Competition for Capital in Two Oil Ventures

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The literature of business history contains numerous examples of competition for markets, technology, and labor, but fewer demonstrations of how the competition for capital affects business operations and the long-run development of ventures. Yet the tactics and strategies of today's large multinational corporations clearly show that business strategies are not uncommonly devised primarily to relate to the supply and cost of capital. Similarly at the other end of the business spectrum the small entrepreneur, whose sources of capital may be sharply limited, often tailors his operations to fit his strategy for raising money. The latter type of businessman predominates among the independents of the petroleum industry's upstream sector. Indeed, the strategies these businessmen use in competing for capital often have as much to do with their eventual success or failure as how expert they are at finding and producing oil. Competition for capital, particularly in boom times, can become an end in itself for some participants in the oil business, taking precedence over finding and producing oil. This concentration of effort tends to produce problems that can weigh more heavily against the success of ventures than the notorious risks of wildcat exploration.

In upstream oil, oilmen compete for geological prospects, leases, and capital. They do not compete for markets; they cannot control how much petroleum they will find in exploration and, since petroleum belongs to whomever produces it, they must keep pace with competing leaseowners in production, thus limiting their ability to control the quantity of oil and gas they produce. Prospector/producers cannot control the quality of what they produce and, unless they are within the ranks of the majors, they have no control over petroleum prices. But upstream oilmen can look for money on advantageous terms, just as they can look for land to lease cheaply or for geological ideas of special promise, and here they compete with other prospectors and producers looking for the same things.

The recurrent boom and bust cycles of the petroleum industry, however, create additional dimensions in upstream competition. As a boom gains momentum established operators increase the number of prospects they drill, producers scramble for additional reserves, and newcomers swarm into the

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industry seeking to join the action. As one observer commented on the last oil boom, "Everybody and his damn dog is getting into the oil business" [8, p. 162]. The greater the number of participants in the game the fiercer competition will be, not only for capital, land, and prospects, but also for labor, supplies, and services necessary to drill wells and produce oil. That means that costs and risks rise sharply.

In the accelerated competition of a boom the advantage lies with the oilman who has experience, income from operations, and an established circle of investors. His experience allows him to make careful assessments of risks; his cash reserves, taken with what he can raise at minimal cost from his investors (often drawn from within the industry), allow him to purchase leases and production in the most profitable areas for exploration and development. His business connections give him access to relatively efficient and reliable drilling services and scarce equipment. His risk and that of his investors is relatively low, in part because he expends little capital and effort raising capital. The career of R. R. Penn, described in our *Wildcatters: Texas Independent Oilmen*, offers a good example of such successful business strategy [8, p. 35-41].

The newcomer to upstream oil, lured by visions of boomtime fortune, seldom enjoys the veteran's advantages. He often knows too little about petroleum to know a good prospect from a poor one or a promising lease from what the industry terms "scenery." He has no income from operations to meet his bills. He is at the mercy of whichever contractors he may find and will pay a premium price for supplies and equipment, if he can locate them. His biggest liability, of course, is lack of capital. Without an established circle of investors, he will have to work harder to draw investors into his venture. Because his ventures are highly risky they rarely appeal to investors within the industry. Thus, the new independent typically appeals to naive small investors who lack access to better investment opportunities [7].

Since boomtime excitement encourages investors to put money in oil, the novice oilman expects to locate them quickly and cheaply. Indeed, he may perceive that there are so many eager investors that he can build a business empire upon an apparently inexhaustible supply of other people's money. The newcomers whose strategies we will describe shared this perception. Though they had grand plans for integrated oil operations, most of their activity involved exploration and production. The failure of their ventures offers a particularly clear demonstration of the hazards of competition for capital in upstream oil.

The industry-wide boom our newcomers entered took place during the late teens and early twenties of this century and was the result of both wartime demand and the rapid expansion of the domestic market for petroleum products. Prices rose at a rate unprecedented in industry history. The average price per barrel of Mid-Continent crude (Oklahoma-Kansas grade), for example, rose from $ .64 in 1915 to $1.10 in 1916, $1.56 in 1917, and $1.99 in 1918. Prices stabilized for several months in 1919, but late in that year they again climbed rapidly,

peaking at $3.07 in March 1920. Some grades of crude fetched far higher prices; Pennsylvania grade, for example, brought as much as $6.10 per barrel by January 1921 [11: 1917, p. 688; 1918, p. 874; 1921, pp. 262, 299, 302].

Despite weakening demand, prices stayed high until January 1921, when they began a precipitous slide to $1 per barrel in July. Six months later prices recovered to $2.25, but they continued to fluctuate over the next two years, an instability produced by a sequence of great discoveries in California, Oklahoma, Texas, and Arkansas. Though unstable, prices nonetheless remained well above pre-war levels [11: 1922, p. 403; 1923, p. 365; 1924, pp. 296, 433].

High petroleum prices combined with spectacular oil discoveries between 1917 and 1925 acted as a powerful inducement to enter the oil business and to invest in it. Thus, between March 1, and June 1, 1918, some 270 oil companies capitalized at over $100,000 received charters [5]. The pace of company formation continued to accelerate until the month of November 1919, when 141 such firms incorporated [6]. And these figures greatly understate what was happening for they take no note of small corporations or of ventures organized as proprietorships, partnerships, or common law trusts [4, p. 69]. Investors seemed to buy into these newly-organized ventures as readily as they were created. In the year following Armistice, for example, investment in petroleum securities rose from $1.8 billion to $3.2 billion. Large financial houses as well as small investors joined in what observers termed an "orgy of speculation" in petroleum securities. Investor enthusiasm for all sorts of speculation, and for oil in particular, made it seem as though it had never been easier to find the capital to build a petroleum empire [9, p. 12].

This was the assumption of the four Texas and Oklahoma promoters who organized the Big Diamond Oil and Refining Company in July 1917. Drawn to oil by the boom, they lacked both capital and oilfield experience, but that did not keep them from launching what they hoped would become a large integrated company. Capitalizing Big Diamond at $3 million with three million shares with par value of $1 each, they intended to raise funds to purchase producing leases, drill at least one wildcat well, and build a refinery. They also expected to make their fortunes. At their first meeting the directors awarded themselves and a business associate five hundred thousand shares in exchange for assets they transferred to the new company. These assets amounted to 227 wildcat acres in Oklahoma, a drilling rig, and about $1000 in cash [1].

To these assets they expected to add a 6 2/3 acre lease with one oil well in the Humble, Texas oil field. If Big Diamond picked up the lease the new company would have real production: between four and seven barrels per day, yielding a daily gross income of $10 to $12. But the owner of the lease would not sign it over until an $18,000 encumbrance upon it was paid by Big Diamond. Since Big Diamond did not have $18,000, it settled for the assignment of production runs from the lease in exchange for taking over the debt. In other words, Big Diamond never owned the lease, but the company nonetheless paid on

its debt and claimed it as an asset. It was the company's sole source of income from operations [1].

Since it was short of cash, Big Diamond's future lay in finding other people's money. After the ink was dry on the company's Arizona charter the promoters began their hunt for investors. The first step was to concoct attractive promotional literature. There was no money for professional advertising, so Oscar Houston, the most experienced promoter of Big Diamond's directors, assembled materials produced by other promoters and wrote Big Diamond's brochure, with the help of anyone who happened into his office. Mixing the standard appeals to greed with a totally misleading view of investors' risks, Houston stressed that because Big Diamond would have its own oil production its refinery business would be "entirely independent of any market conditions" and invulnerable to increases in the price of crude oil. The brochure went on to affirm, "No refinery, properly managed, can ever do a losing business that owns its own production [sic]." Refining your own oil, regardless of the market for refined products, was a can't-lose proposition. Or so it seemed in boom times; and the Texan directors, P. M. Faver and J. F. Dofflemyer, came to believe this. Unfortunately for Big Diamond, few prospective investors took Houston's amateurish prose as seriously [1].

As they concocted promotional materials, Big Diamond's directors attempted to launch operations. They put the rig at drilling on part of their wildcat acreage, hiring inexperienced hands to work on it. They also began to construct a refinery and worker housing at Addington, Oklahoma. All this had to be done on credit, extended by a local lumber yard and, in effect, by workers willing to wait for payment until the well was completed. Big Diamond also tried to establish a branch sales office in Kansas City, but lack of cash or credit closed it down within two weeks [1].

Without capital to hire professional sales assistance to sell stock, Big Diamond's directors had no choice but to organize their own sales operation. They put together a salesman's kit, consisting of the company prospectus; photographs of gushers, overflowing oil tanks, and vistas of derricks-- none of which Big Diamond owned; and sales application blanks. They then advertised for sales personnel in Oklahoma, Texas, and the Upper Middle West. As one might expect, they drew a very uneven group of applicants. Some were experienced enough to find fault with the company's brochure; others were only marginally literate. But since the war and oil boom combined to create a labor shortage Big Diamond had to take what it got, and that was disappointing. Most salesmen sold little stock, and when they did they were slow to forward remittances to the home office; one absconded with five hundred stock certificates and was never heard from again. As a director observed, "It is hard to get the right type of man to work." But without a reliable corps of salesmen Big Diamond could not raise the operating capital it so desperately needed. Its future depended on stock sales [1].

They went slowly. At the suggestion of a Dallas broker the directors declared a 2.5 percent "dividend" to enhance their offering. Of course, Big Diamond did not have income from operations to pay it. Not ones to quibble over fine points of finance and law, the directors simply paid it out of the limited cash on hand. Despite the dividend, however, investors did not surge forward to buy Big Diamond stock and by the end of July 1918, only 41,000 shares were sold. The cause of this disappointing showing lay in the formidable competition for investors' dollars offered at this time, not only by other oil men but also by the United States government. With the country at war, patriotic citizens were urged to put their money into Liberty Bonds rather than get-rich-quick schemes. As a further control over investment during wartime, a company intending to sell stock had to register with federal Capital Issues Committee, which then had to approve the company's objectives and decide how much money it could raise. In response to Big Diamond's application the Committee grudgingly allowed sale of 23,000 shares. Big Diamond never took this limitation seriously and it presented the Committee's action as federal endorsement of the company [1].

With stock sales lagging by mid-summer 1918, Big Diamond's two Oklahoma directors took to the field to sell the shares they had received at incorporation with the understanding that they would turn over half of the proceeds to the company treasury, which was empty, as usual. On the road they found few takers and a fifty dollar sale was so rare as to warrant an enthusiastic telegram to company headquarters. They arrived in southern Indiana in time for the influenza epidemic, which placed many homes under quarantine. Broke, one of them wired the company for cash: "I didn't want to do it but no one would cash my check and I was 1200 miles from home, in debt to Hotel and 90 cents in my Pockett [sic]" [1].

As this poignant situation indicates, their inexperience at raising money and their haste to do so led Big Diamond's directors to forget that whether they used salesmen or went out to sell stock themselves, there would be substantial costs in raising capital. They thought to save on sales commissions but forgot that they themselves would need money for room, board, and expenses. As a result, when the epidemic eased and the Oklahomans began to sell stock, they often took to bartering shares for daily necessities as well as larger items. When they brought in money from sales little of it found its way to the company treasury [1].

By March 1919, Big Diamond's directors had to recognize that none of their efforts had gotten the company off the ground. Amateurs at stock sales, they could not make enough peddling stock to support themselves, let alone build a company. Raising capital, however, absorbed so much of the directors' effort that they neglected the meager operations already underway. The wildcat well, unsupervised by management, was an expensive disaster: the drilling rig had to be sold to pay Big Diamond's office rent. The refinery project, seldom visited by the directors, stopped when a contractor placed a mechanic's and materials lien on the operation and the local lumberyard cancelled Big Diamond's credit. In

desperation, the directors turned to a New York brokerage firm to push their stock. In September 1919, they discovered that it was a swindle: it sold 25,000 shares and closed without leaving a forwarding address. A disgruntled former salesman sued the company and was awarded the income from the Humble, Texas lease: that cut off the company's meager income from operations. And, several weeks later, an investigator from the Federal Trade Commission paid Big Diamond's president a lengthy visit. In May 1920, Big Diamond fell into the hands of a receiver. The only assets he located were the partially-built refinery and its site. By that time petroleum prices were higher than they had ever been [1].

There were many reasons why Big Diamond's promoters failed at the height of record industry prosperity. Like many small businessmen, they had negligible assets, a trickle of cash from operations, and great reliance on the prospect of investors' capital; their amateur efforts in the capital market meant the cost of the last was underestimated. But even relatively well-funded newcomers to oil, who made full use of professional services, could fail to compete successfully in the industry because they overlooked the boomtime difficulties of competing for capital. Such a newcomer was Dr. Frederick A. Cook.

Cook was an old hand at promotion outside oil. He had raised funds for expeditions to Alaska, the North Pole, and the Himalayas. Though he operated on a modest scale compared to Captain Peary and other better known explorers, he had secured several hundred thousand dollars for his treks. Cook also had some experience in the oil business by 1919. After his various claims to geographical discovery had been discredited he moved to Wyoming, where he worked with a group of New York investors in two different oil ventures. He came through them with about $50,000 in additional capital, which he applied to new oil promotions in Texas [3, chapters 1 and 3].

Cook launched his first Texas promotion, the Texas Eagle Oil and Refining Company, in January 1919. After several reorganizations he rechartered it in Delaware with authorized capital of $2.5 million, a sum that was later doubled. Even Cook, however, found it difficult in 1919 to raise capital adequate to his plan for an integrated company with producing leases, wildcat operations, a pipeline system, and a refinery. Texas Eagle was a multi-million dollar dream and it required at least one million dollars for successful initial operations. In the end Cook received barely half that sum. Brokers sold about $800,000 worth of stock, but after sales commissions and selling costs were covered, Cook had less than half a million dollars to work with. At that, about one-tenth of the amount raised for Texas Eagle actually came from Cook's personal bank account. What he acquired for the company, at peak boom prices, was a collection of inefficient equipment, wildcat leases, and declining properties, no bargain unless one assumed that inefficiency would be offset by the continual rise in the price of oil. In reality the ramshackle operation could not be run at a profit during the best of times. When the price of oil declined Cook was hard pressed to pay his

bills. By mid-1921 the company came under attack by its creditors and went into receivership [7, 10].

Cook's investors lost their stakes in Texas Eagle and Cook probably lost most of the assets he placed in the company, but the venture was not a total loss for him. He learned a number of valuable lessons about boomtime exploration: it was more profitable to sell goods and services to other promoters than it was to explore for oil; the real money in the oil game, as he came to understand it, was made by promoting investors; and it was better to take risks with other people's money. He applied this costly knowledge in his next and final venture, the Petroleum Producers' Association. It was intended, above all, to compete effectively for capital.

Cook launched PPA by soliciting investors in Texas Eagle. After a few thousand interests in PPA had been sold, he declared a 25 percent dividend to attract additional capital. Like Big Diamond's more modest dividend, or the famous postal coupon scheme of Carlo Ponzi, this sum was paid out of the proceeds of stock sales. Cook also bought about 300 lists of investors from other oil promoters for $200 to $300 each. These investors were then given the opportunity to trade in their stock in failed ventures for PPA stock if they paid a 25 percent conversion fee. The investors were told that PPA would take over the assets of previous companies and realize a profit by operating and developing them more efficiently than their original managers [10].

Thus far in its development PPA was like many another "fold-in" scheme, as they were known at the time. Cook's real departure from prevailing promotional techniques came with the actual operation of PPA, in high gear by October 1922. Cook worked on a grand scale. He organized a brokerage house to peddle his stock and that of other promoters, charging commissions ranging from 25 to 50 percent plus most direct selling costs. To turn out promotional letters, glossy brochures, and industry "tip sheets," Cook's contract promotion operation employed 53 full-time stenographers, two addressograph operators, two printers, and a full-time mail boy. His new multigraph machines printed from 24,000 to 30,000 pieces of literature per day. All of this material swamped the PPA mailroom during the latter half of 1922, when peak weekly volume reached 300,000 [10].

Thus, PPA's mechanism for raising capital created income from promotional services operations. Paul Vitek, for example, one of Cook's best customers, paid him $50,000, hiring PPA to write, print, and distribute all of his mail-order solicitations while he spent his time in the field acquiring properties in Texas and Arkansas. Cook also sold Vitek's shares through his securities operation, netting an additional $20,000. This contract alone produced more income than Cook ever received as an oil producer. Though he did not realize it, by the end of 1922 Cook was more ad man than oil man [10].

Little of the money Cook made, however, went to build PPA as a producing oil company. Income from the contract work covered PPA's office expenses, but

it did little more, and management of the services operation and fundraising came to require exhausting work schedules of Cook and his managers. Worse yet, Cook tended the hired work more closely than PPA's. In any event, the sale of PPA's securities lagged and ever greater proportions of PPA's capital were required to raise more capital [7].

Cook's response was to raise the level of hyperbole in his promotional literature. His own prose tended to be unexciting, so he hired one of the best "pens" in the business, Seymour E. J. "Alphabet" Cox, to write high-powered material at a weekly salary of $5,000 plus commissions on some stock sales [7].

Cox was worth the price. PPA's new sales literature fairly sparkled when Cox worked it over. PPA's oil came not from mere geological formations, it flowed "From the Bowels of Mother Earth and direct from the Reservoir of Nature's Eternal Gift ..." The oilfield was described vividly, with the blast of whistles and derricks "grinding and churning." Cox's imagination soared when he described PPA's prize holding, extensive acreage over a vast secret oil field, "a place where many of the big oil sands converge, forming a basin of oil so much larger than anything yet discovered that bringing in the first well will startle the oil men of the world and start a stampede for the district such as had never been heard of" [10].

Cox's genius as a copy writer soon was obvious. The collaboration of Cook and Cox brought in $250,000 in less than two months-- as much as Cook alone had raised in nearly a year. By the end of 1922 PPA had taken in about $500,000. Still, about one-fifth of this sum came in the form of cash advances from Cook. Nearly three-quarters of the gross income from PPA stock sales went to pay the costs of selling the stock. PPA's capital was exceedingly expensive [10].

With so much effort directed to competing for capital, Cook paid little attention to what happened in the oilfield; so little that his best service customer, Paul Vitek, swindled him. Vitek sold PPA a sizeable interest in a Smackover, Arkansas well on the basis of a photo of an oil gusher. Cook examined neither the photo nor his deed or he would have discovered that Vitek doctored the photo and that he had purchased a royalty interest and not a working interest in the well. Thus he actually acquired a part interest in one-eighth of the income from the well, while he thought he had acquired a part interest in seven-eights of the income. Overwhelmed with the details of contract operations and fund-raising, Cook ignored details relating to finding and producing oil. By the time the company went into receivership in 1923 PPA had spent nearly $600,000 to acquire assets that generated less than $100 per week [7, 10].

PPA's dismal end, however, meant much more than financial loss to Cook. The scale of PPA's promotion, taken with the involvement of Seymour Cox, who had been under investigation by the FTC and the Post Office Department for more than three years before he went to work for Cook, led to Cook's indictment for mail fraud in PPA's promotion. Cook received a twelve-year prison sentence and $12,000 fine [2].

That PPA, like Big Diamond, could fail in a boom seems contrary to common sense, for the apparent prosperity of boom times offers the prospect of easy success. Since both Big Diamond's directors and Frederick Cook engaged in questionable and illegal business practices, it might be tempting to dismiss their ventures as aberrations in the competition for capital in the upstream sector of the petroleum industry in boom times. It is accurate, however, to see them as extreme cases of the typical problems newcomers to the industry face in competition for capital at such times: extreme because even illegal means in competition for capital did not bring success. Despite a bumper crop of oil investors produced by boom times, they found raising capital difficult in the absence of expensive professional services and, whether they tried to remedy these difficulties through amateur or professional means, they found raising capital costly: so costly that they could not make a success of the oil business at a time of record-high oil prices. Their failures help explain why some ventures fail well before a boom is over-- and, indeed, why so much of the growth of boom times proves illusory when the boom is gone.

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