, \_\_\_\_\_\_\_\_\_\_, between

*Pacific Oil Company,* hereinafter called Seller, and \_\_\_\_\_\_\_, hereinafter called Buyer.

WITNESSETH:

Seller agrees to sell and deliver and Buyer agrees to purchase and receive commodity (hereinafter

called “product”) under the terms and conditions set forth below.

1. Product:

2. Quality:

3. Quantity:

4. Period:

5. Price:

6. Payment Terms:

*a.* Net \_\_\_\_\_\_\_\_\_\_.

*b.* All payments shall be made in United States dollars without discount or deduction,

unless otherwise noted, by wire transfer at Seller’s option, to a bank account designated

by Seller. Invoices not paid on due date will be subject to a delinquency finance

charge of 1% per month.

*c.* If at any time the financial responsibility of Buyer shall become impaired or unsatisfactory

to Seller, cash payment on delivery or satisfactory security may be required. A

failure to pay any amount may, at the option of the Seller, terminate this contract as to

further deliveries. No forbearance, course of dealing, or prior payment shall affect this

right of Seller.

7. Price Change:

The price specified in this Agreement may be changed by Seller on the first day of any

calendar \_\_\_\_\_\_\_\_\_\_ by written notice sent to the Buyer not less than thirty (30) days prior to

the effective date of change. Buyer gives Seller written notice of objection to such change at

least ten (10) days prior to the effective date of change. Buyer’s failure to serve Seller with

written notice of objection thereto prior to the effective date thereof shall be considered

acceptance of such change. If Buyer gives such notice of objection and Buyer and Seller fail

to agree on such change prior to the effective date thereof, this Agreement and the obligations

of Seller and Buyer hereunder shall terminate with respect to the unshipped portion of

the Product governed by it. Seller has the option immediately to cancel this contract upon

written notice to Buyer, to continue to sell hereunder at the same price and terms which were

in effect at the time Seller gave notice of change, or to suspend performance under this contract

while pricing is being resolved. If Seller desires to revise the price, freight allowance, or

terms of payment pursuant to this agreement, but is restricted to any extent against doing so

by reason of any law, governmental decree, order, or regulation, or if the price, freight allowance,

or terms of payment then in effect under this contract are nullified or reduced by

reason of any law, governmental decree, order, or regulation, Seller shall have the right to

cancel this contract upon fifteen (15) days’ written notice to purchaser.

8. Measurements:

Seller’s determinations, unless proven to be erroneous, shall be accepted as conclusive

evidence of the quantity of Product delivered hereunder. Credit will not be allowed for

shortages of 1/2 of 1% or less of the quantity and overages of 1/2 of 1% or less of the

quantity will be waived. The total amount of shortages or overages will be credited or

billed when quantities are greater and such differences are substantiated. Measurements

of weight and volume shall be according to procedures and criteria standard for such

determinations.

(*continued* )

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9. Shipments and Delivery:

Buyer shall give Seller annual or quarterly forecasts of its expected requirements as

Seller may from time to time request. Buyer shall give Seller reasonably advanced notice for

each shipment which shall include date of delivery and shipping instructions. Buyer shall

agree to take deliveries in approximately equal monthly quantities, except as may be otherwise

provided herein. In the event that Buyer fails to take the quantity specified or the pro

rata quantity in any month, Seller may, at its option, in addition to other rights and remedies,

cancel such shipments or parts thereof.

10. Purchase Requirements:

*a*. If during any consecutive three-month period, Buyer for any reason (but not for reasons

of force majeure as set forth in Section 12) takes less than 90 percent of the

average monthly quantity specified, or the prorated minimum monthly quantity then

applicable to such period under Section 12, Seller may elect to charge Buyer a

penalty charge for failure to take the average monthly quantity or prorated minimum

monthly quantity.

*b.* If, during any consecutive three-month period, Buyer, for any reason (but not, however,

for reasons of force majeure as set forth in Section 12) takes Product in quantities

less than that equal to at least one-half of the average monthly quantity specified,

or the prorated minimum monthly quantity originally applicable to such period under

Section 12, Seller may elect to terminate this agreement.

*c*. It is the Seller’s intent not to unreasonably exercise its rights under (*a*) or (*b*) in the

event of adverse economic and business conditions in general.

*d*. Notice of election by Seller under (*a*) or (*b*) shall be given within 30 days after the end

of the applicable three-month period, and the effective date of termination shall be

30 days after the date of said notice.

11. Detention Policy:

Seller may, from time to time, specify free unloading time allowances for its transportation

equipment. Buyer shall be liable to the Transportation Company for all demurrage charges

made by the Transportation Company, for railcars, trucks, tanks, or barges held by Buyer beyond

the free unloading time.

12. Force Majeure:

Neither party shall be liable to the other for failure or delay in performance hereunder to

the extent that such failure or delay is due to war, fire, flood, strike, lockout, or other labor

trouble, accident, breakdown of equipment or machinery, riot, act, request, or suggestion of

governmental authority, act of God, or other contingencies beyond the control of the affected

party which interfere with the production or transportation of the material covered by this

Agreement or with the supply of any raw material (whether or not the source of supply was in

existence or contemplated at the time of this Agreement) or energy source used in connection

therewith, or interfere with Buyer’s consumption of such material, provided that in no

event shall Buyer be relieved of the obligation to pay in full for material delivered hereunder.

Without limitation on the foregoing, neither party shall be required to remove any cause listed

above or replace the affected source of supply or facility if it shall involve additional expense

or departure from its normal practices. If any of the events specified in this paragraph shall

have occurred, Seller shall have the right to allocate in a fair and reasonable manner among

its customers and Seller’s own requirements any supplies of material Seller has available for

delivery at the time or for the duration of the event.

13. Materials and Energy Supply:

**EXHIBIT 1A** | (*continued* )

(*continued* )

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If, for any reasons beyond reasonable commercial control, Seller’s supply of product to be

delivered hereunder shall be limited due to continued availability of necessary raw materials

and energy supplies, Seller shall have the right (without liability) to allocate to the Buyer

a portion of such product on such basis as Seller deems equitable. Such allocation shall

normally be that percentage of Seller’s total internal and external commitments which are

committed to Buyer as related to the total quantity from Seller’s manufacturing facilities.

14. Disclaimer:

Seller makes no warranty, express or implied, concerning the product furnished hereunder

other than it shall be of the quality and specification stated herein. Any implied warranty

of FITNESS is expressly excluded and to the extent that it is contrary to the foregoing

sentence; any implied warranty of MERCHANTABILITY is expressly excluded. Any recommendation

made by Seller makes no warranty of results to be obtained. Buyer assumes

all responsibility and liability for loss or damage resulting from the handling or use of said

product. In no event shall Seller be liable for any special, indirect or consequential

damages, irrespective of whether caused or allegedly caused by negligence.

15. Taxes:

Any tax, excise fee, or other charge or increase thereof upon the production, storage,

withdrawal, sale, or transportation of the product sold hereunder, or entering into the cost of

such product, imposed by any proper authority becoming effective after the date hereof, shall

be added to the price herein provided and shall be paid by the Buyer.

16. Assignment and Resale:

This contract is not transferable or assignable by Buyer without the written consent of

Seller. The product described hereunder, in the form and manner provided by the Seller, may

not be assigned or resold without prior written consent of the Seller.

17. Acceptance:

Acceptance hereof must be without qualification, and Seller will not be bound by any

different terms and conditions contained in any other communication.

18. Waiver of Breach:

No waiver by Seller or Buyer of any breach of any of the terms and conditions contained

in this Agreement shall be construed as a waiver or any subsequent breach of the same or

any other term or condition.

19. Termination:

If any provision of this agreement is or becomes violate of any law, or any rule, order, or

regulation issued thereunder, Seller shall have the right, upon notice to Buyer, to terminate

the Agreement in its entirety.

20. Governing Law:

The construction of this Agreement and the rights and obligations of the parties hereunder

shall be governed by the laws of the State of \_\_\_\_\_\_\_\_\_\_.

21. Special Provisions:

BUYER: SELLER:

(firm) (firm)

By: By:

Title: Title:

Date: Date:

**EXHIBIT 1A** | (*concluded* )

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process. Most contemporary contract prices are determined by an elaborate calculation

called a *formula price,* composed of several elements:

**1.** *Feedstock characteristics:* Petrochemical feedstock supplies differ in the chemical

composition and molecular structure of the crude oil. Differences in feedstocks

will significantly affect the refining procedures and operating efficiency of the

refinery that manufactures a product, as well as their relative usefulness to

particular purchasers. While some chemical products may be drawn from a single

feedstock, large-volume orders may necessitate the blending of several feedstocks

with different structural characteristics.

**2.** *Fuel costs:* Fuel costs include the price and amount of energy that the manufacturing

company must assume in cracking, refining, and producing a particular chemical

stream.

**3.** *Labor costs:* Labor costs include the salaries of employees to operate the manufacturing

facility for the purpose of producing a fixed unit amount of a particular

product.

**4.** *Commodity costs:* Commodity costs include the value of the basic petrochemical

base on the open marketplace. As the supply and demand for the basic commodity

fluctuate on the open market, this factor is entered into the formula price.

A formula price may therefore be represented as a function of the following elements:

Formula price \_ Feedstock cost \_ Energy cost \_ Labor cost

\_ Commodity cost (per unit)

If only one feedstock were used, the chemical composition of the feedstock would

determine its basic cost and the energy, labor, and commodity costs of producing it. If

several feedstocks were used, the formula price would be a composite of separate

calculations for each particular feedstock, or a weighted average of the feedstock components,

multiplied by the cost of production of each one.

Each of the elements in the formula price is also multiplied by a weighting factor

(coefficient) that specifies how much each cost will contribute to the determination of

the overall formula price. The supplier generally sets a *ceiling price,* guaranteeing that

the formula price will not exceed this amount. Below the ceiling price, however, the supplier

endeavors to maximize profits while clearly specifying the costs of production to

the purchaser, while the purchaser attempts to obtain the most favorable formula price

for himself. Since basic cost data and cost fluctuations are well known, negotiations

typically focus on the magnitude of the coefficients that are applied to each element in

the formula. Hence the actual formula computation may be represented as follows:

Formula price \_ (Weighting coefficient \_ Feedstock cost)

\_ (Weighting coefficient \_ Energy cost)

\_ (Weighting coefficient \_ Labor cost)

\_ (Weighting coefficient \_ Commodity cost)

A fairly typical ratio of the weighting coefficients in this formula would be 70 percent

(0.7) for feedstock cost, 20 percent (0.2) for energy costs, 5 percent (0.05) for labor

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costs, and 5 percent (0.05) for commodity costs. Multiple feedstocks supplied in a particular

contract would be composed of a different set of costs and weighting elements

for each feedstock in the supply.

The computation of a formula price, as opposed to the determination of a market

price, has a number of advantages and disadvantages. Clearly, it enables the supplier to

pass costs along to the purchaser, which minimizes the risk for both parties in the event

of rapid changes in cost during the duration of the contract. The purchaser can project

directly how cost changes will affect his supply costs; the supplier is protected by being

able to pass cost increases along to the purchaser. However, when the market demand

for the product is very high, the formula price constrains the seller in the ceiling price he

can charge, hence curtailing potential profit for the product compared to its value on the

open marketplace. Conversely, when market demand is very low, the contract may guarantee

a large market to the supplier, but at a price for the product that could be unprofitable

compared to production costs.

**Quantity**

Formula prices are typically computed with major attention given to quantity. Costs will

fluctuate considerably based on the efficiency with which the production plant is operated,

number of labor shifts required, and so on. Hence, in order to adequately forecast

demand, attain particular economies of scale in the manufacturing process, and plan production

schedules, suppliers must be able to determine the quantities that a particular

customer will want to acquire. (Because of the volumes involved, no significant inventory

is produced.) Quantities will be specified in common units of weight (pounds, tons,

etc.) or volume (gallons, etc.).

Quantity specifications are typically treated as minimum purchase amounts. If a

purchaser desires significantly more than the minimum amount (*overlifting*) in a given

time period (e.g., a year), the amount would be sold contingent on availability and

delivered at the formula price. Conceivably, *discount* prices or adjustments in the

formula price could be negotiated for significant purchases over minimum quantity.

Conversely, underpurchase of the minimum amount (*underlifting*) by a significant

degree typically results in penalty costs to the purchaser. These are typically referred to

as *liquidated damages* in the industry and may be negotiated at rates anywhere from a

token fine of several thousand dollars to as much as 30 percent of the formula price for

each unit underlifted. Faced with the possibility of underlifting (due to market or product

demand changes that require less raw material in a given time period), purchasers

typically handle underlifting in one of several ways:

**1.** Pay the underlifting charges (liquidated damages) to the supplier, either as stated

or according to some renegotiated rate.

**2.** Not pay the liquidated damages, under the assumption that the supplier will not

want to press legal charges against the purchaser at the expense of endangering

the entire supply contract.

**3.** Resell the commodity to another purchaser who may be in need of supply, perhaps

at a discounted price. Such action by the purchaser could cause major

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instability in the market price and in supply contracts held at the original manufacturer

or other manufacturers. For this reason, sellers typically preclude the right

of the purchaser to resell the product as part of the standard contract language.

**Quality**

The quality of the product is related to the particular feedstock from which it is drawn, as

well as the type and degree of refining that is employed by the supplier. Standard descriptions

for gradations of quality are common parlance for each major chemical product.

**Delivery**

Most contracts specify the method of delivery, point of delivery, and way that the quantity

amounts will be measured as the product is delivered. Gases are typically metered

and delivered by direct pipeline from the manufacturer to the purchaser; liquids and liquefied

gases may be sold by pipeline or shipped via tank truck, railroad tank car, tank

barges, and tank ships.

**Contract Duration**

Most typical supply contracts extend for a period from one to five years; significantly

longer or shorter ones would probably only be negotiated under extreme circumstances.

Negotiations for contract renewal are typically begun several months prior to contract

expiration.

**Payment Terms**

Payment terms are determined by the credit ratings and cash flow demands of both parties.

Typical contracts specify payment within 30 days of delivery, although this time

period may be shortened to payment on delivery or lengthened to a period of three

months between delivery and payment.

**Contract Language**

As can be determined from Exhibit 1A, there are a number of elements in the contract

that delineate the conditions under which the parties agree to bind themselves to the contract,

or to deviate from it. Terminology and agreements are typically standard unless

altered by negotiation prior to contract signing. These elements include the following:

**1.** *Measurements:* A mechanism for specifying how quantity amounts will be determined

and how disputes over differences in delivered quantity will be resolved.

**2.** *Meet competition:* The seller agrees to meet competitive market prices for the product

if they become substantially lower than the current negotiated formula price.

**3.** *Favored nations:* The supplier agrees that if he offers a better price on the product

to any of the purchaser’s competitors, he will offer the same price to this buyer.

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**4.** *Purchase requirements:* The purchase requirements govern the conditions and

terms under which liquidated damages may be invoked.

**5.** *Force majeure:* The force majeure clause exempts the parties from contract default

in the event of major natural disasters, strikes, fires, explosions, or other events

that could preclude the seller’s ability to deliver the product or the buyer’s ability

to purchase.

**6.** *Disclaimers:* The disclaimers protect both buyer and seller against unreasonable

claims about the product or its quality.

**7.** *Assignability:* The assignability clause limits the right of either party to assign the

contract to another purchaser or supplier if they so desire.

**8.** *Notifications:* The notifications section specifies the lead time during which one

or both parties must notify the other party of any change in the contract or its

renewal.

**9.** *Other clauses:* Other clauses include conditions under which the product may be

assured delivery, application of taxes, provisions for resale, definitions of contract

breach and termination, the legal framework used to enforce the contract (in the

event of cross-state or cross-national agreements), and methods of notification of

one party to the other.

**Contract Management and Maintenance**

While a supply contract is a legally binding document that attempts to articulate the way

two companies will work together, it more commonly stands as the cornerstone of a

complex long-term social relationship between buyer and seller. This relationship

requires constant monitoring, evaluation, and discussion by representatives of both

organizations. Thus, while similar supply contracts may exist between a particular manufacturer

and three different buyers, there may be major differences in the day-to-day

interactions and quality of relationships between the manufacturer and each buyer.

Experienced sales representatives have defined a good seller–buyer relationship as meeting

the following criteria:

**•** *The purchaser can be counted on to live up to the terms and conditions of the contract*

*as negotiated.* The purchaser accepts a fair formula price in price negotiations

and does not attempt to push the supplier into an artificially low price. The

purchaser lifts as much of the product per time period as he agreed to lift under

the contract. The purchaser is trustworthy and follows a course of action based on

sound business ethics.

**•** *The purchaser does not attempt to take advantage of fluctuations or aberrations*

*in the spot market price to gain advantage.* He accepts the fact that a formula

price has been negotiated and that both parties agree to live up to this price for the

duration of the contract. He does not seek contract price changes as the market

price may drop for some time period.

**•** *When there is a mutual problem between seller and purchaser, it can be openly*

*discussed and resolved between the two parties.* Problems resulting from the

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continued inability of the supplier to provide the product, and/or the continued

inability of the buyer to consume the product, can be openly addressed and resolved.

Problems in the quality of the product, labor difficulties resulting in problems

in manufacturing, loading, shipping, unloading, cleanliness of the shipping

equipment, and so on can be promptly explored and resolved to mutual satisfaction.

Finally, changes in the business projections of one or both parties can be

shared, so that difficulties anticipated by the supplier in providing all of the product,

or difficulties anticipated by the purchaser in consuming all of the product,

can lead to amicable and satisfactory resolutions for both parties. Ability to resolve

these problems requires mutual trust, honesty, open lines of communication,

and an approach to problem solving that seeks the best solution for both sides.

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