Leasing of Gas Engines

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ABSTRACT

Gas engines can be leased for a fixed monthly fee, including complete maintenance. In many cases this leasing service is the most economical method of lifting crude oil.

INTRODUCTION

During the past few years, all phases of the petroleum industry have accepted the leasing of equipment, from electronic data processing equipment to and including all types of production equipment. Dozens of papers and articles have been presented concerning the pros and cons of leasing. Schools, firms and individuals have expressed divergent opinions on this subject; but there has been offered no formula that could be applied to determine whether a company should lease or purchase.

Robert Sheridan, President of Nationwide Leasing Company, states, in an article in The Petroleum Engineer,[1] September, 1960, that the petroleum industry averages 85% profit on net working capital before taxes. But this figure does not indicate that the oil industry has an extremely high rate of profit, because the industry averages 86 per cent of its net worth in fixed assets; thus, when the average producer ties up $100,000 of his working capital in purchase of new equipment, he is sacrificing $85,000 in before-tax profits. To show that the foregoing is not fantastic, an oil company with the total net worth of $1,000,000 will be considered. If 86 per cent of that amount, $860,000, is tied up in fixed assets, there remains 14 per cent or $140,000 working capital. If the company realizes the profit of 85 per cent on the working capital, this profit amounts to $119,000 or 11.9 per cent of its net worth, before taxes. But, if 52 per cent of the profit goes for taxes, the company nets $57,120 or 5.7 per cent after taxes.

Since leasing amounts to just another method of borrowing capital for comparatively long term periods, an oil company has only to figure out what it costs for its cash to be frozen in equipment, as against whether it is cheaper to pay the leasing company to use its capital to acquire this equipment. For companies which do not have spare cash to put into equipment use of the leasing concern's cash proves a great boon.

ADVANTAGES AND DISADVANTAGES

"The Foundation for Management Research"[2] in May, 1960, presented a study that listed certain advantages and disadvantages to leasing of equipment; leasing as a method of finances has its proper application and appropriate uses. But, every firm must examine for itself the advantages and disadvantages. There is no one best method of obtaining additional financing for all firms at all times under all circumstances.

MAJOR BENEFITS OF LEASING

1. Leasing is valuable to a firm whose growth is impeded by a shortage of capital.
2. Leasing offers virtually 100 per cent financing rather than 66 2/3 to 75 per cent financing.
3. Leasing is valuable to a company which is anxious to modernize its equipment, methods or processes, but which does not wish to use up its short-term or long-term credit for the acquisition of such equipment.
4. Leasing is valuable to a growing company which needs more capital, but of which the owners do not wish to dilute their equity by acquiring stockholders or partners.
5. Under certain circumstances leasing may offer tax advantages.
6. While the gross dollar cost of leasing is greater than cash purchase, the net cost is less than any other method of acquiring equipment.
7. Financing through leasing usually offers a longer term than does any other means of short-term financing.

MAJOR OBJECTIONS TO LEASING

1. Leasing is of no value to a firm which has all the cash that it requires to meet its needs.
2. Leasing has no value to a firm that has all modern equipment and that can compete with the industry leaders.
3. Leasing has no value to a firm which prides itself on owning all its equipment, buildings and land.
4. The gross dollar outlay for leased equipment is greater than is the equipment that is purchased through cash.

There are definite reasons why producing companies have turned to leasing. First, without turning liquid working funds into capital expenditures, it offers a method of increasing output in profit. Second, it is a simple means of broadening its borrowing base. Third, it is a means of expanding production and yet keeping pace with the ever-increasing cost of newer and more complex equipment, thus staying on par with the leaders in the field.

Leasing permits a company to use more fixed assets while retaining more liquid working capital. This working capital is kept in the business longer under leasing than by any other method of acquiring assets, and the capital is productive of more profit. It is the best method of obtaining equipment for limited term use.

TAX SAVING

Leasing is not a method of tax avoidance. Some, less dependable leasing companies use a selling point of a tax saving as a decided advantage for leasing. However, it might be better to eliminate the consideration of tax saving when the company makes a study to decide whether to lease or purchase. For example, the Department of Internal Revenue ruling #55-540[3] states: "A significant motive may, in some cases, be the tax advantage which might result because of the different timing of the deduction for rent as compared to depreciation." (Sec. 162 A, sub para. A-3).

The Harvard Business Review of March-April, 1955 states,[4] "Leasing does not save taxes; it postpones them. It only changes the tax incidents or timing. Leases for the base period, usually three to five years, saves taxes, but renewed lease rates are usually 10% or less of the base period. On a ten year average, the tax may even be the same as if purchased. However the timing of the tax may have reacted to the benefit of the operator if he has invested free capital in some profitable venture."

When one leases he pays for equipment entirely out of income before-tax dollars. In true leasing, there is no intention of purchase; therefore, it avoids the danger and pitfalls found in conditional sales contracts from a tax standpoint.

LEASING VS. PURCHASING

As ownership of an asset may not necessarily be an advantage to a company and as it can replace equipment when business opportunities demand it, each company should make an accurate appraisal of capital expenditures. It is apparent then that, once made, expenditures cannot be retracted but that they are committed for the life of the project. Thus, all investment possibilities must be investigated in the light of profitability, as a means of selecting the most advantageous method of financing.

If outside financing through leasing can be acquired at less cost than the company's use of its own working capital and if the financing can produce greater net profits, then it is sound to use leasing. If not, it is sounder to purchase.

LEASING OF GAS ENGINES

Because of the flexibility of a gas engine and the many different applications that are available to its use, the approach to gas engine leasing is somewhat similar to that of the data presented above. Certainly many of the advantages and disadvantages do apply. And certainly a study should be made of the financing involved to determine whether it is best for the company to lease or purchase.

The approach to leasing outright the gas engine as a prime mover to drive a given piece of equipment differs in the length of the lease. The flexibility of the units allows the return of the engine from perhaps a producing pumping application and re-leasing it in another field such as waterflood pump application.

The usual average base rate for leasing specialized equipment in packaged units varies from three to five years, but gas engines can be leased for a minimum period of a year. Certainly a leasing company would like to be assured that the lease would extend for a three to five year period, but the above approach renders certain additional advantages not pointed out previously.

ADDITIONAL ADVANTAGES

1. Along with the leased engine is offered a complete maintenance contract, which includes regularly scheduled service trips and covers emergency breakdown service, and all repairs through the life of the lease, including complete overhaul if required.
2. Leasing with maintenance frees operating personnel for other company duties with the possibility of a reduction of personnel for the company.
3. With a maintenance contract, the company gets a uniform quality of maintenance service by trained personnel; this service keeps the unit in top shape, with less down time and loss of production.
4. There is no necessity for the company to over design the prime mover at the beginning of the project. Under leasing, the engine can be initially sized for the exact requirements and, after a reasonable length of time, replaced by a larger unit if required.
5. The engines used in the leasing program have been carefully designed to offer to the company lower operating costs in both fuel and oil consumption.
6. The company has no requirement for a spare engine under leasing and does not need to stock spare replacement parts, and even minor items like spark plugs, etc., a situation which helps reduce inventory.
7. There is no obsolescence in equipment; therefore, the company is able to keep up with improvements and design.
8. Included in the lease rate are insurance and local taxes, other savings for the company.
9. As the leasing with complete maintenance is all billed on one invoice, the amount of bookkeeping, paper work and record keeping is reduced.
10. The company has a predictable cost of operation for the life of the project. To appear are no hidden costs or unpredicted expenses that were not included in the plans originally.

ADDITIONAL SERVICE

In addition to leasing engines on a short-range basis, the company is also able to lease complete packaged units for waterflood service, pipeline applications, salt water disposal systems, generator sets, etc. The packaged units can also be leased with complete maintenance including prime mover, pump, drives, etc. Packaged units are also offered on a relatively short-term basis, usually two to three years where the national average has a base of three to five years.

CONCLUSION

All the foregoing results in this conclusion: if a company has a surplus of cash which is not needed for working capital and which would otherwise be idle, it is probably better that they purchase equipment. However, if buying equipment means dipping into working capital, which could be used to gain higher returns than the interest charged by the leasing company, it would be advisable to seriously consider leasing, which presents a large investment in equipment when there is a strong possibility of rapid obsolescense. Leasing by passes this possibility and allows the user to acquire the best equipment on short-term basis.

REFERENCES

1. The Petroleum Engineer, September, 1960.
2. The Foundation for Management Research, May 1960.
3. Internal Revenue Service #55-540.
4. The Harvard Business Review, March-April, 1955.