

Case 2

Pacific Oil Company (A)

For the discussion of Pacific Oil Company, please prepare the following:

1. As background information, read the appendix to this case: "Petrochemical Supply Contracts: A Technical Note" (p. 601).
2. Read the Pacific Oil Company case.
3. Prepare the following questions for class discussion:
 - a. Describe the problem that Pacific Oil Company faced as it reopened negotiations with Reliant Chemical Company in early 1985.
 - b. Evaluate the styles and effectiveness of Messrs. Fontaine, Gaudin, Hauptmann, and Zinnser as negotiators in this case.
 - c. What should Frank Kelsey recommend to Jean Fontaine at the end of the case? Why?

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.

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 calendaring (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 for partial organization charts.)

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	<u>60</u>	<u>1.5</u>
	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	<u>50</u>	<u>1.2</u>
	1,500	38.2
Electrical		
Wire and cable	390	9.9
Home furnishings		
Appliances	32	0.8
Miscellaneous	<u>286</u>	<u>9.8</u>
	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	<u>80</u>	<u>2.0</u>
	300	7.6
Recreation		
Records	136	3.4
Sporting goods	46	1.2
Miscellaneous	<u>68</u>	<u>1.7</u>
	250	6.3
Transportation		
Auto mats	36	0.9
Auto tops	32	0.8
Miscellaneous	<u>164</u>	<u>4.2</u>
	232	5.9

EXHIBIT 1 | (concluded)

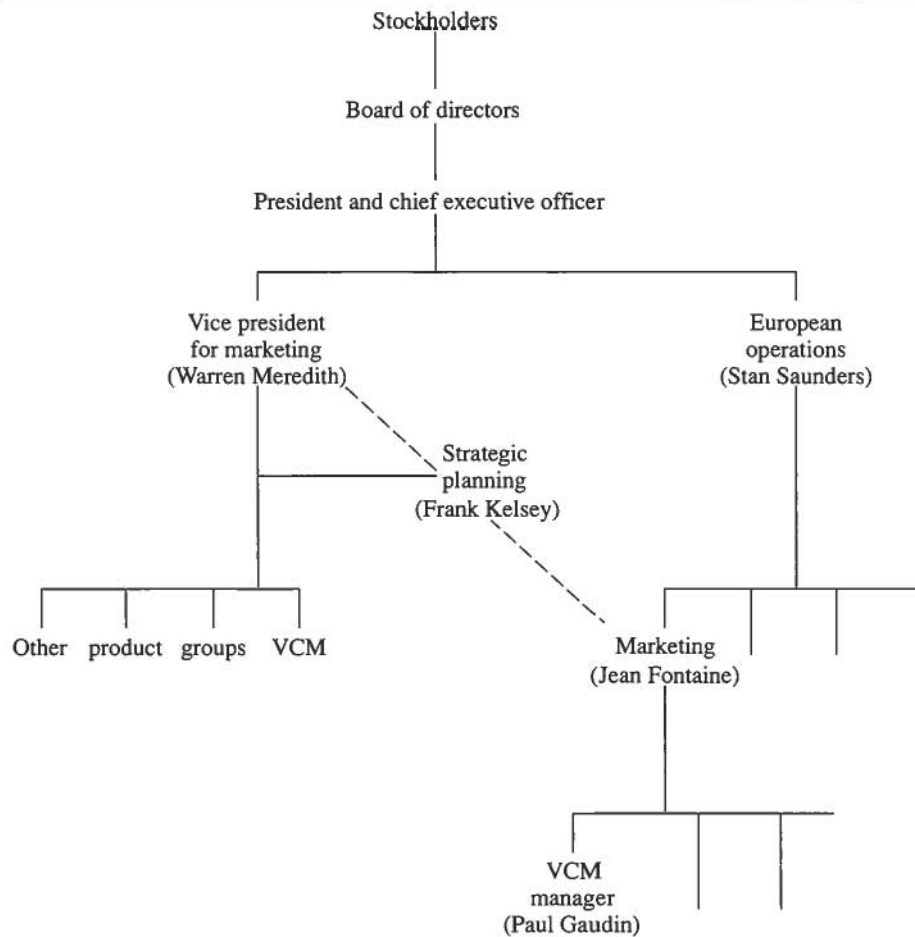
Market	MM Pounds	Percentage of Market Share
Miscellaneous		
Agriculture (including pipe)	106	2.6
Credit cards	24	0.4
Garden hose	40	1.0
Laminates	44	1.1
Medical tubing	42	1.1
Novelties	12	0.3
Stationery supplies	32	0.8
Miscellaneous	12	0.3
	<u>312</u>	<u>7.6</u>
Export	146	3.7
Miscellaneous	98	2.5
	<u>244</u>	<u>6.2</u>
Total	3,850	100.0

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). 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.

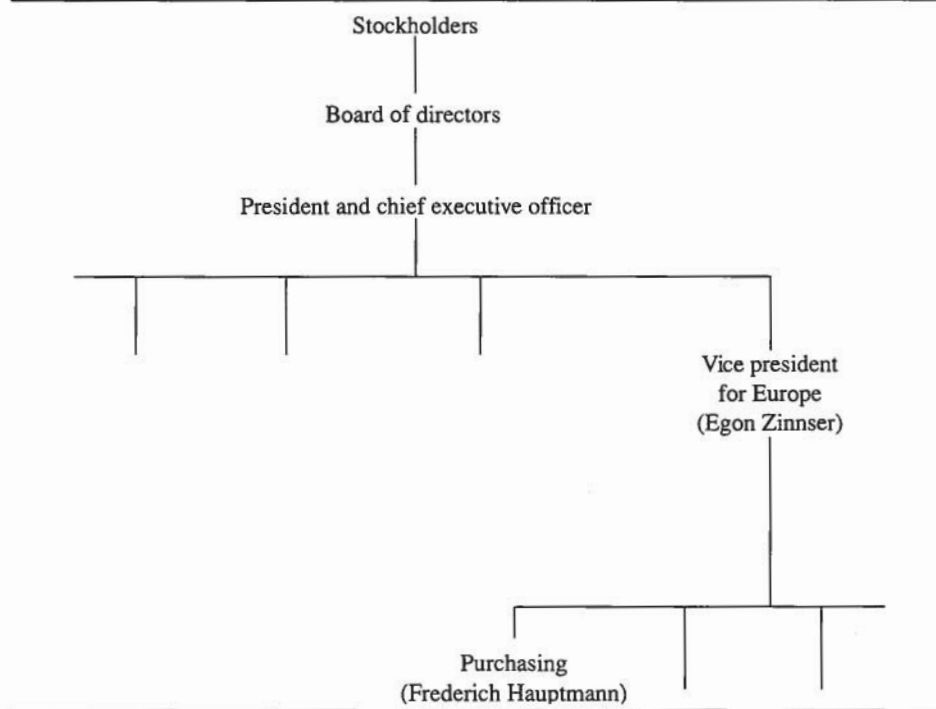
Fontaine and Gaudin decided that they would approach Reliant with an offer to renegotiate the current agreement. Their basic strategy would be to ask Reliant for their five-year demand projections on VCM and polyvinyl chloride products. Once these pro-

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.

EXHIBIT 3 | Partial Organization Chart—Reliant Chemical Company**EXHIBIT 4** | Memorandum, January 17, 1982

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.

Year	Total Projected Demand (in MM pounds)	Supply Plant Capacities	Operating Rates to Meet 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

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.

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). 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.

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. 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 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)

EXHIBIT 5 | *(continued)*

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.

EXHIBIT 5 | *(concluded)*

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:

(firm)

By:

Title: Senior Purchasing Manager

SELLER:

PACIFIC OIL COMPANY

By:

Title: Marketing Vice President

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.

Year	Total Projected Demand (in MM pounds)	Supply Plant Capacities	Operating Rates to 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

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 was 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

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 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.

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 to 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, believing 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

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.

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

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 of VCM 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.

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 rela-

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 Company. 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

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 the 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

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

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)

EXHIBIT 1A | (continued)

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:

(continued)

EXHIBIT 1A | (concluded)

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:

(firm)
By: _____
Title: _____
Date: _____

SELLER:

(firm)
By: _____
Title: _____
Date: _____

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:

$$\text{Formula price} = \text{Feedstock cost} + \text{Energy cost} + \text{Labor cost} \\ + \text{Commodity cost (per unit)}$$

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:

$$\text{Formula price} = (\text{Weighting coefficient} \times \text{Feedstock cost}) \\ + (\text{Weighting coefficient} \times \text{Energy cost}) \\ + (\text{Weighting coefficient} \times \text{Labor cost}) \\ + (\text{Weighting coefficient} \times \text{Commodity cost})$$

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

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, per-

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.

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

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.