TWENTY-SIXTH ANNUAL REPORT
OF THE DIRECTORS OF
THE PURE OIL COMPANY
For the Year Ended December 31, 1939

CHICAGO, FEBRUARY 28, 1940.

To the Shareholders:

THE COMPANY made satisfactory progress in the year 1939 despite generally adverse conditions in the industry. The net surplus earnings were $8,290,418, and its net quick position improved by $3,392,973. It disbursed $3,885,519. in dividend payments to the preferred shareholders and $995,237. to the common shareholders.

Although product prices were materially lower, the operations were improved to such an extent that the net surplus earnings were $2,877,515. in excess of those of the previous year. Of the four principal operations, that of the refineries showed the most improvement, due in substantial part to the installation of new equipment.

REFINING

Our extensive rebuilding and modernization program in the refineries was in operation in 1939 for the first time for a full twelve-month period. The economies which have resulted from this have been greater than were anticipated. We believe that the quality of the Company's products has not been excelled by that of any of its competitors and that our costs have been comparable with the best in the industry. During the year, as a result of research work carried on in our own laboratories, the Company was able to sell its solvenized gasoline at the price of the regular product. This solvent addition has reduced injurious carbonization, as well as improved the general efficiency of the gasoline in other respects. The plans for the coming year should enable us to more than meet the constantly increasing demand for better quality gasoline. Such additions will be made to facilities for polymerization and other equipment as are necessary to accomplish this economically. The Company has made an intensive study of polymerization for many years, and some of its basic patents date back to 1928. In making these improvements, we will have the benefit not only of our own patents, but of the general progress in the art which has taken place since our study was first initiated. The total crude oil throughput of the refineries in 1939 was 27,600,000 barrels, an increase of 2,400,000 barrels over 1938.

TRANSPORTATION

No major changes took place during the year either in the construction of facilities or operations. The transportation earnings of the Company and its affiliates were, however, materially less because of a very general reduction and readjustment of pipe line rates. To a certain extent, this was offset by increased volume, and these rates naturally decreased refinery charges.

The general readjustment of the pipe line rate structure has, in the opinion of the writer, resulted in composing on a reasonably satisfactory basis the relations of the oil producers and refineries with the transportation companies. This has at various times in the past years been a source of friction.
Other elements in the industry, more vociferous but less influential than the producers, have from time to time made a somewhat fantastic argument to the effect that pipe line operations should be segregated and carried on entirely by companies not engaged in other phases of the business. Concisely stated, the reason given is that it is alleged that certain integrated companies were making inordinate profits in their pipe lines, which made it possible for them to offset the losses that they were supposed to have made by selling gasoline and other products to the public at lower prices than their competitors. The reduced profits of the pipe line operations will probably somewhat dampen the ardor of these agitators.

In the necessary endeavor to reduce the cost involved in bringing our products to the consumer, our Company has joined with other interests in the construction of a pipe line from an ocean terminal at Port St. Joe, Florida, which extends some 450 miles, to the vicinity of Chattanooga, Tennessee. This has become feasible and should be profitable because of the extent to which the Company has developed its markets in the area served by this line. The Company will be able to deliver its gasoline to its customers from terminals located on this line, either by truck or by rail, with comparatively short hauls.

MARKETING

The Company's over-all sales of gasoline were 682,000,000 gallons in 1939, which is 3% more than in 1938. About the middle of the year it disposed of certain marketing properties in New York State and New Jersey. The Company's operations were not large enough in that area to constitute an economic unit, and to have made them so would have required very heavy capital expenditures and the diversion of products which could be marketed in the better consolidated districts of the Company's operations under more favorable conditions.

The general market for gasoline has been badly disturbed during the year but at the close the recovered price was about 2/10 cents more than it was on January 1, 1939. However, the average service station price reported for the industry through the year is 13.29 cents, ex-tax, as compared with 13.91 cents, ex-tax, in 1938, an average reduction of 62/100 cents.

The operating efficiency of this department has been greatly improved during the year, and it seems reasonable to expect that on this account and because of readjustments in marketing territory, the operating results in 1940 will be very satisfactory.

PRODUCTION

The Company's producing operations were satisfactory in spite of the fact that the average price received for crude oil in 1939 was $1.04 per barrel, which is 15 cents less than that which prevailed on the average during the previous year. The gross production for the twelve months was 25,500,000 barrels and the net amount accruing to the Company after the payment of royalties, etc., was 22,200,000 barrels, or approximately 2,600,000 barrels net production in excess of 1938. The increased production was, however, not sufficient to entirely offset the reduction in average prices, and the net income of the department was consequently slightly less than last year.

The difficulties involved in producing oil at the rate and at the time best adapted to the needs of the refineries and the other departments of the business, and consistently with general market conditions, are very great. The Producing Department, to quite an unusual extent, has been able to synchronize its operations to meet these conditions.

BALANCE

The matter of balance between the departments of marketing, refining, production and transportation is, in an integrated company, a constant problem. During the year the Com-
pany has succeeded in adjusting its marketing requirements very closely to the amount which its refineries can process most economically. There is a critical volume in refineries and if operations either exceed or are less than it, costs increase. The effort this year to synchronize marketing and producing operations with the volume requirements of the refineries has been accomplished to an unusual degree. The gross production of crude oil by the Company was 92% of the refinery requirements.

The drastic changes which are so frequently recurrent in the oil business make it impossible to maintain a very complete balance for a long period. So far, however, as it is possible to forecast 1940 operations, the prospects of accomplishing this on a scale comparable with that established in 1939 seem very bright. For obvious reasons, the greatest possible flexibility and preparedness to meet changing conditions is the greatest safeguard a company such as ours can have. Nothing can contribute more to this than an adequate transportation system consisting of gasoline and oil pipe lines, terminals, tank trucks, tank cars, and ships and river boats. It makes it possible to concentrate resources promptly and efficiently upon points of necessity.

GENERAL CONDITIONS

Both the amount produced and the prices of the various derivatives of crude oil changed radically during the year in their relationship to one another, some increased in price and volume while others declined. Stocks of some were excessive from time to time, while others were occasionally low, only to have these conditions reversed within the twelve months. There is no reason to believe that 1940 will be immune from similar ups and downs.

The over-all figure of the stocks of refinable crude oil and the major products thereof are the best criterion of the inventory situation. This shows a 6% decrease during the year, and bearing in mind that a substantially increased demand is anticipated for 1940 and that the prospects of state regulation of production are improving, it would seem that the general inventory situation is not unfavorable.

One must be very foolish or consider himself inspired if he would make dogmatic prophecies as to the course of the oil business in 1940. One inclined to pessimism would stress the uncertainties of an election year, wartime possibilities and particularly the dangers of governmental tinkering. A more reasonable consideration would balance against this a fair over-all inventory situation, brighter prospects for better state regulation of production, the fact that the average prices of gasoline in 1939 were, with two exceptions, the lowest in ten years, and a consistently increasing demand. Starting from average prices in 1939 which were so low as to warrant the expectation of an increase, and with greater volume generally anticipated, it seems to me that the oil industry should have a better year in 1940 in spite of the clouds of doubt and uncertainty which hang over the general business situation.

TAXES

It is estimated that the 1939 taxes assessed against the oil industry aggregate the sum of $1,334,000,000. The following comparisons suggest the extent of this burden. It is equivalent to $10.26 for every man, woman and child in the United States, based on a population of 130,000,000. It is almost three times the cost of maintenance of all of the colleges and universities in the United States in 1936. It is about $300,000,000 more than the total expenditures of the Army and Navy of the United States in 1938. It is more than three and one-third times the total farm taxes levied in 1935. It is more than one-third of the total operating income of the railroads of the United States in 1938 and more than three times their taxes. It is almost double the total wealth of New Mexico and equal to the total 1938 income of the citizens of Minnesota. It is 10% of the total amount collected for all taxes by the national, state and local governments.
Probably the extent of the burden which is imposed upon the motoring public and the industry by this colossal tax is accounted for by the very simple reason that it is easy to collect. Various extended comments might be made on the subject, but the results of laying such a burden on any one industry are so obvious that they do not need to be dilated upon.

GOVERNMENTAL ATTITUDES

Governmental attitudes have had a very important influence upon the activities of the oil business in the last few years. They affect its current conduct as well as the general theory of its operation. So inconsistent with one another are these attitudes that those who have the daily task of finding oil and delivering its products to the public are in a condition bordering on bewilderment. To conform rigidly to the wishes of one authority sometimes puts one in opposition to those of another, and it is frequently impossible to ascertain with any definiteness the intent of laws and how they will be administered. When lawyers can not agree as to the meaning of laws, is it any wonder that the responsible business man is confused?

There is at the present time before Congress a bill for the regulation of the oil business. A study of it exposes the attitude of many in authority towards industry in general and the oil business in particular. It is a concrete and a graphic illustration of what the industry must combat if it is to survive, as well as of the atmosphere in which its daily work must be carried on. The broad economic and governmental theories upon which it is framed are not altogether obscured by ingenious phraseology. Analysis shows it to be based on a conception of the relations of government to industry and of the Federal Government to state and local government, entirely foreign to the American tradition.

The various state governments have recognized the desirability of the regulation of the production of crude oil under their own control. They have recognized the necessity and the propriety of acting in concert with one another. The Congress of the United States has approved a compact by which these states may work together with a proper regard for the interests of the other states and in protection of the general interests of their own citizens. From its inception this organization has bettered conditions, and the progress which it has made in the last few years is a fine demonstration of the initiative and enterprise of private citizens cooperating with their local and state governments which coordinate their activities under compact with other states. It is with no record of failure, but one of fine achievement, that the oil producing states are faced with the threat of having the federal government usurp their functions within their own territories. The oil industry is almost a unit in opposition to the proposed legislation and the Governors of twelve oil states have appeared in protest against it. Their protests are not based upon any jealous fear that unexercised prerogatives may be taken away from them, but against the presumption of a Washington bureau's attempting to do better what they have already done well. Under the circumstances, it would seem doubtful if such a bill could pass Congress against such opposition. If it should be held constitutional, it could not be effectively enforced, and if it were declared constitutional and if it were enforced, the incompetence and ignorance of a Washington bureau, as contrasted with local state control, need no demonstration, even assuming that the most intelligent and public-spirited men should compose this bureau, which would direct detailed operations sometimes three thousand miles away.

One might wonder why an industry which is opposed to centralization and regimentation in all other respects should advocate the regulation of the production of its raw material by state and local authorities. This apparent inconsistency is not real but due to physical conditions which differentiate oil from any other commodity. Without such regulation a very great physical and economic waste would ensue.
The question of correlative rights also is involved because oil in the ground will migrate from one property to another, and because the withdrawal of gas from a well affects not only the immediate property upon which it is drilled, but all in the field. The principle which requires a property owner to shore up the foundations of a building adjoining land upon which he may dig a cellar is exactly the same as is involved in compelling an oil operator to drill a well in such a way as will not adversely affect his neighbor.

Fortunately, the physical regulation of the production of oil which is the most effective in bringing about its most economical recovery and result in the elimination of all possible waste is exactly the same as that involved in the protection of correlative property rights. Any of these objectives would justify the steps that have been taken by the various states in their regulatory programs, and paradoxical as it may seem, they are necessary if the laws that are associated with a free economy and the unimpeded play of the law of supply and demand in the industry are to control. The conditions governing the production of crude oil are radically different from those which apply to the mining and recovery of all other mineral commodities. The production of iron ore, for example, and the price thereof, is determined by the relationship between the available supply and the market demand for it. The ore producer regulates his business by the conditions which exist at his particular mine, and whether those conditions justify production is largely dependent upon the demand for his product. Without some voluntary or enforced cooperation on the part of the operators in an oil field, the individual is compelled to drill in the way which will result in his getting the largest proportion of the total reserves regardless of demand or price because if he stops or curtails his production, the other operators in the field will secure a part at least of the oil which is under his land. On this account, the production of oil at times has no relationship to the need or demand for it. This upsets the whole cycle of operations in the industry,—refining, marketing and transportation.

It is obvious that the periods of irregular supply of raw materials such as have occurred frequently in the past must disturb the orderly and economic conduct of any industry. As the production of this raw material becomes stabilized in the oil business through state regulation and compacts, the working of natural competitive law will cure those practices in the other phases of the business which are now being cited as justification for all sorts of weird experiments, prosecutions and persecutions which keep the oil man in a state of perpetual jitters.

It would be little less than a tragedy if some Washington bureau or administrator should paralyze a constructive movement now well on the way to success.

SUMMARY

The Company increased its earnings very materially over last year and improved its net quick position by $3,392,973. After paying $4,880,756. in dividends, the Company carried to surplus $3,409,662. It has no funded or bank indebtedness, and its properties have been maintained during a period of depressed prices.

By Order of the Board of Directors,

Henry M. Dawes, President.
THE PURE OIL COMPANY

Consolidated Balance S

ASSETS

CURRENT ASSETS:
Cash in banks and in transit, working funds, etc. .... $ 8,915,476
Receivables—
   Notes ........................................ $ 977,855
   Accounts ..................................... 7,184,478
   Less—Reserve for doubtful receivables ........... 303,321
   $ 8,162,333 ................................... 7,859,012

Inventories—
   Crude oil (Note 1) ............................. $ 4,176,725
   Refined oils and merchandise (Note 1) ........... 9,228,096
   Materials and supplies, at current cost less allowance
      for condition ................................ 3,612,400
   17,017,221 ..................................... 33,791,709

INVESTMENTS, ADVANCES, ETC.:
   Investments in and advances to subsidiaries not consolidated, at cost (Note 2) .......... $ 5,089,805
   Investments in securities of other companies (Note 3) ......................................... 5,080,762
   Deferred receivables, etc., less reserve of $341,647 ........................................ 1,855,726
   12,026,293 .....................................

PROPERTY, PLANT, EQUIPMENT, LEASEHOLDS, RIGHTS, ETC. (Notes 4 and 5):
   CLASSIFICATION
   Gross                        Reserve
   Producing .................................. $124,547,138 $ 61,048,309
   Transportation ......................... 15,920,660 8,108,798
   Manufacturing ............................ 30,137,828 12,266,340
   Marketing ................................... 35,301,749 14,131,574
   Other properties .......................... 3,011,668 879,500
   Total ....................................... $208,919,043 $ 96,434,521
   Net total ................................... $112,484,522

Contracts, rights, patents, trade-marks, etc. .......... 19,425,001 131,909,523

PREPAID AND DEFERRED CHARGES .......................... 839,862

$178,567,387

The attached notes are an inte...
(Ohio) AND SUBSIDIARIES

—December 31, 1939

LIABILITIES

CURRENT LIABILITIES:

- Purchase obligations, etc. $ 638,063
- Accounts payable 6,959,009
- Dividends payable January 1, 1940 971,798
- Accrued liabilities 2,936,084 $ 10,604,954

LONG-TERM DEBT:

- Deferred purchase obligations, etc. 2,361,852

MINORITY INTERESTS IN CAPITAL STOCK AND SURPLUS OF SUBSIDIARIES
(approximately $400,000 under commitments for purchase over a period of years):

- Capital stock $ 1,889,973
- Surplus 893,767 2,783,740

CAPITAL STOCK AND SURPLUS:

Capital stock—

- Cumulative preferred—authorized 1,000,000 shares, par value $100;
  outstanding 725,431 shares, including 3,475 shares held in treasury
  (Note 6)—

  Rate | Shares
  ---- | ----
  5%  | 442,434
  6%  | 282,997

  725,431 $ 72,543,100

- Common—authorized 10,000,000 shares, no par value
  (Note 6)—outstanding 3,982,031 shares, assigned
  value $10 per share 39,820,310 $112,363,410

Surplus (per summary attached)
(Notes 4, 5 and 6)—

- Paid-in surplus $ 28,207,088
- Earned surplus 22,574,375 50,781,463

Total capital stock and surplus before deducting treasury stock $163,144,873

Less—6% cumulative preferred shares held in treasury; 3,475 shares
at cost 328,032 162,816,841

CONTINGENT LIABILITIES (Note 7)

$178,567,387

part of the above statement.
S U R P L U S  A C C O U N T S

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<tr>
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<th>Paid-in Surplus</th>
<th>Earned Surplus</th>
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<tr>
<td>BALANCE—DECEMBER 31, 1938</td>
<td>$28,438,897</td>
<td>$19,164,713</td>
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<td>ADD—Net income for the year per income account</td>
<td>—</td>
<td>$8,290,418</td>
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<td>DEDUCT:</td>
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<tr>
<td>Cash dividends declared on—</td>
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<tr>
<td>Preferred shares</td>
<td>$ —</td>
<td>$3,885,519</td>
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<tr>
<td>Common shares</td>
<td>—</td>
<td>995,437</td>
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<tr>
<td>Transfer to contracts, rights, patents, trade-marks, etc. of credits arising in prior years from the purchase of capital stocks of subsidiaries at less than underlying book value</td>
<td>231,809</td>
<td>—</td>
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<tr>
<td></td>
<td>$231,809</td>
<td>$4,880,756</td>
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<tr>
<td>BALANCE—DECEMBER 31, 1939</td>
<td>$28,207,088</td>
<td>$22,574,375</td>
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The attached notes are an integral part of the above statement.

AUDITORS' CERTIFICATE

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS,
THE PURE OIL COMPANY:

We have examined the consolidated balance sheet of The Pure Oil Company (an Ohio corporation) and its subsidiaries as of December 31, 1939, and the consolidated statements of income and surplus for the year ended that date. In connection therewith we have examined or tested accounting records of the companies and other supporting evidence and have reviewed the system of internal control and the accounting procedures of the companies by methods and to the extent we deemed appropriate, but we did not make a detailed audit of the transactions.

As set forth in Note 4 of the financial statements, the company, as of April 1, 1932, reflected an adjustment of its properties by a charge to paid-in surplus. In our opinion, the preferable treatment would have been to charge to earned surplus such portion of the adjustment as would have exhausted the balance in earned surplus at that date.

Subject to the comments in the foregoing paragraph and to the lower provisions to date under the method of determining depletion and depreciation of producing properties as explained in Note 5 of the financial statements, in our opinion the accompanying consolidated balance sheet and related statements of income and surplus fairly present the financial position of the companies at December 31, 1939, and the results of their operations for the year ended that date, in conformity with generally accepted accounting principles maintained by the companies on a basis consistent with that of the preceding year.

Chicago, Illinois,
February 26, 1940.

ARTHUR ANDERSEN & CO.
NOTES:

(1) In accordance with a policy adopted as of December 31, 1937, inventories of crude and refined oils have been priced at cost, on the "last-in first-out" method computed on an annual basis beginning with the inventories at January 1, 1937. Inventories of crude and refined oils at December 31, 1939 are stated in the aggregate below market. Merchandise other than refined oils is stated at the lower of cost or market.

(2) Investments in and advances to subsidiaries not consolidated include (a) $3,593,044 representing 75% of the outstanding capital stock of and advances to a subsidiary whose assets consist mainly of undeveloped concessions in Venezuela, South America, and (b) $1,496,761 representing 99.11% of the outstanding common capital stock (presently nonvoting) and 72.09% of the preferred stock of and advances to a domestic marketing subsidiary. The South American subsidiary follows the policy of capitalizing carrying charges, which are advanced by the parent company, and therefore reports no profit or loss; the marketing subsidiary reported a nominal loss for 1939.

(3) Investments in securities of other companies consist of (a) capital stock of Great Lakes Pipe Line Company at a cost of $1,335,820; (b) capital stocks of Hickok Oil Corporation at a cost of $1,093,047 of which $507,563 represents approximate market price of 5% preferred stock of that company received as dividends in prior years; (c) capital stocks of Ajax Pipe Line Corporation at a cost of $1,618,385; and (d) other security investments, at cost or lower, of $1,033,510. The foregoing securities are not listed.

(4) As at April 1, 1932, the net ledger amount of the parent company's tangible properties was reduced (either directly or through the reserves for depreciation and depletion) to reflect fair value as determined in an appraisal as of that date by company executives under authority of the board of directors. Subsequent additions and the properties of subsidiaries are included at cost, and subsequent retirements and provisions for depreciation and depletion have been made on the basis of appraisal or cost values. Contracts, rights, patents, trade-marks, etc. are stated at values determined in the above-mentioned appraisal, less relatively minor net changes since the appraisal date and are considered by the company to represent intangibles of a character which do not require amortization.

In reflecting such appraised values, the company charged the net amount of $28,083,743 to paid-in surplus. Had the company charged to earned surplus such portion of the above adjustment as would have exhausted the balance in earned surplus at that date, the balance in the consolidated earned surplus account at December 31, 1939 would be reduced to $12,219,608 and the balance at that date in the consolidated paid-in surplus account would be increased to $38,561,855.
(5) Since January 1, 1934, the company has provided for depletion and depreciation of producing properties by applying to the total barrels produced an "over-all" rate (per barrel) determined by dividing the total amount of producing properties subject to depletion and depreciation by the net oil reserves (in barrels) estimated by the company's production engineers. The "lease" or unit method of providing depletion and depreciation is used by many oil producing companies. Both the "lease" and "over-all" methods contemplate the ultimate amortization of the investment in oil producing properties on the basis of estimated oil production; however, the yearly provisions to date under the "over-all" method have been materially less than would have been the case under the "lease" method. This is due to the fact that a disproportionate amount of oil has been produced from leases having a relatively high book value. The application of the "lease" method to such production would require a depletion and depreciation provision on a basis believed by the management to be inconsistent with the company's total oil reserves. Under the "over-all" method the provision for depletion and depreciation is computed upon the basis of the average rate for all producing leases.

(6) The 5% cumulative convertible preferred shares may be exchanged, at the option of the holders thereof, for common shares on the bases of \( \frac{4}{2} \) shares of common for each share of preferred to October 1, 1940, 4 shares of common to October 1, 1942, and \( \frac{3}{4} \) shares of common to October 1, 1947 when the conversion privilege terminates. At December 31, 1939, 1,990,953 common shares were reserved for such conversion.

So long as any preferred shares are outstanding the company may not pay any dividend on its common shares which will (a) reduce consolidated current assets below an amount equal to twice consolidated current liabilities or (b) reduce consolidated surplus below an amount equal to two years' dividend requirements of the preferred shares of the company and of the preferred shares of its subsidiaries held by minority interests.

(7) The companies are contingently liable under pending lawsuits, all of which, in the opinion of the Counsel of the company, are ordinary and routine in the oil industry and will result in an ultimate liability not exceeding $300,000.

The audit certificate of Arthur Andersen & Co. appears herewith and it is the intention of the Directors to continue the services of these accountants for the year 1940.
The accompanying report and financial statements are submitted for the general information of the shareholders of The Pure Oil Company, and are not intended for use in connection with any sale or purchase of, or offer or solicitation of offers to buy or sell any shares or securities of this company.