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Strategic U.S. Oil Release May Crimp Record Refining Profits
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By Joe Carroll

June 27 (Bloomberg) -- Holly Corp., CVR Energy Inc. and other refiners that posted record first-quarter profits by processing the cheapest types of crude are facing shrinking margins thanks to the U.S. government's entry into the oil market.

The Energy Department will make 1 million barrels of stockpiled crude available daily as part of an effort by International Energy Agency member nations to replace high-value Libyan oil cut off amid that nation's civil war. Since the plan was announced on June 22, the profit earned from processing crude into fuels has fallen 16 percent, based on New York energy futures contracts.

Holly, CVR and Western Refining Inc. have enjoyed rising profits as the spread widened between prices for the Texas crude they process and Brent, the North Sea oil that serves as a benchmark in gasoline and diesel markets. The refiners' shares surged more than 60 percent in the six months preceding last week's stockpile announcement, almost 10 times the 6.5 percent increase posted by an index of major oil companies that includes Exxon Mobil Corp. and BP Plc.

"Refiners who've been benefiting from this spread are going to see it begin to close and that's going to diminish profits," said Blake Fernandez, an energy analyst at Howard Weil in New Orleans.

Brent oil futures tumbled as much as $8.49 a barrel, or 7.4 percent, after the Paris-based IEA disclosed plans for a coordinated release of emergency oil stockpiles by its 28 member nations. A Standard & Poor's index of some of the world's biggest energy producers, including Chevron Corp. and Exxon, dropped the most in more than a year in the first 45 minutes after the announcement.

Libyan Barrels

The IEA, formed by nations such as the U.S., Germany and the U.K. in 1974 as a counterweight to the Organization of Petroleum Exporting Countries, said it's seeking to make up for supplies of light, low-sulfur crude that disappeared from global markets when Libyan oil production was shut-in. Crude output of the North African nation plunged 87 percent, according to Bloomberg estimates, after a February uprising against Muammar Qaddafi spurred foreign oil producers to shut operations and flee.

Light, low-sulfur crude such as that pumped in Libya, the North Sea or Nigeria is preferred by many refiners in Europe and on the U.S. East Coast because their plants are not configured to run corrosive, sour grades of fuel, which require more processing to convert to fuels such as as diesel and gasoline.

Thick, high-sulfur oil like that produced across the U.S. Southwest and Midwest requires specially lined pipes and tanks, and additional processing steps and equipment.

Stockpile Release

The IEA decided to marshal a unified release of stockpiles for just the third time in its 37-year history after a failed effort by Saudi Arabia earlier this month to plug the Libyan shortfall with a blend of Arabian crudes, Fernandez said. The blend wasn't similar enough to Libyan crude to attract buyers, he said.

The IEA pledged last week to make 60 million barrels available worldwide over the next 30 days. The Energy Department in Washington said half those supplies will come from storage caverns in Gulf Coast states that mostly hold light, low-sulfur oil.

Record Profits

Holly, operator of refineries in New Mexico, Oklahoma and Utah, posted net income of $84.7 million in the first quarter, the company's highest-ever for a January-to-March period. During that time, the spread between West Texas Sour crude and Brent averaged $15.18 a barrel, compared with 52 cents a year earlier, according to data compiled by Bloomberg.

The spread widened to $24.94 a barrel on Feb. 16, just days after the Libyan rebellion jolted worldwide oil markets. The Feb. 16 spread was the widest since at least 1988, according to Bloomberg data.

Dallas-based Holly agreed in February to acquire rival refiner Frontier Oil Corp. of Houston in an all-stock deal valued at $3.1 billion. The transaction, which is scheduled to close on July 1, will add Frontier plants in Kansas and Wyoming with combined daily refining capacity of 187,000 barrels of crude.

CVR, a Sugar Land, Texas-based refiner whose biggest investor is Daniel Loeb's Third Point LLC, reported first- quarter profit of $45.8 million, compared with a loss of $12.4 million a year earlier. Western Refining of El Paso, Texas, said it swung to a $12.2 million profit in the first three months of the year after posting a $30.7 million loss in the first quarter of 2010.

Tightening Spread

Analysts including Chi Chow of Macquarie Capital USA Inc. said adopting a bearish outlook on domestic refining would be an overreaction to the IEA announcement. Growing crude output from new wells in Texas' Permian Basin and North Dakota's Bakken shale will continue to give some refiners a cost advantage and prop up margins, even as new SPR supplies deflate gasoline prices.

"We'll see the spread tighten a little bit but these companies still have a huge advantage" over rivals that are more distant from the new wells or are unequipped to process lower-quality oil, said Chow, who is based in Denver and has "outperform" ratings on Holly and Western Refining.

"Production growth will continue to outstrip takeaway capacity in that region."

Any decline in refining stocks should be construed as an opportunity to snatch up shares at a bargain, said Sam Margolin, an analyst who follows the oil industry at Dahlman Rose & Co. in New York.

"I'm still bullish on these refiners," Margolin said.
"It's a small amount of oil the IEA is going to release and it makes for a nice headline but it doesn't change the fundamental picture. Nobody thought the $20 spread was going to last but it's still looking pretty healthy."

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