Factors Determining Operating Methods of Independents

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There are several factors which differentiate the operating methods of the independent operator from those of the major company. Some of these differences have a rational basis, some of them are debatable, while others may prove costly to the independent in the long run. As a starting point for this paper on the methods of independent operators, a definition of the independent operator, as used in this paper, should be given. This paper is concerned with the independent operator who is either a small individual operator beginning operations with limited cash, or who is that same operator after he has established production and whose main task is to increase his reserves through the investment of his existing oil income. The large intergrated independent operation does not fall within the scope of this paper.

The operating problems of the small independent are not different from those of the major company. They include such things as the selection and care of equipment, paraffin and corrosion control, equipment operation, and safety of personnel. In addition the independent operator must select and train personnel, and must consider his operations in light of possible secondary recovery. These are a few of the problems that are common to all oil operators. The text of this paper is concerned with the factors which cause the independent operator to handle these problems in a different manner than do the major companies.

The financial factors determining the operating methods of an independent operator are in most cases the most important single group. In the first instance, many independent operators are short of cash and have limited income with which to do business. As a result, their primary aim is to complete and operate a lease as cheaply as possible and to keep their cash outlay at a minimum. A second financial factor is the requirement that all fixed equipment, such as casing, pumping units, tanks, separators, etc., be capitalized for Federal Income Tax purposes. This means that the operator must spend cash today for equipment, the cost of which can only be recovered through depreciation over the life of the equipment which probably averages between eight and twelve years. Even though the independent operator may have a good cash income from oil sales, he must spend this income on intangibles like the cost of the hole, or pay high federal income taxes on the portion unspent, or that spent on capitalized tangible equipment. As a result the independent operator tends to "drill up" all of his income, and use bank loans or outside financing to purchase his equipment. Therefore, there is a tendency to keep capitalized equipment costs at a minimum, using equipment which maybe too small or otherwise inadequate. Sometimes the proper equipment necessary to do a good job producing oil is not used because of this important financial factor.

Many times when less expensive equipment is purchased for original installation it will wear out or break down early in the useful life of the lease or well. Replacements and repairs to the equipment in many instances can be written off as expense against current income. Again what appears foolish from an engineering standpoint, makes sense from a financial and tax standpoint. Many independent operators, by necessity, (and some for other reasons) have the short run point of view in making equipment purchases and operating decisions, in contrast to the point of view of the large major company that is looking at a lease from the standpoint of its useful life. The independent operators current financial and tax problems are sometimes so important that he can not afford to look much beyond the short range view.

A final financial factor is that many independent operators find that the only manner in which they can harvest the fruits of their efforts, in the form of personal security and money, is to sell their property, and pay the tax for the long term capital gain. In this case the price which a property will bring is largely determined by the reserves, with only a minor consideration given to the quality of the well and lease equipment. Therefore, the independent operator is inclined to spend his dollars looking for reserves which will give him a big return on his investment in contrast to spending his dollars on lease and well equipment which will provide him with no profit whatsoever.

The second group of factors determining the operating methods of the independent operator is the size and type of his staff. By the nature of his operation, the small independent operator has himself and possibly an engineer or geologist to assist him in his operations. Many times a geologist will do the geological work on a well, and then double as an engineer in the completion and equiping of a well. He is not a trained engineer and his decisions must be based on the recommendations from other operators, supply companies and manufacturers, and on his own experience. One of the reasons why independent operators can drill and produce wells that are uneconomic for the major company is the fact that he has a low fixed overhead. Should he employ specialists in the different engineering phases of the oil business, he might well find himself in a position where he could not profitably drill and operate marginal wells which were profitable before the addition of a large staff.

Another point is that many engineering problems are slow to develop, and even though the independent operator has a problem which needs a professional engineer to handle, he may not become aware of this problem until several years after the completion of his well. Reference is made to such things as installing too small a pumping unit, which worked at first, but will wear out due to over loading prior to the end of the life of the well, or the possibility of a large increase in the fluid to be handled, necessitating a larger capacity unit during the final life of a well. There is no question but that many independent operators are in need of professional engineering advice on their operating problems, but the cost to the independent operator of a well rounded staff is too great for the size of his operations.

The third category determining the operating methods of the independent operator are the ownership factors. The independent operator is an individual or closely held corporation whereas the large major company is usually a public corporation, with ownership in many hands. The large major company is interested in public relations and the advertising of its products wherever possible. Therefore, the major company is likely to spend larger sums in lease improvements and lease maintenance for these reasons than is the independent.

A second point in the ownership factor is that many times an independent operator is operating as a partnership with a promoter as the operator and with outside capital provided by others not familar with the oil business. As a result the promoter is interested in getting his well dug and put on

production -- possibly using a consulting geologist to help him in his completion work. Once the well is on production the operator is unconcerned about the engineering aspects of the operation as long as the well continues to make oil. In the event the operator desired to hire professional engineering assistance, he might have a difficult time convincing his partners of this necessity due to their lack of familarity with the business. Many of these partners have tax dollars to spend on intangible drilling but would be hard pressed to come up with large sums for fixed tangible equipment. If there are several partners in an operation, they could possibly be so situated that it would be difficult to get them all together at the required time to make the cash expenditures for engineered well and lease equipment. The ownership factor has been responsible for many operations in oil production that are not in accordance with the best accepted engineering practices.

The control factor of a good independent operator should not be overlooked. There are many independent operators who have had engineering experience themselves, and as a result can very capably handle the engineering problems along with the other varied problems that arise in an independent operations. In an operation which it is not too large for one qualified man to control personally efficiency and economy can be achieved.

Another factor is that oil production is a side line with many operators who act as their own principals in the oil producing business. These operators have good businesses with large cash incomes which would be appropriated by the tax gatherers if this income could not be spent on such things as intangible development in a drilling operation. Therefore, these operators look at the oil business merely as a salvage operation for tax dollars and they are satisfied with any return on their investment. As a rule they do not concern themselves with the engineering factors of oil production.

A final factor in determining the operating methods of an independent operator is ignorance and indifference. From the text of this paper, the conclusion can be drawn that many operators operate as they do because of the lack of knowledge of the engineering involved in the production of oil. Again there are some operators who are indifferent to engineering problems in oil production, men who are professionals in their own fields of endeavor but who are indifferent to the place of professional engineering in the production of oil.